OPTIMIZE®

OPTIMIZING MID-SIZED BUSINESSES

A performance analysis of Europe's mid-sized companies

MAZARS

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Foreword

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Mid-sized businesses are vital to Europe's economy, and are a cornerstone of the continent's prosperity. These businesses occupy their very own niche: they are typically 40 times larger than micro enterprises but around 40 times smaller than their largest global counterparts. They deliver key products and services, and provide employment for many millions of workers. They are also a vital cog in the wider economy. They support smaller and larger enterprises, promote innovation and build long term capital value for their owners.

Their importance far outweighs their number. Mid-sized companies with a turnover of between €10 million and €200 million currently account for just 1 to 2 percent of EU enterprises. Yet they are the backbone of the national economies in which they operate, providing an essential link between the plethora of local small and micro entities beneath them and the powerful, mainly global, corporates above them. Mid-sized companies have the potential to deliver enormous benefits, not only for their own sustainability and long term capital value, but also for their communities and the economy as a whole.

Mazars has supported the growth of mid-sized companies for many years, and takes a deep interest in what really drives this key segment of the market. To further our understanding, we analysed the financial data from 72,000 European mid-market companies over a four year period from 2012 to 2015, assessing them both by business model and by four key performance indicators that determine a company's long term sustainability and capital value – its profitability, return, liquidity and strength.

This report highlights our findings. We are delighted to be able to share it with you and hope that these insights contribute to mid-sized companies achieving their full potential.

1| Executive summary

The findings of our analysis shed a fascinating light on Europe's middle market companies. They show that these businesses have enormous potential to achieve long term sustainable success, but that many of them are failing to make the most of their opportunities and so are not performing nearly as well as they could.

Owners who adopt the right business model at the outset, or who position themselves correctly in the market, stand to reap far greater rewards than others.

Our survey found that there is a large gap between the best performing and worst performing companies in every business model, yet there is almost no difference in overall performance between different EU countries.

This suggests two things. First, that there is considerable scope for mid-market companies at all levels to improve their performance. And second, that within a particular business model, it is primarily internal, rather than external factors, which are limiting their achievements. While businesses often talk about the external factors that stand in the way of their growth, for example the impact of national economic factors, our research shows that in reality the critical drivers of success are often within a company's control. That means that the ability of a business to achieve more lies firmly with its owners and management.

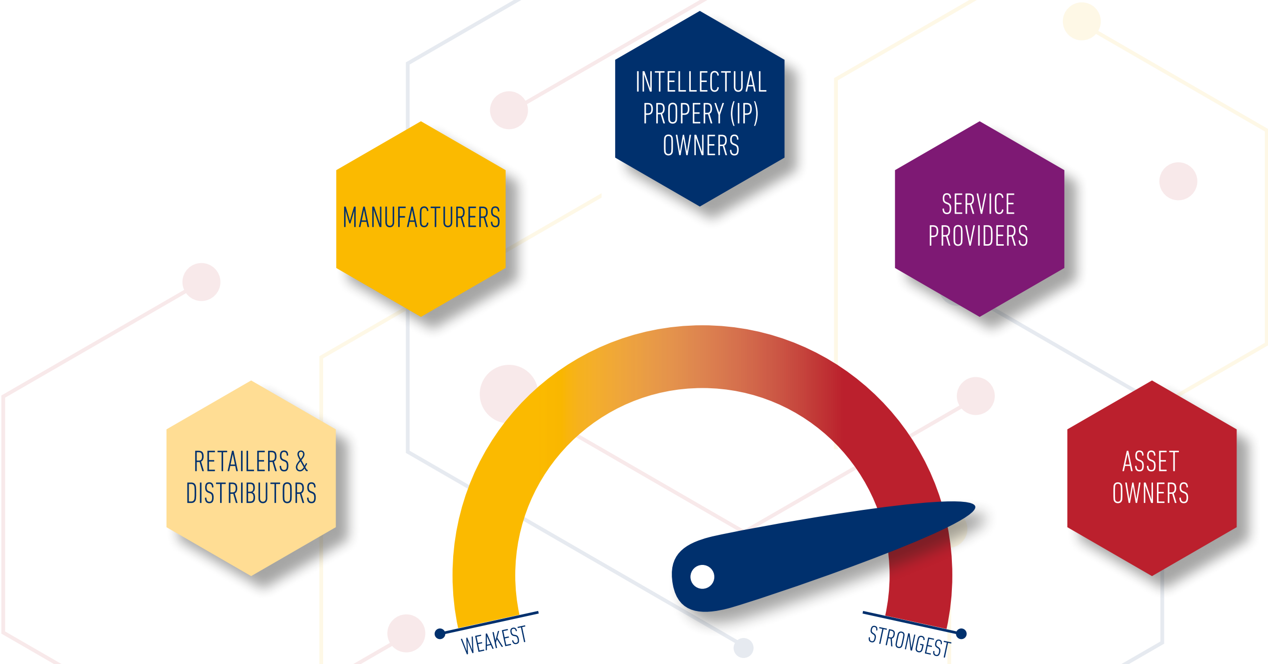
The reasons for a lack of performance are not hard to find. Our survey of 72,000 companies found that all mid-sized businesses, even the best-performing ones, and from every business model, have worryingly low levels of liquidity. This suggests that many companies simply don't have the internal resources for either: (i) long term investment to enable growth; (ii) for providing a financial buffer through economic downturns; or (iii) more simply for weathering the storm during a poor trading period.

