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Advanced Manufacturing Quarterly

Analyst themes from 2Q19 earnings calls

AM sector companies are reporting differences in growth outlooks for 2H19 by subsector. Aerospace and defense (A&D) companies, buoyed by defense spending and steady aerospace demand, are looking ahead with confidence. Chemical and industrial products (IP) companies are more cautious, citing mixed growth in key end markets such as automotive and electronics. A commitment to investment in innovation is becoming even more critical to keep products and services competitive in all market conditions.

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Outlooks diverge by subsector as key end markets face challenges

Welcome to the quarterly review of the top themes discussed by leaders of 28 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 2Q19 include:

- **Developments in end markets,** again at No. 1 on the list. Demand for defense systems and equipment and new aircraft remained strong, supported by rising military spending and steady air passenger traffic. A&D company leaders are looking at 2H19 with more confidence than many of their peers in chemicals and IP. Declines in automotive and electronics production were significant enough to affect results despite more positive trends in customer segments such as oil and gas.
- **Innovation and new product/service launches,** which returned to the list at No. 4. Several companies have increased spending on R&D to secure a pipeline of new offerings, including an increased use of digital technologies. This increase in spending, which bucks the overall trend of cost control, is viewed as critical in holding on to market share. Digital solutions are also being deployed within facilities, particularly for chemical and IP companies, to maximize efficiency programs and improve employee safety.
- **Financial initiatives,** also back on the list, at No. 6. Companies are continuing their commitments to share buyback programs, often aided by temporary drops in stock prices that can create windows of opportunity for cost-effective repurchases. Several peers reported increases in capital expenditures to support facility upgrades, including those gained in recent acquisitions. With an ever-present focus on cost control, leaders must be prepared to address the benefits of increased capex spending in the context of a company's overall growth strategy.

Jerry Gootee
EY Global Industrial Products Manufacturing Subsector Leader

Top 10 themes from quarterly earnings calls

	2Q19		1Q19
↔	1.	Developments in end markets	1. Regional demand
↔	2.	Critical projects	2. Evolution of mobility
↑	3.	Geographic developments	3. Operating costs
New	4.	Innovation and new product/service launches	4. Restructuring initiatives
↑	5.	Working capital and cash flow management	5. Inorganic growth (M&A, joint ventures and partnerships)
New	6.	Financial initiatives	6. Regulatory issues
↓	7.	Change in financial outlook	7. Manufacturing and supply chain management
↓	8.	Cost reduction	8. Product evolution
↓	9.	Changes in production rates	9. Working capital management
↔	10.	Geopolitical environment	10. Geopolitical issues

Key themes

↔ 1 Developments in end markets

Trends in key customer segments impacting demand for products and services

- Weakness in global automotive manufacturing lowers overall revenues for multiple companies and is forecast to continue into 2H19.
- Government spending on defense in the US and Europe, increases demand for fighter jets, communication systems, and other A&D products and services.
- Commercial aircraft demand is shifting toward narrow-body jets as air passenger and cargo traffic volumes grow more slowly.
- Semiconductor demand falls on slower electronics manufacturing activity in China and South Korea.
- US residential construction slows on a delayed spring season and lower consumer confidence in homebuying.
- Extraction and refining activity by oil and gas and mining customers rises, lifting demand for equipment and chemicals.

> "Traditional original equipment manufacturers [OEMs] are not about to wait. They are going to recognize innovative changes to the way cars are made and how we use those cars. Striking a balance will be critical to maintaining the value of the company and mitigating the risk of an overnight stock wipeout.
>
> **Sven Dharmani, EY Global Advanced Manufacturing & Mobility Supply Chain Leader**

↔ 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 Middle East.
- Chemical companies are investing in efficiency measures ranging from plant upgrades and turnarounds to new enterprise resource planning (ERP) systems.

