

Grant Thornton Manufacturing Insights 2007: A Canadian Perspective

Grant Thornton 



The landscape
is changing.
Be in control.



Grant Thornton [Manufacturing Insights](#) 2007

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“The Canadian manufacturing and distribution industry is entering into a ‘new industrial age,’ a period of fast-paced change that is fundamentally affecting every aspect of business. Manufacturers and distributors need to distill the challenges of this evolving global landscape into a clear, distinct advantage. *Manufacturing Insights 2007: A Canadian Perspective* brings this landscape into sharper focus.”

Alex MacBeath
Executive Partner & CEO
Grant Thornton LLP

A new industrial age

It is undeniable. Canadian manufacturers and distributors are operating in a tremendously challenging environment, one characterized by fast-paced dynamics and a rapidly changing global landscape, flattened by technology. At Grant Thornton we call it a “new industrial age,” an age the impact of which has perhaps not been experienced since the Industrial Revolution. Although the potential for disruption is significant, and undoubtedly there will be some fallout, the challenge we issue to manufacturers and distributors is to seize control of your own destiny, now. You still have time. The challenges are daunting, but the opportunities that exist are very exciting and offer substantial returns if solutions are effectively executed.

Grant Thornton International recently conducted research on the opinions and expectations of business leaders, including 2,744 private mid- to large-sized manufacturing and distribution businesses in 32 countries. Our analysis focused on four key dimensions: economic outlook, revenue, profit, and employment. The results offer an informative Canadian perspective on a multifaceted landscape and provide us with the opportunity to share useful insights into not only the current and expected future economic and competitive environment, but also the strategies and solutions manufacturers and distributors need to consider in an effort to take

control. While expectations for the coming year remain positive overall, optimism has declined for all four key dimensions among Canadian manufacturers and distributors, with economic outlook reaching its lowest level in three years. Furthermore, there are significant regional differences, perhaps reflecting regional responses to fundamental and disrupting influences in the Canadian economy. This in itself is important in that it reflects, in our opinion, the general sense of frustration those in the industry feel in reaction to the game-altering events of the past couple of years: the appreciation of the Canadian dollar, the emergence of new economies, spiraling costs, skilled labour shortages, and the deceleration of the economy in the United States — still our largest trading partner.

Manufacturers and distributors are a very resourceful breed and have not flinched in the face of past challenges. These latest pressures can be addressed but will require a radical change in thinking. Management teams, with the full support of owner-managers, must step back and critically assess fundamental business models, tear them apart, and then rebuild. But they must rebuild with a sense of urgency and vision adapted to the truly global business environment that is today's new reality. Upon thorough analysis, you may find the results of this study startling. The research indicates gaps in management systems,

processes, and corporate cultures; weaknesses and inefficiencies in supply chains; and a general innovation deficiency. This is where the real work will begin. Companies must embrace change and develop strategies that directly address the identified gaps through effective execution.

These are challenging times that require an immediate and uncompromising response. We hope you are prepared to accept that challenge. At Grant Thornton we are equipped to support you in your mission to create and implement a blueprint for change in this new industrial age.



[Jim Copeland](#)
[National Leader](#)
[Manufacturing & Distribution](#)
[Grant Thornton LLP](#)

About the Grant Thornton *Manufacturing Insights 2007* series

Prompted by the unprecedented pace and magnitude of economic change affecting Canadian industry, Grant Thornton created a series of strategic reports called *Manufacturing Insights 2007*. This series probes both the outlook for private mid-sized businesses across the country and their competitive position relative to the rest of the world. *A Canadian Perspective* is the first of four planned reports in the series.

Significant primary and secondary research was undertaken in the fall of 2006 and winter of 2007. In Canada, Grant Thornton interviewed business owners and senior executives at 198 private mid-sized manufacturers and 102 distributors about the issues that matter most to their businesses. *A Canadian Perspective* draws from in-depth interviews with Grant Thornton practitioners, who provided insights from their client- and industry-based experience, and from roundtable discussions with industry experts who support Canada's manufacturing and distribution industry.

Forthcoming reports in the *Manufacturing Insights 2007* series will feature findings and insights from interviews with 1,868 business owners and senior executives at private mid- to large-sized manufacturing and distribution businesses in 17 countries.

For more information on the *Manufacturing Insights 2007* series of reports, visit www.GrantThornton.ca/Manufacturing

About the 2007 Grant Thornton Survey

In the fall of 2006, business-owners and senior executives at more than 7,200 mid- to large-sized businesses were interviewed in 32 countries. The purpose of the survey was to uncover new insights regarding how respondents were dealing with current economic opportunities and challenges.

This year's survey, formerly known as the International Business Owners Survey (IBOS), was renamed the 2007 International Business Report (IBR), in recognition of the fact that businesses of varying size operate in an increasingly global economy.

In Canada, 472 telephone interviews were conducted among business owners and senior executives of mid-sized businesses, including 300 manufacturers and distributors. For the purposes of this survey, mid-sized was defined as businesses with annual revenues in the range of \$15M to \$500M. Data was weighted to reflect the regional distribution of mid-sized manufacturing and distribution businesses based on information provided by Statistics Canada.

For more information on the 2007 IBR survey methodology and participation, visit www.internationalbusinessreport.com

Unless otherwise noted, all data in this report is derived from the 2007 Grant Thornton International Business Report, hereafter referred to as the "2007 Grant Thornton Survey".

Key research insights

Results from the 2007 Grant Thornton Survey show that the mood of Canada's private mid-sized manufacturers and distributors has moderated. Optimism about the Canadian economic outlook has declined from a high of 81% in 2005, according to that year's results, to 64% in 2007, a statistic that sinks to 58% for manufacturers alone. Currency appreciation, increased competition, and unprecedented investment in oil and gas development are all contributing to a changing industrial landscape, where regional disparities are heightened and global market forces hold sway.

Faced with significant employment migration within the industry and among the provinces, Canada's manufacturers and distributors are finding it increasingly difficult to navigate the volatile domestic labour market. The industrial workplace is rapidly changing: concern over a lack of skilled labour has increased to 38% since the 2004 Grant Thornton Survey, when just 25% of companies rated it as a constraint to growth. Other constraints include shortage of orders/reduced demand (23%) and regulations/red tape (20%), but the real issue for many is a lack of governmental support that can help improvement-minded manufacturers and distributors tackle current economic challenges.

It is clear that the manufacturing and distribution industry remains under great pressure in 2007. Rising costs in nearly every facet of the business are chipping away at bottom-line growth for many Canadian companies, with half of those we surveyed expecting major impacts from raw material and transportation costs in the coming year. Still, Canada's manufacturers and distributors are reluctant to pass these costs on to customers in the form of higher selling prices (only 45% expect an increase in the coming year), focusing instead on lowering their already low cost structures and risking their competitive positions. Overall, risk management preparation varies in regions across the nation.

Strategic investments will not only improve the global competitiveness of a sector held back by a lack of skilled labour, but set the stage for the implementation of critical internal efficiencies and productivity improvements. Yet many of the nation's manufacturers and distributors are still on the sidelines when it comes to embracing modern improvement methods. The 2006 Canada Manufacturing Study presents data that one in five plants (19%) have no improvement method in place; close to half of the companies Grant Thornton in 2007 surveyed expect no change in their short-term capital spending plans.

