3Q 2013

MIDDLE MARKET INDICATOR

NATIONAL CENTER FOR
THE MIDDLE MARKET

In Collaboration With

THE OHIO STATE UNIVERSITY
FISHER COLLEGE OF BUSINESS

GE Capital

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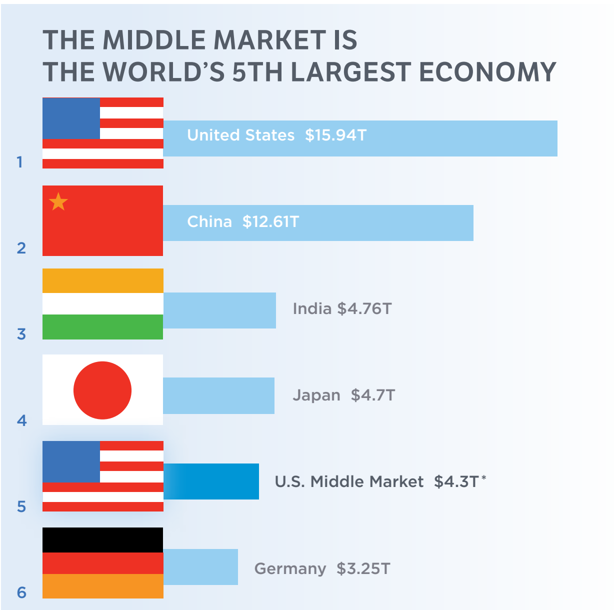
Middle Market Indicator

from The National Center for the Middle Market



Source: CIA World Fact Book, *National Center for the Middle Market (estimate)

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 44.5 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: "Leading from the Middle," 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 upper and lower 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.

Executive Summary

U.S. middle market companies extended their string of solid revenue and employment gains during the third quarter of 2013 and anticipate those trends will continue over the next 12 months, albeit at a decelerating pace. Though markedly improved from the same period a year earlier, revenue increases, employment gains and confidence in the global and local economy all appear to have hit plateaus.

Nearly two out of three middle market companies – defined as those with annual revenues between $10 million and $1 billion – reported improved company performance. Overall revenue increased 5.5% in the third quarter, which matches gains in the third-quarter of 2012 but marks the slowest rate of increase over the past four quarters. Employment also grew with four in ten companies expanding their workforce. Employment at middle market companies increased 2.8% in the quarter, a marginally higher pace than that of the past four quarters.

Prospects for future growth – while up significantly from a year ago – have moderated over the past three months as middle market executives face strong headwinds both at home and abroad. Concerns about impending health care and other regulation on the domestic front, destabilization in the Middle East, and economic turbulence in former fast-growing markets (India, Brazil and Turkey, among them) are giving middle market leaders pause, and could lead to more restrained hiring and spending.

Middle market companies anticipate that revenue will grow 4.4% over the next year, a sharp drop from the 5.1% estimated growth in the prior quarter. That would represent the first time in more than a year that top-line growth would dip below 5% for the segment.

The recent results and tempered growth outlook still outpaces by nearly two-fold the performance of the broader market – underscoring the middle market's critical role as an economic driver. Analysts anticipate a 2.6% increase for the S&P 500 Stock Index in the third-quarter (down from 3.0% estimated at the end of the second quarter). And analysts expect revenue gains for the S&P 500 during the fourth quarter to be a scant 1.0%.

A significant proportion of middle market executives continue to express confidence in local, national and global economic conditions – though the steady gains in confidence have come to at least a temporary halt. The most severe factors that are muting company confidence largely, if not entirely, are geo-political in nature, over which these companies have little sway. If these issues are resolved, growth might accelerate at a more rapid clip. In the interim, though, fewer middle market companies anticipate introducing new products or services or adding plants or facilities.

> *"The government shutdown has had very little if any impact on us so far. However, an extended shutdown could affect the mortgage markets, which would then trickle down to our company."*
>
> *— CEO, Business Services, $55MM annual revenues, 270 employees*

Key Findings:

COMPANIES EXTEND PERFORMANCE GAINS:

Revenue growth continued during the quarter as 63% of middle market companies reported top-line improvements during the past 12 months. That's up from 60% in the third quarter of 2012, a decline to the 65% in the prior quarter. The mean revenue growth declined to 5.5%, its lowest gain since hitting that number a year earlier. There was a giant surge in revenue gain in the retail sector, where mean growth soared to 6.3% from 4.3% in the prior quarter and 4.4% a year earlier.

Companies also expect performance to improve in 2014, with 60% projecting revenue to grow. These companies expect increases to be 4.4%. That's down from 5.1% in the second quarter of this year, but still an increase from the 3.7% forecast back in the previous year.

EMPLOYMENT GROWTH CONTINUES, BUT COULD SLOW:

In the third quarter, four of 10 companies said they added workers, on par with results over the previous quarter, and up from 35% a year earlier. These companies reported mean job growth of 2.8%, up from 2.2% a year earlier and 2.6% in the second quarter.

The largest middle market companies fueled the gains, with 45% of respondents in the $100 million to $1 billion segment adding workers. Retail trade added workers at a 3.2% rate, up substantially from 0.8% a year earlier and 1.5% in the prior quarter. Construction companies also added workers, offsetting declines in hiring within the wholesale trade, manufacturing and financial service sectors compared to a year ago.

Looking ahead, the middle market expects hiring to slow to 2.1%, down from 2.5% a quarter ago. The core middle market, representing firms with $50 - $100 million in revenue, expects hiring to slow to 1.5% in the year ahead, down from 2.6% in just three months. Services companies forecast 2.7% growth, down from 4.1% in the second quarter. In contrast, retail companies expect to increase employees by 2.4%, compared to expecting to shed 0.2% a year earlier.

CONFIDENCE HAS LEVELED OFF:

Confidence measures leveled off in the third quarter. While considerably higher than a year ago, the steady increases in confidence for the global, U.S. and local economies has halted, though the numbers have not declined.

Still, 48% of surveyed companies report they are somewhat confident in the global economy. That's unchanged from the second quarter of 2013, but up from 29% a year earlier. Almost two-thirds of respondents said they are least somewhat confident in prospects for the U.S. economy, up from less than half a year earlier. A resounding 77% of companies are confident or somewhat confident in their local economies, up from 66% a year earlier, though down slightly from 79% in the prior three months.

CAPITAL INVESTMENT STRONG, BUT MODERATING:

Middle market companies plan to invest additional capital, rather than hold onto excess cash by a margin of 61% to 39%. That's up from 56% planning to invest a year earlier. The percentage of companies likely to invest is down for the second consecutive period, from 63% and 64% in the previous two quarters respectively.

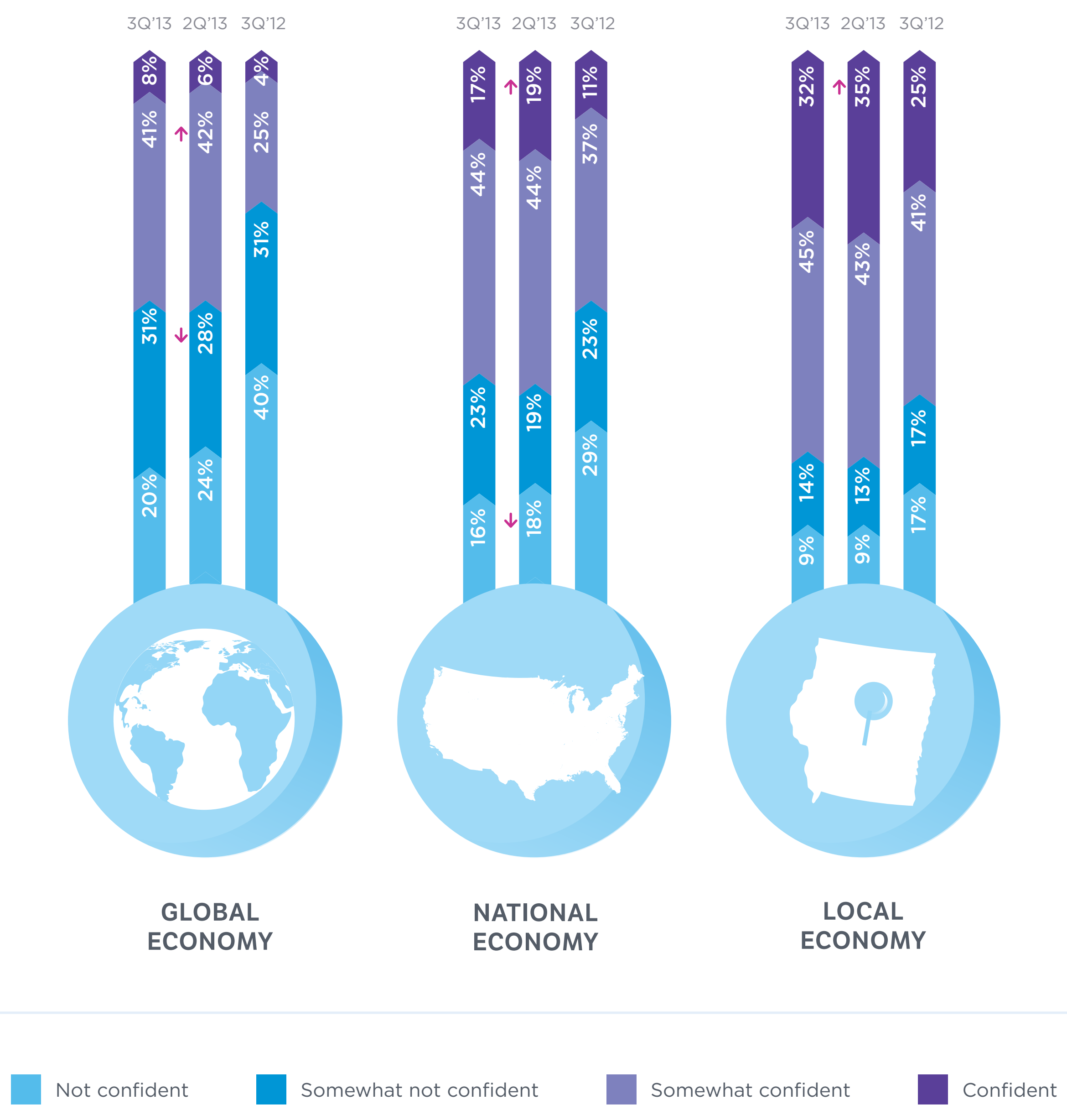
Companies in the $50 - $100 million segment are more likely to hold cash, though a growing number of lower middle market companies plan to save cash for making financial investments down the road.

