Enterprise Minnesota
310 4th Ave So., Suite 7050
Minneapolis, MN 55415
612-373-2900 or 800-325-3073

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HELPING MANUFACTURERS GROW PROFITABLY

Five Key Priorities Manufacturing Should Focus on Now

As we watch the political drama unfold in our nation's capital, it is easy to fall into the trap of waiting and reacting to what might happen next. However, great leaders seek to control what they can during uncertain times, knowing their actions can create a competitive advantage in any economy.

By Virginia A. Harn, CPA, CliftonLarsonAllen LLP

Virginia Ham and Mike Nyberg, founder and CEO of Packnet Ltd., inside Packnet's Eagan facility.

Given the uncertainty of the economy and public policy decisions ahead, manufacturers find themselves in a unique position heading into 2013. They are reserving cash and looking at opportunities to build value every day and improve the bottom line. When the economy stabilizes and regulatory policies become more predictable, they will be poised to execute additional growth strategies and watch profits rise.

Successful manufacturers are focusing on five key areas in their control as they await public policy decisions.

Concentrating on these priorities before the next economic "race" begins is the difference between being ready for the starting flag and being asleep at the wheel. The five key priorities for manufacturers now are: 1) Build on your business plan, 2) plan for uncertainty and volatility, 3) get close to the customer, 4) control the controllable, and 5) protect profitability. Regardless of outside forces, a robust operating model, strong leadership team, and healthy workforce remain essential factors in economic success.

Mike Nyberg, Founder and CEO of Packnet Ltd. In Eagan, is keeping all five priorities top of mind heading into 2013. Packnet designs, manufactures, and distributes custom packaging for shipping a broad range of products within North America and overseas. While Nyberg credits his executive team, employees, and outside advisors with the company's success, it's clear that his leadership has been the most important factor in the company's solid foundation and its adaptability.

Build on Your Business Plan

Owning a small manufacturing business creates significant opportunity, but realizing this opportunity requires continuous planning. In a time of uncertainty, one best practice is to build a margin of plus or minus 20 percent revenue into the plan and anticipate potential scenarios that could disrupt operations. With a good plan, the company will be well-positioned for the future.

Nyberg and his team have been building and expanding their business plan in the 25 years since he launched the company as an entrepreneur. The Packnet management team meets annually with a trusted strategic planning professional to update the plan.

“We brainstorm to come up with different ways to remain relevant in our marketplace and provide the best value,” Nyberg says. “I also have a number of outside professional sources that have been key to our success in offering their help and advice with our business.”

Nyberg says the team concentrates on three primary aspects of the plan: 1) resources and “energies” that add value for the customer, 2) cost containment, and 3) sales and marketing.

“One of our first goals is optimizing our resources,” he says. “This includes our facility space, our equipment capacity, and our people utilization. In order to add the most value, we try to determine how to maximize utilization of our resources. Secondly, we’re either looking to reduce costs or minimize any cost increases in our direct manufacturing or administrative expenses.”

Many Minnesota manufacturers also use strategic planning to focus on pricing, inventory control, capacity including number of shifts, volume purchases, shop-floor machinery placement to maximize productivity, and organization of parts and tools. Business owners also may take a close look at more complex decisions, such as performing an assessment of the opportunities of a merger, acquisition, expansion, or consolidation.

Sales and marketing is also a major strategic focus: Savvy companies find novel ways to differentiate themselves by communicating their exceptional service and high-quality products. Planning here should emphasize opportunities to build new business, communicate potential new products and resources to existing customers, and budget and plan marketing strategies and tactics. A slower economy can stimulate customer diversification and strategies targeting current customers.

Two marketing tactics Packnet deploys are opening its facility for tours and leveraging its website to proactively communicate with customers and prospects. “Tours give people a visual picture of what we can do,” Nyberg says. And we have a blog that keeps our customers up to date on industry and company news.”

Plan for Uncertainty and Volatility

Very few small and midsized companies succeed at taking big risks during economic readjustment periods. Now is not the time to bet cash on an unknown outcome — no matter how attractive it appears — as the economy has not picked up momentum. It is wise, however, to build enterprise risk into day-to-day business operations.

