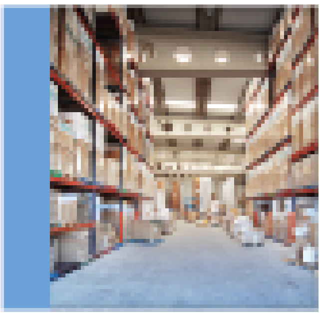
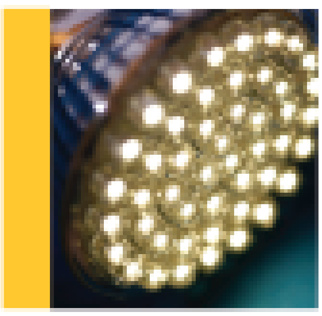
MANUFACTURING OUTLOOK

Findings of a National Survey of the Manufacturing and Distribution Industries

2011 and Beyond





INTRODUCTION

At Clifton Gunderson, we are committed to listening to and learning from companies in the industries we serve. Knowing what's happening "out there" is a top priority throughout the firm.

As the economic outlook slowly improved late in 2010, we saw an opportunity to reach out and learn where the manufacturing and distribution sector sees itself heading in the next few years. By gathering feedback on the concerns, priorities and growth strategies within the sector, we believe we can provide better support and greater value to the companies we serve.

This special report assembles the input of manufacturing and distribution executives so it can be studied, analyzed and acted upon. It is one of the ways we are staying in touch with the issues and concerns that matter most in manufacturing and distribution.

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EXECUTIVE SUMMARY

Most manufacturing and wholesale distribution companies would like to say "goodbye and good riddance" to the Great Recession. However, judging by important statistics like employment, the nation as a whole will not be putting this historical economic downturn behind them in the immediate future. The National Bureau of Economic Research declared the recession over in June 2009, but many are still skeptical.

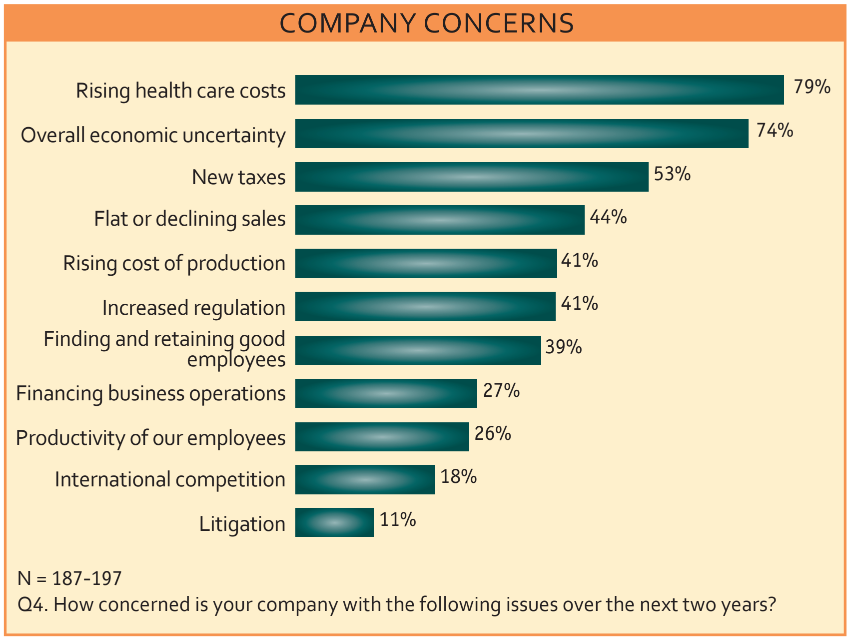
Based on the input of more than 200 manufacturing and wholesale distribution executives, it is safe to say that ongoing caution and uncertainty are lingering effects of the recession. This cautious outlook can be seen in a number of the survey findings.

- Of the small (<50 employees) and midsize (50-99 employees) companies responding, 63 percent say they are delaying major business initiatives.
- Almost half of all survey respondents (48 percent) have delayed hiring additional staff.
- Of all survey respondents, 74 percent say they are concerned with overall economic uncertainty; 59 percent say overall economic uncertainty will be one of their top two concerns over the next two years.
- Revenue has an impact on how companies are dealing with the economy. Those with revenue between $15 million and $50 million are making more staffing adjustments (26 percent) and increasing marketing efforts (12 percent) more than companies with revenues over $50 million (10 percent and 2 percent, respectively).
- Eighty percent of companies responding to the survey feel the Patient Protection and Affordable Care Act will have a negative impact on their organization over the next three years.
- Only 28 percent of companies feel they are prepared to implement the provisions of the Patient Protection and Affordable Care Act.
- Nearly half of responding companies (45 percent) say they are currently exporting, while 49 percent say they have no plans to export in the near term.

