

Business Prospects for Australian Manufacturing in 2006

Another testing year ahead for manufacturing

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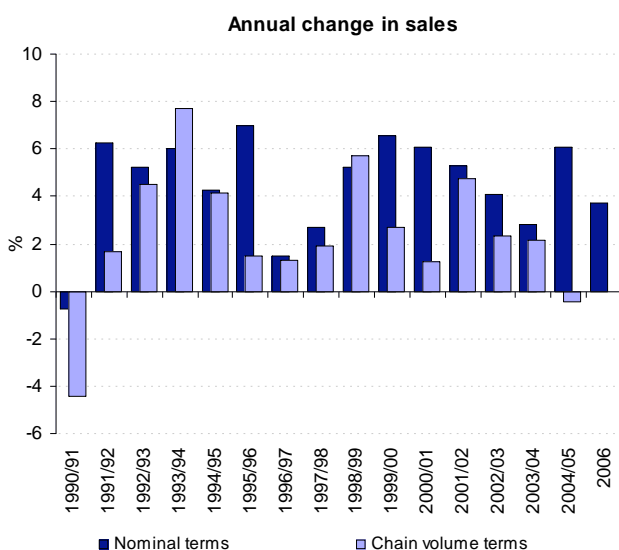
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Business Prospects for Australian Manufacturing in 2006

Another testing year ahead for manufacturing

Summary

- Australian industry is forecast to experience further testing conditions in 2006, as it continues to adjust to the changing pace of global competition and more moderate growth in domestic demand.
- Official Australian Bureau of Statistics (ABS) data shows that in 2004/5 manufacturing experienced what appears to be a healthy 6% jump in nominal sales. However, after taking into account price movements, the ABS notes that the sector experienced an overall 0.4% decline in sales volumes, the worst outcome in 14 years.
- Prospects for 2006 appears little improved on the previous year, with nominal sales forecast to rise by 3.7%. While it is difficult to be precise on how this will translate into volume terms, at best manufacturers are likely to see only marginal real growth in activity.
- The brunt of the soft conditions are likely to be most felt in the manufacturing heartland of Victoria and South Australia, with Queensland and Western Australian manufacturers benefiting from strong infrastructure and mining activity.



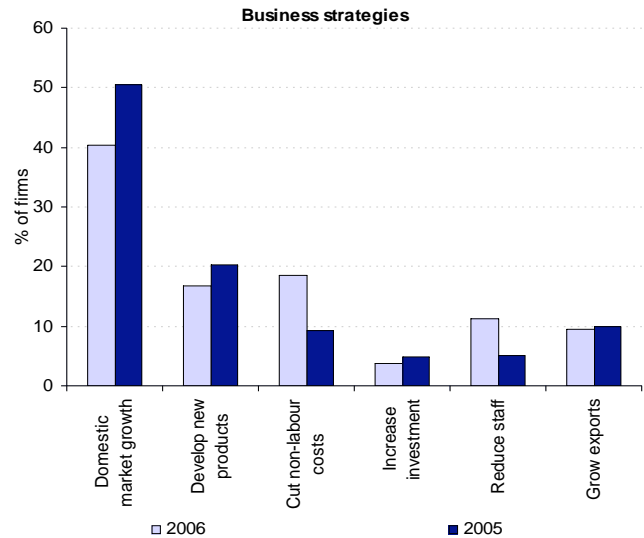
- In summary, the forecasts (in nominal terms) for 2006 are for sales to lift by 3.7%, investment to fall by 1.8%, exports to rise by 3.9%, with employment to fall by 3.9%. Selling prices are expected to rise by 3.6% and wages by 4.2% in 2006. Expenditure on research and development is only expected to rise by 5.0%.
- Strategically, companies are placing less emphasis in 2006 on market growth and more on cutting labour and non-labour costs, in order to boost productivity and maintain competitiveness.
- New products will continue to represent a greater share of sales (26.1%, rising from 23.0% in 2005), and companies will be more reliant on offshore inputs (through production offshore and more imported material in domestic production), equivalent to 37.8% of sales (up from 30.2% last year), generating a cost saving of around 10.2%.
- Five factors appear to underline these forecasts. First, expectations of continued moderate growth in domestic demand, as households restrain spending to reduce debt and respond to flat housing prices. Second, prospects for sustained weakness in housing activity, flowing directly into the pipeline of demand for manufactured goods. Third, the impact of the high Australian dollar, resulting in stronger import competition and constraining the growth of export earnings. Fourth, the impact of China, positive in terms of follow-on demand from mining activity, but negative in terms of increased domestic competition. Fifth, the impact of higher fuel costs on household spending.
- The forecasts are based on an annual survey conducted as part of the Australian Industry Group-PricewaterhouseCoopers **Survey of Australian Manufacturing**.
- The survey was conducted in late November and December 2005 based on a random sample of manufacturers in all states.
- The results incorporate the projections of 663 firms with an annual turnover of \$50 billion (15% of industrial activity).
- Full details of the survey findings are outlined below based on these underlying parameters.

