Keeping the Middle-Market Growth Engine Humming:

Three key growth drivers to consider

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Executive Summary

Until very recently, the middle-market just hasn't gotten the respect it deserves. The performance of midsized firms following the recent global economic downturn, however, has been extremely impressive as statistics compiled by the National Center for the Middle Market (NCMM) reveal. At last, people are beginning to take note.

With many industry experts forecasting lackluster growth for as far as the eye can see and a host of other challenges threatening growth, middle-market firms, like all companies, need to consider new strategies that will help position them to thrive—not merely survive.

Three proven growth drivers—concepts many forward-thinking midsized companies have already embraced—just might be what your organization needs to help keep your growth engine humming.

- Transform your business through investments in improved technology and processes
- Tap into new domestic or international markets by expanding through strategic acquisitions, alliances or partnerships
- Commit to managing risks across the enterprise

Henry R. Luce, publishing giant and creator of *Time, Fortune* and *Life* magazines among others, is quoted as saying, "Business, more than any other occupation, is a continual dealing with the future; it is a continual calculation, an instinctive exercise in foresight."

The future is rarely clear. Challenges are constant. But despite today's uncertain economic climate, opportunities for growth exist. And no segment of the business community is better equipped to deal effectively and efficiently with change than the middle market.

Much of the hoopla in the business press understandably revolves around the "bigs" of business—banks too big to fail, BP, Apple and hundreds of other publicly traded multi-nationals. But a strange thing happened following the financial meltdown of 2008. The importance of middle-market companies to the U.S. economy began to be recognized more widely. And with good reason.

Who knew?

Middle-market businesses are truly an impressive group. According to data compiled by the National Center for the Middle Market[1], U.S. mid-market firms—those with revenues from $10 million to $1 billion—amount to approximately one-third of private sector gross domestic product (GDP). They employ about 43 million people at companies that include sole proprietorships, limited liability and S-corps, family businesses and private and public corporations.

Even more impressive, the NCMM's *Q4 2012 Middle Market Indicator* noted the following:

- The average revenue growth of middle-market businesses in 2012 was 7 percent, or about $650 billion
- In 2012, the approximately 197,000 middle-market companies created about 1.17 million jobs

As all companies struggle to recover from the worst economic downturn since the Great Depression, middle-market firms have been real leaders. An article in a prominent business publication referred to the middle market as "the Goldilocks Spot[2]"; small enough to be nimble and react more quickly than larger firms, but big enough and with sufficient resources to withstand the downturns. The article goes on to describe the advantages one mid-market pizza restaurant and frozen pizza manufacturer sees in not having to answer quarterly to shareholders, and a publicly traded boat company's ability to counteract the economic downturn by quickly introducing four new, lower-priced models to its product line.

It's not all rosy

But like companies of all sizes, middle-market firms face significant challenges today, including:

- A less-than-bright U.S. and global economic outlook
- Increasing regulations
- Rapidly rising health care costs that may become even more onerous if the Affordable Care Act proves less affordable than originally billed

The KeyBank *Middle Market Business Sentiment Survey*[3], released December 13, 2012, found "67 percent of middle market executives have a fair to poor outlook for the U.S. economy in the next 12 months. In addition, the percentage of middle market business executives planning on increasing cash reserves nearly doubled."

Like their large business counterparts and growing numbers of individual consumers, middle-market firms are cautious about spending in what appears to be a very murky economic climate. The NCMM concurs that confidence is low, but improving.

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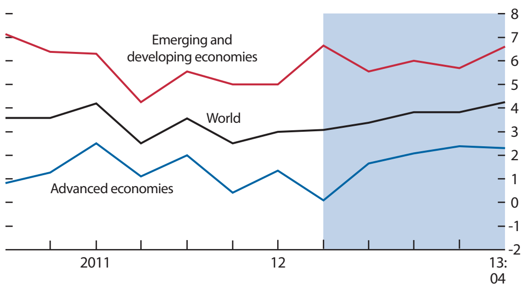
1 Housed at The Ohio State University's Fisher College of Business, The National Center for the Middle Market is a partnership between GE Capital and The Ohio State University's Fisher College of Business.

2 *"Middle-Market Business: The Goldilocks Spot,"* October 24, 2012, CFO.com.

3 *"America's Middle Market Businesses Share Bleak Outlook Post Election,"* December 13, 2012, WSJ.com.

