NATIONAL CENTER FOR
THE MIDDLE MARKET

1Q | 2018

MIDDLE MARKET INDICATOR

New Thresholds of Growth

IN COLLABORATION WITH

The Ohio State University
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Executive Summary

The middle market is firing on all cylinders for the first quarter of 2018. Nearly three-quarters (72%) of companies say that overall company performance has improved compared to one year ago—a new record for the Middle Market Indicator. Additionally, the proportion of companies reporting year-over-year revenue growth and year-over-year employment growth—77% and 55% respectively—are both at the highest levels recorded in MMI history. The rate of growth for both revenues and employment is near peak levels, and nearly every industry reports faster growth than in the quarter before, with the exception of the services industry, where growth is flat this quarter. Global and local confidence levels have reached record highs, and investment plans have strengthened accordingly, with a larger-than-ever majority of leaders saying they plan to increase investment rather than hold cash in reserve.

As middle market companies continue to flourish, talent remains the number one challenge for the year ahead. In a tight labor market, finding and keeping people is becoming increasingly difficult. Middle market companies are considering increasing salaries, offering additional compensation, and investing in training and development to improve retention. These actions will increase costs. That, combined with healthcare, may be driving the growing concern over costs in the short term, and companies say they expect to see an increase in their cost structure in the 12 months ahead. Leaders, however, are relaxing their concerns related to government rules, regulations, and taxes.

Going forward, companies expect both revenue and employment growth rates to remain strong. Two-thirds of middle market businesses anticipate increases in revenue over the next 12 months, and 46% say they will add workers, many indicating that they will make hires in the coming quarter. Almost half (49%) of businesses plan to introduce a new product or service in the next 12 months and more than a quarter (27%) anticipate adding a new plant or facility. Plans for expansion are particularly robust among upper middle market firms. These largest middle market companies are most likely to predict increases in short-term sales and demand.

The construction and financial services industries continue to report impressive gains in revenue and employment. Growth in the business services industry appears to have flattened, albeit at a high 8.2% annual rate. Manufacturing and healthcare report modest gains in revenue growth, but employment in both areas has jumped. Across industries, upper middle market firms report the strongest growth this quarter.

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.

FOR COMPLETE TRENDING, INDUSTRY, & REGIONAL DATA, VISIT **MIDDLEMARKETCENTER.ORG**

Revenue Growth

Revenue growth escalates

Since mid 2017, the rate of year-over-year middle market revenue growth has climbed steadily, reaching 8.4% for 1Q 2018, the second highest rate recorded in MMI history. The number represents a substantial increase from the previous quarter and is well above the average annual growth rate of 6.7% for the past six years. Upper and core middle market firms account for the largest share of growth, and companies across nearly every industry segment report increases, with the most notable gains occurring in construction and financial services.

Companies of all sizes anticipate strong growth will continue over the next 12 months. Two-thirds of businesses say revenue will increase, and leaders predict a 5.9% growth rate for the year ahead. Core and upper middle market firms are more aggressive in their growth projections than their smaller peers. Across revenue segments, only 5% of companies believe that the rate of revenue growth will slow during the year ahead.

1Q'18 **77%** of middle market companies reported positive revenue growth. 1Q'17 74%

MIDDLE MARKET

	PAST 12 MO.	NEXT 12 MO.
1Q'18	8.4%	5.9%
4Q'17	7.6%	5.4%
1Q'17	9.2%	8.8%

S&P 500

	PAST 12 MO.
1Q'18	7.4%*
4Q'17	6.9%
1Q'17	5.8%

Employment Growth

Hiring is strong

To start 2018, middle market companies report that their headcount is 6.3% larger than it was one year ago, near record levels and well above the six-year average employment growth rate of 4.0%. Upper middle market businesses, which were largely responsible for the slower employment growth reported last quarter, have come back into the labor market and once again lead the middle market in job creation. As with revenue growth, employment is up across nearly all industries.

Projections for future employment growth are aggressive as well. Nearly half of middle market businesses expect to add jobs over the next 12 months at a rate of 4.6%, and most of those companies anticipate increases during the next quarter. Just 3% of firms expect to decrease the size of their workforce during this time period. Companies are primarily looking for full-time operations people to add to their staffs. Upper middle market companies have plans to onboard IT professionals.

1Q'18 **46%** of middle market companies expect to add jobs. 1Q'17 42%

MIDDLE MARKET

	PAST 12 MO.	NEXT 12 MO.
1Q'18	6.3%	4.6%
4Q'17	5.2%	4.7%
1Q'17	7.5%	6.0%

ADP *(Past 12 Mo.)*

	LARGE CORP.	SMALL BUS.
1Q'18	2.4%	1.9%
4Q'17	2.6%	1.4%
1Q'17	1.6%	1.4%

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

Economic Confidence

Local and global confidence peak

At 94%, middle market leaders' confidence in their local economies reaches an all-time high in 1Q 2018. Global confidence levels, too, peak at 82%. National confidence has risen slightly to 87%, just below its high of 90%, recorded in 1Q 2017.

