NATIONAL CENTER FOR
THE MIDDLE MARKET

2Q 2017

MIDDLE MARKET INDICATOR

SOLID GROWTH; STRONG EMPLOYMENT

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

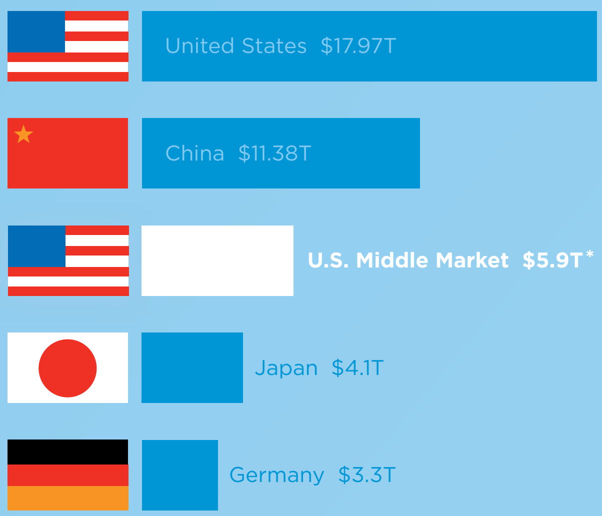
LOWER MIDDLE MARKET
$10MM - $50MM

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

Following a record-setting first quarter, growth and confidence indices in the middle market have cooled slightly. Nevertheless, at the mid-year point, middle market firms continue to report strong performance, particularly for employment growth. The overall business atmosphere and outlook among middle market executives are decidedly positive. The largest middle market firms (with revenues between $100 million and $1 billion) maintain their trend of outperforming their smaller peers. Service and retail trade companies also continue to post strong numbers; in fact, the retail trade segment shows an increase in both the rate of year-over-year revenue and employment growth this quarter. Companies expect healthy growth to persist, both in the short- and long-term, and a significant percentage (especially larger firms) anticipate growing, in part, through merger and acquisition deals. However, finding enough of the right people to support growth is becoming more and more of a challenge for middle market leaders; concern over government activities is mounting as well.

The percentage of middle market leaders reporting improvements in company performance over the past 12 months fell slightly from last quarter, but at 65%, it remains above the historical MMI average of 61%. The percentage of executives reporting deteriorating conditions remains very low at just 5%. A slight majority of middle market firms believe they are outperforming their competitors and doing an excellent job of attracting new customers (55% and 51% respectively). Most say they are adept at managing banking relationships, leading their industries, and retaining profitable accounts. However, fewer than half rate themselves highly on innovation, sales force effectiveness, or ability to withstand an industry downturn.

At 72%, the proportion of firms reporting increases in gross revenue compared to one year ago remains near its peek level. This quarter, only 11% of firms say that revenue has decreased over the past 12 months. After surging last quarter, the rate of year-over-year revenue growth has slowed for all industries (with the exception of retail trade), but it remains robust at 6.7%. While growth is strong across all revenue segments, the largest middle market firms continue to grow the fastest, reporting an 8% gross revenue growth rate since mid 2016.

Expansion activity has remained consistent since the beginning of 2015. Over the past year, 45% of middle market companies introduced a new product or service and 38% expanded into new domestic markets. Additionally, 27% of the largest mid-sized firms made an acquisition. Companies say they spend 8% of revenues on product development, and about a quarter of firms (24%) say they derive 20% or more of their revenues from recently introduced offerings. However, in terms of innovation, companies say that the greatest impact on company performance stems from incremental improvements to existing products or services. A majority (53%) of middle market companies added jobs over the past 12 months and just 12% of firms downsized. The rate of employment growth remains high at 5.7% with the largest middle market companies increasing their headcount by 6.6%. Middle market leaders are generally satisfied with the capabilities of their workforce; most believe they have high-performing management teams and 63% say their employees are more productive than those at other firms.

The short-term middle market index, which measures anticipated changes in business climate, demand, and sales for the coming three months, is down from last quarter, but significantly higher than a year ago. Many leaders anticipate an increase in demand for products or services along with an increase in sales for the next three months, but they are more cautious in their assessment of the short-term business climate. The largest middle market companies tend to be the most optimistic about the near future.

Looking out across the next 12 months, companies expect both revenue and employment to grow, though projected growth rates have dropped in both areas. The new order pipeline continues to increase for more than one-third of middle market firms. While expansion expectations have dropped slightly, about four in 10 companies anticipate introducing new products or services and expanding into new domestic markets by mid 2018. Among the largest middle market companies, 35% say they will open a new plant or facility and 30% plan to make an acquisition. Fewer than a quarter of firms expect to take on new debt in order to fuel growth.

