

Perspectives from America's economic engine: US middle market outlook 2007



A report from the Economist Intelligence Unit

In association with



Preface

Perspectives from America's economic engine: US middle market outlook 2007 was created by the Economist Intelligence Unit in association with CIT Group, Inc. Dan Armstrong was the editor and project manager. Nigel Adam was the writer. James Rubin performed the interviews with many of the companies profiled. Daniel Larose provided valuable statistical analysis of the survey findings. Christina Rae and Doug Rozman of CIT offered valuable insights and commentary.

Our thanks go out to the 22 CEOs and other senior executives who generously agreed to be interviewed for this paper, as well as the hundreds of financial decision-makers who participated in the survey.

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Introduction

Middle market companies are key drivers of the US economy's growth. Their influence stems not just from the number of people they employ, but from the diversity of industries they represent, including, but not limited to, media, energy, real estate, healthcare and information technology. US companies with revenue between US\$25m and US\$1bn—the subjects of this study—account for more than US\$6trn in sales and employ nearly 32m Americans, according to the US Census. This represents more than twice the revenue and four times the number of employees of the blue chips that comprise the Dow Jones Industrial Average.

As these statistics show, the health of the middle market sector greatly affects consumers, government agencies, financial services providers and other key constituencies. All have a stake in ensuring that this sector successfully overcomes its challenges to future

expansion. Yet despite their impact, middle market companies are often overlooked and misunderstood in terms of their effect on the US economy.

This report, conducted by the Economist Intelligence Unit in association with CIT Group Inc, provides an in-depth look at one of the strongest engines of the US economy: the middle market sector. It examines the views of middle market executives on the US economy, their own future growth prospects and the obstacles that they face. It details what measures of success, both tangible and intangible, these companies deem most important. It explores the arguments both for and against taking privately held companies public. And it describes how and why these companies will seek to finance their growth while measuring the degree of satisfaction with both their access to, and their cost of, external financing.

Key findings of the research

- **Despite their size**, middle market companies have a disproportionate impact on the economy, employing more Americans than the large-cap companies that make up over half of the US stock market's valuation.
- **About two-thirds** of middle market companies believe that their revenue will grow during the next 12 months—even though almost the same proportion believes that overall US economic growth is likely to decline.
- **Middle market companies** agree that profitability is slightly better than revenue growth (73% compared with 66%) as a measure of tangible success. Cited as the biggest intangible influences on success are customer relationships (46%), followed by company reputation (36%), with the quality of products and services coming in a surprising third (35%).
- **More than 40%** of middle market companies plan to grow by focusing only on the domestic market. Moreover, among all financial decision-makers at middle market companies, geographic expansion



comes in a distant fifth among growth strategies. However, one-half of those that are expanding overseas say that Asia-Pacific will account for the most international growth, followed by Europe with 21%.

- **Middle market companies** are determined to hold the line on pricing. Despite pressure on prices, only a small minority—13%—of senior executives say that aggressive pricing is part of their growth strategy. The remainder plan to build demand, mainly through more aggressive sales and marketing initiatives.

- **Middle market firms** are taking aggressive measures to combat talent shortages. “Shortage of talented staff” is the number-one obstacle to growth cited by financial decision-makers. Nearly one-half of the companies (47%) are increasing their workforces to acquire the talent necessary to compete—even though “labour costs” is the number-two growth obstacle.

- **More than one-half** of financial decision-makers say that their companies have no plans to go public (even though these companies, on average, are larger and more successful than the other companies surveyed). Surprisingly, only 25% of these firms cite the burden of regulatory requirements such as Sarbanes-Oxley (SOX) as a primary reason for staying private. Nearly three-quarters of companies instead cite the desire to retain control and flexibility in decision-making, and one-third seek to avoid disclosing financial information. SOX is clearly a burden – but it is not the primary reason that middle market companies avoid going public.

- **Most middle market companies** believe that environmental sustainability is important. Influenced by customers, the government, energy costs and their own consciences, 54% of senior execu-

tives confirm that environmentally friendly policies are important at their middle market companies. However, a majority of companies (55%) also say that the cost of gearing up for greener operations represents a major obstacle to implementation.

- **The cost of financing** and access to financing is a concern to middle market companies. About 44% of respondents call their current capital structure “optimal”. But among the remainder – who are almost evenly split between desiring more debt and more equity – cost is the most frequently cited problem (41%), followed by access (29%). The reasons appear to stem mainly from insufficient debt capacity (16%) or inadequate asset valuations (14%)—although some executives say that it is simply too difficult to get the attention of banks (13%).

- **Of the top three criteria** cited as most important in choosing a financing provider, “industry understanding” (41%) and “loyalty through good times and bad” (40%) surprisingly rank above preferential rates and pricing (39%). All are important, say middle market executives. But although large corporations may switch providers to save a few basis points, middle market companies generally do not.

- **Neither political party** commanded respondents’ confidence when they were asked about the 2008 presidential election. While Democrats were seen as most likely to strengthen the economy than Republicans if elected to the White House in 2008 (36% to 26%), they were also thought to be more likely to weaken it (35% to 30%). A Democrat is expected to have more of an affect on the economy than a Republican—for better or worse. Only 22% said a Democrat will not affect the economy, compared with 36% who said a Republican’s election will not affect the economy.



The outsized influence of middle market companies

Beneath the blue chips with billions in capitalisation lies a group of companies that, while seldom household names, together wield more economic clout than companies such as Wal-Mart and General Electric that dominate the headlines. But measuring the influence of these companies is difficult. Investors, the press and the public tend to focus on companies with large and liquid pools of public shares. Since most are privately held, they do not appear in the indices watched by investors, and they are under-represented in databases and news stories as well.

In addition, the middle market is so fragmented, diverse and dynamic that it is difficult to characterise. “It [the middle market] is comprised of companies that are growing and moving up, experiencing issues and moving down, or getting acquired” says Walter Owens, president of CIT Corporate Finance. “It’s a volatile sector and therefore it is difficult for people to understand.”

As a result, investors, the press and the public focus on companies with significant market capitalisation to the exclusion of other dimensions that may have a more tangible impact on the economy, such as employment and revenue. It is in these areas that the middle market shines.

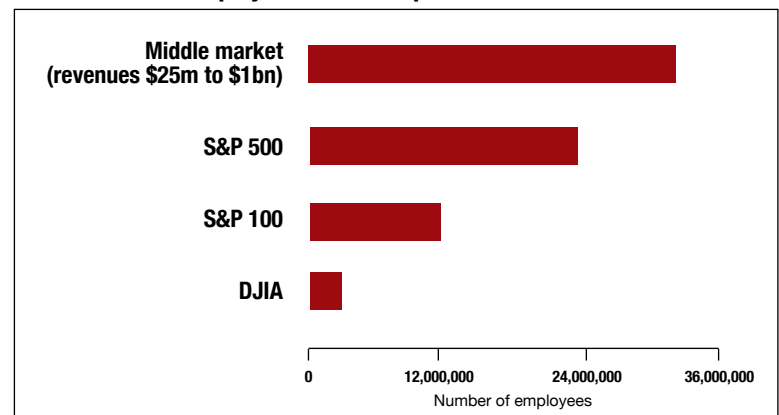
There are many more middle market companies than there are large companies. When a company’s rank (in terms of annual revenue) is plotted against its annual revenue, the resulting line follows a power-law distribution with a small number of large companies and a large number of small companies.¹ This distribution shows that the revenue of the large universe of middle market companies (and hence their contribution to the economy) add up to a number larger than is generally believed. In other

words, what middle market companies lack in size, they more than make up for in numbers.

For instance, consider the companies in the S&P 500, which comprise about 75% of the market capitalisation of the US equity markets – far more than the middle market, most of which is privately held.² As a group, the S&P 500 companies (of which 13 are non-US) employ about 22m people.³ Meanwhile, companies with annual revenue between US\$25m and US\$1bn, while short on stock market clout, employ about 32m people—far more than the S&P 500, according to the most recent US Census data.⁴

In the area of annual revenue, the story is similar, although less dramatic. The companies of the S&P 500 generate about US\$8.3trn in revenue each

Total number of employees at US companies



¹ For the seminal article, see “Company size distribution in different countries” in *Physica A* 277 (2000), JJ Ramsden and Gy. Kiss-Hayp, 220-227.

² Standard & Poor’s S&P 500 Overview, available at <http://www2.standardandpoors.com>.

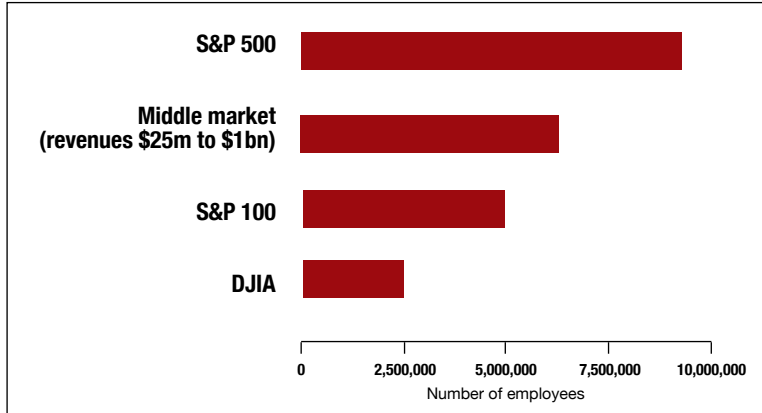
³ Bloomberg

⁴ See “Statistics about Business Size” at <http://www.census.gov/epcd/www/smallbus.html>



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Annual revenues at US companies



“You have to be a risk-taker in an aggressive way, but if you are wrong about the product or the timing you are in serious trouble. For big companies, a mistake like that is just a bump in the road; for start-up companies it probably means you are dead. In the middle market, you end up in intensive care.”