Packnet literally relies on its customers’ unpredictability. The company was set up to respond quickly to customers— a must in packaging, the last phase in the product cycle before transportation. “We have the manufacturing flexibility to produce either a single requirement or a large production run,” Nyberg says, “so we’ve become flexible in order to meet both of these needs.”

Designing cost-effective custom packaging that will never be used again and standardizing products that will be produced regularly require two different “disciplines” for product design and manufacturing capabilities, he says.

“We have an internal system that includes proprietary design software that allows us to develop a print for packaging very, very quickly that we can get out to the floor and into the production cycle as soon as possible,” Nyberg explains. “If someone needs something the next day, we can’t spend the majority of that first day in engineering. It’s got to be designed, it’s got to be priced, we have to receive a purchase order, we have to develop our internal order, we have to produce it, and then it has to get shipped to the customer. This all might happen in the same day.”

Nyberg says flexibility has always been a factor in business success and is a mindset for everyone at Packnet. At the launch of the company, he handled sales, production, and even delivery at times by himself.

“As people have been added to our team over time, everyone has had the same priority for our customers,” he says. “They know that if we don’t meet the customer’s needs, somebody else will.”

Get Close to the Customer

In the current marketplace, supply chains are shifting and consolidating and international markets represent some of the best growth opportunities. This environment calls for close and regular contact in order to know where customers are headed and how to stay relevant. At times of slower growth, lack of communication is a business relationship killer.

Business owners and customers need to be partners in the truest sense of the word: Too many people in their micro-economies depend on the cost-effective, on-time deliverables involved for them to be distant relatives.

As Nyberg explains about Packnet: “With some customers, we get to the point where we know their packaging needs better than they do. They ask us to get involved in package design while the product development cycle is still occurring, which can reduce costs for packaging and shipping in the end. Over time, we’ve built up enough trust that we’re viewed as part of their team.”

Packnet’s blog provides information about regulations and industry news for customers, which builds trust from a credibility standpoint.

“The trust that develops with our customers is intentional but it’s natural also, as both of us exceed each other’s expectations,” Nyberg says.

Control the Controllable

Perhaps the most challenging aspect of running a business now is that everyone is looking at a blank slate with regard to the regulatory environment. It will be a while before new laws and regulations are enacted and take hold following the elections in Washington and Minnesota. While business owners do what they can to participate in business associations, most are taking a wait-and-see approach to the regulatory environment.

Nyberg sums up the situation many people say they face: “As a small business with lean resources, we really don’t have the wherewithal to be proactive with

things that sometimes feel out of our control. We're more reactive than anything when it comes to outside government regulations and influences. A lot of times we are uncertain; we're small and we're lean and we don't have the resources to do anything more than react."

Like other manufacturers, Packnet has long-term relationships with professionals who help the executive team manage tax, employee benefits, and other aspects of the company relating to government regulations. These professionals help them make decisions that impact profitability and also affect customers and employees. Packnet also frequently passes along regulatory information to customers.

Even though the company does not have a formal wellness program beyond regular safety and injury-prevention programs, it has controlled its health care costs. "Our costs have decreased slightly in the last two years because we have a healthy group of people," Nyberg says. "Our claims against premiums have gone down, so the insurance companies have viewed our group in a more positive light. We've gotten a 1 or 2 percent reduction and haven't had to increase our employee or company contributions, so that's been helpful for us."

Packnet has 44 people on the payroll, which exempts it from some of the provisions of health care reform. Employers with 50 or more full-time equivalent employees do need to factor the Patient Protection and Affordable Care Act (ACA) into their business plans overall. The best practice is for each manufacturer to perform an analysis of costs under ACA and determine the best approach for the individual company, as ACA's impact varies dramatically from company to company.

