CliftonLarsonAllen

Manufacturing and Distribution Outlook

Findings of a National Survey of the Manufacturing and Distribution Industries

2012 and Beyond

Introduction

Listening is a powerful force in every business relationship. At CliftonLarsonAllen, we are passionate about improving the competitiveness of the U.S. manufacturing and distribution industries by helping the business owners we serve achieve their dreams.

The second annual *Manufacturing and Distribution Outlook* is a reflection of our commitment to listening to, and learning from, the manufacturing and distribution industries. The 2011 study revealed a number of insights that have helped companies better understand their current position and future direction. The 2012 study offers a snapshot of the manufacturing and distribution industries. This report is intended to be a launching point for in-depth discussions on continuous financial and operational performance improvement and long-term growth.

Contents

Executive Summary

Early in 2012, more than 350 manufacturing and distribution executives offered their opinions on a wide range of topics related to the business climate and their strategies for success. The answers to our inquiries revealed concerns with the lackluster growth of the U.S. economy. However, through a combination of cost cutting and increasing revenue, companies are remaining profitable. There has also been a significant increase in the number of manufacturing and distribution companies looking for, and benefitting from, growth outside of the United States. Health care reform remains a concern of executives as they begin to better understand what it may mean for their business.

Among the findings of the 2012 study:

- More than half of the manufacturing and distribution leaders responding to the survey said "overall economic uncertainty" is tempering investment and is one of their top challenges for growth.
- Health care costs remain one of the top concerns.
- Leaders of large companies (100+ employees) said they are most concerned with "finding and retaining good employees" (81 percent) and a "shortage of skilled workers" (68 percent).
- Nearly half of the manufacturing and distribution leaders surveyed (46 percent) said their growth strategy is focused on increasing domestic sales.
- While 41 percent of companies said that they are not currently exporting, 55 percent said that they are (an increase from 45 percent in 2011). Another 4 percent said they will start exporting in the next two years.
- The most frequently mentioned tax strategies that companies have investigated are energy-related tax incentives (17 percent). However, it is noteworthy to mention that these companies are not implementing the incentives they say they have investigated.

The Mood in Manufacturing and Distribution

In the 12 months since the release of our 2011 *Manufacturing Outlook*, the overall economy has shown positive signs of growth: employment is slowly increasing, though not as quickly and consistently as most would like; home prices seem to have bottomed out and are beginning to rise; new home starts are up; and the gross domestic product is slowly rising. These are all good signs. The trouble is that it all seems to be happening in slow motion.

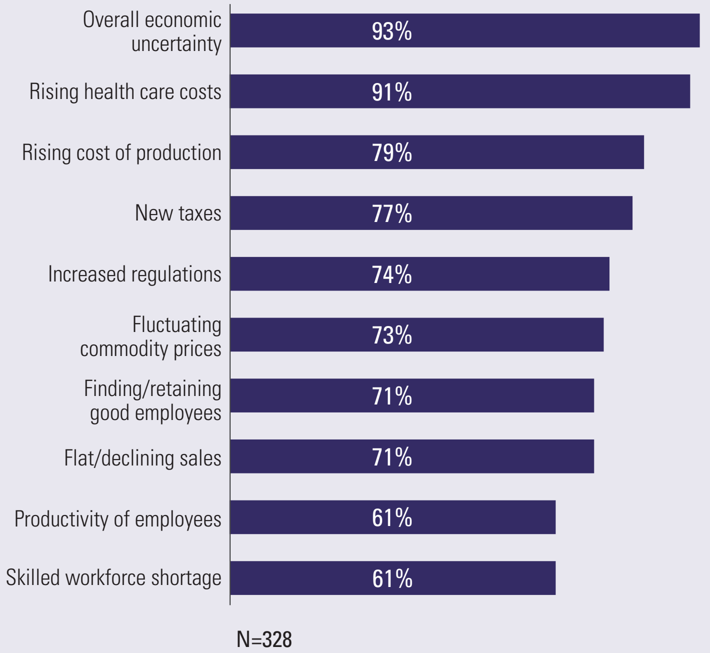
The Great Recession officially ended in 2009, but rather than a quick climb out of a deep hole, there have been ups and downs for three years. There has even been speculation that, with the looming crisis in Europe, there is potential for the economy to slip back into recession.

Few are declaring victory or claiming anything close to robust economic expansion. As always, there are pockets of prosperity, but by most standards, the economy is still struggling.

