# 3Q 2014

# MIDDLE MARKET INDICATOR

NATIONAL CENTER FOR THE MIDDLE MARKET

In Collaboration With

The Ohio State University Fisher College of Business

GE Capital

# Middle Market Indicator

## from The National Center for the Middle Market

**THE MIDDLE MARKET INDICATOR (MMI) FROM THE NATIONAL CENTER FOR THE MIDDLE MARKET IS A QUARTERLY BUSINESS PERFORMANCE UPDATE AND ECONOMIC OUTLOOK SURVEY CONDUCTED AMONG 1,000 C-SUITE EXECUTIVES OF COMPANIES WITH ANNUAL REVENUES BETWEEN $10MM AND $1B.**

There are nearly 200,000 U.S. middle market businesses that represent one-third of private sector GDP, employing approximately 45.6 million people. These businesses outperformed through the financial crisis (2007–2010 period) by adding 2.2 million jobs across major industry sectors and U.S. geographies, demonstrating their importance to the overall health of the U.S. economy. They are private and public, family owned, and sole proprietorships, geographically diverse, and span almost all industries. The health of these businesses and their respective outlook serve as a solid indicator for the greater U.S. economy as a whole. (See www.middlemarketcenter.org: “The Market that Moves America,” seminal research on the definition, significance, and role of the middle market, Oct. 2011.)

### HOW IS THE RESEARCH CONDUCTED?

The MMI surveys 1,000 CEOs, CFOs, and other C-suite executives of America’s middle market companies on key indicators of past and future performance in revenues, employment, and allocation of cash. The survey also reports middle market company confidence in the global, U.S., and local economies and identifies key business challenge areas. The survey was designed to accurately reflect the nearly 200,000 U.S. businesses with revenues between $10MM and $1B, the upper and lower limits on middle market annual revenue. The quarterly survey is designed and managed by the National Center for the Middle Market.

### ABOUT THE NATIONAL CENTER FOR THE MIDDLE MARKET

Founded in 2011 in partnership with GE Capital, and located at The Ohio State University Fisher College of Business, the National Center for the Middle Market is the leading source of knowledge, leadership, and innovative research 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. The Center’s website, which offers a range of tools and resources for middle market companies, can be visited at www.middlemarketcenter.org.

## U.S. MIDDLE MARKET DEFINED

**ANNUAL REVENUE**
RANGING FROM
**$10MM – $1B**

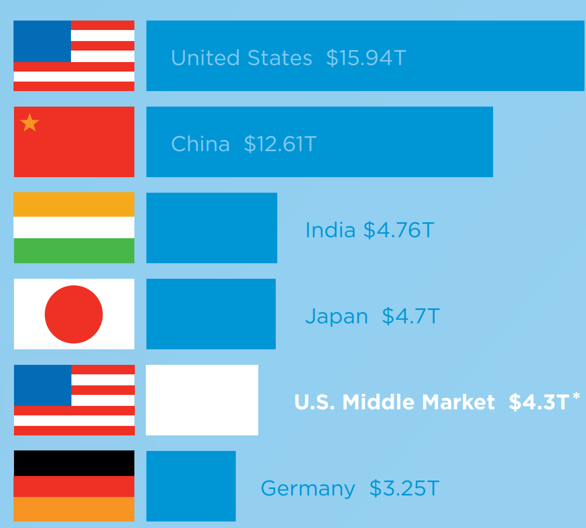
LOWER MIDDLE MARKET
**$10MM - $50MM**

CORE MIDDLE MARKET
**$50MM - $100MM**

UPPER MIDDLE MARKET
**$100MM - $1B**

NEARLY
**200,000**
**BUSINESSES**

**5TH LARGEST**
GLOBAL ECONOMY




*Source: CIA World Fact Book, *National Center for the Middle Market (estimate)*

# Executive Summary

**While year-over-year revenue growth continued to accelerate significantly in the third quarter of 2014 for U.S. middle market firms—7.5% as compared to 6.6% reported last quarter—the increases are driven primarily by the lower middle market—firms with annual revenues between $10 million and $50 million. Growth among the largest middle market firms has remained fairly stable. However, growth is softening among core middle market firms with annual revenue between $50 million and $100 million. This uneven distribution across middle market revenue segments is also reflected in overall company performance, employment growth, and future prospects for continued growth and hiring, with core middle market firms lagging behind their smaller and larger counterparts in all key metrics.**