CONTACT

Heather Ridout Chief Executive, Ai Group, work 02 9466 5504
Tony Melville, Director, Public Affairs and Government Relations, (02) 6233 0716

Business directions

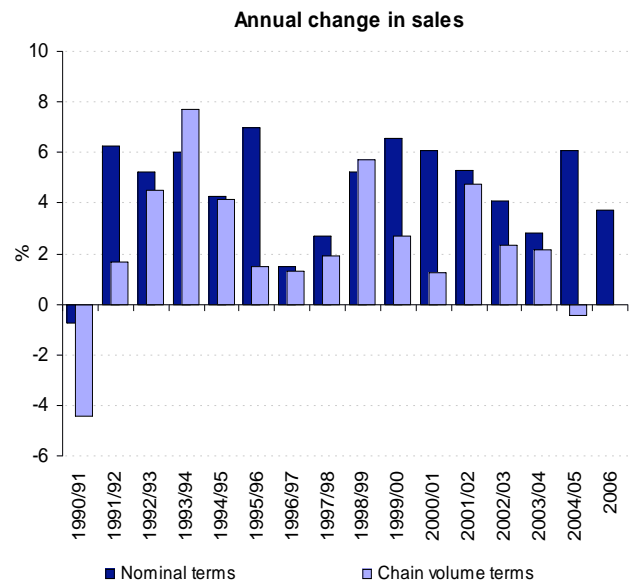
- In 2006, companies are expected to shift the focus of their business strategies away from market growth to cost cutting. Domestic market growth will be the prime focus for 40% of firms compared to 51% a year ago.
- By contrast, the proportion of firms looking primarily to cut non-labour costs is expected to rise from 9% in 2005 to 19%, while those seeking firstly to reduce labour costs rise from 5% to 11%.
- Cost reduction is expected to be most intense in the transport equipment; basic metals; wood, wood products & furniture; textiles; and clothing & footwear sectors.
- Export growth will continue to remain the key priority for 10% of firms (as in 2005).
- Developing new products will be a primary business focus for 17% of firms (although new product intensity is expected to continue to rise overall – see p.8).



2006 will see an increased focus on cost cutting ...

Sales

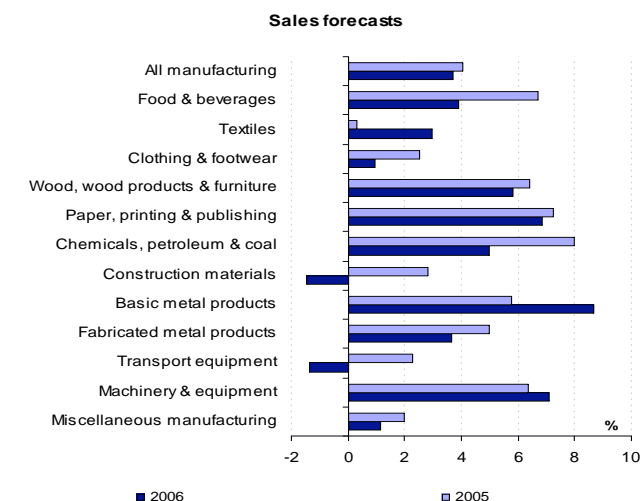
- Nominal sales based on ABS data rose by 6% in 2004/5. However, after taking into account of price and exchange rate movements, the sector experienced an overall 0.4% decline in sales volume, the worst outcome in 14 years.
- Prospects for 2006 appears little improved on the previous year, with nominal sales forecast to rise by 3.7% (down slightly on the forecast for the previous year).
- While it is difficult to be precise on how this will translate into volume terms, manufacturers are likely to see only marginal real growth in activity, after taking account of the expected increase in selling price (see p.8).
- Sales growth is expected to be strongest in the Western Australia and Queensland (7.2% and 5% respectively), supported by strong mining and infrastructure activity, and weakest in South Australia and Victoria (1.5% and 2.2%). Surprisingly, NSW firms expect sales to rise by 4.4%.



