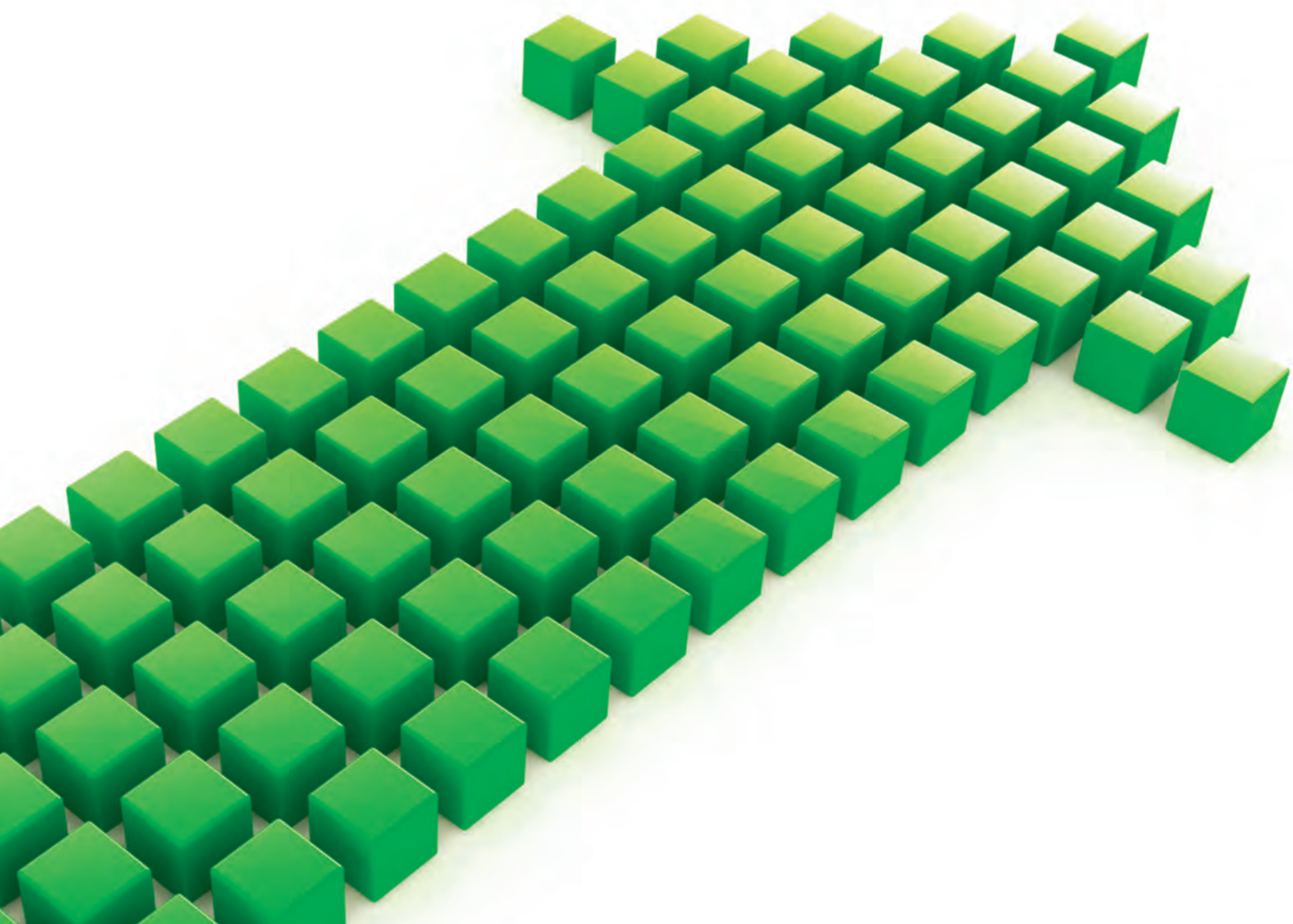
Deloitte.

Mid-market perspectives
Moving ahead



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Executive summary

For more than three years now, Deloitte has been asking mid-market executives about their views on the economic outlook and their own business plans. As the surveys have progressed, the findings have portrayed a middle market that is recovering, albeit modestly, from the country's deepest recession in six decades. In our spring 2013 survey, we remarked how this important segment of the economy appeared "poised for growth." This characterization was supported by respondents' increasing optimism about the economy's prospects and gradual improvement in their companies' key balance sheet metrics.

Six months later, we are seeing evidence that this long-awaited growth is now taking place. Despite the fact that the U.S. government shutdown occurred while this survey was being conducted, the respondents — more than 500 in all — appear to be increasingly confident in the economy's ability to grow and even more confident in the performance of their respective companies. More companies are experiencing revenue and profit growth, with the best-performing among them moving past cost-cutting to carving out differentiated and valuable positions in their respective markets even as they increase profits through higher volumes and higher prices. What is more, middle-market businesses report that productivity is up and full-time employment is recovering.

Taken together, these findings suggest that mid-market firms aren't letting lingering uncertainty stand in their way. While it is true that headwinds such as the European debt crisis began to abate or continued to lessen this year, new challenges emerged or intensified. For instance, many companies are now bracing for higher borrowing costs as they await word from the Federal Reserve about when it will tighten monetary policy, most likely causing interest rates to rise.

Middle-market businesses report that productivity is up and full-time employment is recovering.

Despite the fact that 44 percent of the respondents believe that the level of uncertainty has increased over the past 12 months, companies we surveyed are moving forward with strategic spending initiatives. In fact, less than a third said that uncertainty in the current business environment is causing them to defer major investments, representing a dramatic decrease from our spring survey. As a result, they are moving ahead by investing in equipment, technology and manpower, with many reporting that the benefits of these investments show up in their bottom lines.

To be clear, these commitments do not represent major increases but rather incremental steps, in line with the modest nature of the economic recovery. But the findings suggest that many mid-market companies are proceeding with purpose as they put the recent past behind them on the road to growth.

Improving prospects

By and large, the mid-market executives in our survey see an improving situation in their company's results and in the economy as a whole:

- More than three-fourths are at least somewhat optimistic that the U.S. economy will continue to improve over the next 24 months, and nearly one half expect it to grow by at least 2 percent over the next 12 months.
- Sales are trending higher, with 58 percent reporting higher revenues over the past 12 months, up from 44 percent in the spring survey.
- Profits also are up since our spring survey, with more firms reporting higher earnings (44 percent vs. 35 percent) and gross profit margin (40 percent vs. 30 percent).
- Technology and employment investments are yielding efficiency gains, as 49 percent of respondents reported higher productivity over the past 12 months, compared to 38 percent six months ago.

Already a major contributor to the U.S. labor market, the mid-market may be poised to provide more support in the year ahead, as we saw a doubling in the percentage of executives who predict their companies will increase their full-time headcount by 10 percent or more over the next 12 months (8 percent vs. 4 percent in the spring). Technology investments also will likely continue, as technology was rated as the top priority for capital invested.

From survival to exceptional long-term performance

As we emerge from the recession and companies increasingly turn their focus from weathering the storm to charting a more deliberate course, we felt it was worth exploring how mid-market companies might drive superior long-term performance. We turned to Dr. Michael E. Raynor, director, Deloitte Services LP, and Mumtaz Ahmed, Deloitte's Chief Strategy Officer, who co-authored *The Three Rules: How Exceptional Companies Think,* a nearly decade-long study of more than 25,000 companies and 45 years of data from 1966 to 2010. (For more, see www.thethreerules.com.)

Their research concluded that the drivers of long-term exceptional profitability and growth are a company's ability to follow three decision-making principles:

1. Better before cheaper: Don't compete on price, compete on value.
2. Revenue before cost: Don't increase profits through lower cost, but through higher price or higher volume.
3. There are no other rules: Make every other decision — culture, leadership, expansion, diversification, innovation, and so on — in light of its impact on your alignment with rules #1 and #2.

We asked mid-market companies a number of questions about competitive position, profitability, and priorities for investment. Based on their responses, Raynor concludes that mid-sized companies in our survey, similar to those companies analyzed in *The Three Rules,* tend to perform better when they follow the rules than when they don't. However, when it comes to how to follow Rule #2 (Revenue before cost), far more mid-market survey respondents tend to focus on volume more than price, while the majority of the best performing companies in the public markets tend to put price over volume. For reasons explained later in this report, Raynor suggests that to follow in the footsteps of exceptional performers generally, companies should spend more effort pursuing a price premium and place less relative emphasis on total revenue.

The improving general economic outlook is of course welcome, as is the fact that mid-market companies are beginning to increase investment. But these are merely tailwinds: they say nothing about what path forward will prove most fruitful. At this critical juncture in the economy's recovery, the strategies mid-sized companies implement — to expand or stand pat, to judiciously cut cost or selectively invest, to follow the herd or blaze a new trail — will likely sow the seeds of success or failure. In the coming months, we are excited at the prospects of working with them as they proceed with purpose and make the choices that will define their futures.

Tom McGee

Tom McGee
Deputy Chief Executive Officer, Deloitte LLP
National Managing Partner
Deloitte Growth Enterprises Services

About the survey

From September 24 to October 21, 2013, a Deloitte survey conducted by OnResearch, a market research firm, polled 503 executives at U.S. mid-sized companies about their expectations, experiences, and plans for becoming more competitive in the current economic environment. Respondents were limited to executives at companies with annual revenues between $50 million and $1 billion.

Eighty percent of the companies represented were privately held; only 20 percent were public. Of the private companies, about one-third were family-owned and another one-third were closely (non-family) held; just over one-quarter were private-equity backed, and the rest were VC-backed, employee-owned, or other structures.

Almost half of the respondents were owners, board members, or C-suite executives; the remainder included vice-presidents, department or business line heads, or managers. Industries were diverse: the five with the largest representation were consumer and industrial products; financial services; technology, media and telecommunications; life sciences and health care, and energy and resources.

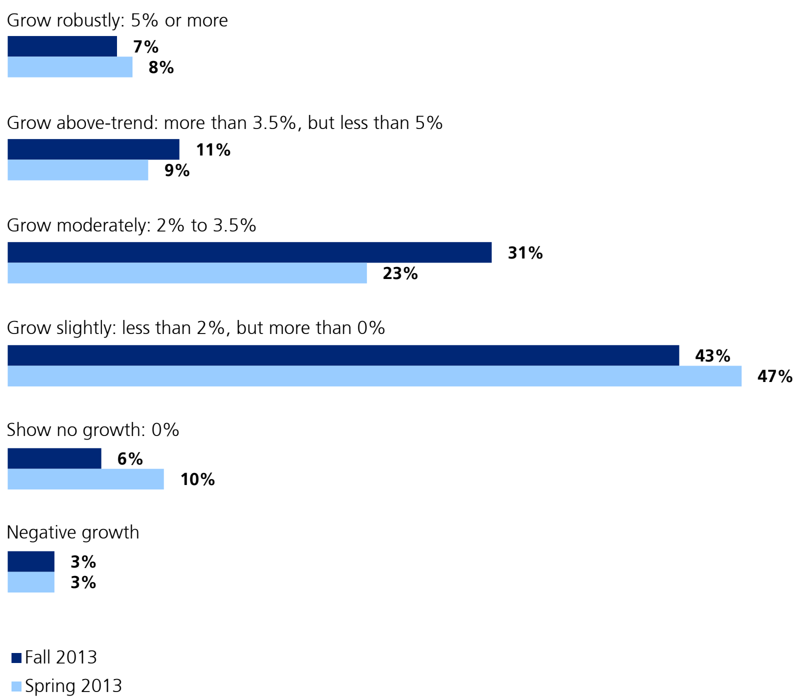
The full survey results are included in the appendix; some percentages in the charts throughout this report may not add to 100 percent due to rounding, or for questions where survey participants had the option to choose multiple responses.

Adapting to uncertainty

The current survey marked the fourth time we have asked mid-market executives to comment on the level of uncertainty and its impact on future business prospects. Each time we pose this question, we see a sizable representation of respondents who believe uncertainty has increased over the past year. This time was no different, as 44 percent of the executives said the level of uncertainty is higher than a year ago, the same percentage as in the spring survey.

Still, the mid-market executives' responses to a host of other questions — spanning from their expectations for key economic data to their own business prospects — suggest that the high level of uncertainty isn't as big a deterrent to companies' growth initiatives as it once was. If anything, the middle market appears to be getting a firmer grasp on how to deal with uncertainty as a basic tenet of doing business. Companies that are waiting for the level of uncertainty to dissipate may in fact risk losing their competitive edge.

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



Stronger outlook

While the respondents as a group largely are seeing improved macroeconomic conditions, they are even more optimistic about the outlook for their respective businesses. More than three-fourths are at least somewhat confident that the U.S. economy will continue to improve over the next 24 months. We also saw gains — to 49 percent from 40 percent — in those who believe the economy will grow by at least 2 percent over the next 12 months.

A greater sense of optimism in the economy's prospects was overshadowed by the respondents improving sentiments about their own businesses. We saw significant improvement in companies' overall financial performance compared to the spring survey, with increases in those reporting higher revenues (58 percent vs. 44 percent), gross profit margin (40 percent vs. 30 percent), profits (44 percent vs. 35 percent), productivity (49 percent vs. 38 percent) and cash balances (41 percent vs. 34 percent) over the past 12 months. What is more, a greater number of respondents also anticipate those key metrics to show continued improvement over the coming 12 months.

Bolstered by such improvement, significantly fewer respondents (31 percent compared to 43 percent in the spring survey) said that uncertainty in the current business environment is causing them to defer major investments. In fact, higher revenues, profits and productivity may serve as a confirming factor for many mid-market companies to start investing in their businesses and expanding their reach into new markets.

Among mid-market companies, strategic investments such as facility improvements or new equipment purchases are "not being delayed" due to lingering uncertainty, according to Kevin McFarlane, Managing Director, Deloitte Corporate Finance LLC. "If it's a strategic imperative to make the investment, companies appear to be doing so."

Employment gains

The survey portrays a middle market that also is making new investments in talent, at least at the margins, despite continued lackluster jobs figures from the Labor Department.

