CliftonLarsonAllen

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Manufacturing and Distribution Outlook

Planning for 2015 | Based on Findings of a National Survey

Introduction

Over the past 12 months, and certainly over the past two decades, U.S. manufacturing and distribution companies have shown that they are highly *adaptable* to the ever-changing business environment. This *Manufacturing and Distribution Outlook* confirms the extent of this adaptability. In the last year, owners and leaders have dealt with increasing health care costs and governmental regulations, leadership and ownership succession issues, skilled workforce shortages, and the challenge of balancing capacity with demand. All of this was done within a backdrop of an increasingly competitive global pricing environment.

Even with these internal and external challenges, those who took our survey continue to be optimistic about the future growth and profitability of their business. This reflects a pervasive attitude among those surveyed: Success is not an option or a choice to these owners and leaders, it is a necessity.

CliftonLarsonAllen's fourth annual survey results are a composite of opinions from hundreds of metal fabricators, printers, food processors, contract manufacturers, original equipment manufacturers (OEMs), and others from across the country, with approximately 80 percent of the companies having less than 100 employees and less than $50 million in revenue.

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

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Executive Summary

If you're looking for teamwork, look no further than the manufacturing and distribution industry. To achieve success, these companies must coordinate people, parts, markets, and events on a playing field that is constantly changing, and packed with competitors. The winners know that you can't cut corners in this game. It takes a collective commitment to a common goal, along with personal commitment to the role that each person plays in their team's success.

To illustrate this interdependency and teamwork, we have developed a simple visual model called *The Value Triangle* that illustrates the competencies (and balance) required to achieve long-term success in business.

Four engines drive healthy and sustainable manufacturing and distribution companies:

- Leadership
- Execution
- Growth
- Financial

Business leaders and owners often focus on one engine, but the most successful organizations have the ability to collaborate and integrate all areas when making decisions and driving value for the organization. Excellence in any of these areas can create bursts of short-term success. However, consistent attention to all four creates high-performance companies that can compete in the global marketplace.

This report offers a summary and analysis of feedback received from manufacturing and distribution leaders, including key observations related to each of the four engines.

Leadership:

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

While it is critical for companies to manage financial events and indicators, it is just as important to understand the nonfinancial events that can have an impact on the business.

One of those events is succession of leadership or ownership. We are about to experience one of the largest wealth transfers in U.S. history, so we wanted to understand how many of our respondents are expecting a transition in the next five years. We also wanted to know how many truly feel prepared for the changes.

While the survey results were not surprising, we believe the numbers could point to an executive workforce shortage similar to the skilled workforce shortage that companies are experiencing. Advanced planning is needed during this time to get the right individuals in the right seats.

Leadership — In Your Own Words

"We are in the process of becoming an ESOP (employee stock ownership plan). Over the next year we will devote considerable effort to making this transition in an effective manner. We have succession plans in place that we are very comfortable with."

"We have established a strong succession plan ahead of actual need."

"We have hired a better caliber of managers over the past two years to create a core team to lead the future growth and success of the company."

"The overall aging workforce and turnover as the Baby Boomer generation retires will have an impact on our manufacturing, particularly as new generations are less interested in working for manufacturing firms."

"We are building a strong leadership team around the next generation of family ownership."

Execution:

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

This area of *The Value Triangle* represents the heartbeat of the organization, where people and culture are essential to success, as are flexible operations, aligned business processes and systems, and well-maintained assets. One of the most important elements is the ability to make connections to the growth and financial engines. In the most recent survey, respondents noted that continuous improvement efforts are a primary way that they are able to be successful in this engine of their business.

High-performing manufacturing and distribution companies are able to execute and flex in the face of ever-changing customer demands. Understanding areas of capacity and constraint should have a direct connection to pricing and should help manage flexibility to meet customer demand. In addition, concentrating on lead-time reduction and improving quality will reduce a company's cost structure and reduce working capital requirements, while increasing profitability and cash flow.

Execution — In Your Own Words

"We continue to revise products to reduce cost without reducing quality."

"We have focused on creating a culture of continuous improvement."

"We continually seek out new trading partner opportunities in order to improve facility utilization."

"We are focusing on innovation within our manufacturing process to improve quality, reduce cost, and lower lead times."

Growth:

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

Sustainable growth is one of the greatest challenges facing the entrepreneurial segment of the industry. There are a number of reasons: limited visibility to end user demands, the impact that economic and regulatory uncertainty can have in a specific industry niche, and continual pricing and margin compression.

Growth can occur domestically and on the international stage. When we asked about the global market, survey respondents noted that it was not a primary strategy or concern at this time. Even so, consideration should be given to the global environment due to the expected movement of wealth out of the United States. By assessing the risks relating to customers and suppliers and their strategies for global activities, companies can react quickly to any pressures or expectations in the future. Understanding where this will happen and how your company will navigate possible business interruptions can be the key to retaining customer relationships, minimizing risk, and controlling costs.

Growth — In Your Own Words

"Our customers drive our activities."

"We are attempting to grow the business while leveraging our fixed cost structure."

"Our customers have global locations; we want to continue to expand our customer relationships."

"We know that the majority of people on the Internet are not in the United States, and we want to be where the people are."

