San Diego County Manufacturing Industry Report
"Recovery has Begun"
June 2009
By Michele Nash-Hoff

San Diego's manufacturing industry has fared better than rest of state during this recession. Some market segments have been able to maintain a steady level of business, and some have even been busy.

According to Tatum's May Survey of Business Conditions, "we are now seeing the beginning of the end of the 2008-09 recession…" All indicators were rising as of May 1st, except for the outlook for improvement in the price and availability of capital." Tatum's Index of Business Conditions climbed back up to 2.3 from its all-time low of 0.4 in December 2008. For the 4th month in a row, there was an improvement in backlogs, as well as a slight increase in capital expenditures. "If the current trends continue, we believe the economy is likely to turn positive in the second half of this year." Tatum regularly surveys nearly 1,000 financial and technology executives nationwide, but only 25 percent are manufacturing executives.

However, the Manufacturing Institute for Supply Management's Report on Business wasn't as optimistic. It reported that the manufacturing sector contracted in April for the 15th consecutive month, while the overall economy contracted for the 7th consecutive month. The PMI registered 40.1 percent, up from the low of 32.9 percent in December 2008. A reading of 50 percent indicates that the manufacturing economy is generally expanding and below 50 percent indicates that is generally contracting Six of the 18 manufacturing industries reported growth in new orders, and three industries reported growth in production. None reported growth in employment for April. The backlog of orders rose to 40.5 percent from the low of 29.5 percent in January. New export orders contracted for the 7th consecutive month "The decline in the manufacturing sector continues to moderate. After six consecutive months below the 40 percent mark, the PMI, driven by the New Order Index at 47.2 percent shows a significant improvement," said Norbert J. Ore, C.P.M., chair of the Manufacturing Business Survey Committee. Supplier deliveries were faster for the 7th consecutive month. On the plus side for manufacturers, prices for materials and commodities have stabilized after six months of dropping lower.

The results of the 1st Quarter 2009 survey by the National Association of Manufacturers and *Industry Week* was more pessimistic, showing that the "manufacturing sector remains in a deep recession and prospects for a near-term recovery are dim." The vast majority (83 percent) of 504 member respondents reported a slowdown in production, and a clear majority (60 percent) expects the downturn will continue into 2010. Just 28 percent had a positive business outlook for their company, a new record low in confidence. Respondents expect sales to decrease by 5.2 percent, only the second time in the 11-year history of the survey. Manufacturers expect their capital investment plans to decline by 4.1 percent, the most negative expectation in the history of the survey. They also expect to reduce inventories by 4.8 percent and decrease employment by 3.6 percent over the next 12 months. The negative results of this survey reflect the fact that the members of NAM are primarily large businesses with over 500 employees.

San Diego's Manufacturing Industry Starts to Recover

Since about 98 percent of San Diego's manufacturers are small business with fewer than 500 employees, San Diego's manufacturing industry has fared better than other parts of the county during this recession and started to show signs of recovery in late January, after significantly slowing down throughout 2008.

Another reason San Diego has fared better in this recession is that San Diego's technology industry has greatly diversified since the recession of the early 1990s when defense and electronics/instruments dominated. Today, San Diego has several technology-based segments: telecommunications, information technology, energy/environmental, computer and electronics, biotech/biomedical, and defense/national security.

Most of San Diego's manufacturing is high-tech in contrast to the more traditional industrial manufacturing of the greater Los Angeles basin. In fact, as a state, California ranked first in high-technology employment totaling 942,700 in 2007, according to the TechAmerica (formerly AeA) "Cyberstates 2009" report. This total is nearly twice the number of jobs as second ranked Texas, with 474,100 high-tech jobs.

The meltdown and radical transformation that the financial industry underwent last year left the San Diego's high-tech industries relatively unaffected until the money supply tightened to the point that companies are having difficulty in borrowing money, resulting in "belt tightening" in expenditures and employee layoffs.