Our analysis also found that a company's choice of business model has a significant impact on its performance. The best performing middle market companies in Europe can have very different levels of profitability and financial strength depending on the business model that they operate. For example, Intellectual Property (IP) owning companies, in the highest performing tier enjoy profitability of at least 17.8 percent, whereas in the highly competitive Retailer and Distributor model, companies in the highest performing tier show a profitability of around 8.7 percent. This suggests that owners who adopt the right business model at the outset, or who position themselves correctly in the market, stand to reap far greater rewards than others.

Taken together, these findings suggest that mid-market companies may need to readjust their focus. Our analysis indicates that, at present, many of them are getting too tied up in the day to day operations of their business and so are failing to invest enough time in strategic planning and thinking ahead. This has major implications for their competitiveness, their sustainability and their ability to grow and deliver long term value within their business.

The good news is that there is a lot that a company can do to improve its situation. Profitability and performance are not set in stone. Our survey shows that it is possible for ambitious companies to move sharply upwards, even from the poorest performing tier to the highest, within the space of four years. There is an enormous scope for management and owners to improve their company's performance. And as our analysis reveals, the rewards are there for those companies who get it right.

There's considerable difference between the weakest and strongest* business models



* Strength: net assets/turnover

2| Key findings

1. There is considerable variation in the performance of Europe's middle market companies, with a large gap between the best and worst performers.

2. The business model operated, and its position in the market place, have a significant influence on a company's performance.

3. Most mid-sized businesses have extremely low levels of liquidity, even those in the top tier.

4. The performance of a business can be significantly improved in the space of four years, with almost half of the poorest performing companies moving up one or two tiers over this time.

5. IP owning businesses yield the highest return, with the best performing companies in this category having a return on assets of at least 22 percent.

3| Methodology

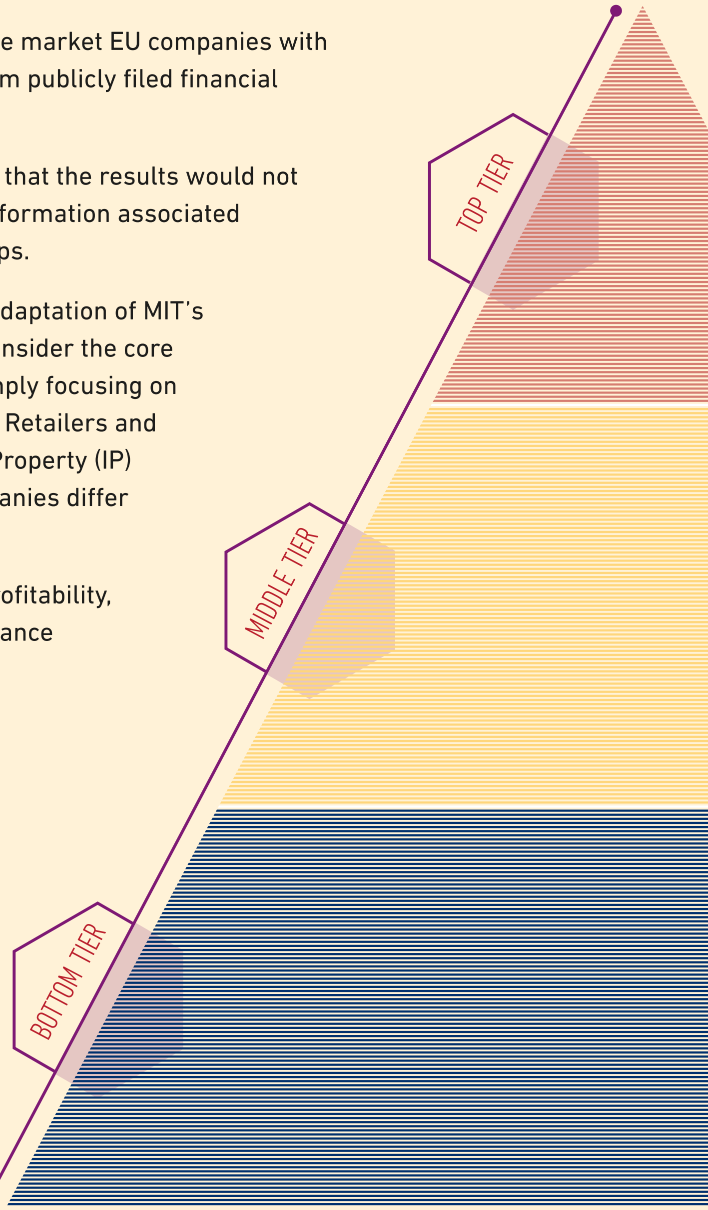
The findings of this report are based on a study of 72,011 middle market EU companies with a turnover of between €10m and €200m using data sourced from publicly filed financial statements.

