# Mid-market perspectives
## America's economic engine — competing in uncertain times

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# Introduction

In April 2011, Deloitte Growth Enterprise Services released the findings of a Deloitte-sponsored EIU survey of mid-market executives, *Mid-market perspectives: 2011 report on America's economic engine,* which indicated a trend of tempered optimism among respondents. When asked about their outlook for the remainder of 2011, 93 percent said they expected the economy to grow and 81 percent expected their annual revenue to increase.

A lot has changed in the months since that first report was published, including the U.S. debt ceiling debate, instability in European financial markets, and the S&P downgrade of U.S. debt. What are the implications for U.S. mid-market companies? The importance of this sector and the views of its leaders prompted Deloitte to undertake its second survey of 2011. To provide real-time perspective on the changing economy, we fielded this survey in July and August to take the pulse of 696 executives from U.S. mid-market companies. The results are included in this new report, *Mid-market perspectives: America's economic engine — competing in uncertain times.*

Not surprisingly, respondents to our July-August survey were more pessimistic: in April, executives estimated 2011 growth at 2.3 percent; by July, it was 2.1 percent, and it dropped even further, to 1.6 percent, in August. Despite macroeconomic expectations, executives continue to focus on improving their respective businesses. A full 70 percent said that productivity had increased — by an average of 6.1 percent — at their companies since the recession began. Further, 44 percent indicated that their companies are prepared to increase the size of their U.S. workforce and to increase hiring over the next 12 months. In our April report, executives talked about adapting to the "new normal," but just a few months later, the definition of what that means seems to have already changed. The survey responses and executive interviews included in this study illustrate how companies in this segment continue to address challenges and capitalize on opportunities despite economic uncertainty.

We are committed to providing substantive research to assist mid-market companies and hope you will find this report helpful for your business.

Sincerely,

Tom McGee

Tom McGee
National Managing Partner,
Deloitte Growth Enterprise Services
Deloitte LLP

# Executive summary

When financial markets become volatile, it is easy to lose sight of the fundamental ways that companies create value: innovation, productivity, and efficiency. Amid the global economic turmoil of the past three years, these fundamentals have become even more important. Rather than riding a rising tide of robust economic growth, companies have been forced to grow through incremental improvements: creating more with less, more with the same, or a lot more with a little more. On the cost side, it is increasing efficiency; on the revenue side, it is boosting volume or pricing.

Isn't this what managers have always done? Yes. The difference today is one of degree. With the U.S. economy growing at a rate of below one percent in the first half of 2011, achieving revenue and profit objectives requires more ingenuity. Like state and local governments seeking to maintain services in the face of revenue shortfalls and individuals retooling skills to switch into high-demand fields, executives at mid-market companies are working to adapt to major structural shifts in the U.S. economy. And the success of mid-market companies is tightly intertwined with the recovery of the economy as a whole.

There are three reasons why that is a good thing for the U.S. economy: mid-market companies are influential, they tend to be relatively optimistic about their own futures, and — at least among the private firms that dominate this segment — they are less directly affected by securities market fallout than their public counterparts.

The survey results provide compelling insights into what these executives are thinking and doing to retain a productive edge for their companies.

First, as mid-market companies go, so goes the U.S. economy. Companies with revenues between $50 million and $1 billion have aggregate revenue of approximately $6.1 trillion, more than the combined revenue of the companies comprising the S&P 100 and equivalent to roughly 40 percent of U.S. GDP.* Although mid-market companies may not dominate the headlines, they are the engine of the American economy.

Second, their realism about the troubled economy belies a relatively optimistic view of their own companies. In Deloitte's July-August 2011 survey more executives expected to see improvement over the next year across a range of metrics, including revenues, profits, and cash balances.

Finally, privately held companies, which are less influenced than public firms by external stakeholders, dominate the mid-market company sector. Deloitte's survey found that private companies compare favorably with public companies in several areas, particularly their plans to hire and their reluctance to reduce their workforce.

The survey results, plus secondary research and interviews, provide compelling insights into what these executives are thinking and doing to retain a productive edge for their companies. Four key findings emerged from the research:

- **Less low-hanging fruit.** Easy growth in revenues and profits is gone. It is unlikely to come from an expanding economy. Expectations for growth have been declining, and the later the respondents answered the survey, and the more information they had about unfolding economic developments, the more pessimistic they became. Although they anticipate improvements in revenue and profitability in the year ahead, they also see the potential for significant problems (e.g., increasing input costs).
- **Caution on hiring.** Executives at mid-market companies talk about hiring in the context of targeted hires to boost productivity. While 38 percent of the companies said that "strategic hiring in critical areas" offers a path to higher productivity, 45 percent agreed that, "the need for companies to become more productive is restraining new hiring." Although a slight majority of companies expect their workforces to be larger in 12 months, the single cost category that companies said they focus on controlling most is labor.

* U.S. Economic Census, 2007; S&P 100 Factsheet, Standard & Poor's – http://www2.standardandpoors.com/spf/pdf/index/SP_100_Factsheet.pdf

- **Tech trumps talent.** Seventy percent of the executives surveyed said that productivity has increased since the recession began. When asked why, respondents ranked new hiring fifth. The two most-cited reasons were improvements in business processes and better technology, including data analytics and business process automation. For now, technology rather than hiring is on the mind of most mid-market companies.
- **Where is the tipping point?** Productivity has grown; the question is when and if employment will follow. In the short term, higher productivity can be a function of lower employment — fewer people producing the same amount of goods and services. That's the situation in the United States now. Over the past 80 years, however, productivity and employment have generally risen together. Productivity gains drive growth in output, which translates to higher incomes, more spending, and new hiring. Is it different this time? And if not, when will unemployment fall back to the levels that the U.S. public has grown accustomed to?

The executives surveyed confirm that the future is opaque: 64 percent said that factors such as taxes, regulations, credit availability, and the economic outlook are more uncertain or much more uncertain than normal. Nevertheless, the U.S. mid-market companies surveyed are keeping up with, or even increasing, the pace of capital spending. Three out of four of the companies surveyed are maintaining or boosting the level of long-term investments, despite higher levels of uncertainty.

This is good news because long-term investment typically drives higher productivity, which — if accompanied by rising output — is associated with job growth. In a flat, open, and competitive world, productivity gains are crucial to U.S. job creation and prosperity. Fifty-eight percent of respondents said that if they could increase productivity, they would engage in "strategic hiring in critical areas." The 70 percent of respondents reporting higher productivity estimate an average increase of 6.1 percent since the recession began. The question: When is the payoff in terms of new jobs?

### About the survey

In July and August of 2011, a Deloitte survey conducted by OnResearch, a market research firm, polled 696 executives at U.S. mid-market companies about their expectations, experiences, and plans for becoming more competitive in today's difficult economy. Respondents were limited to senior executives at companies with annual revenues of between $50 million and $1 billion.

Two-thirds of the companies responding were privately held, while one-third was public. The private companies were almost evenly divided between family-owned, closely (nonfamily) held, and venture capital-backed.

Industries were diverse: the two largest, consumer/manufactured goods and professional/business services, comprised only 25 percent of the responses. The other 75 percent were spread across 15 different sectors. IT and finance professionals contributed about one-third of the responses; operations and sales accounted for about 10 percent each. Exactly half of the respondents were C-suite executives, owners, or board members; the other half included managers, department heads, vice presidents, or leaders of business lines.

# Four trends from executives at U.S. mid-market companies

The business headlines of the recent months have focused on the big banks, giant technology firms, and a handful of IPO candidates. The thousands of mid-market companies with annual revenues below $1 billion — the backbone of the American economy — are seldom mentioned. But these are the firms that form the vital center of U.S. employment and output. According to the U.S. Economic Census, companies with 50 to 5,000 employees account for more employment than those with over 5,000. And in terms of output, the sheer number of mid-market firms accounts for the fact that, in aggregate, their revenues surpass those of the top 100 U.S. companies by capitalization and are equivalent to roughly 40 percent of the U.S. GDP. If the U.S. economy is to grow robustly, the actions of mid-market companies will be a big part of the story.

The importance of this sector, and the views of its leaders, led Deloitte in July and August to undertake its second mid-market company survey of 2011. The survey examines executive views on the outlook for the economy and their own businesses. It also drills deeply into corporate plans to enhance competitiveness in a difficult economic environment.

In particular, the survey examines the question of productivity: the quantity of goods and services produced per hour of employee work. Productivity is about creating more. The faster productivity grows, the faster incomes and the U.S. standard of living will increase. Productivity growth depends on the quality of the workforce, the amount of reinvestment in the business, and the extent to which new technology is introduced. More importantly, it depends on how management does its job. That's what this survey sought to determine.

All survey results are presented in the appendix. Ultimately, however, there are four key lessons in the findings. First, companies are prepared to work harder to achieve growth in a difficult economic environment. Second, there will be some new hires, but they'll be carefully targeted at areas of strategic need. Third, when there is a choice between technology and talent, technology wins. Finally, despite a massive number of unemployed Americans, many companies report that they can't find people with the right skills.

| | |
|---|---|
| 1 | Companies are prepared to work harder to achieve growth in a difficult economic environment. |
| 2 | There will be some new hires, but they'll be carefully targeted at areas of strategic need. |
| 3 | When there is a choice between technology and talent, technology wins. |
| 4 | Many companies report that they can't find people with the right skills. |

## How private companies differ

Leaders of private companies, without the expectations of thousands of shareholders, often can take a longer view than their public counterparts.

But the differences between public and private companies are deeper. The survey of mid-market companies drew from a sample of public and private firms in the $50 million to $1 billion revenue range. The private companies were distinct across a number of dimensions.

**Private companies are more likely to cite lower overhead and higher productivity as key competitive advantages.** Forty percent of private companies called attention to their lower overhead and 47 percent to their higher levels of productivity. Among public companies, the figures were 29 percent and 39 percent.

Dr. Kam Ghaffarian, president and CEO of SGT, a Maryland-based, $350 million government contracting business, explains it this way: "Our decision-making process is simple. We have very few levels. We sit around a table and decide. Our costs are lower than those of our competitors. We gather a lot of the same information that public companies do, and we track it internally, but we don't have to do the external reporting."

**Respondents from private companies are less optimistic.** Respondents from private companies are more likely to view the economy as stagnant, the business environment as uncertain, and their own companies as fragile. When asked about the pace of U.S. economic growth over the next 12 months, more private companies expect zero or negative growth (13 percent versus 5 percent among their public counterparts) and fewer expect a relatively high rate of growth (16 percent versus 33 percent). Executives from private companies are more uneasy about uncertain business conditions, with 28 percent saying that the environment is "much more uncertain" than usual, compared to only 19 percent of the executives from public companies.

In terms of their own financials, half still expect improvement in profitability. But they are less optimistic than their public counterparts, where the comparable figure is 61 percent. Similar gaps are seen in expectations for cash balances and capital investments. One reason may be that the private companies are more likely to be domestic: almost half have no non-U.S. workforce, and one-third derive no revenues from outside of the United States. With no foreign workforce, they do not take advantage of low-cost overseas labor; with no foreign revenues, they do not benefit from faster-growing overseas markets.

