2012 Manufacturing & Distribution Monitor Report

McGladrey

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Executive summary

Businesses in manufacturing and distribution are still growing in 2012, but that growth — and the optimism that accompanied it — is tempered by a number of influences. Following a relatively positive year for sales performance and expansion, executives of midsize companies find themselves in an uncertain business landscape complicated by faltering economies in Europe and elsewhere, with a growing apprehension that potential changes in U.S. policies and tax rates could have a negative impact on business.

Outlook for growth

Despite their concerns about the U.S. and world economies, however, executives are generally optimistic about their prospects in the next 12 months. Since most businesses reported they are thriving or holding steady; this may be a factor in their optimism.

U.S. sales at most organizations rose in the past 12 months, and are expected to keep growing in the next 12 months, albeit at a much lower rate. That increased performance is echoed in non-U.S. sales growth, which is expected at a much lower rate. The stark difference in U.S. and non-U.S. sales growth may be best illustrated by the number of companies expecting sales increases in these markets in the next 12 months: 82 percent expect an increase in U.S. sales; only 56 percent expect an increase for sales overseas.

Notably, nearly all of thriving businesses expect to increase U.S. and non-U.S. sales in the next 12 months; their average sales increases are anticipated to be approximately double that of businesses that are holding steady or declining.

Cost expectations and maintaining margins

Most businesses expect costs in many categories to increase in the next 12 months, particularly in areas such as transportation and fuel costs, equipment and machinery, and energy and fuel; some expect transportation and fuel costs to increase by more than 10 percent.

To combat these rising costs, the most common strategy to maintain profit margins is to lower costs through operational efficiencies — such programs are in place at 88 percent of organizations. More than half of businesses also are working with suppliers and/or customers to improve processes and costs. Just under half plan to continue the strategy seen in previous Monitor surveys: increasing prices to a majority of customers, and 36 percent will increase prices to select customers and markets. As a result, net income is expected to increase at 74 percent of businesses in the next 12 months.

Given the low cost of capital and expectations for rising income, two-thirds of businesses plan to increase their capital equipment investments in 2012 as compared to 2011. The top two business objectives for the next 12 months among industrial firms are to expand existing facilities/warehouses, and to build or acquire new ones.

Yet there may be some hesitation when it comes to these types of investments. As the year enters its final quarter and national elections loom on the horizon, capital expenditure decisions may be made in the fall with more caution than what might have been in the spring. Of concern to many businesses is the expiration of Bush-era tax cuts at the end of 2012.

Workforce

Years of reduced staffing may be catching up with the industry. A majority of businesses plan to increase total employment in the next 12 months, for both U.S. and non-U.S. workforce personnel.

Finding new hires with the right skill sets, however, could be challenging. Approximately 41 percent of businesses report that they find the skilled talent they require only rarely or some of the time. A majority of businesses manage this skills gap through internal training and development programs.

Manufacturers and distributors differ considerably on where they will add employees. A majority of manufacturers will focus on production/operations, but nearly half of distributors will focus on customer service/support functions. With a growing workforce, of course, comes an expected rise in costs for wages, benefits and other variable compensation.

Process improvement

Few organizations can survive without continuous efforts to improve productivity. Indeed, with workforces so lean, organizations relying on getting more from fewer employees have needed to be as efficient and productive as possible.

Businesses will increase their investments in process improvements this year. Thriving organizations are more likely to increase these investments than firms holding steady or declining; they also are more likely to have increased productivity in the past year. The primary objectives cited for improvement initiatives are to reduce costs as well as to improve quality, customer satisfaction and speed.

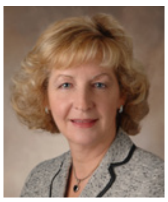
Manufacturers are more likely to focus on reduced costs, while distributors are more likely to focus on customer satisfaction. The efforts are having an effect: A majority of Monitor participants say they have improved productivity in the past 12 months. According to a number of sources, including the Bureau of Labor Statistics, U.S. workers are the most productive in the world.

Information technology

Information technology is critical for businesses to grow their organizations and optimize their supply chains. Two-thirds of distributors report at least moderate use of business analytics companywide and/or among senior leadership. Business analytics is most likely to be used to forecast customer demand, to identify market opportunities, and to allocate resources. Notably, of those businesses with extensive use of business analytics, 43 percent are thriving, as compared to 37 percent of other businesses.

Not all IT applications are being leveraged, however. While more than half of businesses use some form of social media, slightly less than half use cloud computing. And while these and other IT applications can pose new security concerns, surprisingly few executives believe their information or data is at risk.

Outlook for growth



"Manufacturers and distributors continue to feel 'steadied' in the wake of the turmoil of the past several years, however, their confidence in the U.S. and world economies is beginning to decline. Even though a healthy percentage of them are thriving or at least holding their own; they are concerned with the uncertainty that looms in the U.S., given the upcoming elections, as well as the weakening global economy."

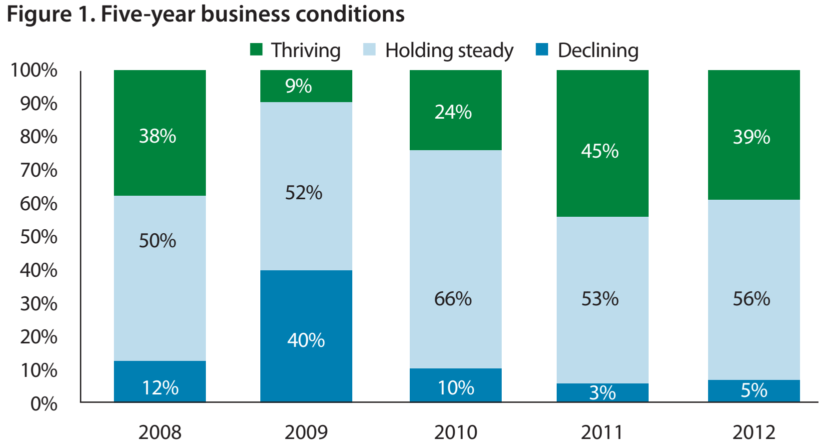
Karen L. Kurek, Partner and, National Manufacturing & Distribution Practice Leader, McGladrey LLP, Chicago, Ill.

Business executives have tempered their optimism from where they were in 2011, but they remain significantly more optimistic than they were during 2009 and 2010.

Business conditions

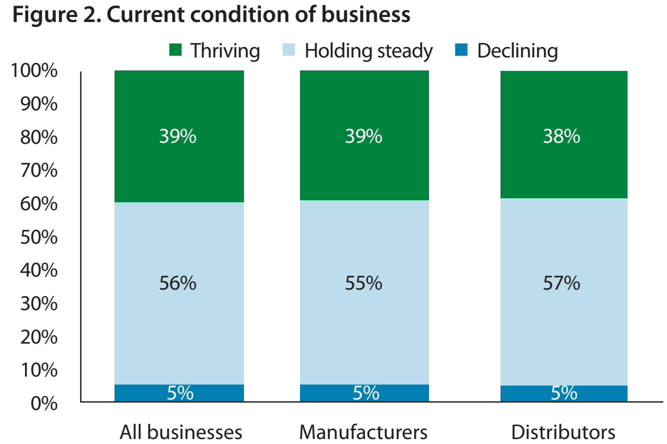
In spite of the slowing recovery the U.S. economy has been experiencing, most businesses report that they are holding steady (56 percent) or, in fact, thriving (39 percent). Compared to the Monitor Study fielded in the spring of 2011, the overall condition of industry has declined modestly — last year 53 percent of businesses reported that they were holding steady, and 45 percent indicated that their organizations were thriving. We believe these results highlight the strength and importance of middle market companies on our overall economy and the need for policies to support their growth.

Figure 1. Five-year business conditions



But the tempered optimism of 2012 has a long way to go to meet the low mark of 2009, when just 9 percent of businesses reported that they were thriving (Figure 1).

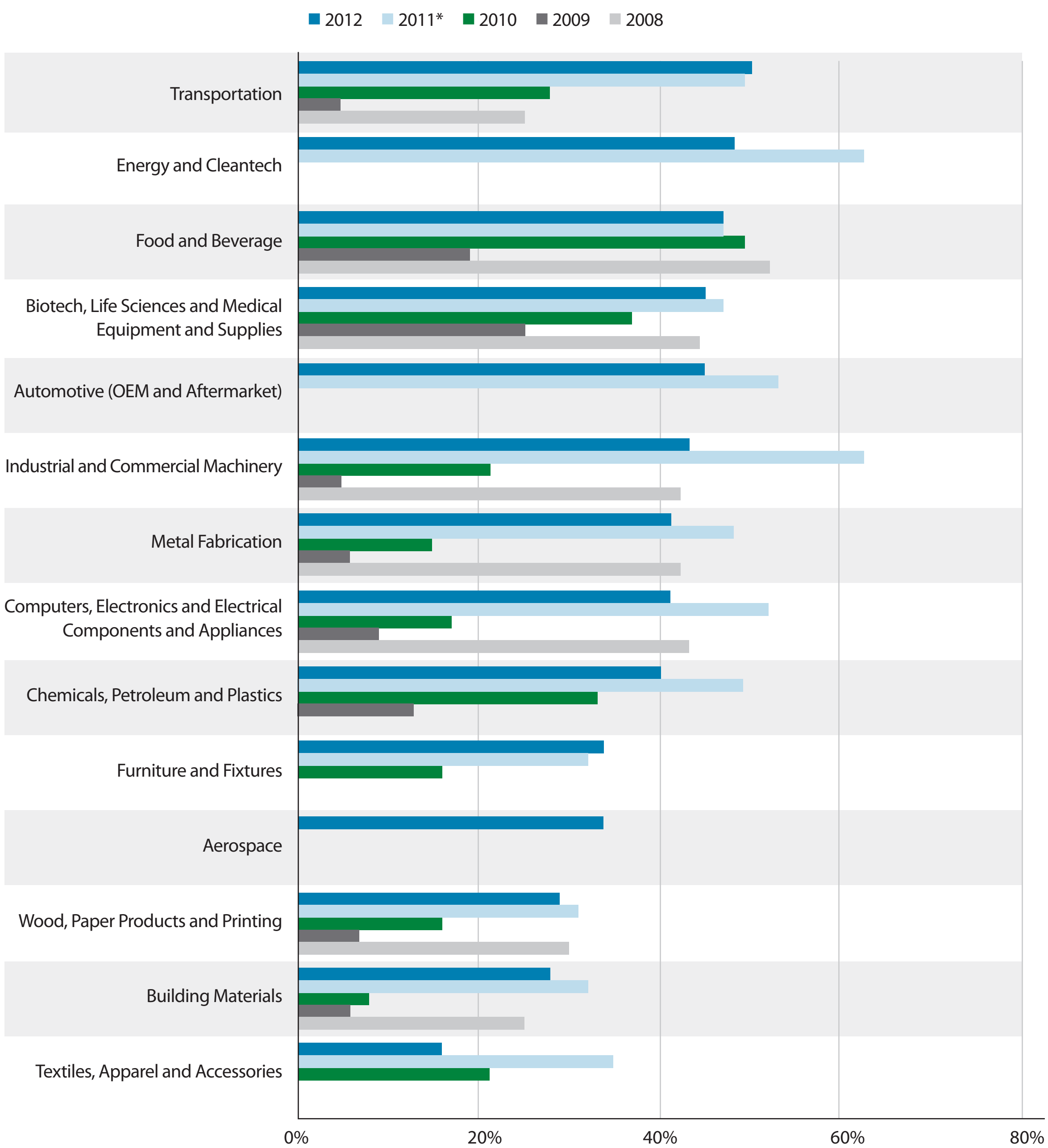
Figure 2. Current condition of business



Interestingly, when viewing business conditions for manufacturers and distributors, the results were comparable, reflecting the interdependence of these two sectors in the economic supply chain (Figure 2).

Manufacturing and distribution companies are divided into numerous industry sectors across the U.S.; the fortunes of those companies that were reported to be "thriving" over the past five years have been driving forces behind the success of their industry sectors (Figure 3).

Figure 3. Business conditions by industry segment— five-year trend of thriving companies



* 2011 data from quarterly spring Monitor Study.
Notes: Five-year categories based on 2012 Monitor Study. In 2012,
Energy and Cleantech (25 businesses) and Furniture and Fixtures (29 businesses) were the smallest sample sizes for this Monitor question.
Because some sectors were added or split during the time period, comparative information for all five years is not available for all industry sectors.

Some 50 percent of the respondents from the **Transportation** sector reported their businesses were thriving, as did 45 percent in the **Automotive** sector. This is reflective of the continued improvement in these sectors: According to WardsAuto, North American vehicle production was up nearly 20 percent in the third quarter (through calendar-year-to-date August 2012) compared to the same period last year.

Also topping the list is the **Energy & Cleantech** sector, where 48 percent of respondents are thriving. While this has waned somewhat since 2011, this sector continues to show strong results that reflect the activity in companies pioneering new energy sources such as wind, solar, bio fuels and clean coal.

The **Food & Beverage** sector continues to reflect a strong showing, with some 47 percent of these companies reporting they are thriving and growing.

"A significant reason for the growth in the food sector is due to companies capitalizing on new product innovation, which is driven by changing demographics and consumer tastes. Innovation is turning up in every food category and generating more varieties of niche products for consumers to purchase.

Additionally, there are now more and more outlets beyond just the traditional grocery store where consumers can buy food, including on-line retailers and roving food trucks. Drug stores and convenience stores continue to expand their food options that are attractive to consumers, including more fresh foods and gourmet foods."

Cristin Singer, National Leader, Food and Beverage Industry, McGladrey LLP, New York, N.Y.

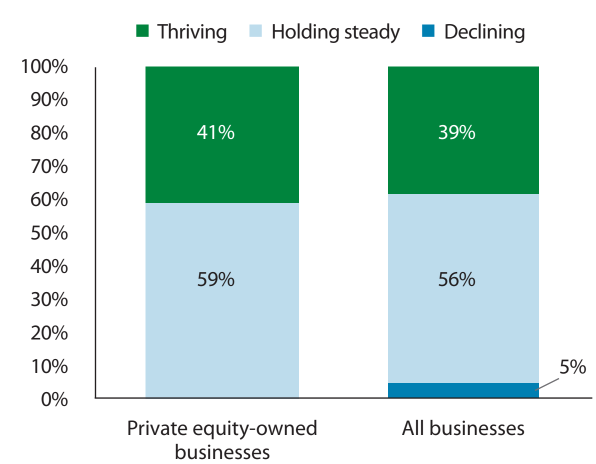
The **Industrial and Commercial Machinery** sector had a large decrease in the number of participants reporting they were thriving. This is reflective of the decrease in demand for products in this sector due to the softening of the economies in Europe and developing countries. Our work with exporters finds that companies exporting to China and India have also seen a decrease in demand.