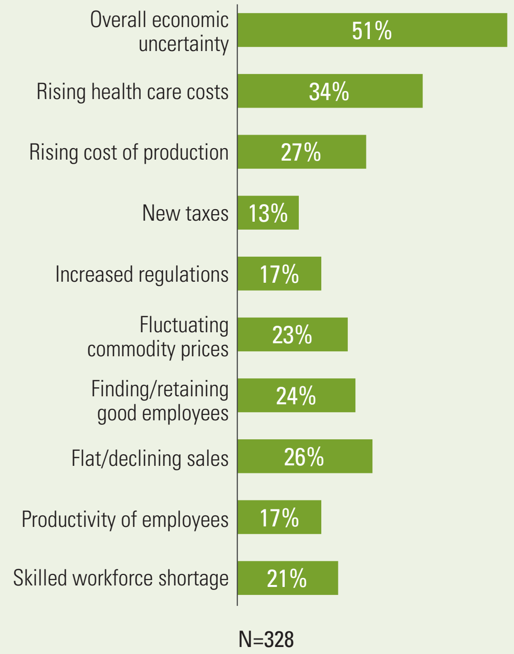
Knowing this, it is not surprising that companies responding to the 2012 survey continue to see "overall economic uncertainty" as their number one concern.

- Overall economic uncertainty remains one of the top challenges for more than half of the manufacturing and distribution leaders responding to the survey. This was followed by concern for rising health care costs (34 percent) and rising costs of production (27 percent).
- Although the list of concerns expanded to 19 items for 2012, the level of concern reported for each of the 11 items presented both years was significantly higher in 2011.
- Companies with fewer than 100 employees expressed more concern than companies with more than 100+ employees on several issues, including "flat or declining sales" (76 percent compared to 66 percent), "financing business operations" (54 percent compared to 42 percent) and "credit/funding availability" (50 percent compared to 38 percent).
- For 81 percent of companies with 100 or more employees, "finding and retaining good employees" is a top concern. Sixty-eight percent are concerned with a "shortage of skilled workers."

Top Concerns Over the Next Two Years



Top Challenges for Growth Over the Next Two Years



What it Means

Few are surprised to learn that manufacturers and distributors are still not bullish on the economy, in spite of nearly 30 months of economic expansion. We believe this uncertainty is actually masking a sense of calm that is underlying the industry. For decades, manufacturers have been able to handle almost any kind of challenge. The current situation is no exception. They see current economic conditions as something they can survive, but many are unwilling to expand their workforce or add capacity until the future is clearer.

Manufacturing and distribution leaders are seeing and reacting to uncertainty in at least three areas:

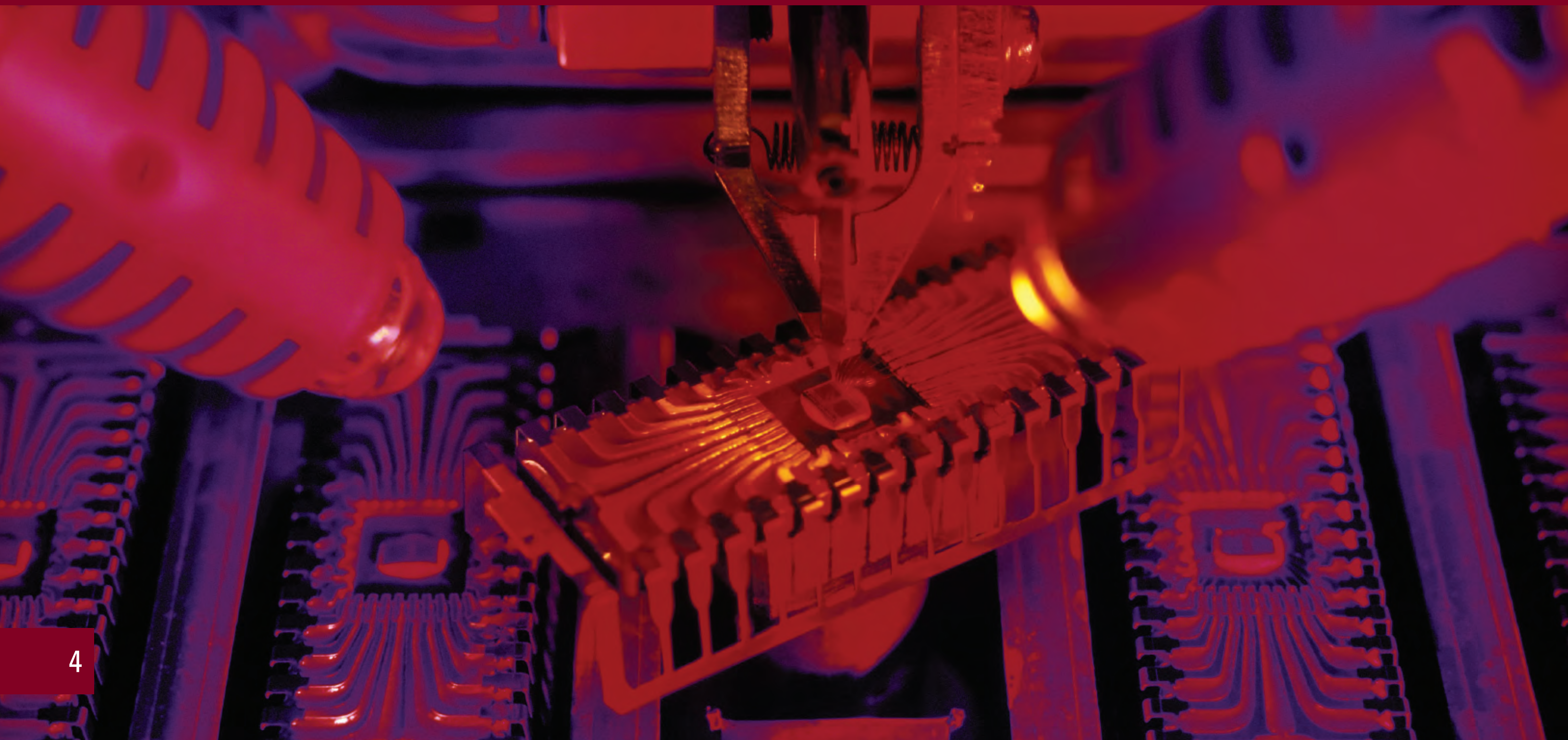
- **Policy uncertainty** — Company leaders are still wondering what will happen with health care reform, tax reform, and other issues that seem to be tied up until after the federal election.
- **Economic uncertainty** — The economy is growing, but at an unusually slow pace. Until there are more robust, more consistent indicators, manufacturers are hesitant to make longer-term commitments.
- **Global uncertainty** — Exports are growing, but economic uncertainty in Europe and reduced demand for U.S. goods in Asia give good reason to wait and see.

