Manufacturing:
adapting in difficult times.

International Business Report 2008 - Industry focus

Introduction

Having seen world trade in goods expand at over 8 per cent a year during the global economic boom of 2003-07, manufacturers are bracing themselves for difficult times. The industry's problems stem largely from rapidly waning demand but are being compounded by turmoil in the financial sector.

The Grant Thornton International Business Report (IBR) results highlight the onset of further difficult times for privately held manufacturers with the ending of the global boom.

The impact of the downturn is shown by the proportion of businesses exporting, with figures down in 2008 following five years of robust growth. Employment growth remained robust in the survey with a balance of +35 per cent reporting an increase. But investment intentions are already easing and look set to fall further as uncertainties intensify.

Global conditions for manufacturers have deteriorated significantly, as the impact of the cataclysmic events in the financial sector have hit the real economy. Prospects are for a very tough period for manufacturing businesses, especially those in the mature economies, as demand weakens and even good companies find difficulty in obtaining credit.

The challenge for manufacturers is to try to protect their customer base, while carefully managing costs and cash flows. Lack of credit, even for the best run businesses, will severely constrain growth prospects into 2009.

Alex MacBeath
Global leader – privately held business services
Grant Thornton International

A difficult phase

The effect of rapidly slackening demand applies most forcefully to companies in the mature economies of North America, Japan and Western Europe, many of which are experiencing an abrupt slowdown with some countries currently in recession. Consumer spending and investment in these countries have eased markedly in recent quarters and weakening international demand is exacerbating the impact.

Manufacturing output has already turned down quite sharply in some countries, including the United Kingdom where the fall was 1.9 per cent in the six months to September 2008. Anecdotal evidence suggests that in the eurozone, activity in September 2008 was at its lowest point for seven years, while manufacturing output in Japan was 6.9 per cent lower in August 2008 than the previous year.

Manufacturing

Manufacturers in Eastern Europe and Asia, who rely on demand from the mature markets for the bulk of their export orders, are also feeling the impact. However, with domestic demand generally remaining buoyant they will continue to fare less badly than their counterparts in the mature economies in the difficult period ahead.

However, in the biggest producer of all - mainland China - the downturn in major markets has affected factory orders severely and although domestic demand remains brisk, manufacturing output is faltering. The survival of many manufacturers the world over will hinge on how China fares and responds to the deepening economic slowdown.

Exchange rates

Exchange rate movements have a strong impact on total manufacturing output, but also affect the distribution of output among various producers.

Canada is a major example of a country whose manufacturing sector has suffered in recent years from exchange rate trends. The global commodity boom underpinned a strong rise in the Canadian dollar reducing price competitiveness at a time when pressures from newly emerging markets were intensifying. The result was highlighted by the fact that mainland China overtook Canada as the largest trading partner of the United States.

Production

Weakening production apart, the sector faces serious problems. With demand still buoyant at the onset of the oil price surge, it was possible to raise selling prices and pass the cost to consumers.

However, as demand has weakened this has become progressively more difficult. At the same time, cash flow problems that emerge will be more difficult to resolve even for the most credit-worthy firms as the global liquidity crisis impairs banks' lending capacity. Injections of liquidity by central banks and government bail outs have helped, but the cost and lack of available credit will remain a severe constraint on the global economy.

"The pain for Canadian manufacturing is intensifying. Under pressure from currency appreciation and growing global competition during the recent boom, the industry contracted. It now faces a severe shortage of orders as the global slowdown hits demand."

Jim Copeland
Grant Thornton, Canada

International Business Report results

Exports

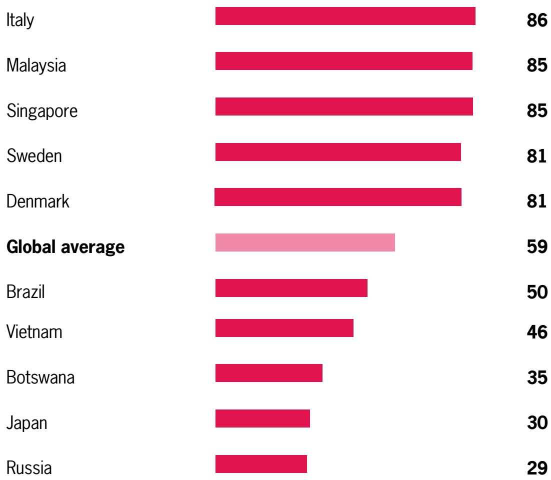
The proportion of manufacturers exporting fell in the 2008 survey from the peaks seen in 2007. This follows five years of robust expansion in trade and manufacturing in line with the global economic boom. The proportion exporting eased from 63 per cent to 59 per cent globally in 2008, and looks set to deteriorate further in 2009 as global demand wanes.

