NATIONAL CENTER FOR
THE MIDDLE MARKET

1Q 2017

MIDDLE MARKET INDICATOR

UNPRECEDENTED GROWTH, CONFIDENCE & OPTIMISM

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

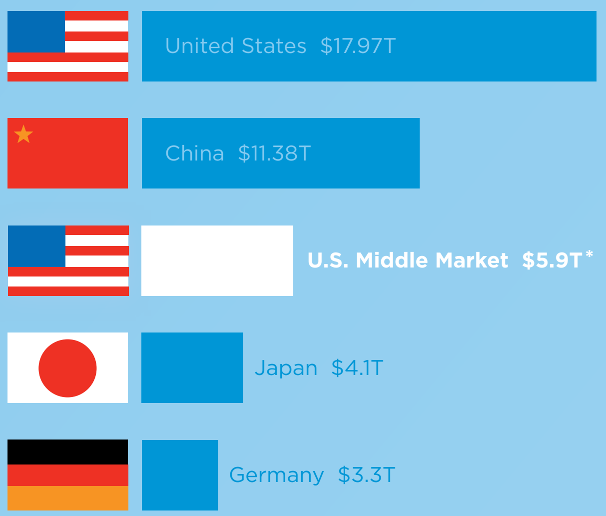
$ LOWER MIDDLE MARKET
$10MM - $50MM

$ $ 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 U.S. Middle Market closed 2016 on a high note and has carried that momentum forward into 2017, with all indices pointing to an increasingly robust middle market. Actual and projected revenue and employment growth rates continue to rise significantly, and economic confidence is keeping pace, with all measures at their highest levels since the inception of the Middle Market Indicator in 2011. While every revenue segment and industry plays a part in the success story, the largest middle market firms (with revenues between $100 million and $1 billion) are driving rapid growth, and the construction industry in particular continues to report the most impressive gains, building on the trend seen last year. Middle market leaders clearly have an expansionary mindset for the year ahead, which includes a growing appetite for acquisitions; but companies will continue to face challenges as they grow. Changes in federal regulations and policies and the tightening labor market may present headwinds as companies aim to achieve their anticipated growth rates.

With the first quarter of 2017 under their belts, seven in 10 middle market leaders report that overall company performance has improved compared to last year. Just 5% of companies say performance has deteriorated. Middle market firms of all sizes rate themselves highly on business performance and operational excellence metrics. The largest middle market firms are more likely than their smaller counterparts to say they perform well in terms of innovation, customer acquisition, recruiting and retaining talented employees, and maintaining profit margins.

Over the past three quarters, the proportion of firms experiencing year-over-year revenue growth has steadily increased, with nearly three-quarters (74%) of firms reporting increases since Q1 2016. The revenue growth rate for the past 12 months is 9.2%, well above the five-year average of 6.6%. The largest middle market firms continue the upward trajectory seen last quarter, reporting revenue growth of 11.9%. Construction firms show the strongest performance, reporting an astonishing year-over-year growth rate of 20.5%, accounting in part for the dramatic spike in growth seen this quarter. However, when construction is removed from the equation, the rate of year-over-year revenue growth for the rest of the middle market remains an impressive 8.5%.

Innovation and new product development continue to be driving factors behind middle market growth, along with a surge in M&A activity. One-quarter of firms derive more than 20% of their revenue from recently introduced products, and 47% of middle market companies introduced a new product or service in the last 12 months. Companies are also growing through expansion into new domestic markets, and the number of companies making acquisitions has grown considerably over the last year.

From an employment perspective, more companies reported year-over-year employment increases this quarter than ever before in the history of the MMI. The overall middle market shows a 7.5% mean rate of employment growth since the first quarter of last year. With employment growth rates of 9.5% and 16.6% respectively, the largest middle market businesses and the construction industry are responsible for the most aggressive hiring. Once again, when construction numbers are removed, the year-over-year employment growth rate for the remainder of the middle market nets out at 7.0%. While 51% of businesses say the workforce expanded over the past 12 months, just 11% report decreases in employment. Compared to Q1 2012, when 22% of middle market firms reported dwindling workforces, the percentage of middle market firms that are currently downsizing has been cut in half.

Middle market leaders anticipate maintaining high growth rates in the year ahead. A slight majority of firms (51%) have plans to introduce a new product or service in 2017, and 45% say they will expand into new markets. The largest middle market companies maintain a particularly expansionary mindset, with 47% planning to add a new plant or facility and 42% expecting to make an acquisition in the year ahead. However, fewer than one-third of middle market companies anticipate needing to open a new line of credit or take on new debt in order to finance this growth.

