Q&A

How Trade Challenges Affect the Manufacturing Industry

An interview with Doug Schrock

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U.S. manufacturers faced a volatile 2019, and with continued trade negotiations and industry consolidation, they might continue the bumpy ride. The Financial Education and Research Foundation (FERF) talked with Doug Schrock, Crowe IT advisory services leader, about the outlook for the manufacturing sector in the new year.

FERF: 2019 has been a year filled with trade tensions. From your perspective, how has the manufacturing industry been most affected and why?

Doug Schrock: I have a pretty good feel for what our clients are seeing across the market. We have roughly 2,000 manufacturing and distribution (M&D) clients, including many in the middle market.

I think my most important takeaway in viewing the environment is that it's proving to be a no-win trade war. Certainly, individual companies might find themselves with some advantage, but across the many different subsectors of manufacturing clients we work with it is having an overall detrimental effect.

I'll give a couple of examples.

From a supply side, parts that are high cost density – for example, a circuit board that has a high cost within a low volume – are often more prone to be sourced from China due to the relatively lower impact of freight against total cost. These parts are being hit hard with trade tariffs, which is affecting the cost structure in sectors like electronics and automotive.

On the sell side, countries like China have been big consumers of a wide variety of U.S. commodities such as metals or grains. The Chinese demand had grown to historical volumes, but the Chinese now are seeking to buy elsewhere, overall lowering demand on U.S. product. This is a natural result as the buyers in foreign countries are incentivized to find alternative providers that now become viable when U.S. tariffs are considered in their purchase price.

The clear bottom line our clients see is that tariffs are paid for through either shrinking company margins or price increases passed on to the consumer – neither a winning position. Our clients are spending energy and focus on dealing with this supply chain step-function cost disruption. Rather than focusing on value-added items like innovation and customer experience, they're dealing with this self-inflicted speed bump.

FERF: What would you say about middle market manufacturers that don't necessarily have all of the options that a larger manufacturer has when there is a disruption like the tariffs? Is the middle market being hurt more than the larger manufacturers?

Doug Schrock: Companies do experience widely varying impacts, but size isn't the major factor. The degree of impact is rather straightforward in that it hits hardest those whose supply chain is most globally exposed.

A small manufacturing organization might have a few facilities in China from which it sources product. These small organizations might have only one or two persons who regularly travel to China to navigate supply chain relationships and sourcing. For such an organization to find an alternative source – say to look to Thailand or Mexico – can be quite challenging and disruptive. The small set of Chinese suppliers affected by trade could be a significant element of the company's manufacturing supply chain profile.

A large manufacturer is more likely to have a deeply developed Chinese strategic sourcing group. And it will have a number of tax, trade, and supply chain experts. The large company is affected more deeply due to scale, but it has better mechanisms to respond. My clients of all sizes are not indicating this new dynamic is driving more U.S. manufacturing.

FERF: What are you hearing from manufacturers regarding their outlook for trade policy in 2020? Do they expect trade wars to escalate or ebb, and how will they respond?

Doug Schrock: My clients don't have enough confidence to act definitively based on their speculations. They didn't expect to be in this spot three years ago, they don't know where trade is going right now, and they sure don't know what it's going to be like in two years.

This unknown trade dynamic is married with the uncertainty of an impending threat of recession that might be 12 to 18 months out. Many middle market clients have held that feeling a long time, though recession hasn't arrived yet, so it's impossible to know what will happen.

I would characterize their feelings as a degree of somewhat warranted cynicism that this is not going to suddenly resolve itself leaving everything notably better than it was before.

FERF: Manufacturing has gone through several years of consolidation. However, some analysts forecast a slowdown. What are your expectations for mergers and acquisitions (M&A) in manufacturing in 2020?

Doug Schrock: You raise two different yet related points here – sector contraction and investment potential. A little background on manufacturing is helpful.

