KPMG

INDUSTRIAL MARKETS

Strategic Growth and New Markets

KPMG LLP

in association with

CLB MEDIA Inc.

AUDIT ▪ TAX ▪ ADVISORY

Foreword

How do companies look beyond immediate economic challenges to develop long-term strategic goals to compete and win in the global marketplace?

We know that we are living in turbulent times; credit is tightening, the dollar is fluctuating wildly against major currencies, and commodity prices have plummeted. Economists warn that we have entered what looks to be a global recession. Tough as conditions are, however, the current economic environment provides opportunities for companies to not just survive, but also prosper.

To understand how manufacturers are coping, KPMG, in partnership with CLB Media, surveyed and engaged in a candid dialogue with senior executives of Canadian manufacturing companies across industrial sectors to garner their opinions on their current growth plans. Conducted in late 2008, KPMG's *Canadian Manufacturing Executive Survey* of nearly 175 public and private companies identified the risks, opportunities, and winning strategies for survival as well as growth. The lessons and discoveries of that study were further explored by some of Canada's top executives who participated in KPMG's half-day executive roundtable.

Executives who participated in the survey and the roundtable have identified their three "top of mind" strategies in the current environment:

- Process improvements
- Investment in R&D and technology
- Global expansion.

Also of concern to these executives is the scarcity of capital, and the constraint that scarcity can place on any growth strategy.

This publication outlines these executives' views on growth strategies and challenges, together with KPMG analysis and comment.

Companies surveyed report that process and efficiency improvements are their most important strategies for growth.

Nearly one-half (45 percent) of companies identified process and efficiency improvements as their most important strategy for growth. One roundtable participant, the North American general manager of an electronics manufacturer, stated that his company's main strategy was innovation coupled with building products in low-cost jurisdictions. However, the company then realized that simply setting up shop in the lowest-wage country was not a guarantee of success, as competitors in emerging markets are producing complex products with quality as good as or better than North American standards. "Innovation and speed is the only way that we can compete," he concluded.

Another executive, the president of a major supplier of specialized moulding equipment to manufacturers, said his firm is focused on the quality and cost equation as well, but warns that an overemphasis on cost can lead an enterprise to a dead end. "Companies need new products and new services," he advised. Barriers impeding the free flow of information internally between departments and externally with suppliers and customers should be reduced or eliminated to help ensure ideas and designs have a chance to be examined.

KPMG's publication *Rethinking Cost Structures* confirms that the majority of businesses continue to miss major opportunities to boost profits. Even more surprisingly, 30 percent of the manufacturing companies polled in KPMG's *Canadian Manufacturing Executive Survey* said that they have implemented no productivity improvement strategies at their plants. A lack of focus on costs is understandable in times of increasing revenue and profit, but difficult to understand in today's business environment.

KPMG Comment

The Grass Is Not Always Greener. KPMG's *Competitive Alternatives 2008* study graded more than 100 cities in developed countries and Mexico on 27 cost component measures. While Mexico emerged as the leader with a 20 percent overall cost advantage, Canada maintained a second-place ranking despite the 17 percent appreciation in our dollar relative to the US. The pullback in the value of the Canadian dollar relative to the US dollar at the end of 2008 and into this year has only improved Canada's competitive position. Canada's closest competitors in the developed world are usually Australia and the United States. The study found Canada especially competitive in chemicals, medical devices, pharmaceuticals, and telecommunications.

So where does Canada get its competitive cost strength? Credit a low income tax rate—planned to go lower still with further planned reductions out to 2012—and relatively low costs for statutory and other benefits.

Where are the lowest cost centres in Canada? Second-tier cities such as Sherbrooke, Moncton, St. John's, Charlottetown, and Saskatoon come out as cost leaders.

