

# HOW TO MANAGE COSTS IN TIMES OF COVID-19

Short term actions will not suffice to ensure profitability  
for manufacturing firms

April 3, 2020

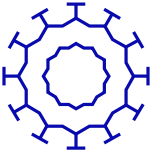
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# EXECUTIVE SUMMARY (1/2) – IMPACT OF COVID-19 ON MECHANICAL ENGINEERING



**COVID-19 recession:  
neither short  
nor shallow**

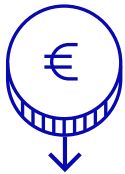
- Unlike downturns through more limited events (e.g. SARS), previous broad crisis or recessions have had significant negative impact on **mechanical engineering** and recovery has taken more than 3 years
- **COVID-19** will likely fall in the **pattern of broad crises / recessions**
- While it is still **unclear, how the COVID-19 crisis will unfold** ultimately, there are **3 main scenarios** for the course the pandemic – differing mainly in **length and breadth** of the pandemic



**Negative EBITs in  
2020 to be expected  
for the majority of  
companies**

- Current main stream thinking suggests that mechanical engineering firms will experience at least U-shaped recession
- In that case (“two quarter recession”) already **~60% of European mechanical engineering companies** will experience (significant) **losses in 2020**
- Assuming a **four quarter ‘financial crises like’ recession** (‘L’) **more than 90%** of the mechanical engineering companies **will be writing losses**
- **OEM-like businesses will be hit harder** than component manufacturers

# EXECUTIVE SUMMARY (2/2) – REACTION PATTERNS



## Short term cost cutting necessary but not sufficient

- **While short term actions** (e.g. short-time work, discretionary spend reduction) are **necessary**, they will be **insufficient** to cope with a longer-term ‘new normal’ driven by **COVID-19**
- **Sustainable, mid-term & structural actions necessary** to ‘come back stronger’
- **Lessons from the past show that using the recession to drive corporate transformation** (incl. M&A, structural adjustments) yielded **clearly higher returns** (in terms of EBIT-margin) **than pure, short term focused cost cutting**



## Cost transformation: Clear target picture and programmatic approach

- **Structural cost transformation** requires a clear **target picture** of the **company** serving as a reference point, incl. business model, portfolio, operating model, etc.
- **A structured, holistic cost reduction program** to be executed, **addressing** large parts of the **P&L**, to build a **lasting lower cost base**
- Achieving **sustainability** via high level of **top- and middle-management commitment** and fostering a **cost & performance culture** is key



## No time to be lost

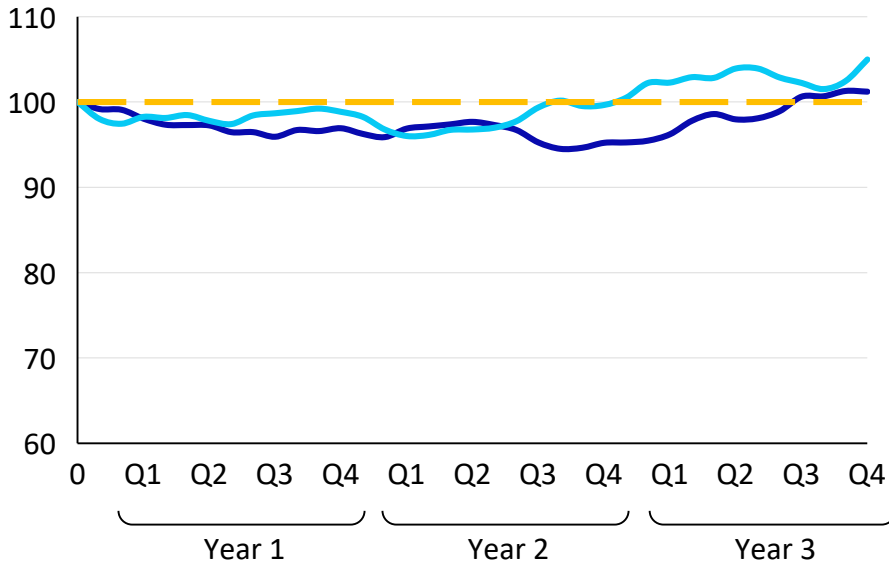
- Strong and **forward-looking companies** are starting to **develop sustainable cost transformation programs now**
- **Short-term measures and mid-term planning have to go in parallel**, with separate, dedicated teams

# COVID-19 RECESSION NEITHER SHORT NOR SHALLOW

As in previous broad crisis, COVID-19 will likely lead to a strong reduction of production levels in mechanical engineering and recovery will take years

## Local and timely limited crises

Monthly Production index (DE)<sup>1</sup>; Index M0 (Ø 12 months prior to event) = 100

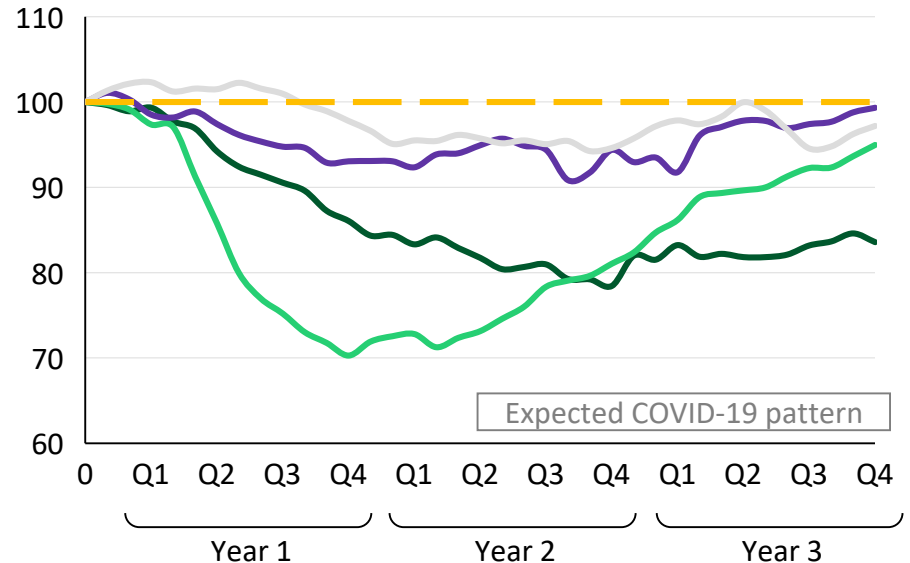


— September 11th 2001    — SARS

- Crisis with modest impact on production (<-5%)
- Comparative quick recovery after crisis

