Manufacturing and Distribution Outlook

Findings of a National Survey of the Manufacturing and Distribution Industries

2013 and Beyond

CliftonLarsonAllen

CLAconnect.com/manufacturing

Introduction

One word describes U.S. manufacturing and distribution over the past decade: *resilient.*

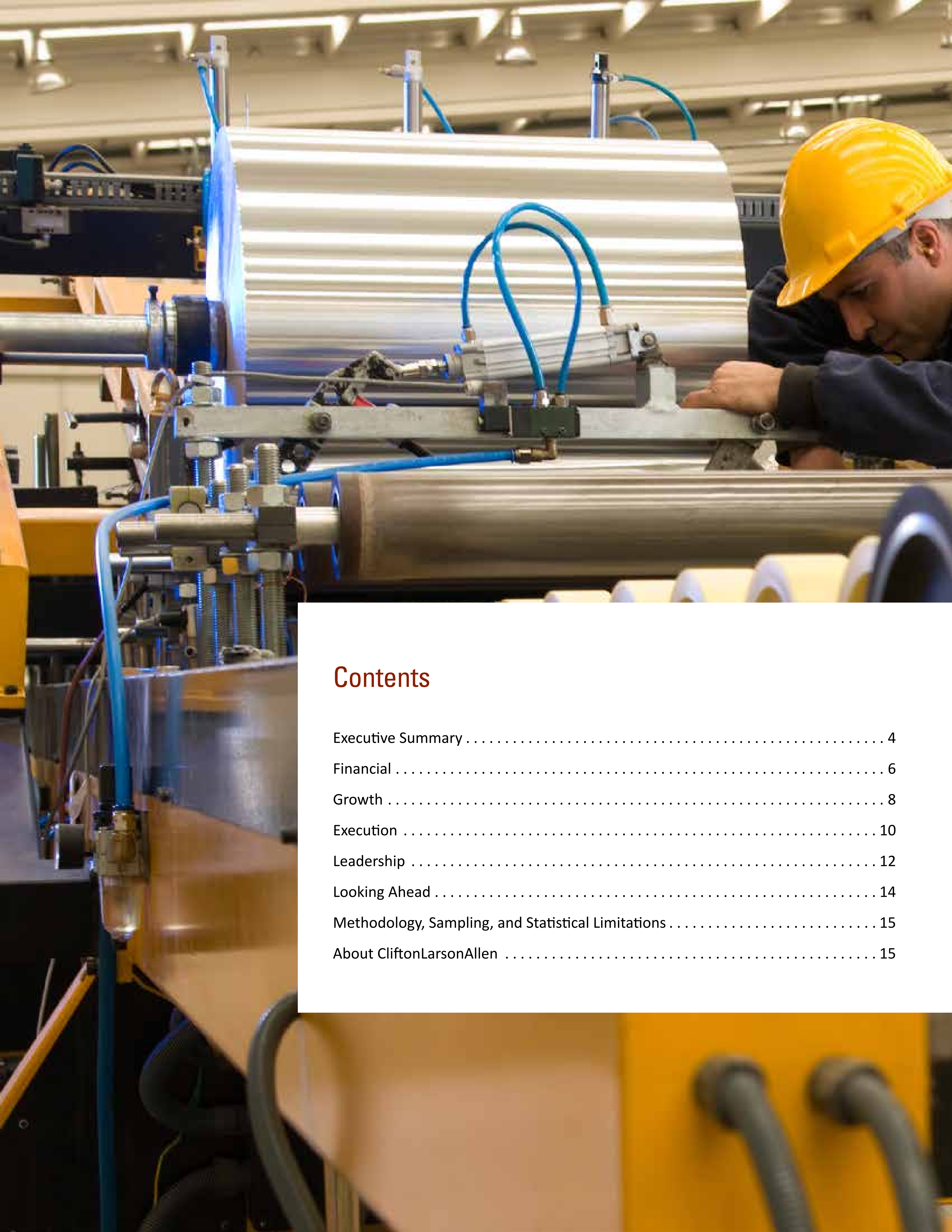
The innovation and resiliency in the face of adversity demonstrated by the owners and leaders of manufacturing and distribution companies is truly inspiring. While the most recent recession recast the competitive landscape for many industries, manufacturing has been meeting the challenge for well over a decade and continues to move forward.

