

MANUFACTURING MATTERS

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HOW QUALITY OF EARNINGS CAN DRIVE VALUE TO YOUR MANUFACTURING ENTERPRISE

By Jerry Dentinger & Ryan McCaslin

Dealmaking in the manufacturing industry is poised to accelerate in 2017, buoyed by investor optimism around proposed pro-growth economic policies. Despite the modest slowdown in volume last year, multiples and valuations stayed high going into 2017. Therefore, buyers remain laser-focused on understanding a target's profitability model to justify the expensive prices they are paying. The due diligence process continues to be critical to making informed investment decisions and capturing value after closing.

As part of the due diligence process, buyers typically seek out a detailed analysis of a target's Quality of Earnings (QofE). QofE analyses aren't new, but attention continues to grow around Big Data and how to navigate the exponential increase in volume and variety of structured and unstructured data in a due diligence process. This development has added a new layer of complexity—demanding a near-forensic level of detail, further increasing the burden on sellers and raising buyers' appetite for information. For small and mid-sized manufacturers, where QofE processes often start immediately after receiving a Letter of Intent (LOI), introducing another layer of unexpected complexity can add serious anxiety to the sale process.

The proliferation of data, however, is also a major opportunity for both buyers and sellers to analyze and glean meaningful insights and thus gain important leverage during negotiations. For sellers, QofE analysis proactively identifies new areas to create value. For buyers, it helps confirm or challenge value to justify the investment or re-trade the deal.

Increasingly, manufacturers are proactively using data analytics tools to identify new areas where value can be created and proven. No longer viewed as a burden, the QofE process is enabling sellers to take more objective looks at their business and operations prior to sale. It's crucial to understand where your business generates

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Managing a manufacturing or distribution company is not for the faint of heart. Competitive environments can be brutal, consumer demands are relentless and costs seem to rise on a daily basis. With the influx of global imports, rapidly changing technologies and an ever-changing economic landscape, manufacturers of today are facing some very challenging times.

Success in this sector demands swift management decisions, an accurate prediction of future trends and the ability to reduce costs and enhance operational efficiencies. Companies can no longer "go it alone" when tackling these "make-it or break-it" issues. It is crucial to have the guidance and expertise of a trusted business advisory firm. Barfield, Murphy, Shank & Smith is just that firm.

Our highly skilled professionals have the knowledge and experience to guide your organization through complicated situations and tough business decisions. We focus our efforts on the specific issues that are unique to the success of manufacturing and distribution companies. As your partner, we can help you get to the places that you've only dreamed of going before.

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How Quality of Earnings... Continued

value well before bringing a buyer into the picture. Data analytics has proven to be an extremely important means to identify, create and hold value for companies going through a sale.

HOW IS BIG DATA CHANGING THE QofE PROCESS?

QofE is not simply an accounting function—it also helps a buyer understand how and where a business makes its profits. Buyers request QofE analysis to be performed on targets to help them confirm value and identify areas where they can begin to drive returns post-close. The process requires sellers to disclose a significant amount of company data to allow buyers to drill into profitability by customer, product, SKU, geography, distribution channel and a variety of other metrics to understand where value is generated. Sellers are not always comfortable sharing such sensitive information with potential buyers. This friction has increased with the introduction of data analytics.

Historically, sellers have responded to QofE requests by providing as little information as possible. Today, they provide significant confidential information, most of which is delivered in electronic form with multiple large data extracts from their operating systems. QofE teams analyze these data sets manually through sophisticated spreadsheet modeling. All of this is done under tight time frames and often requires significant effort to reconcile and ensure completeness of the information. Most sellers have never provided or analyzed this volume of data—much less in an electronic form—until entering a sale. This can result in a slow start to the QofE process, delays and sometimes cost overruns if sellers are not prepared.

In the manufacturing industry, embedded sensor technology, wireless connectivity and mobile technologies have given companies access to unprecedented levels of data, enabling more sophisticated reporting and metrics. However, combing through these disparate data sets to create actionable

information poses a significant challenge for mid-sized manufacturers unless they use data analytics software that links to their ERP systems. Even then, companies may still struggle to design management reporting that combines operating data with the financial information to meet the rigors of a QofE analysis. Today, few manufacturing companies are able to implement a comprehensive, cost-effective data analytics approach. But that is changing.