Sales are forecast to rise by 3.7% ...

Sales by sector

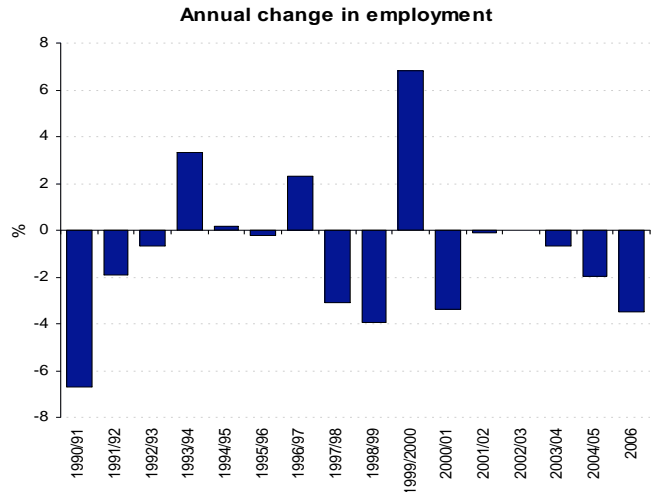
- Three sectors expect sales growth above 6% in 2006 – machinery & equipment; paper, printing & publishing; and basic metal products (a growth rate of 8.7%, the highest of any sector).
- More moderate growth (between 3% and 5%) is expected in the food & beverages; chemicals, petroleum and coal products; textiles; and fabricated metal products sectors.
- Low sales growth (below 2%) is anticipated in the clothing & footwear and miscellaneous manufacturing sectors.
- In contrast, sales are expected to fall in the construction material products (hit by slower housing activity) and transport equipment sectors, the latter facing intense competition from global sourcing.



Sales growth expected to be above 6% in three sectors ...

Employment

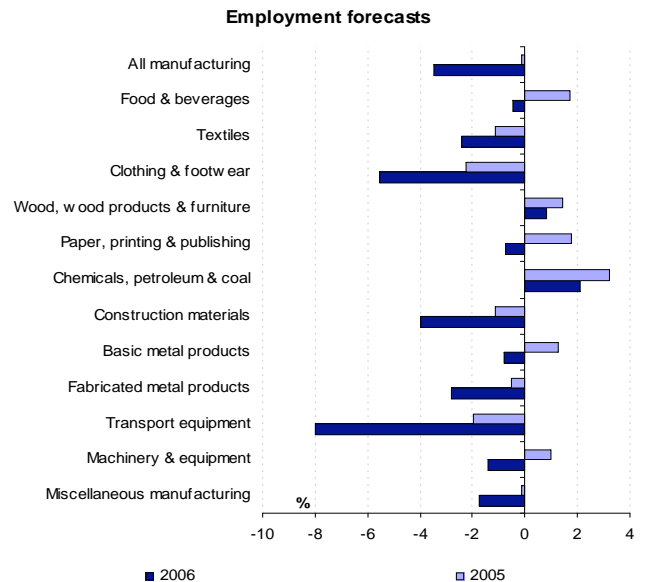
- Employment in manufacturing is forecast to fall by 3.9% in 2006, reflecting both cyclical weakness in activity as well as the restructuring process in response to heightened global competition.
- While ABS data on manufacturing employment is subject to significant swings (resulting in large changes in annual growth rates over a 12 month period), the forecast reflects an acceleration in the job losses seen in earlier years, with employment falling 2.0% in 2004/5. If the forecast materializes, it will be the weakest employment outcome since 2000/1.
- This is consistent with the intended focus of companies on reducing labour and non-labour costs in 2006.



Employment is expected to fall by 3.5% ...