Compared to mid 2012, when fewer than half of leaders felt sure of the national situation and fewer than a quarter were confident about the global state of affairs, today's numbers show a transformation in perception that is helping to drive growth rates. Overall confidence levels mask some revealing differences by region and industry. (See Perspectives.)

1Q'18

GLOBAL ECONOMY	NATIONAL ECONOMY	LOCAL ECONOMY
82%	87%	94%
CONFIDENT / SOMEWHAT CONFIDENT	CONFIDENT / SOMEWHAT CONFIDENT	CONFIDENT / SOMEWHAT CONFIDENT
4Q'17 75%	4Q'17 86%	4Q'17 88%
1Q'17 77%	1Q'17 90%	1Q'17 88%

Short Term Index

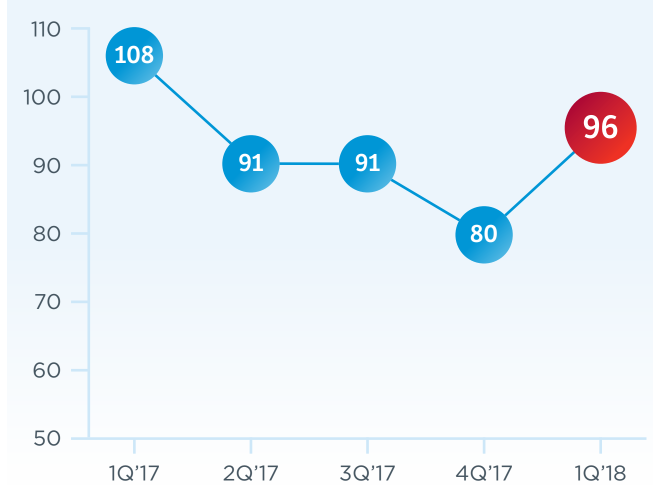
Companies expect a strong second quarter

After declining throughout 2017, the Short Term Middle Market Index has risen this quarter, jumping from 80 to 96. With the exception of 1Q 2017, this represents the highest Short Term Middle Market Index level since the Center began tracking the metric in 2015. The Short Term Index reflects middle market leaders' expectations for sales, demand, and business climate over the next three months. During the second quarter, a majority of executives are anticipating increased demand and sales; however the majority expect the business climate to largely remain the same.

Specifically, 51% of companies—primarily upper middle market companies—say that sales will increase during 2Q 2018. The largest middle market businesses are also the most likely to expect an increase in demand for their products and services in the short term.

Core middle market companies are somewhat less optimistic about the next three months than their smaller and larger peers. Among this segment, just 15% expect a more favorable business climate next quarter. However, very few middle market businesses of any size are forecasting deteriorating conditions or decreases in demand or sales.

PAST 12 MONTHS



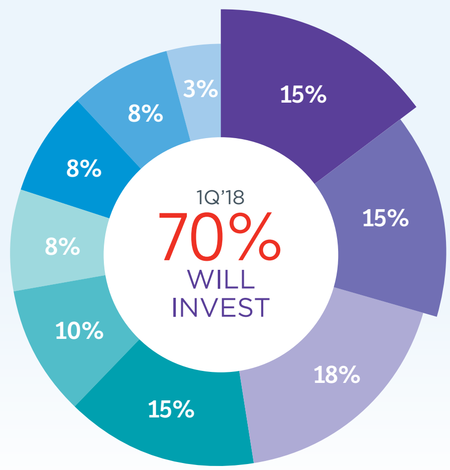
Short Term Index is calculated by taking expected net positive change in business climate plus expected net positive change in demand plus expected net positive change in sales over the next 3 months.

Capital Investment

Fewer companies will save cash

Investment appetites in the middle market have steadily grown over the past six years. At the close of 1Q 2018, 70% of leaders say they would invest an extra dollar, compared to 51% who said the same in mid 2012. This quarter, information technology edges out new plant and equipment as the most likely area for investment. Of the 30% who would put money aside, fewer than half—14% of the total—say they would hold more cash in reserve,the lowest percentage recorded by the MMI. The remaining savers are holding cash to build up their funds in order to finance future investments. Companies adding to cash reserves tend to be lower or emerging middle market businesses; this is something we have seen before andprobably reflects the fact that smaller companies have less access to outside rainy-day capital.