More than three-quarters (78%) of mid-sized firms say the size of their workforce is just about right, however, 42% say they will hire new people in the year ahead. The majority of new jobs will be full-time positions in operations and marketing and sales; the largest middle market firms anticipate increasing their IT staffs as well.

Finding the right people for these jobs may prove to be a challenge, however, with half of all middle market firms citing talent issues as a top concern for the year ahead. Many firms are considering improving salaries and offering flexible work arrangements to attract the best employees. Some firms are also looking at mergers and acquisitions as a means of acquiring new talent and leadership. Additional headwinds to growth include government regulations, changing market conditions, and increasing costs.

REVENUE GROWTH

Revenue growth returns to typical levels

After spiking to 9.2% last quarter, the year-over-year revenue growth rate in the middle market has settled back to 6.7%. While firms of all sizes and within all industries experienced this softening (with the exception of retail trade), overall middle market revenue growth is strong and slightly above the average growth rate of 6.6% for the past five and a half years. For the third consecutive quarter, the largest middle market companies report the highest rates of revenue growth. Service firms are also enjoying solid growth with a year-over-year growth rate of 9.9%.

Middle market leaders have toned down their expectations for the year ahead. At 5.5%, the projected growth rate for the next 12 months remains healthy and is half a point above the anticipated growth rates reported one year ago. Despite posting the highest rates of actual growth since Q4 2016 and showing the most optimism short-term, the largest middle market firms are the most conservative in estimating their growth for the year ahead.

2Q'17 **72%** of middle market companies reported positive revenue growth. 2Q'16 **72%**

MIDDLE MARKET

PAST 12 MO.

2Q'17 **6.7%**

1Q'17 9.2% 2Q'16 7.2%

NEXT 12 MO.

2Q'17 **5.3%**

1Q'17 8.8% 2Q'16 4.8%

S&P 500

PAST 12 MO.

2Q'17 **4.8%***

1Q'17 5.8% 2Q'16 1.2%

EMPLOYMENT GROWTH

Employment growth remains strong

More and more middle market companies are increasing the size of their staffs; this quarter, 53% of firms report year-over-year increases in employment. Like revenue growth rates, the 12-month employment growth rate has come back down from its surge last quarter. But at 5.7%, it is the second-highest rate of employment growth reported by the MMI, well above the five-and-a-half year average of 3.7%. Since the end of 2015, the largest middle market firms have been the most significant contributors to employment increases.

Over the next 12 months, 42% of firms expect to add to their headcount, and 35% expect to make hires in the short term, or the next three months. Overall, middle market companies expect employment growth to increase by 4.7% in the year ahead, an estimate that has decreased since last quarter, but is well above the employment projections made one year ago. The largest middle market firms will likely be responsible for providing the most new jobs.

2Q'17 **42%** of middle market companies expect to add jobs. 2Q'16 **37%**

MIDDLE MARKET

PAST 12 MO.

2Q'17 **5.7%**

1Q'17 7.5% 2Q'16 4.4%

NEXT 12 MO.

2Q'17 **4.7%**

1Q'17 6.0% 2Q'16 3.3%

ADP [PAST 12 MO.]

LARGE CORP.

2Q'17 **2.5%**

1Q'17 1.6% 2Q'16 2.3%

SMALL BUS.

2Q'17 **1.3%**

1Q'17 1.4% 2Q'16 1.9%

**2Q numbers include only companies who have reported 2Q earnings results. Numbers change as more businesses report financial results.*

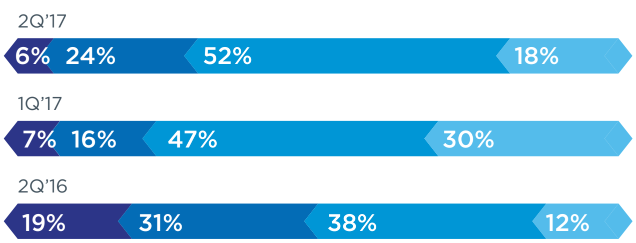
ECONOMIC CONFIDENCE

Confidence remains historically high

Although economic confidence levels have dipped slightly from record levels reported last quarter, confidence in local, state, and global economies remains well above their five-and-a-half year averages. As always, confidence is strongest closest to home, with more than eight in 10 executives reporting positive perceptions about their local and U.S. economies. Executives maintain a bullish outlook on the worldwide state of affairs as well, with seven out of 10 leaders saying they feel at least somewhat confident in the global economy.

