CapEx decisions in a downturn

A rigorous process for stronger growth
Who will make the respective changes?

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What the past can teach us

Fears of a pending recession may continue for for many months, leading some businesses to react—sometimes in dramatic fashion—to the associated economic uncertainty.

In the latest KPMG CEO survey from August, 91 percent of 400 U.S. respondents said they expect a recession in the next 12 months. But the U.S. Bureau of Economic Analysis recently reported volatile real GDP growth numbers over the past three quarters, with two quarters of contraction followed by a 3.2 percent pickup in the third quarter,[1] while the Federal Reserve Bank of Atlanta's GDPNow tool forecasts another quarter with more than 3 percent real GDP growth.[2]

Clearly no one knows for certain whether the economy will nosedive or normalize, but troubling memories from the recent recessions won't dissipate overnight. Back in 2007–2009, many executives cut capital expenditures (CapEx) in order to focus on research and development.[3] However, this current downturn—and its high-interest-rate environment—may make a pending recession unlike previous ones because supply constraints on both labor and material remain top concerns for companies across the U.S. and globally.

Some companies will outperform, using the downturn to invest in technology and physical assets that are aligned to their growth strategy. Others will shed business units or assets that are no longer productive. In this paper, we examine how such companies—particularly capital-intensive businesses—should manage their CapEx. We will explore ways you can continue to deliver the right projects for your business, and how to execute in an uncertain environment. Along the way, we will also share advice from KPMG professionals across industries about what to do now.

[1] Gross Domestic Product, U.S. Bureau of Economic Analysis

[2] GDPNow, Federal Reserve Bank of Atlanta

[3] Ioannis Ioannou and Caroline Flammer, "Save or Invest? How Companies Should Navigate Recessions," Harvard Business Review, May 31, 2019

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What to prepare for

As the U.S. Federal Reserve (the Fed) has raised interest rates throughout 2022, respondents to KPMG surveys[4,5] have clearly indicated a desire to reduce capital expenditures as a way to fortify balance sheets and improve their ability to service and refinance existing debt.

This is an appropriate response in a rising-rate environment, and is likely one of the Fed's key goals in its fight against inflation—decreasing corporate and household fixed investment will slow the economy, and should help lower demand-pull inflation.

Regardless of the interest rate or economic environment, executives are charged with preserving their profit margins and directing their investments toward future profits and growth. To accomplish these goals, executives must align and prioritize their remaining CapEx toward their objectives and outcomes, rather than make across-the-board CapEx cuts.

According to these recent surveys, many executive teams are looking to shift their strategies, including 58 percent of leaders who revised their product lineups to include lower-cost products. Other leaders seek to mitigate future supply chain uncertainty by "nearshoring" production, either to the U.S. or simply by diversifying production locations that are less reliant on China.

While executives consider CapEx reductions and reprioritizing projects and initiatives, business units and delivery teams simultaneously grapple with continued supply chain uncertainty and an inflationary environment that challenges them to deliver the remaining projects with less buying power. A key, near-term driver for successful management teams is to control these risks while executing their growth strategy.

The Biden Administration has responded to some of these challenges with a suite of legislation, including the Infrastructure Investment and Jobs Act (IIJA), the Inflation Reduction Act (IRA), and the CHIPS and Science Act (CHIPS). Combined, this package of legislation can provide significant opportunities for grants or loans to select manufacturers (solar panels, minerals processing, batteries, and semiconductors, among others), and boost demand for key infrastructure components (such as steel and cement). Many of the programs under these spending packages are aimed at encouraging "nearshoring" of production, such as limiting electric vehicle tax credits to vehicles with final assembly in North America.

Key questions from our clients:

1. How do we best scale down our capital spend?

   Which projects are highest priority, and will support us in the recovery?

2. How can we retain cost control with supply chain uncertainty and an inflationary environment?

3. What are our opportunities for government funding (CHIPS, IRA, IIJA)?

4. How can we accomplish our ESG goals with limited CapEx budgets? Is it possible to decarbonize during a downturn?

[4] Riding the wave

[5] How to make the most of a downturn: Industrial Manufacturing

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What KPMG thinks about these issues

1 How do we best scale down our capital spend? Which projects are highest priority, and will support us in the recovery?

We wrote about how executives can create a resilient, high-value capital projects portfolio to prioritize CapEx and align it to their growth plans back in 2021. This same framework can be used right now to rationalize and cut CapEx if your business is changing its capital structure to pay down debt or is required to fund more capital spending from existing cash flows.