On one hand, strong financial performance and sustained hiring increases for the overall middle market for the third straight quarter clearly indicate that the middle market continues to perform well post-recession. Yet, the declining growth and more cautious outlook of core middle market firms, coupled with less confidence in the global economy, suggests that the middle market continues to contend with significant challenges to sustained growth.

A majority of middle market leaders (62%) continue to report improved company performance over the last 12 months. However, only 51% of core middle market firms say their company is performing better than one year ago, a significant decrease from the 65% of core firms that reported improved year-over-year company performance just last quarter.

*"As a manufacturer that provides equipment to contractors in the construction industry, we're seeing increased investment in new machines, rather than just repairs. This is a good indication that the economy is accelerating."*

***Chief Executive Officer, Manufacturing Company***
***$18.5MM Annual Revenue***
***80 Employees***

Furthermore, while the percentage of overall middle market firms reporting year-over-year increases in revenue in 3Q 2014 remained near 70% for the second straight quarter, just over half (57%) of core middle market firms reported improved financial performance over the last 12 months, down significantly from 74% last quarter. These core firms grew by 5.3% versus the 8.9% growth experienced by smaller middle market firms and the 6.4% growth reported by larger middle market firms since the third quarter of 2013. Even so, revenue growth for all middle market firms once again outpaced revenue growth for the S&P 500, which was 5.5% for the same period.*

Since the significant increase in employment reported in 1Q 2014, employment growth has remained stable at this higher level for the second straight quarter, with more than 4 out of 10 middle market firms adding employees over the past 12 months. The healthcare industry in particular has seen a significant year-over-year increase in hiring with employment gains near 6%. While the proportion of firms experiencing revenue growth continues to outpace the proportion that added workers in the past year, the gap is narrowing slightly.

In general, the middle market remains optimistic about the potential for both revenue growth and employment growth over the next 12 months. Core middle market firms are more cautious, which helps explain the overall decrease in firms expecting revenue growth in the next year—from 70% last quarter to 64% this quarter. Mean total expected revenue growth for the next 12 months dropped slightly from 5.8% last quarter to 5.5% in total; but dropped significantly among core middle market firms, from 5.4% to 3.1%. Nonetheless, revenue growth projections remain a full 1% higher than at the end of 2013 and the first quarter of 2014.

While confidence among middle market leaders in the global economy is decreasing, most middle market executives remain confident in the national and local economies. This suggests middle market leaders do not view global issues as having a direct impact on their firms.

*Based on Sales/Share data for the S&P 500

## REVENUE GROWTH

### Smaller middle market firms drive surge in revenue growth

The majority of middle market firms (68%) continue to report year-over-year increases in revenue growth this quarter with mean total revenue growth of 7.5%— the highest percentage of growth reported since the beginning of the survey in 2012. While growth is evident in a broad cross-section of industries, the growth is not evenly distributed across all middle market revenue segments. Growth in smaller middle market firms is accelerating, and the largest middle market firms are experiencing stable growth; however, growth is slowing in core middle market firms.

Core middle market firms are also more cautious about growth prospects for the coming year than their larger and smaller counterparts. Less than half (49%) of core firms expect to grow revenues over the next 12 month, as compared to 67% of organizations on both the smaller and larger ends of the middle market revenue spectrum. Additionally, core middle market firms expect only 3.1% mean total growth over the coming year, whereas the overall middle market expects 5.5% mean total growth.