Only businesses registered on or before 2012 were included so that the results would not be distorted by newly registered entities presenting financial information associated with launch, high growth and unstable phases typical of start-ups.

The companies were divided into five business types using an adaptation of MIT's business models, in the belief that it would be most useful to consider the core activity of a business and how they create value rather than simply focusing on industry type. These five business models were Manufacturers, Retailers and Distributors, Service Providers, Asset Owners and Intellectual Property (IP) Owners. Financial Services were excluded because these companies differ significantly from other business types.

These five business models were then analysed according to profitability, return, liquidity and strength, as these are the four key performance indicators that determine a company's long term capital value.

The companies within each business model were divided into three tiers, depending on how well they ranked in terms of the four key indicators. The top 20 percent were labelled high performers, the middle 60 percent were labelled mid performers and the bottom 20 percent were labelled poor performers. The movement of the individual companies in these tiers was tracked over a four year period from 2012 to 2015.



Based on profitability, return, liquidity and strength, companies were split into 3 tiers

The Five Business Models

Manufacturer	Buys raw materials from suppliers and transforms them to create a product to be sold to a buyer
Retailer and Distributor	Buys a product and resells essentially the same product to someone else. Distributors may provide added value such as repackaging or customer service
Service Provider	Sells a service provided primarily by people such as consultants, education, personal care, package delivery and healthcare
IP Owner	Licences or gets paid for the use of intangible assets
Asset Owner	Sells the right to use a physical asset

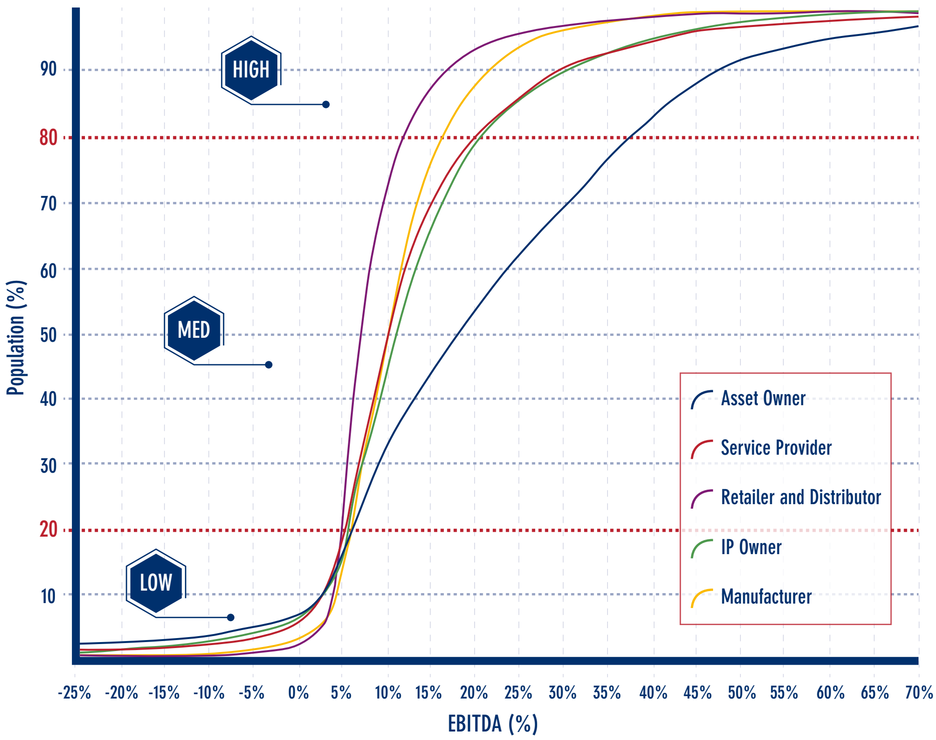
4| Performance indicators

Profitability (EBITDA)

The profitability of a company was measured by looking at its EBITDA (earnings before taking into account the effects of interest, tax and depreciation of tangible and intangible assets) margin.

Our survey found that a company's relative position within its business model category is the most reliable indicator of performance. In the highly competitive Retailer and Distributor model, for example, even the best performing companies returned profitability starting at just 8.7 percent. In comparison, the best performing Manufacturing companies showed profitability of 13 percent upwards. This rose to 16.7 percent for Service Providers, 17.8 percent for IP Owners and 35.8 percent for Asset Owners, as shown in the diagram below.

