NATIONAL CENTER FOR
THE MIDDLE MARKET

2Q | 2018

MIDDLE MARKET INDICATOR

Strong Performance; Mounting Concerns

IN COLLABORATION WITH

The Ohio State University
Fisher College of Business

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Executive Summary

Business conditions in the middle market remain decidedly positive. A solid majority (72%) of companies continue to say their overall performance is stronger today than it was one year ago. Middle market leaders are predicting a strong third quarter and they expect to continue growing at a healthy clip for the next 12 months. While the rate of revenue growth has slowed somewhat from last quarter, middle market businesses continue to add jobs at an aggressive pace. Even in industries where revenue has increased least (wholesale and retail trade), hiring remains strong. Nearly half (46%) of all middle market companies expect to increase the size of their workforce in the 12 months ahead.

Companies will not achieve growth without surmounting challenges, of course. Talent issues continue to be a top concern as companies look for more people in a tightening labor market. Leaders are paying more attention to costs as well, particularly the costs of healthcare, wages, and energy. Apprehensions over tariffs and other costs associated with doing business abroad have risen considerably, especially among wholesale trade and manufacturing leaders, pushing costs nearer to the top of executives' list of concerns. The tariff issue may account for the decrease seen this quarter in executives' confidence in the global economy. Overall, however, the vast majority of middle market leaders remain positive about economic conditions at home and around the world.

Mounting concerns do not appear to be cooling leaders' expectations for growth, especially in the short term. For 43% of businesses, the new order pipeline is stronger today than it was one year ago. The Short Term Middle Market Index is up, too, indicating that leaders expect sales, demand, and overall business conditions to be favorable in the third quarter. Expectations for continued future growth are likely driving executives' increased willingness to invest in their businesses, to continue innovating new products and services, and to expand into new markets. Upper middle market businesses in particular have strong expansion plans for the 12 months ahead, which include investing in new plants and facilities and opening new international markets for about a third of the largest middle market firms.

Nearly every industry is performing well, with construction companies boasting the fastest rates of both revenue and employment growth. Manufacturing businesses show increases in the rate of growth in both areas as well. Retail and wholesale trade are the only two segments showing marked decreases in the rate of revenue growth. From a size perspective, upper and core middle market companies have performed the best, but lower and emerging middle market businesses show signs of catching up with their larger peers.

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 slows

The rate of year-over-year revenue growth reported by middle market companies dipped for the first time since mid 2017. However, at 7.4%, the growth rate remains strong and well above both the average revenue growth rate recorded by the MMI (6.8%) and the growth rate reported by companies surveyed one year ago (6.7%). Upper middle market firms and businesses operating in the wholesale and retail industries report the sharpest declines in the rate of growth while companies in the manufacturing, healthcare, and services industries continue to experience increased growth.

Projections for future revenue growth remain strong and on par with last quarter's predictions, with 62% of companies anticipating increases in revenue over the next 12 months. While core and upper middle market businesses grew the fastest over the past year, it is the lower middle market firms that are most optimistic about the year ahead. This group says it will grow at an average rate of 6.5%.

2Q'18 **75%** of middle market companies reported positive revenue growth. 2Q'17 72%

MIDDLE MARKET

	PAST 12 MO.	NEXT 12 MO.
2Q'18	7.4%	6.7%
1Q'18	8.4%	5.9%
2Q'17	6.7%	5.3%

S&P 500

	PAST 12 MO.
2Q'18	8.25%*
1Q'18	7.4%
2Q'17	4.8%

Employment Growth

Companies continue to staff up

Following a significant bump last quarter, the rate of year-over-over employment growth is up again. Nearly six out of 10 companies (57%) say their workforce is larger today than it was one year ago, and companies say they've grown their headcount by 6.7% since mid-2017. Employment growth continues to remain the strongest for upper middle market businesses; however, companies in the lower middle market have made significant increases in the size of their workforce since the close of 2017. Construction, retail trade, financial services, and manufacturing businesses have staffed up most notably over the past 12 months.

Companies don't anticipate a hiring slowdown anytime soon. Over the next 12 months, they anticipate an increase in work force of 4.8%, up slightly from expectations last quarter. Close to half (46%) of middle market businesses say they will build the size of their staff in the year ahead, and 41% say they will make additional hires over the next three months. Upper middle market businesses are estimating the most aggressive hiring.