CHALLENGES PERSIST:

Domestically, the impact of healthcare legislation continues to concern almost all middle market executives. Leaders of middle companies also expressed concern about another fiscal cliff.

Globally, concern about escalating tensions in the Middle East and socio-political unrest in key developing markets (including Brazil and India) have combined to put a cloud over potential growth.

Economic Confidence Indicators



Note: Arrows indicate significant difference compared to immediate previous time period.

Growth Indicators

Revenue Growth

MIDDLE MARKET

PAST 12 MO.	NEXT 12 MO.
3Q'13 5.5%	3Q'13 4.4%↓
2Q'13 5.8% 3Q'12 5.5%	2Q'13 5.1% 3Q'12 3.7%

S&P 500

PAST 12 MO.	NEXT 12 MO.
3Q'13 2.6%	3Q'13 1.0%
2Q'13 3.1% 3Q'12 1.6%	2Q'13 1.2% 3Q'12 1.5%

Employment Growth

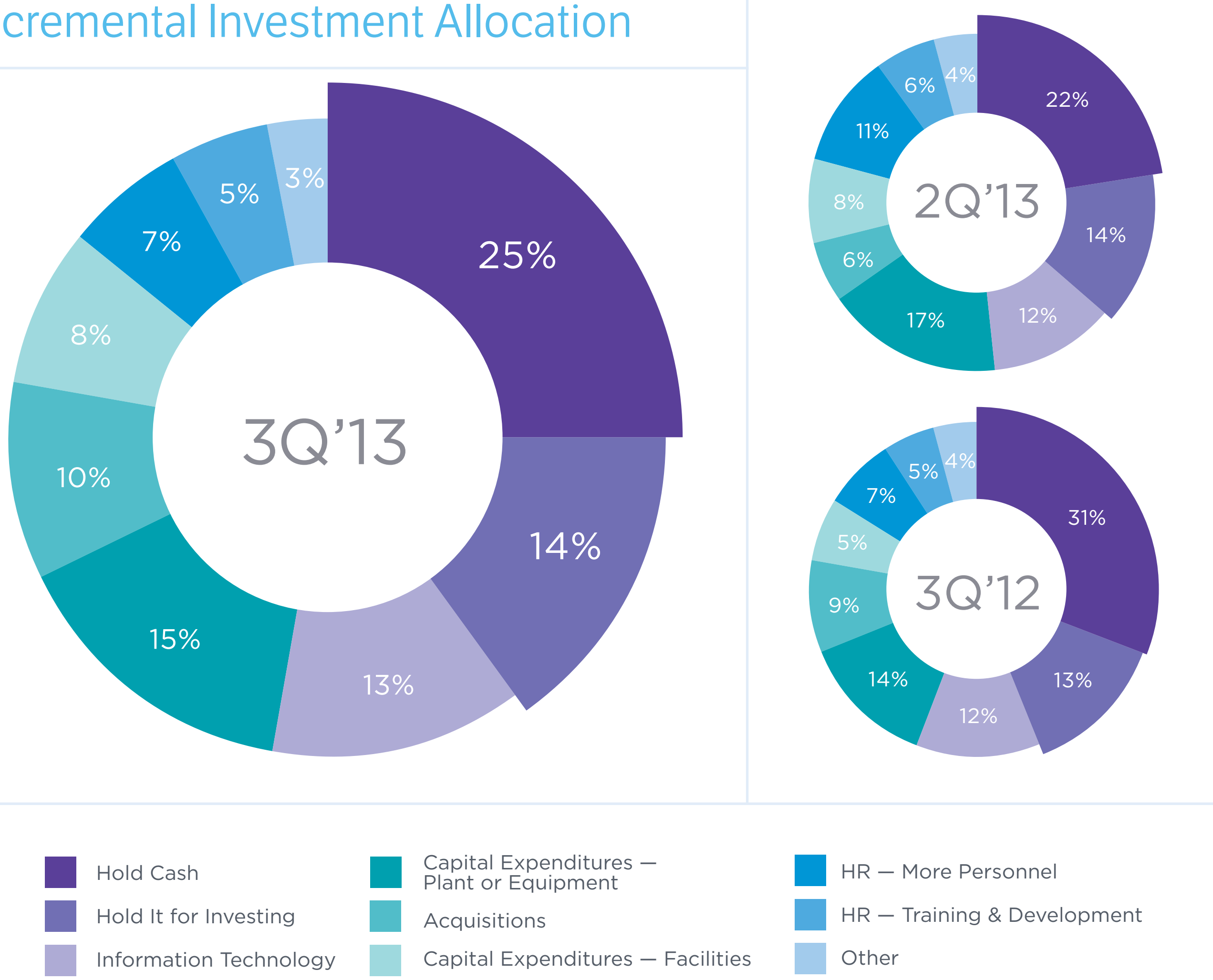
MIDDLE MARKET

PAST 12 MO.	NEXT 12 MO.
3Q'13 2.8%	3Q'13 2.1%
2Q'13 2.6% 3Q'12 2.2%	2Q'13 2.5% 3Q'12 1.3%

ADP (PAST 12 MO.)

LARGE CORP.	SMALL BUS.
3Q'13 2.4%	3Q'13 1.8%
2Q'13 2.2% 3Q'12 3.4%	2Q'13 1.6% 3Q'12 1.2%

Incremental Investment Allocation



Recent & Expected Growth

Revenue

The overall performance of middle market companies stabilized during the third quarter of 2013. Of the companies surveyed, 62% said business in the period improved. That remains in the range of 58% to 62% over the preceding three quarters, but still represents a notable increase from the 51% in the third quarter a year ago. Only one in ten middle market companies said that business deteriorated compared with 8% in the prior quarter and down from 13% a year earlier.

Average revenue growth decelerated moderately to 5.5% in the period. That's below the 5.8% reported during the first two quarters of 2013. While it's well below the 7.0% surge in revenue reported during the fourth quarter of 2012, it's on par with the 5.5% showing during the third quarter of 2012.

The results, while below highs hit last year, indicate a foundation of sustainable annual revenue growth in excess of 5% – at least for now.

It was the core middle market companies that powered the top-line gains in the period. Revenue growth among those with revenues of $50 - $100 million rose to 5.9%, up from 5.6% in the previous quarter. That offset a decline among the larger middle market companies, which reported revenue gains of 5.6% down notably from 6.9%.