↑ 3 Geographic developments

Market conditions by region

- In China, while manufacturers are reporting lower order activity from automotive and electronics customers, demand remains high in sectors such as construction, infrastructure and defense. Optimism for growth in 2H19 continues and is based on local economic stimulus efforts and projections for consumer holiday spending.
- Chemical companies are seeing lower demand from Western Europe based on reduced automotive manufacturing and drier weather conditions for agrochemicals. Weather also affected water levels in major shipping channels such as the Rhine River, causing at least one peer to use more rail and truck transportation to move inventory.

- Optimism on growth in North America is coming primarily from A&D companies, as defense spending for FY20 and FY21 has been stabilized. Reports of growth in industrial and construction markets are mixed, though an interest-rate reduction may bring greater spending in 2H19.
- Latin America, particularly Brazil and Mexico, is showing stronger signs of growth, though currency headwinds are persisting in Brazil.

New

4 Innovation and new product/service launches

Focus on digital technologies, R&D and product innovation

- IP companies are continuing to increase R&D spending to support a pipeline of innovative products and services, including a wider range of digital offerings.
- A&D companies are also spending more on R&D, supported by growing government defense budgets.
- Digital technologies are increasing both efficiency and safety in manufacturing processes for chemical and IP companies, lowering operating costs.
- Partnerships, especially with startups, are continuing to provide opportunities to commercialize new technologies

> Technology is a tactic, not a strategy. It's not simply about what you want to change, but what you want to improve. A sound manufacturing reinvention strategy should align with business strategy, focus on workforce skills and abilities, and address cybersecurity. Focus on value and the opportunities to be unlocked.
>
> **Mark Heidenreich, Ernst & Young LLP Supply Chain and Operations Executive Director**

5 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.
- Improved receivable collection is a growing priority, especially for A&D companies.
- Inventory levels are challenging working capital for some IP peers because of seasonal issues such as weather but are expected to improve in 2H19.

New

6 Financial initiatives

Capital management and deployment

- Share buyback activity is continuing on track for many peers, boosted by occasional drops in stock prices.
- Dividend commitments, including plans for increasing payouts, are continuing.
- Capital expenditures are increasing for companies in all sectors to support new product and service launches, facility upgrades and investments in assets acquired through M&A transactions.

7 Change in financial outlook

Changing forecasts for revenues or earnings per share

- While revenue growth outlooks for A&D companies are largely optimistic, several chemical and IP companies are reducing their outlooks or taking a more cautious tone for 2H19 on macroeconomic uncertainty and on lowered demand in key markets such as automotive.
- Margins are still expected to improve as cost management programs continue to yield positive results, but leaders acknowledge that gains may be smaller if revenue growth slows.

8 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.
- Common areas of focus are the streamlining of organizational structures, divestment of non-core businesses, improved plant productivity and tighter supply chain management.
- Automation and digital systems are supporting some of these efforts, but investments and returns must be made clear to investors to support the overall case for cost reduction.

9 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.
- Some chemical and IP companies are reducing production of materials for automotive and electronics applications in response to weaker demand

10 Geopolitical environment

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

- Trade relations between China and the US are not seen as likely to improve in 2H19. Company leaders are expressing concern about the effect that prolonged trade conflict may have on investor confidence and macroeconomic stability.
- As tariffs continue to increase costs for manufacturers, some companies are raising prices, while others are absorbing costs to keep from losing customers.
- In preparation for Brexit, manufacturers are asking suppliers to maintain higher levels of inventory within the UK to lower the likelihood of shortages and delivery delays. One company is moving its product certifications from UK authorities to those in the EU for end-market stability.

> "Companies will need to buckle up for an extended period of global trade uncertainty. Almost three-quarters of 2,300 respondents surveyed during a recent webcast see the disruption continuing for the foreseeable future. The longer this goes on, the more important it becomes to plan for now and into the future as more than half of our respondents have already done.
>
> **Armando Beteta, EY Global Trade Services Leader, Latin American Business Center**

Companies included in our analysis

- ABB Ltd.
- Airbus SE
- Akzo Nobel NV
- BAE Systems plc
- 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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