At the time this survey was taken, the nation's jobless rate stood at 7.3 percent and monthly job growth was steady though modest in scope. Given the labor market's sluggish rate of improvement, it wasn't surprising that nearly one half of our survey respondents — 46 percent — said they expected the unemployment rate to hold steady over the next 12 months. This was a statistically significant increase from the spring survey, in which 38 percent expected more of the same on the jobs front.

And yet, asked about their own companies' workforce changes and prospects, our respondents were decidedly more upbeat. We saw a major improvement in both hiring levels and the outlook for new hires. For instance, 12 percent said their company's full-time domestic workforce had grown by more than 10 percent over the past 12 months, up from just 4 percent in the spring survey, and 18 percent reported growth between 5 and 10 percent, up from 8 percent. Looking ahead to the next 12 months, 9 percent forecast their full-time domestic workforce to grow by more than 10 percent, up from 4 percent in the spring, and 16 percent expect that growth to be between 5 and 10 percent, up from 9 percent.

Jeff Alderton, principal, Deloitte Consulting LLP, acknowledges the employment gains as a positive sign of growth in the mid-market. "We're seeing a clear upturn in hiring for the more market-facing and product development areas," observes Alderton. Regardless of the types of jobs being filled, "mid-market companies are paying particular attention to their organizational culture as hiring decisions are being made," states Alderton. "They rightly view culture as an important corporate asset."

"If it's a strategic imperative to make the investment, companies appear to be doing so."

Kevin McFarlane — Managing Director, Deloitte Corporate Finance LLC

Bridger LLC: Supporting growth through technology and talent

It is often said that there is an inverse relationship between technology spending and hiring, but even when technology improvements allow companies to be more productive with fewer people, they often need additional workers to accommodate growth in their business.

Such is the case at Bridger LLC, an integrated crude oil transportation and logistics company that was recognized this year as the fastest-growing energy company by *Inc.* magazine. After receiving a $300 million private-equity commitment to help accelerate growth, Bridger President and CEO Julio E. Rios II gave his IT department an assignment: find an electronic solution to replace the flood of paper tickets that help track the 5.7 million barrels of oil the company moves around the country each month. A ticket is produced each time one of the company's contract operators picks up oil and delivers it along each step in the supply chain.

Demand for talent is so critical, Bridger actually moved its headquarters to gain access to a larger pool of skilled workers.

"You can imagine how many tickets are floating around a company that moves that much oil each month," Rios says. "It introduces a lot of redundancy and potential for human error into our business, and it takes a lot of people to track those tickets."

This year, the company spent a "considerable amount of money" to develop its own electronic ticketing system, Rios says. The new system integrates with other third-party applications and allows customers to track their oil deliveries and adjustments against monthly commitments. "The system is not only helping us to be more efficient, it's also creating an additional service for our customers that they didn't have before. It gives us a competitive advantage."

That doesn't mean Bridger is going to dispatch all the accountants once assigned to tracking and analyzing the paper tickets. "We're going to take those people and move them up the accounting ranks to help accommodate our growth," Rios says.

In fact, the company's full-time workforce has grown from 25 last year to about 100 today. Demand for talent is so critical, Bridger actually moved its headquarters from Shreveport, Louisiana, to Dallas to gain access to a larger pool of skilled workers.

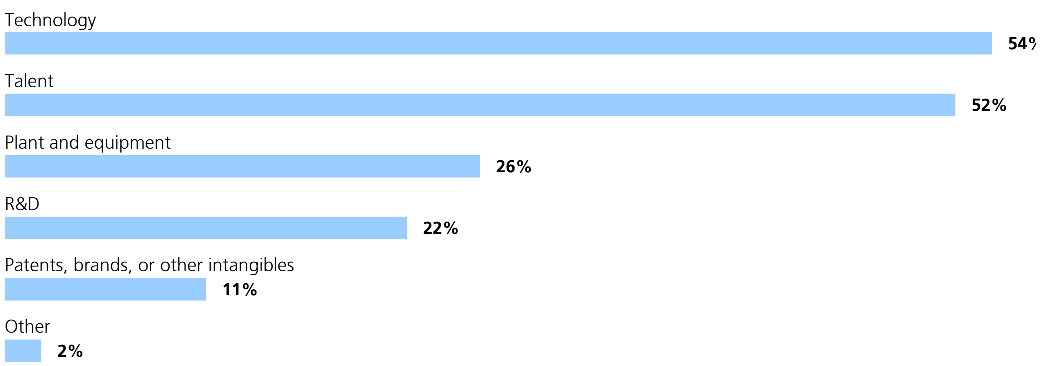
Technology spending

Our previous surveys found that mid-sized firms continued to invest in new technologies during the downturn, and technology remains a top spending priority now that they are beginning to consider growth initiatives again. Technology took over as the top priority for capital invested, and retained its top spot in terms of time invested when votes were tallied for the top three spending priorities. Technology investments also were seen as holding the greatest investment potential to boost productivity.

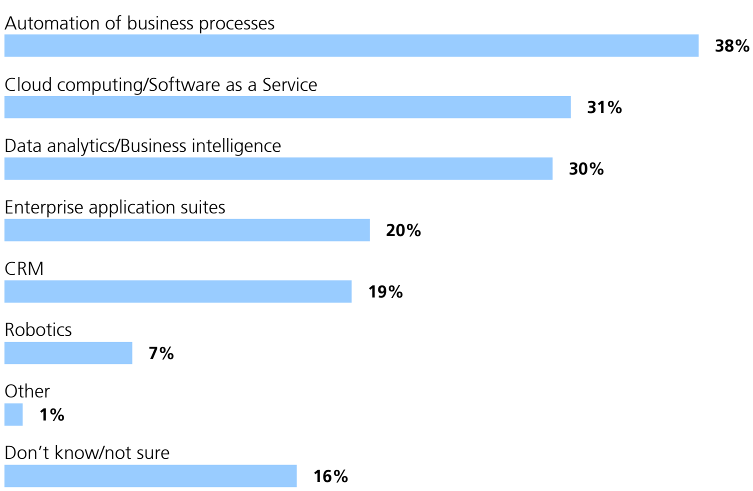
When asked to specify the technologies their companies were investing in, automation of business processes came in first, followed by cloud computing, and data analytics and business intelligence.

These findings reflect a growing recognition among mid-market business leaders that technology can be a source of strategic advantage, according to Harvey Michaels, principal, Deloitte Consulting LLP, and Consulting leader for Deloitte Growth Enterprise Services. "For mid-market companies, cloud-based technology has really become a game changer as it provides affordable platform alternatives to compete against much larger companies. Overall, these companies see technology as a catalyst for growth, helping them compete on a differentiated basis and supporting expansion and globalization efforts," Michaels says.

Which investments offer the greatest potential for increasing productivity at your company? (Please select all that apply.)



Which investment(s) in technology is your company most likely to make in the next 12 months? (Please select up to three.)



Leviton: Going global at a deliberate pace

Seven years ago, the management at Melville, New York-based Leviton decided it was time to diversify and expand the company's reach beyond the North American market, where its reputation as an electronic wiring device maker was well established. In plotting the right course for overseas expansion, the company identified a number of challenges that significantly altered its globalization strategy.

"We found that in our core wiring device business it would be tough to break in to certain new markets because there were entrenched competitors and the local standards for box sizes and wire sizes were different," says Leviton's Chief Financial Officer Mark Baydarian.

The company discovered something else: that its data communications products could be sold worldwide because of Leviton's strong brand and because there are universally set standards for this product. Instead of pushing its wiring devices broadly and competing on price, it began marketing its high speed copper and fiber cable, data connectors, patch panels and other communications products across the world while going after wire device sales in markets such as Central and South America that shared the same standards. Today, the company's products can be found in 80 countries around the world, in addition to every nine out of 10 homes in America.

CFO Baydarian said the recovering U.S. housing market has led to a "very good year" for Leviton.

"Our global growth is coming steadily, kind of piece-by-piece as we learn each new market, but it's important that we grow profitably," Baydarian says. "We definitely don't want to be a low-end manufacturer. We're creating a quality brand that means service, innovation, quality and value — but you have to pay for that. In those markets where the low-end manufacturer is the sales leader, we won't compete there."

Leviton's global growth ambitions recently received a boost from its acquisition of JCC Advanced Lighting, a lighting fixture company in the United Kingdom. Additional acquisitions may follow soon.

Baydarian said the recovering U.S. housing market has led to a good year for Leviton, and he anticipates 2014 will bring similar growth — and capital to invest. "As business improves cash flow will also improve because we manage our balance sheet closely and that allows us to reinvest the money back into our business," he says. "It's not magic."

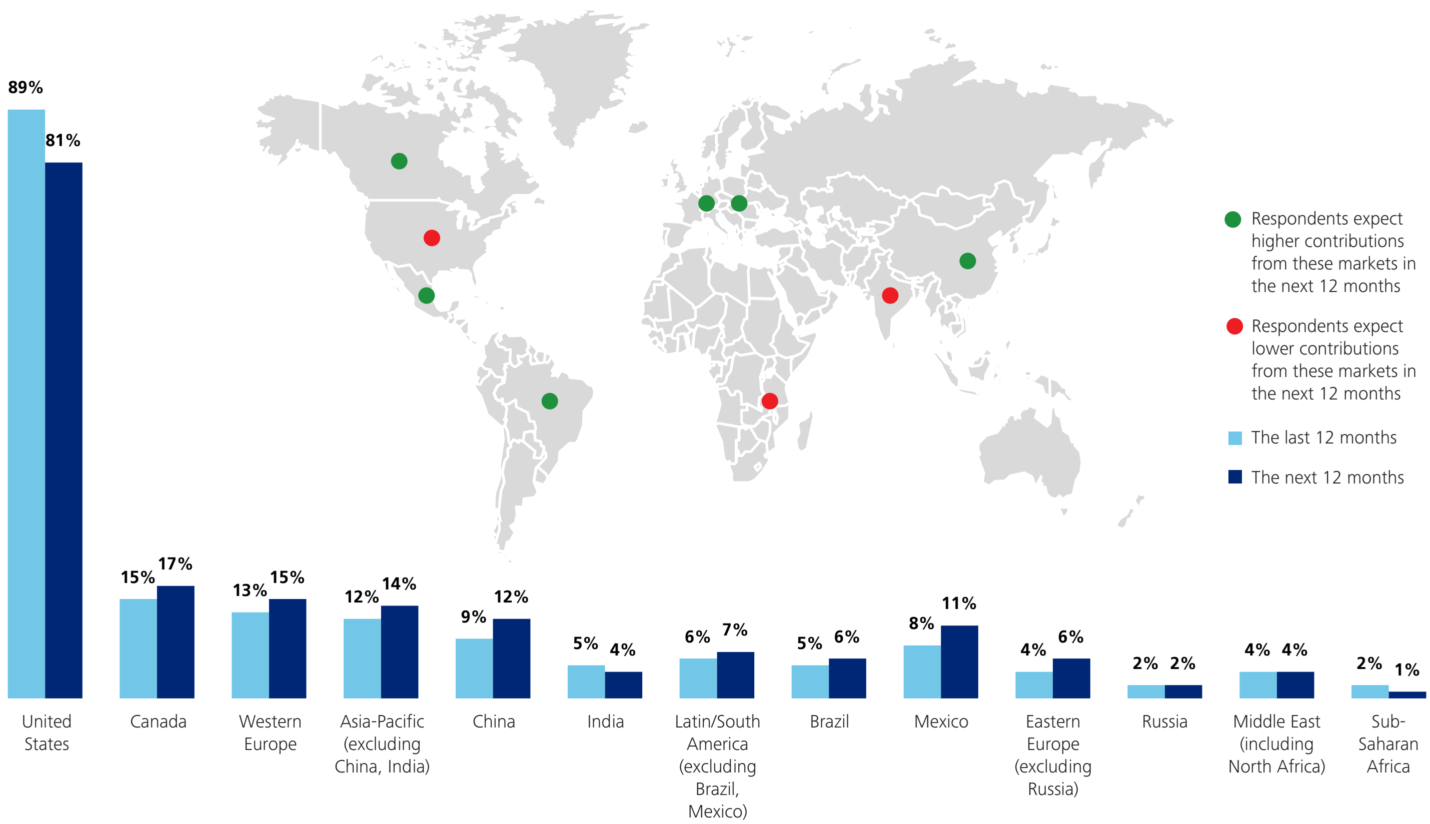
Global expansion

The United States is far and away the largest contributor to growth for companies in our respondent universe, as an overwhelming 89 percent said the domestic market accounted for most of their business' growth over the past 12 months.

Looking ahead to the next 12 months, however, this number drops to 81 percent, demonstrating a renewed focus on global growth opportunities. Both Western Europe and Eastern Europe saw an uptick among respondents who said the majority of their company's growth over the coming year will come from those regions, which is not particularly surprising given the significant drop-off we saw in those who expressed concern over the European debt crisis.

Other gainers included Asia-Pacific (excluding China and India), and Brazil. India saw the biggest decline among non-U.S. markets; 4 percent now see that market as a growth driver versus 7 percent in the spring.

Which geographic markets have contributed the most to your company's growth over the last 12 months and will do so over the next 12 months? (Please select all that apply.)



Access to capital

The general consensus among our respondents appears to be that most forms of credit have been easier to secure than they were a year, or even six months ago, especially asset-based and cash-flow financing, and through the public markets. Of course, with borrowing rates on the rise, it was little surprise that the respondents reported that the cost of credit increased across all sources.