ADDITIONAL INVESTMENT ALLOCATION



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

Key Challenges

Talent challenges escalate

As middle market companies continue to grow and increase the size of their staffs, and the labor pool continues to tighten, talent management, including finding and retaining people with the right skill sets and developing the current workforce, continues to be the number one internal long-term challenge. More than half (54%) of companies say that talent issues will potentially present problems for their businesses over the next 12 months. Externally, executives are primarily focused on core business growth issues, such as sales, acquiring new customers, and innovation.

Concerns over government rules and regulations, however, continue to subside, and just 3% of middle market business leaders say that taxes are an issue. Over the next three months, maintaining growth is the most pressing challenge, but talent management concerns continue to mount in the short term, and worries over costs are rising as well. Only about one out of 10 leaders express short-term concerns related to the economy.

SHORT TERM CHALLENGES *(Next 3 months)*

INTERNAL CHALLENGES	
1. BUSINESS	70%
2. TALENT MANAGEMENT	63%
3. COSTS	28%
EXTERNAL CHALLENGES	
1. BUSINESS	45%
2. COMPETITION	26%
3. GOVERNMENT	23%
4. COSTS	18%
5. ECONOMY	11%

LONG TERM CHALLENGES *(Next 12 months)*

INTERNAL CHALLENGES	
1. TALENT MANAGEMENT	54%
2. BUSINESS	48%
3. COSTS	20%
EXTERNAL CHALLENGES	
1. BUSINESS	35%
2. COMPETITION	23%
3. GOVERNMENT	19%
4. COSTS	17%
5. ECONOMY	14%

Spotlight

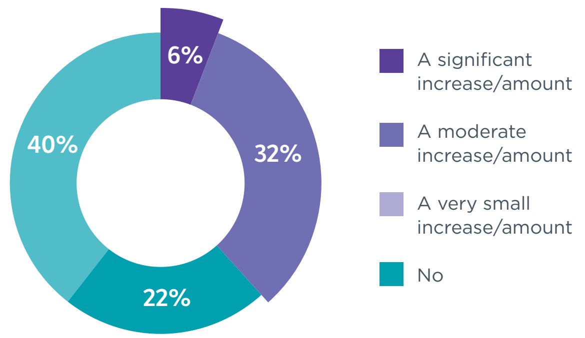
Will Tax Law Changes Increase Capital Investment?

Reduced corporate tax rates, changes in the accounting treatment of capital expenses, and other provisions of the tax bill signed into law in December were partly intended to accelerate investment by U.S. businesses. More than three out of five middle market executives say they intend to increase capital spending plans as a result. Most of these changes will be modest, but a handful of companies (6%) say they will accelerate or increase capital spending to a significant degree.

Bigger companies are more likely to be aware of tax-law changes and more likely to change capex—67% compared to 61% for the middle market as a whole. Part of this difference is due to simple awareness: Just 57% of lower middle market companies say they are aware of tax-law effects on capital spending, compared to 67% among companies with revenues between $100 million and $1 billion. Further, the Center has seen in previous studies* that larger companies are generally more knowledgeable about and responsive to the cost of capital than smaller firms.

Information technology will be the biggest beneficiary of accelerated capital investment. For every dollar executives plan to put into real estate, they will put $1.50 into plant and equipment and $2.00 into IT. Bigger middle market companies expect to invest more aggressively across the board.

Companies Planning to Increase or Accelerate Capital Spending as a Result of Tax Law Changes



*NCMM and the Milken Institute, *Access to Capital: How Small and Mid-Sized Businesses Are Funding Their Futures,* 2015

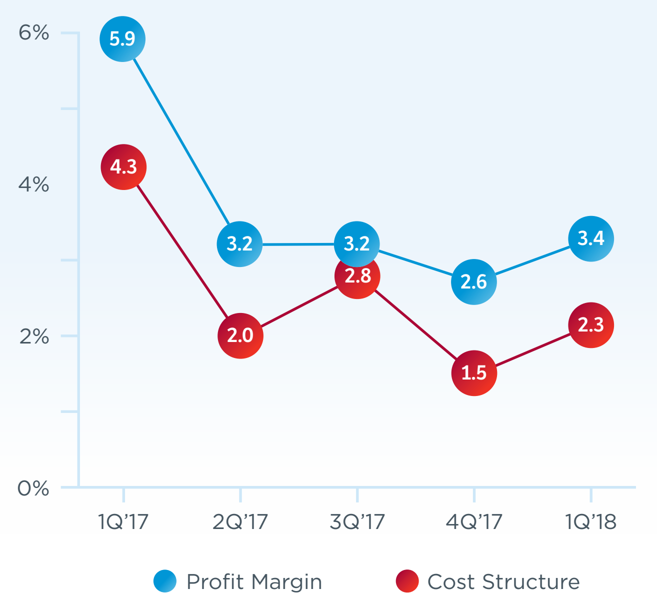
Profit Margins & Cost Structure

Profit margins and costs will increase

Over the next 12 months, middle market leaders expect to see an increase in profit margins of 3.4%. This number fell at the end of 2017, but it currently matches the predictions made at the end of 2016. To help fuel these gains, 45% of companies say they will increase the prices of their products and services. Just 5% of businesses expect to lower prices over the next 12 months.

