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# The Quarterly

## Analyst themes from advanced manufacturing earnings calls

### 2Q18



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### Confidence in markets boosts outlooks, production rates

Welcome to *The Quarterly*, a review of the top themes discussed by leaders of 19 advanced manufacturing (AM) sector companies during public earnings calls with analysts. *The Quarterly* tracks the movement of these themes from quarter to quarter to provide perspective on shifts in the AM landscape.

We view the themes in *The Quarterly* as providing a timely snapshot rather than a universal assessment of importance, revealing insights into the minds of both AM leaders and industry analysts during the quarter.

Themes that stood out in 2Q18 include:

- ▶ **Change in financial outlook**, which was the number 1 issue for the quarter. As in 1Q18, AM company leaders are expressing confidence in growing demand for industrial products and services. About half of the peers in our analysis raised their revenue and earnings outlooks for the second half of 2018. Demand has been especially strong in end markets such as defense, commercial aerospace, automotive, transportation and consumer products. Rising revenues are, in turn, supporting margin growth. These increases in activity have also driven more discussion from leaders about **changes in production rates**, which debuted on our list in ninth place.
- ▶ **Geopolitical environment**, which remained among our top issues (No. 4) for the second quarter in a row. Many leaders recognize the potential for tariffs and changes in trade policies to increase market uncertainty. Rising costs for raw materials could lead to price increases. Again, global manufacturing footprints have been cited by leaders as a strategy to provide agility. Aerospace and defense (A&D) companies continue to experience growing demand for defense equipment and services, with increased spending coming from the Middle East and Europe.
- ▶ **Transaction strategy**, which returned to the list at No. 8. During 2018, acquisition integration and identification of competitively priced targets have become a focus. While concerns about high valuations for targets are still a factor, AM peers are prioritizing the acquisition of new technologies and innovations to support the commercialization of market-leading (and market-disrupting) products and services.

# Top 10 themes from quarterly earnings calls

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

## Key themes

**1** **Change in financial outlook**

Changing forecasts for revenues or earnings per share

- ▶ Outlook on revenues and earnings per share (EPS) was raised by half of peers.
- ▶ Margins continue to improve based on the success of ongoing productivity programs, boosting EPS.
- ▶ Several leaders expressed heightened confidence for improving performance in 2H 2018.
- ▶ The potential for extensions of tariffs and more restrictive trade policies is acknowledged by some, but it is not seen as significant enough to outweigh industrial sector fundamentals.
- ▶ Increased demand in key end markets is driving expectations for revenue growth. End markets mentioned most often are defense, commercial aerospace, automotive, transportation, construction and electrical systems.

"Markets may be facing some uncertainties, but the tone from the top in advanced manufacturing right now is confident. Industry fundamentals have been strong for months. Our most recent Industrials Capital Confidence Barometer found that 71% of respondents see the global economy as improving. Leaders are prepared to demonstrate this confidence to investors by raising outlooks for revenues and margins. Even more remarkable is that leaders are taking these steps for the second quarter in a row in 2018. By raising outlooks, companies are also raising the stakes by which their success is measured."

Dominic Iannazzo, Partner, Transaction Advisory Services, Ernst & Young LLP

**2** **Geographic developments**

Market conditions by region

- ▶ The growth outlook across regions is generally positive.
- ▶ While peers have traditionally expanded in China through local partnerships and joint ventures, one peer is planning a wholly-owned facility.
- ▶ Statements about growth in Europe were generally more optimistic than in 1Q.
- ▶ Chemical peers have experienced supply chain constraints due to tightening environmental regulation enforcement in China.
- ▶ Several company leaders see China as an ongoing source of revenue growth, led by expansion in end markets such as consumer products.

## Key themes



### Developments in end markets

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Trends in key customer segments impacting demands for products and services

- ▶ Optimism is supported by growth across a range of industrial markets.
- ▶ Electric vehicle (EV) innovations are creating a growth market in segments such as vehicle systems and charging stations.
- ▶ Strong growth in air traffic and a high load factor are continuing to drive demand for commercial aircraft.
- ▶ Expanded defense budgets in many countries are driving demand for military equipment.
- ▶ For agrochemical companies, large-scale transactions are changing competitive dynamics in key markets such as Brazil and China.
- ▶ Demand is increasing for advanced materials and specialty chemicals from semiconductor, nutrition, construction and automotive markets.
- ▶ In the energy sector, order activity has been growing more quickly from clients in renewables than from those in traditional power generation.



### Geopolitical environment

4

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

- ▶ Trade policy conflicts and the evolution of new tariffs are creating some uncertainty for industrial markets. However, many leaders remain confident that global markets are fundamentally strong.
- ▶ Leaders acknowledge the potential for tariffs to raise costs in the supply chain, particularly for steel and aluminum. These costs may be passed on to customers through higher pricing.
- ▶ Flexibility of global manufacturing footprints is cited as a hedge against higher costs due to restrictions affecting imports from targeted countries.
- ▶ Chemical peers are watching for changes in buying decisions by farmers in major agricultural markets as new tariffs may shift global trade flows.

“International trade information continues to be ‘breaking news’ halfway through 2018. Brexit, NAFTA and most recently the US-China tariff dispute are keeping many companies on edge. For example, the back-and-forth retaliation efforts between the US and China have created challenges most companies never anticipated. The timelines of these implementations are short – weeks instead of years – which leaves little time for companies to proactively and strategically plan. Companies must understand their entire supply chain and examine options for mitigating the additional duties which to date have included manufacturing shifting and product value reduction.”