Donal Massaro, president and CEO, Sendmail

year; for the S&P 100, the figure is about US\$4trn. The middle market sector has annual revenue of just over US\$6trn, about midway between the two and comparable to companies comprising somewhere in the area of 60% of the US equity market’s capitalisation. Although the average S&P 500 company has about US\$17bn in revenue, the sheer number of companies in the US\$25m-US\$1bn category (about 106,000, according to the US Census) combine to make the middle market a formidable force.

Demographics of the US middle market outlook 2007

The universe for the survey and interviews conducted as part of the US middle market outlook 2007 consisted of both private and public companies, with annual revenue between US\$25m and US\$1bn. The Economist Intelligence Unit surveyed 502 senior financial decision-makers at these companies. Over one-half (53%) were C-level executives such as owners, CEOs and CFOs. The remainder

came from the ranks of business line heads, senior vice-presidents, vice-presidents and directors. Respondents represented three functions: finance, strategy and general management.

A range of industries were represented, with healthcare contributing the most responses (16%), followed by IT and construction (12% each). Participants also came from a wide range of company sizes,

with 37% reporting annual revenue between US\$100m and US\$500m. (For more detail on the sample and the results of the survey, please see Appendix I.)

In addition to the survey, a series of in-depth interviews were conducted with 22 senior executives of middle market companies in different industry sectors to gauge their views on the opportunities and changes they face. ■



The growth story

Amid the widespread debate over the pace of economic growth in the US, as a whole, middle market companies are optimistic about their future. About 59% of respondents confirm that their revenue has expanded over the past 12 months, compared with 31% who report no change. Looking forward to the next 12 months, a slightly higher number of respondents anticipate that their companies' revenue will expand, with 64% expecting revenue increases and 30% expecting no change.

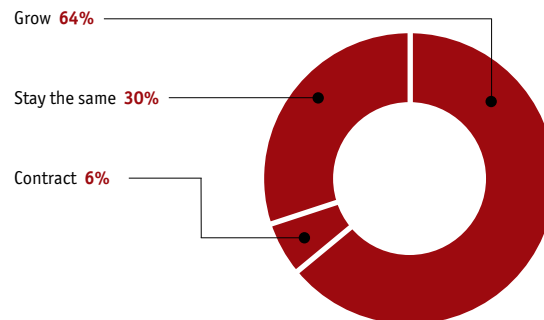
Reflecting this confidence, an overwhelming majority say they expect the size of their company's workforce to increase (47%) or stay the same (43%). Only 10% forecast a decline. These predictions come despite a lukewarm view of the US economy. Asked about its likely state over the next year, 38% express a neutral opinion, 30% indicate strength and a similar percentage (24%) expect weakness.

Our research indicates that, at least for the smaller companies in this sector, a no-growth/slow-growth approach is out of the question. Carmine Oliva, chairman and CEO of Emrise Corp, a publicly held maker of aerospace and defence devices, comments: "We believe that remaining as a US\$55m (in revenue) company is not an option for us. Our minimum objective is to get to US\$100m and then we'll probably want to go higher, into the US\$200m to US\$250m range. At that level, you have the strength and the capabilities to truly serve the global market, which is our ultimate ambition."

At the same time, some senior executives interviewed prefer to remain in the middle market category rather than setting their sights on the Fortune 1000. This typically reflects a desire to have a strong niche in a particular industry sector rather than trying to dominate the sector in its

entirety. "We want to be a large player within our specialty, which is the development of high-end resort hotels," explains Antonio Rico, a vice-president of development at The Kor Group, a private real estate investment, development and management firm based in Los Angeles. "To achieve that, we are following a very active growth pattern."

Over the next 12 months, how do you expect your company's revenues to perform?



Expanding the customer base. Asked about specific growth strategies, one-half of our respondents cite increasing their customer base as a top priority. However, 41% are also highly focused on profitability, pointing to the creation of operating efficiencies as a key strategy. In a sign that middle market companies are following their larger counterparts, tapping new geographical markets accounts for 29% of responses. Although 42% of respondents say they only conduct business in the US, one-half of those that are expanding overseas say that Asia-Pacific will account for the most growth, followed by Europe with 21%.

Most companies large and small have grappled with the issue of attracting and retaining customers



on a profitable basis. Middle market companies appear to believe they have an advantage in that their size allows them to be less hierarchical and more nimble, offering the opportunity to develop deeper relationships with their customer base. Yet, in practical terms, a disciplined approach to customer relationship management is required.

VistaPrint, an online supplier of graphic design services and printed products, is growing its annual

“The middle market company needs to work the tension between acting like a large firm and maintaining the benefits of a small one.”

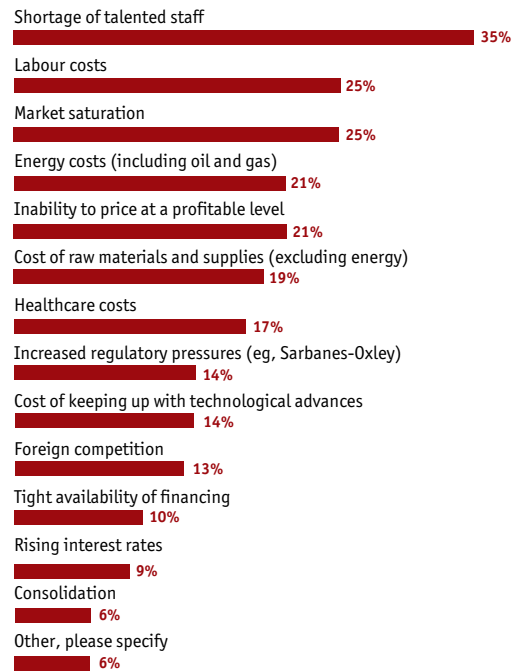
Robert Keane, president and CEO, VistaPrint

revenue at around 65%, effectively tripling sales every two to three years. Robert Keane, president and CEO, points to the combination of two key factors as the driver behind growth of this kind: a better value proposition for customers and a better delivery mechanism for that proposition.

“One without the other will not produce results,” he says. “You need to fundamentally improve multiple dimensions of the value proposition and at the same time vastly improve the delivery process. If you look at great companies like Starbucks or Federal Express, they all have achieved exactly that.”

Clearing the hurdles. When it comes to obstacles to growth, a shortage of talented staff is cited most frequently (35%), followed by labour costs (25%) and market saturation (25%). “It’s hard to grow without a sizable and talented management team,” says Mr Owens. The tight labour market is also reflected in the responses to questions on outsourcing; 28% say they will outsource IT over the next 12 months, and 14% say the same of human resources. Transport, finance and sales agents are also fea-

What are your company’s main obstacles to growth? (Select up to three)



tured as outsourcing candidates.

Our field research shows that the lack of high-calibre staff is especially felt by the healthcare and IT industries. At Akamai Technologies Inc (2006 revenues: \$429m), a global services provider set up to accelerate content and business processes online, the company relies on specialists in applied mathematics and algorithms to sort through congestion and vulnerability problems on the worldwide web. “We have to hire the best people, many of whom have PhDs, so that our customers can trust us to get the job done,” says Sandra Smith, director, investor relations.

Akamai’s challenge is to retain what Ms Smith calls “a corporate culture of very high integrity” as it grows at a substantial pace. The Massachusetts company’s revenue increased by more than 50% in its last fiscal year, and its workforce has doubled to around 1,000 over the past three years. “We must maintain high



standards in our hiring, even if that means waiting a little longer to fill positions," she says.

Staffing issues also face Sentient Jet/Jet Direct, another Massachusetts company in a different industry: aviation. The private airline company is growing revenue at between 60% and 70% annually and is now ten times bigger than it was ten years ago. Yet the company's management team has not expanded at all over that period.

"The number-one challenge for us at this point is finding talent," says Steve Hankin, Sentient's president and COO. "We are looking for new executives, but we also need operations people, and in that area we are at a disadvantage compared with larger, better-known companies that can more easily attract staff."

Running the global race New geographical markets may not yet be the top priority for the middle market sector, but these companies cannot escape the impact of globalisation. For large US manufacturers, foreign competition - especially from Asia - has long been a worry and this unease is trickling down to smaller firms. As Mr Oliva at Emrise puts it: "Increasingly, there are no local markets for aerospace and defence anymore. All markets are becoming global."

Some companies are adopting the niche strategy mentioned earlier to fend off competition. American Leather is a Dallas-based manufacturer of leather- and fabric- upholstered furniture with annual revenues of \$71m. that is seeing prices of traditional furniture products drop as a result of low-cost competition from China. Bob Duncan, founder and CEO, notes that this competition not only takes the form of low prices, but also large volume and little customisation.

American Leather has created its niche in the customised, high-end leather furniture market. Nevertheless, it faces growth issues. "The price challenge from Asia is not as great as what we face in product development," says Mr Duncan. "It's one thing to

"Increasingly, there are no local markets for aerospace and defence. All markets are becoming global."

Carmine Oliva, chairman and CEO, Emrise Corp.

design a new product and quite another step to incorporate it efficiently in our manufacturing process and then in our existing distribution channels. That's the biggest potential obstacle to growth."

Offshore competition is one aspect of globalisation, but there is another, often overlooked consequence of this phenomenon. Middle market companies are increasingly expected to have a global reach in the form of subsidiaries and/or joint ventures in regions outside the US. Frequently, the best customers of middle market companies are larger firms that, whether or not they have an international presence themselves, expect to be served in a global capacity.

