



## 2010 Manufacturing and Wholesale Distribution National Survey

## Preface

**Thomas G. Murphy**  
**Executive Vice President of Manufacturing and Wholesale Distribution**  
**RSM McGladrey, Inc.**

Welcome to the fifth annual McGladrey Manufacturing and Wholesale Distribution National Survey report. Here you'll find a panoramic view of the industry through the eyes of 1,061 company executives, taken at a time when the American economy is fragile, yet showing clear signs of improvement.

After several years of deteriorating business conditions, survey respondents in 2010 express tempered optimism. This is particularly true in their upbeat assessments of company business prospects, their plans to add business capacity and forecasts for near-term job growth. Conversely, many leaders remain concerned about credit availability, the cost of health care and the potential impact several legislative issues may have on their companies. The latter, executives say, makes it difficult to manage risk and make thoughtful decisions on investments in people, technology and capital equipment.

The 2010 report highlights several trends and opportunities alert companies may wish to consider as the U.S. economy continues its recovery:

- Domestic sales are forecast to rebound more sharply than international sales this year. However, companies that build and grow sales in global markets will maintain a strategic advantage over competitors that sell only in the United States.
- Despite continued growth of green product offerings, over half of respondents report they do not know if those products are generating a profit. This underscores the importance for companies to apply metrics that measure performance on a product basis.
- Executives report high levels of concern about how several legislative issues could affect business operations. Even though many of these bills have yet to be enacted, the prospect of such changes is having an immediate and direct effect on economic recovery.
- Hiring for U.S.-based positions is up substantially over 2009 levels. That means companies must carefully walk the line between expense-driven compensation actions and the need to identify, hire and retain high performers. This will be particularly true if an overall recovery magnifies existing skill shortages.

I extend our thanks and deep appreciation to the CEOs, CFOs and other senior executives who responded to this year's survey, as well as to the several industry trade associations and business organizations that encouraged member participation. Through the resulting insights, we all gain a deeper understanding of how manufacturing and wholesale distribution businesses are recovering from the deepest downturn since the Great Depression.



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## Executive summary

McGladrey's fifth annual Manufacturing and Wholesale Distribution National Survey report combines insights gained from the previous four surveys with information about trends in the economic recovery. While the recovery remains fragile, the survey highlights steps many industry sectors are taking to get back on track. In addition, this report points to many available tools and strategies that companies can use to accelerate growth and profitability.

Following is an overview of key findings from the 2010 survey:

**Condition of business.** Survey respondents report modest, but generally positive, improvements in business conditions. This year, 24 percent of business leaders say their companies are "thriving and growing," a 15 percentage point improvement from 2009. Just as important, only 10 percent of executives say company business conditions are "declining." That is a 30 percentage point improvement from last year and the best result in this category since 2007. In terms of economic recovery, 45 percent of companies expect to rebound this year with another 31 percent forecasting recovery in 2011.

**Growth strategies.** In past surveys, respondents have consistently ranked acquiring new customers, increasing sales in domestic markets and increasing sales to current customers as the top growth strategies. However, the 2010 survey demonstrates a renewed emphasis on increasing sales to current customers, rising to 92 percent of respondents from 82 percent in 2009. In a reversal from last year, companies expect domestic—not international—sales to increase at a faster rate in 2010.

**Global economy.** While economies in some areas of the world are improving faster than in the United States, some business leaders may not be fully seizing the moment. Only 19 percent of respondents with international reach participate in three key global business activities—import/export, import/offshore production or export/offshore production. Forty-one percent participate in two global business activities.

**Operational effectiveness.** In this year's survey, 30 percent of companies report they are expanding capacity—double the percentage from 2009. Reports of capacity reductions dropped sharply, from 26 percent in 2009 to just 8 percent this year. Capital spending plans are more robust, particularly for midsized and large companies. On the other hand, smaller firms remain more cautious about big-ticket investments.

**Margin management.** With the depth of the recession behind them, only 31 percent of company leaders say changing economic cycles will affect gross margin this year. That is a 15 percentage point drop from the 2009 survey. However, internal cost-cutting saw a slight year-over-year increase and companies reporting no change in gross margin increased from 24 percent in 2009 to 31 percent this year.

**Innovation.** The top challenge to innovation is rapid implementation from concept to market, which 46 percent of leaders say is a struggle. However, 21 percent of companies say this is a previous challenge they have overcome. Interest in green product development continues to rise, with two-thirds of companies indicating they now produce some environmentally friendly product lines. However, executives also say profitability in the green movement is not yet widespread.

**Health care.** Ninety-four percent of survey respondents are "very concerned" or "somewhat concerned" about recent

health care legislation and how it will affect their companies. While it is too early to evaluate the effect of health care reform, just over half of business leaders say employee health insurance costs will increase 10 percent or more this year. That is an increase over 2009, when 46 percent of executives expected double-digit increases. To help control costs, 22 percent of companies say they are trimming back health benefits this year.

**Tax strategies.** Despite an array of local, federal and international planning tools, the survey continues to suggest many companies are not taking full advantage of tax breaks that can improve cash flow.

**Information technology.** IT continues to gain favor as a strategic asset, with 91 percent of respondents indicating IT is a critical part of their operations. IT's connection to overall business strategy is more pronounced in larger companies, where technology is critical to managing complex organizations. After a year in which over half of companies cut IT spending, the tide has turned: Fully 43 percent of businesses say they will spend more on IT in 2010.

**Workforce.** Hiring is gaining momentum, as nearly half of companies plan to add to their U.S. workforces in 2010. That is triple the percentage of businesses adding jobs one year ago. Businesses continue to report difficulty finding qualified workers, with open positions covering a wide range of roles. Both manufacturing and distribution companies say salespeople are in high demand, and just over half of manufacturers report they are searching for engineers.

**Economic observations and selected findings.** While economic conditions are clearly better than one year ago, the road to full recovery will not be straight and smooth. For example, recent sovereign debt problems in Greece and other European nations have already weakened the euro against the U.S. dollar, making our exports there more expensive. The jitters over debt are slowing the recovery of U.S. financial markets, which will affect both investments and credit in the near term. In short, companies must balance their renewed optimism about the future with a range of contingency plans to address the potential for sudden economic shifts.

The recession was most damaging to smaller companies, particularly in the areas of credit availability and plans for capital investment. Typically, smaller firms lean more on bank financing (rather than cash flow) to fund growth initiatives. This does much to explain why small businesses say they will recover more slowly than their larger counterparts.

Companies are still not taking full advantage of international business opportunities. For example, the number of firms that report exports to China fell from 41 percent in 2009 to 37 percent this year. But China remains an opportunity for exporters, largely because of its strong economy, increasing standard of living and large appetite for U.S. products. Companies that find effective ways to sell in China's domestic markets will be rewarded as demand for Western products continues to accelerate.

While adoption of lean principles continues to grow, the survey shows distributors implement these systems far less frequently than manufacturers. Since these principles to reduce waste and increase efficiency are applicable to any industry, distributors may wish to take a closer look at how lean can help their businesses.

## Research methodology and demographics

McGladrey's 2010 Manufacturing and Wholesale Distribution National Survey was conducted from March 2 to April 5, 2010. The survey analysis includes the results of 1,061 executives and managers of U.S.-based manufacturing and wholesale distribution enterprises. The online survey was designed to assess the current state of the industry and to ascertain what steps CEOs, CFOs and other executives are taking to grow their business and stay competitive.

### Survey distribution

BUSINESS		
Manufacturing	522	49%
Mostly manufacturing, some distribution	196	19%
Mostly distribution, some manufacturing	121	11%
Distribution	222	21%

GEOGRAPHIC REGION		
Midwest	522	49%
Southeast	242	23%
West	144	14%
Northeast	117	11%
Southwest	36	3%

COMPANY REVENUE (IN MILLIONS)		
Less than \$25	407	38%
\$25 - \$99.9	369	35%
\$100 - \$499.9	218	21%
\$500 plus	60	6%
Unidentified	7	<1%

FULL-TIME EMPLOYEES		
0-49	218	21%
50-499	665	63%
500-1,999	117	11%
2,000 or more	35	3%
Unidentified	26	2%

INDUSTRY SEGMENTS		
Machinery Equipment and Supplies	234	22%
Food and Beverage	124	12%
Building Materials	124	12%
Fabricated Metal	122	11%
Chemicals, Petroleum and Plastics	91	9%
Paper Products, Printing and Publishing	73	7%
Electronics, Computers, Electrical Appliances and Components	70	7%
Transportation Equipment and Supplies	58	5%
Textiles and Apparel	47	4%
Furniture	32	3%
Medical Equipment and Supplies	30	3%
Other	56	5%

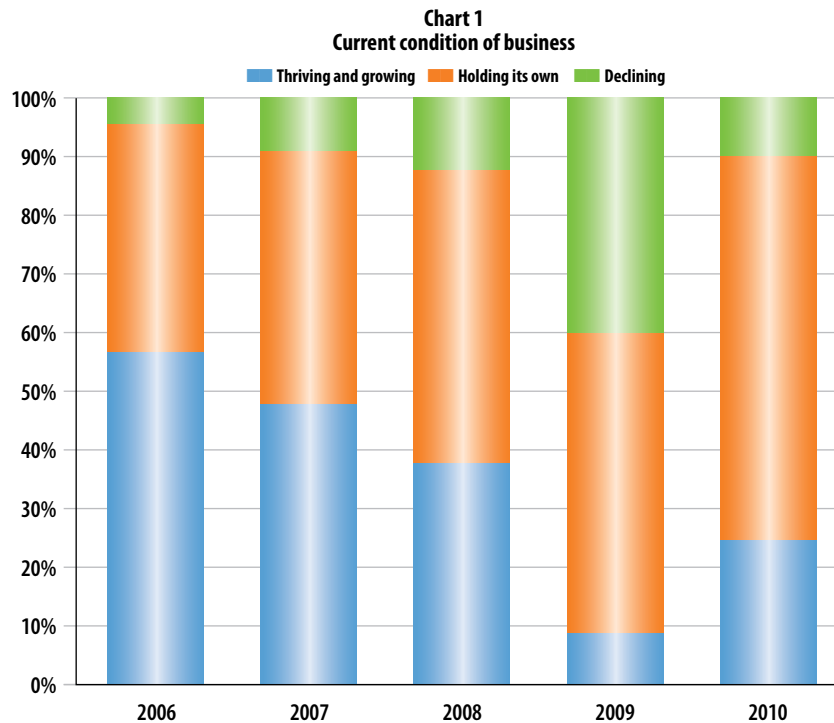
POSITION		
CEO, President or Chairman	376	35%
CFO, Vice President of Finance or Controller	477	45%
Chief Operating Officer	44	4%
Other	157	15%
Unidentified	7	1%

## Condition of business

### Improving outlook, tempered optimism

After weathering the worst recession in decades, respondents to the 2010 Manufacturing and Wholesale Distribution National Survey report modest, but generally positive, improvements in business conditions. One sign of improvement: 24 percent of this year's respondents say their companies are "thriving and growing." This 15 percentage point improvement from the 2009 survey breaks a three-year streak in which the "thriving and growing" measure had declined. Another indicator of resurgence: Only 10 percent of executives polled say company business conditions are "declining." This 30 percentage point drop from the 2009 survey marks the best result in this category since 2007.