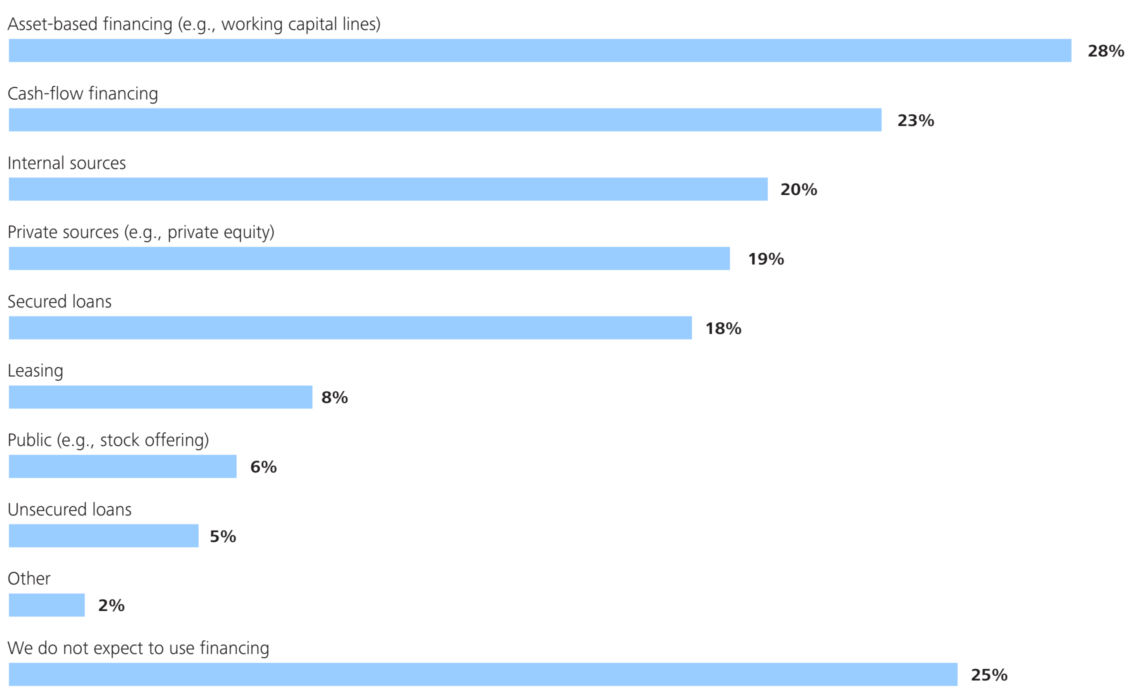
Despite the reported increases in cash on their books, only one quarter of the executives said they didn't expect their company to pursue financing over the next 12 months. Asset-based financing is still the most-favored financing option (28 percent), followed by cash-flow financing (23 percent) and internal sources (20 percent).

M&A outlook

The current survey showed little change in terms of companies' appetite for conducting mergers and acquisitions, even as U.S. merger and acquisition activity continues to improve. While total U.S. M&A deal value increased approximately 39 percent in the first nine months of the year, deal activity in the middle market was off 6 percent, according to Thomson Financial. Deloitte's Kevin McFarlane observes that there seems to be increasing levels of interest and greater consideration given to the specifics of potential transactions.

"Acquisitions are clearly being analyzed more closely and with much more rigor, but many mid-sized companies we meet with indicate a desire to grow through acquisition, whether to find qualified employees, plug a hole in the product portfolio or simply increase their competitive position," says McFarlane.

What types of financing do you expect your company to pursue over the next 12 months? Please select all that apply.



In fact, 51 percent of the respondents said they considered mergers and acquisitions to be at least somewhat important to their company's growth strategy, and 35 percent said their company was likely to conduct an acquisition over the next 12 months.

It was also interesting to note in our survey findings that companies who have been acquisitive of late have purchased multiple businesses. Among those that consummated a deal over the past year, 64 percent reported completing more than one, and 28 percent transacted three or more.

In another notable finding, 37 percent of respondents said their company would be willing to consider a private equity partner, yet only 19 percent indicated that their company had discussed a possible transaction with a private equity firm over the past 12 months.

Going public

A solid majority of privately held company respondents — 87 percent — reported that their companies were unlikely to go public within the next 12 months. The chief reason they cited for remaining private was a desire for flexibility and control in decision-making (78 percent), while keeping financial information private came in a distant second (37 percent).

But the benefits of going public at some point weren't lost on them, either. Our respondents cited accessing capital to fuel growth, broader exposure to their brand and products, and the cost-effectiveness of equity capital as the biggest draws of being a public entity.

Saltchuk: Investing for the long haul

As the holding company for a broad family of businesses focused on transportation and fuel distribution, Saltchuk has its finger on the pulse of the economy. A big slice of Saltchuk's business comes from facilitating trade. In fact, the company gets its name from the Chinook Jargon trading language, which was developed by natives of the Pacific Rim in North America. Saltchuk literally means "Saltwater," reflecting on the company's roots in marine transportation.

Because it moves so many types of goods — by air, land and sea — the company generally has a good sense of whether overall demand is improving or not. Recently, Saltchuk has witnessed moderate growth in cargo shipments and the volume of merchandise its trucks carry, but conditions "haven't really taken off again," says Saltchuk Chief Financial Officer Steve Giese.

You wouldn't know it from the flurry of press releases coming out of the company's headquarters in Seattle. Saltchuk has announced large-scale investments across all of its five major operating units. "Over the next several years, we are undertaking one of the biggest capital spending programs in the history of the company," Giese says. Among other projects, the spending is planned to fund the construction of two new liquefied natural gas (LNG) powered cargo ships for the Florida to Puerto Rico trade, the repowering of two existing vessels operating in the Tacoma to Anchorage trade to operate on LNG, the construction of three new ocean tugboats and a new air cargo facility in Hawaii.

> "Being private lets us take a longer-term view."
>
> Steve Giese —
> Chief Financial Officer, Saltchuk

Being a private company — one of the largest in the State of Washington — allows Saltchuk to invest for growth despite what's happening in the overall economic environment, Giese says. "We have a vision of where we want to go and we continue to do the things we need to grow our business through up and down cycles without worrying about what analysts think or whether shareholders are buying or selling our stock," he says.

The primary way Saltchuk has grown its business has been through acquisitions. Two years ago, Saltchuk hired a former private equity professional to run its business development efforts. His mission is to scout for businesses that would be complementary to one of Saltchuk's five business segments, and are preferably family-owned.

"We are a great option for a company where management wants to stay somewhat involved," Giese says. "We assume a business is going to be in our portfolio for 50 years. Being private lets us take a longer-term view."

Obstacles to growth

While mid-market companies as a group may be getting a better handle on managing uncertainty, they also are keeping an eye out for a number of broader challenges they believe may keep a lid on economic growth in the coming months. While 50 percent of the executives surveyed expressed concern about economic uncertainty affecting their business, this reading represented a drop from 59 percent in the spring survey, adding to other indications that they are more optimistic on this front. Other points of worry were health care costs, increased regulatory compliance and weak market demand.

Worries about Washington top list of challenges

The majority of those we surveyed saw the top obstacles to growth — both for the economy and for their business prospects — coming from a common source: the federal government. Some of these concerns are not new, but still represent sizable worries for mid-market businesses. Chief among these was government budget challenges; at 62 percent, this issue was cited as the top-rated obstacle to U.S. growth.

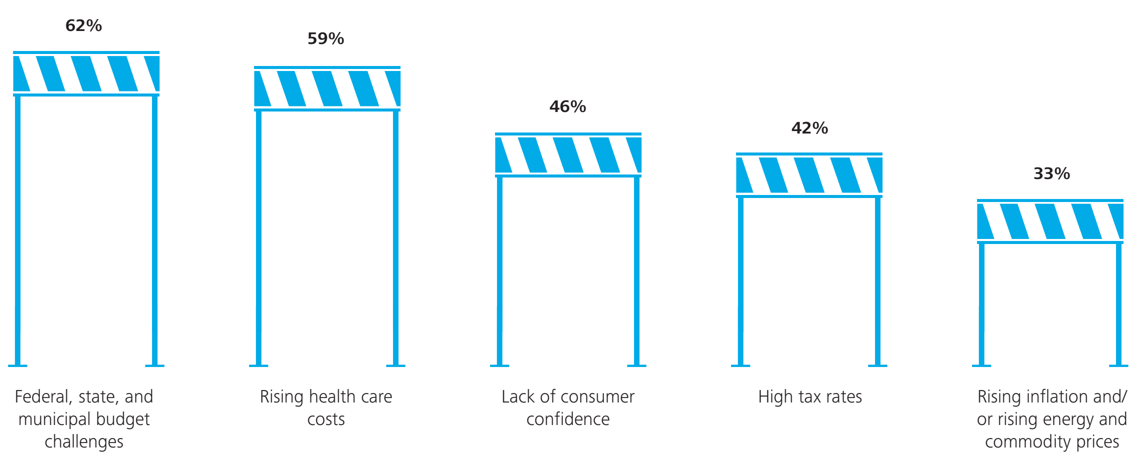
Health care reform also figured prominently. Rising health care costs came in a close second, with 59 percent perceiving the issue as an obstacle to growth. This finding essentially mirrored the fall survey (60 percent), which represented a significant increase over the 51 percent reading in 2012 and 33 percent response rate in 2011.

There can be little doubt that many respondents are linking the threat of rising health care costs to passage and implementation of the Affordable Care Act (ACA), as "rolling back health care reform" was seen as the most impactful measure the U.S. government could take to help mid-sized businesses grow over the next 12 months. In addition, nearly one half of the respondents said they expect ACA compliance costs to "rise sharply" in the year ahead.

Rising interest rates

Most borrowing costs increased since the spring survey was conducted and business attention appears to have turned to how long the Federal Reserve will maintain its rate-suppressing bond buying program. These concerns were reflected in our survey, as there was a significant increase in respondents who listed rising interest rates as a top obstacle to U.S. growth (26 percent vs. 15 percent in the spring). Ira Kalish, Global Chief Economist, Deloitte Touche Tohmatsu Limited, acknowledges this monetary policy risk. He notes that unlike prior programs, the current round of quantitative easing had no maturity date, yet the financial markets reacted strongly this past spring when the Fed discussed the possibility of tapering its bond and mortgage backed securities purchasing program. "As with most things in life, timing is everything," says Kalish. "At some point, the Fed will ultimately stop purchasing assets. The key is to do it while the economy is already strengthening so as not to create damage to a relatively fragile recovery." How important is this issue? According to Kalish, "for now, this remains the biggest uncertainty facing the U.S. economy."

Top five reported obstacles to growth



Among positive economic developments, the robust recovery in U.S. home demand and housing prices caused the housing market to drop significantly as a perceived threat to growth, with 16 percent citing the issue compared to 24 percent in the spring and 59 percent in 2012.

Skills shortage

We have heard for some time now how U.S. employers continue to have a hard time finding skilled workers to fill existing job openings, but our survey saw a notable increase in the number of respondents citing the issue as a top challenge. Nearly one quarter cited a skills shortage as a top obstacle to U.S. growth, up from 16 percent in the spring survey.

Saltchuk, for one, is having a difficult time enticing younger people to replace its aging workforce of tugboat crewman and truck drivers. "These are decent paying jobs but we're just not seeing an interest level," says CFO Steve Giese, who adds that he hears plenty of trucking companies taking to the satellite radio airwaves promising good pay and great benefits.

Deloitte's Jeff Alderton notes that the younger generation of workers has different views on work and their career paths. "We have seen more turnover in jobs because younger workers are generally more nimble, more transient and have less connection to their employers" says Alderton. "They are eager to learn, try new things quicker, and want a multitude of experiences that were not typical of generations before them. As a result, attracting — and more importantly retaining — this generation has become increasingly challenging."

While job training remains the top investment choice for addressing talent needs, it fell in importance as companies increasingly turned to higher compensation to lure skilled talent. When respondents were asked which workforce investment their company is likely to make in the next 12 months, training slipped to 46 percent from 53 percent in the spring survey, while higher pay increased to 26 percent from 17 percent.

Altair: Engineering growth through computer-aided technology

One theme that has emerged in the more than three years we have been conducting this survey is that companies have continued to invest in new technologies despite an uneven economic terrain. Altair is one company that has benefited from this resilience. The Troy, Michigan-based company sells computer-aided engineering tools that enable businesses to innovate.

While Altair is not immune to business cycles, the company has found over the years that demand for its engineering solutions is less cyclical than for traditional business technology equipment.

"No organization is going to completely stop trying to improve their design processes and prototypes," says Howard Morof, Altair's Chief Financial Officer. "We expect to see further growth in our segment of the engineering world as more and more companies move toward design optimization technology solutions."

In turn, that expectation is fueling investments in Altair's own business. The company is coming out of a recent period of elevated R&D investment, Morof says, as the direct result of working closely with its customers and understanding what new capabilities need to be addressed via technology. Those customers are now spread across markets in North America, South America, Europe and Asia/Pacific.

> "If we find great talent, we're going to hire them."
>
> Howard Morof —
> Chief Financial Officer, Altair

Employment at Altair is also trending up. "We are definitely expanding our headcount," Morof says. The company has added more than 150 new employees over the past year, bringing its total workforce to over 2,100. The new additions include developers, engineers, and sales executives with technical backgrounds. "If we find great talent, we're going to hire them," Morof says.

Morof links these investments in manpower and technology back to the company's long-term vision for growth. It is helpful that Altair competes in an industry where demand is sustained by a widely held view that skimping on technology hurts competitiveness over the long run.

"Any time you start to cut back on investments that are geared toward future growth and efficiency, you undercut a company's ability to compete," he says. "You can worry yourself to no end about uncertainty, but the reality is, we live in an economy that is still growing and there is business to be done."

From successful to exceptional

"For some companies, merely succeeding is not enough," says Michael Raynor, Deloitte's Innovation Theme Leader and coauthor of *The Three Rules: How Exceptional Companies Think* (www.thethreerules.com). "Some companies aspire to be exceptional, and it was to help them achieve that goal that we undertook this research."

Raynor and his coauthor, Deloitte Chief Strategy Officer Mumtaz Ahmed, embarked on what turned out to be a nearly decade-long search for the drivers of superior long-term corporate performance. They combed through the histories of more than 25,000 companies and 45 years of data and concluded that what separates the best from the rest — the "Miracle Workers" from the "Long Runners" and the "Average Joes" — is the ability to follow three deceptively simple decision-making rules:

1. Better before cheaper: don't compete on price, compete on value.

2. Revenue before cost: cutting cost rarely leads to superior profitability.

3. There are no other rules: change anything, and maybe everything, about your business to stay aligned with the first two rules.