Flexibility is the key to profitability and sustainability in any economy. In times of uncertainty, flexibility almost always trumps power and speed. It allows the smart, well-managed companies to survive and grow again.

Strategies for Growth and Profitability

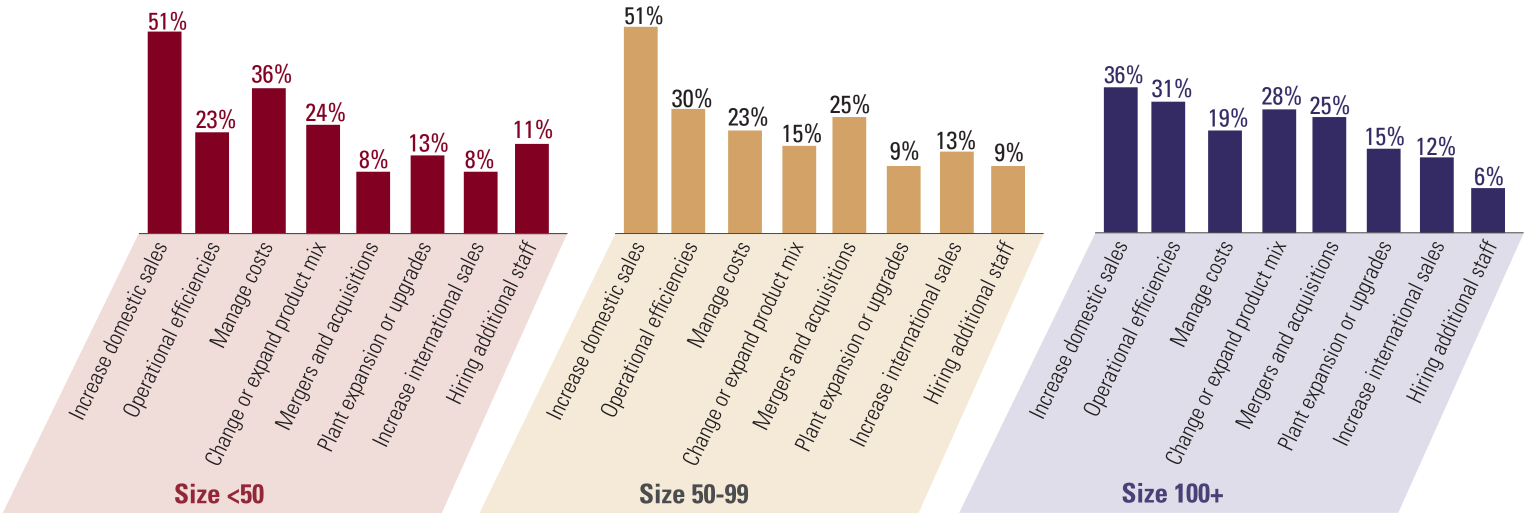
Manufacturing and distribution companies are employing a number of strategies to remain viable and profitable as the economy continues to improve.