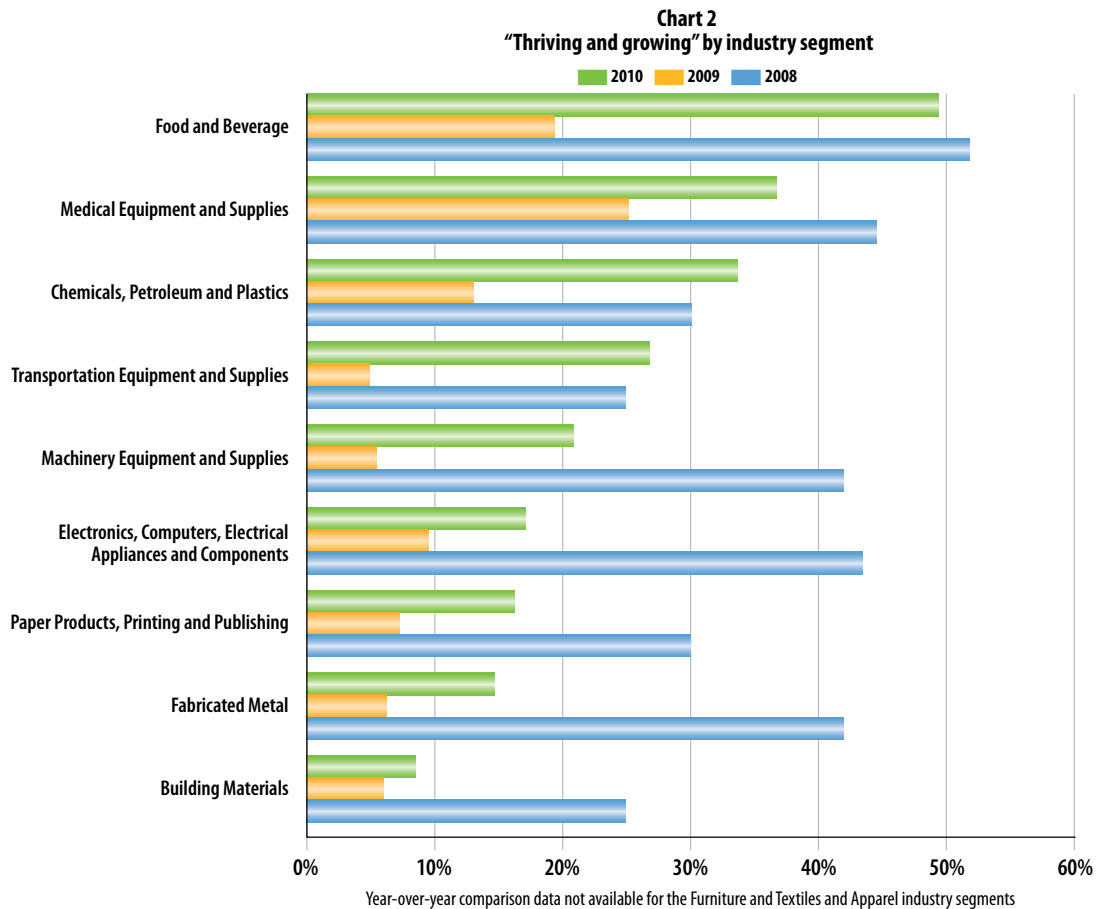
Chart 1 compares survey responses from 2006 through 2010 to the question, "Which of the following best describes the general condition of your business right now?"



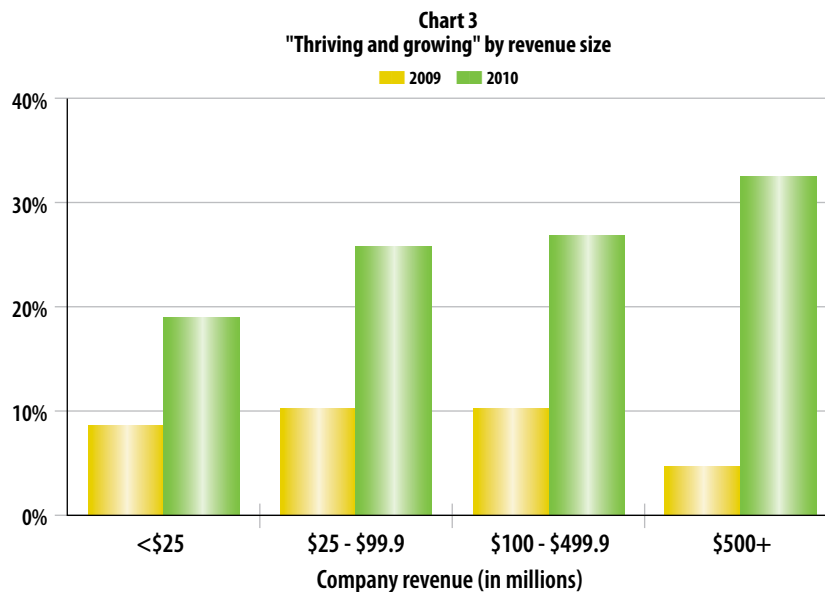
While a rising tide may lift all boats, survey results indicate some industry segments are rebounding higher—and more quickly—than others. Nearly half of Food and Beverage segment executives say their companies are "thriving and growing" this year, followed by Medical (37%) and Chemicals and related (33%).

After a brutal 2009 for the Transportation industry segment—in which just 5 percent of companies indicated they were "thriving and growing"—executives this year forecast a turnaround. Fully 28 percent of Transportation businesses in the current survey say their companies are "thriving and growing."

Industry segments improving, but expecting less than robust growth, are Building Materials, Textiles and Apparel and Paper and related. Weak consumer demand and a slow recovery in commercial and residential construction markets continue to undermine the Building Materials segment. Reduced advertising spend and the continuing shift from print to electronic media are dampening recovery for the Paper and related segment. Textiles and Apparel are affected by extreme competition from an ongoing migration to offshore production.



The survey shows company health is linked to size. For example, of the 407 companies with less than \$25 million in revenue, 19 percent report they are "thriving and growing." That percentage rises as company revenue increases, reaching 32 percent for companies with annual revenue of \$500 million or more. For the largest companies, the notable improvement in business conditions is directly related to increased order levels spurred by global demand and low levels of inventory in the supply chain. That demand increases the need for materials and supplies, which is starting to trickle down to midsized and smaller companies.





### **Economic optimism**

Respondents consistently put prospects for their companies ahead of projections for their industries and certainly ahead of the U.S. economy. Fully 83 percent of respondents report they are either “very optimistic” (21%) or “somewhat optimistic” (62%) about growth prospects for their companies in 2010—well above the 2009 cumulative total of 48 percent.

While 66 percent of business leaders feel positive about growth prospects for their industries, just 52 percent say they are optimistic about the U.S. economy.

When viewed by industry segments, enthusiasm about near-term growth prospects remains fairly widespread. Building Materials and Furniture are the only two segments in which fewer than 75 percent of respondents report being “very” or “somewhat” optimistic. In 2009, Medical was the only industry segment to exceed 75 percent optimism.

While there is often a strong relationship between optimism and hiring, this year’s survey offers some notable exceptions. Among the Food and Beverage segment, for example, 91 percent of companies are optimistic about their growth prospects for this year, but only 35 percent say they are hiring new U.S.-based workers. On the other hand, while Furniture is the least optimistic segment (69%), 44 percent of companies in that industry report they will add to U.S. payrolls this year. These disparities are due in part to how the recession affected each business. Food and Beverage weathered the downturn better than many other industries and did not need to make dramatic staffing cuts. However, Furniture was pummeled by the sharp drop in consumer spending, forcing companies to make deeper payroll reductions in 2009.

### **Economic recovery**

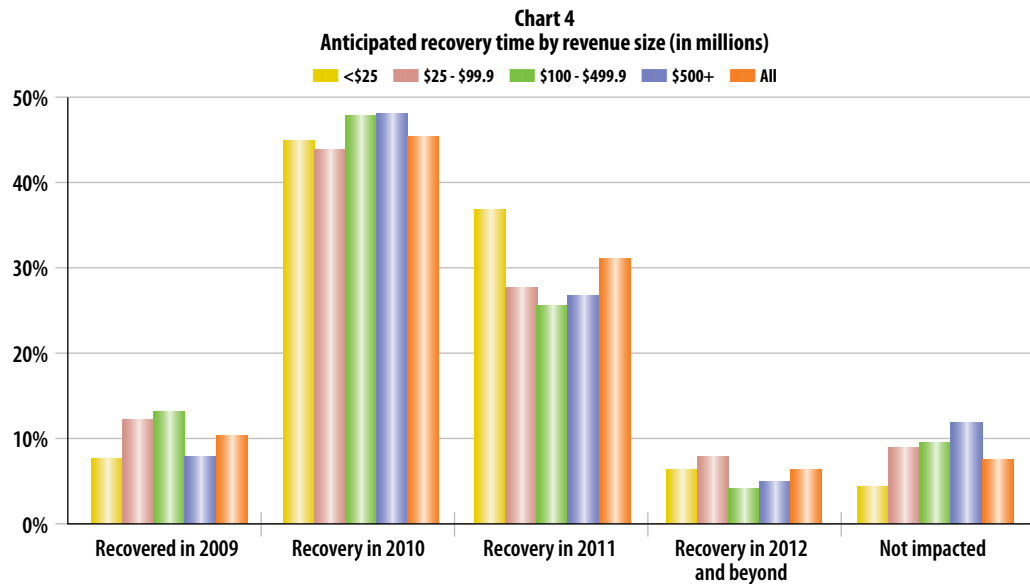
In the survey, 10 percent of leaders say their businesses recovered last year. Forty-five percent expect to rebound in 2010 and 31 percent project recovery for 2011. As expected, those economic conditions translate into employment. Fifty-five percent of companies forecasting a rebound in 2010 say they will increase employment this year.

While 6 percent of respondents believe recovery for their companies will linger into 2012 or beyond, that is remarkably upbeat compared to the 25 percent who believe a rebound for the U.S. economy is still two or more years away.

In 2010, industry segments forecasting the strongest prospects for recovery include Electronics and related and Machinery (each at 51%), followed closely by Paper and related and Fabricated Metal (each at 49%).

Industry segments foreseeing a longer-term recovery are those most severely affected by the recession, including Building Materials, Furniture and Transportation. In 2011, those industry segments are expecting to lead the recovery with rates above the composite survey average of 31 percent. However, 16 percent of Furniture companies and 14 percent of Building Materials firms say they do not expect full recovery until 2012 or beyond. That is well above the cumulative national average of 6 percent.

