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Mid-market perspectives
2011 report on America's economic engine

Preface

Mid-market perspectives: 2011 report on America's economic engine is based on a Deloitte-commissioned survey of mid-market firms conducted by the Economist Intelligence Unit (EIU).

During February 2011, the EIU conducted a survey of 527 executives of private and public companies with annual revenues between \$50 million and \$1 billion. The survey included questions about business metrics (pre-, mid- and postrecession), plans for growth (financing, global expansion, headcount), as well as the executives' outlook for the future and what they view as potential obstacles to success. Concurrently, the EIU conducted individual interviews with 15 chief executive officers of mid-market companies.

We would like to thank all survey respondents and interviewees for their time and the insights they shared. The EIU bears sole responsibility for the interviews and survey results documented in this report.

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Executive summary



Imagine a segment of the U.S. economy that represents \$6.1 trillion in revenue, or 40 percent of the national GDP, and employs 24.6 million people. One could reasonably expect a sector with this impact to dominate headlines and be followed closely by the media, investors, and business leaders.

This segment comprises America's mid-market companies—those with annual revenue between \$50 million and \$1 billion—and its vital importance to the U.S. economy often goes unacknowledged. A few superstars may grab the spotlight on their way to joining the Fortune 500, but these are often the exceptions and not the rule.

Yet with collective size and scale that's impossible to ignore—revenues that surpass the whole of the S&P 100 and an employment level higher than the entire S&P 500—the middle market is the underappreciated engine of the U.S. economy. Its role is impressive, important, and impactful.

The success, struggles, and decisions of mid-market businesses have a profound influence on the national unemployment rate, consumer confidence, investment, spending, and the general health of the American economy. Understanding what the middle market is thinking and where it's moving today is critical to understanding where the U.S. economy is headed.

The middle market is the underappreciated engine of the U.S. economy. Its role is impressive, important, and impactful.

That's why Deloitte commissioned the Economist Intelligence Unit to conduct an extensive survey of U.S. mid-market CEOs and executives. We sought to better understand their experiences while they endured the worst economic downturn in nearly 80 years, and their views on what the future may bring.

Overall, we found tempered optimism about the future:

- **Growth:** For 2011, 93 percent of the survey respondents expect the economy to grow, and 81 percent expect their annual revenue to increase.
- **Productivity:** Levels are on the rise, with 72 percent reporting higher levels than prerecession.
- **Hiring:** A significant majority (69 percent) plan on adding full-time employees to their ranks this year.
- **Business expansion:** While the majority of firms are focusing their growth targets domestically, 34 percent are expanding globally.
- **Access to capital:** Although challenges remain for some in gaining access to capital, 38 percent expect to pursue financing to expand their businesses in the coming year.

While these signs are encouraging, this group indicates that there are fundamental challenges that restrain their optimism and influence their decisions:

- **Modest economic growth:** Even though an overwhelming majority expect the economy to grow, only 20 percent believe it will expand at a pace that will support widespread job creation.
- **Government debt:** Debt at all levels—federal, state, and local—was most often cited as an obstacle to U.S. growth.
- **Regulatory issues:** Health care costs, high tax rates, and other regulatory issues also are frequently cited as obstacles to growth.

Although these overall trends paint a picture that is encouraging but cautious, it is important to remember that in a market this broad and complex, there are some striking distinctions between the performance of individual companies. Our analysis identified three distinct categories: the frontrunners, those keeping pace, and the laggards.

Not surprisingly, the strength of a company's balance sheet has a great deal to do with the category in which it falls. The frontrunners are flush with cash, investing in their businesses, planning to hire, and looking at global acquisitions. By contrast, the laggards have weaker balance sheets, are still looking to cut costs and headcount, and are seeking financing not for business expansion but for refinancing purposes. This group holds a more uncertain view of the prospects for the economy.

One common denominator among all groups is the focus on deleveraging. Sixty-five percent of the companies surveyed report debt below prerecession levels and say it will stay lower over the next year.

As one respondent pointed out in a follow-up interview for the report, the recession has been somewhat Darwinian. Agile and dynamic companies are still standing and even beginning to thrive. Meanwhile, those unable to adjust to the "new normal" have disappeared or are struggling. The good news for those firms that have emerged from the worst of the recession intact is that the nimbleness and adaptability that helped them weather the economic storm of the past few years will position them to capitalize on new opportunities in the future.

While business and political leaders continue to focus on broad issues such as deficit reduction, tax reform, and global events, they must consider the impact of their decisions on the middle market, which is a vital component of the U.S. economy.

As an organization committed to this sector, Deloitte is proud to contribute this research that highlights both the prospect for mid-market recovery and growth and the ongoing challenges to be addressed. We hope you will find this report helpful to you and your business.

Sincerely,



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

About the survey

The survey and interviews conducted for this report encompassed both private and public companies with annual revenues of between \$50 million and \$1 billion. The Economist Intelligence Unit surveyed 527 senior decision-makers at these companies. Over one-half (51 percent) were C-level executives, including owners.

All respondents were from U.S.-based companies. Of the total, 20 percent are in the highest revenue bracket (between \$500 million and \$1 billion) and 30 percent are in the lowest (between \$50 million and \$99.9 million). Fifteen different industries were represented by at least 10 respondents. The most-represented industries were business/professional services (18 percent); consumer/manufactured goods (15 percent); and health care, pharmaceuticals, and life sciences (10 percent).

Sixteen states were represented by at least 10 respondents, and 43 were represented in total. The states that were most heavily represented were California and New York (13 percent and 11 percent of respondents, respectively, said their companies were based there), followed by Illinois (8 percent), Texas (7 percent), Pennsylvania (6 percent), Massachusetts (5 percent), and New Jersey (4 percent).

In addition to the survey, the EIU conducted interviews with CEOs of 15 mid-market companies.

Introduction

Mid-market companies are a hidden powerhouse of the U.S. economy. Although the media and the investment community tend to focus on large public companies, in terms of total revenues and number of employees, the middle market rivals the corporate giants that dominate business headlines. The success of the middle market in the coming years will have a profound impact on U.S. unemployment rates, consumer confidence and spending, and overall economic growth.

For perspective, consider this: according to 2007 data—the most recent figures available from the U.S. Census—mid-market companies generated \$6.1 trillion in annual revenues, equivalent to 40 percent of U.S. GDP in that year, and paid 24.6 million people a total of \$1.13 trillion in salaries¹ (see Figure 1). The S&P 100 companies, which contribute nearly 45 percent of U.S. stock market capitalization, generate only \$3.7 trillion in annual revenues,² while the companies represented in the Dow Jones Industrial Average (DJIA) generate less than half of the annual revenues of mid-market companies.

In terms of employment, which often drives consumer spending and confidence, the middle market is even more influential. In addition to employing more people than the S&P 500, mid-market companies employ more than three times as many people as DJIA companies. Clearly, these employers play a critical role in determining job growth.

This Deloitte-commissioned survey of mid-market firms conducted by the Economist Intelligence Unit (EIU) in February 2011 (see “About the survey,” page 3) indicates growing optimism, with a full 93 percent of respondents expecting the U.S. economy to experience some growth in 2011.

Many of the survey respondents reported that their companies have experienced an improvement in cash balances, productivity, and profits compared with a year ago. Those gains are triggering expectations and plans for steady growth across the segment. In the next 12 months, the mid-market companies surveyed plan to add new products and services (46 percent), expand their reach in the United States (56 percent) and abroad (34 percent), and up-sell or cross-sell to existing customer bases (46 percent) (see Figure 2).

We note, however, that the respondents’ optimism is tempered with caution. Mid-market business leaders recognize that there are still significant obstacles to achieving long-term goals, including an uncertain economic outlook, rising interest rates, uncertain market demand, and a steady increase in the cost of oil and raw materials. In particular, there are efforts under way at a majority of companies to significantly reduce their overall debt levels. They are closely monitoring employment trends, deficits, health care costs, and the potential for tax hikes and holding off on some expansion plans until they see whether the economy will continue to improve.

These challenges threaten mid-market growth and underscore the need for careful business planning. They also identify important measures that respondents believe could be taken by the U.S. government to further bolster the middle market, including tax breaks, low interest rates, and other incentives.

This report, written by the Economist Intelligence Unit, looks at the current state of mid-market companies, their prospects and plans, and the strategic decisions they have made to survive and thrive following the Great Recession of 2008–09.

¹ U.S. Economic Census, 2007

² S&P 100 Factsheet, Standard & Poor’s — http://www2.standardandpoors.com/spf/pdf/index/SP_100_Factsheet.pdf

Figure 1: Annual revenues and total employees

Data from the 2007 U.S. Census

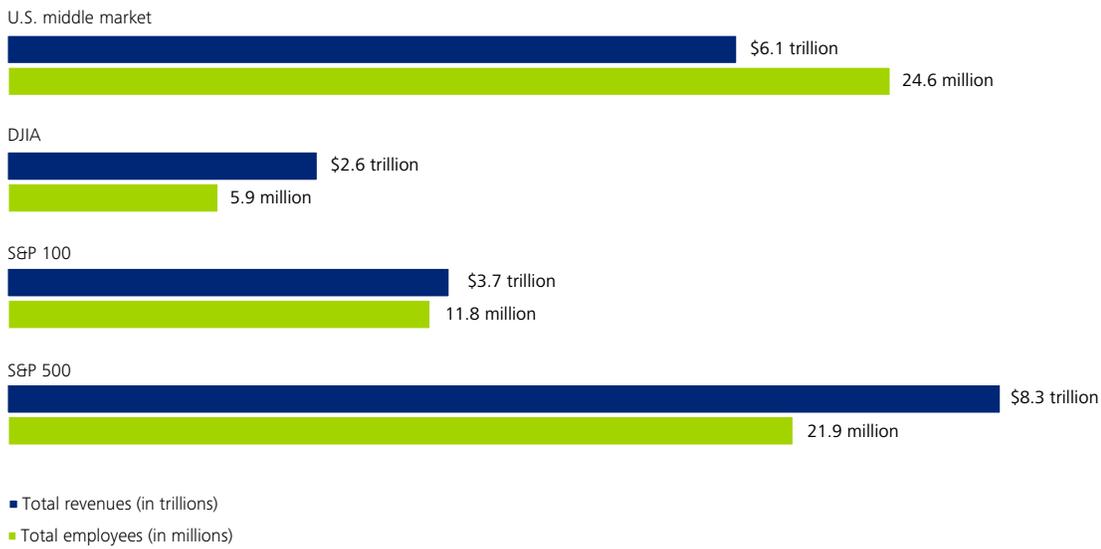
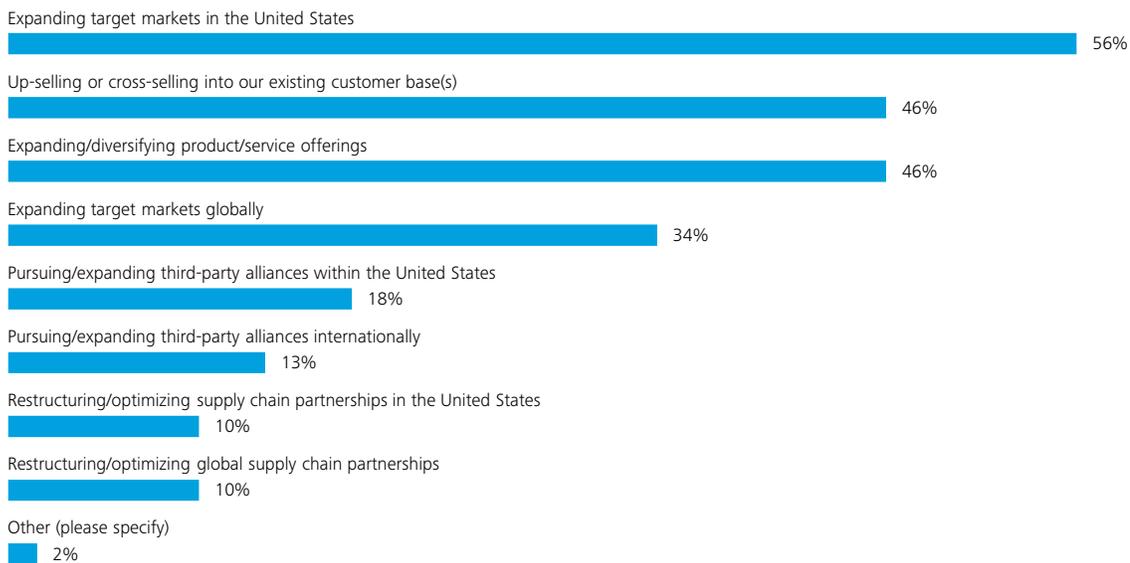


Figure 2: Growth strategies

What will be the main focus of your company's growth strategies over the next year? Select up to three.



Key findings

Signs of optimism

The survey findings reveal that many mid-market firms are well positioned and eager for growth, having spent the downturn improving productivity, deleveraging, and rightsizing their operations. In many cases, headcounts already are climbing toward prerecession levels, and strategic business needs will play a crucial role in future hiring decisions. If mid-market companies can tackle their biggest obstacles, including deficits, taxes, and uncertain market demand, they are likely to exercise even more influence on the U.S. economy in coming years.

Revenues, cash flow, profits, and spending are all expected to rise. The following results suggest some optimism on the part of mid-market companies:

- 81 percent of respondents expect revenues to rise in the next year, with 65 percent expecting revenues to surpass their 2007 levels.
- By 2012, 59 percent anticipate gross profit margins will be higher than they were before the recession.
- 65 percent of respondents report that debt ratios are below prerecession levels and will stay lower over the next year.
- 59 percent of respondents say that in a year's time, capital investment will be higher than it was before the recession.

Productivity increases remain high. Most mid-market companies have realized improved productivity and plan to continue emphasizing gains in this area.

- 72 percent of respondents report productivity today is higher than before the recession; 79 percent believe that by 2012, productivity will be higher than it was in 2007.
- 84 percent think productivity will be higher one year from now.

Headcounts at mid-market companies are rising. After months of downsizing and streamlining, some mid-market companies are hiring again.

- 69 percent expect to hire full-time employees this year, and 54 percent anticipate headcount to exceed prerecession levels.
- 55 percent indicate that they will add full-time employees in the coming year to specifically support growth strategies.

