NATIONAL CENTER FOR
THE MIDDLE MARKET

3Q 2016

MIDDLE MARKET INDICATOR

GROWTH CONTINUES; OUTLOOK IMPROVES

IN COLLABORATION WITH

THE OHIO STATE UNIVERSITY
FISHER COLLEGE OF BUSINESS

SUNTRUST

Grant Thornton

CISCO

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

The National Center for the Middle Market is a collaboration between The Ohio State University's Fisher College of Business, SunTrust Banks Inc., Grant Thornton LLP, and Cisco Systems. It exists for a single purpose: to ensure that the vitality and robustness of middle market companies are fully realized as fundamental to our nation's economic outlook and prosperity. The Center is the leading source of knowledge, leadership, and innovative research on the middle market economy, providing critical data analysis, insights, and perspectives for companies, policymakers, and other key stakeholders, to help accelerate growth, increase competitiveness and create jobs in this sector. To learn more visit: www.middlemarketcenter.org.

U.S. MIDDLE MARKET DEFINED

ANNUAL REVENUE
RANGING FROM
$10MM – $1B

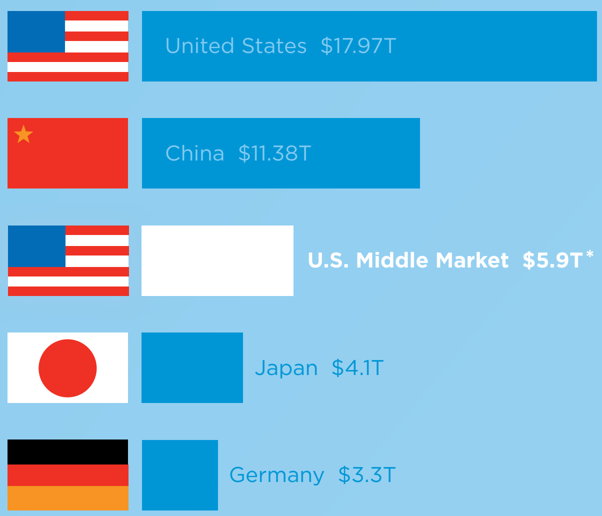
LOWER MIDDLE MARKET
$10MM - $50MM

CORE MIDDLE MARKET
$50MM - $100MM

UPPER MIDDLE MARKET
$100MM - $1B

NEARLY
200,000
BUSINESSES

3RD LARGEST
GLOBAL ECONOMY



Source: 2015 CIA World Fact Book (not adjusted for purchasing power parity),
**National Center for the Middle Market (estimate)*

Executive Summary

The rate of revenue growth in the middle market remains strong, and employment growth rates continue to accelerate across middle market revenue segments and industries. What's more, executives' projections for future revenue and employment growth rates have climbed higher, with the outlook for employment at an all-time high since the inception of the MMI. Most middle market leaders express confidence in the state of the economy. But they worry about the impact of other external factors on growth, including government regulations and the pressure of competition. Internally, companies worry about recruiting and retaining the talent they will need to meet market conditions, drive innovation, and help their organizations continue to thrive.

Six in 10 middle market leaders say company performance has improved since one year ago, while just 6% indicate that performance has deteriorated—a ten-to-one ratio that has been fairly consistent over the last two years. Middle market companies say their performance is strongest when it comes to maintaining banking relationships, retaining profitable accounts, and being industry leaders. They also do quite well at maintaining high-performing management teams, keeping talented employees, controlling costs, and accessing capital at an affordable cost. They perform moderately well on metrics associated with customer acquisition, innovation, and operational excellence. The largest middle market companies, with revenues between $100M and $1B tend to rate their performance in all these core capabilities more favorability than their smaller peers.

Year-over-year revenue growth in the middle market remains healthy overall, with innovation being a driving factor. Some 43% of middle market businesses introduced a new product or service in the past year, and nearly one-quarter of firms derive 20% or more of their revenue from recently introduced products. However, fewer firms reported year-over-year revenue increases this quarter than last, and the rate of year-over-year revenue growth slipped from 7.2% to 6.3%. The largest middle market companies as well as companies in the manufacturing, wholesale, and retail trade sectors contributed to the overall revenue slowdown; growth in other industry segments accelerated compared to the second quarter.