The evidence suggests there are dollars in innovation. However, while only 9% of companies invested a minimum of 10% of revenue in innovation, 19% report generating at least 10% of revenue from new products, services, markets, and business models. Also, nine in ten Canadian manufacturers and distributors perceive themselves as at least as innovative as the leading businesses in their space. Despite this apparent edge and the country's abundant natural advantages, barely half of Canadian companies see globalization as an opportunity, and one-third see it as a threat. In an era of intense global competition, the 2007 Grant Thornton Survey reveals what appears to be collective apprehension in the domestic sector about conducting business abroad.

With this new understanding of the current climate defined by cautious optimism and challenge-filled opportunities, and our extensive client-based experience in the manufacturing and distribution industry, Grant Thornton presents *Manufacturing Insights 2007: A Canadian Perspective*.

Optimism strong – but waning

Critical questions

- Weakening optimism among private mid-sized manufacturers and distributors is reflected in their outlook for revenues, profits, employment, and the economy. How can individual companies ensure a brighter future?
- How can companies leverage the unique economic and market conditions within Canadian regions?
- Distributors are more likely than manufacturers to expect revenues, profits, and employment to rise, in part due to wider participation in globalization. How can manufacturers also grab the global ring?

Looking ahead at external and internal conditions

After years of optimism about the Canadian economic outlook, private mid-sized manufacturers and distributors are tempering their enthusiasm amid uncertain national economic conditions (currency appreciation) and regional disparities (the Alberta oil-fueled boom). Approximately two-thirds of Canadian private mid-sized manufacturers and distributors (companies with revenues of \$15 million to \$500 million) are optimistic about the Canadian economic outlook for the next year; just 15% are pessimistic. Yet after peaking at 81% of companies in 2005, there has been a steady decline in optimism, falling to 71% last year and then to 64% this year.

There are stark differences in economic outlook across the nation: 88% of private mid-sized manufacturers and distributors in Atlantic Canada are optimistic vs. 74% in Western Canada, 65% in Quebec, and only 53% in Ontario. These differences reflect regional responses to structural changes in the Canadian economy as well as provincial differences in resource endowment, population, labour markets, etc. The differences also may highlight the industrial specialization of individual provinces. For example, 73% of private mid-sized distributors were optimistic about the Canadian economy vs. 58% of private mid-sized manufacturers.

Approximately two-thirds of private mid-sized manufacturers and distributors (64%) expect revenues to rise in the coming year; 11% expect a revenue decline. Distributors are slightly more optimistic than manufacturers (68% vs. 61%). This is a marked decline from the 2006 Grant Thornton Survey when 74% of all manufacturers and distributors anticipated sales increases.

There are significant regional differences in revenue expectations: Quebec respondents are the least optimistic about revenues rising (48%) compared to companies in Atlantic Canada (75%), Western Canada (70%), and Ontario (67%). Much of the optimism in Western Canada is likely linked to business activity supporting the booming oil industry.

Ian McDonald, Partner, Manufacturing & Distribution, Grant Thornton LLP, says, “Oil industry development in Western Canada is driving optimism in that region. During the past few years of appreciating oil prices there has been unprecedented investment in the region as the oil industry races to dramatically increase productive capacity. This in turn has created economic spin-off that has impacted virtually every aspect of the region’s social and economic fabric.”

Jayson Myers, Chief Economist, Canadian Manufacturers & Exporters (CME) adds, **“There is \$153 billion in committed investment for the region over the next 10 years and even as the price of oil has declined, the investment figure keeps rising.”**

Just 59% of private mid-sized manufacturers and distributors anticipate rising profits in the coming year (63% of distributors and 55% of manufacturers). External costs are erasing bottom-line growth at many companies, while others are simply not efficient enough to earn reasonable returns on investment. Yet both groups of companies need to improve operations and cut costs while they still have time because rising revenues won't necessarily last forever. Ontario manufacturers and distributors are most likely to anticipate rising profits (63%), while companies in Atlantic Canada and Western Canada are somewhat less optimistic (58% and 55%, respectively). Just 49% of Quebec respondents expect profits to increase in the coming year.

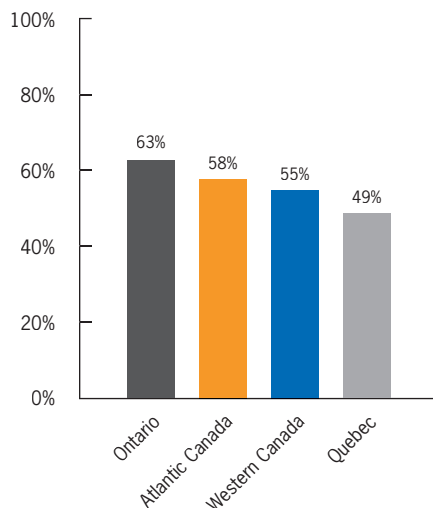


Figure 1: Profit expectations for the coming year among Canadian manufacturers and distributors

Although private mid-sized manufacturers and distributors are relatively bullish on their earning prospects, they're not planning to increase staffing in the near future; just 41% of companies expect to increase employment next year. Companies in Quebec are least likely to expect employment increases (34% expect an increase, 61% expect no change, and 5% predict an employment drop). Almost half of the companies in Western Canada (46%) expect employment to rise, making it the most optimistic of Canada's regions.

Reviewing all four projection dimensions (economic outlook, revenue, profit, and employment) over the past four years reveals that the mood among Canada's private mid-sized manufacturers and distributors has shifted. After three successive years of increasing optimism, companies are less confident in the face of a changing industrial landscape. This begs the following question: How accurate were their predictions in past years?

Objects in rear-view mirror may appear larger

Although Canadian private mid-sized manufacturers and distributors have been realistic in their revenue expectations in recent years, they are finding it increasingly difficult to forecast Canada's volatile employment market.

More than two-thirds of Canadian private mid-sized manufacturers and distributors

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Ian McDonald
Partner, Manufacturing & Distribution
Grant Thornton LLP

(68%) report revenue increases over the last three years. This is similar to the combined average percentage for companies expecting revenue increases during the same period (69%). More than three-fourths of distributors (76%) saw revenues rise vs. 62% of manufacturers; decreases were reported by 7% of distributors and 13% of manufacturers. The average change in revenue over the past three years for Canadian private mid-sized manufacturers and distributors was an increase of 17.1%. Over the last three years, revenues in Western Canada rose at 78% of companies vs. 66% in Quebec, 61% in Ontario, and 58% in Atlantic Canada.

Year-to-year employment growth reported by private mid-sized manufacturers and distributors over the last four years has been modest but consistent, with 40% to 47% of companies reporting an increase for any one year (in 2006, 40% of companies reported an increase and 43% reported no change). For the past year, the average employment change was an increase of 2.2%. Employment projections have been accurate, with the exception of the current year: 50% of companies in 2006 expected employment to increase, but only 40% reported actual increases.

As Canadian companies attempt to staff up, they face an aging Canadian workforce and more retirements, resulting in shortages of senior supervisory and management experience, specialized skills shortages for various trades, leadership succession issues in small- and mid-sized companies, and basic labour shortages across the country, especially in Western Canada.

“The workplace is changing,” says Bill Cloke, Training Director, Grant Thornton Productivity Improvement. “Basic labour jobs are moving to places where labour is cheaper. Product life cycles are shorter and new technology is introduced every day. We must teach our workforce to learn continuously. They need skills to be able to see opportunities to improve, gather the facts, and help develop the solutions.”