Employment by sector

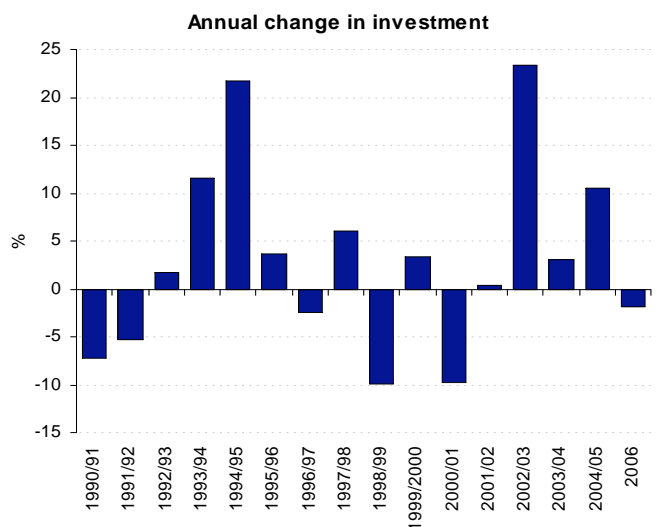
- Only two of the 12 sectors are anticipating an increase in employment (down in 6 in the previous year's forecasts) – wood, wood products & furniture and chemicals, petroleum & coal products.
- The largest forecast falls in employment are in transport equipment (8.0%) and clothing & footwear (5.5%), both facing significant global competition, and construction material products (4.0%), affected by the slowdown in housing activity.
- Smaller falls in employment are expected in the other seven sectors, including the three sectors expecting the strongest sales gain - machinery & equipment; paper, printing & publishing; and basic metal products – reflecting the need for companies to remain globally competitive.
- The results also suggest that companies have moved to become more capital intensive in their operations.



Only 2 sectors expect to increase employment ...

Investment, research and development

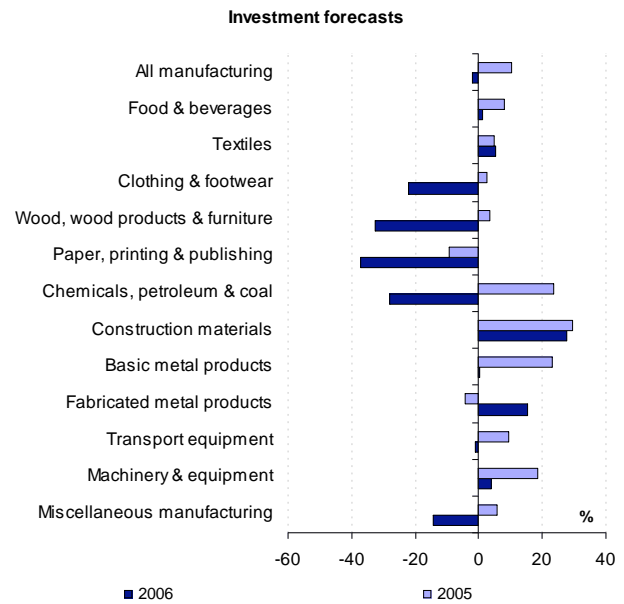
- The shift to a higher capital intensity has been reflected in the strong spend on new plant and equipment in recent years, particularly in 2002/3 and 2004/5, when ABS data shows that new investment rose by 23.3% and 10.5% respectively.
- The focus on stripping out costs and tight business conditions implies new investment will retreat in 2006, with spending forecast to fall by 1.8%. This is consistent with ABS forecast for manufacturing investment in 2005/6.
- Similarly after a number of strong years spending on research and development (averaging over 13% per annum between 2000/1 and 2003/4), the forecast is for more moderate growth of 5% in 2006. Three sectors however anticipate lifting R & D spend by 10% or more in 2006 - printing & publishing; basic metal products; and wood, wood products & furniture



New investment spend forecast to fall ...