While more than half of all companies report they either rebounded in 2009 or will do so this year, the survey again reveals a connection between revenue size and recovery. For instance, 37 percent of companies with annual revenue less than \$25 million say they will rebound in 2011. That is at least 9 percentage points higher than any other revenue category, suggesting smaller companies were harder hit by the recession.



## Growth strategies

### Strategic consistency, with additional focus on current customers

In past surveys, acquiring new customers, increasing sales in domestic markets and increasing sales to current customers appear consistently as the top three growth strategies. In 2010, companies are placing strong emphasis on increasing sales to current customers, rising from 82 percent of respondents in 2009 to 92 percent this year. This indicates the critical reliance respondents place on existing customer relationships and the potential for those relationships to generate growth.

Table 1

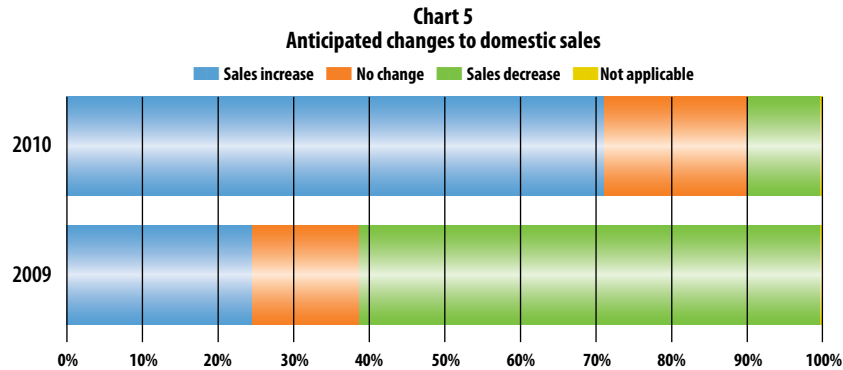
GROWTH STRATEGIES IN 2009 AND 2010		
	2009	2010
Acquiring new customers	94%	96%
Increasing sales in domestic markets	89%	95%
Increasing sales to current customers	82%	92%
Increasing brand recognition	77%	78%
Increasing the number of products offered	76%	77%
Increasing sales in international markets	57%	57%

### Considering mergers and acquisitions

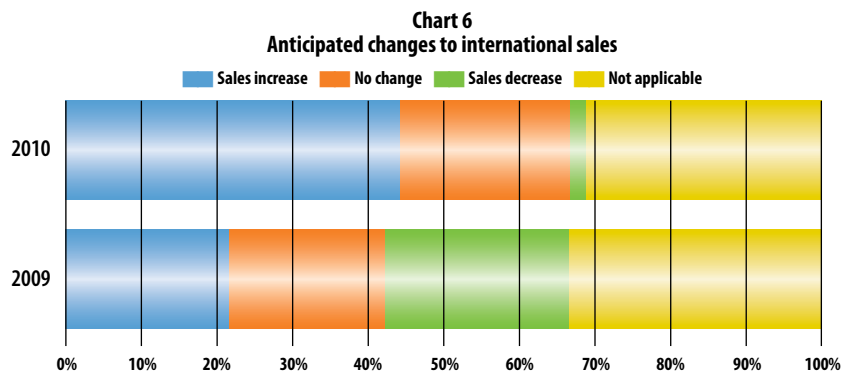
While failing competitors and a focus on cash conservation quashed the market for business combinations in 2008 and 2009, the survey shows some company leaders are regaining an appetite for mergers and acquisitions. Nearly one-quarter of survey respondents report they will engage in some M&A activity this year. Midsized companies in the \$100 to \$500 million range are showing the greatest year-over-year rise in interest, moving up 9 percentage points to 35 percent. Large companies with revenue of \$500 million or more have the most appetite for M&A at 38 percent. Industry segments particularly receptive to M&A include Medical, Fabricated Metal, Electronics and related and Paper and related.

## Domestic sales rebound

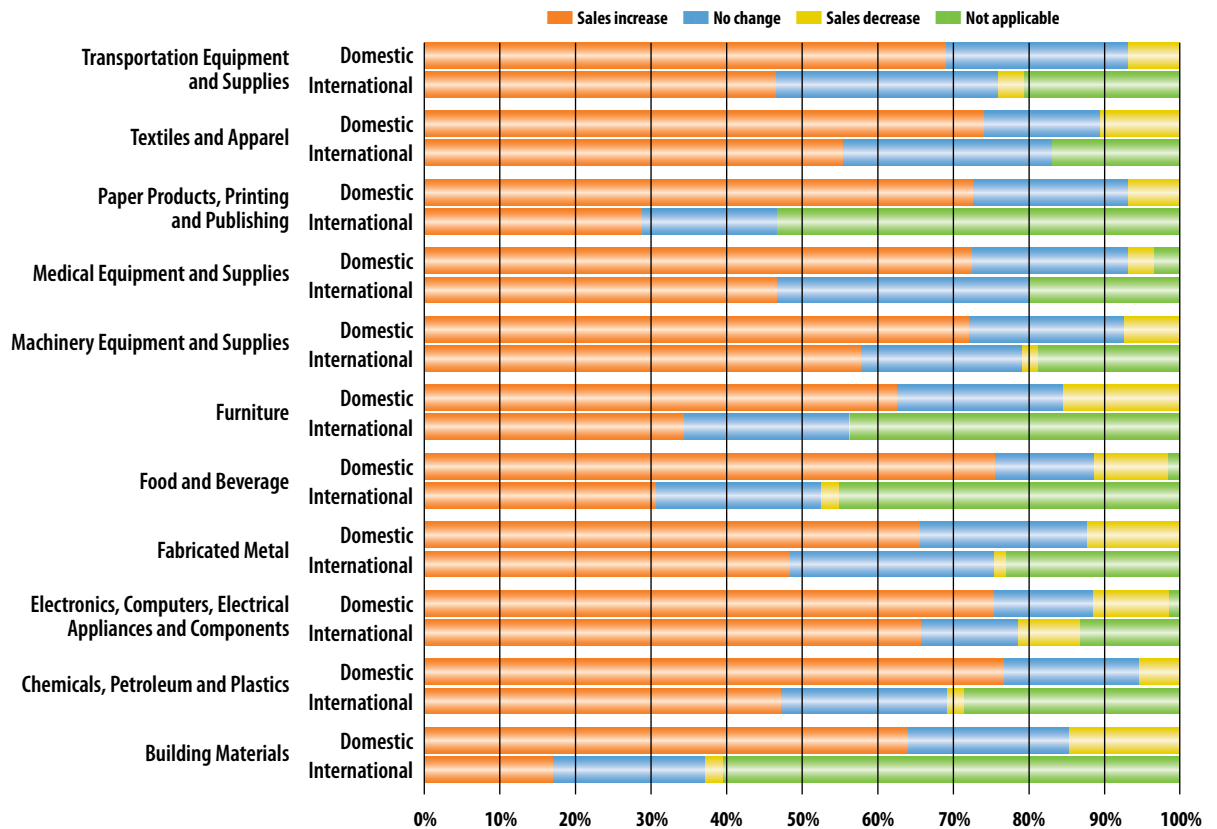
In a sharp change from last year, companies expect domestic—not international—sales to increase at a faster rate. This is due in part to the low baseline created by the recession, as well as low levels of inventory in the supply chain. Fully 71 percent of business leaders project U.S. sales to rise in 2010, nearly three times the percentage forecast last year. Electronics and related, Chemicals and related and Food and Beverage project the highest sales increases. Building Materials and Fabricated Metal are less optimistic about near-term sales growth, but nonetheless show strong improvement over 2009 levels.



Though not quite as dramatic, 44 percent of all respondents expect their international sales to increase this year, up from 21 percent in 2009. The primary beneficiaries of international sales are companies with \$500 million and more in annual revenue, which expect global sales increases of 14 to 27 percentage points higher than their smaller competitors. This year, Electronics and related (66%), Machinery (58%) and Textiles and Apparel (55%) project the highest international sales growth. Meanwhile, only 2 percent of companies expect a drop in international sales this year—a decisive turnaround from 2009 when 24 percent of survey respondents anticipated lower overseas sales.



**Chart 7**  
**Anticipated changes to domestic and international sales by industry segment**



## Global economy

### Global business activities

Increased trade flow between countries has resulted in a globally integrated supply chain. For that reason, the recession's ripple effects were felt across the globe. But the recovery is different, as some global economies are improving more rapidly than the United States economy. Most notably, Asian countries appear to be in double-digit growth mode, creating opportunities for American companies to expand by leveraging global business activities to higher levels.

However, this year's survey shows business leaders may not be fully seizing the moment. Fully 85 percent of respondents report global business activities, such as importing, exporting or conducting production or operations activities outside of the U.S. While that marks a slight rise from the 84 percent reported last year, it is less than the 87 percent reported in 2008.

Of the 905 companies engaged in global business, 60 percent are engaged in more than one global business activity. Forty-one percent are engaged in two and 19 percent participate in all three. Seventeen percent of companies with global involvement engage only in export activity, while 21 percent are involved only in import activity. Just 1 percent of companies are engaged only in production or operations outside of the U.S.



### **Import activities**

While Furniture has the highest percentage of companies engaged in import activities (88%), no year-over-year comparison is possible since the industry segment was not included in previous surveys. Other industry segments with a high percentage of import activity are Building Materials (87%, down 4 percentage points from last year) and Electronics and related (87%, no change from last year). Imports for the Chemicals and related industry segment stood at 84 percent, up 4 percentage points from 2009. The industry segment with the least import activity is Fabricated Metal (66%, down 7 percentage points from last year).

This year, 68 percent of respondents report importing materials for their supply chains, a slight rise from 66 percent in 2009. Fully 25 percent of respondents import one-third or more of their supply chain materials, an increase of 3 percentage points from last year.

The most active importers plan to ramp-up buying from overseas suppliers. The cost benefit of importing appears to have more than offset risk factors associated with international business, especially in cases where companies have established global presence and processes. In this area, the Textiles and Apparel segment stands out, with 80 percent of firms importing at least one-third of their materials and supplies.

After a 7 point dip from 2008 to 2009, the percentage of companies reporting increased reliance on foreign supply chain sourcing is virtually unchanged (46% in 2009 to 47% this year). Nearly six in 10 distributors with some manufacturing capabilities have strong ties to foreign sources for supply chain needs. When viewed by industry segment, at least 60 percent of companies in Textiles and Apparel, Furniture and Medical say they are leaning more heavily on overseas suppliers this year.

### **Export activities**

By industry segment, export activity is led by Electronics and related (92%)—a 9 percentage point increase from last year. Export sales for Fabricated Metal shot up 10 percentage points to 85 percent, while Paper and related fell sharply (71% in 2009 to 46% this year).

