INDUSTRIAL MARKETS

Global manufacturing benchmark survey

How manufacturing corporations preserve and create value

KPMG INTERNATIONAL

AUDIT ▪ TAX ▪ ADVISORY

KPMG International commissioned HPI to undertake this research on our behalf.

Contents

Preface 02

Executive Summary 04

Introduction 06

Regulation and Compliance 12

Risk 18

New Markets 24

Operations and Efficiency 28

Conclusion 34

Preface

Companies often ask KPMG member firms to help them compare themselves with their peers. This global manufacturing benchmark survey is designed to meet that need. This survey compares value creation and preservation in 250 leading manufacturing companies with global operations and allows each participating company to generate an insightful comparison of their performance with that of peers in their own industry as well as across industries.

We think this survey achieves something new. Financial and operating performance benchmarking by the numbers is relatively straightforward. Equally, looking at wider issues of concern to strategists in a single company is also relatively simple. But benchmarking issues of concern to strategists is more challenging.

This is what this survey is designed to deliver. We assess the value-related issues that are taking most top management time in leading companies, and compare the results across businesses worldwide. The result is that companies can begin to match what they are thinking about with what others are thinking.

And the results are surprising. When we look at financial and environmental regulation, we found not only that the cost implications of the growing burden of compliance varies wildly business by business, but that companies have very different concepts of how to manage and ameliorate that cost. When we surveyed the risk issues, we found that companies are much less concerned with external risk factors than might be expected in a period of economic slowdown and financial volatility, and much more concerned with the quality of their processes and relationships. In the area of new markets, there is perhaps more caution than expected, but also more optimism for the long term.

And, finally, when it comes to the key value issue of operational efficiency, there are surprises for anyone who thinks that high-level benefits from big IT investments are easy to obtain (respondents say they are not), or that tax efficiency is now the big company norm (our results suggest that is far from the case).

The companies in this survey were drawn from several closely related sectors: industrial manufacturing; component makers and original equipment manufacturers; and metals companies. We would like to thank the senior managers – most of them CFOs or CEOs – who gave up their valuable time to take part in the research and offer their thought-provoking responses.

Bill Kimble
Global Chairman, Industrial Markets

Uwe Achterholt
Global Chairman, Automotive

Executive summary

KPMG's 2007 global manufacturing benchmark survey suggests that the globalization of manufacturing continues, and as a result manufacturers, wherever they are located, share many fundamental concerns. Differences emerge mainly in differing attitudes to overall growth prospects (with companies in mature economies more concerned with the potential impact of economic slowdown) and to the risks of rapid expansion (with companies in emerging economies more concerned over the need to grow rapidly to meet customer demands). Companies in 'low-cost' economies are also somewhat more concerned with cutting operational costs than are businesses in mature economies.

Regulation and compliance

Overall the companies surveyed are more concerned with the management burden of compliance than they are with its cost. This burden is increased by the rate of change in regulation, say companies:

- High-performing companies* are the most likely to make investments internally and externally to meet financial and environmental compliance demands: they are more likely to add staff, and also more likely to outsource some functions.
- High performers are more likely to report a higher cost impact of compliance, suggesting a more intensive compliance effort among high performers.
- Companies making cross-border acquisitions are more likely than others to be concerned with financial compliance costs.

Risk

For manufacturing companies the perception of risk remains firmly focused on relations with customers and suppliers. Particular risk issues commonly cited in interviews reflect the increasing integration of global manufacturing supply chains, which brings with it supplier-customer relationships that are ever more critical. Companies with global manufacturing processes remain highly concerned about currency risk.

- High performers tend to be more confident about internally manageable risk areas (for example, no high performers considered intellectual property risk as the leading risk area) and less confident about external risk areas.
- High performers were more likely to be concerned by financial risk, IT and tax risk, and most markedly by macro-economic risk; they are less likely to be concerned by labor risk.

* High-performing companies are defined as companies surveyed with operating margins greater than 15 percent and predicted growth of greater than 15 percent.

Where IT risk was cited as a leading risk issue, high performers without exception considered that IT security was paramount, while average performers cited a wide range of internal IT management issues as key. High performers that cited tax risk as a leading issue were mainly concerned with the complexity of tax regulations.

New markets

Two issues dominate corporate concerns regarding sourcing from or manufacturing in low cost economies: cost and quality. While companies with manufacturing operations in intermediate cost locations report very positive results on both cost and quality, manufacturing in low cost east Asia and especially China is seen as more problematic, although several companies argue that quality failings are more often a management failure than a location failure:

- Few companies cite the entering of new markets as a business growth strategy: companies are much more likely to focus on gaining new customers in existing markets and on selling more to existing customers.

- Wholly owned investment approaches in new markets are favored by the majority of companies surveyed; most stress that they prefer not to form manufacturing joint ventures in new markets.

Operations and efficiency

Many companies report difficulties in profiting fully from IT investment, saying that while process automation has yielded great benefits, management reporting benefits are more difficult to win. Companies were sharply divided between those that felt that potential tax-planning benefits were great and those who felt they were minimal:

- Responses suggested that high-performing companies have been more cautious than most when it comes to extending critical operations into low-cost economies; some interview comments suggest this may be because they have proprietary technology they wish to protect by keeping it close to home, and because they have high levels of automation which cannot easily be reproduced in low-cost environments.

- High-performing companies were more likely than others to achieve their optimal effective tax rate, and if they were not achieving it they were more likely to have plans in place to do so.

Introduction

Today, companies are focused on the increase of value – both present-day valuation in corporate asset markets and value in terms of ability to deliver sustainable profits in the markets and businesses of the future.

Corporate value is a large and elastic concept, embracing most if not all of what a business does and how it does it. This survey concentrates on value in four specific areas.

The first area where value is at stake is **regulation and compliance**. As global companies recognize, the burden of compliance has risen sharply in recent years, and continues to be an element of doing business globally. In particular there are two areas where there have been systematic and costly recent alterations to the regulatory framework for business. One is the introduction in the United States of the Sarbanes-Oxley Act (SOX) that regulates the reporting and broad corporate governance functions of U.S. corporations as well as non-U.S. businesses that list in the U.S. The second alteration has been the introduction of International Financial Reporting Standards (IFRS) in Europe and in many other countries, and the continuing effort to harmonize IFRS with U.S. Generally Accepted Accounting Principles (GAAP). These regulatory innovations have imposed a cost on companies, but like all regulatory innovations they also offer opportunities: opportunities for best practice in communicating with shareholders and their representatives, about how a business can secure existing value and build future value, as well as opportunities for superior control of the management costs of compliance. And there are more regulatory challenges to add to SOX and IFRS: in particular the ever-growing list of compliance requirements in carbon and other environmentally sensitive emissions, in labor rights and in product liability.

Secondly, we look at the **management of risk:** not just financial risk but also the risks that need to be quantified and managed if companies are to secure the value derived from current operations and make informed decisions concerning the risks of investments for the future. Some areas of risk concern have always been at the heart of business decision-making – areas like macroeconomic risk, labor risk and financial, taxation and currency risks. Others have been moving up the risk agenda for some time: these include the increasing profile of IT risk as ever more critical functions move to digital and online management systems, and supply chain risk as operations grow increasingly global and in many cases much more complex. There are also some risks that many companies have only recently begun to quantify and manage, such as intellectual property risk in the context of global business operations.

The survey also considers the value implications of entering **new markets**, a critical area of concern to all companies in the survey group. Companies are well aware that new markets offer business opportunities that may be irresistible, especially where emerging markets are showing exponential growth. But they are also aware that high potential return always carries high actual risk: many companies now depend on expansion in new markets for much of their expected growth in value, but the harsh reality is that some businesses have already found that present value can be destroyed by new market ventures, while future value remains no more than a prospect. How can companies limit the risk of value destruction while improving the prospects of value creation? The survey looks at these issues in terms of corporate approaches to the challenges of managing business in new market environments, whether through wholly owned, joint venture or third party approaches.