## Broad crises / recessions

Monthly Production index (DE)<sup>1</sup>; Index M0 (Ø 12 months prior to event) = 100



— Recession 92/93 Germany    — Recession 82/83 Germany  
 — Global financial crisis 08/09    — 1st Oil crisis

- Crisis with strong impact on production (>-10%)
- Comparative long recovery cycles (up to >3 years)

<sup>1</sup> Seasonal adjusted, 3-month-moving-average  
 Source: Destatis, Oliver Wyman analysis

# LENGTH OF IMMEDIATE COVID-19 PHASE UNCLEAR

The COVID-19 development can't be predicted – Oliver Wyman defined three scenarios with varying degree of impact on mechanical engineering

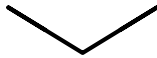
## COVID-19 scenarios

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# 1

### COVID-19 serial outbreaks

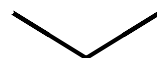
- Public health measures will contain individual outbreaks
- COVID-19 will last 3-4 months



# 2

### COVID-19 pandemic

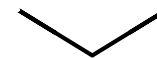
- Public health measure will NOT contain individual outbreaks
- Pandemic will break due to seasonality of virus or virus mutation
- COVID-19 will last 6-12 months



# 3

### COVID-19 ongoing pandemic

- Public health measure will NOT contain individual outbreaks
- Pandemic will NOT break due to seasonality of virus or virus mutation
- COVID-19 will last >12 months



## Manufacturing COVID-19 scenarios

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# V

### “One quarter recession”

- Q1 equals incoming orders 2019
- Q2 is based on average of incoming order development 2019 & max. quarterly revenue decline during financial crisis
- Q3 & Q4 follow the 2019 development

# U

### “Two quarter recession”

- Q1 and Q2 as in scenario V
- Q3 is based on the max. quarterly revenue decline during financial
- Q4 follows the 2019 development

# L

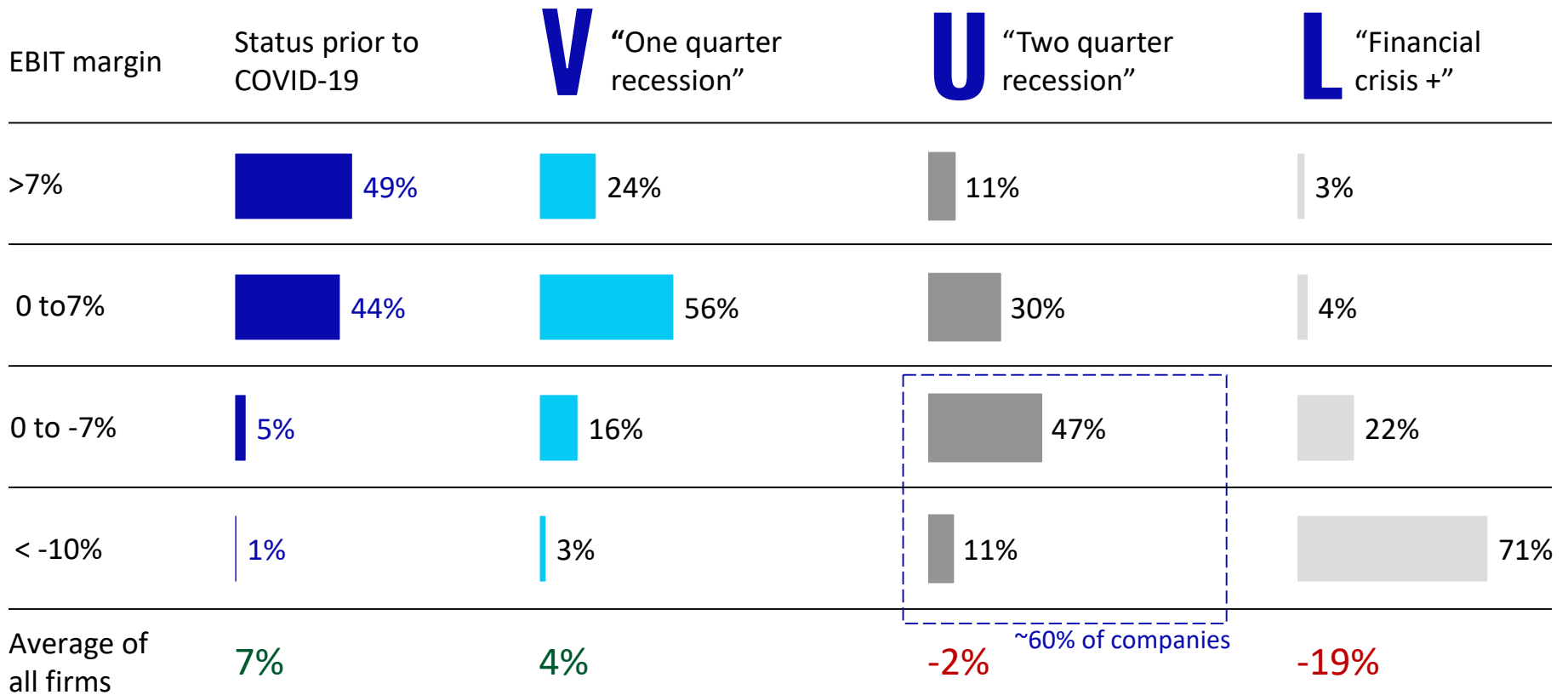
### “Financial crisis +”

- All quarters are based on the max. quarterly revenue decline during the financial crisis

