# 2Q 2015

## MIDDLE MARKET INDICATOR

## MAINTAINING STABLE GROWTH

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 47.9 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 lower and upper 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**

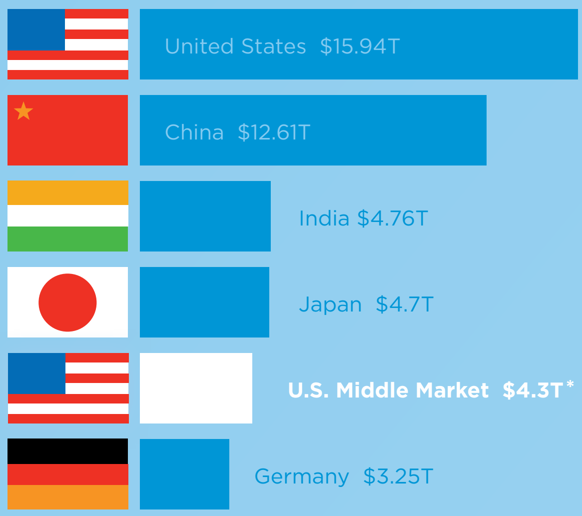
$ LOWER MIDDLE MARKET **$10MM - $50MM**

$ $ 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 the performance of U.S. middle market companies remains undeniably strong expectations for future rates of revenue and employment growth have declined for the second straight quarter. Additionally, the rates of year-over-year mean total revenue and employment growth slipped for most middle market firms this quarter. The healthcare, financial services and construction industries are the exception, with revenue growth remaining above 8% and strong year-over-year employment increases. Overall, the majority of middle market firms anticipate continued revenue growth at moderate, sustainable rates, however more than eight in 10 (81%) believe their workforce is currently sized right.**

For Q2 2015, two-thirds of middle market companies across all revenue and industry segments report improved past year company performance, up from 63% in the second quarter of 2014. In particular, core middle market firms, with revenues between $50 million and $100 million, appear to have rebounded from last quarter.

This quarter, a record high 75% of middle market companies report increased year-over-year revenue growth; but they are growing at a slower rate than experienced over the previous three quarters. After a spurt of rapid expansion, growth appears to be stabilizing across most industries, although healthcare, construction, and financial services industries continue to enjoy higher rates of growth. On the other end of the spectrum, the services and manufacturing segments report the most notable slowdowns in growth. Yet, across the board, the middle market continues its trend of significantly outpacing the S&P 500, where revenue actually declined 1.8%.

After achieving a high of 5% in Q4 2014, year-over-year mean total employment growth has slipped to just under 4% for Q2 2015, continuing the downward trend that began last quarter. Since the end of last year, employment growth has slowed across all middle market revenue segments and all industries, with the exception of construction, which reports 6.5% mean total year-over-year employment growth this quarter. Employment increases remain strong in the healthcare segment as well, at 5.7%.

While close to half of firms experienced some form of expansion in the past year, executives' expectations of future expansion decreased last quarter, and these muted numbers hold for Q2 2015. Still, 40% of companies expect to introduce a new product or service in the next 12 months and 31% anticipate geographic domestic expansion. Two-thirds of firms indicate an appetite for investing additional cash on hand and most firms target and maintain a low debt to asset ratio of about 22%.

The short-term outlook for middle market firms in most industries has declined from last quarter. Fewer middle market business leaders anticipate a more favorable business climate and stronger demand over the next three months. Additionally, less than half of firms predict a short-term increase in sales, with the retail trade industry posting the largest drop in sales expectations. At the same time, over one-third of companies believe their costs will increase in the next three months, and the majority of these businesses expect the increase to affect pricing. Despite these projections, nearly one-third of firms expect to add to their workforce in the short term, with construction and healthcare companies most likely to be hiring.

Looking further into the future, expectations for the rate of revenue and employment growth continue the decline reported last quarter, most notably among firms with more than $100 million in annual revenues. Middle market leaders also anticipate low increases in profitability over the next 12 months. While the majority of businesses do expect some revenue expansion, and 37% anticipate workforce increases over the course of the year, companies continue to struggle with finding and retaining qualified candidates. They also contend with the impact of increasingly complex government regulations.

On a positive note, middle market business leaders believe a strengthening dollar and a slowdown in the rise of healthcare costs will benefit their companies. The majority of middle market leaders remain confident in the local and U.S. economies, and global economic confidence is beginning to rise marginally.

## REVENUE GROWTH
### More middle market firms are growing, but a slower rate

For Q2 2015, three-quarters of middle market firms reported year-over-year increases in revenues, up from 70% last quarter and 69% one year ago. While more middle market companies are currently experiencing growth than at any other time in the history of the Middle Market Indicator, the rate of growth is tapering off. After reporting mean year-over-year revenue growth above 7% for the past three quarters, companies now report growth rates of 6.6%, the same as one year ago. In particular, the largest middle market firms, with revenues between $100 million and $1 billion, report a significant decrease in the rate of year-over-year growth, from 9.1% last quarter to 6.4% this quarter.