Finally the survey rates the value implications of current business **performance and efficiency**. This part of the survey concentrates on cost management in sourcing and labor cost, as well as IT and tax effectiveness. The survey rates companies on the significance and effectiveness of low-cost sourcing and also on businesses' understanding of the challenges of cost-effective sourcing in terms of a wide range of risk factors. The value of IT investment is rated in terms of its ability both to minimize and automate transactional operations and free management time.

A note on methodology

There is no generally accepted method of comparing businesses in terms of owners' value. Although very many companies now position themselves as 'value-focused' businesses, there is no agreement as to how 'value' should be defined or even as to who owns the value that is at stake.

The lack of an accepted measure of corporate value means that comparative measurement of companies is problematic. Hardly two companies agree on precisely what constitutes corporate value. Many agree that shareholder value is a key value, but they may measure this in terms of total return to shareholders, or on a measure based on market capitalization, or perhaps on return on investment, or enterprise value. Also, some companies do not focus exclusively on owners' value but consider corporate value to embrace value to employees, to suppliers, and to wider society.

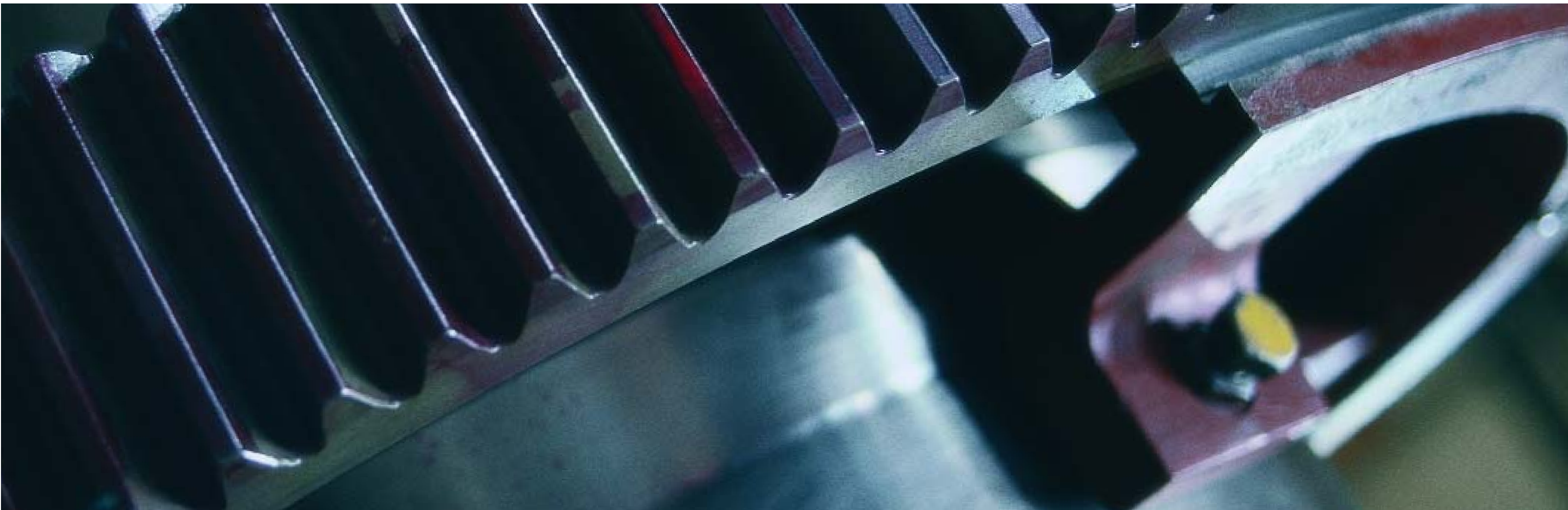
Clearly, measuring corporate value on a like-for-like basis that will be acceptable to a large corporate survey is not viable, since a precisely defined value measure is liable to exclude many companies. For that reason, in this survey we have chosen not to define corporate value itself but rather to measure a number of underlying performance and operational indicators which together form a database from which companies can draw conclusions about value creation and preservation.

How do manufacturing businesses view the balance of risk and opportunity in value creation in 2007?

KPMG's global manufacturing benchmark survey suggests that wherever companies are located, and whatever their background and cultural setting, the similarities between companies are very much greater than the differences. Whether a company has its roots in Beijing or Boise, Mumbai or Manchester, manufacturers across the world share many concerns. In itself this is not surprising: for most companies surveyed here manufacturing is now a global process. Many of the same pressures that concern a U.S. or European business also concern managers in emerging economies.

But there are differences. These differences emerge in attitudes to overall growth prospects: unsurprisingly companies in the U.S., where the economy is clearly slowing in late 2007, are much more alert to the macro-economic threat than companies based in emerging economies, where growth shows absolutely no sign of impairment. As a result even companies in mature economies that expect to benefit from emerging economy growth tend to sound a cautious note about current prospects. "We are in a period where both risk and opportunity are increasing," says a large European industrial machinery manufacturer. "There is more growth at the global level than in the past, but if that growth is not managed well, it becomes a risk."

The imperative to build corporate value through very fast growth is also recognized as a risk by some emerging economy companies. Many companies in Asia say that while they know that they have to grow considerably in order to gain the critical mass that their customers demand, the acquisition path that this growth demands is fraught with risk. "When it comes to acquisitions we worry about everything and particularly size, systems, and culture," says one leading Indian auto parts manufacturer. "It is very important for us to avoid going into mindless acquisitions. But if we don't acquire the risk is that we may end up too small. There is always the risk that customers want more growth from us than we can manage."



Perhaps surprisingly, there is also some evidence that companies in low-cost economies are somewhat more concerned with cutting operational costs than are businesses in mature economies. In interviews companies themselves suggest that this may be the legacy of long operation in protected domestic economies where cost control is a secondary concern. Typically, an Asian auto supplier comments that "cost cutting is the most important part of our value strategy. We don't want to pursue revenue growth at the expense of our cost-cutting focus." Companies in mature economies by contrast tend to be more concerned with extracting value from innovation: a U.S.-based auto supplier, says "the danger is when you are cutting costs you lose sight of product innovation. You have to focus on your proprietary technology."

In both survey and interview responses very few companies cited risks connected with the direction of business policymaking. The one exception to this was the concern of some U.S. companies that the coming U.S. presidential election may result in a more isolationist trade policy. Typical is U.S. construction equipment maker Caterpillar. CFO Dave Burritt says "the biggest risk on the policy side is the risk of the U.S. moving to a more isolationist position. Our fear is that if unemployment were to rise sharply in the U.S. it would encourage a retreat from free trade and then the whole of the U.S. economy will suffer."

Part 1
Regulation and compliance

The burden of compliance with a growing body of regulatory demands is a concern for companies in our survey, both in terms of cost and management time. Of the two, companies are more concerned with the management burden than they are with cost: typical is a leading auto parts manufacturer which says "for us, compliance is more an issue of management discipline than it is a cost issue."

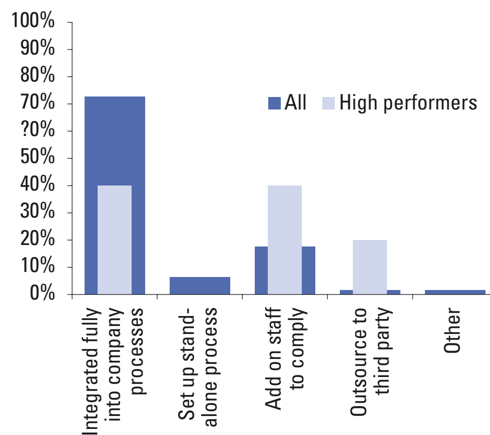
While all companies interviewed said that they were concerned with the cost of financial compliance regulations, many said they were most concerned with the rate of change in regulations. "IFRS is costing us a lot," says a European auto supplier. "It would not be an issue if you didn't have any changes to the regime – the problem is that there are continual changes." In the case of environmental compliance, there was a sharp distinction between companies selling directly to final users and supplier companies. Manufacturers of final products were more concerned with the burden of environmental regulation; suppliers tended to see it as an issue that impacted on operations both upstream and downstream of their own manufacturing.

