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Private company issues and opportunities

What to consider in 2017

A Deloitte Growth Enterprise Services report
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Executive summary

Being king of the mountain isn't what it used to be. These days, it's harder even for the biggest companies in the world to hold onto higher ground. Back in the 1920s, if your company was a member of the Standard & Poor's 500, chances are it would last an average 67 years in the benchmark index. Today, according to Yale University professor Richard Foster, that tenure has shrunk to just 15 years.[1]

What happened? Pure and simple: technological disruption. First came the Internet, which dislodged plenty of large public and growing private companies alike. Then there was the cloud, mobile, and social. Now comes the next big wave. Today, even the most streamlined private organizations are being challenged by the quicksilver pace of technology's progress. Breakthrough innovations such as the Internet of Things, augmented and virtual reality, artificial intelligence and blockchain are disrupting commercial markets and business models on a seemingly daily basis. As our first chapter on digital disruption underscores, no sector of the economy is impervious to this upheaval, and every private company leader has to have a plan of action for channeling these disruptions into new business opportunities.

In this pursuit, we believe certain attributes will distinguish leading private companies. The first is speed. This translates for companies in different ways, but generally means being ready to act before you're called upon to do so and having processes in place to help your organization respond in real time as conditions on the ground change. The second is alignment. Speed for the sake of speed only leads to hasty decisions that can imperil future results if not enough care is taken to understand the implications of transformational change on each aspect of the business. Finally, discipline becomes more important as you're pressed to manage all of these considerations in tighter time frames. After all, sometimes the best business decisions you can make may end with a "no."

This report examines how C-suite leaders can foster these attributes across a range of business dimensions. In the pages that follow, we group these focus areas by speed, alignment or discipline based on what is shaping up to be the most relevant quality for 2017. The truth is, all three matter in every business sense. We believe the potential disruption caused by technology is forcing leaders to master these traits in every strategic decision they make. Act too quickly without adequate deliberation, and your company is more prone to pursue the wrong path. Fail to digest how each decision will impact other parts of your organization, and you run the risk of unintended consequences.

As always, the intent of this report is to provide a starting point. The fact is no two private companies are facing the same issues or pursuing the same opportunities. Competition is much more nuanced. Our mission at Deloitte is to understand each of our client's most pressing needs and help them deliver against those needs. After all, we don't want you to just get to the top – we want you to stay there. We look forward to working to help you realize your ambitions in 2017, and for many years to come.

Roger Nanney

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Digital disruption

First, there was ZipCar. Founded in 2000, the car-sharing company became a hit with urban consumers by eliminating the costs tied to car ownership in providing a cheaper, shared alternative that could be used on demand. In the years since, vehicle-sharing has made way for ride-sharing, with services such as Uber and Lyft granting the gift of go in the palm of their hands. And pretty soon, we'll be talking about driverless cars that can be deployed for revenue-generating opportunities while their owners are shopping for groceries or dining out.

What do all of these innovations have in common? One, they were empowered by digital technologies. Two, they disrupted business models that hadn't fundamentally changed for decades. It's the same story across multiple sectors: online shopping has hurt many bricks-and-mortar retailers, crowdfunding has contributed to the democratization of financial services, and house-sharing has roiled the commercial hospitality industry.

With a raft of new technologies set to disrupt business as usual across every sector of the economy (see sidebar), are private companies doing enough to get ahead of them? The threat of disruption may be bigger than many think, says Doug Palmer, principal, Deloitte Consulting LLP and a leader in Deloitte Digital's strategy practice. In 2016, Palmer was part of a team comprised of Deloitte and *MIT Sloan Management Review* professionals that developed a digital business report based on a global survey of more than 3,700 business executives, managers, and analysts from organizations around the world.

A cultural dilemma

One of the key findings was how business leaders believe digital technologies will disrupt their industry, but how few of them think they are adequately preparing for it. The gap between awareness and execution was even bigger for mid-market companies.[2]

When it comes to digitally transforming an organization, execution can be hampered by many challenges. However, the biggest challenges may actually be internal rather than external. According to Deloitte and *MIT SMR* survey findings, the biggest threat facing companies due to digital trends are issues relating to a lack of company agility, inflexible culture, and digital not being a priority. "There's a pretty clear call to action in these findings," Palmer says. "Digital's simply not as big a priority as it should be, and more often than not companies are simply getting in their own way."

With a raft of new technologies set to disrupt business as usual across every sector of the economy, are private companies doing enough to get ahead of them?

One of the critical ways private and mid-market companies do this is by simply failing to ask the right questions, Palmer says. "The business you're in may not be around in five years," he says. "Companies tend to address problems one as a time as they crop up, but not in the grand scheme of things. If you're just focused on the here and now, that might save you for a year or two but if you're not looking out five to 10 years from now and thinking about where the marketplace is going, you're not going to identify industry or large scale societal trends before it's too late."

To address the digital future while meeting today's needs, John Hagel, co-chairman of the Center for the Edge at Deloitte, suggests that organizations use the zoom-out/zoom-in approach used by many Silicon Valley companies. The zoom-out dimension looks at a time horizon of 10 or more years by predicting and defining what the market will look like and what customers will expect. The zoom-in component addresses the next six to 12 months and identifies the two or three business initiatives that will have the greatest potential to accelerate movement toward the longer-term destination.

Palmer notes that zooming out is a challenge endemic to many private and mid-market companies, and it tends to tie back to a company's focus on surviving and managing the issues impacting it today rather than reimagining what their organization needs to become in order to compete five to ten years from now. To be sure, people generally like working for family-run and other private and mid-market companies because of the working environment they offer: close proximity to senior leaders, more flexible work environments, and a greater commitment to work-life balance. But when it comes to identifying and addressing the impact of technological disruption now and in the coming years, such companies can have a hard time reinventing themselves, Palmer says.

One aspect of this is tightly controlled decision-making. It can be hard for many private and mid-market company leaders to let go of control and allow a bunch of ideas to flourish. "Even when you find people trying to innovate for some end, either the company doesn't fund it enough or it's seen as competing against the organization," Palmer says.

Encouraging risk-taking

Rather, private and mid-market companies need to explore new portfolio approaches, in which innovation is happening in a variety of different contexts and failure is encouraged provided it offers opportunities to learn. In the past, employees might have been concerned about their careers being in jeopardy if the projects they managed didn't pan out. But if your company isn't experimenting enough, then it may not be driving innovation as much as it should. Not only that, the company's employees may be recognizing that they can move to other organizations that do embrace risk taking and learning. According to the MIT/Deloitte research, employees are more likely to leave on their own—even after less than one year—if they're not given the opportunity to pursue opportunities to develop in a digital environment.

