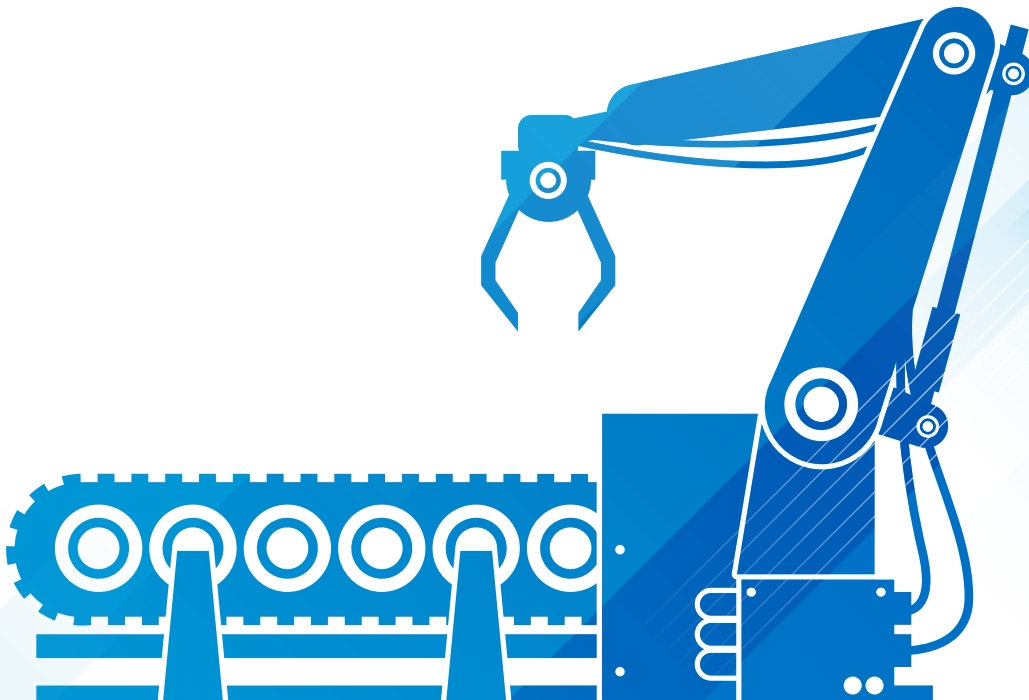




NATIONAL CENTER FOR
THE MIDDLE MARKET



A SPECIAL REPORT BY THE NATIONAL CENTER FOR THE MIDDLE MARKET

MIDDLE MARKET MANUFACTURING

How to Thrive in a Transforming Environment

IN COLLABORATION WITH



THE OHIO STATE UNIVERSITY
FISHER COLLEGE OF BUSINESS



CHUBB®

About This Report

The U.S. middle market over-indexes on manufacturing: Manufacturers represent approximately 17% of middle market companies compared to about 12% of the economy as a whole. Clearly, manufacturing is key to the success of the middle market, which in turn, drives the overall U.S. economy.

While middle market manufacturing is growing and the business climate has markedly improved, these businesses currently face a unique set of challenges to the way they operate. This report serves to better understand the environmental conditions, challenges, and opportunities middle market manufacturers currently face and to uncover what actions the best-performing middle market manufacturers are taking to mitigate new risks and capitalize on new opportunities resulting from the evolution in the industry. The report presents key findings and best practices manufacturers can use to navigate the shifting components of the environment and identify strategies for continued growth and success.

HOW THE RESEARCH WAS CONDUCTED

The National Center for the Middle Market worked with experts from Chubb as well as its sponsors, SunTrust Banks, Grant Thornton, and Cisco Systems, and faculty advisors from The Ohio State University Fisher College of Business, to review research and data and understand the broad challenges middle market manufacturers face. On this basis, the Center then interviewed 250 strategic and financial decision makers from middle market manufacturing companies. Respondents were roughly evenly split between Component Parts Manufacturers (CPMs) and Original Equipment Manufacturers (OEMs). They replied to a 20-minute self-administered online survey conducted between March 26 and April 6, 2018.

Executive Summary

The business climate for middle market manufacturers has improved markedly since the end of 2015, and the manufacturing segment has experienced steady growth in both revenue and employment. But with this growth have come a number of critical and interconnected challenges that have caused manufacturers to rethink and evolve virtually every aspect of their operations.

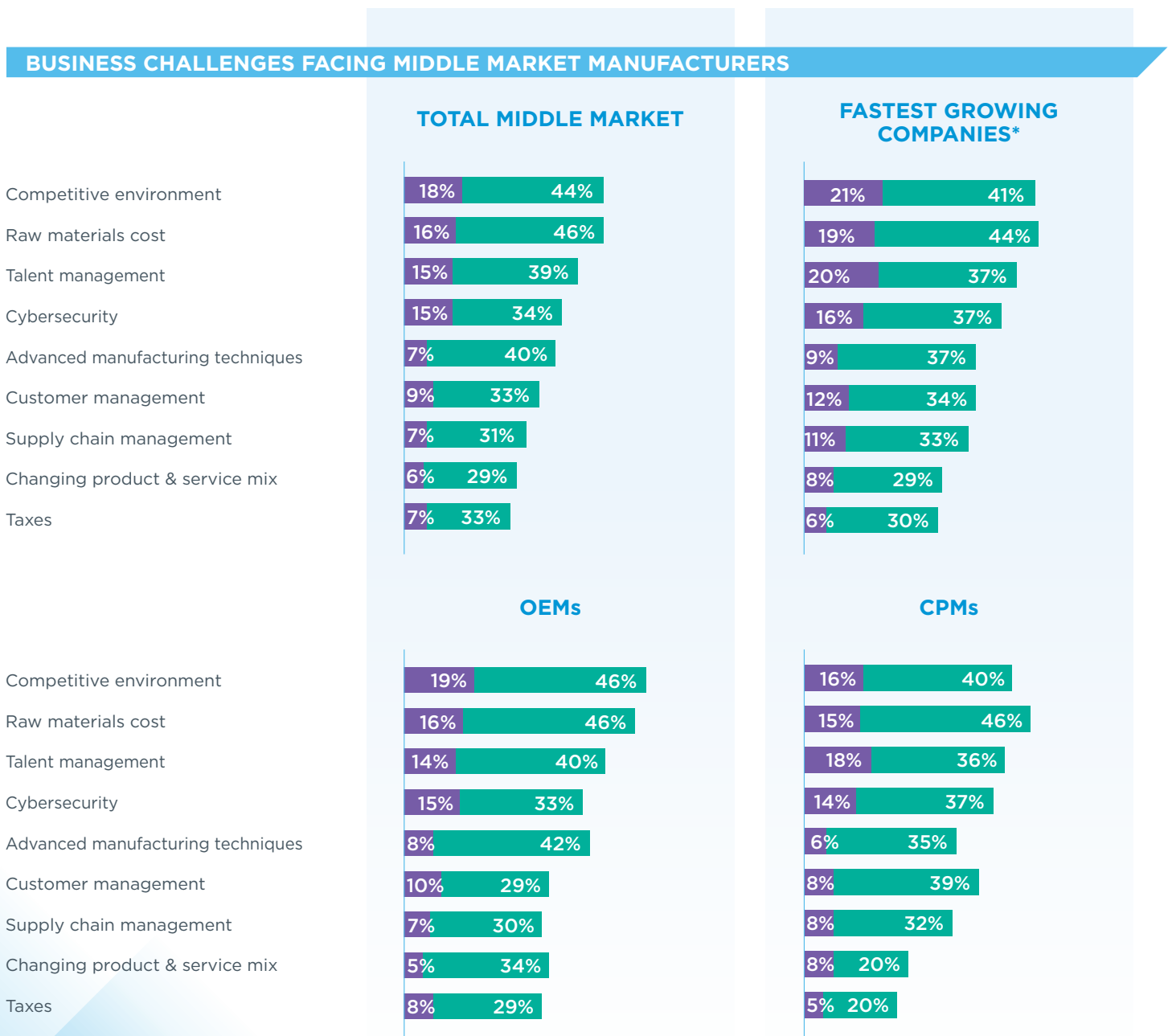
Mounting competition and globalization, rising costs, and skills shortages are urgent issues that each influence the others, making the overall challenge significantly greater than the sum of any one part. This has resulted in a manufacturing environment that is much more complex today than it was five years ago.

At the same time, technological advancements, increasing collaboration among businesses in the same value chain, and changes to product and service mix offer manufacturers new paths to winning, as long as the challenges can be mastered.

While middle market manufacturers have new opportunities—new markets to serve, new ways of winning and keeping customers, and new flexibility in operations—they also confront new exposures for which they may not be fully prepared. These include financial and competitive challenges, safety and cybersecurity risks, regulatory and political uncertainty, and talent and workforce development problems. With a better understanding of the increased potential for growth and how to manage and mitigate new risks, U.S. middle market manufacturers can position their businesses to continue to excel and achieve new levels of performance.

Manufacturers' Challenges: An Overview

Manufacturers cite a host of challenges that impact business performance. They range from generic issues like taxes to more industry-specific concerns, such as the cost of raw materials and the impact of trade policies. The issues can be clustered into five major categories: competition, upstream and downstream relationship management, product and service mix, technology, and talent. While manufacturers describe the individual issues as highly challenging in their own right, when the issues combine (rising costs in a highly competitive environment, for example) they become that much more complex to navigate.