The sectors least likely to report they are thriving include **Building Materials** and **Textiles**. Despite modest growth in the spring and summer, the housing market continues to be challenged and the sectors supporting it are also under pressure.

The largest businesses ($1 billion or more sales) and the smallest businesses (less than $25 million sales) were least likely to be thriving, at 22 percent and 36 percent, respectively, report they are thriving.

It is interesting to note that of the 92 private equity-owned businesses participating in the study none of them indicate that they are declining; in fact, 41 percent of those organizations report themselves as thriving. (Figure 4)

Figure 4. Business conditions by private equity-owned businesses



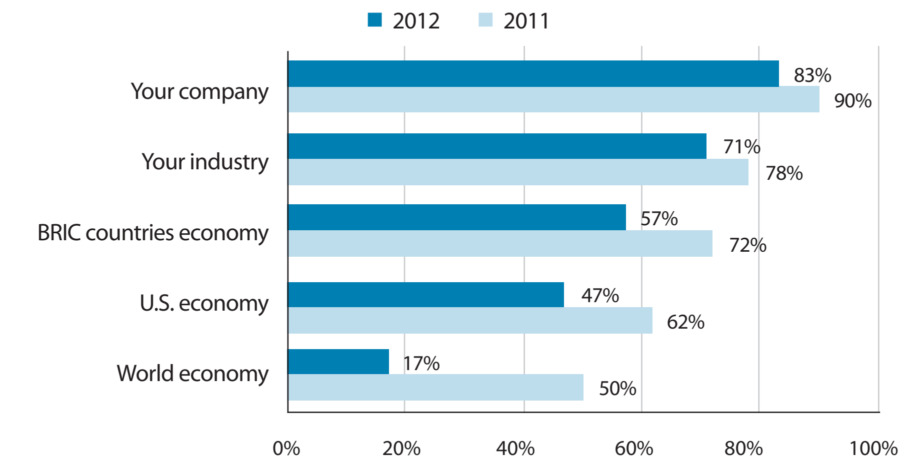
Optimism

Most manufacturers and distributors (83 percent) are optimistic about their current conditions. Their overall view of the world economy is pessimistic, however, due in part to Europe's sluggish economies and corresponding debt crises. Business optimism has fallen in all categories, with the most dramatic drop for the world economy — where only 17 percent of participants have an optimistic outlook (Figure 5).

On the other hand, more than half (57 percent) of manufacturers and distributors with operations in Brazil, Russia, India and China — known collectively as the BRIC countries — have an optimistic view of the global economy.

As noted in previous Monitor reports, manufacturing and distribution executives are often more pessimistic about issues that extend beyond their company walls than they are about their own companies or industry segments. This report finds similar perspectives, but with an important difference: this year's drop in optimism for the U.S. and world economies — a 15 percentage point and 33percentage point decrease, respectively — indicates that the industry outlook has been significantly exacerbated over the past year.

Figure 5. Business optimism year-to-year

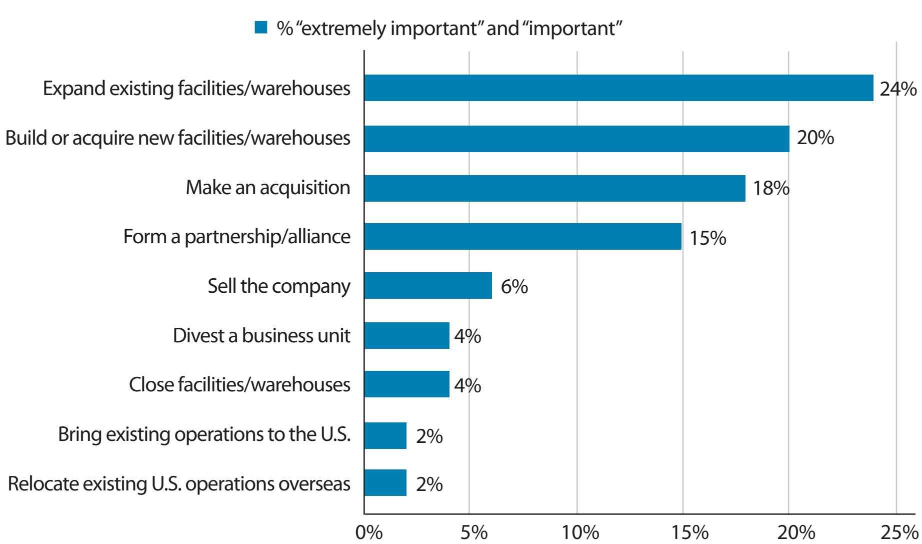


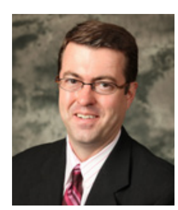
Note: In 2011, BRIC countries were referred to as "Emerging market."

Business environment and taxes

Overall, the respondents are looking to invest in the infrastructure of their businesses, and this is reflected in the top two corporate objectives for the coming year (Figure 6).

Figure 6. Corporate objectives in the next 12 months





"Manufacturers continue to expand despite the number of headwinds they are facing. Yet it is distinctly clear manufacturers are quite worried about the fiscal cliff looming at the beginning of 2013. Uncertainties regarding tax hikes, budget cuts, and slowing global growth hinder manufacturers' ability to thrive moving forward. So while the McGladrey Monitor results suggest some degree of optimism, I would submit that their positivity is a cautious one at best."

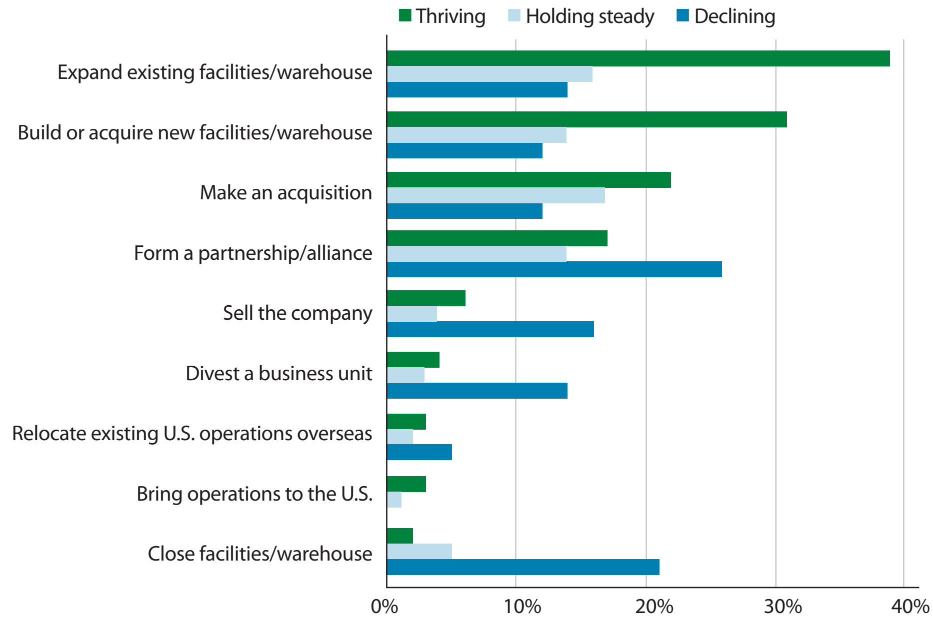
Chad Moutray, Ph.D. Chief Economist, National Association of Manufacturers

Thriving businesses are more likely to pursue corporate objectives to grow the capacity of their businesses (Figure 7): More than twice as many thriving businesses (39 percent) expect to expand an existing facility/warehouse than those that are holding steady (16 percent) or declining (14 percent). In fact, declining businesses are more likely to take action to contract their organizations: 21 percent expect to close a facility/warehouse compared to holding steady (5 percent) and thriving (2 percent) businesses.

The 2012 Monitor Study asked business executives what poses the greatest risk to their companies and business continuity in the next 12 months. Common concerns focused on the U.S. regulatory and political environment, such as:

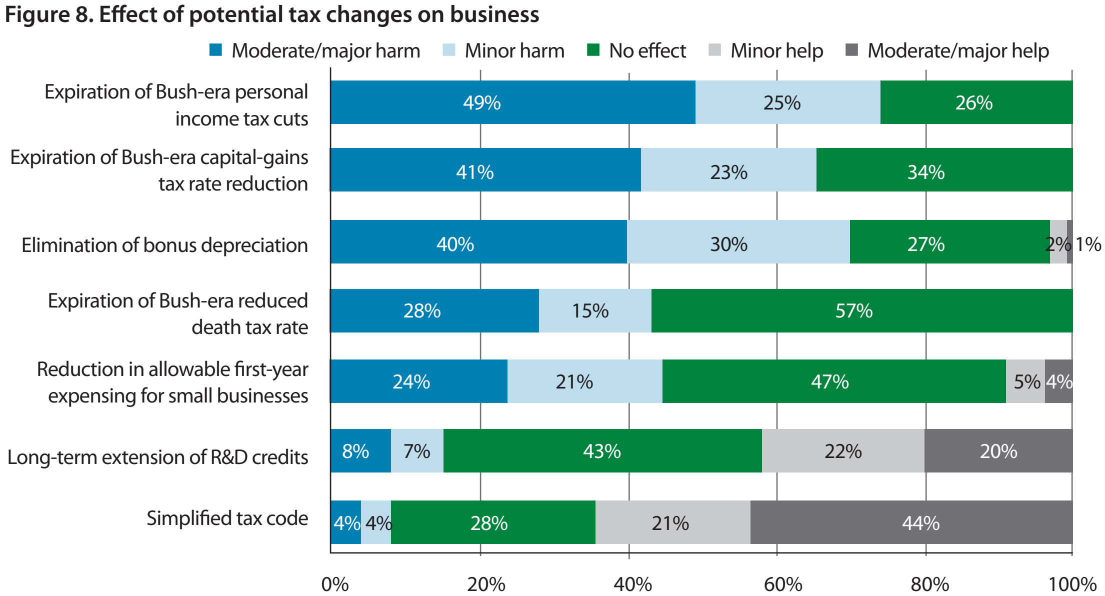
- *"Health care consolidation and governmental interference."*
- *"Overregulation and ever-expanding regulations at both the federal and state levels."*
- *"Uncertainty among our elected officials to do anything, right or wrong."*

Figure 7. Corporate objectives by business condition



Many business executives are awaiting the end of 2012 — and with it, the expiration of Bush-era tax cuts. Both manufacturers and distributors are particularly distressed about expiration of personal income tax cuts, with 74 percent reporting that the expiration would harm their businesses (19 percent report expiration will cause major harm) (Figure 8). This issue is of particular concern to industrial firms, since many in the United States are organized as pass-through entities (i.e., partnerships or S-Corps) and are taxed at individual rates. (Three-quarters of businesses participating in the 2012 Monitor Study are privately or closely held businesses.)

Figure 8. Effect of potential tax changes on business



"With the terms 'taxmageddon,' 'fiscal cliff' and 'budget deficit' often heard these days, midsize manufacturers and their owners may be wondering about the ultimate resolution of expiring tax cuts and extenders and the consequent tax effects. It will not be possible to determine the precise impact on any taxpayer until sometime after the Congressional and Presidential elections have occurred and Congress has done some major work on those matters."

Bob Adams, Partner, Washington National Tax, McGladrey LLP, Washington, D.C.

Another major concern is the elimination of bonus depreciation: 69 percent report elimination will harm their businesses (12 percent report expiration will cause major harm). Forty-four percent of businesses report that a simplified tax code would provide either moderate or major help to their businesses.

There will always be a need to balance corporate objectives designed to grow a business with concerns regarding the consequences of tax legislation. The uncertain outcome of these expiring tax cuts may be causing some manufacturers to put off investing in the growth of their businesses, new equipment, labor expansion and other major business decisions, at least for the time being.

Sales performance and projections

Many industrial firms enjoyed rising sales last year, and many expect sales to increase going forward. Yet sales increases are not expected to be as large in the next 12 months as those recorded over the past 12 months, and non-U.S. sales increases are expected to be substantially lower than U.S. increases, especially among distributors.

Domestic sales

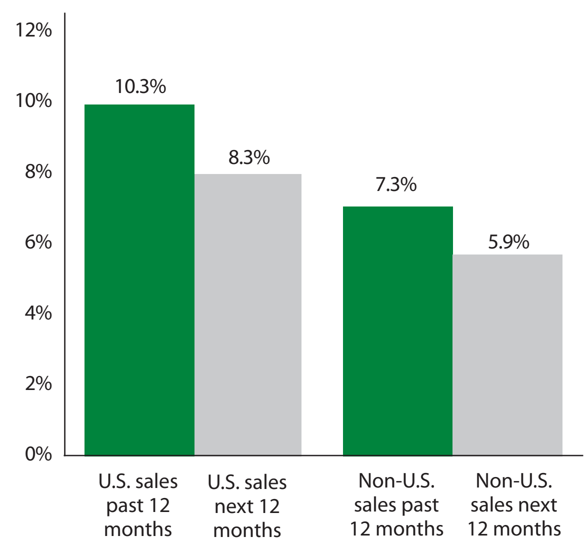
An overwhelming majority (78 percent) of participants experienced an increase in U.S. sales last year, and they expect to do so again in the coming 12 months. On average, businesses enjoyed a 10.3 percent increase in U.S. sales in the past 12 months. In the next 12 months, the increase is expected to be somewhat lower (8.3 percent) (Figure 9).

Manufacturers were more likely to post larger average U.S. sales increases for the past 12 months than distributors (10.9 percent vs. 9.5 percent, respectively); but that gap is expected to narrow as manufacturers expect to post U.S. sales increases in the next 12 months that are only slightly larger than those anticipated by distributors (8.5 percent vs. 8 percent, respectively).

International sales

International sales performances pose a stark contrast to U.S. performances: Only 46 percent of businesses increased non-U.S. sales in the previous 12 months, and 53 percent of businesses expect to increase non-U.S. sales in the next 12 months. On average, businesses increased non-U.S. sales by 7.3 percent in the past 12 months, and expect an average increase of 5.9 percent in the next 12 months (Figure 9).

Figure 9. Sales changes — U.S. vs. Non-U.S. (averages)



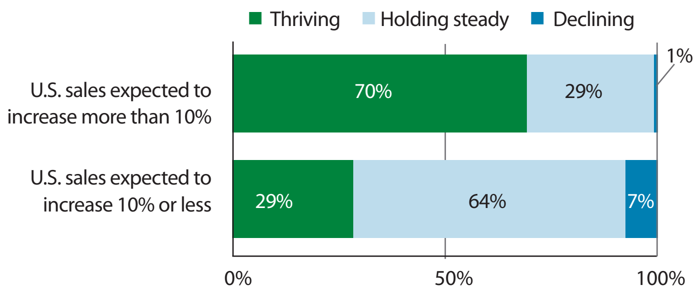
Approximately 78 percent of businesses report at least some percentage of total revenue from customers outside the United States. Yet the sales performances of these companies are only modestly better than participants in total: 56 percent increased non-U.S. sales in the past 12 months, and 64 percent expect non-U.S. sales to increase in the next 12 months.