Biotech and medical device manufacturers were the most insulated from the slow down until the nationwide economic meltdown occurred last fall. Now they are being hit hard with the lack of investment capital, for which biotech companies in particular have a voracious appetite during their long R & D and drug trial phases before having a product ready for the market.

Temporary to permanent staffing companies are always the first to feel a slow down as companies terminate their contracts for temporary workers before laying off any of their permanent employees. San Diego's staffing companies report that there has been a slight upturn in the demand for clerical jobs within the last month. However, retained executive search firms continue to report an increase in resumes being submitted to them by laid-off executives. And, for the first time since the recession of 1991-92, I personally know several highly qualified professionals that haven't been able to find jobs for more than four months now.

In the face of hard economic times, the following companies have grown and prospered during the past year:

BMT Scientific Marine Services, Inc. (Escondido) – providing consulting, instrumentation and testing for the international marine and offshore oil industries.

Datron World Communications (Vista) – a world leader in HF/VHF voice and data radio communications provided to government, military, public safety, and industrial organizations in 100 countries.
General Atomics (San Diego) GA Technologies introduced the next generation of unmanned aircraft in its Predator UAS series - the Predator C Avenger. General Atomics controls 20 percent of the worldwide unmanned vehicle market. Increased demand for the Predator and Predator B required the company to expand into a new production complex in the Sabre Springs Business Park. General Atomics increased its Southern California work force by 15 percent over last year and has about 300 jobs openings in a variety of fields (San Diego News Network)

ISE Corporation (Poway) – a global leading supplier of alternative-fueled, integrated hybrid drive systems for heavy-duty vehicles. ISE was selected a winner of the Clean Technology award at the AeA's 15th Annual High Tech Awards in October 2008. ISE's breakthrough hybrid drive systems will be showcased in the 2010 Winter Olympics in British Columbia and the 2012 Summer Olympics in London.

Northrop Grumman, Inc. (San Diego) – A defense contractor focused on advanced technology for unmanned vehicles, network communications systems, information technology, and ship repair and maintenance. Northrop's unmanned vehicles, including Global Hawk and Fire Scout, control nearly 45 percent of the unmanned vehicle market. Northrop is now one of San Diego's largest employers providing 4,345 jobs in San Diego County (San Diego News Network.)

Outsource Manufacturing Inc. (Carlsbad) – a contract manufacturer of electronic products and turnkey "box build." OMI ranked no. 1 in the San Diego Business Journal's list of Fastest-Growing Privately-held Companies in 2008 and ranked no. 222 in the **Inc. 500** list.

SeaBotix, Inc. (San Diego) – a world-leading miniROV manufacturer (miniature remotely-operated underwater vehicles. The U. S. Army TACOM recently awarded SeaBotix a contract value at up to $1.86M to deliver 27 of its LBV150SE-5 remotely operated vehicles.

Viasat, Inc. (Carlsbad) - a manufacturer of satellite and wireless communications equipment. While Viasat's commercial business declined 17 percent, its government business was up 10 percent, allowing revenue to increase 8 percent and net income to increase 13 percent in 2008.

Manufacturers in the aerospace and defense industry who provide products for the "war on terrorism" have had steady business to date, but they are concerned by the defense cutbacks proposed by the Obama administration. The moderate increase in government R & D funding in the Fiscal 2010 federal budget may benefit some San Diego companies that rely on R & D funds for their business endeavors, but won't make up for cutbacks in other defense sectors.

While the mortgage crisis caused by sub prime loans and the high rate of foreclosures continues unabated, the local industry that first felt the recession, San Diego's off road vehicle industry, has recently increased orders to suppliers, fueled mainly by the consumption of product inventories. As first mentioned in my report of November 2007, the reasons behind this slow down are complicated. Inquiries revealed that a majority of people who purchase off road vehicles (dune buggies, quad wheelers, and dirt bikes) work in the building industry or related industries. With the housing market in a big slump, fewer homes, condos, and apartments are being built so people working in this industry are experiencing a tight money situation and don't have the money to purchase off road vehicles or even keep the vehicles they have already purchased.