Profitability (all business models)

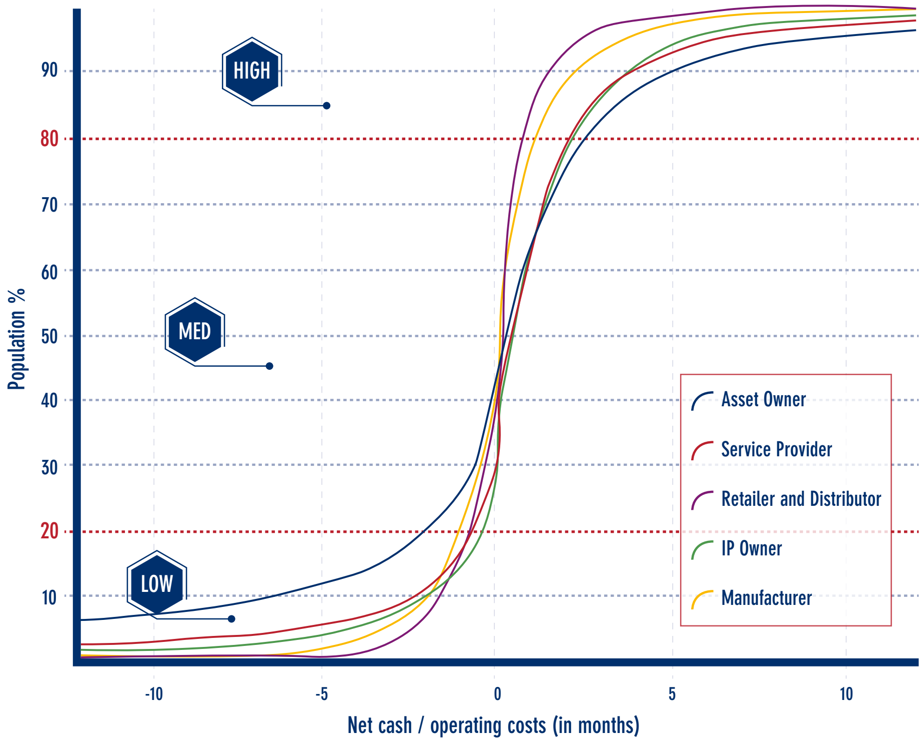


However, these variations diminished significantly in the poorest performing tier. The overall average EBITDA margin of companies in this poorest tier was just under 2 percent, with the weakest EBITDA margin of 1.3 percent or lower for Retailers and Distributors.

Liquidity

Liquidity was measured by dividing the cash a company has available by its monthly operating costs. This shows how long the cash in hand will cover the operating costs of the business going forward. Our analysis found that liquidity was not only extremely weak for all business models, it was also extremely weak for all performance tiers. This suggests that most of the 72,000 companies in our survey will struggle to finance investment and may find themselves in difficulty in the event of an economic downturn.

Liquidity (all business models)



Our findings revealed that the companies in the highest performing tier were the most liquid, with an average of around 15 days of cash available. However, this fell sharply moving down the performance scale, with companies in the middle tier having an average of just two days cash available, and companies in the poorest performing tier having an average of less than one day of cash available. In fact, the analysis showed that 47% of all companies in the study do not have more than a single day's contingency.

This suggests that a significant proportion of middle market companies are relying on overdrafts and short term loans to keep them afloat. It would also suggest that companies facing difficulties would have no option but to go to external funding sources for either growth investment or simply to weather the storm during a period of poor trading.