2Q'18 **46%** of middle market companies expect to add jobs. 2Q'17 42%

MIDDLE MARKET

	PAST 12 MO.	NEXT 12 MO.
2Q'18	6.7%	4.8%
1Q'18	6.3%	4.6%
2Q'17	5.7%	4.7%

ADP *(Past 12 Mo.)*

	LARGE CORP.	SMALL BUS.
2Q'18	2.9%	1.0%
1Q'18	2.4%	1.9%
2Q'17	2.5%	1.3%

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

Economic Confidence
Confidence eases back

Confidence among middle market executives remains extremely high and well above the averages recorded by the MMI over the past six and half years. However, confidence has fallen from the record high recorded last quarter. This is particularly true of confidence in the global economy. The percentage of executives expressing positive sentiments about global economic conditions fell from 82% to 75% this quarter.

The global confidence rate is still above its mark from one year ago. Additionally, the vast majority of leaders continue to remain very positive about local and national conditions, and these rates, too, are both marginally higher than the 2Q 2017 numbers.

	GLOBAL ECONOMY	NATIONAL ECONOMY	LOCAL ECONOMY
2Q'18 – CONFIDENT / SOMEWHAT CONFIDENT	75%	86%	90%
1Q'18	82%	87%	94%
2Q'17	70%	84%	87%

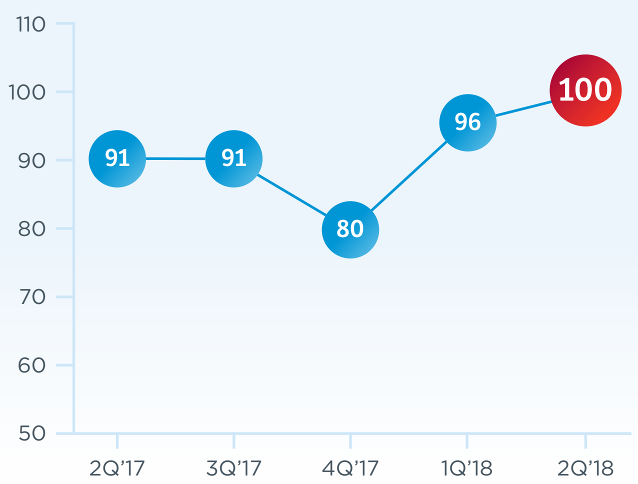
Short Term Index
The outlook continues to improve

For the second straight quarter, the Short Term Middle Market Index is up, rising from 96 to 100, which represents a 20 point improvement since the close of 2017. The Short Term Middle Market Index provides insight into executives' expectations for the three months ahead in terms of sales, demand, and business climate.

For the third quarter of 2018, 55% of middle market companies believe their sales will increase compared to last quarter. This percentage has been on the rise since the end of 2017 and represents the highest percentage recorded for this metric since the Center began tracking the Short Term Index in 2015. Compared to last quarter, slightly more leaders expect increased demand and a more favorable business climate in the short term as well. But the majority of executives believe demand and climate will remain largely unchanged over the next three months.

While the Short Term Index as a whole is up, it is interesting to note that the proportions of companies expecting decreases in demand, decreases in sales, and less favorable conditions are each up as well, though only marginally so.

PAST 12 MONTHS



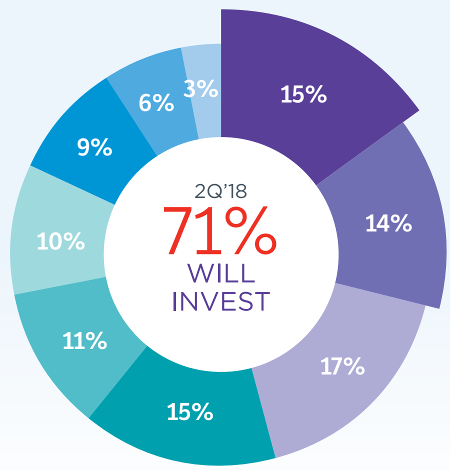
Short Term Index is calculated by taking expected net positive change in business climate plus expected net positive change in demand plus expected net positive change in sales over the next 3 months.

Capital Investment

Companies are investing in the future

At 71%, the proportion of companies willing to invest an extra dollar as opposed to save it is at an all-time high. For the second straight quarter, information technology is the most popular area for these investments, and planned expenditures on plants and equipment is a close second. Indeed, a third of upper middle market firms have plans to add a new plant or facility over the next 12 months. Among those businesses that prefer to hold onto cash, about half indicate they are saving for future financial investments. Lower or emerging middle market companies are by far the most inclined to hold cash in reserve.