Mid-market firms are positioning themselves to grow and globalize. Many organizations are expanding their reach in the United States and overseas and adding new products and services in an effort to diversify.

- 56 percent of respondents say expanding target markets in the United States will be critical to their growth strategies in the coming year.
- 46 percent say they plan to up-sell or cross-sell to existing customer bases or expand or diversify products and services.
- 34 percent of all the companies surveyed and 44 percent of the respondents with \$500 million to \$1 billion in revenues expect to expand target markets globally.

Financing options and access to capital are stabilizing.

While financing options may not be as accessible as they were prerecession, most survey respondents plan on securing new financing and do not seem to consider financing as a major business challenge.

- Only 16 percent do not expect to pursue new financing; 38 percent plan to use new financing for U.S. business expansion
- 35 percent plan to pursue asset-based financing compared with only 10 percent who plan to pursue unsecured loans
- When asked about main obstacles to growth, only 18 percent cited availability and/or cost of credit.

Proceed with caution

While much of this news is positive, optimism is tempered with caution. Factors such as deficits, taxes, and uncertain market demand are deep concerns for leaders of mid-market companies.

The strength of the economic recovery is uncertain.

An overwhelming majority anticipates some form of economic growth, but there are doubts about the strength of the recovery.

- Although 93 percent of survey respondents expect the economy to grow, only 20 percent anticipate it will expand by more than 3.5 percent this year—the pace economists say is needed for real job growth.

Systemic pressure is being caused by government debt.

Strikingly, government debt at all levels was repeatedly cited by business leaders as a barrier to growth:

- 50 percent of those polled believe that federal, state, and municipal challenges pose a significant obstacle to U.S. economic growth.

Government decisions and regulatory challenges cause concerns. Potential tax increases, interest rates, health care costs, and general uncertainty about the economy are causing mid-market business executives to restrain their optimism as they wait to see how and when the economy will improve.

- 33 percent of respondents say rising health care costs are among the top barriers to U.S. economic growth.
- 33 percent of survey respondents say that reducing corporate tax rates would be the best way the government could support mid-market growth in the next year.
- 32 percent of respondents believe the government should keep interest rates low to spur consumer spending.
- 30 percent cite high tax rates.
- 23 percent would like to see the government roll back health care reform.

While much of this news is positive,
optimism is tempered with caution.



Key trends driving growth

Right-sized and ready to grow

The middle market represents a powerful economic engine that is positioned to drive growth in the United States during the next two years. According to the survey, several broad trends point to economic recovery in the middle market:

- Renewal of revenue growth
- High productivity
- Hiring to support growth
- Business expansion
- Access to capital.

Renewal of revenue growth

After surviving the most challenging economic environment in the United States in nearly 80 years, mid-market executives are markedly optimistic about the potential for revenue growth at their companies. A full 81 percent of respondents expect revenues to rise in the next year; 65 percent of respondents anticipate that revenues will be higher in 2011 than they were in 2007.

What is particularly promising is that 59 percent of the respondents expect gross profit margins in 2011 to exceed prerecessionary levels; this is in large part attributable to greater efficiencies, cost-cutting measures, and increased productivity.

In contrast to growth strategies before the recession, the survey suggests that companies will be prudent in their use of debt and will avoid growth plans that require substantial leverage. In fact, 59 percent of respondents say that in a year's time, capital investment will be higher than it was before the recession, indicating that the middle market is returning to an investment mode. At the same time, 65 percent of respondents report that debt ratios are below prerecession levels and will stay lower in the next year.

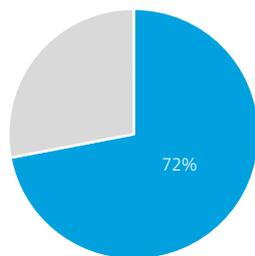
Mid-market companies seem to be returning to more measured, risk-averse growth strategies. It is yet to be seen whether this approach will be sustained as capital becomes more readily available and recent memories of the pain caused by overleveraging recede.

High productivity

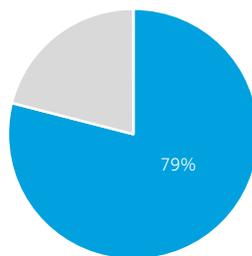
Productivity is on the rise at mid-market companies across America, with 72 percent of survey respondents reporting levels higher than prerecession standards. Even more (79 percent) say that in a year's time, productivity will be higher than it was in 2007. A few different strategies emerged as possible catalysts for increased productivity.

Figure 3: Productivity

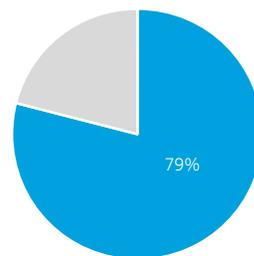
Is productivity up or down, and will it soon top prerecession levels?



Now vs. prerecession
72% say "up"



Now vs. one year ago
79% say "up"



Early 2012 vs. 2007
79% say "up"

For some, it has been a leaner workforce. Neil Koehler, CEO of Pacific Ethanol, notes that his business is focused on staying lean and mean. “We’re selling almost as much ethanol today as we did in our heyday with half the staff. Our business is definitely in a growth mode again, but we are doing it in a more careful fashion than arguably we did the first time around.”

Of those who say productivity has risen since 2007, 64 percent say their full-time domestic workforce is smaller.

While some companies implemented workforce reduction strategies, others took a different route to improve productivity and protect the bottom line. Tom Sanderson is chief executive officer of Transplace, a provider of transportation and logistics management services. He says his firm didn’t implement layoffs, but took a hard look at staffing to determine whether it was as efficient as it needed to be to run the business. “We had to ask, are we as lean as we need to be? How can we do more business with the same number of people so that we can grow more profitably?”

As a result, Transplace focused on setting high, business-driven performance standards and paid top dollar to fill key sales openings. The company was convinced that the investment would pay dividends in the form of new accounts and additional business from existing ones.

Hiring to support growth

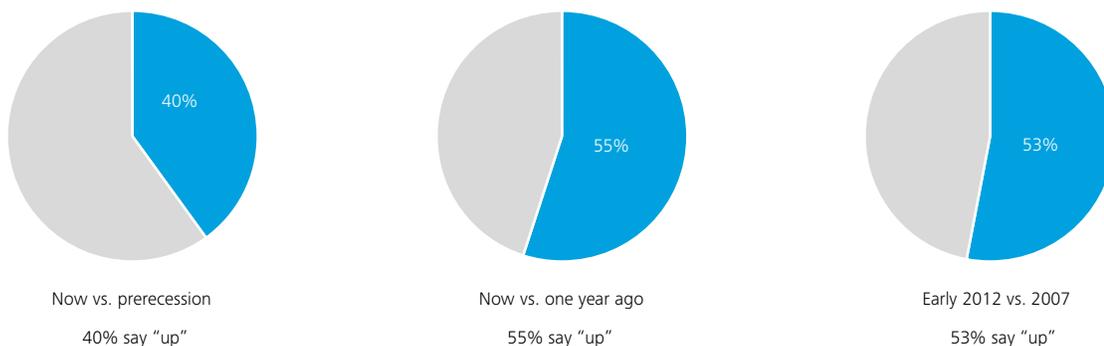
Mid-market companies now appear ready to expand their workforces to meet rising demand for goods and services. Job cuts in the past two years have been widespread. In 60 percent of firms, full-time headcount is lower now than in 2007—and one-third say it is more than 10 percent lower.

Still, a full 69 percent of all respondents say headcount will rise in the next year, at which time more than half expect to have a workforce larger than they had before the recession.

Further, the study shows mid-market firms have worked hard to avoid arbitrary cuts. Many have specifically sought to preserve, or even add, headcount in areas that are key to the business proposition, and will continue to do so (see Figure 4). While some are just starting to add back jobs in the coming year, other firms (23 percent) have been adding jobs all along and most of them will continue to add personnel this year.

Figure 4: Headcount

Is headcount up or down, and will it soon top prerecession levels?



Specialized, a company that manufactures bicycles, took that approach. “We added talent because more talent was available as other companies struggled. We added sales and marketing people, engineers and R&D. When a company has momentum, as we did, people look for you,” says CEO Mike Sinyard.

Looking ahead, the majority of respondents (55 percent) say the main focus of their employment strategy in the coming year will be adding full-time employees to support growth strategies or because crisis-related job cuts were made at suboptimal levels (cited by 23 percent). Only 17 percent say they plan to reduce headcount to cut costs.

Business expansion

Local markets are still the overwhelming target for new business, with a full 81 percent of the respondents saying the United States or Canada have been key contributors to their companies’ growth in the past three years. That percentage is beginning to shift, however; 68 percent of companies expect the United States or Canada to be the driving contributors to their growth in the next three years, and many are looking to overseas markets for new opportunities.

Fifty-two percent of the respondents already earn at least some revenues overseas, up from 46 percent before the crisis. In three years’ time, respondents expect that number to climb to 65 percent, with more than 10 percent saying overseas revenues will exceed domestic revenues.

Approximately one-third of respondents say they will focus on expanding target markets globally in the next year. This figure rises to 44 percent among companies with annual revenues of \$500 million to \$1 billion.

Europe and China are big draws. Western Europe is already a key revenue contributor for about 15 percent of respondents, while 17 percent expect the Asia-Pacific region (excluding China and India) to be an emerging force. Firms also see an increasing role for China; 15 percent of respondents expect China to contribute the most growth to their companies in the next three years (see Figure 5).

While the destinations vary, the message is the same: many mid-market companies expect the share of revenues from overseas to grow.

“The world is flat,” says John Shegerian, chairman and CEO of U.S.-based Electronic Recyclers International. “Globalization is here. Small and new industries like ours cannot think in the historical legacy ways of being just America-centric. If you can’t think globally, you shouldn’t be in this business.”

Replicating local successes internationally. Rather than a general desire to diversify, the move toward globalization stems largely from the need to pursue specific and strategically aligned opportunities, often those that replicate local successes internationally.

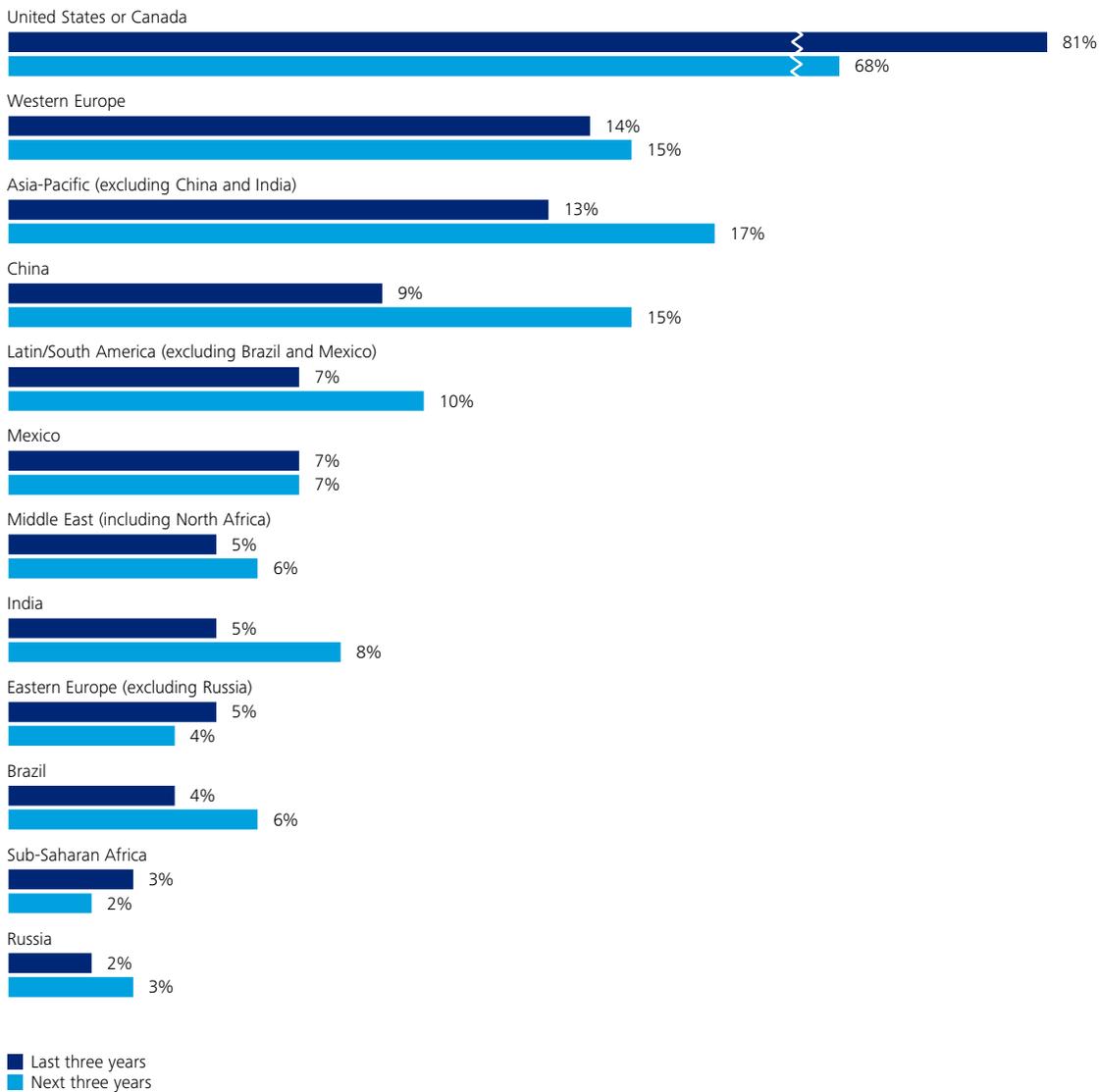
Transplace, for example, “would love to find somebody in Canada to replicate what we did in Mexico without having to start from scratch,” says Mr. Sanderson. “But equally important is to know what you don’t want to do. I think it’s important to be discriminating and to make sure you get something that’s a good fit.”

A failed effort to expand overseas can reflect badly on the brand, be a waste of resources, and draw time and attention away from the core business, warns Trina Gordon, president and CEO of Boyden, an executive search firm. “You want to take advantage of an opportunity, but you don’t want it to be dilutive to who you are and what your brand is,” she says.

Ms. Gordon notes that her company will not enter any new market without first aligning the move with the company’s broader business goals. “Whether it’s Vietnam tomorrow, it’s certainly the BRIC [Brazil, Russia, India, China] countries today. We won’t be opening offices for the sake of opening them,” she says.