In addition to developing their own talent, private and mid-market companies also need to add new employees with digital skills. Asked how their organization was primarily strengthening its digital innovation capabilities, respondents from digitally maturing companies listed this as one of their top four priorities.[3] But this tack didn't make a similar list for mid-market companies.

Palmer cautions that this isn't merely a check-the-box exercise, where companies match job openings to resumes. These new recruits also need to be able to bridge the gap between the company's traditional culture and where it wants to be in the future. That means that soft skills should often trump technology knowledge when it comes to driving the digital transformation, especially for organization leaders. In fact, the survey found that only 18 percent of respondents surveyed across companies of all sizes listed technological skills as being the most important requirement for leaders to succeed in a digital environment. Instead, they pointed to managerial attributes such as having a transformative vision (22 percent), being a forward thinker (20 percent), having a change-oriented mindset (18 percent), or other leadership and collaborative skills (22 percent).

Companies need to explore new approaches, in which innovation is happening in a variety of different contexts and failure is encouraged, provided it offers opportunities to learn.

Intentional effort

Even when you hire the right talent, it still takes time to get everyone on the same page. Palmer said it took the leader of one private organization he worked with an entire year to establish a shared agenda between leadership and those hired to lead the technology charge. For years, the company had embraced a distributed model, in which leaders on the ground in key markets relied on in-person communications and relationships to push the company's strategy. This made it particularly challenging for them to embrace a digital future.

"The new people were using terminology and lexicon that didn't match the way the organization worked," Palmer says. "They knew they needed to change, but it was a process in itself to overcome some of that."

The bottom line: creating an effective digital culture takes an intentional effort. Digitally maturing companies are constantly cultivating their cultures, by engaging in efforts to bolster risk taking, agility and collaboration. "It may seem like a lot to manage, but compared against changes in the market environment and competitive pressures, these internal issues are entirely within your control," Palmer says. "All a company needs is the ambition to change."

Three technology trends that could roil your market

Virtual or augmented reality. VR technology makes it possible for users to immerse themselves in manufactured surroundings that depict actual places or imaginary worlds, while AR overlays contextual information on the immediate physical environments users are experiencing. Already, the disruptive impact of both VR and AR is being felt across consumer technologies as dozens of new products enter the market. Companies are employing them for a range of functions, including communication and collaboration, training and simulation, and field and customer service. But more targeted deployments are underway as well, with AR creating a competitive advantage in building construction, parcel delivery and patient care.

Blockchain. This shared-ledger technology makes it possible to store digital records, share information selectively with others to exchange digital assets safely and efficiently, and proffer digital contracts. These capabilities are transforming reputation into a manageable attribute that can influence one organization's interactions with another. In the next 18 to 24 months, entities across the globe will likely begin exploring blockchain opportunities that involve some aspects of digital reputation, in some cases removing trusted intermediaries who once served this purpose.[4]

Dark analytics. There's an astonishing amount of raw data that lies deep within the Internet, and now technologies are beginning to allow CIOs, business leaders, and data scientists to use that information to unlock valuable business, customer, and operational insights. As innovations such as the use of Internet-enabled devices spread, this dark data will proliferate. In an example of how this information might be utilized, one online subscription shopping service is using images from social media and other sources to track emerging fashion trends and evolving customer preferences. This data is helping them to select style-appropriate items of clothing that can be shipped to individual customers at regular intervals.[5]

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Analytics

A universe of sensors can offer up-to-the-minute reports on the temperature, a personal activity, or the exact coordinates of an online order. The digital platforms providing that information “talk” to one another, forming a vast network known as the Internet of Things (IoT). Those conversations, in turn, become a massive supply of details from which organizations can analyze customers, employees or partners.

While many firms still see challenges in adopting analytics in meaningful ways, it's getting easier to crack the code.

The proliferation of sensors has accelerated the power of data analytics, turning this class of technologies into an increasingly attainable means of translating information into insight. Private companies stand to gain from these developments as analytics technology becomes more accessible and as web-based interactions become more plentiful. Consider, for instance, the more than 4.1 million people "liking" a Facebook post at the same minute every day and the inferences organizations can make by studying such behavior.[6] Rajeev Ronanki, principal, Deloitte Consulting LLP, and leader of Deloitte's cognitive computing practice, says while many firms still see challenges in adopting analytics in meaningful ways, it's generally getting easier to crack the code. "In the next few years, we'll likely start to see analytics used more effectively," Ronanki says. The technology has moved beyond an "emerging" concern, he says, to the current reality of "harnessing the information."

Issues

Private and mid-sized companies can apply analytics across a number of functions, such as human resources, to help add data-driven perspective to their operations. One of the most critical matters organizations should keep in mind is the initial investment in infrastructure to build out such technical capabilities, Ronanki says. Companies need to know how much data they intend to store and collect. There are specific algorithms and software licenses that may be needed to yield certain types of data. Further, there are interfaces and apps that should be developed and adapted for company-specific purposes, such as mobile user data, Ronanki says.

For finance, health care and life sciences, and other regulated industries, both the collection and analysis of data may be subject to reporting requirements that companies must also follow. Meeting compliance standards is likely to become a bigger task for companies as information is produced and shared across a growing number of channels, according to Ronanki: "If you're using personal health sensors, prescribing certain actions, you'll need to consider which way the regulatory framework can be applied."

Opportunities

Private company leaders who intend to make investments in analytics will be doing so in an environment where the cost of storage and acquisition of data has dropped considerably. Prices for hardware components, improved management tools and enhancements in the handling of data sets have helped bring data storage costs down up to 20 percent in recent years.[7]

Open-source software and crowdsourcing can also provide paths for growth-minded companies that wish to make use of analytics. Ronanki offers a hypothetical: a company needs to run a regression analysis to determine relationships among a few variables but doesn't have an expansive team of engineers to carry out the assignment. Instead, a core group can manage such a project by utilizing open-source solutions. "You don't have to write the algorithm from scratch. You harness the open source models that are already out there," Ronanki says.

Another example of analytics and crowdsourcing at work: a manufacturer with hundreds of vendors wants a clearer view of the supply chain. Rather than deploying a team, the company could crowdsource the task to find a team to handle the job. "We've got this data, and now we can turn it into a dashboard that helps a CEO decide on the most effective solution," Ronanki says. "It's all being democratized, so you can make small, strategic bets."

Questions to consider

- What can you do to create competencies in analytics within your company?
- As a leader, how do you educate yourself further in analytics and continue to keep up with developments within the technology?
- What actions should you be taking to ensure you are taking advantage of the possibilities of analytics to avoid getting disrupted in the marketplace?
- Are there areas involved with running your business where open-source software and crowdfunding could help you make sense of the data you're collecting?