In spite of the uncertainty among manufacturers and wholesale distributors, there are reasons to believe that the worst of the recession is over. Even so, it may take more widespread and sustained growth before some of these manufacturers and distributors see the future with more optimism.

THE MOOD IN MANUFACTURING

The mood among those responding to the survey was cautious and reserved. While there are clearly improvements in the overall economy in the past year, there are still deep concerns about rising costs, especially the cost of health care.



Proceeding with Caution

Uncertainty is weighing heavily on the manufacturing and distribution sectors, leading to an unwillingness to hire new workers or undertake large growth initiatives. Most manufacturing executives say they are proceeding with caution. Rather than developing a long-term strategic growth plan, many are simply taking whatever steps they feel are necessary to remain viable in the short term:

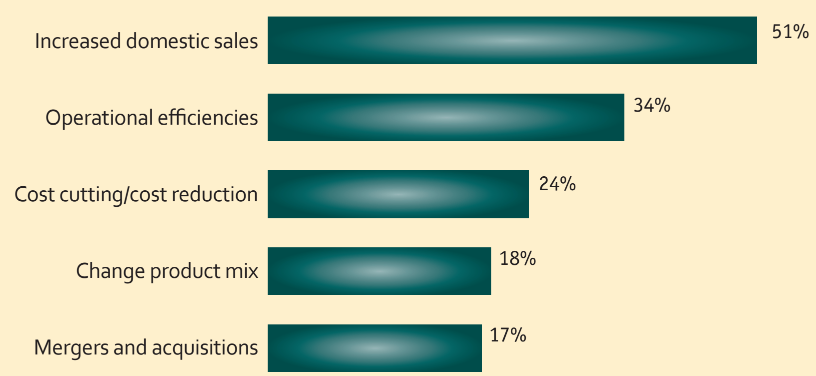
- Slightly more than one-third of companies (35 percent) that responded to the survey say they are working to contain/control costs; 18 percent say they are making adjustments to current staffing.
- Of the small (<50 employees) and midsize (50-99 employees) companies responding to the survey, 63 percent said they are delaying major business initiatives.
- Only 16 percent of respondents say they have plans to expand into new markets.

Taking Action

Manufacturing companies and wholesale distributors of all sizes are employing similar measures to stay afloat. As illustrated in the graph below, the majority of companies say that their strategic focus is on increasing domestic sales and improving operational efficiencies. They are indicating that there will be less focus on cost cutting, and that mergers and acquisitions are the least likely strategy moving forward.

- A small percentage of midsize (50-99 employees) companies are increasing sales and are taking a more aggressive sales approach (18 percent), while even fewer (6 percent) small companies (<50 employees) are doing the same.
- Smaller companies say they are concentrating on customer relationships and customer needs as a step toward increasing viability and profitability.
- Those companies that have improved their profitability in the past year say they are concentrating on customer relationship/needs more than those that have experienced decreased profitability.
- Based on the survey, revenue has an impact on how companies are dealing with the economy. Those with revenue between $15 million and $50 million are making more staffing adjustments (26 percent) and increasing marketing efforts (12 percent) more than companies with revenues over $50 million (10 percent and 2 percent, respectively).

TOP STRATEGIC FOCAL AREAS



Note: Top 5 mentions are shown
N = 197
Q5. Over the next two years, what are your top two strategic focal areas to increase growth?

WHAT IT MEANS

Early on, analysts predicted that recovery from a recession as deep as the one we are now leaving would not be easy or fast. We're seeing those predictions come true. Growth comes with improvements in industrial production and job creation. But those improvements are seldom seen without corresponding improvements in consumer confidence and spending. Companies are holding back on investing in new equipment, facilities and workers due to a perception rather than the reality of economic prospects.