"This is something that is essentially driven by customers," says Korea's leading auto supplier Mando. "For suppliers like us environment is not a big overriding issue, it is more of a tactical issue that just has to be dealt with as it arises." European auto supplier Rieter Automotive agrees: "even with 20 manufacturing plants across the world the environmental issue does not affect our own manufacturing operations, but it does affect customers. We have to support customers who need to reduce emissions."

Companies were asked whether they needed to comply with Sarbanes-Oxley financial operations and if so how they handled that compliance.

Survey results suggest that effective Sarbanes-Oxley compliance requires new compliance capacity. Most companies in the survey (over 70 percent) handle Sarbanes-Oxley compliance as part of their wider in-house compliance functions. High-performing companies are more likely than the overall sample to build new functions to handle compliance: they are more likely to add staff to existing compliance functions and also more likely to outsource compliance functions (barely 2 percent of the sample does this, compared with 20 percent of high performers).

How does your company handle compliance with Sarbanes-Oxley?

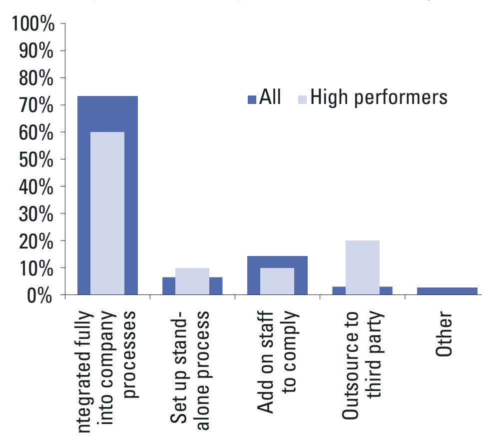


Source: KPMG International 2007

Companies were asked how they handle overall compliance with financial regulations and corporate governance.

When it came to overall compliance with financial regulations and corporate governance requirements, the approach of high-performing companies were not markedly dissimilar from the approaches of the overall sample, with the exception that again high performers were much more likely than average performers to outsource compliance functions.

How companies handle compliance with financial regulations and corporate governance



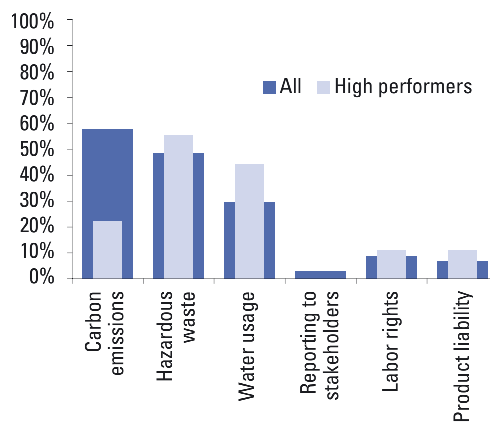
Source: KPMG International 2007

Companies were asked which are the most significant environmental regulation issues that they currently facing or are likely to face in the next few years.

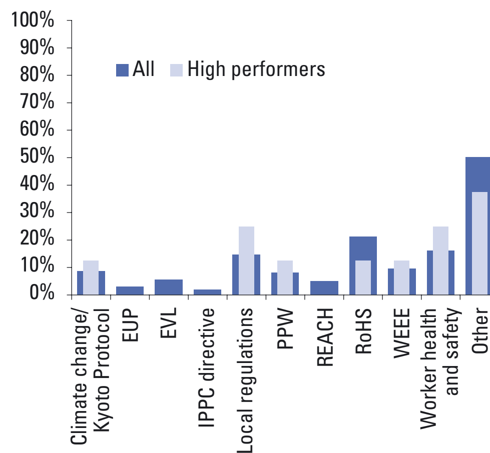
The survey supports the view that costs related to carbon emissions currently have less impact on business performance than might be supposed: while over 60 percent of the total sample cite carbon emissions as a leading issue, that falls to just over 20 percent for high-performing companies. High performers are markedly more likely to be concerned with water usage issues, and marginally more likely to be concerned with labor issues such as workplace health and safety and also with product liability, than are average performers.

In the interviews several companies expressed the view that long-term planning for environmental demands was challenging, saying that public opinion and public policy on environmental matters was liable to develop much faster than manufacturing responses, and this could leave companies with expensive initiatives to meet issues that had disappeared from view. "Issues can be here today and gone tomorrow – what you need to be able to do is judge the longevity of an issue," says a European machinery manufacturer. "The way we see it is that all our businesses use energy, and energy-related issues are the ones most likely to remain issues."

Most significant environment regulations



Source: KPMG International 2007

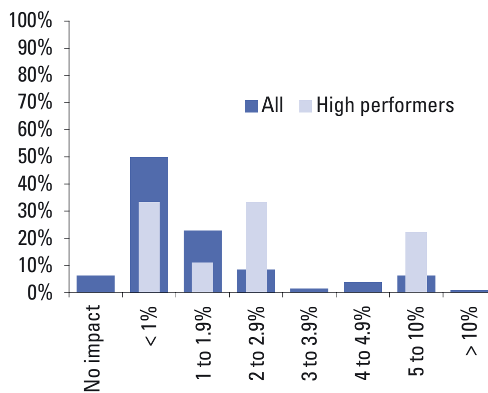


Source: KPMG International 2007

Companies were asked to estimate the cost impact of environmental compliance as a percentage of total sales and the cost impact of financial/corporate governance compliance as a percentage of total sales.

The survey results for cost of compliance for both environmental and financial and corporate governance issues were significant. Results for the entire survey show that a majority of companies believe that the cost impact is less than 1 percent of sales, and that very few are willing to concede a total in excess of 2 percent of sales. For high-performing companies the result is quite different: there was much more variation in responses from high performers which put the cost of compliance at anywhere between 1 percent and 10 percent of sales. Overall, high performers are more likely to report a higher cost impact of compliance, suggesting a more intensive compliance effort among high performers.

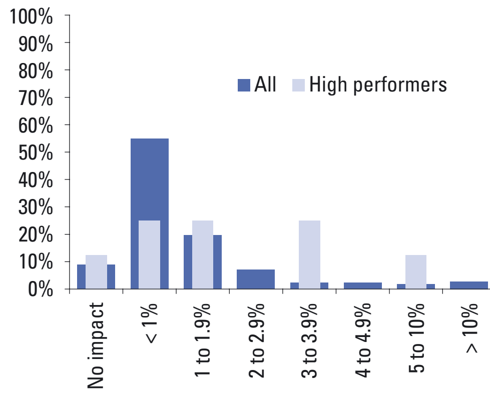
Cost of environmental compliance as a percentage of total sales



Source: KPMG International 2007

In interviews most companies cited financial compliance as their biggest cost concern, although some companies commented that this might be in part due to the difficulty of quantifying the burden of environmental compliance. Also, companies with U.S. listings were markedly more concerned about the competitive impact of costs related to Sarbanes-Oxley compliance. Companies operating under less onerous regimes were more sanguine: A Korean automotive supplier comments “for us the big financial regulation costs were the cost of software, the cost of consultants and the cost of a manager to run the process. It is not a big ongoing cost.”

