KPMG

How to make the most of a downturn

Industrial manufacturing

As the U.S. Federal Reserve continues to raise interest rates to lower inflation, manufacturers are becoming pessimistic regarding the path of the U.S. economy. As rates continue to climb, the U.S. economy's growth may be stifled for the near future or possibly shrink further, after contracting in the first half of 2022. How should manufacturers respond, given these economic headwinds? The answer is to prepare carefully for a range of possibilities, not least a down cycle, because experience has shown that the companies recalibrating early and quickly are more likely to end up on top. To plan ahead, it is critically important to understand what kind of slowdown could occur, which will be unusually difficult to assess this time around.

What to prepare for

The downturn in the U.S. and global economy is unfolding in ways that do not fit the pattern of previous industrial cycles. Consumer confidence in the U.S. picked up in August 2022[1], following three consecutive monthly declines, and consumer demand is high. One example of strong demand is that airline travel is surging, and this is reinvigorating demand for narrow-bodied jets.

The labor market is also strong. Unemployment is at its lowest rate in decades, and manufacturers continue to complain that it is difficult to hire skilled workers. In a July 2022 report, the Federal Reserve Bank of St. Louis said that labor constraints are the greatest challenge to the manufacturing sector.[2] Furthermore, supply chains are still very tight, especially for semiconductors. General Motors said that the global shortage of computer chips and other parts had left it with 95,000 unfinished vehicles during the second quarter of 2022.[3] The chip shortage is likely to hamper automotive production through next year.[4]

Seven steps from KPMG specialists

01. **Prepare for several different economic scenarios.**

02. **Pre-emptively attack costs.**

03. **Strengthen the supply chain.**

04. **Use mergers and acquisitions to improve resilience.**

05. **Reshape the product portfolio.**

06. **Update talent strategies.**

07. **Strengthen balance sheets and improve cash flow.**

[1] Source: U.S. consumer confidence, The Conference Board, Aug. 30, 2022

[2] Source: "Labor constraints remain the greatest challenge for resurgent manufacturing sector," Federal Reserve Bank of St. Louis, July 13, 2022

[3] Sources: Jeanne Whalen, "In Detroit, the chip shortage has left the city eerily short of cars," Washington Post, July 23, 2022 and "Chip shortage leaves 95,000 GM vehicles unfinished," Assembly Magazine, July 13, 2022

[4] Source: Patrick Seitz, "Automotive chip shortage likely to persist through 2023," Investor's Business Daily, Aug. 26, 2022

U.S. manufacturing output accelerated in July,[5] rebounding by 0.7 percent after declining 0.4 percent in June. Automobile production has been surging. But amid the positive news, there are some worrying signs. Retail inventories are rising, and some manufacturers have taken pre-emptive action by laying off workers.

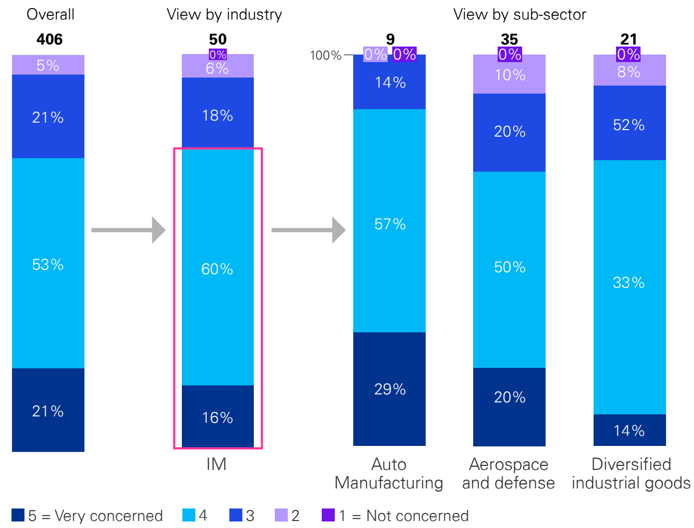
U.S. manufacturers are traditionally major exporters and have seen their profits squeezed by a historically strong dollar and rising input prices. Compensation[6] rose by more than 5 percent in the year to the end of June, and metals prices more than doubled[7] in the year to March, before declining somewhat. At the same time, supply chain issues were ranked[8] the top concern for manufacturing CEOs for 2022, according to the Manufacturers Alliance.