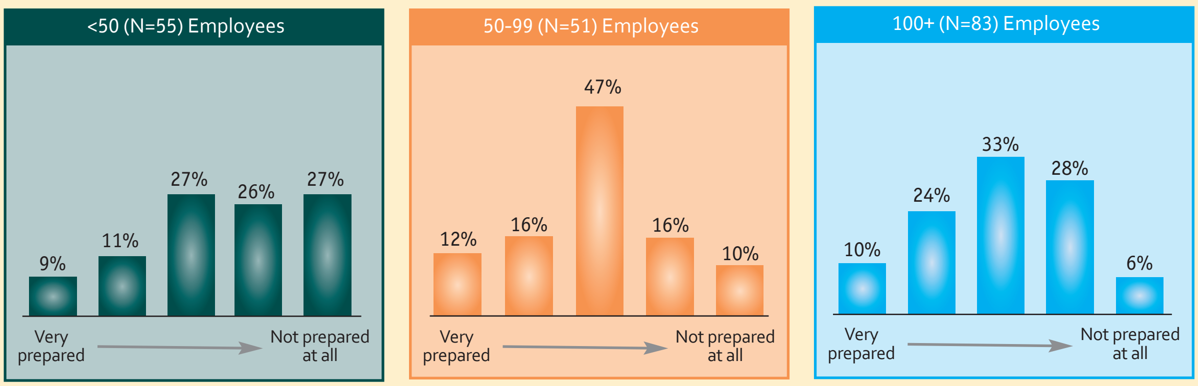
While the lag time from technical turnaround to measurable gains is longer than with past recessions, signs of a sustained rebound are growing stronger. Federal growth initiatives like corporate tax relief, bonus depreciation and liberalized expensing are all aimed at reducing costs, improving cash flow, and stimulating industrial spending and hiring. Manufacturing and distribution companies should give informed consideration to how these options can create opportunities and renew growth.

Concerns with Health Care

Among those companies responding to the survey, most say they are concerned about health care reform. However, only about one-quarter of those responding say they are knowledgeable about what impact that reform legislation will have on their business.

- Eighty percent of manufacturers responding to the survey feel the Patient Protection and Affordable Care Act will have a negative impact on their organization over the next three years.
- Only 27 percent of those who say health care reform will have a negative impact indicated they were knowledgeable about the changes they need to make to their benefits. Only 26 percent say they are knowledgeable about timing for implementing the reform provisions. Even fewer (18 percent) say they are knowledgeable about the tax implications of health care reform.
- Only 28 percent of companies feel they are prepared to implement the provisions of the Patient Protection and Affordable Care Act.
- Small companies with fewer than 50 employees are less knowledgeable than others about health care reform and are not as prepared as others to implement changes.

REFORM PREPAREDNESS BY COMPANY SIZE



Q2. Overall, based on your current knowledge of the Patient Protection and Affordable Care Act, how prepared is your company to implement the reform provisions?

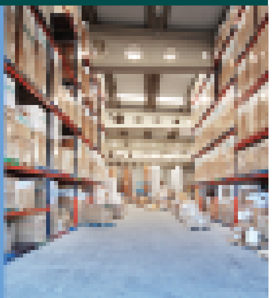
WHAT IT MEANS

There appears to be an urgent need for education regarding health care reform. It has been more than a year since the Patient Protection and Affordable Care Act was passed, and still companies do not know just how it will impact their business. As a result, companies are not planning any financial adjustments or operational changes to handle the new mandates. They are naturally skeptical of what they do not know or understand.

Some believe that the bulk of the health care law will never be implemented, or that it will be repealed after implementation. These skeptics see no reason to invest time and resources into something that they believe will never happen.

Whether it comes from the public or private sector, there must be a major educational effort focusing on the public and the business communities. While there is a current and pressing need to know about some provisions of reform, other provisions will not be implemented until 2014 or later.

Companies should be proactive in seeking out information on this issue that could have a dramatic impact on future profitability. The more detailed information a company has, the better prepared it will be to manage and benefit from the change.

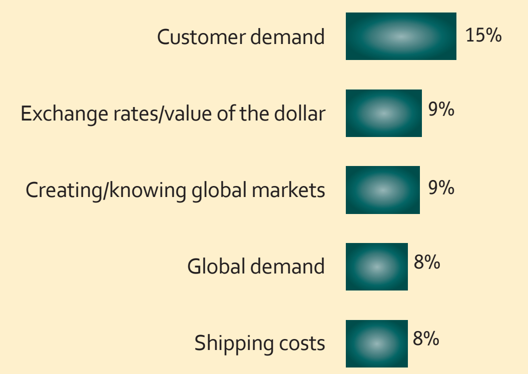


GLOBAL CONNECTIONS AND CONCERNS

Nearly half of responding companies (45 percent) say they are currently exporting, while 49 percent say that they currently do not export and have no plans to export. Of those who do not export, just 6 percent say they plan to start exporting in the next two years.