As with sales in the United States, manufacturers were more likely to post larger non-U.S. sales increases for the past 12 months than distributors — and they expect to post larger non-U.S. sales increases in the next 12 months.

Thriving and growing

Companies with the largest increase in sales expectations are also the ones that are thriving. Approximately 70 percent of businesses with the highest expected sales increases (greater than 10 percent increase) are thriving organizations (Figure 10).

Figure 10. U.S. sales expectations



The majority of thriving businesses recorded sales increases the past 12 months or expect sales increases in the next 12 months. For example, 95 percent of thriving businesses expect to increase U.S. sales in the next 12 months by an average of 12.6 percent. These figures are significantly higher than businesses holding steady or declining (Figure 11a). Thriving businesses also are doing better with non-U.S. sales as well (Figure 11b).

Figure 11a. U.S. sales increase by business condition (averages)

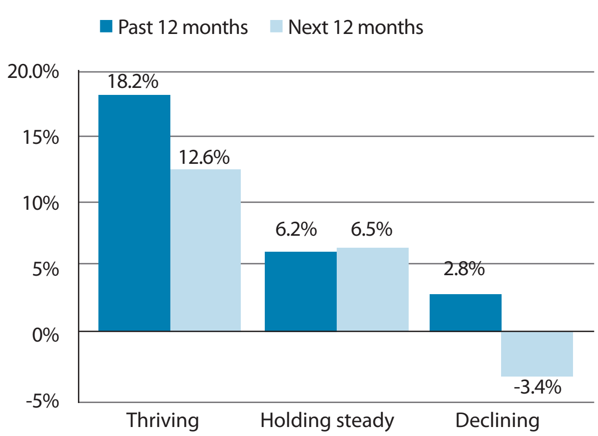
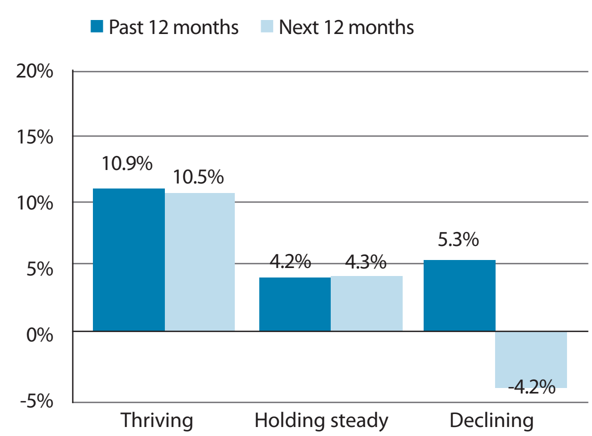


Figure 11b. Non-U.S. sales increase by business condition (averages)

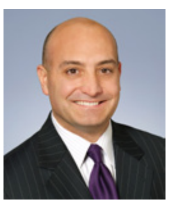


Growth by industry sector

Performance by an industry sector is dependent on so many external variables — natural, economic, political and geographic elements, among them. Monitor surveys have identified the internal strategies and best practices that enable individual companies to thrive and grow. But the fiscal performance of sectors overall can rise or fall (Figure 12) in spite of (and sometimes, because of) these external factors.

Approximately 79 percent of **Food and Beverage** businesses increased U.S. sales the past 12 months, and 80 percent expect to increase U.S. sales in the next 12 months. Not surprisingly, 47 percent of food and beverage businesses report themselves to be thriving. As noted in earlier Monitor reports, this may be attributable to the "recession-resistant nature" of this sector.

The **Biotech**, **Life Sciences & Medical Equipment** sector anticipates sales growth at home and outside the U.S., with increase estimates to be 12 percent and 11 percent, respectively. Growth is expected despite the impending 2.3 percent excise tax that medical device manufacturers will have to pay starting January 1, 2013, as part of the Patient Protection and Affordable Care Act.



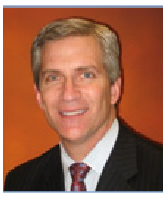
"Political battles aside, the health care reform act will drive the growth of the pool of 'insured patients' served by life sciences companies, including pharmaceutical and medical device firms. Revenue growth will also come from sales into both mature markets (such as Europe) and emerging markets, where governments are enhancing their health care systems in step with economic development. The bottom line: the overall survey results in the Biotech, Life Sciences & Medical Equipment sector accurately reflect our forecasts of greater-than-average sales."

John F. Lanza, Partner, Tax Services, McGladrey LLP, New York City, N.Y.

The **Aerospace** sector is anticipating a reduction in growth this may be due to the sequestration set to take place at the beginning of January 2013, when nondiscretionary spending cuts will begin and defense expenditures are likely to be affected. These cuts in defense spending could be harmful to a range of sectors in the industry that are direct and indirect suppliers of defense equipment manufacturers. The National Association of Manufacturers reports that these pending cuts could result in the loss of as much as 130,000 manufacturing jobs in 2014. Non-U.S. sales are expected to experience even slower growth.

"Pending cuts in defense spending under the Budget Control Act of 2011 will impact the manufacturing sector and the broader U.S. economy. Certain industries will be hit particularly hard, with the aerospace industry losing 3.4 percent of its jobs. This employment impact includes the loss of jobs at defense contractors due to a decrease in purchases for equipment, supplies and services, as well as at firms that supply the contractors."

Dorothy Coleman, Vice President of Tax and Domestic Economic Policy, National Association of Manufacturers



"We believe we are in an economic phase where some sectors may experience better results than others. For example, the impact of lower natural gas prices and new energy exploration methods has supported and nurtured stronger results for companies serving that market. On the negative side, we have seen the continued struggles of housing- and construction-related companies, especially those that depend on activity in the United States."

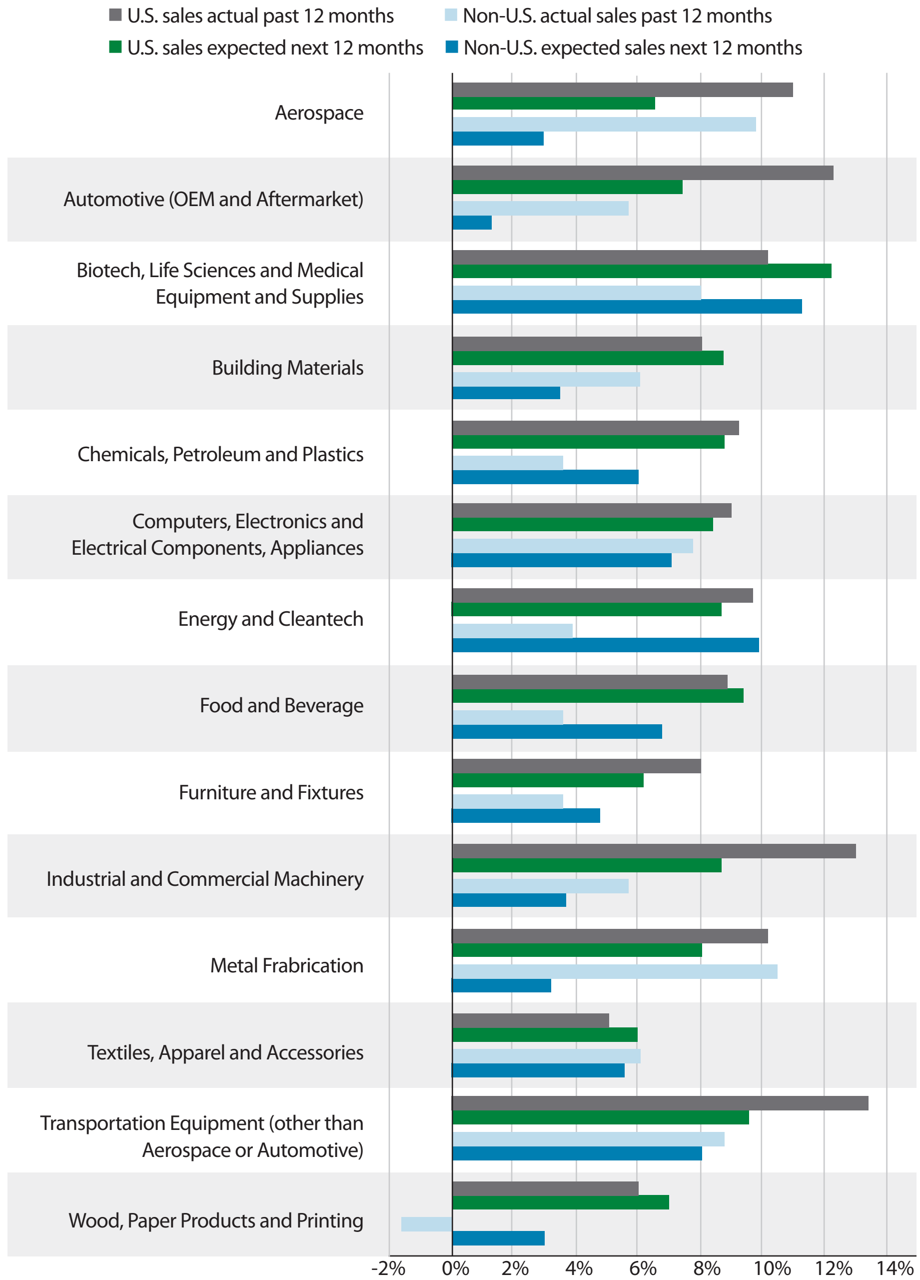
Steven A. Menaker, Assurance Partner, McGladrey LLP, Charlotte, N.C.

Some sectors, in fact, anticipate a significant decrease in sales growth for the coming months. As discussed earlier, the **Industrial & Commercial Machinery** sector is anticipating slower growth of 8 percent over the next 12 months, as compared to last year when it enjoyed a 13 percent growth rate in the U.S. There are similarly diminished expectations for non-U.S. sales in this sector as well.

Similarly, the **Automotive** and **Transportation** sectors are expecting a slowdown in sales growth in both domestic and international sales in the coming year due at least in part to the economic situation in Europe as well as a reduction in consumer confidence in the United States.

Businesses were asked to rate the importance of their sales strategies to their organizations (Figure 13). By far, the primary sales strategy is increase penetration of existing markets, with 80 percent of the respondents indicating its importance. It's worth noting that 86 percent of companies that rank themselves as thriving consider this strategy as the most important.

Figure 12. Sales changes (average) by industry



Note: Energy and Cleantech (28 businesses) and Furniture and Fixtures (32 businesses) were the smallest sample sizes for these Monitor questions.

Figure 13. Sales strategies to drive growth in next 12 months

Sales strategy	% "extremely important" and "important"
Increased penetration in existing markets	80%
New customer segments	59
New products and line extensions	55
New geographies/regions	42
New channels of distribution	24
New services	19

The 2012 Monitor Study asked business executives to describe their most important sales strategies in the next 12 months. Answers from executives focused on capturing more business from existing customers with existing and new products:

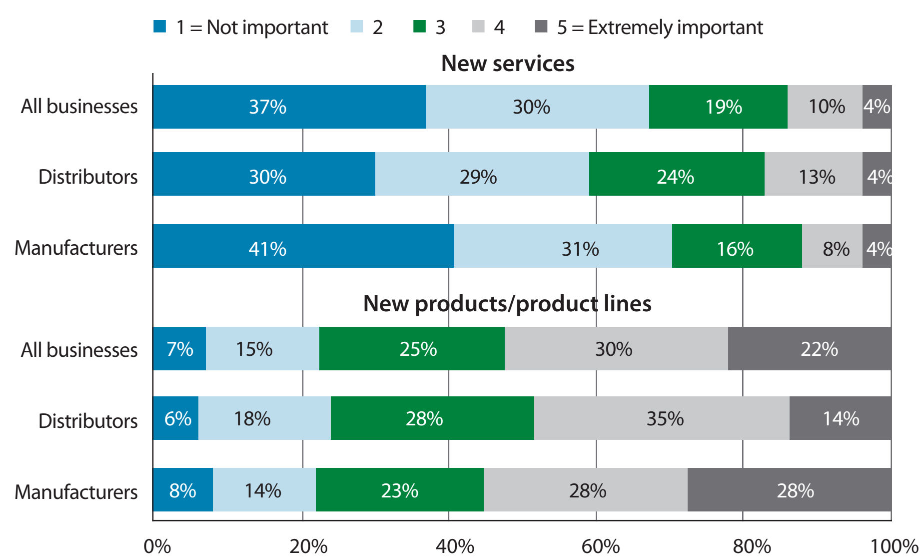
- *"Increasing sales and services to our current business partners."*
- *"Attempting to sell more products to existing customers and also increase margins at existing accounts."*
- *"Developing new products for existing customers while maintaining the same quality and safety in our existing lines."*
- *"Entering new geographic markets [and] partnering with other businesses to research and develop new technology for our industry and products."*

New products and services

Product development is the lifeblood for most industrial firms, especially manufacturers, and while distributors are more likely to emphasize service innovations, even that sector remains focused on products. More than half of businesses (52 percent) rate new products as extremely important or important to company growth, and just 14 percent rate services are extremely important or important (Figure 14).

When Monitor participants were asked about their priorities for company growth and strategies to expand sales, both new products and new services were given as important drivers. Yet surprisingly, 37 percent of businesses report that new services are not important to their growth, despite the opportunity that service innovation has for both manufacturers and distributors to differentiate themselves by adding value beyond products (many of which are considered commodities). Forty-one percent of manufacturers rate new services as not important, and 30 percent of distributors rate new services as not important.

Figure 14. Importance of new products and services to company growth



One-third of the largest businesses (revenues of $1 billion or more) participating in the 2012 Monitor Study rate services as extremely important or important to company growth. Larger organizations can typically devote more resources to service opportunities and are more likely to have taken their organizations to higher levels of service sophistication.

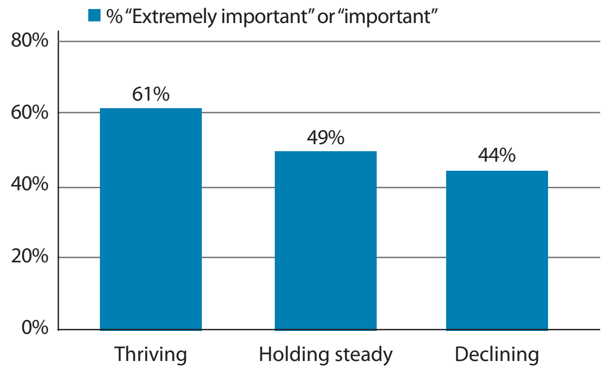
The introduction of new products/product lines is the most common strategy for revenue growth in the next 12 months — 55 percent rate this strategy as extremely important or important (Figure 15). Manufacturers are more likely than distributors to consider innovation strategies important.