Table 2

IMPORT AND EXPORT ACTIVITY BY INDUSTRY SEGMENT IN 2009 AND 2010						
	Import			Export		
	2009	2010	Change	2009	2010	Change
<b>Machinery Equipment and Supplies</b>	74%	79%	5%	88%	86%	-2%
<b>Food and Beverage</b>	76%	79%	3%	67%	61%	-6%
<b>Building Materials</b>	91%	87%	-4%	49%	47%	-2%
<b>Fabricated Metal</b>	73%	66%	-7%	76%	85%	9%
<b>Chemicals, Petroleum and Plastics</b>	80%	84%	4%	82%	76%	-6%
<b>Paper Products, Printing and Publishing</b>	68%	81%	13%	71%	46%	-25%
<b>Electronics, Computers, Electrical Appliances and Components</b>	87%	87%	0%	83%	92%	9%
<b>Transportation Equipment and Supplies</b>	77%	77%	0%	86%	78%	-8%
<b>Medical Equipment and Supplies</b>	71%	73%	2%	79%	83%	4%

Year-over-year comparison data not available for the Furniture and Textiles and Apparel industry segments

In 2010, 47 percent of companies report export sales have increased, up 4 percentage points from 2009. Among companies that say increased international sales are key to business growth, 88 percent are anticipating revenue increases in foreign markets. To accomplish this, companies are more likely to broaden their sights outside of traditional U.S. trading partners.

Canada and Mexico remain the most frequent export target markets, at 86 percent and 67 percent, respectively. The number of companies that report exporting to China fell from 41 percent in 2009 to 37 percent this year. But China remains an opportunity for exporters, largely because of its strong economy, increasing standard of living and growing appetite for U.S. products. The most successful exporters to the Chinese market are Electronics and related (60%) and Machinery (50%).

Table 3

EXPORT ACTIVITIES	
	Currently exporting
<b>Canada</b>	86%
<b>Mexico</b>	67%
<b>Central America</b>	38%
<b>Brazil</b>	31%
<b>Other South America</b>	32%
<b>China</b>	37%
<b>India</b>	23%
<b>Japan</b>	31%
<b>Other Asia</b>	34%
<b>Australia</b>	33%
<b>Eastern Europe</b>	31%
<b>Western Europe</b>	57%
<b>Russia</b>	18%
<b>Middle East</b>	35%
<b>Africa</b>	17%

**The China factor**

Five years ago, China was the undisputed “go-to” location for U.S. manufacturers seeking low-cost production alternatives. Today, faced with increased labor costs, fluctuating currency rates and long ship timelines, many companies are rethinking that assumption. “We have sourced...from China since 1999,” writes one manufacturing leader in this year’s survey. “[But] we see the cost...increasing in 2010 and beyond, making them less and less competitive in the global market over the next five years.”

One good reason to remain (or expand) in China: A fast-growing domestic marketplace. A consensus of forecasts puts China’s economic growth over 10 percent for 2010, with much of that increase coming from domestic consumer spending. That provides a solid opportunity for U.S. manufacturers to reach a dynamic marketplace.

## Offshoring activities

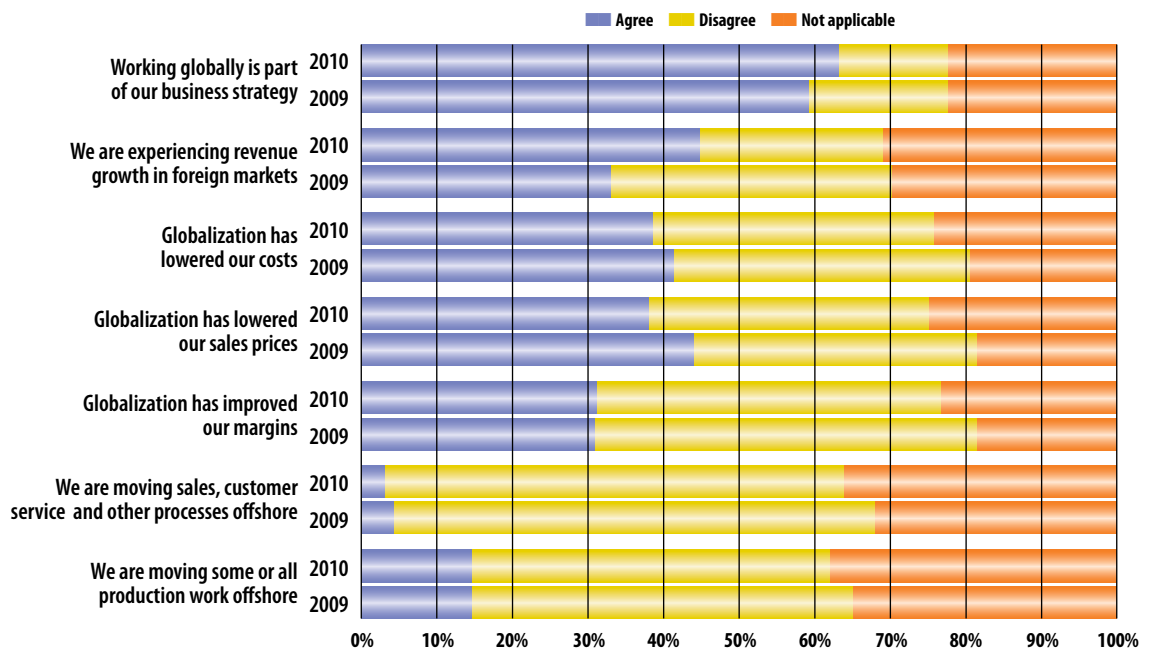
The offshore movement declined for a second straight year. As companies gain experience in offshoring, many have found the indirect costs of quality, transportation, inventory and delivery dates more than offset any direct cost savings. In 2010, only 15 percent of business leaders say they will move some or all production work offshore, with Medical (40%), Textiles and Apparel (32%) and Electronics and related (26%) as the industry segments most willing to take that step. Midsized companies express the most interest in offshoring production, led by 23 percent of businesses in the \$250 to \$500 million revenue bracket.

Only 3 percent of companies indicate they plan to move sales or customer service jobs overseas, with Furniture (6%) and Machinery (5%) as the lead industry segments. The survey shows companies with annual revenue of \$50 to \$250 million may be more prone to moving these operations offshore.

## Impact of global business strategy

In this year's survey, 63 percent of companies say working globally is part of their business strategy—a 4 percentage point increase from 2009. Companies continue to expand globally, largely because many of those markets are growing faster than the U.S. and present the greatest opportunity for topline revenue increases. While companies report a 12 percentage point increase in foreign market revenue growth (45% vs. 33% in 2009), margin remains virtually the same. This is directly related to costs rising faster in foreign markets than in the United States.

**Chart 8**  
Impact of global business strategy in 2010 and 2009

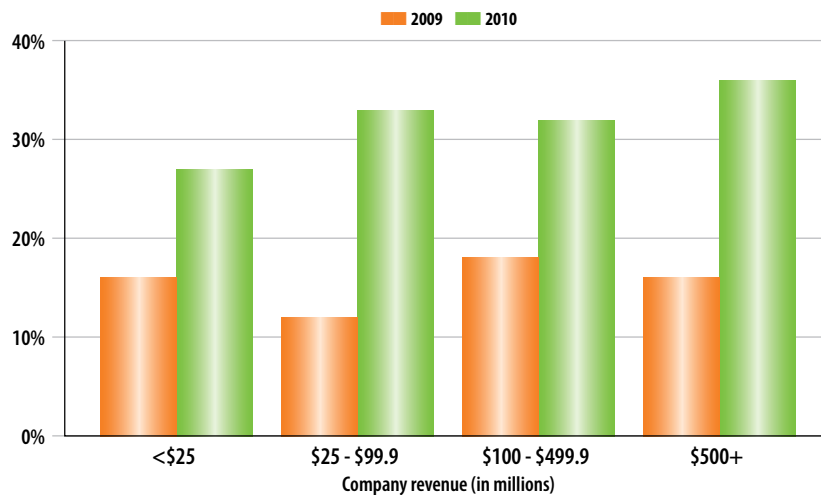


## Operational effectiveness

### Operational capacity

Thirty percent of executives answering this year's survey say their companies are expanding capacity—double the percentage from 2009. Clearly, much of the improvement is due to more favorable business conditions. However, some of the change can also be attributed to an expected ramp-up in capacity after last year's sharp reductions. Another indication of an improving economy: Fewer companies are reporting plans to reduce capacity, dropping from 26 percent in 2009 to just 8 percent this year. Industry segments emphasizing capacity reductions include Building Materials (14%), Fabricated Metal (12%) and Machinery (10%). Meanwhile, the percentage of businesses planning to consolidate operations also fell (25% last year to 17% in the current survey). The industry segment planning the highest level of expansion this year is Medical (50%).

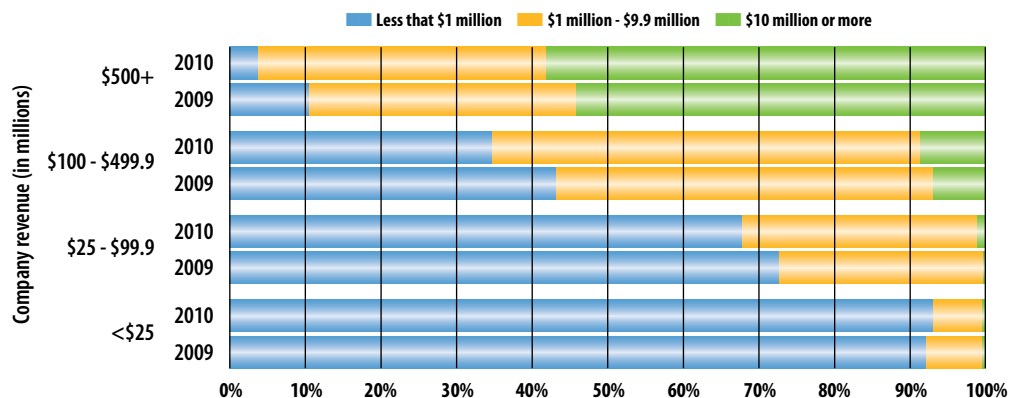
**Chart 9**  
Planned capacity expansion by revenue size



### Capital expenditures

After tightening up in 2009, executives are more open to making capital investments. Nearly 90 percent of companies are planning new capital expenditures this year, up from 83 percent in 2009.

**Chart 10**  
Planned capital expenditures by revenue size  
2010 (n=926) 2009 (n=743)



Cash flow from operations and bank financing remain the primary funding sources for capital expenditures. However, the option business leaders choose is often connected to company size. For example, 90 percent of companies with \$500 million or more in revenue say they will fund capital expenditures with cash flow, while just 31 percent will look to bank financing. By contrast, smaller companies rely much more heavily on bank financing.

### Credit availability

In the big picture of this year's survey, 19 percent of respondents report difficulty securing credit. However, that squeeze is especially tight for companies with less than \$25 million in annual revenue, where nearly 29 percent of leaders say credit is hard to get. Housing crashes in Las Vegas, Phoenix and Southern California are major reasons why the southwest U.S. is the hardest-hit region, with 29 percent of business leaders in that area reporting tight lending conditions. For those reasons it is no surprise executives who report a lack of available financing are also likely to say their companies will not recover until 2011 or beyond.

