

2009 Industry Outlook:
Process & Industrial Products
Challenging Times,
Emerging Opportunities



Process & Industrial Products



Expect the Process & Industrial Products sector to “hunker down” in 2009, as manufacturing companies focus on right-sizing, managing costs and working capital, and taking additional steps to weather a rapidly deteriorating global economy.

The U.S. Process & Industrial Products sector includes chemicals, metals, and paper and packaging companies as well as industrial products and services manufacturers. The sector weathered 2008’s economic slowdown fairly well, thanks, at least in part, to exports that offset lower domestic demand. However, recently released economic data suggests that the manufacturing climate is clearly weakening. Heightening the concern is a financing and credit environment that is currently in turmoil. Historically high prices for oil and commodities are putting a strain on sector margins, while increased competition and weakened domestic demand limit manufacturers’ ability to pass on costs to end consumers. In addition, it is increasingly difficult to obtain financing amid a tightened credit market; this is stunting companies’ plans for expansion and putting increased pressure on managing working capital. One clear sign of growing sector distress was the release of the Institute for Supply Management’s September reading on U.S. manufacturing activity, which

came in at 43.5, the lowest level since October 2001, in the aftermath of the September 11 attacks. To put this into context, a reading above 50 signals growth. Employment levels, inventories and manufacturers’ order backlogs are also dropping.

In addition to managing the fallout from continued economic distress, other issues will challenge the Process & Industrial Products sector in 2009:

Globalization – In the latter half of 2008, this sector saw growing evidence that the Process & Industrial Products market is becoming increasingly global. For example, exports to Europe and Asia that positively impacted U.S. manufacturers earlier in 2008 started to slow as those regions began to curtail large infrastructure projects such as train lines. As we look ahead at 2009, the demand from those markets outside the U.S. will significantly impact companies in this sector.

Globalization is also creating an increasingly complex and geographically diverse manufacturing network and supply chain, which can strain companies’ resources and capabilities. However, a renewed emphasis on supply chain optimization and product quality – driven, in part, by safety concerns about products manufactured in China – is prompting some U.S. companies to bring back manufacturing (and jobs) that they lost to overseas competitors. In fact, some companies are curtailing their China expansion plans overall: No longer is China the low-cost country in Asia; a dramatic rise in the cost of labor and the higher cost to transport products from emerging to developed markets has somewhat dimmed China’s luster. The strengthening of China’s currency also contributes to the rising cost of doing business in China. This is not to say that China is no longer expected to be a global powerhouse; in the short term, though, some companies are benefiting from manufacturing’s return to U.S. shores.

Consolidation – Cost pressures, foreign competition and the strategic need to enter new markets will continue to drive M&A activity in the sector. The major deals announced in 2008 – Dow Chemical’s acquisition of polymers and resins manufacturer Rohm & Haas;

Ashland's acquisition of Hercules, which will create a major global specialty chemicals company; and BASF's intent to buy W.R. Grace & Co. – will likely lead to even further consolidation, particularly in the chemicals, metals and paper and packaging sectors. We envision further consolidation occurring throughout the sector as companies aggressively seek to align their portfolios to maximize profits. The possibility of more layoffs in this sector is also very real: Companies will be looking to become more lean and cost-effective as the current economic situation persists.

One constraining factor to continuing consolidation may be the tightening credit markets, which have already had an impact on closing deals late in calendar 2008. The stability of the credit markets will be a key indicator worth watching in 2009, given the overreaching impact it has on this sector.

Talent Management – Attracting and retaining employees will continue to be a nagging problem for manufacturing companies. A depleting U.S. talent pool – a huge shortage of engineers is forecasted in coming years – and global challenges around recruiting and retaining management talent pose significant issues for sector growth. Complicating the situation is the fact that manufacturing's workforce is older than that of most other sectors, so its replacement timetable is shorter. In addition, the sector must work through an image problem if it hopes to counter aggressive recruiting efforts by more "glamorous" industries. In the near term, manufacturing companies will be challenged to balance the long-term talent reality with the short-term necessity of right-sizing the workforce to address profitability challenges caused by the economic downturn.

Sustainability – The Process & Industrial Products sector will also continue to focus on environmental sustainability ("going green") in 2009. Investor activism, changing consumer demands and increasing regulations are driving companies to incorporate sustainable business practices into their operational strategies. Yet, absent these drivers, manufacturers are still trying to manage their energy costs and reduce consumption, which is good for a green world and companies' bottom lines. Many companies have

named Chief Sustainability Officers to guide their initiatives; other companies are also demonstrating their commitment to sustainability.

In addition to facing a number of common issues in 2009, each of the Process & Industrial Products' four sub-sectors will need to address specific challenges:

Chemicals – This sub-sector is the one most impacted by global consolidation. Mega-chemical companies such as Dow and BASF are anticipated to expand their global reach in 2009 and future years. In addition, volatility in the energy and raw materials markets will continue to create operational challenges. Finally, heightened attention to emissions regulations could increase the already heavy financial burden placed on U.S. chemical manufacturers.

Metals – Metals are in for a bumpy ride as a result of softening demand in the current economic downturn. While China's huge demand for steel positively impacted pricing during the past few years, prices are expected to soften in 2009 due to slowdowns in the automobile and housing industries. As evidence of growing globalization in this sub-sector, BRIC countries (Brazil, Russia, India and China) are leading the consolidation of steel companies; this, in turn, links with the consolidation of the raw materials supply of iron ore and scrap metal.

Paper and Packaging – In this increasingly electronic world, a continued slowing of demand for paper projects is expected to extend into 2009. The resulting fallout could exacerbate plant closing and equipment mothballing. Globalization is also having a detrimental effect on demand: U.S. commodity papers are being undercut by an influx of less-costly imports. Finally, paper manufacturers – particularly those in commodity markets – are seeing huge pressure on margins due to energy cost fluctuations. Recent signs of declining commodity prices do offer needed relief to manufacturers in this sector.

Industrial Products and Services – A year ago, there were pockets of strength among industrial products and service companies, and these still exist. In general, those companies that performed well, such as Caterpillar and Ingersoll Rand, relied on strong exports. The new reality,

however, is that slowing demand globally is catching up with everybody, including this sub-sector. Therefore, 2009's focus will be on top-line growth in a cost-effective manner and investments focused on high ROI.

Given current economic conditions and the high level of market uncertainty, it would be unrealistic to anticipate a strong year for the Process & Industrial Products sector in 2009. Fortunately, companies in this sector have long been preparing for an economic downturn by engaging in rigorous cost reduction efforts. These efforts have resulted in substantially less leveraged balance sheets, which will provide more flexibility for companies during this downturn.

As demand continues to slow, expect to see even a widening separation between winners and laggards. One probable outcome is continued industry consolidation. Also, manufacturers that are suffering significantly from weakened domestic demand should be evaluating opportunities in foreign and emerging markets. Fortunately, those companies with stronger balance sheets should be able to grow and make acquisitions in these challenging times, particularly those focused on operational synergy. "Cost control and disciplined execution" are the watchwords for the U.S. Process & Industrial Products sector in 2009. While it is impossible to say how long this economic downturn will last, forward thinking companies have been working to right-size their organizations, optimize their supply chains, and evaluate their current situation against long-term objectives so that they are prepared to move forward when the economy changes gears from reverse into drive.

Contributors

Process & Industrial Products

Tim Hanley

U.S. Process & Industrial Products Sector Leader

Deloitte LLP

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