"We continue to diversify our customer concentrations through global expansion and development of more value-add products."

Financial:

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

There are three main themes in the financial engine of *The Value Triangle*: owner wealth concentration, working capital management, and sustained profitability and cash flow. The vast majority of companies that completed the most recent survey are privately held and have fewer than five owners. For many of these owners, their business interest represents the majority of their personal net worth.

Many of our clients say they struggled during the recent recession to continue properly capitalizing their business. This was due, in part, to the inflexibility of the owner's personal financial statement and cash flow. Our survey questions focused on this and other financial topics to measure results and develop an outlook for the future.

Financial — In Your Own Words

"To drive sustainability in our organization we are striving to properly manage working capital and critically analyze all major investments to assure a return on investment."

"We have worked to aggressively pay down debt, pay dividends prudently, and make capital expenditures only when there is short payback and a good return on investment."

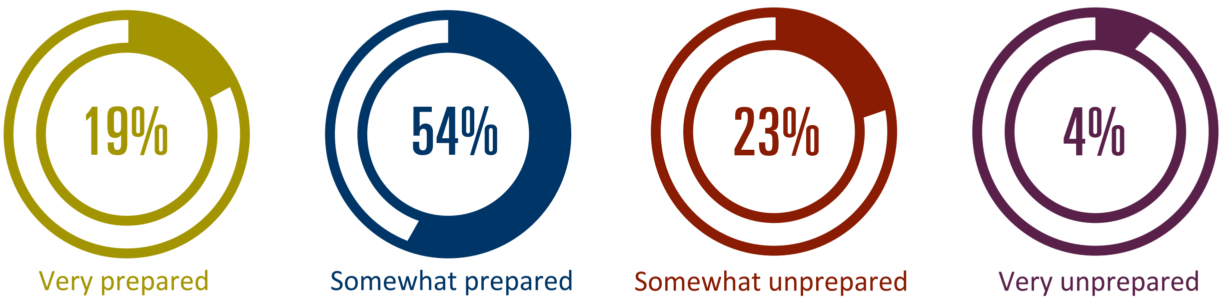
"We work to maintain a value-added business in a price dominant world."

"We have focused on equipment obsolescence, inventory cost control and turns management, and real time manufacturing versus traditional inventory distribution to our customers."

Leadership

An estimated 9 million of America's 15 million business owners were born in or before 1964. As a result, there is an estimated $11 trillion that will soon be transferred from one generation to the next. Though these statistics are daunting, the expected shift in wealth will provide plenty of opportunity for businesses to grow through acquisition, or for the next generation owner to revitalize and re-energize his or her organization.

Ownership/Leadership Transition Preparedness



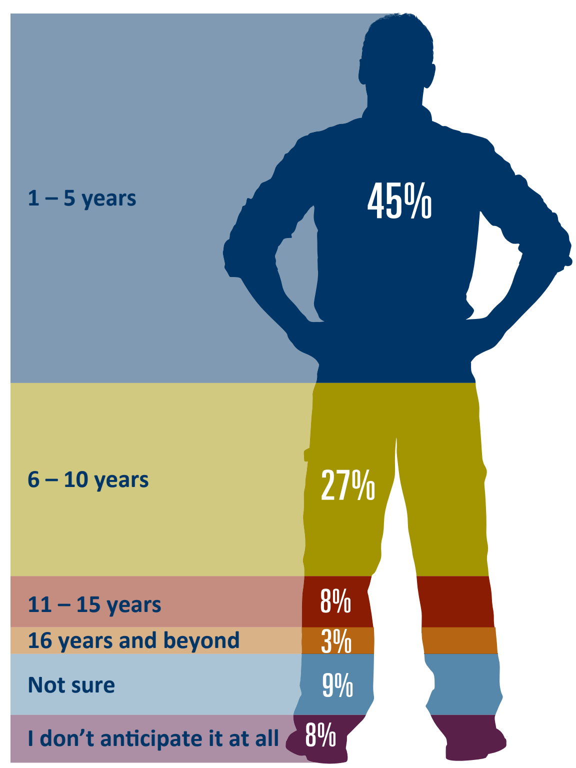
Planning for transitions — When we asked survey participants about potential transition events, most clearly understood that an event is on the horizon and that being prepared is important. However, when asked about how prepared their business is for a pending leadership or ownership transition 19 percent said they are "very prepared," 54 percent said they are "somewhat prepared," and 27 percent said they are "somewhat unprepared" or "very unprepared."

One of the riskiest times for a business is when leadership and ownership transitions occur at the same time. When asked if a leadership transition also means an ownership transition, 50 percent of respondents said yes. Forty-five percent of respondents said they expect a leadership transition within the next one to five years, an increase from the 35 percent who voiced this expectation last year.

In fact, there was an across-the-board shift from long-term expectations of leadership transition to the one- to five-year window. The immediacy of the issue seems to be getting much more attention. This trend is a risk factor for those who have not planned or prepared for succession and a significant acquisition growth opportunity for those with strong leadership and management teams.

Preparing for a transition takes time; the most successful plans start years in advance. This process can be extremely emotional and may seem overwhelming, but it can be simplified and made much less stressful by creating options that don't necessarily predict an outcome. Strengthening all engines of *The Value Triangle* drives the greatest value and creates the most options.