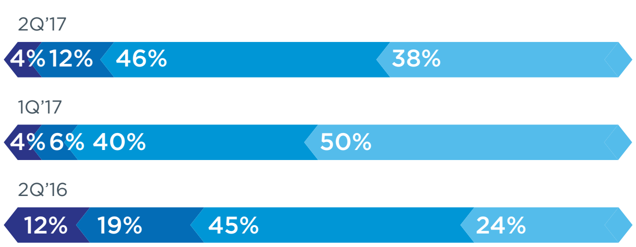
In fact, global confidence has risen the most dramatically over the past 12 months. Whereas local confidence has always been relatively high (the five-and-a-half year average is 78%), global economic confidence currently sits 20 points above its average of 50%. Much of that increase has come since the second quarter of 2016. Similarly, at 84%, national confidence is well above its average of 68%, and it, too, has climbed steadily since mid 2016.

GLOBAL ECONOMY



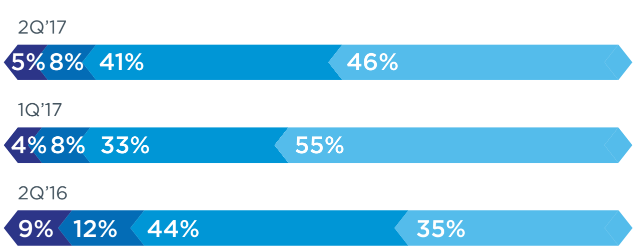
2Q'17
70%
CONFIDENT / SOMEWHAT CONFIDENT
1Q'17 77% 2Q'16 50%

NATIONAL ECONOMY



2Q'17
84%
CONFIDENT / SOMEWHAT CONFIDENT
1Q'17 90% 2Q'16 69%

LOCAL ECONOMY



2Q'17
87%
CONFIDENT / SOMEWHAT CONFIDENT
1Q'17 88% 2Q'16 79%

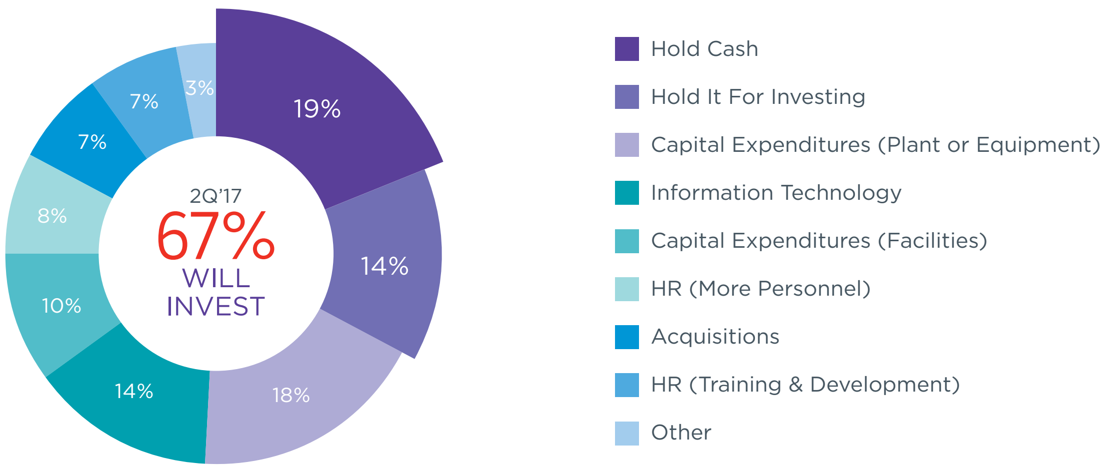
Not confident | Somewhat not confident | Somewhat confident | Confident

CAPITAL INVESTMENT

Most companies would invest extra cash

This quarter, close to seven out of 10 (67%) middle market leaders say they would invest an extra dollar as opposed to save it. While this percentage typically hovers right around two-thirds, it is up from 61% at the end of 2015. Only about two in 10 firms (19%) say they would save their money to hold more cash; the remaining 14% would save up for future financial investments. Capital expenditures for plants and equipment as well as information technology are the most likely areas of investment. A quarter of firms say there is strong likelihood of adding a new plant or facility in the next 12 months, and the larger the firm, the more likely it is to invest in this way.

ADDITIONAL INVESTMENT ALLOCATION



KEY CHALLENGES

Talent challenges and regulatory concerns are mounting

This quarter, half of middle market firms say that talent issues, including recruiting and retention, will be a primary concern over the next 12 months. This is up from 40% last quarter, and talent concerns have surpassed core business issues—such as maintaining growth and managing capital and cash flow—as the number one internal challenge for the year ahead. Externally, worries related to government are also on the rise, with more than a quarter (27%) of firms indicating that various political issues could have a significant impact on company performance. Middle market executives also continue to worry about changing market conditions, demand, and capital management issues. Healthcare costs are a concern for some, and executives cite minimum wage increases, increasing interest rates, and raw materials as other cost concerns.