Some Business is Coming Back from Offshore

DJO LLC, based in Vista, California, with manufacturing plants in the United States and Tijuana, Mexico, makes orthopedic products, including wrist braces, arm slings, back and abdominal supports, rigid knee braces amongst other orthopedic products. As a medical device company, nearly all projects go through strict quality assurance validation. In 2005, DJO's Continuous Improvement Project (CIP) team completed 55 projects, saving the company more than $3 milion. One such project was a cooler that forms part of a cold-therapy unit to reduce pain and swelling. When the company first developed the product line, the coolers were sourced in the United States, but eventually moved to China for a total landed cost of around $10 each. However, the company had to buy the coolers by a boat-container load, and when the molds broke, the Chinese supplier stopped shipping product for two months.

The project team figured out how to economically manufacture the cooler in-house - making their own injection molding tools, sourcing the blow-molded components locally in the U.S., and creating fixtures for the high-pressure foam injection machine. Jerry Wright, Vice President, said "the cooler will cost $2 less than it did to buy it from China, when you factor in the freight, handling, and inventory costs." It's a nice enhancement to the product line, and we don't have to go through the horrible supply-chain frustration with China."

This is just one of several stories from my book, *"Can American Manufacturing be Saved? Why we should and how we can."* (See www.savingusmanufacturing.com)

Harder to Compete for California Companies

California's manufacturers find it harder to compete because the business environment grows increasingly unfriendly. In 2005, California dropped to 50th in ranking in the Small Business Survival Index by the Small Business & Entrepreneurship Council (SBE Council), and its rank did not change in the 2006 and 2007 reports. California rose to 49th in the 2008 survival index by switching places with New Jersey. This low overall ranking was based on California's anti-business environment in the following areas:

- Highest personal income tax rates
- Highest state gas taxes
- Highest capital gains tax
- 5th highest cost of worker's compensation premiums
- 6th highest electric utility costs
- 6th highest Workers' Compensation rates
- 8th highest corporate capital gains tax rates
- 9th highest corporate income tax rates

Since taking office in late 2003, Governor Schwarzenegger vetoed 10 out of 10 of the California Chamber's identified "job killer" bills in 2004, seven of eight in 2005, and nine of the eleven in

2006. In 2007, the California Chamber of Commerce reported that Governor Schwarzenegger vetoed all 12 "job killer" bills sent to his desk for action by the legislature. In 2008, the California Chamber reported that the Governor vetoed nine of the 10 "job killer" bills. Despite California's government being near bankruptcy, the legislature has introduced a plethora of new "job killer" bills. On May 18, 2009, the California Chamber of Commerce released its annual list of "job killer" bills, calling attention to the negative impact the proposed measures would have on California's competitiveness and job climate if they were to become law. The complete list can be viewed at www.calchamber.com/jobkillers, but the following are the most egregious bills that have been introduced:

Barriers to Affordable Housing

AB 212 (Saldaña; D-San Diego) Construction Costs Increase — Substantially increases the cost of new housing by mandating on-site or near-site energy generation for all new residential buildings.

Costly Workplace Mandates

AB 664 (Skinner; D-Berkeley) Increased Workers' Compensation Costs — Increases workers' compensation costs by creating a legal presumption that neck and back injuries, and blood-borne and specific infections suffered by hospital employees are related to employment.

AB 1000 (Ma; D-San Francisco) Paid Sick Days — Unreasonably expands employers' costs and liability for a new protected and paid sick leave for employees.

AB 1421 (Swanson; D-Oakland) Pay for Commuting — Imposes new costs on employers that provide transportation to the worksite by requiring them to pay employees for time spent commuting from the parking lot to the workstation.

SB 145 (DeSaulnier; D-Concord) Workers' Compensation Apportionment — Erodes recent workers' compensation reforms and leads to higher premiums for California employers by undercutting fair and reasonable provisions in current law that protect an employer from paying for disability that was not caused by a workplace accident.

