Building a better working world

Advanced Manufacturing Quarterly

Analyst themes from 3Q19 earnings calls

AM companies are continuing to experience differences in growth by subsector. Aerospace and defense (A&D) companies are facing tighter margins as they expand capacity to keep up with rising demand. Chemical and industrial products (IP) companies are adapting to an environment of slower growth with a stronger focus on cost control, reflecting a shift in mindset from 2Q19. As macroeconomic uncertainty becomes the new normal, companies are focusing on deeper customer connectivity to build stability on both the top and bottom lines.

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Market uncertainty and rising costs increase the need for deeper customer connectivity

Welcome to the quarterly review of the top themes discussed by leaders of 27 advanced manufacturing (AM) sector companies (including those from the A&D, IP and chemical subsectors) during public earnings calls with analysts. This update tracks the movement of these themes from quarter to quarter to provide a perspective on shifts in the AM landscape.

Themes that stood out in 3Q19 include:

- **A change in financial outlook**, which rose to No. 3. As A&D companies continue to raise revenue forecasts, the costs of expanding production capacity are putting pressure on margins for some peers. Chemical companies are lowering revenue and margin outlooks as industrial demand slows, particularly in end markets such as automotive, and production costs rise. IP companies, facing similar headwinds, are keeping margins stable through their commitments to multiyear cost management programs.
- **Financial initiatives,** which remained at No. 6, but with a notable change in tone since the previous quarter. Chemical and IP companies are taking a more disciplined approach to capital expenditures in 3Q19 and are looking to maintain or reduce spending, a departure from the sector's openness to increasing capex in 2Q19 to support innovation and post-M&A integration. Many companies are raising dividends to attract investors and reducing debt to strengthen balance sheets.
- **Innovation and new product/service launches,** moving down to No. 7. As with capex, some companies are viewing R&D spending more conservatively than in the previous quarter and are focusing on the products and services with the greatest commercialization potential. At the same time, peers across the sector are actively investing in customer connectivity through new digital sales platforms and the expansion of services to support deeper relationships.

Jerry Gootee
EY Global and Americas Industrial Products Leader

Top 10 themes from quarterly earnings calls

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

Key themes

↔ 1 Developments in end markets

Trends in key customer segments impacting demand for products and services

- Ongoing slowness in the automotive sector puts pressure on sales and margins for chemical and IP companies as demand falls for materials and auto-building equipment such as robots.
- Government spending on defense, rising in both the US and Europe, increases demand for fighter jets, communication systems, and other A&D products and services.
- While commercial aircraft demand for narrow-body jets remains high, one A&D peer predicts that airlines will buy more wide-body jets over the next decade to replace aging fleets.
- Consumer electronics demand begins to show signs of recovery, though some AM companies continue to report slow materials sales.
- Extraction and refining activity by oil and gas and mining customers continues to grow, lifting demand for equipment and chemicals.
- Within infrastructure, water treatment is one of the highest areas of growth for chemical and IP peers.

↑ 2 Working capital and cash flow management

Changes observed from the prior quarter

- Some A&D peers are seeing increases in working capital because of growing demand and ongoing challenges with collections of receivables.
- For many chemical and IP companies, cash flow continues to improve because of a strong prioritization of working capital discipline, often supported by productivity and cost-control programs.
- Recent M&A activity has affected working capital and cash flow for some chemical and IP peers.

> “When a company believes the next threat will occur within the next 12 months, immediate measures are required, such as brute-force working capital management. However, if a company believes it still has one or more years of ‘runway,’ it can focus on more strategic cost reduction, along with optimization of its capital structure, business model and overall portfolio.
>
> **David Sanders, EY Global Advanced Manufacturing & Mobility Advisory Leader**

↑ 3 Change in financial outlook

Changing forecasts for revenues or earnings per share

- While revenue growth outlooks for A&D companies are largely optimistic, margins are coming under pressure as companies invest in expanded production.
- Chemical companies are reducing revenue and margin forecasts as industrial demand slows and costs for raw materials rise.

- IP companies are moderating their outlook for growth on overall industrial conditions as they maintain their commitments to cost management programs.
- US-based peers are experiencing headwinds from currency due to a strong US dollar.

4 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, particularly in the US and Europe.
- Most A&D product testing programs are on schedule. A few face delays related to the implementation of new technologies.
- Chemical and IP companies are building new plants and innovation centers in globally strategic locations to be closer to customers.