- Nearly half of the manufacturing and distribution leaders surveyed said their growth strategy is focused on increasing domestic sales.
- More than 33 percent of companies reported success in controlling costs and focusing on their pricing structures; another 17 percent said they have had success through domestic or international plant expansions and upgrades.
- The top areas of strategic focus for companies in the 2012 survey were the same as in 2011: increasing domestic sales, operational efficiencies, and cost cutting/reduction.
- Companies are using various customer-centric approaches to differentiate themselves in the marketplace. More than a quarter (28 percent) said they set themselves apart by offering exceptional customer service, and 25 percent emphasize the ability to adapt to customer needs.
- Fewer companies (16 percent) feel they are able to differentiate themselves by offering high quality products.
- More companies with 100+ employees say they will focus on mergers and acquisitions in the next two years than companies with fewer than 100 employees.



Strategic Focus by Company Size

N=368



What it Means

It is important to remember that growth and profitability go hand in hand with flexibility. Businesses at all stages of development need flexibility in their cost structures, in their operations, and in their ability to meet customer demand. While it is tempting to focus on growth strategies aimed at increasing domestic sales, a manufacturer without the flexibility to cut expenses, adjust capacity, and still meet customer demand, is putting itself at risk. If companies are committed to growing through increased sales, it is important to remember that it is generally more profitable to expand sales to existing customers than to develop new customers.

Healthy growth and profitability also require an understanding of the company's profitability model. The cost accounting and estimating tools that are typically used to make growth decisions are not ideal for developing a profitability model. A manufacturer using these estimating tools may walk away from a growth opportunity because the perceived profit margins are not acceptable. All too often, those decisions are being made using tools that take micro guidelines and apply them on a macro level, which are often inaccurate.

It is worth noting that few companies of any size say their top strategic focus is hiring additional staff, in spite of the fact that there are thousands of manufacturing and distribution jobs going unfilled due to a lack of skilled workers. Manufacturers have been forced to rely on technology to mitigate the need for more skilled workers.

Global Connections and Concerns

Significantly more of the companies responding to the survey are exporting this year (55 percent) than last year (45 percent). Another 4 percent said they plan to start exporting in the next two years, but 41 percent are not exporting now and have no current plans to do so.

- More than half of companies report an increase in their levels of exports in the past year. They attribute those increases to higher customer demand (25 percent) and growth of the market (17 percent).
- Only 32 percent of manufacturers report having operations outside of the U.S.; 70 percent say that international sales represent 20 percent or less of sales.
- More companies (61 percent) see international markets as important to their overall revenue than last year (25 percent).
- Companies that are exporting report sending goods to Europe (59 percent) and North America (54 percent), with Asia coming in third (43 percent).
- The primary destinations for U.S. exports in Europe and Asia are the United Kingdom and China respectively. In North America, Canada (40 percent) and Mexico (36 percent) are the primary recipients of U.S. exports.
- Larger companies (100+ employees) are more likely to export than smaller companies (71 percent versus 39 percent). This is true everywhere except for exports to Canada and Australia, where smaller companies reported greater export activity.
- Small companies (fewer than 50 employees) were more likely to report a decrease in export levels since 2011 (20 percent in 2011 versus 5 percent in 2012).