SHORT TERM CHALLENGES (Next 3 months)

INTERNAL CHALLENGES:

1.	BUSINESS	67%
2.	STAFF/EMPLOYEES	57%
3.	COSTS	29%

EXTERNAL CHALLENGES:

1.	BUSINESS	37%
2.	GOVERNMENT	29%
3.	COMPETITION	22%
4.	COSTS	16%
5.	ECONOMY	12%

LONG TERM CHALLENGES (Next 12 months)

INTERNAL CHALLENGES:

1.	STAFF/EMPLOYEES	50%
2.	BUSINESS	43%
3.	COSTS	19%

EXTERNAL CHALLENGES:

1.	BUSINESS	31%
2.	GOVERNMENT	27%
3.	COMPETITION	18%
4.	COSTS	15%
5.	ECONOMY	10%

Perspectives

The performance of the U.S. middle market settled back to normal in the second quarter of 2017, following an exuberant performance in Q1. But it's important to note how remarkable "normal" is: Most companies would kill for 6.7% growth (the average rate reported this quarter) and would be stock market darlings if they delivered average annual growth of 6.6%, which the middle market has done for the last five years.

Almost everybody prospered over the last twelve months. Sixty-five percent of middle market leaders say their company's overall performance improved (vs. a five-year average of 61%), while just 5% said it deteriorated (the five-year average: 8%). With the exception of wholesale trade, every industry enjoyed strong, solid performance over the last twelve months, even retail. The "retail apocalypse" has spared the middle market so far, as the segment added both sales and jobs in substantial numbers. It is worth noting, however, that 18% of retailers told us they expect their industry to contract in the next 12 months, vs. 39% who expect expansion. That is the highest percentage of pessimists in the middle market. (By comparison, the percentage expecting contraction is 8% in construction, 10% in manufacturing, 12% in healthcare, 13% in services, 15% in financial services, and 16% in wholesale trade.)

THE BIG BREAK AWAY

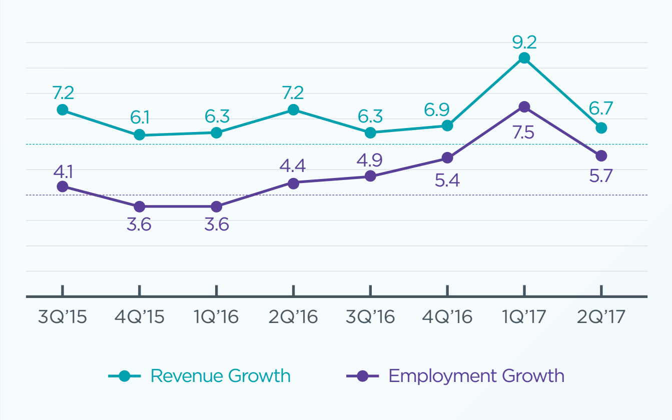
The picture is brightest for the biggest companies in the middle market, those with annual revenues between $100 million and $1 billion. Seventy-nine percent of this group reported increased revenue, and just 8% saw declines, compared to 72% and 11% for the middle market as a whole. Indeed, over the last eighteen months or so, the performance of the larger cohort has diverged, rising above that of core and small middle market firms in all but one quarter. Interestingly, this was not true between 2011 and 2014, when the three subsegments took turns leading the pack.

It is not hard to find explanations for the stronger performance of the upper segment of the middle market. They are expanding capacity; 28% added a new plant or facility in the last 12 months, compared to 17% for the core and 16% for the lower middle market. They are opening new geographic markets more aggressively. They are substantially more likely to have made an acquisition (27%, vs 13% and 17%). They invest a higher percentage of their already higher revenue on R&D (10.6% for the emerging large companies, 8.3% for the core, and 6.3% for the lower middle market–though it should be noted that core middle market companies are introducing new products and services slightly faster.

Given these investments, it is not surprising that larger middle market companies are outpacing the rest. It may be more curious that core and lower middle market companies kept pace with their larger siblings during the 2011-14 timespan. These bigger companies, one should note, are more likely to tap capital markets to finance their growth, which means that a steady, strong rise in interest rates could dampen their ardor for investment.

JOBS AND PRODUCTIVITY

A troubling trend could be hiding in the otherwise cheerful picture of the middle market. In the middle market, as in the economy as a whole, labor productivity–i.e. output per hour of work–is growing slowly if at all. This graph shows revenue and job increases side by side. The narrowing gap between them suggests that revenue gains in the middle market are being achieved by putting more people on the job, not by realizing more revenue per employee.



Now, the mysteries of productivity would baffle even Sherlock Holmes. The equations become even more complex in an Information Age service economy, because it is harder to measure both the dividend and the divisor. Economists say that stubbornly slow growth in labor productivity is one reason wages have risen more slowly than one would expect given how low the unemployment rate has become. Productivity should go up (with a lag) as a consequence of achieving economies of scale or of investing in new equipment and technology. If that is the case, we should start to see the impact of those upper-middle-market investments in the next few quarters.

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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