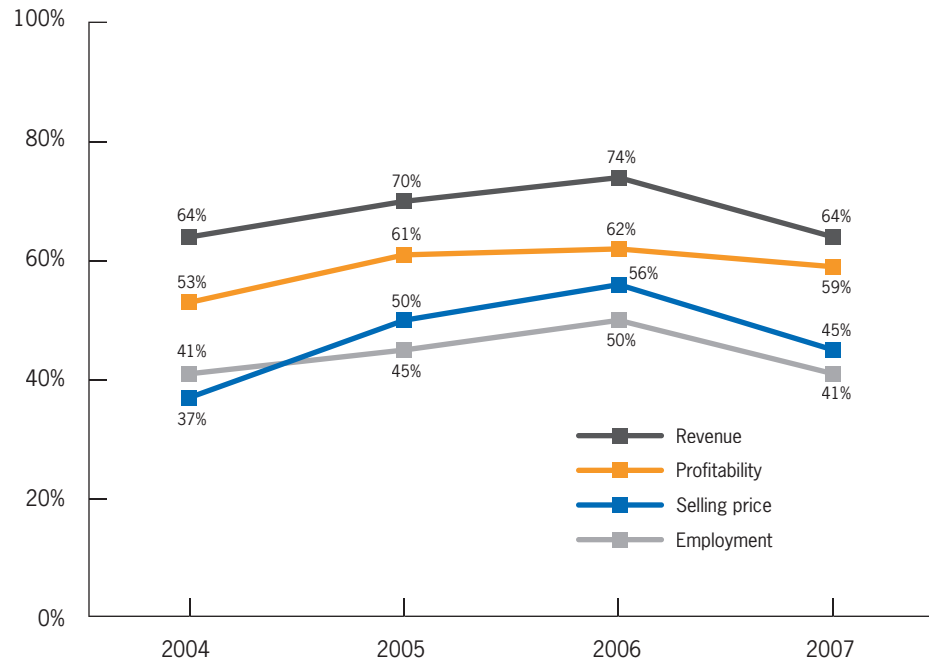


Figure 2: Expected increases in revenue, profitability, selling prices, and employment among Canadian manufacturers and distributors (% of companies)

Source: 2004, 2005, 2006, 2007 editions of Grant Thornton Survey

Manufacturers appear to be less fortunate than distributors regarding employment numbers, with 24% of manufacturers reporting a decrease in employment in the past year (vs. just 9% of distributors), and only 35% of manufacturers reporting an increase (vs. 48% of distributors). At the same time there is significant employment migration within the manufacturing sector, both away from automotive and, more significantly, from East to West: employment levels were most likely to have increased among companies in Western Canada (47% of manufacturers and distributors)

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Bill Cloke
 Training Director
 Grant Thornton Productivity Improvement

vs. Atlantic Canada (40%), Ontario (39%), and Quebec (29%). Quebec, Ontario, and Atlantic Canada were similar in their rates of companies reporting decreased employment — 20%, 22%, and 20% respectively — while approximately half of Quebec companies (51%) report no change in employment.

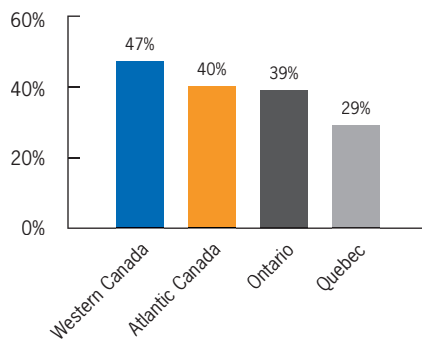


Figure 3: Employment growth over the past year among manufacturers and distributors

Does current optimism translate to an improved future?

Private mid-sized manufacturers continue to be less optimistic than distributors about their prospects for the future (58% vs. 73%). But this group also is more advanced in implementing improvement methods to compete in an increasingly competitive global market.

At many manufacturers, cost-management efforts have been combined with strategic outsourcing of underperforming functions. This may mean that the relatively greater

pessimism of manufacturers is, in fact, a realistic perspective based on their assessment of the degree and complexity of innovation in both product and process required to survive.

Canadian private mid-sized distributors are in a different position, one from which they might leverage trends in globalization. Even in sectors where considerable volumes of production have shifted overseas (e.g., electronics), many Canadian distributors retain a foothold as goods arrive back into the country. For example, imports rose from \$348,957 million in 2002 to \$396,443 million in 2006 (Industry Canada 2007). So even as Canadian producers of those goods might lose business, Canadian distributors in some supply chains may still profit.

Grant Thornton analysis

- Optimism among manufacturers and distributors regarding the economy and corporate performance may be in decline but improvement-minded companies can still survive and thrive. Now is the time to put improvement initiatives and strategic investments to work in private mid-sized companies.
- Not all regions and industries are created equally. Just as companies in Western Canada are taking extreme measures to import labour and skills, companies in every region must understand the tools and resources available to them to address their unique regional challenges.
- Globalization may indeed be kinder to distributors than manufacturers, but manufacturers that improve internally and leverage supply-side opportunities are likely to enjoy revenue and profit increases far into the future.

Facing the new realities

Critical questions

- How can private mid-sized manufacturers and distributors expect to cover rising costs, especially when selling prices don't keep pace?
- What is the nature and extent of Canada's skilled labour shortage? Can human-resource best practices and attractive wage and benefits packages overcome the skill gaps?
- How can private mid-sized companies protect against events and risks that can paralyze or bankrupt a business?

Costs overcoming selling prices

Faced with rising costs in nearly every facet of their businesses, Canadian private mid-sized manufacturers and distributors have been reluctant to pass those costs on to customers in the form of higher selling prices. How long, however, can conflicting cost and pricing conditions co-exist?

Less than half of Canada's private mid-sized manufacturers and distributors (45%) expect an increase in selling prices; 13% of companies expect the prices they charge to fall over the next year. Distributors are more likely to increase prices than manufacturers (50% vs. 41%). Expectations differ significantly among regions when it comes to setting prices. Companies in Atlantic Canada (65%) were most likely to boost prices, followed by those in Western Canada (53%), Ontario (42%), and Quebec (32%). Quebec companies were the most likely to keep prices constant (49%).

Costs, on the other hand, are rising everywhere. For example, 91% of Canadian private mid-sized manufacturers and distributors see transportation costs increasing, with 51% expecting this to have a major impact on their cost pressures in the next year. The anticipated effects of energy, raw material, and staff costs are similarly striking. Across Canada, regional disparities relative to cost pressures also appear (Table 1).