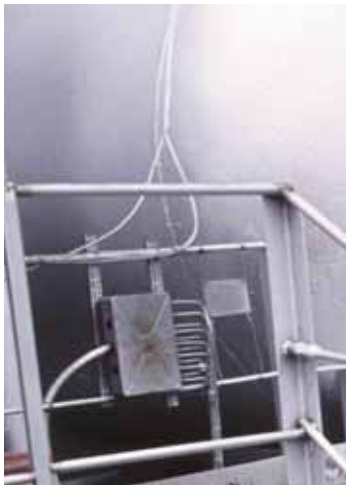
A prolonged economic slowdown in the US could spur productivity improvements and cost advantages for our southern neighbour. Canada currently has a middling ranking in the G7 in terms of GDP growth, innovation, and infrastructure, all of which are factors in competitiveness. Currency swings are a mixed blessing; a fall in the Canadian dollar can make exports more competitive, but can increase the price tag for productivity if new equipment is sourced in US dollars.

Cost Optimization. The only certainty for Canadian businesses in the near term appears to be more uncertainty. Will energy prices spike next year? Perhaps. Will competition get tougher? Likely. Will banks still be reluctant to extend credit or back risky investments? Almost certainly.

The basics of cost optimization—reducing costs while preserving and enhancing value—will be even more critical to businesses attempting to adapt to today's harsh economic realities. In KPMG's experience, isolated quick fixes and conventional cost-cutting exercises come up short because they fail to target underlying cost and value drivers.

It is up to owners, directors, and managers to ensure that their cost reduction programs deliver the anticipated benefits. KPMG's research has found that almost one-half of the savings identified by cost reduction programs are not achieved. Companies should reward their managers for reducing costs, and invest the time (and capital) to make the key strategic changes to the organization to help realize all of the benefits.

Initiating a cost optimization program would have been viewed as a valuable luxury in a period of growth and readily available capital, whereas now it should be viewed as a life insurance policy for a company and a path to free up cash flow to invest in growth.



Investment in R&D and Technology

More than 41 percent of surveyed companies identified new product development and technology as their main path to growth. An executive with a leading producer of high-technology circuit boards noted that his company helped develop an on-line design for manufacturing products that was aimed at helping the firm's customers. "It accelerates their design cycle, and at no cost to them," he said. "You have to invest in equipment and in the manufacturing process, but you need to go beyond that."

An executive with the Canadian subsidiary of a German manufacturer said his firm has had to adapt its R&D efforts because of its isolated location. "It's difficult to attract people to an area perceived as a backwater," he said. "We have to do a lot of training. We have developed our own training programs for technicians and service people, and it costs us a lot of time and money. Retaining those people is key for our HR strategies. The upside is that people tend to stay. We have a lot of people with over 25 years of service."

KPMG Comment

Unfortunately, one of the best-kept secrets in business is the availability of provincial and federal tax credits. Companies often do not recognize that they are engaging in development activities, such as new product or process improvements, which qualify for tax incentives. Canada is not short of credits; there are federal investment tax credits on R&D activities, federal apprenticeship tax credits, provincial credits for R&D activities, provincial co-op education credits, digital media credits, and various other provincial credits. Some credits are fully refundable, while others can be used only to offset taxes payable for a company that is profitable and paying tax. As well, many of the tax incentives can be recovered for the current year and prior years (subject to certain limitation periods) for activities previously undertaken by the company.

The bottom line: It is critical to position your R&D activities so that they attract government funding to enhance what is available, especially in these economic times when it is so hard to get funding of any kind.

Investing in R&D today can generate cash flow, and keeping up with technology and processes will be critical when the economy does turn around. Now is not the time to shut down R&D spending and fall behind your competition.

Global Expansion

When asked what types of international growth strategies they were pursuing, executives surveyed by KPMG stated that importation of goods and services from non-Canadian companies (51 percent) and use of non-Canadian vendors or distributors (42 percent) were the main strategies employed.

The ever-shrinking world has yielded a key advantage for a specialized equipment maker. "Supply chain innovation is absolutely key," said the firm's president. "We have components that we have made from our factory in China that help us to reduce costs here, and 50 percent of our design work comes from our India engineering office. These are our own companies, but the fact is that management is about figuring out 'How am I going to deliver from the customer quote all the way to the product?'"