The global decline in exporting owes much to the experience of the United States, with figures down from 74 per cent in 2007 to 54 per cent in 2008. Exporting in Hong Kong has fallen from 90 per cent of manufacturers in 2007 to 72 per cent this year as weakening United States demand took its toll. These declines were accompanied by pronounced increases over the past year in several other countries, led by Thailand (48 per cent to 73 per cent), Mexico (37 per cent to 53 per cent), Brazil (39 per cent to 50 per cent) and Malaysia (75 per cent to 85 per cent).

The drop in the proportion of businesses in Hong Kong that export means that Italy moves up from second to top place in the rankings (see figure 1). At the other extreme, well below the global average, are Japan and Russia. In both cases the relatively small number of manufacturers trading internationally is explained by the fact that many enterprises focus on the domestic market, providing products to large companies that do export.

Export growth in manufactures, boosted by the global economic boom of 2003-07, is now suffering from the slowdown. The rate of export expansion has eased significantly from 8 per cent to below 4 per cent in 2008. The outlook for 2009 is not favourable as the financial crisis weighs heavily on growth and severely hampering demand for exports.

Figure 1: Proportion of manufacturers exporting
Top and bottom five economies
Percentage balance of manufacturers indicating an increase against those indicating a decrease



Source: Grant Thornton IBR 2008

All global regions will be affected, but the impact will be greatest in the eurozone, Japan and the United States. The IBR results suggest that privately held manufacturers in mature economies face a major growth challenge due to the depressed state of markets in their key trading partners, forcing many businesses to accept periods of weak or even negative growth over the coming year.

With limited increases in sales to help spread fixed costs, any increase in competitiveness will depend on productivity improvements and keeping control of labour costs. Even then, however, gains against international competitors may hinge on exchange rate developments where individual businesses are at the mercy of macro-economic factors.

Employment

Growth in the global manufacturing workforce showed a slight slackening last year, easing to +35 per cent from +38 per cent previously. This is likely to mark the start of a period of significant decline in employment in the manufacturing sector as problems in the financial sector affect the real economy.

Vietnam's manufacturers generated the strongest employment growth last year with a balance of +75 per cent reporting an increase, followed by the Philippines and India. Employment growth was weakest in the European Union (EU), with three countries featuring in the bottom five (see figure 2).

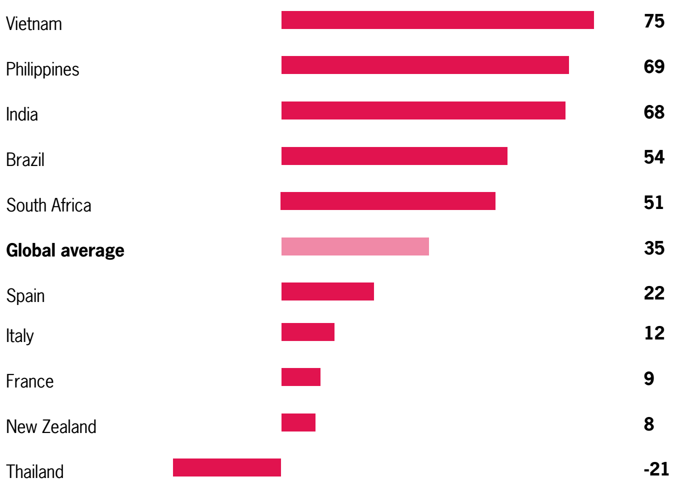
The deteriorating global backdrop points to falling rates of employment in the manufacturing sector globally over the next 12 months. Among the countries that exhibited especially rapid employment growth last year, Vietnam is likely to see the sharpest deceleration as high domestic interest rates and a faltering global economy dampen manufacturing's expansion.