Timing of Leadership Transition



Execution

Manufacturers and distributors are facing many market challenges, including high customer demands and pricing pressures. To successfully balance customer expectations with continued profitability, leaders are focusing on continuous improvement efforts to help reduce costs, improve quality and customer satisfaction, and increase capacity.

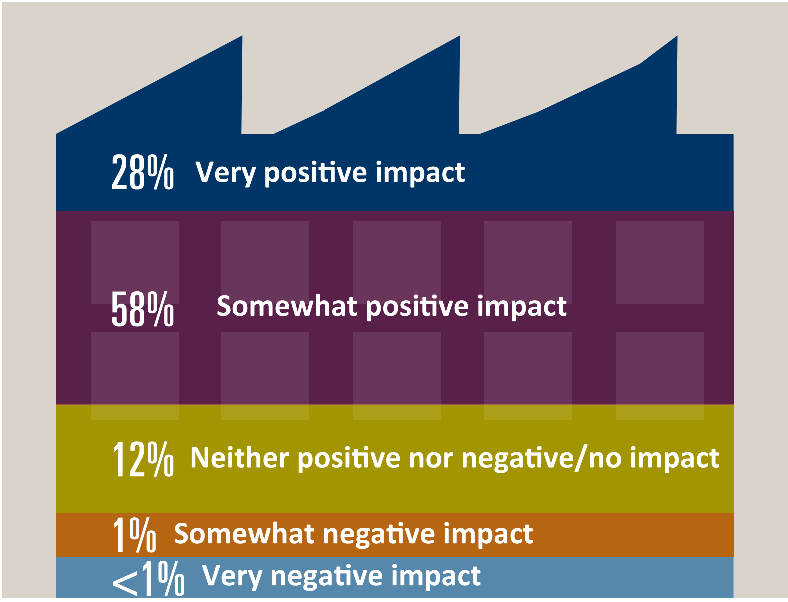
Primary Goal of Continuous Improvement Over the Next 12 Months

Continuous improvement — Focusing on initiatives such as lead time reduction, quality improvement, responsiveness, and flexibility will have a positive impact on profitability, increase cash flow, and reduce inventory requirements.

Only 3 percent of respondents said that their continuous improvement initiatives were targeting inventory reduction, a fundamental indicator of improved flexibility. Even though this is not a primary goal of respondents, we believe it is important to stress that working capital reduction — and specifically inventory reduction — is a positive characteristic of manufacturers and distributors who are able to drive value and diversify risk.

Eighty-six percent of survey respondents said their continuous improvement efforts have had either a very positive or a somewhat positive impact on their business.

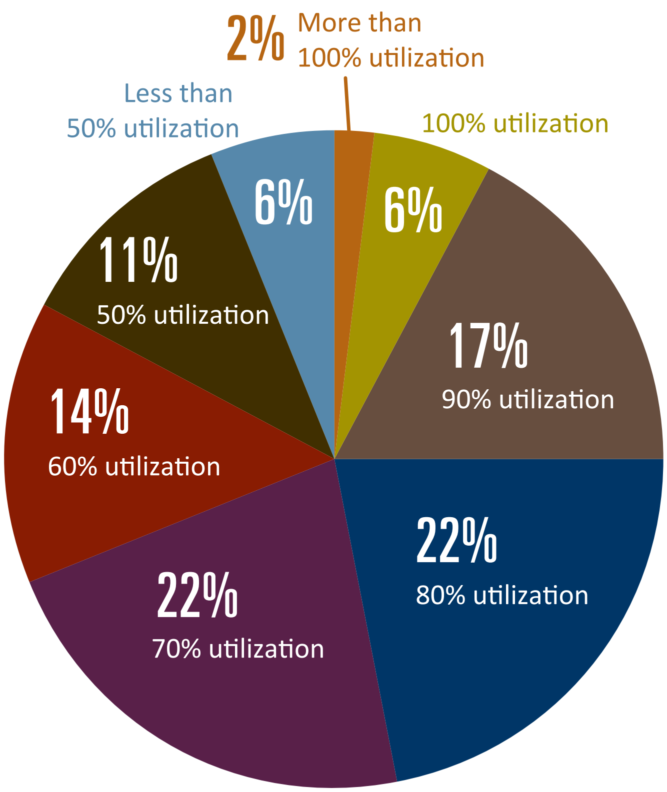
Impact of Continuous Improvement Over the Past 12 Months