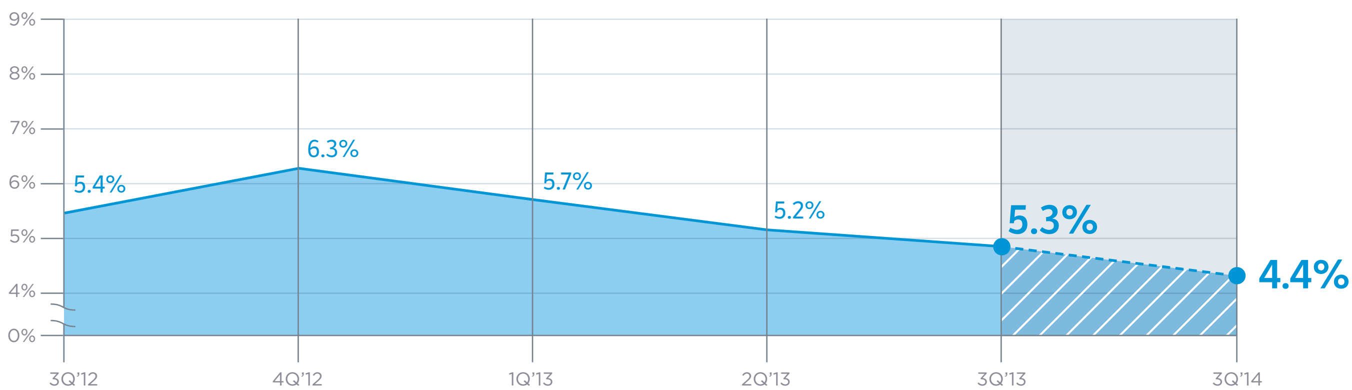
Moving forward, all segments of the middle market anticipate that revenue growth will slow. The core of the middle market anticipates 3.8% revenue gains, down from just 5.0% in the last quarter. Only 56% of these companies expect revenue to grow; 70% projected revenue gains just a quarter ago. Smaller middle market companies expect to taper to 4.4%, down from 4.9%; the largest middle market companies expect top-line growth to slow to 4.6%, from 5.5%.

These projections – while markedly higher than the forecasts a year ago -would mark the first time that revenue growth decelerated to below 5%.

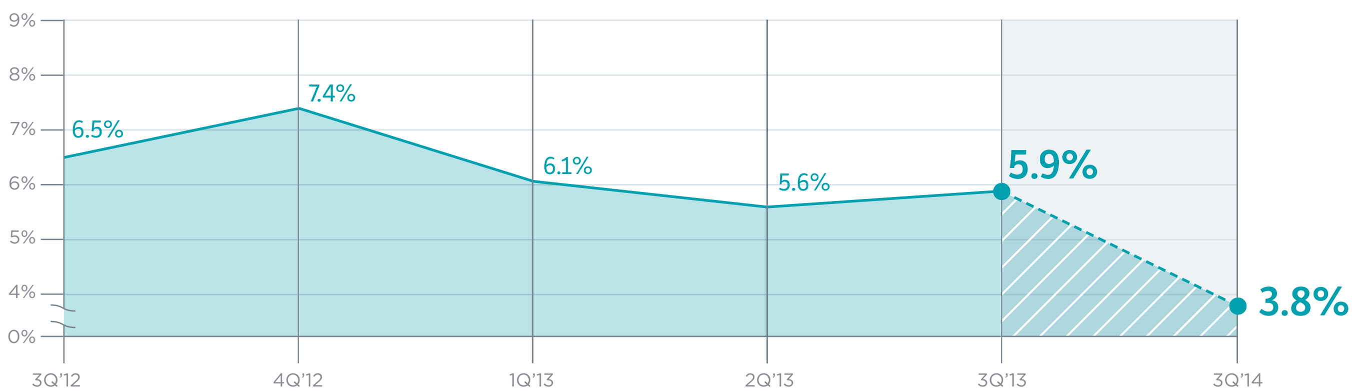
The retail sector stands alone in forecasting increased gross revenue, anticipating 4.6% growth, up from 4.2% in the second quarter, and well above the 1.9% in the year-earlier comparable period. Financial services and healthcare expect the biggest declines, among other sectors.