This year's *Manufacturing and Distribution Outlook* reflects an attitude and mindset in manufacturing and distribution that focuses on capturing opportunities instead of dwelling on challenges that are beyond the control of owners and industry leaders.

The third annual survey results are a composite of opinions from hundreds of manufacturers and distributors across the country; from New York to California, and from Minnesota to Florida; from less-than-10-employee shops to mid-sized public companies; from metal fabricators and printers, to food processors, contractor manufacturers, and original equipment manufacturers (OEMs).

While you can glean your own insights from the information presented here, we believe the survey findings indicate that the industry has moved beyond the Great Recession and is now focused on competing in the global market. Uncertainty has become an accepted reality. Those who took the survey conveyed that while pricing of their products will always be a factor, an intimate knowledge of your customers and adaptability are critical to long-term survival.

We hope you find this information helpful as you evaluate your own opportunities and chart the future course for your organization.



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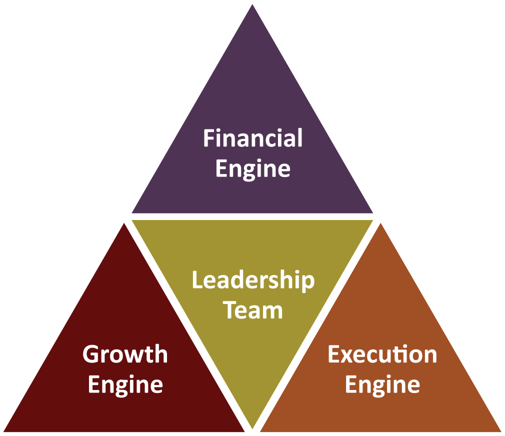


World class manufacturing and distribution is the ultimate display of teamwork. Few industries require the orchestration of so many dependent events in order to achieve success. Consistently high-performing companies understand there is no fast track to success. Instead, it is born from a collective commitment to a common goal combined with a personal commitment to the role each person plays in achieving success.

To illustrate this interdependency and teamwork, we have developed a simple visual model we call *The Value Triangle*, which illustrates the competencies (and balance) required to achieve long-term success. Healthy and sustainable manufacturing and distribution organizations excel in four key dimensions:

- Financial
- Growth
- Execution
- Leadership

Excellence in any of these areas can create bursts of short-term success. However, consistent attention to all four creates high-performance organizations that can compete in the global marketplace.

We have summarized the feedback received from manufacturing and distribution leaders and included key observations related to each of the four dimensions.

Financial:

Sustaining the financial health of a manufacturer requires consistent profitability and cash flow combined with managing the owner's concentration of wealth in the business.

The majority of this year's survey respondents report that they are at or above pre-recession levels in both revenue and profitability. While we often focus on profitability when discussing financial performance, companies in this industry are constantly challenged to turn profitability into much-needed cash flow. Even businesses that were profitable but had limited cash flow were vulnerable when the recession hit and access to capital became more restrictive. The issue of managing cash flow and working capital continues to be a challenge for the sector as a whole.

The vast majority of companies completing the survey are privately held, with fewer than five owners. For many of these owners, their business interest represents the majority of their personal net worth. Just as we are counseled to diversify our assets within a retirement plan, it is critical for privately held business owners to manage the concentration of wealth they have in their business. Diversification helps to ensure the owner will have adequate personal resources to weather a prolonged business downturn. Consistent profitability and cash flow within the business are necessary to achieve this goal.

Growth:

Sustainable growth requires a distinct value proposition and active management of revenue concentrations.

Every manufacturer has revenue concentrations with customers, industry sectors, manufacturing and distribution capabilities, or geographic regions. How companies identify and manage these concentrations becomes critical for long-term financial health and sustainability. Respondents clearly indicated that revenue concentrations are a risk that must be mitigated. They also said that concentrations often continue even as the geographic reach of a company becomes global.

While price will always be a focus of conversation with customers, respondents clearly understand that they must have a unique value proposition that is aligned with their customers' needs if they are going to continue to be relevant in the supply chains they serve. Differentiators included superior engineering or design skills, combined with exceptional quality and delivery performance.

While price will always be a focus of conversation with customers, respondents clearly understand they must have a unique value proposition that is aligned with their customers' needs.

