Trendsetter barometer®
Business outlook

Q2 2014

What's inside:

pwc

Contents

Summertime, and the living is easy. So goes the song. And indeed, on the surface of our latest *Trendsetter* findings, we see an economic picture that continues to brighten for private companies, with some clear growth areas and reduced volatility.

But closer inspection of our second-quarter findings reveals businesses still struggling to make the right hires even in a theoretically soft labor market, and executives contemplating technology investments that could make or break their companies' futures. We also see differences between the outlooks of domestic and international firms, with the latter feeling decidedly more optimistic than their domestic-only peers about revenue prospects and the US economy.

A mix of sun and clouds is how you could sum up the *Trendsetter* forecast. The sunnier aspect is that many of the usual 12-month barriers to growth, including lack of demand and worries about increased taxation, loom less large. There are clear opportunities for companies that are willing to pursue them, particularly as lending rates remain low and private businesses still have easy access to capital.

This report presents what we've learned about those opportunities, and the accompanying challenges, through our conversations with more than 200 private-company leaders in the second quarter of 2014. We are grateful for their insight and pleased to share it with you.

Rich Stovsky
US Leader
Private Company Services

Ken Esch
Trendsetter Partner Sponsor
Private Company Services

At a glance

Private-company sentiment has gone up (↑), down(↓) or held steady (=) across a variety of areas.

Economic optimism

At **59%**, the number of private companies' feeling optimistic about the **US economy** held steady, coming in just a smidgen below last quarter's 60%.

STEADY =

DOWN ↓

Pessimism about the **world economy** is low, with just **9%** of international marketers voicing this sentiment, down from 20% a year ago.

Corporate performance

Private companies expect an average of **8.1% revenue growth**, up slightly from last year's 7.8%. One-third expect double-digit growth.

UP ↑

UP ↑

International marketers project an even higher **9% revenue growth**, up from 7.8 a year ago. Sellers in emerging markets expect 9.8%.

Capital spending

Over one-third (**36%**) of private companies are planning **major new investments**. This is the second highest level we've seen in three years.

UP ↑

UP ↑

At **8.4%**, private companies' new capital spending **as a percentage of sales** is up from last quarter's 6.6%, as well as up from 6.4% a year ago.

Hiring

While the majority (**56%**) still plan **to hire**, the percentage has dropped from last quarter's three-year high of 63%.

DOWN ↓

UP ↑

One-fifth (**20%**) of private companies say they feel **wage pressure** this quarter, up from 13% the prior quarter.

Headwinds

Though **59%** still say **lack of demand** is a barrier to growth, that's markedly less than the 74% saying this a couple of years ago.

DOWN ↓

UP ↑

Lack of qualified workers is a growth barrier for **32%** – the second time since 3Q08 that this data point has risen as high as 30%.

Expansion

Increased spending on **geographic expansion** is planned by **23%**, up from the 17% reported in the prior three quarters.

UP ↑

STEADY =

Just **15%** of companies plan inorganic growth via **acquisitions** – the same as a year ago – favoring strategic alliances instead.

Economic sentiment

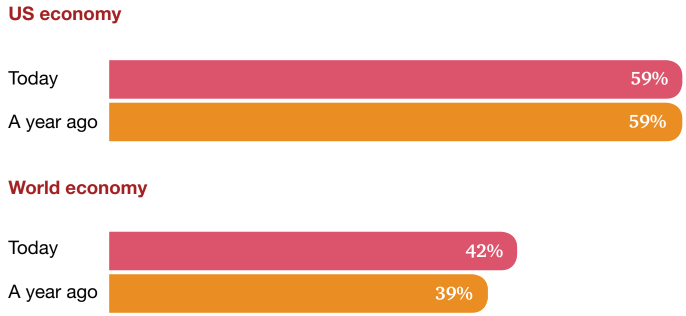
“We are optimistic. The economy has stabilized.”
—President, Factory automation contractor

Private-company optimism was undeterred in Q2 despite US GDP’s poor Q1 performance

A slowed-down economy early in the year didn’t seem to dampen the outlook of privately held US businesses this spring. In June, the US Bureau of Economic Analysis (BEA) revised downward its view of the domestic economy’s 1Q14 performance. BEA economists now believe that as a result of bad weather, shrinking exports, and other pressures, the US GDP contracted at an annual rate of 2.9% during the first quarter. Anecdotal evidence among *Trendsetter* companies, however, is much more positive.