Exporting Practices by Company Size

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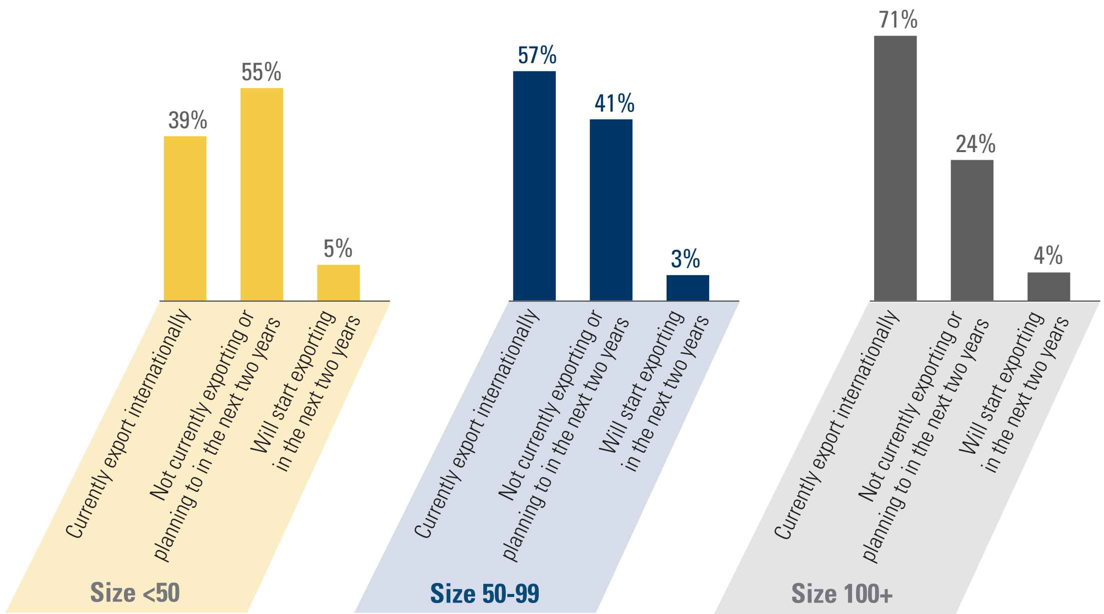


What it Means

Domestic manufacturers used to enjoy the benefits of the U.S. being the largest market in the world. But the U.S. market is maturing, leading companies to look outside of our borders for growth. Overall U.S. exports are enjoying strong growth (up 14 percent or more the last two years), while domestic growth remains an anemic 2 – 3 percent. This is expected to continue as the domestic and European economies remain weak, and Asia's economies continue to grow significantly.

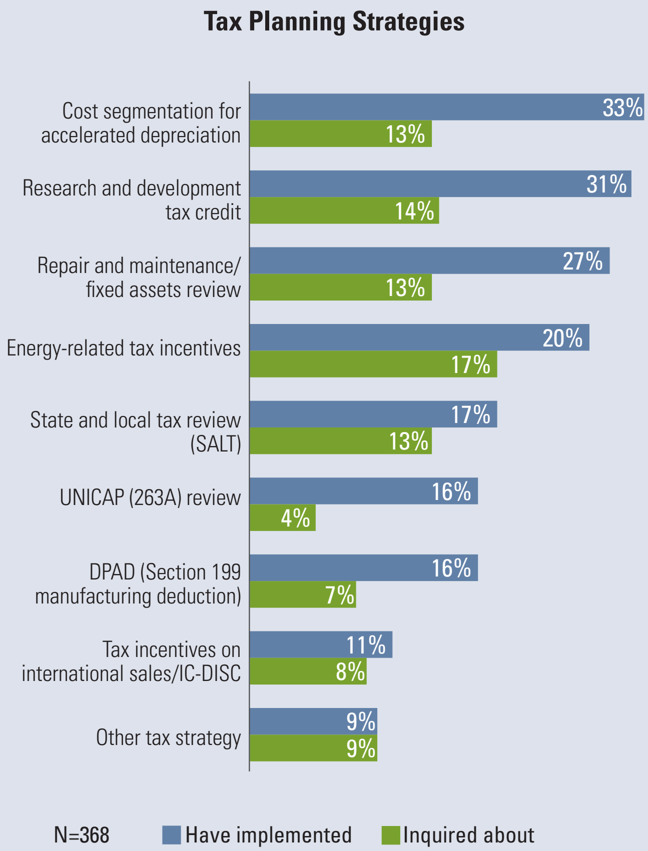
By looking at the report results, it would be easy to believe larger companies are exporting more than smaller companies. Strictly speaking, that's true. But large export products — for example airplanes, automobiles, and machinery — are often made up of domestically produced parts. So in a sense, all companies in the supply chain are participating in, and benefitting from, export markets, even if they don't realize it. (The fact that 51 percent of respondents think their growth in the next year will be domestic suggests this may be the case.)

The key to opportunities in the global marketplace is to stay abreast of the shifting tide, and to have a strategy to take advantage of it. Start by understanding your supply chain: where your products are being used, and where they are ultimately delivered.

Taxes

As in 2011, knowledge and implementation of tax strategies are not well connected in the manufacturing and distribution sector. Of the nine tax-planning strategies mentioned in the survey, none had been implemented by more than one-third of the companies.