Cloud computing

New generations of cloud computing solutions are chipping away at one of the most persistent challenges for growth-minded companies: creating a high-quality customer experience. In addition to their role in powering front-office functions, cloud-based technologies are equipping growing numbers of organizations with fuel for back-office operations.[8] In our most recent survey of technology trends in the middle market, 64 percent of respondents said they were mobilizing or had successfully deployed cloud-based, customer relationship management (CRM) solutions.

The growing ease of adoption of these solutions is a key reason behind this trend: our survey revealed that the rapid time-to-value cycle was the top reason companies chose cloud-based applications.[9] As firms look for new ways to create connections to customers, expect private companies to continue to integrate customer-focused cloud solutions into their technology mix.

As companies move to the cloud, executives should operate under clear guidelines and understand that those guidelines can change frequently.

Issues

While cloud solutions are attractive to many organizations who are looking to shift labor-intensive software management concerns to outside vendors, there are nevertheless management considerations that do not entirely disappear. Companies should fully understand the terms and conditions present in their service agreements. Terms can vary after periods of introductory service. And companies that are investing in cloud solutions should also determine that their users receive effective preparation to apply the technology across the organization.

For companies that are exploring cloud-based solutions, "You need to understand the duration of the subscription, and also understand what the cost profile looks like long-term beyond the initial contract," says Karl Rupilius, principal, Deloitte Consulting LLP. Cost was in fact the top-ranked challenge for mid-market companies in using cloud-based services, the Deloitte mid-market technology survey revealed.[10]

Security came in second, and the stakes are only getting higher. As companies steer additional functionalities to the cloud, layer solutions on top of one another, and extend cloud capabilities to customer-facing operations, executives should operate under clear guidelines and understand that those guidelines can change frequently, Rupilius says. Data security becomes an even trickier concept when companies have cloud-based systems and do business across borders.

"That's when various departments across the organization need to be aligned," Rupilius says. "That's when the legal department and the tech department need to talk.

Opportunities

Across a number of industries and a variety of business functions, cloud-based applications have become more accessible, scalable and powerful. Firms can now take advantage of cloud-based software to quickly map customer demand as it rises and falls. In other words, the cloud can create the type of flexible computing support that can be timed and billed according the business's needs at a particular moment.[11]

Manufacturers, for instance, are using cloud platforms to get up-to-the-minute information on product performance that can eventually reduce equipment downtime.[12] The flexibilities may be even more pronounced when firms choose to run a combination of function-specific solutions on a cloud stack. Such an arrangement creates a layer of solutions working in concert to help power business operations, says Rupilius.

"Think about the old days: you had to install software on-premise, they would send you CDs or DVDs, then you would be responsible for managing it," Rupilius says. "Now, you can sign up for cloud solutions that run entirely in a cloud stack. For small, mid-size, and large organizations, it helps them to be very nimble. It enables them to scale much faster and flexibly than ever before.

Questions to consider

- How can you leverage the cloud in order to grow and scale efficiently?
- What sorts of cloud-based apps do you need to have in place to provide a high-quality customer experience?
- How can you be nimble while running your IT infrastructure with lower IT operational costs?

Cyber risk

The high-profile data breaches over the past couple of years across public, private, and government sectors show that any company or organization is at risk of a cyberattack. Private companies understand this: The management of cybersecurity and information risk continues to be the most pressing assignment for technology leaders at private companies, according to our latest technology survey of the middle market.[13] Information security was cited in the survey as the leading challenge for IT departments, ahead of keeping up with new technology.[14] Confronting cyber risk is now a priority for private companies, but the ever-changing cyber threat landscape means total prevention is close to impossible.

Trying to anticipate hackers' varied motives and prevent theft of digital property is a Herculean effort which is likely to fail on occasion.

Issues

Hackers differ widely in their motivations and in the tools, techniques and procedures they use to carry out their attacks, making it "very difficult to secure an entire company's eco system of data and assets," says Kiran Mantha, a Deloitte Risk and Financial Advisory principal of Deloitte & Touche LLP, who leads cyber risk services for the retail and distribution sector. While some hackers are after personally identifiable information, such as social security numbers or credit card information, others seek to steal intellectual property. Still others engage in "hacktivism" to discredit a company or propagate a particular ideology. Trying to anticipate hackers' varied motives and prevent theft of digital property is a Herculean effort, says Mantha, which is likely to fail on occasion.

Deploying advanced cyber threat technology to manage risk may not be the most advantageous way to make new investments. Phishing—simply defined as a way to steal private information using a digital tool like e-mail or text messages—still remains the most used trick to break into a company's data holdings.[15] Without first "mitigating risk around basic business functions," says Mantha, and educating people about the do's and don'ts when it comes to cyber, costly programs can still leave organizations open to vulnerabilities, and provide cyber attackers low-hanging fruit to plunder.

Even with vigilant employees, staying ahead of the curve on cyber threats necessitates a process for gathering intelligence. Mantha says, "Companies need to ask: How do we gain visibility across our environment and know what to look out for?" Three-fourths of Deloitte's mid-market technology survey respondents said their company spends at least 1 percent of its dedicated technology budget on information security, with only 22 percent spending more than 5 percent.[16] How much of those funds are dedicated to intelligence-gathering, in addition to monitoring and response, is less clear.

Opportunities

Ultimately, a strong cyber risk management program focuses on mitigating risk, not preventing it. Rather than trying to fortify a company's entire digital ecosystem, a focus on protecting companies' "crown jewels" of data and assets from cyber threats is far more likely to mitigate potential disaster. But while most companies generally have a good idea of what their most prized information is, they may not know where it lives. "They may not know where it is housed, or which people can potentially access or copy the data, even for completely benign reasons," says Mantha.