With a variety of Big Data tools available, companies can now obtain greater visibility into key financial variables and their relationships, identify gaps and evaluate business opportunities in significantly less time. For both buyers and sellers, leveraging data analytics in conjunction with a QofE process provides valuable insights into where value is created or exposes whether value is sustainable or if it truly exists.

MANUFACTURERS FACE UNIQUE QofE CHALLENGES

QofE analyses can be more challenging for manufacturers than other industries. Why?

- ▶ **Production volume:** Many manufacturers, particularly in sectors like fabricated metals, plastics and components, operate in high-production-volume environments with thin product margins. Analytics and reporting are both critical and challenging because of product costing, hundreds of bills of materials and the sheer number of SKUs. However, this level of complexity presents a significant opportunity to pinpoint value drivers across product lines, channels, geographies and individual customers.
- ▶ **Difficulty understanding costs:** Manufacturers are proficient at tracking direct costs of production and distribution for specific products, but complications arise when accounting for indirect costs, overhead and allocations of variances, particularly if there is strong seasonality to revenues or volatility in the supply chain or marketplace. Errors can occur in standard costing

and overhead allocation methods that affect fully absorbed product costs and thus raise questions about whether a SKU, product family or entire customer relationship is actually profitable. Further challenges arise when companies operate with multiple business lines. Successfully implementing data analytics here generates visibility and adds significant value.

- ▶ **Inventory and working capital:** Manufacturers typically operate with high inventory levels and overall working capital. In a deal, buyers and sellers negotiate a working capital target or “peg” that will be delivered at closing based on an agreed upon methodology and historical performance. Data analytics is starting to play a critical role in setting pegs by, for instance, proactively identifying inventory obsolescence issues down to the SKU level. These tools are facilitating stronger negotiating positions for their users.

A PROACTIVE APPROACH TO QofE ADDS VALUE

Regardless of whether you're considering an immediate sale or looking to increase value through process improvements, these three proactive practices will improve your readiness for the eventual, extremely thorough QofE process.

- ▶ **Mind the GAAP gap.** Keeping your books on Generally Accepted Accounting Principles (GAAP) and as current as possible is prudent if you are considering a sale. Many companies update their ledgers quarterly or even once a year, whether audited or not, and many keep certain accounts on a cash basis. In QofE, you need the historical bookend of a trailing 12-month period on accrual basis, and scopes are usually no less than two full years, often three. Monthly GAAP-based financials and corresponding monthly metrics are key.
- ▶ **Be proactive and understand the QofE process.** Get ahead of

How Quality of Earnings... Continued

the curve and anticipate the demands you will face in the sale process. A QofE is industry standard, and most third-party debt and equity providers require it. Too often sellers aren't aware of QofE requirements until they have an LOI, and regardless of whether it is a proprietary sale process or a broad auction, due diligence is extremely detail-oriented, with no topic left off the table. Technology enabled tools are making the exercise more complex, not less—but they're also necessary to the process. Thus, QofE preparedness should start no later than 90 days before hiring an advisor:

- ▶ **Look in the mirror.** The sooner QofE disciplines are introduced, the sooner value creation can begin for selling shareholders. Sellers should consider “reverse due diligence” one or two years before starting a sale process so they can identify and capitalize on process improvement opportunities to increase long-term value, identify lower versus higher profit operations, and generate a higher purchase price. Today, however, sell-side QofE typically begins when the seller hires an advisor, who shortly thereafter assists the company in the selection of an accounting firm. Better late than never, a seller-initiated QofE at the time of sale will be instrumental to holding value during the sale process. Holding value and certainty to close are the two biggest reasons why sell-side QofE has become a necessary part of a seller's process in the U.S. market—despite being part of the European M&A landscape for decades. Sell-side QofE pays for itself many times over, whether started at the time of sale or years earlier.