"It is not the absolute existence of foreign competition that presents us with a potential obstacle," says Mr Oliva. "It is the ability to prove that you can serve your customer effectively, not only here in the US but on an international scale. We have overcome that problem by establishing subsidiaries in England, France and Japan; without those, some of our customers would be lost."



Tangible and intangible measures of success

Middle market companies do not appear to be different from the Fortune 1000 when it comes to measuring their tangible success. More than 70% of respondents indicate that profitability is the most important measure, followed by

“The middle market company needs to work the tension between acting like a large firm and maintaining the benefits of a small one.”

Robert Keane, president and CEO, VistaPrint

revenue growth (66%). Market share lags far behind at 30%. Our field research indicates that many companies look at both profit and revenue together—in other words, they see profitable revenue as key. However, the picture varies according to the life cycle stage of a company.

Among less tangible measures of success, strong customer relationships are mentioned by 46% of survey respondents, reinforcing the importance of expanding the customer base as a driver of growth. Surprisingly, this is followed by strong company reputation (36%), just slightly ahead of quality products or services (35%).

Akamai Technologies is a young company—it was founded in 1998 and turned public a year later—in an industry that is also young. “Revenue growth at a fairly rapid pace matters to us because we are not a mature company,” says Ms Smith. “At the same time, there comes a point where you cannot keep promising profitability; you have to deliver it. That’s why we see profitable revenue growth as our key metric.”

Although smaller companies’ clear objective is revenue growth, the profit goal is always on the ho-

rizon. At American Leather, Mr Duncan has a long-term strategy of lifting revenue into the US\$150m-US\$200m range from around US\$80m in 2007.

While he pays equal attention to both the top and bottom line of the company’s income statement, he says profitability is more important overall. “To be a thriving, dynamic, growing company, attracting the best people, you have to be profitable. It also allows you to innovate by investing in R&D.”

Market share, however, is far subordinate to profitability, especially in sectors where competition is fierce. Gibson Overseas Inc is a California-based, privately held manufacturer of housewares that has been operating for nearly three decades. Sam Sun, purchasing director at the company, says that in a highly competitive environment it is difficult to grow share in its traditional table-top product category. “We are focusing on new geographical markets and new products, so profitability to finance those comes first.”

Our field research indicates that the intangible factors behind success vary considerably by industry sector. For instance, Ms Smith of Akamai credits great success to employee talent, while Mr Rico at The Kor Group points to the need to reinforce the hotel company’s brand. And in the technology sector, one of the most competitive in the middle market universe, it seems to be all about “catching the next wave”.

Donald Massaro is president and CEO of Sendmail, an early pioneer of e-mail, located in Silicon Valley, with annual revenues of approximately \$30m. The company is currently working on new technology using cryptology that will enable senders of e-mail to be verified, in a bid to counter the practice known as “phishing”, where seemingly authentic mes-



sages from financial institutions, for example, are used to extract personal information for fraudulent purposes.

This is to be Sendmail’s next “wave”. Mr Massaro explains: “Successful companies in the Valley not only developed the right technology; they got their timing right. There are a lot of waves in this sector and a lot of companies are trying to catch the one you want. In our case, we have a few months’ lead on the competition with this new technology, but we can’t afford to let up.”

Mr Massaro makes a more general point about success that underscores the dilemma facing middle market companies: “You have to be a risk-taker in an aggressive way, but if you are wrong about the product or the timing you are in serious trouble. For big companies, a mistake like that is just a bump in

the road; for start-up companies it probably means you are dead. In the middle market, you end up in intensive care.”

What are your company’s most important measures of success? (Select up to three)



The debate over going public or staying private

Two-thirds of the respondent companies are privately held and one-third are public. Of the privately held companies, about 18% say they are likely to go public within the next 12 months; these companies were over-represented in the healthcare and retail sectors. The remainder plan to stay private, even though many are growing and profitable.

The debate over ownership structure stirs strong arguments on both sides. Overall, our research indicates that privately held companies see few advantages to going public, while those who have taken the IPO route have few regrets about doing so.

Perhaps surprisingly, the burden of regulatory requirements, specifically those resulting from Sarbanes-Oxley legislation, is mentioned by only 27% of respondents as a factor influencing their deci-

sion to remain private. The overwhelming motive for remaining private is the desire to retain control over decision-making (72%), followed by wanting to keep financial information private (30%).

Doug Ducey is CEO of Kahala Cold Stone, a holding company for 13 fast-food brands that are based on franchise operations, and the product of a recently announced merger. Mr Ducey was previously the president and CEO of Cold Stone Creamery, one of the merged companies, and observed its growth from annual revenue of as little as US\$50m.

Having previously worked at two of the nation’s largest public companies—Procter & Gamble and Anheuser Busch—Mr Ducey sees clear advantages to remaining private. “We can make and change decisions without anyone questioning it except our internal team, our external franchisee audiences and ultimately

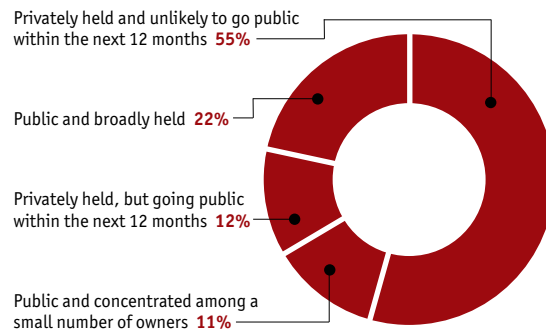


our customers. We can also change our targets.”

At the same time, Mr Ducey believes large public companies typically have disciplines and routines that smaller firms can and should emulate. “The challenge is to take those disciplines – having the right people in the right places, making proactive decisions, continuing to change your business model to exploit future potential – and embed them in the private structure.”

Among those who have taken the public route,

What is your company's ownership structure?



60% of survey respondents say their decision was motivated by the need to fuel growth. One-third of respondents cite the need to find alternative funding, and 20% mention the desire to provide liquidity for owners; only 16% say they are looking to cash out their holdings in the company.

Public companies interviewed for this study generally agreed with these findings. Nooruddin (Rudy) Karsan, chairman and CEO of Kenexa, a software-based provider of talent acquisition and retention solutions, says his company's listing on NASDAQ has helped its acquisition strategy by lowering the cost of capital. “We would not have been able to execute the acquisitions we have as a private company,” he says, adding that Kenexa's goal is to boost annual revenue from the current (projected) level of around US\$190m to

US\$1bn by the middle of the next decade.

Mr Karsan also says that being public helps to reinforce the company's brand name, while the financial transparency demanded by public status helps to reassure its suppliers – again, underscoring the importance of a company's reputation. “We don't have to spend a lot of time convincing them that we will still be around in a few years,” he says.

Mr Oliva at Emrise, the aerospace concern, makes a similar point. “The advantage of being public is that financial information about your company is readily available. So, in our case, a large customer like Raytheon or Lockheed Martin can quickly assess our financial strength.”

However, Mr Oliva also underscores what he terms “the enormous cost” of public status, especially for companies with revenue of around US\$50m, or even US\$150m. Compliance with Sarbanes-Oxley legislation, directors and officers liability (D&O) insurance, auditing fees and tighter financial controls are all necessary cost burdens. “As I said earlier, it makes no sense for us to remain at US\$55m in the face of such costs.” Yet cash flow and profitability are key for both public and private companies in raising capital. “We have an obvious advantage in raising money as a public company, but without cash flow and profits that would not be the case,” says Mr Oliva, adding that “it also helps not to be over-leveraged to begin with.”



Finding finance

An overwhelming majority of survey participants expect their company's capital expenditure to either increase (51%) over the next 12 months or stay the same (40%). This is very much in line with their views on the workforce: 47% expect to hire more and 43% expect to hold the size of their workforce at current levels. At the same time, more than one-half of the respondents say they expect their financing needs to remain the same and 38% say their financing needs will increase over the next 12 months.

At the top of the expenditure list is investment in new technology (36%), followed by acquisitions (29%). Reflecting the earlier-mentioned need to build out global capacity, 22% of respondents cite international expansion, but US expansion ranks higher (27%).

In an era of unusually low interest rates and abundant credit, it is not surprising that few executives interviewed for this study expressed concern over their fund-raising abilities. The head of investor relations at one energy company says, "In all the years I have been in business, equity and debt markets have never been more liquid than they are today. I would say there is more capital available to us now than ever before."

Turning back to the survey, nearly one-half of respondents say they face no challenges in securing financing. Of those who do face such challenges, 16% cite lack of debt capacity as an obstacle and 13% mention insufficient interest or attention by providers of funding.

It is generally perceived that public companies have an easier task raising equity and/or debt by virtue of their higher profile and rating agency assessments. According to Don Morel, chairman and

CEO of West Pharmaceutical Services, listed on the New York Stock Exchange, "We have good cash flow from our existing business, so we have had ready access to external capital either through straight debt instruments or, in a recent case, a convertible bond issue. The capital markets have been readily available to us."

Yet, cash flow and profitability are the key determinants for both public and private companies in raising finance. "We have an obvious advantage in raising money as a public company, but without cash flow and profits that would not be the case," says Mr

"We really want to be recognised for our financials as they look six months out rather than six months previously. You have to get finance providers to understand what you are doing because that influences the cost of money."

Steve Hankin, president and COO, Sentient Jet/Jet Direct.

Oliva of Emrise, adding, "It also helps not to be over-leveraged to begin with."

The importance of cash flow is emphasised in the survey findings. Nearly 40% of respondents plan to use internal sources of funding for finance over the next 12 months, a further 33% point to cash-flow financing and 22% will seek asset-based financing. Only 9% cite public debt, reflecting the dominance of private companies in the survey. Interestingly, 18% of respondents cite private equity firms or hedge funds as a source of finance.