Revenue Growth By Segment

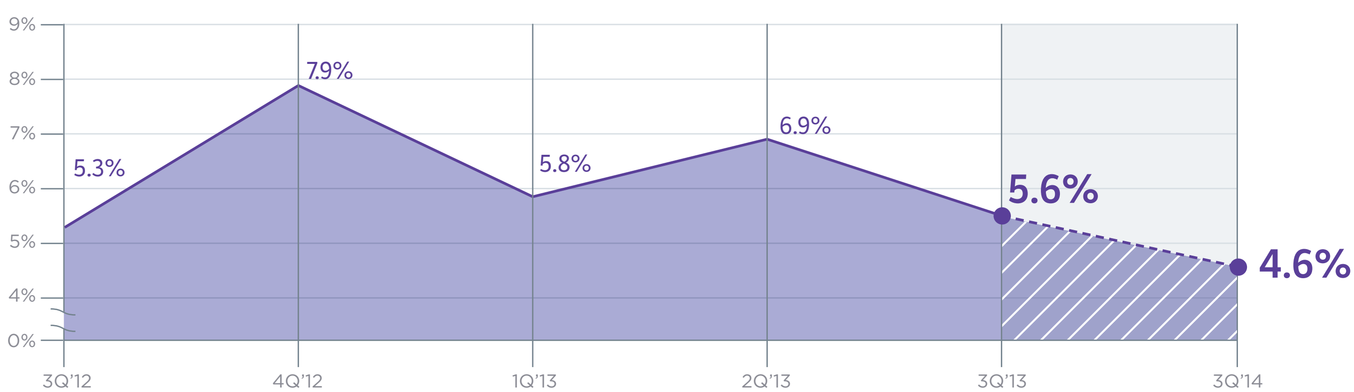
$10MM–<$50MM



$50MM–<$100MM

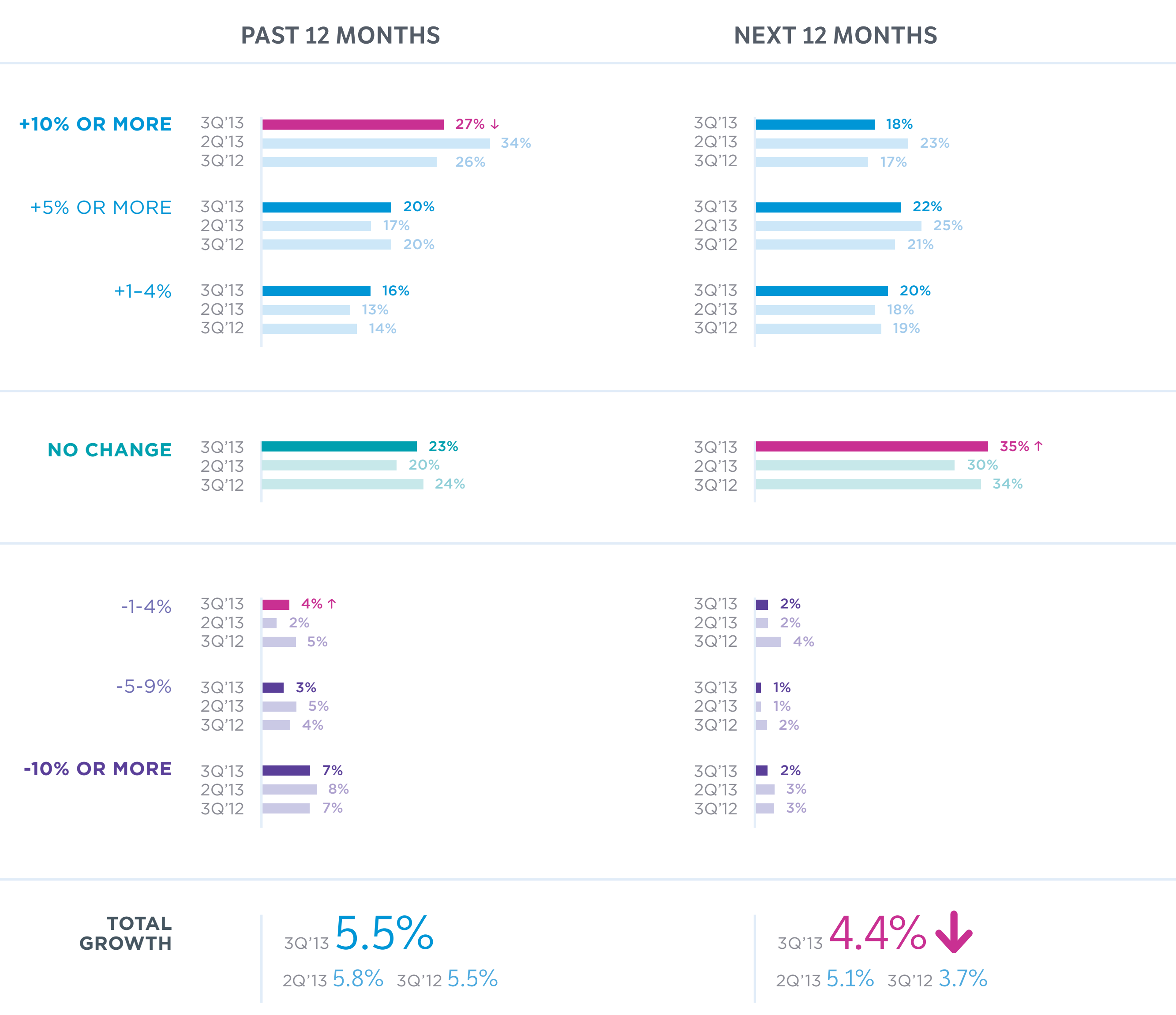


$100MM–$1B



Revenue Performance

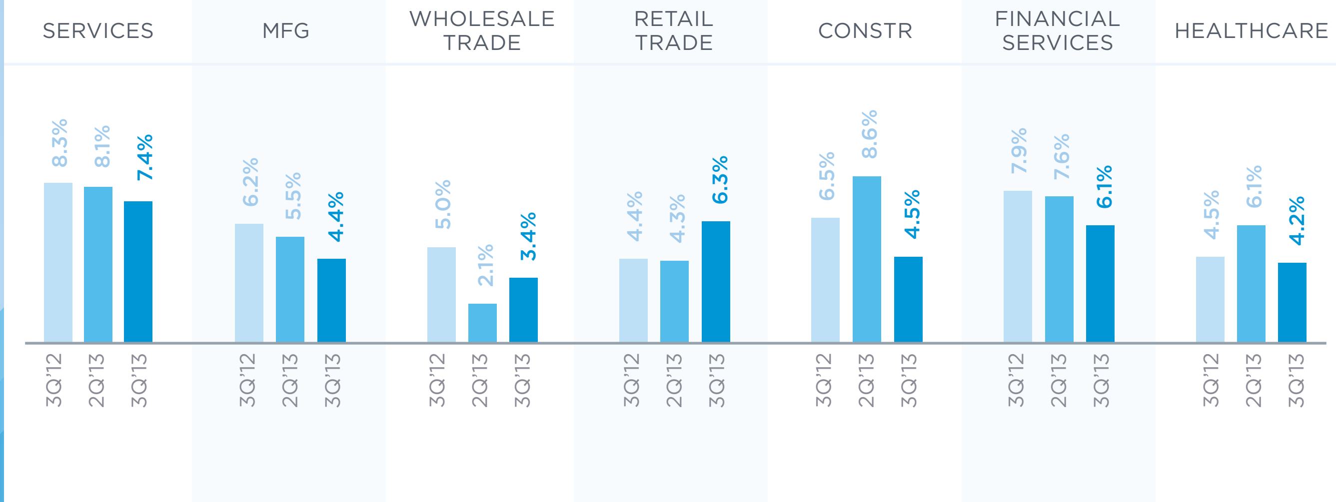
Revenue growth remains stable since 2Q 2013.



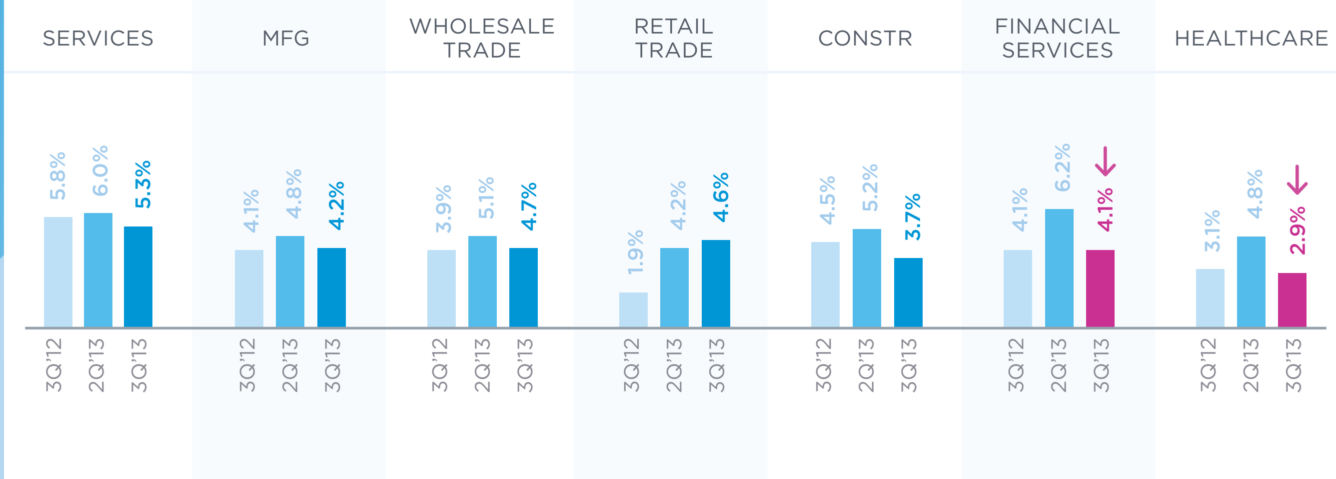
Revenue Performance by Industry

Revenue remains steady vs. last quarter in all industry sectors.

PAST 12 MONTHS



NEXT 12 MONTHS



Recent & Expected Growth

Employment

As companies temper their revenue growth forecasts they also expect to slow the pace of hiring. Of the survey respondents, 40% said they will hire workers, down from 43% in the prior quarter. One in ten companies said they would reduce their workforce. The mean total employment growth forecast – which surged 20% from 2.1% to 2.5% in the second quarter of the year – reverted back to the 2.1% forecast this period.

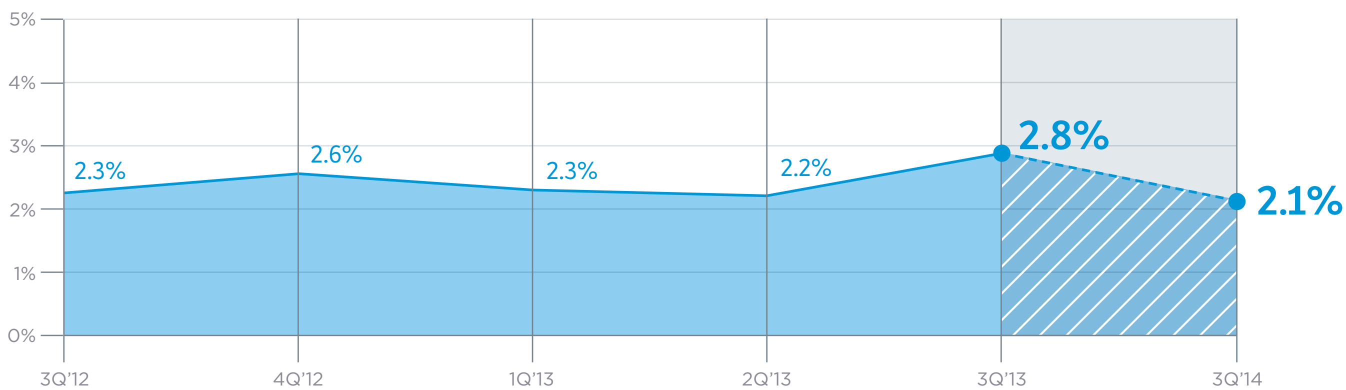
Expectations for job growth slowed among the lower and core middle market firms, while rising nominally among the larger firms, where 46% of respondents said they plan to hire, up from 45%.

The hiring expectations of respondents in the services sector slowed dramatically in the period. While 55% of service sector respondents last quarter said they planned to increase hiring, only 47% expressed a similar sentiment this quarter; hiring is expected to slow to 2.7% among services companies, down from 4.1% just a quarter earlier. Wholesale trade and financial service respondents also said they planned to slow hiring. Only retailers expect increased hiring, up to 2.4% from, 2.1% a quarter earlier.