Looking at the next three months, more executives, and especially leaders from the largest middle market companies, expect a better business climate, increased demand, and more sales in the short term. As a result, leaders anticipate unprecedented rates of revenue and employment growth over the next 12 months. Nearly six in 10 leaders expect revenue to grow at an average rate of 8.8%. More than four in 10 executives believe employment at their firms will increase by an expected mean total growth rate of 6.0%. Many companies plan to add new full-time jobs in the next quarter, mostly in the areas of operations, sales and marketing, and IT.

As middle market firms strive to meet the demands of growth, they will continue to be challenged by a tighter labor market, regulation changes, healthcare costs, and the need to efficiently expand and innovate while managing cash flow, costs, and profitability.

REVENUE GROWTH
Revenue growth swells

At 9.2%, the year-over-year revenue growth rate for middle market firms is significantly higher than any previous quarter in the history of the MMI. While construction companies report the highest growth, nearly doubling the growth rates reported last quarter, revenue growth is up across all industries, with the exception of wholesale trade. Companies at both ends of the middle market spectrum show remarkable increases for the past year, with the largest middle market firms reporting the most significant jump in growth rate. Core middle market firms indicate modest growth rate improvements over the past 12 months.

Middle market companies expect the rapid growth to continue throughout 2017, and projections for future growth are also at an all-time high. Close to six out of 10 leaders believe their firms will experience an increase in revenue growth this year. The largest middle market companies are the most optimistic, calling for a revenue growth rate of 11.4% over the next 12 months.

1Q'17 **74%** of middle market companies reported positive revenue growth. 1Q'16 69%

MIDDLE MARKET

PAST 12 MO.
1Q'17 **9.2%**
4Q'16 6.9% 1Q'16 6.3%

NEXT 12 MO.
1Q'17 **8.8%**
4Q'16 5.5% 1Q'16 4.6%

S&P 500

PAST 12 MO.
1Q'17 **5.8%***
4Q'16 4.4% 1Q'16 -3.4%

EMPLOYMENT GROWTH
Hiring is on the rise

A slight majority (51%) of middle market businesses added to their employment rosters this year while only about one in 10 firms decreased the size of the workforce. All in all, the middle market reports an impressive mean year-over-year employment growth rate of 7.5%, up nearly two full percentage points from last quarter. As with revenue, the largest middle market companies and the construction industry account for the lion's share of growth; however all revenue segments and most industries report hiring.

At the end of 2016, middle market leaders projected a tapering off in the rate of employment growth. Those anticipations have shifted notably, with 42% of firms now reporting expected increases in employment for 2017, at a healthy mean rate of 6.0%. Again, the largest middle market companies lead the charge here, with these firms predicting workforce increases of 9.1% over the next 12 months, presumably to help drive their expected increases in revenue.

1Q'17 **42%** of middle market companies expect to add jobs. 1Q'16 34%

MIDDLE MARKET

PAST 12 MO.
1Q'17 **7.5%**
4Q'16 5.4% 1Q'16 3.6%

NEXT 12 MO.
1Q'17 **6.0%**
4Q'16 3.4% 1Q'16 2.7%

ADP [PAST 12 MO.]

LARGE CORP.
1Q'17 **1.6%**
4Q'16 2.4% 1Q'16 2.2%

SMALL BUS.
1Q'17 **1.4%**
4Q'16 1.4% 1Q'16 2.1%

*1Q numbers include only companies who have reported 1Q earnings results. Numbers change as more businesses report financial results.

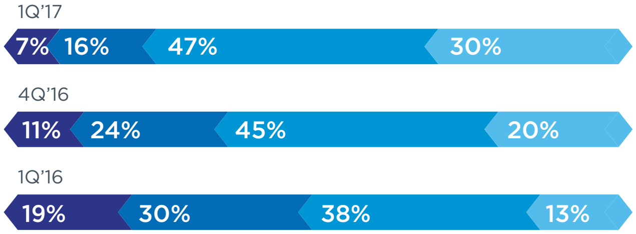
ECONOMIC CONFIDENCE

Confidence continues to grow

Economic confidence, which has been rising steadily since mid 2016, reached a new high at the end of the Q1 2017, with U.S. economic confidence levels surpassing local confidence for the first time in MMI history. Following a significant boost at the end of 2016, confidence levels continue to increase across the board—locally, nationally, and globally. This quarter, nine in 10 middle market leaders indicate a positive perception of the country's economy. Only slightly fewer (88%) believe the economy is solid in their own region.

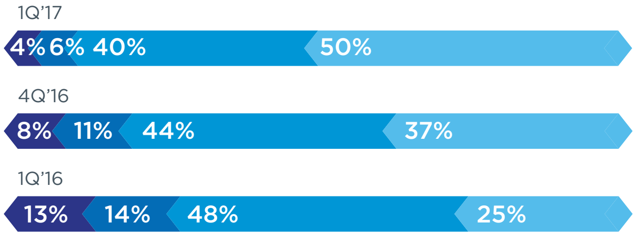
Perhaps due to greater familiarity and visibility, middle market executives have always expressed greater confidence in the state of affairs at home versus abroad. However, the gap between global and domestic confidence has been narrowing over the past year. Global confidence saw another 12-point jump this quarter, with more than three-quarters of middle market leaders currently feeling comfortable with economic conditions worldwide.