**Private companies are less likely to lay off workers and more likely to hire them.** This may seem hard to reconcile with the relative pessimism of executives at private companies. But it makes more sense in light of the fact that private companies report — in both the survey and in interviews — that they already have lower overhead than their public counterparts. Among private companies, 22 percent expect layoffs in the next 12 months, and 51 percent expect new hiring; among their public counterparts, the figures are 39 percent and 30 percent, respectively.

**Private companies are less likely to turn to outsourcing.** Consistent with the domestic footprint of many private companies, they are less likely to view outsourcing as a key cost reduction/ productivity opportunity (31 percent versus 40 percent), less likely to have increased the level of outsourcing since the onset of the U.S. recession (33 percent versus 49 percent), and less likely to outsource in a range of common areas (e.g., technology, finance and accounting, call centers).

Ultimately, the most important difference between public and private companies has to do with freedom and flexibility. Dr. Ghaffarian of SGT explains, "We don't have to focus on the bottom line. Of course we need to make a profit. But that's not the most important focus. When there is a customer who has a need, we have to solve the problem. We address it and then we worry about the money. If we can make a customer happy and develop a longer-term partnership, then we're not going to get hung up on something like an idiosyncratic set of payment terms."

# Key findings

## Less low-hanging fruit

Easy growth comes from two sources: a healthy economy and sweeping changes in business models to cut costs or boost output. Both are in short supply.

In an expanding economy, it is easier to be successful. As the pie gets bigger, each slice can get bigger as well. That's not the case today. From 2003 to 2006, real GDP growth averaged 3 percent per year: bigger pie, bigger slices. From 2008 through the second quarter of this year, the economy shrank and then rebounded somewhat, but the average over the period was close to 0 percent. There were three quarters from the end of 2009 through the first half of 2010 when real growth rates exceeded 3 percent, leading to hopes of a recovery. But those hopes began to ebb in the second half of last year and the first half of this one, reaching a low when the U.S. Treasury Department revised its first-quarter 2011 real GDP growth estimate to a mere 0.4 percent.

The executives in the Deloitte survey see the slowdown in their own businesses. Their views reflect a consensus that did not exist even six months ago. Over the course of the survey, from the relatively benign environment in July though the progressively more dramatic events of August — the downward revisions to U.S. economic growth, the downgrading of U.S. sovereign debt, the deteriorating condition of European banks, and the wild swings in global equity markets — growth expectations shifted downward.

In July, executives' expectations were similar to those that prevailed in April, when the same question was asked in a previous survey. By August, they had become more pessimistic and their opinions had begun to cluster more tightly, with fewer outliers and more predictions in a narrow range.

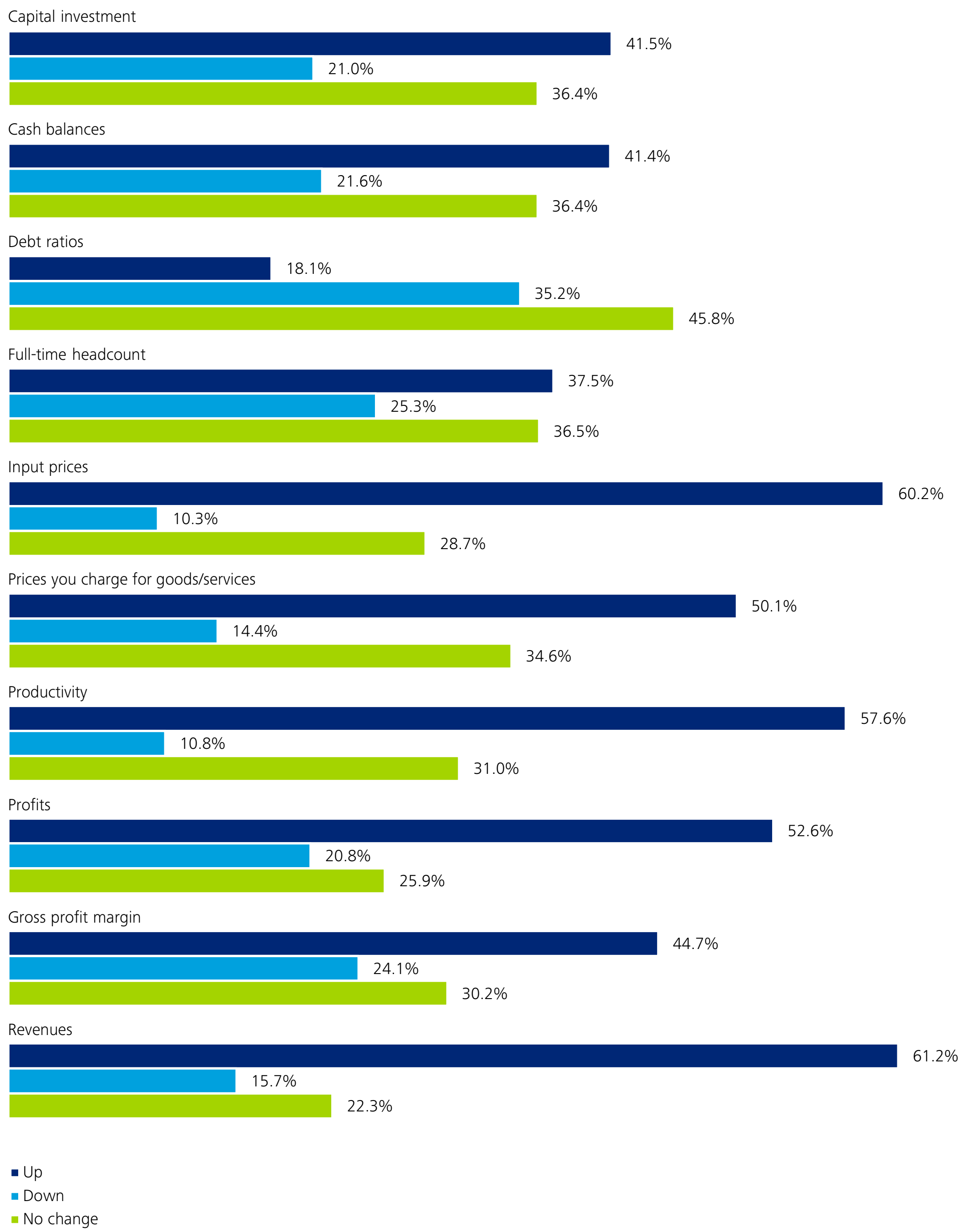
The graphic on page 9 divides the executives into two groups: those who answered in July (July 19 to July 23) and August (August 4 to August 15). The July forecasts of 12-month U.S. economic growth averaged 2.3 percent, the same as the average reported in Deloitte's April survey. By August, the forecast had fallen to 1.6 percent.

The distribution of responses also changed. In April and July, opinions on the direction of the economy were diverse. In August, they began to cluster around a low-growth consensus of under 2 percent. In August, those expecting 12-month growth of over 2 percent fell from 57 percent to 34 percent, and the number of real optimists — those anticipating growth of 3.5 percent or more — dropped from 26 percent to just 12 percent. The consensus is that economic growth over the next year will remain stalled, possibly even negative, and the 3.5 percent growth rate widely seen as necessary for real job creation is unlikely.

**Change in U.S. economic growth expectations**
**July–August 2011**

| | Percent of respondents (July) | | Percent of respondents (August) |
|---|---|---|---|
| Respondents expecting growth of over 5% | 9% | ↓ | 5% |
| Respondents expecting growth of 3.5% to 5% | 17% | ↓ | 7% |
| Respondents expecting growth of 2% to 3.5% | 31% | ↓ | 22% |
| Respondents expecting growth of up to 2% | 35% | ↑ | 49% |
| Respondents expecting growth of 0% or less | 8% | ↑ | 17% |

**Over the next 12 months, do you expect the following key metrics at your company to go up or down or stay the same?**



In conclusion, expectations have gone from modest to minimal. Nevertheless, most executives continue to believe that their businesses will improve in the coming year. The graph on page 10 shows that during the next 12 months, a majority expects higher revenues, profits, pricing, and productivity. On the negative side, the majority also anticipates higher input prices. And more executives see higher gross profit margins, full-time headcount, cash balances, and capital investments.

Finally, there is less room for large-scale cost cutting. Few companies have escaped layoffs and survey responses such as "there are fewer people to do the same amount of work," and "our downsizing requires that those who remain become more productive," suggest that there is less scope for layoffs than before. And while three-quarters of the companies surveyed engage in some type of outsourcing, over half have not changed the level of outsourcing since the recession began, suggesting that they see no benefit in doing so. Moreover, only one-third of the surveyed executives agreed that "outsourcing reduces costs and increases productivity."

Expectations have gone from modest to minimal. Nevertheless, most executives continue to believe that their businesses will improve in the coming year.

### Caution on hiring

A significant number of Americans are unemployed, and a fundamental question is whether the skills of these people will become obsolete as job requirements change. Although 38 percent of companies said that "strategic hiring of new staff with specific skills" offers a path to higher productivity, 45 percent agree with the statement that "the need for companies to become more productive is restraining new hiring." When asked which costs they focus most on controlling, the number one choice, with 49 percent of respondents, was labor costs.

Two-thirds of mid-market companies consider increasing productivity to be one of their three top priorities, and six in 10 measure it using revenue or profitability per employee, which makes them particularly sensitive to actions that increase the denominator (total employees) without an even greater rise in the numerator (total revenue or profit).

There is some good news. According to our survey, 44 percent of mid-market companies are prepared to increase the size of their U.S. workforce and expect to increase the level of hiring over the next 12 months. A smaller proportion, 27 percent, expects to reduce the size of their U.S. workforce.

A significant number of Americans are unemployed, and a fundamental question is whether the skills of these people will become obsolete as job requirements change.

## Productivity at Sunshine Minting

Despite an unemployment rate of over 9 percent, many mid-market companies still face labor constraints. In our survey, 47 percent of mid-market companies reported that they find it difficult to hire employees with the skills to become immediately productive.

This is the number one issue for Sunshine Minting, an Idaho-based supplier of silver coin blanks and other precious metals to the United States Mint, foreign mints, financial institutions, commemorative coin manufacturers, and marketing companies around the world. With greater than $600 million in annual revenues, this private company has seen its output more than triple during the past three years.

"We do a lot of constraint planning," says CEO Tom Power. "We watch the bottlenecks develop as volume ramps up. And then we attack the bottlenecks before we hit the constraints." The company continuously re-evaluates its production capacity based on its product mix, developing a plan and investing in capacity before it is needed.

When volume started to take off, the first constraints were related to equipment. More recently, the issue has been labor. "It's amazing given the unemployment rate, but we need everything from production supervisors to highly skilled machine operators to millwrights to unskilled labor," says Mr. Power. "People come to Northern Idaho for the lifestyle, not because they want to be working on a production shift at 3 a.m. on a Saturday morning."

With a 2010 population of about 138,000, Coeur d'Alene does not have a large and diverse labor pool. "It's not too hard to find senior through middle management," says Mr. Power. "From front-line supervisors to the shop floor, that can be more of a problem."