Distributors, on the other hand, are more likely than manufacturers to rate introducing new value-added services as extremely important or important to revenue generation.

Figure 15. Revenue-generating activities in next 12 months

Revenue-generating activity	% "extremely important" or "important"	Manufacturers	Distributors
Introducing new products/product lines	55%	58%	50%
Introducing existing products in new markets or industries	49	51	46
Introducing line enhancements	49	51	45
Introducing existing products in new countries/regions	33	38	24
Introducing new technologies	31	32	29
Introducing new value-added services	30	28	34
Introducing new generic or private-label products	16	13	20

Figure 16. Importance of new products/product lines to company growth by business condition



A noteworthy best practice is indicated by the importance which thriving organizations ascribe to new products and product lines (Figure 16).

Investment in research and development

Businesses spend an average of 4.4 percent of their annual sales on research and development (R&D), and manufacturers are likely to spend twice as much as distributors. But many firms invest significantly less in R&D, as evidenced by median[1] investment figures: 2 percent for all businesses. Nearly one-quarter of businesses (23 percent) invest nothing in R&D.

The sector with the largest investment in R&D by far is Biotech and Life Sciences, followed by Energy and Cleantech.

"R&D undertaken by life sciences/biotech companies has been responsible for some incredible scientific breakthroughs in medical care and improving the quality of life. We are also seeing a lot of new and exciting innovation coming from energy companies as they discover new renewable energy sources, and develop more efficient ways to produce energy.

"Much work needs to be done, however, to fix certain economic and tax policies to enable innovative U.S. businesses to compete in the global marketplace. A permanent extension of the R&D tax credit, and simplification of a confusing morass of energy tax credits, would go a long way towards a more competitive U.S. tax environment for innovative companies."

Tom Windram, Partner, Washington National Tax and National Leader - Federal Tax Credits & Incentives, McGladrey, LLP, Washington, D.C.

It is also worth noting that thriving companies invest nearly double the amount into R&D (Figure 17).

Figure 17. Annual investment (as a percentage of sales) into R&D by business condition (average)

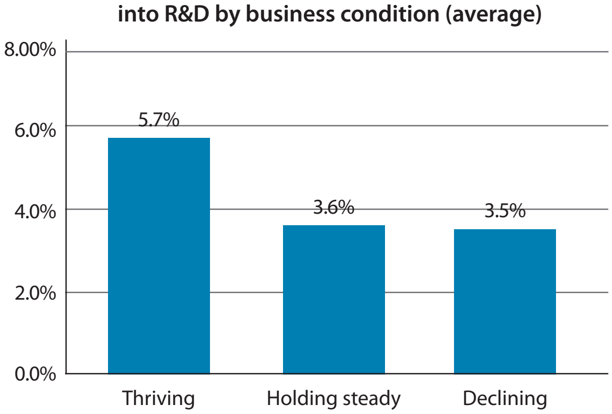
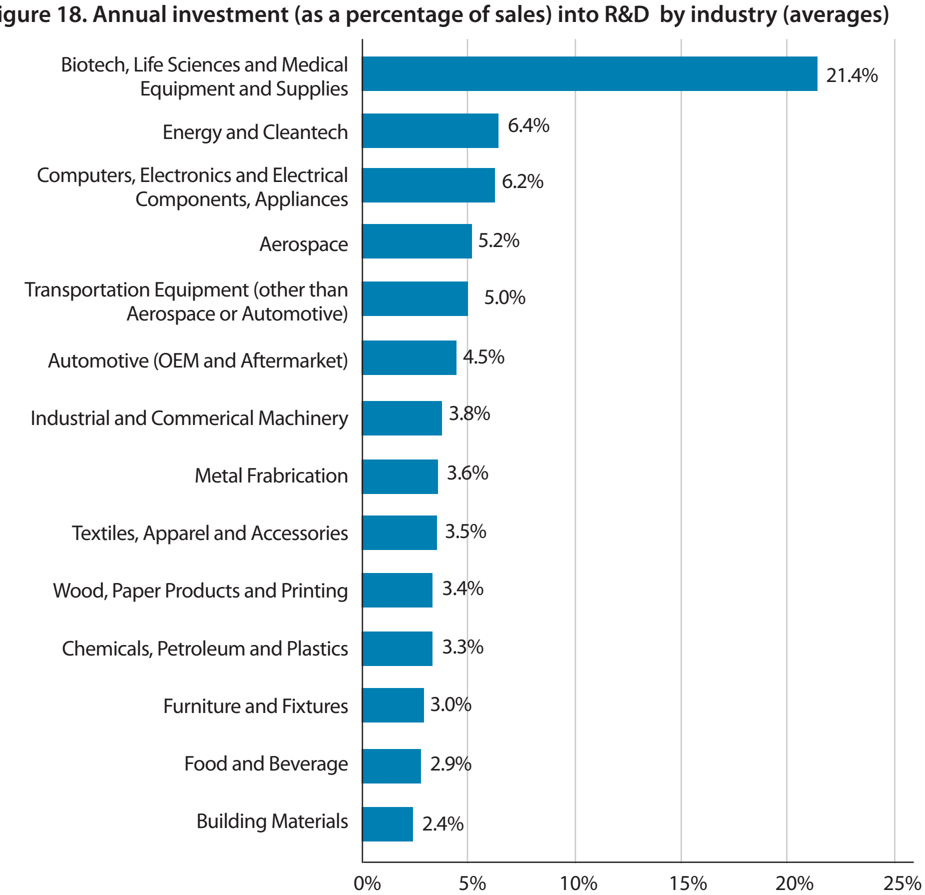


Figure 18. Annual investment (as a percentage of sales) into R&D by industry (averages)



Note: Samples size for Energy and Cleantech (29 businesses).

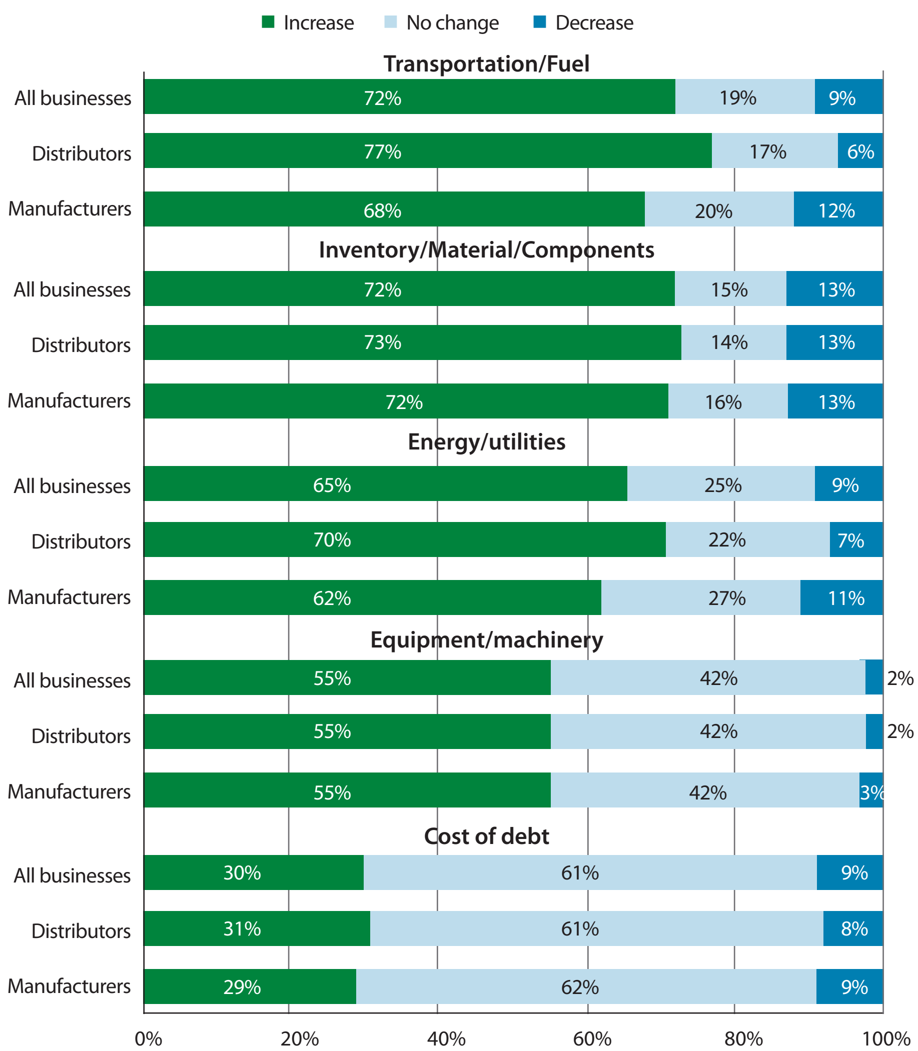
[1] Half of distributors report above 5 percent and half of distributors report below 5 percent.

Cost expectations and maintaining margins

A majority of businesses anticipate that each of the costs listed on the 2012 Monitor Study questionnaire will increase in the next 12 months, with the exception of debt: 61 percent of businesses expect no change in these costs (Figure 19).

Nearly three-quarters of businesses expect the costs for inventory/material/components as well as transportation/fuel to rise in the next 12 months. Distributors are more likely to expect increases for transportation/fuel costs as well as energy/utilities. Manufacturers are paying more attention to energy consumption because of the rising costs associated with energy-intensive production processes (heat treating, paint ovens, etc.). Many are improving energy management via new equipment, devices and systems to monitor consumption and reallocate resources, along with use of alternative fuels, such as natural gas.

Figure 19. Anticipated costs in next 12 months



Inventory

In addition to the prices paid for inventories, inventory levels are expected to rise as approximately 42 percent of businesses will increase their inventory quantities in the next 12 months. Almost half of distributors (48 percent) expect to increase inventory levels, and 38 percent of manufacturers expect to do so as well (Figure 20).

Thriving businesses are more likely to increase inventories than businesses holding their own or declining (Figure 21). This could be in response to increased sales activity expected in the coming months.

Figure 20. Total inventory level change in the coming 12 months

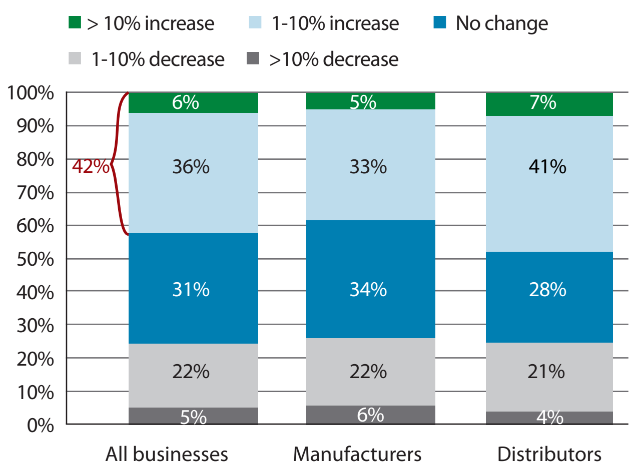
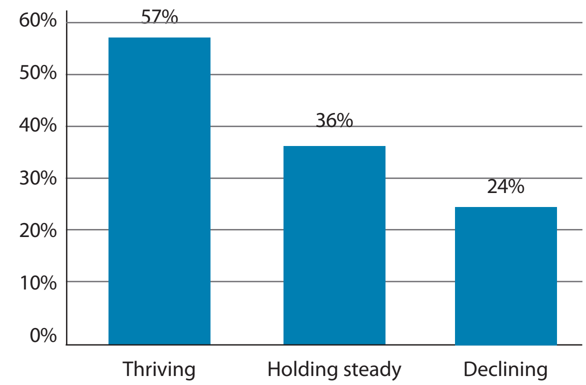


Figure 21. Companies increasing inventories by business condition

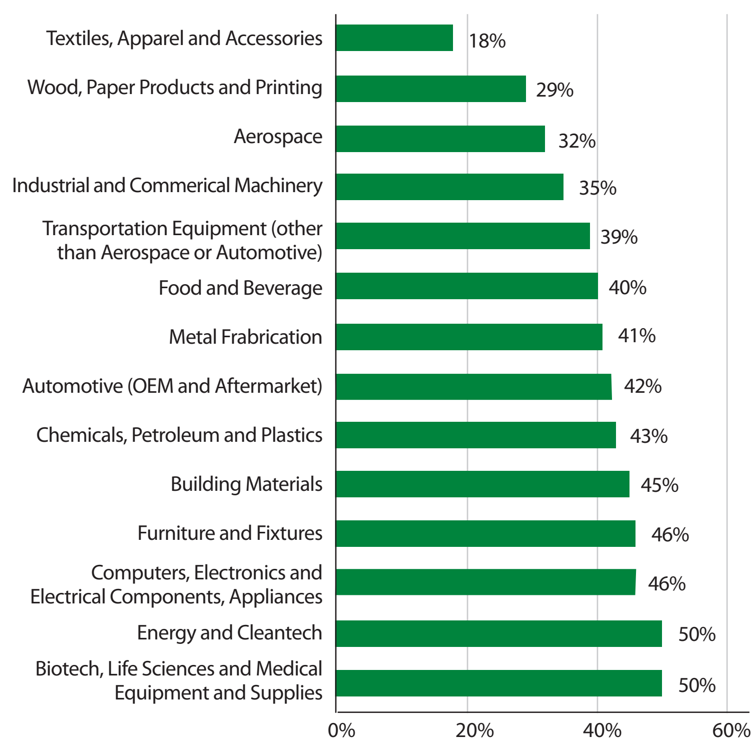


Industries most likely to increase inventories are Biotech, Life Sciences and Medical Equipment/Suppliers, and Energy and Cleantech (Figure 22).

"Manufacturers and their distribution channel partners continue to optimize their value propositions with better business intelligence and shorter replenishment cycles, and some specialty sectors still have an upside potential that justifies inventory investment. The high level of uncertainty regarding tax and regulatory policies, however, is having a negative impact on inventory as original equipment manufacturers and users alike become more cautious in their purchasing policies."