While this quarter's revenue growth rate is almost exactly at the historic average of 6.4%, the employment growth rate has been trending higher each quarter for the last year. For Q3 2016, the rate of employment growth rose across all middle market revenue segments and nearly every industry, continuing its long-term trend of acceleration. Many of these businesses rely on their new hires to help drive innovation, which in turn helps drive revenue growth. Although the employment growth rate increased overall, the number of companies saying they increased the size of their workforces was just over 40%, a percentage that has been consistent over the past year.

Honing in on industries, construction continues to report substantial increases in both revenue and employment growth. The service, financial services, and healthcare industries are also showing notable gains in both areas. The manufacturing industry is the only industry segment to report a slowdown in the rate of employment growth, and revenue growth rates have slipped in manufacturing as well.

Going forward, just over 40% of middle market companies expect an increase in short-term sales. However, most companies expect demand to remain the same and the business climate to remain unchanged. The largest middle market companies are a bit more optimistic in their short-term outlook. Nearly half (46%) anticipate a boost in sales, while 27% expect the business climate to become more favorable. Across the middle market, approximately one-third of firms plan on increasing their workforce in the short term.

Looking further ahead, the outlook is decidedly positive for the next 12 months. The middle market is expecting both revenues and payrolls to grow at a faster clip. In particular, expectations for future employment growth rates are at an all-time high. Middle market businesses also anticipate in an increase in merger and acquisition activity over the next 12 months, which they believe will help create efficiencies through industry consolidation.

With employment on the rise, companies continue to struggle with attracting and retaining the people they need to drive innovation and performance. About one-quarter of firms expect a tighter job market in the short term as companies continue to hire. As businesses prepare to compete for top talent, they look to improve salaries and offer flexible work arrangements to attract the best employees.

Beyond talent concerns, additional headwinds that could impede growth include government regulations, increasing competition, and costs.

REVENUE GROWTH
Revenue growth rates hover around the long-term average

Middle market revenue growth remains healthy with most companies saying it has increased since last year. However, after spiking to 7.2% last quarter, the rate of growth settled back to 6.3% and is currently in line with the long-term average growth rate. The largest middle market companies, which have been driving growth rates for the past year, reported a sharp decline this quarter, from 8.5% to 6.0%. Manufacturing, wholesale, and retail trade companies also reported decreases in their rates of year-over-year revenue growth.

Despite this slowdown, projections for future growth continue to inch up and expectations are at the highest levels since mid-2015. Half of middle market firms anticipate increases in revenues in the year ahead, while only 5% forecast a decline. Middle market leaders at smaller firms express the greatest optimism for the next 12 months. Likewise, services, manufacturing, and healthcare companies have particularly positive expectations.

3Q'16 **63%** of middle market companies reported positive revenue growth. 3Q'15 71%

MIDDLE MARKET

PAST 12 MO.

3Q'16 6.3%

2Q'16 7.2% 3Q'15 7.2%

NEXT 12 MO.

3Q'16 4.9%

2Q'16 4.8% 3Q'15 4.1%

S&P 500

PAST 12 MO.

3Q'16 2.5%*

2Q'16 1.2% 3Q'15 -6.2%

EMPLOYMENT GROWTH
Employment growth accelerates

About four in 10 companies report increases in year-over-year employment. At 4.9%, the rate of employment growth is near the MMI's all-time reported high and is well above the long-term average growth rate of 3.3%. Companies at both ends of the middle market revenue spectrum, and the largest middle market businesses in particular, are driving the acceleration. What's more, every industry, with the exception of manufacturing, is currently adding workers at a faster rate than one year ago.