Under reform, beginning in 2014 health insurance exchanges will allow millions of individuals and small employers to access and compare insurance plans. These exchanges are also central to determining whether individuals are eligible for Medicaid or premium tax credits to assist in purchasing health insurance coverage. Also in 2014, employers with 50 or more full-time equivalent employees become subject to penalties if they fail to comply with the ACA. However, in some cases, the total cost of these penalties may be less than the total cost of providing coverage. CliftonLarsonAllen has a Health Insurance and Penalty (HIP) Calculator to provide employers with specific information about how reform will impact them. The calculator helps manufacturers weigh their options about coverage, cost-sharing, and health plan design. (To learn more, visit http://www.cliftonlarsonallen.com/healthcare/.)

Controlling what's controllable also includes maintaining a skilled workforce. Many manufacturers face challenges with recruiting and training new workers in the current environment. Their strategies for a prepared workforce include building relationships with business associations, technical schools, high schools, and even middle schools. STEM — science, technology, engineering, and math — educational efforts are cropping up across the country, bridging the needs of employers with opportunities for young people.

At Packnet, Nyberg has made a prepared workforce an essential part of his business plan. This year, the business plan includes stepping up cross-training to further improve production capabilities and prepare for uncertainties. Machine operators at the company learn how to operate multiple pieces of equipment and increase their knowledge.

The company's hiring strategy is simple: Recruit responsible people who have the aptitude to learn. "We don't necessarily need any particular outside skills from a production standpoint; we do our own internal training," Nyberg says. "Our machine operators are home-grown."

Preserve Profitability

As many business owners await economic and policy stability, they are carefully managing their assets, including facilities, equipment, and cash. They are also preparing for succession of the business, whether a leadership change is imminent or not.

Packnet is a case in point. "As revenue has fluctuated over the years, whether as the result of recessions or what have you, we've still maintained profitability because we've managed our resources tightly," Nyberg says. "We've made sure that we operated in a lean fashion for our customers. We put together procedures and processes so that we've worked smarter, not necessarily harder."

The executive team made a conscious decision to upgrade and add equipment that increased efficiency and automation. In addition, the company has a detailed preventive maintenance program and keeps extra machine parts on hand to limit down time.

Packnet also pays close attention to minimizing waste and maximizing materials. Nyberg says it has programs in place to reduce waste and maximize the yield on materials as much as possible. Four years ago, a company-wide program was initiated to digitize documents. Now, for example, anyone can access a product spec any time. Also, scrap is recycled. "Not only are we conserving the environment through recycling efforts, we're also adding to the bottom line," Nyberg says.

Employees are included in preserving profitability at Packnet. The company has several committees that employees rotate between, including a safety committee, quality committee, and housekeeping committee. These groups address many short- and long-term issues that together add value for the customers, employees, and company. Even in lean times, Packnet has been able to maintain a year-end cash bonus program for employees, providing them with a "return" on their efforts.

On the intangibles side, "we've worked to preserve our investments internally," Nyberg says. "We've been pretty aggressive with resource conservation. We kept extra capital on hand to take advantage of different projects that we may need to cash-flow. We've used capital to add new equipment that might bring us a new capability. We've been really diligent about how we preserve and then allocate our assets."

Sustainability and longevity are the primary motivators for the work that goes into a manufacturing business plan and daily decisions and operations. This work would not be complete without a succession plan. Ensuring business succession is not a separate priority: It ties into virtually every aspect of the business.

Even though Nyberg is an athlete and exudes vitality, he doesn't take chances with his business or his family. "From a succession standpoint, I've got an awesome executive team; I'm comfortable that they could run the company," he says. "It's been a very conscious part of the plan."

Conclusion
Despite looming changes, successful Minnesota manufacturers are focusing on controllable actions amid uncertainty. In doing so, they have increased profits and hung onto cash in favor of more predictable times ahead. Business owners who concentrate on the five priorities outlined here are making short- and long-term decisions to build profits, regardless of the economic and tax climate. When the environment stabilizes, they will be well-positioned to seize the day.

Virginia A. Harn, *CPA is a tax partner at CliftonLarsonAllen LLP. She has more than 20 years of experience specializing in tax, tax compliance, and tax planning for closely held businesses and their owners. She works closely with small to midsized business owners, primarily in the manufacturing and distribution sector. She is a member of the Minnesota Society of CPAs and American Institute of CPAs, and an adjunct professor in the graduate tax program at the University of Minnesota, specializing in S Corporations. She can be reached at virginia.harn@cliftonlarsonallen.com.*

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Federal Tax Update for Manufacturers

None of us has a crystal ball beyond December 31 when it comes to tax law. However, there are some significant tax issues to be aware of that currently affect manufacturers.