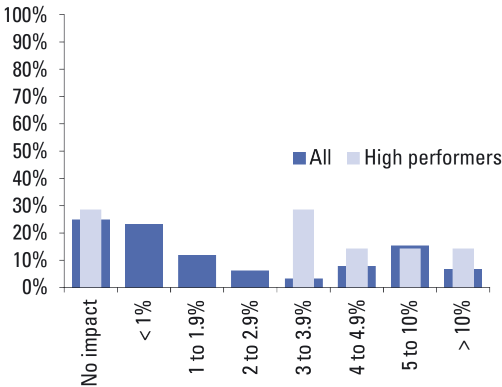
Cost of financial and corporate governance compliance as a percentage of total sales



Source: KPMG International 2007

Companies with growing global operations identified particular concerns with financial compliance costs. "There are so many differences between IFRS and local GAAP that we see compliance as a very significant ongoing cost," says Friedhelm Schwarten, CFO of global automotive supplier IAC. "It is difficult to cap that cost especially if like us you are making acquisitions – we made two acquisitions in the last year and in each case there are big costs in bringing the new businesses into our IFRS accounting."

Cost savings derived from tax planning as a percentage of total sales



Source: KPMG International 2007

Part 2
Risk

For manufacturing companies the perception of risk remains firmly focused on relations with customers and suppliers. Very few companies say they are concerned about macro-economic risk. Despite the slowing of the U.S. economy and the increased volatility of financial markets in 2007, most manufacturers appear to be taking a long view through the economic cycle. A global automotive supplier is typical: 'we are vulnerable because of over-dependence on one customer, and that is our main risk. True, people might stop buying cars, but there is really very little we can do about that.'

Particular risk issues commonly cited in interviews reflect the increasing integration of global manufacturing supply chains, which brings with it supplier-customer relationships that are ever more critical. When asked about leading risk issues in interviews, companies commonly cite customer diversification ("our main business strategy," says an East Asian auto supplier), achieving critical mass ("to meet our customers' global needs we need to be at least double our present size," says an India-based industrial machinery manufacturer), and risks related to the supply chain ("this is a huge risk for us, maintaining the right people and the right processes right across the world, because if you don't achieve perfect timing it gets very, very costly," says a European auto parts group).

> Companies were asked which areas of risk they consider greatest, and which areas are second and third in importance.

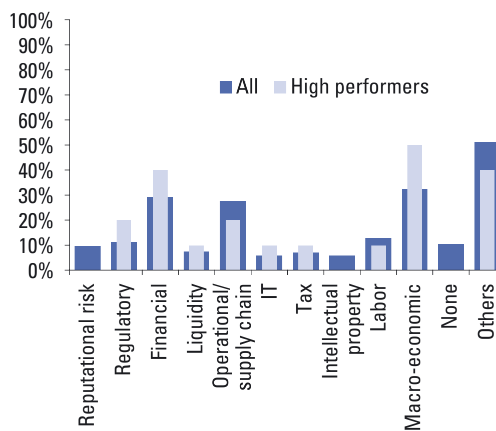
Responses produced few variations when viewed either by industry category or by business performance, with one significant exception: where companies rated an externally driven risk area as significant, high-performing companies rated that risk with greater significance. High performers were more likely to be concerned by financial risk, IT and tax risk, and most markedly by macro-economic risk. The only risk area that high performers were less concerned by was labor risk. The responses suggest that high performers tend to be more confident about internally manageable risk areas (for example, no high performers considered intellectual property risk as a leading risk area) and less confident about external risk areas.

Companies were asked to identify the key elements of the risk areas they had selected.

When companies answered questions about the key elements of the risk areas they believe to be most important to their businesses, some striking differences emerged between average- and high-performing companies. Where companies specified **regulatory risk** as a leading issue, the high performers considered fundamental issues as most important: they cited the lack of standard operating procedures, functional barriers within the organization and the difficulty of using information as key elements. Average performers were more likely to consider communication and corporate resources as key.

Where **financial or liquidity risk** were cited as leading risk areas, high performers were concerned with efficiency and financial assessment of partners, while average performers were more likely to be concerned with financing costs. In the interviews, companies with extensive export businesses were particularly concerned with currency risk.

Most important areas of risk*



Source: KPMG International 2007

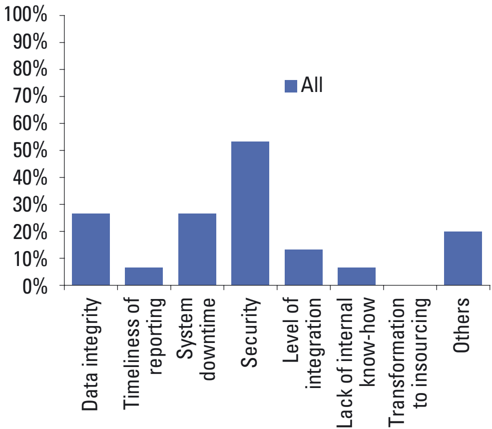
"The problem is not volatility, the problem is when currencies just move in one direction over time as is happening with the U.S. dollar," says one European industrial machinery manufacturer. In particular Indian manufacturers, long used to operating behind high tariff walls, are particularly concerned about dealing with multiple currencies: "managing currencies is top of the risk list," says one Indian auto supplier. "For a long time we were used to operating in only one currency, but now we are operating in euros, yen, rupees, everything. All this is entirely new for us."

* Respondents could select more than one area of risk.

Where IT risk was cited as a leading risk issue, the high performers that selected it considered that IT security was paramount, while average performers cited a wide range of internal IT management issues as key.

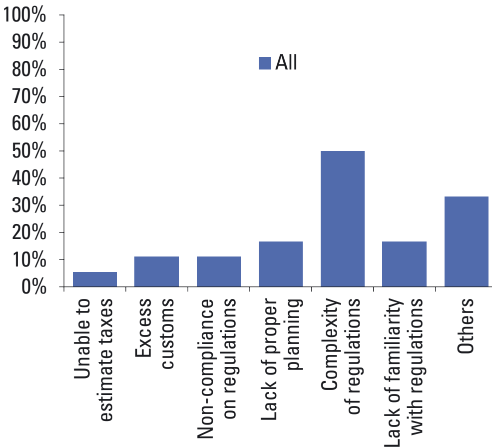
Of the high performers that cited **tax risk** as a leading issue, the focus was on a single issue, in this case the complexity of tax regulations (reflecting perhaps the tendency of high performers to have significant operations in high-growth markets where taxation is complex). Average performers by contrast cited a wide range of tax risk elements.

Most important aspects of IT risk*[1]



Source: KPMG International 2007

Most important aspects of tax risk*[2]



Source: KPMG International 2007

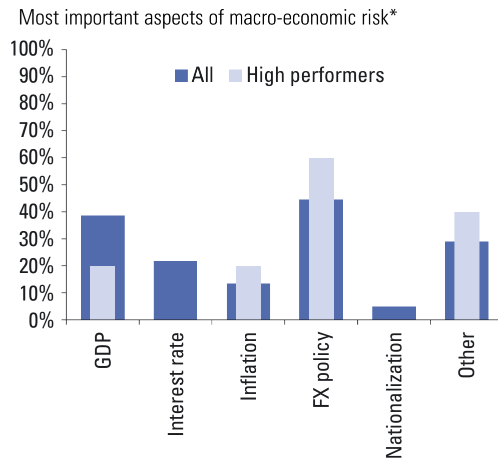
* Not all respondents answered this question.

[1] High performers who answered this question chose Security.

[2] High performers who answered this question chose Complexity of regulations.

The greatest differential between the views of high performers compared to average-performance companies was in the rating of macro-economic risk, which is cited by 50 percent of high performers as a leading risk issue. Those high performers that cited this risk factor were most likely to consider that inflation and foreign exchange policy were the key elements of **macro-economic risk:** significantly no high-performing company cited the threat of nationalization as an element of risk, although some average-performing companies did so.