Execution:

Flexible, responsive operations, aligned business process and systems, and well-maintained assets are the foundation for converting strategy into action.

Manufacturers and distributors told us they are focused on continuous improvement and creating the flexibility to grow in a price-competitive and quick-response marketplace. How they have achieved this is as varied as the respondents themselves, but the economic challenges of the past few years do not seem to have dampened the desire to continue investing in operational excellence. Interestingly, the investments are balanced among people, capital equipment, and business systems such as new software.

Leadership:

Effective leadership includes a clear vision, well-aligned teams, and the ability to develop the workforce and future leaders.

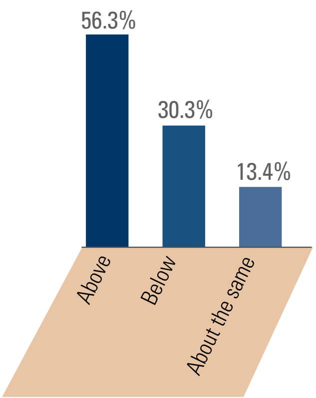
Not surprisingly, the percentage of respondents expecting an ownership change over the next decade (64.3 percent) had a high correlation to the percentage that expected a major leadership change during that same period (62.2 percent). In the end, the ability to attract and build leadership will be critical to business succession and workforce development challenges.

Financial

Conventional wisdom tells us that financial performance depends on a balance of management practices and marketplace dynamics. But in manufacturing and distribution, best-in-class performers see management practices as the driving force to profitability. Average to below average performers tend to credit or blame changes in the marketplace as the most significant force impacting profits. History has shown us that profitability and financial performance are mostly choices made by leadership and management to protect the health and sustainability of the organization.

Profitability and consistent cash flow fuel the investments needed to sustain long-term growth. On the flip side, a consistent lack of profitability or weak cash flow significantly increases business risk and makes an organization vulnerable in periods of volatility.

Profitability Compared to Pre-Recession Levels



While many parts of our economy are nowhere near pre-recession levels of performance, approximately 70 percent of respondents indicated they are at or above pre-recession levels of profitability. While revenue recoveries in many sectors have been well documented, the fact that U.S. manufacturers and distributors have navigated the turbulence of the past four years and returned to 2007 profitability levels is both significant and encouraging. There can be no growth without profitability, and respondents have clearly made a decision to preserve capital and protect their growth opportunities.

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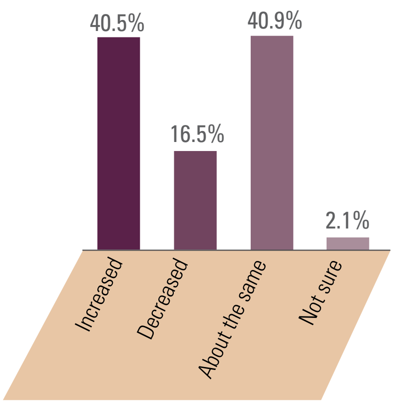
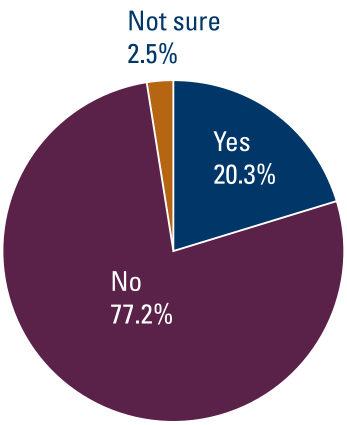
Average Age of Accounts Over the Past Two Years



In most manufacturing supply chains, customer challenges inevitably trickle down to the supplier. Cash flow challenges at the largest OEMs have translated into extended payment terms for many suppliers. This trend has been going on for some time but it is encouraging to see some stability in the aging of accounts receivable.

Has the Availability of Capital Over the Past Two Years Impaired Growth?



Respondents indicated that working capital requirements (including inventory) and availability of credit have not been deterrents to growth over the past two years.

In Your Own Words

"We switched banks to increase our line of credit so we could afford to grow our sales."

"We refused to participate in the recession."

"We revise and adjust budgets quarterly and operate to a budget."

"We are working hard to improve margins through material cost reductions, efficiency gains in labor through lean and other methods, pricing adjustments related to volume and life-cycle needs. We also bring engineering in to design changes for cost savings."