In terms of productivity, Sunshine has several advantages over its competitors, which tend to be either large public companies or government-controlled entities like the Austrian Mint and the Perth Mint. Overhead is low and decisions are made quickly. The workforce is small, lean, and flexible. There are no unions. "We can move and adapt to the market, whereas the government entities might be a little more bureaucratic," says Mr. Power. "In fact, in some cases competitors have become customers after they realize that we can supply blanks at a price below their internal cost of production."

Given the value of the raw materials, the cost of transport, logistics, and insurance has grown in recent years. Sunshine's roster of blue-chip customers helps to restrain those costs. "When we deal with insurers and transportation companies, we show them our customers. When you sell to customers like the U.S. Mint, there's no danger that you won't be paid," says Mr. Power. "That works to our advantage when negotiating rates for transportation and insurance. We've been very successful in bringing down these costs."

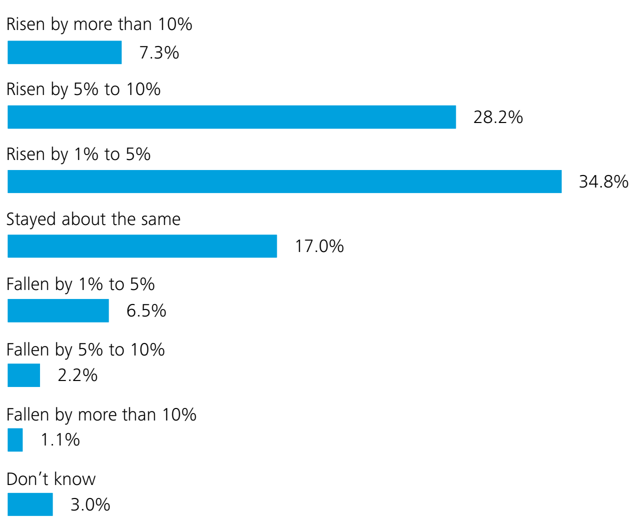
## Tech trumps talent

Productivity — and therefore U.S. competitiveness and the potential for higher incomes — has grown substantially since the onset of the recession. The U.S. government has reported it and the survey respondents confirmed it. The 70 percent of respondents who reported an increase said that productivity had risen by an average of 6.1 percent.

Why did productivity jump? The conventional wisdom points to fewer people producing the same output. If output is close to pre-crisis levels with a smaller number of workers, there appears to be little reason to hire the laid-off workers back. When asked for the reasons behind increases in productivity since the recession began, respondents ranked hiring far down the list.

Our survey found that the two most-cited reasons for the increase in productivity among mid-market companies were improvements in business processes and technology. Among respondents who see technology as the driver of productivity improvement, just over half point to automation of business processes, which cuts costs by reducing the need for labor, and particularly less-skilled labor. This is consistent with U.S. unemployment statistics, which show that the less education an individual has, the more likely he or she is to be unemployed. In other words, if a job can be automated—if it can be reduced to an algorithm, an application, or a set of instructions—it probably will be.

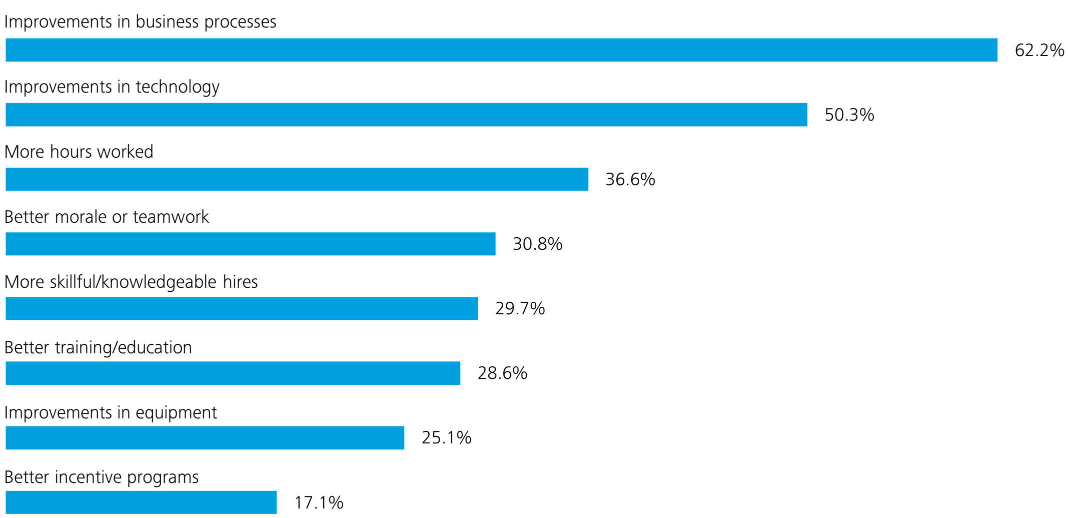
**Since the onset of the U.S. recession, productivity at my company has:**



The second reason cited for higher productivity since the recession is improvements in technology. This covers a range of applications, but those most often cited as having the potential to drive higher productivity are automation of business processes (52 percent), the use of data analytics/ business intelligence (46 percent) and CRM software (30 percent). The latter two can help businesses operate more efficiently, but add even more value by helping companies better understand and respond to customers.

Says Rebecca MacDonald, a vice president at the text analytics company Attensity: "Lots of companies are trying to differentiate themselves based on value rather than efficiency. Otherwise you're in a price war and it's a race to the bottom. Your products become commodities. It's about who does it cheapest. Production moves offshore. Differentiating through customer experience can help you to avoid that — and it's a strategy that can be enabled by technology. Essentially, you're hoping to better understand the voice of the customer, and then use that understanding to differentiate your product."

**What were the top three reasons behind the rise in productivity at your company since the onset of the recession? Rank up to three.**



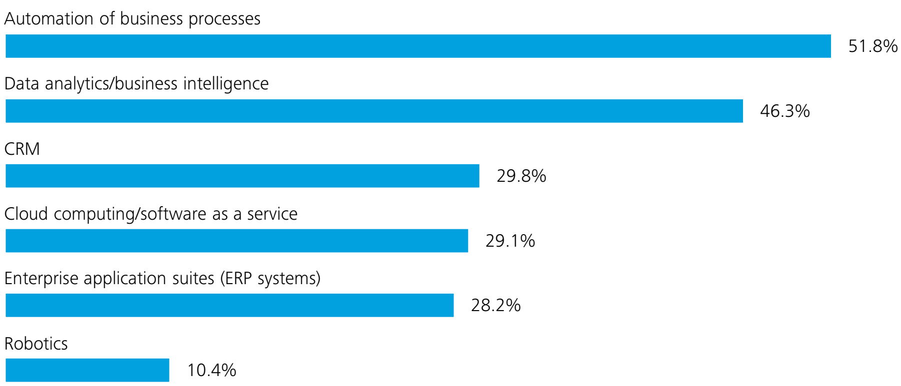
The survey shows that the use of technology to deepen ties with customers is squarely aligned with the business strategies of many mid-market companies. According to the survey, of all the ways of pursuing growth, companies are most likely (47 percent) to seek to "grow revenues by focusing on higher-value customers, getting more revenue per customer, or improving customer retention." Data analytics/business intelligence and CRM software enable this strategy.

In short, technology — rather than hiring — is on the minds of most executives of mid-market companies. It is important to have informed, creative, and empowered employees to interact with customers and suppliers. But to the extent that software can be substituted for people, companies are able to operate more efficiently, scale more easily, and generate higher levels of revenue per employee.

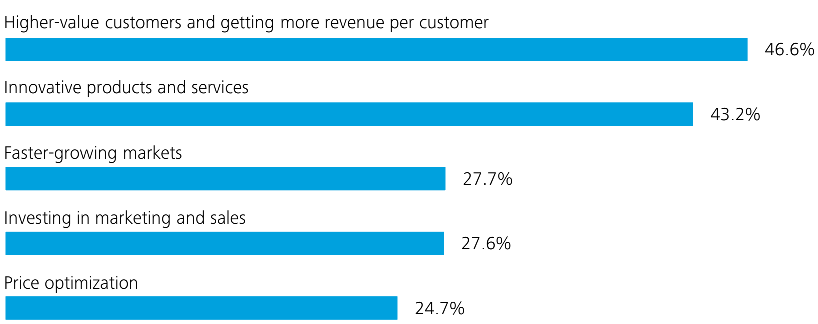
According to John Hagel, co-chairman of Deloitte's Center for the Edge, "All companies need to focus on cost reduction. That's a given. But the effective way to compete, especially in a global economy with low wage rates nipping at your heels, is to be very focused on the differentiation side. One way to do this is to focus on a deep understanding of your individual customer and tailor your product to that customer. The better you understand the customer, the smarter you can be about tailoring. IT has a huge role here."

Technology — rather than hiring — is on the minds of most executives of mid-market companies.

**What technology investments have the most potential to increase productivity at your company? Choose up to three.**




**Where is your company most focused in terms of increasing outputs (revenues)? Choose up to two.**



## Where is the tipping point?

A tipping point is a moment at which a buildup of minor shifts triggers a bigger change. Here it refers to the point at which U.S. companies become sufficiently competitive to expand output and hire at the rate necessary to bring down the unemployment rate. There are reasons to believe that hiring by mid-size companies will grow. The question is: When will profits be reinvested into workforce expansion?

"Higher productivity can increase employment, but only if it enables the company to expand output," says Dr. Chad Syverson, economist at the University of Chicago. "With the ability to produce more output with fewer resources, the company could cut prices and increase volume. It could improve the quality of its products and sell more. Or it could expand its product line and increase volume that way. If output expands, hiring will follow. But if productivity grows and output stays the same, that's a recipe for fewer jobs."

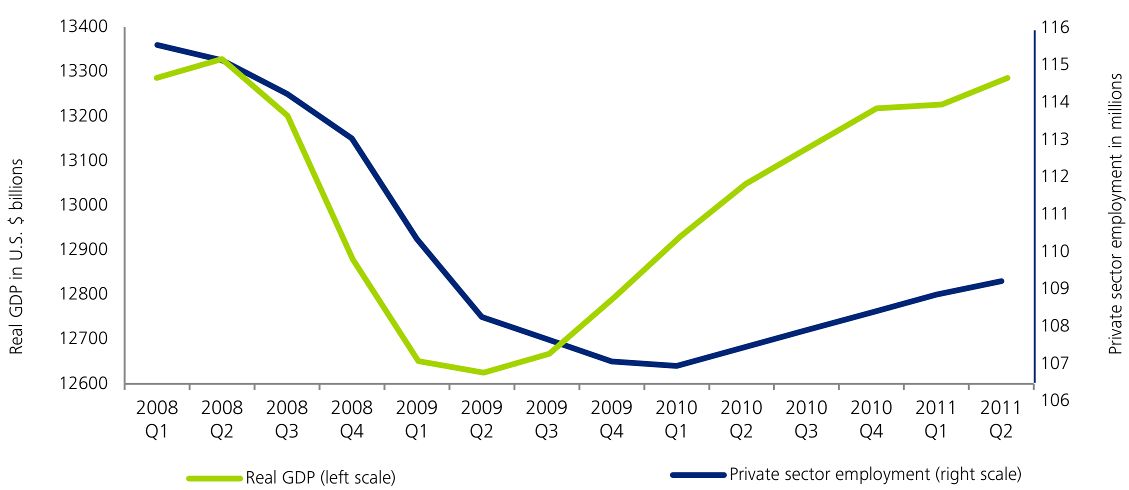
As the chart below shows, real GDP has recovered almost to its pre-recession peak. However, employment has fallen sharply and is recovering slowly. Productivity is up, report both the government and the survey respondents — to the extent that approximately seven million fewer workers are generating about the same level of output as before the recession began. For unemployment to fall, demand will have to grow much faster than the 1.6 percent growth rate recorded over the last 12 months.