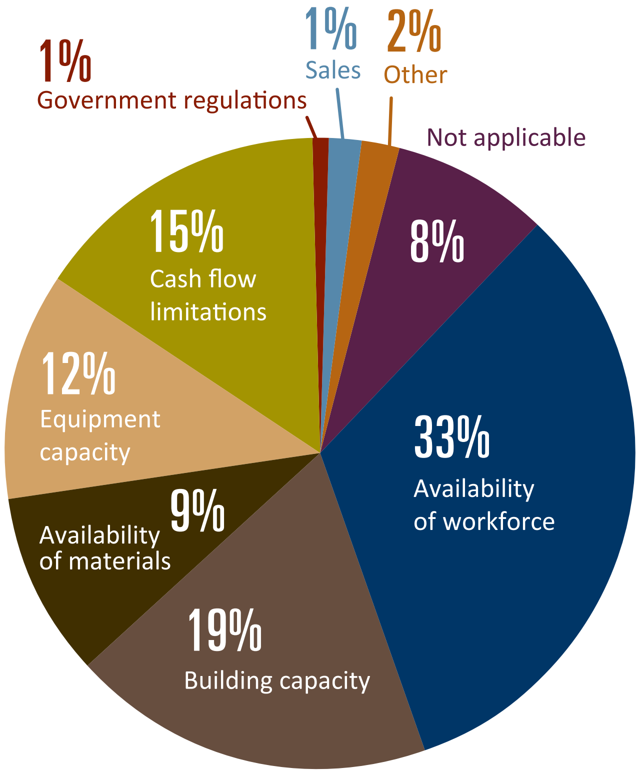
Balancing capacity — Even with improvement initiatives focusing on increasing capacity, there are still indications that, for some organizations, the increase in revenue and focus on customer diversification has started to create capacity constraints. For the companies that are at or above 70 percent utilization, growth goals may be more challenging. Survey respondents said that capacity limitations are mostly driven by the availability of workers and physical space.

In response, manufacturers and distributors are being creative in combating the skilled workforce challenge through cross-utilization and training of current employees, effective use of temporary labor, and working with local educators to develop specific skills in future workers. Automation is also being used, but it is important to consider the inflexibility that automation could bring to the company's cost structure.

Capacity Utilization



Primary Factor Driving Any Current or Expected Capacity Limitations



Similar to prior years there is also a group of respondents who have excess capacity; only 47 percent said they are utilizing 80 percent or more of their capacity. This is exciting news. With this available capacity, companies can reach their growth and profitability objectives without having to invest significantly in increasing their cost structure. Many companies have a cost structure that is significantly fixed; where this is the case, they often realize increases in volume with only minimal incremental costs.

Organizations with excess capacity should evaluate their growth strategies to fill the gap between customer needs, opportunities, and the ability to push work through the facility. This includes strategic pricing decisions that target markets or customers. Creating this connection between the growth and the execution engines of *The Value Triangle* generates great opportunities to maximize profitability.

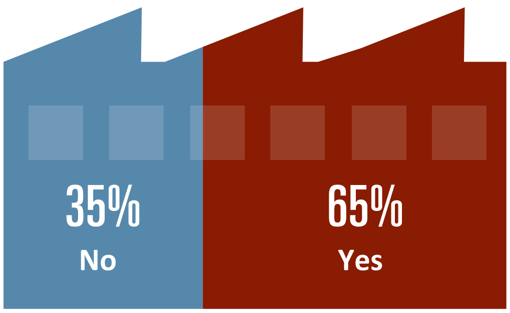
Growth

Top growth initiatives for manufacturers and distributors include expanding current relationships, leveraging core competencies into new industries, and product development.

Top Growth Strategies

Participants were asked to choose their top two strategies.

Participation in the Global Economy



As it has been in prior years, customer diversification is a focus for manufacturing and distribution companies. Forty-two percent of respondents indicated that their top five customers comprise greater than half of their revenues. Companies are addressing this imbalance by developing new products, expanding relationships, entering new markets, and seeking acquisitions.

Although only 6 percent of respondents had completed an acquisition in the past 12 months, approximately 75 percent of those acquisitions were done to add new capabilities or increase exposure to new customers. About 50 percent of respondents said they are addressing their customer or industry concentrations through diversification within their existing customer base, or by entering new markets.

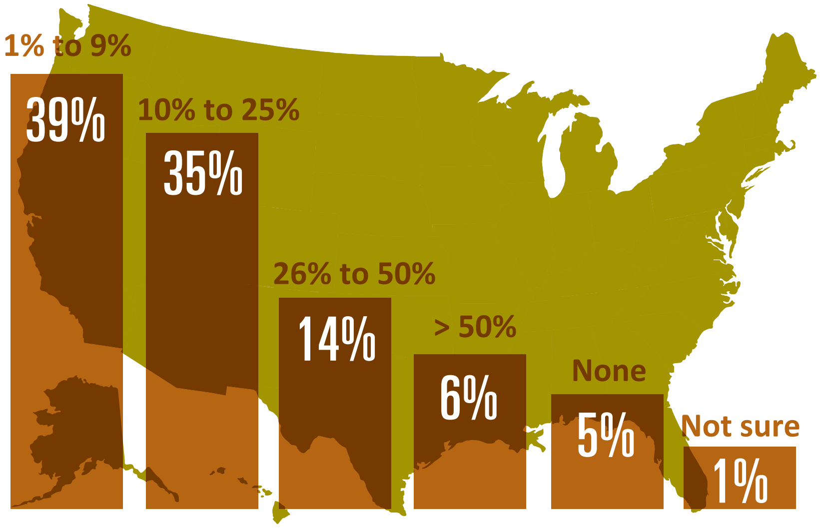
Global sourcing and selling — Manufacturers and distributors participate in the global supply chain in a number of ways. Most companies begin by sourcing products from outside the United States, and gradually begin selling globally to support existing customers. Based on our survey respondents, sourcing and selling products globally continues to increase, and many are finding off-shore growth potential is higher than in domestic markets.