Most important aspects of macro-economic risk*



Source: KPMG International 2007

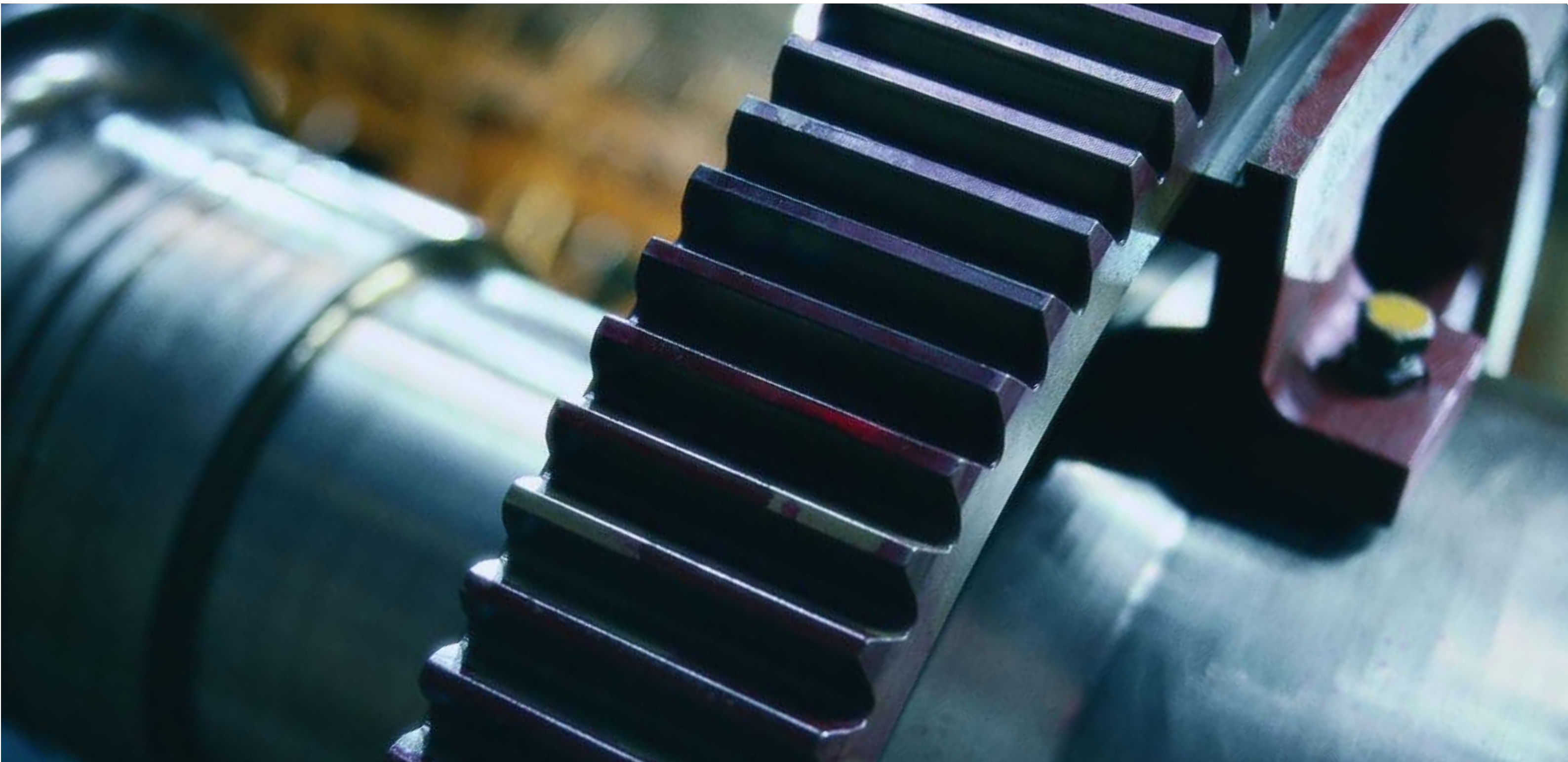
* Not all respondents answered this question.

Part 3
New markets

Two issues dominate corporate concerns regarding sourcing from or manufacturing in low-cost economies: cost and quality. Some companies also voice concerns about the challenges of managing through joint venture approaches, but these are in the minority as most companies report that low-cost manufacturing they consider critical is always accomplished through wholly owned subsidiaries. In interviews companies repeatedly stressed that the quality of management of sourcing and manufacturing in low-cost locations is critical. "Low-cost country manufacturing has to be hands on," says a U.S. auto components manufacturer. "The difficult part of it is not running the manufacturing, it is establishing and maintaining the relationship. You have to be there, you have to know people by name, it is the only way to make it work."

Companies with manufacturing operations in intermediate-cost locations such as economies on the European periphery frequently report very positive results on both cost and quality. For example, auto component manufacturer Rieter Automotive, which has manufacturing plants in Portugal and the Czech Republic, says "costs are rising but you have to factor in productivity improvements in low-cost countries which outweigh direct cost increases. Plus you have more labor flexibility and often a superior work ethic." A European industrial machinery maker, adds: "we have more quality issues in high-cost countries than in low-cost. We make all our critical components in places such as the Czech Republic and Portugal where we have low cost and the highest quality."

Manufacturing in low-cost east Asia – especially China – is more problematic, although several companies argue that quality failings are usually the fault of the manufacturer rather than the location. Says one European industrial products manufacturer: "achieving quality from low-cost markets is entirely dependent on how long you have had to manage the issue."



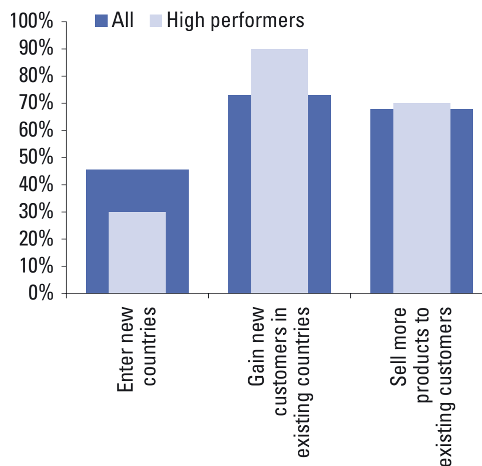
Nevertheless, companies are concerned about both quality and the rising cost of what only recently were ultra-low-cost manufacturing locations. "Manufacturing in China used to be like living in a duty-free zone," says one Asian industrial products manufacturer, who adds "that is eroding rapidly – both in terms of currency and in terms of the scaling back of the duty incentives. The party is over there. Wage levels have already overshot Indian wage levels."

Nevertheless many companies say that the long-term value potential of their Chinese investments outweighs current cost and quality concerns. "You may not be able to get the results you want today in China," says Dave Burritt, CFO of construction machinery manufacturer Caterpillar. "But the point of being there is this: whoever wins in China in the next five years will win in the next 100 years."

Companies were asked what their business growth strategies were for the next five years.

The survey suggests that among a wide range of companies attention may now be shifting somewhat away from primary investments in new markets and towards improving the return of existing investments. All companies were less likely to cite the entering of new markets as business growth strategies, and more likely to cite gaining new customers in existing markets and selling more to existing customers. That pattern was even more apparent in the case of high performers, who exhibit a clear preference for gaining new customers in existing markets, followed by selling more to existing customers.

Main business growth strategies over the next 5 years*

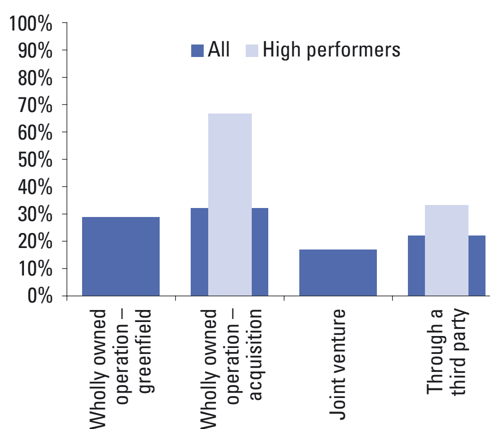


Source: KPMG International 2007

Companies that did plan to enter new markets were asked how they planned to accomplish that strategy.