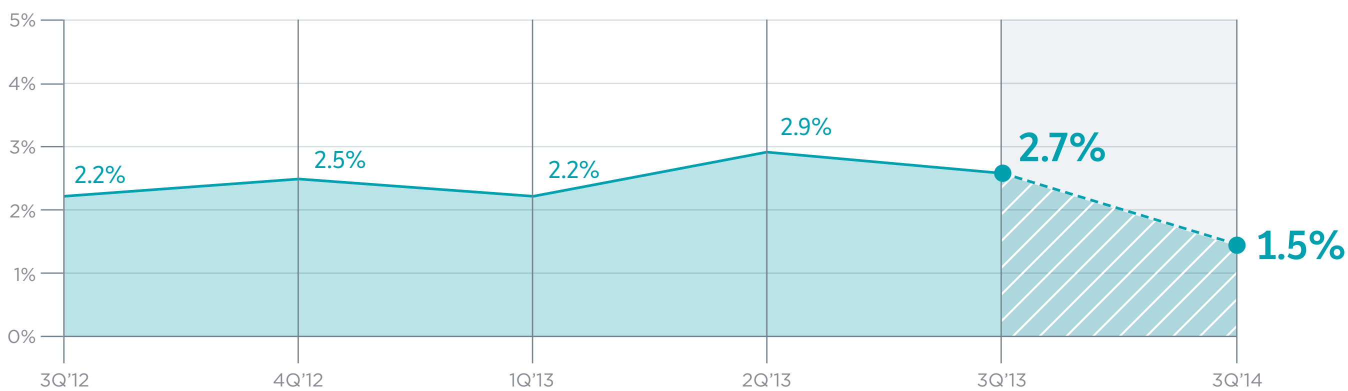
With nearly a third of the private sector GDP and employment in the U.S. coming from the middle market, a slowdown in job expansion could prevent the U.S. economy from accelerating the remainder of this year and into 2014.