These factors are reflected in a high degree of pessimism regarding the path of the U.S. economy, among U.S. manufacturing executives surveyed by KPMG in July 2022. Some 74 percent think there is a greater-than-50 percent chance the U.S. will enter a recession in the 12 months to July 2023. Almost half (48 percent) expect the recession to be moderately severe, and 65 percent expect it to last less than a year.

It will likely be hard to predict trends in the U.S. economy, making navigation very difficult. And yet pre-planning, despite the unpredictability, is more important than ever. In this report, we examine how companies should plan ahead, based on an analysis of previous industrial cycles, as well as the insights from KPMG subject-matter specialists.

76% of IM respondents think there is a greater than 50% chance the US will enter a recession

On a scale of 1 to 5, how concerned are you about the U.S. Economy?
(N=450, all respondents)



Source: KPMG

How manufacturers are getting ahead of the downturn

Based on past experience, we know that companies that take decisive action before downturns and find opportunities to invest in growth ahead of a recovery tend to fare better than ones that do not. Companies that were still growing sales and margin during the 2007-2008 recession outperformed the Russell 2000 index by up to 7.9 percent. The poorest performing companies underperformed by almost 17 percent, on average.[9]

Today, we see some manufacturers are getting ahead of the downturn. Ford announced[10] layoffs in August, in part to position itself better for a predicted increase in production of electric vehicles (the cuts were concentrated among employees working on conventional vehicles). Tesla is cutting the salaried workforce by about 10 percent.[11]

Manufacturers are therefore expecting not just a slowdown in the economy, but a contraction. To them, the economic trends are likely to worsen from the currently mixed picture. The implication is that executives should prepare for not only a prolonged recession, but also the recovery that is likely to follow, by placing bets that will strengthen resilience in the short term and enhance competitiveness in the long term.

[5] Source: "U.S. manufacturing production accelerates in July," Reuters, Aug. 16, 2022

[6] Source: Compensation in selected private industries, 12-month percent change, Bureau of Labor Statistics

[7] Sources: Base Metals Price Index, World Bank

[8] Source: manufacturersalliance.org

[9] Source: "Making the most of the downturn," KPMG, Aug. 18, 2022

[10] Source: Claire Bushey, "Ford to axe 3,000 workers as it 'reshapes' operations for new era of electric cars," Financial Times, Aug. 16, 2022

[11] Source: Dana Hull, "Elon Musk says Tesla job cuts will reduce workforce by 3.5 percent," Bloomberg, June 21, 2022

What you can do now

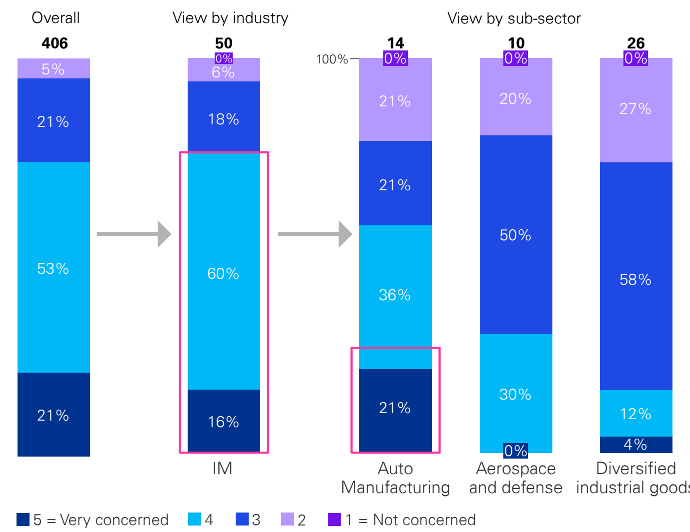
While the signs of recession continue to grow, a deep falloff in demand has not yet occurred. So there is still time to act. Here are seven suggestions from KPMG specialists on what companies can do now.