5 Cost reduction

Focus on controlling costs in all parts of the organization

- Multiyear programs to reduce manufacturing costs and increase productivity continue to yield positive results.
- Common areas of focus are the streamlining of organizational structures, divestment of non-core businesses, improvements to plant productivity and tighter supply chain management.
- Chemical companies are increasing cost management activities, including headcount reductions, to counter rising operating costs.

6 Financial initiatives

Capital management and deployment

- Many peers are continuing or increasing share buyback activity, boosted by occasional drops in stock prices.
- Several companies are raising dividends to demonstrate confidence in near-term financial performance.
- Chemical and IP companies are holding steady on commitments to capital expenditures, a shift in tone from 2Q19, when companies were increasing spending to support innovation and M&A integration. A few peers are reducing capex in response to slower market demand.
- Some A&D companies are increasing capex as they invest in expanded production capacity.
- Peers in all three subsectors are strengthening their balance sheets by reducing debt.

7 Innovation and new product/service launches

Focus on digital technologies, R&D and product innovation

- Customer connectivity is driving innovations such as new digital sales platforms, tools to enable sales teams to offer a wider range of products and data analytics to support aftermarket services. An IP peer has created the new role of Chief Customer and Digital Officer.
- Sustainability is exerting a stronger influence on new products and services, particularly for chemical companies in areas such as plastics recycling and plant-based raw materials.
- IP companies are maintaining commitments to R&D spending but are not expanding budgets as actively as in 2Q19.

> “Manufacturing companies remain committed to digital transformation. Fifty-seven percent of respondents say they are allocating more than 25% of their investment capital to digital initiatives, with an emphasis on new growth opportunities.
>
> **David Gale, EY Global Advanced Manufacturing Transactions Leader**

New

8 Geographic developments – growth markets

Market conditions in Asia-Pacific, Latin America, and the Middle East and Africa

- In China, while manufacturers continue to report lower order activity from automotive and electronics customers, demand remains high in sectors such as construction, infrastructure and defense.
- New environmental standards in China and India are increasing demand for innovative materials that reduce automotive emissions.
- Latin America continues to provide growth opportunities, particularly in agriculture and construction, though currency headwinds persist.

9 Geopolitical environment

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

- Manufacturers are increasingly viewing trade-related conflict as a medium- to long-term market force rather than a short-term disruption.
- Tariffs continue to affect cross-border demand for products ranging from commodities to aircraft, creating headwinds across the AM sector. Manufacturers and their suppliers are relocating facilities to minimize tariff impacts.
- While the outlook on a resolution to the US-China trade conflict is slightly more optimistic than in 2Q19, leaders remain concerned about the negative impact of ongoing uncertainty on industrial markets.
- In preparation for Brexit, some companies are continuing to maintain higher levels of inventory in the UK to protect against shortages and delivery delays.

> “In response to trade and tariff challenges, one-third of manufacturers surveyed by EY teams prefer either to take a wait-and-see approach or do nothing. Without a robust risk management strategy, these manufacturing companies risk falling behind the curve or missing out entirely on sustainably transforming their organizations to withstand the disruptions ahead.
>
> **David Gale, EY Global Advanced Manufacturing Transactions Leader**

10 Changes in production rates

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

- A&D companies are leading discussions about capacity expansions in both aerospace and defense. Orders for narrow-body aircraft are rising, along with demand for new defense equipment and systems.
- As more new chemical plants come online, chemical peers must balance two risks: the potential for margin pressure when plants operate below capacity and the possibility of oversupply, including price softness, when capacity is reached.

Companies included in the analysis

- ABB Ltd.
- Airbus SE
- Akzo Nobel NV
- BASF SE
- Boeing Company
- Bombardier, Inc.
- Clariant AG
- Covestro AG
- Danaher Corporation
- Dow Chemical Company
- DuPont de Nemours, Inc.
- Eaton Corporation plc
- Flowserve Corporation
- FMC Corporation
- General Dynamics Corporation
- General Electric Company
- Honeywell International, Inc.
- Johnson Controls International plc
- Lockheed Martin Corporation
- Mitsubishi Chemical Holdings
- Northrop Grumman Corporation
- PPG Industries, Inc.
- Raytheon Company
- Rolls-Royce Holdings plc
- Siemens AG
- Solvay SA
- United Technologies Corporation

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