GLOBAL ECONOMY



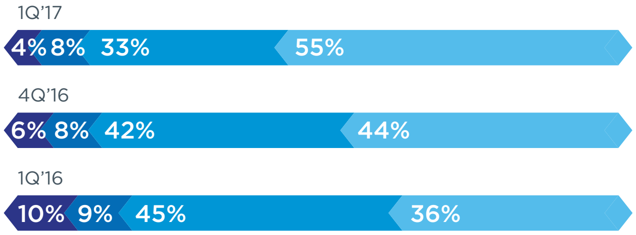
1Q'17
77%
CONFIDENT / SOMEWHAT CONFIDENT
4Q'16 65% 1Q'16 51%

NATIONAL ECONOMY



1Q'17
90%
CONFIDENT / SOMEWHAT CONFIDENT
4Q'16 81% 1Q'16 73%

LOCAL ECONOMY



1Q'17
88%
CONFIDENT / SOMEWHAT CONFIDENT
4Q'16 86% 1Q'16 81%

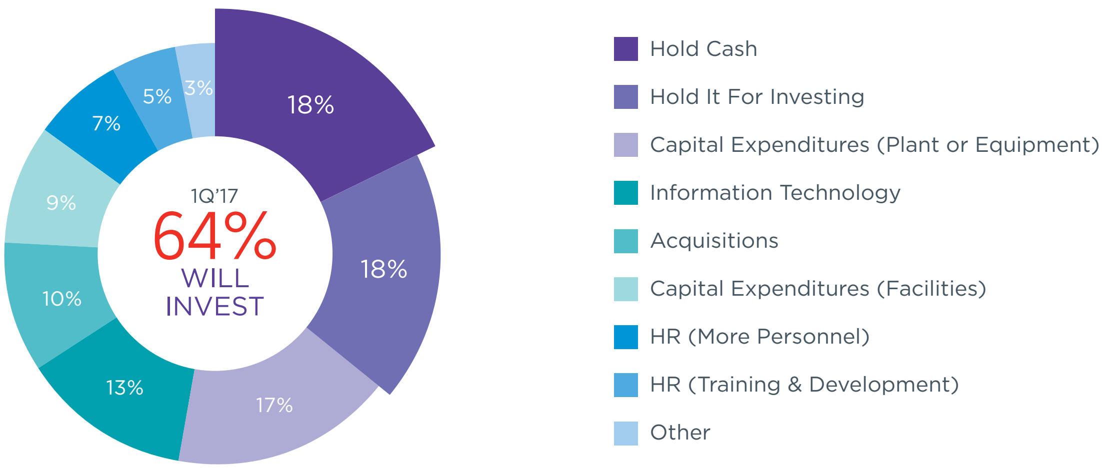
Not confident | Somewhat not confident | Somewhat confident | Confident

CAPITAL INVESTMENT
More companies plan to spend

Around two-thirds of middle market companies continue to say they would allocate extra dollars toward investment, a percentage that has remained relatively consistent since 2013. However, among the one-third of companies that prefer to save cash, fewer are building up cash reserves and more companies are saving for the purpose of future financial investments.

Capital expenditures for plants and equipment is the most likely area for investment in the next 12 months, with 34% of all middle market firms and nearly half (47%) of the largest middle market companies indicating a strong likelihood of adding a new plant or facility in the year ahead. Overall, an increasing proportion of middle market leaders say they expect their firm's capital expenditures to be higher this year than last.

ADDITIONAL INVESTMENT ALLOCATION



KEY CHALLENGES
Growth, talent issues, and political concerns present challenges

While middle market leaders fully anticipate growth in the coming year, they won't achieve it without overcoming some core issues. Following the recent trend, how to efficiently maintain growth and how to best manage talent remain the most pressing internal challenges. Specifically, executives worry about cash and inventory management as well as the ability to find and retain qualified workers.

Outside their four walls, leaders express concern over the changing nature of the marketplace and the political landscape. They speculate about the impact of politics on regulations and trade, as well as potential effects on public spending. Executives continue to contend with controlling costs, especially the cost of healthcare as well as fuel and material costs.