J. Michael Heldebrand, Partner, EY Global Trade, Indirect Tax Services, Ernst & Young LLP



### Working capital and cash flow management

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Significant changes in working capital and cash flow

- ▶ Cash flow continues to improve for several peers due to strong prioritization of working capital discipline, often supported by productivity and cost-control programs.
- ▶ Cash flow is again reduced for some peers due to increased pension plan contributions.
- ▶ Cash flow has been challenged for some peers by higher receivables, higher-than-expected inventory levels, and increased expenses related to new aircraft rollouts.
- ▶ One peer is experiencing a negative impact on operating cash flow due to a decision to hedge against potential tariff costs by pre-buying raw materials.



### Innovation and new product/service launches

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Focus on digital technologies, R&D and product innovation

- ▶ Across all subsectors, the focus on digital and analytics, for internal operations and for product and service offerings, continues to strengthen.
- ▶ Several peers described new services for clients based on analytics, ranging from airline crew management solutions to digital farming applications.
- ▶ Partnerships with clients outside the industrial sector have provided opportunities for some peers to develop sophisticated, highly customized service offerings.
- ▶ The Internet of Things (IoT) is named often as a driver for the creation of connected solutions. One peer forecasts a tripling of IoT-related revenues by 2025.
- ▶ New product launches and a focus on high-growth segments remain priorities for agrochemical and specialty chemical manufacturers.
- ▶ Products designed to perform under extreme conditions are growing in appeal for industrial customers, particularly in the oil and gas sector.

“If you’re driving the disruption, you have more control of it – the timing, the pace, the scale, the overarching strategy. If you wait until the marketplace forces you to react, you’re at the mercy of everyone else’s timetable. What’s more, waiting to act until the disruption gets close is a gamble: you can’t anticipate where the disruption is coming from by monitoring your competitors – because competition is coming from unexpected places.”

Lisa Caldwell, EY Americas Advisory Commercial Leader

## Key themes



### Cost reduction

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Focus on controlling costs in all parts of the organization

- ▶ Ongoing productivity programs are credited for improvements in cost reductions as well as working capital and cash flow management.
- ▶ Increased focus on centralization of business planning and aligning of business unit goals support greater agility across the enterprise.
- ▶ Continued optimization of back-office functions reduces staffing costs.
- ▶ Multiple peers are working toward cost synergy targets in the process of integrating acquisitions.
- ▶ Peers serving the energy sector are rationalizing their workforces and manufacturing footprints in response to uneven demand from customers.
- ▶ Integration and restructuring costs are cited by some peers as affecting working capital and cash flow.

New

### Transaction strategy (future plans)

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Future-facing discussions about mergers, divestitures and joint ventures

- ▶ Following a seasonal pattern also noted in 2017, several peers are sharing more details about acquisition plans in 2Q than in previous quarters.
- ▶ New technologies and innovative processes are attracting buyers looking to improve internal operations and external products/services. Innovation remains a high priority.
- ▶ Valuations for targets remain high, which increases the risk of overpaying for acquisitions. One peer describes the pursuit of acquisitions as a priority but is willing to return cash to shareholders instead if prices are too high.
- ▶ A few peers are considering divestitures of businesses with growth prospects and margins below enterprise-wide goals.

"Industrial companies continue to have a confident outlook on the M&A market, with 87% describing it as improving. This confidence is holding strong, even in the face of growing challenges such as increased competition from private equity funds and corporate buyers. A majority of industrials expect their deal pipelines and deal completion rates to increase. Sophisticated methodologies to source potential targets will support this growth, along with evolving due diligence techniques and analytics to assess planned acquisitions."

David Gale, EY Global Advanced Manufacturing Leader, Transaction Advisory Services

New

### Changes in production rates

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

- ▶ Chemical companies are benefiting from new capacity coming online, particularly at facilities in the US and Middle East for petrochemicals and in Argentina for lithium used in EV applications.
- ▶ A&D manufacturers are reporting increased unit production in several new aircraft product lines. One peer is reducing aircraft production while investing in shipbuilding operations.
- ▶ Supply chain constraints are affecting one manufacturer's ability to meet demand for a new engine for which production was ramped up in 2Q.
- ▶ Another industrial products manufacturer is expanding capacity in Europe to meet demand for short-turnaround orders.



### Business reorganization/restructuring

10

Operational streamlining, business function reorganization and divestments

- ▶ AM companies continue to reorganize portfolios through spin-offs, acquisitions and divestments to achieve a more focused business structure.
- ▶ Activist shareholders continue to pressure leaders to divest operations seen as underperforming. Activists are also targeting businesses as potential spin-offs.
- ▶ Two industrial products manufacturing peers announced plans to carry out large-scale redesigns of their enterprises. These efforts involve a combination of divestitures, staff reductions and new business unit structures. The newly redesigned companies are intended to be leaner and better positioned to serve growth markets.

## Scope, limitations and methodology

This analysis examines key themes from the public 2Q18 earnings calls among 19 global advanced manufacturing peers, including companies from the chemical and A&D sectors.

The identification of the top 10 themes is based solely on an examination of earnings calls held from 18 July through 2 August 2018.

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