3Q'14 **68%** of middle market companies reported positive revenue growth. 3Q'13 63%

**MIDDLE MARKET**

**PAST 12 MO.**

3Q'14 7.5%

2Q'14 6.6% 3Q'13 5.5%

**NEXT 12 MO.**

3Q'14 5.5%

2Q'14 5.8% 3Q'13 4.4%

**S&P 500**

**PAST 12 MO.**

3Q'14 5.5%

2Q'14 3.4% 3Q'13 3.4%

## EMPLOYMENT GROWTH

### Employment growth remains strong

For the second straight quarter, middle market firms have sustained the significant employment gains reported in 1Q 2014. Companies reported 3.5% mean total workforce growth over the past 12 months, as compared to 2.8% mean growth reported a year ago. As with revenue growth, core middle market firms lag behind their smaller and larger counterparts. While more than 40% of small and large middle market firms report increased employment compared to one year ago, in the core middle market, just over one-third report increased employment.

Future employment growth expectations remain stable for the overall middle market with 47% of firms expecting to hire over the next 12 months and a mean total expected growth rate of 3.6%. Smaller middle market firms continue to anticipate larger increases in the workforce. However employment expectations in the core middle market have begun to slip: these core firms expect to grow by 2.6% over the next year, down from 2.8% last quarter and 3.0% reported by core firms in 1Q 2014.

3Q'14 **47%** of middle market companies expect to add jobs. 3Q'13 40%

**MIDDLE MARKET**

**PAST 12 MO.**

3Q'14 3.5%

2Q'14 3.2% 3Q'13 2.8%

**NEXT 12 MO.**

3Q'14 3.6%

2Q'14 3.3% 3Q'13 2.1%

**ADP** [PAST 12 MO.]

**LARGE CORP.**

3Q'14 2.6%

2Q'14 2.6% 3Q'13 2.4%

**SMALL BUS.**

3Q'14 2.2%

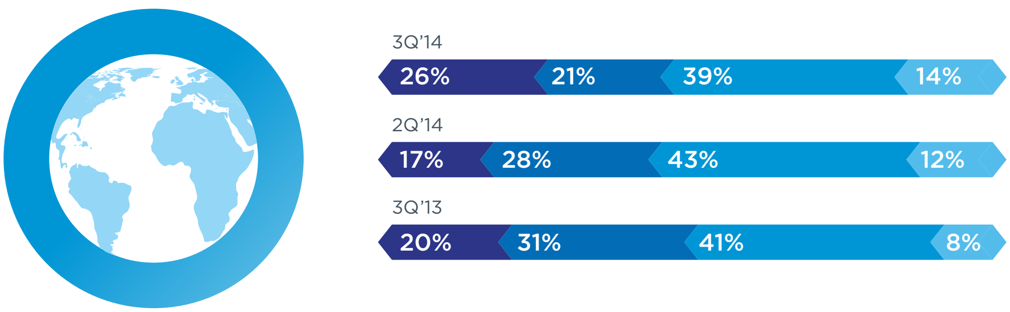
2Q'14 2.1% 3Q'13 1.8%

# ECONOMIC CONFIDENCE
## Confidence in the global economy dips

While the majority of middle market executives remain confident in the global, U.S., and local economies, the number of leaders reporting no confidence in the global economy increased significantly to 26% in the third quarter of 2014, versus 17% in 2Q 2014. This increase is driven specifically by leaders of small and large middle market firms.

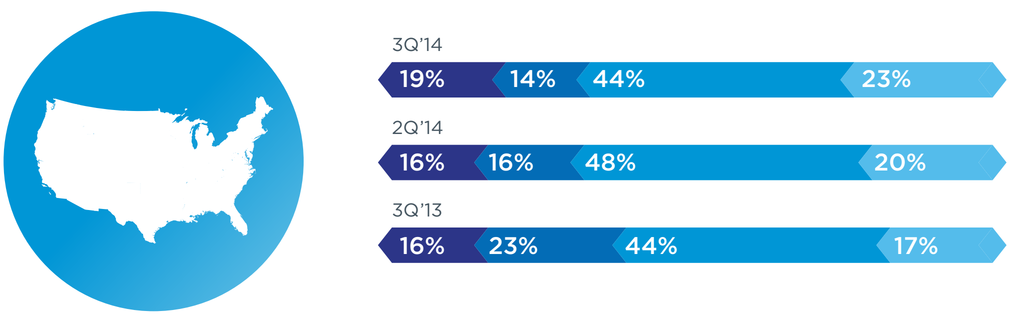
Interestingly, the decline in global confidence is not reflected at the national or local level, where confidence remains strong. Approximately 6 of 10 executives at small and large middle market firms believe the U.S. economy will continue to grow in the coming year; however that number drops to 4 of 10 for core middle market firms. At the local level, nearly 75% of executives across all revenue segments are at least somewhat confident in the economy, and only 12% report no confidence at all in their local economies.