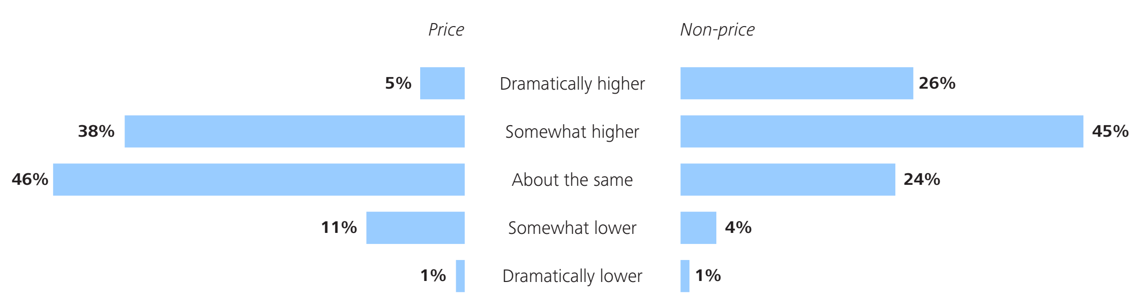
This mid-market survey contained a number of questions designed to explore the extent to which the best performing companies were acting in ways consistent with prescriptions and predictions of the rules. In general terms, many companies are following the rules, and those that do tend to report better performance than those that don't. Critically, the better-performing companies create value for customers with differentiated positions rather than concentrating on price leadership. However, when it comes to capturing value a good many that are following the rules tend to place too much emphasis on driving volume and not enough on earning a price premium. In light of the complex cause-and-effect relationship between the rules and exceptional performance, companies that emphasize volume growth at the expense of capturing higher prices are less likely to achieve exceptional performance in the long run.

Creating value

In our mid-market survey, a series of three questions explored first how respondents see themselves creating value for customers — that is, the extent to which they feel they are following Rule #1 — Better before cheaper.

Faced with a simple binary choice, the vast majority of the respondents see themselves relying on non-price differentiation, with only 17 percent reporting that low-price leadership is the most important dimension of customer value that they provide. Similarly, 71 percent responded that their level of non-price differentiation was somewhat or dramatically higher than their competition and 12 percent reported that their prices were somewhat or dramatically lower (see chart below).

Frequency with which different degrees of price and non-price differentiation feature in respondents' competitive position



Does *The Three Rules* apply to private companies?
By Michael Raynor

Our research for *The Three Rules* was based on an analysis of U.S.-based, publicly traded companies. This population includes many companies of a size and complexity that tracks quite nicely with smaller and typically private companies. In 2012, for example, almost 40 percent of the companies in our database had less than $100 million in revenue and 60 percent had less than $500 million in revenue.

We found that the rules drive exceptional performance regardless of company size. For example, a key part of our analysis decomposes exceptional companies' performance advantages into their underlying economic drivers: return on sales (ROS) and total asset turnover (TAT). The analysis reveals that ROS is the primary determinant of a company's profitability advantage regardless of its sales level.

Of course, revenue size is not the defining characteristic of a private company; it is ownership structure. Here, too, we saw some close parallels with our case study companies, both those with higher and lower levels of performance. Fully a third of the "Miracle Workers" (the best of the best) that we studied in depth had strong family ownership stakes and decades of family leadership.

Not surprisingly, only 6 percent of the total population of respondents reported both higher non-price differentiation and lower prices. This suggests quite strongly that for most companies there is a tradeoff between price and non-price competitive positions, and that few companies are able to innovate in ways that break this tradeoff. (See "Innovation: A Chimera No More" in the July 2013 issue of *Deloitte Review* on www.dupress.com.)

The vast majority of companies have to make a tradeoff between price and non-price strategies for creating customer value. That's what makes the rules so powerful. It is amusing to consider taking Yogi Berra's advice, Raynor says, but when you come to a fork in the road, "taking it" is almost always highly impractical. Forced to choose, as so many are, between lower price and higher performance, Raynor says it is comforting to know that one of those two paths — non-price differentiation— is systematically more likely to lead to exceptional performance. And it is encouraging to see how many of our survey respondents believe they are choosing this path.

Forced to choose between lower price and higher performance, it is comforting to know that non-price differentiation is systematically more likely to lead to exceptional performance.

Capturing value

The arithmetic of profit is deceivingly simple: revenue minus cost. The bottom line responds the same whether you're talking about a unit increase in revenue or a unit decrease in cost. In theory, companies should be indifferent to which of the two is driving their results.

However, companies with exceptional performance tend strongly to put revenue before cost. It was encouraging then that the mid-market survey found respondents also showed a rather strong preference for revenue. However, it is important to note that this preference was not as strong as we observed among exceptional performers in *The Three Rules* research. We also found a much stronger emphasis on volume growth than on higher pricing among the mid-sized companies in this survey.

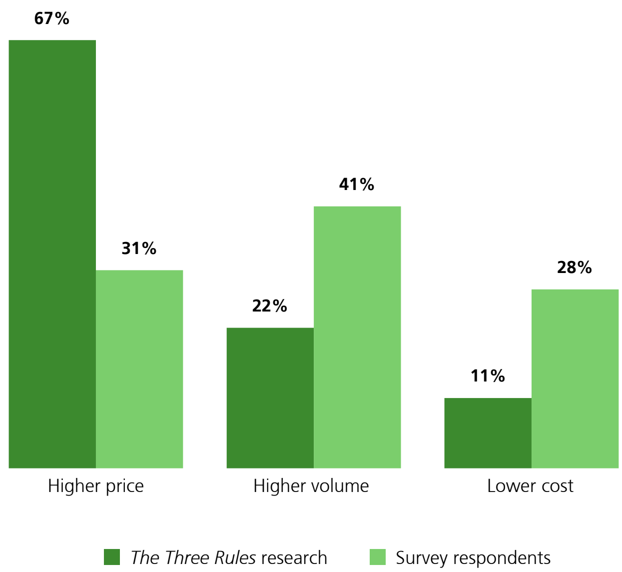
Not only did respondents stump for volume over price, there was a noticeable tendency to favor cost reduction over earning higher prices as a driver of improved profitability. On a scale of importance from 1 to 6, higher prices came in just under 3, while lower materials cost and lower labor cost were just over 3.

Taken together, these findings suggest strongly that mid-sized companies may not be paying enough attention to establishing pricing power as the foundation of their profitability over the long-term. The respondents' emphasis on volume, with lower cost and higher price essentially in a dead heat for second place, runs strongly counter to the findings reported in *The Three Rules,* in which exceptional companies focus on building differentiated positions that earn higher prices. These companies are far less likely to take the benefits of their competitive position through higher volume, and cost leadership is almost never a driver of superior long-term performance.

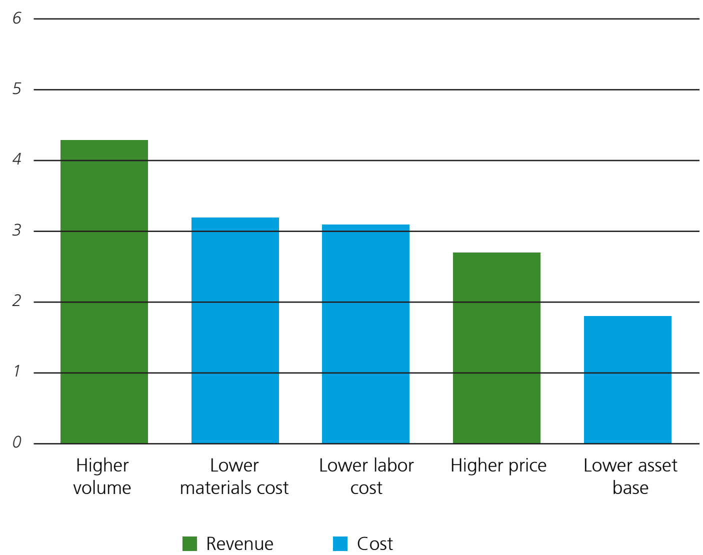
In light of the similarities between the population and sample on which *The Three Rules* is based and the companies in this survey, "these differences in emphasis should sound alarm bells for those companies who see themselves reflected in our survey results," co-author Mumtaz Ahmed says.

The Three Rules reveals that companies with exceptional performance nearly always put revenue before cost.

The relative importance of drivers of profitability:
***The Three Rules* research companies vs. survey respondents**



The relative importance of drivers of profitability:
Survey respondents only



Note: a maximum importance ranking of "6" was possible.

Cause and effect

Some of the most powerful insights from *The Three Rules* research speak to the causal links between choices and financial performance. After all, there is no way one can deduce from the mathematical relationships among differentiation, price, volume, and cost whether emphasis on any particular lever is superior to any other. One can tell any number of stories that start with any of these variables, wending through the other three to revenue, income, and asset levels, and on to superior profits. For example, a low price might increase volume, resulting in lower cost thanks to economies of scale, and ultimately leading to high profitability. Alternately, high quality might drive a high price that leads to profitability, allowing for reinvestment in cost-reduction initiatives that contribute to lower prices, higher volume and still greater profitability.

What *The Three Rules* research reveals is that companies that exploit a particular profitability formula are more likely to achieve superior performance. Companies that focus first on creating differentiation based on non-price value and capture their share of that value through higher prices are more likely to achieve superior profitability in the long run. The additional benefit of increased volume, which contributes to better asset efficiency, is a welcome side effect, but is rarely a strategic priority.

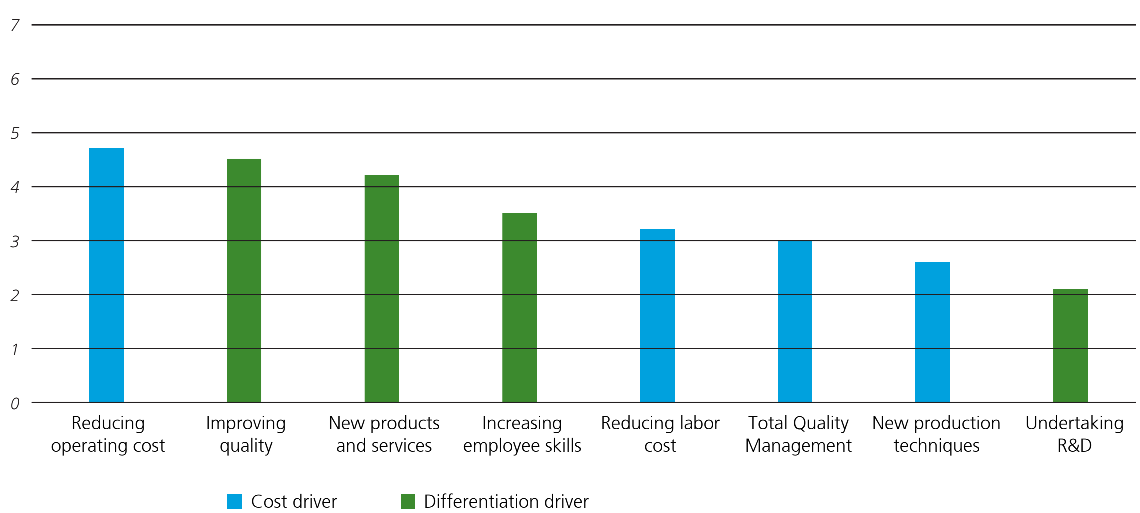
Our mid-market survey results suggest that respondents are sympathetic to the importance of non-price differentiation, rating it far more important than price leadership. In this regard, Rule #1: Better before cheaper, would appear to be an easy sell.

However, when it comes to capturing value, there is a bias toward volume and cost, rather than pursuing a price premium, and that is potentially worrying, Ahmed says.

"When a company's profitability turns on a volume advantage, if those volumes do not materialize, there can be an overwhelming pressure to start cutting price," Ahmed says. "Downward pressure on prices starts the 'death spiral': to preserve margins, there is increased emphasis on cost cutting, which in turn undermines a competitive position based on differentiation — and that, in turn, means yet more downward pressure on both volume and price."

We see how this troubling scenario potentially could materialize in how our respondents prioritized different drivers of cost and differentiation. From among a set of eight — four relating to cost and four to differentiation — reducing operating cost came out at the top of the list. This response was followed by three drivers of

The relative importance of drivers of cost and profitability: Survey respondents only



Note: a maximum score of "7" is possible.

differentiation, then three drivers of cost. It should be noted that investments in research and development — arguably the fountainhead of all differentiation — came in last.

There is nothing necessarily wrong with these preferences, Raynor says. After all, something has to come first. In fact, one interpretation is that differentiation might well be more important than cost in general, given the fact that reducing operating cost comes first, only to be followed by three drivers of differentiation.

At the same time, decisions do not present themselves as a portfolio of choices. It can be very difficult to maintain a long-term perspective on the overall balance and emphasis a company places on increasing non-price differentiation and reducing cost.

"If cost is king, then as choices present themselves, one after the other, it is only too possible that cost reduction ends up defining far more choices than it should — and even more than management wants," Raynor says.

Some companies represented in the survey may be "balancing on the knife-edge," Raynor says, by trying to constantly juggle differentiation, volume and cost. Based on *The Three Rules* research, a far more stable model is one built on differentiation and higher prices, with volume advantages delivering an "extra bonus."

"Relatively few companies say they compete on price," observes Ahmed, "but there's a world of difference between claiming you're a differentiated price-maker in your markets and actually making the hard choices over time to deliver on that intent." The hope is that the rules can provide leaders with the courage and the confidence to make those choices consistently, despite the uncertainty that characterizes many difficult decisions.

Raynor concludes, "You have to make the really tough choices based on your deeply held beliefs about how the world works. And we've concluded that the rules capture something fundamental about the mechanisms that drive the results sought by any company that aspires to greatness."

"The rules capture something fundamental about the mechanisms that drive the results sought by any company that aspires to greatness."

