3Q 2015

MIDDLE MARKET INDICATOR

STEADY GROWTH – CAUTIOUS OUTLOOK

NATIONAL CENTER FOR
THE MIDDLE MARKET

In Collaboration With

The Ohio State University
Fisher College of Business

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

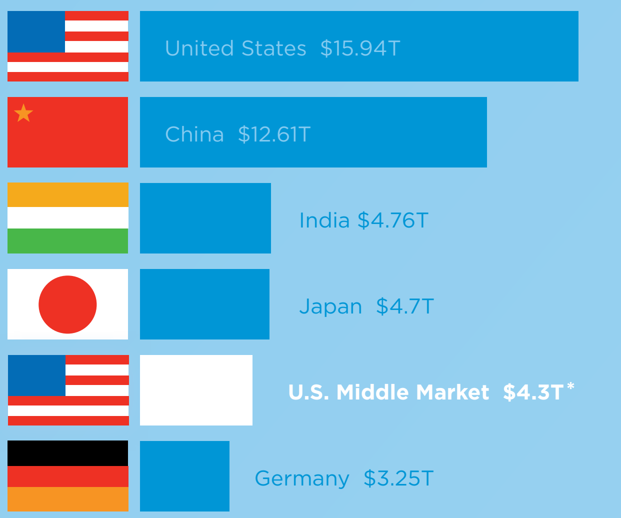
$ LOWER MIDDLE MARKET
$10MM - $50MM

$ $ 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

U.S. middle market firms continue to report improved company performance along with increases in revenue and employment. However, the outlook for the future—both in the short term and over the course of the next year—continues to soften across the middle market. In some industries, company performance and leader sentiment are much stronger in some industries than in others, with the retail, financial services, and services sectors outperforming segments such as wholesale trade and construction. The largest middle market firms are experiencing the greatest year-on-year growth (averaging 8.3%), while companies in the core middle market—with revenues between $50 million and $100 million) grew slower (5.4%) and are least likely to expect revenue to grow in the year to come.

For Q3 2015, nearly two-thirds of middle market companies report improved company performance versus one year ago—a percentage that has remained stable over the course of the year. Performance among core middle market firms has fluctuated over the last four quarters with significantly more companies reporting a deterioration in performance this quarter. The wholesale trade industry also experienced a sharp drop in the proportion of companies reporting improved performance. Conversely, more companies in the retail trade and financial services sectors say performance improved.

Seven in 10 middle market companies continue to report increases in year-over-year revenue growth. Following a slight dip in the rate of growth reported last quarter, mean revenue growth has returned to above 7%, and the middle market continues its ongoing trend of outperforming the S&P 500, which experienced -6.2% revenue growth for the same period. As with performance, clear differences exist between industries. Services, retail trade, construction, and financial services companies report the strongest rates of growth, while the healthcare, manufacturing, and wholesale trade industries indicate declining growth rates this quarter.

While the overwhelming majority of middle market firms (78%) feel their workforce is the right size for current market conditions, a significant and stable proportion of companies continue to increase the size of their staffs at a respectable rate. Mean total year-over-year employment growth has remained near 4% for the first three quarters of 2015. The service and retail trade sectors experienced the strongest employment growth this year, with both segments reporting year-over-year employment growth rates of 5.4% for Q3 2015.

Despite improved performance and revenue gains for most middle market firms, many leaders are cautious about the future. Global confidence has slipped and more firms plan to hold their cash as opposed to invest it. Only one in five business leaders expect a more favorable business climate in the short term, and just one third of companies expect demand to increase in the next three months. Sales expectations are also muted for the time being, with fewer than half of middle market companies expecting higher sales in the coming quarter.

For the next 12 months, anticipated revenue growth is at the lowest level measured in the past year. Expectations have dropped significantly since last quarter, with the most profound drop coming from core middle market companies. The outlook for hiring, however, remains stable: lower anticipated hiring rates among core middle market firms are offset by a rebound in hiring expectations among larger companies.

Major headwinds for middle market firms in both the short and long term will continue to be staffing challenges, government regulations, and competition. To offset staffing difficulties, many firms will focus on salaries, flexible work arrangements, and training and education as ways to retain talent.

Despite the challenges, middle market leaders do expect profit margins to increase modestly over the next 12 months, with financial services companies anticipating the greatest profitability gains. Companies across all revenue segments and industries also plan on continuing to invest about 10% of annual revenue in research and development in the hopes that new products and services will play an ongoing key role in fueling revenue growth.