At 4.0%, expectations for future employment growth are the highest ever reported by the MMI, although the number of companies saying they will increase employment is down slightly. The largest middle market firms are most optimistic. About a quarter of large firms believe their existing workforce is insufficient for meeting market conditions, and some 40% plan to increase employment by an average of 5% in the year ahead.

3Q'16 **37%** of middle market companies expect to add jobs. 3Q'15 42%

MIDDLE MARKET

PAST 12 MO.

3Q'16 4.9%

2Q'16 4.4% 3Q'15 4.1%

NEXT 12 MO.

3Q'16 4.0%

2Q'16 3.3% 3Q'15 3.2%

ADP [PAST 12 MO.]

LARGE CORP.

3Q'16 2.3%

2Q'16 2.3% 3Q'15 1.7%

SMALL BUS.

3Q'16 1.8%

2Q'16 1.9% 3Q'15 2.4%

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

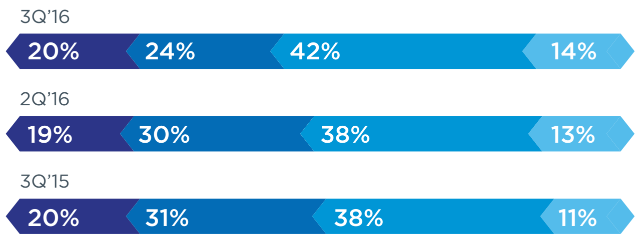
ECONOMIC CONFIDENCE

Global confidence recovers

For the past year and a half, middle market leaders' confidence in their local and national economies has been relatively stable with a large majority of leaders expressing positive opinions on the state of affairs in their immediate area and throughout the country. This quarter, eight in 10 companies are satisfied with economic conditions closest to home. Nearly three quarters (72%) of businesses have a positive outlook regarding the national economy.

Since plunging in mid-2015, confidence in the global economy appears to be recovering and is nearing the highest levels reported by the MMI. As always, global confidence lags behind local and national confidence. However, this quarter, a majority of middle market leaders report a comfort level with current economic conditions around the world. In fact, despite Brexit, weak growth in China, and other sources of global disquiet, confidence in the global economy jumped from 50% last quarter to 56% today.