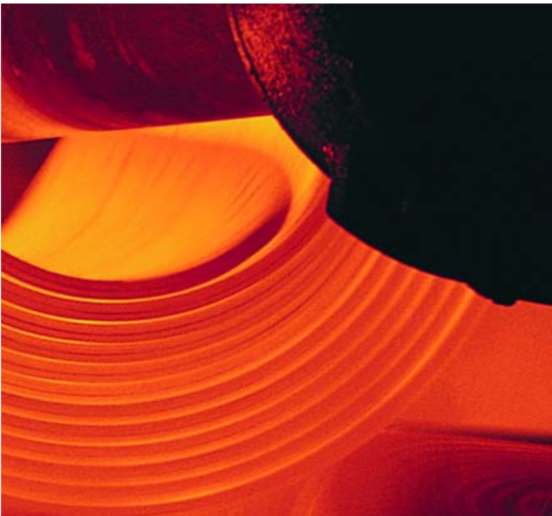
The survey showed that joint ventures in new markets are not in favor. While the survey group as a whole preferred wholly owned approaches to joint venture and third party approaches to new markets, there was a clear preference among high-performing companies to acquire existing operations as wholly owned subsidiaries or to approach new

Preferred strategies for entering new markets*



Source: KPMG International 2007

* Respondents could select more than one answer.



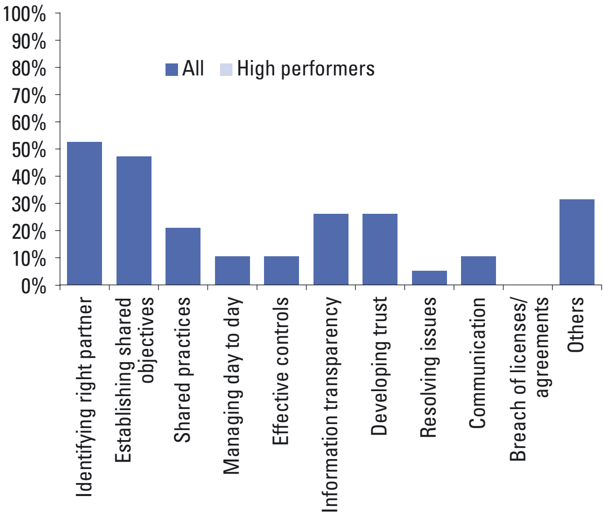
markets through third parties. No high-performing companies favored joint venture approaches.

"For us managing a JV would be very difficult on the quality front," says Robert Meese, CFO of Korean auto components maker Mando. "If you have a JV that you do not control it is not really your product, so our general approach is to avoid JVs, although if it is a small market a JV may work for the time being." Friedhelm Schwarten of IAC agrees, saying "my personal view of JVs is that I dislike them. The agreement process takes far too long. You have to make too many compromises. And often enough the outcome of the JV is not what you expected or need, and not just in terms of product quality – with JVs there are likely to be problems with the quality of the whole process. 100 percent ownership is better in itself, but that does take more time and more cash."

Those companies that did favor joint venture approaches to new markets were asked to cite the top three challenges in participating in, and successfully operating, joint ventures.

Companies that favored joint ventures were far more concerned with the nature of their JV partner than with operational issues. Identifying the right JV partner was cited as the leading challenge, followed closely by establishing shared objectives. It is significant that there are no high performers among this group of companies.

Major challenges in executing a joint venture approach



Source: KPMG International 2007

Part 4
Operations and efficiency

How can companies build value by reducing the cost of existing operations? KPMG's global manufacturing benchmark survey asked companies what cost-cutting opportunities they found in areas like low-cost sourcing, IT implementation and tax planning.

The prospects for easy cost reduction through low-cost sourcing were viewed skeptically and cautiously by many companies. An Asian industrial supplier was typical: "some people think you can just move operations to China and make the same stuff cheaper, but unfortunately that is not how it works. It actually takes a huge commitment to develop a capacity in a location like that. But this is something that creates a lot of tension in a lot of companies. The president of the company will say 'you have to buy more from China and cut costs', while the purchasing guy says 'I'd love to – but how can I find the quality?'"

The value of IT-driven cost reduction was also questioned by many companies in the survey. One factor that limits value is resistance to the imposition of common IT standards across a decentralized group, says German auto supplier IAC. "Our IT cost is relatively low but in my opinion its effectiveness is poor," says CFO Friedhelm Schwarten; "The problem is always that the system should support entrepreneurship, but entrepreneurs want to be independent and there is resistance in the different plants and locations to the imposition of one common system." A large proportion of companies in our survey consider that their implementation of process automation has yielded great benefits, but that management reporting benefits are more difficult to win. For example, a European industrial machinery manufacturer concedes that high-level benefits from new IT implementations can take a long time to emerge, saying that three years after implementing SAP, "the benefit is still ahead of us. I think that if we were to do anything differently we should have stopped after the first round of implementation and optimized what we had, rather than just pressing on." Many companies add that well-planned

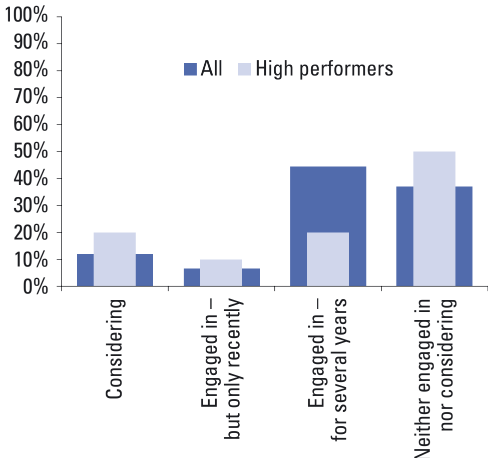
implementation of IT platforms that affect the whole business is important. One auto component company that recently implemented SAP said "for us the lesson was, plan, plan and plan. Don't worry too much about execution, everything will follow if you plan well."

On the value of tax planning, companies were sharply divided between those that felt that tax-planning benefits were enormous and those that dismissed the exercise outright. This difference may well be due to the nature of some supplier businesses: as one European auto supplier says, "we are constrained, like many suppliers. We have given customers, and we have to locate where those customers are whatever the tax implications are of that."

Companies were asked whether they were engaging in, or considering, low-cost country sourcing for raw materials, components or production.

High-performing companies from our survey were overall somewhat less likely to have engaged in long-term low-cost country sourcing for raw materials, components or production, although they were more likely to be considering low-cost sources and more likely to have made recent commitments to sourcing raw materials and production from low-cost sources. The results suggest that some high-performing companies have been more cautious than most when it comes to extending critical operations into low-cost economies. KPMG remains cautious over the interpretation of this result which may be skewed due to the particular business characteristics of the high performer group of companies. Corporate responses in interviews suggest that this may be because some high performers have proprietary technology they wish to protect by keeping it close to home, and because they have high levels of automation which cannot easily be reproduced in low-cost environments.

Low-cost country sourcing of raw materials, production or components

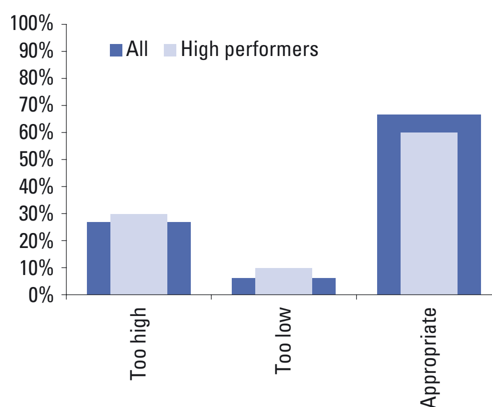


Source: KPMG International 2007

> Companies were asked whether inventory levels were too high, too low or where they should have been over the last year.