- The most-used strategy, cost segmentation, had been implemented by 33 percent of companies. Close behind were the research and development tax credit (31 percent), and repair and maintenance/fixed assets reviews (27 percent).
- Less than 20 percent of companies had inquired about any of the listed tax strategies.
- The most frequently inquired-about strategy was energy-related tax incentives (17 percent).
- In 2011, 41 percent of respondents said they had inquired about the research and development tax credit; that number fell to just 14 percent in 2012. However, those who said they had implemented the tax credit strategy increased from 28 percent in 2011 to 31 percent in 2012.
- In general, companies with 100 or more employees are more likely than small and mid-sized companies to have already implemented tax strategies such as the research and development tax credit, state and local tax reviews, uniform capitalization (UNICAP) reviews, and tax incentives on international sales.



What it Means

Consistent with last year's report, companies are saying they are not using a specific strategy to reduce taxes, increase cash flow, and improve profitability. For most of these companies, that's a missed opportunity. The tax incentives we asked about are well known, low risk, and they are probably going to be available in the long term, even though there might be changes in details like a maximum credit level or a qualifying threshold.

There is also clear evidence that companies are not always aligning their business strategy with their tax strategy. Fifty-five percent of companies are exporting, and yet only 11 percent have implemented an IC-DISC (Interest Charge Domestic International Corporation). Thousands of companies could benefit from this incentive, which is specifically designed to boost exports. In fact, virtually every manufacturer should be able to take advantage of the domestic production activity deduction (DPAD) because they are adding value in producing something. Roughly 75 percent of respondents tell us that they haven't even considered DPAD.

Ongoing, year-round tax planning is a proven boost to profitability. In any economy, but especially in the current economic landscape, it is a strategy most companies can pursue successfully.

Health Care

Health care reform is still a significant factor to consider when planning for future growth and profitability, according to survey respondents.

The difference between 2011 respondents and 2012 respondents is pronounced. Where last year there was little knowledge or preparation to implement the *Patient Protection and Affordable Care Act* (PPACA), there is now a greater understanding of health care reform and what it means to manufacturers and distributors.

- Forty-one percent of survey respondents said the PPACA has had a positive impact on their organization. On the other hand, the majority (56 percent) said the law has had neither a positive nor a negative impact on their organization.
- Almost half of respondents (49 percent) said they are as knowledgeable and prepared for health care reform as they were a year ago. In the 2011 survey, just 28 percent of companies said they were prepared to implement the PPACA.

What it Means

Considering all of the media coverage on health care reform, it's not surprising that manufacturing and distribution leaders believe they are more knowledgeable and better prepared than they were at the same time last year. Their confidence is encouraging in light of the complexity of health care reform and the uncertainty that remained until only recently.

Although, the majority of respondents said that the PPACA has had little impact on their business, the main provisions of the law do not take effect until 2014. Surprisingly, 41 percent of respondents found the PPACA has already had a positive impact on their organization. The survey, however, was conducted prior to the Supreme Court's decision to uphold the law, and one might speculate that the results might be different if the survey were conducted today. The Supreme Court's ruling should at least reduce some of the uncertainty surrounding the issue.

Interestingly, 91 percent said rising health care costs will be a major concern for their company in the future. The PPACA focuses on ensuring individuals have access to health care coverage, but it remains to be seen if it will lower overall health care costs once it is fully implemented. The Supreme Court's ruling to uphold the law will likely bring a renewed focus on health care, and some manufacturers and distributors may choose to pay the employer "taxes" instead of offering health care coverage.

Finally, manufacturers and importers of medical devices will need to consider the new tax on their sales that accompanies the PPACA. Most medical devices sold after December 31, 2012, will incur a 2.3 percent federal excise tax. (Items such as eyeglasses, contact lenses, and hearing aids purchased directly by individual consumers are not subject to the tax.) There is a chance that Congress could repeal this tax before it becomes effective — the House did so in early June, but it is uncertain whether the Senate will take action as well. Without its repeal, manufacturers will need to adjust their recordkeeping systems to identify sales subject to this 2.3 percent tax beginning January 1, 2013.

Looking Ahead

Feelings of uncertainty will likely continue in the manufacturing and distribution industries as long as major concerns like the global economy and health care costs remain unresolved. However, this uncertainty can be effectively addressed by remaining flexible, staying responsive to customer needs, and being prepared for opportunities that arise as the pace of recovery improves. Some uncertainty will also be erased after the November election, when voters choose to continue on the current path or take a new direction.

Study Methology, Sampling, and Statistical Limitations

This study was conducted by the Dieringer Research Group, an independent research firm.

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 7,645 email invitations were sent on February 24, 2012. Reminder emails were sent less than a month later.