SB 773 (Florez; D-Shafter) Workers' Compensation Cost Increase — Increases workers' compensation costs significantly and makes it more expensive to employ Californians by arbitrarily increasing permanent disability benefits.

SB 810 (Leno; D-San Francisco) Government-Run Health Care — Creates a new government-run, multibillion-dollar socialized health care system based on a yet-to-be specified 'premium structure' — in essence, a tax on all employers.

Economic Development Barriers

AB 89 (Torlakson; D-Antioch) Targeted Tax Increase/Flawed Budget Philosophy — Exacerbates state budget problems and harms tobacco industry by unfairly targeting it for a new cigarette tax, a declining revenue source, to fund new government spending programs.

AB 231 (Huffman; D-San Rafael)/ AB 1405 (De León; D-Los Angeles) Climate Change Tax Increase — Increases costs and discourages job growth by granting the Air Resources Board broad authority to implement unlimited fees and taxes with little or no oversight.

AB 656 (Torrico; D-Newark) Gas Price Increase — Increases gas prices and dependence on foreign oil by targeting the oil industry for a tax on oil extracted only in California.

AB 1404 (De León; D-Los Angeles) Discourages Emission Reductions — Significantly increases business costs and threatens state jobs and businesses by severely limiting the amount of offsets California industries can use to meet their greenhouse gas emission goals.

SB 96 (Ducheny; D-San Diego) Increased Tax Burden — Imposes a new tax increase on personal income.

Expensive, Unnecessary, Unnecessary Regulatory Burdens

AB 283 (Chesbro; D-Arcata) Expanded Waste Bureaucracy — Leads to increased cost for consumers and businesses by requiring producers of select products sold in California to collect their products after use by the consumer and manage the recycling and/or disposal of those products.

AB 479 (Chesbro; D-Arcata) Expanded Waste Bureaucracy — Increases costs by giving the California Integrated Waste Management Board broad authority to impose any policy, program or incentive to reach a 75% solid waste diversion rate by 2020.

Inflated Liability Costs

AB 2 (De La Torre; D-South Gate) Health Insurance Litigation — Drives up the cost of health care premiums and increases the number of uninsured by establishing litigation as the only meaningful approach to resolving disputes over rescinding coverage.

SB 95 (Corbett; D-San Leandro) Vehicle Price Increase — Imposes new surety costs on car dealers in an already-difficult economy by placing excessive restrictions on the sale of trade-in vehicles and eliminating a voluntary consumer mediation program.

“There can be no more business as usual in California,” said Cal Chamber President Allan Zaremberg. “Our unemployment rate now exceeds 11 percent and we rank 6th in the nation as one of the most expensive places to do business. We are feeling the weight of overly burdensome regulations, unique to California, passed by legislators when times were good. Now more than ever, legislators must get serious about doing what is good for California and our workers. Legislators must vote no on every bill that has the potential to drive up costs for consumers and businesses and to harm the economy. The private sector will bring this economy back and legislators must make job creation their top priority. A robust private sector economy will provide our state government with sufficient resources for a quality educational system and the public safety services we deserve.”