Michael Raynor — Director, Deloitte Services LP, and Deloitte's Innovation Theme Leader

Conclusion

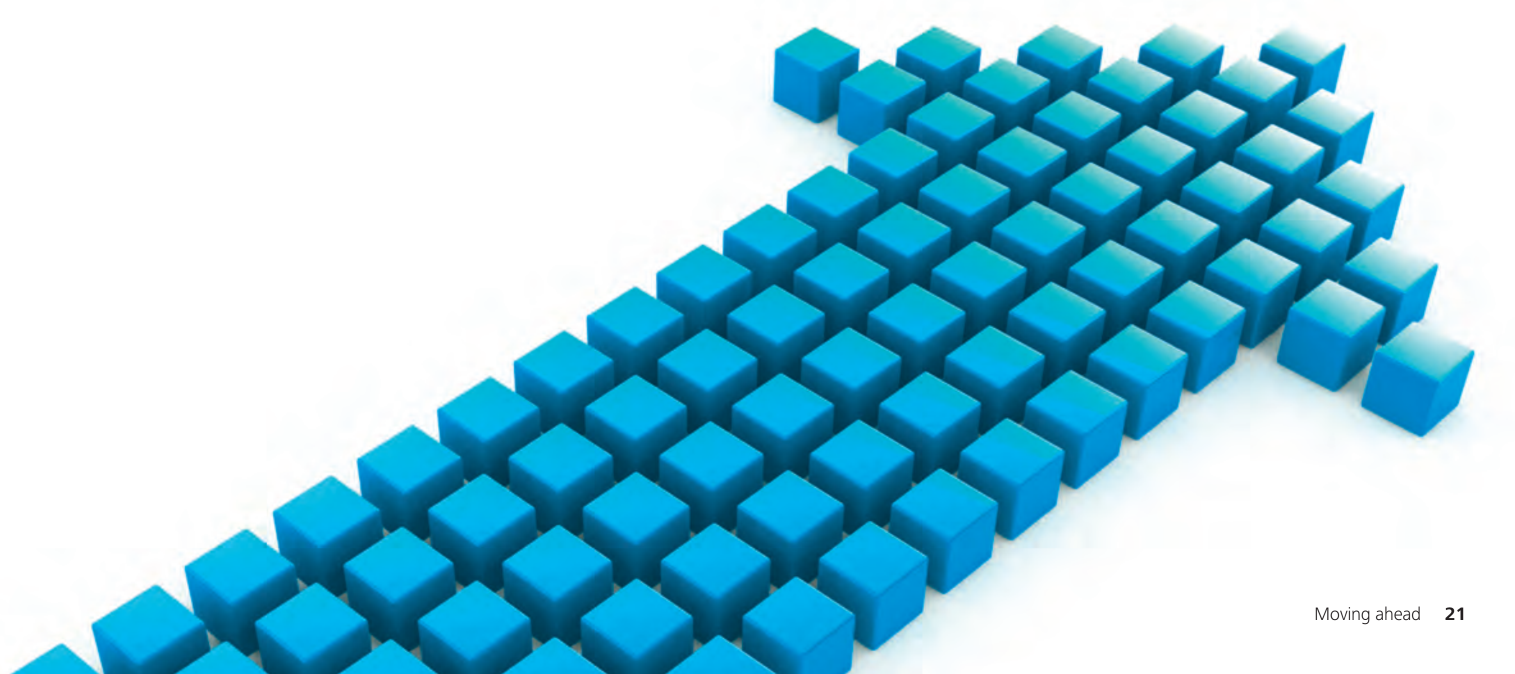
While much remains unsettled on the economic and political fronts, mid-market companies don't seem to be letting those uncertainties prevent them from investing for the future. Rather than waiting for an all clear, most say they are moving ahead with growth initiatives, seizing opportunities where they present themselves. They appear to recognize that passively waiting for the future to arrive before taking action defers not only the risk but also the associated returns. And so they are taking action, and reporting positive results to a degree not seen in previous surveys.

Purposeful action is not reckless abandon, however. There are still a number of significant challenges worth monitoring and managing. Successful companies consider both risks and returns based on a wide variety of possible futures. This has always been the case and remains so today.

Put simply, there are some things companies can control and some things they can't.

The Three Rules, derived from the analysis of 45 years' worth of data and the study of hundreds of exceptional performers, identifies the choices that, more than any others, determine whether a company is likely to achieve exceptional long-run performance or not. Achieving such an outcome demands making tough choices — and the rules offer a fact-based set of principles to guide those choices.

As with each of our surveys and reports, it is interesting to look back and see how accurate projections ultimately were and how priorities shifted over time. If the projections and priorities identified in this report hold true, we may be seeing a growing resurgence of performance and a momentum that leads to greater overall economic performance. Should this occur, the credit will go to those business leaders who had the insight to understand their respective markets and the confidence to make the decisions that propelled their organizations forward.



Appendix: full survey results

Note: some percentages in the charts throughout this report may not add to 100% due to rounding, or for questions where survey participants had the option to choose multiple responses.

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: moving ahead*.

Performance and growth

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

Grow robustly: 5% or more	7.0%
Grow above-trend: more than 3.5%, but less than 5%	11.4%
Grow moderately: 2% to 3.5%	30.6%
Grow slightly: less than 2%, but more than 0%	42.6%
Show no growth: 0%	5.9%
Negative growth	2.6%

What is your company's main growth strategy over the next 12 months? (Please select only one.)

Growing organically in new markets	27.7%
Development of new products and services	19.7%
Increased productivity	17.1%
Strategic alliances and collaborative projects	13.2%
Mergers and acquisitions	12.7%
Entry into new markets globally	5.1%
Strengthen management team	4.6%

Which investment(s) in technology is your company most likely to make in the next 12 months? (Please select up to three.)

Automation of business processes	38.3%
Cloud computing/Software as a Service	31.4%
Data analytics/Business intelligence	30.0%
Enterprise application suites	20.2%
CRM	19.3%
Robotics	6.5%
Other	1.4%
Don't know/not sure	15.6%

What is your business' projected percentage revenue growth over the next 12 months?

31% or higher	1.6%
21% - 30%	4.3%
16% - 20%	5.8%
11% - 15%	13.9%
5% - 10%	41.6%
1% - 4%	25.1%
0%	4.4%
Negative 1% - 4%	2.4%
Negative 5% - 9%	0.8%
Negative 10% or lower	0.1%

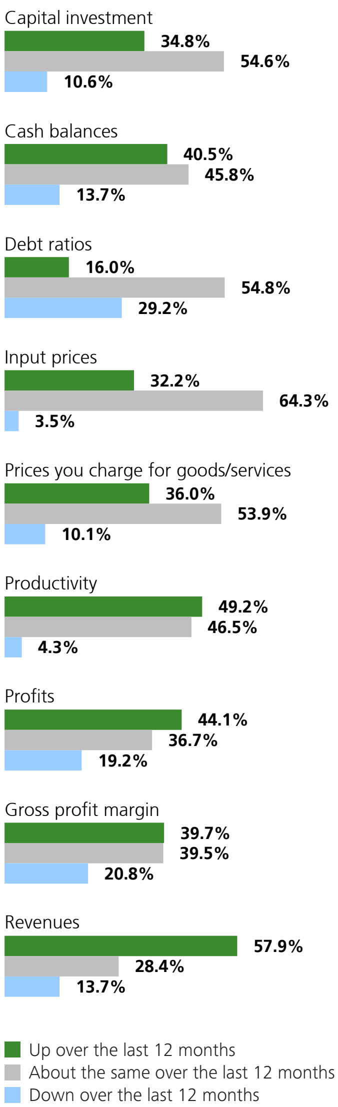
What are your company's main obstacles to growth? (Please select up to three.)

Uncertain economic outlook	50.0%
Health care costs	35.9%
Increased regulatory compliance	33.7%
Weak market demand	30.7%
Skills shortage	20.1%
Cost of raw materials and other input costs (incl. energy)	18.0%
Cost of keeping up with technological advances	16.6%
Budget cuts by government (federal, state, municipal)	14.1%
Availability and/or cost of credit	6.2%
Other	3.1%

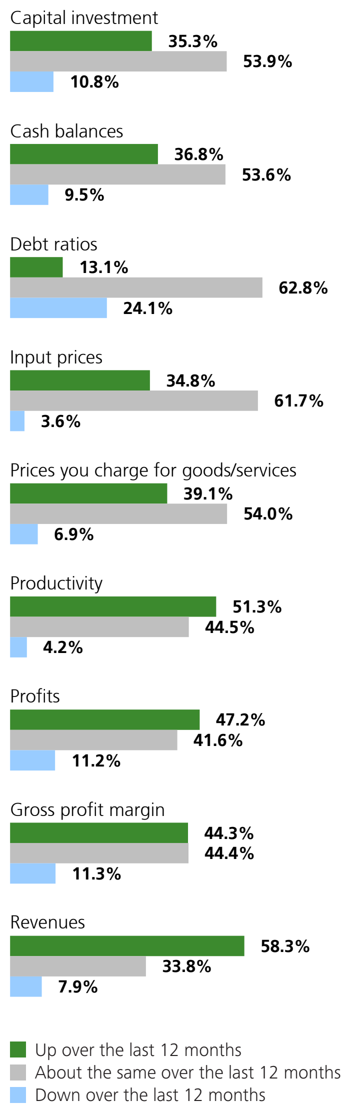
Which of the following measures by the U.S. government would most help U.S. mid-sized businesses to grow in the next 12 months? (Please select up to two.)

Rolling back health care reform	40.9%
Reducing corporate tax rates	39.6%
Keeping interest rates low	26.5%
Stimulating private consumption	16.7%
Supporting increased infrastructure investment	15.4%
Easing bank lending practices	10.2%
Protecting U.S. firms better from global competition	8.2%
Subsidizing vocational and other skills training and development	5.2%
Easing immigration restrictions	4.7%
Passing currently pending free trade agreements	2.8%
Relaxing export/import regulations	2.1%
Other	3.2%

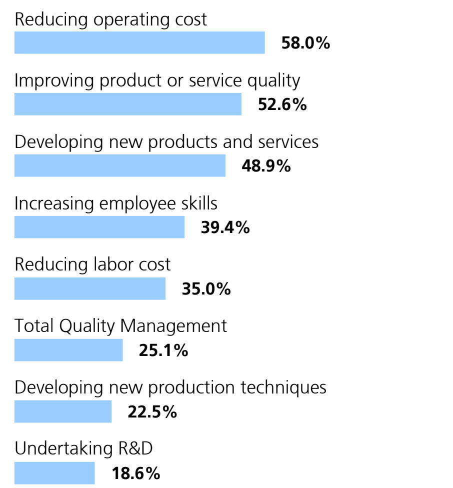
Are the following key metrics of your business up, about the same, or down over the last 12 months?



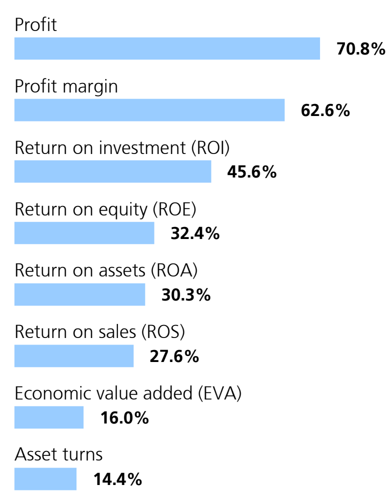
Do you expect these same key metrics of your business to go up, stay about the same, or go down over the next 12 months?



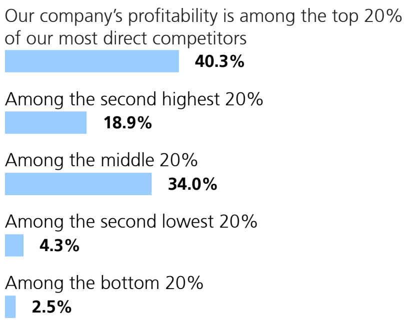
Please rank the importance of the following factors with respect to their relative importance to your company's business strategy.



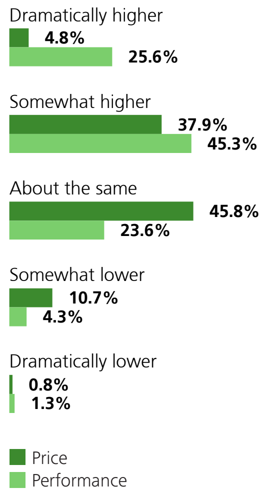
Please rank the following key performance measures in terms of importance to your company.



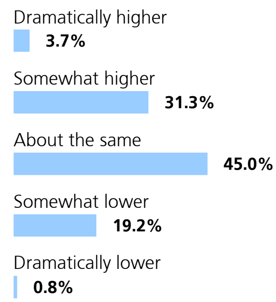
How does your company's profitability over the last five years compare with your most direct competitors?



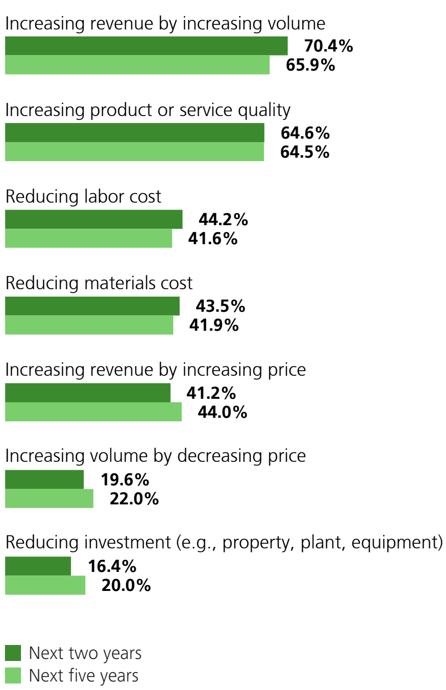
How would you characterize your company's competitive position (price and performance) compared to your most direct competitors?