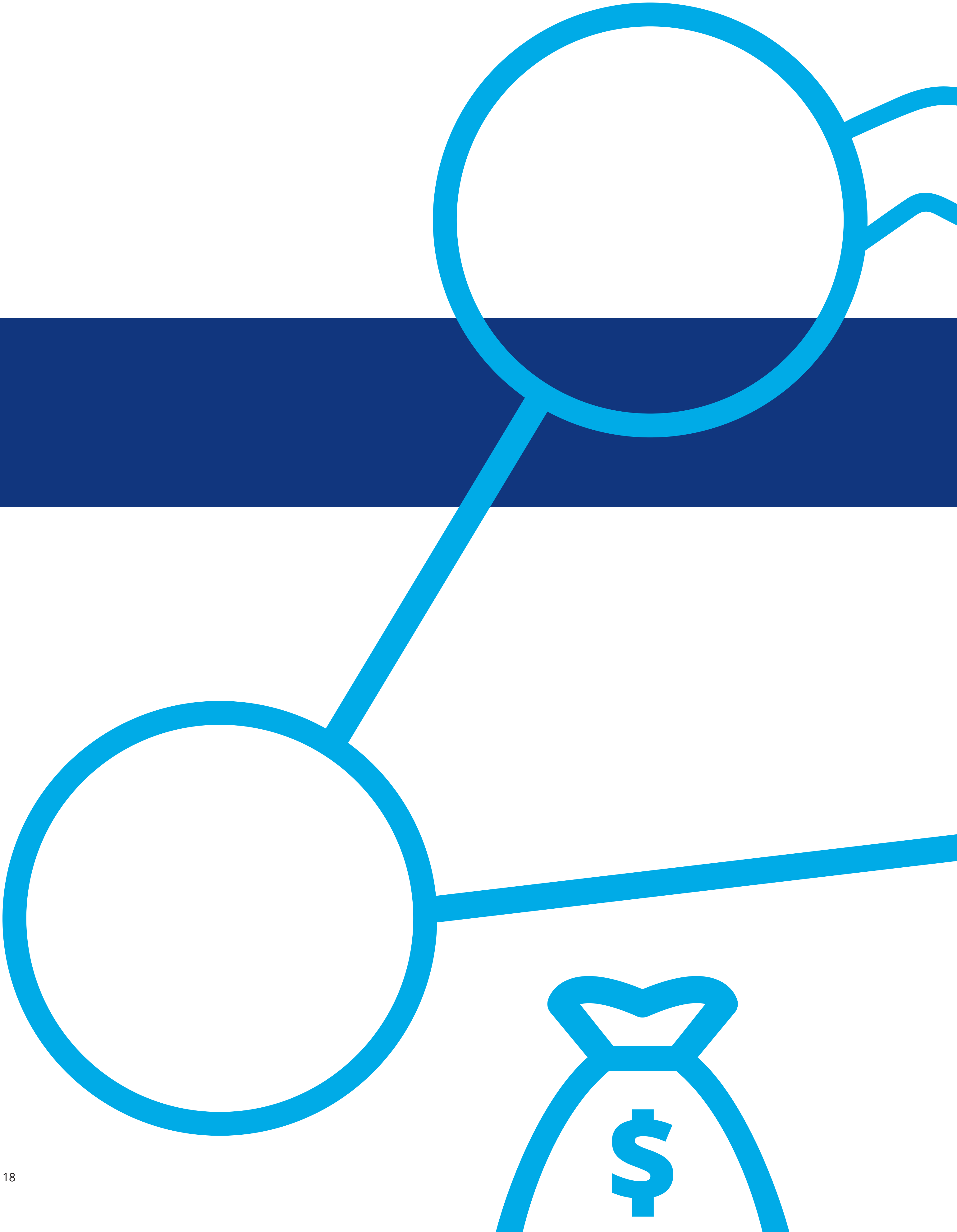
Investing in educating individuals who take part in a company's daily operations is important to protecting a company's most prized assets. This education must extend to third-party vendors, who often have the same or similar access to valuable data as full-time employees. Integration among private companies and their vendors will only continue to increase, as will the risks associated with transition to use third-parties, when data and other assets can be at its most vulnerable for being stolen.[17]

Keeping up with regulations about data protection and consumer privacy can be complicated, but it's an important piece of the cyber risk management program because such rules are constantly changing, and may differ by country or region. As business models change as a result of evolving data use and application, companies can find themselves being regulated in new ways. As an example, when a company in possession of consumer data decides to expand their operations beyond the United States, the company may then be subject to new consumer privacy laws, "which means their cybersecurity framework will very likely need to change," says Mantha.

According to Deloitte's annual mid-market technology survey, this exact situation is happening more and more: The proportion of revenue these companies generate outside the United States is expected to grow in the coming year, particularly among companies generating 26 percent to 40 percent of their revenues in international markets. An overwhelming majority—84 percent—said global trade is important to their company's supply chain.[18]

Questions to consider

- Do you know where your company's most important data information and assets live within your digital operation?
- Are your company's third-party vendors part of your cyber risk employee education program?
- Have you considered what the impact of a data breach could be for your company?
- Do you have visibility into unauthorized activity that may be occurring in your digital environment?
- Is your compliance operation up-to-date with data privacy regulations?



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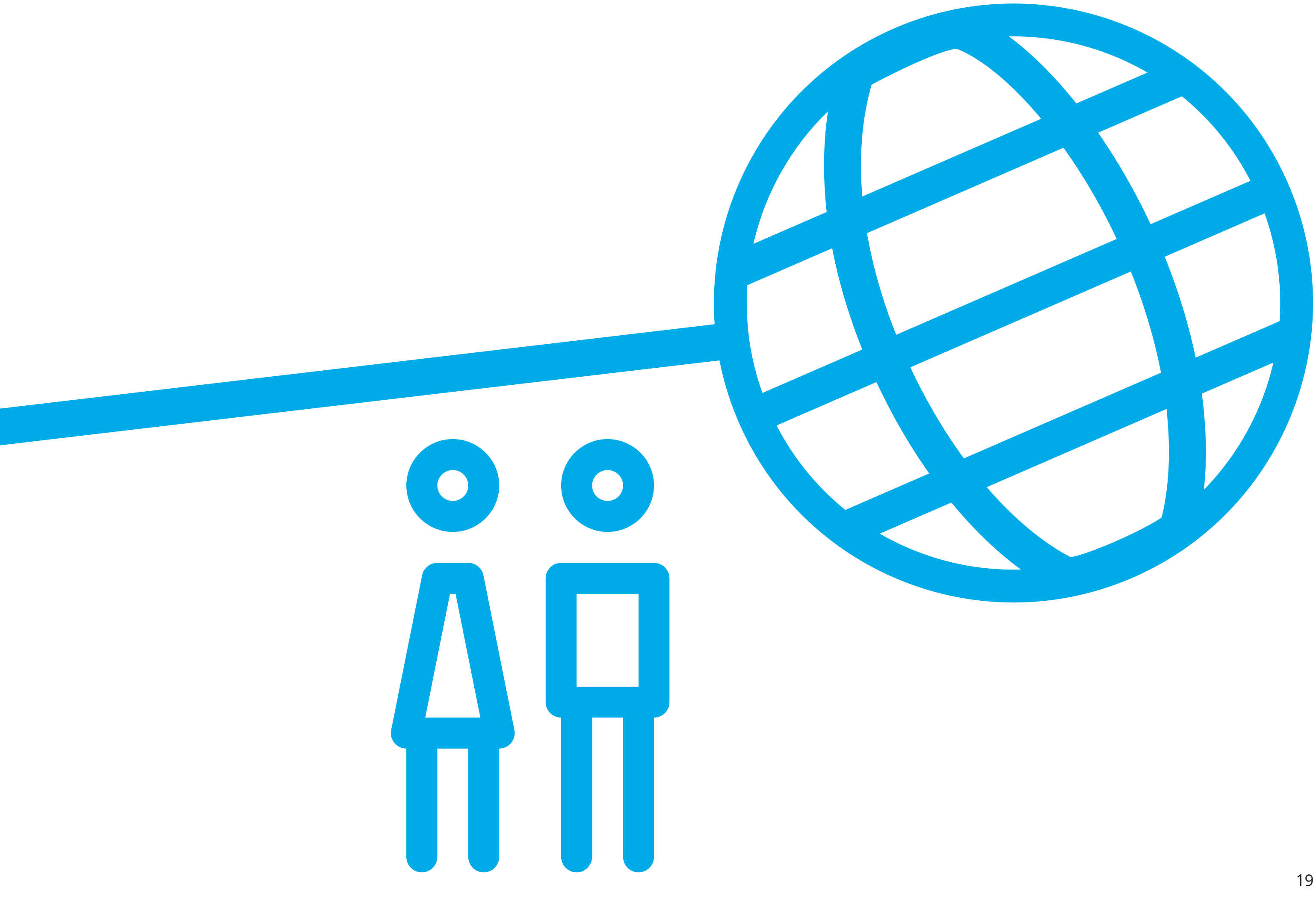