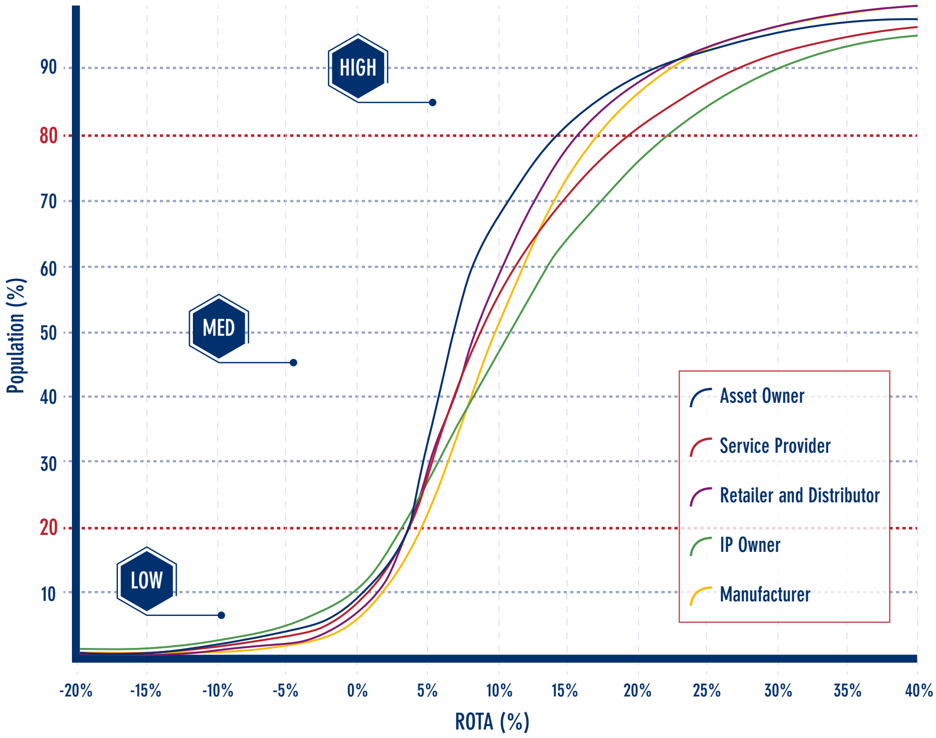
When we looked at liquidity by business model, 80 percent of Asset Owners have less than 80 days of cash on hand. For Service Providers and IP Owners this figure was less than 66 days, while for Manufacturers and Retailers and Distributors it was less than 33 days.

3

Return on Total Assets (ROTA)

The Return on Total Assets was calculated by dividing the EBITDA of a business by its total assets. A high ROTA suggests that the management of a business is using the company's asset base efficiently. However, businesses that operate in capital intensive industries tend to have a lower ROTA than other businesses.

Return (all business models)



Our survey found that for companies in the highest performing tier, the difference in ROTA between different business models was much narrower than the differences in profitability. This suggests that the business model operated has a far smaller impact on a company's return on assets than on its ability to make profits.

The best performing Asset Owners had a ROTA of 14.3 percent or more, while for Retailers and Distributors the corresponding entry point was 15.8 percent, rising to 17.1 percent for Manufacturers, 19.5 percent for Service Providers, and 22.0 percent for IP Owners.

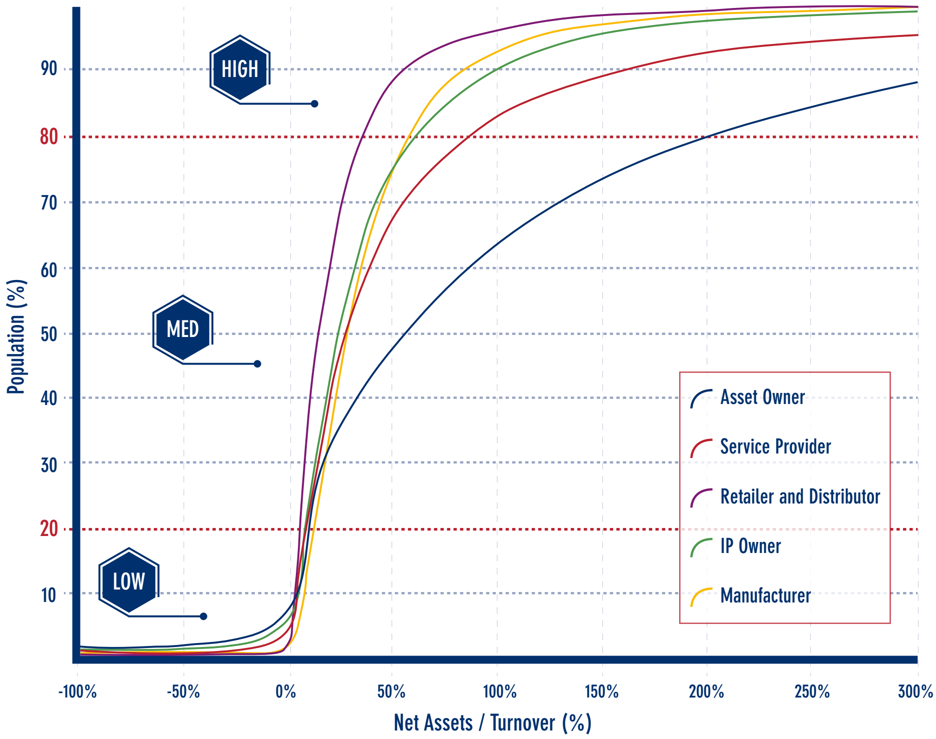
Within the poorest performing tier, Service Providers had the lowest ROTA of below 2.7 percent. For companies in the middle tier, ROTA for Asset Owners ranged from 3.2 percent to over 14 percent while for Service Providers, it ranged from just under 3 percent to 19.5 percent. For Retailers and Distributors it ranged from 3.4 percent to 15.8 percent, while for Manufacturers it ranged from 4.2 percent to just over 17 percent. IP Owners showed the biggest range in ROTA, ranging from 3.0 percent to 22.0 percent, a difference of 19 percentage points.