According to Ms Smith of Akamai Technologies, internal cash flow takes care of the company's financing

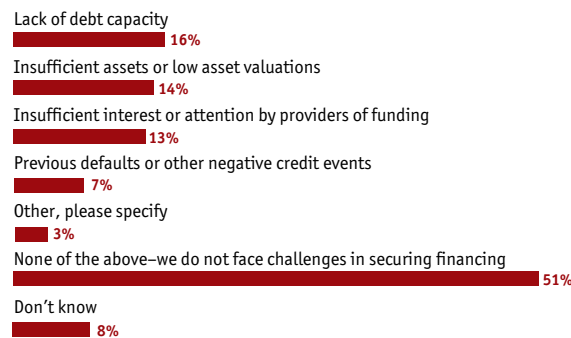


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requirements. “We don’t depend on external finance, although we will look opportunistically at the capital markets and we have done a couple of transactions in recent years to gain flexibility in our funding.”

Down the credit spectrum While our research shows that finance issues are not generally inhibiting growth among middle market companies, concern exists over the potential for higher interest rates and

What are your company’s biggest challenges in securing financing? (Select all that apply)



a credit squeeze. If default rates begin to increase, banks and other lenders that have not done proper due diligence will take their losses and pull back, reducing the availability of finance in general.

Even without a deterioration of this kind, companies at the lower end of the middle market can find it difficult to attract financing from traditional banking sources. Their low profile typically means that they must actively seek out lenders or, as mentioned in the survey, they would prefer lenders to seek them out. In either case, industry practitioners agree that these companies need a clear business model and a comprehensive plan to execute it.

If a company’s model is not yet fully proven, it may be difficult for them to secure debt or equity because of insufficient cash flow. Lenders will look at them from a collateral perspective, but once the model

starts to work, they should be able to switch from secured lending to cash-flow financing. However, achieving performance according to plan is critical, however the performance targets are defined.

On the issue of planning, 31% of survey respondents say they have a formal business planning process extending one to two years into the future. Around 24% look out more than three years, but as many as 21% only have 6- to 12-month plans in place. Furthermore, our research indicates that financial rather than strategic planning is the norm among smaller, privately held companies. “Middle market companies tend to be more focused on day-to-day operations and have less time to focus on big strategy pieces,” says CIT’s Mr Owens.

In other words, these companies think more in terms of financial targets—revenue and/or profits—than strategic plans for, say, diversification, to avoid being overly dependent on a single product. Gibson Overseas is one company that is convinced of the need for diversification, leveraging its table-top and kitchenware business into the food service business, among others.

The cost challenge Despite the high levels of liquidity, financing is not cheap and plentiful for everyone. When asked about their capital structure, only 40% of respondents believe it is optimal, with 27% looking for a higher proportion of debt and 21% more equity. The high cost of financing is the principal reason respondents consider it to be sub-optimal (40%), while 29% cite lack of access to desired financing and 25% mention difficulties in buying back or retiring current financing.

The cost obstacle almost certainly reflects lower credit quality. The worse the standard of credit, the more underwriting the lender has to put in place, which certainly affects costs. However, our research indicates that an improvement in the cost factor is possible if the following best practices are kept in mind.



- Look for the right lender—one who understands your business.
- Be open about the business and your plan—what is working well and what is not.
- Show that you have a reasonable grasp of finance. You may be too small to have a CFO or treasurer, but lenders will respect a basic understanding of how financial markets operate.
- By way of example, consider leasing rather than buying equipment as a means of easing pressure on cash flow.

In our survey, we asked what attributes a company values most in a financing provider. Forty-one percent of respondents say that a deep understanding of their industry is most important, followed by a willingness to work with the company in both good and bad times (40%). Surprisingly, preferential rates and pricing comes in third, at 39% of respondents.

Our field research generally corroborates these findings. While the cost of finance will always be a major factor, flexibility and knowledge of a borrower’s business emerge as key prerequisites for choosing a provider. “Not so long ago, lenders had no interest in our business, our customers or our technology,” says the CEO of one middle market company. “They just wanted to see our balance sheet and our profit and loss account. And if they offered us credit, it was on a take-it-or-leave-it basis. Today, we work with lenders who know our company inside out.”

“Partnership” is a term frequently used by executives to describe the ideal relationship. One such example is Tom Malkoski, president and CEO of Penford Corp, a publicly held supplier of specialty starches for food and industrial applications, with annual revenue of around US\$320m. We asked a hypothetical question about which lender Mr Malkoski would select: one who could provide slightly better terms or one who was more in tune with Penford’s business?

“It depends how much better the terms are, but if the difference is marginal, I would opt for a relation-

ship with someone who understands our business,” responds Mr Malkoski. “That lender would be less concerned when external conditions impacting our business change and more inclined to work with us in finding customised solutions.”

What attributes does your company value most in a financing provider? (Select up to three)



Other interviewees also underscore the commitment factor in their relationship with providers. “We look for investors that share our long-term view and want to be long-term holders of our stock,” confirms Neil Koehler, co-founder and CEO of Pacific Ethanol, a renewable fuels concern with around US\$60m in annual revenue. “On the debt side, we look for financing partners who understand ethanol and get their arms around the risks involved in this industry.”



Variations among industries

Responses to our survey show considerable variation by industries; some are surprising and some are expected.

Growth expectations. Most executives across all industries believe that their companies' revenue will increase over the next 12 months. However, real estate executives are most pessimistic (14% forecast a decline), while those in the energy sector are most optimistic (84% look for growth).

Growth strategies. Tapping new geographic markets is cited by nearly 60% of real estate firms, a sign of the increasingly global nature of that market. Yet only 23% of real estate concerns cite expanding their customer

base as the main growth strategy, whereas 75% of retailers underscore that factor. Retail also leads with pricing more aggressively as the key objective, followed by construction (24%) and consumer goods (23%).

Growth hurdles. Labour costs are cited by at least 30% of respondents in the entertainment/media, construction, healthcare, retailing and telecoms industries. One-third of chemical companies mention foreign competition, compared with only one in 40 in the retail sector. Increased regulatory pressures are felt by one-third of healthcare companies and 20% of financial services and energy companies. Unsurprisingly, market saturation is

Four personalities of middle market companies

Every company has its own personality, partly driven by its leaders and corporate culture and partly caused by external factors such as the industry and growth trajectory. Similarly, groups of companies can have their own personalities. These personalities can often be uncovered using a group of statistical techniques called clustering: the classification of objects into different groups. More precisely, clustering involves partitioning a data set into subsets that fall within some defined distance of a measure—in this case, survey responses.

Using a form of cluster analysis called K-means, we categorised survey responses into four groups in order to discover the underlying personalities of the middle market

companies that we surveyed. Each cluster's personality has distinct attitudes based on the history, challenges and aspirations faced by those companies.

THE OPTIMISTS With 208 responses from the largest companies, this cluster contains more than 40% of survey respondents. Most are located in the Midwest or West. These companies are dominated by men (87% of these respondents) and tend to be in male-dominated industries: construction, energy and natural resources (although retailing is also strongly represented).

Respondents from this group are more optimistic than average about the economy. Most have seen their company's revenue grow during the past 12 months.

They are very satisfied with their financial structure and access to financing. About 70% are private, and only one among the privately held companies has plans to go public (although given their size and financial strength, most could probably go public if they wished).

THE DISENCHANTED With 132 responses from smaller than average companies, this cluster is the second largest of the four. Most are located in the Northeast or South, and are over-represented in the business services and IT industries.

These executives see stagnation all around them. Nearly one-half (48%) see the economy as weak or very weak, and another 40% see it as neutral. Unsurprisingly,



mentioned by one-half of the telecoms companies. **Hiring.** Energy companies are the most optimistic, with 60% anticipating an increase in their workforce. On the flip side, 20% of entertainment, media and publishing companies expect a decrease in employment. Most business service, chemicals and consumer goods companies expect no change.

Success drivers. When asked about drivers of their companies' success, majorities in two industries—consumer goods (58%) and chemicals (53%)—cite the importance of a strong brand. However, less than 20% of respondents in the construction, energy, healthcare and IT sectors hold that opinion. More than one-half of retailers cite quality products and service, and an even higher proportion (70%) point to strong customer relationships.

Ownership and finance On the subject of ownership structure, most construction and real estate companies (79% and 77%, respectively) are privately held and unlikely to go public, in line with the overall survey trend. About 30% of business service respondents plan to go public in the next 12 months. Among reasons for remaining private, nearly all retailers (97%) cite the desire for control of decision-making. High proportions in that category are also reported by construction (85%), consumer goods (87%) and financial services (81%).

Obtaining financing. When it comes to obtaining financing, industries with a majority facing no challenges include construction, energy, healthcare and retailing, but only 17% of business services report no challenges. More than one-third of respondents in the business services sector say the obstacle is

their companies' revenue over the past 12 months is unchanged or lower. Given their lack of growth, they tend to focus on efficiency, as evidenced by their tendency to outsource whenever possible. In addition, 40% would like to take on more debt, but more than 90% say they face financing challenges. The fact that one-third of respondents from this cluster would like to go public probably has more to do with the strong equity market than a story appealing to investors.

THE GREEN BULLS The third cluster contains 81 smaller than average companies, yet it also has the highest proportion (38%) of public companies. What these companies have in common is bullishness

on the economy, strong revenue growth and expected increases in capital expenditure. Although the green bulls have no problem obtaining new financing, they tend to be most interested in new equity to support their growth.

Even more interesting is the fact that a slight majority of these executives are women, and that more than 80% say that environmental commitment is important to their companies. Although there are no strong industry concentrations, healthcare, pharmaceuticals and IT are over-represented.