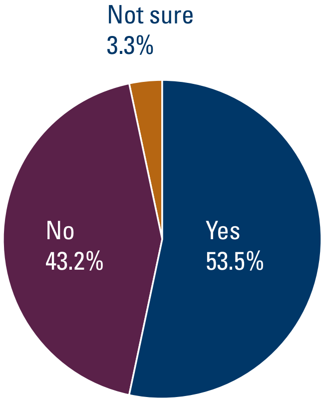
Overall, respondents indicated that working capital requirements (including inventory) and availability of credit have not been deterrents to growth over the past two years. Also, a number of respondents said they are exploring capital equipment or other fixed investments as a means of accommodating growth. This trend is consistent with prior year responses, and confirms that capital is available for well-managed organizations, even in a stringent lending environment.

We indicated in our introduction that uncertainty has become an accepted reality in manufacturing and distribution, but that uncertainty continues to weigh on the minds of owners and leaders of manufacturing and distribution firms. It can take many forms, including areas like health care reform. While conventional wisdom would suggest that this would dampen the appetite for investment, respondents say they are continuing to invest in capital equipment. Capital equipment purchase can also be used to mitigate a skilled workforce shortage by substituting technology for people to get the same work done.

Growth

Growth and profitability are at pre-recession levels for the majority of this year's survey respondents. This is welcome news and confirms that growth opportunities do exist, especially for strong performers at the entrepreneurial end of the supply chain. Survey respondents told us what they see as the source of this growth, where they see future growth, and what it takes to compete.

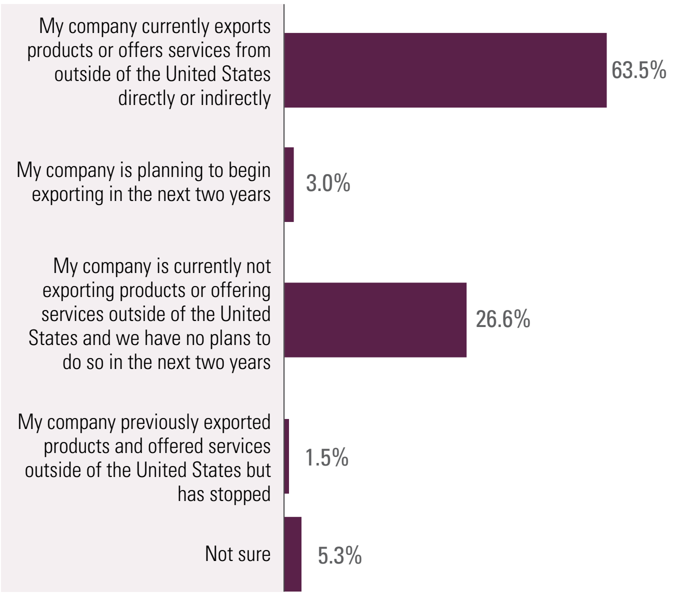
Does One Industry Sector Account for More Than 50 Percent of Revenues?



Revenue concentrations exist in every manufacturing and distribution enterprise. How effectively those concentrations are managed and mitigated can be critical to survival during periods of volatility. While the economic downturn was traumatic, it also forced many companies that were captive to a single industry or customer to look for other growth prospects.

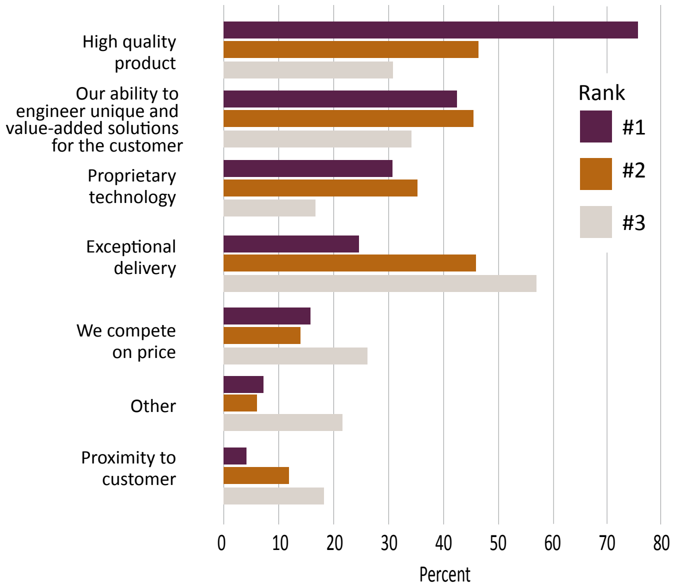
Although respondents have managed customer concentrations relatively effectively, more than half still have an industry concentration that comprises more than 50 percent of their revenue base. They have also indicated they have excess capacity with their current cost structure. For most, a 10 percent change in pricing could result in significant additional revenue volume. The combination of these factors presents a compelling opportunity for an agile, well-capitalized manufacturer to diversify into other industries that leverage their core competencies.