4

Strength

Strength was calculated by dividing a company's net assets by its turnover. Our analysis found that the top performing companies had different levels of strength depending on the business model they had adopted, as shown in the diagram below.

Strength (all business models)



The strongest business model was found to be Asset Owners where companies in the highest performing tier had a strength rating of upwards of 200 percent. For Service Providers in this tier the strength was 87.4 percent, while for IP Owners it was 62.3 percent. The corresponding figure was 57.2 percent for Manufacturers and 35.9 percent for Retailers and Distributors.

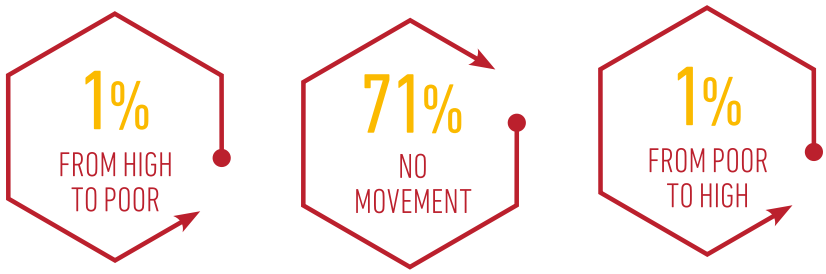
5| Comparison by country

Our research analysed middle market companies across the EU. Although there are more of these businesses in some countries than others, we found that there was little variation between the performance of companies in different countries on any of the four key performance measures of profitability, return, liquidity or strength.

This suggests that the factors which influence a company's long term value have less to do with national economic conditions and more to do with its business model and the quality of the internal decision making and operational management.

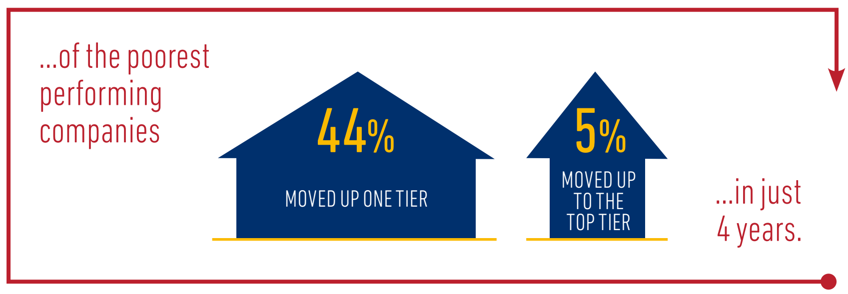
6| Movement between performance tiers

Our analysis found that most companies remained in the same performance category over the four year period from 2012 to 2015. Overall 71% of companies in the study remained anchored to the same performance tier over the 4 year period.



However there was some movement, in some cases quite dramatically. Our analysis shows that 44 percent of companies in the poorest performing tier in 2012 had moved up a step to the middle tier by 2015, while 5 percent of those in the poorest tier had risen to the highest performing tier over the four year period. Meanwhile 10 percent of companies in the middle tier advanced to the highest tier between 2012 and 2015.

Change is possible...



In each case the improvement in a company's performance was accompanied by a dramatic improvement in its profitability, demonstrating what was possible and achievable within each business model. Asset Owners moving from the poorest performing tier to the highest performing tier, for example, saw their profitability improve from less than 2.2 percent to upwards of 35 percent, an improvement of nearly 33 percentage points. For Service Providers making a similar move the improvement was around 15 percentage points while for IP Owners it was over 15 percentage points. Manufacturers saw an improvement of at least 10 percentage points, while Retailers and Distributors saw an improvement of at least 7.5 percentage points.

Not all companies were so fortunate, however, and our analysis also found that 22 percent of companies in the highest tier in 2012 fell back to the middle tier by 2015, while a further 4 percent dropped to the poorest performing tier. Our survey also found that 13 percent of the middle tier companies fell back to the poorest performing tier over the four year period.

7| The capital value equation

Capital value:

the price a seller would expect to achieve on the open market should the business be put up for sale.

While it is an important metric at the point of sale, capital value also acts as an objective measure of the worth of a business at a given point in time. The movement in capital value from one year to the next gives an excellent indication of the overall shareholder value for that period. Businesses with high capital value are likely to have greater access to finance, be performing well against their competitors, and more likely to strengthen the value of its brand.