Investment by sector

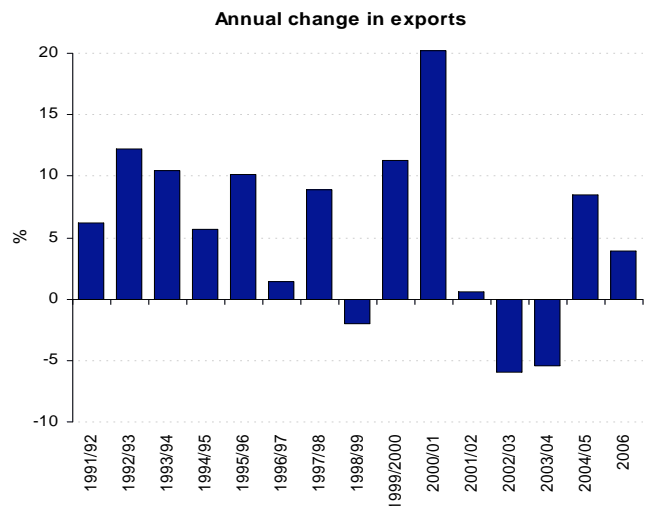
- With the exception of the fabricated metal products sector, investment intentions are down across all sectors compared to last year.
- While 10 sectors forecast a lift investment in 2005, only five sectors are expecting to do so in 2006. This in part reflects the lumpy nature of investment spending, which can change significantly from year to year.
- Investment spending is expected to rise significantly in two sectors – construction material products and fabricated metal products.
- In contrast, significant falls in investment spending are forecast for four sectors – clothing & footwear; wood, wood products & furniture; paper, printing & publishing; and chemicals, petroleum & coal products.



Five sectors expect to lift investment ...

Exports

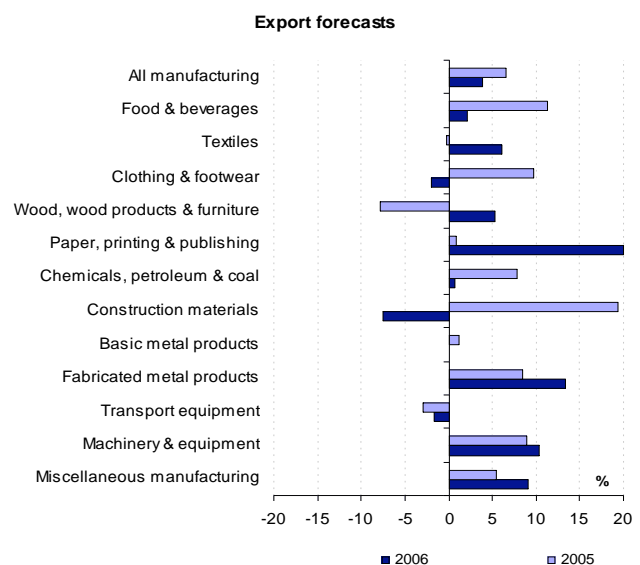
- The improvement in manufactured exports in 2004/5, with ABS data showing growth of 8.5%, is forecast to weaken in 2006.
- Exports are forecast to grow by 3.9% in 2006, down on last year's forecast increase of 6.5%.
- The 2006 forecast was derived when the Australian dollar was around 74 cents to the US dollar. Consequently, a higher dollar throughout 2006 would see this forecast weaken, while a lower dollar would contribute to a higher forecast.



Export growth forecast weakens ...

Exports by sector

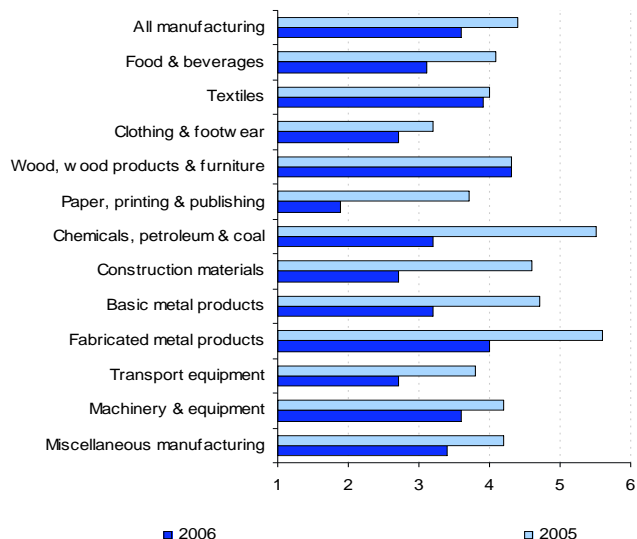
- Eight sectors (compared to nine last year) are forecasting an increase in exports.
- In terms of sectors with high export intensity, significant improvements are expected in machinery & equipment and fabricated metal product exports, forecast to rise by 10.4% and 13.4% respectively. As well, more moderate gains are expected in the food & beverages (2.1%) and textiles (6.1%) sectors.
- Exports are forecast to fall in the transport equipment sector. While car and engine exports are likely to continue to rise in 2006, the results reflect lower forecast exports for automotive components, which have witnessed significant drops in exports in recent years.



Exports export to lift in eight sectors ...

