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Advanced Manufacturing Quarterly

Analyst themes from 1Q19
earnings calls

AM leaders on 1Q19 earnings calls faced analyst questions about revenue growth strategies as demand patterns are shifting in several key end markets. The tone from leaders continues to be positive about the strength of industrial fundamentals in general, fueled by construction growth and demand for A&D products and services. Pricing discipline has kept revenues and margins stable as production costs rise, another sign of strength in demand across the industrials sector.

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Leaders remain confident on revenue and margin growth based on strong industrial fundamentals

Welcome to the quarterly review of the top themes discussed by leaders of 20 advanced manufacturing (AM) sector companies (including those from the aerospace and defense, industrial products, and chemical subsectors) during public earnings calls with analysts. This update tracks the movement of these themes from quarter to quarter to provide perspective on shifts in the AM landscape.

Themes that stood out in 1Q19 include:

- ▶ **Developments in end markets**, now at No. 1 on the list. Many AM companies are reporting slowdowns in demand from key customers in automotive and consumer electronics, segments that were leading growth a year ago. Construction activity is driving demand for electrical systems to support projects such as technology-intensive commercial sites and electric vehicle charging stations. Aerospace and defense (A&D) companies continue to report strong demand, particularly from customers in the US and the Middle East.
- ▶ **Change in financial outlook**, which returned to the list at No. 3. In spite of challenges in what were previously high-growth segments, AM companies are generally positive about revenue growth prospects in the second half of 2019. Leaders view industrial fundamentals as strong and are optimistic about the potential of initiatives such as economic stimulus programs in China. Forecasts for earnings per share have been raised by several peers on revenue growth and on margin expansion, supported by the success of ongoing cost reduction programs.
- ▶ **Competitive environment**, which moved up to No. 9. Revenue growth for many companies has been fueled in part by pricing discipline in products and services. As the costs of raw materials have increased and tariffs have added to supply chain expenses, AM companies in all subsectors are managing these costs by raising prices. Quality and innovation are becoming even more important as manufacturers seek to stand out from the competition and hold on to market share even as prices rise.

Jerry Gootee

EY Global Industrial Products Manufacturing Subsector Leader

Top 10 themes from quarterly earnings calls

1Q19			4Q18	
↑	1.	Developments in end markets	1.	Geographic developments
↑	2.	Critical projects	2.	Financial initiatives
New	3.	Change in financial outlook	3.	Developments in end markets
↓	4.	Geographic developments	4.	Working capital and cash flow management
↑	5.	Cost reduction	5.	Innovation and new product/service launches
↓	6.	Working capital and cash flow management	6.	Cost reduction
New	7.	Changes in production rates	7.	Business reorganization/restructuring
↓	8.	Business reorganization/restructuring	8.	Critical projects
↑	9.	Competitive environment	9.	Geopolitical environment
↓	10.	Geopolitical environment	10.	Competitive environment

Key themes

↑ 1 Developments in end markets

Trends in key customer segments impacting demand for products and services

- ▶ Orders from automotive customers miss forecasts as manufacturing activity slows.
- ▶ The new US defense budget increases demand for fighter jets, communication systems, and other A&D products and services.
- ▶ Strong growth in air traffic and high load factors continue to drive demand for commercial aircraft.
- ▶ Electrical systems see higher sales from increasing construction activity, including technology-intensive commercial sites and electric vehicle charging infrastructure.
- ▶ Oil and gas customers are investing in liquefied natural gas (LNG) infrastructure and clean fuel technology, but order growth is still limited because of volatile oil prices.

↑ 2 Critical projects

Production updates and milestones for key projects crucial to company strategy

- ▶ New contracts for military aircraft, defense programs and weapon systems have been signed by A&D peers, primarily in the US and the Middle East.
- ▶ Innovation centers are providing spaces where industrial products (IP) companies can connect with customers to demonstrate new technologies and create customized solutions.

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Defense budgets in emerging economies are growing at higher rates than those in developed markets and are becoming increasingly higher percentages of their local GDPs. Fulfilling commitments to the US government while pursuing growth beyond the borders is a true balancing act. Yet the payoffs are great: you gain not just a new end market but a place where you can incubate future technology, explore ways to find and develop talent, and operate production plants at a lower cost.

Mike Iacono, Transaction Advisory Services, Ernst & Young LLP

New 3 Change in financial outlook

Changing forecasts for revenues or earnings per share

- ▶ Leaders in all subsectors are optimistic that revenues will continue to grow in 2H19 on strong industrial sector fundamentals.
- ▶ Margins are improving as cost management programs continue to yield positive results, boosted by ongoing sales growth.
- ▶ Earnings-per-share forecasts are up for several A&D and IP companies on margin and revenue growth.
- ▶ Areas of concern for some peers include exposure to slower growth in automotive and consumer electronics end markets, currency issues and missed performance targets for select A&D products.



4 Geographic developments

Market conditions by region

- ▶ Companies are pursuing growth opportunities in India and Vietnam and noticing China's ongoing potential.
- ▶ While some companies have reported reduced order activity from the automotive sector in China, one peer saw growth. Other companies are seeing positive results in the industrial sector in China, supported in part by local economic stimulus efforts.
- ▶ Agrochemical demand in North America has been down significantly because of weather-related delays in planting crops.
- ▶ Growth in demand for industrial products in Europe was mixed, with several companies reporting either drops in volume or slower growth than in other regions.