# ~60% OF COMPANIES LOSSMAKING AFTER 2 QUARTER RECESSION

Already 2 bad quarters will have significant impact on profitability of mechanical engineering companies

## Evolution of EBIT margin % of firms<sup>1</sup> per EBIT range



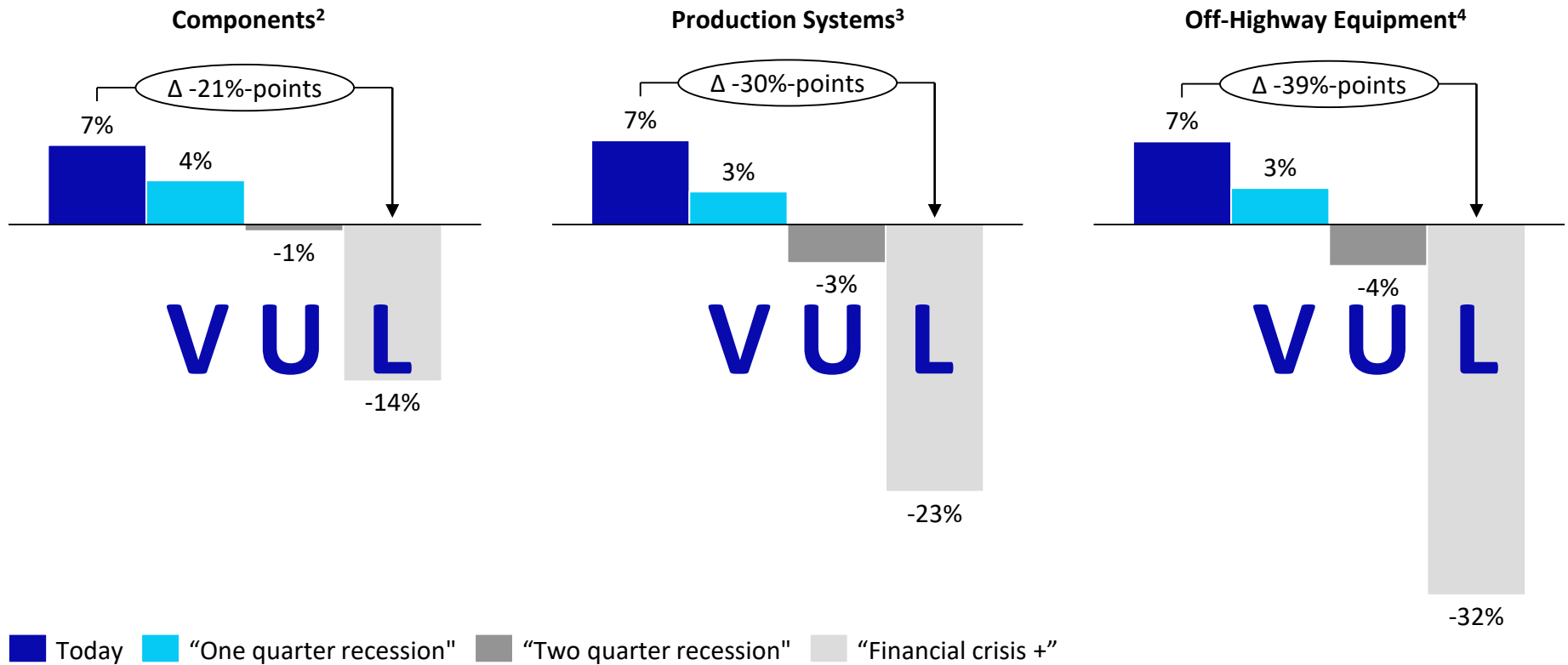
<sup>1</sup> Based on last available year (2018 or 2019), sample size of ~160 companies, revenue decreases while fix costs are constant and material costs decrease proportionally to revenue, deviations due to rounding  
Source: Amadeus, Destatis, Oliver Wyman analysis

# OEM TYPE BUSINESS MORE STRONGLY EXPOSED

Off-Highway Equipment companies face especially high EBIT-margin risks – reduction of up to 39%-points possible

## Evolution of EBIT margin by company focus

Ø-EBIT margin<sup>1</sup> in %



1 Based on last available year (2018 or 2019), sample size of ~160 companies, revenue decreases while fix costs are constant and material costs decrease proportionally to revenue; 2 Fluid power, power systems, pumps & compressors, valves, tools & other mechanical components; 3 Machine tools, metallurgical equipment, food, paper, plastic & textile machines; 4 Agricultural, construction & mining equipment