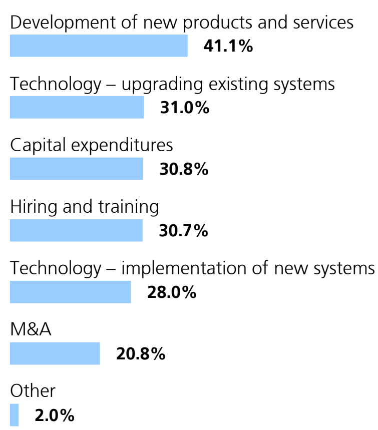
How would you characterize your company's overall cost position compared to your most direct competitors?



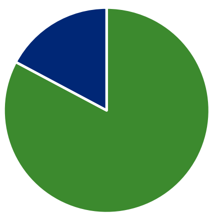
Please rank the following seven items with respect to their relative importance in improving your company's profitability over the next <u>two</u> years and next <u>five</u> years.



What are your company's top two investment priorities in the next 12 months? (Please select two.)

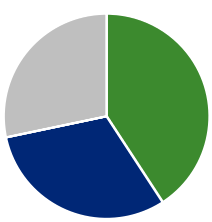


Which goal is more important to your business in terms of delivering customer value in your market? (Please select one.)



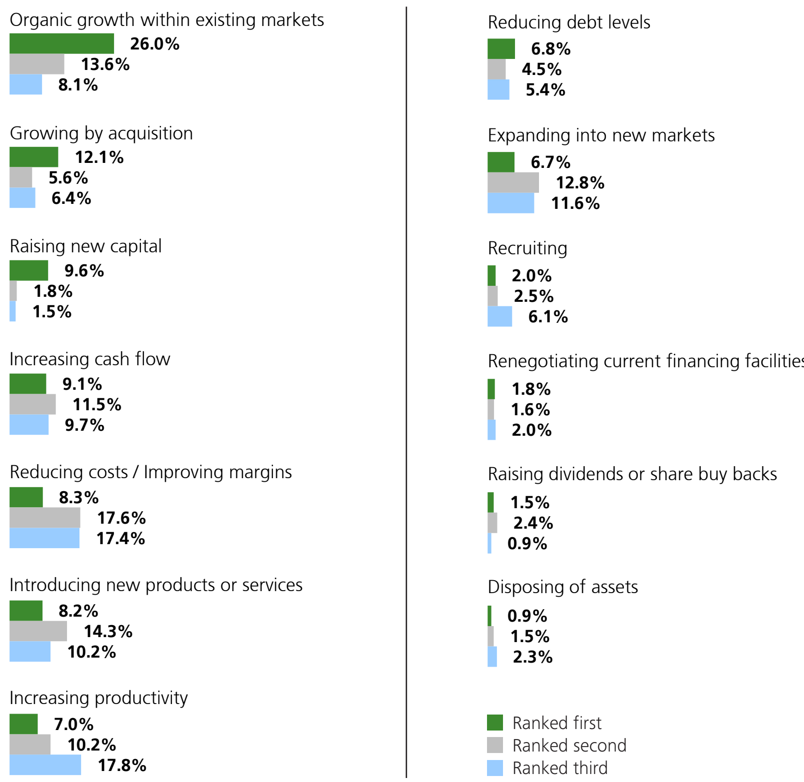
- Achieving a product/service position that differentiates me from my competitors in the market: 82.8%
- Achieving a price position that is lower than that of my competitors in the market: 17.2%

Which goal is the most important contributor in driving profitability for your business? (Please select one.)

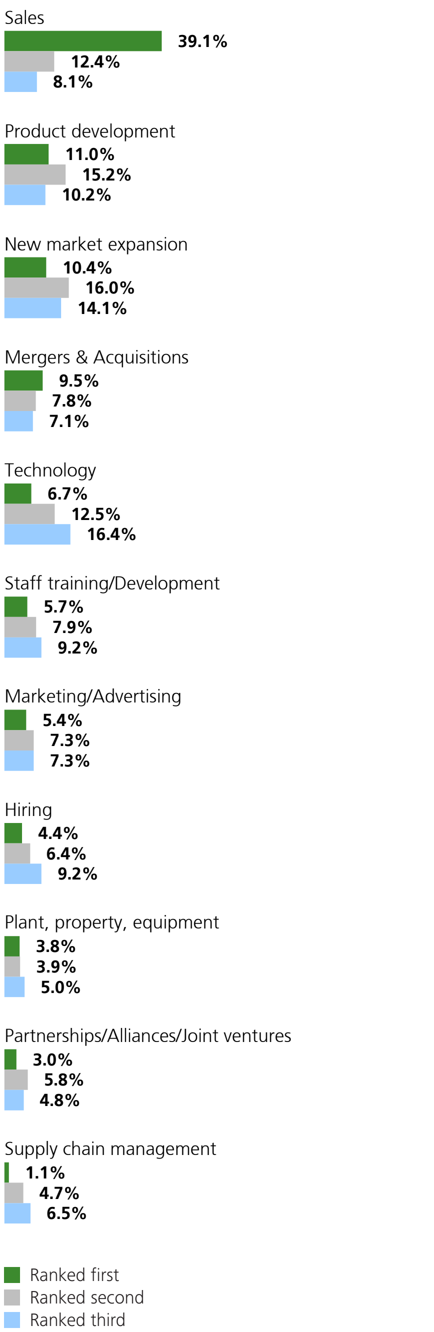


- Maximizing revenue by achieving superior unit volumes to expand gross margins: 40.8%
- Maximizing revenue by achieving superior pricing power to expand gross margins: 30.9%
- Minimizing costs to expand gross margin: 28.3%

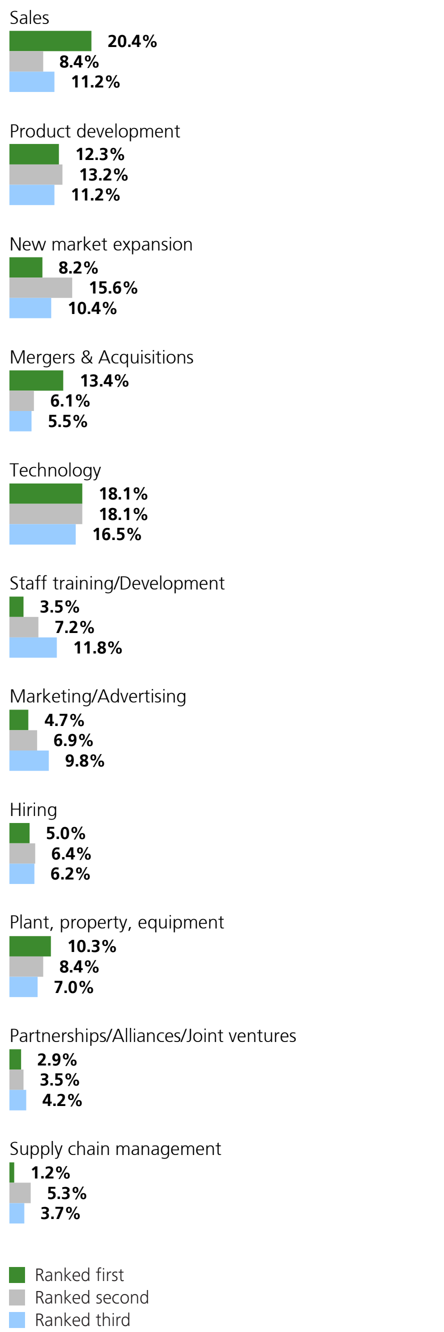
Please rank (in order of importance) your top three priorities for the next 12 months in terms of business strategies.



Rank your management's top three priorities for the next 12 months in terms of time invested.



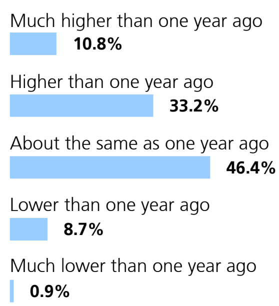
Rank your management's top three priorities for the next 12 months in terms of capital investment.



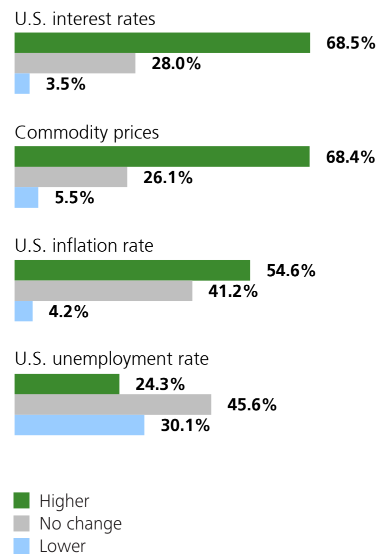
The business environment

Which of the following issues present the greatest obstacles to U.S. growth over the next 12 months? (Please select all that apply.)

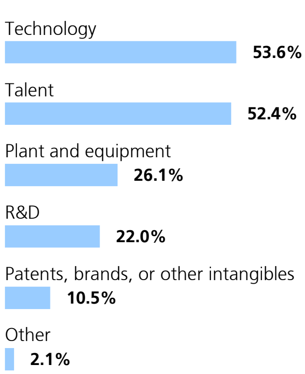
The level of uncertainty in terms of factors that drive future business prospects (e.g., taxes, regulations, credit availability and the economic outlook) is …



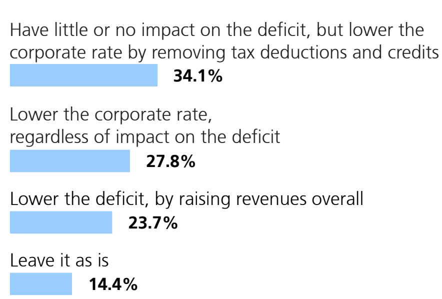
What do you believe is the most likely outlook for the following over the next 12 months?



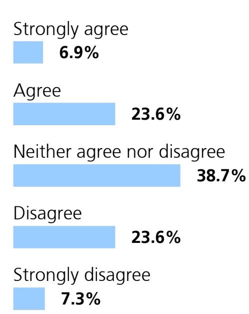
Which investments offer the greatest potential for increasing productivity at your company? Please select all that apply.



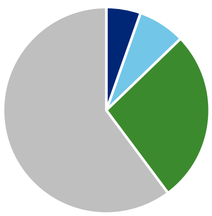
Regarding the potential for tax reform, what outcome would be most helpful to your business and its ability to grow and hire?



"We are deferring major investments due to the uncertainty in the current business environment."

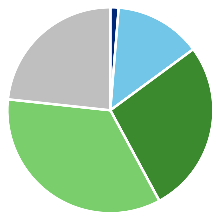


How would a change in U.S. immigration law easing issuance of work visas to skilled immigrants affect your ability and willingness to hire?



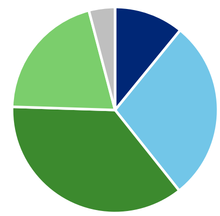
- Substantial impact/ It would change my business for the better: 5.4%
- Moderate impact/ I would hire people right away: 7.4%
- Marginal impact/ I would consider adding staff: 27.0%
- No impact at all: 60.2%

What is your level of confidence that the U.S. economy will continue to improve over the next 24 months?



- Extremely confident: 1.3%
- Very confident: 13.6%
- Confident: 27.2%
- Somewhat confident: 34.6%
- Not confident: 23.3%

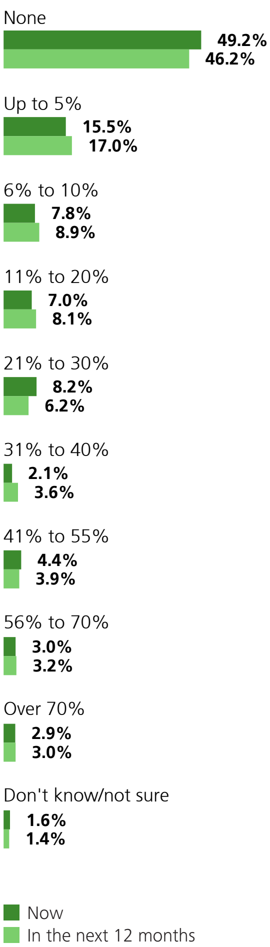
What is your level of confidence in the success of your company (based on revenue, profitability and growth) over the next 24 months?



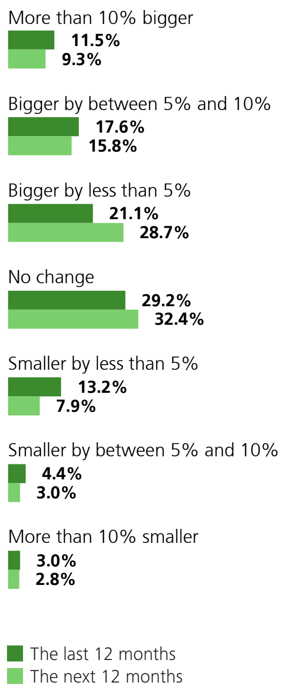
- Extremely confident: 10.9%
- Very confident: 28.4%
- Confident: 36.2%
- Somewhat confident: 20.4%
- Not confident: 4.1%

Workforce/hiring

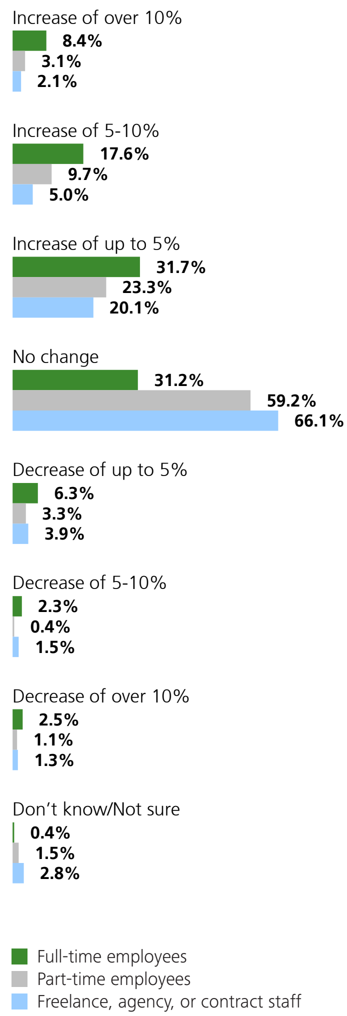
Please specify the percentage of your workforce based outside the United States.