Figure 5: Contributions of various geographic markets

Which geographic markets have contributed the most to your company's growth in the past three years?
Which will contribute most over the next three years?



Globalization means a greater share of the workforce is located overseas. Before the recession, 61 percent of the respondents had no overseas workers. In three years' time, this number is expected to drop to 43 percent (see Figure 6). Given the middle market's sheer size as an employer, this trend is significant. However, because it also coincides with the planned globalization of revenues, there is no firm evidence yet that U.S. companies will send existing jobs overseas.

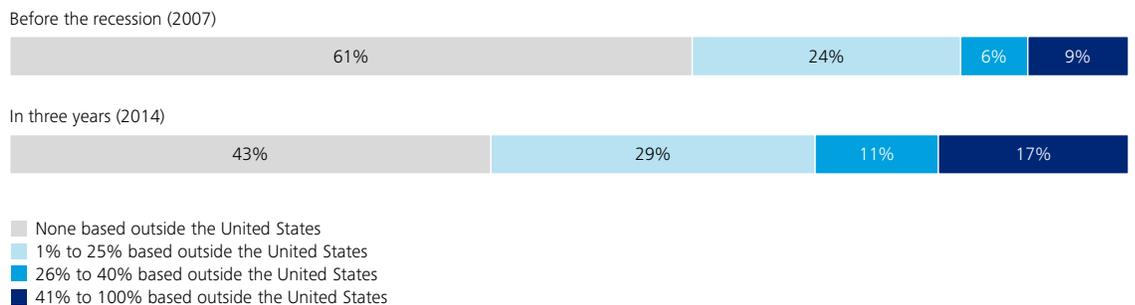
Expect mergers and acquisitions from the middle market. According to the survey, mergers and acquisitions will be a common feature of mid-market expansion and growth strategies in 2011. One-third of the respondents say they are likely to acquire companies in 2011 (see Figure 7), with almost half of those transactions involving direct U.S. competitors. Merger activity is also expected to increase, driven by consolidation to expand or diversify the customer base (47 percent), to capture efficiencies of scale (38 percent), and to bargain hunt for underpriced assets (29 percent).

About 80 percent of those who indicate that they are quite likely or very likely to participate in a deal as an acquirer also say cash balances are up from a year ago, so mergers and acquisitions could be a productive use of that cash in the coming year as companies look to expand their market share and reach.

Echo Global Logistics has already experimented successfully with strategic acquisitions, even though its overall growth has been largely organic. "When we make an acquisition," says CEO Doug Waggoner, "it's usually a company that has a lot of knowledge of a local market." Acquiring a company with an established presence and a solid customer base offers companies like Echo Global Logistics an immediate benefit. "Essentially, we're buying a book of business and we're buying a sales force or buying some geographic expertise," Mr. Waggoner says.

Transplace's Mr. Sanderson says his firm can also see the value of strategic acquisitions in areas where it doesn't yet have a strong presence. "For example, we don't do much in the automotive industry or the chemical industry, so somebody who serves a vertical that we're not strong in would be good," he says.

Figure 6: Adding foreign workers
Percentage of mid-market workforce based outside the United States



Access to capital

Expansion is a priority for many mid-market companies looking to the future, and access to financing plays a significant role in achieving that goal. Among survey respondents, 38 percent say U.S. business expansion will be one of the main uses of new financing in the next year, while one in four companies intends to use financing for international business expansion.

On an upbeat note, financing appears plentiful for healthy borrowers. "There is plenty of bank financing available for companies that are growing and making money today, and the interest rates are incredibly low," says Thomas Sanderson, CEO of Transplace. "And if you don't have a good story, you don't need to talk about the rate because you're not going to get the money anyway."

Pacific Ethanol can attest to that. The company, an integrated producer and marketer of ethanol, has suffered shocks in recent years from the recession and difficult economic conditions specific to its fairly new industry. "At one point in 2009, we had probably 40 percent of the ethanol industry shut down and many bankruptcies, including our own plants," says CEO Neil Koehler.

Pacific Ethanol is a public company, and it was able to tap some financing alternatives it couldn't have tapped if it had been private. Nevertheless, "the cost of capital increased for us significantly, partly because of the economy and the capital markets and partly because the industry went from being the darling of investors to a pariah," Mr. Koehler says. The firm has since worked aggressively to reduce its debt leverage, but "the cost of money went through the roof," he says (see Case studies, page 23).

Flexible financing provides options. Access to financing is expected to come from a variety of sources for mid-market companies in the next 12 months. The most popular options are asset-based financing (35 percent) and cash-flow financing (32 percent; see Figure 8).

Only 25 percent of respondents expect to use internal sources for financing, reflecting a dramatic decrease from prerecession levels. Internal sources also topped the list in a 2007 survey of a similar demographic, with 40 percent of respondents saying they expected to tap such financing.

Figure 7: Mergers and acquisitions

Is it likely you will participate in a merger or acquisition in the coming year?

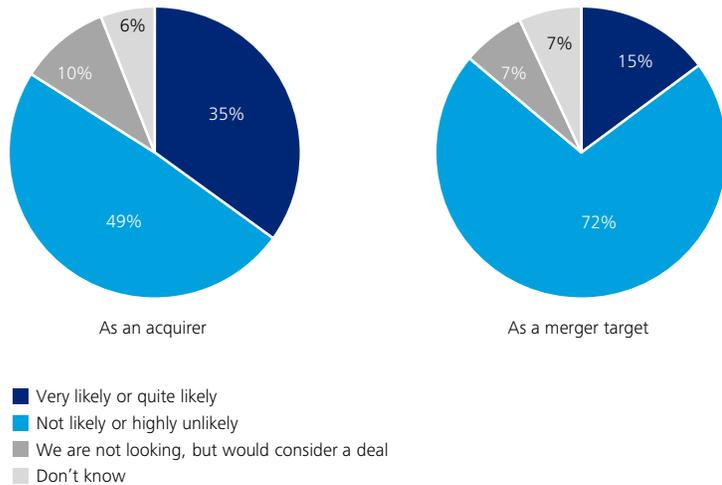
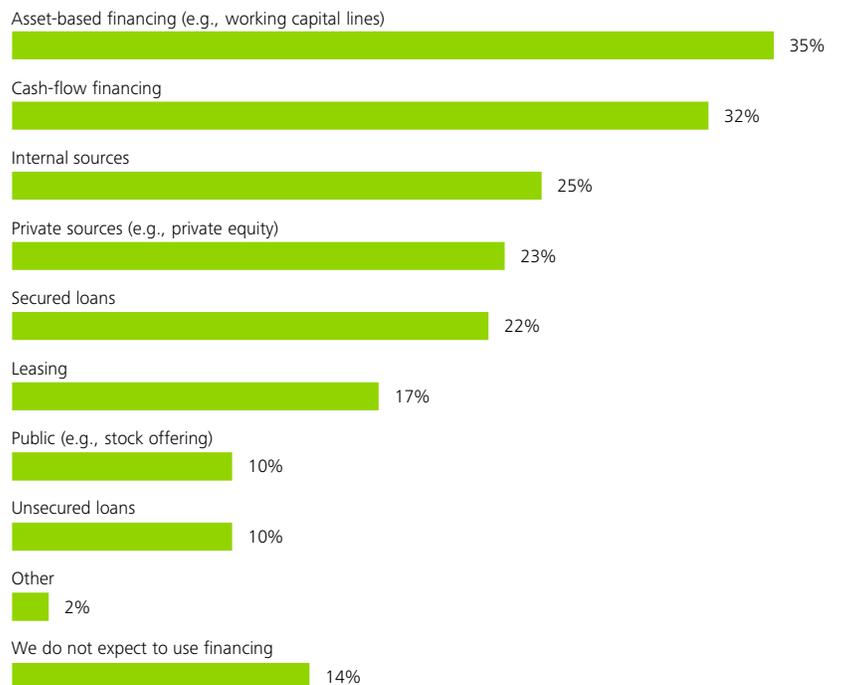


Figure 8: Financing

What types of financing do you expect your company to pursue in the next year?



Tempering optimism with caution

Trends driving growth aside, mid-market companies are managing their expansion plans with an eye toward risk. They are closely monitoring employment rates, deficits, health care reform, and potential tax hikes, and they are holding off on some growth plans until they see proof that the economy will continue to improve. In particular, there are efforts under way at a majority of companies to significantly deleverage and reduce overall debt.

Tempering the optimism, mid-market leaders identified several factors that could present obstacles to company growth, as well as overall U.S. growth:

- Uncertain economic growth
- Government debt
- Regulatory issues.

Uncertain economic growth

Although companies largely expect their revenues to grow and also anticipate an increase in the American GDP in 2011, there is some speculation that the recovery could trigger higher employment and spending. If economic indicators like unemployment, consumer confidence, and spending do not improve, the national economy could impede growth of individual businesses.

If economic indicators like unemployment, consumer confidence, and spending do not improve, the national economy could impede growth of individual businesses.

The challenge here is not expectations as to whether or not the GDP will grow—in fact, 93 percent of the survey respondents expect the economy to grow. The issue is how robust that growth will be. Only 20 percent of the respondents anticipate it will expand by more than 3.5 percent this year—the pace economists say is needed for real job growth.

Government debt

One would expect government debt to be a major issue for legislators, federal contractors, sectors dependent on government financing, public employees' unions, and government budget officers. But it was striking that government debt at the federal, state, and municipal levels was most commonly listed as a hurdle to growth in this survey of mid-market executives. Specifically, 50 percent of those polled believe federal, state, and municipal debt is among the obstacles to U.S. growth in the coming year.

Regulatory issues

Unsurprisingly, concerns of mid-market executives include a mix of rising costs and legislation in areas such as taxes and health care, as well as general uncertainty about the impact of regulation on the economy. Combined, these factors are adding a significant degree of caution to the optimism of mid-market business leaders. Many are taking a more risk-averse, "wait and see" approach to investment and growth, reflecting a somewhat guarded approach to the prospects of economic growth and recovery.

In addition to government debt, a significant portion of the mid-market community points to rising health care costs (33 percent) and high tax rates (30 percent) as barriers to growth. Another 23 percent identify recent federal health care reform as an obstacle and express interest in rolling back that legislation.

Companies cited a number of other policies that they believe would spur mid-market growth, including reducing corporate tax rates (33 percent) and keeping interest rates low (32 percent).



Stay private or go public? An ongoing debate

Staying private versus going public is a question that many private companies consider at some point. And although going public may seem to be the most logical next step for high-growth companies, recent headlines have centered on several prominent ones that are holding off on IPO filings longer than normally would be expected. The survey picked up on this trend, confirming a desire to stay private or at least stay private for a little while longer.

Of the companies surveyed, nearly 80 percent indicate they are privately held. Only 8 percent of those companies reported possible plans to go public in the next year, which is a surprisingly small number. The actual number of companies that will execute a public offering will likely be much smaller than that.

There are a variety of reasons companies are choosing to stay private longer. The most popular, with 68 percent responding, is the desire to maintain control and flexibility when it comes to decision-making. Just over one-third (36 percent) want to keep their information private, and 32 percent consider regulatory requirements too burdensome.

However, according to those companies in the survey that are public or considering going public, there are benefits to going public, including some that go beyond financing. The decision can be a way to raise the visibility of their business (43 percent), to provide liquidity for owners (33 percent), and to harness the cost-effectiveness of equity capital (32 percent).

Lessons from the recession: Thriving in the “new normal”

The tempered optimism expressed by mid-market firms is driven in large part by their own survival. Many companies learned valuable lessons about how to maintain operations when business conditions deteriorate. The fact that more than 40 percent of those surveyed fall among “frontrunners” highlights the resiliency and nimbleness of the mid-market segment.

Approaches that helped firms survive the recession, and should serve them well in the future, include a focus on reducing debt, making necessary capital investments without overleveraging, limiting overhead through cost-cutting, and attracting and retaining customers. Some thrived and others struggled to adjust to this new reality, but both sides validated the concept of “corporate Darwinism”—survival of the fittest in the middle market.

Many mid-market firms have navigated the recession well and are ready to push ahead with national and international growth plans. However, they are more watchful of economic indicators, and are ready to retreat from growth plans if the marketplace, operational costs, and government decisions do not continue to move in their favor. Having survived the worst of the crisis, they understand the need for caution, recognizing that risk management is critical to every new endeavor.

The lessons shared by the mid-market leaders are helpful in understanding the “new normal” and what companies in this critical segment face today.

Deleveraging: the common denominator

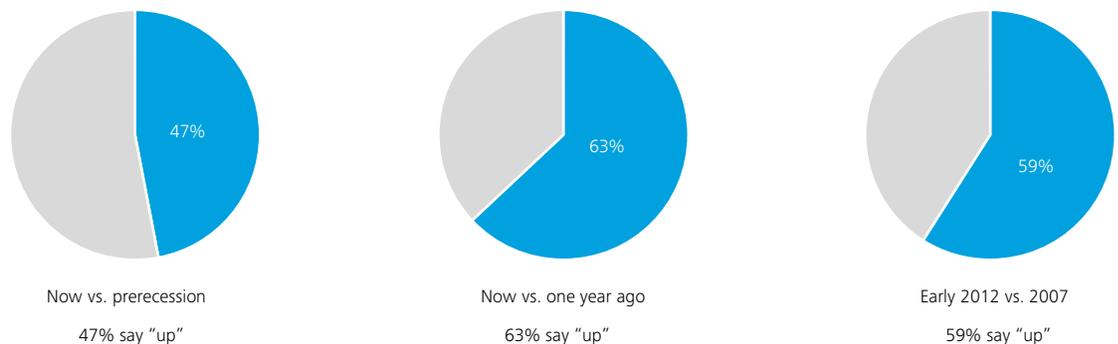
Although growth is important, when companies must choose between expansion and taking on new debt or paying down obligations and improving their core businesses, most mid-market companies are opting to reduce their debt. In fact, 65 percent of respondents report debt ratios below prerecession levels and say they will stay lower during the next year.

Some mid-market CEOs say deleveraging is a lasting impact of the downturn. Looking ahead, most respondents say that any new financing will be used to support only the most critical strategic growth plans.