Prepare for several different economic scenarios: With economic trends pointing in varying directions, it will be highly advantageous to plan for the possibility that industrial demand may move along different paths, too. Will a recession be short and mild? Will it be V-shaped like the "COVID recession" or a deep, prolonged downturn with a U-shaped recovery? Could it be a "W" with a recovery followed by another contraction? Business leaders should plan for each of these scenarios—and for a recession that does not conform to established patterns.

Right now, it looks as if manufacturers are slow to plan. Only 24 percent of executives in our survey have a comprehensive plan to navigate an economic downturn/recession, and 30 percent are either formulating a plan or do not have one at all.

21% of auto manufacturing respondents don't have a clear plan to navigate a recession

Company's plan to navigate an economic downturn/recession
(N=50, all respondents)



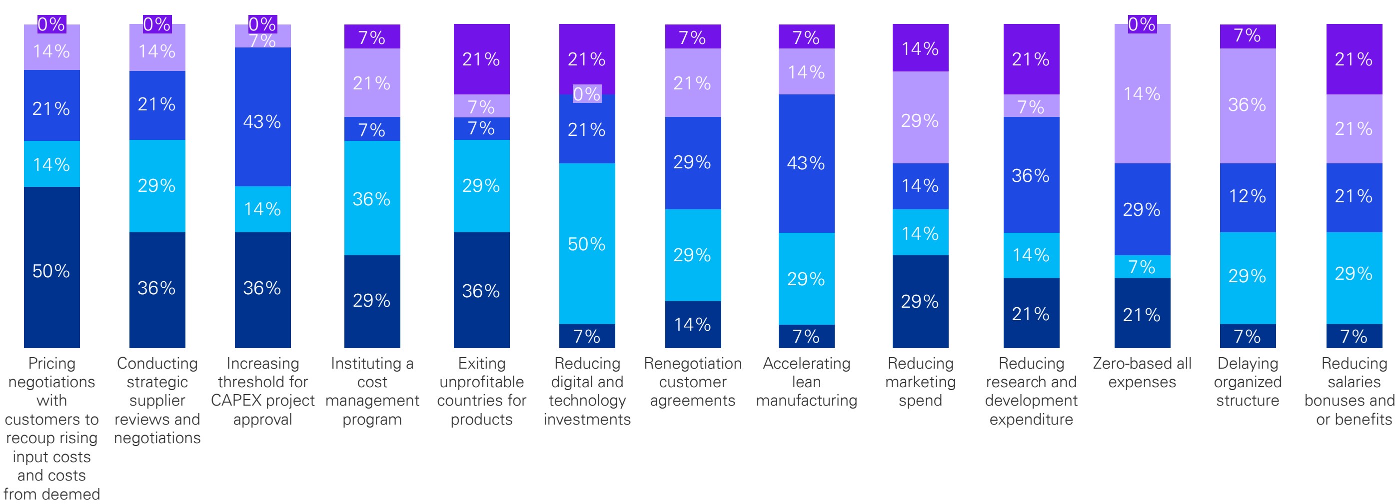
Source: KPMG

Pre-emptively attack costs: Whatever shape this downturn takes, it always pays to get ahead of costs before demand weakens. The strong recovery from the pandemic led to complacency on costs and growing inefficiencies in many businesses. Organizations should redouble efforts to find these inefficiencies by assessing all industrial processes and removing wastage. Some 65 percent of auto executives are likely to institute a cost-management program, according to KPMG's survey.

During a recession

Negotiating prices with customers and conducting strategic supplier reviews would be key initiatives to auto manufacturing executives

Likelihood of actions to be taken by the respondent's company during recession – Auto Manufacturing Industry
(N=14, all respondents)