In mature economies, employment contraction continued even during the boom as production gains were achieved through rising productivity. The United Kingdom lost almost 400,000 jobs (11 per cent) from the sector from 2003 to 2007 and Canada 300,000 (13 per cent). Over the same period, job losses in the United States were higher in absolute terms, but more modest in percentage terms. The loss of manufacturing jobs has gathered pace in 2008 as demand has weakened and the mature economies as a whole seem set for a year of severe employment contraction in 2009.

The key challenge in these circumstances is to retain skilled labour and key workers at a time of weak activity and financial constraints, in anticipation of an eventual upturn.

Once lost, skilled workers may retrain or leave the labour force and it may not be easy to re-employ them when conditions improve. Skills shortages in some areas can persist even during recession, and losing key workers during a downturn can worsen the position and impede long-term progress.

Figure 2: Employment growth
Top and bottom five economies
Percentage balance of manufacturers indicating an increase against those indicating a decrease



Source: Grant Thornton IBR 2008

Selling prices

Manufacturers are less confident of being able to increase selling prices this year compared to last. A balance of +32 per cent, compared to +34 per cent last year, were confident of raising selling prices over the next 12 months (see figure 3).

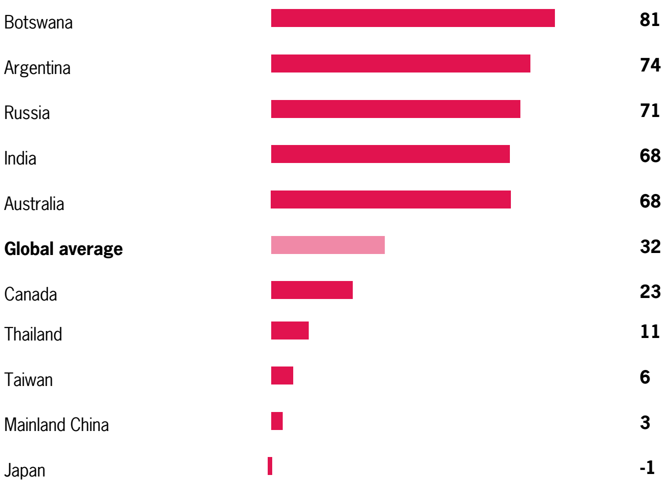
As in last year's survey, Botswana shows the largest balance of respondents expecting to increase selling prices at +81 per cent, reflecting the combination of high input costs, an economy still growing at around 5 per cent and inflation running at near 8 per cent.

A similar picture of solid growth and high inflation explains Argentina's presence in second place. The appearance in the top five of Russia and Australia reflects their ability to capitalise on high energy and raw material prices up until Q3 2008, while India's presence in this group is due to rapidly growing domestic demand and mounting inflation.

At the other extreme is Japan, whose manufacturers display a small negative balance for selling price expectations. The country continues to experience very low inflation and weak economic growth, a combination that inhibits increases in selling prices. The major surprise is the appearance of mainland China only just ahead of Japan. In previous surveys the economy has been much higher in the rankings but exporters have been hit in the past year by weakening demand from the United States and the appreciation of the renminbi, and have countered this by price cuts. The survey suggests that there are widespread expectations that this will continue.

The combination of last year's oil price surge with, in most countries, still solid demand produced a strong rise in manufacturers' selling prices. As demand has weakened this year it has become more difficult to pass on cost increases to consumers.

Figure 3: Expectations for selling prices
Top and bottom five economies
Percentage balance of manufacturers indicating an increase against those indicating a decrease



Source: Grant Thornton IBR 2008

At the same time the recent fall in the price of oil has alleviated pressure on input costs, and has removed some of the imperative for manufacturers to raise prices.

During the next 12 months, it is likely that the sharp deterioration in market conditions will make it even harder for manufacturers to increase prices. Faltering consumer demand in the mature economies will provide severe resistance to moves to improve margins. Softer activity in the global economy will, however, continue to bear down on the oil price, in the absence of major disruption or planned cuts in supply, continuing to ease energy costs and reduce stress on margins.