Pacific Ethanol is a prime example of a mid-market company with high debt when the economic crisis hit. The company borrowed heavily to grow fast in the boom years, and found itself overleveraged and unable to maneuver during the recession. As a result, the manufacturing facilities were forced to file for bankruptcy. But the company restructured and is now rebuilding. “We now have three of the four ethanol plants running ... and are back on our feet as the ethanol industry has stabilized and the economy is also coming around,” CEO Neil Koehler says.

Mr. Koehler now recognizes that he should have built those same plants with more equity and less debt. The company has emerged with a 20 percent equity ownership and a management contract for all production assets, which puts it in a better position than many competitors,

Figure 9: Capital investment
Is capital investment up or down, and will it soon top prerecession levels?



and its \$300 million debt is down to \$60 million. But “certainly we would have been more resilient in dealing with the economic downturn if we had had less debt,” Mr. Koehler says.

Interestingly, when survey participants were asked to identify the three main obstacles to their own company’s growth, availability and cost of credit was eighth in popularity. This response, coupled with the fact that 59 percent of mid-market firms expect debt burdens to be lower in one year’s time, suggests that companies will continue to rely less on credit than they have in the past. Whether this trend will be temporary or represents a new operating baseline remains to be seen.

Investing in the future:

low-risk capital investment to support growth

Although they are not planning to increase debt, many firms also have focused capital-investment decisions on making sure to support, or at least not jeopardize, their long-term goals. Fifty-three percent of respondents say that capital investment is lower than it was before the recession, but 63 percent indicate that it is higher than it was a year ago—a figure that rises to 71 percent among companies with annual revenues of \$50 million to \$1 billion. Moreover, 59 percent of respondents say that in a year’s time, capital investment will be higher than it was before the recession (see Figure 9).

Again, investment decisions have been deeply strategic. For example, Trina Gordon, president and CEO of Boyden, says, “One of the things we’ve learned from our history is that if you do not continue to consistently invest, good times or bad, you’re going to feel the impact. Those levels may have to vary, but consistency against the strategy, consistency in the investments that we know will result in elevating our name and sharpening our abilities to better serve clients, has to be paramount year in and year out.”

Others agree. “We just kept investing in our technologies and the research and development of continually improving our technologies,” says John Shegerian, CEO of Electronic Recyclers.

Similarly, Specialized chose to increase spending on research and development by 15 percent during the downturn, says CEO Mike Sinyard. “We had been planning to do it anyway and saw no reason not to go forward because our riders rely on our quality,” he says.

Winners and losers: mapping the postrecession landscape

When analyzing the survey data, the EIU identified three distinct types of companies with a number of differences and similarities. For instance, many mid-market firms have positioned themselves for growth by using the downturn to optimize operations and clean up balance sheets. A cluster analysis¹ of the survey responses shows that a significant number expect the coming year to bring global and U.S. expansion, higher revenues and profits, a general deleveraging, and strategic hiring while maintaining high productivity. Others are still reducing their headcount, having difficulty finding credit, and are seeking financing for debt restructuring instead of expansion. Although some are lagging, even those that are not out in front are cautiously optimistic and expect to see some growth.

Group 1: Frontrunners

These 230 high-performing companies are flush with cash and continuing to invest capital in their businesses, despite the downturn. They outperform the mid-market masses in most major performance metrics, report better credit availability and costs, and intend to hire and expand. Nearly a quarter of these companies expect to acquire a direct overseas competitor.

Group 2: Keeping pace

These 112 companies hover between the frontrunners and the laggards, reporting business metrics that fall between the two. They expect to use new financing for expansion at nearly the rate of the frontrunners. A larger-than-average proportion of these companies say the uncertain economic outlook is a major obstacle to their growth.

Group 3: Laggards

These 185 companies exhibit substantially weaker business health than the frontrunners. They report more difficulty finding credit and higher costs for the credit they do find. They more often plan to seek financing for debt restructuring than for expansion. They are far more likely than the frontrunners to reduce their workforce to cut costs and less likely to be adding jobs to support growth strategies. Most see the uncertain economic outlook and weak market demand as major obstacles to growth.

¹ Each “cluster” comprises companies that are statistically shown to share a significant number of characteristics based on Kohonen self-organizing network mapping.

Creative cost-cutting: limiting overhead

For most, the recession was a call to attention with respect to overhead, staffing, and productivity. For those that were on a high-growth trajectory before the crisis, the sudden pause led to hypervigilance and a regrouping, rather than a restructuring.

“Our reaction to the onset of the recession was just to stop hiring and freeze salaries,” says Mr. Waggoner of Echo Global Logistics. “It kind of reset the baseline. By the end of the second quarter [of 2009], we had resumed our growth rate, started hiring again and resumed our business plan.”

Mr. Shegerian of Electronic Recyclers says his company, which recycles electronics from consumers, businesses, and government agencies, recognized that the demand for recycling was dropping because the rate of turnover in electronics declines as business and household spending contract. At the same time, depressed commodities prices meant less income from the sale of recycled components such as metals.

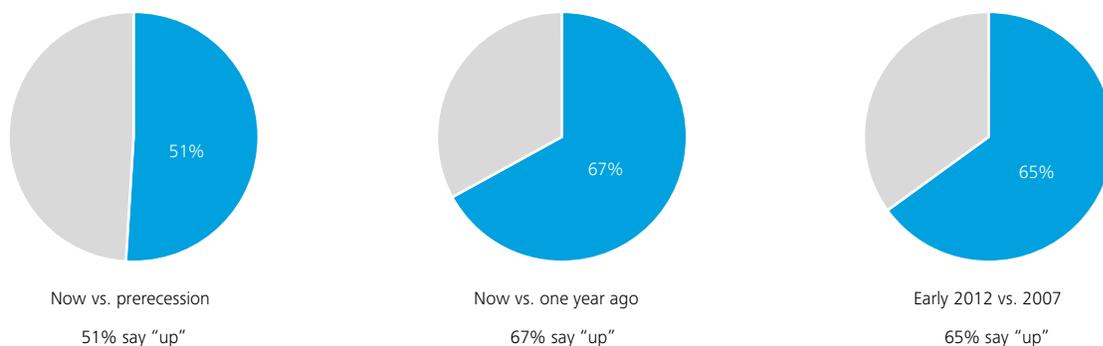
The economics “forced us to be a smarter business, rightsize our company, and reevaluate everything we were doing,” he says. As a result, the recession brought a slowdown in the rate of growth, not a contraction. In fact, the company’s revenues rose by 15 percent to 20 percent in 2008 and 2009, and then by 30 percent in 2010.

Even when revenues contracted, farsighted firms remained profitable by being nimble and creative (see Figure 10). Bob Duncan, CEO of American Leather, a custom furniture maker, says the company first targeted easier cuts in advertising spending and small-scale staff reductions. As conditions worsened, they looked for more drastic solutions such as eliminating 401(k) matching, furloughing workers for a week over school breaks, then docking pay over three months to ease the impact.

Today, as conditions improve, American Leather remains vigilant, says Mr. Duncan. “What we don’t want to see is overhead increasing at the same rate sales are coming back.” The recession, he says, has reinforced the importance of knowing the business’s cost structure and setting and adhering to a budget.

Others concur. “At the same revenue level, we’re much more profitable than we were before the downturn, because of our attention to detail and focus in those areas,” says Patrick Henry, CEO of Entropic Communications. Mr. Henry credits lessons learned from the 2001–02 semiconductor recession for his firm’s success this time around: “We were proactive. We made tough choices around what to stay and what to get out of—all based on previous experience.”

Figure 10: Revenues
Are revenues up or down, and will they soon top prerecession levels?



With that stated, mid-market CEOs approached downsizing cautiously during the recession because they recognized that even small reductions would have a powerful impact on culture and morale.

Mr. Waggoner, CEO of Echo Global Logistics, notes that his firm was hiring 40 people per month before the recession. Then he had to make tough decisions. "I didn't want to destroy the culture if I could help it," he says. "So, I withheld laying people off and cutting pay, and we just reacted by stopping the hiring rate and regrouping—making sure we could continue to grow in that economy."

Customer-centric: finding new ways to provide value to customers

"In many ways, we got stronger as a business during the downturn," says Diane Irvine, CEO of Blue Nile, the largest global online retailer of diamonds and fine jewelry. When the recession caused Blue Nile's business to drop off, the company used it as an opportunity to refocus, investing in improving the customer experience and expanding product lines and its customer base to meet the needs of a broader population. Those efforts helped the business survive, and positioned it as an industry leader for the future. "We firmly believe we will gain more market share than the rest of the industry," says Ms. Irvine (see Case studies, page 22).

Dealer.com's CEO, Mark Bonfigli, says his business actually thrived during the recession thanks to its limited size and niche market. The online company provides marketing solutions to the majority of the auto dealers in Canada and about a third of those in the United States. "We had very aggressive growth during the downturn, mainly because when auto dealers and manufacturers have their backs against the wall, they transition money out of conventional advertising," says Mr. Bonfigli. In 2010, the company experienced about 60 percent revenue growth, and he is projecting revenues will surpass \$100 million for 2011. Clients "are probably only using one-fifth of what we offer," he says. "The big opportunity for us is to start educating our clients on everything we have, and get them to use maybe half or three-quarters of the products we offer. That's an opportunity that's in the hundreds of millions annually."

Corporate Darwinism: become the best at what you do

As mid-market firms look ahead, they take with them important lessons learned from the downturn: stay hypervigilant to changing market conditions but firmly focused on long-term strategic goals; keep investing in strategic imperatives but remain agile; maintain a healthy balance sheet; and use customers and suppliers as divining rods of potential disruptions and opportunities. These strategies can enable them to keep their business propositions relevant and vibrant for the long term, while helping increase market share and expand into new markets in a sustainable way.

"These kinds of downturns become a form of corporate Darwinism," says Mr. Shegerian of Electronic Recyclers International. "It either makes you the best at what you do, or it wipes you off the board."

That sentiment was echoed by others, including Mike Sinyard, CEO of Specialized. "We looked at the downturn as a beginning to a new world order," he says. "Our attitude was 'never waste a crisis.' A crisis is a tipping point. It often requires quick change, and if you respond quickly, it offers opportunities. You can seize the moment or let it pass."

"These kinds of downturns become a form of corporate Darwinism. It either makes you the best at what you do, or it wipes you off the board."

John Shegerian — Chairman and CEO, Electronic Recyclers International



Conclusion

As economists, politicians, policymakers, and the media ponder the outlook for GDP, employment, consumer confidence, and demand, little attention has been paid to the middle market. Yet this segment generates an enormous amount of wealth and employment in the United States, making it a vital player in the recovery and the overall economy.

Mid-market firms do not seem to be relying on growth alone to ensure their success. Rather, the recession taught them how to assess the benefits and risks of opportunities and how to deliver high-quality goods and services with a lean staff and a limited budget. The nimbleness and adaptability that served them well during the recession can help them take advantage of future opportunities.

Still, concerns loom on the horizon. The threat of inflation remains, and oil prices spiked sharply just after these executives were polled. Many will have to consider to what degree they should pass input-cost increases on to customers. Companies have been successful in doing so thus far, but if they face weak demand while trying to expand their customer bases and target markets, microeconomic decisions such as pricing will prove to be even more critical. It should be noted that the tragedy in Japan also hit after the study was completed, and it is too early to gauge its impact on global supply chains and economic growth.

Good business practices honed during the worst of the recession should help mid-market businesses maximize their growth potential in the coming years. They've streamlined their operations, invested in their people and culture, and proven to themselves and the marketplace that they are agile and resourceful enough to weather any storm.

Mid-market business owners are smarter and more experienced today for having survived the recession. The knowledge they've acquired can help their organizations grow and better enable them to manage unexpected crises in the future.

Is inflation on the horizon?

Only time will tell if the prevailing environment will be inflationary or not as the economy recovers. Among survey respondents, 28 percent report that the cost of raw materials and other input costs, including energy, is a main obstacle to their companies' growth, indicating that inflationary pressures would seriously jeopardize strategic growth plans.

"We probably have a couple of them [challenges to growth], since it's very topical at this point in time," says Bill Wulfsohn, CEO of Carpenter Technology. "The price of oil and the general health of the U.S. economy are very important to us. If the price of oil goes up to the point that it affects, for example, the prices of airfares and as a result there's less demand for people to fly and fewer aircraft needed to be built, that would affect our business. That would be something that we would be concerned about as so many other businesses would be."

Case studies

Carpenter Technology: “Our customers are increasingly global in their operations ...”

When the recession hit, many crumpled under the pressure, giving up strategic goals and hunkering down to survive. But Carpenter Technology would not be pressured into giving up its long-term vision. The company produces specialty alloys and highly technical applications to segments such as aerospace, energy, and medical devices. This niche positioning has given the company longevity while other steel companies have faltered, largely because of constant investment in new and innovative solutions for its customers.

Carpenter Technology’s aim did not waiver during the recession, says CEO Bill Wulfsohn. The decision to expand in research and technology, market new technology, and build capacity in premium alloys was made before the recession, and the company opted to sustain those investments while reducing costs and downsizing productive capacity to match declining demand.

“If we hadn’t made that investment or sustained that investment, we would have run the risk of falling back into more of a commodity-type market orientation as technology typically matures—and that would affect our differentiation over time,” notes Mr. Wulfsohn. “That would have been a dangerous strategic proposition for the company.”

“... we have to keep our financial model intact and pull the right levers ...”

Diane Irvine — CEO, Blue Nile

Its strategic ambitions also required Carpenter Technology to look for opportunity globally and to make sure it was globally competitive. “We very much want to capture the growth that’s associated with markets that are growing, and support our customers as they grow their operations,” says Mr. Wulfsohn. “But we also have unique materials and production capabilities. If we don’t fill those needs, competitors will emerge that will fill those needs, and—over time—they’ll come back into other markets in which we’re stronger today. So, globalization is both an opportunity and a means to strategically sustain our existing competitive differential and position.”

Today, about 36 percent of what Carpenter Technology produces or sells is consumed outside the United States. “Our customers are increasingly global in their operations, and with that, we need to support them,” says Mr. Wulfsohn.

Blue Nile: “We firmly believe we will gain more market share than the rest of the industry.”

Blue Nile, the largest online retailer of diamonds and fine jewelry, used the recession to refine its reach and improve its customers’ experiences. Its careful investment in new markets and technologies enabled the company to develop a broad global reach and provide a high-quality experience for its customers.