GLOBAL ECONOMY



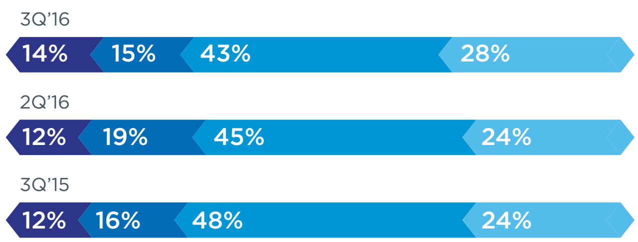
3Q'16

56%

CONFIDENT / SOMEWHAT CONFIDENT

2Q'16 50% 3Q'15 49%

NATIONAL ECONOMY



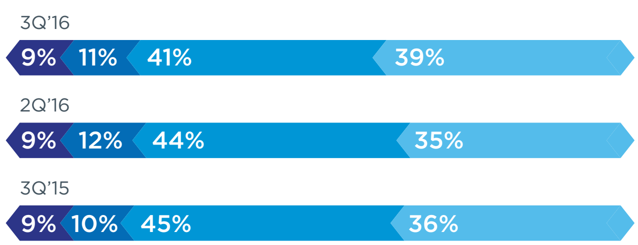
3Q'16

71%

CONFIDENT / SOMEWHAT CONFIDENT

2Q'16 69% 3Q'15 72%

LOCAL ECONOMY



3Q'16

80%

CONFIDENT / SOMEWHAT CONFIDENT

2Q'16 79% 3Q'15 80%

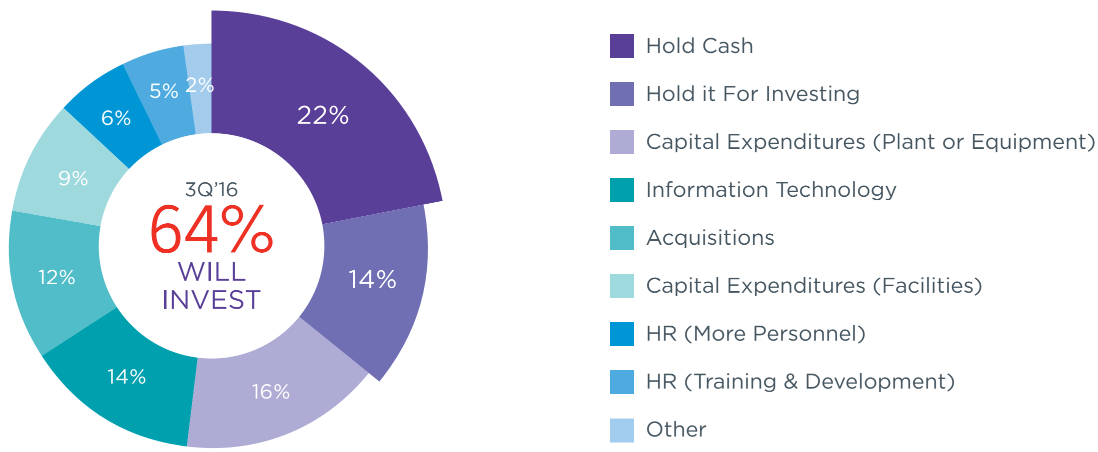
Not confident | Somewhat not confident | Somewhat confident | Confident

CAPITAL INVESTMENT

Appetite for investment stays strong

Approximately two-thirds of middle market companies continue to report that they would invest extra dollars, while a third of businesses prefer to save their money. Core middle market businesses are the most likely to hold on to cash while the largest mid-sized firms are the most likely to invest it. Most of the savers prefer to hold more cash; however 14% of companies say they would stow it away for future financial investments. Investment appetites would shrink if interest rates rise. Twenty-nine percent say they would be likely to reduce capital investment, 28% would slow down hiring, and 25% would increase cash reserves.

ADDITIONAL INVESTMENT ALLOCATION



KEY CHALLENGES

Core business issues remain the largest hurdle to growth

The greatest challenges for middle market leaders continue to revolve around core business issues, including finding new customers, expanding the business, and innovation. Talent management remains a key concern, especially as more middle market businesses are looking to grow at faster rates. A significant number of businesses also cite costs, especially healthcare costs, as an obstacle. From an external perspective, government regulations have a negative impact on two-thirds of middle market firms. Increasing competition continues to be a key hurdle as well. Companies rely on innovation to tackle some of these key challenges, and many focus on attracting and retaining innovative people.

SHORT TERM CHALLENGES (Next 3 months)

INTERNAL CHALLENGES:

1. BUSINESS	56%
2. STAFF/EMPLOYEES	46%
3. COSTS	16%
4. GOVERNMENT	10%

EXTERNAL CHALLENGES:

1. BUSINESS	35%
2. COMPETITION	20%
3. GOVERNMENT	19%
4. ECONOMY	12%
5. COSTS	12%

LONG TERM CHALLENGES (Next 12 months)

INTERNAL CHALLENGES:

1. STAFF/EMPLOYEES	43%
2. BUSINESS	40%
3. COSTS	12%
4. GOVERNMENT	4%

EXTERNAL CHALLENGES:

1. BUSINESS	29%
2. GOVERNMENT	17%
3. COMPETITION	16%
4. ECONOMY	11%
5. COSTS	11%

Perspectives

THE HUMAN SIDE OF GROWTH

Every quarter of continued strong performance by the middle market—and this was another one—raises the question, how long can this keep going on? Annualized revenue growth in the third quarter of 2016 was 6.3%. That is well below the 7.2% rate recorded three months ago, but is the same as the first quarter's growth, within the range we have observed over the last year and a half, and a good number however you look at it. Middle Market Indicator revenue growth rates jump around (and are not seasonally adjusted) but the overall trend is stable. This is the nineteenth Middle Market Indicator—just under five years of data—and during this time revenue growth has averaged 6.4%.