SHORT TERM CHALLENGES (Next 3 months)

INTERNAL CHALLENGES:

1.	BUSINESS	64%
2.	STAFF/EMPLOYEES	53%
3.	COSTS	24%

EXTERNAL CHALLENGES:

1.	BUSINESS	37%
2.	GOVERNMENT	25%
3.	COMPETITION	20%
4.	ECONOMY	15%
5.	COSTS	14%

LONG TERM CHALLENGES (Next 12 months)

INTERNAL CHALLENGES:

1.	BUSINESS	40%
2.	STAFF/EMPLOYEES	40%
3.	COSTS	17%

EXTERNAL CHALLENGES:

1.	BUSINESS	30%
2.	GOVERNMENT	23%
3.	COMPETITION	16%
4.	COSTS	13%
5.	ECONOMY	12%

Perspectives

The performance documented in this Middle Market Indicator is remarkable–in fact, the highest growth rates reported since the MMI was created in 2012. But the numbers are right: in the last 12 months, top-line revenue for middle market companies grew 9.2% on average; the previous high, 7.4%, came two years ago. Employment increased 7.5%, again faster than the previous record of 5% posted in the 4th quarter of 2014. The numbers are solid; they are also surprising. GDP grew 1.6% in 2017; from March 2016 to March 2017, overall employment increased 1.5%. How can we explain the middle market's numbers?

DEAL FEVER

The biggest cause is a surge in middle market M&A activity. Remember, a company that buys another will see revenue and employment rise, even if divisors like profitability or revenue per employee change little. In the last 12 months, 25% of middle market companies made an acquisition. That contrasts with 19% in the same period a year ago–an increase of nearly a third.

The most voracious acquirers were companies in the $100 million to $1 billion segment, which we call the upper middle market, 36% of which made an acquisition, up from 23% in the year-ago period; this group also grew fastest. Interestingly, public companies (which tend to be in the upper middle market) were less active in the deal market than others of their size (32% bought something), and also grew less. A lot less: Average top line growth was just 3.6%.

The data do not explain what lies behind the dramatic increase in deal-making, but a number of causes come to mind. First, a lot of capital is looking for work. The Macro Trends Group of the consulting firm Bain & Company estimates that total global financial capital has more tripled since the late 1990s. Private equity firms are launching large numbers of new funds. Prices paid are high relative to EBITDA, tempting people to sell who otherwise might not. Second, a major demographic transition is upon us, as baby-boomer owners look for the exit. Third, the specter of rising interest rates may be causing some executives to strike now rather than later when interest rates are higher.

Whatever the cause, the effect is clear: Acquirers grew twice as fast as the rest of the middle market. That doesn't mean they grew smarter or more profitably–but they sure did grow.

We also can credit some of the middle market's growth to construction companies, whose revenues rose a stunning 20.5% last year. Remove construction from the overall mix, and middle market growth was still a robust 8.5%. Nearly half of these builders expanded into new domestic markets, often by means of M&A. Thirty-four percent of construction companies made an acquisition last year, double the number the year before. A mild winter also spurred building projects.

	MADE ACQUISITION PAST YEAR	NO ACQUISITION PAST YEAR
Mean revenue growth	15.0%	7.3%
Mean employment growth	11.2%	6.3%
Projected revenue growth	12.6%	7.5%
Projected employment growth	8.9%	5.1%

Organic growth was strong, too, for almost all industries. Across the middle market, non-acquirers grew 7.3%, which exceeds the overall growth of the middle market for all but two quarters in the last five years.

The long-rising economic tide has lifted almost every middle market boat. Companies simply did better, in the same way that workers across the nation began to see bigger paychecks last year. Only 5% of middle market companies say overall performance deteriorated in the last year, 25% said it was unchanged, and 70% say it improved. A year ago those numbers were 6%, 36%, and 58%. Thus, one out of nine middle market companies went from no change to positive change–a delta that by itself would jolt the overall numbers higher.

Retail trade is a dark spot in this picture. Though retailers' revenue overall grew decently (6.8%–only wholesale grew less), 14% of retailers reported declining sales, a worrisome sign. Employment growth fell a point and a half–at 4.2%, it is the lowest in the middle market. Newspapers have headlined store closings by big retail chains, and the middle market is clearly not immune. Internet retailing is one cause of this sluggish growth, with big outfits like Amazon taking business from competitors of all sizes, but when it comes to employment we should not discount the increasing role of automation, as kiosks take over from cashiers. There may also be a secular shift in consumer spending: Data from the St. Louis Fed suggest that consumers are buying fewer things, like clothes, and more experiences, like travel and meals out.

BULLISHNESS

Many other signs point optimistically forward. The short-term middle market index–a projection of business conditions three months ahead–has reached 108, the highest number we have seen in two years. Overall economic confidence is the highest we have seen in five years–and for the first time ever, middle market executives express more confidence in the national economy than in their local economies. Some of this may be the so-called "Trump Bump" – MMI data were collected in early March. But capital spending plans show executives expect to put their money where their mouth is: 39% of middle market companies expect to increase capex in the next 12 months, a huge jump from 23% a year ago. And 40% expect deal-making to increase.

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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SUNTRUST

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Grant Thornton

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