Tax Rates
Individual Income Taxes
The majority of privately owned manufacturers in the United States are taxed as flow-through entities (S Corporations, Partnerships, or Sole Proprietors). Beginning January 1, 2013, a mix of expiring tax provisions and newly enacted taxes are scheduled.

Assuming no compromise is made, on January 1, the graduated individual income tax rates on ordinary income jump from 35 percent for high-income taxpayers to 39.6 percent. Even individual taxpayers in the lower-income brackets will see a minimum increase of 5 percent. The rate increases are due to expiring provisions dating back to the Bush administration.

Capital Gains
The tax rates on capital gains are also set to increase from 15 percent to 20 percent and will be as high as 23.8 percent when considering the newly enacted surtax on investment income for high-income taxpayers.

Owners of manufacturing companies who sell their businesses in 2012 and utilize an installment sale should consider the potential benefit of electing out of the installment sale and recognize the entire gain in 2012. Owners might also consider deferring the sale of loss securities until 2013 to maximize the benefit of the loss.

Dividend Income
Another tax increase is scheduled on dividend income. Currently qualified dividends are taxed at the capital gains rates, but come 2013, the dividend rates jump back to the ordinary income rates. For high-income taxpayers, this could result in a 39.6 percent income tax plus a new 3.8 percent investment income surtax.

Due to this potential significant increase in tax rates, manufacturers who are taxed as C corporations or S corporations which were previously taxed as C corporations should consider a plan to accelerate dividends into 2012.

Health Care Reform Surtax
New surtaxes are also being imposed for the first time. For high-income individuals, additional taxes are set to take effect. These were enacted with the Patient Protection and Affordable Care Act. The first tax is a 0.9 percent surtax on earned income for single taxpayers earning greater than $200,000 ($250,000 for married couples). The second tax is a 3.8 percent surtax on "net investment income" for single taxpayers with adjusted gross income greater than $200,000 ($250,000 for married couples). Net investment income includes more than traditional investment income and encompasses income from passive business and rental activities. (Although the dollar limits are the same, note that the 0.9 percent surtax threshold is based upon earned income and the 3.8 percent surtax is based upon modified adjusted gross income.)

Excise Tax on Medical Device Manufacturers
Beginning January 1, a 2.3 percent excise tax on the sale of any taxable medical device will be imposed on the manufacturer. A taxable medical device refers to any device defined in Sec. 201(h) of the Federal Food, Drug, and Cosmetic Act which is intended for humans. A retail exemption exempts any medical device which is generally purchased by the general public at retail for individual use such as eyeglasses, contact lenses, and hearing aids.

Fixed Assets
The annual limit for Sec. 179 expensing and qualified property additions drops from $139,000 to $25,000. Bonus depreciation, currently set at 50 percent in 2012 for new shorter-lived property, expires. For manufacturers considering purchases of new or used equipment in the first quarter of 2013, making these purchases and placing them into service prior to January 1 would accelerate the depreciation of the property. A number of bills submitted in Congress have proposed to increase the Sec. 179 expense levels for 2013 or extend 100 percent bonus depreciation to 2012 and 50 percent bonus depreciation for 2013, but at the time of writing, none had passed Congress.

Research & Development Credit

At the time of writing, Congress had not extended the R&D credit for 2012. Senate Bill 3521, The Family and Business Tax Cut Certainty Act of 2012, proposes to extend the R&D credit through the end of 2013. How long will it be before Congress comes to some compromise? It appears that federal lawmakers might not address the majority of the expiring tax provisions until the post-election lame-duck session. They will need to address a temporary “tax extenders” bill pending Senate and House approval.

Ultimately, taxpayers need to stay informed and develop flexible tax plans; the only certainty is that tax law will change. Every taxpayer situation is unique; business owners should consult their personal tax advisors.