Welcome to The Quarterly!

We are pleased to introduce The Quarterly: a review of the top themes as discussed during the current earnings season for 20 sector peers. The Quarterly examines, identifies and ranks the critical themes and presents them in an easy-to-browse format.

The Quarterly also tracks the movement of these themes from quarter to quarter to provide a time-based perspective on shifts in the industrial sector landscape. The issues captured in a particular quarter’s earnings calls vary widely because most of the calls take place within a few weeks of each other and are strongly influenced by forces such as recent news events. In a time of unprecedented disruption for industrial companies, there can be profound shifts in the attention given to certain issues from quarter to quarter.

We view the themes ranked in The Quarterly as providing a timely snapshot rather than a universal assessment of importance, revealing insights into the minds of both industrial leaders and sector analysts during the current quarter.

Operational excellence, customer focus are top of mind in 1Q17

Working capital management remained in the number one spot from 4Q16 to 1Q17 for the 20 industrial peers. Productivity programs implemented in previous quarters are meeting (and often exceeding) targets.

A focus on the customer was also apparent as the topic of end market developments moved into the second-highest spot. Specialty plastics for high-efficiency vehicles are seeing increased demand from automotive manufacturers, while aerospace and defense companies are reporting greater order activity from military customers.

Investments in innovation, particularly in digital and software, have remained a critical part of company strategy as companies explore aftermarket and service opportunities.

Disruptive times call for an ever-increasing focus on high operational performance and competitive strength. We hope you find our insights on these themes clarifying.

Lisa A. Caldwell
EY Americas Advisory Sector Leader, Industrial Products
Top 10 themes from quarterly earnings calls

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Key themes

1. Working capital and cash flow management
   - Improvement in working capital and significant changes in cash flow
   - Benefits realized from productivity and cost control programs introduced in previous quarters
   - Continued focus on strong cash generation and returning capital to shareholders through dividends and share buybacks
   - Timing of milestones for major projects and the accounting standard update on revenue from contracts with customers, particularly for aerospace & defense (A&D) companies

“IT’s not surprising that working capital remains a top priority for the Industrials sector. Company leaders are improving working capital through process improvements and extracting additional value before and after transactions. Liquidity provides the fuel for strategic initiatives across the capital agenda, including geographic growth, investments in innovation and portfolio optimization.”

David Gale, EY Americas Industrial Sector Leader, Transaction Advisory Services

2. Developments in end markets
   - Trends in key customer segments affecting demands for products and services
   - Continued growth in demand for specialty materials from automotive manufacturing
   - Positive turnaround, rising demand from consumer electronics makers
   - Increased government orders for military aircraft
   - Strong growth in renewable energy, especially solar and wind
   - “Improvement” in demand from downstream oil and gas customers, though upstream remains weak
   - Customer inventory levels rising after several quarters of destocking activity
“As industrial companies seek growth opportunities, they are taking a page from the playbook of B2C companies and are increasing their focus on the customer. Concepts such as customer experience design, micro-segmentation and strategic pricing are all being applied in order to capture top- and bottom-line growth. The winners in the market will be the companies that can most effectively adopt these approaches and make their application a part of how they operate.”

Bernard Kang, Executive Director, Americas Strategy, Ernst & Young LLP

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**Geographic developments**

3 Changes in market conditions by region

- Signs of growing strength in Europe, particularly Germany
- Continued optimism on China, led by increased demand for sustainable products (water treatment, paint/coatings, etc.)
- For A&D, increased demand from military customers in the US and the Middle East
- For chemicals, seed and crop protection sales rising among farmers in Brazil; growth still forecasted in light of recent political challenges

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**Supply chain management**

4 Optimization programs and challenges; logistics/warehouse management

- Strategic investments in supply chain optimization systems
- Increases in raw materials costs pushing up product pricing in chemicals, industrial products
- Hedging strategies with suppliers to reduce impact of rising materials costs
- Greater efforts to engage suppliers at enterprise level to maximize cost savings
- Pressure to lower inventories while remaining agile in response to quick changes in customer demand

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**Innovation and new product/service launches**