Employment Growth By Segment

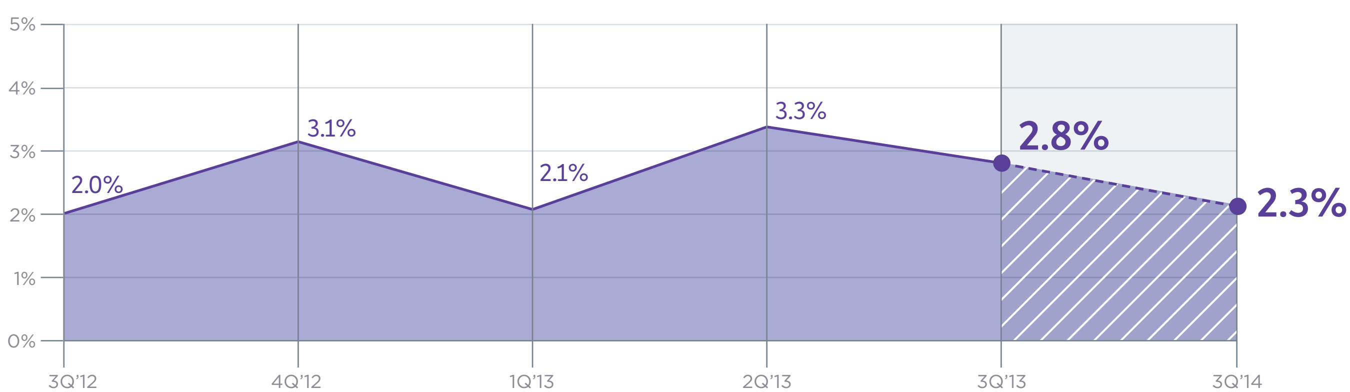
$10MM–<$50MM



$50MM–<$100MM

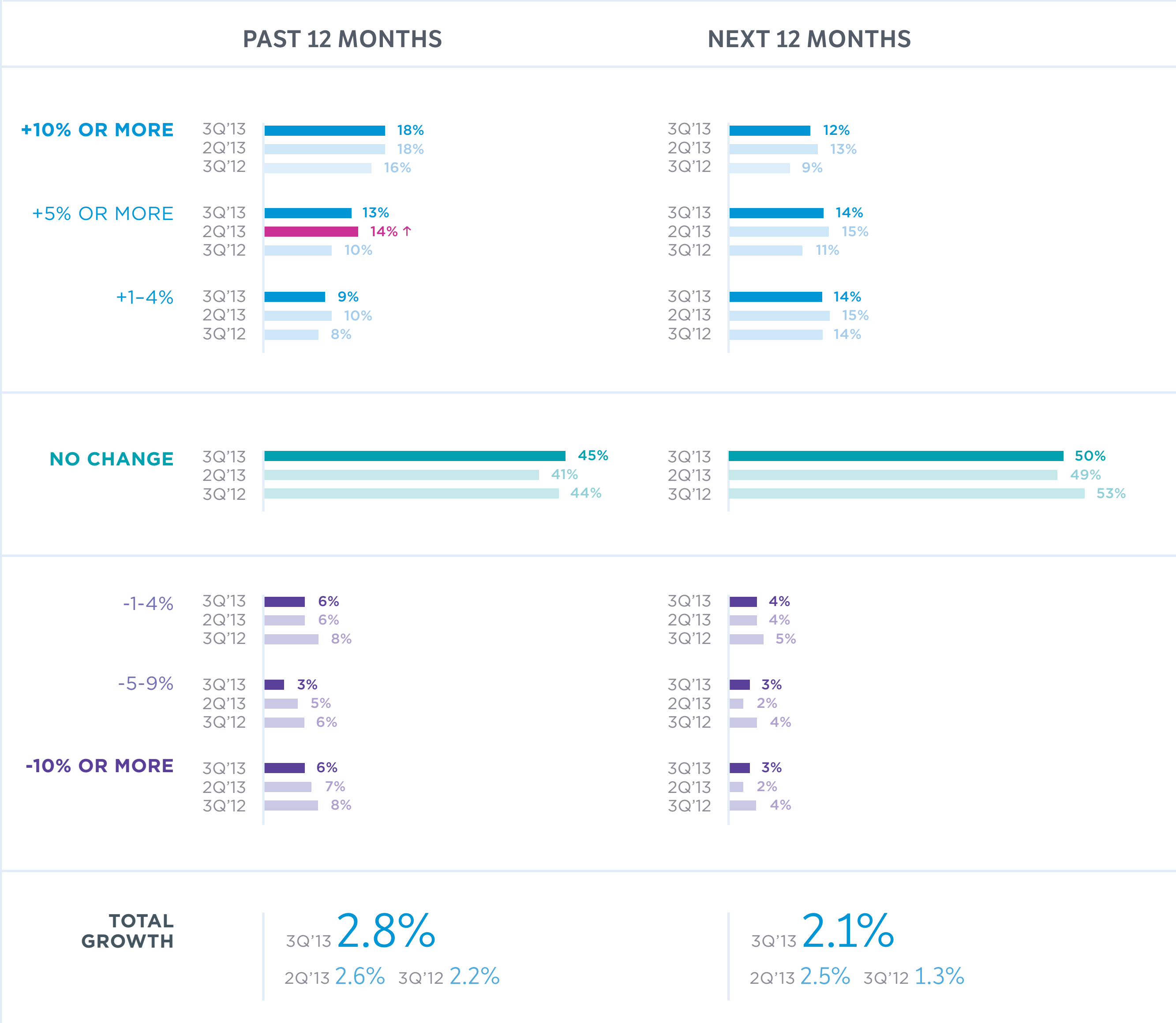


$100MM–$1B



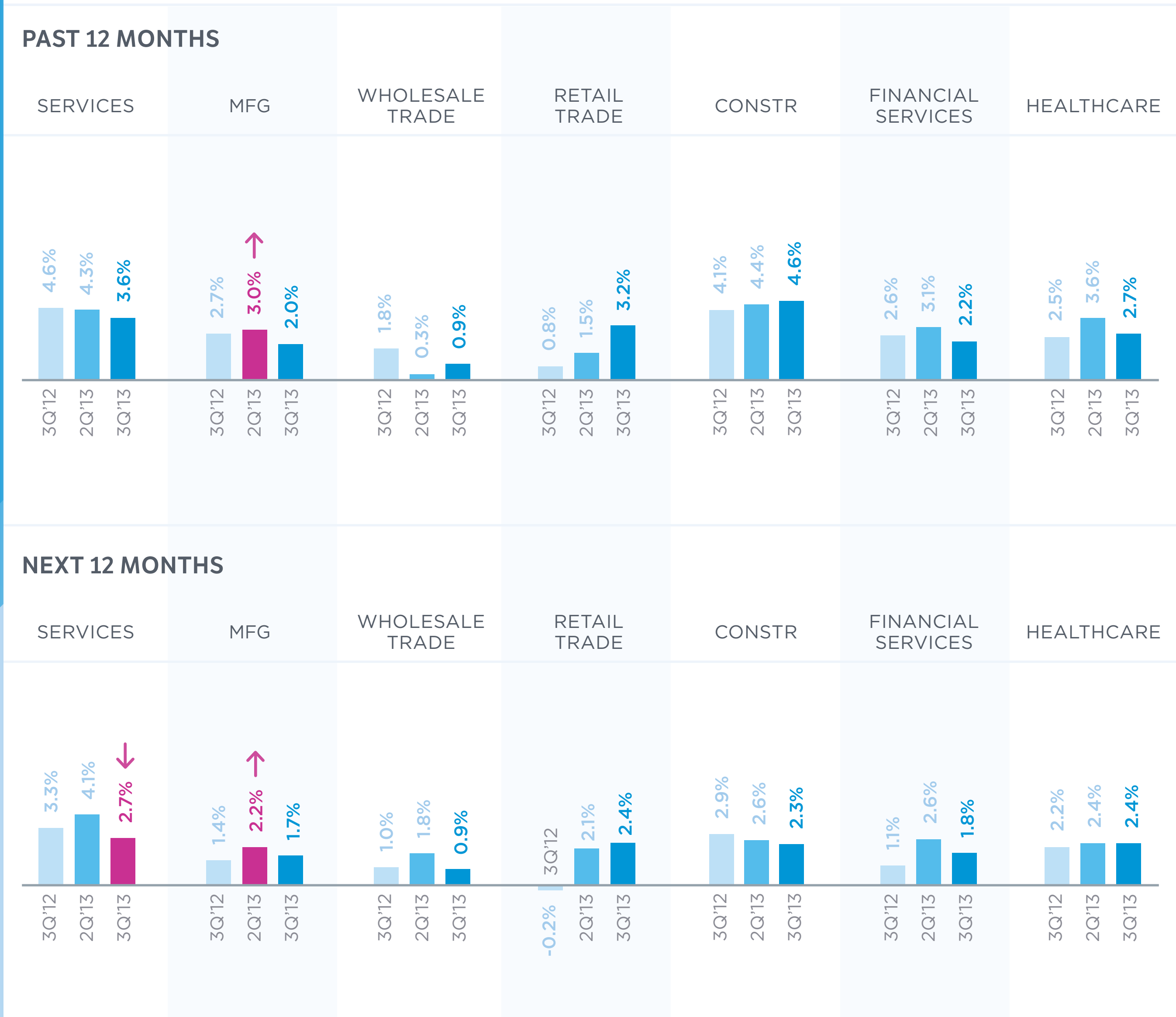
Employment Performance

Employment growth is stable over the past year.



Employment Growth by Industry

Employment growth is stable across industries.



Confidence & Future Outlook

Financial decision makers at middle market companies of all sizes remain confident in the economy, though the increases in confidence that had marked the previous several quarters have halted, at least for now.

The year-over-year increase in the number of respondents who say they are somewhat confident or confident in economic conditions still reveals a marked shift in sentiment. For the second straight quarter 48% of those asked are at least somewhat confident on the global economy, up from 29% who responded in kind in the third quarter of 2012. For the U.S. economy, 62% of respondents said they are at least somewhat confident, up from 48% a year earlier; for the local economy, 77% are at least somewhat confident, a rise from 66% in the year-ago period. But those numbers have stabilized over the last three months.

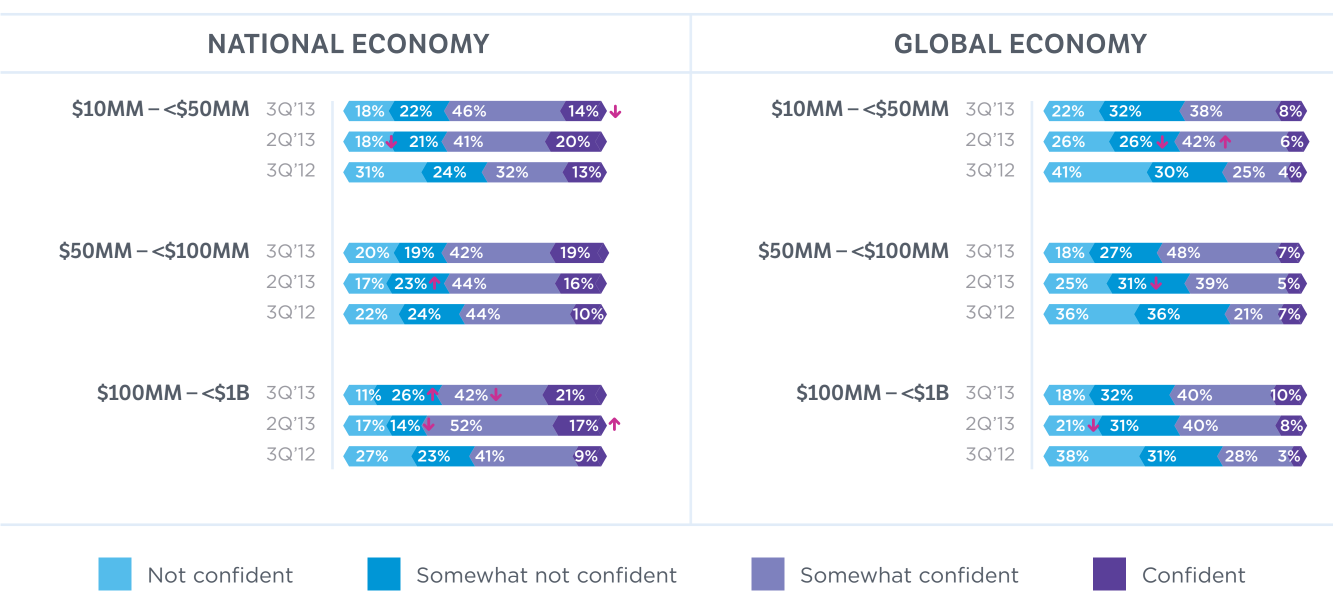
Confidence in the U.S. economy appears to be most notably weakening among the smaller middle market companies, where 14% of respondents said they were confident in prospects, down from 20% in just one quarter. There also are concerns among the larger companies, where the percentage of executives who said they are somewhat not confident in U.S. prospects surged to 26% from 14% in this quarter.

Decision makers within wholesale trade reported the largest decreases in confidence. Only 6% of that group said they were confident about the U.S. economy, down from 19% a quarter ago, while 37% of that group said they were somewhat not confident, up from 21% in three months. Retail leaders expressed the largest increases in confidence.

> *"All of our global operations continue to evolve due to the changes underway in our industry. Overall, I am more optimistic about the economy than I was one year ago."*
>
> *— Chairman, Communications, $25MM annual revenues, 150 employees*

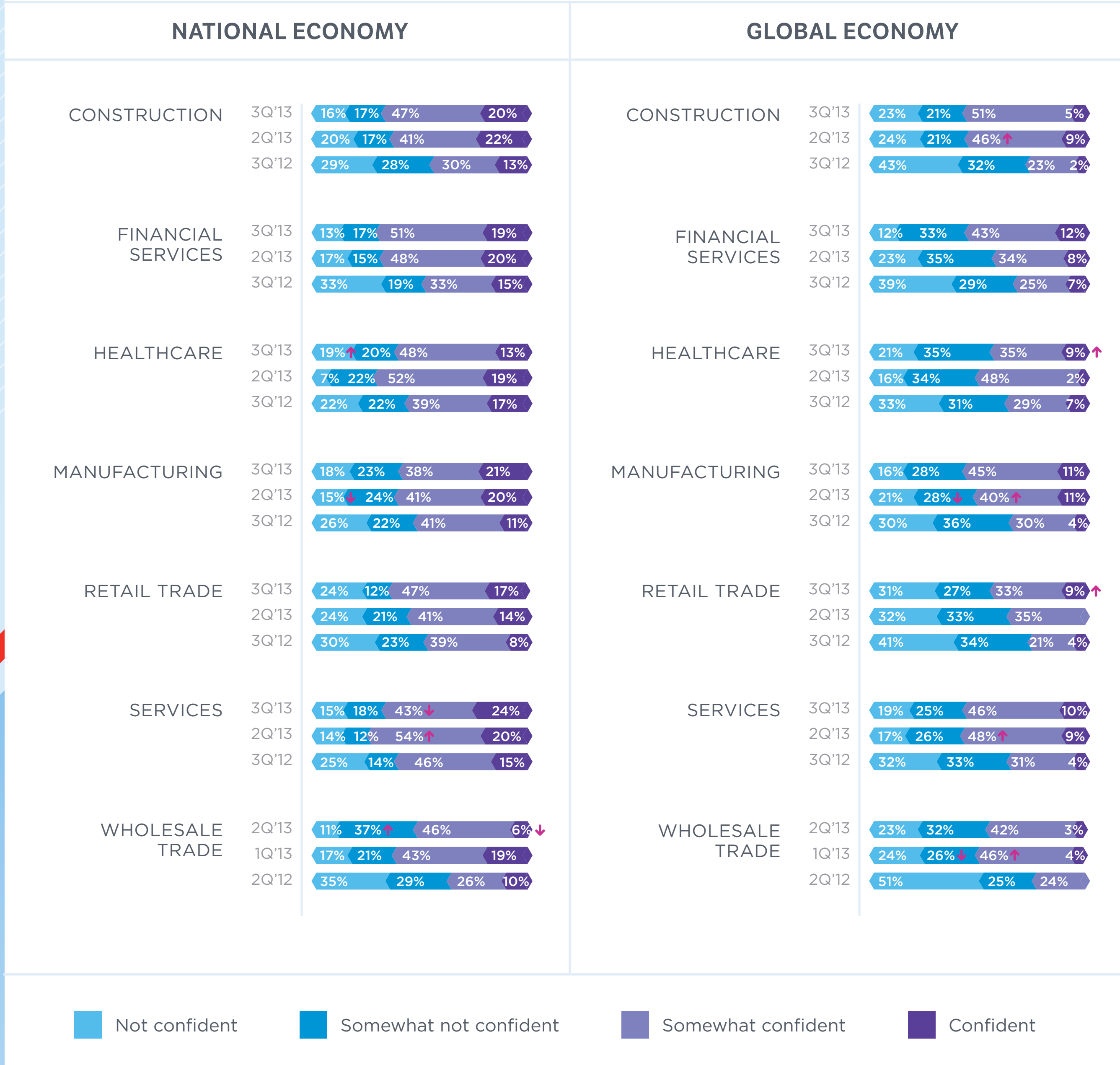
Confidence by Revenue Segment

Confidence in the U.S. economy is waning among leaders of smaller MM firms.