Two data points from the survey provide some grounds for hope. First, the fact that mid-sized companies are investing in the future is positive for hiring. Almost two-thirds of respondents say that factors such as taxes, regulations, credit availability and the economic outlook are more, or much more, uncertain than normal. Yet despite the high levels of uncertainty, three out of four are maintaining or boosting the level of long-term investments.

Second, mid-sized companies want to hire. Almost sixty percent of respondents say that if they could increase productivity — which 70 percent have done — they would engage in "strategic hiring in critical areas." It's the highest-ranked response. But there's a problem: Almost half (47 percent) agree with the statement that, "It is difficult for us to find employees with the skills and education to become productive immediately." Only one-quarter disagrees.

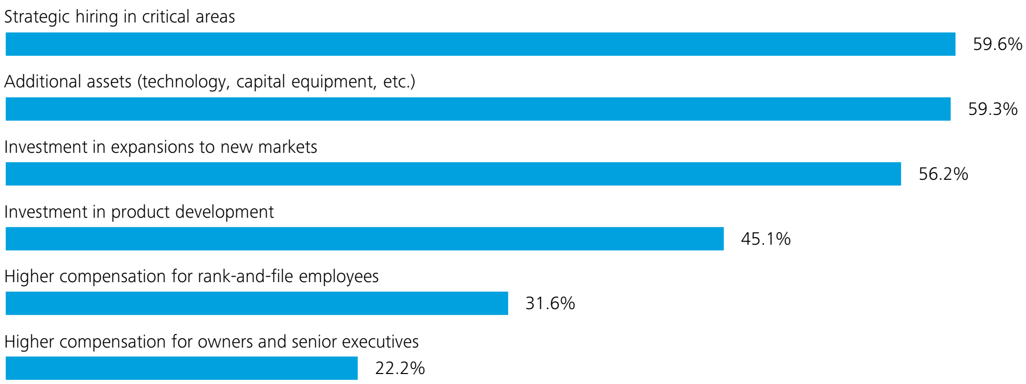
In other words, there is a mismatch between job requirements and available skills. These mismatches always exist, however, and the high unemployment rate appears to be driving more people to relocate and retrain themselves to qualify for new jobs.

**Real GDP and private sector employment**

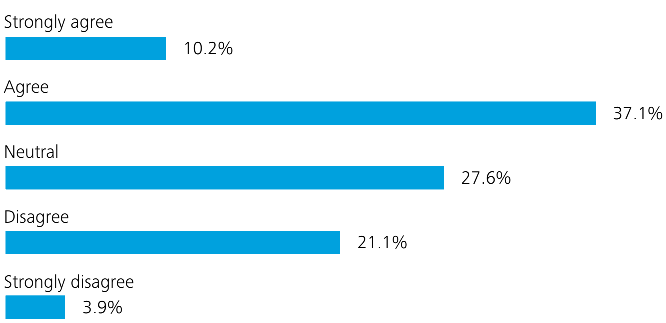



*Source: For employment data, Bureau of Labor Statistics; for real GDP, U.S. Department of Commerce, Bureau of Economic Analysis.*

**If your company were able to find ways to become more productive and increase profitability, what actions would management be most likely to take? Rank up to three.**




**Please indicate your level of agreement with this statement: "It is difficult for us to find new employees with the skills and education to become productive immediately."**



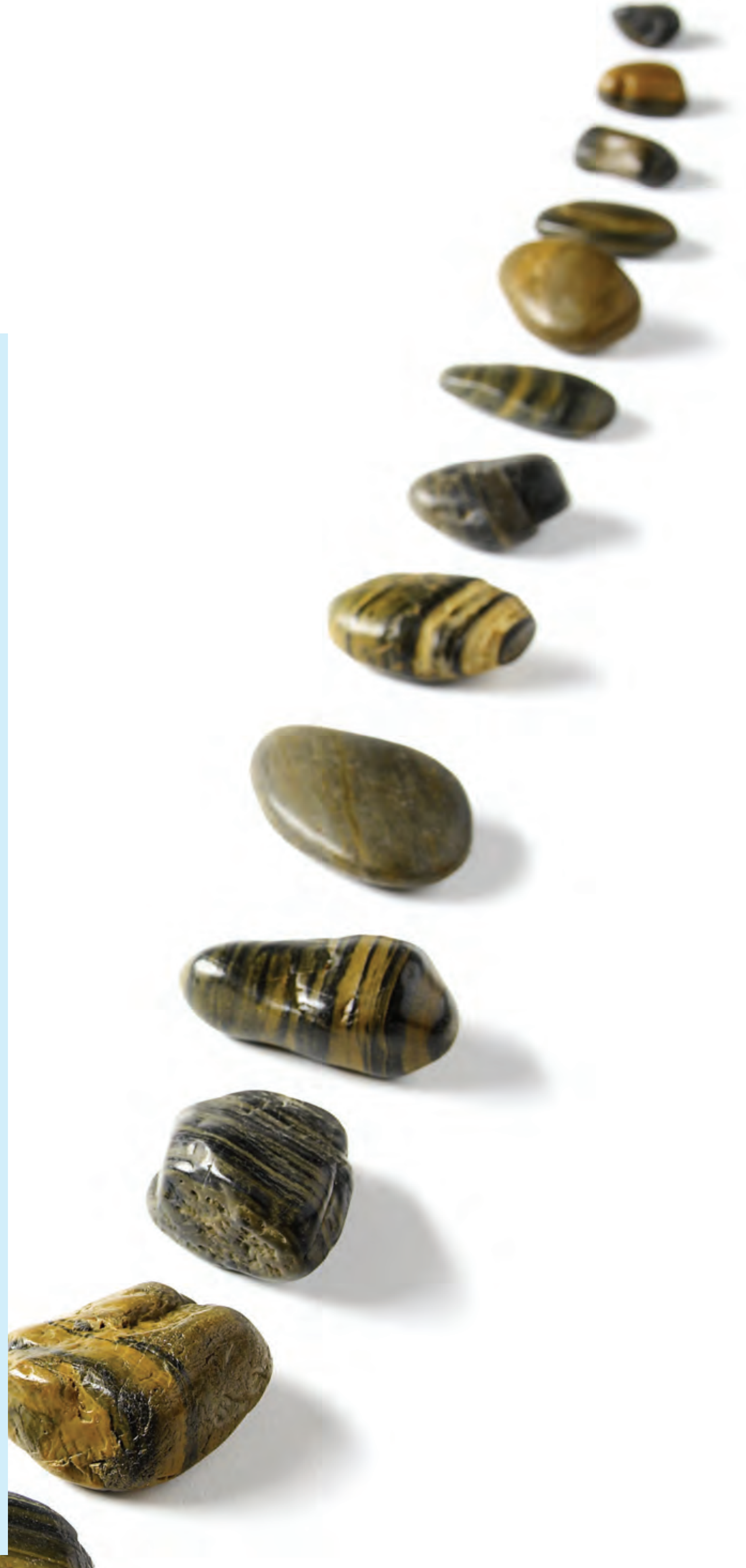
# Conclusion

The actions of mid-market companies have a major impact on the U.S. economy. Although there are many sources of intelligence on large corporations, the thousands of mostly privately held mid-market companies exist primarily beneath the radar of analysts, economists, and the news media. Their activities influence national trends in employment, output, productivity, and lending. Understanding the thoughts and actions of those who lead mid-market companies is critical to grasping the big picture of the U.S. economy.

In this survey, we explored both the expectations and actions of mid-market executives. Given the macroeconomic events of the past six months, it comes as no surprise that the cautious optimism they expressed in April is waning. But while economic expectations seem to be diminishing, confidence in their respective enterprises is not. The survey results show that many companies have ongoing plans for investment despite an exceptionally uncertain environment.

If character is revealed though action amid uncertainty, business leaders are now demonstrating the strength of their characters. They're buying technology to better understand and penetrate their highest-value customers. They're enthusiastic about improving business processes. They're seeking employees with the skills to help their businesses run better. They see a number of ways to improve productivity and are ready to invest new profits into becoming more productive. They may not know what's coming, but they're clearly taking action to exploit opportunities beyond the current horizon. This is how companies, and economies, grow.

Privately held companies seem intent on moving forward. Of course they are being responsive to economic conditions, and no doubt have altered plans and activities accordingly, but they are also looking for advantage and opportunity.



### Distinctive outlooks

There is a subgroup of 153 executives, or about 22 percent, of the 696 corporate leaders who responded to Deloitte's survey in July and August. Three things make them distinct: optimism, priorities, and aggressive investment in their businesses.

Despite a summer of bad news, these leaders remain upbeat about the U.S. economy. All 153 expect economic growth to top 3.5 percent during the next 12 months, a prediction that makes them optimistic outliers. The average size of their companies is significantly larger — about $520 million in annual revenues as compared to $359 million for the sample as a whole.

Within this group of 153 optimists, 39 percent say that productivity is their top priority. For the respondents as a whole, the rate is 17 percent. The implications: these individuals are focused on maximizing profits per employee or revenue per employee. They're also more likely to hire carefully and be open to ways that technology can make them more efficient or help them add value.

Our survey suggests that the optimists also are more likely invest in their businesses aggressively. In this group, 48 percent are making long-term investments at a rate higher than normal, compared to 29 percent for the entire sample. And 19 percent are making long-term investments at a rate much higher than normal (compared to 7 percent for the group as a whole).

Time will tell if these executives are accurate in their economic forecasts. But they are unlikely to be wrong about the need to invest in efficiency and value. In a stagnant economy, these companies will survive — in an expanding economy, they will prosper.

# Case studies

**Pelican Products:**
**A U.S. manufacturer selling into China**

Contrary to popular wisdom, China is the third largest buyer of U.S. exports (after Canada and Mexico), and four of the five top export categories are manufactured goods. One reason is globally competitive mid-sized manufacturers like Pelican Products, Inc., a Torrance, CA-based maker of flashlights, lighting systems and protective cases for electronic equipment and other high-value items.

The $350 million company manufactures in high labor-cost locations in Southern California, Massachusetts and Germany, and the price of its key raw material trends closely to the variation in the price of oil. On the surface, these don't sound like the ingredients of a globally competitive firm. But they are.

The key is constant scrutiny of costs and a continued focus on quality and customer service. "Over the last few years, we've been constantly focused on reducing our cost structure," says Pelican CFO Don Jordan. "A lot of what other companies are going through now, we've already done."

"The Los Angeles area may not seem like the ideal site for manufacturing, and it's true that it is a high labor-cost location," says Mr. Jordan. "We have looked at lower-cost manufacturing alternatives in other geographic locations, but our operations are very efficient and our current manufacturing costs have remained competitive across various geographies. Surprisingly, the cost to ship our product has become a cost advantage to Pelican, especially if you compare an Asian manufacturing alternative."