An executive roundtable participant noted that the international opportunities go both ways and that Canadian companies have much to offer the world, as well as many untapped countries to explore. "There are huge opportunities everywhere," the crown corporation executive said. "Poland is a great example. They have $100 billion to spend on infrastructure projects. The challenge is connecting the nuances of the Canadian supply chain with global opportunities."

KPMG's survey found that nearly half of respondents indicated that they were disappointed with their global expansion experience, which leads to the following question: Is this indicative of a failure to plan for and respond to global competition, or is something else at work?

"Most companies that dip their toe in the water for the first time have a challenging experience," said the general manager of an electronics manufacturer. "The trouble is that it can create hesitancy for other firms. It's not an overnight thing and people often forget how long it took them to make their own company successful." He pointed to central Europe, now one of the largest hubs for automotive production, but where few Canadian firms currently operate. "Global competition was (and is) tough, but the company would not be around if it had not done it."

The rate of success abroad can be increased by diligent preparation, noted the president of a specialty equipment maker. "I can't say that we've had one bad experience in global expansion. You need good people, good planning, and good local management. It's like farming—you've got to get out there and plow the field, water it, nurture it."

KPMG's survey found that tax considerations are top of mind for most companies when looking at conducting business in or expanding to other countries. Two of the three top considerations of businesses were tax related: customs taxes (39 percent) and income tax (32 percent). Financing expansion (16 percent) and repatriating earnings after tax (15 percent) were also concerns.

"It's a risk to go there, and you have to be big enough to sustain it," a president of a Canadian auto parts maker said of global expansion. "You have to be stable in your own business and you need to be able to finance it (the international growth)."

"Different tax and regulatory regimes are an issue," said the general manager of an electronics manufacturer. "We were forced to go international. We have had to deal with all of that; we had to figure it all out. We had a complex tax structure (and) had the right people in local markets who helped us understand the tax and regulatory regimes."

KPMG Comment

Recall Nation. Recently Canadians have been inundated with consumer product recalls. In all cases, the recalls were voluntary and were initiated by the importer or manufacturer. In 2008, the government introduced the Canada Consumer Product Safety Act (Bill C-52), which imposed important new monitoring obligations on industry and provided for government oversight measures. It would give Health Canada the power to force a company to recall a product, impose penalties for non-compliance, and ultimately fine or jail persons for non-compliance. Long overdue, Bill C-52 is intended to protect consumers from companies with less than adequate measures in place. A concern for business regarding Bill C-52 is the removal of the right of an importer or manufacturer to use the defence of due diligence or reasonable care in respect of

fines that could run to a maximum of $25,000. (If the business does not act on a notice of violation, the penalty can be reissued cumulatively for each day of non-compliance).

It's Not All or Nothing. Companies with a foreign expansion bug do not necessarily have to commit wholeheartedly to a market by setting up foreign corporations. An initial foray could be as simple as sourcing a product with the assistance of a local representative, looking for local partners, or perhaps examining the market as a place to sell its product. The "all the way, right away" approach to foreign markets simply sets the stage for making critical mistakes. First, determine how a foreign market might help your strategy, and then plan your approach.

Don't Be Held Hostage. When it comes to sources of supply, relationships in foreign markets can help. However, just as you would not rely upon one local supplier as the only source for critical parts or materials, you should not look to one foreign market, or worse, one foreign supplier, as the sole source for a critical product component. A balance between foreign and domestic supplies for key materials can help ensure your operations keep running. Foreign factories can experience strikes or be closed, trade wars can erupt, and dock strikes occur regularly in North America.

Be Shock-Proof. Your supply chain should not only include redundant suppliers of key materials and products, but also be flexible and robust enough to weather increasingly turbulent times. The two largest swings to Canadian organizations' supply costs in the past few years have been oil prices and the fluctuating value of the Canadian dollar. Oil does not look like it will revisit US $150/barrel—or even close to $100/barrel—anytime soon, but there are no guarantees.

Low-cost-country sourcing is no longer a "no brainer." Spiraling labour costs, the risks of insufficient or low-quality materials, and the fluctuating cost equation mean that companies need to be sure that any cost advantage obtained by sourcing or producing in that country outweighs the risk factors and does so for a reasonable period.