The survey revealed a number of factors that determine whether or not a company exports. Of those that say they are currently exporting or plan to do so, 15 percent say that customer demand has the most influence on their export activity.

DRIVERS THAT INFLUENCE EXPORT PLANS



Note: Top 5 mentions are shown
N = 99
Q2. What internal or external drivers have the most influence on your export plans?

When determining where to export, companies say they look first at countries where they have been successful in the past, and those where they believe they will be successful in the future. The majority say they choose to focus their exports on certain countries because they have existing business there, while 31 percent say they choose a country for exports because they see opportunities for growth.

When asked about trade issues and challenges in specific countries:

- Just over 10 percent of U.S. companies responding say they are concerned with trade issues in South Korea (13 percent) and Columbia (12 percent).
- One in six manufacturers say they currently export or plan to export to Columbia (17 percent) and South Korea (16 percent).
- Most companies plan to focus their exports on North America, with 56 percent mentioning Canada and 37 percent mentioning Mexico.
- Twenty-one percent say they plan to focus their exports on the United Kingdom and/or China.

While more than half of survey respondents say they are currently exporting or planning to export, many do not see international markets as critical to their future growth.

- Only one-quarter consider international markets to be important to their total revenue.
- More than half (58 percent) indicate that international revenue accounts for less than 1 percent of their business.
- Less than one-third of respondents either currently have or are considering overseas operations.
- Among those who either currently have or are considering overseas operations, more than half are unaware of transfer pricing issues, while 23 percent have obtained a formal transfer pricing study.

WHAT IT MEANS

The drumbeat for increasing exports grows louder every year, and yet it would appear that the majority of companies are still not able or willing to answer the call. Some believe they never will export due to their size or the nature of their products. The fact that more than half of survey respondents say international revenue is less than 1 percent of their business indicates why exports may be a very low priority.

Companies of all sizes are engaged in exporting, but the economic climate is leading many to remain focused on domestic markets. The fact that most exporters in the survey are selling to Canada and Mexico may be a product of the North American Free Trade Agreement, or it may be a further illustration of the risk aversion that still exists in the post-recession economy.

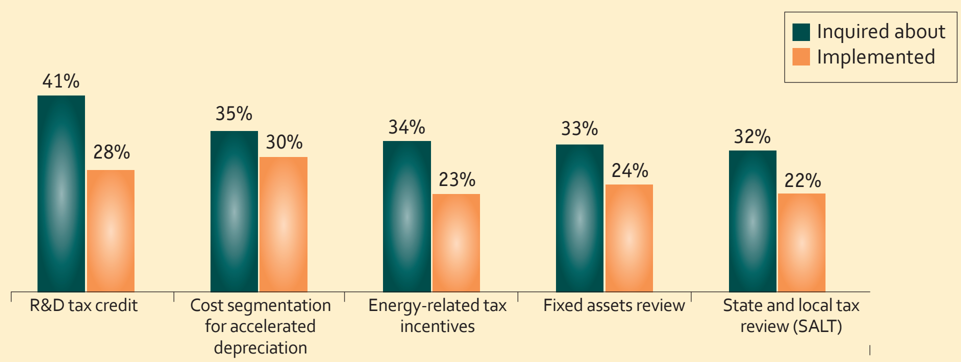
Public incentives, private capital and overseas demand drive exports. If all three are plentiful, even the smallest companies will be able to access the resources they need to expand into the global marketplace.

TAXES

Many of the surveyed companies say they have investigated tax strategies and have implemented at least one, yet no one strategy can be seen as a clear favorite. Research and development, cost segregation, fixed asset reviews, energy-related incentives, and state and local taxes are among the issues mentioned.

- Forty-one percent of companies say they have inquired about the research and development tax credit, but only 28 percent have actually used it.
- Similarly, 35 percent have inquired about cost segregation and accelerated depreciation, but only 30 percent are using them.
- One in five survey respondents (21 percent) says they are not using any special tax strategy.
- Companies with fewer than 50 employees are less likely to be using a specific tax strategy than those with more than 50 employees.