Two-thirds of the executives we surveyed felt the national economy was growing. And 59% felt good about the domestic outlook for the coming year. Their optimism extends to the world economy, with 92% of *Trendsetter* executives in companies that sell abroad describing it as either growing or remaining unchanged. Just 8% said it was declining, the lowest number in several years.

Optimism snapshot – Today and a year ago



The long view – Economic optimism over time

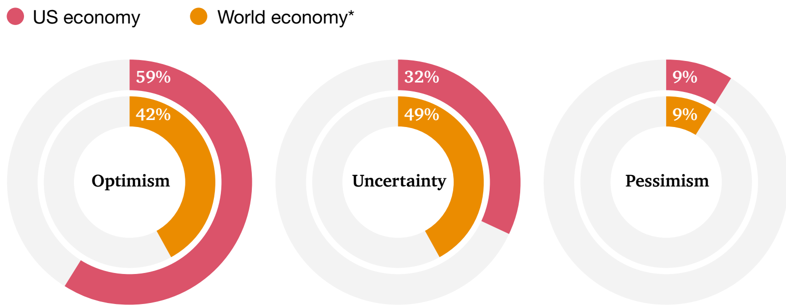
Percentage of respondents

* World optimism reflects responses only from private companies selling internationally

This positive world view is evenly distributed across global regions, in contrast with the beginning of the year, when markedly more private-company leaders were optimistic about economic growth in the emerging markets than in international markets as a whole.

"Looking at the big picture, private-company optimism about the world economy overall has been consistently higher in the past year than it was in the 18-month stretch before that, with as many as 42% of companies recently expressing this sentiment," says PwC's Rich Stovsky. "While these are not giddy levels of confidence, they certainly suggest that private companies are seeing greater resilience in the global economic recovery."

Economic barometer – 12-month outlook



*Optimism about the world economy reflects responses only from companies selling internationally

Corporate performance

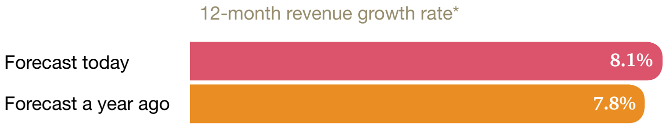
“The economy’s getting better and consumer confidence is going up.”
—Treasurer, Plastics manufacturer

Growth continues, but less erratically, signaling a maturing recovery

Executives at leading private companies are upbeat about revenue prospects, in line with their broader economic outlook. Overall, they expect average growth of 8.1% over the next year. While this is up from the 7.8% figure of a year ago, it does reflect a slight cooling off from 1Q14, when there was an expectation of 8.5% growth.

It’s here that we see divergence between domestic-only firms and those that sell abroad. In mid-2013, there was no difference between the revenue forecasts of these two groups. Now, companies serving global markets anticipate growth of 9% through next spring, while domestic-only firms expect growth of 7.3%. We saw a similar disparity last quarter. In fact, we’ve seen this split in most quarters since the recession, except for a brief closing of the gap in 2013. For growth-focused *Trendsetter* firms (those planning new capital investments, business acquisitions, R&D and the like), international sales tend to be a key component of their growth strategy.