We expect many executives to cut capital budgets in the coming year—CapEx reductions can help shore up balance sheets and improve cash flow metrics. When making such a decision, you must reprioritize remaining CapEx and deploy capital to your growth strategy and scenarios.

A key lesson of the recovery from the global financial crisis was that executives who planned for the recovery were rewarded. They moved projects beyond the aspirational phase and into planning and permitting stages—allowing for stronger growth in the recovery.

A downturn is the perfect time to shore up your CapEx program—designing a resilient CapEx plan that can not only weather the downturn, but also take advantage of it.

To help ensure that capital is deployed efficiently, teams should use a rigorous process to weed out "pet" projects and those that are not aligned to key objectives. To prioritize capital projects, your capital allocation process should include the steps listed below:

Your capital allocation prioritization process

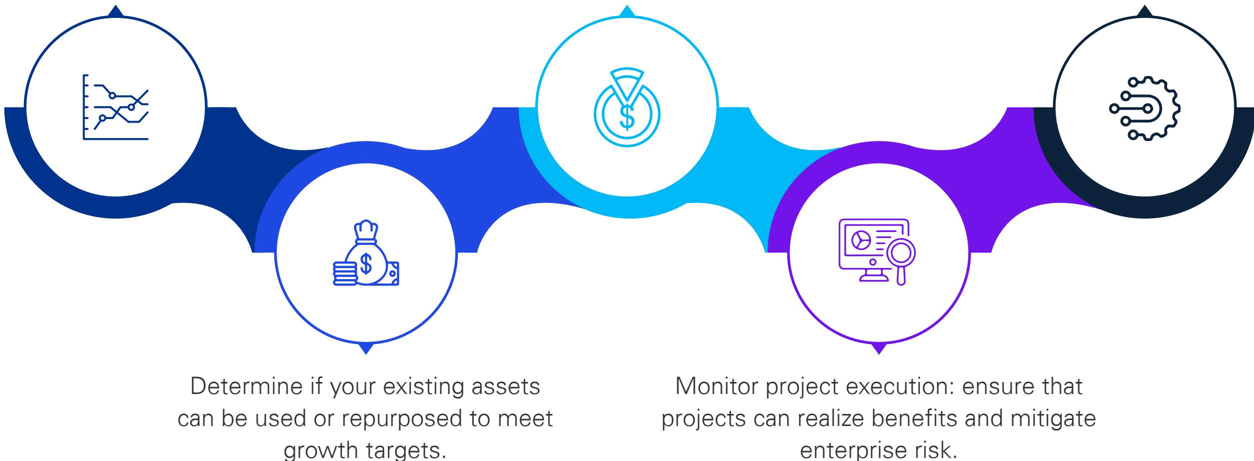
Understand your desired growth outcomes and define the metrics you will use to achieve your goals.

Determine if your existing assets can be used or repurposed to meet growth targets.

Prioritize CapEx to support maintenance and continued operations in core businesses, and new capital projects in growth areas.

Monitor project execution: ensure that projects can realize benefits and mitigate enterprise risk.

Leverage technology solutions to provide insights between portfolio management and project execution teams.



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2 How can we retain cost control with supply chain uncertainty and an inflationary environment?

Post-pandemic supply chain disruptions and labor shortages continue to complicate the ability of delivery teams to realize benefits from their capital projects. Job openings in the construction sector were just as high in November 2022 as they were in November 2021,[6] indicating continued pressure for contractors to have enough labor to deliver projects on-time, and continuing upward pressure on wages.

Executives and business unit leaders will need a multipronged approach to mitigate delays and cost impacts from supply chain disruptions, as well as cost impacts from an inflationary environment. Key strategies for management teams to mitigate post-pandemic supply chain disruption and cost escalation include modifying contractual provisions, such as changing reimbursement mechanisms for supply chain delays, and rebalancing commodity price risks between owners and contractors.

Other changes include advancing design maturity further prior to tender, and giving contractors greater visibility of equipment and building supply chains prior to construction. However, this may slow down traditional fast-track processes in engineering-procure-construct or design-build models.