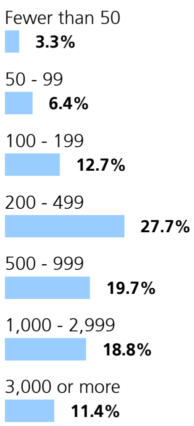
How has the size of your full-time domestic workforce changed over the last 12 months? How do you expect it to change over the next 12 months?



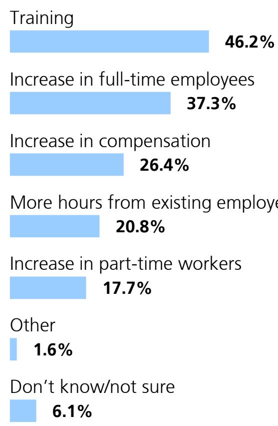
What is likely to be the main focus of your company's domestic employment strategy in the next 12 months?



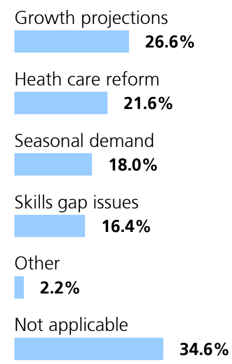
Approximately how many full-time staff are employed by your business?



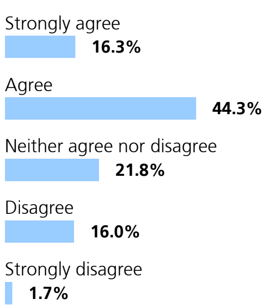
Which investment(s) in talent is your company most likely to make in the next 12 months? (Please select up to two.)



If you expect to hire more part-time or contract employees over the next 12 months, is this due to… (Please select all that apply.)

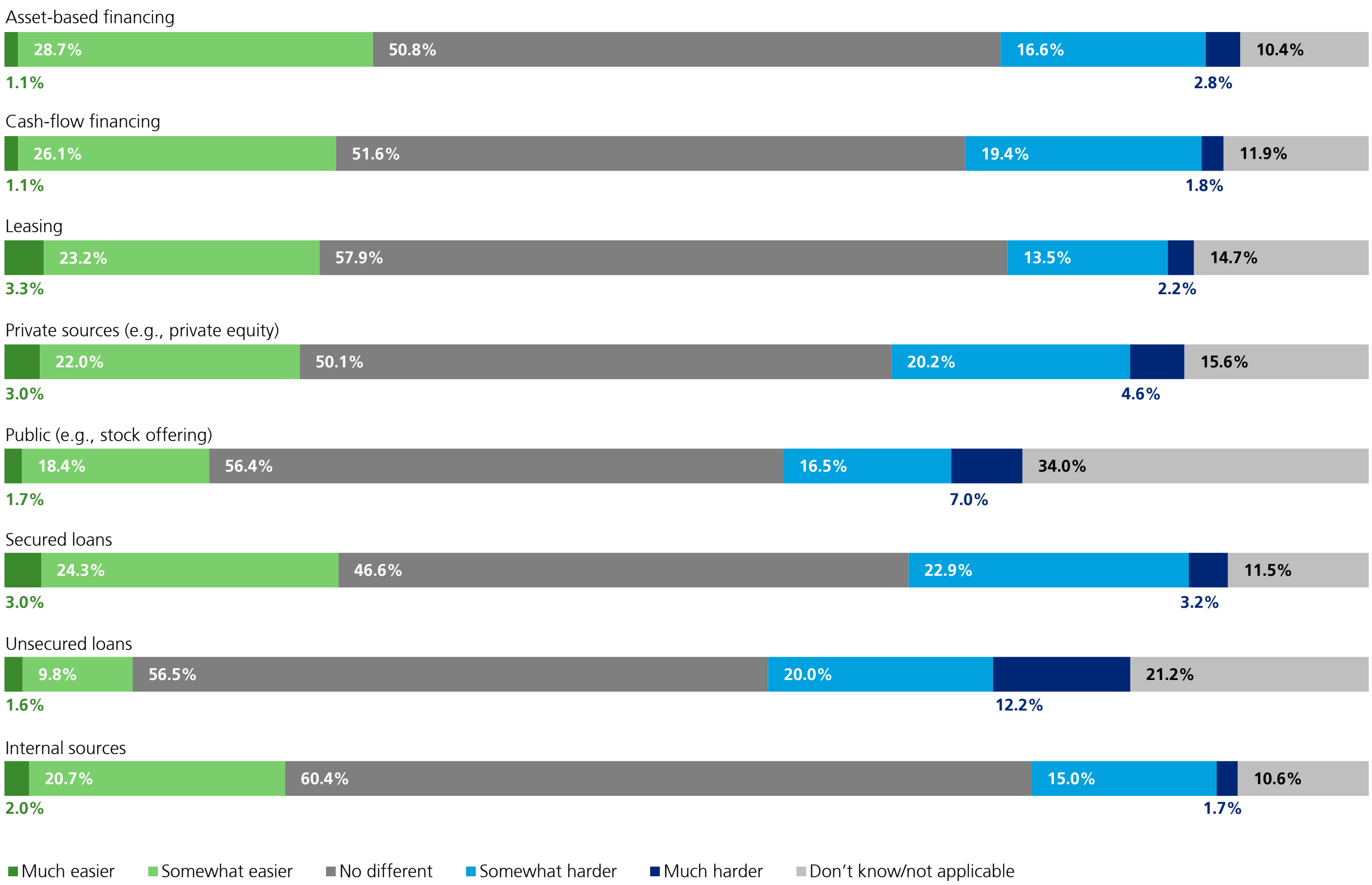


"It is difficult for us to find new employees with the skills and education to meet the needs of our business."

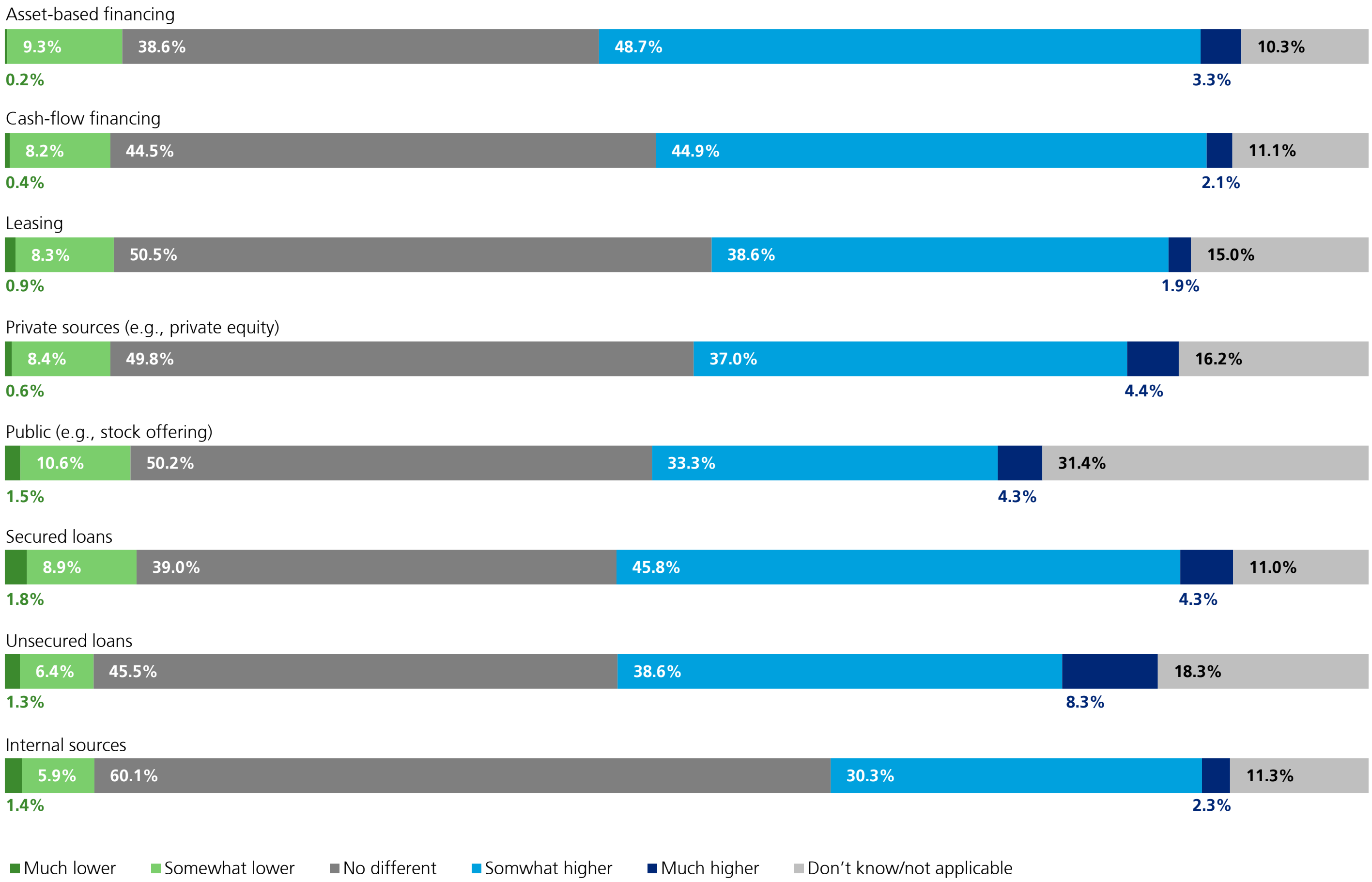


Financing

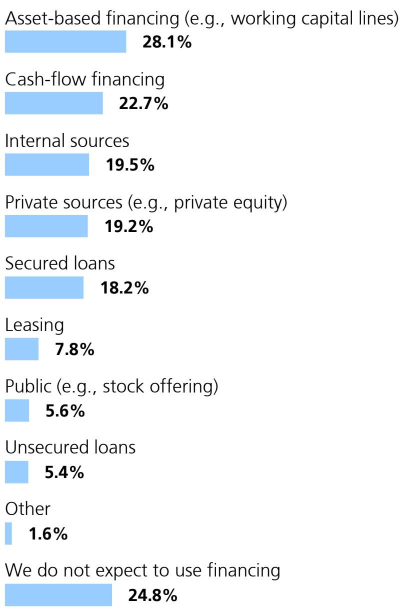
Do you believe it is easier or more difficult for mid-market companies in your industry to secure credit now than it was a year ago? Please respond based on your understanding of industry conditions.



Do you believe that the costs of credit are higher or lower now than they were a year ago? Please respond based on your understanding of industry conditions.

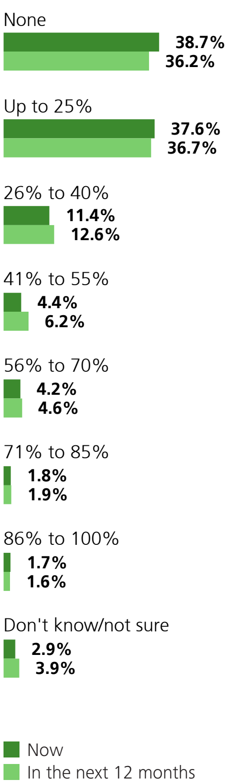


What types of financing do you expect your company to pursue over the next 12 months? (Please select all that apply.)