5 Cost reduction

Focus on controlling costs in all parts of the organization

- ▶ Multiyear programs to reduce manufacturing costs and increase productivity are continuing to yield positive results. Some companies are increasing cost reduction targets in 2H19.
- ▶ Mergers are providing opportunities to benefit from cost synergies.
- ▶ Rising raw materials costs and foreign exchange rates are creating headwinds for some companies, particularly in North America.



Manufacturers have long pursued excellence programs to continually improve the performance of their facilities and equipment. The smart factory is an environment in which cyber-physical systems monitor the physical processes of the factory, provide analysis, and automate or support controls and decision-making to improve manufacturing efficiency and effectiveness. The potential cost savings alone are a major incentive to make the shop floor 'smarter'.

Craig Lyjak, Smart Factory Global Solution Leader



6 Working capital and cash flow management

Changes observed from the prior quarter

- ▶ Cash flow continues to improve because of a strong prioritization of working capital discipline, often supported by productivity and cost-control programs.
- ▶ Companies are integrating cash flow management into functions such as supply chain to better align efforts across the enterprise.
- ▶ Executive incentive programs are being used by two industrial peers and a chemical peer to increase leadership accountability for 1H19 improvements in cash flows.
- ▶ Industrial products peers are examining recent M&A transactions for additional cost synergy opportunities.



7 Changes in production rates

Expansions or reductions of activity in key product lines and capacity adjustments

- ▶ Production increases are creating supply chain bottlenecks in specialized areas such as casting and forging as manufacturers rely on local suppliers amid global tariff exposure.
- ▶ As passenger traffic grows, commercial airlines are increasing orders for both wide-body and narrow-body aircraft, driving up production demand and increasing backlogs.
- ▶ The grounding of one commercial aircraft model has created a ripple effect for suppliers in the industrial and chemical sectors as well as A&D. These suppliers are revising forecasts to accommodate lower demand for materials used in this model.



8 Business reorganization/restructuring

Operational streamlining, business function reorganization and divestments

- ▶ Manufacturers continue to reorganize portfolios through spin-offs, acquisitions and divestments to achieve a more focused business structure.
- ▶ Business segments are being realigned to correspond more closely with customer segments to break down silos and meet customer needs more efficiently. One industrial peer has combined manufacturing and aftermarket businesses by customer segment.
- ▶ Centralization of business functions has been a key productivity improvement strategy at peers in all subsectors for years and continues at many companies.
- ▶ At the same time, some industrial peers are transferring accountability for product and sales decisions from corporate and geographical leaders to business unit leaders, increasing agility and bringing decision-making closer to the customer.



9 Competitive environment

Pricing, market share and changes in business models

- ▶ Companies are successfully increasing prices in response to higher raw materials costs and tariff impacts.
- ▶ Premium products based on innovative technologies are best positioned to maintain market share, even when prices are increased. In emerging markets, where competition from lower-priced products can be more intense, leaders are confident that quality and performance for premium products will grow market share over time.
- ▶ Industrial and chemical companies are attributing revenue growth to strong pricing discipline.
- ▶ One industrial company has implemented a program that shortens the new product development cycle, with the goal of bringing innovative products to market more quickly. These new products can command higher prices based on their unique features.



10 Geopolitical environment

Effects of government policies and trade flow on industrial revenues and margins

- ▶ Leaders are expressing concern that ongoing trade and tariff uncertainties are lowering business and consumer confidence, potentially reducing economic growth.
- ▶ While there was significantly less Brexit-related discussion in 1Q19, compared with 4Q18, leaders acknowledge that the situation still contributes to short-term uncertainty.
- ▶ Companies continue to adjust their manufacturing footprints and supply chains to reduce exposure to tariff-related risk, including a stronger focus on production for local customers.
- ▶ Economic stimulus efforts in China are viewed by several companies as a potential source of growth, both for revenues and margins, in 2H19.



The next three to five years are likely to be turbulent ones, marked by continued shifting forces for both protectionism and free trade. To succeed in the future, companies need to develop a dedicated global trade function.

Yoichi Ohira, EY Global Trade Leader for Japan



By doing so, they will be better able to manage the risks of the new world of global trade and to increase opportunities.

Armando Beteta, EY Global Trade Services Leader, Latin America Business Center

Companies included in our analysis

- ▶ ABB Ltd.
- ▶ Airbus SE
- ▶ Akzo Nobel NV
- ▶ BASF SE
- ▶ Boeing Company
- ▶ Bombardier, Inc.
- ▶ Danaher Corporation
- ▶ DowDuPont, Inc.
- ▶ Eaton Corporation plc
- ▶ Flowserve Corporation
- ▶ FMC Corporation
- ▶ General Dynamics Corporation
- ▶ General Electric Company
- ▶ Honeywell International, Inc.
- ▶ Johnson Controls International plc
- ▶ Lockheed Martin Corporation
- ▶ Raytheon Company
- ▶ Siemens AG
- ▶ Solvay SA
- ▶ United Technologies Corporation

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