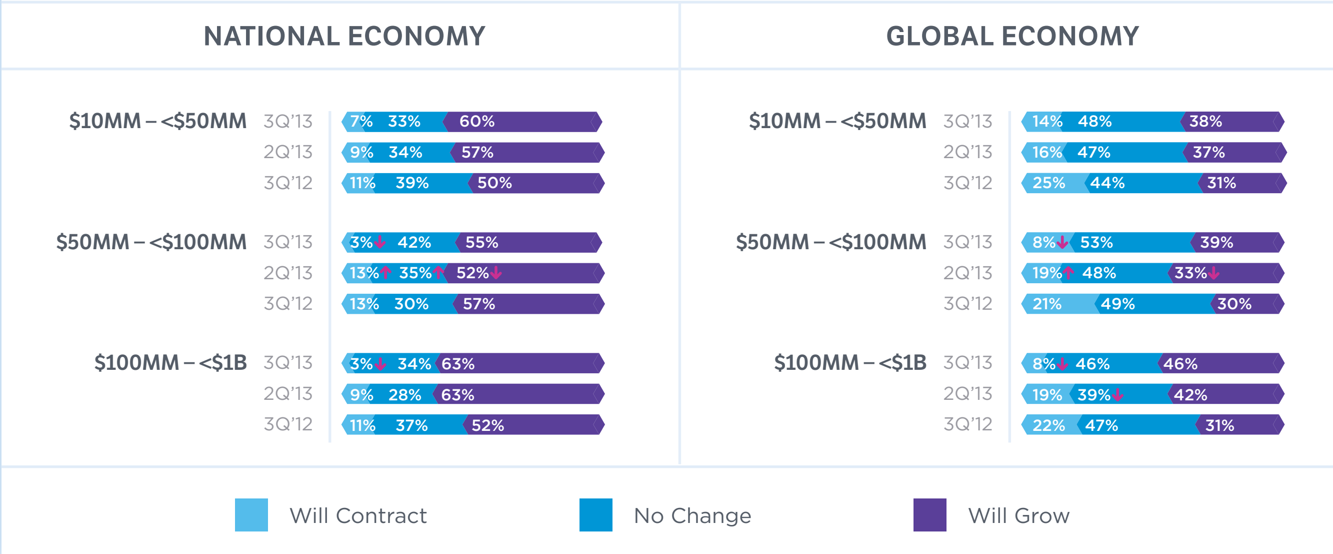
Confidence by Industry

Failing confidence in the U.S. economy is most evident in the Wholesale Trade sector.



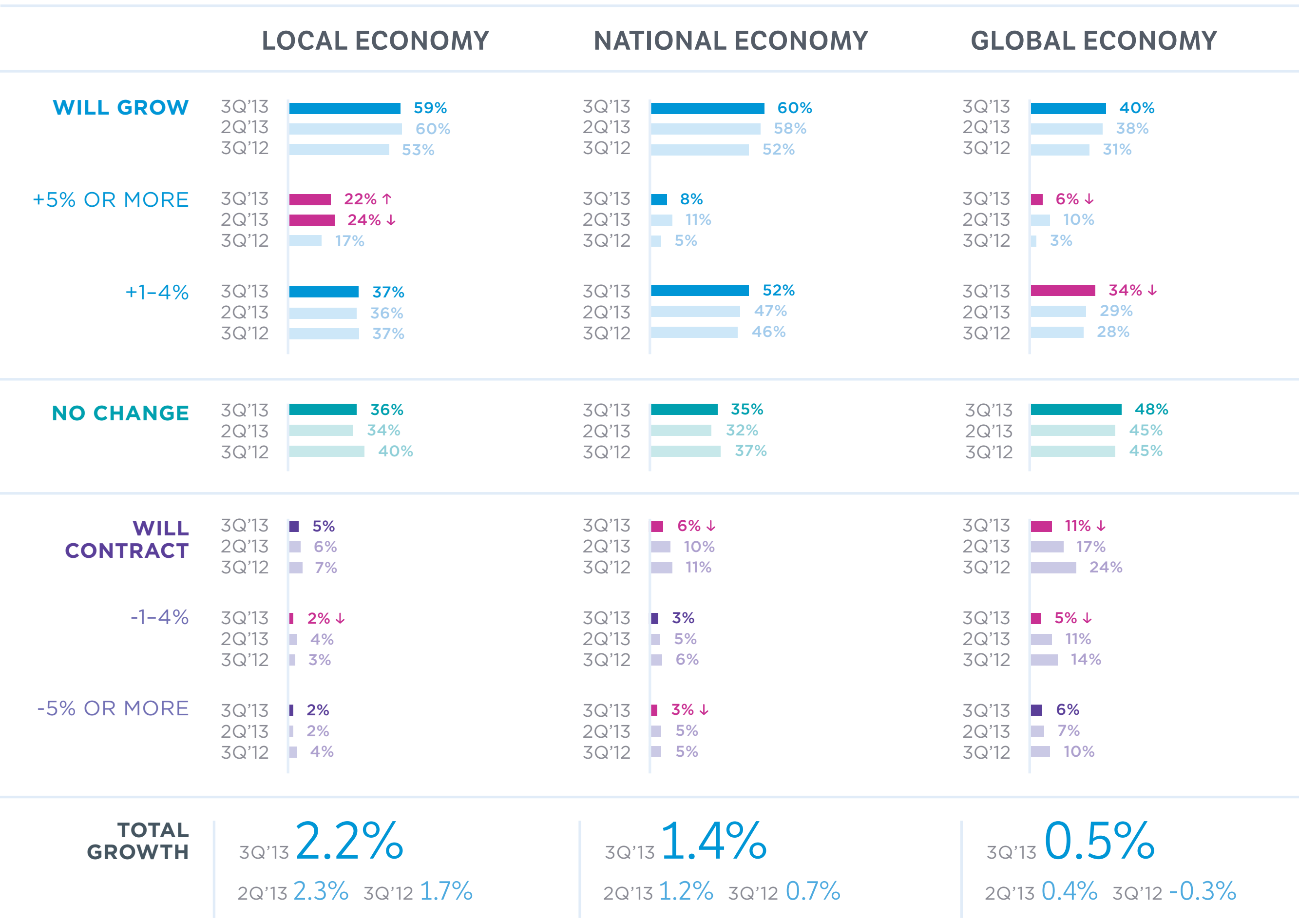
Economic Growth Outlook by Revenue Segment

Growth expectations for the Global and U.S. economies are similar to what they were in 2Q 2013. The number of MM leaders of Core and Emerging MM businesses expecting Global and U.S. economies to contract is lower than in 2Q 2013.



Economic Growth Outlook

Middle market leaders expect their firm to grow faster than the local, national and global economies.



Economic Growth Outlook by Industry

Leaders in the construction sector have a higher expectation for Global economic growth than they did in 2Q 2013.

Challenges

"Our primary challenges have resulted from legislative and regulatory issues. This has resulted in an increase of activity with our trade associations and lobbying teams in an attempt to advocate on our behalf."

— CEO, Business Services, $55MM annual revenues, 270 employees

Persisting concerns over the cost of healthcare – even as the U.S. enters the implementation stage– is the major challenge facing middle market companies. The ability to grow revenue and maintain margins and the cost of doing business follows as other major concerns.