5 Digital; software as a service; Internet of Things; R&D budgets

- Continued strong investments in software platforms for customers, especially cloud-based
- Enhancements of products through digital services, such as customer-focused virtual reality
- Increased capital expenditures, led by investments in automation programs, new digital manufacturing processes
- New R&D spending benchmarks at 6% to 10% of sales to ensure product pipeline strength

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**Critical projects**

6 Production updates, milestones and/or delays for projects crucial to company strategy

- Successful test flights for new aircraft models at multiple A&D manufacturers
- New orders and increases in previous orders for military aircraft, primarily from the US but also from countries expanding or upgrading their fleets
- Petrochemical plant construction and launch in the Middle East, creating additional processing capacity as well as service opportunities
- Increased government investments in power projects, requiring new equipment as well as service support

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**Changes in production rates**

7 Rising or falling plant output; shifts in demand

- In A&D, resources concentrated on increasing military aircraft production in response to large and growing backlogs
- Slowing production in commercial aerospace due to low sales growth
- In chemicals and industrial products, new plants and capacity expansions focused on growth markets by targeted customer group, particularly in Asia and Latin America
- Plant closures or consolidations in response to shifts in product demand

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Regenia Sanders, Advisory Principal, Supply Chain and Operations, Ernst & Young LLP

“With continued focus on operational excellence, companies are looking to their supply chain to balance the need for efficiencies and working capital reductions with customer responsiveness. Now more than ever, this requires the utilization of advanced technology and analytics for visibility to all nodes in the supply base as well as insight into customer behavior, enabling industrial companies to both anticipate and be responsive to demand and disruptions. This requires end-to-end collaboration throughout the supply chain, including sales, warehouse operations and logistics to meet growing customer expectations, even in the B2B world.”

Regenia Sanders, Advisory Principal, Supply Chain and Operations, Ernst & Young LLP
This analysis examines key themes from the 1Q17 earnings reporting season among 20 global industrial products peers, including companies from the chemicals and aerospace and defense sectors.

The identification of the top 10 themes is based solely on an examination of the transcripts of earnings conference calls held from 20 April to 11 May.

### Key themes

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| 8 | Cost reduction                                                       | - Focus on achieving efficiencies and cost savings across the enterprise, not just at the business-unit level  
                              |                                                                         | - Manufacturing footprint management, such as moving facilities to lower-cost locations  
                              |                                                                         | - Ongoing, multiyear cost reduction programs with regular milestone targets  
                              |                                                                         | - Headcount reduction  
                              |                                                                         | - Outsourcing of functions such as tax departments  |
| 9 | Change in financial outlook                                         | - Success of ongoing productivity programs supporting growth in EBITDA (earnings before interest, taxes, depreciation and amortization), earnings per share forecasts  
                              |                                                                         | - Mixed outlooks from industrial products manufacturers due to variations in performance by customer segment; some sector optimism, but most peers are cautious  
                              |                                                                         | - Raised outlooks on revenues for A&D companies as defense-related orders increase  |
| 10| Product/service mix                                                 | - Innovative digital services, which set companies apart competitively and establish long-term, high-margin relationships with customers  
                              |                                                                         | - For A&D and industrial equipment manufacturers, strong and growing focus on aftermarket service relationships to boost both revenues and margins  
                              |                                                                         | - Third-party support through alliances and joint ventures to bring new services to market more quickly  
                              |                                                                         | - Movement from products to services or solutions: software, maintenance services, etc.  |

“We are seeing increasing balance between cost and revenue oriented strategic initiatives at industrial companies. Digital strategy is critical to both. Internally, digital and the Industrial Internet of Things (IIoT) are driving productivity through improved transparency and decision-making. Externally, digital and IIoT are enabling manufacturers to diversify revenue streams, supported by information-based products and services. With a deeper knowledge of their own businesses and a growing set of services to offer to customers, industrial products can use digital to better balance strategic investments and improve both revenue and operating costs.”

Brian Meadows, Advisory Principal, IoT and Digital, Ernst & Young LLP

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**Scope, limitations and methodology**

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