Export Practices

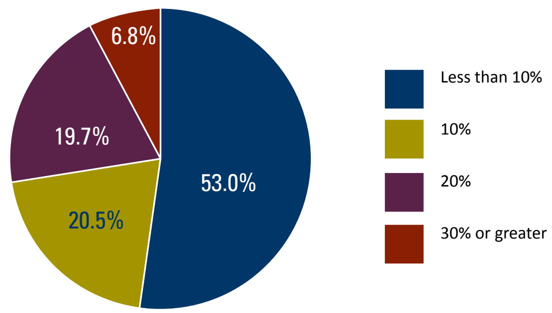


Exports have represented half of overall U.S. economic growth since the end of the Great Recession, so we asked manufacturing and distribution leaders about their export strategies. More than 63 percent said they are currently exporting, either directly to overseas customers, or indirectly through other domestic manufacturers. Approximately 27 percent of respondents said they have not exported products and do not plan to start in the next two years. This can be a strategic decision, or a reflection of an industry where proximity to the customer is critical (e.g., a dairy farm).

How Do You Differentiate Yourself From Foreign Competition?

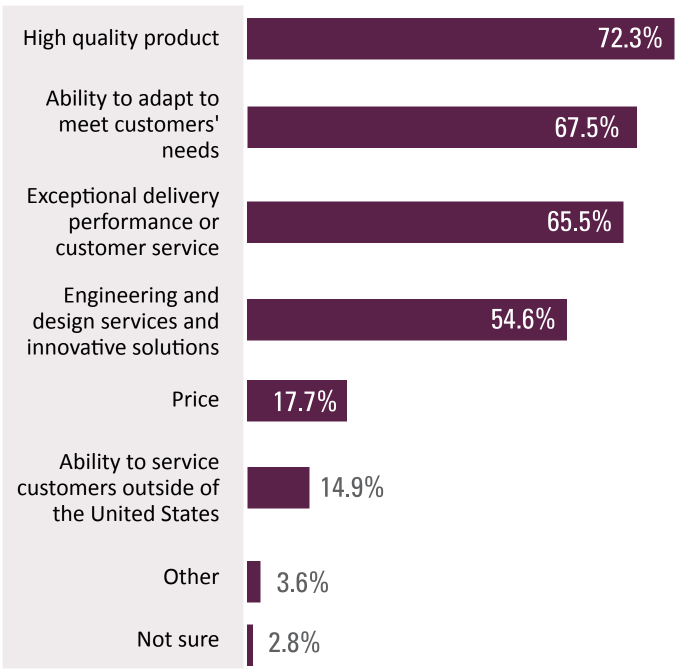


Minimum Pricing Reduction That Would Result in Significant Additional Revenue



Almost 75 percent of respondents indicated that a price reduction of 10 percent or less could result in significantly more volume. Given the excess capacity that most respondents report, this is a significant opportunity to further grow a diverse revenue base. Due to the high fixed cost structure of most manufacturers and distributors, a 10 percent reduction in pricing would likely still generate more marginal profitability than the existing revenue base.

How Do You Differentiate Yourself From Domestic Competition?



While much is made of the challenges of global competition, respondents do not see a meaningful difference between what it takes to compete domestically or abroad. High quality products, flexibility to meet customer needs, and customer service continue to be the attributes most mentioned by respondents as their keys to success.

In Your Own Words

"We sought new markets during the downturn and now those markets are generating sales."

"We have a rule that we do not allow any one customer to exceed 30 percent of our total revenue. We actively market to other markets and industries when current customers in one industry are growing."