While almost 70 percent of companies in the overall survey believed their inventory levels were appropriate, high performers were marginally less likely to be satisfied with inventory levels, with a larger number of high performers than average performers citing both excessively high and excessively low inventory levels. One European auto component manufacturer believes that inventory levels are always too high, adding "it is something that you have to work on constantly. The distributed supply chain is making it more challenging to manage inventory than it was in the past. Customers ask for the security of extra inventory. And the more content you have in cars, the more difficult it gets." An Asian auto manufacturer argues that whether too high or too low, inventory is not as fully manageable as manufacturers would like. He says, "What if your customer goes on strike? Suddenly you have too much inventory. What if you go on strike? Suddenly you are too low."

Inventory levels in the current financial year

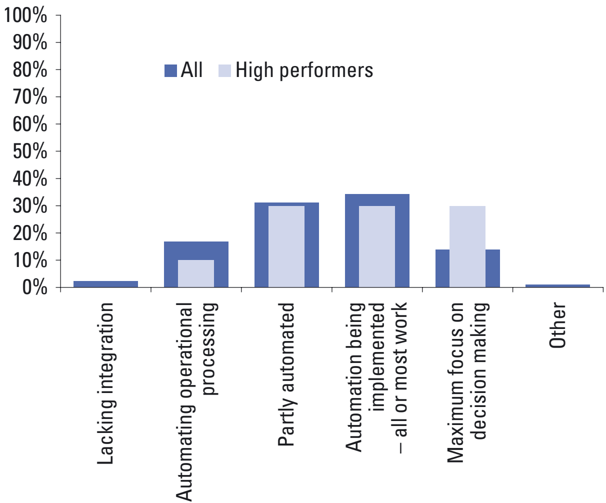


Source: KPMG International 2007

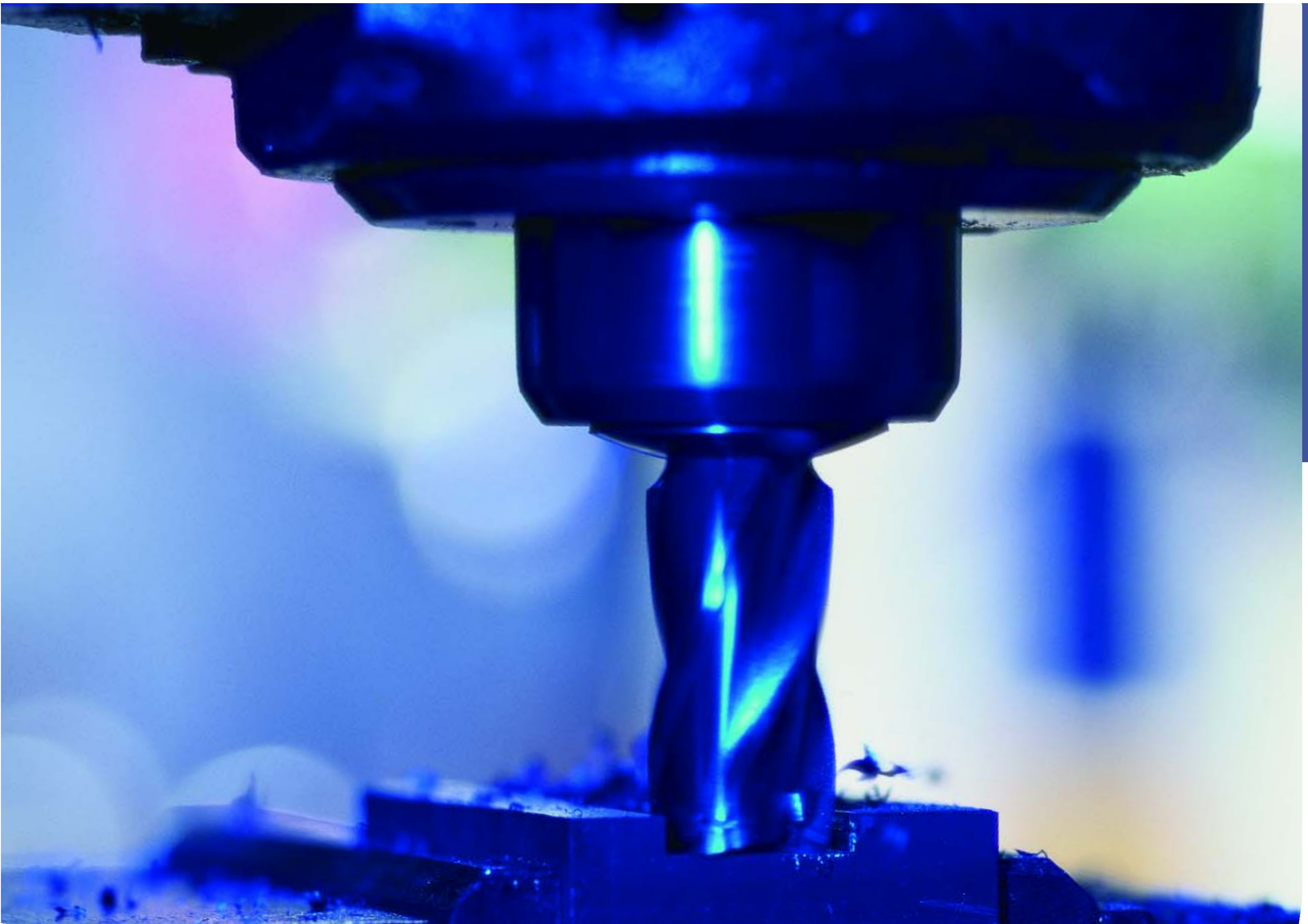
Companies were asked to rate the effectiveness of their IT in terms of operational needs and management reporting activities.

KPMG's global manufacturing benchmark survey suggests that high-performing companies are more focused on the effectiveness of IT investments than average-performing companies. As noted earlier, high performers were more likely than average performers to cite IT risk as a leading risk concern for their businesses; asked about the effectiveness of their IT functions, somewhat fewer high performers than average performers expressed partial reservations about their IT effectiveness, and 30 percent of high performers were confident that they had maximum return from IT compared to 15 percent of average performers. No high performers rated their IT as lacking integration to the detriment of management decision making. The inescapable conclusion is that IT excellence is a key supporter of outperformance.

Effectiveness of IT – operational needs and management reporting activities



Source: KPMG International 2007



Companies were asked whether they were achieving their optimal effective tax rate (ETR) and if not whether they had plans in place to achieve their optimal ETR.

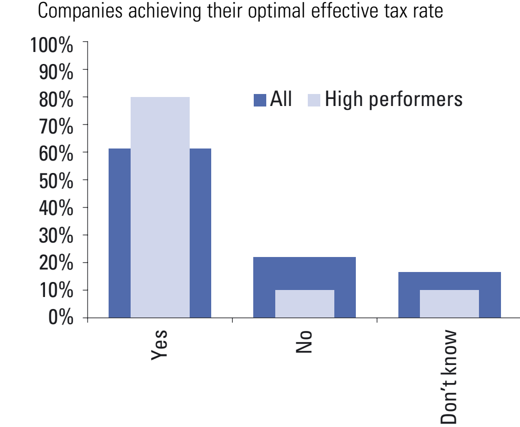
Our survey suggests that high-performing companies are more focused on tax effectiveness than companies with average performance. For example, when asked about the challenges of sourcing raw materials, components, or production from low-cost locations, high-performing companies were much more likely than other companies to cite the challenge of using tax incentives and other tax-related benefits (one other area where a clear differential between high performers and others emerged was in the rating of supply chain management, an area which high performers were less likely than others to consider problematic). Also, more high-performing companies than average performers believed they were achieving their optimal effective tax rate (ETR) and of those companies that believed they were not achieving their optimal ETR, all high-performing

companies had plans in place to achieve this. The inescapable conclusion is that strategic tax planning is a key element in outperformance.