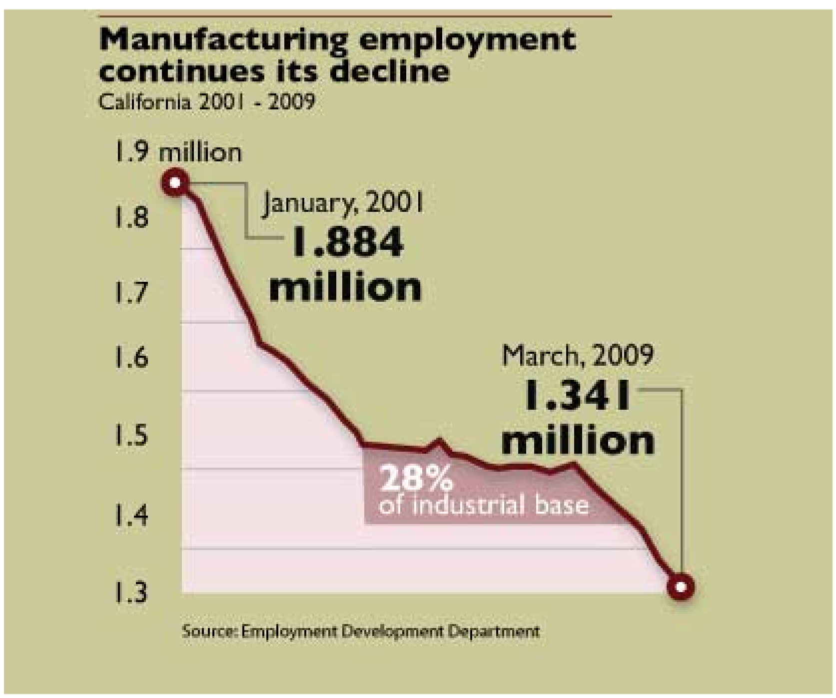
Please note that San Diego legislators Saldaña and Ducheny have introduced two of these bills. If you agree that these bills will hurt California's businesses, please contact Assembly member Saldaña and State Senator Ducheny to express your opinion in opposition to these bills.

California's Deficits Tied to Loss of Manufacturers

One of the major reasons for California's budget deficit is the loss of manufacturing companies. When companies close shop and employees are let go, it means less taxes for the government.

Up until 2007, California was one of the largest manufacturing states, employing the most number of people nationwide. In 2006, we still had more than 14 million manufacturing employees nationwide. Now, it's down to 12.4 million.

The California Employment Development Department reported that California lost 100,600 manufacturing jobs in between March 2008 and March 2009. The following chart shows that a total of 536,000 jobs have been lost in this sector since the decline started in December 2000, nearly a 28 percent decline. No wonder California's unemployment rate increased from 5.7 percent in 2006 to 11.2 percent in April 2009. San Diego County's unemployment rate rose to 6.8 percent, up from 4.8 percent in October 2007. This rate is the highest point since summer 1995, when military contractors were closing their doors after the end of the Cold War.



"San Diego's manufacturing base has dropped by 23 percent, falling from 125,100 workers at its peak in June 1998 to 96,400 today. Manufacturing's share of the private-sector workforce has dropped from 13.6 percent in June 1998 to 9.3 percent today." "Rethinking Commerce Quotient on the Border," by Dean Calbreath, San Diego Union-Tribune, Sunday, May 24, 2009)

All this means fewer taxes for the government at the city, county and state levels.

Some 90 percent of manufacturing companies are small businesses, with less than 500 employees. Many of these companies are not incorporated, so they are taxed at the personal income tax rate, not the corporate tax rate. California has the highest personal income tax rate at 10.3 percent.

These business owners make a big contribution to the state's coffers. In California, the top 10 percent of income earners contribute about 75 of the state's total tax revenue, according to the state Franchise Tax Board.

But now, many of California's top earners are leaving the state and taking their tax dollars elsewhere.

According to the 2009 report "Rich States, Poor States," by Arthur Laffer, Stephen Moore, and Jonathan Williams, "there were some 44,000 millionaires in California in 2000, and they contributed $15 billion to the state treasury in that year" (about 20 percent of the state's income tax revenues!) "According to data provided to the audit committee by the State Board of Equalization, about 80 percent of the state's revenue losses between 2001 and 2003 were a result of disappearing millionaires. The number of reported millionaires in California astonishingly dropped from 44,000 in 2000 to 29,000 in 2002" (a loss of 44 percent.) Some of the loss of millionaires wasn't a result of people leaving, but people losing money in the dot-com bust of 2000-2001.