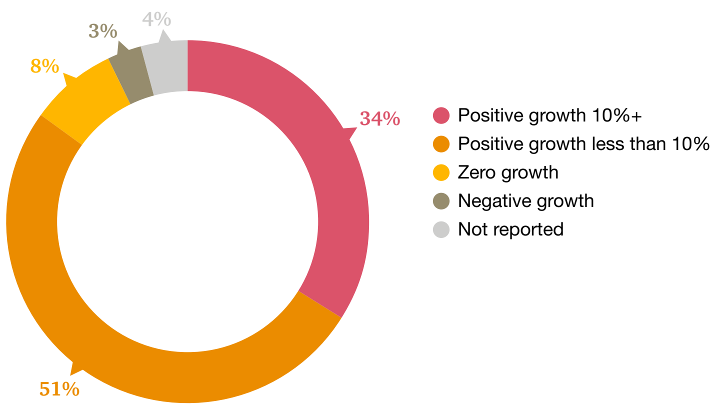
Private companies forecast stronger revenue growth today than a year ago



* Projected

Growth expectations

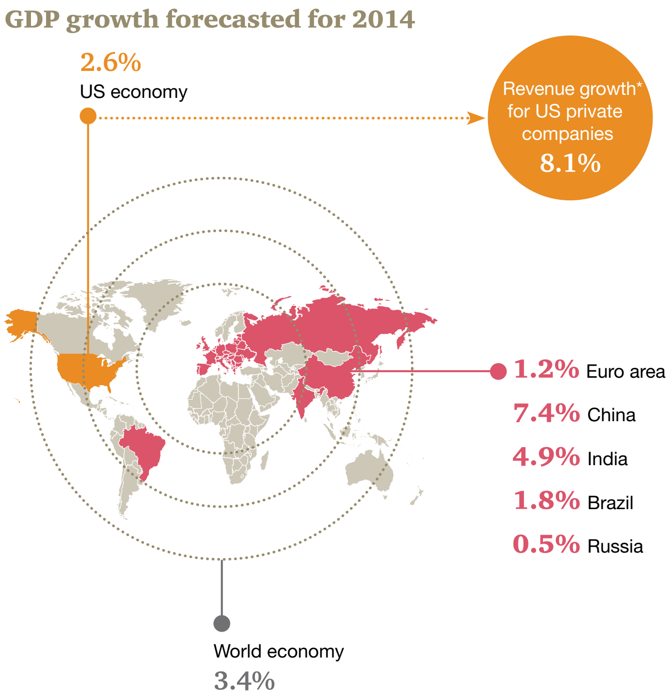
Most private companies project revenue growth for the next 12 months. Over one-third expect double-digit growth.



Private-company revenue forecasts are also becoming less erratic – a sign of a maturing recovery. For example, a few years ago, we were far more likely to see some *Trendsetter* companies predicting annual growth of 20% or more; this past quarter, only 7% of those surveyed thought they would see 20+% revenue growth in the next year. This trend toward stability tells a reassuring story. Whether asking about 2014 growth forecasts for a *Trendsetter* company's industry (4%) or predictions about the company's own revenue outlook (typically double that of its industry projections), we're hearing results that are favorable and near historical highs.

"While we continue to hear companies ask what more they can do to grow their business, most of them no longer worry that their revenue will flatten or contract." says PwC's Ken Esch. "The real challenge is to *accelerate* growth. Many of them had hoped business would pick up at a faster rate this far out of the recession."

Revenue forecasts for private companies continue to outstrip GDP projections for the US and world economies



* *Trendsetter* private companies' projected revenue growth for the next 12 months
GDP figures sourced from the OECD

Opportunities and barriers

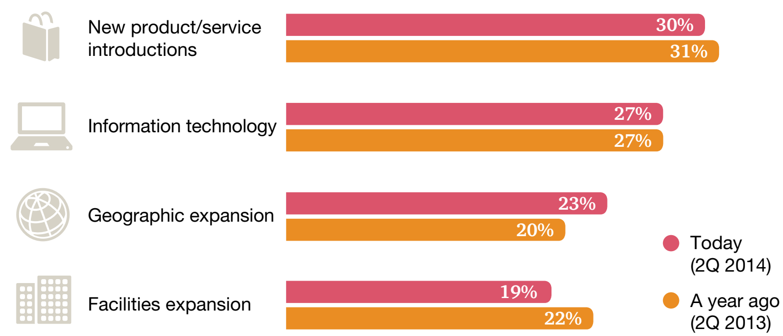
"Previous investments in the company are paying off now."
—CEO, Travel and medical insurer

More confidence means more capital investment, the highest in two years

In a clear sign of sustained optimism, 36% of *Trendsetter* business leaders say they'll make major new capital investments in the next year to upgrade manufacturing equipment, streamline production processes, introduce new technologies, and more. This is the highest number in over two years, signaling a real bet on long-term growth. The size of the investments matter too: Executives told us they'll put an average of 8.4% of their total sales into capital projects, up from 6.4% projected a year ago. Only once in the past several years have we seen so high a level of spending commitment (10% in 3Q13). Two-thirds of *Trendsetter* companies also plan to increase operating expenditures across a range of areas, including new products and geographic expansion.