Ronald D. Bullock, Chairman, Bison Gear & Engineering Corp; Chairman, Illinois Manufacturers Association; Director and former Vice Chair, National Association of Manufacturers; 2010 Lifetime Achievement Award Winner

Figure 22. Total inventory level change — industry



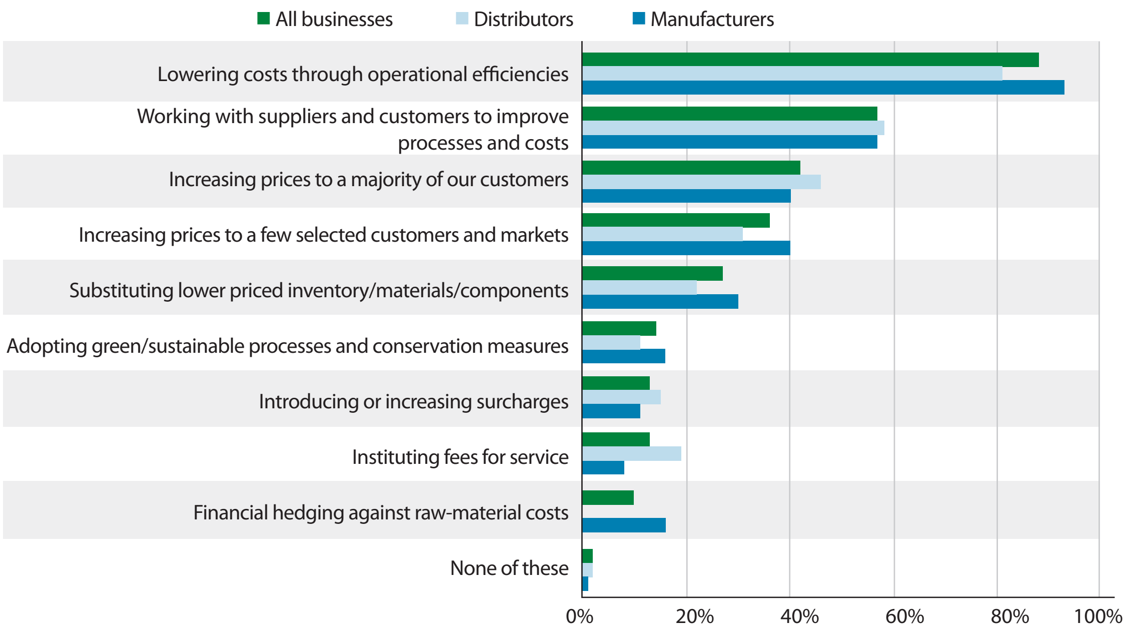
Note: % indicating an increase in inventory.

Maintaining margins

The most common strategy to maintain profit margins is lowering costs through operational efficiencies — in place at 88 percent of organizations (Figure 23). Approximately 57 percent of businesses also are working with suppliers and/or customers to improve processes and costs.

While 42 percent of businesses are increasing prices to a majority of customers, manufacturers are more likely to increase prices to a few selected customers and markets. They are also more likely to adopt green/sustainable processes and conservation measures and/or use financial hedging to protect themselves against raw-material costs. Distributors are more likely to impose blanket price increases (that is, target a majority of customers) as well as institute fees for services and/or introduce or increase surcharges.

Figure 23. Strategies to maintain profit margins given current commodity and services environment



Note: Multiple responses possible

Nearly 90 percent of businesses will increase prices for goods in the next 12 months (average 4.7 percent increase). Approximately 60 percent of businesses will increase prices for services in the same period by an average of 3.3 percent (Figure 24). But increases by most companies will be relatively small — 53 percent of businesses will increase goods prices by 3 percent or less, and 51 percent of businesses will increase service prices by 2 percent or less.

Distributors expect larger price increases for both goods and services than manufacturers (Figure 24). In addition, smaller businesses (less than $25 million in sales) also expect to have the largest price increases: 5.3 percent increase (average) for goods and 4.2 percent increase (average) for services.

Figure 24. Approximate percentage change in prices in next 12 months

	All businesses	Manufacturers	Distributors
Goods			
Average	4.7%	4.5%	5.1%
Median	3.0	3.0	4.0
Services			
Average	3.3	2.9	3.8
Median	2.0	2.0	3.0

Net income

Net income is expected to increase at 74 percent of businesses in the next 12 months, with an average increase of 13.1 percent. It's important to note that these profit growth findings are influenced by a group of exceptionally successful organizations. Although median net income change for businesses was a 5 percent increase, one-fifth of businesses expect net-income increases of 20 percent or more. Private-equity owned businesses are more likely to expect higher increases in net income in the next 12 months than other ownership structures — 17.1 percent increase (average) (Figure 25).

Distributors expect net income to increase by 13.9 percent (average) and 5 percent (median), and manufacturers expect net income to increase by 12.5 percent (average) and 5 percent (median). Industry sectors reporting the highest net income increases are:

- Computers, Electronics and Electrical Components/Appliances: 13.5 percent increase (average) and 7 percent increase (median).
- Industrial and Commercial Machinery: 15.4 percent increase (average) and 7 percent increase (median).
- Building Materials: 14.9 increase (average) and 6.5 percent increase (median).

Thriving organizations expect net income to increase in the next 12 months, almost double the anticipated increases for businesses holding steady and a sharp contrast to the decrease expected at declining businesses (Figure 26).

Figure 25. Net income by business entity

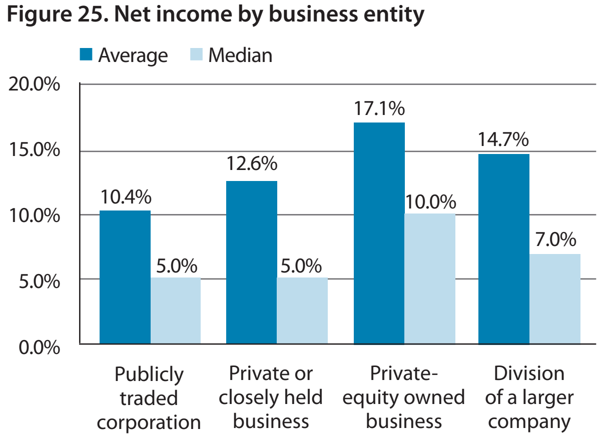
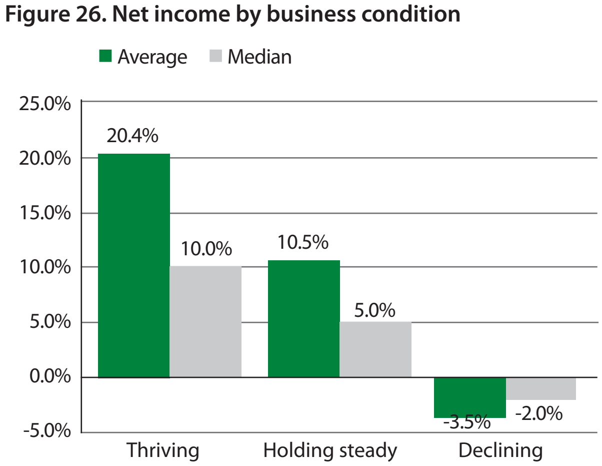


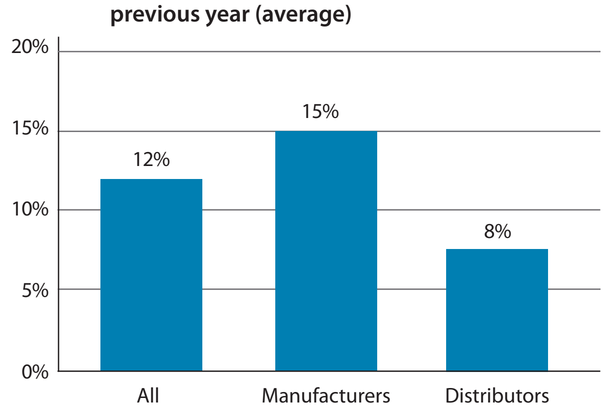
Figure 26. Net income by business condition



Capital expenditures

Two-thirds of businesses expect to increase their capital-equipment investments in 2012 as compared to 2011 — only 9 percent of businesses will decrease capital-equipment spending. The low cost of capital, which most companies expect to stay low, is likely motivating some firms to invest. Capital-equipment spending will increase by 12.1 percent on average, with manufacturers' spending expected to increase substantially more than distributors (Figure 27).

Figure 27. Capital equipment spending compared to previous year (average)



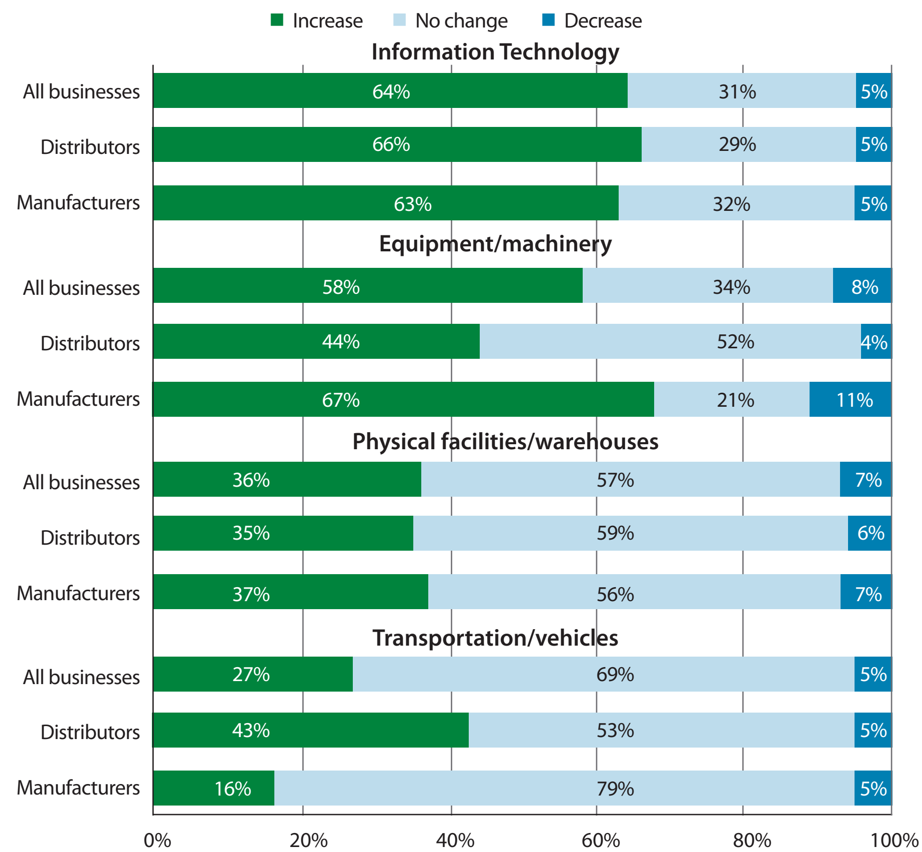
The biggest capital expentidure targets in the next 12 months are information technology and equipment/machinery (Figure 28). Manufacturers are more likely to increase equipment/machinery spending and distributors are more likely to increase spending on transportation/vehicles.

Among those businesses with a corporate objective to expand existing facilities/warehouses, 78 percent will increase investments for facilities/warehouses. Similarly, 81 percent of businesses that have an objective to build or acquire new facilities/warehouses will increase these investments.

"More businesses are planning to expand their acquisition of capital assets used in their operations and facilities. Although there are many favorable federal and state tax incentives for companies to invest in property and equipment in the U.S., companies need to be aware of and comply with the new tangible asset tax regulations which became effective for tax year beginning after January 1, 2012. The new temporary regulations allow companies to expense repair costs made to property and equipment versus capitalizing them. These new IRS rules will have a major impact on corporate tax planning. Companies need to evaluate these new rules carefully in order to minimize IRS audit risk and manage tax obligations."

Murat Tasel, Partner, Tax Services, McGladrey LLP, Baltimore, Md.

Figure 28. Specific capital-expenditures changes in the next 12 months



Workforce

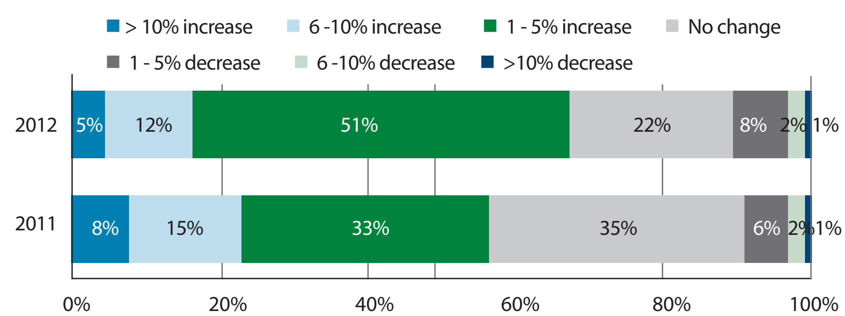
Businesses participating in the 2012 Monitor Study:

- *Total employees: 857 (average) and 125 (median). At businesses with sales of $1 billion or more, there are 12,364 (average) and 4,750 (median) total employees.*
- *Employees in the United States: 496 (average) and 110 (median).*
- *Employees outside the United States: 345 (average) and 0 (median). Approximately 71 percent of businesses do not have employees outside the United States.*
- *Part-time employees: 57 (average)*
- *Temporary employees: 38 (average)*
- *Individual independent contractors: 23 (average)*

Employment outlook

After years of decreasing staff and increasing overtime, many organizations are now planning to restore or grow their workforces. Two-thirds of businesses (67 percent) expect to increase employment levels in the next 12 months compared to 56 percent expecting an increase in 2011 (Figure 29).

Figure 29. Change in employee levels in next 12 months



U.S. employment increases are anticipated at 65 percent of businesses, but employment increases outside the United States are anticipated at just 16 percent of all business. The outlook is stronger at organizations that already have employees outside the United States: 54 percent will increase non-U.S. employment. Manufacturer and distributor employment patterns are similar (Figure 30). Only 2 percent of businesses without non-U.S. employees will increase employment outside the United States.

Not surprisingly, 85 percent of thriving organizations plan to increase total employment (28 percent will increase employment by more than 5 percent). Private equity-owned businesses are the most likely (based on ownership structure) to increase hiring: 76 percent will increase total employment. This certainly calls into question the reputation of private equity firms to simply cut employees as a way of earning a return on their investments (Figure 31).