* >10% annual revenue growth

■ Extremely challenging ■ Very challenging

Middle market manufacturers face increasingly intense competition driven by globalization and consolidation

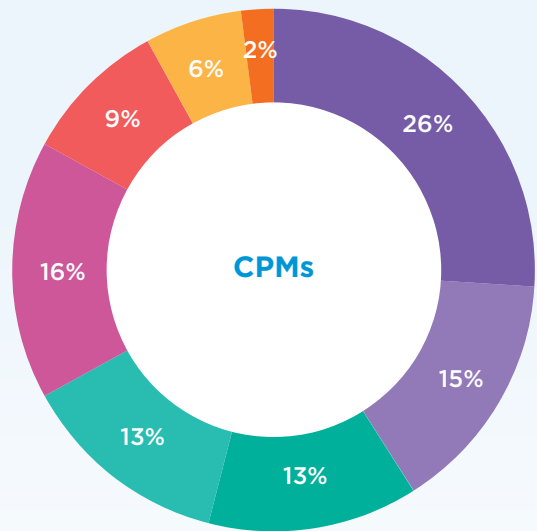
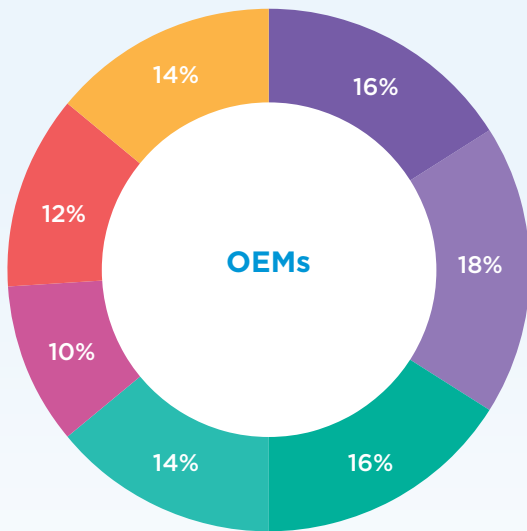
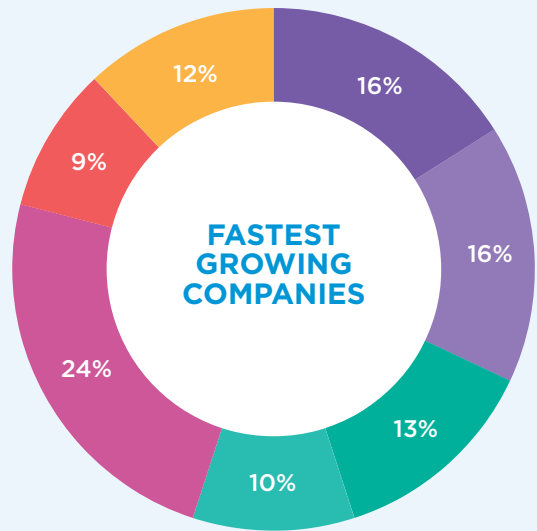
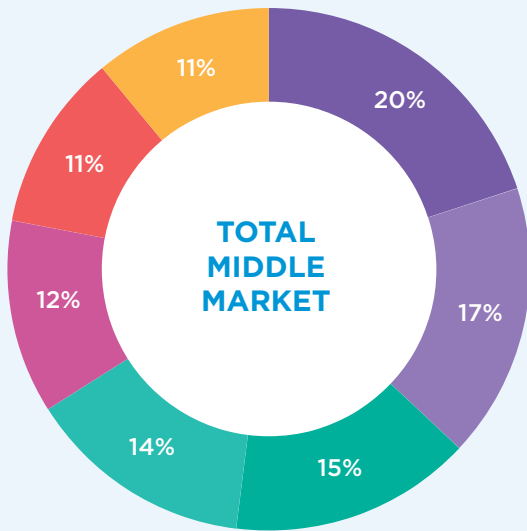


- » *Margins are under pressure*
- » *To maintain a competitive edge, manufacturers must innovate across product mix, technology, and service*

The vast majority—86%—of middle market manufacturers say the business environment is more competitive today than it was five years ago. This is especially true for original equipment manufacturers, who list competition as their number-one business challenge. However, component parts manufacturers feel the pressure, too. CPMs are particularly affected by globalization, the number-one factor contributing to the intensified competition in the industry. For OEMs, consolidation of suppliers and competitors is just as much of an issue as globalization. Customer consolidation is having an impact as well.

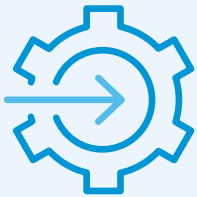
The squeeze of competition all along the value chain is putting tremendous pressure on costs. The cost of raw materials ties competitive environment as a top business challenge, and for CPMs, costs are the biggest headache right now. Manufacturers are also worried about the impact of potential tariffs, and competition is making it difficult for manufacturers to pass on costs in the form of price increases. Manufacturers must find other ways to make up or cover the additional expenses.

WHAT IS HAVING THE BIGGEST IMPACT ON THE COMPETITIVE ENVIRONMENT



- Globalization
- Consolidation of customers
- New competitors from other industries
- Consolidation of firms like yours
- Businesses like yours expanding
- Consolidation of suppliers
- Disruptive entrants
- Other

Manufacturers' relationships with suppliers and customers are in flux



- » *Supply-chain customers demand greater speed and transparency*
- » *CPMs and OEMs are forging increasingly collaborative relationships and growing faster as a result*
- » *Integration between suppliers and customers is on the rise*

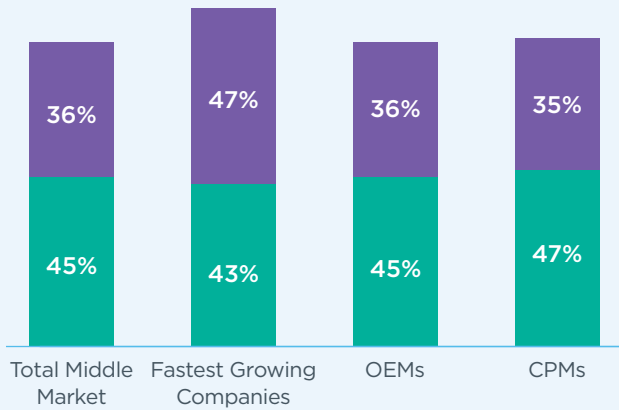
As consolidation along the value chain drives increased competition in the industry, it's changing the nature of both upstream and downstream relationships for middle market manufacturers. The majority of manufacturers, and particularly CPMs, say collaboration has increased with their suppliers and—especially—with their customers over the past five years. The fastest-growing manufacturers are strengthening relationships both up and downstream to a greater extent than their slower-growing peers.

At the same time, and due in part to this increased collaboration, 71% of all manufacturers (and 88% of the fast growers) believe their role in the supply chain has become increasingly important in recent years. Just-in-time inventory management and tightening timelines make it more critical than ever for manufacturers to hit deadlines. As customers demand more speed, more reliable cycle times, and more transparent relationships, manufacturers are expecting the same from their suppliers. All of this has led to greater integration between suppliers and customers and with providers of third-party logistics, IT, and financial services—a trend that we also saw among the fastest-growing middle market companies in *The Perfect Link*, our supply chain report published in 2017.