As for headwinds, private-company leaders appear less worried about those than they've been in quite a while. One outlier is lack of qualified workers, flagged by nearly one-third (32%) of our respondents. The last time concern about finding skilled workers inched this high (or nearly so) was a year ago, when 30% of private companies cited it; the time before that was in 3Q08. Further evidence of a tightening labor market can be seen in apprehension about wage pressure, with 20% of *Trendsetter* executives citing this as a growth barrier – up seven points from 1Q14, after steadily declining for three consecutive quarters.

Top areas where private companies plan to increase their spending over the next 12 months



Percentages denote the number of companies who plan increases.

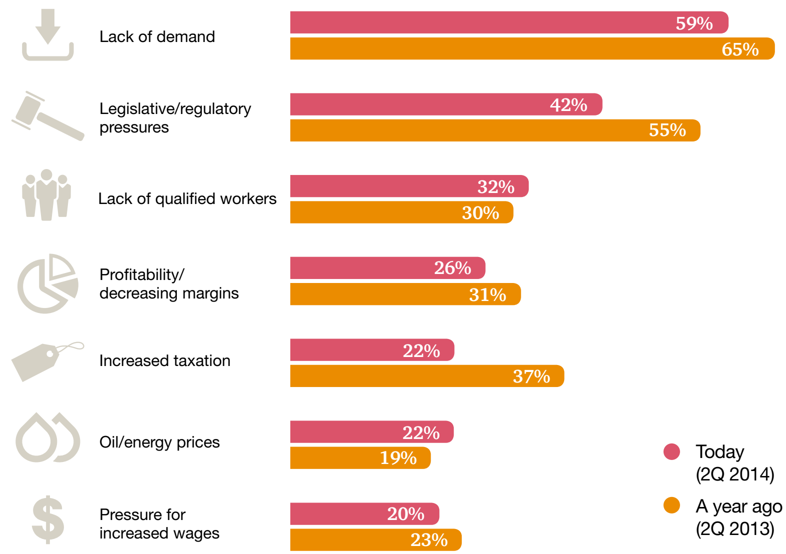
In Q2, we also asked a subset of *Trendsetter* companies about the investments they're making to keep pace with global trends in technological advances, demographic changes, urbanization, climate change, resource scarcity, and shifts in economic power.[1] Three-quarters of these executives said that technological advances will have the biggest effect on their businesses over the next several years. Advances such as 3D printing are already beginning to make their way into everything from biomechanics and aerospace to food production and jewelry manufacturing. It stands to reason, then, that 68% of *Trendsetter* executives said that investments in R&D and product/service innovation will be important or critical over the next year or two.

Most *Trendsetter* executives (88%) also said this of IT investments, with 57% of these businesses focusing on data management and analytics in particular. "Companies have seen how data analytics can help, particularly when it comes to understanding their customers," says PwC's Ken Esch. "They're deciding to invest in this area now before their competitors leave them behind." Fittingly, another 42% of *Trendsetter* companies said they'll direct their IT spending toward researching and engaging customers, including those outside the United States.

We also see spending in defensive functions, such as cybersecurity – 60% of *Trendsetter* companies plan to devote their IT dollars to strengthening cybersecurity in the next two years. And, as always, cost savings are a priority – 70% of businesses plan to invest in further automating production processes, back office functions, and other operations.

Growth barriers in the next 12 months

Top barriers loom less large than a year ago



Percentages denote the number of companies who cited these factors as growth barriers.