Figure 30. Change in employee levels in next 12 months — manufacturers and distributors

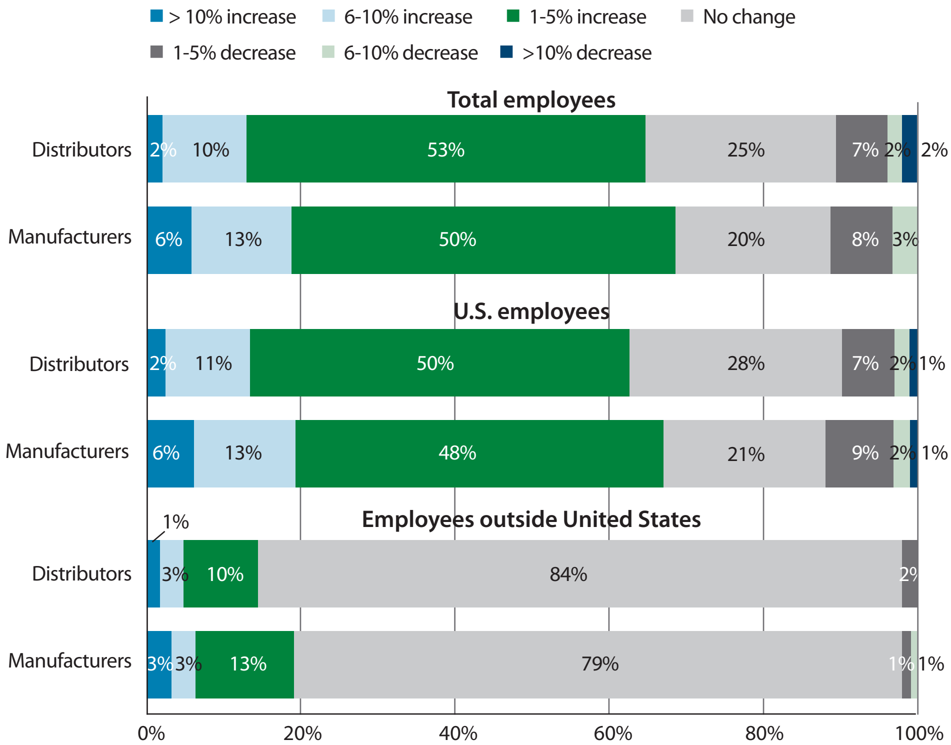
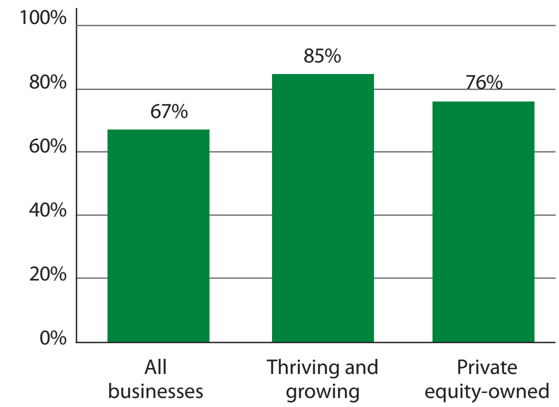
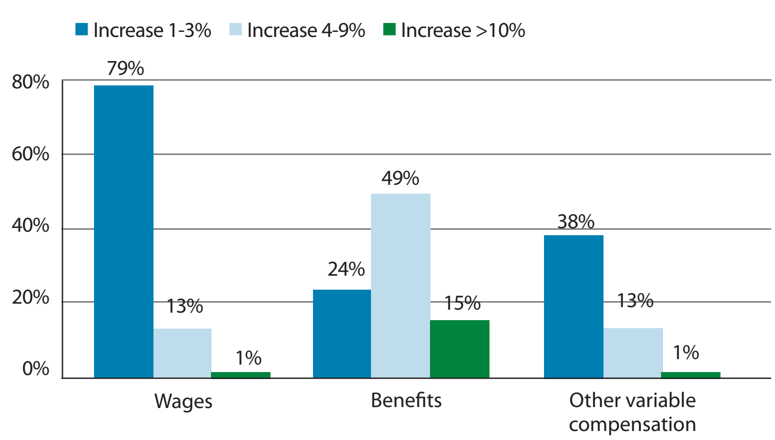


Figure 31. Businesses expecting to increase employment



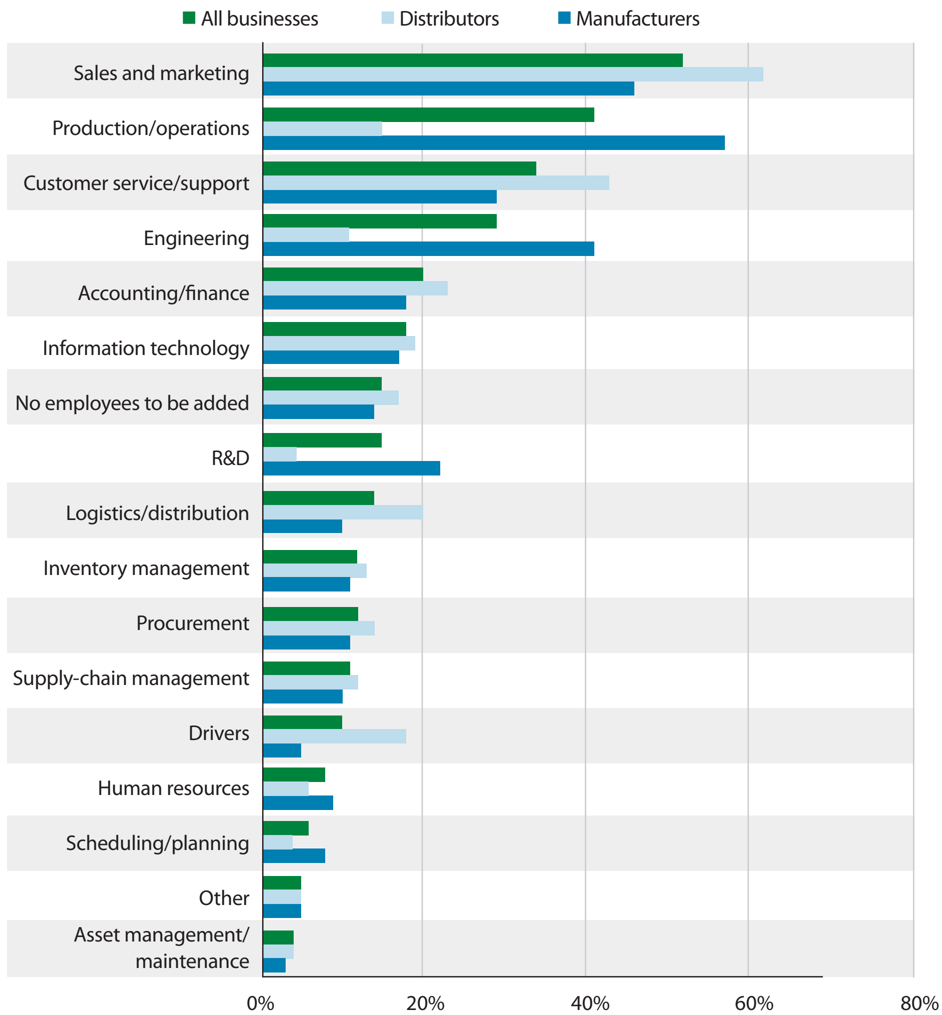
Most businesses expect employee costs for wages, benefits and other variable compensation to increase in the next 12 months. The anticipated increases may be due to a number of factors: increased hiring will likely increase cumulative wages paid by companies; benefits costs are expected to increase due to rising health care costs; and an older workforce may mean more paid out in retirement benefits (Figure 32). Although a significant majority of businesses expect wages and benefits costs to rise, more than 60 percent of businesses anticipate benefits to rise more than 4 percent. Just over half of manufacturers and distributors expect a rise in other compensation.

Figure 32. Anticipated employee cost increases in the next 12 months

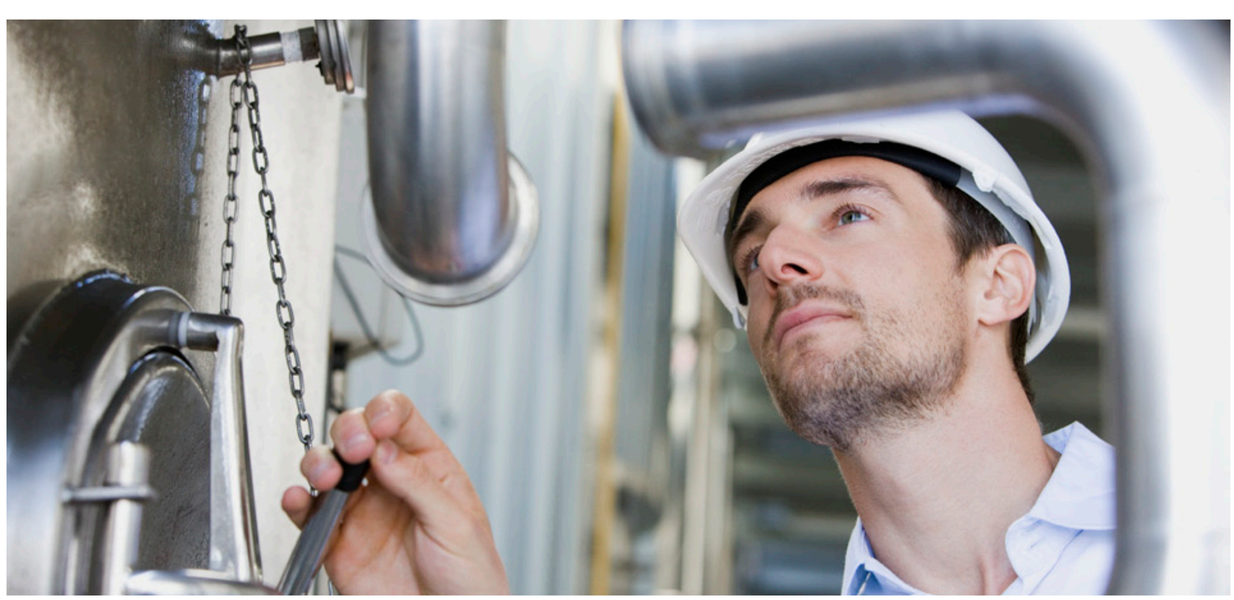


Industrial firms are most likely to add employees for sales and marketing functions, production/operations, and customer service/support (Figure 33). But manufacturers and distributors differ considerably on where they will add employees. For example, a majority of manufacturers (58 percent) will focus on production/operations, compared to just 15 percent of distributors. But some 43 percent of distributors will focus on customer service/support functions, compared to just 29 percent of manufacturers.

Figure 33. Change in employee levels in next 12 months — annual sales



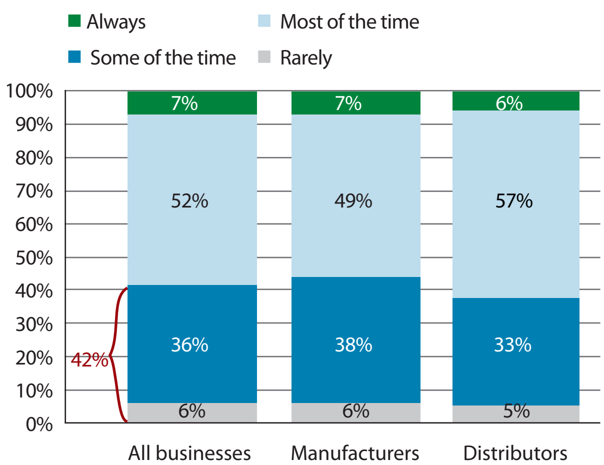
Note: Multiple responses possible



Skills gaps

It is somewhat paradoxical given the persistently high levels of unemployment in the U.S. that approximately 42 percent of the businesses in the study are having difficulty finding talent to fill open positions (Figure 34). Many participants are concerned with the limited supply of workers who possess the right skill sets. Thriving organizations and businesses holding steady are comparable in their search for talent, but declining businesses face significant hiring challenges: 44 percent find the talent they need only some of the time, and 14 percent rarely find the talent they need.

Figure 34. Finding skilled talent



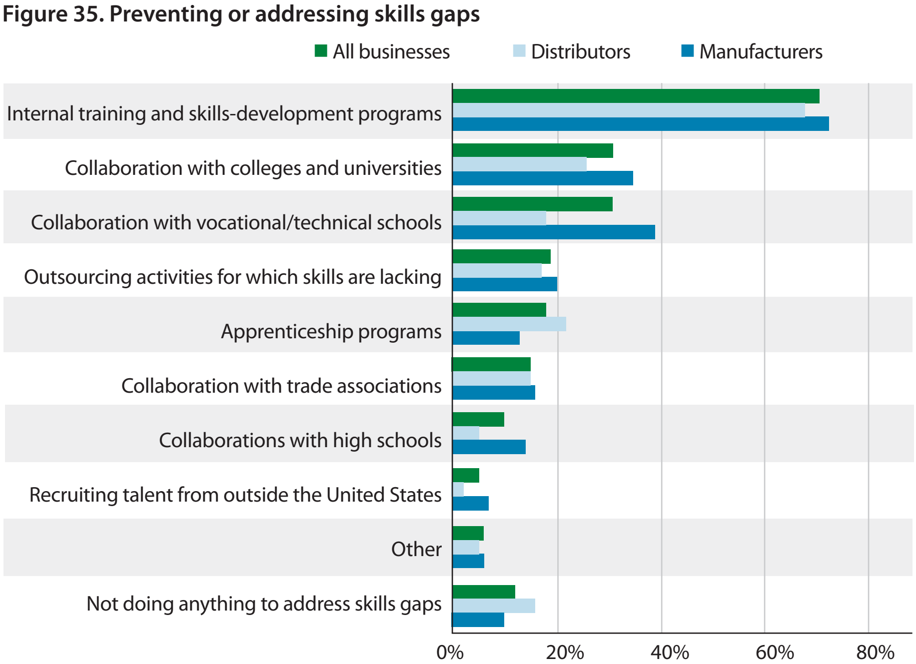
"There needs to be a different approach to manufacturing education at the technical school and community college level to ensure relevant and rigorous training for today's manufacturing jobs. Schools that use industry-based certifications have demonstrated success in increasing the quality of education programs, providing a better workforce solution for manufacturers."

Jennifer McNelly
President. The Manufacturing Institute

Businesses are most likely to address skills gaps with internal training and skills-development programs (Figure 35). In addition, collaboration with colleges and universities or vocational/technical schools are common methods to address skills gaps. Yet businesses using collaboration programs are not more likely to find the skilled talent they need. It may be that organizations with especially challenging position requirements are more likely to establish collaborations, in hopes of improving their odds.

Manufacturers are more likely to use all the approaches listed on the 2012 Monitor Study to address skills gaps. In addition to internal training and collaboration programs, organizations may outsource activities, implement apprenticeship programs or look for talent outside the U.S. when they can't find the personnel with the skills they need.

Figure 35. Preventing or addressing skills gaps



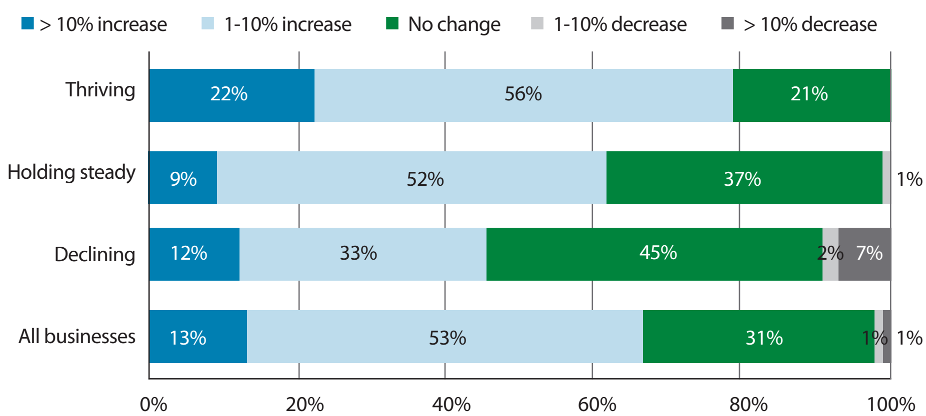
Note: Multiple responses possible

Process improvements

Few organizations can survive without continuous effort to improve productivity. Indeed, with workforces only now beginning to increase, organizations have relied on getting more from fewer employees and needed to be as efficient as possible. At many organizations, process improvements are the only way to achieve or maintain competitive advantage. Two-thirds of businesses will increase investments in process-improvements initiatives this year compared to last.

