



THE MID-MARKET ADVANTAGE

Investing in middle market manufacturing can yield significant benefits.

A STRONG AND COMPELLING CASE can be made for investing in middle market manufacturing companies in the United States, even in the face of what may seem to be insurmountable and overwhelming forces from foreign competitors, and a sluggish economy unable to absorb available capacity. These conditions are certainly not to be taken lightly. But as Mark Twain once quipped to an audience of onlookers, "The rumors of my death have been greatly exaggerated." The same can be said for manufacturing businesses operating in the U.S. middle market.

First of all, the market is very sizable. According to Dun & Bradstreet, there are over 125,000 companies operating in the United States with revenues between \$10 million and \$250 million. The very vast majority of these are private businesses. It is also safe to say that far more companies grow into the bottom echelons of this club than graduate out the top, further adding to this population each year. In addition to the usual assembly of family-owned companies and scrappy skunk-works, the population is now being supplemented with a wave of corporate spin-offs and divestitures, creating a whole new universe of middle market companies.

Second, the labor cost advantage of manufacturing goods outside the United States is not universally applicable to all products. Clearly, victims tend to be low value-added, labor-intensive products where capital cannot readily be employed to offset labor through investment in automation or more efficient equipment. Goods requiring extensive handwork, such as textiles, cabinetry and products that must be individually decorated come to mind. Beyond automation, there are a number of other ways to neutralize the apparent advantage of cheap, plentiful offshore labor. Investing in the human assets of the business develops the knowledge base, skill sets and

leadership that can drive quality, productivity, and innovation.


A close corollary to product innovation available to manufacturers is to redefine the value proposition for customers. Branding and promotional support are often desirable, but may be out of reach for many middle market companies. We've seen manufacturers successfully segment their market and preserve or expand margins by introducing "value-added" service aspects into the products. This can take on many subtle but often very profitable forms. We often see it manifest in the handling of products on behalf of the customer, such as fulfillment services (i.e., "We ship it to our client's customer") "picking and packing," offering special packaging capabilities, inventory management and shelf maintenance.

Nimbleness is key

Innovation relates to the third, but perhaps most compelling reason to invest in middle market companies: their inherent nimbleness and ability to adapt to changing business circumstances. While it is true they may lack the scale and resources of a large corporation, their key survival advantage is a flat, lean organizational structure, with minimal bureaucracy or red-tape. This gives them an innate ability to reinvent themselves, to identify shifts in the market and bring innovative new products and services to their customers with break-neck alacrity. Larger enterprises have so much momentum that it is extremely difficult to get them to change direction. Try to slow down Jupiter in its course, or for that matter, try to get it to move faster. In the natural world, size is rarely a sustainable long-term competitive advantage. Just ask any dinosaur.

A final reason to invest is the breadth of financing and capital markets products available to these companies. To begin with, man-

ufacturers by their nature tend to have balance sheets rich with tangible (and therefore leverageable) assets: receivables, inventory, plant and equipment. Banks, finance and leasing companies all have a strong preference for using these assets to collateralize their loans, and it is much easier for them to perfect these interests when the assets are located in the United States. According to Standard & Poor's, debt has become more readily available to finance buyouts, with the second half of 2003 exhibiting particularly strong leverage multiples. They report six sizable buyouts in this time frame where leverage multiples (that is, total debt divided by earnings before interest, taxes, depreciation and amortization) were five times or higher. This is a significant increase from 2001, when leverage multiples fell to the mid-three-times level. Standard & Poor's goes on to report that today's low interest rate environment, the "cleaned up" balance sheets of both banks and businesses, and the improving economy all augur well for increased availability of financial leverage.

This investment strategy, steeped in the U.S. middle market, has numerous advantages but requires a lot of heavy lifting. Researching and selecting the right market niches is a continuous, deliberate process. Partnering with the right managers is essential to ensure success. Nonetheless, there is the occasional nugget, and companies should be quite content to keep panning right here in the U.S. middlemarket. 

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