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Perspective

Fourth Quarter 2009

Practical ideas for manufacturers and distributors

Current Lending Environment for Manufacturers

Today's lending environment remains challenged; leaving many manufacturers struggling to finance capital needs from current cash flows. The future is starting to appear brighter as analysts' claims that the recession is ending, or already over, begin to be reported. However, the credit markets are not likely to recover until late 2010 or even 2011. Until then, manufacturers will need to carefully understand and negotiate credit terms and sources if they are going to preserve or obtain new funding from reluctant lenders.

Is it true, the recession is really over? That was the question recently put to 52 leading economists by The Wall Street Journal. Only seven thought the recession would end after September 2009. Most thought the worst was past and the recession actually ended before June 2009. The general opinion held that the Federal Reserve would focus on unwinding its balance sheet before raising the Federal Funds rates sometime in late 2010 or in 2011. That balance sheet, the total of all Federal Reserve loans and securities holdings, has more than doubled in the past two years as Federal Reserve Chairman Ben Bernanke expanded lending facilities to battle the financial crisis. What does this imply for future policy? Now standing at $2 trillion, the composition of the Federal Reserve's holdings should begin shifting toward a more normal mix of treasuries, mortgage backed securities and agency debt. This, along with economists forecasting a 2 percent annual GDP growth through the first half of 2010 and less than a 1-in-5 chance of a "double-dip" second downturn occurring before 2010, indicates a stronger economy going forward.[1]

What does this mean for lending markets? Prior to the recession, credit markets experienced significant competition, which provided options for both lenders and borrowers. Today, this is not the case. Lenders and borrowers are unwilling or unable to make significant changes to their lending agreements and capital structure. Instead, short term re-negotiations, forbearance agreements and demands for additional equity are the norm. Lenders remain risk-averse and continue reducing their exposure to certain industries and/or companies.[2]

What about lending terms? According to the Federal Reserve Board, the net percentage of U.S. banks tightening standards for commercial and industrial loans rose steadily through 2007 and 2008, peaking in late 2008 at 84 percent for companies with sales of more than $50 million and 75 percent for companies with sales of less than $50 million. According to a recent survey of chief financial officers, 84 percent expected credit providers to require stricter debt covenants and other business terms in 2009.[3]

What is the outlook in late summer 2009? A recent survey of the U.S. lending climate showed that lenders remain divided on the near-term direction of the U.S. housing market – the most critical indicator of future economic health. Roughly 30 percent expected foreclosures to increase and 27 percent expected lower home prices to stabilize the housing market this year. Among lenders, 17 percent expected mortgage rates to continue rising amidst increasing inflation concerns. Nearly 61 percent expected the sluggish housing market and constrained liquidity in the capital markets to have the greatest impact on the economy in the next six months. Despite all the uncertainty, half the respondents expected their customers to raise additional capital in the next 6-12 months; with 19 percent of lenders indicating that their customers were planning on introducing new products or services, and 12 percent planning on making an acquisition in that same time frame. Clearly, no consensus outlook has emerged.[4]

What about manufacturing? The RSM McGladrey Annual Manufacturing and Wholesale Distribution National Survey of over 900 manufacturing executives points towards a rebound. Businesses reacted to major declines experienced in 2008 and 2009 by reducing costs and capacity. Nearly 26 percent of respondents reduced capacity and 25 percent consolidated operations. Revenue generating strategies, product innovations and protecting supply chains from disruption have proven critical for survival. Workforce reductions also continue. Despite the recent challenges, 95 percent of companies now indicate that they have plans to innovate products or processes with new product development, product line extensions and "green" initiatives. As these companies strengthen their balance sheets, they are relying less on bank financing and more on cash flow as a primary means to fund capital expenditures. That trend is likely to continue for the near term.[5]

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Workforce Skill Shortages Continue

Employment Levels

Unemployment has climbed sharply throughout this recession. Twice as many survey respondents to the 2009 RSM McGladrey Manufacturing and Wholesale Distribution National Survey (52 percent) plan reductions in their U.S. workforces in 2009 as did in 2008.The outlook for 2010 appears significantly brighter, with only 11 percent of companies projecting cuts in their U.S. workforces, while 44 percent project they will be adding employees. The anticipated improvement in the employment picture corresponds with respondents' projections that the U.S. economy will rebound in 2010.