REVENUE GROWTH
Growth remains strong, but future expectations continue to weaken

For Q3 2015, 71% of middle market firms reported year-over-year increases in revenue, a slight increase from one year ago. The 7.2% rate of growth has rebounded from its dip last quarter. The largest middle market firms, with revenue between $100 million and $1 billion, are driving the rebound. Likewise, the service and retail trade sectors experienced significant jumps in revenue growth. Growth remained strong—well above 8%—in the construction and financial services sectors.

Despite sustained healthy growth, expectations for future revenue increases continue to drop since plunging earlier this year. For the first time, fewer than 50% of firms say they anticipate revenue growth in the next 12 months. Those that do except growth believe it will come at a slower rate—4.1% for the coming year versus 5.1% reported last quarter. Revenue projections are down in nearly every industry with the exception of financial services.

3Q'15 **71%** of middle market companies reported positive revenue growth. 3Q'14 68%

MIDDLE MARKET

PAST 12 MO.

3Q'15 7.2%

2Q'15 6.6% 3Q'14 7.5%

NEXT 12 MO.

3Q'15 4.1%

2Q'15 5.1% 3Q'14 5.5%

S&P 500

PAST 12 MO.

3Q'15 -6.2%*

2Q'15 -1.8% 3Q'14 5.5%

EMPLOYMENT GROWTH
Employment growth remains stable

Since leveling off in the first quarter of 2015, the percentage of middle market firms growing their workforces has remained relatively stable. Slightly more than four in 10 companies have expanded their headcounts over the past 12 months. Since falling from a high of 5% in Q4 2014, the rate of year-over-year employment growth has remained consistent at around 4%. As with revenue growth, service and retail trade businesses are experiencing the strongest employment gains.

The number of firms expecting to increase the size of their workforce in the coming year has also remained stable throughout 2015. Today, 36% of middle market companies say they have plans to hire in the next 12 months, and firms anticipate a modest growth rate of 3.2%—the same as reported at the beginning of 2013. In the short term, the majority of middle market leaders across revenue segments expect their workforce to remain the same size.

3Q'15 **42%** of middle market companies expect to add jobs. 3Q'14 47%

MIDDLE MARKET

PAST 12 MO.

3Q'15 4.1%

2Q'15 3.9% 3Q'14 3.5%

NEXT 12 MO.

3Q'15 3.2%

2Q'15 2.7% 3Q'14 3.6%

ADP [PAST 12 MO.]

LARGE CORP.

3Q'15 1.7%

2Q'15 1.7% 3Q'14 2.6%

SMALL BUS.

3Q'15 2.4%

2Q'15 2.7% 3Q'14 2.2%

**3Q numbers include only companies who have reported 3Q earnings results. Numbers change as more businesses report financial results.*

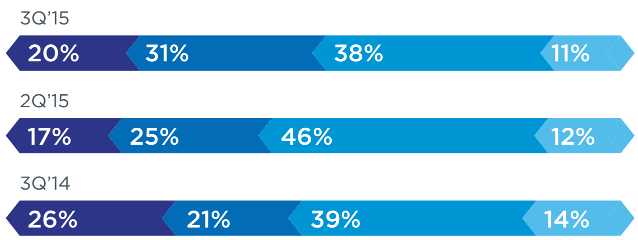
ECONOMIC CONFIDENCE

Global confidence falls while confidence remains solid closer to home

After trending relatively flat since the end of 2013, global confidence dropped significantly for the third quarter of 2015. Today, fewer than half—or 49%—of middle market leaders say they are somewhat to very confident in the global state of affairs, down from 58% last quarter. Two in 10 leaders are not at all confident in the global economy. Despite this setback, global confidence remains much higher than in 2012 and early 2013.

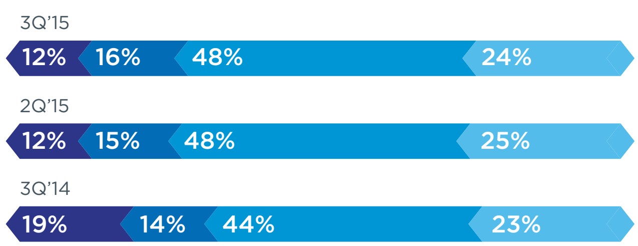
Closer to home, confidence in the national and local economies remains strong. U.S. confidence has dipped just slightly since a four-year high reported at the beginning of this year. However, close to three-quarters (72%) of middle market executives continue to express at least some confidence nationally. For the fourth straight quarter, local confidence levels remain in the 80th percentile. Just 9% of leaders lack any confidence in their local markets.