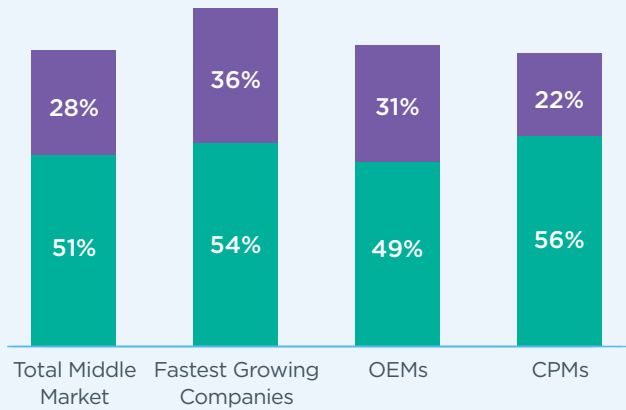
SUPPLY CHAIN PERCEPTIONS

SPEED

Our customers expect faster cycle times now than they have in the past

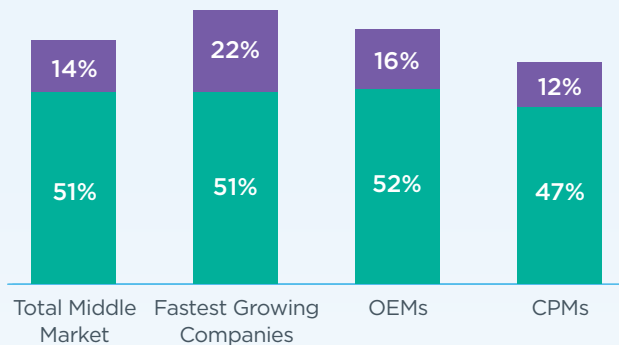


We expect faster cycle times from our suppliers than we have in the past

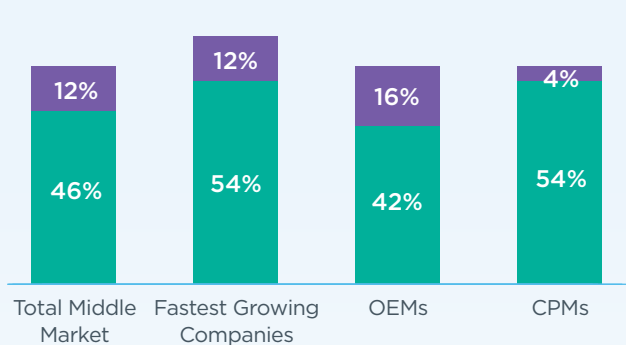


DIGITIZATION

Digitization has made supply chain management simpler

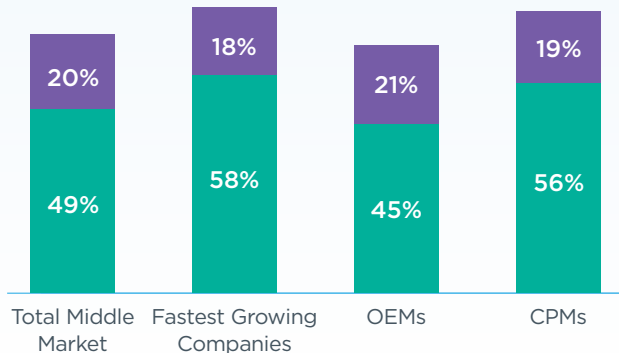


Digitization of the supply chain has resulted in shorter timelines

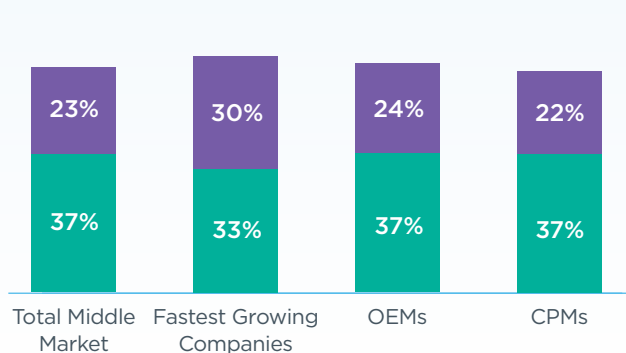


POLICY & REGULATION

Regulations make supply chain management more complicated



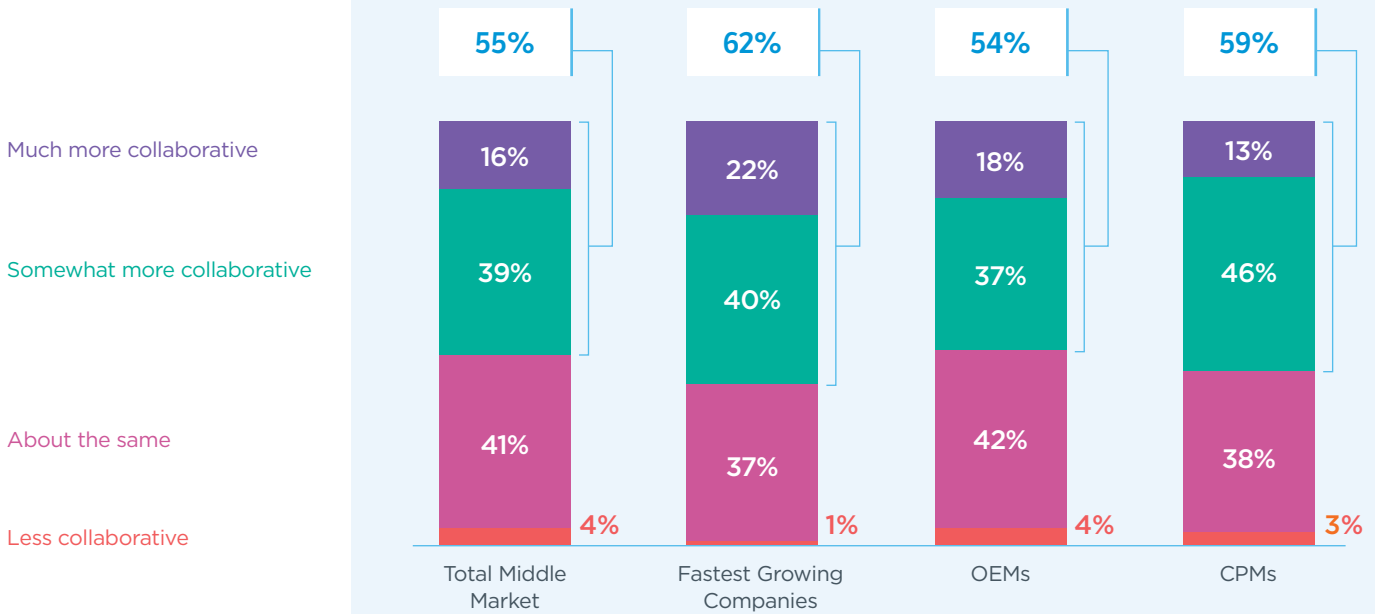
Import tariffs would likely have a major negative impact on my supply chain