Although stating "significant risk remains," and stressing "policies must address downside risks to bolster growth," the International Monetary Fund's *IMF Survey Magazine*[4] expects growth to strengthen gradually in 2013. It points to emerging markets, developing countries and the United States as the main sources of growth.

Figure 1. Global GDP Growth[5]
(Percent; quarter over quarter, annualized)



Source: IMF staff estimates.

Lastly, the Conference Board's *Economic Outlook 2013*[6] projects U.S. growth in 2013 at 1.8 percent, with a 2.3 percent annual growth rate from 2013 to 2018, before falling to 2 percent from 2019 through 2025. A more significant slowdown is expected in less mature economies, and a long-term global slowdown to 2025.

Now, contrast those gloomy outlooks with the Commerce Department's February 27, 2013, report that non-defense capital good orders, excluding aircraft, jumped 6.3 percent, when economists expected a mere 0.2 percent rise.[7] In January in the U.S., new home sales also jumped to the highest level since July 2008, and consumer confidence also rose strongly.[8]

With vast uncertainty amid all this conflicting data, how can middle-market companies position themselves for growth?

Three strategies for growth

Companies seeking growth could consider taking a page from the books of leading middle-market companies—companies looking to thrive for years to come, not just survive the downturns. The ideas below aren't new. Forward-thinking midsized companies have been quick to embrace these concepts. If your company isn't there yet, it may be time to reconsider. One or all of the ideas below just may help you keep your own organization's growth engine humming.

- Transform your business through investments in improved technology and processes
- Tap into new domestic or international markets by expanding through strategic acquisitions, alliances or partnerships
- Commit to managing risks across the enterprise

4 *"International Monetary fund IMF Survey Magazine: In the News, "Modest Growth Pickup in 2013, Projects IMF,* January 13,2013.

5 *IMF World Economic Outlook Update,* January 2013, Figure 1

6 *"Global Economic Outlook 2013," The Conference Board, www.conference-board.org/data/globaloutlook.cfm,* January 25, 2013.

7 *"Factory Orders Fly Even as Defense in the Dumps,"* CNBC.com, Reuters, Wednesday, February 27, 2013.

8 *"US New Home Sales, Consumer Confidence Soar,"* CNBC.com, Reuters with AP, February 26, 2013.

1. **Transform your business through investments in improved technology and processes**

   Unquestionably, recent challenging macro-economic data and an ever-evolving U.S. regulatory landscape have contributed to great uncertainty. An investment in the right technology or process improvement initiative, however, may provide the game-changing spark you need to ignite new growth and improve operational effectiveness.

   Despite the economic conditions over the last five years, many middle-market leaders have been investing in next-generation technologies, like cloud and mobility. They've enhanced their use of business intelligence and advanced analytics to help drive performance. Naturally, decisions to pursue today's "hot" cloud and mobility technologies must be based on their ability to drive real business value and how closely they align with the organization's larger strategy. No organization should move forward without carefully considering all the available options and their respective risks. These advanced technologies are more than "cool." Done right, they really can help transform your business, by helping to reduce costs and increase productivity and organizational effectiveness.

   McGladrey's *2012 Private Equity Survey: Creating value; spurring growth*, in partnership with research firm PitchBook, **www.pitchbook.com**, found that private equity firms concentrating on the middle market are focused on "creating value rather than relying on financial engineering or leverage to generate returns…The private equity firms surveyed report that effective value creation—which includes reducing costs, increasing efficiencies, streamlining reporting processes and enhancing revenue—requires a capable management team; a comprehensive, customized performance improvement plan; and the ability to generate key performance indicators and financial information…IT upgrades can be costly, but firms can mitigate the associated investment risk and increase the opportunity for value creation by ensuring that systems are properly designed, implemented and managed."[9]

   Enterprise resource planning (ERP) and customer relationship management (CRM) are two technology-enabled performance improvement initiatives that can also make a real difference. ERP solutions leverage business processes and technology, enabling management to monitor performance in real time, create standardized measurements and react quickly to changing conditions. The technology involved means more time can be spent in analysis, rather than in the collection of important business data. Not only can you improve your planning and forecasting processes, you can improve visibility into the effects of management decisions, and a whole lot more. You will truly move from "management-by-feel" to data-driven decision making.

   A well-thought-out and implemented CRM system enabled one manufacturer to automate its sales order processing, which reduced paperwork and 80 percent of the manual workload, and increased efficiency by 99 percent! The new technology and processes mean orders are filled faster, the company's sales team is more effective and customer satisfaction is considerably increased. That's just one small example of how strategically rethinking technology and processes transformed an organization's day-to-day business operations.