THE DOUBTERS This group of 81 larger than average companies – of which nearly one-half are from the Midwest – also has a pessimistic streak. Although one-half (52%)

say their company's revenue has increased, this group also has the highest percentage stating that their company's revenue has dropped (21%). And while one-half (52%) say their company's capital expenditure will increase, this cluster also has the highest percentage thinking their capital expenditure will contract (16%).

This cluster tended to be neutral on the economy, and more than 94% face financing challenges (the highest of any group). Moreover, members of this group are the least inclined to say that an environmental commitment is important (only 35%). Although no industries dominate this group, healthcare is over-represented. ■



US middle market outlook 2007

insufficient interest or attention by providers of funding. Only 5% of retailers cite this factor.

Variety and use of financing. More than one-third (34%) of financial services companies agree strongly that they are satisfied with the variety of available financing; two-thirds of retailers say the same. As for the use of future financing, international expansion is cited by nearly 40% of respondents from the business services sector and by more than 30% in the IT, entertainment and financial services sectors.

Capital structure. One-half of the respondents from chemical companies seek a higher proportion of debt, whereas 40% of consumer goods companies say they would prefer more equity. Energy companies are satisfied with their current capital structure.

Most valued attributes of financing providers. Among attributes most valued in providers of financing, at least one-half of the respondents in construction,

energy and financial services cite a deep understanding of the company's industry. When asked about future funding from private sources (both debt and equity) and from hedge funds, the real estate sector leads the way with 41%. In retailing, the figure is less than 10%.

Optimism on the US economy: the key to action

Many of the responses to this middle market survey can be traced back to a single question: whether the executive believes that the US economy will strengthen, stay the same or weaken. Once the answer to that question is provided, many of the other answers fall into place.

Optimism about the economy means optimism about the business Those respondents who stated that the economy is strong also expect their revenue to grow; plan to borrow, invest and hire more; see fewer growth constraints (such as energy or healthcare costs and inability to obtain financing); and are more satisfied with

their company's capital structure and cost of financing.

A strong economy means labour shortages As their optimism on the economy increased, respondents expressed more concern about the difficulty of finding talented, affordable staff to support their business's growth.

A strong economy focuses companies on expanding the customer base The survey listed a number of growth strategies and asked respondents to answer which ones their company planned to pursue. The stronger the economy, the more likely respondents were to choose "expanding

the customer base" as their primary growth strategy.

A strong economy enhances environmental commitment A respondent's optimism about the US economy was strongly associated with a commitment to environmentally sustainable practices in their business. Pessimists were far less likely to express interest in sustainable practices.

The effects of revenue growth A corollary of optimism about the economy is optimism about a company's revenue growth. Most executives who said the economy will remain strong also said that their company's revenue will grow. And, the expectation of



An important balancing act

This report has looked closely at the various challenges facing the middle market, as well as the opportunities available to it.

To summarise, we draw on the words of Mr Keane, president and CEO of VistaPrint. As he sees it: “The middle market company needs to work the tension between acting like a large firm and maintaining the benefits of a small one.”

Large firms have an international perspective, possess talented staff with good management systems and spend substantial amounts on technology. Small firm benefits typically include a niche market, abundant innovation and staff energised by the intimate nature of the workplace. “The steepest

challenge for the middle market”, concludes Mr Keane, “is always to be able to play those two different sides of the coin.”

revenue growth leads to the other responses listed below.

When revenue grows, thoughts turn to acquisitions Respondents who thought their company’s revenue would grow over the next 12 months were also the ones saying that they intended to use new borrowing to finance acquisitions.

Revenue growth enhances the importance of inexpensive financing Although it may seem counterintuitive, companies that expect their revenue to grow also cited the importance of preferential pricing as the most valued attribute of financing partners.

Revenue growth makes strong customer relationships more important Companies that expected their revenue to grow over the next 12 months also cited the importance of strong customer relationships as key to their company’s success. However, it is equally plausible that strong customer relationships are the cause of revenue growth rather than the effect.

Privacy is less important when revenue is growing One of the top reasons cited by respondents for staying private was to avoid disclosing financial and operating information. But the companies who cited this as a reason for staying private also tended to be those with stagnant or shrinking revenue.

The more revenue is expected to grow, the less important this rationale becomes.

Executives are polarised about the prospect of a Democratic president When asked about the impact of a Democratic or Republican victory in 2008, about the same number of respondents said that a Republican president would lead to a stronger economy as to a weaker economy. The same is true for a Democratic president. However, when asked about a Democratic victory, respondents were more polarised, with 36% saying it would lead to a stronger economy and 35% to a weaker economy (compared with 26% and 30% respectively for a Republican president). ■



Sentient Jet: meeting the growth challenge

April 2007 witnessed a merger between two providers of private jet membership in the US: Sentient and JetDirect. Behind this simple announcement lies a middle market growth story that shows how opportunities can be successfully exploited and yet leave many challenges still to be met.

Middle Market Case Study



Sentient was established in 1999 as a privately held firm funded by investors such as HSBC and AIG. In the past few years, the company has experienced “hyper-growth”, in the words of Steve Hankin, president and COO of the newly combined entity. Mr

Hankin joined Sentient in 2004 from Starwood Hotels & Resorts, where he was chief marketing officer for one of Starwood’s subsidiaries.

Prior to the merger Sentient had been growing organically at between 60% and 70% a year. Part of that growth is attributable to the boom in private jet travel, although Mr Hankin is quick to point out that “we have a product that people love, a service reputation that is great, and a sales organisation that really hustles.”

At the same time, rapid expansion presented a formidable challenge: finding talented executives and staff. “We are significantly resource-constrained when it comes to leadership, not just at the top, but at the second and third levels of management,” agrees Mr Hankin. “I’m sure this is true of many mid-market firms, but this company is very young and lacks the experience of larger enterprises.”

If people are one issue, process presents another. “All the processes we had in place three years ago, especially in the technology area, have been replaced and now we are going through the whole exercise again,” continues Mr Hankin. “As a middle market company growing at this speed, you have to be on top

of replacing technology in particular, looking 12 to 18 months out.”

Sentient Jet’s senior management, including Mr Hankin, had mostly worked in much larger companies previously. They were attracted, he says, by the benefits of working in a smaller company in a “hands on” capacity where a “passion for winning” is what counts. He also likes private company status. “As a middle market company, you are at a very formative stage and to subject yourself to the scrutiny of the marketplace can be very constraining.”

Unlike most survey respondents, Sentient Jet measures success primarily through market share. While profitability is clearly a requirement to be in business, notes Mr Hankin, market share is the ultimate measure because “it tells us whether clients are moving towards us or away from us”. The company also closely watches its execution capability on a flight by flight basis.

When it comes to financing, Sentient Jet’s biggest challenge is the rapid change in its economics. “We really want to be recognised for our financials as they look six months out rather than six months previously,” he says. “You have to get finance providers to understand what you are doing because that influences the cost of money. The end-objective is to work with people who really support you, want to be in the business you are in and are 100% aligned with what you are trying to achieve.”



Pacific Ethanol: riding the alternative fuel wave

If middle market companies are sometimes perceived to be off the radar screen when compared to their larger counterparts in the Fortune 500, Pacific Ethanol is definitely the exception. A fast-growing company in a high-profile industry, it is the centre of attention from security analysts and politicians alike. When the US Senate approved an energy bill in mid-June requiring greater production of the fuel, Pacific Ethanol's stock price jumped by almost 5%.

The company was only founded in 2003, but its sales are now running at an annual US\$400m, double the level of 2006 -- and compared with only US\$84m in 2005. In a sector dominated by the major oil companies, Pacific Ethanol has not only managed to achieve a public listing in its short life, but it has the advantage of being an early, successful entrant to the renewable energy field.

The rapid growth of the ethanol industry is due partly to its attraction as an alternative fuel and partly to its contribution to domestic fuel supplies, reducing dependence on foreign energy sources. This explains the support for the industry in Congress, where the Senate's move would require ethanol fuel production to grow to 36bn gallons a year by 2022, a sevenfold increase on production in 2006.

Unlike other ethanol producers confined to the Midwest, Pacific Ethanol also produces in other locations in the western US, giving it the advantage of serving local markets without heavy transport costs. But the company does face a challenge from the oil industry as a whole, which, according to Neil Koehler, the company's CEO, "is frankly pretty ambivalent about ethanol".

According to Mr Koehler, although the industry recognises its supply problems and its refining

shortages, it wants control of any alternative. "They want ethanol, but they want it on their own terms. So, I do have concerns how our product will be successfully absorbed into the market-place over the next couple of years. We are in a high-risk environment, both from a commodity perspective and because we are dealing with a customer base that is not necessarily as receptive to our product as it should be."

However, Mr Koehler is convinced that ethanol has a viable life-span. The challenge is over-riding short-term scepticism about its future. "How do we do that? We keep a long-term focus and we communicate that very clearly. In particular, we have shown that even in lean times this company can make money."

Communication has been key to the company's success, especially in securing financing. Mr Koehler spends a lot of time talking to institutional investors who initially found it hard to grasp the profitability potential of ethanol and even now wonder about profit margins.

As for banks, "they wanted to see some sort of guaranteed revenue stream, and in our world we don't really have that because the oil companies are not willing to give us long-term contracts for ethanol. That was a challenge, but we have overcome it by showing we can produce it, market it and do that with a reasonable margin."

**Middle
Market
Case
Study** **2**



MGI Pharma: focusing on profitability

There are more than 300 publicly traded biopharmaceutical companies in the US but only several dozen are actually profitable," says Lonnie Moulder, president and CEO of MGI Pharma, Inc., a company in that sector focused on oncology. Mr Moulder is naturally pleased that MGI is now part of that profitable minority, but it has been a hard-fought achievement.