Capital spending

Faced with growing uncertainty surrounding technology, globalization, and political and economic policy changes, many private companies are re-examining how they allocate capital. Demands on capital budgets are becoming more complex, from cybersecurity to maintaining global supply chains. Many private companies find themselves having to make spending decisions more quickly in an environment in which they already must do more with less. Senior management faces the challenge of improving their strategy development and processes for measuring risk to ensure that capital is spent where the company needs it most.

Issues

Many private companies feel they do not spend capital as effectively as they should.[19] Often, the items that are given priority aren't necessarily the ones that will benefit the company most at a given point in time. "You have a lot of stakeholders and a lot of different kinds of requests," says Charles Alsdorf, a managing director and capital efficiency leader for Deloitte Transactions and Business Analytics LLP. One division may ask to increase spending on maintenance, another to deploy capital for entering a new market or developing a new product, and yet another for sprucing up the office and improving employee morale. Each of these is important, and senior management must determine which spending options get priority. They are looking for better ways to make these hard trade-off decisions.

In an increasingly complex global marketplace, private companies are refining their planning and decision making to improve the effectiveness of their capital spending.

Technology is advancing rapidly, and new data and analytics programs can help companies operate more efficiently and reduce costs; however, adding technology potentially could create a greater vulnerability to hacking and other cyber threats. Globalization poses similar challenges, offering potential markets for growth, but also present new risks for companies unfamiliar with local politics, tax policy, or currency issues. This can create added complexity that can complicate capital spending decisions. In an uncertain political and tax environment, senior managers must decide if they should invest in a foreign factory or outsource production. They are searching for more insights on how to plan for and respond to strategic and operating risks.

Credit markets, too, are changing. Private companies must weigh their capital spending needs against the prospect of higher interest rates. "In the past, when there's been a shift in the credit markets, we've seen greater separation between the haves and the have nots," Alsdorf says. "Private companies should think about how to prepare if credit gets tighter." That may mean refinancing debt for a longer tenure, or securing credit at current rates even if a capital project is several years away. "Now is a good time to build in some flexibility," he adds.

Opportunities

In an increasingly complex global marketplace, private companies are refining their planning and decision making to improve the effectiveness of their capital spending. In our recent annual survey of private companies, many senior executives said they feel a need to cut back: 63 percent said their company was holding off on making major investments because of uncertainty in the business environment, up from 39 percent a year ago.[20] "There are more constraints on capital, and when you add in the uncertainty, that can create some tough decisions," Alsdorf said.

Typically, senior management sets strategic targets once a year, with little input from the front lines of the business. "The opportunity at the senior management level is to bring that strategic discussion into a manageable framework that measures the hard trade-offs and the impact of risk, so that people throughout the company can get better feedback on their capital proposals," Alsdorf says. This enables mid-level managers to determine if spending requests align with the overall company strategy.

At the same time, the process can provide broader feedback on risks that could hurt the business or that could open new business opportunities. By assessing and monitoring the biggest risks and their potential impact, private companies can adjust capital spending accordingly to ensure resources are allocated dynamically where they can do the most good.

Big data also can help companies identify potential risks and potential savings. "There are lots of ways that big data can help you make smarter capital investments," Alsdorf says. For example, it is increasingly possible to use sensing technology to assess the actual condition of capital equipment and forecast potential failures across several factories, enabling the company to improve maintenance operations and capital spend.

The evolving nature of big data means that companies must have a long-term strategy for evaluating and adopting new technology and data, as well as assessing the risks that can come from having more equipment networked and potentially vulnerable to cyberattacks. Concerns about technology often get overshadowed by the potential benefits. Many companies are willing to spend more on technology they believe will boost revenue, but are less willing to spend on security.

Adding to the decision making challenge is that it is generally easier to measure the cost of these technology investments than it is to measure their business benefits. "Security spending is all about risk mitigation," Alsdorf says. "The onus is on senior management for setting the stage on strategy, for translating strategic objectives into a trade-off framework and key observable metrics, and for measuring risk and opportunity."

As political and economic policy changes make global markets more uncertain, leading companies are developing contingency plans for each market that could affect their operations or supply chains. This helps them make decisions such as whether to reduce or increase production, how to prioritize capital expenditures, and what capital structure and financing options may provide the best risk-return profile.

Questions to consider

- Are your capital spending plans contingent and do they give you the flexibility to react to changes in each market?
- Do you have processes and metrics in place that incorporate input from the front lines of each business in your capital spending program and prepare you for making hard trade-off decisions?
- Have you thought about how targeted capital spending can address various risks that could result threats to your business?
- How are you using data analytics to improve your spending decision-making?

Financing

Driven by an economy that continues to pick up speed, private companies are gearing up to borrow more in the year ahead. Our latest annual survey of private and mid-market companies found that more of them plan to tap cash-flow financing, secured loans and private sources of capital as their optimism in the economy's direction grows.[21] Some may be looking to get ahead of rising interest rates. Three Federal Reserve rate hikes since December 2015 have started to push up borrowing costs, though rates remain low by historical standards and a growing economy is expanding private companies' borrowing capacity.

Private equity firms are not seeing as many deals compared to this time a year ago.

Issues

Interest rates have risen enough in recent months that private companies are getting more "rate-conscious," says John Deering, a managing director at Deloitte Corporate Finance LLC. That's because in recent years the London Interbank Offered Rate (LIBOR)—a benchmark rate for establishing interest rates on many loans—was well below the 1 percent floor established for many financing arrangements. Now that LIBOR has risen above that mark, variable-rate deals are rising, and so are private companies' interest expense. "It's a major consideration in our world," says Deering.