Understanding the methodologies behind a QofE analysis, and then approaching it as a best practice—rather than as an accounting function or “check the box” requirement for due diligence—

can help sellers maximize value upon exit. Incorporating data analytics solidifies the understanding where value is created and where to drive the business after sale. Sophisticated buyers are already looking to the future on how to drive value in their targets long before they submit an LOI. Sellers who understand that perspective and prepare for diligence

accordingly will facilitate greater success for themselves and all parties in the transaction.

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Advanced Software Checklist: 4 Steps Manufacturers Should Take Before Investing in ERP in Industry 4.0

By *Eskander Yavar*

The arrival of Industry 4.0, or the fourth industrial revolution, signifies the next era in manufacturing, in which plants, processes, products and people come together in an entirely new way, enabling decentralized, autonomous decision-making on factory floors. Sometimes used interchangeably with the “Industrial Internet of Things”—a term coined by GE CEO Jeff Immelt—Industry 4.0 refers to digitally connected manufacturing, characterized by “smart” factories and smart supply networks. Born out of a confluence of technology advancements—from the Internet of Things to artificial intelligence to 3-D printing—Industry

4.0 ultimately hinges on the ability to integrate data with physical processes across the entire value chain.

That's where Enterprise Resource Planning (ERP) and Material Requirements Planning (MRP) come in. ERP is a system for integrating a company's data from all core business components into a single place to automate decisions and streamline operations.

The question for manufacturers isn't whether they have an ERP system in place, but whether their ERP system is

Advanced Software... Continued

compatible with the way they use information now and the way they want to use information in the future. Can your ERP software capture information from third-party systems? Can it process and contextualize data in real time? Can you easily add new features when you add new applications or business processes? The answers to these questions aren't one-size-fits-all. Most manufacturing companies can orient themselves within a process continuum. One end corresponds to the repetitive and discrete and the other to the highly sophisticated and engineered-to-order. ERP software strategy should align with where the company falls along that spectrum and where it wants to go, informing the level of technological sophistication required in the software and the level of discipline in planning.

For middle-market manufacturers, investing in an ERP and/or MRP system can help manage resources, drive efficiencies and position them to more effectively compete with larger players with more resources. ERP may not be as "sexy" as artificial intelligence or robotics—but it's a necessary precursor to embarking on any Industry 4.0 journey.

Here are four things manufacturers should do to maximize their investment in an ERP system:

BALANCE RISK AND REWARD ALONG THE COMPLEXITY CONTINUUM

The more complex the manufacturing process, the more rewarding it can be for operations and the bottom line to build and implement strategies for ERP systems to eliminate redundant systems and processes. And conversely, manufacturers with complex operations can also experience more painful financial and operational consequences if they don't do that well.

UNDERSTAND WHAT FUNCTIONALITIES YOU NEED

ERP software can afford companies many benefits, including:

- Managing compliance and regulatory requirements
- Increasing inventory accuracy and materials planning
- Increasing on-time deliveries
- Enabling more efficient and meaningful reporting
- Improving management decision-making
- Improving customer service
- Consolidating databases
- Enabling a paperless factory

While even the smallest manufacturer can achieve all these benefits, it's important to consider how ERP needs to work for your business and which vendor's software will best position you to achieve your goals. Across the board, though, ERP can empower manufacturers to understand how they've historically sourced, made and distributed a product, as well as how they can repeat cost-effective processes and drive efficiencies across the entire enterprise.

MASTER THE BASICS

The flashier and more sophisticated ERP software gets, the more companies will need to be mindful of how the tool can help them solve a specific organizational problem, or their investment could risk going to waste. Before investing in an advanced supply chain planning tool, for example, they need to master the basic modules. Mastery of the basics will be more critical than ever as we look toward the next technological advances—things like Industry 4.0 and widespread adoption of the Internet of Things and more data-driven business intelligence.