Mitigate Tax Risks. All too often, tax is considered after the fact and it is too late to structure efficiently. As Canadians, we perhaps don't realize that we have one of the most advantageous systems for bringing profits back into the country. Canada boasts an excellent treaty network with most countries. By utilizing that network, companies can help reduce the cost of repatriating profits.

In *Indirect Taxation and Business – a Global Perspective*, by KPMG International, many companies appeared unaware of the risk dimension of global tax compliance and also appeared unfamiliar with the concept of structured tax planning. One frequent comment was that in industrial manufacturing, client demands dictated location, so opportunities for tax planning were limited. Yet, where companies do engage in formal tax-planning projects, they say the benefits are significant.

Companies are often attracted to foreign markets by the presence of low corporate taxes; however, less obvious taxes or idiosyncratic rules in certain markets can reduce the benefits of "low-tax" jurisdictions. In emerging markets, for example, embedded value-added taxes are often not fully refundable—although a Canadian company might assume differently based on its domestic experience. Thorough research of a particular market's tax regime and how it impacts your import and export activities is one of the only ways to ensure no surprises.

China recently changed its export tax rules, making it more expensive for foreign companies to manufacture and export from China where the goods involved are in sectors that the Chinese government no longer supports. The rule change has led one Canadian mining company to abandon plans to establish a Chinese source for capital equipment. Because it is difficult to predict the future, companies should also consider likely tax changes and their potential impact.

Other Issues to Consider. CIBC World Markets Inc. estimates that the cost of shipping a standard 40-foot container has tripled since 2000 (*StrategEcon – May 2008*). Combined with the known annual wage inflation in BRIC countries that has averaged between 14 percent and 21 percent since 2003, the result is a growing backlash against conventional low-cost-country sourcing strategies. Should Canadian manufacturers be rethinking where sourcing value-added activities are in their value chains?

It is important for Canadian manufacturers to develop plans to control and mitigate potential risks when developing and managing their global supply chains. Some of these risks include the rise of global energy prices, volatile financial markets, potentially hazardous material sourcing, and challenging regulatory regimes.

When most Canadian manufacturers think of India and China, they think of low-cost labour and materials. Given the rapid expansion of the middle class and its buying power in these countries, and not withstanding the global recession, which has also significantly impacted China, companies should also be looking at these countries as long-term markets.

Scarcity of Capital Slowing Expansion

Primary lending is proving scarce, as most banks have to allocate available capital to meet the needs of existing customers, and the lending ability (and willingness) of individual institutions varies significantly. As well, alternative lending instruments such as bank syndication and securitization vehicles, major injectors of liquidity earlier this decade, are not functioning well. Credit limits and lending terms available to companies, even those with a good credit history, may be scaled back. Just as importantly, credit is more expensive as capital costs increase; therefore, borrowers should expect some changes to bank covenants as well as banks possibly taking equity, with potentially far-reaching implications for capital structures.

Cash truly is king, both defensively and offensively, in any prolonged downturn. Tough times can also provide the environment for opportunistic acquisitions of competitors, domestic or foreign, as well as expansion into foreign markets. While border-hopping at first seems to be the sole purview of well-financed public companies, a recent study by KPMG Enterprise™ entitled *Taking on the World: Positioning Canadian Private Companies for Global Success*, found that more than one-half of privately owned companies reported that their global expansion had been successful.

Profitability at home is a prerequisite for international expansion, noted the president of an auto parts maker. "You have to be stable in your own business and you need to be able to finance (international growth). Financing is not as readily available. These are issues we face as Canadians. The desire is there, but the ability to execute may not be."

The president of a specialty equipment maker agreed that credit pools began drying up in mid-2007 and that small to mid-sized manufacturers were particularly hurt by the rise to currency parity between the Canadian and US dollars. "The Canadian dollar was so strong for so long," he said.

"The fact that the government decided not to intervene and prop it up has destroyed a lot of small and mid-sized manufacturers. The larger ones that have survived are international companies that just happened to be located in Canada."