Source: Amadeus, Destatis, Oliver Wyman analysis

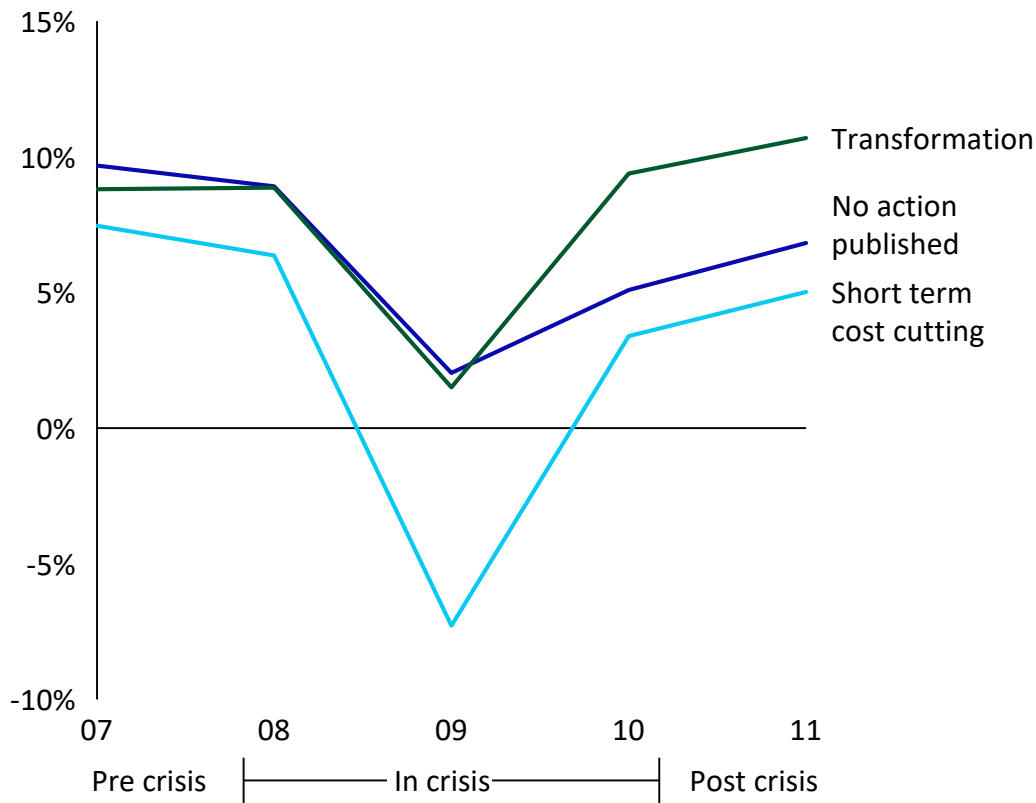


# TRANSFORMATIONAL RECESSION STRATEGIES PAY OFF

Based on the financial crisis learnings, transformation is the fastest option to reach and outperform former EBIT margin levels after a crisis

## Reaction pattern during financial crisis

Adj. EBIT margin<sup>1</sup> development during 2009 recession<sup>2</sup>



### “No action published” companies

- Companies had a strong pre crisis  $\emptyset$ -EBIT margin
  - They didn’t feel high pressure for actions
- $\emptyset$ -EBIT margin recovered slowly from the 2009 dip,  $\emptyset$ -EBIT margin 2011 is below the pre crisis margin

### “Short term cost cutting” companies

- Companies had a weaker pre crisis  $\emptyset$ -EBIT margin
  - They felt strong pressure for actions and focused on cost cutting by lay-offs
- $\emptyset$ -EBIT margin recovered quickly from the 2009 dip, but it wasn’t able to reach pre crisis level until 2011

### “Transformation” companies

- Companies had a strong pre crisis  $\emptyset$ -EBIT margin
  - They executed cost cutting but also transformed the companies through e.g. M&A, reorganization, new business models, etc.
- $\emptyset$ -EBIT margin 2011 higher than pre crisis  $\emptyset$ -EBIT margin

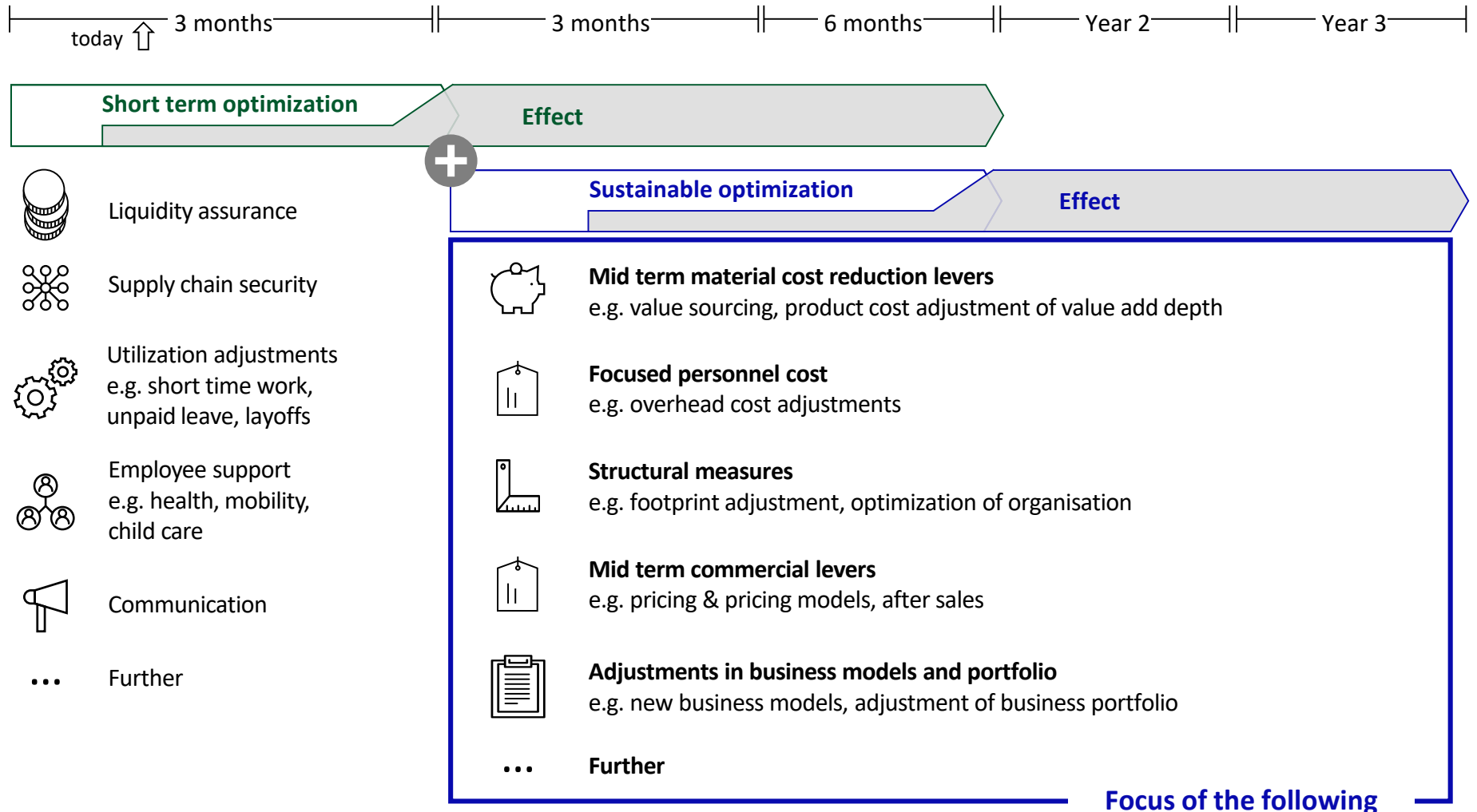
<sup>1</sup> Adjusted for restructuring and one-off costs; <sup>2</sup> Sample of 100 public manufacturing excluding bankrupt companies  
Source: OW Financial Benchmarking, Oliver Wyman analysis