The value of private equity deals was 25 percent lower in 2016 than the year before and reached the lowest level since 2013, according to Preqin.[22] While higher pricing certainly played a part, Deering says uncertainty around the recent US election is also making private sponsors cautious about committing capital until the impact of the new administration's policies on demand and profitability are clear. "Private equity firms are not seeing as many deals compared to this time a year ago," Deering says. "It appears the entrepreneurs are taking a short term, wait-and-see attitude and part of that is related to the election results." On the other hand, "the private equity firms expect the buy side pace to accelerate in the very near future."

Meanwhile, the market for initial public offerings was chilly in 2016, after a host of new offerings received a poor reception from investors.[23] While our mid-market survey picked up a large increase in the number of respondents expecting their companies to pursue an IPO in the next 12 months, Deering says the current market may be better suited to big technology companies with "explosive" growth opportunities. "The biggest red flag in the current environment is feasibility," he says. "It's very challenging to attract research coverage for traditional mid-market companies and, at the end of the day, if you're not trading at above-average volumes, you're almost treated as a private company anyway."

Opportunities

Despite these warning signs, Deering says most lenders are staying active and aggressive in working with younger, entrepreneurial companies. Business development companies—or BDCs—have been much more active in the middle market recently as their stock prices have rebounded and they are under investor pressure to deploy capital. Deering says there are now more than 40 BDCs vying for investment opportunities, up from only a handful five years ago. "They are very motivated to get dollars out the door," he says.

Private equity firms are staying busy as they have increased their appetite for dividend recapitalizations amid investor pressure and more aggressive debt markets. Such arrangements are meant to generate early returns for investors before portfolio companies are sold, and Deering says PE firms are turning to recaps much earlier in the investment cycle. A dividend recap can help reduce investor pressure and buy company management more time to execute their strategy, but it's only meant for companies that are healthy enough to absorb the extra debt.

"It's like putting 30 percent down when buying your home and then turning around and taking equity out of it only a year later," he says. "It beats trying to sell your home too soon."

Private companies can also take action to stave off the impact of rising interest rates. Deering says "more sophisticated" borrowers in the middle market are entering into interest-rate protection products in which they swap variable-rate terms for fixed rates on a portion of the debt. "If you are highly levered, this is something to be seriously considering," he says. "You don't want a great year of operating performance to be derailed by rising interest expense."

Questions to consider

- Have you considered partnering with a BDC to tap additional expansion capital?
- If your company is backed by private equity, is it financially healthy enough for a dividend recapitalization?
- Have you considered interest rate swap or cap products to reduce your exposure to rising interest rates?
- If you're considering going public this year, have you laid enough groundwork that you're confident of a warm reception by investors?

Globalization

Tapping new markets and customers. Reducing labor and production costs. Realizing tax efficiencies. Gaining access to new pools of talent. All of these reasons factor into private companies' desire to take their business global.

Today, a supportive economic backdrop and a strong dollar are adding to the business case for international expansion and pushing the decision past the tipping point for more private company leaders. Our annual survey of privately held and middle-market companies found a significantly greater proportion—40 percent versus 26 percent—expect to generate more sales abroad this year. In addition, a higher percentage—58 percent versus 42 percent—predict their businesses will have 11 percent or more their workforce located outside US borders.[24]

Companies doing business abroad will face extra scrutiny... Many private companies may be impacted by this push for additional transparency.

Issues

Key uncertainties await private companies that have not done business in a select overseas market before. The time and cost associated with setting up new infrastructure may vary greatly depending upon variables such as the local regulatory regime or the local talent pool available. In addition, moving money and other resources may be slower, more difficult or more costly than similar moves made in the domestic market.

One given is overseas tax authorities' increasing focus on tax revenues and foreign companies doing business in their home markets. At the behest of the G20 nations, the Organization for Economic Cooperation and Development (OECD) finalized plans in October 2015 on base erosion and profit sharing (BEPS), and tax authorities around the world have been aligning their policies and resources to comply. For instance, many jurisdictions are enacting unilateral legislation in light of the OECD's recommendations. Further, tax authorities around the world have enacted tax legislation that requires more information reporting as evidenced by country-by-country tax data reporting that is being required under the rules of various jurisdictions as early as this year.

This means companies doing business abroad will face extra scrutiny of their global operations, as certain tax authorities seek to identify companies allocating revenue and profits to low taxed jurisdictions without significant people, assets, or local country sales. Many private companies may be impacted by this push for additional transparency, as evidenced by the fact that 84 percent of the respondents in our recent mid-market survey said global trade is important to their company's supply chains.

"In the past, multinational companies would be able to set up operations without additional requirements being in place for reporting to various tax jurisdictions around the globe," says Mike Fonseca, a partner at Deloitte Tax LLP. "In an era of tax transparency, it really behooves you to consider tax as you align your supply chain to determine that there is sufficient substance and functions in any specific jurisdiction to justify earning profits there and to understand the nature of the reports that may be required to be provided to the tax authorities around the world."

Opportunities

Despite current uncertainties regarding US trade policies, Fonseca sees little argument for ceasing to consider investing abroad. "While there are certainly challenges and changes in tax rules to be cognizant of, it may still be an opportune time to be able to reach broader markets to fuel growth and access talented labor forces that are closer to these fast-growing international markets," he says.

One reason is the historically strong dollar, which is increasing interest to invest abroad, Fonseca says. Second, companies can address mounting skills shortages—the issue was cited by more than a quarter of the respondents in our recent mid-market survey—by accessing talent in other countries. "You're seeing more companies employ shared service centers where talent is available to conduct various functions in a consistent manner," Fonseca says.

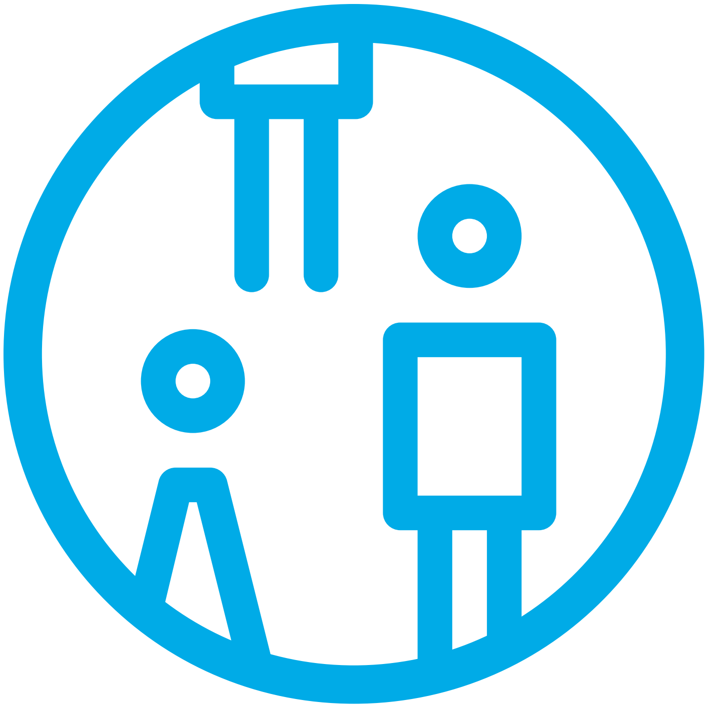
A third driver is the burgeoning middle class in large economies such as China and India.[25] With US economic growth currently averaging less than 3 percent, emerging nations may offer access to consumers who have more discretionary income, allowing companies to utilize improved marketing to them through the Internet.[26]