KPMG Comment

Vanishing credit pools should put the issue of costs, business structures, minimizing cash taxes, and maximizing cash flows at the forefront for Canadian organizations. Costs can slowly and imperceptibly build in companies, drag on profits and, in today's environment, threaten the viability of a business.

Manage Cash Taxes. There are a number of strategies companies can employ to help manage their cash taxes:

- Tax cash flow. A company may operate via different separate legal units or entities, some profitable and some losing money. However, it may make sense to combine these entities and manage them closely to help reduce paying cash tax.
- Make the tax system work for you. Pursue GST refunds, R&D credits, and investment tax credits; expedite loss carry-backs to get extra cash; and investigate the benefits of revised transfer pricing.
- Question everything. A surprising number of businesses continue to pay tax installments based on the prior year's tax bill, regardless of whether their profits are down or, in fact, they are facing a loss for the current fiscal year.
- Enhance the benefits of capital spending. For example, buy that major asset a week before year-end, put it in use, and get the half-year rule on claiming tax depreciation out of the way.

Enhance Your Borrowing Capacity. There are a number of key initiatives that borrowers should undertake in current credit markets to help ensure they are prepared for the changes that are going to impact their borrowing capacity:

- Undertake a review of your organization's capital structure and scheduled debt maturities.
- Consider your working capital requirements and the ratios that might be required in the new credit environment. This may necessitate a change in accounts receivable invoicing and collection practices. Look for opportunities to reduce overall financing requirements by speeding up accounts receivable collections and, where practical, slow discretionary spending.
- Review your current syndicated loan facilities as new bank participants may be needed in order to maintain credit availability and pricing at manageable levels. This will be difficult without a thorough canvassing of the market.
- A change to asset-based lending may be a viable alternative that might free up additional collateral and alleviate covenant pressure.
- Evaluate the potential to divest of redundant assets or non-core business units.
- Be prepared to re-evaluate the amount of equity and subordinated debt employed in the business, as the amount of available debt is limited.

Conclusion

The rules have changed and the climate has become much more competitive for Canadian businesses today. While economic turmoil may provide rare M&A opportunities, securing credit may prove either very difficult or near impossible. Nevertheless, companies can control their own costs, structures, and processes.

Revamping processes and cost structures, managing cash costs—including tax, and ensuring your company can enhance the strength of its balance sheet and its liquidity position, can help your company not only survive these uncertain times, but also exploit growth opportunities.

The current environment will force businesses to put increasing focus on cash. Those that do will have cash and liquidity, and will be best positioned to respond to market conditions, take a lead role in their industry, and preserve and create value for shareholders. Besides ensuring the ongoing health of a business, the focus on working capital ensures the opportunity to expand into emerging markets such as the BRIC group of Brazil, Russia, India, and China.

The executives who participated in KPMG's *Canadian Manufacturing Executive Survey* and related roundtable were confident that Canadian companies can make it through this period of economic upheaval and emerge ahead of their competitors. They recognize that now is the time for companies to look at capital conservation and generation in areas such as cost optimization, cash and working capital management, recapitalization and M&A, distressed investing, and tax cash flow management strategies.

Although Canada is swept up by the global recession and our industrial manufacturing sector is fighting for its life, the fundamentals of our economy are strong and our banking system is recognized as the soundest of the G8. If companies maintain a sound balance sheet they will be in a strong position for success and profitability.

Recent Thought Leadership

Rethinking Cost Structures
A global survey by KPMG International and the Economist Intelligence Unit reveals that today's businesses are under constant pressure to reduce costs, yet many find it hard to do so in a sustainable fashion. Nine out of 10 cost reduction programs fail to achieve their targets, and the gains that are achieved appear to be short lived.

New Markets: Cost, Insight and Opportunity
As part of a global manufacturing benchmark survey of large manufacturing businesses across the world, KPMG International created a new objective score of how corporate value is derived from new markets, as seen by CEOs and CFOs at some of the world's biggest manufacturers.

Coping Strategies and Preserving Value in Uncertain Economic Times
Canadian business has always been vulnerable to swings in the general economic cycle and, for the most part, business owners have learned to cope. However, fundamental structural change in capital flows and credit markets exacerbates the impact of a weaker economy, and with that comes uncertainty. In order to address the immediate impact of the contraction in credit and a slower economy, business owners should reassess their financial position.