Generally speaking, larger companies have an easier time accessing credit. But many of their leaders are concerned about more restrictive credit standards hindering business development. For example, while only 15 percent of executives in companies with annual revenue of \$100 to \$250 million are concerned about credit availability, two-thirds of those leaders are worried how tight credit will affect future growth.

### Lean principles and efficiency

Lean principles are production practices focused on workflow optimization to increase efficiency and reduce waste. Adoption of lean programs has grown each year since this survey was first conducted, rising to 65 percent in 2010—a 4 percentage point increase over 2009.

In 2010, industry segments leading the way on lean implementation are Fabricated Metal (81%), Furniture (72%), Electronics and related and Transportation (both 70%). While the survey shows distributors implement these systems far less frequently than manufacturers (45% vs. 73%), lean principles are applicable to any industry. With that in mind, distributors may wish to take a closer look at how lean can help their businesses become more efficient.

### Inventory levels

Fewer companies are projecting formal plans to reduce inventory in 2010 vs. 2009, reflecting the result of actions taken this past year to conserve cash and reduce costs. For example, 59 percent of Furniture and 57 percent of Building Materials company leaders say they will not cut inventory in 2010, despite the fact those industry segments are still working their way back to profitability. Interestingly, fewer than half of companies with less than \$25 million in annual revenue are planning to scale back inventory this year, compared with 50 percent of the largest businesses who say they will do so.

Table 4

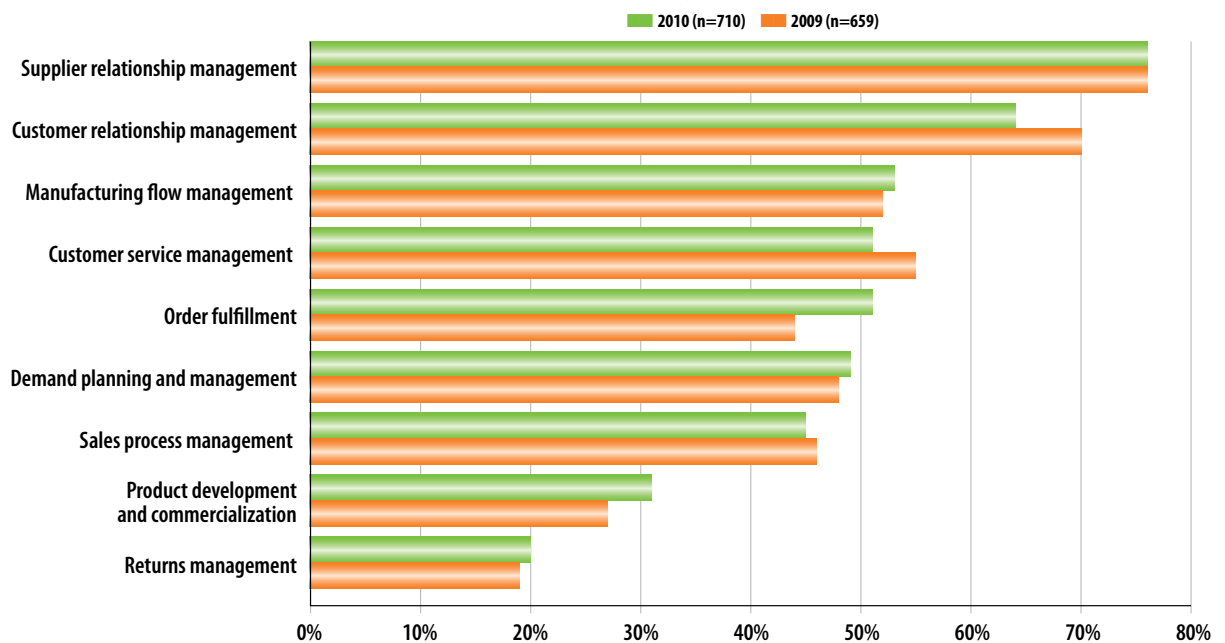
PLANS TO REDUCE INVENTORY		
	2009	2010
Yes, by 20% or more	24%	9%
Yes, by less than 20%	45%	40%
No plans	31%	51%



### Supply chain management

The number of businesses planning supply chain improvements slipped from 71 percent in 2009 to 67 percent this year. The decline raises a cautionary flag for businesses wanting to improve customer relationships. Although the percentage of companies seeking to enhance supplier relationships remained the same from 2009 to 2010, the percent of businesses with plans to improve customer relationships and customer service management fell by 6 and 4 percentage points, respectively.

**Chart 11**  
Planned supply chain process improvements



## Margin management

### Gross margins

Of the 1,061 respondents to this year's survey, 1,004 provided gross margin data for 2009, 2010 and 2011. Factors affecting gross margin changed between 2009 and 2010. Last year, 46 percent of survey respondents said changing economic cycles was the top reason for shifts in gross margin. In 2010, the impact of changing economic cycles on gross margin fell 15 percentage points to 31 percent. Internal cost cutting measures is the only category posting a year-over-year increase, moving up 2 percentage points to 30 percent. Meanwhile, companies reporting no year-over-year change in gross margin increased 7 percentage points to 31 percent.

### Cost expectations

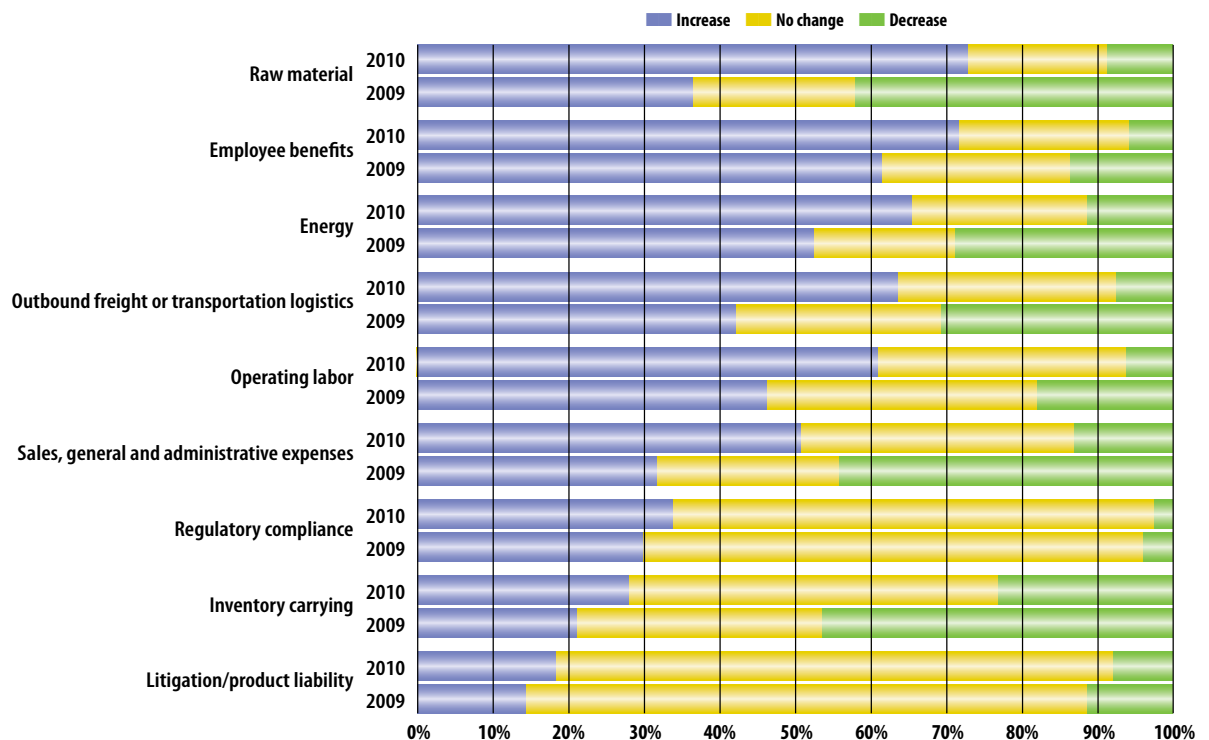
Due in large part to a recovering global economy, 72 percent of business leaders predict a spike in raw material costs this year—double the percentage forecast for 2009. Just over seven in 10 companies believe employee benefit costs will rise this year and 65 percent say energy costs will increase. Seventy-four percent of executives say litigation costs will hold steady and 64 percent believe their companies will hold the line on regulatory compliance expenses.

Nearly one in four companies say their inventory carrying costs will decrease in 2010. This is largely attributable to recession-related efforts to draw down inventories over the past year.

Table 5

INFLUENCES ON GROSS MARGIN		
	2009	2010
Product (sales) pricing	44%	39%
Changing economic cycles	46%	31%
No change	24%	31%
Internal cost-cutting measures	28%	30%
Commodity pricing	32%	25%
Supply chain-related issues	17%	17%
Health care costs	20%	12%
Energy costs	20%	10%
Global competition	12%	9%

Chart 12  
Anticipated changes in costs for 2010 and 2009

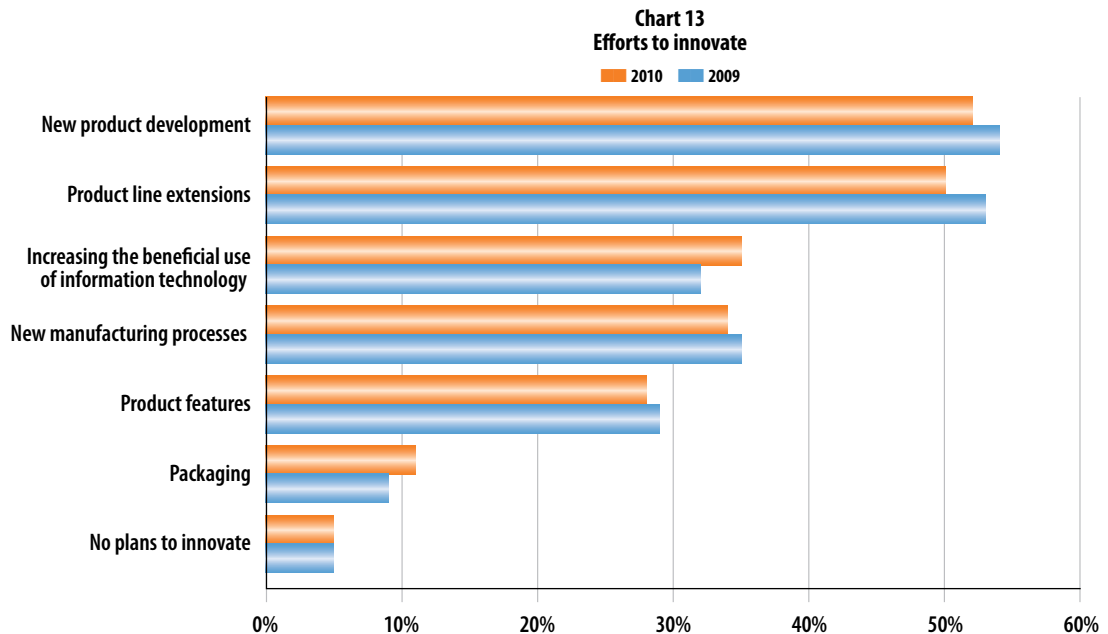


## Innovation

### Use of tools mixed, but green products continue rise

Even in a challenging economy, companies remain interested in creating new products and finding more efficient ways of doing things. In the 2010 survey, 95 percent of businesses say they are investing in innovation activities, with new product development and product line extensions leading the way.