Aside from shipping, 75% of Pelican's cost of goods sold is variable, linked primarily to material and direct labor. "Our primary raw material is plastic, polypropylene and polyethylene, and the price movement corresponds to the variation of oil prices. Pelican had absorbed the variation in cost and has not passed it on to our customer," explains Mr. Jordan.

The variable labor costs are primarily manufacturing related. Since 2008, Pelican has maintained a larger percentage of temporary employees, which has enabled them to control costs by flexing up and down to match volume. Pelican has held the line on adding permanent employees and has used temps to manage the peaks and valleys of the business.

The main area where the company is adding permanent workers is in sales. "Like many companies, we're very much a volume-driven business," says Mr. Jordan. "As sales increase, our cost leverage improves and we see the impact in our margins."

Pelican has also had success from the integration of acquired companies by both lowering costs and gaining pricing flexibility. "Through our integration efforts, we materially lowered costs when we bought Hardigg Industries in 2008," says Mr. Jordan. Hardigg was a similar-sized company to Pelican and one of the largest manufacturers of protective cases.

"The integration was very well planned and executed, definitely one of the best integrations I had experienced. In the end, the merger of the two companies improved our margins significantly," explains Mr. Jordan.

Pelican is proud to manufacture product in the United States and sell into China. There are Chinese manufacturers of cases and lighting systems that compete with Pelican in China. "But we don't believe that their quality is as high as ours," according to Mr. Jordan. "Our customers there — firefighters and police departments — buy Pelican products because they need and demand the quality that we offer. In many instances, their lives depend on it."

"A lot of what other companies are going through now, we've already done."

Don Jordan — CFO, Pelican Products

**Advanced Technology Services: Why manufacturers can't find the skills they need**

According to the survey, 47 percent of executives at mid-market companies say that it is difficult to find new employees with the skills and education to become immediately productive. This is especially true at companies seeking to hire skilled technicians — people who understand production machinery, troubleshoot problems, prevent failures, and keep machines operating at full capacity.

For manufacturers, becoming more productive requires increasing machine availability and throughput. That means finding and retaining people who can keep the machines running. Unfortunately, there aren't enough out there to meet demand, which represents an opportunity for Advanced Technology Services (ATS), a $300 million private company based in Peoria, Illinois. Its tagline is: "We make factories run better."

Once, the job of maintaining complex production machinery was held by graduates of apprenticeship programs. However, these programs no longer exist at most companies. As manufacturing moved offshore, hiring slowed. As a result, skilled technicians at many plants are aging baby boomers. "The average age is in the high 50s or even the low 60s," according to Jeff Owens, president of ATS. "When you see the retirements up ahead, you start to get concerned."

The supply problem is exacerbated by a demand problem. "For several years we have been seeing both new manufacturing investment and expansion of existing manufacturing facilities," says Mr. Owens. "Manufacturing increasingly happens in the region where the product is consumed. As a result, there is a lot of interest in U.S. manufacturing — I'm talking about aerospace, automotive, agricultural machinery, things like that — compared to five years ago."

If every problem masks an opportunity, this skills shortage is ATS's opportunity. The company's agreements specify that it keep the customer's production machinery operating at specified levels of throughput.

"We don't offer a markup on labor. We define a scope of work and charge a fixed cost," says Mr. Owens. "We guarantee a certain level of cost savings and improvement. It is up to us how we do that. It could be more frequent lubrication. It could be energy savings. The lower the cost at which we can meet the objectives, the better our margins."

The metric ATS and its customers use to measure productivity is machine availability or throughput. To keep production machinery operating efficiently, the company relies on root cause analysis. But its methodology is applied not just to machinery, but to every activity and process in the business. "How we send out a bill. How we do a sales call," says Mr. Owens. "Everything we do is evaluated using a rigid process. To fix the problem so it doesn't happen again, you have to understand and address the root cause."

The key to ATS's business is finding employees with the skills necessary to do the job. If customers can't find these skills, how can ATS? There are two ways: growing and hunting.

Grow your own. The most knowledgeable and loyal employees, and those most likely to develop into leaders, are typically those who start at a young age, according to Mr. Owens. As a result, ATS's outreach programs involve going to middle schools and high schools and helping students — "actually, it's mostly parents and guidance counselors," says Mr. Owens — understand how manufacturing has changed. "People think it's dirty, physical work in dark and dangerous environments. It's not. It's safe, clean, and usually air conditioned," says Mr. Owens. "Our job is to change perceptions."

From high school, the students go into a work-study program developed with local community colleges. Their days are spent in the classroom and working at ATS; in about a year, they have an associate degree and become associate technicians.

"When they begin working full time, the real learning takes place," says Mr. Owens. "It's the transfer of knowledge from the old to the young." After three to four years, they become full-fledged technicians, with salaries ranging from $30,000 to $90,000 and good benefits packages.

The company's target is not people who want to go to professional school. Instead, it is people who like working with their hands — who enjoy working on cars and tackling do-it-yourself projects. "Many people get forced into a four-year university when it doesn't work for them," says Mr. Owens. "They often end up frustrated and struggling."

*(ATS, continued)*
The company also offers free scholarships to children or grandchildren of customers and employees. "There is a lot of generational employment in the skilled trades," says Mr. Owens. "We tap into that."

Go hunting. The military is a fertile place to recruit skilled technicians. "There is a close fit between military culture and our culture," Mr. Owens explains. "Ex-military people are clean-cut, presentable, and respectful to customers. They get excellent technical training in fields like avionics, diesel propulsion, electrical and hydraulic systems. We deal in machine tools and robotics, not submarines, but the skills are very similar." About 30 percent of ATS employees originally came from the military. The company also finds the skills it needs by recruiting from other companies and taking advantage of plant closings.

### 7digital: Leveraging the talents of outside partners

One way to produce more with less is to leverage the talents of outside partners: suppliers, developers, sales agents, and others with common interests. "It's about getting creative and aggressive in figuring out who has complementary resources that add value," says John Hagel, co-chairman of Deloitte's Center for the Edge. "Then you find ways to make it worth their while to work with you."

Internet companies in particular have been able to leverage the efforts of outsiders, first by creating communities in which people freely contribute content, and later by building in hooks for outside developers to redistribute existing data and content.

This is a key strategy of 7digital, a venture capital-funded digital music delivery company with undisclosed revenues "in the eight figures." Incorporated in the United States in 2004 and operating mostly out of the United Kingdom, the company has negotiated licensing agreements with all of the major and most of the independent music labels. It now has a catalogue of more than 15 million tracks available for downloading and playing on computers, phones, iPads, digital music players, and other platforms.

"The labels get global distribution and a rich set of licenses and rights," says CEO and co-founder Ben Drury. "Consumers get access to the digital content."

The company's business model has two parts. One is a resale business: selling content licensed from music labels. "That business grows as we build out our content library and pipe the content into more devices," says Mr. Drury. But because it is a volume resale business, the profit potential is limited.

The other part depends on enlisting developers to write programs to access digital content; this leverages the talents of outside partners to build the business. "You can license just the Web API [application programming interface] and supply your own content or buy it elsewhere," says Mr. Drury. "Or you build your own store and sell songs from the catalog, as downloads or streams, across multiple territories, with various kinds of licenses."

Ultimately, the API offers 7digital a way to extend its reach by leveraging the resources of outsiders. However, success depends on the willingness of developers to adopt the API. "To get developers to invest in the API, we have to show them that it offers real value," says Mr. Drury. "It helps when our API is being used by Samsung, RIM, Toshiba, even Google." The company also offers a free noncommercial license and provides documentation, sample code, a discussion group, a blog and other resources to help speed adoption.

> "It's about getting creative and aggressive in figuring out who has complementary resources that add value."

John Hagel — co-chairman of Deloitte's Center for the Edge

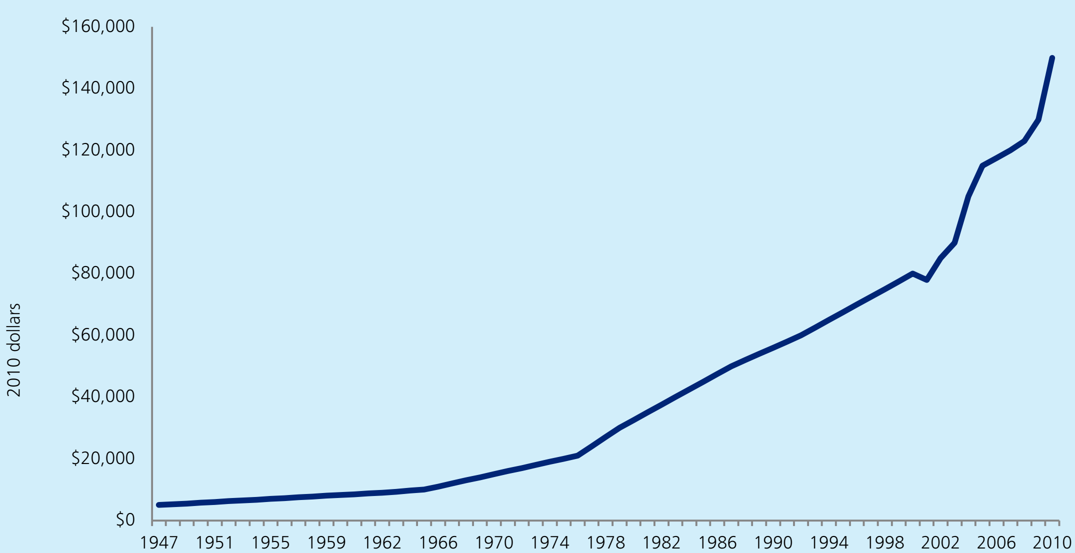
### As comparative advantage shifts, jobs may return

U.S. manufacturing employment has fallen 43 percent from its peak 30 years ago, yet a steady rise in productivity has caused output to grow by an average annual rate of 3.4 percent since 1950, according to the Federal Reserve Bank of Chicago. Now a shift in competitiveness suggests that some manufacturing and service jobs that formerly would have migrated overseas are now finding a home here.

"For several years we have been seeing both new manufacturing investment and expansion of existing manufacturing facilities," says Jeff Owens, the president of ATS, a private company engaged in maintaining production machinery. "Partly it's because of transportation costs. Partly it's due to the weak dollar. Mostly it's the fact that manufacturing increasingly happens in the region where the product is consumed. As a result, there is a lot of interest in U.S. heavy manufacturing—I'm talking about aerospace, automotive, agricultural machinery, things like that—compared to five years ago."

This shift in comparative advantage is affecting not just manufacturing jobs, but outsourced services as well. Only one-third of survey respondents agreed with the statement that "in our experience, outsourcing reduces costs and increases productivity." Adds the chief operating officer of a U.S.-based corporate IT infrastructure provider: "Moving our data center support operations from India to North Carolina enabled us to provide the same services at the same cost but with higher levels of customer satisfaction." In fact, wage inflation in China, combined with stagnant wages, flexible work rules, and sharply higher manufacturing productivity in the United States (see chart) have led some researchers to suggest that large parts of the manufacturing supply chain may return to the United States in the next 10 to 15 years.