CLEAN UP YOUR DATA

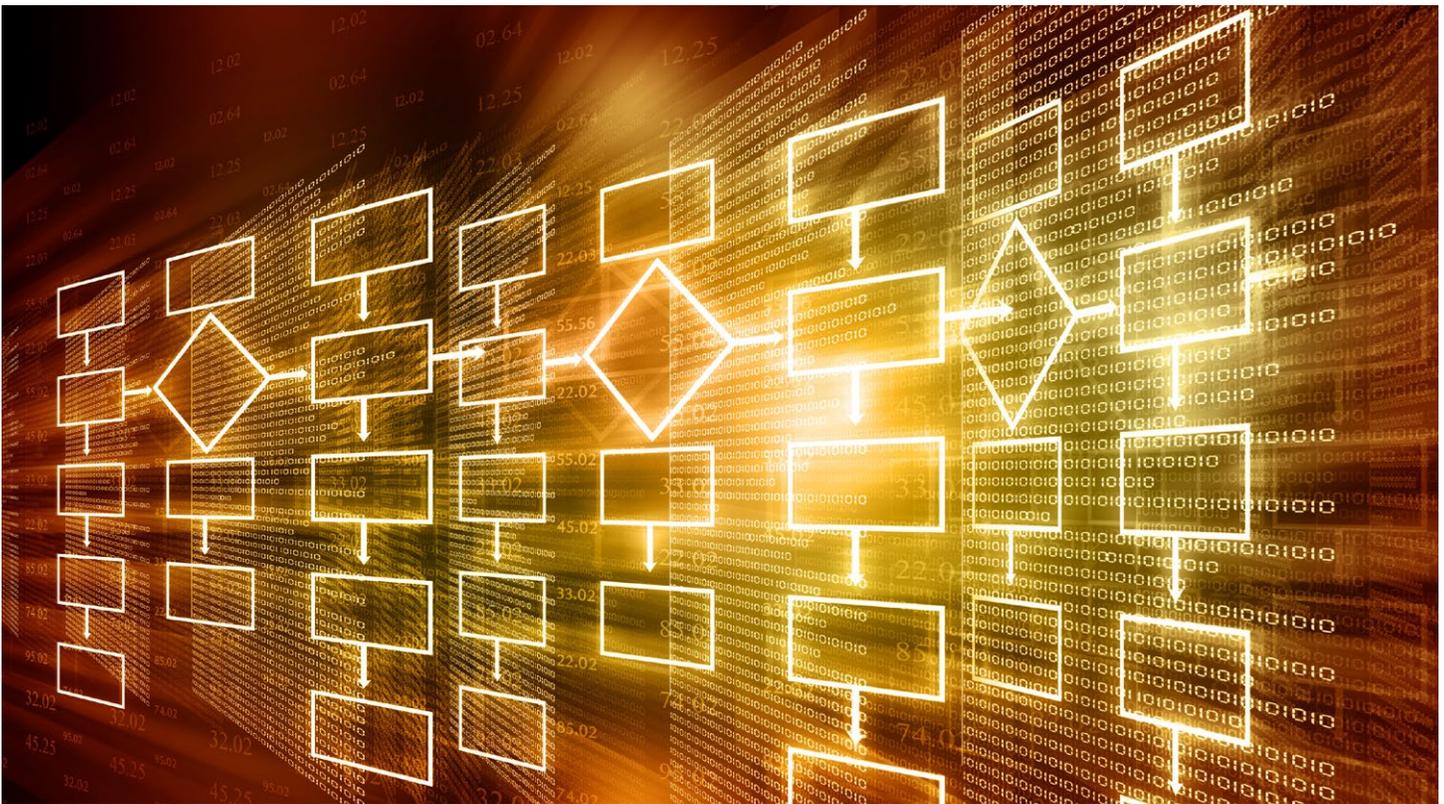
Successful adoption of Industry 4.0 technologies is predicated on a disciplined process, clean data and organized teams.

And at the core of ERP strategy and implementation is the integrity of an organization's data. There are more opportunities for errors when machines cooperate autonomously with one another based on flawed data.

Because Industry 4.0 fundamentally changes the role of the operator, building systems that maintain the integrity of certain production processes without the same level of human oversight remains one of the main challenges to implementation. If the underlying data or data analysis has errors, the automated decision-making based on that data will be riddled with errors too. This means it's critical to ensure data is clean, accurate and accessible as part of an overall information governance strategy. Just as a contractor wouldn't build over a cracked foundation, embracing technological advancements without the right fundamentals of information governance, IT strategy and analytics capabilities could result in a flawed execution.