**HOW TO REACT?**

# THE TIME FOR SUSTAINABLE COST TRANSFORMATION IS NOW

As short-term actions are being implemented and executed, the focus needs to shift to designing a program that safeguards profitability sustainably



# OLIVER WYMAN REINVENT PROGRAM AS SOLUTION

Oliver Wyman's approach focuses on delivering the right balance of 'programmatic approach' and simplicity of execution

## PHASE 1

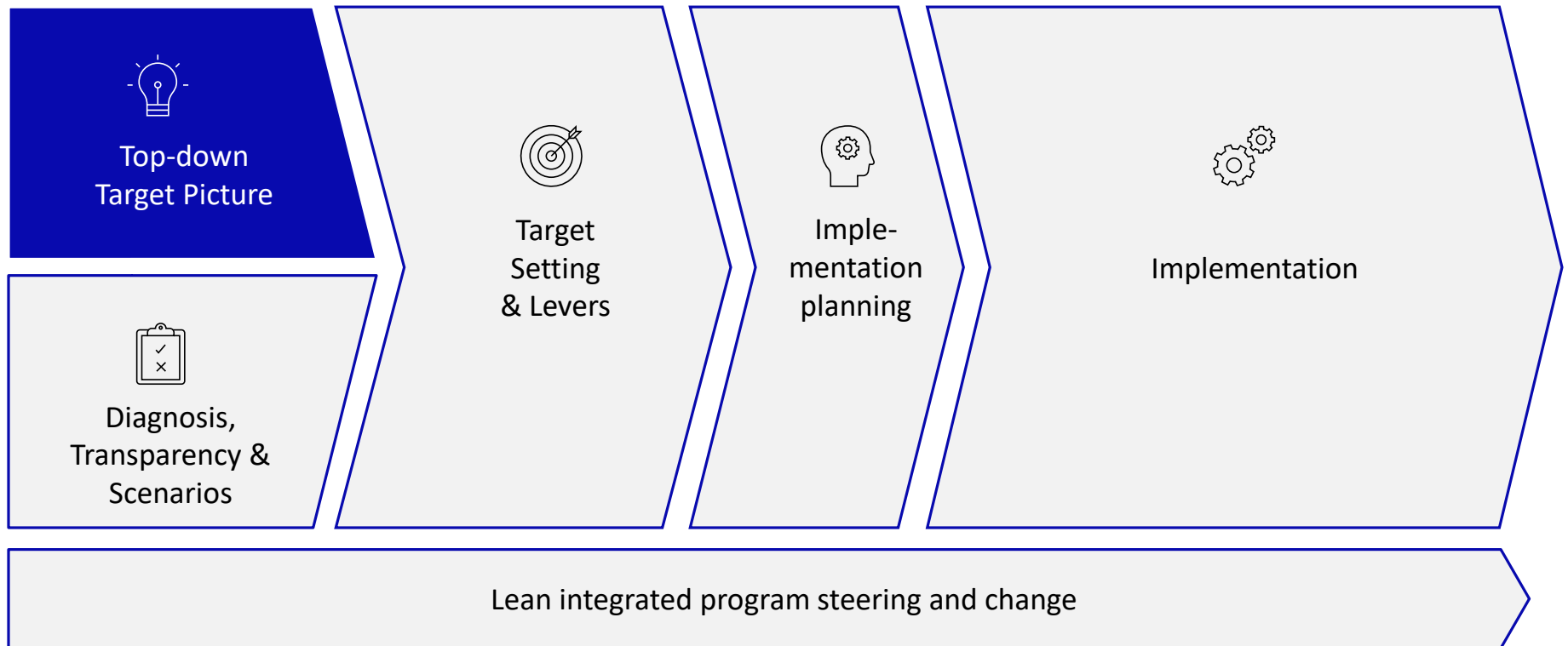
### Target setting & implementation planning

(~20% of time)

## PHASE 2

### Sustainable realization

(~ 80% of time)



A structured approach with focused but well grounded target setting and clear implementation focus

# TARGET PICTURE CRUCIAL FOR STRATEGIC COST TRANSFORMATION

Based on the target picture the *reinvent* program addresses adequate cost and performance levers, sustainably

## A A defined *target picture* is used as the reference point



### Target picture: What should the company look like in 5 years?









- Business model** How should the company create, deliver, and capture value?  
*E.g. share of product sales vs. recurring revenues*
- Portfolio strategy** How much value should be generated by which business unit?  
*E.g. which businesses to build out strategically, which to wind-down*
- Operating model** How can the company accomplish the defined business model and which structures are needed?  
*E.g. production footprint, target value creation share, organizational model, target cost structure*



## B Based on the target picture, a holistic *reinvent* program can be defined & executed



### Potential levers (depending on situation)

-  Value Sourcing
-  Product Cost Down
-  Supply Chain Optimization
-  Manufacturing & Process Optimization
-  Engineering & Product Development Excellence
-  Service Optimization
-  Overhead Optimization (incl. IT-efficiency)
-  Commercial Effectiveness (e.g. pricing, offer optim.)
- ...