This report also commented "When times are good, California citizens earn more, pushing many of them into a higher tax bracket, thereby giving the state a larger fraction of a bigger pie. But then the opposite holds true during recession: People earn less income in general, thereby shrinking of the tax base, as man fall into lower tax rackets and pa a small fraction of small paychecks. This one-two punch explains why hard times seem to hit California harder than other states."

California's state budget relies too heavily on capital gains taxes, and the capital gains tax rates is the highest in the country at 10.3 percent. Capital gains tax filled the coffers of California government during the boom years of the late 1990s when stock options from high-tech ventures reached their peak, creating a huge spike in temporary millionaires and multimillionaires. It is estimated that revenues from stock options and capital gains generated a $5 to $10 billion one-time revenue windfall in the late 1990s. The state legislature did not put aside money in a rainy day fund. They just started spending it on new programs. Thus, politicians who did not understand the source of the revenue squandered it.

When the bubble burst, the state's capital gains revenue plummeted, and when the revenue dried up, the state legislature didn't have the money to fund the programs they had initiated during the boom years. Of the some 25,000 families making seven-figure incomes in 2006, more than 5,000 of them left in 2007. The loss of their tax payments accounted for half of the state budget hole in 2008, according to the above-mentioned report.

We have an unfavorable business climate that is driving businesses out of California. Besides the highest personal income tax rate, California has the 5th highest corporate tax rates in the country at 8.84 percent.

And, as we lose business, we're losing tax revenue -- both corporate and individual.

For many years now, I have been prescribing what we need to do. Here are my top four suggestions:

- Lower taxes. We need to reduce the corporate and personal income tax rates by about two percent, to be competitive with other states. On average, we're about two to four percent higher than other states.

- Restore the capital equipment investment tax credit. In 2003, the legislature repealed the capital equipment investment tax credit, which penalized companies for investing in the future. That needs to be changed. The people we have elected in Sacramento think that California business is big and has deep pockets. The large companies in Silicon Valley skew their opinion. But the reality is that the vast majority of California businesses are small and do not have deep pockets.

- Reform workers' compensation to address the issues of fraudulent claims and frivolous lawsuits and reduce workman's compensation rates. Even after the reductions in 2004, California still has the 6th highest rate nationwide.

- Eliminate burdensome regulations on small businesses

San Diego Regional Chamber of Commerce Chairman Ben Haddad appointed a State Budget Task Group to develop r on behalf of the San Diego business community. Key considerations include:

- Significant budgetary reform, including spending caps, two-year budet periods, and penalities for failing to meet budget declines;

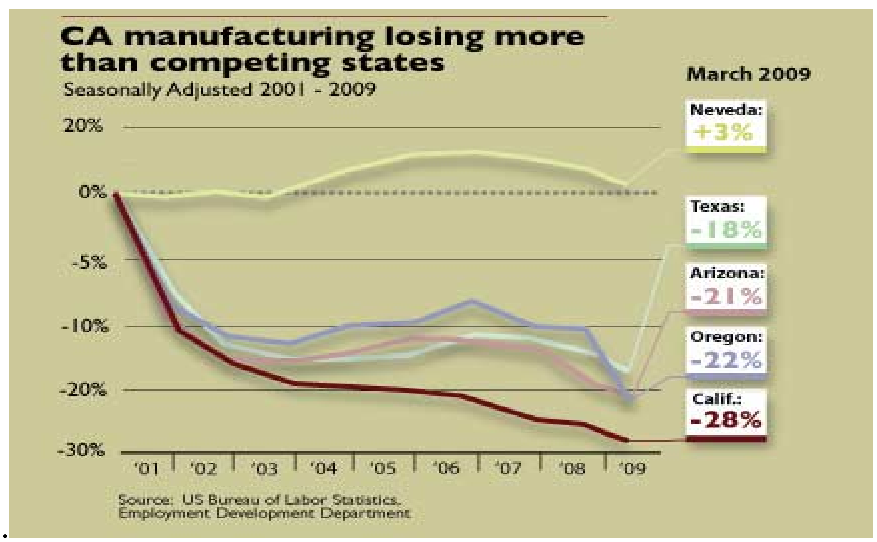
- Tax reform, moving toward fairer, broader-based (as opposed to higher) taxes;
- Consolidation of duplicative government agencies to promote greater efficiency and lower costs;
- Referendum reform to increase financial stability and decrease ill-advised, unfunded public mandates. (Chamber Business Online June 09 Feature)