MGI was founded in 1979, and its revenue did not exceed US\$30m annually for the first 20 years of its life. Last year, revenue passed the US\$300m level, boosted by FDA approval in 2003 of its flagship product, Aloxi, a treatment for chemotherapy-induced nausea and vomiting. "As a public company, we intend to keep growing; we have an obligation to our shareholders to grow and at the same time provide them with returns," states Mr Moulder.

The company's prime challenge has been regulation, whether related to financial controls or compliance with the FDA. "There is no question that regulations place an extra burden on middle market companies by comparison with our larger counterparts. We need to be constantly aware of and proactive about new regulations or threats of new ones stemming from political debates in Washington," adds Mr Moulder.

Nevertheless, with limited resources, the company has been able to take two major products through clinical development, receive FDA approval for both and then grow its business to profitability market. In addition to Aloxi, the other product is Dacogen, a drug that treats a pre-leukaemic condition. One factor that has been a focus is what Mr Moulder calls differentiated products that stand out from the competition. Aloxi, for example, is a more

potent, more effective and a longer-lasting agent compared to its rival products.

MGI is also careful to select markets that do not require the same resources as the largest ones from the standpoint of customer size. "We can deploy our medical, sales and marketing resources at a level that match those of large pharmaceutical companies by virtue of the size of our customer audience," says Mr Moulder.

In measuring success, the company looks closely at financial performance. While its focus has been more on revenue growth, that is now shifting towards profitability, as indicated earlier. However, Mr Moulder is of the opinion that MGI also takes careful stock of its corporate culture and reputation. "It's important for us to be viewed as a quality partner, both by smaller companies looking to advance their technology and by our customers as well."

As for financing, the FDA approval of Aloxi in 2003 opened the door for MGI to tap the capital markets through convertible note issues that allowed it to build out its drug pipeline and acquire additional products and technology. "That's one advantage of being public: raising capital as a middle market company without yet being profitable," notes Mr Moulder.

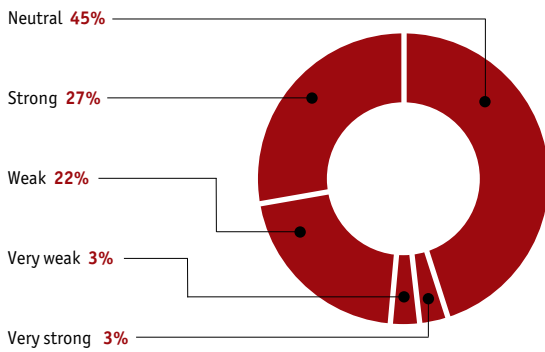
Even though MGI is now in the black, it cannot afford to rest on its laurels. Mr Moulder believes that companies in this sector always need to be thinking about extending the commercial life of their products. "We are fortunate that our product portfolio has patents that extend significantly into the future. But you have to keep investing in the pipeline and bring new products to market that also have long patent protection."



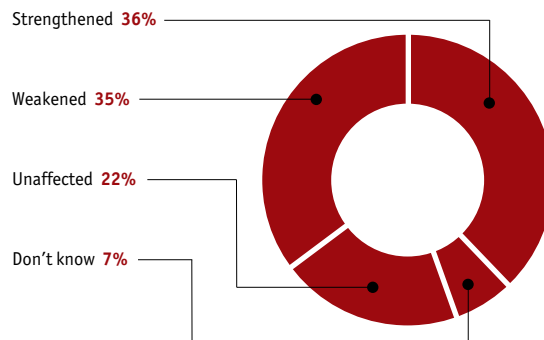
Appendix: Survey results

In June of 2007 the Economist Intelligence Unit conducted a survey of 502 senior financial decision-makers on the key issues facing US middle market companies. Our sincere thanks go to all those who took part in the survey. Please note that not all answers add up to 100%, because of rounding or because respondents were able to provide multiple answers to some questions.

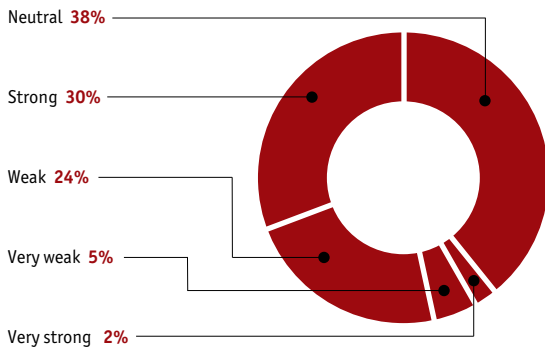
How would you rate the current state of the US economy?



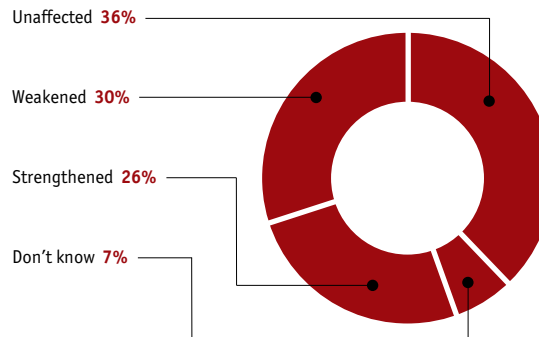
If a Democrat is elected, the economy will be:



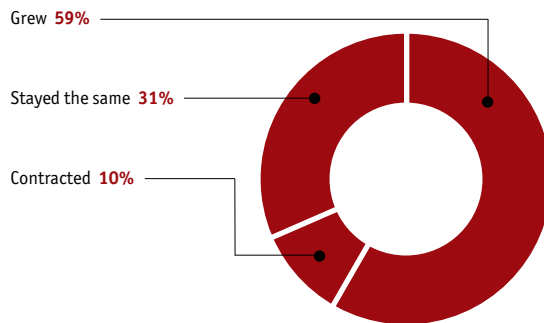
Over the next 12 months, what do you expect the state of the US economy to be?



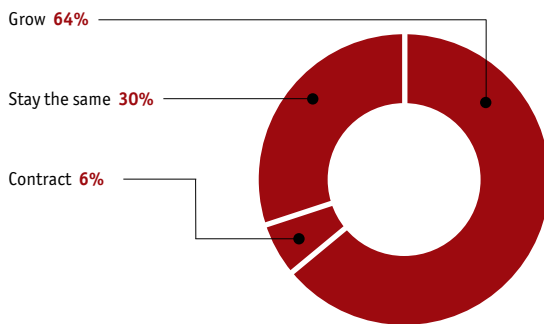
If a Republican is elected, the economy will be:



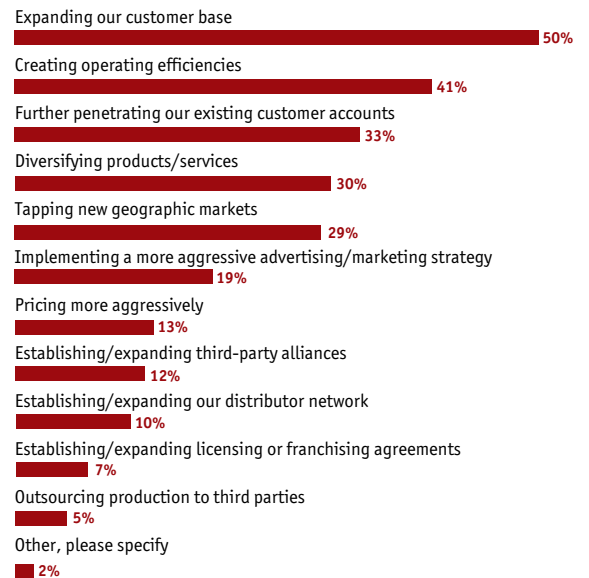
Over the past 12 months, how did your company's revenues perform?



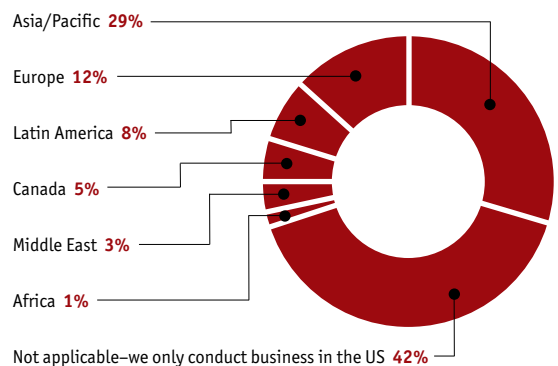
Over the next 12 months, how do you expect your company's revenues to perform?



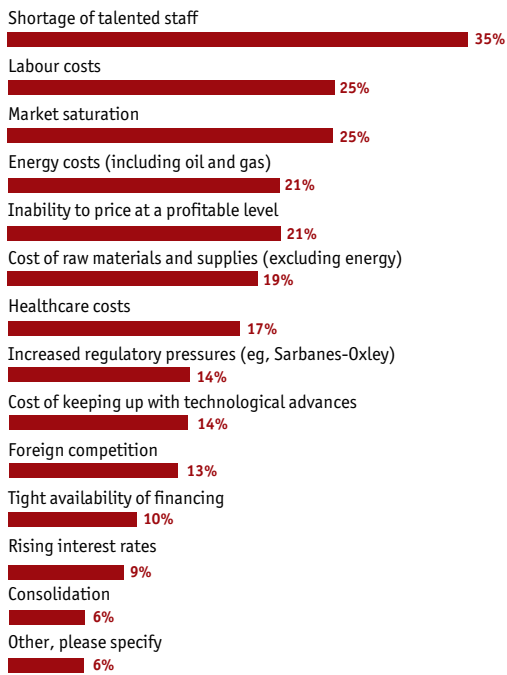
What will be your company's main growth strategies over the next 12 months? (Select up to three)



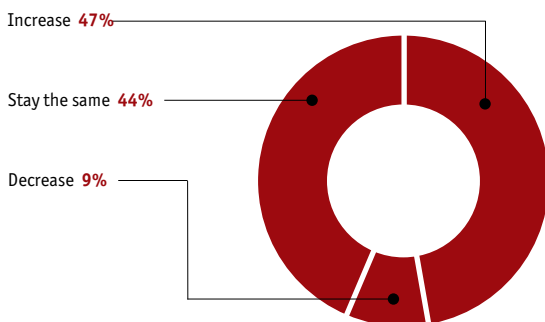
In which non-US market does your company expect to see the most growth?