Throughout 2017, expectations for increases in cost structure fluctuated. At the end of the year, leaders were predicting a 1.5% increase in costs for 2018. With the first quarter of the new year under their belts, companies have upped that number, saying that costs will increase by 2.3% over the next 12 months. The cost of healthcare continues to be a greater concern for companies than the cost of energy, and four out of five companies indicate that healthcare costs will have an impact on their businesses going forward.

PAST 12 MONTHS



Perspectives

Testing Limits

Average annual revenue growth for middle market companies has risen four quarters in a row—reaching 8.4% in this report. That's more than two and a half points higher than the Middle Market Indicator's historical average. On its face, growth that fast appears to be unsustainable over time: A company that grows at 8.4% a year doubles in size in fewer than nine years. Yet the expansion experienced by the middle market is echoed by growth in the broader economy.

The data in this MMI were collected in the first two weeks of March 2018, so the annualized numbers executives report is for the period that began in March 2017. Public-company data during that period tell a similar growth story for the last year, if not quite such a powerful one. The NASDAQ Index rose from 4861 to 7560, a 29% increase. The Dow rose just a little less. The S&P index increased 17% and revenues of S&P component companies increased 7.4%. While the middle market led the way, it doesn't seem to have been sprinting ahead unconnected to the rest of the economy. Moreover, as we noted last quarter, just about every company has been participating in the middle market's growth. In the first quarter a record high 72% of middle market leaders said their company's performance improved in the last year, while only 3%—a record low—said it deteriorated. That is a 24:1 ratio of winners to losers.

Whether this is sustainable growth or the final acceleration of an expansion that is about to slow, middle market companies continue to play the role we've seen and documented for seven years: turning in the strongest performance and providing the fastest job creation in the American economy.

Looking Confident

Given the excellent results of the middle market across the board, it is not surprising that executives express high confidence in the state of the economy. The data on page 4 show the sum of the top three boxes on a seven-point scale: extremely confident, very confident, or somewhat confident.

A more complex story emerges if we look at only the top two boxes, which include executives who say they are "extremely" or "very" confident about economic conditions.

+ The global number drops quite a lot, to 29%. And there are regional differences, with companies in the West and Northeast more confident about the world economy than companies in the Midwest or South.

+ High confidence in the national economy comes in at 50%. Again, the West is most bullish, with 55% of companies saying they are extremely or very confident.

+ Local conditions vary most. Overall, 53% of middle market companies are extremely or very confident about local conditions. But in the South, local confidence comes in at 57%; in the Midwest, 55%; the West, 53%; and the Northeast, just 42%.

Company size also plays a role in executive confidence. Across the board, leaders of larger middle market companies (with revenues between $100 million and $1 billion) are more confident than their smaller kindred; for example, 57% of upper middle market companies are extremely or very confident about the U.S. economy, vs. 48% of the core middle market ($50-$100 million in sales) and 46% of those with revenues between $10 million and $50 million.

The most striking difference by industry is the ebullience of people in wholesale trade, 60% of whom express high confidence in the U.S. economy. (We should note that the wholesale trade sample size is small and therefore prone to volatility: Three months ago, 42% of wholesalers were similarly confident.) It's notable that local-economy confidence is high among construction and business and financial services, which arguably have more intimate knowledge of demand in their region than, say, manufacturers. Retailers fall into the middle of the range.

Going Boldly

Confidence is both the begetter and the progeny of growth investments. Given an extra dollar of revenue, the typical middle market company would bank 14 cents as a cushion and put 86 cents to work immediately or soon. For very or highly confident companies, 91 cents would go to work. Those confident executives would put 28 cents into new capital spending (vs. 23 cents for the typical company) and 12 cents into new hiring (vs. a dime).

Interestingly, confidence doesn't seem to affect IT spending. The highly confident would put 18 cents of that extra dollar into more information technology, a penny less than the middle market as a whole. Tax treatment affects IT spending more—see Spotlight, page 6. It may be that a majority of companies still view IT primarily as a cost of operating or defending their business rather than as a tool for transformation and growth.

NATIONAL CENTER FOR
THE MIDDLE MARKET

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GrantThornton

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