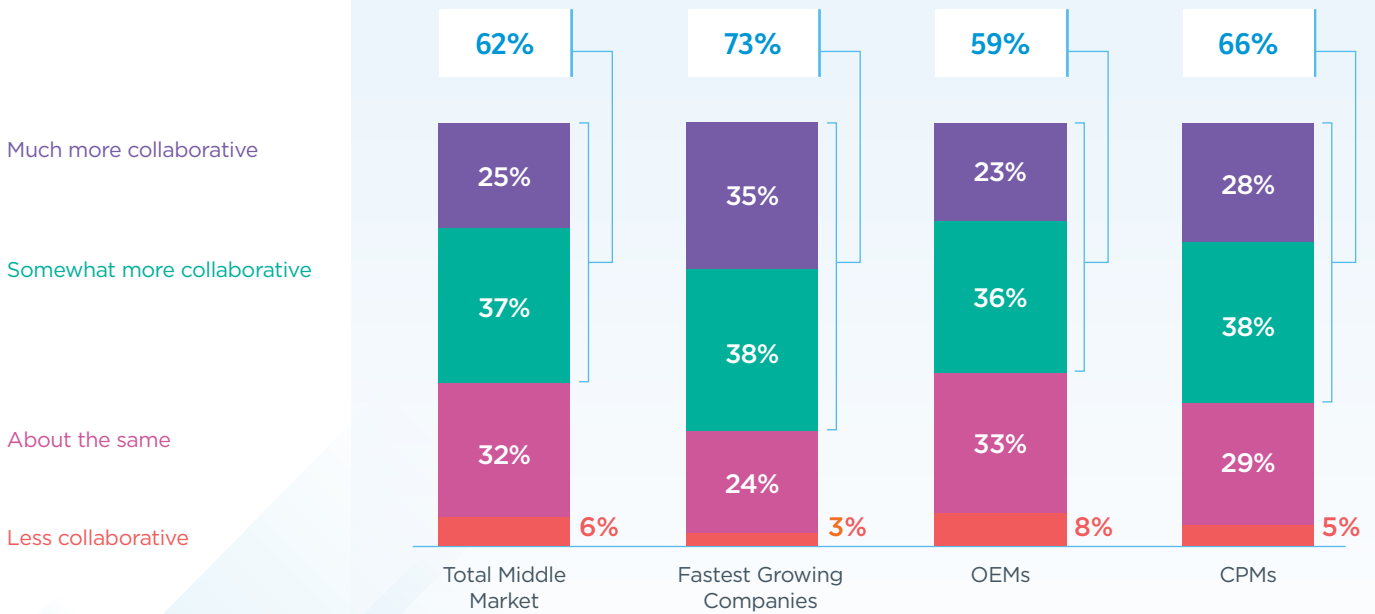
■ Agree completely

■ Agree somewhat

RELATIONSHIPS WITH SUPPLIERS

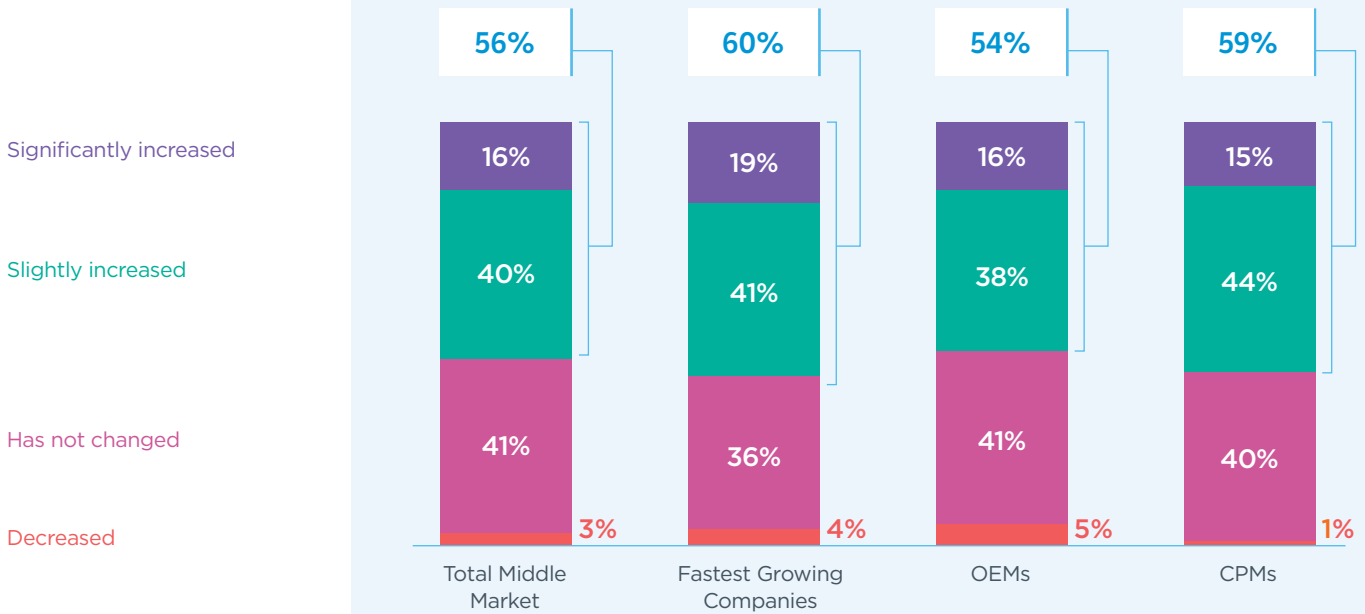


RELATIONSHIPS WITH CUSTOMERS

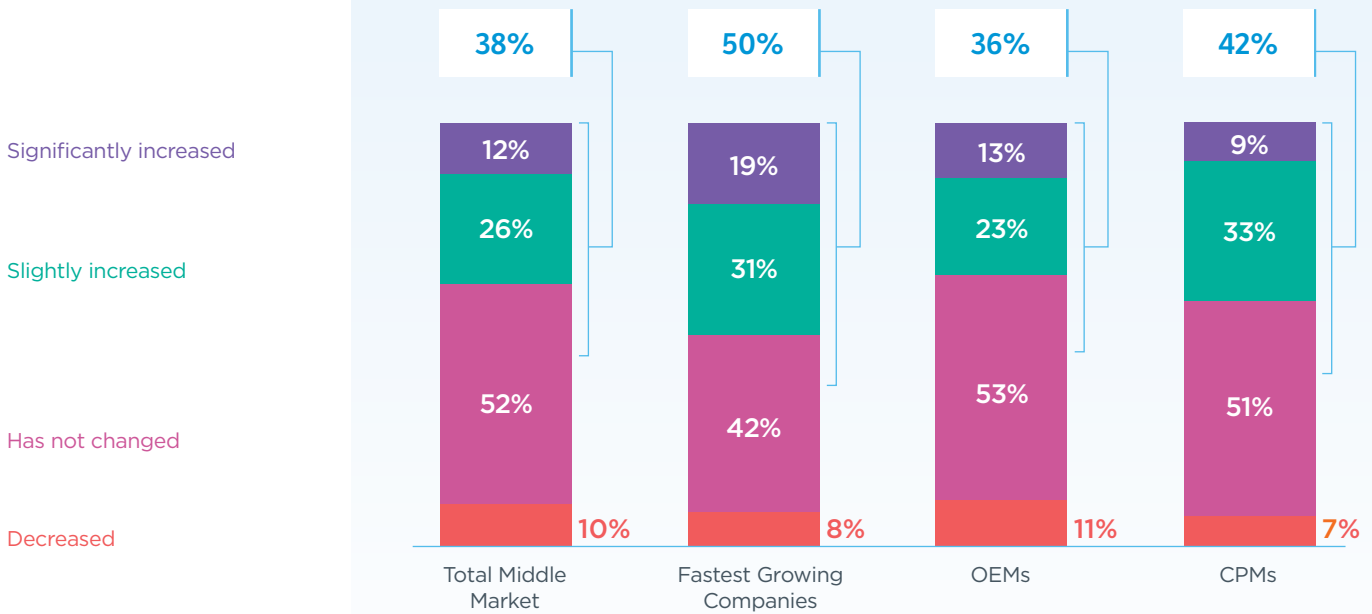


CHANGE IN INTEGRATION OVER PAST 5 YEARS

UPSTREAM



DOWNSTREAM



Manufacturers are changing the mix of what they sell



- » *A majority now offer value-added services*
- » *Product lines have become somewhat less diversified*
- » *"Smart products" are steadily entering the market*

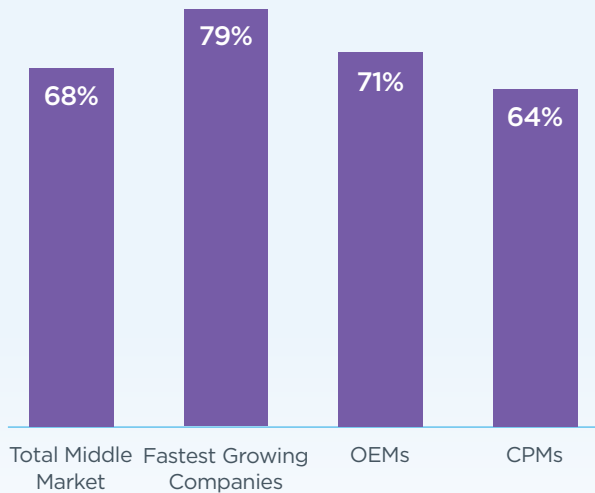
As supply chains integrate and competition mounts, middle market manufacturers are switching from a product-only model to selling value-added services in order to stand out in the market, solidify customer relationships, and bring in more revenue. These offerings may include installation, maintenance, financing, consulting, and more. More than two-thirds of manufacturers, OEMs in particular, have added services or “solutions” to their offering in the past five years, and half of these businesses say they generate more revenue as a result—17.1 percentage points more on average. Additionally, this group experienced year-over-year revenue growth of 9.7%, compared to 5.7% for all others. Among the fastest-growing middle market manufacturers, nearly four out of five have added services or solutions, and 62% have enjoyed boosts in revenue.

Product mix is evolving, too. Overall, the industry is moving toward specializing on a more focused product mix—being the best at fewer things—but this trend is not universal. While 44% say they have become more focused, 36% say they are more diversified. Overall, diversification seems to drive faster revenue growth, especially for CPMs. Looking forward, diversified manufacturers make stronger revenue growth predictions for the next 12 months than focused manufacturers. Top-line growth is not the same as profitability, of course, and it is possible that the more focused group places more emphasis on profits.

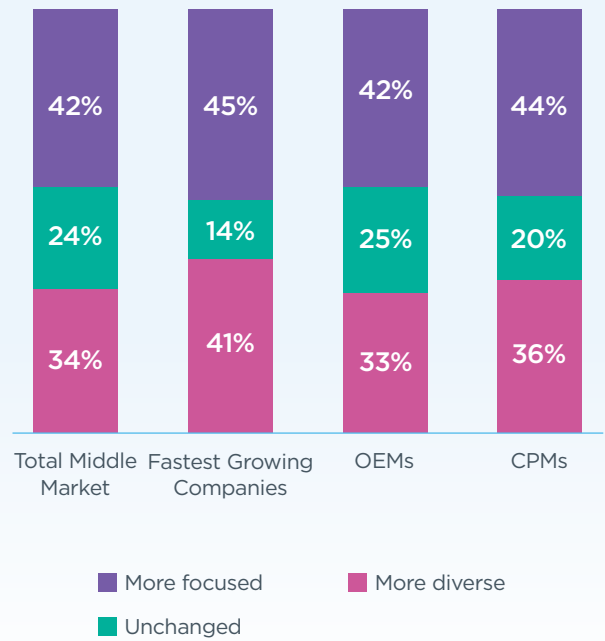
Given advancements in technology, smart products—products equipped with microchips, sensors, and other electronic components that allow them to communicate with other products or services—are coming off many manufacturers’ production lines, and are being planned by many other companies. About three out of five manufacturers produce some smart products, but these devices typically make up less than 25% of the product mix. Fast-growing manufacturers are somewhat more likely than slower-growing firms to produce intelligent devices. Companies that do make smart, connected devices for the so-called Internet of Things (IOT) boast faster revenue growth and have healthier predictions for growth in the future.

With most manufacturers changing products or adding services or both, companies must rethink their business models and talent mix in order to support their new offerings. They may be exposed to new risks and liabilities. They probably need new capabilities, new types of selling skills, and new ways of measuring profitability and productivity, adding yet another element of change to the equation.

HAVE BEGUN OFFERING VALUE-ADDED SERVICE IN PAST 5 YEARS



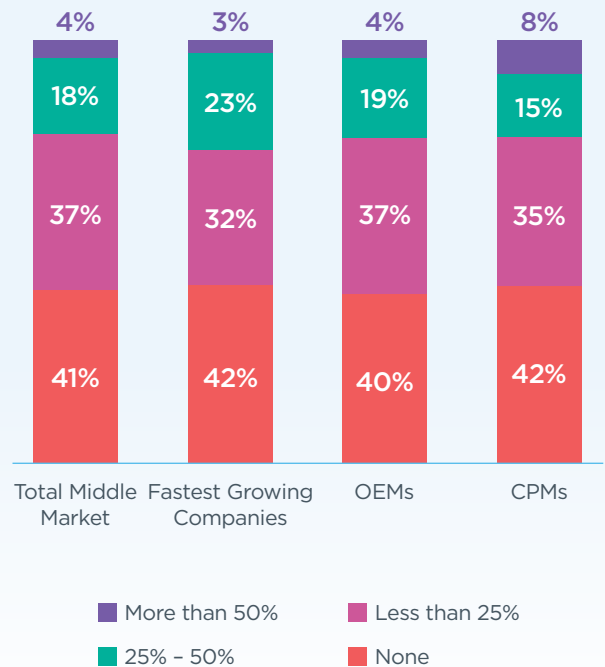
CHANGE IN PRODUCT MIX OVER PAST 5 YEARS



CHANGE IN REVENUE FROM VALUE-ADDED SERVICES

	Total Middle Market	Fastest Growing Companies	OEM	CPM
More revenue	50%	62%	50%	51%
Same revenue	45%	36%	44%	46%
Less revenue	5%	2%	5%	4%
Average change	8%	11.8%	8%	8%

PROPORTION OF OUTPUT CONSISTING OF "SMART PRODUCTS" (IOT)



Technology is rapidly changing factory floors and manufacturing processes



- » *Technological advances positively impact productivity and growth*
- » *Wearables are becoming more prevalent*
- » *Cybersecurity will become increasingly important*

Technology has altered not only what manufacturers make, but how those items are made. Factory operations have changed rapidly because of automation, robotics, and the implementation of advanced manufacturing techniques—which manufacturers view as both a challenge and their greatest area of opportunity.