The reduced expectations for future growth seen in the first quarter of the year continue today. Six in 10 firms expect to grow revenues over the next 12 months, however at a slower growth rate of 5.1%. This anticipated revenue growth rate is the lowest level measured over the past year.

2Q'15 **66%** of middle market companies reported positive revenue growth. 2Q'14 **69%**

**MIDDLE MARKET**

**PAST 12 MO.**
2Q'15 **6.6%**
1Q'15 7.4% 2Q'14 6.6%

**NEXT 12 MO.**
2Q'15 **5.1%**
1Q'15 5.3% 2Q'14 5.8%

**S&P 500**

**PAST 12 MO.**
2Q'15 **-1.8%**
1Q'15 2.9% 2Q'14 3.4%

## EMPLOYMENT GROWTH
### Slower employment growth persists

While middle market firms continue to hire, with close to half (46%) of companies reporting year-over-year increases in the size of the workforce, the rate of growth has continued the decline reported last quarter. Mean total employment growth slipped to 3.9% from 4.3% reported in Q1 2015, with the most notable decreases in the largest middle market firms. However, mean employment growth remains above the levels reported one year ago.

Expectations for employment growth over the next 12 months continue to soften, with the largest middle market firms anticipating the greatest decrease in the future rate of hiring. Additionally, significantly more lower middle market firms (revenues between $10 million and $50 million) expect to downsize over the course of the year. For the overall middle market, close to four in 10 middle market firms expect to increase the size of their staffs, but at a reduced growth rate of 2.7%.

2Q'15 **38%** of middle market companies expect to add jobs. 2Q'14 **47%**

**MIDDLE MARKET**

**PAST 12 MO.**
2Q'15 **3.9%**
1Q'15 4.3% 2Q'14 3.2%

**NEXT 12 MO.**
2Q'15 **2.7%**
1Q'15 3.2% 2Q'14 3.3%

**ADP** [PAST 12 MO.]

**LARGE CORP.**
2Q'15 **1.7%**
1Q'15 2.1% 2Q'14 2.6%

**SMALL BUS.**
2Q'15 **2.7%**
1Q'15 2.7% 2Q'14 2.1%

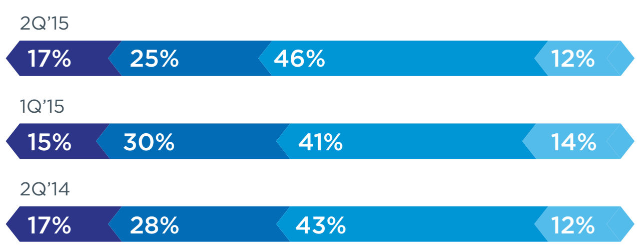
# ECONOMIC CONFIDENCE

## National and local confidence continue to outpace global confidence

Over the past 12 months, middle market leaders' confidence in the national economy has increased steadily, approaching the high levels of local economic confidence that have persisted over the past three years. However, global economic confidence has remained relatively flat since the first quarter of 2014. Interestingly, in Q2 2015, confidence in the U.S. economy has taken a slight step back, and local confidence has declined slightly as well from three months ago; but global perspectives have improved marginally.

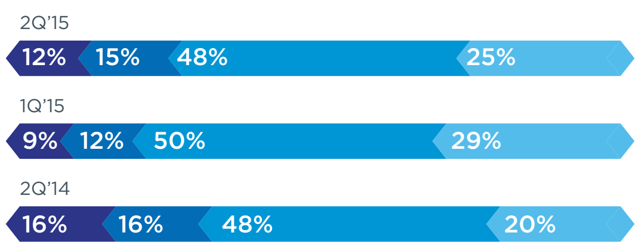
Despite these fluctuations, attitudes toward local and national conditions remain notably stronger than the global outlook. Nearly three-quarters (73%) of middle leaders remain somewhat positive about the national state of affairs, and eight in 10 leaders report at least some confidence in local conditions. Global confidence lags behind at 58%, but the gap continues to narrow, and global confidence remains well above levels reported in 2012 and early 2013.