Cost category	% Expecting minor impact	% Expecting major impact	Region with highest % expecting major impact	Region with lowest % expecting major impact	Leading impact by region*
Transportation	40%	51%	Quebec (54%)	Western (46%)	
Energy	50%	37%	Atlantic (60%)	Quebec (26%)	
Staff	57%	26%	Western (55%)	Quebec (15%) Ontario (15%)	Western (49%)
Raw material	31%	50%	Ontario (55%)	Western (47%)	Quebec (51%) Ontario (51%) Atlantic (30%)
Property	46%	11%	Western (19%)	Quebec (1%)	

* of companies selecting a given cost category as the one that they expect to impact them the most in the coming year

Table 1: Expected cost pressures among Canadian manufacturers and distributors in the next year

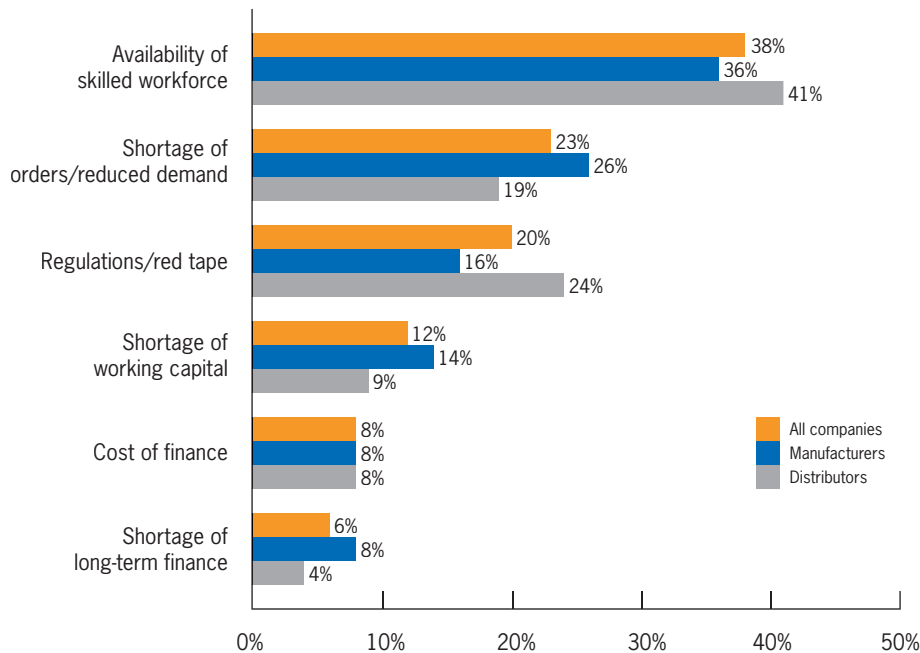


Figure 4: Constraints on business growth among Canadian manufacturers and distributors (% of companies citing as constraint)

Cost pressures were significant for all companies, but industrial specialization leads to varied responses: distributors were more likely to report transportation costs as a major impact (58% of distributors) than manufacturers (44%). When asked to select the single factor having the largest impact on cost pressures, 39% of Canadian companies cited raw material costs. Not surprisingly, this number reflects a strong response from manufacturers, 48% of whom believed raw material costs would exert the largest impact (vs. just 27% of distributors), while 27% of distributors also cited transportation costs as the leading source of cost pressure (vs. 9% of manufacturers).

Business constraints

Canada’s private mid-sized manufacturers and distributors were asked to assess several factors as constraints on their ability to grow or expand operations. Leading the list was the availability of a skilled workforce (38% of companies), followed by shortage of orders/reduced demand (23%) and regulations/red tape (20%).¹

Concern over a lack of skilled labour has grown since the 2004 Grant Thornton Survey when just 25% of companies rated it as a constraint. Indeed, in nearly every industry survey fielded over the last decade

a perceived scarcity of skilled labour appears as a primary concern. Some companies providing exceptional wages, working conditions, and employee benefits may be maintaining or growing their talent pools, indicating that good labour practices offer some benefit, but the labour shortage is real for much of Canada.

Fully 90% of the Canadian manufacturers and distributors surveyed by Grant Thornton believe that skilled labour heading out of the country has no impact on them, meaning that talent is simply in short supply. And while there is evidence that the Canadian workforce is migrating between sectors and geographically, other major trends are reshaping Canada’s workforce:

- increasing demand for skills in the face of advanced technologies and the “knowledge-based economy”;
- a working population that is increasingly made up of older people; and
- growing reliance on immigration as a source of skilled labour.

Not surprisingly, the need for labour is closely related to a company’s growth expectations. This is readily apparent in the regional data, as 68% of companies in Western Canada saw the availability of skilled labour as a constraint. This booming region was the most optimistic about future employment growth and led the country in reported employment growth over the past year (Figure 5).

¹ Respondents were asked to rate each factor on a scale from 1 to 5, with 1 as ‘not a constraint’ and 5 as ‘major constraint’. This data and Figure 4 shows the percentage of responses rated either a 4 or a 5.

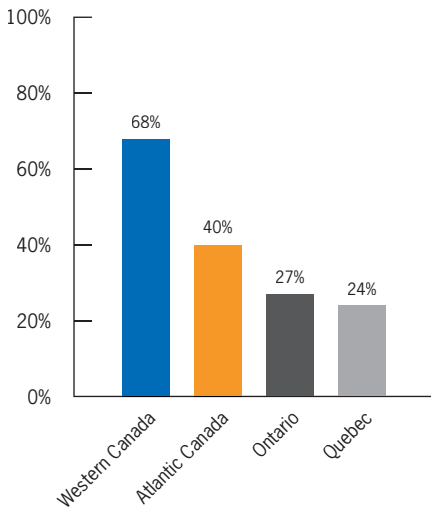


Figure 5: Availability of skilled workforce as a growth constraint among Canadian manufacturers and distributors

Concern regarding a shortage of new orders has risen slightly over the last four years from 19% of companies in 2004 to 23% in 2007. The latest results suggest that this concern, cited by 26% of manufacturers, is a lesser factor for distributors (19%) and is currently affecting slightly more companies in Ontario (26%) and Quebec (24%) than in the West (21%) and Atlantic Canada (15%).

True to their industrial heritage, Quebec companies are, by a large margin, most likely to generate high percentages of revenue from exports. About half of Ontario companies report a 25% or greater revenue share from exports (vs. 80% in Quebec). One quarter of the companies in both of these regions are still concerned about falling orders. Currency appreciation is a key factor, significantly raising the price of Canadian exports. This is keenly felt

in Ontario, Quebec, and Atlantic Canada, where shipments to the United States are high, but it affects all Canadian companies. **“About 87% of all goods exported from Canada go into or through the United States, and 55% of all manufacturing output in Canada goes into the United States,”** says Jayson Myers, Canadian Manufacturers & Exporters. **“Everybody who has been exporting into the United States has been affected by the 45% appreciation of the Canadian dollar, and that has significantly reduced returns on investment and led to tremendous downward pricing pressures.”**

One in five private mid-sized manufacturers and distributors (20%) views government red tape as a business constraint, a percentage that has decreased somewhat over the years from a peak in 2005 when 31% of companies reported it as a constraint. But the real issue for many of these companies has not been bureaucracy that inhibits growth, but a lack of support for their survival. That began to change in March 2007 when manufacturers won a \$1.3 billion government tax break over the next two fiscal years from federal Finance Minister Jim Flaherty. Through 2008, manufacturers can claim an accelerated capital cost allowance at a rate of 50%, allowing them to completely write off new investments in equipment over a two-year period. They can also take advantage of an increase in the capital cost allowance rate for buildings used in manufacturing from 4% to 10% (Thorpe 2007).

The capital investment initiatives can, to some extent, help private mid-sized manufacturers and distributors. Many companies that had been contemplating new equipment and tooling are moving up the schedule of those investments.

“The Tax Act provides a variety of incentives for manufacturers and exporters including corporate structuring, SR&ED tax credits, and accelerated write-off of certain property and equipment,” says Keith MacIntyre, Leader, Nova Scotia Tax Service, Grant Thornton LLP. **“The economic contribution made by this industry to skilled labour and GDP is undeniable and it is important for governments, at all levels, to continue working hard to create a tax regime in which manufacturers and exporters can flourish.”**

Exposure to risks

Consumed by their quest for growth, profit, or merely survival, many private mid-sized manufacturers and distributors neglect to establish practices and policies that limit their exposure to business risks. **“The dynamics of our fast paced global economy are giving rise to new and different risks that have never been tracked on company radar screens,”** says Doug Steele, Partner, Business Risk Services, Grant Thornton LLP. **“Time and effort is spent on developing offensive strategies to ensure growth and market superiority, but at the same time it is**

important to ensure that a business has a defensive game plan for dealing with the risks in a structured way.”