Data for the non-U.S. labor force suggests that more than half of all companies will not be making any changes in 2009 or 2010. While the percent of companies increasing their non-U.S. workforce in 2010 will grow, the percent of companies increasing their U.S. workforce will be even greater.

Companies that move production work offshore are portrayed as taking jobs from the U.S. workforce, with the perception that the practice is widespread. The survey data indicated that the percent of companies moving offshore and that also plan to decrease their U.S. workforce, is only 15 percentage points higher (59 percent vs. 44 percent) than the percent of domestic-only companies who are planning U.S. workforce reductions. The loss of U.S. jobs is more related to U.S. economic conditions than offshore business activity.

In this recession, however, some companies are faring better than others. Sixteen percent of companies report they will increase their workforce in 2009. The industry segments with the largest percentage of companies reporting increases are Medical Devices (38 percent) and Food and Beverage (26 percent). On the other hand, some industry segments have been impacted far worse than others. The Industrial Equipment industry segment has the lowest percentage of companies reporting hiring increases (9 percent).

Skill Shortages Persist

Despite the recession, respondents to the survey continue to struggle to find workers with the skills required by today's technologically advanced work environment. Companies report an ongoing need for sales persons; a reflection of the four most frequently reported growth strategies cited in the survey – acquiring new customers, increasing sales in domestic markets, increasing sales to current customers and increasing brand recognition. Sales persons are identified as an urgent need by 6 percent of companies and as a general need by 43 percent. Even companies anticipating decreases in their workforce for 2009 indicate a need for sales professionals.

After salespeople the most frequently noted labor need is for engineers, with 5 percent reporting an urgent need and 32 percent reporting a need. Manufacturing technicians, supervisory personnel and entry-level workers are in demand by 33 percent of respondents. Survey respondents reported a 26 percent need for machinists.

This level of demand for skilled workers underscores the lack of technological skills in the current workforce. As the economy improves, the shortage of skilled workers will only get worse. Companies need to partner with the educational community, government and industry associations to develop programs which will prepare our workforce with the skills needed to thrive in today's changing economy.

Skills Certification Program

The Manufacturing Institute (MI) was recently awarded a $1.5 million grant from the Bill & Melinda Gates Foundation to comprehensively plan and implement postsecondary education programs that include the National Association of Manufacturers (NAM) Endorsed Manufacturing Skills Certification System. These integrated educational programs in community colleges will prepare students, particularly low-income young adults and transitioning workers, with entry-level skills necessary to succeed in advanced manufacturing careers.

A postsecondary credential is a fundamental prerequisite for economic success. The current economic climate has only reinforced the importance of obtaining a college education. Adults 25 and older with at least an associate's degree have average earnings of 30 percent higher than those of high school graduates who don't attend a postsecondary school.

In the MI initiative, the worker credentials needed by the industry will be integrated into associate degree programs offered in community colleges. Community colleges enroll nearly half of all higher education students nationwide. With relatively low tuition and open admissions policies, they are a vital pathway to better jobs and higher earnings for many adults.

The NAM Endorsed Skills Certification System focuses on the core skills required for entry-level workers in all sectors of manufacturing – from alternative energy and computers to aerospace and life-saving pharmaceuticals. The skills certifications address personal effectiveness competencies, foundational academic competencies, general workplace skills and manufacturing industry-wide technical skills. Entry-level science, technology, engineering and math skills are included in the system.