# 5 IMPORTANT REINVENT SUCCESS FACTORS

Based on our experience of large performance transformation programs, we see five key success factors for ensuring sustainable impact

1

Shared target picture

Set ambitious **improvement targets**, based on **future-proof, shared target picture and target operating model** that provides clear view on future strategic priorities and serves as **reference model** on how to operationalize it

2

Programmatic approach

Run a **holistic, end-to-end program approach** that closely integrates all relevant focus topics for improvement with a **cost- and top-line focus**

3

Focused but innovative levers

**Enable realization** of targets through a **focused and innovative set of levers**, including **cross-industry** proven approaches and use of new technology

4

Ensuring sustainable cost performance

Ensure high level of **top- and middle-management commitment** and invest in mobilization and **change** to apply a sustainable 'cost-/ performance -culture'

5

Ensuring target realization

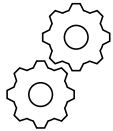
**Ensure realization** of defined targets **through thorough steering, bottom-line impact** focus, and close alignment with all relevant **performance management system** components

# BREAKTHROUGH IMPACT AND SUSTAINABLE BOTTOM LINE EFFECTS

Reinvent program leads to sustainable results through short term and transformational measures



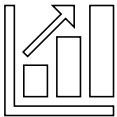
Clear view on challenges and their impact



Redefined operating model to the extent needed



Fundamental optimization measures implemented



Program results embedded in budgets & P&L

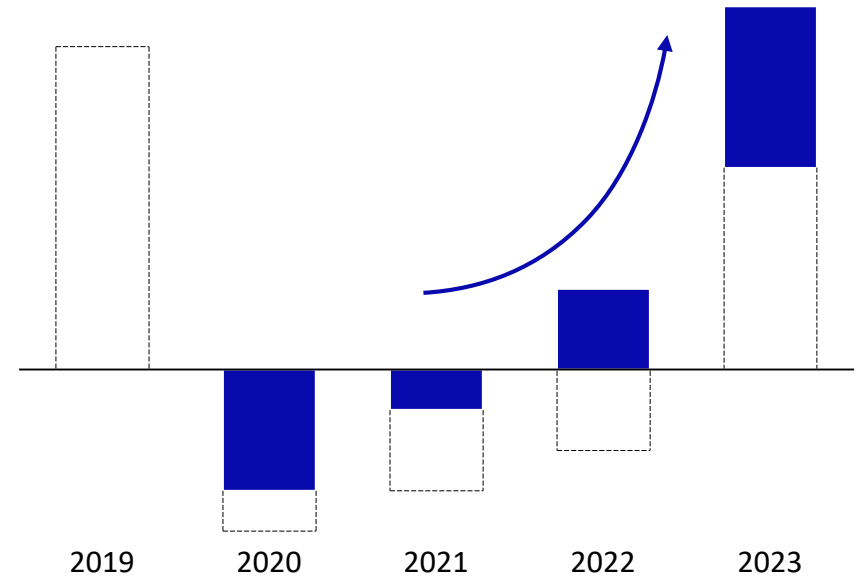


Cost performance embedded in corporate culture to achieve sustainability

## Impact: Sustainable improvements achieved

### EBIT margin over time

Illustrative



Without measures

With short term & transformational measures

# TRANSFORMATION OF ENTIRE BUSINESS AFTER FINANCIAL CRISIS

Case study of the transformation of a construction equipment manufacturer

## Situation and objective

- Client:** Construction equipment OEM
- Disruptor:** Revenue declined of more than 50% due to a major financial and economic crisis
- Task:** Secure company, define short term actions and transformation of the entire business

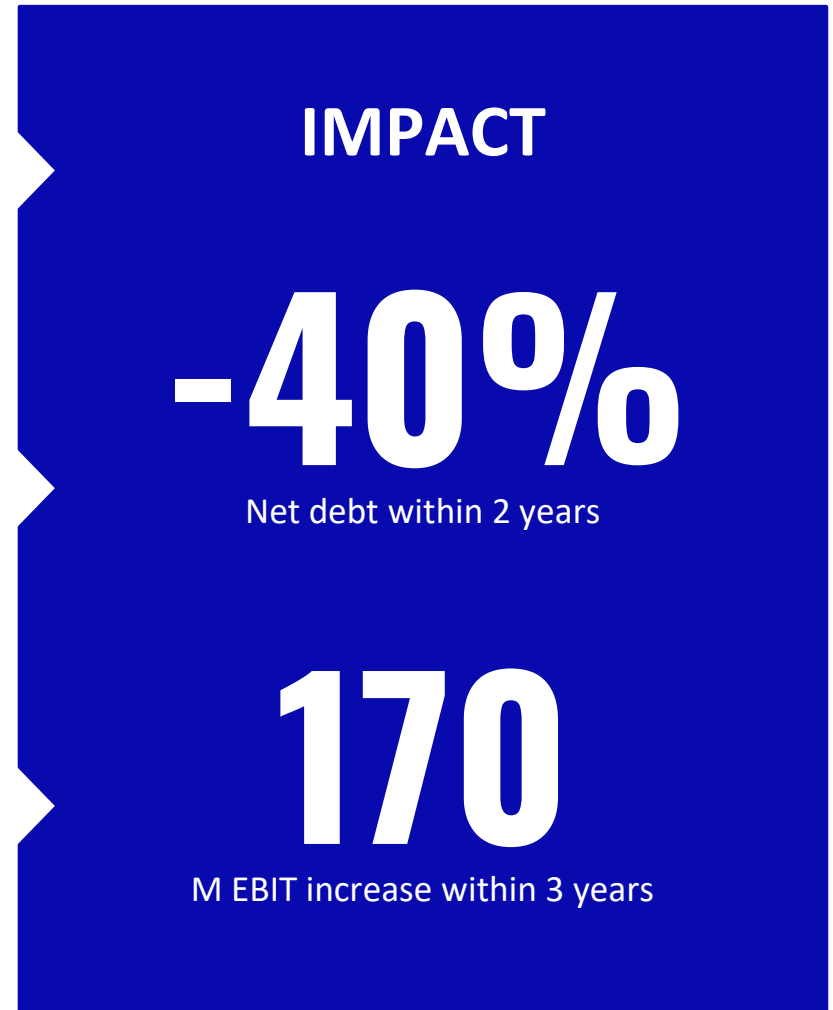
## OLIVER WYMAN role

- Set-up of a comprehensive transformation program
- Short term measures: Securing of financing, short term adjustment of labour force (short work and permanent reduction), reduction of discretionary spend etc.
- Mid term measures: Redefinition of target picture, reduction of value add depth, streamline production footprint, and organization, ...