While three-fourths of companies have a formal mechanism to address fundamental risks — security of electronic information (76% of companies), a business plan/strategy (74%), and an HR policy (76%) — many lack policies or procedures to address lower-profile issues that could just as easily undermine their businesses. Even those issues or events that appear to allow time for reaction (e.g., regulatory change, succession planning) can rapidly affect a company. Others can damage or destroy a company overnight (e.g., loss of key customers, major IT failure, privacy of information risk). Yet many Canadian manufacturers and distributors have not prepared for these potential disasters:

- reputation/media crisis (77% of companies do not have a formal mechanism to address this issue)
- major regulatory change in industry (69% of companies)
- loss of key customers (59%)
- loss of key personnel (58%)
- disaster recovery (41%)
- major IT failure (41%)
- succession planning (41%)
- loss/destruction of property (38%)
- privacy of information risk (33%)

Savvy companies not only plan for risk management to mitigate risks, they also leverage those plans to create opportunities.

Here are examples:

- In developing a strategy to replace the sudden loss of a major customer, new customers and market opportunities are revealed.
- In defining how a company should react to a major IT failure, the plan’s information is used to assess current IT applications, systems, and service vendors.
- In developing succession plans for key personnel (from a senior executive to those holding proprietary knowledge on the plant floor), employee hiring and development criteria are developed and refined.

“This industry faces many challenges. Often succession and estate planning is not included as an element to building a solid foundation within a business. Without a succession plan, businesses are typically left without an effective strategy for communicating the founder’s vision to the subsequent management team, significantly impacting the future value of the business.”

Shelagh Rinald
National Leader, Succession & Estate Planning
Grant Thornton LLP

Grant Thornton analysis

- Selling prices will rarely keep pace with costs to produce the product or provide the service if all the customer sees is the “product” or “service.” Canadian manufacturers and distributors must differentiate themselves from commodity providers by offering greater value in the form of services and support, and in doing so increase the likelihood of customer loyalty and improved profitability.
- Some business constraints cannot be controlled, so companies must have policies and procedures in place to manage these issues.
- Manufacturers and distributors need to first assess their organizations for risk, and then develop a mitigation strategy that addresses a prioritized list of business threats.

Creating opportunities

Critical questions

- How can private mid-sized manufacturers and distributors continue to improve the productivity of operations within their companies as well as efficiencies throughout their supply chains? And for companies that are only now awakening to the need for serious improvement, how can they get started?
- How can Canadian companies compete on the world stage? Have they given themselves a fair chance by wisely investing in tools, technology, and people in order to leverage global opportunities?
- How can Canadian companies get the specialized support they require in order to innovate and commercialize new products, services, processes, and technologies?

Despite the challenges that private mid-sized manufacturers and distributors face, opportunities for increased profitability and growth are available in the form of operational improvements, improved supply-chain management, outsourcing, technology and capital investments, and a renewed focus on innovation.

Organizational improvements

Many private mid-sized manufacturers and distributors have embraced improvement methods to reduce costs and improve productivity. In fact, this is no longer an option but a necessity. Many Canadian companies, however, are still on the sidelines when it comes to embracing modern improvement methods. For example, while 45% of Canadian manufacturing plants have implemented some form of lean manufacturing (lean, lean and six sigma, or the Toyota Production System) and 36% have implemented other improvement principles (e.g., agile manufacturing, theory of constraints), one in five plants (19%) have no improvement method in place (Manufacturing Performance Institute 2006 and Advanced Manufacturing Magazine 2006). This is incredible, especially since the adoption of an improvement methodology addressing the critical areas of process, management systems, and organizational culture is almost always rewarded with business benefits that improve short-term performance (e.g., delivery times, quality levels) and long-term performance (e.g., reduced inventories, freed-up capital, and higher margins). Given the 2007 Grant Thornton Survey data on rising costs, is there any alternative but to improve?

A company's internal improvement effort must eventually be extended across its supply chain. Improved management of upstream activities with suppliers, such as sharing resources, best practices, and personnel, often alleviates supply-chain concerns among manufacturers and distributors, particularly volatile pricing (41% of private mid-sized companies report this as a challenge), quality assurance (26%), and days of supply (21%). This last concern can also be affected by improved relations with customers, such as developing a value-added approach to products and services. Better management downstream with customers in the form of becoming more of a partner, and getting better information sooner can also address the challenges of changing customer expectations (32%) and forecast/demand planning (28%). Changing customer expectations were a particular challenge for distributors (cited by 40% vs. 27% of manufacturers).

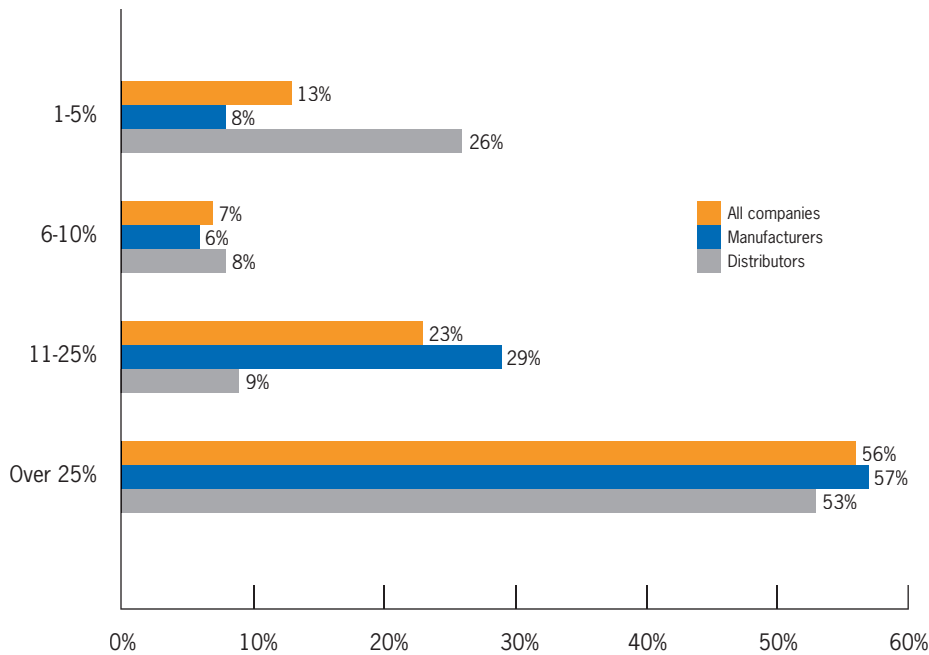


Figure 6: Revenue from exports among Canadian manufacturers and distributors

Leveraging globalization

Canada is one of the largest industrial nations by many measures (e.g., GDP, labour force), yet still lags behind other nations in globalization. This ambivalence is reflected in the survey results; about half (51%) of Canadian private mid-sized manufacturers and distributors see globalization as an opportunity, while one-third see globalization as a threat (38% of manufacturers vs. 27% of distributors). Given the increasing scale of globalization, Canadian companies are at a complex crossroads: embrace the opportunities

that globalization affords, or risk being left behind.