A total of 368 survey responses were received, with 297 coming back from CliftonLarsonAllen clients and 71 from nonclients. The overall completion rate was 5 percent. Responses were received from 25 states. Twenty-eight percent of those who completed the survey in 2011 (59 out of 207) also participated in 2012.

Sampling

In the second year of the study, more small businesses and more CliftonLarsonAllen clients participated than in 2011. A total of 297 CliftonLarsonAllen clients completed the survey, versus 137 the year before. The number of nonclients that completed the survey changed very little (70 in 2011 and 71 in 2012), representing a smaller percent of the total respondents (19 percent versus 34 percent).

Consistent with 2011, CliftonLarsonAllen clients that responded tend to have fewer employees than the nonclients that responded (median average of 80 employees versus 115 for nonclients).

Six in ten companies reported an increase in overall profitability over the past 12 months, while 22 percent experienced a decrease in overall profitability, and 17 percent remained the same. Nonclients were more likely than clients to report a decrease in profitability over the past 12 months.

Nearly half (46 percent) of the respondents in 2012 reported revenue of less than $15 million. Twenty-nine percent were between $15 million and $50 million, and 26 percent were more than $50 million.

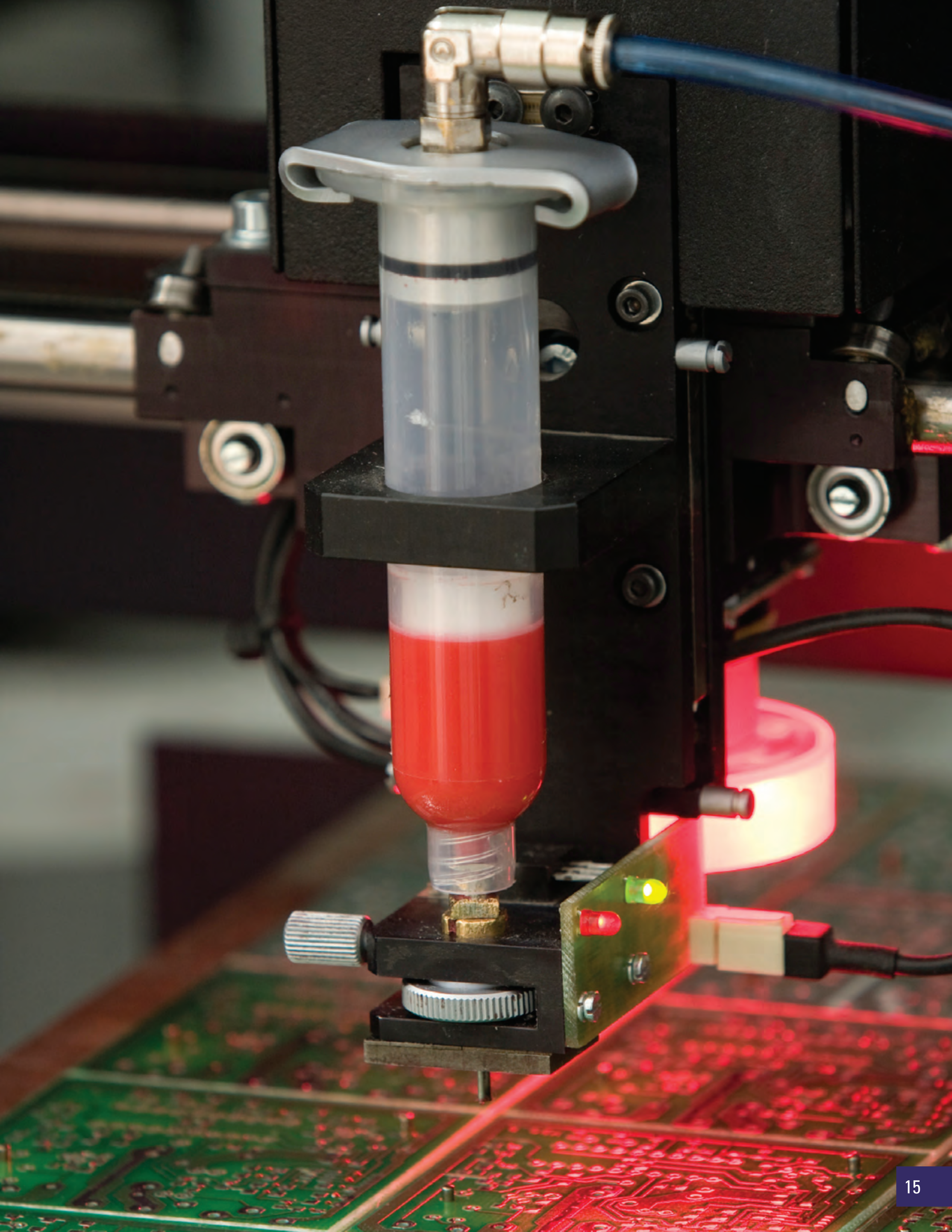
Respondents represent a wide variety of manufacturing and distribution industries with no single category making up more than 15 percent of the total responses.