Investment in plant & machinery

Investment intentions in plant & machinery are much less buoyant at the global level than in recent years when business sentiment was supported by healthy economic prospects. The balance of respondents expecting an increase in investment spending over the year ahead eased from +45 per cent in 2006 and +55 per cent in the 2007 survey to +42 per cent on this occasion (see figure 4).

This decline was largely due to a substantial erosion of investment expectations in East Asia, where balances fell in most countries, notably mainland China (from +71 per cent last year to +22 per cent) and Hong Kong (+61 per cent to +39 per cent), dampened by the dramatic economic slowdown in the important United States market.

Other countries in the region are similarly affected and three of them occupy the bottom places in the rankings for investment in plant & machinery (see figure 5). However, within the region there was a significant rise in the Philippines' balance from +40 per cent to +64 per cent.

The coming 12 months will see subdued investment in plant & machinery as the global economic outlook continues to deteriorate. The depressing impact of an economic slowdown can be seen from the behaviour of overall investment over the cycle. In the last downturn of the business cycle in 2001, total world investment eased from 7 per cent expansion in the previous year to -1 per cent this year. Mature economies bore the brunt of the downturn, registering a 4 per cent contraction. Emerging markets still expanded investment, but the growth rate slowed from 9 per cent in 2000 to 2 per cent.

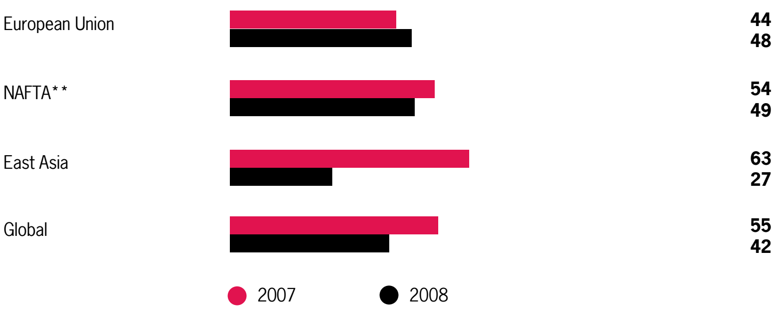
The current cycle is likely to see a much sharper slowdown in global activity than in 2001 and prospects for manufacturing exports and domestic sales are gloomy in most economies. With a high proportion of firms already working well below capacity, there is little incentive to boost spending. Furthermore, the availability of finance will be restricted in the current financial market turmoil. In these circumstances, the outlook for plant & machinery investment in the economies of North America, Western Europe and Japan is particularly bleak, and it would not be surprising if several countries posted significant contraction following the buoyancy of the past few years.

Despite the current difficulties, many businesses will take a long view, appreciating the need to improve productivity to gain competitive advantage when conditions eventually improve.

However, appropriate investment can only be undertaken provided finances are in place, and decisions to proceed will often have to be postponed until the economic background is more secure and the financial climate improves.

Figure 4: Expectations for investment in plant & machinery - by region 2007-2008

Percentage balance of manufacturers indicating an increase against those indicating a decrease*

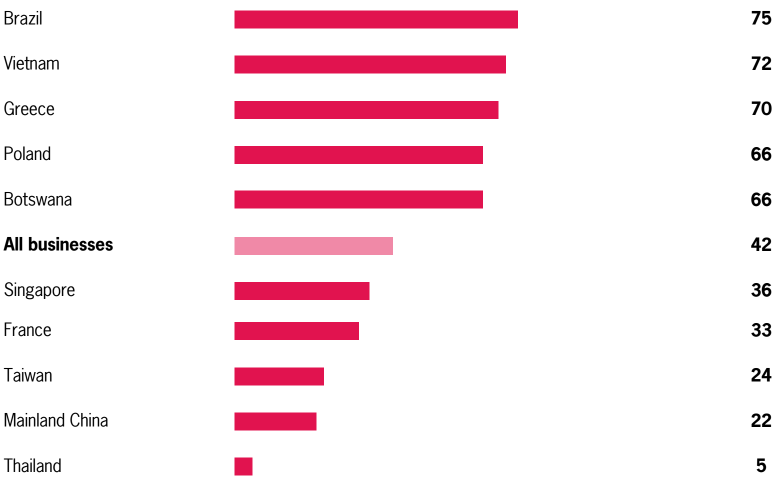


*The balance is the proportion of businesses indicating an increase less those indicating a decrease
**North American Free Trade Agreement countries