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9 *McGladrey 2012 Private Equity Survey: Creating value; spurring growth,* in partnership with research firm PitchBook, **www.pitchbook.com**

2. **Tap into new domestic or international markets by expanding through strategic acquisitions, alliances or partnerships**

   As sales began to stagnate or slump over the last 10 years, organizations sitting on healthy balance sheets started searching for new markets as a way to grow the bottom line. Naturally, geographic expansion into adjacent territories is one of the first places organizations look. Expansion into other countries, where the culture and ways of doing business may be very unfamiliar, can present a much bigger leap.

   Expansion outside the borders of the United States, however, can have some very big upsides, including quicker access into global markets. Also, with huge uncertainty swirling around U.S. tax policy, companies that opt for a strategic alliance with an international company could benefit from potential operational synergies, thereby reducing the cost of capital. And, with the United States, Europe and other more developed markets in slow-growth modes, many experts believe emerging markets offer the largest growth potential in the near term, especially given the rapid growth of a consumer class in Asia and other areas.

   There are a variety of options for expansion—each with upsides and downsides. Conducting a strategic option analysis that considers the needs of the organization, available resources, risk-taking ability and management objectives can be helpful in determining the right approach for today's complex conditions.

Five options for expansion

Option	Potential upside	Potential downside
1) Domestic strategic acquisition	New markets, products; increased revenue, earnings; retain control; synergies in marketing, purchasing, distribution	Drain on cash; time, effort required to do the deal and integrate the new operations
2) International strategic acquisition	New markets and products, entrée to emerging economies; increased revenue, earnings; retain control	Drain on cash; time, effort required to do the deal and integrate the new operations; foreign exchange risk and tax implications; cultural and regulatory risks
3) Strategic alliance	New markets, products; entrée to emerging economies; increased revenue, earnings; operational synergies, reduced business risk, retain control of your own business	Dilutes ability to concentrate on the core business; control issues; cultural conflicts
4) Strategic partner	New markets, products; entrée to emerging economies; increased value due to synergies; lower costs and easier route to new markets and tax benefits	Identity concerns; control issues
5) International joint venture	New markets, products; entrée to emerging economies; ability to pool capital, expertise and reduce risk	Conflicts regarding rewards for actual contributions versus rewards based on a percentage of the original investment

Organizations considering the acquisition option should be aware that an estimated 50 to 70 percent of acquisitions fail to deliver on their expected value. Given those statistics, rigorous buy-side due diligence by specialists in the right industries and with the appropriate backgrounds is mandatory to address the risks and opportunities of any potential transaction. The target must absolutely be the right fit for your organization culturally and for your business goals. Thorough due diligence should cover the financial, tax, information technology and post-transaction integration issues critical to completing the transaction efficiently and effectively.

3. **Commit to managing risks across the enterprise**

Every organization has to accept some level of risk in order to succeed. How much and what kind are unique to the organization. But like successful investing, business success isn't just about the size and scope of your wins, it's also about minimizing your losses—not losing so much that future recovery is impossible.

Enterprise risk management (ERM) helps the entire organization create an awareness of risk, identify the organization's unique risk profile, minimize surprises and mitigate any issues and exposures. ERM is really a necessity when developing a sustainable business plan.

ERM is not, however, simply a defensive tactic. "Effective ERM should provide management with the information necessary to optimize earnings, and ultimately, the organization's value, while remaining within a well-defined and acceptable risk tolerance. It should include a new and clearer language to communicate information about management's intention and capabilities. Furthermore, it should improve business performance, establish a competitive advantage and optimize the cost of managing risk. Accomplishing this requires a positive culture that strongly influences and affirms corporate judgment in executives, managers and employees." [10]

Importantly, ERM enables the organization to understand which risks are worth taking, providing a clearer path to success. ERM has gotten a bad rap by some as an activity with no end and no real answers. It doesn't have to be that way. With a little guidance, and by following some common-sense "rules of the road," your organization, too, can reap the many benefits of ERM.

Growth opportunities do exist

Despite today's uncertain economic climate, opportunities for growth exist. And no segment of the business community is better equipped to deal effectively and efficiently with change than the middle market. By transforming your business from the inside out, looking for growth opportunities with the right fit, performing the necessary due diligence and managing risks, your growth engine can continue humming for many years to come.

10 *Enterprise risk management: A pragmatic, four-phase implementation plan,* John Brackett, McGladrey LLP

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