**Manufacturing output per worker (2010 dollars)**



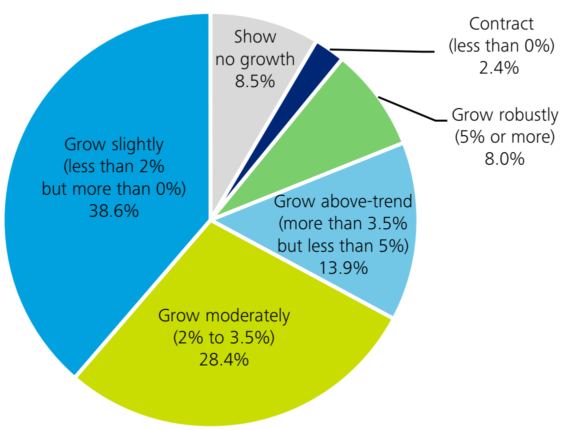

*Source: U.S. Department of Commerce, Bureau of Economic Analysis, and Federal Reserve Bank of St. Louis.*

# Appendix: full survey results

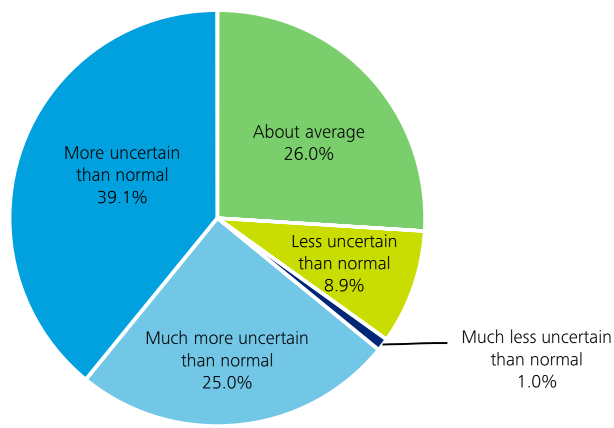
**Acknowledgment**
We would like to thank all survey respondents and interviewees for their time and the insights they shared for this report, *Mid-market perspectives: America's economic engine — competing in uncertain times.*

# The economic environment

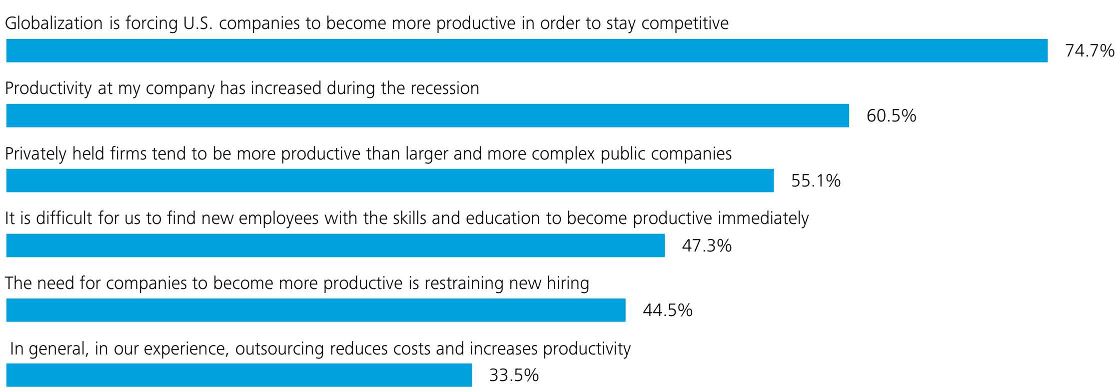
**At what pace do you expect the U.S. economy to grow over the next 12 months?**




**The level of uncertainty in terms of factors that drive future business prospects (e.g., taxes, regulations, credit availability and the economic outlook) is:**

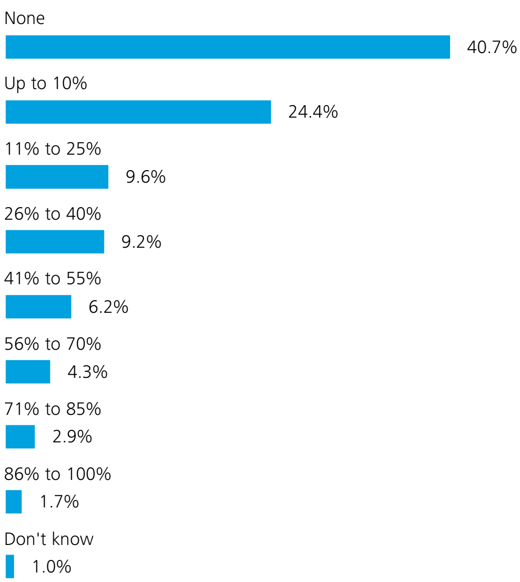



**For each of the following statements, please indicate your level of agreement with each. (Responses shown indicate "agree" or "strongly agree.")**

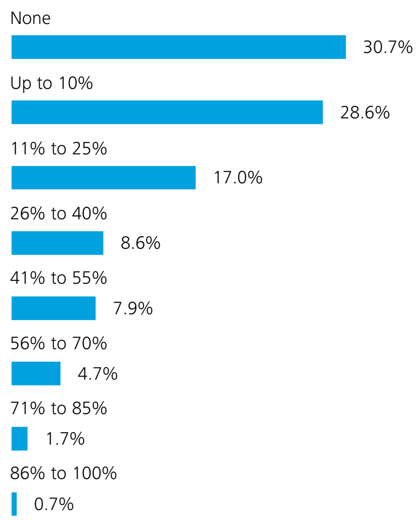


# Workforce / hiring

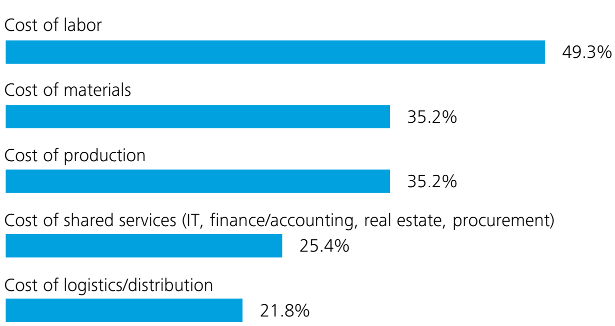
**Please specify the percentage of your workforce based outside the United States.**



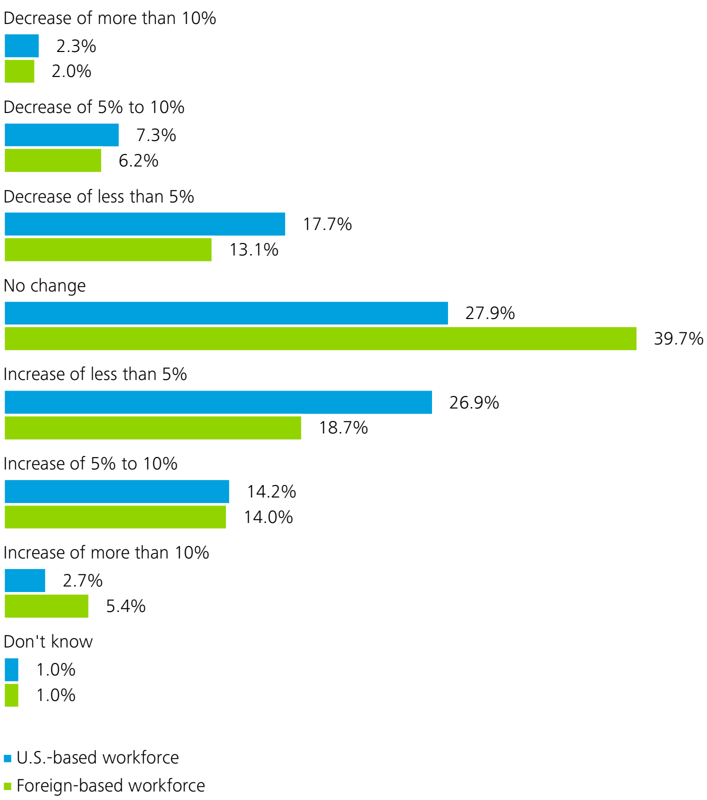

**What proportion of revenues comes from outside of the United States?**



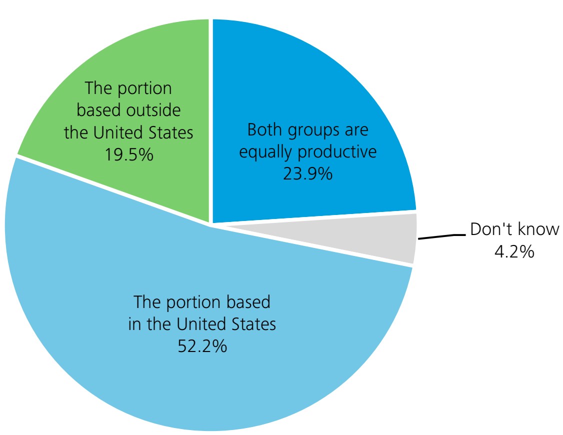

**Which costs is your company most focused on controlling? Choose up to two.**



**Thinking about now versus one year from now, how do you expect the size of your full-time workforce to change for the U.S.-based and foreign-based workforces?**

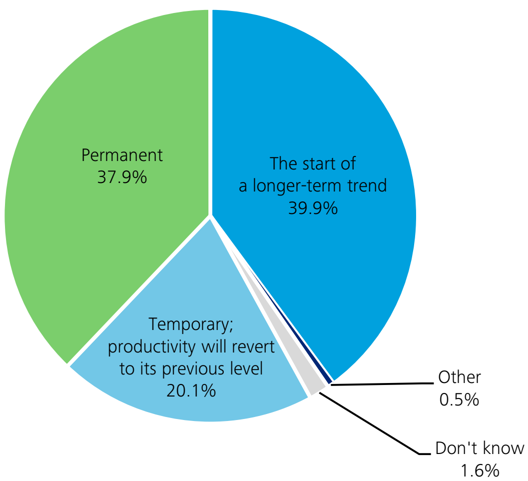



**Which portion of your workforce is more productive?**

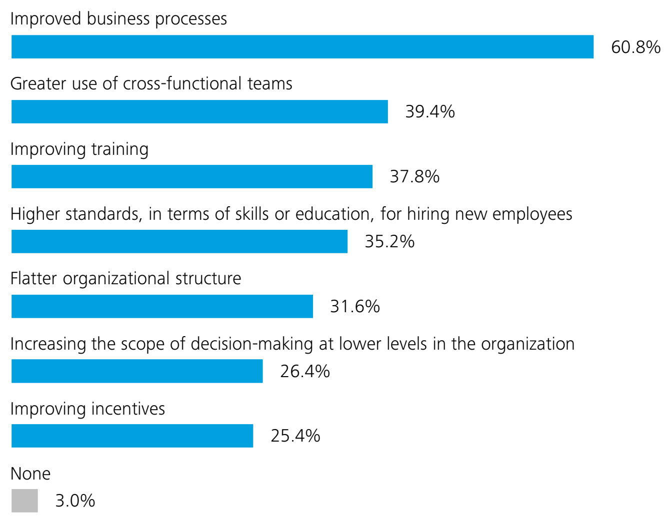


# Productivity

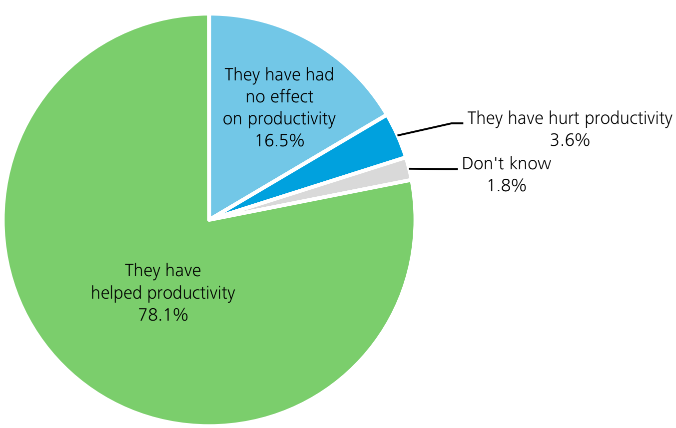
**The change in productivity at your company since the start of the recession is (select one):**