Blue Nile’s online-only presence means it can procure from suppliers on a real-time basis, optimizing cash flow and minimizing overhead. Its revenue per employee is about \$1.6 million—“almost unheard of in most retail businesses,” says CEO Diane Irvine—and gross margins are 21 percent to 22 percent.

While the business model is efficient and profitable, it’s also lean. And when sales suddenly slowed after the Christmas of 2007, it was the beginning of a tough year.

But rather than cutting corners, Ms. Irvine’s focus remained on investing in the customer experience—everything from broadening the product assortment to enhancing Web site features and functionality. “We learned that we have to keep our financial model intact and pull the right levers ... and keep the customer at the forefront of what we’re doing,” says Ms. Irvine.

The recession also caused the company to explore new avenues for sales. In 2008 and 2009, despite the downturn, Blue Nile expanded its reach overseas. “We felt we needed to cast a wide net, and launch Web sites and offer the ability to purchase in local currency to consumers around the world,” Ms. Irvine says. International sales, across 40 markets, now represent 13 percent to 14 percent of overall revenue and are likely to be the source of robust growth.

In 2010, Blue Nile made mobile a bigger priority, launching an iPhone app and a mobile Web site to help consumers comparison-shop. E-commerce is now Blue Nile’s fastest-growing revenue stream. The company is also looking to expand its core diamond-engagement business, broaden the assortment of non-engagement jewelry, encourage repeat business, and drive growth in related purchases at lower price points.

All of these efforts helped the company ride out the recession, and positioned it as a leader among its peers. “We firmly believe we will gain more market share than the rest of the industry,” Ms. Irvine says.

She notes that the key was to focus on the things that were within her control. “We cannot control the economy or the external environment, and we can’t control how consumer spending operates,” she says. “But we can be here for the people who are in the market, and give them a better and better experience.”

Pacific Ethanol: “The world has changed ... our strategy really hasn’t.”

For ethanol producers, the effects of the recession were compounded by industry specifics. The industry had been on a high-growth trajectory to meet the growing needs of a robust economy and the ever-increasing call for renewable fuels for refining. But then the recession tamped fuel demand, while the sector simultaneously dealt with the effects of rising corn prices. “We hit the proverbial wall,” says Neil Koehler, CEO of Pacific Ethanol.

Pacific Ethanol had borrowed heavily to grow fast in the boom years, and the company was too overleveraged to maneuver when the recession began. As a result, the manufacturing facilities were forced to file for bankruptcy. But the company restructured and is rebuilding. “We now have three of the four ethanol plants running ... and are back on our feet as the ethanol industry has stabilized and the economy is also coming around,” he says.

Mr. Koehler recognizes now that he should have built those same plants with more equity and less debt. The company has emerged with a 20 percent equity ownership and a management contract for all production assets—which puts it in a better position than many competitors—and its \$300 million debt is down to \$60 million. But, he says, “certainly we would have been more resilient in dealing with the economic downturn if we had had less debt.”

Being a public company in a highly visible industry proved to be an advantage in the restructuring, says Mr. Koehler. “We’re a very public industry, so there is a lot of interest from investors and great liquidity in our stock, which has allowed us to access capital markets in a way that would not have been possible if we were a private company.”

Certainly, there was no guarantee of survival or success as a public company, he notes. “But in our case, it was very much worth the cost and was a key ingredient for our continuing to be able to proceed with our business.”

Pacific Ethanol was able to restructure its plants as a separate entity and, working with lenders, converted much of its debt into equity: “The public markets allowed us to go out and raise financing so that we could then recapitalize our ownership interest in the plants.”

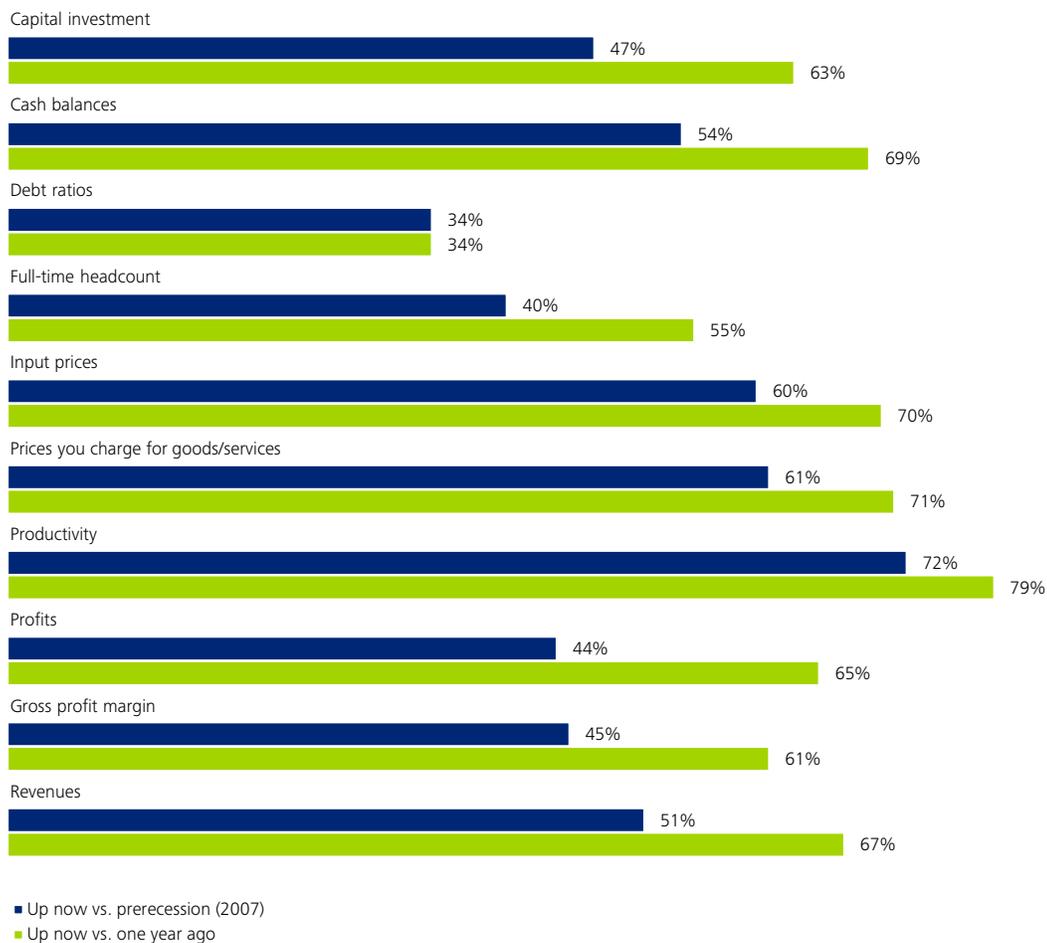
Despite the turmoil, Pacific Ethanol remains focused on the same strategic vision it espoused when it went public in 2005: “The world has changed and our industry has changed, but our business strategy really hasn’t. It still is to be the leading producer and marketer of the lowest carbon renewable fuels in the western United States.”

Appendix: full survey results

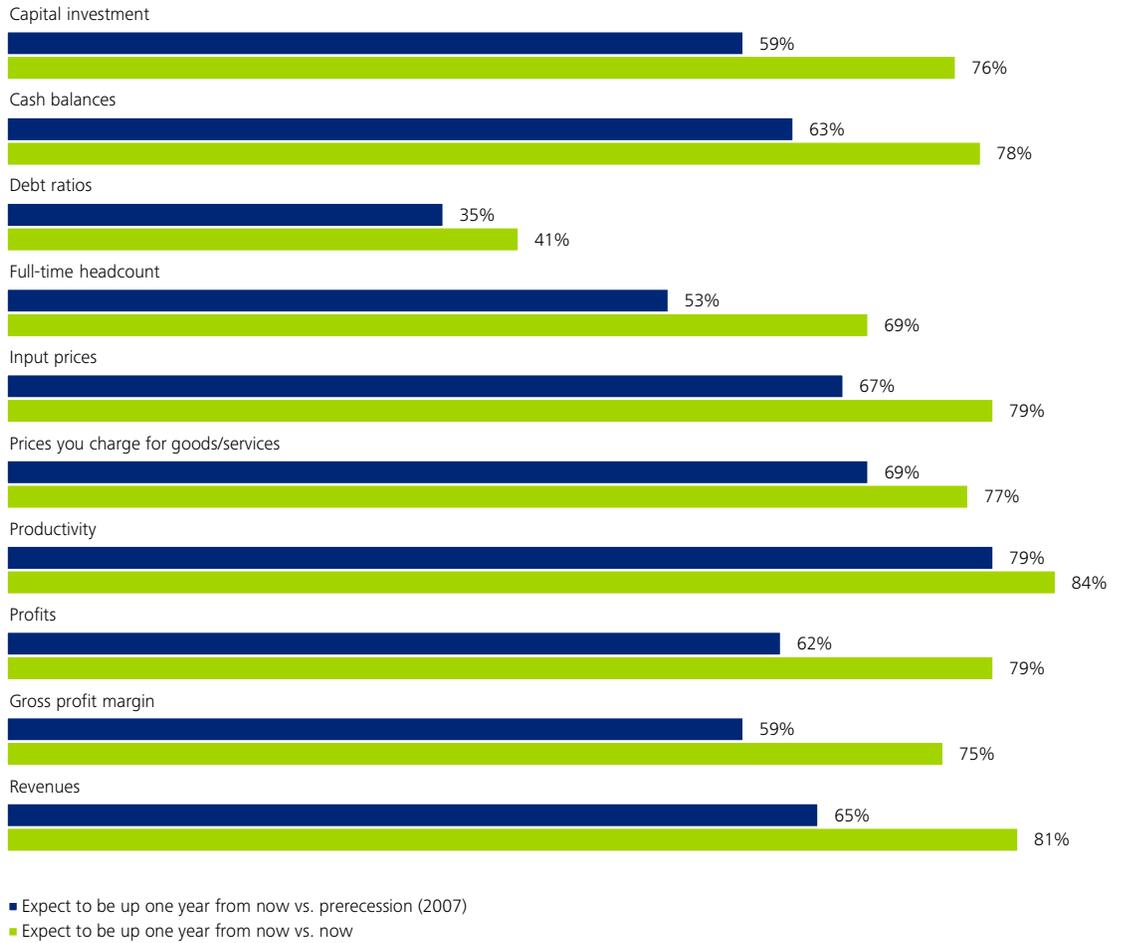
The survey conducted for this report encompassed both private and public companies with annual revenues of between \$50 million and \$1 billion. The Economist Intelligence Unit surveyed 527 senior decision-makers at these companies. Percentages may not add to 100% due to rounding or the ability of respondents to choose multiple responses.

Business metrics

Are the key metrics of your business up or down?

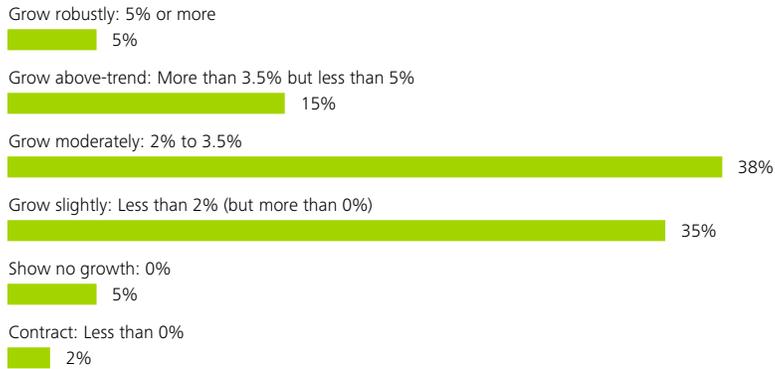


Do you expect the key metrics of your business to go up or down?

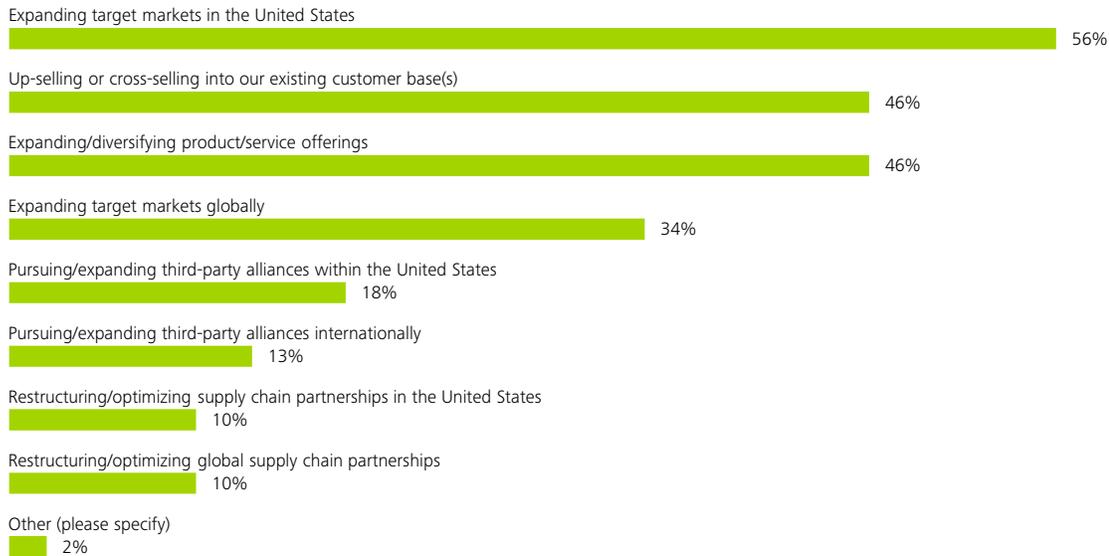


Growth

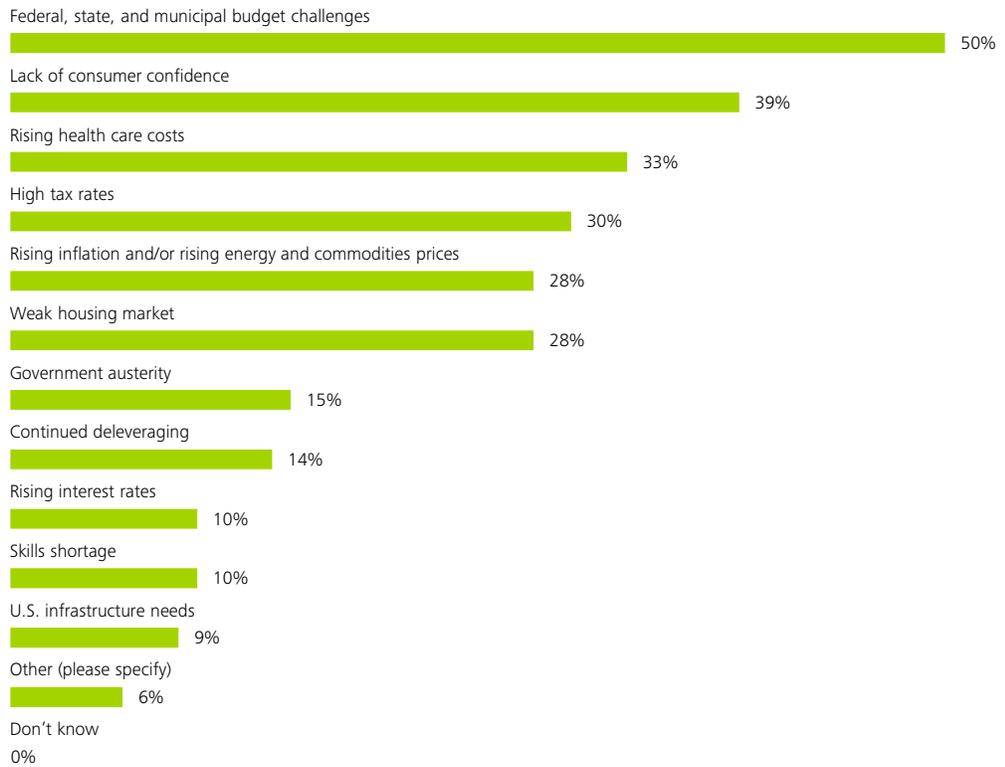
At what pace do you expect the U.S. economy to grow in 2011?