More than three-quarters of thriving businesses will increase investments in process-improvement initiatives, compared to 61 percent of businesses holding steady and 45 percent of declining businesses (Figure 36). In addition, midsize companies ($100 million to $999.9 million annual sales) are more likely than companies of other sizes to increase investments.

Figure 36. Investments in process improvement initiatives — overall and by business condition

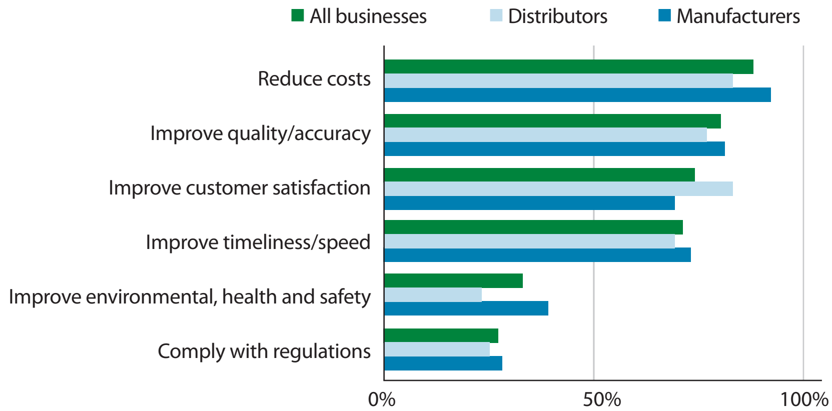


Primary objectives of improvement initiatives are to reduce costs, improve quality/accuracy, improve customer satisfaction, and improve timeliness/speed (Figure 37). Manufacturers are more likely to focus on reduced costs, while distributors are more likely to focus on customer satisfaction.

"Process improvement initiatives for manufacturers are oftentimes evaluated and selected based on a return on investment analysis that can show a short payback cycle. Global competition and pressure to reduce prices from large customers have increased the importance of the cost reduction focus. Lean and Six Sigma continue to be widely used methodologies for achieving process improvements and cost reductions but most manufacturers have not embedded ongoing continuous improvement into the company culture."

Dale Billet, Director, Performance Improvement Consulting, McGladrey LLP, Elkhart, Ind.

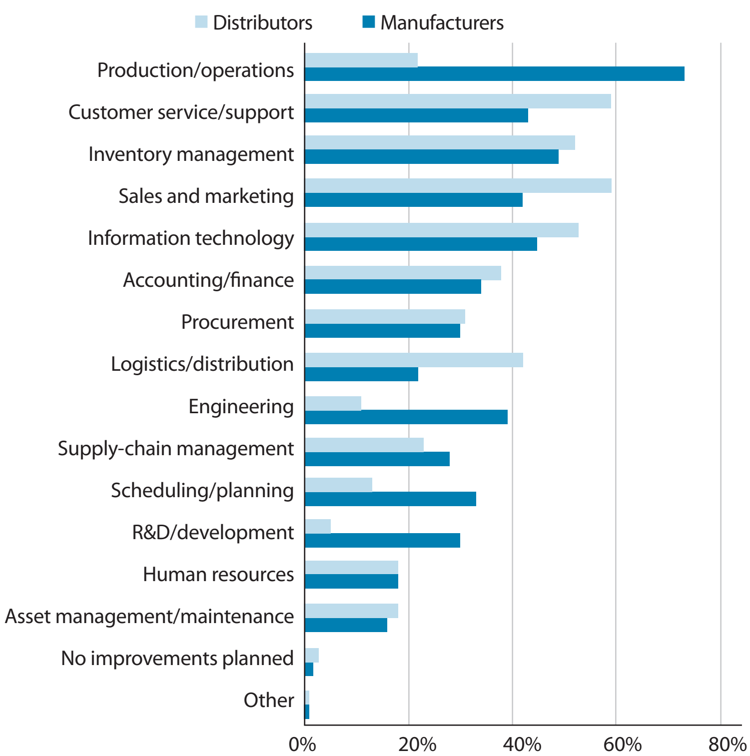
Figure 37. Primary objectives of improvement initiatives



Note: Multiple responses possible

Half or more of businesses will focus their improvement initiatives in the next 12 months on production/operations, inventory management, and customer service/support (Figure 38). Manufacturers are more likely to focus on activities that can improve productivity, such as production, engineering, and scheduling; distributors are more likely to focus on sales and marketing activities, such as customer service.

Figure 38. Location of improvements initiatives in next 12 months



Note: Multiple responses possible

A majority of businesses (70 percent) have increased productivity (sales per employee) in the past 12 months; only 8 percent of businesses indicate that productivity has decreased (Figure 39). Notably, approximately 87 percent of thriving businesses increased productivity in the past 12 months, versus 63 percent of businesses holding steady and 47 percent of declining businesses.

At businesses that increased productivity, the most commonly cited factors driving improvement are general process improvements; improved labor utilization; investments in equipment; and training (Figure 40). Not surprisingly, manufacturers cite investments in equipment and improved labor and equipment utilization as most helpful in enhanced productivity. Distributors, however, are more likely to focus on technology to drive improvement.

The efforts are having an effect. According to a number of sources, including the Bureau of Labor Statistics, U.S. workers are the most productive in the world; the value added per manufacturing worker in the United States is just over $118,000. This is well ahead of Japan, the United Kingdom and the Republic of Korea, countries with the next most productive workforces with productivity value between $76,000-$93, 000; by comparison, the value added per worker for manufacturers in China is just over $13,000.

Figure 39. Productivity (sales per employee) changed in the past 12 months

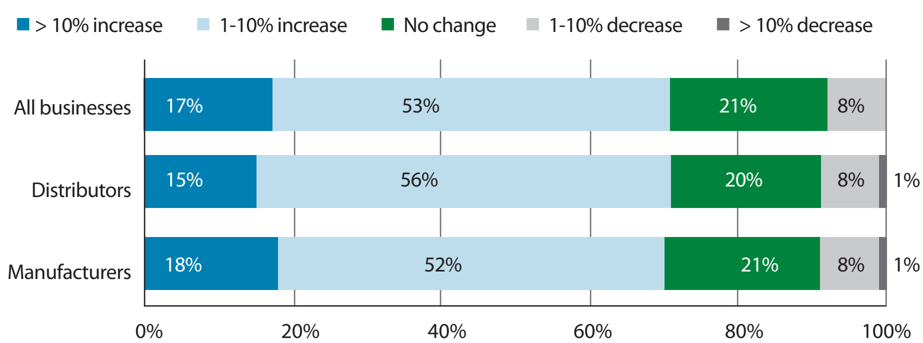
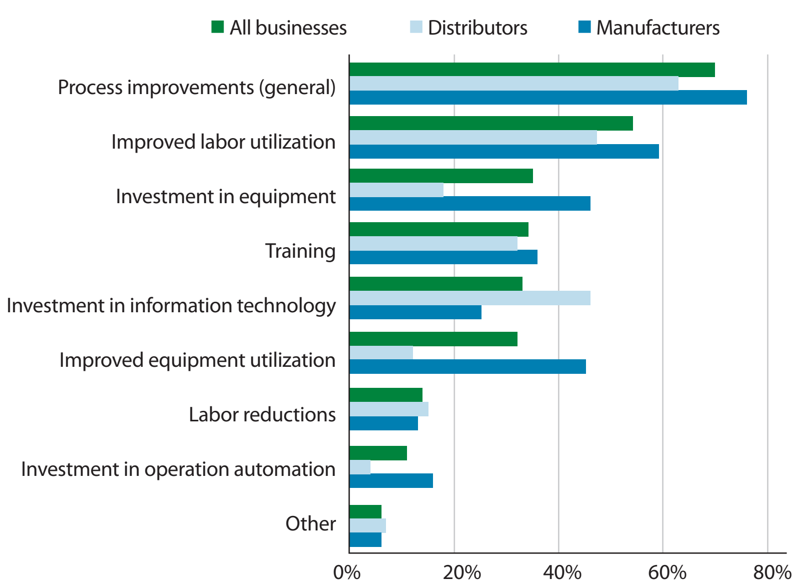


Figure 40. Factors that most improved productivity



Note: Multiple responses possible

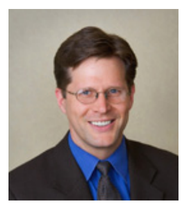
The 2012 Monitor Study asked businesses to name their most significant process improvements in the last 12 months, and to describe the impact they had on their companies. Responses ranged from application of new equipment, enhanced automation, and new information technologies to hiring new employees and empowering employees. Many responses provide insight into philosophies, techniques, and practices that can be applied in many organizations:

- *"Lean implementation [resulted in] 20 percent increase in production with same number of employees."*
- *"Reorganized sales administration and support functions to free up sales staff to do more selling and less administration. Sales increased by 10 percent."*
- *"Upgraded to new ERP system, impacting production/operations, customer-relations management, financial reporting, and providing timely information to sales personnel."*
- *"Decentralized production control, and allowed shop floor to make more decisions."*
- *"Improved purchasing procedures resulting in lower inventory and [carrying] costs."*
- *"Lean improvements in several facilities that have reduced inventory and space requirements, and improved customer responsiveness."*

Despite these improvement efforts, most businesses are still on the journey to developing cultures of continuous improvement (CI). Only 3 percent of businesses report having a fully mature CI culture, and another 20 percent have made significant progress toward an improvement culture (Figure 41). Manufacturers were more likely to have a mature CI culture than distributors, which isn't surprising given the investments that manufacturers have devoted to process improvement in recent years.

The challenge of developing a mature CI culture is illustrated by the fact that thriving businesses are only slightly more likely to have a mature CI culture compared to businesses holding steady or declining (Figure 42).

Businesses with the most mature CI cultures (rate 4 or 5 where 5 equals fully mature culture) are more optimistic; in fact, 30 percent are very optimistic about economic growth prospects for their businesses in the next 12 months compared to the 21 percent of businesses with less mature CI cultures and 12 percent of businesses with no CI culture.



"It is interesting to note that organizations with a more mature continuous improvement culture are considerably more likely to be thriving. This is consistent what we have observed in practice: a culture of continuous improvement permeates how an organization goes to market, serves its customers and performs financially."

Greg Maddux, Principal, Performance Improvement Consulting, McGladrey LLP, Kansas City, Mo.

Figure 41. Culture of continuous improvement

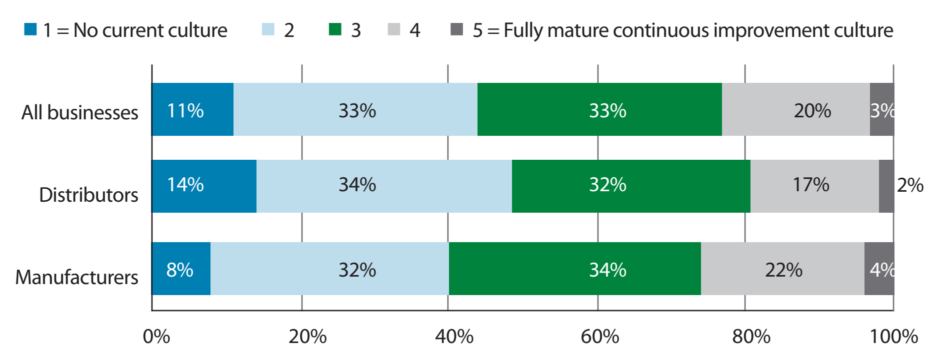
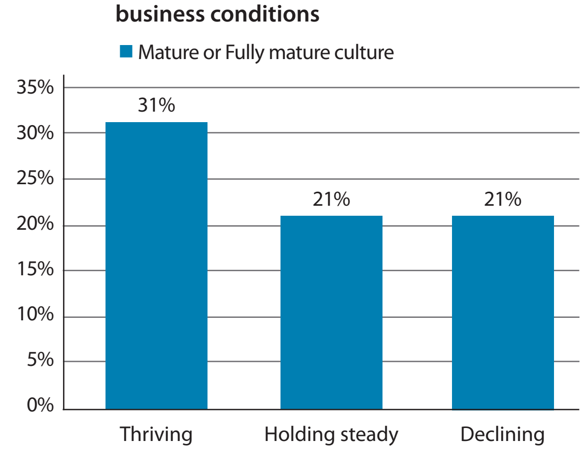


Figure 42. Culture of continuous improvement by business conditions



Information technology

Of those businesses with extensive use of business analytics — companywide or by senior leadership — 43 percent are thriving, as compared to 37 percent of other businesses. Similarly, 25 percent of businesses with extensive use of business analytics report that they are very optimistic about economic growth prospects for their businesses in the next 12 months, as compared to 21 percent of other businesses that are very optimistic.

Information technology (IT) continues to be a focal point of improved organizational productivity and growth. At a time when supply chains are broadening around the globe, IT serves as the lynchpin for managing increasing complex relationships among firms.

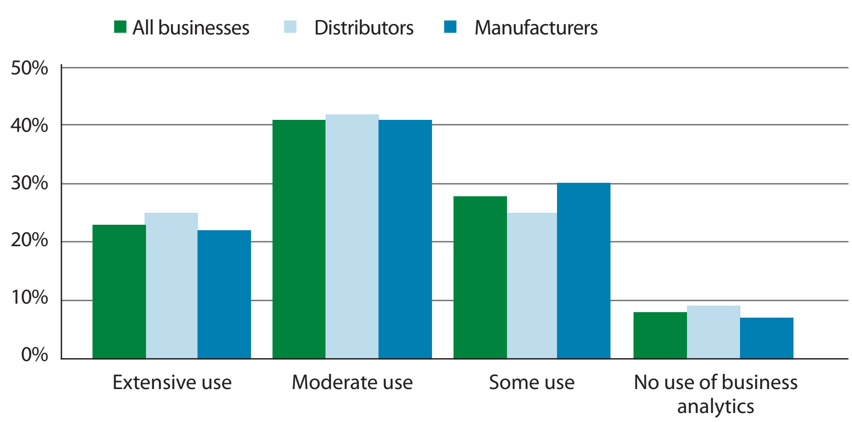
Business analytics

One technology intended to help businesses make business decisions for both internal operations and supply-chain activities is business analytics. Two-thirds of businesses (64 percent) report at least moderate use of business analytics companywide or among senior leadership — but almost one-third are not widely leveraging the capabilities of this tool. Eight percent indicate "no use" of business analytics (Figure 43).