With these fundamentals in place, ERP can be a useful tool for middle market manufacturers looking to save on time and material costs and drive efficiencies enterprise-wide. And as Industry 4.0 becomes a reality for more manufacturers, smart, strategic use of ERP software can help middle market manufacturers leverage those benefits to maintain their competitive edge.

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SOFTWARE DEVELOPMENT PRODUCES SIGNIFICANT TAX BENEFITS FOR MANUFACTURERS

By Rick Schreiber, Chai Hoang and Chris Bard

Last year, over 6,000 manufacturers claimed more than an estimated \$10 billion in research tax credits (RTCs), with each manufacturer's average benefit exceeding \$1 million. Generated in part by manufacturers' efforts to develop new and improved products and processes, these benefits were also generated by their continued investment to develop or improve software to manage or automate production processes and business intelligence, among other things. This year, thanks to new regulations that broaden the range of software development activities eligible for the credit, more manufacturers may be able to take even greater advantage of these dollar-for-dollar offsets against tax liability, enabling them to invest more in new technologies, expand their labor force and finance other business objectives.

RTC EXPLAINED

Often also called the "R&D credit," the

research tax credit is an activities-based credit. Federal and state RTCs are available, in general, to businesses that attempt to develop or improve the functionality or performance of a product, process, software or other component using engineering, physics, biology or the computer sciences to evaluate alternatives and eliminate uncertainty regarding the business' capability or method to develop or improve the component or the component's appropriate design (Qualified Research). RTCs equal to up to an average of 10 percent of qualified spending, which generally includes taxable wage, supply, contractor and cloud-computing expenses related to these attempts. More than 6,000 manufacturers reported performing qualified activities last year, and a recent [BDO/MPI Survey](#) shows that this number could be double that. More than a majority (57 percent) of survey respondents said they weren't planning to claim tax incentives like the RTC, even though they were planning to do development work to leverage

the Internet of Things to capture and communicate more data more accurately and reliably. This type of work likely qualifies for the RTC, but many respondents said they weren't going to claim it because they thought they lacked sufficient documentation or weren't performing qualified activities. Happily, these aren't good reasons not to claim the RTC: several court cases have affirmed that oral testimony can be used to claim and support RTCs; and any manufacturer trying to make something better, faster, cheaper or greener is likely to be performing qualified activities, whether the activities succeed or not. To that point, manufacturers in the following sub-sectors reported RTCs in 2013, the latest year for which IRS statistics are available:

Software Development... Continued

Manufacturing Sub-sector	Credit Amount	% of Total	# of Returns	% of Total	Average Credit
Computer and electronic	2,058,428,000	30%	1,230	20%	1,673,519
Transportation equipment	1,638,899,000	24%	390	6%	4,202,305
Chemical	1,507,507,000	22%	812	13%	1,856,536
Machinery	424,007,000	6%	882	14%	480,734
Electrical equipment, appliance, component	334,405,000	5%	590	9%	566,788
Miscellaneous	268,509,000	4%	698	11%	384,683
Food	105,584,000	2%	234	4%	455,915
Fabricated metal	99,027,000	1%	556	9%	178,106
Paper	86,658,000	1%	85	1%	1,019,506
Petroleum and coal	81,873,000	1%	54	1%	1,514,500
Plastics and rubber	64,530,000	1%	243	4%	265,556
Primary metal	63,233,000	1%	151	2%	418,762
Nonmetallic mineral	25,220,000	0%	74	1%	340,811
Beverage and tobacco	21,113,000	0%	22	0%	959,682
Furniture and related	14,588,000	0%	56	1%	260,500
Textile mills and textile mills	10,923,000	0%	39	1%	280,077
Printing and related support activities	9,834,000	0%	45	1%	218,533
Apparel	7,390,000	0%	21	0%	351,905
Wood	7,280,000	0%	51	1%	142,745
Leather and allied	2,281,000	0%	7	0%	325,857
Total	6,832,299,000	100%	6,240	100%	1,094,920

And although many of these credits related to attempts to design and develop new products and processes, many also related to efforts to develop new or improved software.

SOFTWARE DEVELOPMENT RTC OPPORTUNITY EXPANDED

New final Treasury Regulations issued in October will increase the RTCs manufacturers claim for software development.