### GLOBAL ECONOMY



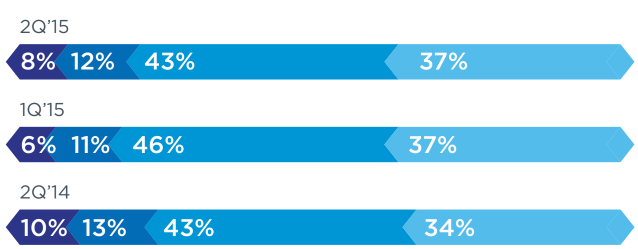

2Q'15
**58%**
**CONFIDENT / SOMEWHAT CONFIDENT**
1Q'15 55% 2Q'14 55%

### NATIONAL ECONOMY




2Q'15
**73%**
**CONFIDENT / SOMEWHAT CONFIDENT**
1Q'15 79% 2Q'14 68%

### LOCAL ECONOMY




2Q'15
**80%**
**CONFIDENT / SOMEWHAT CONFIDENT**
1Q'15 83% 2Q'14 77%

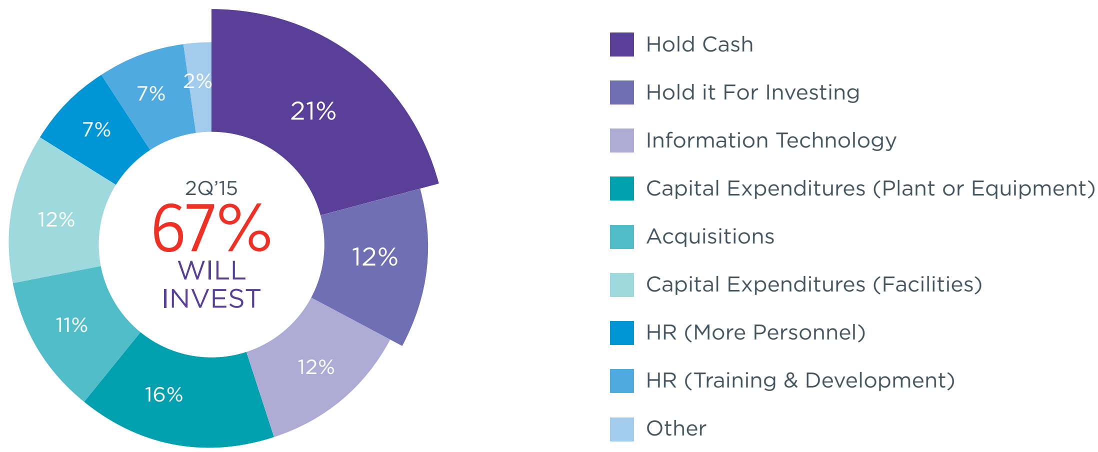
Not confident | Somewhat not confident | Somewhat confident | Confident

# CAPITAL INVESTMENT

## Appetites for investment remain consistent

About two-thirds (67%) of middle market companies remain willing to invest additional dollars as opposed to saving cash, a percentage that has remained consistent since increasing from 61% to 68% at the end of 2014. One-third of companies prefer to hold onto cash. Over the coming year, middle market firms are most likely to invest in new products or services or expansion into new domestic markets. However, local competition, regulations, and limited resources will be challenges to geographic expansion. For those companies that increase their offerings, many expect the investment to pay off: about two in five firms—or 42%—anticipate an increase in the proportion of company revenues that will come from newly introduced products and services.

### ADDITIONAL INVESTMENT ALLOCATION




# KEY CHALLENGES

## Talent and regulation concerns are growing

For the second straight quarter, middle market leaders had the opportunity to write in their key challenges for both the near and long term as opposed to responding to a pre-defined list of issues. Once again, employment issues—including hiring, retention, and workforce qualifications—remain the top internal concerns facing companies right now and over the coming year. Externally, leaders are expressing growing concerns related to competition and the impact of government regulations. Leaders expect these challenges to be the greatest hurdles to overcome over the next three months and throughout the year ahead.

### SHORT TERM CHALLENGES (Next 3 months)

| INTERNAL CHALLENGES: | |
|---|---|
| 1. STAFF/EMPLOYEES | 44% |
| 2. BUSINESS GROWTH | 30% |
| 3. FINANCES | 21% |
| 4. COSTS | 19% |
| 5. GOVERNMENT REGULATIONS | 10% |
| **EXTERNAL CHALLENGES:** | |
| 1. COMPETITION | 25% |
| 2. GOVERNMENT REGULATIONS | 22% |
| 3. COSTS | 15% |
| 4. ECONOMY | 15% |
| 5. BUSINESS GROWTH | 13% |
| 6. FINANCES | 13% |

### LONG TERM CHALLENGES (Next 12 months)

| INTERNAL CHALLENGES: | |
|---|---|
| 1. STAFF/EMPLOYEES | 47% |
| 2. BUSINESS GROWTH | 22% |
| 3. FINANCES | 15% |
| 4. COSTS | 17% |
| 5. GOVERNMENT REGULATIONS | 5% |
| **EXTERNAL CHALLENGES:** | |
| 1. GOVERNMENT REGULATIONS | 24% |
| 2. COMPETITION | 19% |
| 3. COSTS | 14% |
| 4. ECONOMY | 14% |
| 5. BUSINESS GROWTH | 13% |
| 6. FINANCES | 11% |

# Perspectives

## SPEED ZONE AHEAD

The middle market, still cruising quickly, has lifted its foot off the accelerator. The rate of middle market growth has softened, with middle market companies averaging revenue growth of 6.6%, down from 7.4% in the previous quarter, which is still impressive. Middle market growth is also widespread: 75% of middle market executives report increased revenue, and the construction, healthcare, and financial services industries reported revenue growth rates of about 8.5%.