While the survey reveals few differences by company size regarding innovation, a small exception may be the beneficial use of information technology. Only 28 percent of companies with less than \$15 million in annual revenue say they are ramping up efforts to improve the beneficial use of IT. That is well below the 46 percent of firms with \$1 billion or more that say the same thing. A lack of resources may be one reason why the smallest companies are unable to fully leverage the innovation potential in information technology.



New product development is the top innovation focus area for 548 of the companies responding to the 2010 survey. Executives at these companies say the top challenge to innovation is rapid implementation from concept to market, with 46 percent saying it is a struggle. However, 21 percent of leaders say this is a previous challenge their companies have overcome. The next most pressing challenge is the ability to turn ideas into commercial products, followed by the ability to identify needs of the marketplace. Industry segments facing the greatest challenges in moving from concept to market include Textiles and Apparel (66%), followed by Furniture and Electronics and related (64%).

Table 6

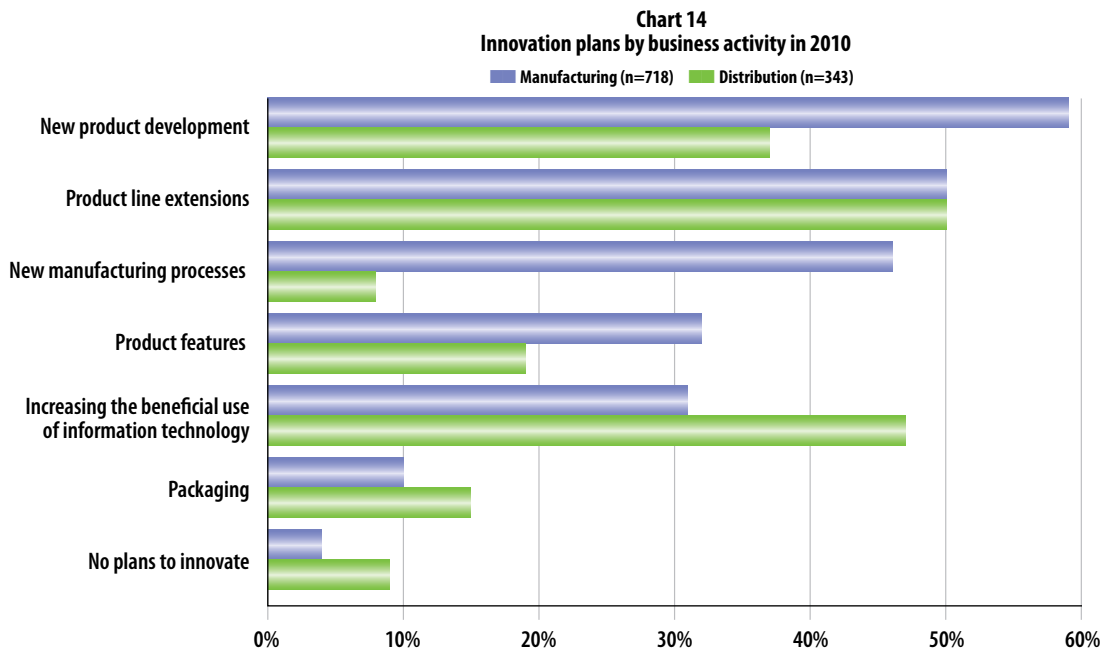
CHALLENGES OF NEW PRODUCT DEVELOPMENT		
	Yes, currently a challenge	Yes, previously a challenge that we have overcome
Rapid implementation from concept to market	46%	21%
Ability to turn ideas into commercial products	34%	22%
Ability to identify needs of the marketplace	32%	22%
Supply chain	30%	23%
Creating an environment that fosters idea generation and creativity	28%	22%
Available funding	26%	19%
Commitment by company ownership and/or leadership	9%	8%

The least challenging element of innovation reported by leaders is commitment by company ownership, which is noted only 9 percent of the time. This is an encouraging sign, since any successful innovation activity requires support from the top. Another significant finding: Companies are relying on implementation of new innovations to drive revenue. Fully 75 percent of companies planning innovations are also projecting increases to domestic sales.

### Innovation plans by business activity

The percentage of companies reporting new manufacturing process innovations remained relatively flat among manufacturers between 2009 and 2010. Distributor interest in innovation tools showed a marked decline. Only 37 percent of distribution leaders say their companies are investing in new product development, down from 41 percent in 2009. Interest in product line extensions, historically a popular innovation strategy for distributors, fell to 50 percent—8 percentage points lower than last year.

Consistent with responses from past surveys, manufacturers will outpace distributors in applying innovation in 2010. But also consistent with past years, the major exception is the beneficial use of information technology by distributors over manufacturers (47% vs. 31%). Distributors also have the edge on packaging innovations. Both manufacturers and distributors emphasize product line extensions equally.

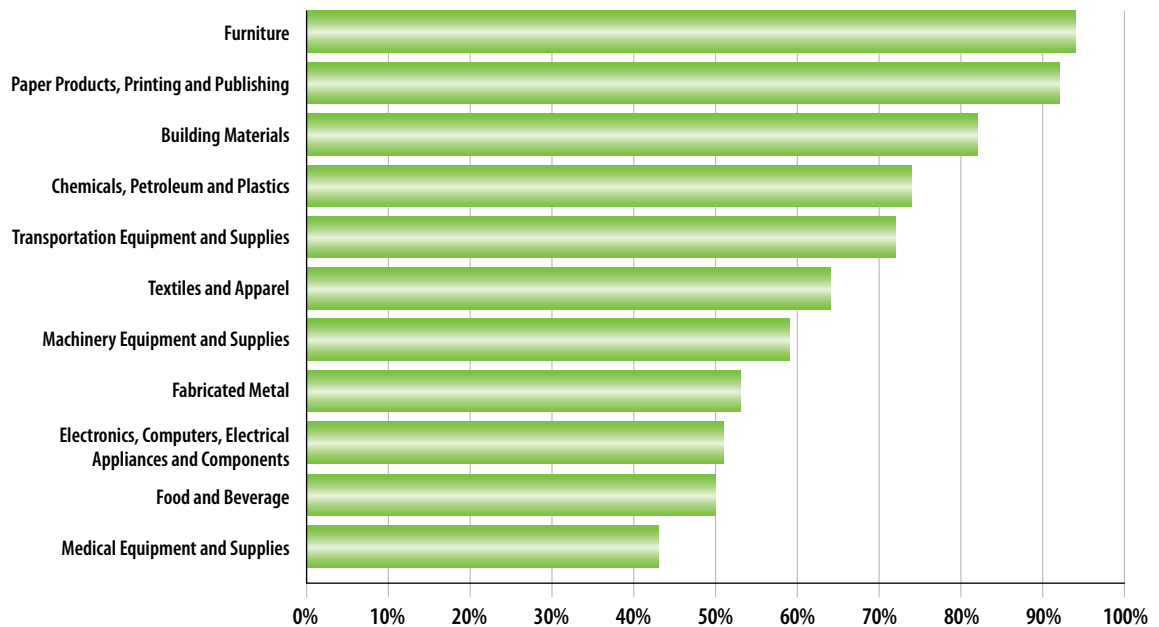


### Green initiatives

Interest in green product development rose sharply in this year's survey, with two-thirds of companies indicating they now produce some environmentally friendly product lines. Furniture and Paper and related are the "greenest" industry segments, based on the percentage of companies offering such products. However, a number of respondents expressed skepticism about the validity of the green movement and customer willingness to pay a premium for green products.



**Chart 15**  
Industry segments offering green products

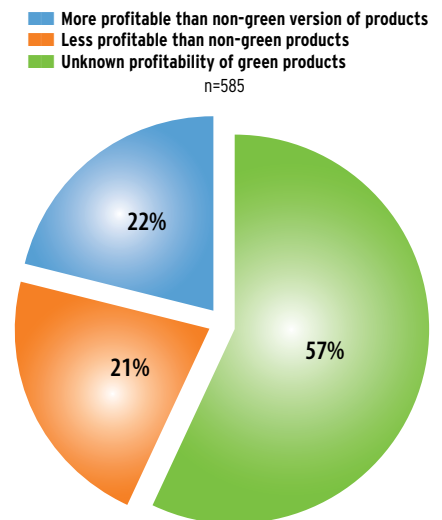


The most popular target market for green products is existing customers (84%). This approach is especially true for distributors (95%) and for industries like Paper and related, Medical and Building Materials, all of which rely heavily on stable customer relationships. On the other hand, leaders of Electronics and related companies say the appeal of their green products will draw first-time customers from new (85%) and existing (67%) markets at a much higher rate than the composite averages (63% and 38%, respectively).

To date, the rise in green product development has not translated to topline growth. Only 20 percent of companies this year report revenue increases directly tied to green activities, with Paper and related, Furniture and Transportation leading the way. But long-term trends show increasing numbers of consumers are embracing green products. Companies overlooking green products in exchange for short-term balance sheet improvement may miss an opportunity to establish themselves as a future marketplace leader.

Currently, the profitability of green remains elusive. Of the companies offering green products, 22 percent report they are more profitable and 21 percent less profitable than non-green products. The vast majority (57%) say the profitability of their green products is “unknown.” Under any new product scenario, including green, companies need to make sure they have the proper metrics to measure performance on a product basis.

**Chart 16**  
Profitability of green products



### Sustainability goes green

The sustainable business movement, once defined by a handful of organic farms and manufacturers of outdoor products, has gone mainstream. For proof, look no further than *Newsweek's* "Green Rankings," which made its debut in 2009. The list ranks the 500 largest U.S. companies based on their actual environmental performance, policies and reputation.

While most people agree green (or sustainable) practices are gaining favor with consumers, the survey shows business leaders are split on its immediate costs vs. value. The sentiment of one respondent was voiced by several: "Green products have the same profit level as non-green products. Most of our customers will not pay more for green products." Others suggest the green movement is more marketing than a sustained trend: "In my opinion," says one executive, "the entire green movement will have a limited life." Still, a number of companies implement sustainable practices, even if they don't use that language: "We have been recycling raw materials since the 1930s. It's not being green, it's how we do business. We were green before it was cool." Says another respondent, "Green initiatives for us have resulted in significant cost reductions in the form of energy and materials reductions."

As increasing numbers of companies delve into green products, efficiencies will improve and costs will fall. As a result, businesses will eventually be able to price such products more competitively, helping make it easier for environmentally minded consumers to vote with both their hearts and wallets.