"We invested in sales and distribution channels in key markets, exhibited at international trade shows, and invested in after-sale service resources to support the product."

"Higher contact and involvement with our customers has led to additional services performed."

Execution

Executing against growth plans is a challenge in today's dynamic supply chains. Product life cycles are shrinking, and the calling card of U.S. manufacturers and distributors over the past decade has been new product or process development, or adapting current products or processes to changing market expectations. Flexible and scalable operations, systems, and processes, and a well-maintained asset base, are common characteristics of companies that handle this challenge effectively.

The best manufacturing and distribution companies have a strong ability to execute that manifests itself throughout the organization. Execution is not just the ability to produce a quality product on time. It includes the ability to implement strategic plans, to flex and scale operations (up and down), and to continually drive improvements. Companies that are strong in execution have a robust operating system that makes daily performance and continuous improvement the norm and not a fire drill. Organizations with strong execution also maintain company assets, building a strong foundation for the future.

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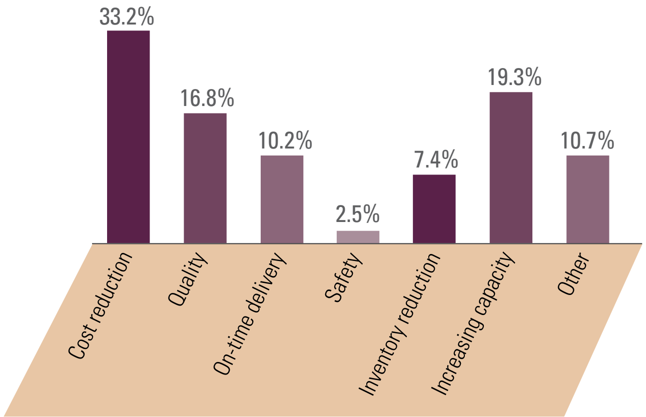
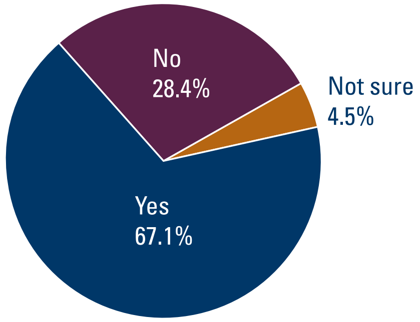
Primary Goal of Improvement Programs Over Next 12 Months



The survey showed that continuous improvement is alive and well in manufacturing and distribution, and for most companies, it is a way of life. Sixty percent of the respondents indicated that their continuous improvement efforts primarily target market pressures like costs, quality, and on-time delivery. These are the improvements required to remain competitive and profitable. Nineteen percent of respondents said their improvements aim to increase capacity, which is an encouraging sign that some are reaching capacity or entering new markets. Interestingly, only 7 percent of respondents are targeting inventory reduction. Inventory exists as a buffer against challenges in the supply chain, so driving down inventory almost always exposes waste and opportunities for improvement.

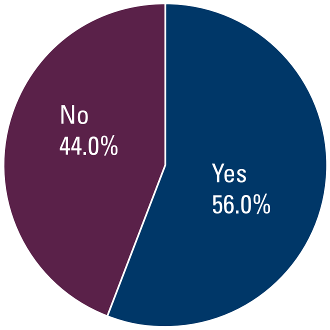
A number of respondents stated that they were investing in equipment and systems. While there are risks associated with these investments, it indicates that many companies have confidence in the future.

Do You Have Excess Capacity?



It is encouraging to see that roughly 70 percent of companies are at or above pre-recession profit levels, but almost as many respondents (67 percent) still feel that they have excess capacity. This represents an opportunity to increase profitability. Most costs in manufacturing and distribution companies are fixed, and the additional volume typically requires only nominal cost additions. Much of the new revenue would fall to the bottom line. Companies with excess capacity should consider strategies to fill the gap, including strategic pricing decisions that target new markets or customers.

Do You Have Any Skilled Workforce Issues?



We expected that a shortage of skilled workers would still be an issue this year, so it's no surprise that more than half of the respondents said they are still experiencing problems. The ability of a manufacturer to remain flexible amid changes in volume or product mix is limited by the shortage of skilled workers. Respondents are showing their resilience by implementing workforce training, lean manufacturing and distribution, and automation.