Large organizations ($1 billion or more annual sales) are more likely to report at least moderate use of business analytics companywide or among senior leadership (73 percent of such firms), and thriving organizations are somewhat more likely to use business analytics to that degree (67 percent).

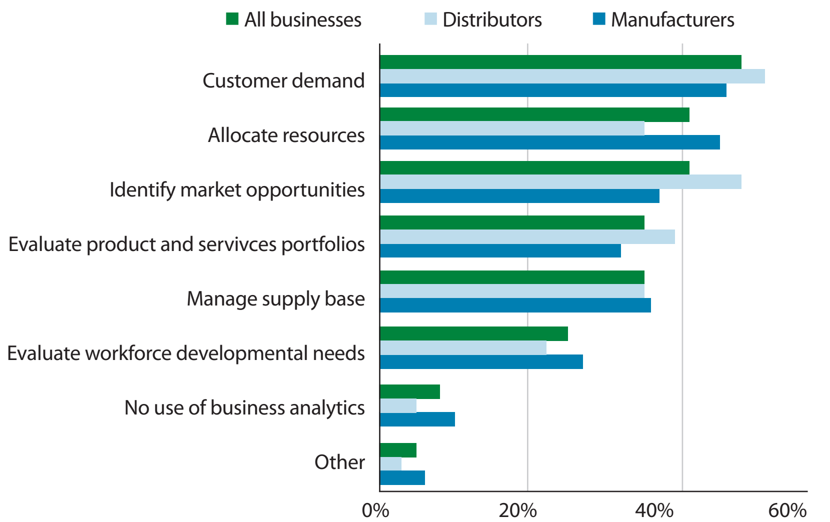
Businesses are most likely to leverage business analytics to forecast customer demand, identify market opportunities, and allocate resources (Figure 44). Distributors are more likely to rely on business analytics for outward-facing activities, such as customer demand and market opportunities; manufacturers are more likely to use analytics in assessing internal operations, such as resource allocation and developmental needs.

Figure 43. Use of business analytics to evaluate past performance to inform business planning



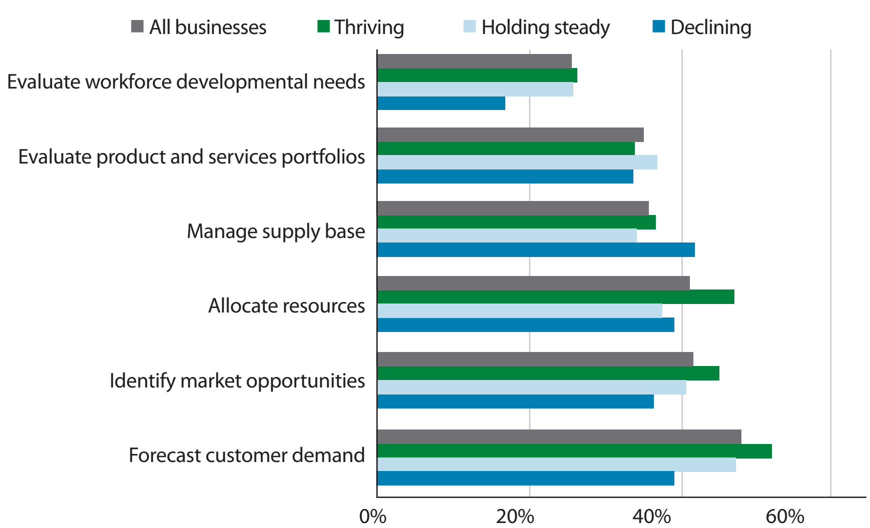
It's interesting to note that the use of business analytics by senior leadership has an impact on its use companywide. This appears to be particularly true for thriving companies, where extensive use of business analytics by senior leadership appears to increase its use companywide at a greater rate than for businesses in general; notably, in allocating resources, identifying market opportunities and forecasting customer demand (Figure 45). But even moderate or some use by senior leadership of techniques or technologies to evaluate past performance has a positive effect no matter what the company's business condition. Note the relationships between grey and green bars, particularity in 'Allocate resources,' 'Identify market opportunities' and 'Forecast customer demand.'

Figure 44. Leveraging business analytics for organizational improvement



Note: Multiple responses possible

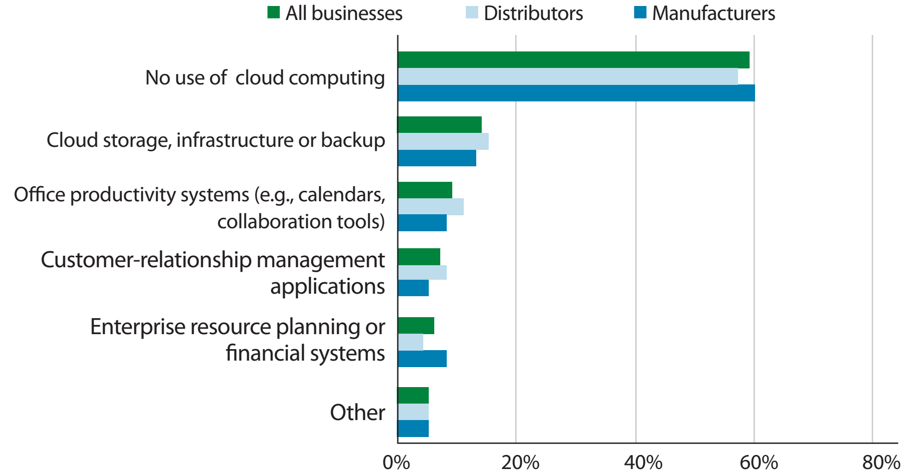
Figure 45. Use of business analytics by senior leadership by business condition



"We are observing more companies using business analytics to quickly make well-informed management decisions. Approximately 45 percent of manufacturers are using business analytics related to allocation of resources, which likely correlates to the skills gap in manufacturing. Distributors continue to rely heavily on data for analyzing customer demand and market opportunities."

Gordon Opland, Principal, Consulting Services, McGladrey LLP, Des Moines, Iowa

Figure 46. Cloud computing use for systems or applications

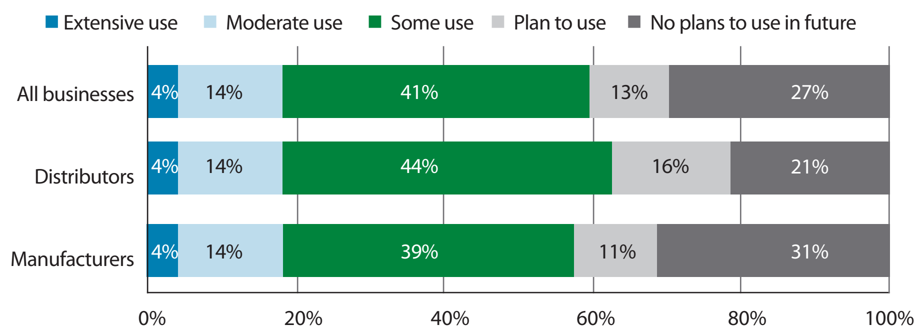


Cloud computing and social media

Approximately 41 percent of businesses use cloud computing for IT systems or applications (Figure 46). The most common use is for storage, infrastructure, or backup and office productivity systems, such as calendars and collaboration tools.

Almost 60 percent of businesses are using social media (e.g., LinkedIn, Facebook, Twitter), and another 13 percent indicate that they plan to use social media (Figure 47). Use of social media is more likely among distributors and large organizations.

Figure 47. Use of social media (e.g., LinkedIn, Facebook, Twitter) for business activities



Corporate IT risks

More than three-quarters of businesses report that their information/data is not at risk or at little risk (Figure 48). Despite the concerns of some executives (see sidebar), only 5 percent of businesses report that their information/data is at risk. Those businesses expecting to have large increases (that is, more than 10 percent) in capital-equipment spending for information technology are more likely to report that their IT is at risk.

"The information security company Symantec reported that they blocked more than 5.5 billion malware attacks (that is, attacks by malicious software) in 2011, an 81 percent increase over 2010. There is a lack of understanding and knowledge of the impact of new technologies and their related information security risks. Company executives should have a high-level assessment performed to understand their information security risks so they can proactively manage them. When it comes to IT security, ignorance is definitely not bliss."

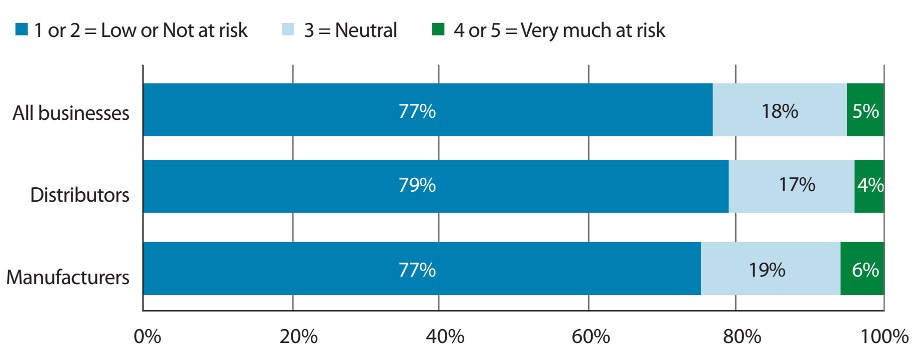
Hussain Hasan, Principal and Practice Leader, Risk Advisory Services, McGladrey LLP, Schaumburg, Ill.

Are IT systems as secure as executives believe? The 2012 Monitor Study asked executives what worries them about the security of their company's data and information. Some executives said they had "no worries," and a few were extremely confident ("Most data have good back up plans and with strong autonomous system accountability."). Nevertheless, there are a number of IT security issues on the minds of many executives:

- *"Existing ERP software system version is so old it is no longer supported by the supplier. A planned upgrade is scheduled for summer. If it crashes we are dead."*
- *"No formal disaster recovery plan in place, but it is on the 2012 business plan."*
- *"The ever-changing IT world and the increased ability of hackers to get into our system or other systems that disrupt things."*
- *"That hackers will get information about our suppliers and processes that we have spent countless hours developing and refining."*
- *"Breach of our server units via hacking and computer viruses as a result of data transfer."*
- *"Overall, I would like to feel there is no risk, but I don't think that is a true statement that anyone could make."*

Perhaps one executive summed up the IT concerns of management everywhere: "My greatest worry is what I am not even aware of today."

Figure 48. Perception of information/data risks



Profile of participants

The following charts provide a profile of participants in the 2012 Monitor Study:

Figure 49. Business activity

Business activity	% of respondents
Manufacturing	44%
Mostly manufacturing, some distribution	16
Mostly distribution, some manufacturing	9
Distribution	31
Not a manufacturer or distributor	0

Figure 50. Annual gross revenue for most recent fiscal year

Annual gross revenue	% of respondents
$500 million - $1 billion or more	8%
$100 million - $499.9 million	21
$50 million - $99.9 million	15
$25 million - $49.9 million	18
$15 million - $24.9 million	13
Less than $15 million	24

Figure 51. U.S. region

U.S. region	% of respondents
Great Lakes	35%
Central	20
Southeast	19
Northeast	13
West	11
Other/not disclosed	2

Figure 52. Countries and/or regions in which products sold

Country or region	% of respondents
United States	99%
Canada	67
Mexico	47
United Kingdom	34
Western Europe (excluding Germany and United Kingdom)	33
China	28
Central America	28
Australia and New Zealand	27
Germany	26
South America (excluding Brazil and Columbia)	26
Southeast Asia (excluding China, India, Hong Kong and Japan)	24
Japan	24
Brazil	24
Middle East	24
Eastern Europe	22
India	19
Russia	16
Hong Kong	14
Africa	14
Colombia	13
Central Asia (excluding Russia)	11
Other countries or regions	8

Note: multiple responses possible

Figure 54. International activities

Percentage of revenues sold to customers outside the United States	
Median	5.0%
Average	14.1
Percentage of physical assets reside outside the United States	
Median	0.0%
Average	6.3

Figure 53. Countries or regions with a physical presence (e.g., offices, warehouses, facilities)

Country or region	% of respondents
United States	99%
Canada	13
China	13
Mexico	9
United Kingdom	9
Western Europe (excluding Germany and United Kingdom)	9
Germany	7
Brazil	5
India	5
Australia and New Zealand	5
Southeast Asia (excluding China, India, Hong Kong and Japan)	5
Japan	4
Hong Kong	4
South America (excluding Brazil and Columbia)	3
Middle East	3
Central America	3
Eastern Europe	3
Africa	2
Russia	2
Other	3

Note: multiple responses possible

Figure 58. Title of respondent

Title of respondent	% of respondents
Chief Executive Officer, President, Chairman, Owner	41%
Chief Financial Officer, Senior Finance Executive	38
Chief Operating Officer	5
Principal, Managing Partner, Partner	3
Chief Marketing or Sales Officer	2
Other title	12

Figure 55. Products primarily made or distributed

Products	% of respondents
Industrial and Commercial Machinery	21%
Metal Fabrication	14
Food and Beverage	12
Building Materials	11
Chemicals, Petroleum and Plastics	8
Automotive (OEM and Aftermarket)	8
Computers, Electronics and Electrical Components/Appliances	7
Biotech, Life Sciences and Medical Equipment/Supplies	6
Transportation Equipment (other than Aerospace or Automotive)	5
Aerospace	5
Wood/Paper Products and Printing	4
Furniture and Fixtures	4
Textiles, Apparel and Accessories	4
Energy and Cleantech	3
Other	24

Note: multiple responses possible

Figure 56. Core customers

Customer type	% of respondents
Manufacturers	49%
Distributors	34
Retailers	29
Government	17
Consumers	14
Healthcare	11
Service industries	11
Institutional	10
Transportation	9
Other	12

Note: multiple responses possible

Figure 57. Corporate entity

Corporate entity	% of respondents
Private or closely held business	77%
Private-equity owned business	12
Publicly traded corporation	5
Division of a larger non-U.S.-based company	4
Division of a larger U.S.-based company	2

Methodology

The 2012 McGladrey Manufacturing & Distribution Monitor was conducted using an online questionnaire promoted by McGladrey and various industrial associations to principally U.S.-based manufacturing and distribution organizations. There were 924 total valid respondents to the 2012 McGladrey Manufacturing & Distribution Monitor (categorized as 554 manufacturers and 370 distributors), with completed questionnaires received in May and June 2012. Responses were received by The MPI Group, an independent research firm, and then entered into a database, edited, and cleansed where necessary to ensure answers were plausible. All respondent answers to the 2012 McGladrey Manufacturing & Distribution Monitor are confidential. As incentive to complete the study, participants are being provided a customized benchmark report.

Additional resources

More than 2,000 manufacturing and distribution professionals participated in the McGladrey Manufacturing & Distribution Executive Summits held throughout the country in the fall of 2011. Contact your local McGladrey office or go to www.mcgladrey.com/manufacturing for details on the 2012 Summits and to learn about our other industry events, resources and services.

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