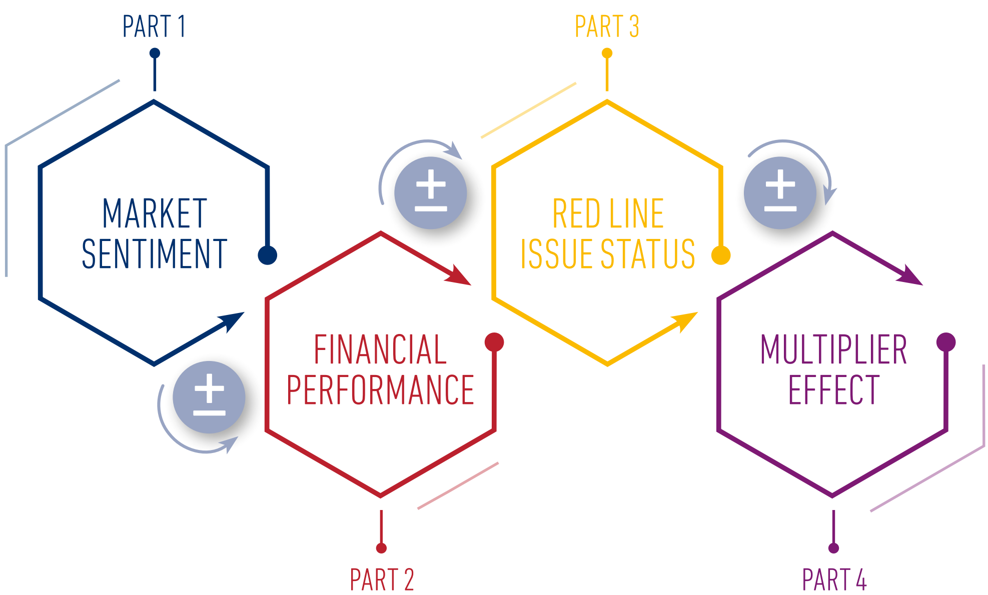
There are many ways to value a business. To further complicate matters, each business sector may have its own specific 'industry norms'. However, there are key dimensions to the capital value equation which are equally applicable to every type of business.

The equation comprises market sentiment and the company's financial performance history such as level and consistency of turnover and cashflow, the quality of its asset base, its debt, and its balance sheet strength. In addition, 'red line issues' such as overdependence on key customers, the risk profile of the company's activities, overdependence on owner-managers and poor quality information and processes are considered. Finally, the 'multiplier effect' is factored in: this is derived by considering a company's significant attributes, which would affect the number of times its profit is multiplied in order to arrive at a market value.

Key drivers of this multiple include:

- the market position and the quality of the product or service offering
- the resilience, quality and efficiency of business operations
- the competence and capabilities of the management team
- the risk profile of the company

This equation is represented graphically below:



8| Optimizing business performance

The findings of our survey indicate that all mid-market companies have the potential to improve their performance and capital value, often considerably. However, in order to do this, they need to operate the right business model and carve a favourable position in the market place to maximise their profitability, liquidity, strength and return.

Mazars has many years' experience in helping mid-market companies to achieve their potential. In our experience, there are six key considerations which underpin long term success:

1. Proactively and continuously managing the **capital value equation.** It is a dimension which is often overlooked, but should be placed at the centre of business planning. Owners and managers should be rigorous in determining goals and clear about their long term objectives.

2. Setting **ambitious but realistic goals**, and communicating these clearly with all shareholders, management and employees. This will help to build alignment across shareholder and management teams, and should be reinforced by incentivising managers to support these shared objectives.

3. Considering the **underlying drivers of business performance**, rather than focusing solely on the results of those drivers, such as turnover and EBITDA. Market positioning, product innovation, operational improvements and team engagement are the sustainable sources of long term value creation and should be at the forefront of management's priorities.

4. **Evolving with the customer base.** This requires continual analysis and innovation. It includes developing more sophisticated ways to identify potential clients, to manage sales channels, and to communicate with those targets.

5. Identifying and rigorously **measuring a company's key performance indicators (KPIs)** against clear strategic objectives.

6. Encapsulating the entire approach within a clear, logical and practical **business plan**.

9| Optimize

Owners and leaders of middle-market companies can find it hard to focus on longer term goals because they are so immersed in the day to day challenges of running their business. With this in mind, Mazars has developed a three-step programme to help business owners and management teams to focus on the long term agenda of their company. This programme, Optimize, will enable them to assess opportunities, cope with change, improve their decision making, and align their actions with strategic objectives.

These three steps are:

1

UNDERSTAND

Businesses need to clarify the long term direction and goals of the business and ensure that owners and the management team have a shared understanding of the company's strategy and objectives.

2

ANALYSE

A business needs to assess and analyse its current position. This should include current positioning in target markets, quality of business operations, effectiveness of people and teams, financial and risk management.

3

OPTIMIZE

A business must develop practical plans, tactics and tasks to close the gap between their current performance and where they want to be.