Most executives believe technology advances are a good thing. Over the past year, they have invested most heavily in new materials, advanced process controls, robotics and automation, along with cybersecurity. Nearly all—90%—say the impact of these technologies has been positive, and they believe they will continue to foster greater productivity, enable more customization, and allow for growth.

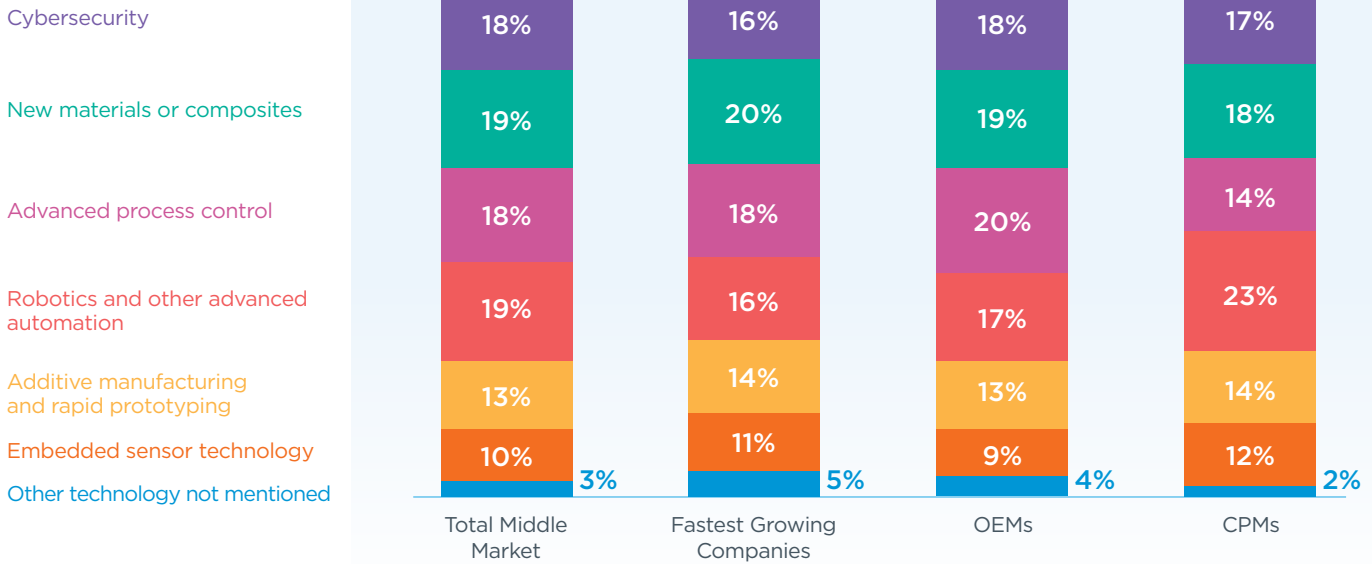
Looking ahead, priorities will change. Cybersecurity will become increasingly important to manufacturers as older machines that were not built for security are now being connected. Both products and processes have become attractive targets, with the result that cybersecurity is considered the most important area for technology spending in the coming year and over the next five years. New materials and advanced process controls will also be major areas of investment and importance for companies moving forward, especially fast-growing businesses. CPMs in particular will be paying increasing attention to robotics and automation. Indeed, technological advances have introduced a bit of an upgrade challenge—the need to keep up with a rapidly-advancing productivity frontier, which Harvard Business School professor Michael Porter defines as the “sum of all existing best practices at any given time.” The fastest growers are placing greater importance on a variety of advanced manufacturing techniques, and those that embrace technologies most effectively will have an edge going forward.

Advanced technology means retooling factories. It will increase companies’ need for capital. Smart factories and integrated supply chains will also raise security risks because “air gaps” between processes will disappear. But they will convey tremendous benefits, too. Productivity increases are foremost among them, followed by the ability to increase customization. It is often said that advanced manufacturing techniques will enable companies to produce small lots as economically as large ones; but by nearly two-to-one, middle market executives say they will use the new technologies to increase lot sizes.

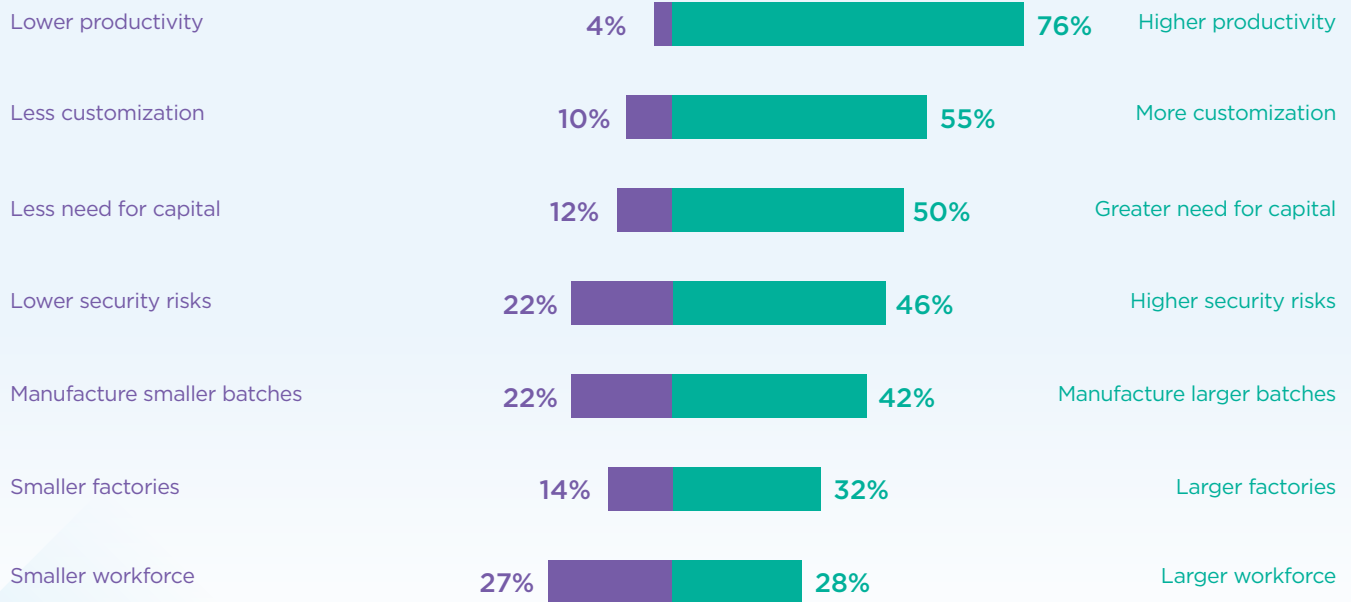
Interestingly, many manufacturers (45%) believe technological advancements won’t change the size of their workforce, and the remaining 55% are equally split between companies that think the workforce will need to grow and those who forecast employment will shrink. The fastest-growing businesses are much more likely to believe they will need more people onboard in the years to come while they increase output per worker.

IoT technology is also becoming more prevalent in manufacturing and distribution, mostly to measure environmental conditions or vehicle driving speed and distance, and, to a lesser extent, to monitor employee location and movement. Heavy users of IoT wearables tend to be larger, faster-growing companies that have more collaborative and integrated relationships with suppliers and customers and that see themselves as playing a more important role in the supply chain.