Exporting: The percentage of Canadian manufacturers and distributors that export has shrunk over the last four years, falling from 73% of companies in the 2004 Grant Thornton Survey to 60% of companies in 2007. The percentage that plan to increase exports has decreased as well (from a peak of 60% in 2005 to 46% in 2007). Even as these indicators dropped, Canadian exports rose from \$396,381 million in 2002 to \$439,500 in 2006 (Industry Canada 2007). The disparity between these numbers is

better understood when looking at the exuberance with which some companies have embraced exporting. A majority (56%) of the private mid-sized companies that export report that exports represent more than 25% of revenues (Figure 6). The top export destinations are the United States (mentioned by 90% of companies) and Mexico (16%), followed by the United Kingdom (11%), Japan (10%), and China (8%).

Manufacturers are far more likely to export than distributors (77% vs. 39%), and more companies in Atlantic Canada (75%) and Ontario (71%) currently export than in Quebec (60%) or Western Canada (54%).

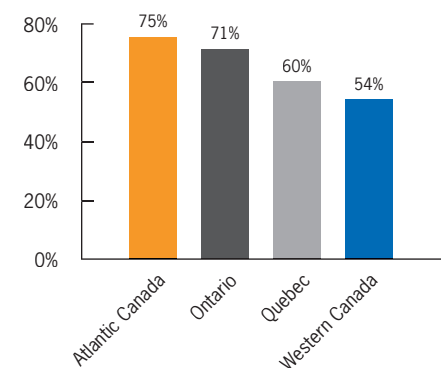


Figure 7: Percentage of Canadian manufacturers and distributors that currently export

Importing and outsourcing: With the exception of importing from China (38% of companies), Canadian manufacturers and distributors are taking a cautious approach to importing from the so-called “hot” low-cost countries known collectively as BRIC (Brazil, Russia, India, and China).

“No company should rush into global sourcing arrangements without a solid sourcing strategy and rigorous due diligence focused on ‘total costs’ to the organization, but there appears to be a collective apprehension among many Canadian companies about even the prospect of sourcing goods from overseas, a delay that could prove costly.”

Darcy Verhun, MBA, FCMA
Partner, Grant Thornton Consulting

India sees less than half of the activity of China with just 18% of Canadian companies currently importing from there. Respondents are relatively inactive in Brazil and Russia (8% and 3% importing respectively), and few from among the balance of Canadian companies have plans to start importing from the BRIC countries (6% or less are eyeing each country).

“No company should rush into global sourcing arrangements without a solid sourcing strategy and rigorous due diligence focused on ‘total costs’ to the organization,” says Darcy Verhun, Partner, Grant Thornton Consulting, “but there appears to be a collective apprehension among many Canadian companies about even the prospect of sourcing goods from overseas, a delay that could prove costly.”

Additionally, a clear majority of Canadian manufacturers and distributors (60% of companies) say they currently do not outsource, nor do they plan to do so in the future. Outsourcing activity is higher in Western Canada (45%) and Ontario (44%) vs. Atlantic Canada (30%) and Quebec (28%).

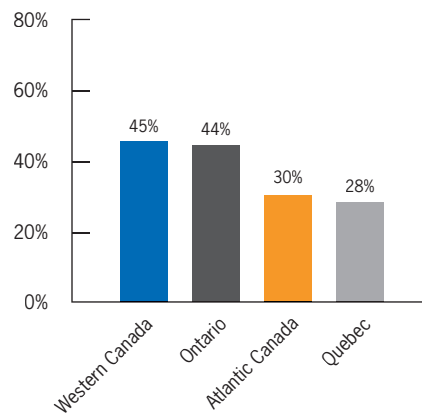


Figure 8: Outsourcing of non-core functions among Canadian manufacturers and distributors

Where outsourcing does occur or is planned among private mid-sized manufacturers and distributors, the most frequently outsourced activities are tax compliance (61% of companies currently outsource), payroll (60%), IT services (54%), and training (48%).

Investments

Prior to the latest federal budget and its improved tax treatment for capital investments, few private mid-sized manufacturers and distributors were planning to increase their level of investment

in new buildings in the next year (25% of manufacturers and 30% of distributors). New building investments are most likely to happen at companies in Atlantic Canada (49%) and Western Canada (33%) vs. Ontario (24%), and Quebec (17%).² Increased investment in new plant and machinery, however, was more likely, both by industrial specialization (51% of manufacturers and 39% of distributors) and region (72% of companies in Atlantic Canada, 51% in Western Canada and Ontario, and 31% in Quebec).

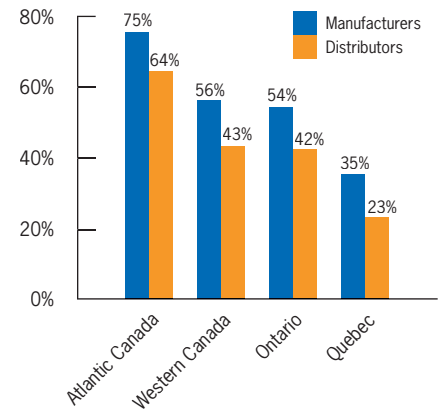


Figure 9: Expectations for increased investment in new plant and machinery among Canadian manufacturers vs. distributors in the next year

While the investment data on plants and machinery is encouraging, it pales in comparison to what is occurring elsewhere. For example, the Institute for Competitiveness and Prosperity (ICP) presents evidence that in 2005, Canada’s private sector businesses invested \$5,700

² ‘New building’ investment based on those who own a building; plant and machinery investment based on those who own plants and/or machinery.

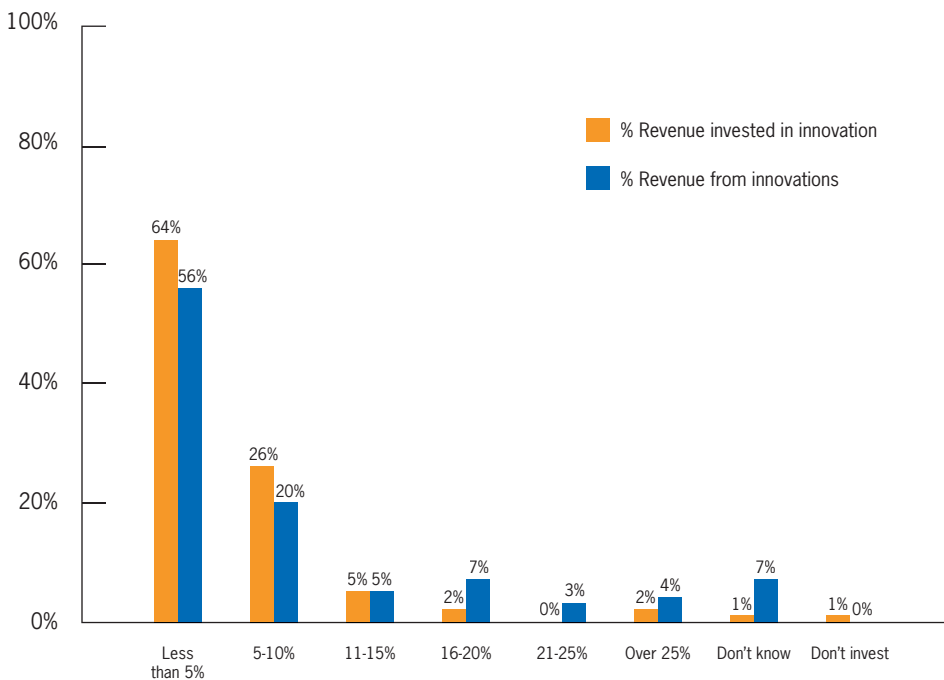


Figure 10: Innovation investment vs. ROI among Canadian manufacturers and distributors (% of companies)

in new equipment, machinery, and software per worker compared to \$8,000 per worker in the United States. These recent numbers reflect a decade-long trend of annual deficits in the range of \$2,000 to \$3,000 in new investment by Canadian businesses compared to their United States counterparts (ICP, March 2007). Machinery and equipment investments in recent years have been flat even as the dollar has strengthened, making imports substantially more affordable for Canadian businesses.