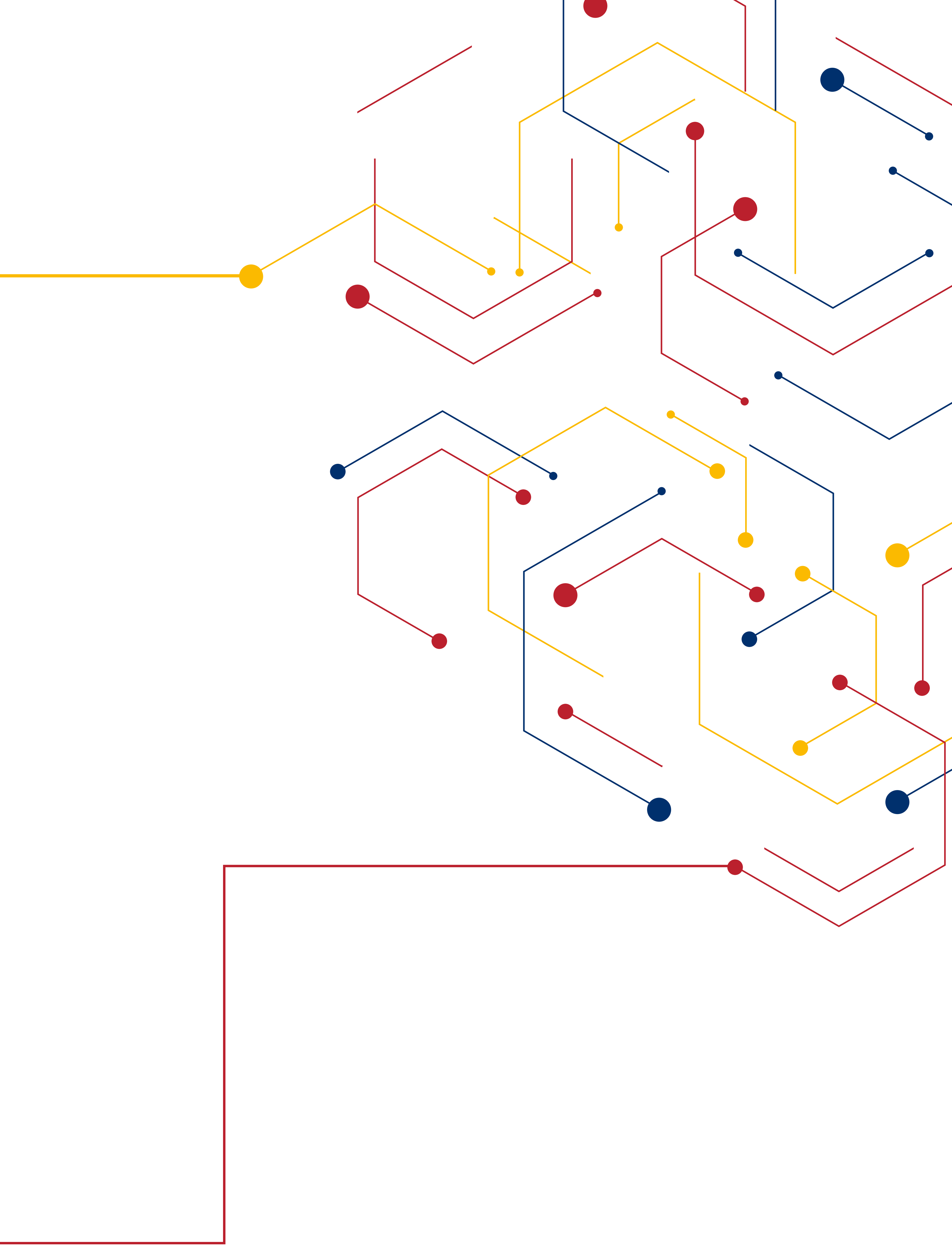
To provide clarity to the owners and leaders of middle market companies, Mazars has developed benchmarks based on the findings of this study, which businesses can use to objectively assess their current position and compare their performance to their peers. These can be found at the end of this report.

If you would like to find out more about how Optimize can benefit your business, please contact a member of our team.

Appendix| Performance benchmarks

		BOTTOM TIER	MIDDLE TIER	TOP TIER
IP Owner	Profitability	< 2.1%	2.1% to 17.8%	>17.8%
	Return	<3.0%	3.0% to 22.0%	>22.0%
Asset Owner	Return	< 3.2%	3.2% to 14.3%	>14.3%
	Strength	<6.4%	6.4% to 202.9%	>202.9%
Service Provider	Profitability	< 1.9%	1.9% to 16.7%	>16.7%
	Return	<2.7%	2.7% to 19.5%	>19.5%
Manufacturer	Profitability	< 2.6%	2.6% to 13.05%	>13.05%
	Return	<4.2%	4.2% to 17.1%	>17.1%
Retailer and Distributor	Profitability	< 1.3%	1.3% to 8.7%	>8.7%
	Return	<3.4%	3.4% to 15.8%	>15.8%

OPTIMIZE®



If you would like to find out more about how Optimize can benefit your business, please contact a member of our team using the email address:

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