Selling prices

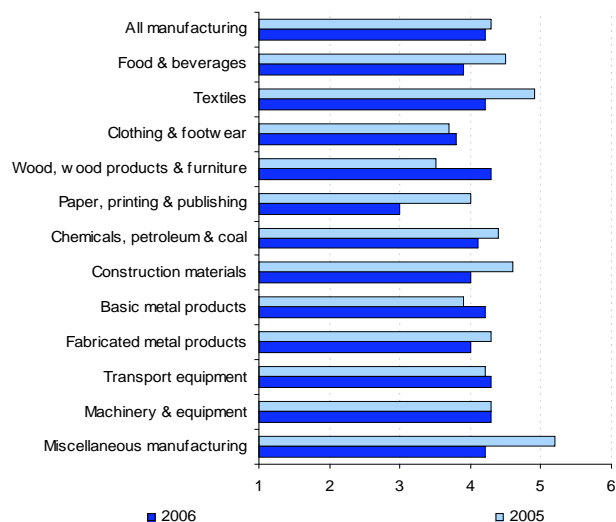
- Manufacturers expect selling prices to rise by 3.6% on average in 2006, a decrease from the 4.4% rise predicted in the previous year.
- In large part, this appears to reflect that many firms expect metal price increases to moderate over the year.
- The strongest price rises are forecast for the wood, wood products & furniture (4.3%); fabricated metal products (4.0%); and textiles (3.9%) sectors.
- Forecast rises are weakest in the paper, printing & publishing sector, with an anticipated rise of 1.9%. Other sectors expecting selling prices rises of less than 3% in 2006 include transport equipment and clothing & footwear (both 2.7%).



Selling price forecast moderates to 3.6% ...

Average wages

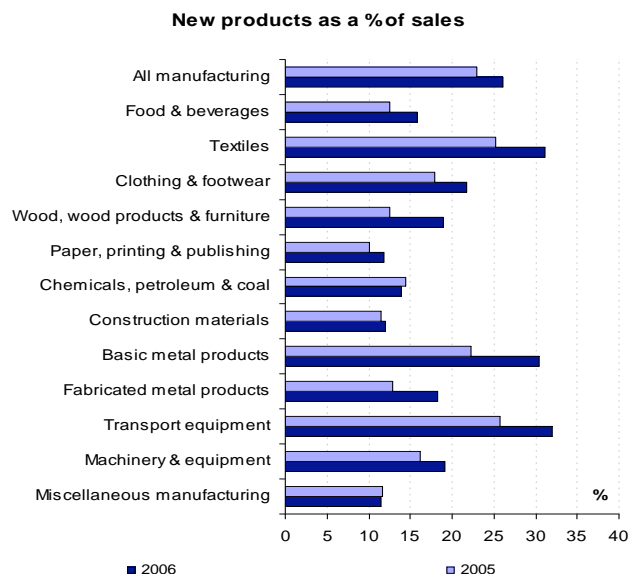
- The outlook for average wage growth in 2006 fell marginally from 4.3% in 2005 to 4.2%.
- Average wage growth is forecast to be strongest at 4.3% in the machinery & equipment; transport equipment; and wood, wood products & furniture sectors.
- The paper, printing & publishing sector forecasts the weakest growth in average wages in 2006, with a growth rate of 3%. A further two sectors forecast growth of less than 4%, including clothing & footwear and food & beverages sectors, with rates of 3.8% and 3.9% respectively.



Wages growth forecast to rise by 4.2% ...