An emphasis on technology investment can also be seen in planned business initiatives (joint ventures, mergers, alliances, partnerships, acquisitions, etc.), which about half the *Trendsetter* executives in our broader *Business Outlook* survey group are pursuing. They're showing the greatest interest in strategic alliances – 25% of firms say they'll pursue these in the coming year, up from 17% a year ago. Top goals *Trendsetter* companies hope to achieve through these business initiatives include obtaining new technology, reaching more customers, and adding skilled employees to their workforce. Roughly one-quarter of these initiatives is slated to take place outside the US, with many firms contemplating foreign acquisitions and other inorganic growth. We expect M&A activity to pick up in coming months, as companies with strong balance sheets and good access to credit seek further ways to hit their growth targets.

"We're beginning to see tangible connections between big global trends and everyday tactical decisions that private companies make. For example, the coming decade will witness explosive growth in some countries and population segments, with declines in others. This presents a sizable business opportunity if — and it's a big if — a company can make adjustments, such as tailoring its supply chain to be more responsive to different customer demographics. Companies that don't adapt to meet the needs of their changing customers will find robust growth hard to achieve."

—Rich Stovsky, US Leader, PwC's Private Company Services

Hiring

"We are happy to have aging workers who are qualified. Their experience and knowledge are essential to helping our clients."

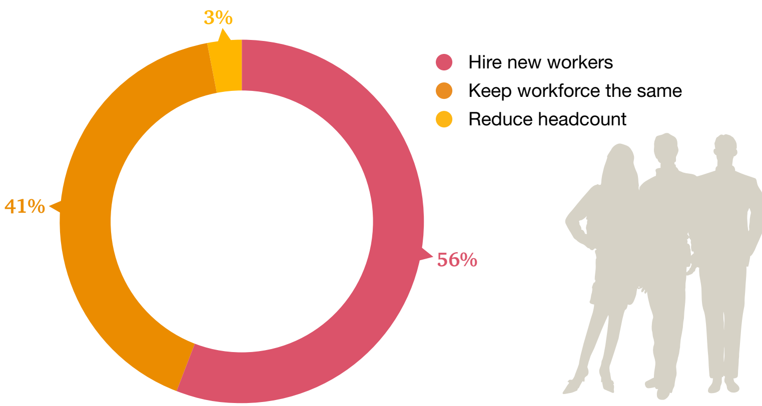
—CFO, Financial services personnel provider

Headcount additions remain highly targeted in the face of ongoing skills gaps and rising wage pressure

In the first quarter of this year, 63% of *Trendsetter* companies told us they'd add staff in the next quarter, the highest level we've seen in several years. So we weren't particularly surprised when the US Bureau of Labor Statistics announced that June's unemployment rate had dropped to 6.1%. In fact, average unemployment in 2Q14 was more than a full percentage point below what we saw in the previous quarter and has budged only slightly since then, rising to 6.2% in July.

In our latest survey, a still healthy 56% of *Trendsetter* businesses told us they'll add employees to their workforce over the next year, though this was down from the prior quarter's high-water mark. Should we be concerned? Not especially; after all, a mere 3% of firms reported that they plan to cut back headcount. Still, any hiring is apt to be narrowly targeted. Overall, the planned hires would represent a net increase of 1.8% above current employee levels. A year ago, this figure was 3.2%, and it's been drifting down over the past six quarters.

The majority of private companies plan to hire in the next 12 months



One reason for this may be that finding qualified workers has proved chronically difficult for a number of *Trendsetter* companies. The challenge partly stems from demographic shifts. Roughly one-third of *Trendsetter* companies plan to invest in replacing Baby Boomers, who will take a wealth of knowledge and skills with them as they leave the workforce. But the main hiring goal is to match talent with the needs of the business. For instance, 67% of *Trendsetter* companies will devote HR dollars to attracting, developing, and retaining workers who can keep pace with technological advances.