KPMG's Corporate and Indirect Tax Rate Survey 2008
Tax rates on corporate profits have continued their long decline in the past year, but governments worldwide are increasingly looking to taxes on goods and services to make up shortfalls in public revenues, KPMG International's latest annual survey of tax rates affecting business has found.

Doing Deals in Tough Times
A global study based on input from over 160 global companies. This paper is intended to give M&A executives a better understanding of how and why certain attributes can lead to success, and to provide the information and tools to help them improve their own organization.

Danger and Opportunity Ahead for Corporate Canada
This piece investigates Canadian insolvency and restructuring activity over the past decade. Based on the identified trends, this report provides insights into the current economic downturn.

The Evolution of Risks and Controls
In 2007, KPMG International commissioned the Economist Intelligence Unit to conduct a global survey of 435 senior executives to establish their views and vision for the risk and controls within their organizations.

Restore Magazine – Issue #3
The third issue of *Restore Magazine* includes an interview with Simon Whicker (Partner, KPMG in the Cayman Islands) on how financial institutions are responding to the credit crunch, as well as an article written by the Economist Intelligence Unit. Other features include interviews with Mark Raddan and Chris Laverty on early warning signs and declining liquidity, and an article that focuses on the current "conundrum" surrounding pensions.

Forecasting with Confidence
This research report by KPMG and the Economist Intelligence Unit examines how leading organizations enhance the reliability and confidence of forecasts and, as a result, drive and sustain long-term value.

Please visit www.kpmg.ca to obtain electronic copies of any of these publications, and for a listing of KPMG's latest publications.

Governance, Risk, and Compliance: Driving Value through Controls Monitoring
This white paper explores the potential benefits of controls monitoring as a means of improving decision making, reducing the costs of control performance and monitoring, and driving greater business value.

Beyond the Credit Crisis: The Impact and Lessons Learnt for Investment Managers
This report produced by KPMG International in cooperation with the Economist Intelligence Unit examines in detail how fund flows, returns, and reputations of investment managers have been impacted by the credit crisis and the economic conditions of the past 12 months. It investigates how, in light of the challenges presented by the credit crisis, investment management firms are managing the increasing complexity of the instruments and strategies they adopt.

Managing Market Risk: New Attitudes, Old Wisdom
Banks have long faced the risk of losses from undesirable market movements. But how many could have predicted how very hostile the market would become? This paper explores the interrelated nature of a variety of risks, including credit, liquidity, operational, strategic, and reputational.

frontiers in Tax – June 2008
The financial services sector has been in a dynamic—and perhaps even frantic—mode since our last edition of *frontiers in tax*. The sector has experienced the impact of the credit crunch on the liquidity of major financial institutions, watched the rise of investment in the financial sector by Sovereign Wealth Funds, and has begun to understand the greater financial strength that increasing oil prices have given the Gulf region generally.

A Rough Road – Financial Crisis and the Automotive Industry
This white paper takes an overview of the global automotive industry before going further to discuss specific regional issues. It also discusses the issues from a supply chain perspective and provides possible strategies for automotive companies moving forward.

Exploring Global Frontiers: The New Emerging Destinations
This publication aims to provide an overview of the options that are available for companies who would like to set up a shared services centre, or outsourcing companies setting up operations in locations beyond their existing locations.

Sustaining Value in a Changing Economy
Canadian public and private companies are finding themselves in an economic environment that reflects a convergence of factors: the fluctuating Canadian dollar, rising energy costs, restricted access to credit, pressure from advancing offshore competitors, and the general economic slowdown in North America and globally.

Taking on the World: Positioning Canadian Private Companies for Global Success
Based on a survey of Canadian private company executives, *Taking on the World* explores their current experiences and future plans for expansion. The report documents the extent of private companies' foreign operations to date, sheds light on the benefits of global expansion for private companies, and the key challenges and risks of doing so, and provides information about local employee and supply resources in foreign markets.

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