ALLOCATION OF TECHNOLOGY INVESTMENTS OVER PAST YEAR

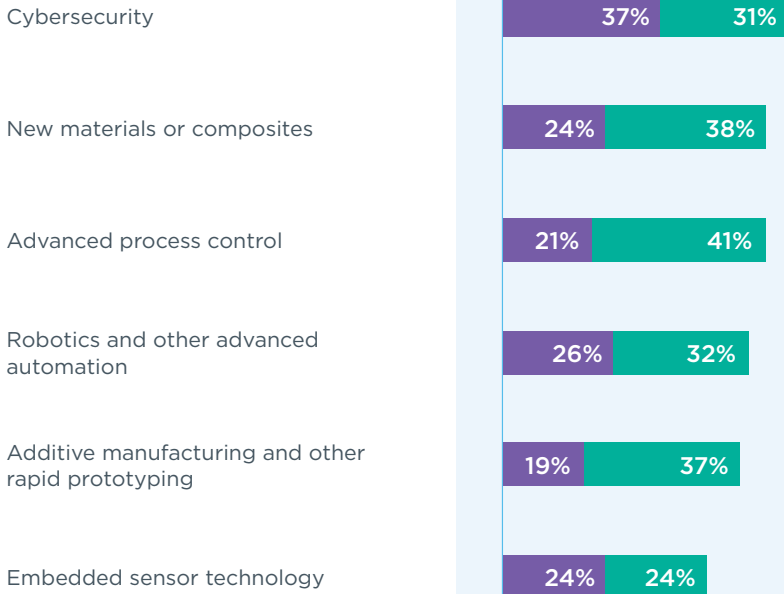


IMPACT OF TECHNOLOGICAL ADVANCEMENTS

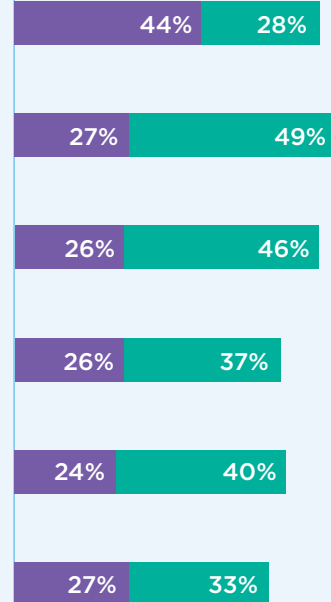


IMPORTANCE OF TECHNOLOGIES: NEXT 5 YEARS

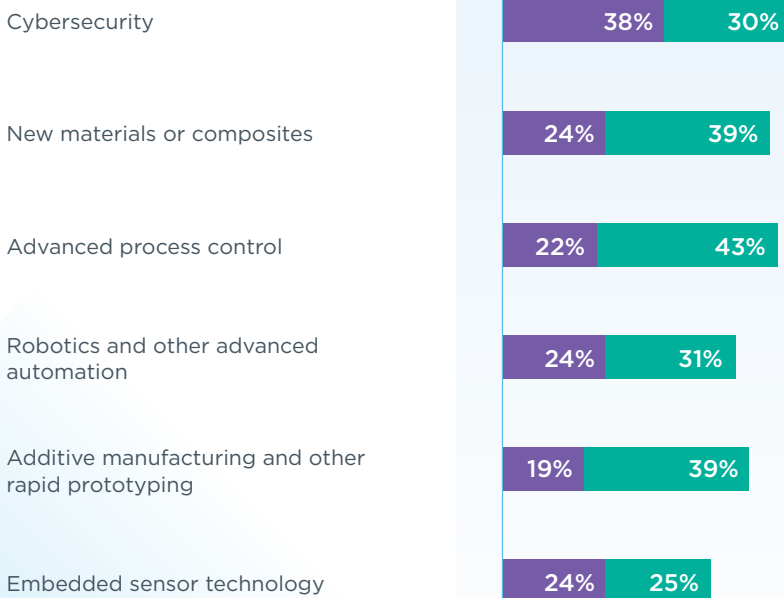
TOTAL MIDDLE MARKET



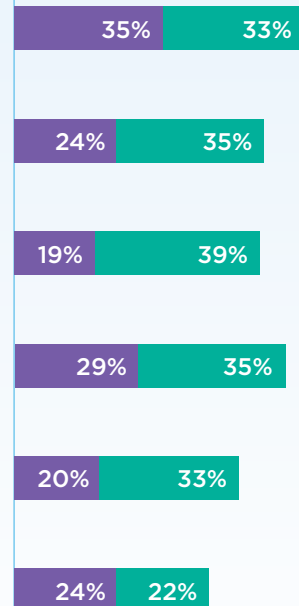
FASTEST GROWING COMPANIES



OEMs



CPMs

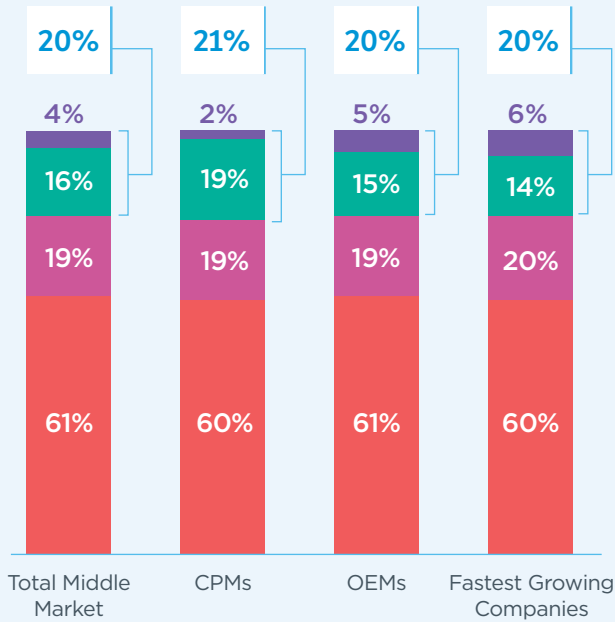


■ Extremely important

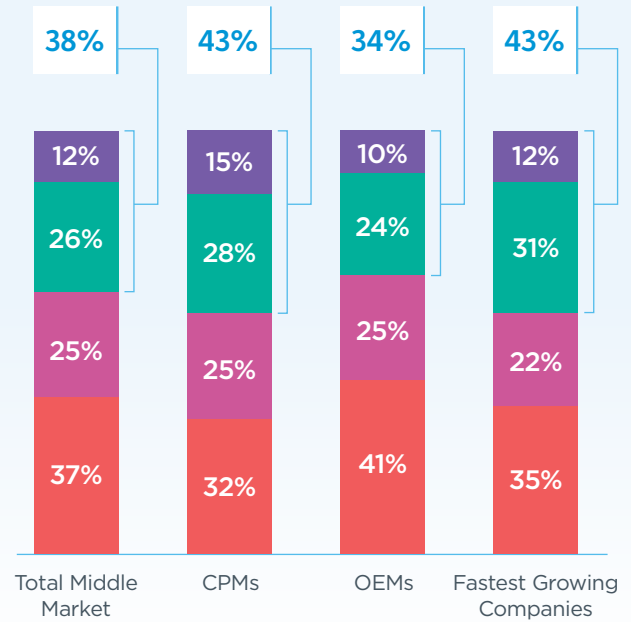
■ Very important

HOW MANUFACTURERS IMPLEMENT WEARABLE IOT TECHNOLOGY IN THE WORKPLACE

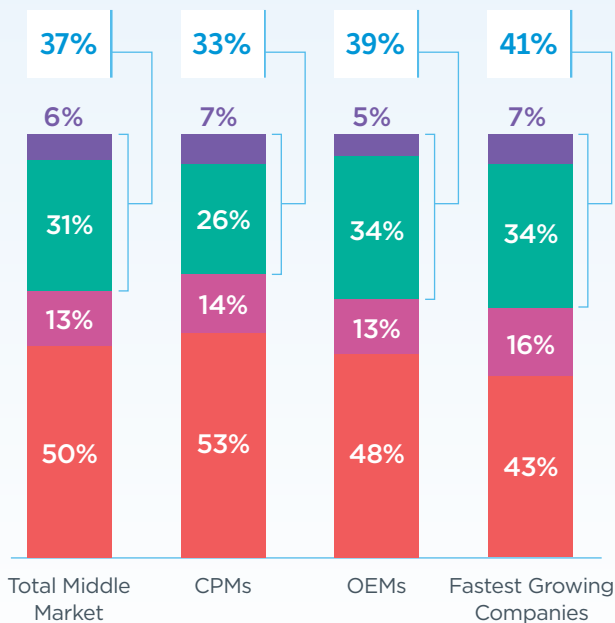
MONITOR EMPLOYEE LOCATION/MOVEMENT



MEASURE ENVIRONMENTAL CONDITIONS



MEASURE VEHICLE DRIVING SPEED OR DISTANCE



» *Manufacturers are increasingly leveraging wearable IoT technologies to monitor environmental conditions and driving behaviors. They are slower to adopt these technologies to monitor employee location and movement.*

■ Using for more than 5 years ■ Expect to begin using in next 5 years
■ Began using in the past 5 years ■ Do not expect to use

Talent management issues stem from and compound every other challenge manufacturers' face



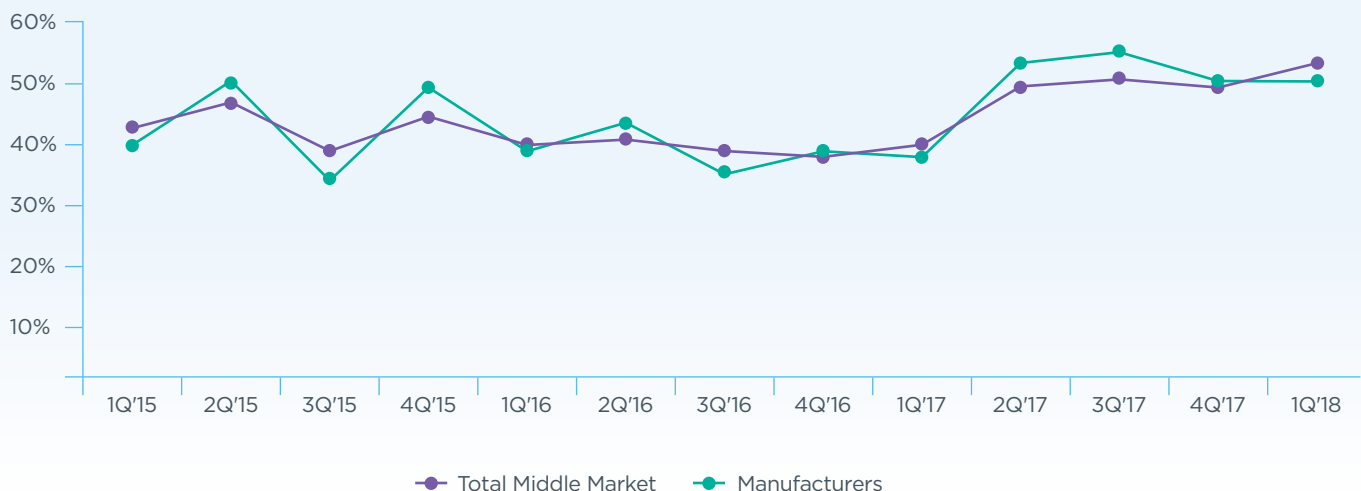
- » *Finding workers with the right technical skills is difficult*
- » *The fastest growers experience the greatest talent management challenges*
- » *The ability to train and grow talent internally is becoming increasingly important*

Like middle market companies in all industries, manufacturers say talent management issues have escalated over the past several years. More than half—54%—say talent is a big issue, earning it a top spot on manufacturers' list of challenges. Manufacturers that are growing the fastest, and probably have more positions to fill, tend to find talent management more difficult than their peers.