Under current and former rules, software development activities fall into two categories, depending on whether the software being developed is intended primarily for the taxpayer's internal use or not. What category the software falls into is important because "internal use software" (IUS) development activities must meet a higher standard to qualify than activities to develop non-IUS software.

The Final Regulations narrow the

definition of IUS considerably. This means that considerably more software development activities are eligible for the credit, which means that more manufacturers may claim more RTCs going forward.

IUS is software developed for use in general and administrative (G&A) back-office functions that facilitate or support the conduct of the company's trade or business. G&A functions are defined as financial management functions, human resource management functions and support services functions. Whether software is IUS depends upon whether the taxpayer, at the beginning of development, intended the software to be used primarily for G&A purposes. Software is not IUS if it is developed to enable a taxpayer to interact with third parties or to allow third parties to initiate functions or review data on the taxpayer's system.

IUS development may also qualify. The regulations also provide that Qualified Research to develop IUS qualifies if it:

1. Is intended to develop software that would be innovative, i.e., result in a reduction in cost, improvement in speed or other measurable improvement that is substantial and economically significant;
2. Involves significant economic risk, as where the taxpayer commits substantial resources to the development and there is substantial uncertainty, because of technical risk, that such resources would be recovered within a reasonable period. The focus should be on the level of uncertainty and not the type of uncertainty; and
3. Is intended to develop software that isn't commercially available for use by the taxpayer without modifications that would satisfy the first two requirements.

MANUFACTURERS AND THE RTC TAX CREDIT

The new regulations apply to a vast array of manufacturers' activities, and businesses in this space should consider whether they're missing out on opportunities to benefit from the RTC. Manufacturers have undertaken

Software Development... Continued

an effort to digitalize their operations, supply chains and markets. Companies are increasingly engaged in the development and improvement of business-intelligence software systems and enterprise-resource-management tools. The development, optimization and integration of the Internet of Things to enhance manufacturing and related processes also often qualify for RTCs.

Additionally, sales and operations planning require data from all aspects of a business, from production throughput and distribution and warehousing to financial metrics. The development and implementation of software to monitor and manage back-office functions could qualify for the RTC, e.g. activities to develop software related to:

- Supply chain functionality;
- Forecasting based on historical baselines, promotions and sales;

- Pricing optimization, of both sales to consumers and procurement of supplies;
- Inventory management;
- Order management;
- Revenue management;
- Routing engineering/software development; and
- Security against cyber-attacks.

Because the final regulations exclude from the definition of IUS software that is developed to enable a taxpayer to interact with third parties or to allow third parties to initiate functions or review data on the taxpayer's system, manufacturers should review their software against the new definition and standards. For example, software developed to manage supply orders, sales or production data with third parties, or to enable customers or third parties to track delivery of goods, search inventory, or receive services over the internet, may qualify under the new regulations, without having to meet the

higher standards for IUS.

CONCLUSION

Manufacturers of all sizes have been benefitting from the RTC since its inception in 1981. Now, with the new regulations on software development, many more should be able to benefit more than ever before, thus reducing their taxes, freeing up capital and gaining a competitive advantage. In addition, smaller manufacturers may be able to use the RTC against up to \$250,000 of their payroll taxes or even their Alternative Minimum Tax.

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PERSPECTIVE IN MANUFACTURING A FEATURE EXAMINING THE ROLE OF PRIVATE EQUITY IN THE MANUFACTURING SECTOR

The new administration's pro-economic growth agenda has spurred optimism among the investment community, and most agree the coming year is primed for a healthy cadence of deals.

In fact, in a poll BDO conducted in January, 71 percent of fund managers characterized the investment environment as favorable. That represented a 15 percentage point jump from managers who said the same prior to the November election results (56 percent).

While the industry continues to barrel toward innovation, traditional manufacturers of components and parts for a variety of applications—including industrial application and consumer products—continue to garner interest from private equity and strategic buyers. With trade policy front and center and, if proposals aimed at fortifying domestic manufacturing come to fruition, companies in the sector could be poised

to see a much bigger influx in private equity investment.