However, companies are divided on the benefits of tax planning. An Asian auto supplier says "frankly we believe you can't do much through tax planning. There are hardly any tax incentives left. And if I need to spend money on a new investment I will do it – those kinds of decisions are never driven
by tax." Yet a U.S. automotive manufacturer believes "the benefit of tax planning is enormous: over the last ten years we have achieved a reduction in our total tax rate of about ten percentage points."

These differences may be partly accounted for by the different constraints businesses operate under, according to whether they are tied to customer locations. But Robert Meese, CFO of a Korean auto parts supplier, believes that companies should take a larger view of the potential of tax planning. "Before I came to this company nobody had heard of tax planning," he says, adding, 'Now we are looking at tax planning in terms of structuring legal entities, reorganizing our inter-company transactions, dealing with our intellectual property. All of these give opportunities to generate tax savings and increase our net income. Cash is also important: you have to make sure you don't end up with cash that is trapped in a certain location for tax reasons. It is not so much a matter of relocating operations

Companies achieving their optimal effective tax rate



Source: KPMG International 2007

Part 5
Conclusion

In all four of the areas on which this survey concentrates companies voice specific concerns about the challenges of preserving and creating value.

In the area of **regulation**, the cost of compliance with new financial and environmental rules is a leading concern. "Even in Korea where the rules are less onerous than Sarbanes-Oxley it generates a significant cost," says Robert Meese, CFO of Korean auto components supplier Mando. But he adds "it can be much worse than that – I helped implement Sarbanes-Oxley in a U.S. company and the administrative and cost burden there was absolutely mind-boggling." Yet companies also point out that regulation offers opportunities as well as costs. Says Hartmut Reuter, CEO of Rieter Holding, a global industrial machinery manufacturer, "for us there is a value creation opportunity in environmental issues and regulation, but only if you can achieve change within a realistic timeframe. Otherwise it becomes a value destruction issue." The challenges of meeting compliance rules can also be turned to advantage, says Robert Meese of Mando: "we realize we are not yet very sophisticated about monitoring compliance from a risk point of view. As a result of that I'm starting a review that looks at the risks and opportunities on the tax side, and then I'm going to go on to use that review to manage tax compliance on a global basis".

It is in the area of **risk** that companies show the most marked differences in approach according to their geographical location. While companies everywhere cite supplier and customer risks as very significant concerns, it is striking that labor risk now plays a diminishing part in the thinking of companies located in the OECD industrial economies, largely because their competitive position is founded on a high level of automation. A U.S.-based auto component company says "we manufacture around two million brake drums a year, all on two highly automated production lines. Each one of those lines is run by six people, so labor cost is a very small part of our equation." Manufacturers located

in low-cost countries are much more likely to cite labor cost as their leading risk concern: an Asian component manufacturer says "our labor costs are rising and that means that a huge advantage is becoming a smaller advantage. Even for a company that has a large labor pool to draw upon, it is still an emerging problem." Such companies concede that the pace of automation and productivity increase will prove critical, although many believe that the falling cost of automation and the widespread introduction of business process management approaches gives them the opportunity to meet this competitive risk. A leading Indian auto supplier says "overall our labor costs are not increasing. The cost per person is increasing, but so is productivity, so overall there is no cost increase."

Manufacturers' attitudes to using low-cost **new markets** for sourcing or for manufacturing were surprising in that the KPMG survey revealed that high-performing companies were more cautious than others about the benefits new markets offer. It appears that businesses located both in emerging markets and mature industrial economies take the view that 'low cost' is not always what it seems. One large Asian manufacturer of auto

and industrial components says "low-cost country sourcing is certainly important but you have to look at the total cost – there is no doubt the benefit is decreasing." Erwin Stoller CEO of Switzerland's Rieter Automotive, agrees: "we talk about 'low-cost countries' but it is not really fair just to focus on cost. You have to look at flexibility. Switzerland for example has the highest wage in Europe, but labor is flexible." Many companies also cite the continuing challenge of ensuring quality in low-cost locations. "There is no doubt that quality is the biggest challenge in low-cost country sourcing, and getting and keeping the right skills is the next most difficult issue," says one large Asian component manufacturer.

In the area of increasing **operational efficiency**, many companies cite two leading issues as their main value concerns: the need to increase benefits from their IT investments, and the relentless pressure to take costs out of their manufacturing operations to meet customer demands for price reductions. On IT, many companies report that automation of transactions is well advanced; equally many report that expected higher-level management reporting benefits have yet to materialize. This large Indian auto component manufacturer is typical: "in IT we have achieved a great deal in terms of automation of processes. In terms of management reporting we still need to achieve a lot more." And on customer demands for price reductions, a large number of companies cite this as their leading value concern. Says one German automotive component manufacturer: "the biggest challenge we face overall is in meeting customer demands for 'give backs' whenever you get new orders. Customers continually demand price reductions. That is why a lot of companies in the auto supply business are in the red zone right now." The CEO of another European auto supplier agrees: "customer demands on cost mean that we have to take 80 to 100 million euro out of our cost structure every year. The only way you can do that is to treat your supplier relationships as critical."

All companies in the survey do agree that building long-term value is the key to long-term survival. Is there a conflict between building value for shareholders and value for other stakeholders such as customers, employees, or suppliers? Many argue not. Says Hartmut Reuter, CEO of industrial machinery manufacturer Rieter Holding: "there is no fundamental conflict. You might improve value for shareholders in the short term, say by cutting back on R&D – but soon you will find you have no customers. You might improve value for customers by reducing prices, but soon your share price will be collapsing. You can always make life nice for a lot of people in the short term, but that won't build value in the long term."

In fact, it may be just a timing issue – short-term decisions do not always yield long-term benefits and stability. Yet as our survey and interviews suggest, building value is a challenge that belongs to the whole business, not just the executive board.

Compliance demands have to be met and their costs controlled. Risk has to be identified and managed – not just within the company, but also within the supplier and customer network. New market opportunities have to be grasped with a clear understanding of where investment will find real returns, while existing operations demand a continual cycle of efficiency improvements and cost reductions.

The foregoing survey results present a detailed picture of how companies are meeting all of these demands. And while results differ company by company due to many factors, one result is common: for all companies the rate of change continues to increase.

kpmg.com

KPMG's Global Industrial Products and Automotive Contacts

Bill Kimble
Global Chair, Industrial Products
KPMG in the U.S.
wkimble@kpmg.com
Tel: +1 713 319 2148

Uwe Achterholt
Global Chair, Automotive
KPMG in Germany
uachterholt@kpmg.com
Tel: +49 89 9282 1355

Michele Hendricks
Global Executive, Industrial Products
KPMG in the U.S.
mhhendricks@kpmg.com
Tel: +1 212 872 3641

Roland Schmid
Global Executive, Automotive
KPMG in Germany
rolandschmid@kpmg.com
Tel: +49 89 9282 1147

Fiona Sheridan
Global Senior Marketing Manager,
Automotive and Industrial Products
KPMG in the U.K.
fiona.sheridan@kpmg.co.uk
Tel: +44 20 7694 8507

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act upon such information without appropriate professional advice after a thorough examination of the particular situation.

The views and opinions expressed herein are those of the interviewees and do not necessarily represent the views and opinions of KPMG International or KPMG member firms.

© 2007 KPMG International. KPMG International is a Swiss cooperative. Member firms of the KPMG network of independent firms are affiliated with KPMG International. KPMG International provides no client services. No member firm has any authority to obligate or bind KPMG International or any other member firm vis-àvis third parties, nor does KPMG International have any such authority to obligate or bind any member firm. All rights reserved.
KPMG and the KPMG logo are registered trademarks of KPMG International, a Swiss cooperative.

Designed by Roundel
Publication name: Global manufacturing benchmark survey
Publication number: 310-059
Publication date: November 2007
Printed on recycled material