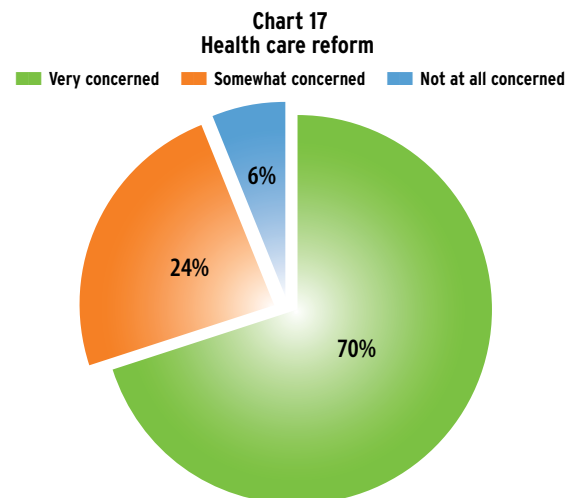
## Health care

### Concerns over policy, cost-containment

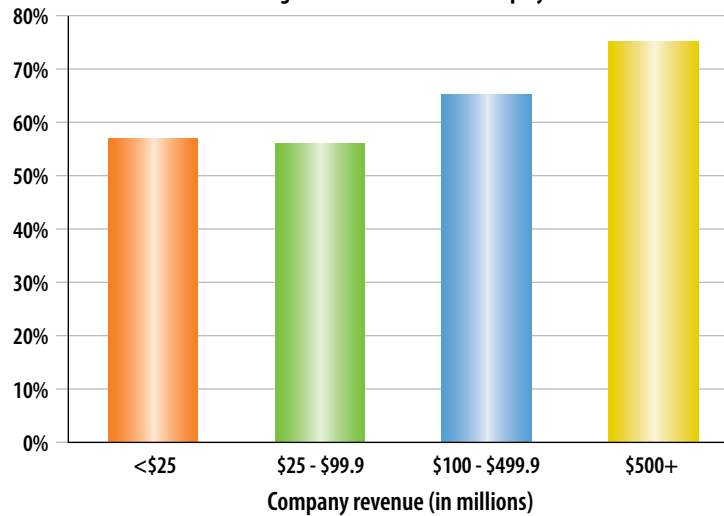
Recently passed health care legislation is a significant issue for respondents of this year's survey. Ninety-four percent say they are "very concerned" or "somewhat concerned" about how health care policy will affect their companies.

While it is too early to evaluate the effect of health care reform, companies expect near-term costs to continue upward. Just over half of business leaders say their employee health insurance costs will increase 10 percent or more this year. That is an increase over 2009, when 46 percent of executives expected double-digit premium increases. There is a strong relationship between company size and health care costs, since larger employers can effectively spread risk experience across greater numbers of employees.

While passing costs on to employees remains the top overall cost containment strategy, smaller companies are taking a stand against passing health care cost increases to their workers. The percentage of companies offering wellness programs—far more prevalent among larger firms—remains constant with 2009 results at 36 percent. The number of businesses looking for a break by changing insurance carriers fell from 25 percent in 2009 to 21 percent this year.



**Chart 18**  
Passing health care costs on to employees



There are no indications employers plan to drop medical benefits in the face of health care reform. Only 2 percent of businesses say they are eliminating health care benefits this year. However, 22 percent report they are trimming health benefits, with smaller companies more prone to take that step.

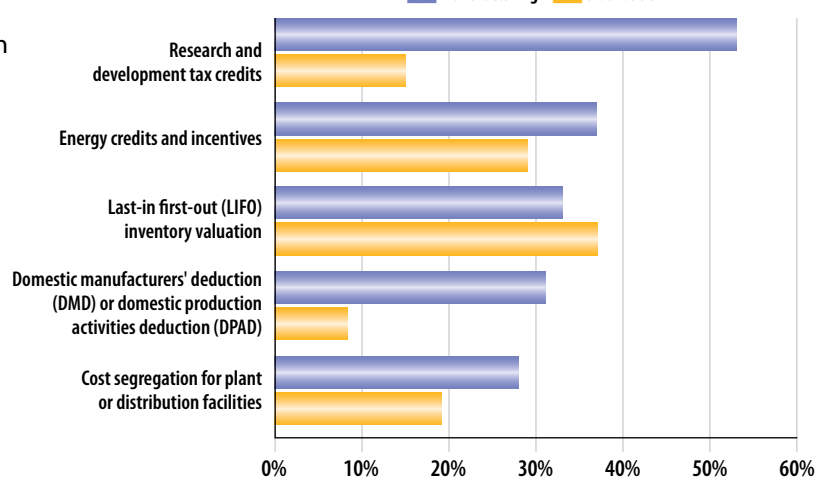
## Tax strategies

### Companies still overlooking valuable tools

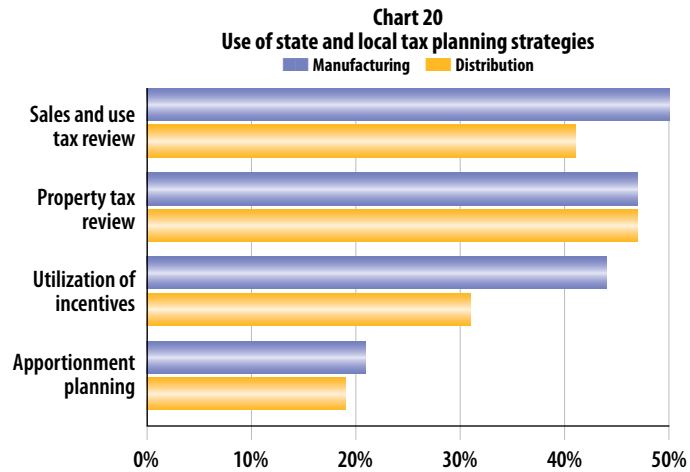
In this year’s survey, respondents provided insights on their use of tax strategies at three levels: federal, state/local and international. Questions were also asked regarding potential changes in tax policy (see the “Policy issues” section of this report). Despite the availability of these strategies for both manufacturers and distributors, survey results continue to suggest many companies are not taking full advantage of tax breaks that can improve cash flow.

With regard to federal tax strategies, a larger percentage of manufacturers than distributors use research and development (R&D) tax credits and the domestic manufacturers’ deduction (DMD). Although these credits are more applicable to the manufacturing industry, there are circumstances that make them available to distributors. While a larger percentage of manufacturers than distributors use cost segregation to accelerate facility depreciation deductions, distributors increased their use of this tool from 10 percent in 2009 to 19 percent this year. Another slight surprise: A higher percentage of distributors report using last-in first-out (LIFO) accounting tools for inventory management. This marks a reversal from the 2009 report, where manufacturers held the edge.

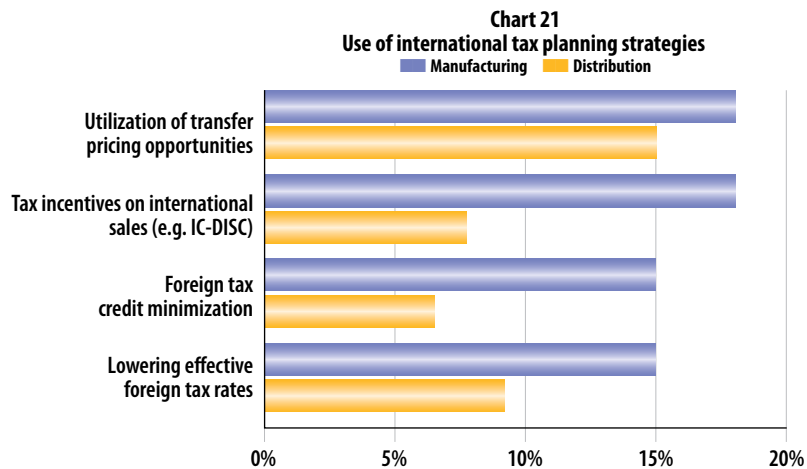
**Chart 19**  
Use of federal tax planning strategies



At the state and local tax (SALT) level, manufacturers report greater use of tax planning strategies. This includes the use of apportionment planning, which fell for the third straight year among distributors in the survey. While thresholds may come into play, both distributors and manufacturers should review their tax strategies to make sure all applicable state and local credits are applied.



For globally active companies, transfer pricing overtook tax incentives on international sales as the most frequently used overall strategy. Consistent with previous surveys, manufacturers are more likely than distributors to use these tax strategies, since manufacturers are more often globally engaged.



## Information technology

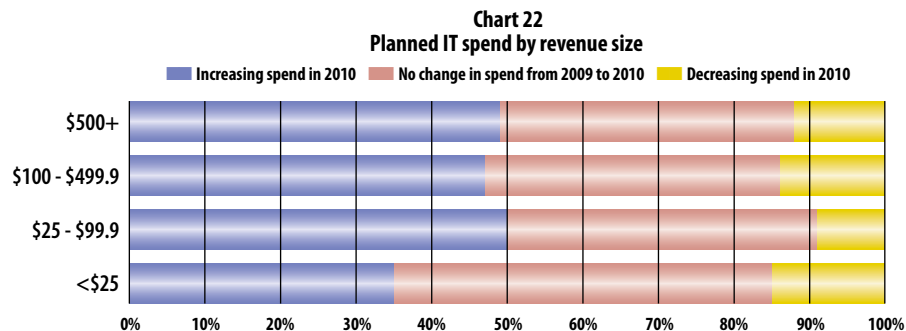
### Strategic value of IT often size-specific

Following a strong trend line over the survey's five-year history, information technology (IT) has clearly grown as a strategic asset. This year, 91 percent of companies say IT is a critical part of their operations, up 1 percentage point from 2009. However, leaders reporting integration of IT strategy with business strategy slipped to 78 percent, down 2 percentage points from last year.

The importance of IT is much clearer in larger companies, where technology is critical to managing organizational complexity. Consequently, a greater percentage of large companies report integration of corporate and IT strategies. Still, smaller businesses should consider increasing the use of IT to help improve efficiencies. This may include consultation with outside resources that provide turnkey solutions or fully outsourced IT operations.

### Information technology expenditures

After a notable drop in IT spending last year, respondents report the tide has turned. Only 13 percent of companies say they will spend less on IT this year, compared to 57 percent that cut back in 2009. Overall, 43 percent of companies expect to increase IT spending, with businesses in the \$25 to \$100 million revenue bracket leading the way. By industry segment, 60 percent of Medical companies are planning higher IT expenditures in 2010, followed by Food and Beverage at 55 percent.



