

Magnetics: Industry Overview *by* **Walt Benecki**

What is That Light at the End of the Tunnel?

The magnetics industry has been greeted with a series of good news recently. Inventories have pretty much been depleted, most order rates are showing improvement, lead times are beginning to increase and the telecommunications industry is showing some signs of life. In addition, the Chinese are showing some weakness as electrical power shortages loom, steel availability and cost remains an issue and raw material prices are generally on a modest uptrend. Many Chinese manufacturers are also desperately attempting to increase their prices to achieve profitability. Plus the prospect of a revaluation of the Yuan remains a possibility!

Many of these recent trends are most certainly good news for western producers; however, much of this good news must be viewed in perspective. Western producers have their own array of issues. Volume requirements continue to be far below historical levels, medical expenses continue to escalate, steel prices have shot up and many larger customers continue to demonstrate a strong preference for Chinese suppliers.

The optimist may certainly view the light at the end of the tunnel as a very favorable sign. Increased volume will make most businesses more profitable and the ability to compete with the Chinese can be considered much more favorably than during the past few years. For many businesses, this upturn in business may well be sufficient to satisfy shareholders or owners. The problem is that future business cycles may occur sooner than most of us expect. The war on terrorism will also continue to be a massive business wildcard.

But the realist may wish to take a closer look at “the light” and think about some of the longer term trends. It is true that the Chinese will continue to experience margin pressures and business issues similar to most industrialized nations. But just as western producers have learned to deal with inflationary cycles, competitive pressures, material shortages and supply chain issues, the Chinese will find effective ways of operating in a similar environment.

The Chinese are continuing to build infrastructure at a phenomenal pace, increases in electric power capacity are being addressed and the banking system is beginning to tightening up credit policies to weed out the mismanaged enterprises. It is likely that we are about to see a period of business closures and consolidation in the Chinese magnetics industry that will result in fewer, but better managed and more profitable businesses.

There are three major factors that one must consider to determine whether the light at the end of the tunnel is the sun or an oncoming train. First, the cost differential between manufacturing in the United States or Europe versus China remains immense. It would take decades of inflation, combined with massive exchange rate adjustments, to eliminate the cost advantages the Chinese currently enjoy.

Secondly, multinational companies who have rapidly repositioned themselves into China will continue to have a strong preference that their key suppliers are with them in China. If they have a choice, these major customers would gladly select western suppliers manufacturing in China when they are available. This simply means that western magnetics suppliers with China capability will enjoy a massive commercial advantage moving forward. This, in itself, is not a panacea because the large buyers will continue to demand very low prices from all suppliers.

Lastly, the Chinese will become far more sophisticated in doing business and selling their products in the West. To this point, many Chinese companies have been clumsy and relatively inept in their attempts to sell their products beyond their borders. It would be foolhardy to assume that they will not improve their ability to market their products to the West. They will most certainly do so.

In summary, western magnetics producers must candidly assess the true nature of the light emerging at the end of today's business tunnel. Those who choose to continue to "hunker down" and rely on an incoming tide to carry them to the profitable Promised Land may be in for a surprise when reality sets in. The Chinese will continue to represent a formidable competitive force in the worldwide marketplace and they will be a major economic power for decades to come.

On the other hand, those western companies who have positioned themselves with Chinese capability, by either strategic sourcing or China manufacturing, may well be in for the warmth of the sunlight as they emerge from the tunnel.

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