Finding the right people with the right skills – at the right place and cost – will require more than hanging up a "help wanted" sign. When we asked geographically expanding *Trendsetter* businesses why they're heading into new US markets, they said that tapping a better skills base was their top reason. We heard the same story when we asked *Trendsetter* companies why they're pursuing M&A, joint ventures, and strategic alliances – 54% said their chief objective was to access skilled employees.[2]

"The survey results remind us that good hiring isn't just an HR issue," says PwC's Ken Esch. "Workforce planning needs to be tied closely to a company's business objectives. The overall number of anticipated hires may be small, but if the vacancies are for critical roles? An inability to fill those could quickly turn into a growth barrier for businesses."

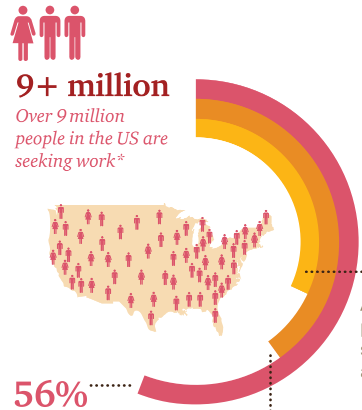
Finally, we've been told to expect wage increases to flatten. Current employees should see an average increase of 2.62% in hourly wages over the next year, down from 2.70% last quarter. We view this slight pullback in wages and hiring as a matter of the economy catching its breath for a moment before resuming a steady if slow climb upward.

Hiring riddle

Despite running below capacity, companies are increasing headcount just slightly. Why?

Less than half of private companies are running at full capacity, but that doesn't mean they'll be hiring in droves. Instead, they plan to increase headcount by just 1.8% in the next year — the lowest figure in some time.

This conservatism partly reflects heightened concern about wage pressure — cited as a growth barrier by 20% of private companies — as well as highly targeted hiring, with companies seeking workers that have specialized skills, such as technological knowhow, which are in short supply.



* Bureau of Labor Statistics

International expansion

"We're looking for foreign market growth... we have a total international focus."

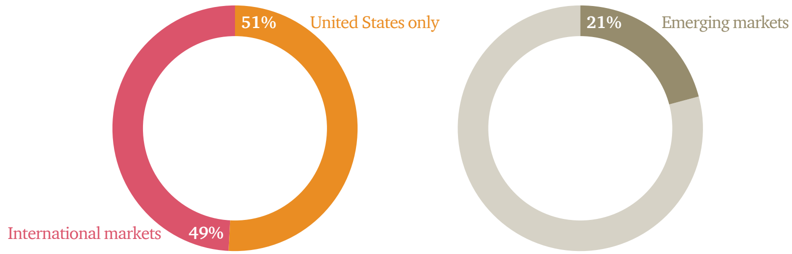
—Controller, Automotive parts manufacturer

Fast-growth companies cross borders, with businesses in emerging markets reaping the biggest rewards

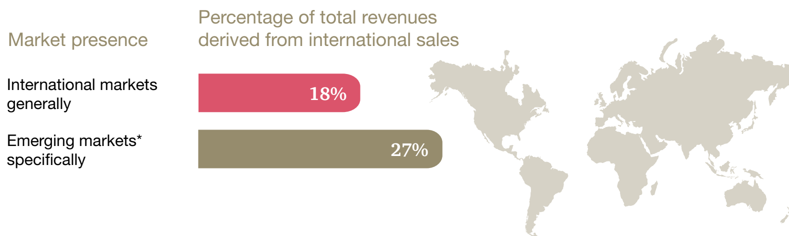
Our *Trendsetter* companies represent a cross-section of American business: manufacturers and service companies, a basket of industries, and a mixture of exporters and firms with US-only operations. Even among those firms selling internationally, roughly four out of every five dollars of revenue comes from activity in US markets. Throughout the past year, this ratio has held relatively steady. Companies with international sales projected that foreign activity would contribute 18% of this quarter's top-line number, exactly the same as last quarter and slightly higher than a year ago.

But this apparent consistency doesn't tell the whole story. For one thing, companies with international sales expect to grow corporate revenue at 9%, compared with the 7.3% projected by their domestic-only peers. And the rate of major capital expenditures by international companies is also sharply higher – 46% vs 27% for domestic-only companies.