This activity is consistent with the major shift in the world middle class from North America and Europe to Asia. It is estimated that by 2030 more than 60 percent of the world's middle class will be located in the Asia Pacific. This movement is significant because approximately 70 percent of economic consumption is driven by the middle class. Companies will participate in the global supply chain in order to capitalize on this changing middle class structure.

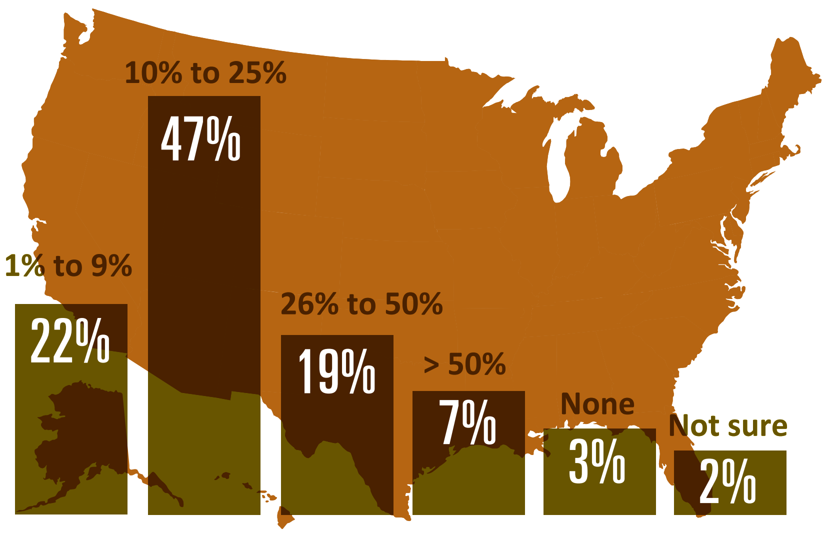
Of our survey respondents, 65 percent indicated they source component parts or sell products outside the United States. The majority of these (55 percent) say global sales account for more than 10 percent of their revenue, and 73 percent of companies say global sales will account for more than 10 percent of their revenue over the next three years. The percentage reporting no revenue from foreign sales fell from 22 percent last year to 5 percent in 2014.

Companies that do not sell outside the United States continue to see cost and uncertainty as key deterrents. The majority of those not exporting feel that there is enough domestic growth opportunity to fit their current needs. We believe this to be a reflection of current thinking that does not consider future growth in domestic opportunities or more cost-competitive and reliable suppliers overseas.

Percentage of Total Revenue From Sales Outside of the United States (Directly or Indirectly)



Expected Percentage of Total Revenue From Sales Outside of the United States (Next 3 Years, Directly or Indirectly)

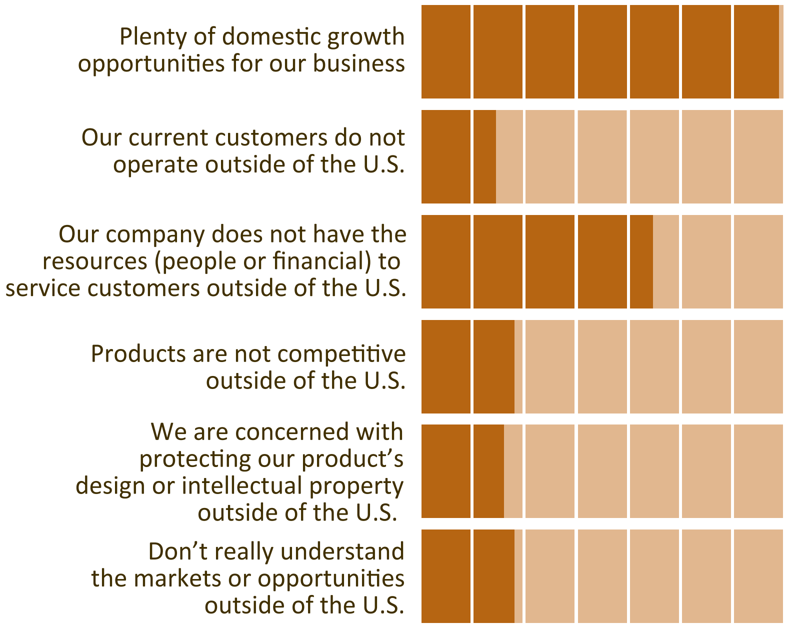


The most common way companies are participating in a global supply chain continues to be through their sourcing of parts or components from a nondomestic supplier. This trend may continue in certain industry niches that are experiencing the greatest pricing and margin compression.

While there may be cost advantages to cross-border sourcing, there is also additional risk. Many factors outside of company control (issues with logistics, currency fluctuation, customs, ports of entry, natural disasters) can interfere with reliable, cost-effective parts supplies. This could create issues with customers if a backup plan is not in place. This balance of flexibility and cost is a part of the resurgence in U.S. manufacturing of components previously produced overseas.