The shortage of skilled workers has been widely reported in the media, so it's no surprise that it is an issue for more than half of the respondents.

In Your Own Words

"Our management team is held accountable for profitability and customer service."

"Increasing the density and utilization of our warehouse and multiple quality initiatives have improved the effectiveness and efficiency of operations."

"We have a risk management program that ensures we are monitoring all of our risks and mitigating them whenever possible."

"We have improved our planning and monitoring of our backlog to reduce scrap and overhead."

"We are implementing the theory of constraints and continuous improvement processes in our facility."

Leadership

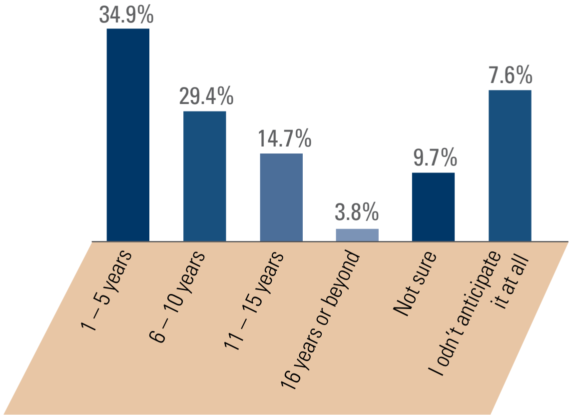
Leaders are responsible for tying the financial, growth, and execution areas into a cohesive, high-functioning team. But leadership teams are not static. They evolve over time as people join and leave. Strong organizations actively manage and plan for the ebb and flow of the leadership team to ensure the long-term health and sustainability of the company.

Many in the Baby Boom generation are reaching an age where they are planning for the next phase of their lives, and small to mid-sized manufacturing and distribution ownership is dominated by Baby Boomers. Accordingly, the Small Business Administration reports that at any point in time, approximately 40 percent of current business owners are contemplating their succession or transition.

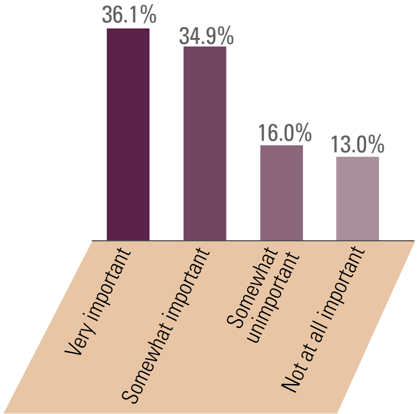
One of the riskiest periods for a small business occurs during leadership or ownership transitions. With the right planning and approach, this can also be a period of revitalization and new ideas. Thirty-five percent of respondents said they are expecting an ownership transition in the next five years. When asked about the importance of a leadership transition in the next five years, 70 percent of respondents said that it is “somewhat important” or “very important.” While the context of any respondents answer can vary, it is clear that a significant transition of manufacturing and distribution firm ownership will occur in the coming decade.

Preparing for a transition that maximizes value for the current owners and ensures sustainability for the new owners takes time. The best organizations start the process years ahead of an expected change.

When Do You Anticipate Some Type of Succession Event?



Importance of Transitioning Leadership in the Next Five Years



In Your Own Words

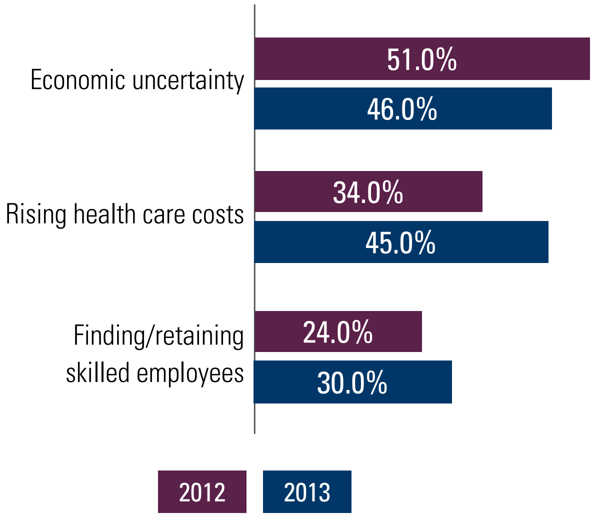
"We participate in a youth apprentice program through local high schools, along with technical college machine tool programs. The development plan for future owners in succession planning has been a top priority for the past two years, with top management participation and support."