Finally, although the new BEPS rules place a higher focus on tax considerations, some local jurisdictions continue to offer incentives for foreign companies to locate in their markets. Grants, property and indirect tax holidays, or research and development tax credits, in addition to other incentives, may be available to businesses that commit to establishing operations in these locales, much in the same way that economic development incentives exist across the United States.

Still, Fonseca says it's important for private companies to fully understand the nuances of operating in an international market before they set up shop to put processes in place that address compliance with local rules and regulations. "The concept of having your business and tax structure aligned to achieve your desired business and tax objectives is becoming more important in this more transparent environment," he says. "Accordingly, companies should ensure that they are set up to comply with various local country tax rules and regulations." One step private company leaders can take is to ensure their enterprise resource planning (ERP) systems are set up to comply with local country and international tax rules and help support their tax-aligned business model.

Questions to consider

- Do you have a sufficient in-market presence in your company's overseas markets to stay in compliance with BEPS guidelines?
- Do you have a deliberate process in place to identify local rules and regulations that may impact your company's operations in every overseas market in which it operates?
- Is your ERP system designed to help your business comply with local country and international tax rules?
- If your company's expansion target is an emerging market, do you have an up-to-date picture of where the market really stands?



Talent

The US labor market is tighter than it's been in years. After unemployment peaked at 10 percent in October 2009, it's been on a steady descent; by January 2017, it had dipped all the way down to 4.7 percent.[27] As the labor market tightens, small- to midsized businesses report having a harder time finding qualified workers. The share of small businesses with few or no qualified applicants for job openings recently hit a 17-year high in November 2016.[28] These findings are backed up by Deloitte's annual survey of the US middle market, in which more than a quarter of the respondents listed skills shortages as a top obstacle to their company's growth.[29]

With nearly half of those companies expecting to increase their full-time headcount in the year ahead, the question becomes how they are going to find and retain top talent, particularly among younger people just entering the workforce.

Leadership development is more about education and self-growth now, and encouraging that in a multi-generational way.

Issues

The unprecedented change of pace in the development of new technologies has caught many private companies flat-footed, as the explosion of new innovation has outpaced both business productivity and the ability of firms to keep up. One challenge they face is that the younger, tech savvy workers they need to help deploy such technologies are attracted to employers that are already making use of them, says Jeff Alderton, principal, Deloitte Consulting LLP.

"There's a certain expectation among younger workers when it comes to the use of technology," Alderton says. "And when they don't see that, they're going to assume the company isn't on the technology grid."

Another constraint is the way many private companies are organized. For example, family-run businesses can be pretty traditional in their corporate hierarchy, in what Alderton calls "sticks and boxes" reporting relationship between managers and their subordinates. This tends to conflict with younger workers' expectations for autonomy and team-based collaboration. "They've spent their school lives working in teams and ruling by consensus, and that structure contrasts with the way family-owned businesses and most mid-market firms are oriented," Alderton says.

Other expectations they often have coming into the workforce are being able to work in urban centers or remote locations that suit their lifestyle needs, he says. That can be an issue for smaller companies confined to smaller suburban or rural communities where they were founded.

Opportunities

While many private companies are worried about the cost of keeping up with technological advances—it tied with regulatory compliance as the top obstacle to the growth of the business in Deloitte's latest mid-market survey—many technology solutions are becoming more affordable. For instance, the cost of putting computing and data storage into the online cloud is getting cheaper as cloud providers rush to build new data centers and battle for market share.[30]

Alderton says one way private companies can get off on the right foot with younger job candidates is by relying on emerging technology platforms when it comes to recruiting. New cognitive analytical tools provide visibility to candidates' social media feeds, while virtual calling platforms are allowing employers to handle interviews in remote settings. "Not only does this send the right signal to potential employees but it can significantly reduce onboarding costs," Alderton says.

It might be a stretch to expect smaller, family-run businesses to abandon their traditional organizational structures, but here too, companies can experiment at the edges by forming teams to collaborate around specific business challenges. "You need to be thinking about how to apply team-based approaches to part of your decision-making," Alderton says. He adds that it's important for younger workers to be able to collaborate with co-workers of their own age, and from diverse backgrounds.

With more mid-market companies looking to expand their operations abroad, Alderton sees a great opportunity to build loyalty among younger workers by sending them on business trips with more seasoned co-workers. Coaching and mentoring opportunities are a critical aspect of leadership development, as they can be used to expose high-potential employees to diverse challenges and solutions that go beyond the usual assignments with established managers. Smaller, private companies often have an inherent advantage in this respect, because they typically provide closer access to senior leaders. "If your younger talent wants to go somewhere, send them there, but do it in a way that helps form bonds and creates opportunities to learn," Alderton says.

On this last point, many leading companies are now espousing learning and educational opportunities for employees in addition to traditional technical training programs. Technology has made training on specific skills readily accessible to those who need them, and often times they can learn more quickly on their own without having to go through a company-sponsored program. "You can learn a skill online these days in the blink of an eye, and this is a generation of fast learners," Alderton says. "Leadership development is more about education and self-growth now, and encouraging that in a multi-generational way."

Questions to consider

- Are you using digital technologies to their fullest potential when it comes to recruiting new employees?
- Have you considered how your organization might benefit from team-based approaches for solving specific strategic decisions?
- Are you encouraging mentor relationships between new employees and business leaders?
- Do you have a formal leadership development program that includes ongoing educational opportunities?

DISCIPLINE

Governance and succession planning

Managing and growing a private company may take more decision-making expertise and leadership than ever before. The growing complexities of globalization, electronic commerce, risk and supply chains, to name a few, require greater professionalism among company leaders, board members, and a deeper bench of senior managers. As labor markets tighten, finding and retaining the best and most relevant talent and leadership often can be the biggest governance challenge facing private companies.