## OLIVER WYMAN capabilities covered

Commercial effectiveness	✓	Product cost	✓
Sourcing	✓	SG&A	✓
Production	✓	IT	✓

Source: Oliver Wyman





# REINVENT IDENTIFIED 280 M EBT IMPROVEMENT POTENTIAL WITHIN FOUR YEARS

Case study of a wide-ranging profit improvement program for a global production equipment manufacturer

## Situation and objective

- Client:** Production equipment manufacturer
- Disruptor:** Drop in margin was driven by external (e.g. decreasing demand) and internal factors (e.g. rising material costs)
- Task:** Define saving potentials and validate improvement initiatives and product portfolio optimization

## OLIVER WYMAN role

- Analysis of root-causes, identification of levers and validation of P&L effects (both, € and FTE)
- Detailing an implementation roadmap, piloting a set of measures and set-up of PMO tools
- Integration of the entire board to strengthen buy-in

## OLIVER WYMAN capabilities covered

Commercial effectiveness		Product cost	
Sourcing	✓	SG&A	✓
Production	✓	IT	

Source: Oliver Wyman

## IMPACT

# 280

M identified EBT improvement potential within four years

# 1,500

FTE identified overhead reduction

# 6%-PTS. EBIT MARGIN IMPROVEMENT THROUGH BROAD RANGE OF MEASURES

Case study of a comprehensive performance transformation plan to realize 6%-pts. EBIT margin improvement for an Automotive OEM

## Situation and objective

- Client:** European Automotive OEM
- Disruptor:** Severe tightening of CO2 legislation with potentially significant EBIT reduction from 2020 onwards
- Task:** Design and support holistic EBIT improvement program to counter this effect

## OLIVER WYMAN role

Design of holistic program, incl.

- Top-line (e.g. sales push, digital)
- Margin improvement (e.g. VBtO)
- Product cost down
- Classical SG&A cost reduction

## OLIVER WYMAN capabilities covered

Commercial effectiveness	✓	Product cost	✓
Sourcing	✓	SG&A	✓
Production		R&D	✓

Source: Oliver Wyman

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## EBIT IMPACT

# 6%

EBIT margin improvement  
addressed by program

# ~500

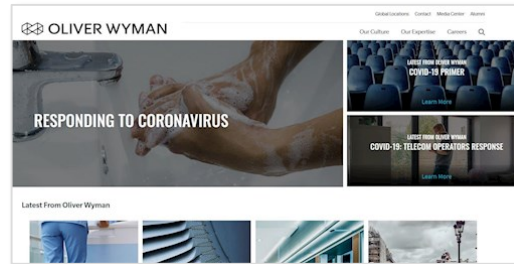
M EUR EBIT improvement realized  
short term

# TO GO FURTHER: REACH US

Benefit from Oliver Wyman expertise on “COVID-19 developments” and COST transformation



**Explore**  
our COVID-19 Hub



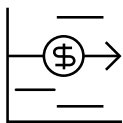
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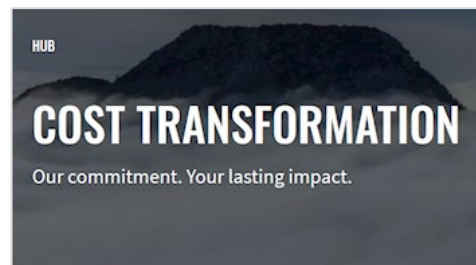
**Checkout**  
our recession heatmap



[www.oliverwyman.com/our-expertise/insights/2019/mar/recession-heatmap.html](http://www.oliverwyman.com/our-expertise/insights/2019/mar/recession-heatmap.html)



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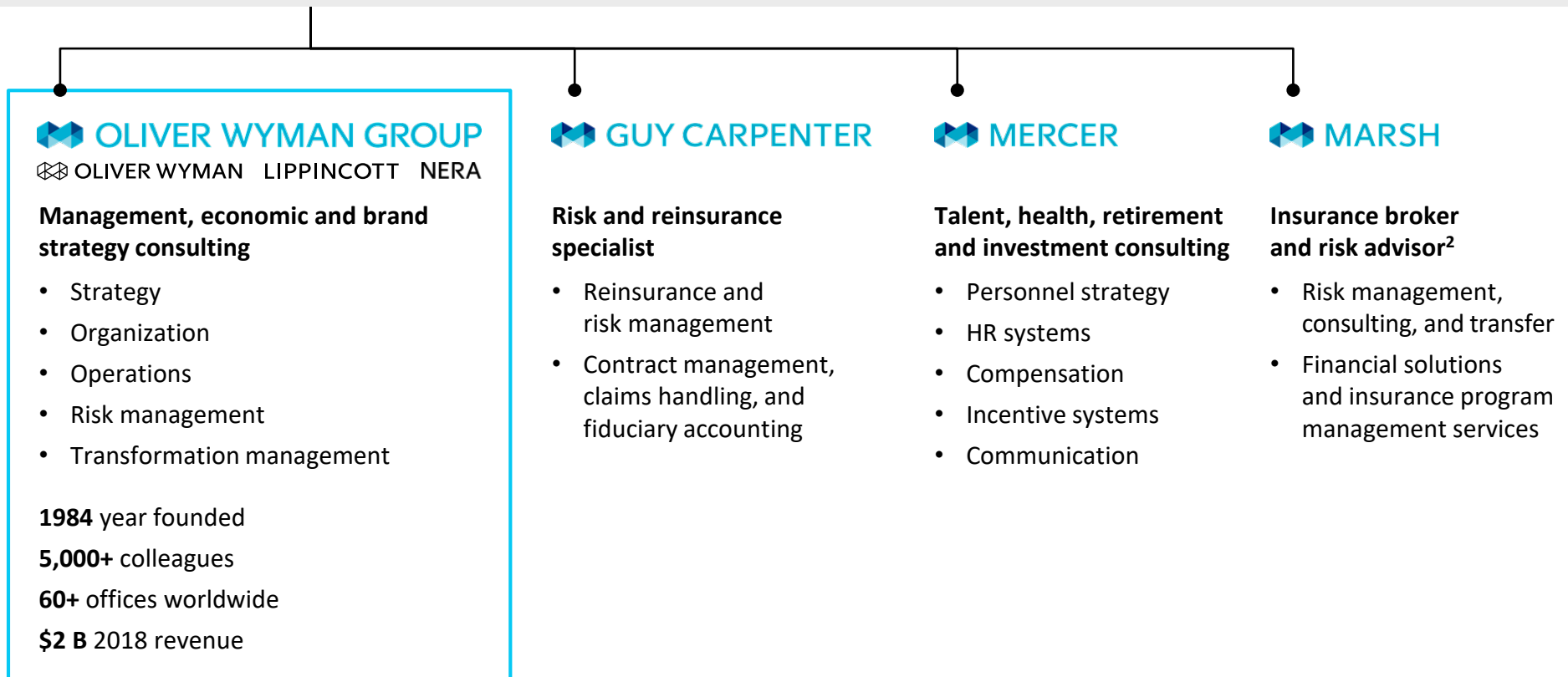
# WE HAVE UNRIVALLED ACCESS TO A COMPLEMENTARY SUITE OF CAPABILITIES FROM OUR SISTER COMPANIES WITHIN MARSH & MCLENNAN