All three of the past annual surveys show more companies selling outside the United States each year, and the increase is more than the number indicating they had plans to export. This isn't surprising since most begin supporting global sales when requested by (or given an opportunity by) an existing customer. In other words, they are "opportunistic" when they begin cross-border selling, which can be a highly effective approach.

Reasons for Not Increasing Participation in Activities Outside of the United States

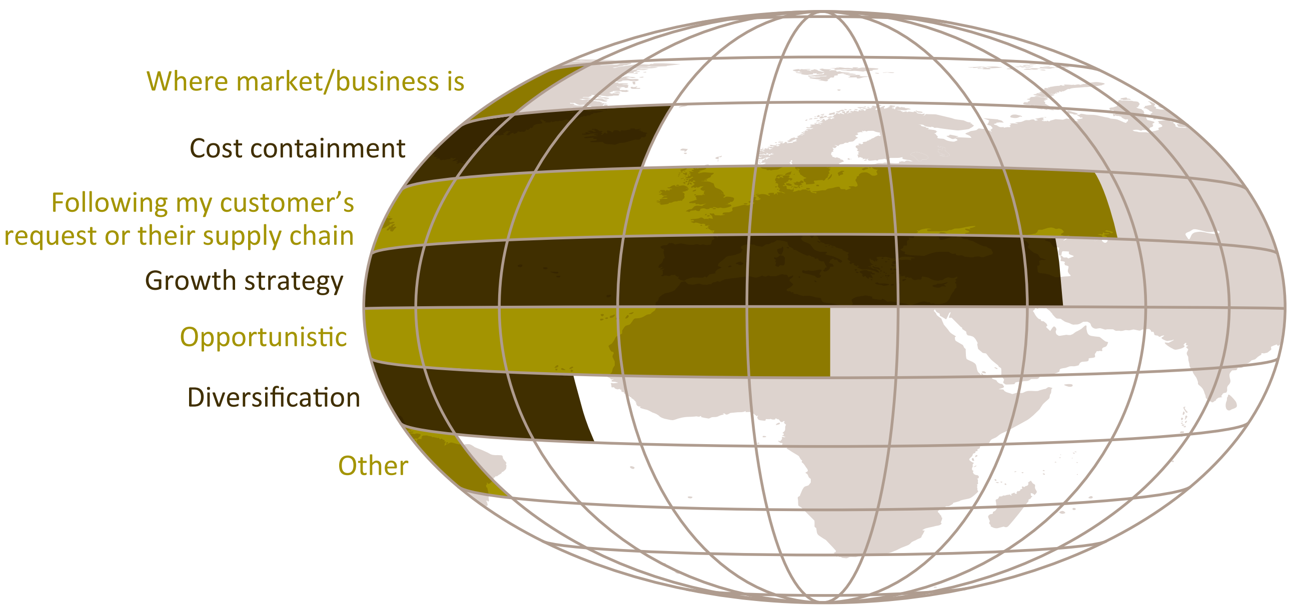


Participants were asked to choose their top two reasons.

However, taking this approach also comes with risk, as there can be issues associated with selling globally that can be highly disruptive without adequate preparation. Taking the time to understand and develop a basic plan that addresses the risks associated with global sales greatly improves the chance of success and minimizes the risks of the "opportunistic" approach.

Entering the global marketplace requires preparation, and for some organizations, will contribute significantly to the growth engine of *The Value Triangle*. Understanding the plans of customers and the risks of the global supply chain can help anticipate and navigate international challenges, manage the risks of interruption to the customer's operations, more assertively support current and future customer relationships, control costs, and ease the anxiety and stress associated with doing business overseas.

Reason for Participating in the Global Economy



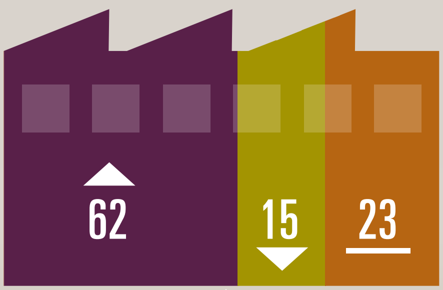
Participants were asked to choose their top two reasons.

Financial

U.S. manufacturers and distributors continue to face numerous challenges in sustaining a healthy business, even though 62 percent said their revenues increased over the past 12 months, and 55 percent said their profitability increased. We expect revenues to continue the upward trend. However, the number of respondents who said their profitability increased was down by nearly six percentage points from 2013, and a greater percentage said their profitability remained the same.