GLOBAL ECONOMY



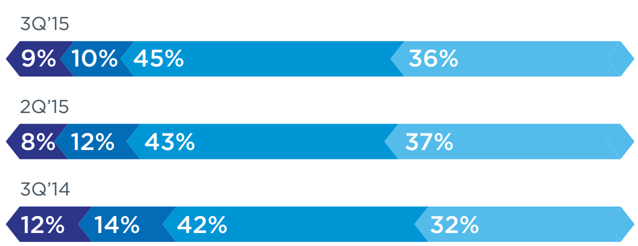
3Q'15
49%
CONFIDENT / SOMEWHAT CONFIDENT
2Q'15 58% 3Q'14 53%

NATIONAL ECONOMY



3Q'15
72%
CONFIDENT / SOMEWHAT CONFIDENT
2Q'15 73% 3Q'14 67%

LOCAL ECONOMY



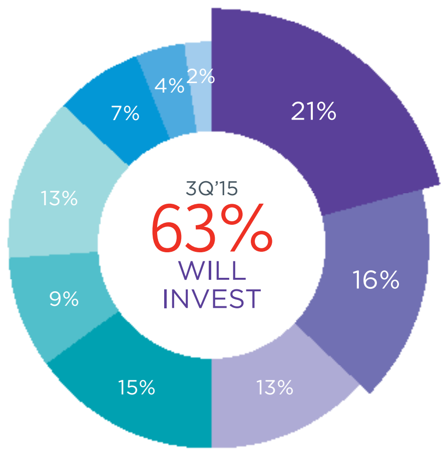
3Q'15
81%
CONFIDENT / SOMEWHAT CONFIDENT
2Q'15 80% 3Q'14 74%

Not confident Somewhat not confident Somewhat confident Confident

CAPITAL INVESTMENT
More firms will hold on to cash

The proportion of middle market firms willing to invest extra money fell slightly this quarter from 67% in Q2 2015 to 63% today. The appetite for investment peaked in the fourth quarter of 2014 and held steady for nine consecutive months before tapering off. Fewer middle market firms have future expansion plans as compared to the end of 2014. However, two in five companies (39%) do intend to introduce a new product or service in the next 12 months, and 33% of firms expect to increase the proportion of revenues coming from new products and services this year. Just under one-third (32%) of firms hope to expand into new domestic markets. Strict regulations and local competition will remain barriers to such expansion.

ADDITIONAL INVESTMENT ALLOCATION



- Hold Cash
- Hold it For Investing
- Information Technology
- Capital Expenditures (Plant or Equipment)
- Acquisitions
- Capital Expenditures (Facilities)
- HR (More Personnel)
- HR (Training & Development)
- Other

KEY CHALLENGES
Talent, regulations, and competition remain the greatest hurdles

For the third straight quarter, staffing issues—including recruiting, assimilating, and retaining quality professionals—are the leading internal challenges for middle market executives. Externally, concerns over government regulations remain top of mind, and the majority of firms in every industry report at least some negative consequences as a result of such regulations. Competition is an equally difficult challenge for many middle market leaders. Leaders are contending with each of these key issues in the short-term, and they expect the issues to remain the top challenges throughout the course of the coming year.

SHORT TERM CHALLENGES (Next 3 months)

INTERNAL CHALLENGES:

1. BUSINESS GROWTH	**57%**
2. STAFF/EMPLOYEES	**49%**
3. COSTS	**16%**
4. GOVERNMENT REGULATIONS	**16%**

EXTERNAL CHALLENGES:

1. BUSINESS GROWTH	**35%**
2. GOVERNMENT REGULATIONS	**22%**
3. COMPETITION	**21%**
4. COSTS	**15%**
5. ECONOMY	**15%**

LONG TERM CHALLENGES (Next 12 months)

INTERNAL CHALLENGES:

1. STAFF/EMPLOYEES	**39%**
2. BUSINESS GROWTH	**25%**
3. COSTS	**12%**
4. GOVERNMENT REGULATIONS	**5%**

EXTERNAL CHALLENGES:

1. BUSINESS GROWTH	**27%**
2. GOVERNMENT REGULATIONS	**19%**
3. COMPETITION	**13%**
4. ECONOMY	**13%**
5. COSTS	**12%**

Perspectives

HOLDING BACK

It's fun to drive downhill in a Prius or other hybrid, lifting your foot and letting gravity do the work, so that the fuel-economy display shows that you are getting infinite miles per gallon. That cannot last, of course. Sooner or later you need to put your foot down and ask for fuel. U.S. middle market companies had a Prius-on-a-slope kind of summer in 2015. Average year-over-year revenues grew 7.2%—tied for third-best in the 14 quarters the NCMM has been tracking this number. Employment growth also turned in its third-best performance: Payrolls are 4.1% bigger than they were a year ago.