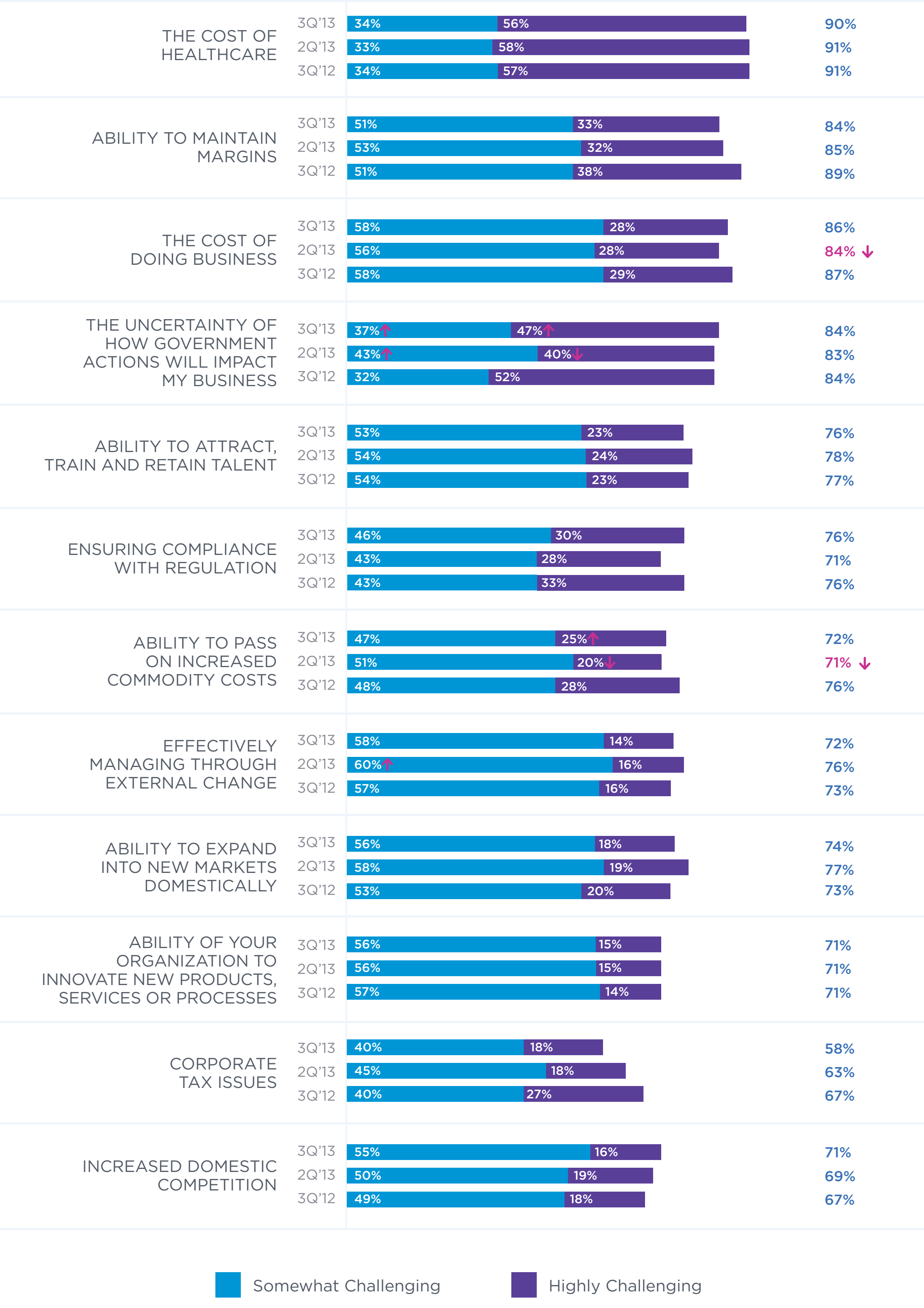
Nine of 10 of all respondents cited healthcare uncertainty as their chief challenge, with 56% saying the topic was highly challenging. It was the lone concern in which more than half of respondents said the issue was highly challenging.

Few middle market leaders feel their companies are prepared to implement the new health care laws. Only 43% of companies said they were mostly or completely prepared to implement the law. One quarter of businesses said that modifying the employer mandate part of the health care legislation would help their business. That's the same percentage of respondents that said avoiding a government shutdown through budget negotiations also would help. Secondary concerns include financial regulatory reform, immigration laws and the debt ceiling.

The unrest in the Middle East and growth slowdown in emerging markets is having a negative impact on about one in four middle market companies. Most firms impacted by the tensions in the Middle East are holding or curbing investments to combat supply chain disruptions, diminished prospects for international growth and reduced access to capital.

Key Challenges

Healthcare costs and other margin pressures are most challenging to Middle Market Leaders. The uncertainty of government actions is also a key issue.



Perspective

A RECOVERY AT RISK

The U.S. economy has experienced a tepid recovery so far. After nudging along at a disappointing pace of 1.1% annualized real growth in GDP in the first quarter of 2013, the economy showed some promise when it grew at 2.5% in the second quarter. However, early results for the third quarter suggest an annualized growth rate of less than 2%. Indeed, large firms (those in the S&P 500) saw revenues grow at 2.6% for the past twelve months. Looking ahead the S&P 500 firms are projected to grow revenue at a mere 1%.

In contrast, the middle market has been a shining light in this recovery to date with revenue growth rates typically well above 5%. But the data for Q3 suggests that growth is tapering off. The rate of growth of revenues for the past 12 months was 5.5%. Unfortunately, the latest survey from the National Center for the Middle Market shows that the expected rate of growth of revenues in the middle market is only 4.4% for the upcoming year. When it comes to job creation, the good news is employment grew at a stable rate of 2.8% in Q3. What is less reassuring, however, is that executives predict slower employment growth of 2.1% in the year ahead. The percentage of middle market executives willing to invest an extra dollar, a figure that had been increasing for the previous six quarters, has now dipped from 64% for Q2 to 61% in Q3. Not a large change, but significant because of change in direction. Similarly, the percentage of middle market managers expressing some confidence in the local/regional economy, the main hub of operations for middle market firms, has dipped from 79% in Q2 to 77% in Q3. Altogether, the middle market, thus far an engine of growth in the economy, seems to be "peaking out."

THE ECONOMIC DRAG FROM GOVERNMENT UNCERTAINTY

A clear drag on the economy is the relentless creation of man-made uncertainty, which cannot be good for investment and growth. Within the past year, markets have been roiled by uncertainties arising out of the fiscal cliff (recall the Bush era taxes?), the ongoing saga of sequestration, the threat of government shut down, and debt ceiling debates. A default by the U.S. government on its debt on account of a failure to relax the debt ceiling is the latest potential problem, and it has serious consequences. Currently, the interest rate on U.S. 10-year Treasury bonds is about 2.7%. In other words, we are financing the operations of the U.S. government at very favorable rates. All of us, businesses included, are beneficiaries of the good faith and standing of the U.S. government. A default would surely raise these government interest rates with an impact on other rates, consequently increasing interest costs for businesses. It would also shake the confidence of those around the world that have financed our deficits. An increase in interest rates would automatically lower the value of the bonds now held by the Chinese and the Japanese, for example. Their losses could be enormous, since they hold $1.28 Trillion and $1.14 Trillion of U.S. Treasuries, respectively. Imagine the impact on the willingness of foreign investors to buy U.S. government bonds and on the future borrowing costs to the U.S. government and businesses!

IMPACT OF U.S. DEBT DEFAULT ON MIDDLE MARKET FIRMS

While middle market managers seem to have taken the government shutdown in stride (only 15% say that it will have a negative impact on business), a U.S. default on debt is an entirely different matter. Nearly half of middle market executives surveyed claim that government default would have a negative impact on business. In our survey, they tell us that default can lead to higher interest rates, reduced consumer confidence, reduced confidence among businesses, reduced foreign direct investment, and reduced confidence in the creditworthiness of the country. Some 94% of middle market executives consider higher interest rates as the most adverse impact of a U.S. default on its debt. At the time of this report, the current debt ceiling crisis appears to have been averted. However, ongoing uncertainty in Washington will continue to put pressure on this vital segment of the economy.

In sum, in a cross-sectional comparison, the middle market is doing well relative to other segments. But in an inter-temporal comparison, its growth has hit a plateau. Instead of its intended role as a facilitator, government seems to be instead playing the role of spoiler in this case, at a time when the unemployment rate is still hovering around 7.3%.

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

Fisher College of Business at The Ohio State University is dedicated to training the next generation of business professionals through world-class faculty and a highly innovative curriculum elevated by close partnerships with industry leaders. The market has spoken: a recent survey of corporate recruiters conducted by The Wall Street Journal ranked Fisher second in the nation among business schools with the most sought-after graduates. Stay connected to Fisher via Twitter.

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