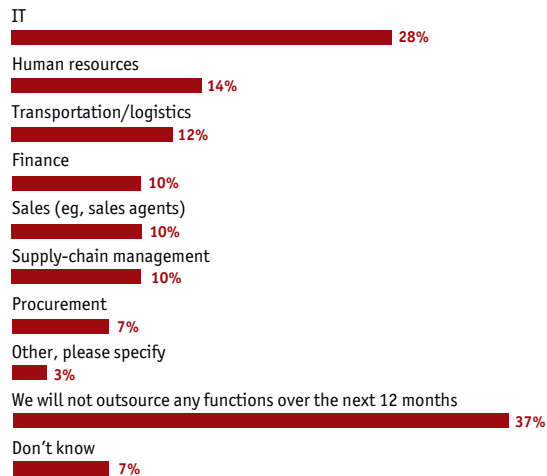
What are your company's main obstacles to growth?
(Select up to three)



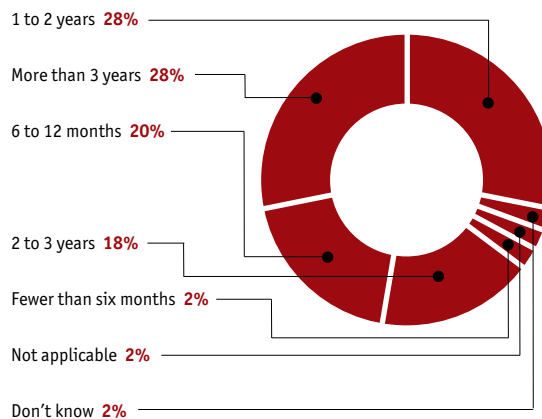
Over the next 12 months, how do you expect the size of your company's workforce to change?



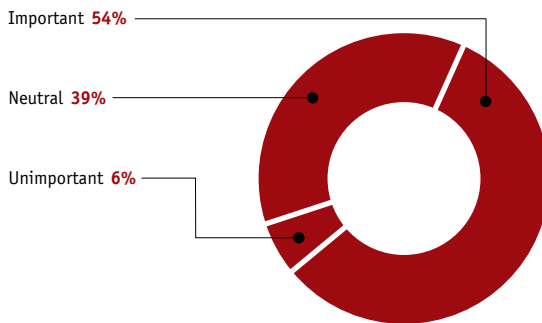
Which of the following areas do you expect your company will be outsourcing over the next 12 months? (Select all that apply)



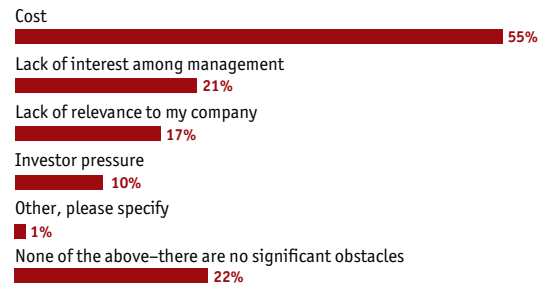
In your company's formal business planning process, how far into the future do you plan?



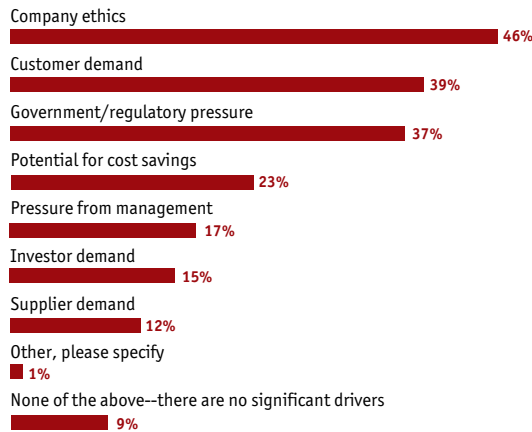
How important to your company is operating in an environmentally friendly manner?



What are the main obstacles to your company operating in a more environmentally friendly manner? (Select all that apply)



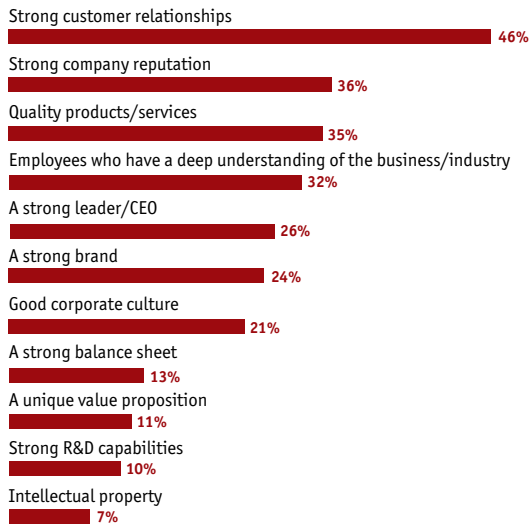
What are the main drivers of your company's environmental practices? (Select all that apply)



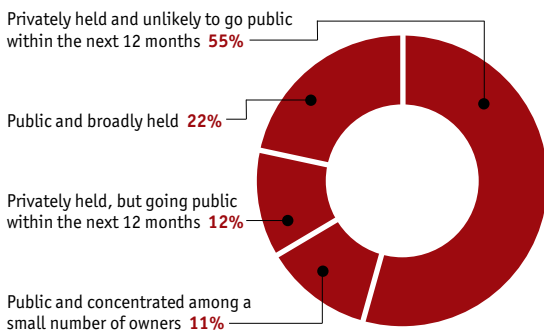
What are your company's most important measures of success? (Select up to three)



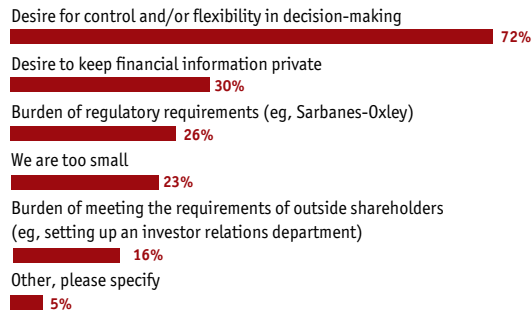
Which of the following would you say have the most influence on your company's success? (Select up to three)



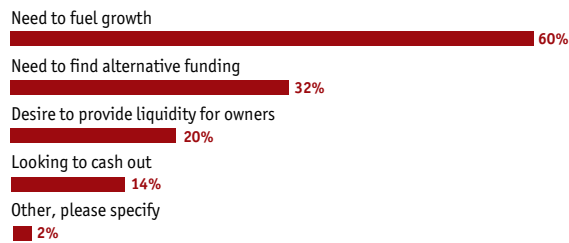
What is your company's ownership structure?



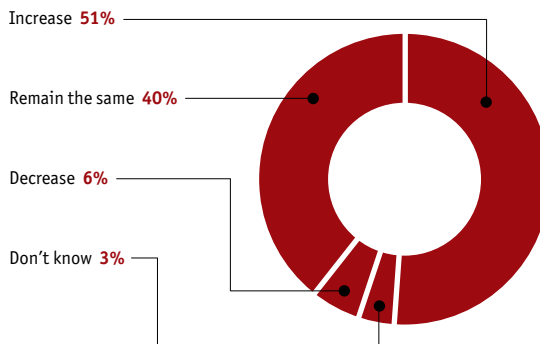
What factors have influenced your company's decision to remain private? (Select all that apply)



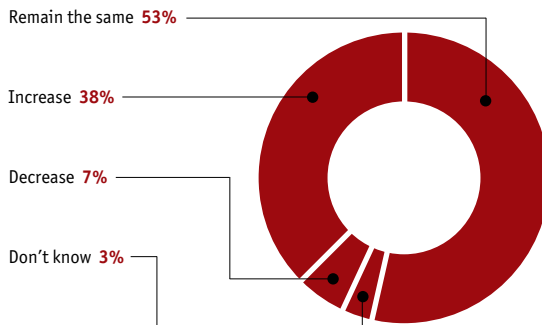
What factors have influenced your company's decision to go public? (Select all that apply)



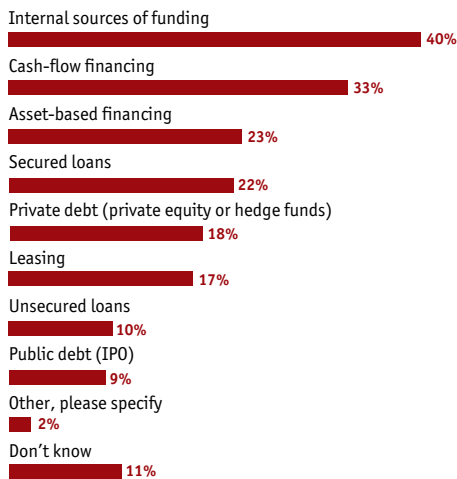
How do you expect your company's capital expenditures to change over the next 12 months?