### GLOBAL ECONOMY



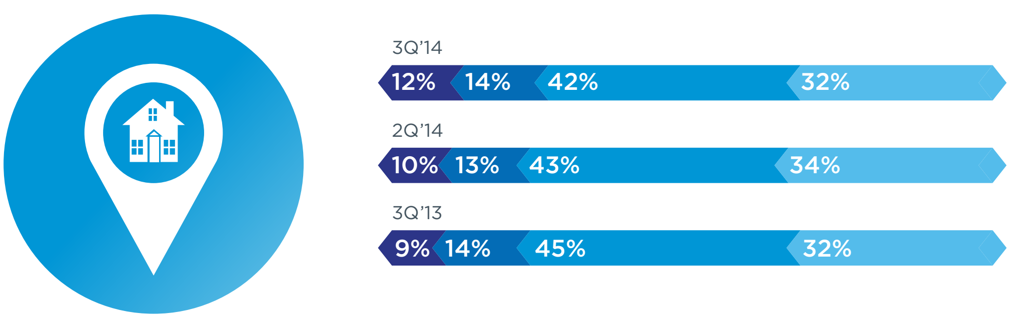

3Q'14
**53%**
**CONFIDENT / SOMEWHAT CONFIDENT**
2Q'14 55% 3Q'13 49%

### NATIONAL ECONOMY




3Q'14
**67%**
**CONFIDENT / SOMEWHAT CONFIDENT**
2Q'14 68% 3Q'13 61%

### LOCAL ECONOMY




3Q'14
**74%**
**CONFIDENT / SOMEWHAT CONFIDENT**
2Q'14 77% 3Q'13 77%

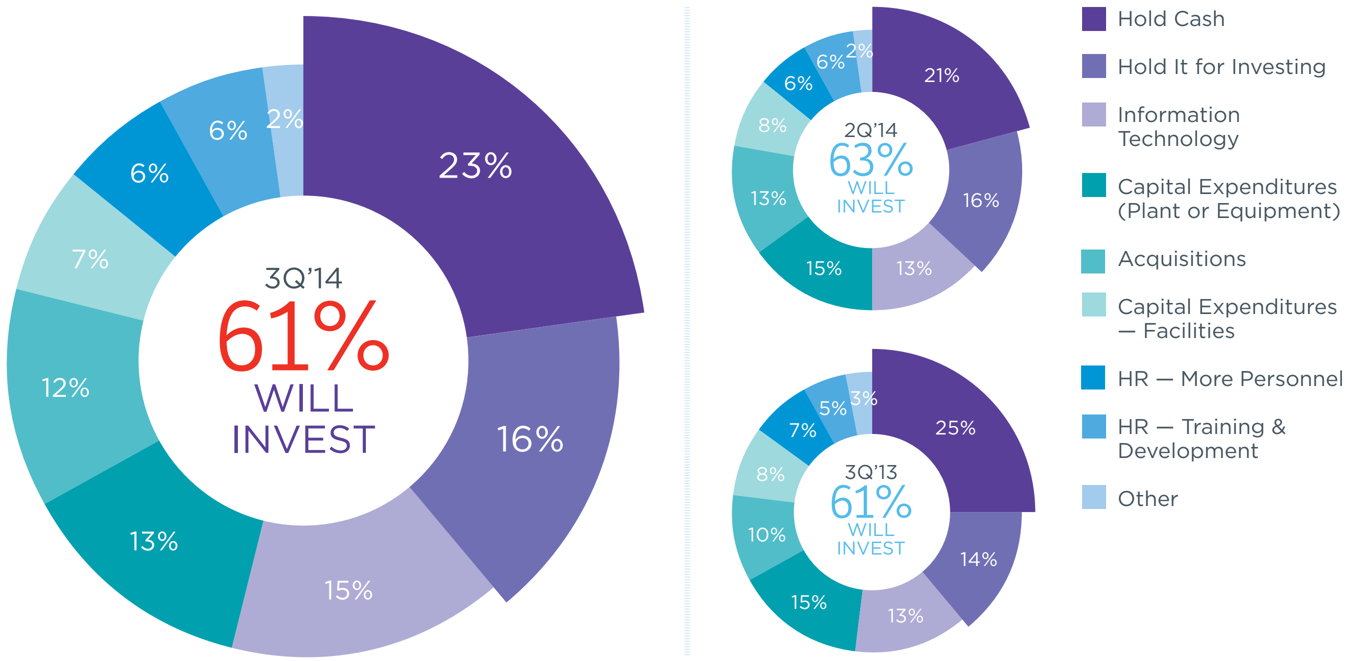
Not confident | Somewhat not confident | Somewhat confident | Confident