Canadian companies must invest to remain globally competitive. Is it possible that,

with recent regulatory changes to write-offs for capital investments (as fast as two years), the pace of capital expenditures will increase in Canada?

Innovation

Too often, industrial organizations — particularly private mid-sized companies — view change as a traumatic experience, even when that change comes in the form of innovation that can produce great benefits. Yet this doesn't have to be the case. Incremental innovations in products, processes, services, and markets can and

do achieve significant results. In short, innovation is both scalable and attainable; however, many Canadian companies have not developed the culture, infrastructure, incentives, and rewards to be strategically innovative on a day-in, day-out basis.

Two-thirds of manufacturers and distributors (64%) report that they invested less than 5% of revenue in the past 12 months in innovation³; 26% invested 5-10% and 9% invested more than 10%. Remaining respondents didn't know the extent of their investment or didn't invest in innovation. Manufacturers were more likely to invest more than 5% in the development of new products, services, markets, and business models (39% of manufacturers vs. 29% of distributors). A slim majority of companies (56%) report that less than 5% of revenue came from innovations over the past 12 months; 20% report 5-10%, and just 19% report more than 10% (Figure 10).

“Someone said that change is constant. We all know that change can be difficult, but companies that stay on task, constantly looking for ways to improve themselves are the ones that will win the day.”

William Surphlis
 Managing Partner
 Grant Thornton Productivity Improvement

³ 'Innovation' is defined in the 2007 Grant Thornton Survey as 'the development of new products, services, markets, and business models'.

The remaining 7% of respondents didn't know their return on innovation-related investment. Distributors were clustered in the less than 5% range (60% of distributors vs. 53% of manufacturers), while manufacturers held a slight edge in generating more revenue from innovation.

On a positive note, some Canadian companies are getting high returns on their investment dollars: while only 9% of companies invested more than 10% of revenue in innovation, 19% report generating more than 10% of revenue from innovations.

“This clearly tells me that there are dollars in innovation. The challenges need to be managed, but at the end of day there are results to be had,” says William Surphlis, Managing Partner, Grant Thornton Productivity Improvement.

Surprisingly, regional disparities and industrial specialization appear to have limited influence on perceptions of organizational innovativeness. Similar numbers of private mid-sized manufacturers and distributors across the country consider themselves either more innovative (45%) or the same (44%) as other leading companies in their industry. Just 8% of Canadian companies describe themselves as less innovative than leaders in their industry. Western Canada is the region with the highest proportion of companies

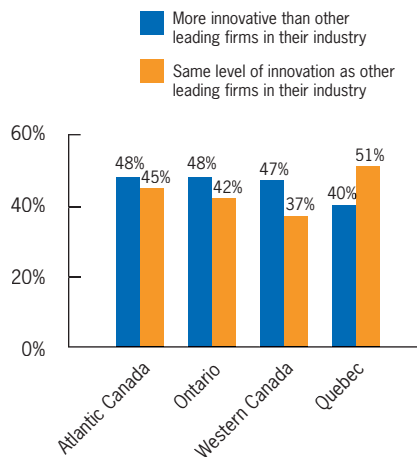


Figure 11: Perceptions of innovation relative to industry leaders among Canadian manufacturers and distributors

claiming to lag the competition when it comes to the development of new products, services, markets, and business models (13%). With so many manufacturers and distributors sharing favourable perceptions of their innovation edge, a question needs to be asked: To whom are we comparing ourselves?

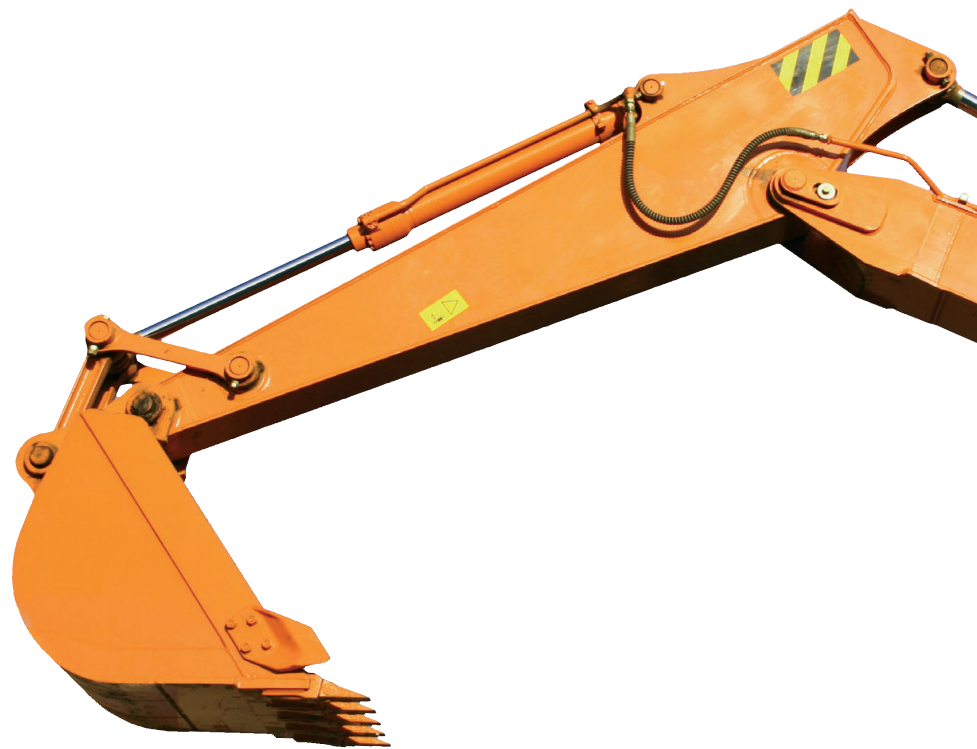
Canadian companies rank lower than many countries in company spending on R&D, often competing on the basis of low cost or natural resources rather than on innovation. Even when available, tax credits on intangible investments in R&D have often been under-utilized in this country, in part because of Canada's historically high tax rates on tangible business investment.

There are alternatives:

- mechanisms to shift cultural attitudes that currently undermine entrepreneurial spirit, individually, and as companies;
- increased cooperation among industries and companies with leading academic and thought-leadership institutions;
- adoption of innovation as a key element of corporate strategy;
- development of innovation best practices that embrace the Canadian perspective;
- bonus schemes, rewards, and incentives to attract and retain innovative, good people;
- succession-planning strategies that ensure a continuation of corporate leadership dedicated to innovation and entrepreneurship (even in large companies);
- increased understanding of the government incentives offered and how to apply them within individual companies.

Grant Thornton analysis

- Companies such as Magna, Research in Motion, and Bombardier constantly seek to improve using lean methods, believing that regardless of past successes there is always more to be done. All Canadian companies must adopt similar continuous improvement attitudes.
- Private mid-sized Canadian manufacturers and distributors can compete with anyone, anywhere around the globe, but not without investments in people, processes, equipment, and technology. Support from government in the form of tax credits and accelerated depreciation is critical. At the same time, companies must take advantage of these programs.
- There are innovative companies throughout Canada. Benchmarking against them is vital for companies hoping to differentiate their products, services, and processes through innovation. Resources such as outside advisers, academia, and government institutions can boost a company's ability to profit from innovation.