TAX PLANNING STRATEGIES



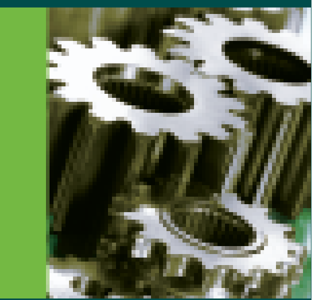
N = 142
Q25. Which of the following tax planning strategies have you inquired about for your business?

WHAT IT MEANS

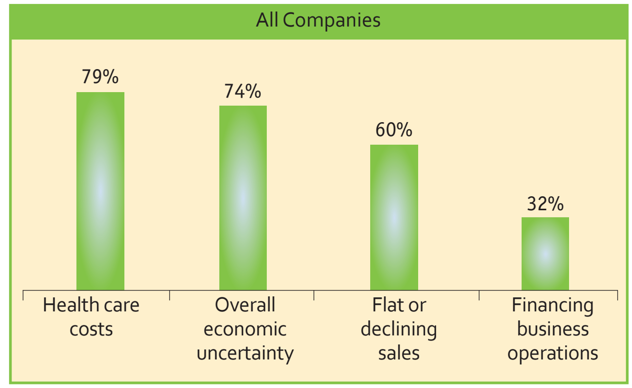
The survey does not reveal the reasons that companies are not using specific tax strategies or taking advantage of certain incentives. The fact that 41 percent of companies have inquired about the research and development credit is a positive indicator, but the conversion of interest into application is not nearly as strong. Some companies may falsely believe themselves to be too small, too large or otherwise not qualified.

Also significant is the fact that 21 percent of companies are not using any tax strategy. Ongoing, year-round tax planning is a proven strategy for reducing costs and improving cash flow, and the fact that 79 percent of companies surveyed use some level of tax planning is a positive sign. Increasing that percentage even further could have immediate and long-term effects on profitability.

LOOKING AHEAD



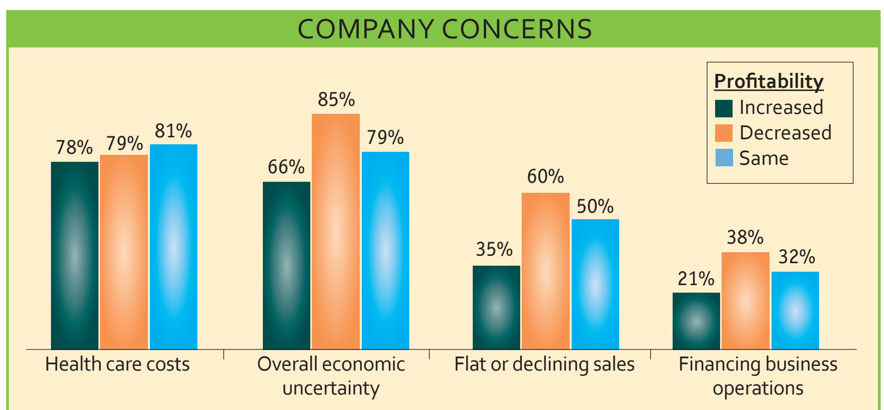
The concerns that companies have in today's marketplace mirror those they expect to have over the next two years. A consistently high percent (79 percent) of companies are concerned or very concerned with rising health care costs. This concern is consistent regardless of company size, revenue or profitability last year.



Other areas of high concern are the economy, sales and financing. The level of concern in these three areas is often higher among companies with decreased or flat earnings.

Overall economic uncertainty was cited by 74 percent of respondents as one of their greatest concerns over the next two years. A significantly higher number of companies with decreased profitability in the past year say they are concerned with the cost of health care.

- Companies are significantly less concerned with financing business operations and flat or declining sales than they are with overall economic uncertainty.
- Over the next two years, 51 percent of companies responding to the survey say they will focus on domestic sales to increase growth; 34 percent say they will focus on operational efficiency; and 24 percent say they will be looking for ways to reduce costs.
- Mergers and acquisitions are an area of focus for only 17 percent of companies.



N = 195-197
Q4. How concerned is your company with the following issues over the next two years?