Now is not the time to raise taxes or fees. This is not the time to implement regulations that kill jobs. We need to make some drastic changes in California's business climate so that we can maintain as much as possible of our manufacturing base in California.

San Diego has always been a "start-up business" area where companies grew to a certain size and were acquired by mostly out-of-the area companies. The new owners usually kept the division or subsidiary in San Diego because they were afraid of losing key people if they moved have taken a look at their bottom line for their San Diego-based acquisition and decided they couldn't afford to stay in California.

This line of thinking has changed as the costs of doing business in California have escalated over the past several years and the overall business climate became more unfavorable. San Diego companies have been moved to such former business unfriendly states as Ohio, Minnesota, Maryland, and New York.

Most western states have endured large job losses in their manufacturing sector, but California's situation is worse..



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The initial list of 40 companies that had gone out of business or moved out of California that accompanied my first report of March 2003 more than doubled to 85 by the end of 2003. The mass exodus of companies moving out of San Diego County slowed down after the Schwarzenegger reforms in early 2004. Even so, another 65 companies have either gone out of business or moved out of state since 2004 for a total of more than 150 companies no longer in business or located in San Diego County. Based on employment data for companies listed in the 2000 Technology Directory for San Diego County and estimating 20 employees for companies not listed in the directory, the current list of companies represents a loss of nearly 8,000 jobs.

The economic data indicates that each manufacturing job creates three to four other jobs while service jobs only create one to two other jobs. Therefore, the loss of over 400,000 manufacturing jobs may have caused more than one million other jobs to vanish. Nationwide, a staggering 3.2 million manufacturing jobs have disappeared since the year 2000. The U. S. Department of Labor predicts that another 1.5 million manufacturing jobs will be lost between 2006 and 2016. If this trend is not reversed, it is only a matter of time before California's economy and America's economy becomes primarily a service and retail one. It will difficult, if not impossible, for the United States to remain the world's super power if this trend becomes a reality. It will take the cooperative effort of government, industry and individuals to restore California and our country to the "land of opportunity" they once were.

Background: As background for how this series of reports came to pass, ElectroFab Sales is a manufacturers' sales representative agency for "job shop" companies that perform custom fabrication services. Our primary market is OEM's (Original Equipment Manufacturers) in San Diego County that utilize sub-contract manufacturing services.

We began losing customers and prospective customers in early 2001 because of the adverse business climate in Caifornia and the effects of the recession. We started keeping a record of the companies that moved out of state or had gone out of business since January 2001. This list evolved into an analytical report that I have been e publishing periodically since then in an effort to make key policy makers aware of the seriousness of the situation. This16th report provides an update on the state of various San Diego industry sectors, along with a focus on the effects of outsourcing offshore and California's competitiveness in the challenging global economy.

About the Author: Michele Nash-Hoff is President of ElectroFab Sales, an independent manufacturer's representative agency, which she founded in 1985. She is past president of the San Diego Electronics Network, the San Diego Chapter of the Electronics Representative Association, and The High Technology Foundation, as well as several other community and non-profit organizations. She was a candidate for San Diego City Council in 1996 and the California State Assembly in 2000. She has a B.A. from San Diego State University and later earned a certificate in Total Quality Management. Prior reports are accessible at Michele's website of www.electrofab.com. Michele is also the author of the newly published book, *"Can American Manufacturing be Saved? Why we should and how we can."* You may read/download the free chapter, "Why should we save American manufacturing?" and /or order her book at: www.savingusmanufacturing.com