Still, the cautious sentiment perceived three months ago has persisted, manifested clearly in hiring behavior and plans. In the last three quarters, mean year-on-year employment growth has slipped from 5.0% to 4.3% to 3.9%. The middle market is also less ebullient about prospects for profits than it was at the start of the year. Though the vast majority (86%) expects profit margins to grow or stay the same, the average projected increase in profitability is down from 3.1% to 2.4%.

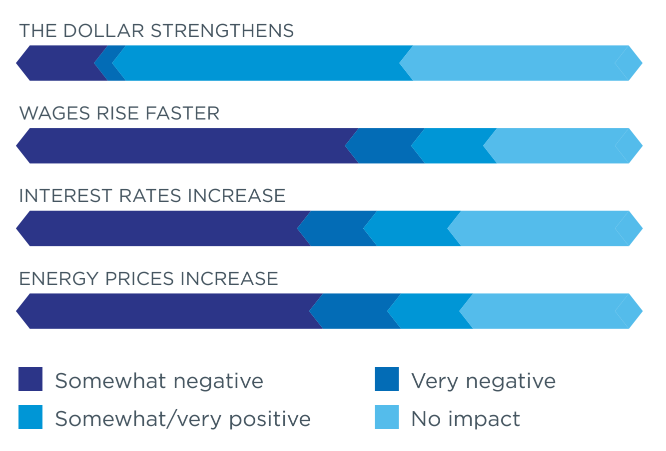
None of this is alarming. While the economic recovery has been slow, it is now six years old and slower rebounds are considered normal. More important, the middle market's appetite for investment remains strong—67% say they'd invest an extra dollar vs. save it; 18% say they have opened a new plant or facility in the last year; R&D spending is solid, and 36% of manufacturers say it is increasing.

## SO WHY THE LONG FACE?

Three things appear to be weighing heavily on executives' minds. First is the availability and price of labor. Minimum wage increases and a tighter labor market have made workforce issues a top challenges for executives. Second and more immediately, middle market executives worry whether the pace of the economy and overall business climate will continue to support growth. For only the second time since the MMI began, confidence in both local and national economies has dipped slightly. And the Canadian economy—the middle market's largest trading partner—has also been sluggish.

Finally, the middle market is anxious about the potential impact of increases in interest rates and energy prices. Forty-eight percent of executives would welcome a stronger dollar because it would reduce the cost of imported raw materials (see chart). If wages, interest rates, and energy prices all went up, the hat trick would squeeze profits and tamp down growth. These factors are largely outside management's control, with the exception of labor costs. They can be held down by restraining hiring itself, which appears to be what executives have in mind.

WHAT WOULD BE THE IMPACT ON YOUR BUSINESS IF....




## PUBLIC MATTERS

While executive gatherings can often turn into gripe sessions against the government, it is important to keep these complaints in perspective. By a wide margin executives are more worried about the invisible hand of the market than the heavy hand of the state. Business and competitive issues—expanding geographically, foreign rivals, financing growth—lead executives' list of challenges by a wide margin over government: more than 3 to 1 in the short term, nearly 3 to 1 in the long run.

***Still, there are grounds for grousing. Discernable in the data are four points of a middle market policy agenda:***

**Tax fairness:** Middle market executives tell us their effective tax rates are 17.9% (federal) and 8.9% (state). While these self-reported numbers are impossible to compare to the overall effective corporate tax rate, it is clear that the complexity of the tax code bedevils middle market companies, which are often too big to qualify for exemptions and too small to exploit tax arcana.

**Regulatory burden:** Middle market executives are caught in the middle: unable to claim exemption from requirements and forced to pile the cost of compliance on a lower revenue base than larger companies. Policymakers should reexamine the distribution of tax and regulatory burdens, at whatever level they are set.

**Infrastructure:** Seventy-three percent of middle market executives say investment in physical infrastructure—roads, bridges, airports—should be a top priority for government; a third say it should be <u>the</u> top priority. Three out of five prioritize public investment in digital infrastructure (e.g., broadband and cybersecurity) and 15% say it should be job one.

**Human capital:** One in four middle market executives cite education as the top need; 50% say workforce training should be a public priority, with 14% putting it first on the list. Middle market executives struggle most in finding qualified candidates (57% say it is a major challenge) and hiring new talent (49%).

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