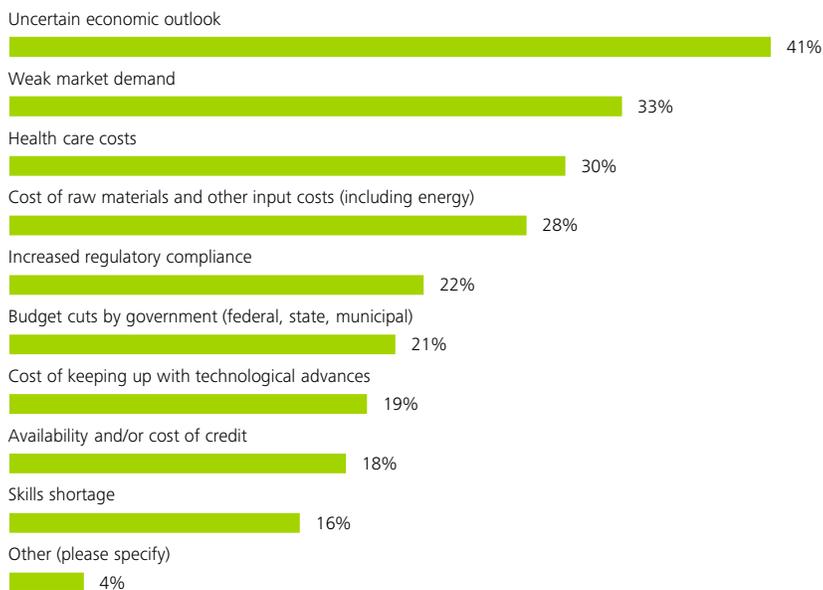
What will be the main focus of your company's growth strategies over the next year?



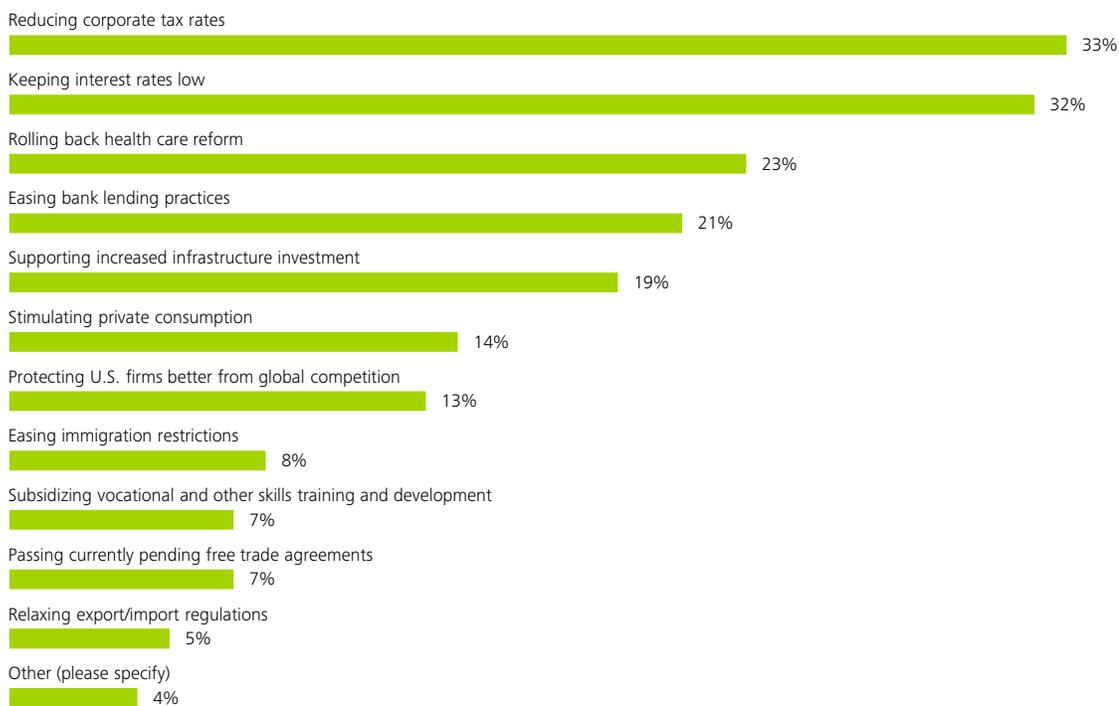
Which of the following issues present the greatest obstacle to U.S. growth in the coming year?



What are your company's main obstacles to growth? Select up to three.

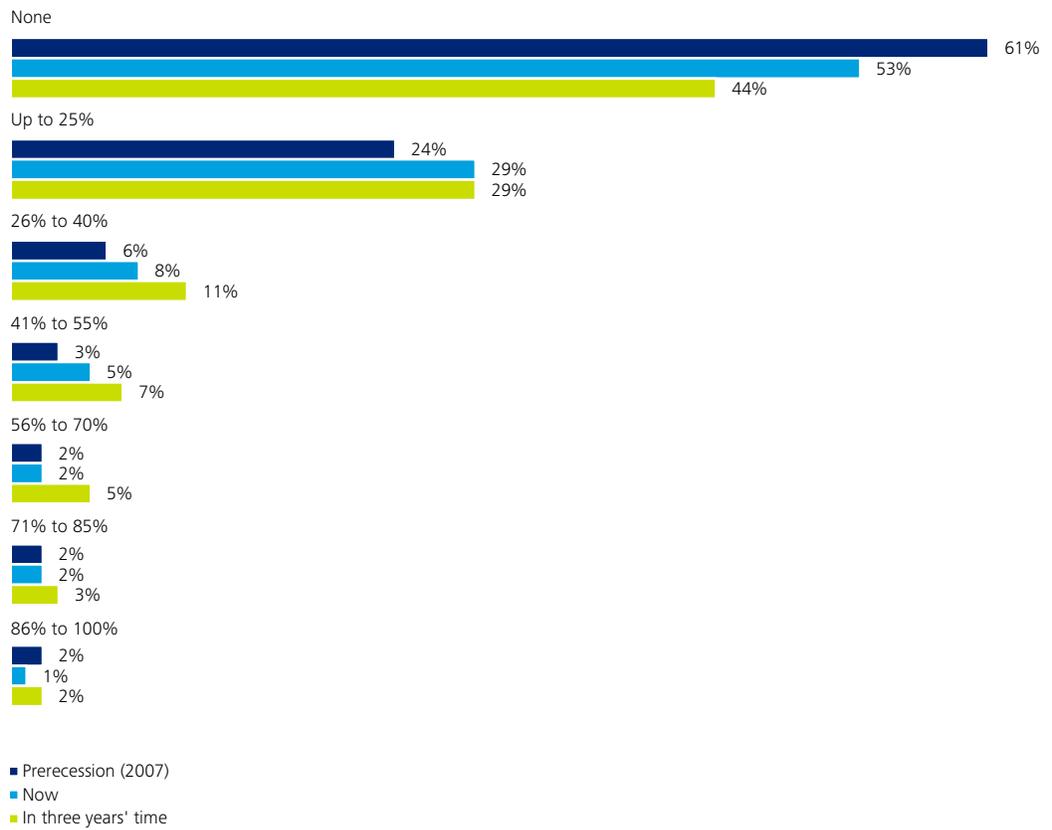


Which of the following measures by the U.S. government would most help U.S. mid-sized businesses to grow in the next year? Select up to two.

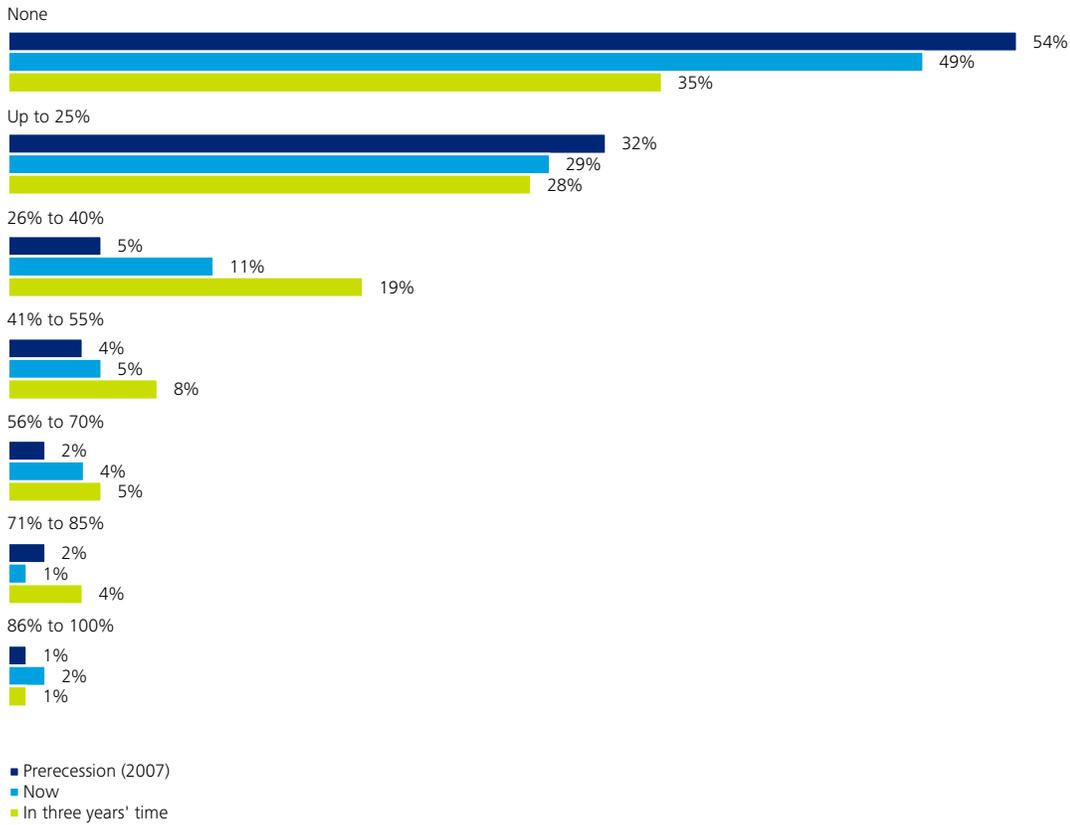


Global

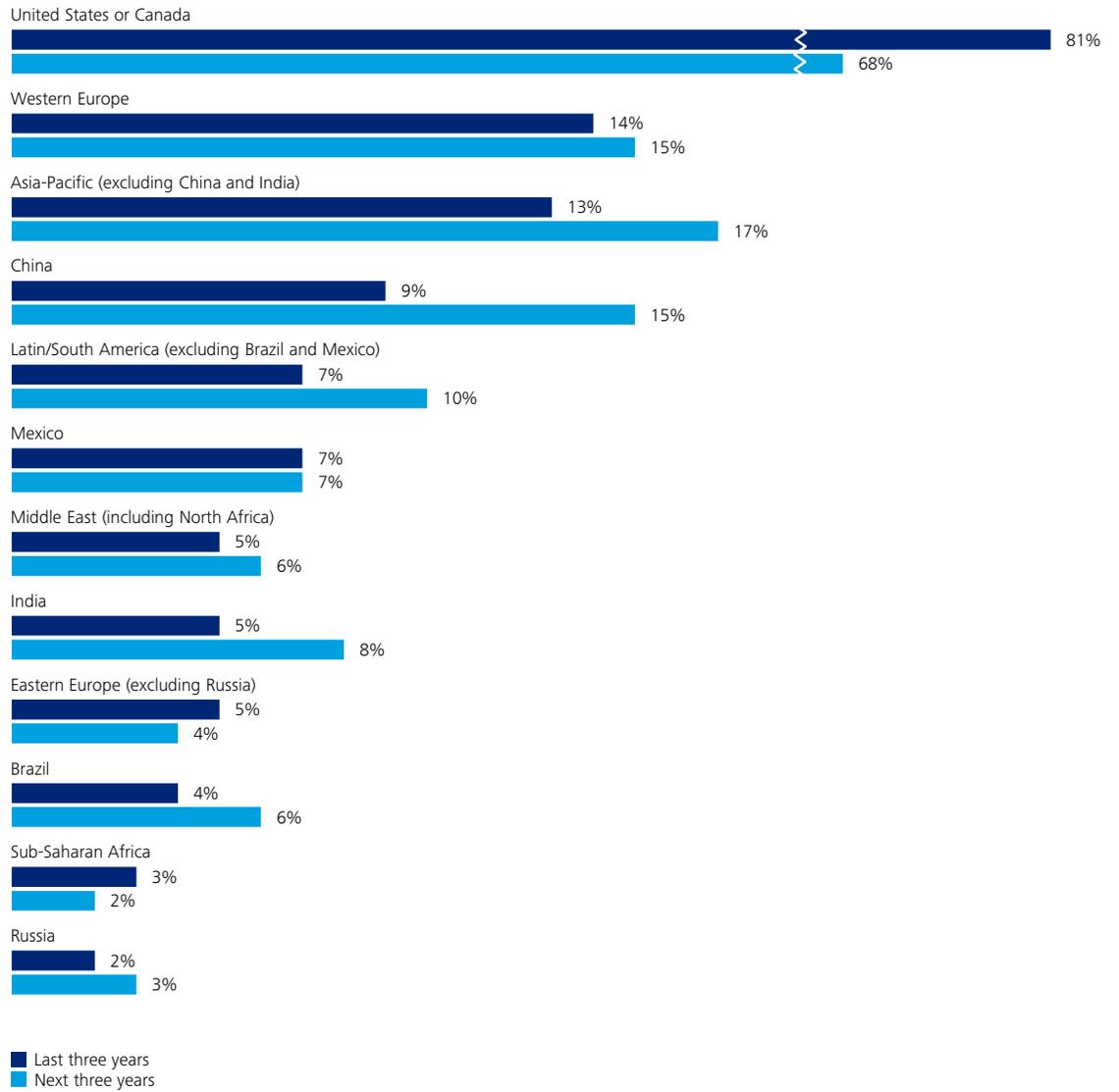
Please specify the percentage of your workforce based outside the United States.