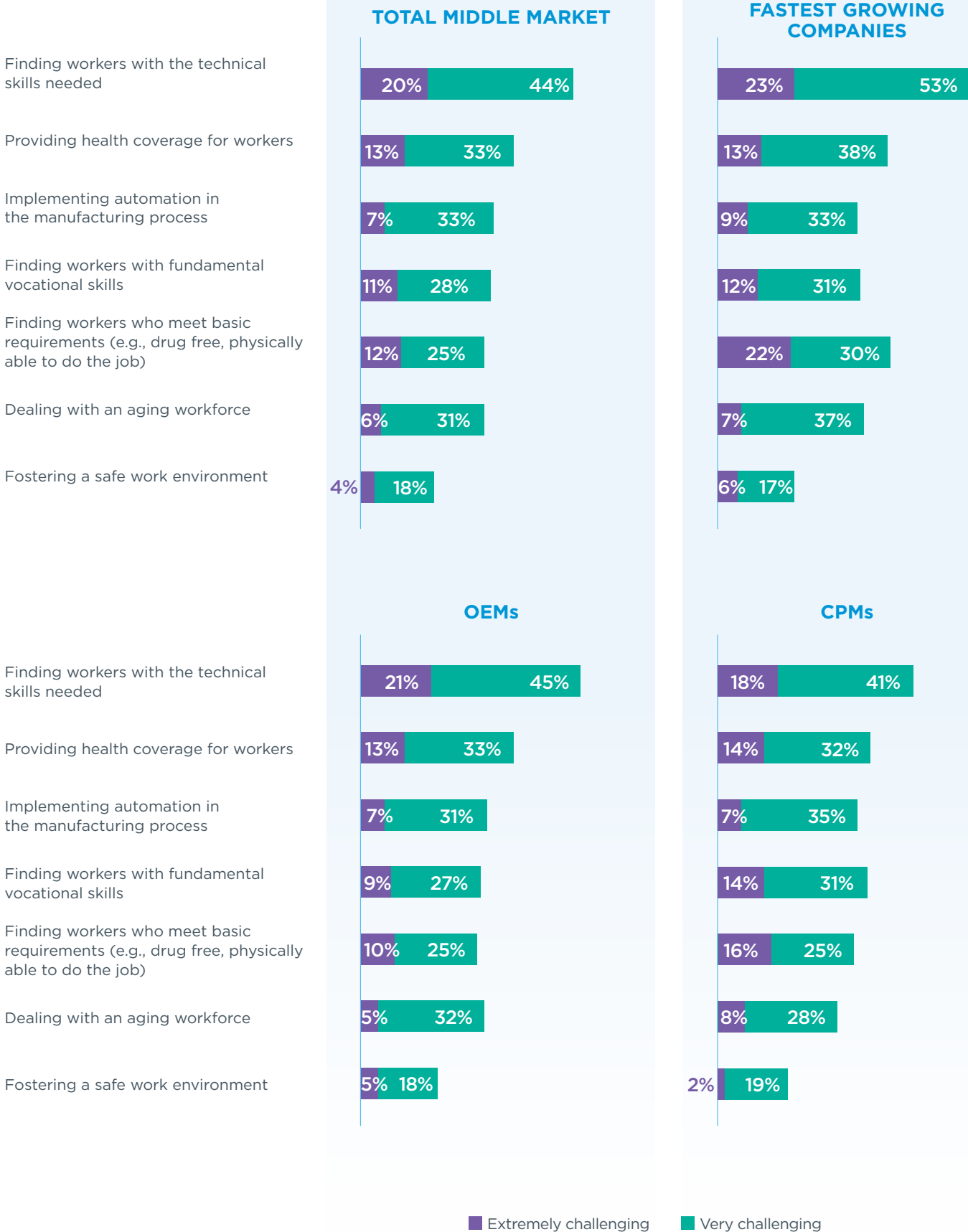
This isn't surprising. Given other changes manufacturers contend with—increasing competition and globalization, a changing mix of products and new services, an increasingly important role in the value chain, and integrating new technologies—finding people with the right technical skills is a tall order and is far and away the most challenging talent issue, cited by more than two-thirds (64%) of manufacturers. That percentage rises to 76% for the fastest-growing companies.

Other talent challenges—implementing automation, an aging workforce, finding people with vocational or basic skills—come in at about 40% each: formidable individually, almost overwhelming collectively. Executives are responding with expanded outreach to colleges, technical schools, and economic development organizations to increase the labor pool. They also are offering higher pay and benefits for skilled workers, along with more training. In the words of one respondent, “If you can't hire them, you have to grow them.”

TALENT MANAGEMENT IS A LONG TERM INTERNAL CHALLENGE

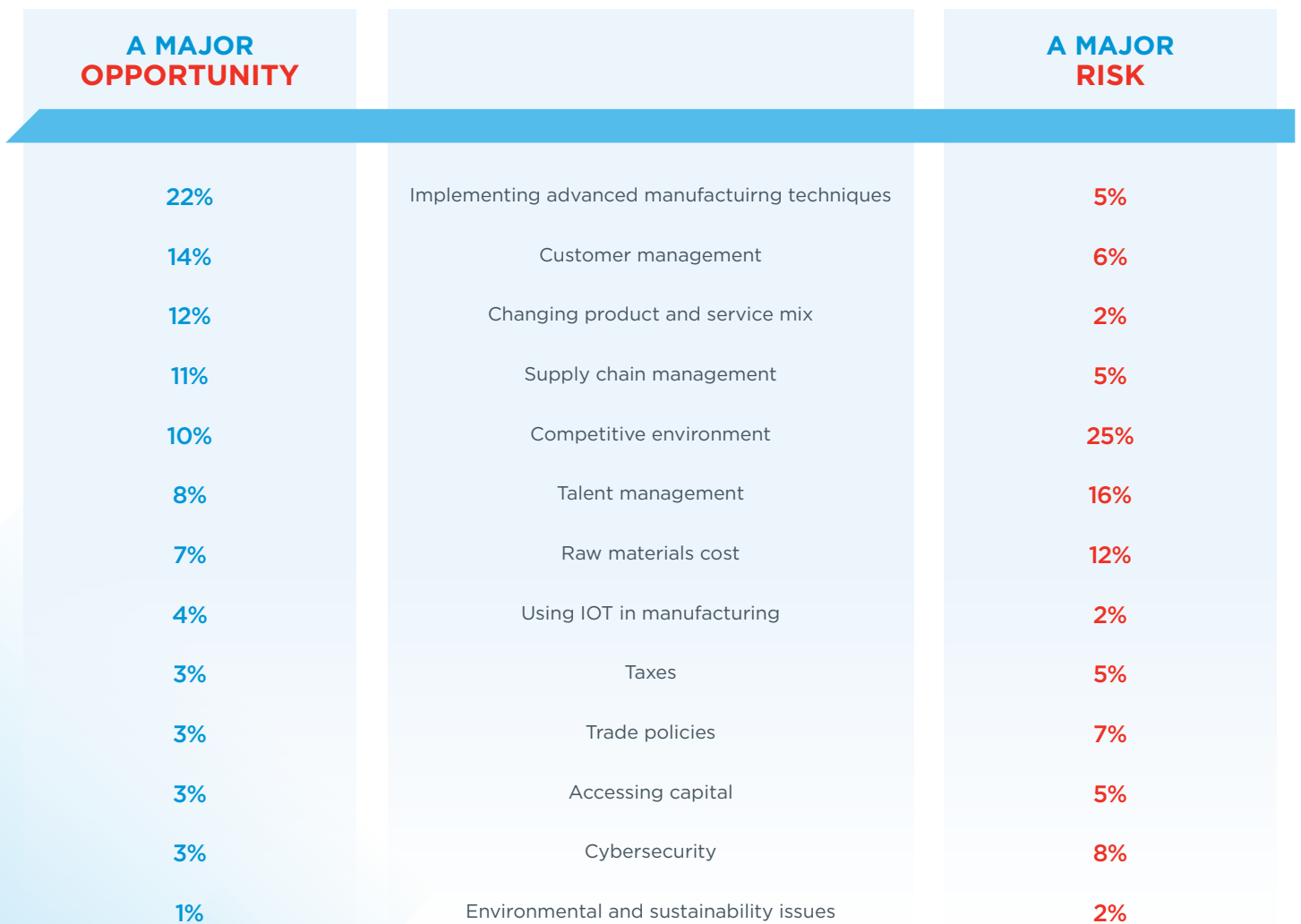


CHALLENGES ASSOCIATED WITH WORKFORCE/WORKPLACE



Risk and Opportunities: Navigating the Changing Landscape

With so many intersecting, overlapping, and simultaneous changes taking place in the manufacturing environment, companies require new strategies to manage and mitigate risks so they can free up resources to better take advantage of emerging opportunities. Indeed, some challenges manufacturers currently face are viewed as both a downside risk and an opportunity to move the business forward: For example, manufacturers see great opportunity in advanced manufacturing, which also exposes them to greater cybersecurity risk. Overall, competition, talent management issues, and costs pose the greatest threats. Smart mitigation or protection strategies for managing these risks can enable companies to better focus on their opportunities: implementing advanced manufacturing techniques, enhancing customer relationships, and evolving their mix of product and services.