Major changes to delivery strategies and new construction technologies, such as increases in modular construction, integrated resource planning and equipment sourcing, or increased adoption of enhanced Building Information Model (BIM) and digital twins, can transform how organizations deliver projects. If these are strategies that your organization has chosen to pursue, executives should review their internal operating models and realign their organization to be purpose-built for the chosen delivery strategy.

3 What are our opportunities for government funding (CHIPS, IRA, IIJA)?

The recent federal funding through IIJA, IRA, and CHIPS provides an unprecedented level of funding to support CapEx programs, across both state and local government, as well as other sectors that will directly impact the economy. The IIJA provides discretionary and competitive grant opportunities to support rebuilding U.S. transportation, energy, water, and telecommunication networks. With an additional $550 billion over baseline levels in funding available, IIJA will test supply chain capability necessitating transparency in planning.

The CHIPS Act provides semiconductor manufacturers opportunities to fast track investments in manufacturing capabilities through tax credits, loans, and grants to build, expand, and modernize semiconductor manufacturing in the U.S. The IRA provides credits, loans, and grants to advance the decarbonization agenda across the U.S. and provides both government and corporate clients with an opportunity to accelerate their asset strategies and advance their CapEx programs.

Nationwide investments in infrastructure—including electric grid improvements, broadband, ports, and airport facilities—will influence site selection and expansion considerations for many businesses in the decades ahead. New investments by federal, state, and local governments will continue to change the investment calculus for executives looking to expand onshore, or reshore production.KPMG teams have successfully supported site selection and facility development growth for many manufacturers over the past year.

Investments under IIJA, IRA and CHIPS will continue to influence CapEx targets indirectly over the coming years. The funding creates an opportunity for capital programs to make the most of the downtown by investing in the asset capabilities to support recovery.

[6] Table A. "Job openings, hires, and total separations by industry, seasonally adjusted – 2022 M11 Results," bls.gov

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4 How can we accomplish our ESG goals with limited CapEx budgets? Is it possible to decarbonize during a downturn?

The U.S. Security and Exchange Commission's (SEC) March 2022 climate disclosure proposal was lauded by many as a landmark decision. It underscored the consensus that climate change presents significant financial impact, both risk and opportunities, much of which is not currently priced into the plans and valuations of companies. Moreover, the proposal was also viewed as a catalyst to accelerate the estimated annual $90 trillion in capital spending that is needed globally by many estimates to reach net-zero emissions targets by 2050.[7]

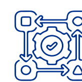
Following the SEC's decision, decarbonization was elevated on the agendas of every boardroom. In our 2022 CEO Outlook, 69 percent of CEOs saw increased demand for reporting and transparency, with 72 percent saying that stakeholder scrutiny on ESG issues will accelerate in the future.[8]

In the months following, however, the effects of the economic outlook, inflation, and the interest rate environment combined to dampen climate change investments. Recently, the IRA has put climate back on the top of many CEOs' agendas, but even before the enactment of the IRA, our experience supporting decarbonization efforts indicated that most companies were seeing positive financial returns from their climate actions. The IRA, with its array of tax incentives, improves on those economics, fundamentally recasting the envelope of climate investments that can generate positive returns.

Implications for executives

Mine the IRA-enabled "pay for" opportunities

Revisit the business cases for your climate change investments—many will prove to be "ROI resilient"



Prioritize those climate change investments targeted not simply at incrementally improving your current operations but also focused on evolving your business model for a net-zero world in which customers and investors reward leading businesses

[7] IPCC, "Climate Change 2021: The Physical Science Basis," Cambridge University Press

[8] CEO Outlook | ESG and diversity trends - KPMG Global (home.kpmg)

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How to implement these changes

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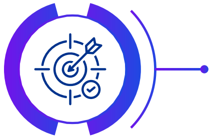
What to do now



Review how your current assets and asset ownership/use structures achieve your go-forward objectives

Many of your key assets can be utilized to meet your go-forward capacity strategies. However, some of these assets and associated capacity may not be necessary in product lines that may be discontinued—these could be repurposed to better support the core business. Teams should also evaluate ownership models (buy/lease/build) of existing and new assets.

Increase hurdle rates for projects that reflect a higher cost of capital, and adjust capital spending budgets to a changing capital structure

Many previously planned projects may no longer make sense in a rising interest rate environment with an increased cost of capital. Teams should move to defer or cut projects that no longer deliver appropriate financial returns.