Source: Grant Thornton IBR 2008

Figure 5: Expectations for investment in plant & machinery - top and bottom five economies

Percentage balance of manufacturers indicating an increase against those indicating a decrease*



*The difference between the proportion of businesses indicating an increase less those indicating a decrease

Source: Grant Thornton IBR 2008

Constraints

Regulations/red tape has diminished as an expansion constraint on manufacturers. It is now below shortage of orders/reduced demand, which has leapt into first place, as demand for goods has suffered from the global economic slowdown.

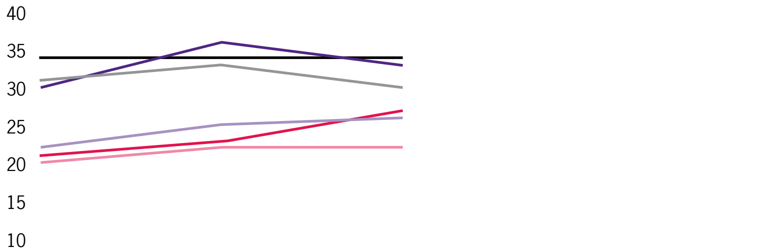
Lack of availability of a skilled workforce is also still regarded as a major constraint as skills shortages, which rose markedly in 2007 after five years of robust output expansion, remain an issue. The economic crisis of the past year is reflected in the much increased prominence for financial factors (shortage of working capital, cost/availability of finance and shortage of long-term finance).

Shortage of orders/reduced demand was a major problem in East Asia, where 49 per cent of respondents cited this as a constraint, against 28 per cent in the EU and North American Free Trade Agreement (NAFTA) countries. Japan (61 per cent) showed a very high proportion reflecting the sluggishness of the domestic economy. At the other extreme are a number of economies with low concerns about order volumes, including Argentina and Singapore with only 13 per cent citing this issue.

Lack of skilled workers was also most noticeably a problem in East Asia, but with 38 per cent of businesses citing it, the gap against the EU (33 per cent) and NAFTA (27 per cent) was much less marked than for shortage of orders.

Financial constraints were most evident in emerging markets but only in Argentina did it emerge as the most serious constraint.

Figure 6: Global constraints on expansion for 2006-2008
Percentage of manufacturers rating this 4 or 5 on a scale of 1 to 5 where 1 is not a constraint and 5 is a major constraint



2006	2007	2008	
35	35	35	Shortage of orders/reduced demand
31	37	34	Lack of availability of skilled workforce
32	34	31	Regulations/red tape*
22	24	28	Cost/availability of finance
23	26	27	Shortage of working capital
21	23	23	Shortage of long-term finance

*Excludes mainland China
Source: Grant Thornton IBR 2008

The year ahead

The next 12 months will be an extremely tough period for many manufacturing businesses. Expansion, especially in the mature economies, will be constrained by slack consumer demand and sluggish export growth. In many countries, these key elements of demand will actually contract as the current recession bites.

On top of this, the current paralysis in the financial markets will take time to unravel. Finance to expand the business will be in short supply and its cost will remain high. Expansion for many privately held manufacturers will have to be deferred until the cost and availability of capital makes projects viable. Skills shortages are likely to persist, but will become a much less significant constraint than in this year's survey, being replaced by shortage of orders/reduced demand in most mature economies.

"Manufacturing businesses in Taiwan experienced robust output growth last year, but still highlighted shortage of orders in our survey as the major constraint on expansion. There is concern that as the economic backdrop worsens, this factor will loom larger."

Jay Lo
Grant Thornton, Taiwan

Competitiveness

Manufacturers cited product/service quality as their main source of competitive advantage. Over 70 per cent of respondents globally cited this factor, while in the EU the proportion was 82 per cent, well ahead of the next factor, workforce skills at 60 per cent. In Latin America, the proportion rating product/service quality was even higher at 86 per cent, followed by ethical business practices, at 73 per cent.