"More and better communication from ownership has helped us, as well as paying attention to culture improvements and leadership training."

"Our company invests in machinery, technology, and people — we provide educational opportunities for the current leadership team and training programs for our new and future leaders."

"We have been strategically involved with our community on education, bringing high school and university students into our engineering department and factory. We have invested in record levels (for us) of training across the company. We are very positive about our approach to training."

Looking Ahead



A year ago, manufacturing and distribution leaders told us that economic uncertainty, rising health care costs, and rising production costs were foremost on their minds. Though not as strong as last year, uncertainty remains a top concern in 2013, and will likely become an accepted reality as global economies and governments continue to resolve longer-term structural issues. But unlike in 2012, the challenge of finding and retaining skilled workers has risen. This shift can be seen in both a positive and a negative light: the need for skilled workers coincides with an expansion of manufacturing and distribution activities, while the inability to fill skilled positions could ultimately hold companies back from their full growth potential.

While the challenge of finding skilled workers to service rising demand is front of mind today, the challenge to fill the leadership void left by retiring Baby Boomer business owners is quickly becoming tomorrow's crisis. For smaller companies, this is raising questions about succession. For larger companies, this trend is creating increased uncertainty and sustainability questions with smaller supply chain partners. Many of our survey respondents see this transition of leadership as coinciding with a potential ownership transition as well. While this is a natural reaction, this sort of forced succession often limits the options available to retiring leaders and owners.

Our goal in the organization of this year's survey was to focus on the fundamentals that create options for today's business owners and leaders. A balanced approach to managing the financial, growth, execution, and leadership engines of the business can dramatically improve performance and increase succession options. Indeed, the healthiest manufacturing and distribution operations are embracing all four dimensions of *The Value Triangle*.

Study Methodology, Sampling, and Statistical Limitations

Methodology

Data was collected through a web survey that identified CliftonLarsonAllen as the research sponsor. Outside of an offer of a complimentary copy of the results, no incentives were used to encourage participation. A total of 6,469 email invitations were sent on May 14, 2013. Reminder emails were sent less than one month later.

A total of 358 survey responses were received, with 267 coming back from CliftonLarsonAllen clients and 91 from non-clients. The overall completion rate was 5.5 percent. Responses were received from 27 states.

Sampling

In the third year of the study, the number of non-clients that completed the survey increased (91 in 2013 and 71 in 2012), representing a larger percentage of the total respondents (25 percent versus 19 percent).

Seventy-five percent of the respondents have a privately held/family ownership structure, 27 percent were reported as one owner organizations, and 54 percent reported two to five owners in the organization.

More than half (59 percent) of respondents experienced an increase in company revenues over the past 12 months, while 16 percent experienced a decrease, and 25 percent remained the same.

Consistent with 2012, survey respondents represent a wide variety of manufacturing and distribution industries with no single category making up more than 15 percent of the total responses.

Statistical reliability and limitations

To judge the significance of total responses given for a particular question, the researcher must find the applicable sampling error for the sample size under examination. The sampling error is then added or subtracted from the percentages under examination. If the two percentages overlap, there is no significant difference. However, should the two ranges not overlap, there is a high probability that the selected level of variation is due to real differences and is not due to chance.

It is important to understand that the smaller the sample size, the larger the margin for error. The reader should use caution when examining data from a segment that has a small sample size. Under these circumstances, survey results are less projectable to the population they represent.

About CliftonLarsonAllen

CliftonLarsonAllen's 3,600 people are dedicated to helping businesses, governments, nonprofits, and the individuals who own and lead them. From offices coast to coast, our professionals practice in specific industries to deliver audit, tax, advisory, and consulting capabilities best aligned with our clients' needs. Integrated wealth advisory services address their personal financial goals, and our international resources help organizations successfully enter and compete in all markets, foreign and domestic.

Investment advisory services are offered through CliftonLarsonAllen Wealth Advisors, LLC.

Our professionals are passionate about improving the competitiveness of the U.S. manufacturing and distribution industries by helping the business owners we serve achieve their dreams. We help our clients improve profitability, reduce risk, build business value, and plan for succession. For more information, visit CLAconnect.com/manufacturing.

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