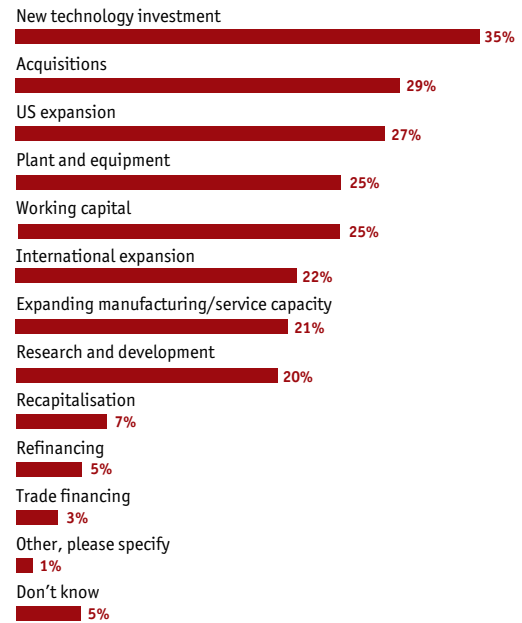
How do you expect your company's financing needs to change over the next 12 months?



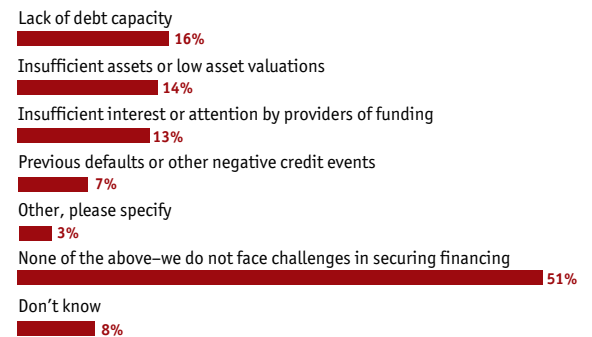
Which of the following types of financing does your company plan to use over the next 12 months? (Select all that apply)



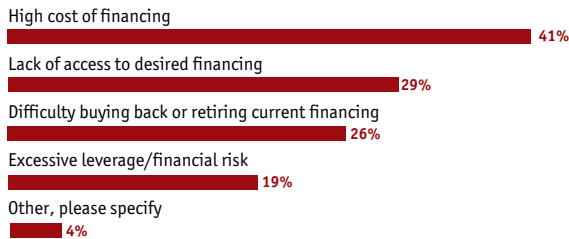
What do you expect financing will be used for at your company over the next 12 months? (Select all that apply)



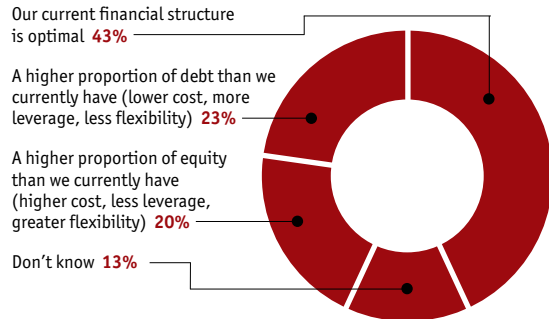
What are your company's biggest challenges in securing financing? (Select all that apply)



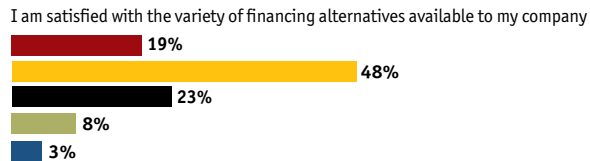
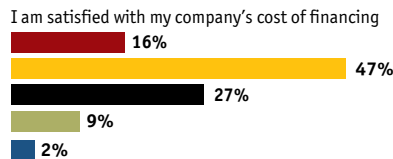
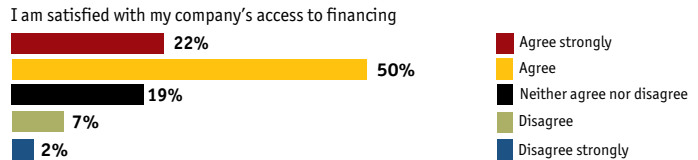
Why is your current financial structure not optimal?
(Select all that apply)



What type of capital structure do you think would best support your company's business objectives?



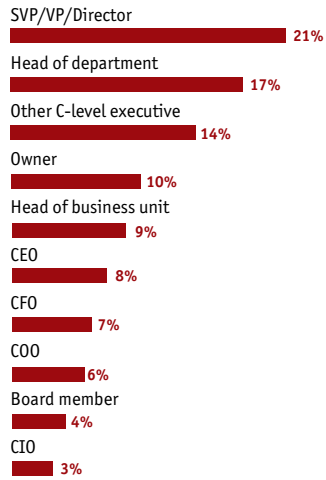
Please rate your agreement with the following statements.



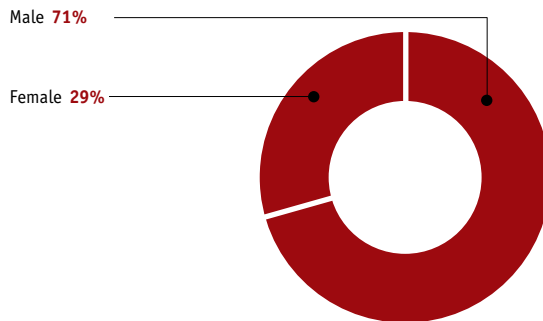
What attributes does your company value most in a financing provider? (Select up to three)



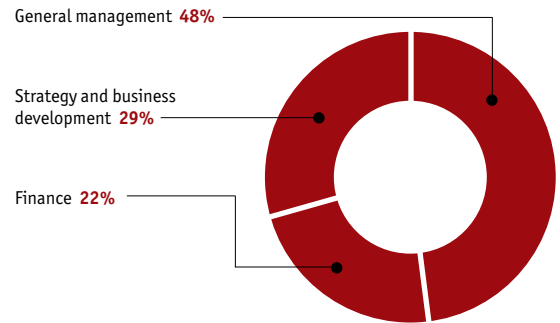
Which of the following best describes your title?



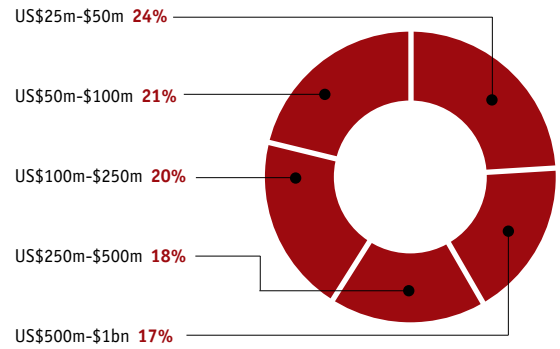
Are you male or female?



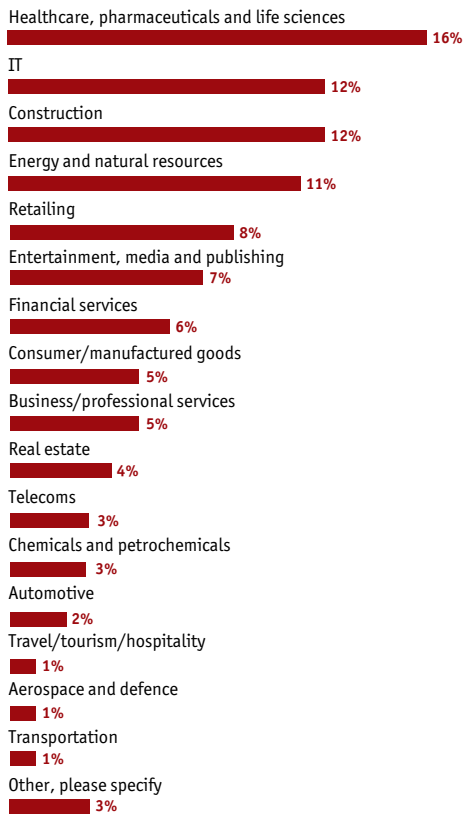
What is your main functional role?



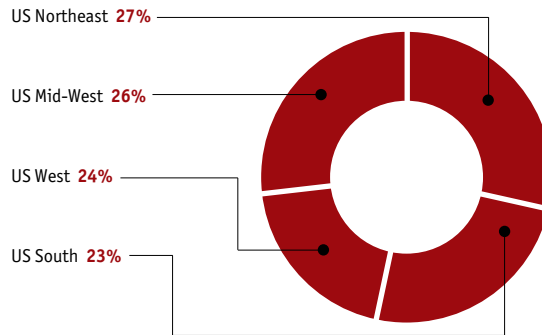
What is your company's annual revenue?



In which sector does your company belong?



Where is your company based?



While every effort has been taken to verify the accuracy of this information, neither The Economist Intelligence Unit Limited nor the sponsor of this report can accept any responsibility or liability for reliance by any person on this white paper or any of the information, opinions or conclusions set out in the white paper.

LONDON
26 Red Lion Square
London
WC1R 4HQ
United Kingdom
Tel: (44.20) 7576 8000
Fax: (44.20) 7576 8476
E-mail: london@eiu.com

NEW YORK
111 West 57th Street
New York
NY 10019
United States
Tel: (1.212) 554 0600
Fax: (1.212) 586 1181/2
E-mail: newyork@eiu.com

HONG KONG
60/F, Central Plaza
18 Harbour Road
Wanchai
Hong Kong
Tel: (852) 2585 3888
Fax: (852) 2802 7638
E-mail: hongkong@eiu.com