ADDITIONAL INVESTMENT ALLOCATION



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

Key Challenges

Cost concerns are on the rise

While talent management and core business issues, such as maintaining growth and managing capital, remain top concerns for companies in both the short and long term, apprehensions related to costs are beginning to rise. Half of middle market companies indicate that their costs have increased in the past 12 months. Internally, executives worry over the costs of talent and healthcare. Externally, they are particularly focused on the impact of tariffs and costs associated with imports and exports.

Since last quarter, concern over the tariff issue has jumped by six percentage points, pushing costs to the number two spot on executives' list of long-term external challenges, surpassing worries related to competition and the government. In response to increasing costs and cost concerns, many middle market companies are focusing on accelerating topline sales and driving cost efficiencies through improved processes and upgraded equipment.

SHORT TERM CHALLENGES *(Next 3 months)*

INTERNAL CHALLENGES	
1. BUSINESS	72%
2. TALENT MANAGEMENT	63%
3. COSTS	29%
EXTERNAL CHALLENGES	
1. BUSINESS	46%
2. COMPETITION	25%
3. COSTS	25%
4. GOVERNMENT	21%
5. ECONOMY	9%

LONG TERM CHALLENGES *(Next 12 months)*

INTERNAL CHALLENGES	
1. TALENT MANAGEMENT	54%
2. BUSINESS	50%
3. COSTS	26%
EXTERNAL CHALLENGES	
1. BUSINESS	37%
2. COSTS	26%
3. GOVERNMENT	20%
4. COMPETITION	19%
5. ECONOMY	10%

Spotlight
Change at the Top

In the last three years, 30% of middle market companies experienced some kind of major transition. An almost equal number, 28%, expect a major change in the next three years. Just under half of those were a change at the top—a new CEO. For the others, a major transition came in the form of an acquisition big enough to be transformative or the sale of all or a significant part of the shop.

These data come from a set of business-transition questions included in this quarter's Middle Market Indicator survey. Overall, the data show middle market companies trying to seize the benefits of change without letting go of the value of continuity. For example:

+ Normal transition due to age or retirement is the biggest reason for a CEO's departure, ranked No. 1 by 32%; but a nearly equal number, 31%, say a CEO change was provoked by a scale-up (17%) or a "need to change leadership" (14%)
+ "Maintaining the continuity of business operations" during a transition is the top concern of executives, cited by 49%; but the second-biggest, at 44%, is "taking the company to the next level of performance."

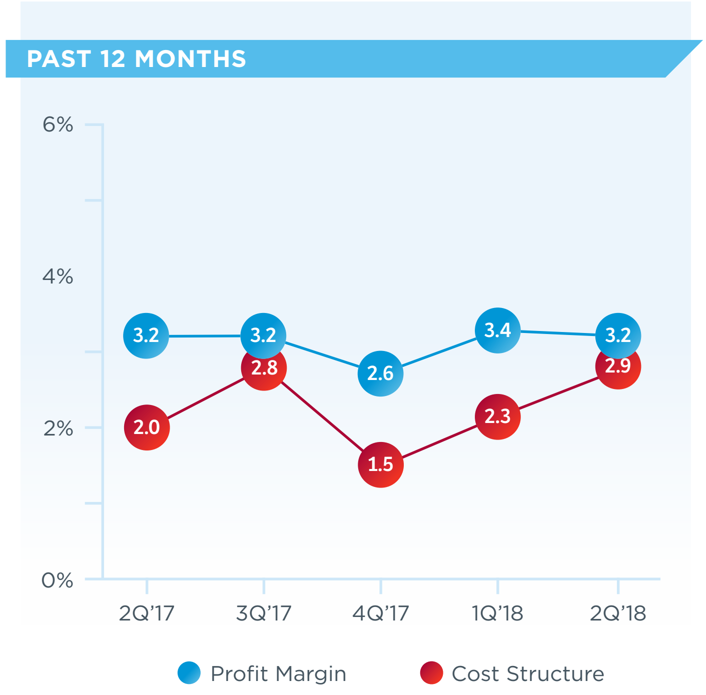
Major transitions come most often to publicly traded companies—41% in the last three years. Within that group, 62% switched CEOs, which is substantially higher than the percentage for any other type of company. Private-equity-owned companies come next. Sole proprietorships, partnerships, and family firms are much less likely to replace CEOs.