## CAPITAL INVESTMENT
### Capital investment plans have not changed

Since 2012, the percentage of middle market leaders planning to hold cash versus those who plan to invest has remained quite stable. Specifically, in 3Q 2014, 61% say they would invest additional dollars while 39% plan to hold on to cash, identical to the numbers reported in 3Q 2013. The inclination to hold cash is similar across all middle market revenue segments and spending and saving patterns are relatively stable across industries.

Capital expenditure is likely to increase over the next 12 months, with 44% expecting to introduce a new product or service, 41% expecting to expand domestically and 24% of middle market firms likely to add a new plant or facility.

### ADDITIONAL INVESTMENT ALLOCATION




## KEY CHALLENGES
### Concerns about healthcare costs are easing

While healthcare costs and other margin pressures, including the cost of doing business, remain the most significant challenges for middle market firms, the percentage of executives indicating healthcare costs as "highly challenging" decreased significantly in 3Q 2014 to 47%, down from 54% last quarter. In addition, concerns over government actions have remained somewhat muted throughout 2014 as compared to mid-to-late 2013. Looking at internal challenges, 70% of firms find it at least somewhat challenging to attract, train, and retain talent, and it is becoming increasingly difficult to fill senior positions. Furthermore, nearly two-thirds (62%) of firms are experiencing wage pressures including paying more to retain existing workers.

### TOP CHALLENGES

1. THE COST OF HEALTHCARE **84%**
2. THE COST OF DOING BUSINESS **83%**
3. ABILITY TO GROW REVENUE **82%**
4. ABILITY TO MAINTAIN MARGINS **78%**
5. THE UNCERTAINTY OF HOW GOVERNMENT ACTIONS WILL IMPACT MY BUSINESS **75%**

# Perspectives

## ACCELERATING GROWTH

U.S. unemployment has at long last fallen below 6%. Gross domestic product growth has recovered following a stumble early in the year. The economy seems to have settled into a decent growth rate—better than desultory but worse than ideal.

Things are different in the middle market, which continues to outperform the economy as a whole. America's mid-sized companies have completed a remarkable run in which revenue growth has accelerated for four quarters in a row: 5.0% in the fourth quarter of 2013, then 6.5%, 6.6%, and now 7.5%. For the last year, employment growth in the middle market has averaged about three and a half percent—a full percentage point higher than the average in the eight previous quarters. The middle market has found a higher gear.

But like a car that develops a shimmy above a certain speed, the middle market shows some unevenness in its growth. Three months ago, executives from companies in the core of the middle market expressed less confidence in their future growth than the rest of middle market, and they were right. In the quarter just ended, these firms enjoyed notably lower growth (5.3%) than smaller (8.9%) and larger (6.4%) companies. Now, within this group only one of eight executives say business is getting worse, and that number has not increased; but the number saying business is *better* has fallen from two-thirds to half. It's not clear where the problem is or whether it's temporary; but core middle market executives are, again, conspicuously more cautious in their future revenue projections than the other groups.