Source: KPMG

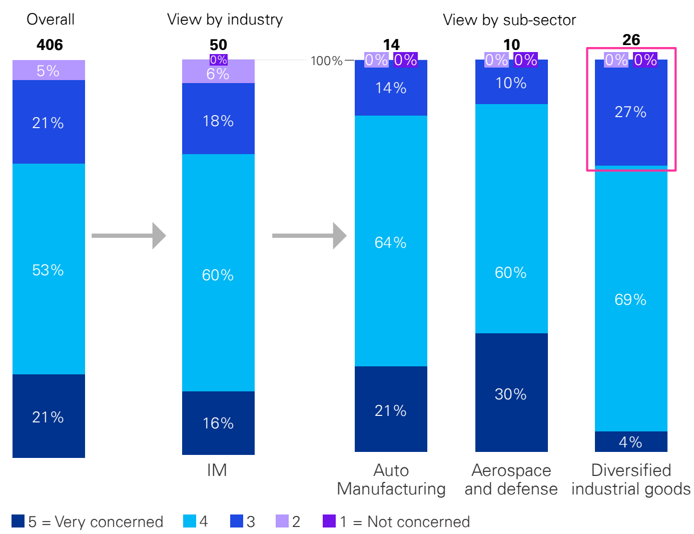
Strengthen the supply chain: Manufacturers have focused intensely on enhancing their supplier relationships, especially since the onset of the pandemic. Now is not the time to take the eye off this ball; in fact, a downturn may present opportunities for original equipment manufacturers and Tier-1s to tighten their supply chains by picking up distressed assets more cheaply and by using a strong balance sheet to help vendors in financial difficulties. Tier-2 companies that fiercely guarded their independence may become more amenable to forming partnerships, joint ventures, and alliances to weather out a storm. Sixty-five percent of auto executives in our survey say they are likely to conduct strategic supplier reviews during a recession, compared with only 40 percent of A&D executives.

Use mergers and acquisitions to improve resilience: When the economy slows the cost of owning under-performing assets rises. And companies looking for future growth may be able to acquire assets that might have been out of reach before the downturn. Our survey shows that 86 percent of executives have a moderate to high appetite for acquisitions over the next three years, and only 44 percent have a similar appetite for divesting. If executives take a dispassionate view of their assets and are prepared to let go of those that do not strengthen core activities, they may become more even-handed in their approach to buying and selling. Both types of transactions offer tremendous opportunities to enhance growth. KPMG research demonstrates that when companies announce divestitures, their market valuations tend to be higher 12 months after the transaction.[12]

Update talent strategies: Fifty percent of manufacturers say they will reduce their workforce, a higher proportion than other sectors, apart from energy and natural resources (60 percent). Letting go of employees may fit this strategy, but it may also leave a company vulnerable to future skills shortages if a recession does not materialize or proves short-lived. A better way to plan is to consider how a recession may provide opportunities to alter the skills portfolio to enable the company to grow faster. This may mean holding onto people with key skills and hiring others to fill critical talent gaps. Both strategies require a fine tuning of employee value propositions, to attract and retain the appropriate talent.

27% **of Diversified Industrial Goods executives have a high M&A appetite**

Respondent's Company's M&A appetite over next 3 years
(N=50, all respondents)



Source: KPMG

Reshape the product portfolio: Seventy percent of manufacturing executives tell KPMG they will develop new products at lower price points, compared with an average of 58 percent for all sectors. This can be done relatively expediently by buying companies that can fill quickly gaps in the product portfolio or by re-tooling production lines and re-designing products.

[12] Source: "Think like an activist: To maximize value, CEOs can borrow from the activist playbook," KPMG, Apr. 9 2020

Strengthen balance sheets and improve cash flow: In an environment of rising interest rates, manufacturers should re-evaluate their debt structure and look for alternative sources of capital. While doing so, they should build covenant-testing models and work to ensure adequate liquidity through the trade cycle. In a downturn, cashflow is a key variable, so a timely review and clean-up of past-due balances before market risk affects receivables is wise. In addition, manufacturers should engage in renegotiation of payment terms with vendors.

How KPMG can help

In good times and in recessions, we help clients address their greatest challenges and pursue the most profitable opportunities. KPMG advises leading industrial organizations on strategy, transactions, and performance transformations. We have deep experience helping companies plan and implement growth strategies, cost improvement initiatives, talent enhancement programs and M&A efforts. Our people bring deep knowledge of corporate functions——human resources; technology; finance; supply chain; environmental, social, and governance; etc.——as well as decades of industry experience. We rely on data-driven techniques to help clients quickly solve problems and uncover new sources of value.

There are storm clouds ahead, but we are confident that whatever the economy has in store, business leaders will rise to the occasion. The past two years have taught us all to expect the unexpected and to be agile in adapting strategy to changing conditions, as well as plan for the next disruptive event. We look forward to helping you succeed in what promises to be a very challenging environment.

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