Companies younger than 15 years are only 75% as likely to undergo a major transition than older ones. Beyond 15 years of age, the rate of change flattens out.

Profit Margins & Cost Structure
Costs will climb but profit margins will hold steady

Middle market companies expect their cost structures to increase by 2.9% over the next 12 months. This percentage has been rising since the end of 2017 and is now at the second highest level recorded by the MMI. Healthcare costs drive this number; however, an increasing proportion of firms are saying energy costs will also have an impact on company performance in the year ahead.

As a result, nearly half (49%) of middle market businesses intend to raise their prices over the next 12 months. This represents an increase of seven points compared to companies that indicated the same one year ago. These increases will help companies maintain their profit margins despite rising costs. Companies believe profit margins will grow by 3.2% over the next 12-month period.



Perspectives

The Short and the Long of It

Business is excellent for most companies in the middle market, but amid the resounding boom of the present can also be heard an ominous rumble of thunder.

Before getting to the thunder—or before it gets to us—we should look at how well middle market companies are performing. Annualized revenue growth rates have been 7% or higher four quarters in a row—something we have not seen since the MMI began in 2012. Projected revenue growth for the year ahead is running just under its historical high (apart from an anomalous spike in the first quarter of 2017). Seventy-two percent of companies report improved overall year-on-year performance, which ties the record set three months ago. In the background, meanwhile, the U.S. economy as a whole has expanded for eight years and 11 months, only 13 months shy of the longest expansion in its history.

For now, middle market executives are reporting strong sales order activity. Forty-three percent say their new order pipeline has increased since a year ago, and among those companies the average increase in orders is 12.3%. Both are the highest numbers ever recorded. The NCMM's short-term index stands at 100, the highest since that standout first quarter of 2017. The index combines positive and negative opinions about three things: the business climate, overall demand for the products or services a company sells, and how much of that demand executives think their company will book as sales. Of those three elements, sales (the most concrete) is up the most, followed by demand; business climate (the most subjective) is more or less unchanged.

And therein—in subjective sentiments—lies the rub. The MMI measures executives' confidence in global, national, and local economic conditions. All three declined this quarter, with confidence in the global economy dropping most. At 75% (global), 86% (U.S), and 90% (local), all remain higher than they were a year ago, and one quarter's decline doesn't necessarily constitute a turning point. But a dip in confidence is of more than psychological importance: New and related research from the Center, derived from analysis of five years of MMI data, shows that economic confidence accounts for more than 30% of overall company growth.[1]

It is not hard to find a cause for the anxiety: Ten percent of middle market executives are concerned about the cost implications of tariffs. That is five times the average of the previous three years.

The sentiments reported in this MMI were gathered during the first two weeks of June 2018, at the beginning of what it appears will be a U.S-instigated global trade war. Just before the survey went out, the U.S. imposed tariffs on steel and aluminum from Canada, Mexico, and the EU; they reciprocated with tariffs on baskets of U.S. goods. A month later, in early July, the U.S. hit China with $34 billion in tariffs, which struck back in retaliation.

Not surprisingly, wholesalers are most anxious about trade conflict, since they will have to deal with tariffs on both exports and imports—33% of wholesalers worry about the impact of tariffs. Manufacturers come next: Twelve percent are concerned. Manufacturers, too, might be taxed both coming (raw materials and components) and going (intermediate or finished goods). The cost of raw materials is an issue as well: Twice as many executives cite raw material costs as a major issue as did a year ago. Those, too, may be affected by trade policy.

We have noted before that the middle market is primarily domestic, but that internationally-minded middle market companies outperform their peers,[2] which means that their fate in a trade war will disproportionately affect the overall growth of the middle market. It is worth adding that globally-minded mid-sized companies are much less likely than big firms to have production facilities abroad, which makes them less able than large multinationals to skirt trade barriers by relocating operations from one country to another.

Overall, 26% of executives listed a cost issue among their three biggest long-term challenges, which is a big jump from the 17% who cited costs a year ago. The biggest driver is wages and benefits, as companies offer better packages to attract and keep employees in what has become a seller's market for talent.

And how are they going to cope with cost increases? Far and away the most popular plan among executives is to sell more products and services—which means they'd better hope the economy stays strong.

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[1] NCMM, *The DNA of Middle Market Growth*, 2018
[2] NCMM and The Brookings Institution, *Accelerating Exports in the Middle Market*, 2014

NATIONAL CENTER FOR
THE MIDDLE MARKET

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