WHAT IT MEANS

Companies are deeply concerned about health care costs and do not know how health care legislation will affect them. Whether or not health care reform will actually slow the growth of costs remains to be seen. Taking action to learn more about health care reform and its intended impact on costs would be a strong, proactive strategy. As it relates to long-term profitability, health care reform becomes a risk factor that should be addressed in all strategic planning.

The less pressing concern with the financing of business operations may be the result of companies hoarding cash and not expanding their operations. Many have plenty of cash on hand to maintain day-to-day operations. Evidence of this "hunker down" and wait mentality can be seen in the slow recovery of production and employment. Until the decision is made to increase production, hire new workers and expand facilities, demand for financing will remain low.

STUDY METHODOLOGY, SAMPLING AND STATISTICAL LIMITATIONS

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

Methodology

Data were collected with a Web survey that identified Clifton Gunderson as the research sponsor. Outside of the offer of a complimentary copy of the results, no incentives were used to encourage participation. A total of 207 Clifton Gunderson clients and prospects completed the survey, exceeding the target of 150.

Sampling

It is important to note that the sample size is not reflective of the population. Of the 207 manufacturers and wholesale distributors that responded to the survey, 30 percent were small companies (<50 employees), 27 percent were midsize companies (50-99 employees) and 43 percent were large companies (>100 employees).

Over half of the companies reported an increase in overall profitability over the past 12 months. Less than one-quarter experienced a decrease in overall profitability and 21 percent remained the same during the past year.

Of the respondents, 40 percent reported revenue of less than $15 million. One-third were between $15 million and $50 million, and 27 percent were over $100 million. Revenue tied closely with the size of the company, with the majority of small companies (<50 employees) earning less than $15 million, midsize companies (50-99 employees) earning between $15 million and $50 million, and large companies (>100 employees) earning more than $25 million.

The industries where respondents were employed were metal fabrication (18 percent), industrial and commercial machinery (12 percent), agriculture supply/production (9 percent), food and beverage (7 percent), other manufacturing (28 percent), other distribution (12 percent) and other single mentions (14 percent).

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, it can be deduced that the selected level variation is due to real differences in opinion and not due to chance.

For example, the sampling error for this survey (combined clients and prospects) is +/-6.8 percent at the 95 percent confidence level. This means that if the study were repeated 100 times with this sample size, the results would be within +/-6.8 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, between 53.2 percent and 66.8 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 onto the population they represent.

IN THEIR OWN WORDS

What manufacturing and distribution companies say they are doing to increase viability and remain profitable.

"Trying to be efficient with our workforce, and maintain our gross margins."

"Starting to increase inventory levels and hiring new employees to keep up with demand."

"I believe the recession is not over. We need to watch our accounts receivable closer to avoid any write-offs."

"We have delayed the purchase of some fixed assets."

"We have been taking several steps to further increase profitability: Being more aggressive with our sales team, really challenging all current assumptions and looking at all costs as an opportunity for reduction."

"Cash management is important. Productivity improvements must be continued."

"We're doing our best to make our products very cost effective and position our products as capital investments, rather than profit and loss expenditures."

"Trying to refinance our bank debt and obtain additional working capital."

"Buying out other businesses and closing down the ones that are not profitable."

"The marketplace is picking up and we are seeing our customers start spending. We continue to invest in research and development and infrastructure."

"Investing in and initiating lean manufacturing principles."

"We are continuing to use technology to streamline our processes."

"The business climate is steady and showing growth from restrained investment and deferral of repairs."

"We are investing in inventory, manpower and facilities."

"Continued international expansion and expense reduction are the keys to profitability."

ABOUT CLIFTON GUNDERSON

Clifton Gunderson, ranked as one of the nation's largest certified public accounting and consulting firms and the largest U.S. member firm of HLB International, provides a wide range of assurance, tax and consulting services to clients in a variety of industries. Founded in 1960, Clifton Gunderson has a staff of more than 1,900 professionals serving clients from 46 offices across the country.

Manufacturing and wholesale distribution have been a concentration for the firm throughout its 50 year history. Client service teams include members with strong backgrounds and experience in manufacturing and wholesale distribution, as well as additional training on trends and issues affecting the industry.

Clifton Gunderson, and the separate and independent member firms of HLB International, provides personal and high-quality service to clients in over 100 countries through the HLB International "Global Care" approach. For more information about Clifton Gunderson, visit **www.cliftoncpa.com**.

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