Summary

As the economy starts to improve the need for skilled workers will only increase. The NAM Endorsed Skills Certification System is part of a program being developed and implemented by the Manufacturing Institute's National Center for the American Workforce. This program is designed to help community colleges start filling gaps within the economy. With programs like this in place, we will be able to fill the positions in today's advanced manufacturing and distribution work environments.

Can Your Operations be any Leaner?

In this current economy, many manufacturers have needed to make their operations leaner. Most have done this by redesigning the assembly line, implementing JIT or creating quality teams to reduce defect. Just when it seems like all steps toward being lean have been taken, the economy forces you to dig even deeper. An area that can put a strain on many companies budgets are technology expenses because they are forced to commit to additional finances when their IT systems fail them.

Remote monitoring and IT remediation services allow organizations to not spend money when systems break, but provide for continual monitoring at a set cost. This allows for a consistent expense to be accounted for, rather than worrying about significant unplanned expenses.

Most IT issues organizations face can be proactively identified and alleviated by a remote service and dealt with without any downtime. A virus attack or server failure could be tremendously expensive both financially and in lost productivity, while possibly compromising sensitive information. A remote monitoring and IT remediation service will allow you to concentrate on the operations of your organization without worrying about whether your technology is reliable.

For more information on remote monitoring and IT remediation services, read the article “Is Technology Sapping Your Productivity” at www.rsmmcgladrey.com.

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Where can you obtain credit? Traditional factors, typically used for accounts receivable lending, remain under pressure from their own capital sources and have pulled back. Those who were financed by hedge funds have likely had their credit lines altered or withdrawn. Asset based lenders, also funded by banks and private investors are facing the same issues and continue to be reluctant to lend. Formulas used for lending on eligible accounts receivable and inventory have been revised, requiring increases in collateral cushions resulting in asset based lines of credit affording less availability and more restrictive covenants. Mezzanine debt or subordinated debt instruments and other convertible debt remain difficult to obtain.[6]

Regional banks have proven the most likely to support local borrowers. Many regional banks have largely avoided toxic lending and the subsequent loan problems. Their balance sheets remain strong, and they have the resources to offer credit to healthy companies. Although record numbers of local banks continue to be closed by the Federal Deposit Insurance Corporation (FDIC), the large regional banks offer the most likely avenue for manufacturers to find financial support.

What should you watch for the rest of 2009? The U.S. and world economies are currently operating in a historically low interest rate environment. The Federal Discount Rate, the interest rate at which an eligible financial institution may borrow funds directly from a Federal Reserve Bank, remains at historic lows of 0.5 percent. The Prime Rate, the interest rate charged by banks to their most creditworthy customers, is at its lowest level since the early 1950s, now 3.25 percent. Yet credit remains tight. The Institute for Supply Management, a trade group of purchasing executives, recently signaled that U.S. manufacturing activity should increase for the first time since January 2008 as industrial companies begin to restock. The U.S. Commerce department also indicated that construction spending rose rather than fell in June as commodity prices began to rise.[7]

The news indicates a brighter future lies ahead, and the recession may be over. However, the keys to the credit market lie in overall confidence. Credit may only begin to flow again after business and consumer confidence returns later this fall. In the meantime, a cautious approach to capital financing and spending is advised.

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2 Peltz, S. and Stoettner, R. “Reading The Fine Print: What Borrowers Need To Know About Loan Agreements In The New Recession”. RSM McGladrey White Paper. 2009.

3 Ibid.

4 *Lending Climate In America Survey – 2nd Quarter 2009*. Phoenix Management Services.

5 *RSM McGladrey Annual Manufacturing and Wholesale Distribution National Survey*. June, 2009.

6 See “Distinct Chill Maintains Grip on Credit environment”. *The Journal of Renewal*. Turnaround Management Association. July/August 2009.

7 “Manufacturing Outlook Boosts Stocks”. *Associated Press*. August 3, 2009.

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