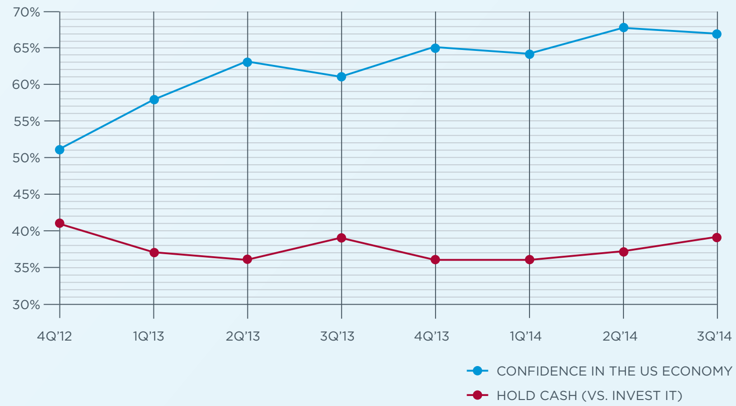
Balancing that out is ebullient growth in the lower end of the middle market and steady progress among firms in the upper middle market—those with revenues between $100 million to $1 billion. The smaller firms are now projecting 6.5% revenue growth, a forecast that is 67% higher than their prediction a year ago. It's also encouraging that almost every industry shows growth that's at least as high as its second-quarter growth. The exception is financial services, where, it should be noted, second quarter-numbers were anomalously high.

## THE PRODUCTIVITY PLAY

One possible explanation for somewhat slower going in the middle of the middle market: These companies may be pushing against the limits of the strategy of trying to grow without increasing investments in people or capital equipment. We've noted before that sooner or later, executives will have to open one or both purse strings. There's some evidence that core middle market companies are facing the choice now, especially in the talent market. They are more likely than either smaller or larger firms to say that it is becoming more difficult to attract and retain entry-level and STEM workers. They are also the most likely to say that they'd rather hold onto an additional dollar of revenue as cash than invest it. And they are more concerned than the other groups about their ability to maintain margins, which might indicate they feel pressure to increase wages, capital spending, R&D and marketing budgets, or all of these.

## THE CASE OF THE MISSING CAPEX

What are we to make of the middle market's apparent reluctance to make capital investments? Consistently—one might say stubbornly—nearly 40% of middle-market executives tell us they would hold additional revenue as cash rather than invest it, even as their revenue and confidence have increased.




Partly the middle market is reflecting broader realities; in the economy as a whole, net business investment is where it was in 2007, which means it is lower as a share of GDP—though corporate profits have never been higher in relation to GDP.*

But there exist more optimistic explanations for the middle market's low appetite for capital investment. First, rising revenues means that CapEx is increasing in dollars terms even if not as a percentage of sales. Second, a number of trends are lowering the capital intensity of business. There's the long-term move toward a services economy. More intriguing is the rapid rise of cloud-based information technology services. No longer do middle-market companies (and others) have to invest billions in servers, switches, and software; instead, they can rent what they need as they need it. Economists may have underestimated the speed with which the cloud is affecting IT capital spending, though it's evident in the flat sales of enterprise computing companies like IBM and Hewlett Packard. If companies can acquire capabilities without CapEx, that's a good thing for everyone except equipment sellers.

The second explanation has to do with discipline. Jim Collins has documented the fact that the most successful middle market companies manage their finances conservatively to provide stability against crosswinds. We see that discipline in the middle market's focus on investing to strengthen the core business. They want to put money to work to introduce a new product or service (44%) or expand into new domestic markets (41%) more than to expand abroad or add a new facility (25%) or make acquisitions (24%). They are most likely to tap close-to-home sources of funds like local banks or their own profits.

The seemingly low rate of capital expenditure results from a combination of cyclical, structural, and self-imposed factors. Judging from the growth of the middle market, executives have so far done an admirable job of sorting through their choices.

*http://www.stephens.com/PDF/Stephens-Viewpoint-4Q2014.pdf

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THE OHIO STATE UNIVERSITY
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