Reassessing Risk Exposures

Companies that are embracing new technologies, integrating more with suppliers and customers, adding new services, and becoming more global are growing faster than their counterparts. As a result, however, they face exposure to risk that did not exist in their old environment.

Manufacturers can benefit from giving consideration to the following issues and speaking with their business partners, including insurance agents, bankers, advisors and auditors, and lawyers, to ensure they evaluate and manage new risks. A comprehensive enterprise risk management strategy is increasingly important—one that is regularly updated to keep abreast of change.

PLAYING A MORE IMPORTANT ROLE IN THE SUPPLY CHAIN LEADS TO GREATER RESPONSIBILITY.

As manufacturing supply chains become increasingly integrated, turnaround times continue to shrink, and products become more customized, companies' margin for error shrinks. Enterprise resource planning and lean, agile operations become critically important.

THE GEOPOLITICAL CLIMATE IS INCREASINGLY IMPORTANT.

Globalization requires a greater awareness of customs regulations, currency, and changing foreign and domestic trade policies. Executives may need to learn new forms of governance, such as joint ventures, and add new capabilities and tools to their finance operations, such as understanding currency risks, the use of trade credit insurance, and so on.

DIGITIZATION OPENS NEW DOORS.

Processes that used to be physical are now digitized, and the products themselves have more technology embedded. Developing, producing, protecting, and maintaining those processes and products and the equipment that makes them are new areas of concern. At the same time, digitization can accelerate new product development and introduction. It also opens opportunities to sell new services (such as predictive maintenance) and gather valuable information that can spark innovation in next-generation products.

ADDING NEW SERVICES LEADS TO CONTINUING RESPONSIBILITY.

Many manufacturers have moved beyond simply delivering a product to installing, monitoring, and servicing it. They are connected with customers and consumers in more ways and for a larger part of the product's life cycle. Their revenues grow from these activities; so do their potential liabilities.

IT AND OPERATIONS SYSTEMS MUST BECOME MORE INTEGRATED.

Manufacturers can integrate IT and operations (including robotics, process controls, and data analytics) to improve productivity and profitability. IT also should be used to strengthen operations' safety and cybersecurity.

What the Fastest Growing Manufacturers Do Differently

Manufacturing is thriving in the middle market. The average annual revenue growth rate among the 250 companies interviewed for this survey is 7.7%— exactly the same as the growth rate reported by the middle market manufacturers who responded to the Center’s 1Q 2018 Middle Market Indicator Survey. According to that same survey, taken in March 2018, middle market manufacturers see the good times continuing— they predict a growth rate of 7.2% for the next 12 months. Historically, companies deliver higher growth than they forecast.

Clearly, then, while manufacturers face complex, intense tests, the best of them have been able to spin challenges into gold. Looking at the actions of manufacturers that reported 10% or higher revenue growth last year, we see:

COMPETITION

The best performers combine strong domestic sales with some (but not too much) global exposure. Purely domestic sellers grew 7.5% in the last year, whereas companies that earned 1-25% of their revenue from abroad grew 8.6%—more than a percentage point higher. The growth rate was a little less (8.2%) for companies whose revenue was 26-50% international. But the most internationalized companies, which earn more than half their sales from foreign markets, grew slowest, at 5.9%.

There may be three lessons in these numbers: First, exposure to demanding global markets improves performance, the way exposure to heat anneals steel. Second, most middle market companies have lots of room to expand domestically, and that growth might be easier to achieve. Indeed—the third insight—pursuing global sales can be risky if it comes at the expense of protecting and expanding a strong domestic base.

COLLABORATION

Faster growing middle market manufacturers embrace the opportunity to collaborate with customers and along supply chains. Collaborators grew a little more than 9% last year. Collaboration is valuable both upstream and down—that is, with suppliers and with customers. But there is also a penalty for non-collaboration, and it is greatest downstream, when companies do not work closely with their customers. Those firms grew just 4.4% last year—less than half as fast as those that are willing to let down barriers and allow their customers to influence product lines and have visibility into operations. (The Center uncovered similar findings in its 2017 study of supply chains, *The Perfect Link*.)

The clear lesson here: Customer relationship management—a mindset, not just a tool kit—is increasingly important for manufacturers. The deeper their connection with customers, the more likely they are to succeed.

SMART PRODUCTS & VALUE-ADDED SERVICES

Advanced product and service offerings are associated with superior growth. Companies delivering these offerings experienced year-over-year revenue growth of 9.7%, compared to 5.7% for all others, and 7.7% for the sample as a whole. The services component of these companies’ businesses grew more than 17% last year.

There is almost certainly a link between services and smart products on the one hand and collaboration on the other. Both kinds of new offerings imply a more intimate relationship between a manufacturer and its customers, whether it is sharing data from smart products or installing and servicing products after they have been sold. Managing these new lines of business requires new sales, marketing, and customer support capabilities. Their performance may need to be tracked in new ways, too; for example, measurements such as return on assets may be meaningful for factory operations, but less relevant to a service arm, which has fewer assets.

ADVANCED MANUFACTURING

It is clear that the companies growing most rapidly place greater importance on a variety of advanced manufacturing techniques. Often by wide margins, companies growing 10% or more last year assign more importance to every advanced technique about which we asked.

TALENT MANAGEMENT

Talent challenges bedevil the most successful middle market manufacturers more than their less-successful peers. Among fast-growers, 68% say talent management is extremely or very challenging. As noted above (page 17), the biggest talent hurdle for manufacturers lies in finding workers with the right technical skills—skills that are also changing for technologically-advanced companies. It is easier for the rest, but not much: In the group that is growing less than 10%, or not at all, 58% report severe talent-management difficulties.

The most likely explanation for the difference is simply that fast-growing firms have more positions to fill. As the Center and The Brookings Institution reported (*Help Wanted*, 2017), middle market employers confront a triple whammy: Having relatively unknown employer brands, they do not attract as many over-the-transom applications as larger firms; their lean human resources teams may not have deep capabilities in employee development; and the public-private system of community colleges, workforce improvement boards, and the like has not been designed to serve middle market companies well. It is interesting—and perhaps heartening—that automation does not seem to provide a path out of this thicket: Companies are as likely to say that advanced manufacturing will cause them to add jobs as to eliminate them.

IMPORTANCE OF TECHNOLOGICAL ADVANCES: NEXT 5 YEARS

	REVENUE GROWTH		
	10%+	1-9%	Same/Decreased
Cybersecurity	72%	71%	52%
New materials or composites	76%	58%	44%
Advanced process control	72%	63%	44%
Robotics and other advanced automation	63%	60%	44%
Additive manufacturing and rapid prototyping	64%	57%	38%
Embedded sensor technology	60%	49%	23%

EMBRACING THE OPPORTUNITY

From these data, a picture emerges of a manufacturing sector that is split. Manufacturers whose revenue is stagnant or sinking—about one in five in our sample—are also significantly lagging in their use of new technologies. In the middle, about two-fifths of the sample are steadily deploying new technologies, chiefly, it would seem in pursuit of higher productivity and security. On the other end, companies growing faster than 10% a year—another two-fifths of the group—are ahead in all areas. But the fast-growers are particularly likely to emphasize the use of new materials and embedded sensors, which suggests that they are not only manufacturing in advanced ways, but that they are also manufacturing advanced things.

Middle market manufacturers can have little direct influence over a number of the challenges they face, such as industry consolidation, political risk from potentially changing trade policies, overall workforce conditions, and rising costs of energy, healthcare, and raw materials. However, they can minimize their impact through operational efficiency or negotiation with vendors and service providers.

The data show that the most successful manufacturers are not overwhelmed by the rapidly changing environment; they are energized by it, riding the change to greater success. These opportunities—expanded markets, more collaboration along the value chain, leading-edge products and value-added services, and advanced manufacturing—expose them to new risks that must be understood, mitigated, and managed. But they also expose manufacturers to new revenues. The best in the bunch have demonstrated that the rewards far outweigh the risk.

About The U.S. Middle Market

The U.S. middle market comprises nearly 200,000 companies that employ 44.5 million people and generate more than \$10 trillion in combined revenue annually. The middle market is defined by companies with annual revenues between \$10 million and \$1 billion. In addition to their geographic and industry diversity, these companies are both publicly and privately held and include family-owned businesses, sole proprietorships, and private equity-owned companies. While the middle market represents approximately 3% of all U.S. companies, it accounts for a third of U.S. private-sector GDP and jobs. The U.S. middle market is the segment that drives U.S. growth and competitiveness.



The National Center for the Middle Market is the leading source of knowledge, leadership, and innovative research focused on the U.S. Middle Market economy. The Center provides critical data, analysis, insights, and perspectives to help accelerate growth, increase competitiveness, and create jobs for companies, policymakers, and other key stakeholders in this sector. Stay connected to the Center by contacting middlemarketcenter@fisher.osu.edu.



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