Issues

Between 1992 and 2011, the number of all US companies with 100 or more employees rose by 19 percent.[31] Private companies have contributed to that trend, and as they have grown, they have faced increasing demands from a global marketplace. Boards are becoming more independent as companies seek a broader range of perspectives and experience, and senior management is expanding at many companies. A decade ago, many private companies had neither an independent board nor an advisory board. Now, many are formalizing their governance structures and professionalizing their boards to engage talent that can advise on the complexities that could impact a successful growth strategy.

Succession planning remains a governance challenge for private companies, and particularly for family businesses.

"The scale and complexity is driving the need for a broader range of influencers," says Maureen Bujno, a managing director of Deloitte LLP, in Deloitte's Center for Board Effectiveness.

In addition to the board governance layer, as companies grow, they should take a proactive approach to their talent model and recognize that the workforces of tomorrow will likely require different skills than those of today. As they become more global, for example, companies may need leaders who are knowledgeable about international business practices and customs.

Family-owned businesses can present special challenges, especially if some family members are not active in the business yet still have a stake in it. Many are looking for better ways in which family members can interact with the company. This is particularly important in succession planning, in which development of the next generation of leaders is critical.

Many private businesses may not consider talent and succession in terms of how they affect the company's strategy and long-term sustainability, says Tom Plaut, a partner with Deloitte Tax LLP, who works with private companies on business succession planning. "You see this specifically with technology and governance issues," he says. "Private company boards and executives have to work to understand the implications that technology has on the business, or at least be able to tap expertise when they need it."

Opportunities

Private companies are adapting their governance practices to address these complexities. In the past, companies may have used word-of-mouth in hiring board members. Now, they are paying greater attention to the competitive landscape. "They might be looking at someone who was a chairman or CEO of a competitor or who worked in a similar industry," Plaut says. "If they're looking at selling the business, they might bring in someone with investment banking expertise."

Bujno says many private companies also are looking more closely at education at the board level to contribute to the overall success of the business. "More focused skills and experiences in the company and in the board recruitment process often put companies in a better position to continue innovating and reacting to the competition," Bujno says. Ongoing board education, in-house or through external programs, can help them better understand the business and the markets in which the company operates. "This can really help directors advise on growth strategies and related risks," she adds.

Succession planning, which remains a governance challenge for many private companies and particularly for family businesses, should be seamless. The need for deeper management ranks can create opportunities for more family members to become involved, which can facilitate a wider selection of potential successors while keeping the company in the family. Regardless, a successful succession hinges on a shared vision for the future of the business.

Before companies can consider succession, however, they should consider formulating a deep understanding of the company's strategic direction and how technology may influence it. Companies from map makers to newspaper publishers to kiosk retailers that depend on mall traffic have had their business models upended by technology. "You've seen such disruption of long-standing and well-established business models," Plaut says. "Technology is such a key changer of businesses that boards need to make sure their strategy embraces technology."

As private and mid-market companies continue to grow, they will face new complexities involved with governing a larger enterprise. But as long as the board matures along with the organization—from the standpoint of governance practices, board recruitment and succession planning—companies can enhance their decision-making processes and help align their expanding resources and strategies for growth.

Questions to consider

- Is your board sufficiently independent, diverse and complementary to deal with the complexity of the global marketplace?
- Do you have the leadership skills in place to position the company for the future?
- How can you improve your company's talent model to attract a workforce with the skills needed to compete and adapt to innovation?
- Do you have the leadership and knowledge in place to expand internationally? If not, do you know where to acquire it?
- What is your plan for continued education of the workforce? Do you have formalized plan for board education?
- Is your succession plan clearly formulated to provide a seamless transition of leadership?

M&A preparation

Private companies are confident that corporate combinations will grow in frequency and size in 2017. The predictions for a prolonged M&A spurt follow a year in which global volume dropped 15 percent from the previous year.[32] Market observers had to wait until the fall of 2016 for the environment to show measurable signs of traction.

Our work with private companies reveals the depth of the pent-up demand: in our most recent M&A trends report, 70 percent of mid-sized firms expect their total number of deals to grow moderately or significantly this year. And nearly two-thirds of survey respondents expect the dollar value of these transactions to increase over the next 12 months.[33]

Preparation is one of the main reasons deals sputter when they might otherwise soar.

Nonetheless, a number of hurdles have the potential to upset those plans. Private companies will have to focus their efforts on strategic opportunities. They'll need to pay close attention to the details within the structure of deals. And they'll need to have the right teams, advisors and financial resources in place to secure and sustain their M&A endeavors.

Issues

Preparation is one of the main reasons deals sputter when they might otherwise soar. Organizations without strategic planning committees or other mechanisms to react quickly to prospects operate at a disadvantage in a bullish environment. A senior executive might appear to be the natural candidate for such transactions, but resources can get quickly stretched, leaving even the most skilled leader in a reactive posture.

"Sourcing acquisitions is complicated. You have to be consistent, keep up the frequency, and much of the time, there's no bandwidth to do so," says Phil Colaco, CEO of Deloitte Corporate Finance. "That's often the reason transactions don't go well."

Access to financing is another consideration that determines success. For private companies lacking sufficient lines of credit or lenders skilled in the complex world of combinations, deals can often suffer or disintegrate altogether. "That adds time and effort to the process," Colaco says of financing, adding that well-prepared acquisitive firms "have constant relationships with financing sources and have financing readily available."

Opportunities

One of the yet-to-be-settled matters in the new administration that could spur a wave of M&A activity is the easing of constraints on regulated industry. The financial services industry in particular could see more deals with bigger price tags as regulations are revised. For instance, 82 percent of financial services firms expect deal size to increase in the coming year. But despite the predictions for an accelerating market and moves by the new administration to relieve regulatory pressure, it's still too early to tell how the factors will interact.[3] According to Colaco, "there's a very palpable sense that people are trying to figure out what the new world is going to look like."

Digitization is also working in favor of private businesses in the M&A environment, particularly as they look to acquire non-US assets. Our M&A trends survey revealed that 91 percent of mid-sized companies had deals among companies operating in foreign markets. The emergence of data analytics affords greater precision to the process, from identification of targets to scrutiny of financials during due diligence.[4] As the flow of information becomes more sophisticated, acquisitive firms can more accurately assess the legal, currency and management considerations in cross-border transactions. "Companies are much more able to find, contact and evaluate non-US firms than they ever have been," Colaco says

Questions to consider

- Is your management team ready? Do you have people in mind who could help you if you were presented with an acquisition today?
- Do you maintain an active pipeline of acquisition opportunities domestically and outside the US?
- Do you have a group of banks and/or advisors to support an acquisition in terms of valuation, financing, and tax advice?
- For family-owned firms, is your ownership group ready for dilution? What would you want to gain from the transaction, and do you know what your constraints are?

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