Few businesses will be able to avoid the contraction in output that slackening global demand is generating, no matter how competitive they are through recognised product/service quality, ethical business practices or brand strength. Firms might attempt to gain or restore competitiveness by cutting costs, with labour costs the main target. However, the contraction of output implies that large-scale workforce contraction will be forced upon businesses throughout the industry, suggesting that comparative gains may not be achieved in this way.

Figure 7: Main sources of competitive advantage - globally
Average percentage of manufacturers rating strength of advantage 4 or 5 where 1 is not very strong and 5 is very strong

Source: Grant Thornton IBR 2008

Corporate social responsibility (CSR)

With growing scrutiny of business operations, organisations are increasingly being driven to satisfy the expectations of opinion formers, governments and customers in order to thrive. When privately held manufacturers were asked what they had done in the past year to manage their corporate social responsibility, workforce related matters topped the list.

Three of the top five initiatives were directly associated with people and their workplace – active promotion of workforce health and well-being (69 per cent of respondents); provision of internships/apprenticeships/work experience 65 per cent) and promotion of diversity/equality in the workplace (61 per cent) (see figure 8). These all have an important role in the context of social responsibility, though the initiatives also play a key role in human resource management.

Public attitudes towards CSR have changed dramatically over the past few years with consumers increasingly expecting companies to not only provide green solutions to consumers, but also to develop remedial actions directly addressing the environmental footprint of their businesses. Those companies not actively pursuing these strategies risk being outpaced by those more attuned to public pressure/perception and that participation in CSR will become a necessity, not a choice.

As global demand falls, companies will be competing in increasingly restricted markets where an ability to differentiate themselves from competitors will become even more critical. CSR may offer that competitive advantage.

Not only can a good CSR framework act as a differentiator against the competition, environmental measures promote good business practice and can help firms reduce costs and streamline processes during the economic downturn.

Figure 8: Corporate responsibility initiatives undertaken in the past year - globally
Percentage of manufacturers

Source: Grant Thornton IBR 2008

The demand for action

Manufacturers need to prepare for a tough year in 2009 in all aspects of their operations.

Exports will be severely constrained by the global downturn, with a recession likely in many important countries.

Financial constraints will be exacerbated by lack of working capital from the hard-pressed financial sector. Domestic demand, even in countries that display resilience in the face of global downturn, will slacken.

Employment growth globally will be weak at best, with many countries cutting their manufacturing labour force into 2009. Firms will find it extremely difficult to raise selling prices, although recent retreats in commodity prices will help to reduce the pressure to pass on cost increases.

During difficult times manufacturers will do well to remember the basics and follow good business practice. By doing the right things quickly and decisively, businesses can even turn the crisis on its head.

Simple strategies for both product lines and production processes will be key. Having cash on the balance sheet, which will offer a greater degree of flexibility when making decisions, and reviewing accounting processes and tax liabilities, could help to strengthen systems and increase cash flow.

Difficult decisions may need to be made and consideration should be given to cutting costs quickly and cheaply to avoid repeated morale sapping cuts.

Manufacturers, however, must still be alert to opportunities for expansion as valuations drop when owners look for quick exits. Research and marketing may also be key, enabling strong positioning to take advantage of the future upturn.

As in any economic downturn, it will be the best managed, most dynamic manufacturers who survive. Those failing to act or respond adequately will face a very uncertain 2009.

IBR contacts

The Grant Thornton International Business Report (IBR), formerly known as the International Business Owners Survey (IBOS), provides insight into the views and expectations of over 7,800 privately held businesses (PHBs) across 34 economies. This unique survey draws upon 16 years of trend data for most European participants and six years for many non-European economies. The research was conducted by Experian Business Strategies.

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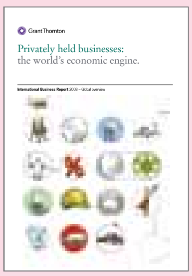

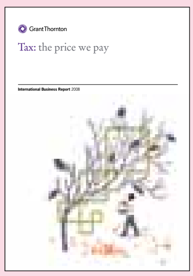

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