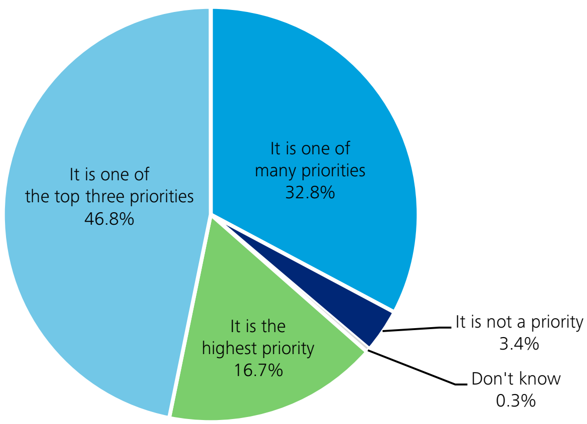

**What organizational changes, if any, has your company attempted to implement since the onset of the U.S. recession? Select all that apply.**



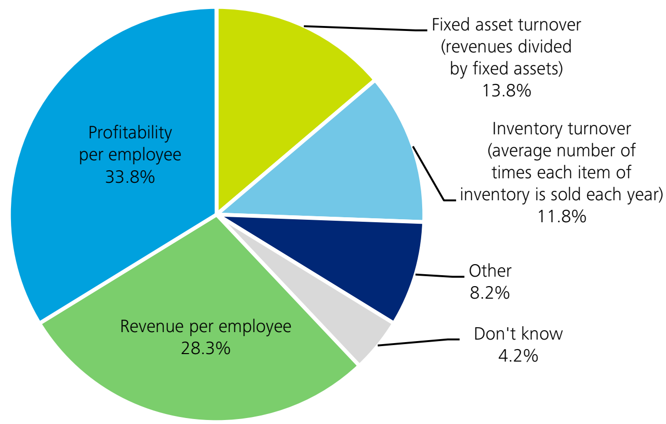

**How have these changes affected productivity at your company?**



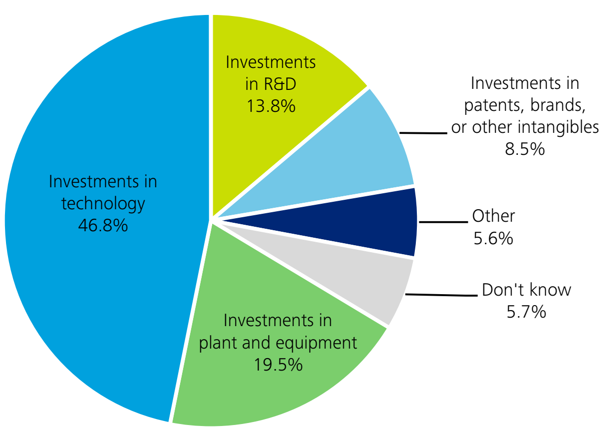
**Compared to other corporate goals, to what extent is increasing productivity a priority at your company?**



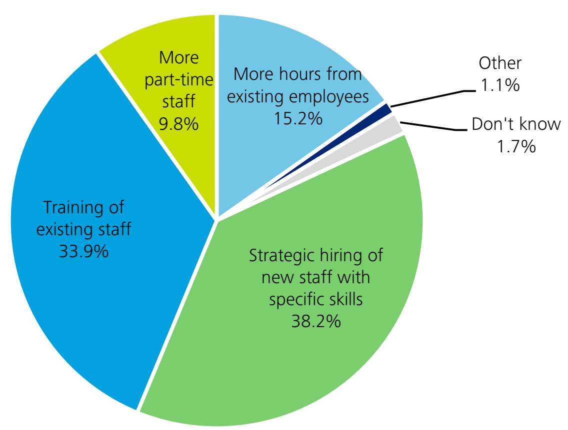

**Of the metrics below, which one is used most at your company to measure productivity?**




**What investments do you believe offer the greatest scope for increasing productivity at your company? Select one.**

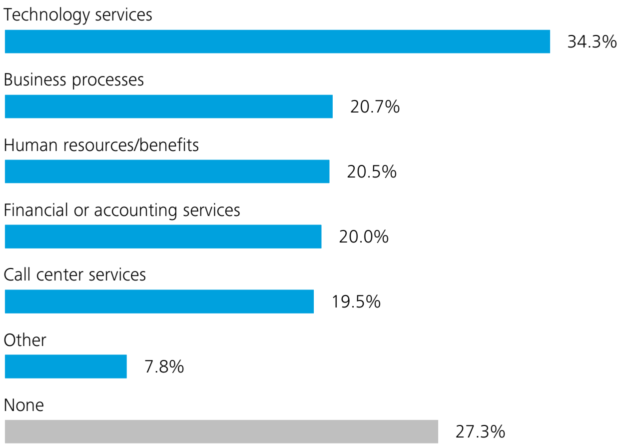



**What investments in human capital do you believe offer the greatest scope for increasing productivity at your company? Select one.**

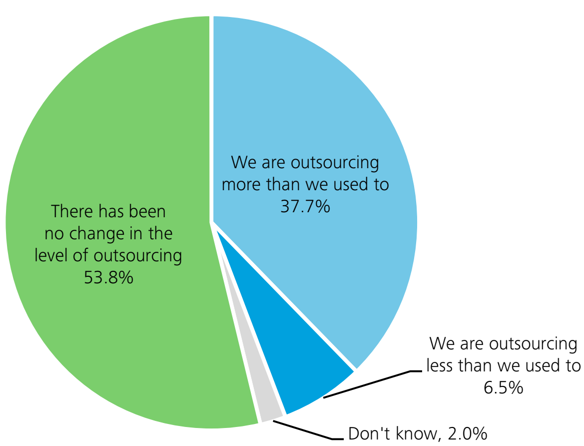


# Outsourcing

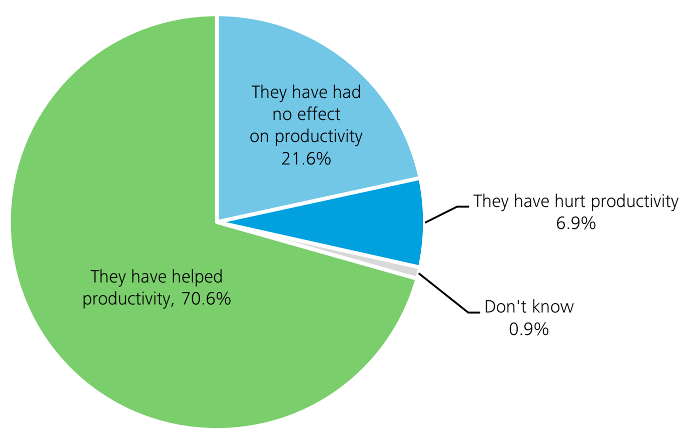
**What type of outsourcing does your company engage in, if any?**




**How has outsourcing changed at your company since the onset of the U.S. recession?**

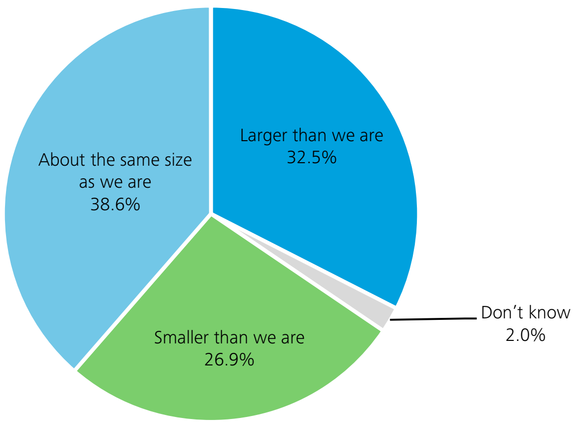



**How have the changes in the level of outsourcing affected productivity at your company?**

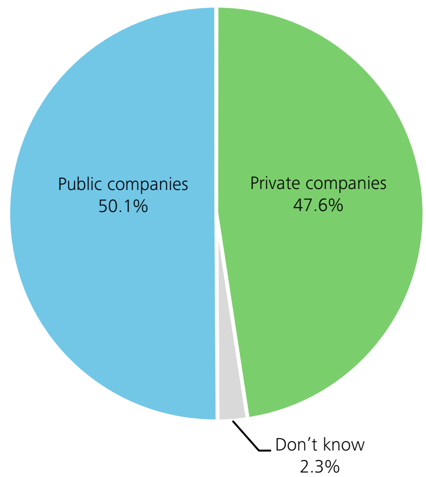


# Competitors

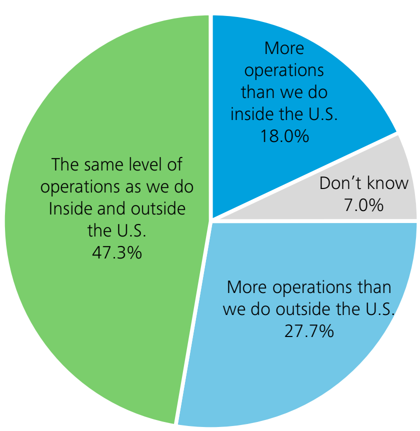
**Which of the following is most accurate?**
**More often than not, our competitors tend to be:**