In 1960, roughly 16 million people worked in manufacturing, which represented about 24% of the workforce. Fast-forward 40 years to 2000, and manufacturing employment was still at around 16 million, though by then the fraction of the workforce had dropped to roughly 13% due to growth in other areas such as healthcare and service.[1]

Around this point, companies made a huge investment in the information infrastructure to deal with the Y2K problem. This also enabled much less friction in communication with foreign nations, which opened the door to alternative, global supply chains and a shift of manufacturing jobs out of the U.S. Employment in real numbers has dropped rapidly since then to about 12 million people today.[2]

Though the employment labor count has fallen, the thousands of U.S. manufacturing companies represent a slow-moving boat that is not sinking anytime soon. Manufacturing remains an important cornerstone of the economy.

So, consolidation isn't quite as big as one might think, but does it make sense to invest in M&D? To make money, a financial buyer naturally would be attracted to a sector that has more attractive growth – like healthcare, services, or technology. These sectors have a rising tide of industry growth, which an investor can buy into – though at the price of a higher purchase multiple.

An M&D company, on the other hand, might be growing at 2% and on the surface might not seem as attractive. However, through purchase at a lower multiple and with aggressive improvements in operations, platform creation, pricing, and product, we are seeing positive results in the M&D space from our clients.

FERF: For those manufacturers that have consolidated over the past several years, from your experience how successful have their due diligence and integration efforts been? What are the biggest barriers to post-deal success?

Doug Schrock: I do a lot of due diligence and a lot of integration. If you look at those two parts, where do companies fall down?

In due diligence, typically the financial and tax areas get the most thorough treatment because findings in those areas affect earnings before interest, taxes, depreciation, and amortization (EBITDA), which translates directly to the purchase price and the likelihood of close. Financial diligence can be roughly characterized as backward looking at historical numbers.

Forward-looking areas like operations and IT diligence account for baseline status but often project in a speculative manner as to what it's going to cost to deal with IT and what synergies will be obtained as operations and integrations move forward. I typically see that IT costs for integration are underestimated when compared to actual, and increased revenue potential of integration synergies is overestimated. When you later look at M&A results, you need to ask, "Were the surprising results bad diligence or bad execution?"

The time spent in diligence is limited and might result in limited information, so there certainly are issues with the ability of the providers to project precise numbers with confidence and accuracy. That said, a primary issue is the lack of post-close execution rigor in delivering on the expectations. In my experience, I find execution is most often where the problems occur – where potential goes unrealized.

FERF: Finally, what role do you see the finance function (CFOs, etc.) playing in the manufacturing industry this year? How will trade challenges and post-merger efforts affect their roles?

Doug Schrock: I see CFOs as the leaders in organizations at executing on the corporate strategy. They're so integral to almost everything, I feel their importance can't be overstated here.

One of the things CFOs do great is helping to shine a light on this new reality that we're dealing with. On the cost side they can communicate explicitly how the tariffs are affecting product costs and can put some pressure toward a drive for an alternative supply chain strategy. CFOs are vital to putting numbers on tariff impacts and forcing operations to make things happen.

On the sales side, CFOs also are extremely important. CFOs can create clear insight into the true margins across different product lines and customer segments with tariff impacts built into decision-making cost models. They can drive for a reevaluation of margins by Pareto stratification (e.g., C customers and C products get a 20% price increase, while A customers and A products stay flat). CFOs can be a real driver to having their organization simplify, focus, and improve profitability.

Learn more

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[1] U.S. Bureau of Labor Statistics, "All Employees, Manufacturing [MANEMP]," retrieved from FRED, Federal Reserve Bank of St. Louis, Dec. 24, 2019, https://fred.stlouisfed.org/series/MANEMP; Heather Long, "U.S. Has Lost 5 Million Manufacturing Jobs Since 2000," CNN Business, March 29, 2016, https://money.cnn.com/2016/03/29/news/economy/us-manufacturing-jobs/index.html

[2] U.S. Bureau of Labor Statistics, Dec. 24, 2019.

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AUDIT2005-008D