Grant Thornton solutions

Canadian mid-sized manufacturers and distributors are facing multiple, complex challenges today, but the solutions for addressing those challenges and leveraging opportunities are numerous, varying by region and industrial sector. Jayson Myers, CME, suggests that companies need to look for value (the narrower you are at solving your customers' problems, the more vulnerable you are) and develop the flexibility to deliver whatever customers require.

Even with regional and industry complexities, each company ultimately confronts its own inherent strengths and weaknesses in being able to address today's current challenges, find solutions, and improve (Table 2). Companies need to realistically and rigorously assess the core facets of their business by determining current state, identifying challenges, and seeking to find and implement solutions and processes. More importantly, in order to take control in this new industrial age, Canadian manufacturers and distributors must create a culture of innovation to compete successfully and drive profitable growth.

The time for change is now. And Grant Thornton is ready to provide companies with the tools and solutions needed to effectively compete in today's changing landscape.

Table 2: The Grant Thornton solution model

	Underperforming		Sustaining		Excelling	
	Current state	Solutions	Current state	Solutions	Current state	Solutions
Growth and innovation	Trying to stay in business; product mix rarely changed since startup; markets becoming more challenging; no formal innovation strategy; little market diversity	Clarify strategic focus; develop minimum growth objectives; explore viability of new products, markets, processes, and customers; evaluate corporate culture diversity	Profitable business predominately around mature products and processes; majority repeat customers; new entrants threatening relationships and markets	Establish innovation culture; foster relationships with external partners – customers, suppliers; critically evaluate core competencies; investigate supply chain partnerships and opportunities	Corporate culture focused on new ideas and innovation; expanding markets and customers; growth	Planned product obsolescence; develop and foster continuous improvement culture; more complex management systems; market-leading products, processes, ideas; leverage “innovator” aura; corporate subsystems aligned with corporate strategy
Operations excellence – internal	Rarely getting orders out on time or accurately; little idea of cost efficiency or productivity	Management commitment to change; undertake operational analysis to determine opportunities for improvement and develop execution plan; seek external assistance to support efforts	Reasonable performance in some areas; ability to improve at numerous points: end-of-chain numbers (delivery, quality); waste, overtime, expediting, inventories, firefighting, etc.; basic management systems; acceptance of continuous improvement concepts and opportunities	Develop sound process metrics that support end-of-chain objectives and guide day-to-day performance; identify further opportunities for process improvement; refine management systems; improve cultural alignment with systems and processes	Excellent process and supply chain performance; lean operations with minimum time, materials, resources, costs; strong cultural alignment with corporate objectives	Organizational mindset, processes, and systems that drive continuous improvement and extend to supply chain; development of more complex supply chain relationships
Operations excellence – supplier relations	Low-cost focus; frequent supplier turnover; poor supplier quality and delivery	Establish supplier criteria; extend buy decision beyond price (total cost) and begin to apply to vendors	Improved supplier quality and delivery; total cost supplier perspective; little leverage with most suppliers	Establish sharing relationships with key suppliers (IP, resources, cash, technologies, forecasting)	True partnering relationships with majority of suppliers in place; exchange of ideas/assets; strategic outsourcing	Develop joint problem-solving and continuous improvement activities as supply-chain with suppliers
Operations excellence – customer relations	Low customer retention rate; high customer complaints; extensive price pressures; insufficient understanding of margins	Develop and implement sales plan; foster open communication with customer base; succinctly identify customer demands; align operations with key demands; sales force training	Satisfied customers; continued price pressures; perceived by customer as a “commodity supplier”; insufficient understanding of relationship between input costs and margins by sales force	Work to develop value-add solutions for customers beyond products; share IP, resources, assets, etc.; support sales force with management systems and reporting	Long-term contracts and established relations with customer base; perceived as market leader and innovator; true partnering customer relationship; utilization of complex margin management tools by sales force	Design and implement partner (supplier/customer) problem-solving and continuous improvement programs
Workforce development	Substantial employee turnover; high absenteeism; poor safety performance	Establish baseline training for all employees; evaluate compensation against industry and region	Safe working environment and sustainable workforce; low initiative and improvement impetus	Rigorous 20-60-20 analysis; diverse training offerings aligned with corporate strategy; career paths linked to leadership planning; coaching and mentoring programs	High-performing, engaged workforce; organization is “the” place to work; clear expectations	Continue pushing the envelope both in what employees receive as well as what is expected of them; higher levels of accountability; more complex incentive mechanisms aligned with corporate strategy and long term value growth
Leadership and succession planning	No vision beyond current quarter and no succession plan	Develop plan to keep company intact in event of key personnel loss; set leadership development goals	Modest leadership development; a few executive successors identified; no long-term succession plan	Leadership benchmarking to identify and fill gaps; define successor criteria for management team; develop ownership succession strategy	Aggressive and ongoing leadership recruiting, development, and rewards; executive benchstrength throughout; clarity with respect to ownership succession plan	Keep feeding executive pipeline; explore corporate expansion opportunities to retain/leverage abundance of talent; understand and develop strategies for the key components of corporate valuation model
Risk management	Challenge to provide timely and accurate financial information; financial and accounting inconsistencies; legal, financial, and operational risks are many	Apply standard accounting principles, and audit standards and systems; mechanisms in place to identify and address high-risk factors	Sound accounting principles for major reporting in place; fundamental risk mitigation strategy in place; basic risk identification practices and procedures adopted	Expand audit role to investment, partnering, and expansion opportunities; enhance risk identification capabilities; develop procedures for systemic risk-elimination/reduction	Company-wide activities efficiently roll up for timely and accurate reporting and ongoing analysis of key risks	Expand accounting role beyond reporting to lead strategic management; development of “lean” accounting measures and practices

“Companies must put themselves in a position where they are able to be more responsive to the needs of their customers and anticipate future trends and demand. They must develop innovative cultures to be competitively successful and drive profitable growth. Finally, they need to critically assess every element of their supply chain in an effort to improve performance and productivity.”

Jim Copeland
National Leader
Manufacturing & Distribution
Grant Thornton LLP

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Grant Thornton LLP is one of Canada's largest accounting and consulting firms focused on serving entrepreneurial organizations. Our team of dedicated practitioners offers a full range of services, including audit, tax, business and financial advice and more. With offices from coast to coast, and access to a network of member firms worldwide, rest assured you'll be receiving a wealth of experience accumulated on a global scale with the professionals at Grant Thornton.

Leaders in services for manufacturing and distribution companies

When it comes to serving your sector, many of our practitioners are leaders in their area of practice. With over 60 years of experience in the manufacturing and distribution industry across Canada, business owners have counted on us to provide the advice they seek to compete and grow in their industry sector.

What makes us different?

Grant Thornton has extensive experience in working with clients in manufacturing and distribution. Why? Like our clients, we are entrepreneurial in how we do business. Not only do all our practitioners commit to ongoing sector-specific training, our integrated, team-based approach means your business benefits from Results-Driven Advice.™ Our regular interaction with clients is why Grant Thornton has many long-term relationships, and the reason why many business owners turn to us to better position their business for success every day. For more information, visit www.GrantThornton.ca/Manufacturing

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