Nearly half of Trendsetter private companies sell internationally



Private-company revenue from international sales

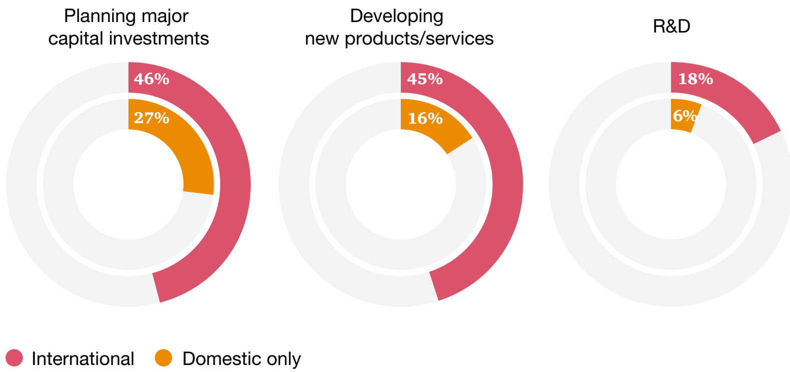


* Here, the term *emerging markets* refers to Brazil, China, and India only.

When we look more deeply at this foreign activity, we actually see two types of companies: those with sales operations in emerging markets, and those active elsewhere. About one-fifth of the surveyed companies with an international presence sell in the emerging markets of China, India, or Brazil. For those firms, a solid 27% of their total revenue is expected to come from international sales – and they're forecasting an even faster 9.8% growth rate over the coming year. For companies that aren't active in these markets, international sales will account for a smaller 12% of overall sales.

This apparent split is in line with the shift of economic power from mature economies to emerging markets. As this trend continues, it'll have an increasing impact on where growth opportunities arise for companies – and where they invest to capitalize on those opportunities. Indeed, one-third of *Trendsetter* companies said they thought that the shift of global economic power would have a moderate to major impact on their businesses in the next couple of years, and one-quarter said that investments in new geographic markets outside the United States would be either important or critical to their corporate strategy during that time. The latter group's foreign-investment focus is split almost evenly between mature and emerging markets, with the majority planning to invest in both.

International companies plan to be more growth-focused than their peers over the next 12 months



"Some industries and companies are better suited than others for cross-border expansion. There are a lot of unknowns when you venture into new markets, particularly emerging markets, and not all companies are comfortable with that. But emerging markets clearly have demographic tailwinds behind them, and they will only strengthen as the consumers in China, Indonesia, and elsewhere keep growing in number."

—Rich Stovsky, US Leader, PwC's Private Company Services

End notes

1 Of the 205 companies who answered our quarterly *Business Outlook* survey in Q2 2014, 179 answered additional questions about five major global trends: technological advances, demographic changes, shifts in global economic power, urbanization, and resource scarcity and climate change. These *Trendsetter* companies talked to our researchers about the near-term investments they feel will be critical to corporate strategy in order for their businesses to keep pace with these five transformative trends.

2 Ibid

3 Ibid

About this report

Since 1995, PwC's *Trendsetter Barometer Business Outlook* has tracked the views of top executive officers at privately held US businesses and the trends these reveal. This quarter, we spoke with 205 private-company leaders, including 118 from companies in the product sector and 87 in the service sector.

How the *Trendsetter* companies break down

- Products 58%
  - Manufacturing 30%
  - Trade/Distribution 14%
  - All other 14%
- Services 42%

	All (205)	*Product (118)*	*Service (87)*
Average number of employees	1,330	1,596	968
Average enterprise revenues	$355 million	$500 million	$160 million
Five-year growth rate	42%	42%	42%

Survey interviews were conducted by the independent research firm BSI Global Research, Inc. by phone between April 4, 2014 and July 1, 2014. The same companies are interviewed and tracked from quarter to quarter, with occasional changes made to the survey population due to turnover.

To find out more about private-company trends and discuss the survey findings, please contact:

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To see more charts and graphs, including those showing trends over a span of years, and to download the complete survey findings, go to our website:

http://www.pwc.com/us/en/private-company-services/publications/pcs-trendsetter-barometer.jhtml

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