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 good chance that the selected level of variation is due to real differences and is not due to chance.

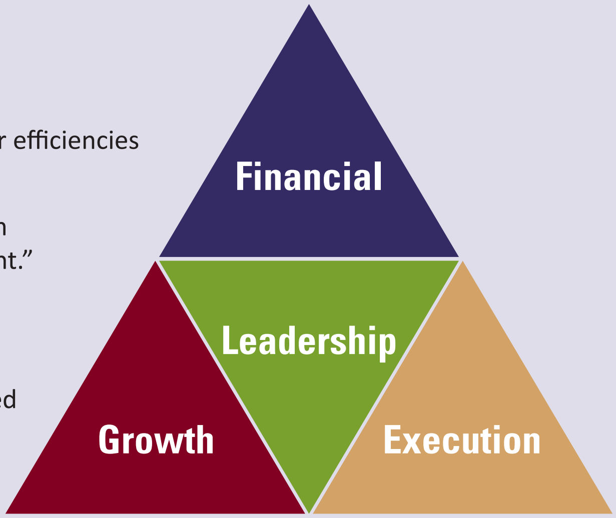
For example, the sampling error for the 2012 *Manufacturing and Distribution Outlook* survey at the aggregate level (combined clients and nonclients) is +/- 5.1 percent at the 95 percent confidence level. This means if the study were repeated 100 times with this sample size, the results would be within +/- 5.1 percent of the current values in 95 out of 100 trials. Looking at it another way, if 60 percent of the respondents answered “yes” to a question, chances are that 95 times out of 100 that between 54.9 percent and 65.1 percent of the total surveyed population would give a “yes” response.

It is important to understand that the smaller the sample size, the larger the margin of 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.



In Their Own Words

Building a healthy and sustainable business requires a balanced approach to four key elements of the value triangle: *financial*, *execution*, *leadership*, and *growth*. When manufacturing and distribution executives were asked what they were doing to increase viability and remain profitable, not surprisingly, their responses aligned with these categories.



Financial

"Build a cash reserve and keep the hiring of new people at a minimum. Look for efficiencies internally with new technologies or outsourcing to free up staff."

"Focus is on quality, top-line growth, and opportunities for new customers from competitors that went broke. We have continued to invest in capital equipment."

"Reduce costs through layoffs and attempting to restructure various lease and maintenance contracts."

"We are building features into our system that will increase revenue, as opposed to building things that only satisfy the desires of our customers."

"We are trying to exercise tighter control on receivables."

"Produce product outside of the U.S. to take advantage of lower labor rates."

"Look for ways to decrease costs of strategically sourced raw materials."

"Close money-losing units that have no prospects of becoming profitable within an acceptable time-frame; reduce production staff and revert to one shift versus two shifts."

Leadership

"Increase research and development, adding key employees to improve products and sales, being focused on results by empowering and holding employees responsible for results."

"Get out there and meet clients and potential clients at semi-casual events."

"We are using connections in organizations to discuss our product and health care solutions."

Growth

"Take on new products, increase marketing and sales efforts."

"Increase marketing efforts, focus on diversification of our customer base."

"Acquired one company and continue to look for others to acquire. Organic growth isn't cutting it."

"Continual reinvestment and evaluation of flow in our plant."

"Invent new products and be present at trade shows when others are pulling back."

Execution

"Deliver products that exceed customer expectations and are supported by an unmatched dealer network."

"Emphasized excellent customer care towards customers we have."

"Automated most of our operations for efficiency and accuracy."

"Website enhancements to increase search engine optimization."

"Stress internet marketing, website optimization to increase leads/business."

"Invested in new enterprise software including customer relationship management."

"We were very careful and selective about our inventory levels. We reduced our total inventory, but maintained our good inventory at an acceptable level."

About CliftonLarsonAllen

CliftonLarsonAllen is one of the nation's top 10 certified public accounting and consulting firms, but the only top 10 firm focused on serving privately held businesses and their owners. Structured to provide clients with highly specialized industry insight, the firm delivers its audit, accounting, tax, consulting, and advisory services from an industry-specific perspective. The firm has a staff of more than 3,600 professionals, operating from more than 90 offices across the country. For more information about CliftonLarsonAllen, visit www.cliftonlarsonallen.com.

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