Given the private nature of most transactions, it is difficult to say whether the following proved to generate good returns for the sellers or smart investments for the buyers, but here are a few transactions that characterize the pace and breadth of activity in recent weeks:

In a deal announced Jan. 4, Graham Partners sold blow molder Western Industries to Michigan-based Speyside Equity Fund. Terms of the deal were not disclosed, reports *Plastics News*. Speyside, a 12-year-old fund, targets manufacturing businesses in specialty chemicals, food and metal-forming, among others. Western Industries' plastics unit, which the company says is home to one of North America's biggest collections of plastic presses, specializes in large and complex plastics products and components for industrial and consumer end-markets. They also offer assembly, packaging and logistics services.

Gladstone Investment Corporation, a publicly traded business development firm that makes debt and equity investments, has announced plans to sell its equity interest and the prepayment of its debt investment in Behrens Manufacturing to Mill City Capital, a producer of branded metal containers. Gladstone, which acquired Behrens in 2013, has seen its shares rally six percent since that announcement on Dec. 19.

Bain Capital Private Equity, meanwhile, has announced it will buy Innocor Inc. from Sun Capital Partners Inc. in a deal set to close in the first quarter of this year; according to *The Middle Market*. Innocor, a New Jersey-based manufacturer of polyurethane foam products and home furnishings, owns 22 plants and distribution centers across the U.S. The Middle Market reports that home furnishings manufacturers are the beneficiaries of increased demand tied to an uptick in new home sales. Z Capital Partners' investment in Twin-Star

PEerspective In Manufacturing... Continued

International and Mattress Firm Holding Corp.'s deal with Sleepy's are two examples of buyer interest driving deals in this space.

In the food sector, PE Hub reports Charlesbank Capital Partners announced in January the sale of food manufacturer and packaging and supply chain management provider Peacock Foods to Greencore Group plc, an Ireland-based convenience foods producer. Illinois-based Charlesbank focuses on companies in the automation, packaging and processing subsector. The firm operates seven manufacturing facilities.

In December, Platinum Equity completed the acquisition of two Asia-based manufacturing enterprises: Foam Plastics Solutions, a leading maker of protective packaging; and Flow Control Devices, a manufacturer of valves, fittings, sensors and other components, reports PE Hub. The Trump administration's focus on reshoring American manufacturing, however, could dampen interest in foreign manufacturers in the coming months. This will be a trend for domestic manufacturers to watch as it could add to buy-side demand and drive up valuations for U.S. manufacturing firms.

FUTURE PERSPECTIVES: WHAT'S UP NEXT FOR MANUFACTURING INVESTORS

In light of uncertainty around U.S. global trade policy under the new administration, we could see technology companies in particular begin expanding U.S. manufacturing operations, according to Business Insider. For example, Nikkei reports that Japanese manufacturer Sharp, owned by Foxconn—Apple's top manufacturing partner—is mulling a screen factory in the U.S. Foxconn is an investor in Softbank's Vision Fund, which insiders report could be leveraged to purchase technology assets or make a private equity deal. U.S.-based factories may be subject to increased costs due to higher labor costs and reliance on Asian parts suppliers. If tech darling

Apple begins increasing its manufacturing footprint in the U.S., other companies could follow suit. This trend would likely lead to more private equity dollars investing in the domestic technology sector.

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DID YOU KNOW?

A new [study](#) by the Motor & Equipment Manufacturers Association found auto parts manufacturing jobs in the U.S. have risen 19 percent since 2012, with more than 871,000 Americans employed in the sector.

Fifty-seven percent of small- to medium-sized manufacturers reported they were likely to see strong to mild month-over-month growth, according to [Xometry's Small Manufacturing Index](#).

According to a late January [projection](#) from the Congressional Budget Office,

President Donald Trump inherited a government on track for a \$559 billion budget deficit in the ongoing budget year.

Readiness for the Food Safety Modernization Act, which processors are required to comply with by September, ranked as the third most important issue for the food production sector in 2017, according to Food Processing's [Manufacturing Outlook Survey](#).

The Institute for Supply Management's employment gauge for manufacturing [grew](#) to 53.1 percent in December 2016, the highest level since mid-2015.