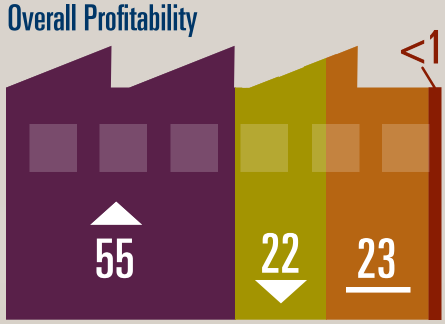
The past 12 months

Revenues



Increased	62%
Decreased	15%
Stayed the same	23%

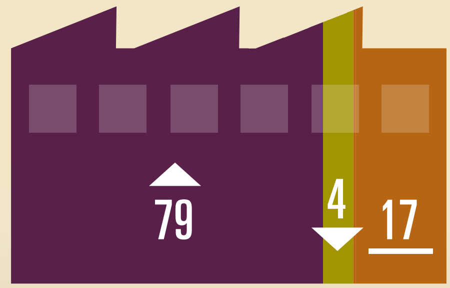
Overall Profitability



Increased	55%
Decreased	22%
Stayed the same	23%
Not sure	<1%

The next 12 months

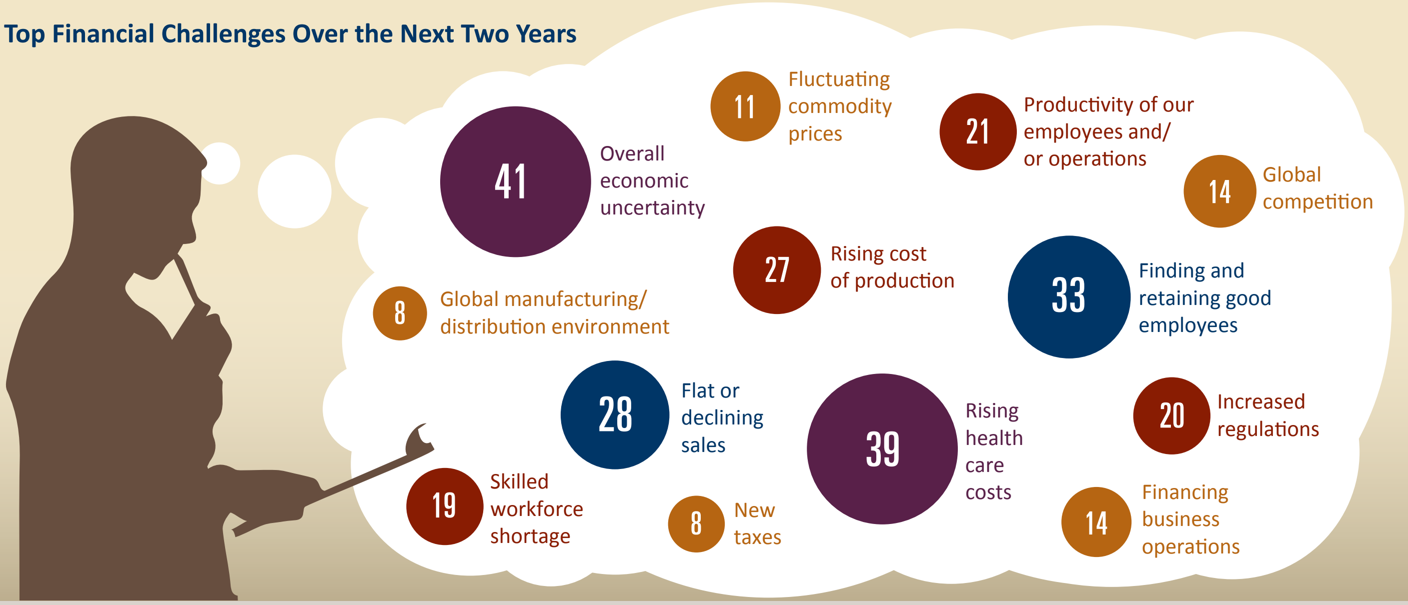
Revenues



Increase	79%
Decrease	4%
Stay the same	17%

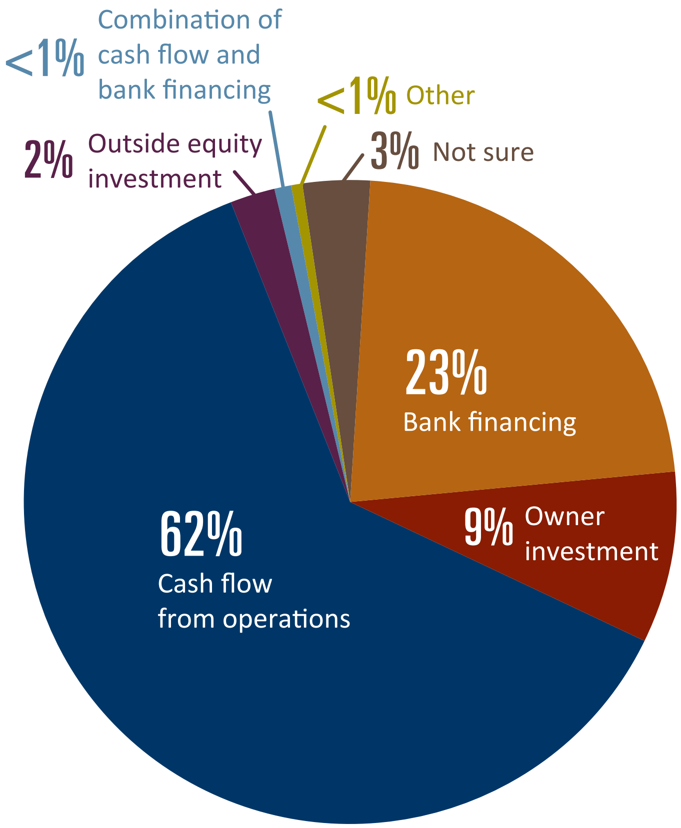
Revenue and profitability growth — Survey respondents noted that current and anticipated growth in revenue and profitability can be attributed to increased product demand, successful product development efforts, and improving and expanding customer relationships. Not surprisingly, owners and executives also indicated that their positive outlook will be challenged by continued economic uncertainty, rising health care costs, and the availability of good employees. Companies said they are using continuous improvement to offset these challenges, with cost reductions being the primary focus.