Relentlessly prioritize CapEx and direct spending toward your growth scenarios in core products and growing business units

Understand your strategic objectives and key drivers for success to reach your organization's goals. Each of your capital investments over the near term should clearly support a key objective. Focus CapEx on core products and growing business units, and avoid across-the-board cuts. Many strategies that organizations want to pursue—introducing lower-priced products or reshoring production—will require increasing CapEx or new fixed investment.

These initial steps will establish how your CapEx and asset footprint will change to achieve your strategy. Now that you've made these plans, your organization will need to adjust—rightsizing the number of assets you own, your organizational size, and how your team manages the changing environment—to execute on that strategy.

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What to do next

1

Consider asset divestiture or other restructuring

If assets remain unneeded by your organization in long-term planning, then consider raising cash by selling real assets. This additional cash can allow teams to deleverage the business, invest in new product areas, and meet other key goals. KPMG analysis[9] shows that business unit sales can contribute to long-term success—the same outcomes of reallocating human resources and redeploying capital could be achieved from specific asset sales.

2

Manage depreciation

Cost segregation and other strategies can help accelerate depreciation costs and improve company EBITDA margins and cash flow metrics.

3

Scale your workforce to a changing capital plan or asset footprint.

Your workforce (in-house and independent contractors) will need to be properly adjusted and scaled to a changing capital plan or asset footprint to meet production or cost reduction targets.

4

Review existing capital projects for potential leakage or cost recovery

It may be possible to recover cost leakages in your existing construction or other capital spending contracts, either as a one-off review or as part of a regular third-party audit program.

5

Consider alliances/partnership structures to reduce risk to your business

Some projects may meet your increased hurdle rates, but still represent a high risk in an uncertain economic environment. Partnership, alliance, or joint venture structures can help distribute costs and risks of economical projects that align to your growth strategy.

6

Pursue applicable government grants or loans in key industries benefitting from recent legislation.

Some industries (semiconductors, electric transmission, etc.) may benefit from recent legislation to support U.S. production of critical industries. Consider applying for tax credits or low-cost loans that may be available under these programs.

[9] Divesting in a downturn as a long-term strategy

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How KPMG can help

The past two years have taught us all to expect the unexpected and to be agile in adapting strategy to changing conditions, as well as plan for the next disruptive event. We look forward to helping you succeed in what promises to be a very challenging environment.

KPMG professionals have deep experience supporting clients to get the most out of their capital plans and grow their businesses. Key areas of support we can offer our clients in a downturn include:

Business cases, economic analysis, and funding models of major projects

Provide an outside economic analysis on the capital projects proposed by business units in the coming years, as well as funding models your organization can pursue.

Capital planning and prioritization

Assist business units and capital planning teams to propose the highest-value projects for funding in your future capital budgets.

Asset strategy review

Support your teams to review how your organization utilizes its existing assets, and identifies assets that could be retooled to support future objectives or assets that may no longer support your strategy.

Cost segregation

KPMG tax professionals can help you conduct cost segregation studies on your existing capital investments. This should enable management teams to accelerate depreciation expenses, with the goal of lowering current tax bills and improving EBITDA and other profitability metrics.

Project cost audit

KPMG professionals have experience across different project delivery models (design-build, design-bid-build, integrated project delivery) that can enable owners to monitor cost leakage and recover unallowable costs.

Sell-side diligence and asset valuation

KPMG teams can support valuation studies of your existing assets in preparation for a potential sale.

Workforce optimization

Our teams have extensive experience developing operating models to support your changing CapEx targets or operating footprint.

Capital program benchmarking and delivery optimization

Perform a targeted capital program review and benchmarking assessment focused on reducing cost and increasing program productivity and performance.

Project performance analysis, benchmarking, and optimization

Perform a quantitative assessment and benchmarking of major in-flight projects in order to optimize performance and increase likelihood of targeted outcomes.

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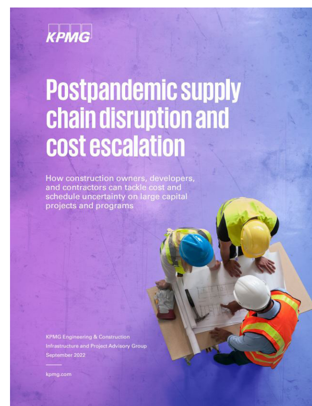

Postpandemic supply chain disruption and cost escalation

Global Construction Survey

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