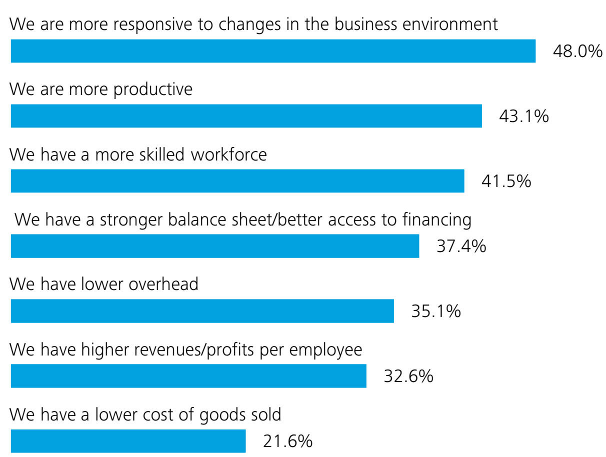

**Which of the following is most accurate?**
**More often than not, our competitors tend to be:**




**Which of the following is most accurate?**
**More often than not, our competitors tend to have:**

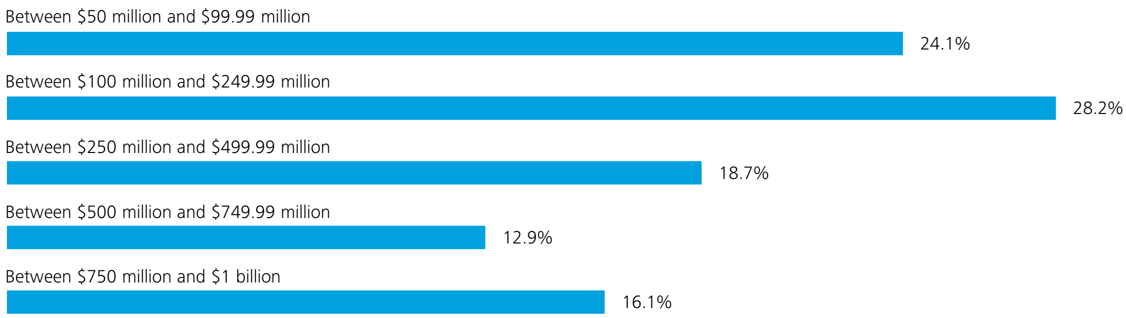



**Which of the following is true regarding your advantages relative to your competitors? Select all that apply.**

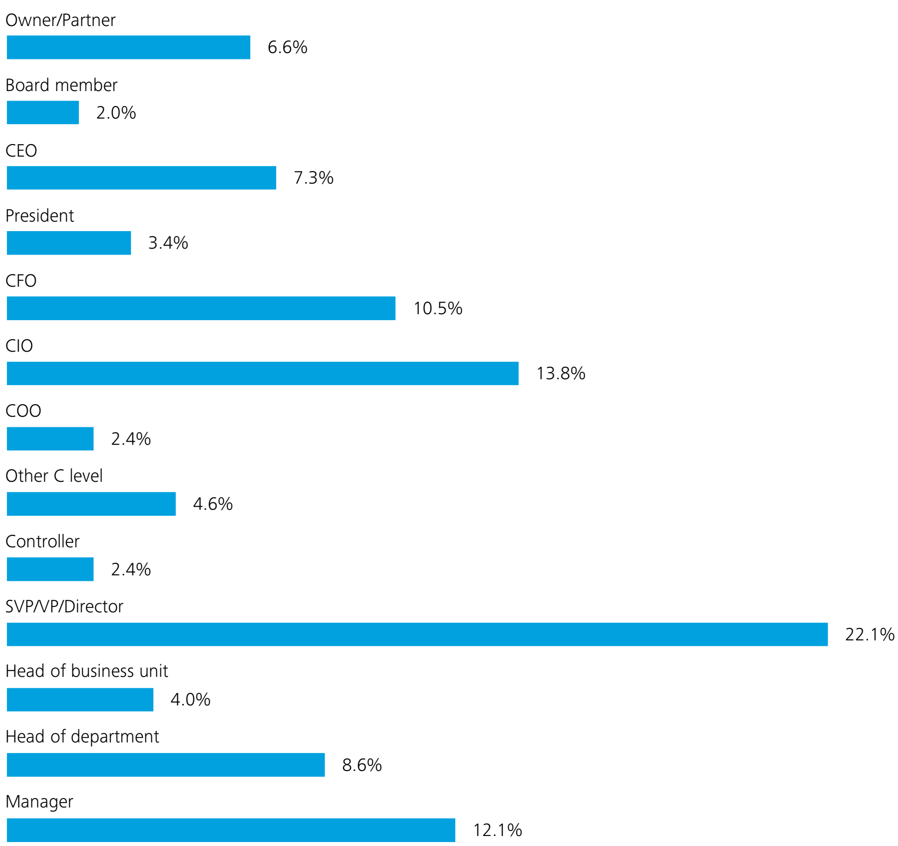


# Survey respondent demographics

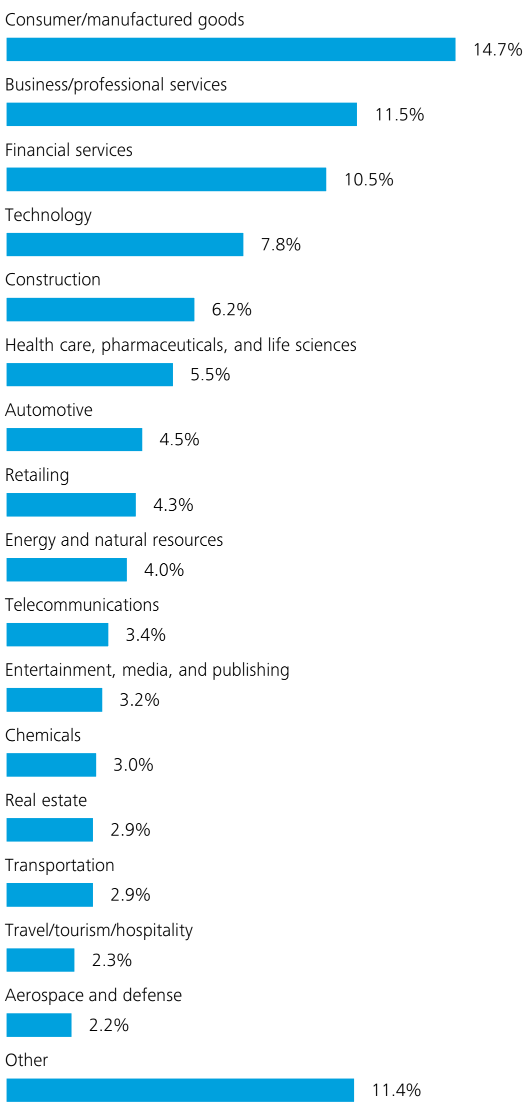
**What were your company's 2010 annual revenues?**



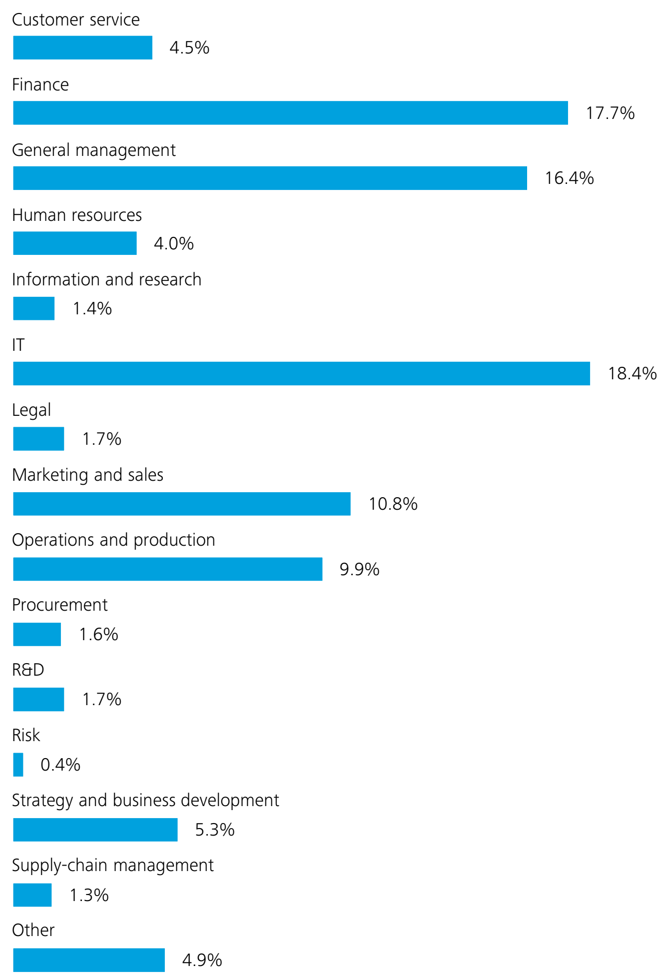

**Which of the following best describes your title?**



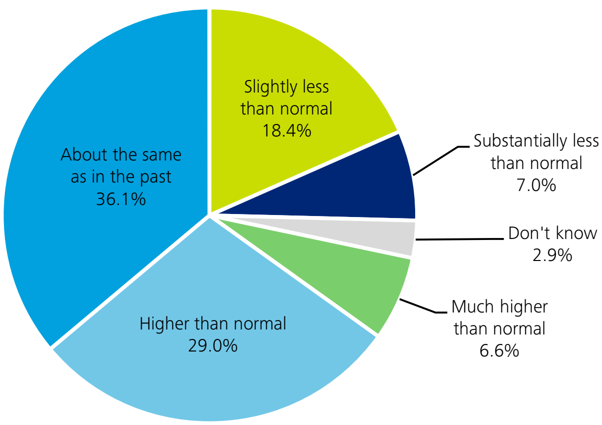
**In which sector does your company belong?**



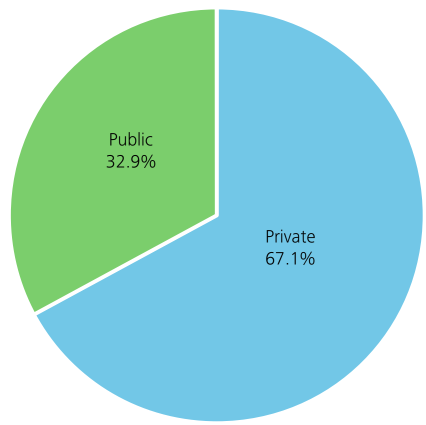

**What is your main functional role?**



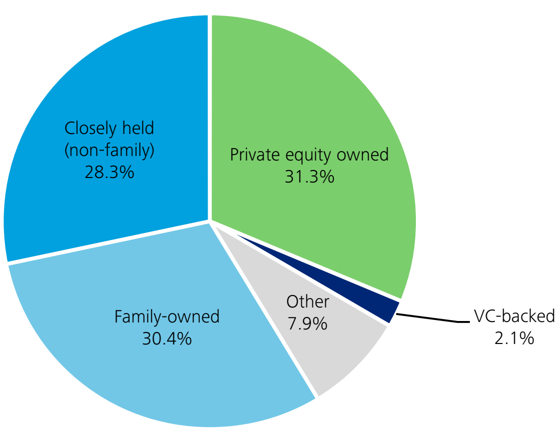
**Which of the following best characterizes your plans for long-term investments in the business?**



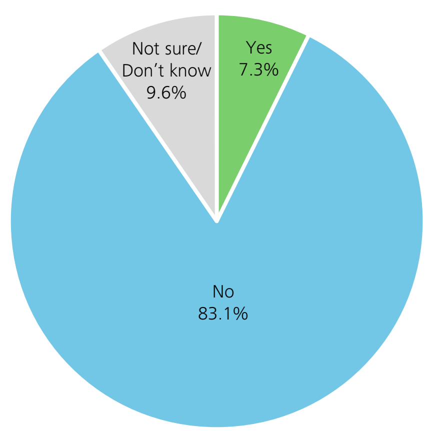

**Is your company public or private?**




**Is your company family-owned, closely held (non-family), private equity owned, VC-backed, or other? Select one response only.**




**Does your company plan to go public in the next 12 months?**



**Perspectives**

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