Top Financial Challenges Over the Next Two Years



Participants were asked to choose their top three challenges. Numbers represent respondent percentages.

Investment Funding Sources



Working capital — Overall, respondents indicated that the availability of working capital has not impaired their growth plans, though working capital requirements for inventory and accounts receivable have increased for 30 to 40 percent of respondents. To fund business investment, companies are overwhelmingly using cash flow from operations rather than bank financing, owner investment, or other funding mechanisms.

Increases in working capital requirements could indicate that the discipline in capital management has slipped. It could also be the result of continued growth or diversification. The key to substantiating increases in working capital is to understand if there is an appropriate return for the additional investment. The higher demand for working capital has not limited the ability to grow, but continued scrutiny of the balance sheet is essential to cash flow, sustainability of business value, and the overall healthy management of the business.

Pairing working capital with sustained profitability can create flexibility (from a cash flow and leveraging perspective) to diversify owner wealth outside of the business. Owners should consider this when making a choice between external financing or cash flow from operations. This type of planning allows the company to withstand unforeseen circumstances that could negatively impact the business.

An environment of improving revenue and profitability is an ideal time to proactively engage in managing the balance of investing in the business and moving cash flow outside of the business to diversify the wealth of the owner. This balance of wealth will reduce enterprise risk and strengthen the financial engine of *The Value Triangle*.

Looking Ahead

In 2013, manufacturing and distribution leaders told us that economic uncertainty, rising health care costs, and finding and retaining skilled workers were the foremost issues on their minds. It is encouraging to see a downward trend in concern with economic uncertainty over the past three years. Economic uncertainty topped the list for 51 percent of respondents in 2012, and 46 percent of respondents in 2013. In 2014, it fell to 36 percent, and has now been replaced as the top concern by pricing and margin compression.

This trend could be due to a belief that the economy has recovered to an acceptable level, or it may be due to the fact that there is always some uncertainty about the future; it has now moved to a more comfortable level. In any case, it shows manufacturers and distributors who are more focused on the business issues that they can control, and not on forces that are, for the most part, out of their hands.

It is also not surprising that pricing and margin compression and increasing customer requirements have moved up on the list considering the heightened competition both locally and globally.

Manufacturers and distributors are becoming very creative in meeting customer demands and they continue to balance profitability and return for business owners. Continuous improvement is the backbone of meeting this balance.

Another concern that has surfaced in the last year relates to ownership and leadership succession. Although it is not there yet, we expect to see it as a primary concern in the future. Preparing for a transition takes time and the most successful transitions occur when the process starts years ahead of the need.

To continue building upon their value and addressing their concerns, companies said they have five strategic investment priorities over the upcoming year:

1. People, plant, and equipment capacity
2. Product development
3. Customer diversification
4. Workforce development
5. Information technology

Surprisingly, we did not see the preparation for leadership and ownership transitions to be an investment priority in the next year. We expect to see future priority on preparing for these transitions.

The goal of this survey was to show how the engines of *The Value Triangle* allow manufacturing and distribution companies to address their primary concerns and meet their priorities now and in the future. An intentional focus on integrating the leadership, execution, growth, and financial engines of the business simplifies the complexities of managing a manufacturing and distribution operation while increasing flexibility for the future.

Issues Causing the Most Concern Over the Next Two Years

Investment Priorities in the Next 12 Months

✔ Capacity (people, plant, and equipment)	39%
✔ Product development	33%
✔ Customer diversification	24%
✔ Workforce development	20%
✔ Information technology	20%
✔ Leadership development	13%
✔ New technologies	13%
✔ Repair and maintenance	12%
✔ Acquisitions	10%
✔ Industry diversification	9%
✔ Increased Sales	1%
✔ Market development	1%

Participants were asked to choose their top two priorities.

Study Methodology, Sampling, and Statistical Limitations

Methodology

Data was collected through a web survey that identified CliftonLarsonAllen as the research sponsor. Email invitations were sent to clients and nonclients. A total of 358 survey responses were received, with 212 coming from CliftonLarsonAllen clients and 146 from nonclients. Responses were received from 26 states.

Sampling

In the fourth year of the study, the number of nonclients that completed the survey increased (146 in 2014 versus 91 in 2013), representing a larger percentage of the total respondents (41 percent versus 25 percent).

Eighty-seven percent of the respondents have a privately held/family ownership structure, 31 percent were reported as one owner organizations, and 53 percent reported two to five owners in the organization.

Sixty-two percent of respondents (compared to 59 percent in 2013) experienced an increase in company revenues over the past 12 months, while 16 percent experienced a decrease, and 23 percent remained the same.

Consistent with 2013, survey respondents represent a wide variety of manufacturing and distribution industries with no single category making up more than 17 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

CLA'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, consulting, and outsourcing 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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