### Information technology effectiveness

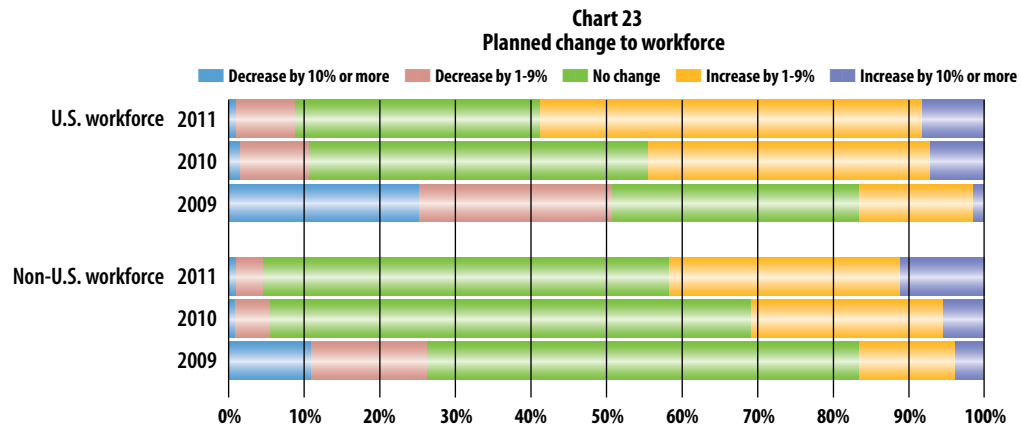
Executives say their IT departments effectively manage a number of key business requirements. Around 90 percent agree their technical resources handle IT security risks, infrastructure management and delivery of projects on time and on budget. However, business leaders are a bit less confident in how well IT resources identify new technologies to improve efficiency, with 17 percent saying IT is not at all effective in this area. That sentiment is especially pronounced in the Textiles and Apparel industry segment, where 34 percent of respondents say IT is not helping improve efficiency.

## Workforce

### Hiring jumps, but qualified applicants still scarce

Consistent with other signs of an improving economy, hiring is gaining momentum. Fully 48 percent of companies plan to add to their U.S. workforces in 2010—triple the percentage of businesses hiring one year ago. After being especially hard hit by a sharp drop in consumer spending, Transportation is leading the hiring rebound (67%). On the other hand, the Building Materials segment anticipates a slower recovery, with only 32 percent of those businesses planning to hire in 2010. Business confidence extends into 2011, with nearly six in 10 companies projecting increases to their U.S. payrolls.

While executives project modest growth for non-U.S.-based positions, larger companies—which are more likely to have international locations—forecast greater hiring increases. For instance, 12 percent of businesses in the \$25 to \$100 million annual revenue bracket expect to grow their non-U.S. labor pool this year, with 13 percent of those businesses expecting to hire in 2011. On the other hand, 30 percent of companies with \$500 million or more in annual revenue are projecting job growth for both 2010 and 2011.



During the recession, both manufacturing and distribution companies reported difficulty finding qualified workers. That trend continues this year, with needs reported across a wide range of positions. Carrying over from 2009 is a continued need for sales professionals, with 65 percent of distribution companies ranking this as a need (12% as an urgent need). Sales is also a sought-after skill on the manufacturing side (47%). Slightly more than half of manufacturers say they are searching for engineers (12% as an urgent need). As the economy improves and companies increase hiring, competition for skilled personnel will intensify. Companies fortunate enough to have high-performing employees on board may want to consider incentive and retention strategies to keep them from jumping ship.

#### Sales needs differ for manufacturing, distribution

While the need for sales talent is clearly defined, the demand in manufacturing and distribution has some connection to company size. In manufacturing, the need is most critical in the largest companies. For example, 17 percent of companies with revenue of \$500 million or more say sales is an urgent need, while 10 percent of manufacturers with revenue less than \$25 million report an urgent need for salespeople. On the other hand, a greater percentage of small distributors report an urgent need for sales talent. While only 7 percent of distributors with revenue of \$500 million or more have an urgent need for salespeople, 13 percent of companies in the \$25 to \$100 million range have an urgent need for people to sell their products.

Table 7

SKILLED LABOR RECRUITING NEEDS (MANUFACTURING)			
	Urgent need	Need	Total Need
Engineers	12%	40%	52%
Entry-level workers	6%	42%	47%
Salespeople	8%	39%	47%
Machinists	6%	33%	38%
Quality control personnel	8%	31%	38%
Supervisory personnel	4%	34%	38%
CNC machinists	7%	28%	35%
Welders	6%	25%	30%
CNC programmers	5%	23%	29%
CAD/CAM technicians	4%	23%	27%
Information technology personnel	3%	23%	26%
Accounting personnel	2%	20%	22%
Tool and die makers	2%	16%	18%

n = 522

Table 8

SKILLED LABOR RECRUITING NEEDS (DISTRIBUTION)			
	Urgent need	Need	Total Need
Salespeople	12%	54%	65%
Warehouse personnel	2%	42%	44%
Customer service/support personnel	2%	36%	39%
Truck drivers	5%	30%	35%
Forklift operators	2%	31%	32%
Entry-level workers	2%	31%	32%
Management personnel	5%	26%	31%
Supervisory personnel	4%	23%	26%
Information technology personnel	4%	21%	25%
Accounting personnel	2%	19%	21%
Inventory control personnel	1%	19%	21%

n = 222

Workforce needs were reported across the entire skill spectrum. As manufacturers and distributors continue to modernize facilities, invest in new products and improve efficiencies, the need for a skilled workforce will only increase. This is also true for entry-level roles. Within manufacturing, 6 percent of companies report an urgent need for entry-level talent and 47 percent of companies report an overall need. Among distributors, 2 percent of businesses report an urgent need for warehouse workers, with 44 percent of companies reporting an overall need. This suggests a lack of skill availability among applicants. Given the current level of displaced workers, it is imperative companies partner with appropriate educational resources to help develop a deeper pool of qualified workers. For example, a Manufacturing Skills Certification System endorsed by the National Association of Manufacturers is establishing the standards and training necessary for new employees to succeed in today's advanced manufacturing and distribution environment.

**The balance of cost control and talent management**

In the depths of the recession, many companies cut back on cash compensation and employee benefits as an immediate expense control measure. While businesses have eased up on the brake, three in 10 firms indicate they are still enforcing pay freezes.

Given the skill shortages that abound in manufacturing and distribution, companies must handle compensation actions with great care. In the near term, businesses need to identify and retain high performers, including employees with in-demand skill sets. As the economy grows stronger, companies must ensure their compensation and benefit offerings are robust enough to attract—and keep—the new talent that can help their firms thrive.

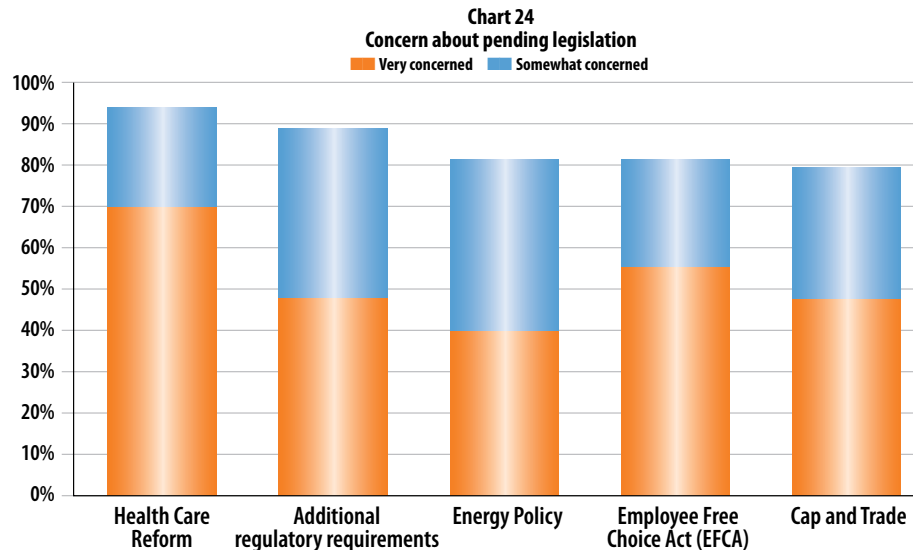
Table 9

EMPLOYEE COMPENSATION ACTIONS		
	2009	2010
Freezing pay	48%	30%
Deferring increases	34%	21%
Reducing pay	27%	8%
Reducing benefits	26%	10%
None of the above	28%	54%

## Policy issues

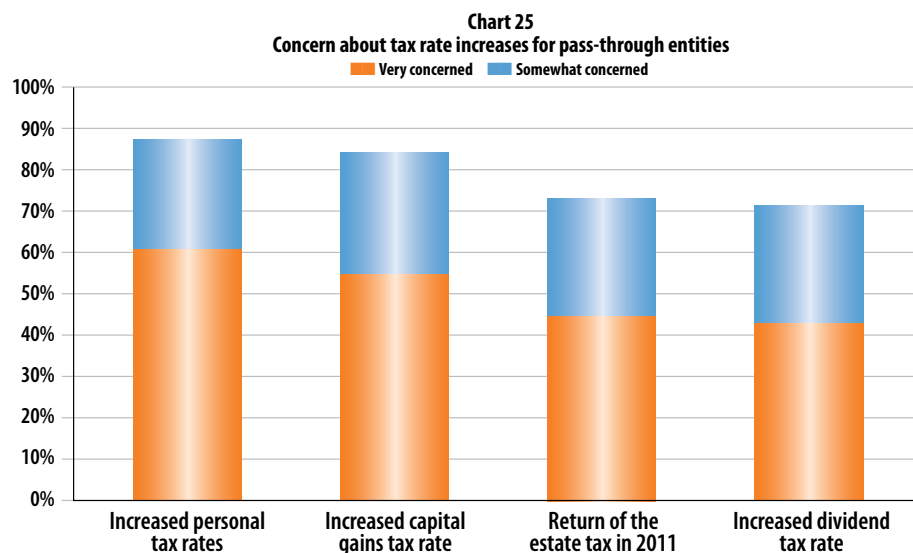
### Big concerns over recent legislation

Executives report high levels of concern about how several legislative issues could affect business operations. Even though many of these bills have yet to be enacted, the prospect of such changes is having an immediate and direct affect on economic recovery. Uncertainty hinders business leaders' ability to evaluate risk and make thoughtful investments in people, technology and capital equipment.



Of the 1,061 respondents included in the survey analysis, 91 percent are privately held companies. Of the private companies, 35 percent are structured as C Corporations, 63 percent are pass-through entities (S Corporations, LLCs or Partnerships) and 2 percent identified themselves as "other." Responses from pass-through entities are of particular importance, since the earnings of these companies are passed through to individual shareholders and taxed at individual tax rates. This differs from C Corporations, which are taxed at the corporate rate.

The survey asked executives four questions regarding potential tax increases (on individuals, capital gains, estates and dividends) that would result from the scheduled 2011 expiration of rate cuts enacted in 2001 and 2003. The responses show a startling level of worry. For example, 87 percent of respondents say they are concerned about individual rate increases, with 61 percent saying they are "very concerned."



The 2010 Manufacturing and Wholesale Distribution National Survey finds that many companies are recovering, but still struggling with how to take full advantage of available tools that can help their businesses grow. We invite you to visit McGladrey's online Manufacturing and Wholesale Distribution site at [www.mcgladrey.com/Industries/Manufacturing/Wholesale-Distribution](http://www.mcgladrey.com/Industries/Manufacturing/Wholesale-Distribution). This site contains extensive resources for success in your business niche.

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