New product intensity

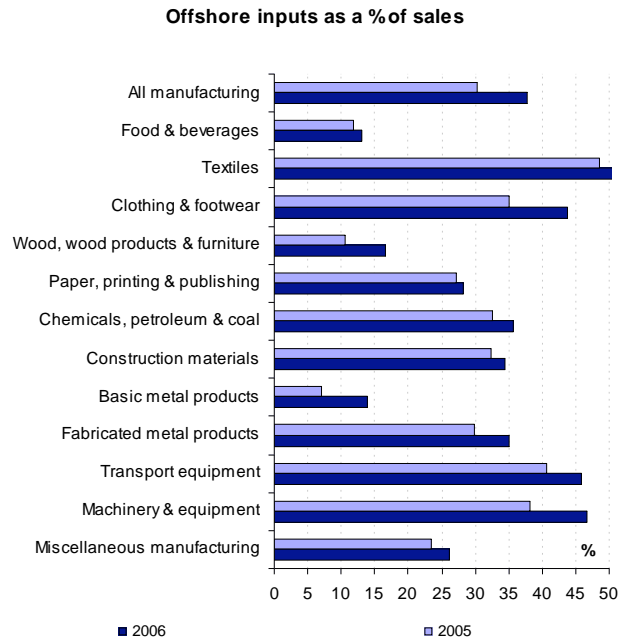
- New product intensity (the percentage of sales derived from new products introduced in the last three years) is expected to rise from 23.0% in 2005 to 26.1% in 2006.
- Eleven sectors anticipate raising their new product intensity in 2006.
- Significant increases in intensity are expected in three sectors – transport equipment; basic metal products; and textiles – all with intensity of over 30%. These sectors also make significant investments in research and development.
- Moderate gains (with intensity levels between 15% and 25%) are also expected in the food & beverages; clothing & footwear; fabricated metal products; and machinery & equipment sectors.



New product intensity to lift in nearly all sectors ...

Offshore intensity

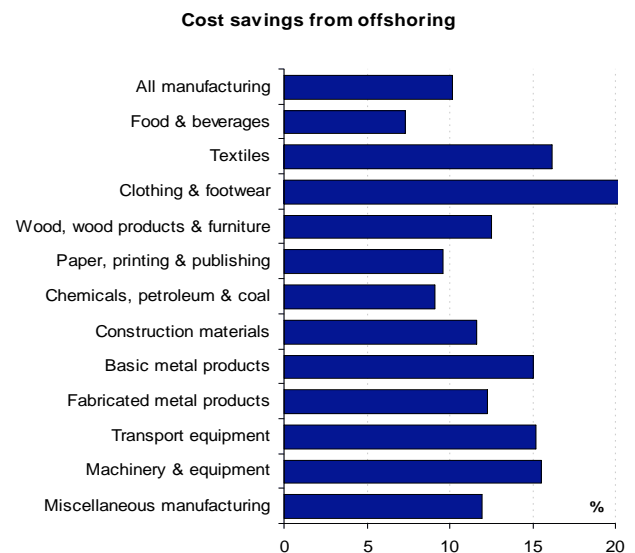
- The other major trend set to accelerate in 2006 is offshoring. This takes two forms: companies moving part or whole of their operations overseas; and/or using a greater share of imported materials/components in domestic production. Both are seen as a major means of achieving cost reductions.
- The level of offshore intensity (offshore activity as a percentage of sales) is forecast to rise from 30.2% in 2005 to 37.8% in 2006.
- Sectors with high levels of offshoring (over 40%) include textiles; transport equipment; and machinery & equipment.
- In contrast, sectors with low levels of offshoring (below 20%) include food & beverages; wood, wood products & furniture; and basic metal products.
- This trend is likely to see manufacturers move to accelerate the development of global supply chains.



Offshoring set to accelerate ...

Savings from offshore activity

- Manufacturers estimate offshoring will generate cost savings in the order 10.2% in 2006.
- Highest cost savings (15% or more) are expected in the textiles; clothing & footwear; basic metal products; transport equipment; and machinery and equipment sectors.
- The lowest cost savings were reported in the food & beverages; paper, printing & publishing; and chemical, petroleum & coal products sectors.



Finished stock rises sharply ...

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METROPOLITAN OFFICES						AFFILIATES
<p>SYDNEY 51 Walker Street, North Sydney NSW 2060 PO Box 289 North Sydney NSW 2059 Tel: 02 9466 5566 Fax: 02 9466 5599</p>	<p>MELBOURNE 20 Queens Road Melbourne VIC 3004 PO Box 7622 Melbourne VIC 8004 Tel: 03 9867 0111 Fax: 03 9867 0199</p>	<p>BRISBANE 202 Boundary Street Spring Hill QLD 4004 PO Box 128 Spring Hill QLD 4004 Tel: 07 3244 1777 Fax: 07 3244 1799</p>	<p>CANBERRA 44 Sydney Avenue Forrest ACT 2603 PO Box 4986 Kingston ACT 2604 Tel: 02 6233 0700 Fax: 02 6233 0799</p>	<p>ADELAIDE Engineering Employers Association South Australia 136 Greenhill Road Unley SA 5061 Tel: 08 8300 0133 Fax: 08 8300 0134</p>		
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