What proportion of revenues comes from overseas?

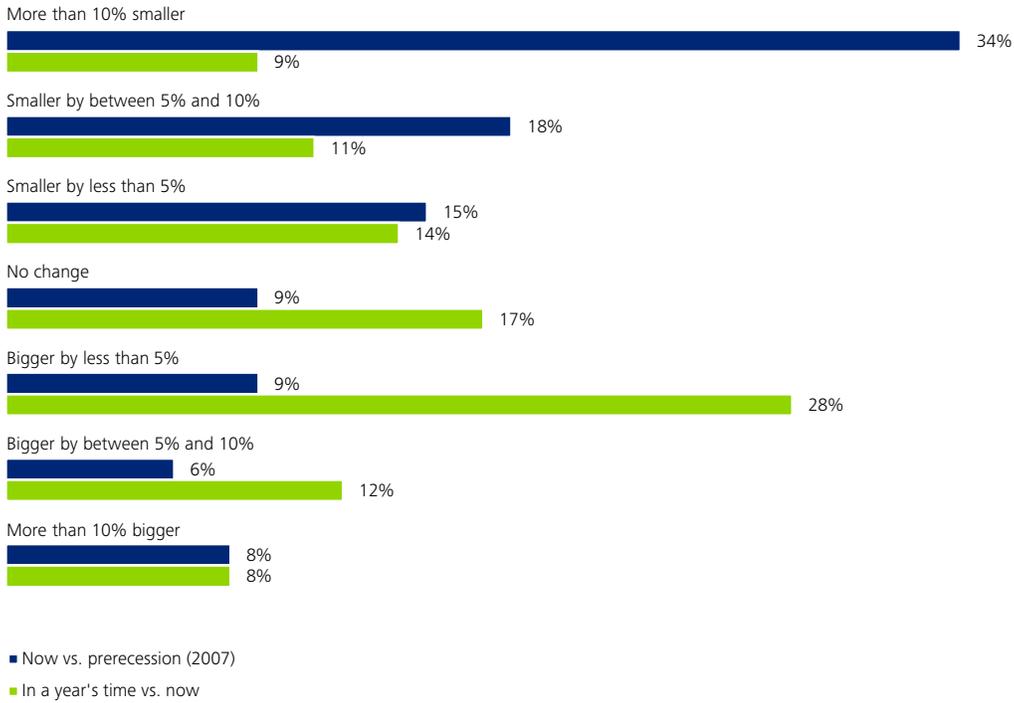


Which geographic markets have contributed the most to your company's growth?

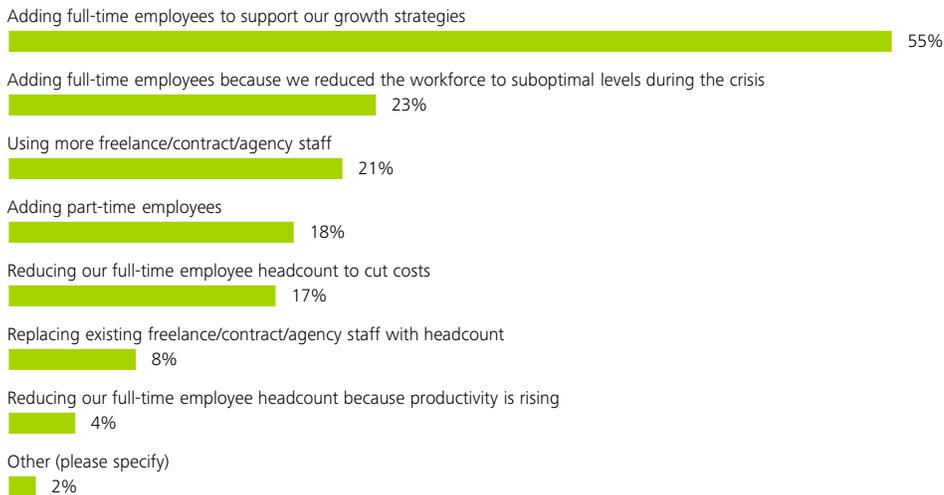


Workforce

Is the size of your full-time domestic workforce changing?

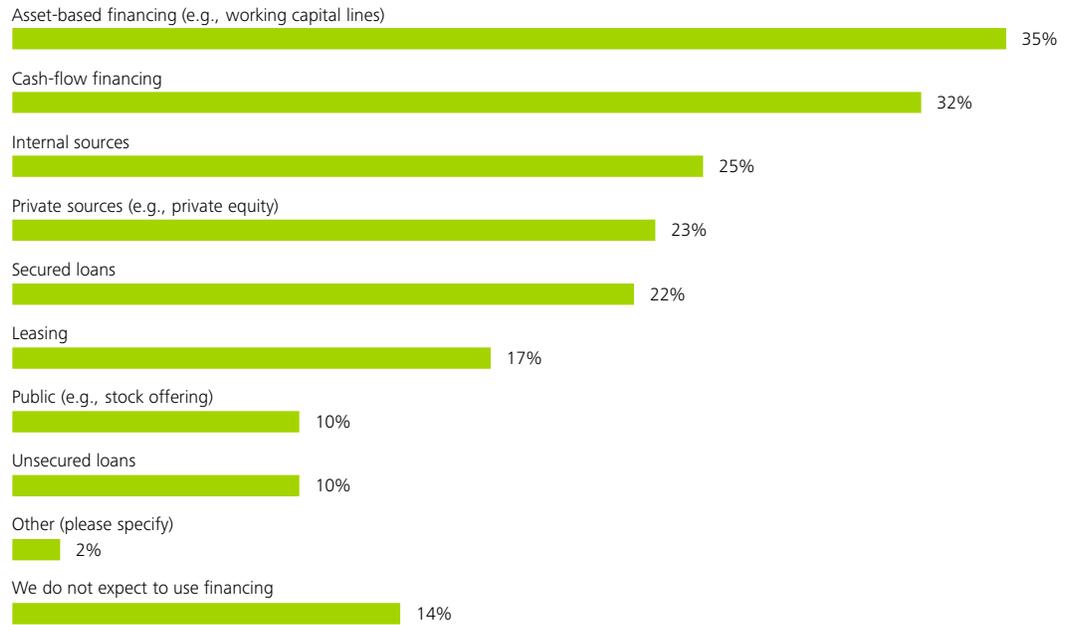


What is likely to be the main focus of your company's domestic employment strategy in the coming year? Select up to two.

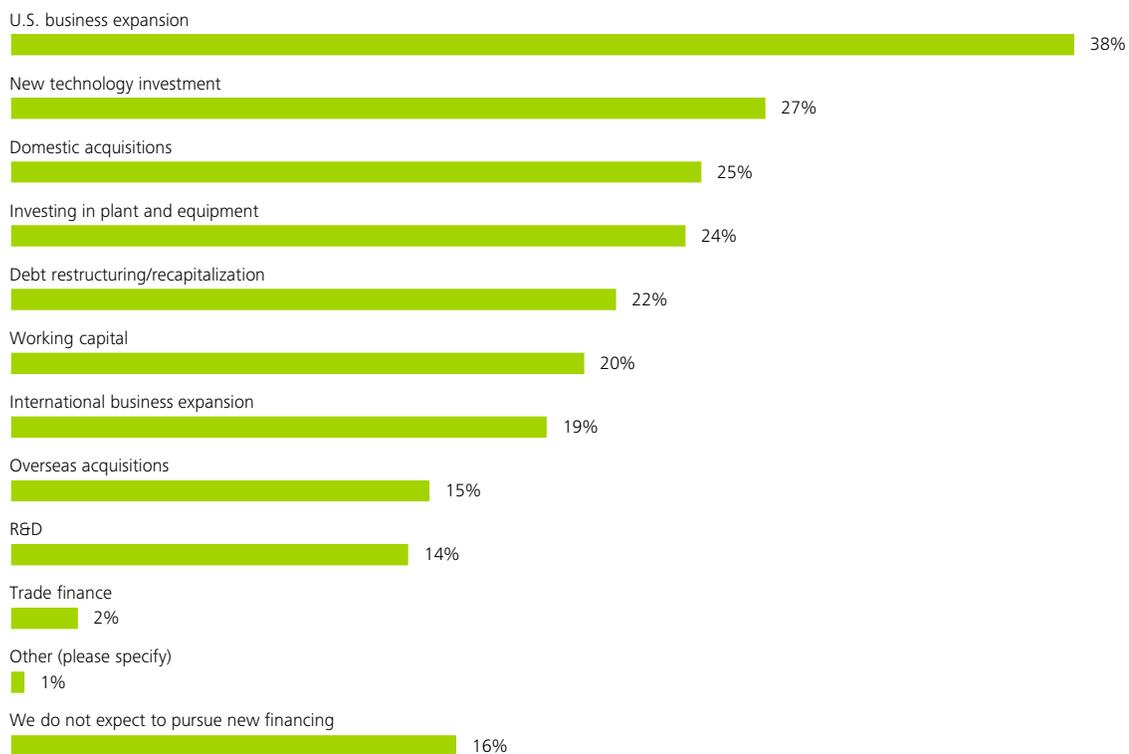


Financing

What types of financing do you expect your company to pursue in the next year? Select all that apply.



For what purposes will your company pursue new financing in the next year? Select all that apply.



Is it easier or more difficult for mid-market companies in your industry to secure credit now than it was a year ago?
Please respond based on your understanding of industry conditions, whether you have applied for each type of financing or not.

Asset-based financing



Cash-flow financing



Internal sources



Leasing



Private sources (e.g., private equity)



Public (e.g., stock offering)



Secured loans



Unsecured loans

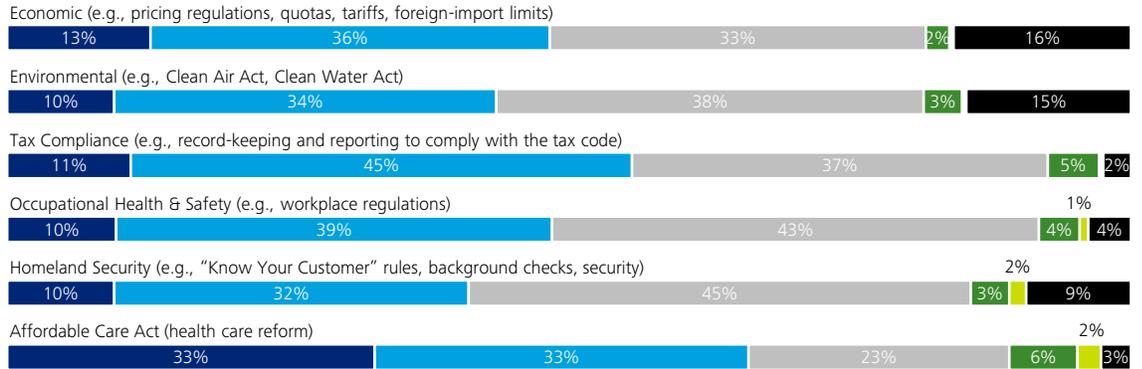


■ Much easier
 ■ Somewhat easier
 ■ No different
 ■ Somewhat harder
 ■ Much harder
 ■ Don't know
 ■ Not applicable

Are the costs of credit higher or lower now than they were a year ago? Please respond based on your understanding of industry conditions, whether you have applied for each type of financing or not.



How will the costs of regulatory compliance change for your business in the next year?



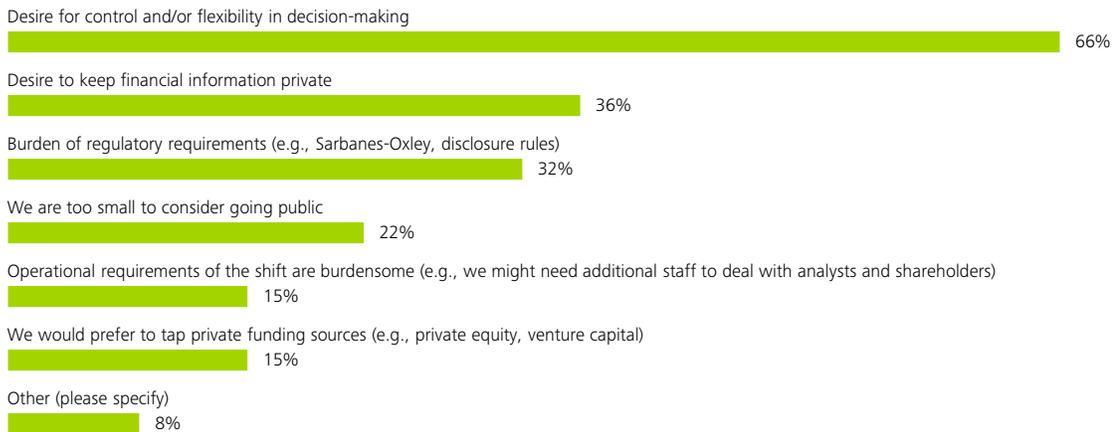
■ Costs will rise sharply
 ■ Costs will rise slightly
 ■ Costs will be the same
 ■ Costs will drop slightly
 ■ Costs will drop sharply
 ■ Not applicable

Public vs. private

What is your company's current ownership structure?