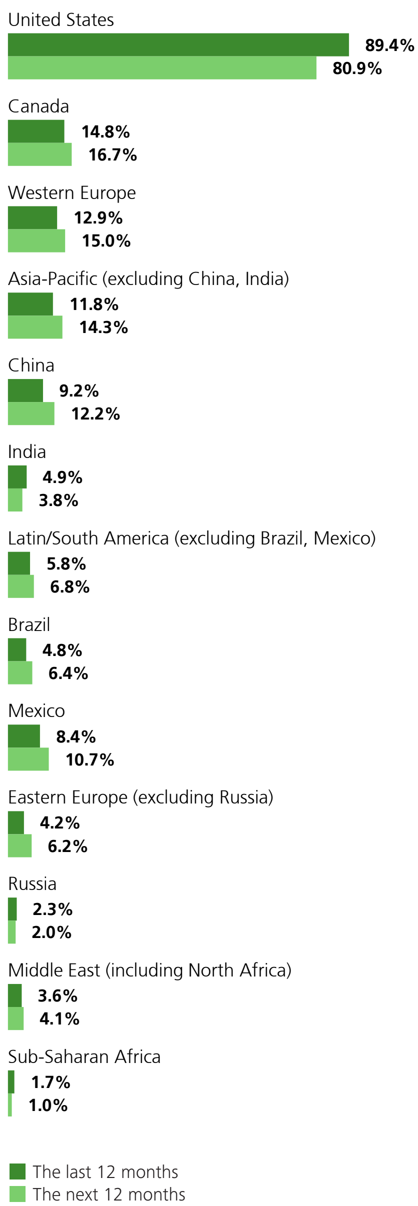


Emerging markets

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

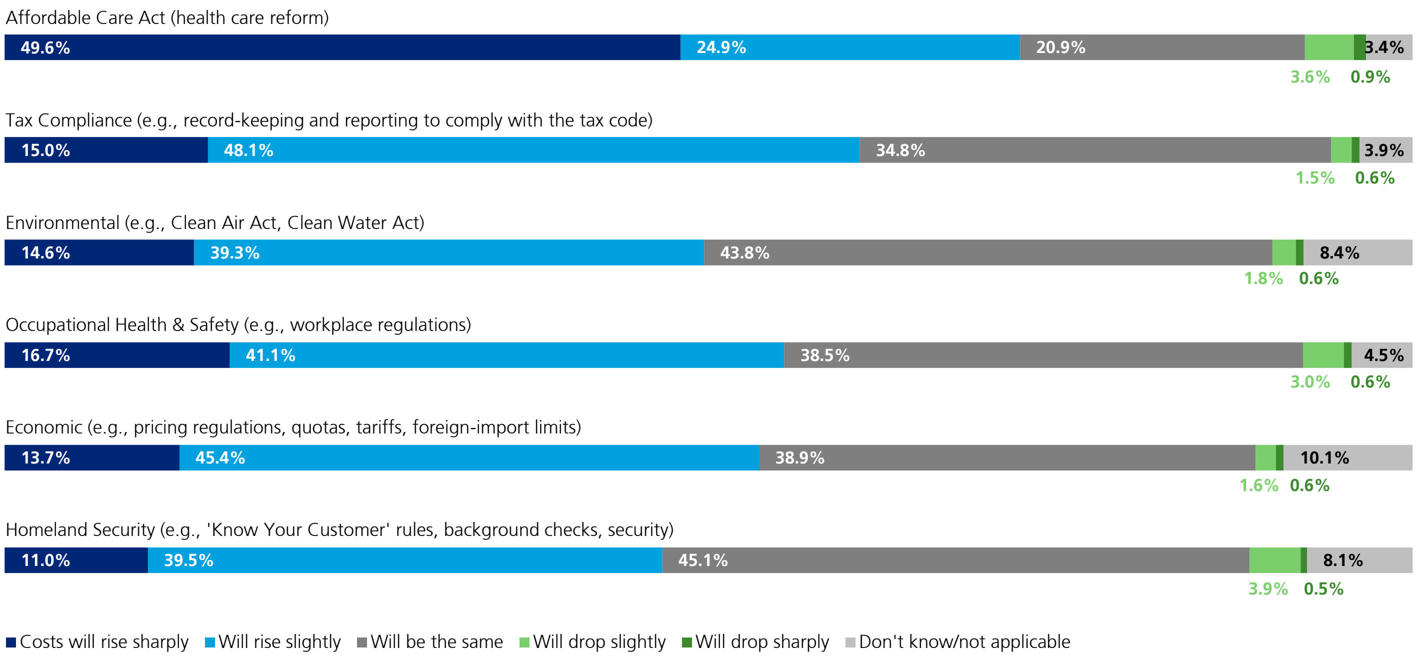


Which geographic markets have contributed the most to your company's growth over the last 12 months? Which geographic markets will contribute the most over the next 12 months? (Please select all that apply.)



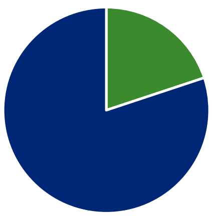
Regulatory compliance

For each of the following, please indicate how the costs of regulatory compliance will change for your business in the next 12 months:



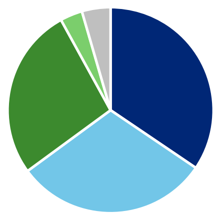
Public vs. private

Is your company public or private?



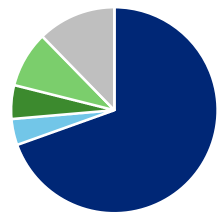
- Public : 19.9%
- Private: 80.1%

Is your company…?



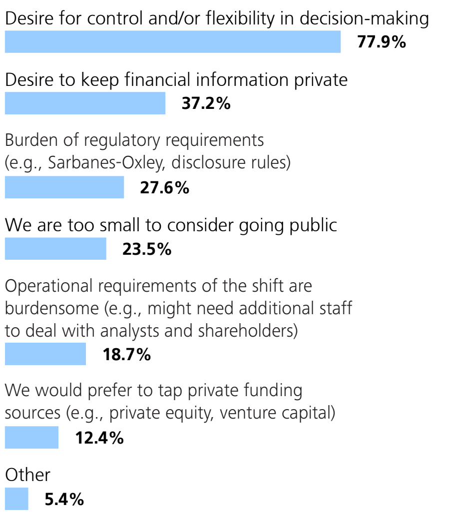
- Closely-held (non-family): 34.5%
- Family-owned: 30.5%
- Private equity owned: 27.1%
- VC-backed: 3.5%
- Other: 4.5%

Which of the following best describes your company's ownership status?

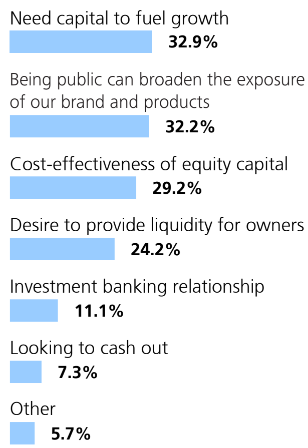


- Privately held, and unlikely to go public within the next 12 months: 69.6%
- Privately held, but likely to go public within the next 12 months: 4.1%
- Privately held, but likely to go public sometime after the next 12 months: 5.3%
- Public, but held by a small number of owners: 8.8%
- Public and broadly held: 12.3%

What factors influence your company's decision to remain private for now? (Please select all that apply.)

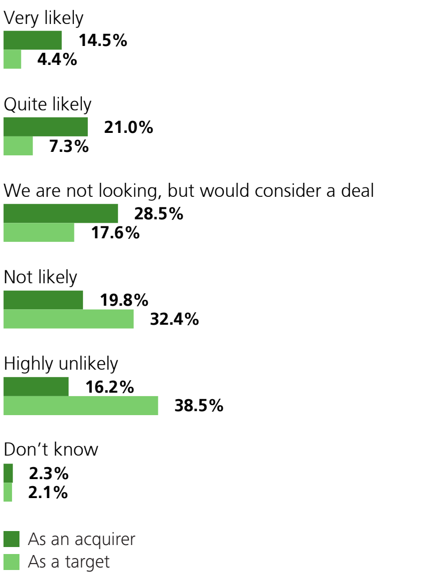


What factors influence your company's decision to be or go public? (Please select all that apply.)

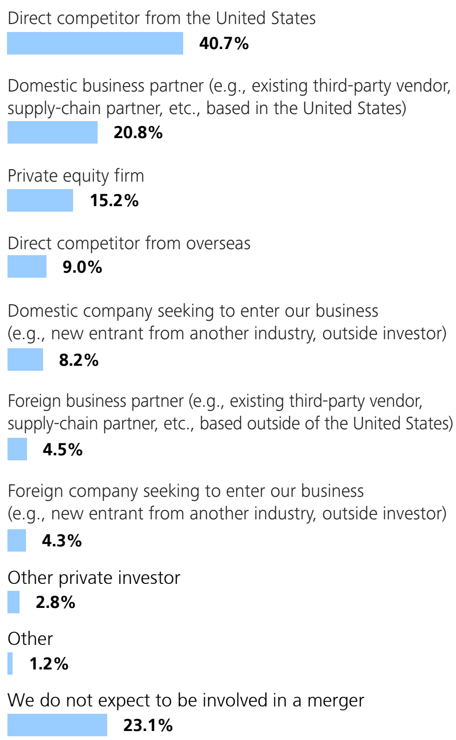


Mergers and acquisitions

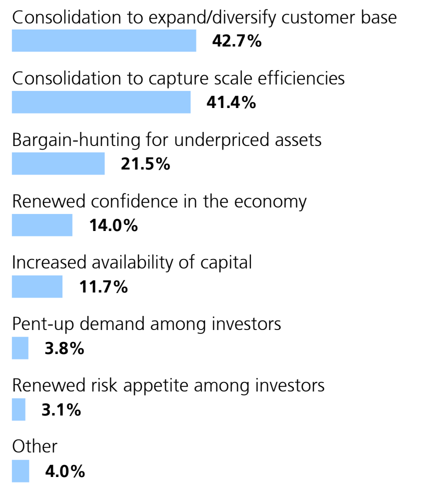
How likely is it that your company will participate in a merger or acquisition in the next 12 months?



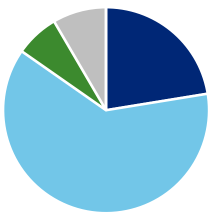
If you participate in a merger or acquisition, which of the following entities is most likely to be the counter-party? (Please select up to two.)



What will be the main drivers of merger activity in your industry over the next 12 months? (Please select up to two.)

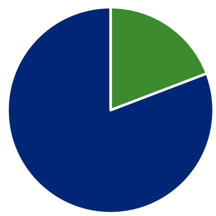


Over the past 12 months, the level of M&A activity in my company's industry has…



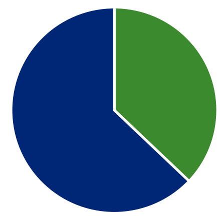
- Increased: 24.5%
- Stayed the same: 68.0%
- Decreased: 7.5%
- Don't know: 9.2%

Have you talked with a Private Equity firm about a possible transaction in the past 12 months?



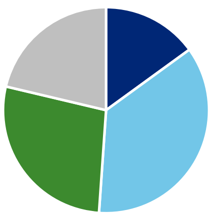
- Yes: 19.2%
- No: 80.8%

Would you consider a Private Equity partner?



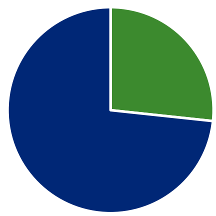
- Yes: 37.1%
- No: 62.9%

What is the level of importance of M&A to your growth strategy?



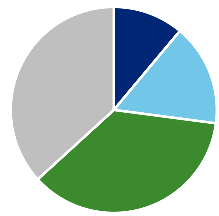
- Very important: 15.0%
- Somewhat important: 36.1%
- Of minor importance: 27.6%
- Not important at all: 21.3%

In the past 12 months, have you completed any mergers or acquisitions?



- Yes: 26.1%
- No: 73.9%

If you have completed any mergers or acquisitions in the past 12 months, how many?



- More than 3: 11.1%
- 3: 16.0%
- 2: 36.2%
- 1: 36.8%

Survey respondent demographics

What was your company's 2012 annual revenue in U.S. dollars?

Between $50 million and $99.99 million	26.2%
Between $100 million and $199.99 million	25.6%
Between $200 million and $499.99 million	25.6%
Between $500 million and $1 billion	22.5%

Which of the following best describes your title?

Owner/Partner	9.3%
Board member	1.2%
CEO	3.6%
President	5.2%
CFO	12.5%
CIO	6.2%
COO	5.6%
Other C level	4.2%
SVP/VP/Director	20.5%
Head of business unit	3.4%
Head of department	7.4%
Manager	21.1%

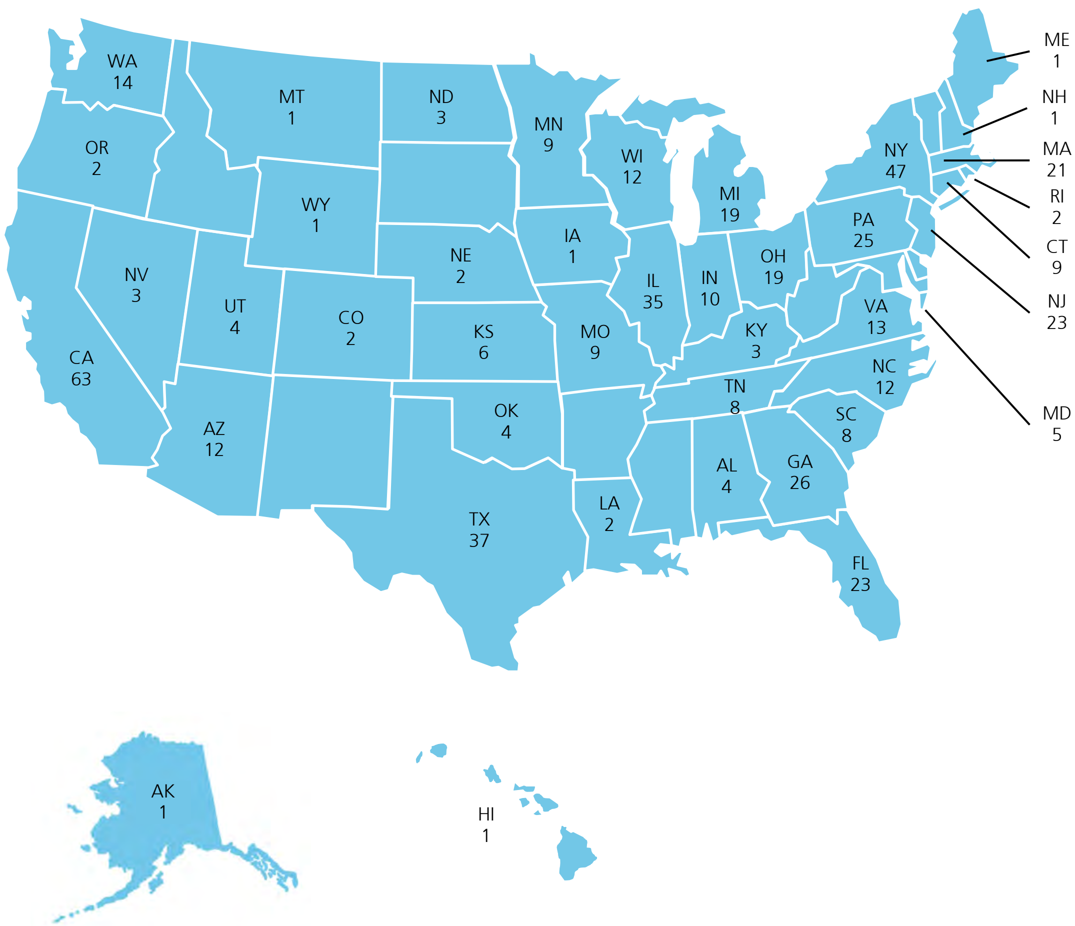
What is your main functional role?

Finance	22.1%
General management	19.3%
IT	10.5%
Operations and production	10.1%
Marketing and sales	8.2%
Strategy and business development	6.6%
Human resources	6.4%
Customer service	2.8%
R&D	2.8%
Legal	2.6%
Supply-chain management	1.4%
Information and research	1.2%
Procurement	1.2%
Risk	1.0%
Other	4.0%

In what sector does your company belong?

Consumer & Industrial Products	29.2%
Financial Services	12.9%
Technology, Media & Telecommunications	11.1%
Life Sciences & Health Care	9.1%
Energy & Resources	5.6%
Other	32.0%

In which state is your company's headquarters located? (Number of respondents shown.)



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