Staff: 75,000<sup>1</sup>

Annualized revenues: nearly US\$17 B\*

Clients in more than 130 countries  
New York Stock Exchange (MMC)

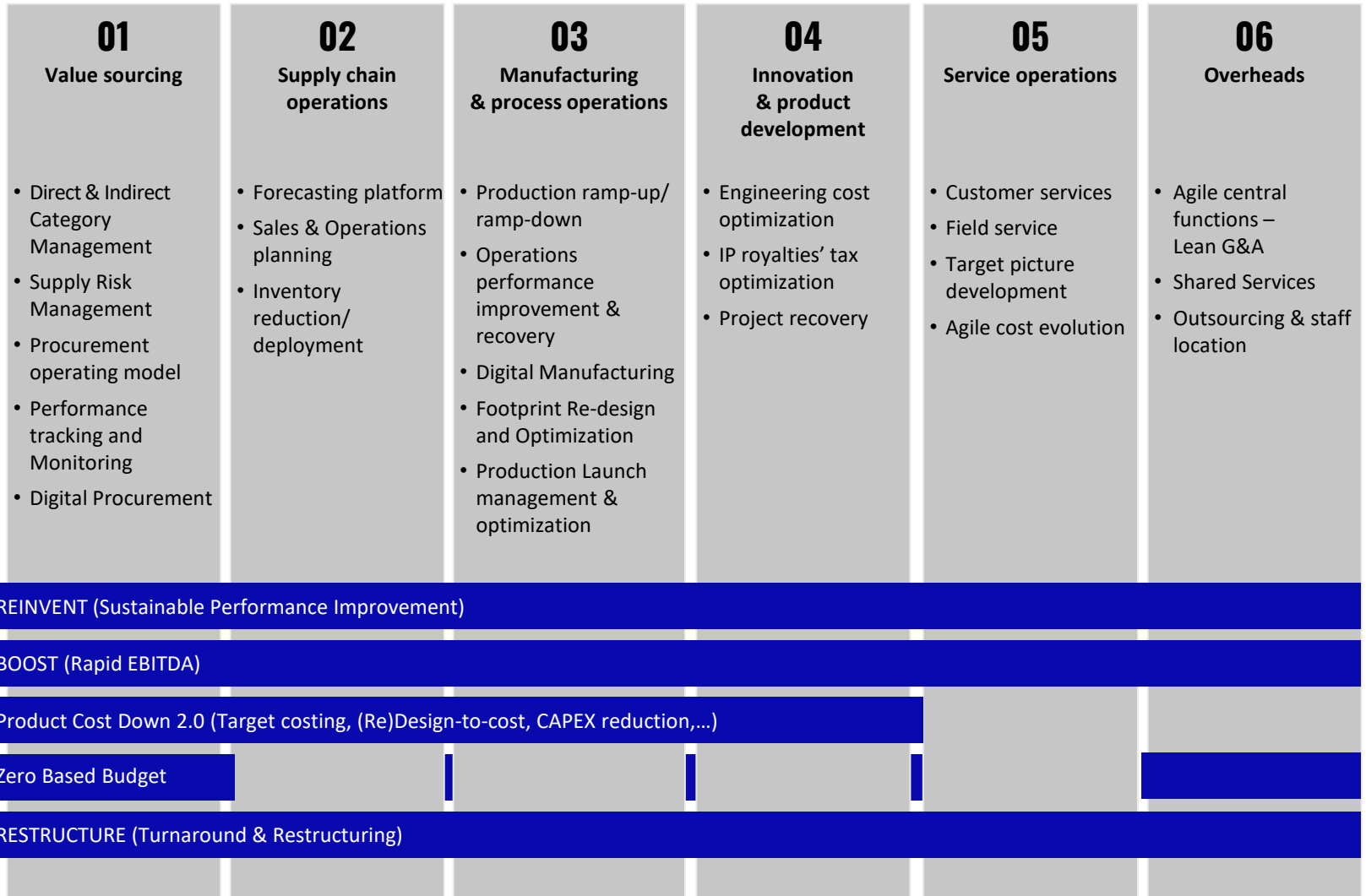


1. As of Q1 2019, includes JLT

2. Y/E 2018 data, excludes JLT

# OLIVER WYMAN COST TRANSFORMATION OFFERINGS

We offer 30+ tailored approaches to engage cost transformation, from capability turnkey solutions to large overarching platforms



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