While racking up these impressive gains, middle market executives are flashing indications that they see hills and hazards ahead. The number who express confidence in the global economy plunged to 49%, from 58% just three months before. The abrupt change is clearly a response to the widely publicized difficulties in the Chinese economy (the fourth-biggest export destination for middle market companies and a key source of imports); but economies are sluggish in Canada (the middle market's number-one trading partner), Mexico (number two), Brazil, and other key markets. The Chinese-induced tremor that shook Wall Street in August—just before our survey went out—affected the middle market only tangentially, since 85% is privately held. To the degree that the confidence drop reflects real conditions rather than market sentiment, therefore, it becomes of even greater concern.

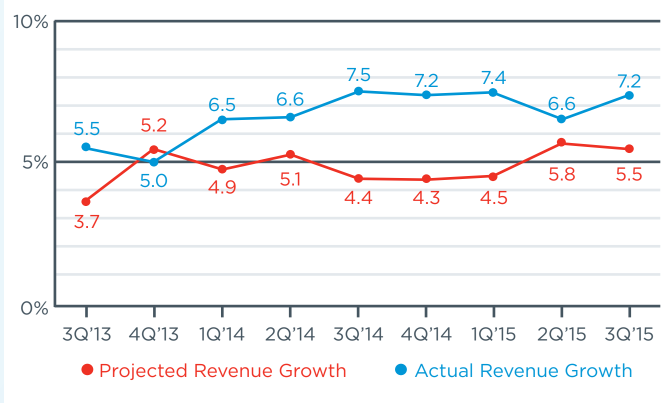
To be sure, executives have kept faith with the U.S. and their local economies—both are strong, and stronger than they were a year ago. Last year, however, middle market companies were forecasting 5.5% top-line growth for the year ahead; this quarter, they predict just 4.1% (a 25% drop). A year ago, they were forecasting 3.6% growth in employment; this quarter, they predict 3.2% (a 10% decline).

Should they be as worried as they are? Should we? Perhaps not: The middle market continues to outperform the S&P 500 by a substantial amount. Executives also say that their biggest challenges are adjusting to growth and attracting, assimilating, and retaining employees—which are not the problems of companies in trouble. Few people expect the business climate to deteriorate or demand to fall; instead, substantial majorities expect them to stay the same.

Further, middle market leaders have a track record of under-promising and over-delivering. Historically, middle market managers have projected revenue growth 1 to 3 percentage points lower than the actual rate of growth, with an average understatement of 1.6 percentage points. The data for employment growth are similar. Adjusting for the middle market's ingrained pessimism, however, still leaves us with a lower rate of growth ahead.

[1] *For the U.S. plan, see http://www.state.gov/documents/organization/219039.pdf. For a fact sheet and analysis from The World Resources Institute, see http://www.wri.org/sites/default/files/WRI14_Fact_Sheet_US_GHG_singles.pdf*

WHAT THEY SAID, WHAT THEY DID



Executives also are canceling, cutting, or delaying investments. Compared to this time last year, middle market companies are less likely to be planning to introduce a new product or service (39% this quarter vs. 44% in 3Q14), add a new plant or facility (21% vs. 24%), open new domestic markets (32% vs 41%) and expand internationally (18% vs. 25%).

Not for the first time, then, we see the middle market keeping cool and putting its foot on the accelerator—i.e. investing in people, projects, or assets—only when the business case is clear cut.

GREENER PASTURES

In November 2015, a crucial meeting of the United Nations Conference on Climate Change opens in Paris. The United States has announced greenhouse gas reduction targets of about 17% by 2020 and 26-28% by 2025. Most of that opportunity (or burden, depending) will come in power generation, but there will be substantial roles for transportation, industrial, and agriculture.[1] Energy efficiency in transportation, industrial production, and commercial real estate are also key parts of the plan. All affect the middle market, and the middle market—the fastest-growing third of the private sector—affects them all.

We therefore asked companies about their attitudes and actions concerning sustainability and energy efficiency. About a fifth (19%) put sustainability and energy efficiency among their top five priorities. Another 43% say they are important but other things come first. Retailers, interestingly, are most likely to rank them among their five highest priorities (27% do), with manufacturers next.

Why act? Cost reduction is the single most motivating factor—the savings can be significant. However, three out of five retailers say their customers care at least a little about their environmental responsibility.

Perhaps the most revealing datum is that the most motivated middle market companies are the biggest: 72% say sustainability and efficiency are at least important, 24% in the top five. By contrast, smaller companies are most likely to say that the only barrier standing in their way is the determination to act. They just don't care—yet.

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