Though the overall rate was down in the third quarter, growth accelerated in the majority of industries, slowing only in wholesale and retail trade and, to a lesser degree, manufacturing. In terms of company size, this quarter's entire dip in revenue growth can be laid at the feet of larger middle market companies (with revenues between $100 million and $1 billion); topline growth among this segment fell from 8.5% to 6%. This is an exception to the usual pattern, in which larger companies outperform the others. Notably, however, the larger companies' growth forecasts are up slightly from three months ago.

There are cautionary notes in the tune played by a number of forward-looking numbers. Eight percent of middle market company leaders expect sales to decrease, up from 5% last quarter, while 41% expect sales to increase, which is down a tick. There is a similar tightening in the spread between executives who expect demand to fall vs. rise and between executives who expect the overall business climate to deteriorate vs. improve. An index of those three prognostications—sales, demand, and business climate—has fallen for two quarters in a row.

Still, executives' confidence in the global economy has risen from 49% to 56% in the last four quarters, and confidence in national and local economies is high (72%, 80%) and unchanged since the third quarter of 2015. At the firm level, companies expect their own profits to increase by 3.1% in the next twelve months, while costs rise just 2.1%. Interest-rate increases could raise costs, of course, trimming profit margins.

PAYROLLS EXPAND

Company-level confidence and profitability may explain some of the big jump in employment shown in this MMI. Revenue and payroll growth usually run in parallel, but this quarter job growth rose from 4.4% to 4.9% while top-line growth fell from 7.2% to 6.3%. Three quarters of the new jobs are full-time, and just two percent are reported to be temporary or seasonal.

The rate of hiring has been picking up for a year now—it is up from 3.6% four quarters ago. Is this a case of the middle market playing catch-up, finally acceding to demand by opening its doors to more staff? Is it a trend that will continue? We don't know, but for the moment it's good news for workers.

To explain the increase it helps to look at which industries added workers fastest. Construction was the star, with 8.5% payroll growth (and 10.5% revenue growth), followed by services (6.5% payroll increase, 9.0% revenue) and healthcare (6.1% and 8.1% revenue). All three industries are relatively automation-resistant (so far, at least), so that the labor content of a dollar of revenue shrinks less quickly than in manufacturing or even in retail, where store-level staffing levels have been falling.

What are these new employees doing? Sixty-three percent of companies say they have added jobs in operations, 51% in marketing and sales, and 36% in IT—that is, these are mostly revenue-generating jobs, though presumably many of the IT jobs are in data processing or cybersecurity.

CREATIVE BRAINS, WELL-OILED MACHINES

Some not-insignificant number of new employees are inventing the future. Math we did last quarter shows that middle market companies' growth is driven by investing in market expansion, innovation, and talent, in that order.[1] But, we noted, these are not mutually exclusive: Talent investments are a necessary element of both of the other initiatives. In fact, we learned this quarter, talent is the #1 lever for innovation. Asked how they make innovation happen, 54% of executives say that they hire new talent, 39% increase R&D, and 19% make acquisitions. (Twenty-one percent say they do none of these. Perhaps they innovate by rubbing a lamp.)

Company size leads to some interesting differences in emphasis. Asked which capabilities are most critical for innovation, everybody agrees that Job One is to attract and retain innovative people. But that is ranked most important in the core middle market ($50-100 million), where 70% say it is critical, vs. 60% overall. The bigger companies, with revenues between $100 million and $1 billion, place more of a premium on understanding customers and markets (65%, vs. 59% overall), want to take more risk (38% to 31%), and emphasize the importance of having structured processes to manage a pipeline of innovations (again, 38% to 31%). We've seen something like that before: As companies grow, they necessarily place more emphasis on process. The trick is to add structure without becoming restricted.

[1] Perspectives, 2Q 2016 Middle Market Indicator, p. 7

NATIONAL CENTER FOR
THE MIDDLE MARKET

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.

THE OHIO STATE UNIVERSITY
FISHER COLLEGE OF BUSINESS

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Grant Thornton

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