What factors influence your company's decision to remain private for now? Select all that apply.

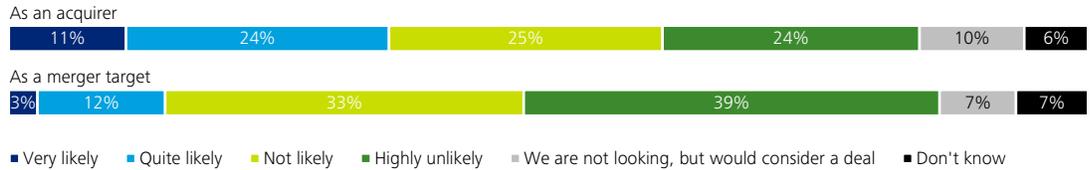


What factors influence your company's decision to be or go public? Select all that apply.

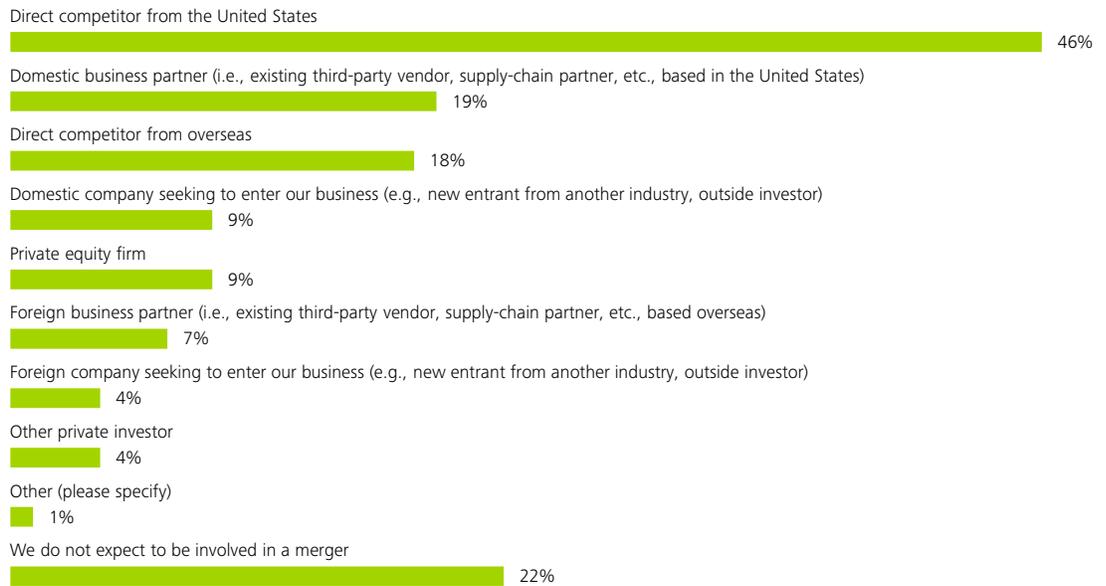


Mergers and acquisitions

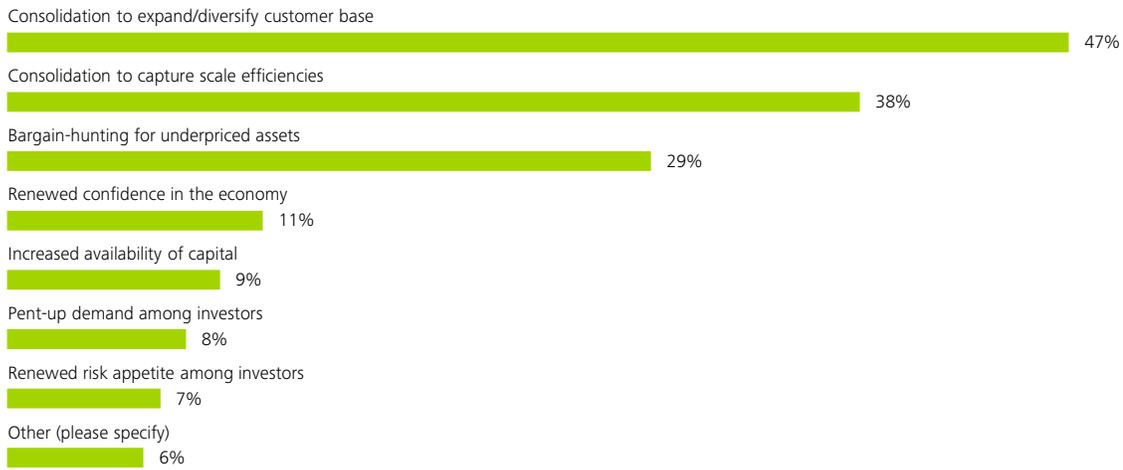
Is it likely you will participate in a merger or acquisition in the coming year? Select one.



If you participate in a merger or acquisition, which of the following entities is most likely to be the counter-party? Select up to two.



What will be the main drivers of merger activity in your industry in 2011? Select up to two.

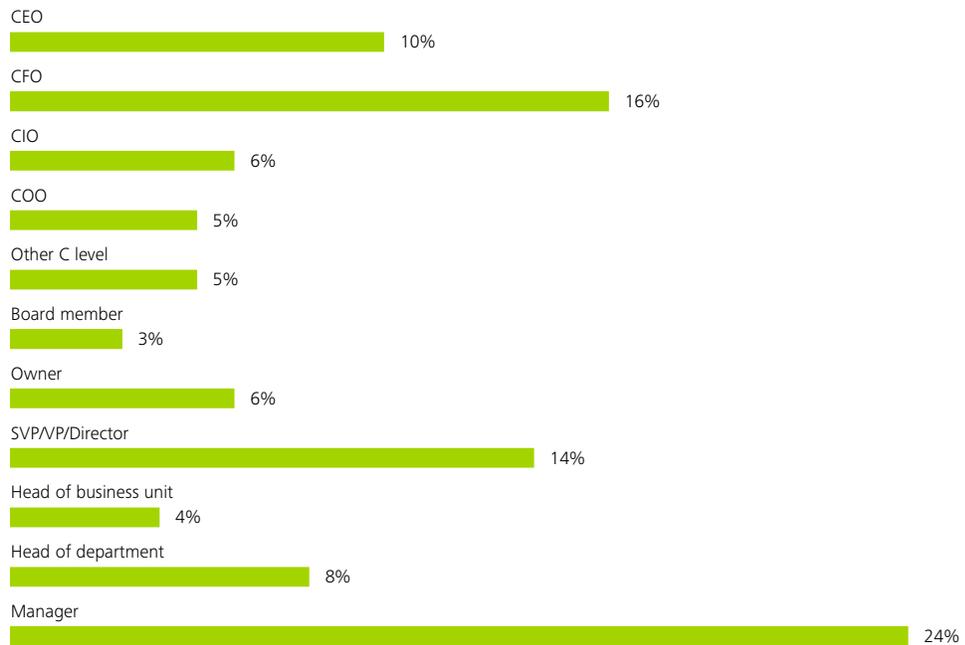


Survey respondent demographics

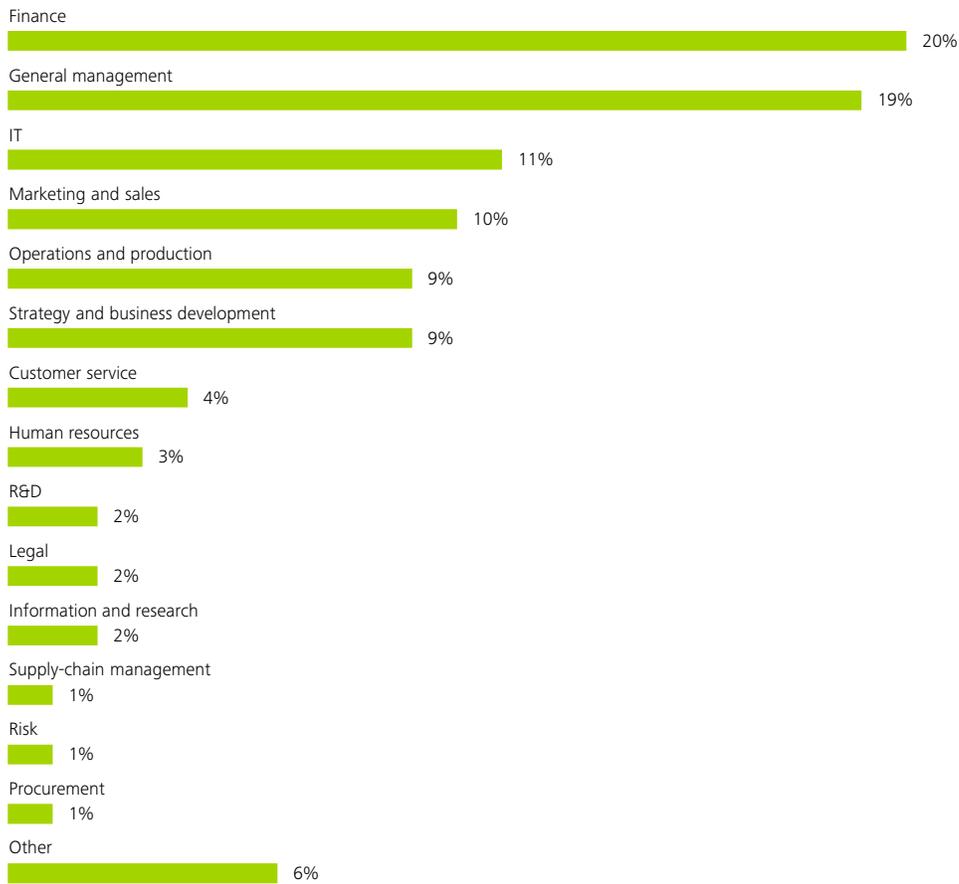
What is your company's annual revenue in U.S. dollars?



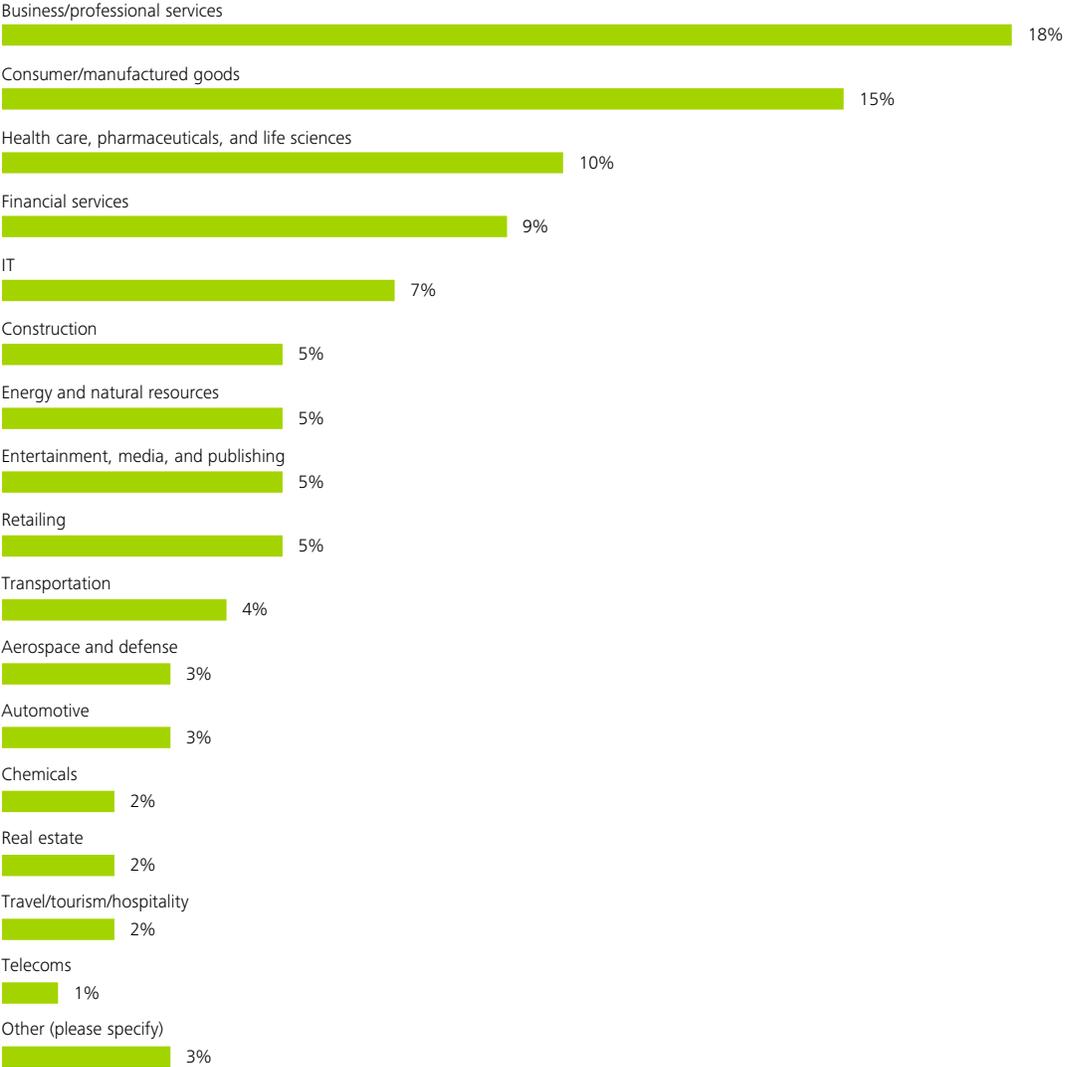
Which of the following best describes your title?



What is your main functional role?



In which sector does your company belong?



This survey was conducted by the Economist Intelligence Unit and sponsored by Deloitte Growth Enterprise Services. Our professionals are focused on delivering a distinctive client experience through service offerings tailored to address the unique needs of mid-market companies. For more information, please visit Deloitte Growth Enterprise Services at <http://www.deloitte.com/us/dges>.

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