NATIONAL CENTER FOR
THE MIDDLE MARKET

1Q | 2019

MIDDLE MARKET INDICATOR

Growth Remains Strong; Cautions Mount

IN COLLABORATION WITH

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Executive Summary

With the first quarter of 2019 in the books, the performance indicators from the U.S. middle market are somewhat mixed. At 8.7%, the average rate of year-over-year revenue growth is the second highest ever recorded by the Middle Market Indicator. Yet, compared to 2018, fewer companies indicate that revenue has increased from one year ago. Additionally, the number of firms reporting overall improvement in company performance dropped from 73% last quarter to 67% for Q1 2019. After falling significantly at the end of 2018, the rate of employment growth has inched back up slightly to 5.6%, but it remains below the growth rates reported during most of 2018. As with revenue growth, the proportion of companies reporting year-over-year increases in the size of their workforce fell from last quarter.

Despite challenges for some companies, the majority of middle market businesses are enjoying strong and healthy growth. This is particularly true in the services, healthcare, and wholesale trade industries, where both year-over-year revenue growth and employment growth rates are up compared to the last quarter. Growth in the construction industry is also steady. Other industries report more mixed returns, with a notable drop off in retail hiring, possibly due to seasonality.

Future expectations, however, continue to soften across the middle market. The projected rates for both revenue growth and employment growth over the next 12 months, as well as the proportion of firms indicating that revenue and the size of the workforce will increase in the year ahead, are down from three months ago. The Short Term Index, which reflects expectations for the next three months, has stabilized at a much lower number than we saw during most of 2018. Perhaps more telling, economic confidence levels slipped for the third straight quarter, and for the first time in several years, the proportion of leaders saying they would save an extra dollar as opposed to invest it rose significantly.

The robust growth seen throughout most of 2018 has flattened—albeit at a high level. Many middle market companies are proceeding with more caution as we continue through 2019. Their innovative spirit and desire to reach new customers with new offerings, however, remains strong. Compared to last year, a similar proportion of firms (44%) say they have plans to expand into new domestic markets over the next 12 months, and 48% say they will be introducing a new product or service. Indeed, the proportion of revenue that middle market executives expect to spend on new product development is up from 8.3% last quarter to 9.8%, and this number is well above those reported over the last several years. Additionally, more than a third (35%) of companies expect the proportion of revenue generated from new offerings to increase over the next year.

Talent management and core business issues around maintaining growth remain the most cited challenges among middle market leaders. However, across the board, fewer executives are mentioning these issues when asked about challenges on an unaided basis. Leaders may be feeling less pressure to hire as growth stabilizes and the outlook turns cautious.

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.

Revenue Growth

Growth resurges for some core and upper middle market firms

Fewer companies report year-over-year revenue growth compared to last quarter, but the companies that are growing are doing so at a rapid clip. The average rate of growth accelerated to 8.7%, the second highest rate recorded by the MMI. Middle market companies with revenues between $50 million and $1 billion are driving the increase. However, the rate of revenue growth remains flat for lower middle market businesses (annual revenues between $10 million and $50 million). Just 67% of these smaller companies report increases in revenue growth over the past year compared to 79% of core middle market firms and 81% of upper middle market firms.

The smallest middle market companies are also least likely to project increases in revenue growth for the next 12 months; core middle market leaders are most optimistic. Overall, a smaller percentage of executives believe revenues will continue to increase, and the anticipated rate of future revenue growth has regressed to 5.4% from 5.9% three months ago.

1Q'19 **74%** of middle market companies reported positive revenue growth. 1Q'18 77%

MIDDLE MARKET

	PAST 12 MO.	NEXT 12 MO.
1Q'19	8.7%	5.4%
4Q'18	7.9%	5.9%
1Q'18	8.4%	5.9%

S&P 500

	PAST 12 MO.
1Q'19	3.3%*
4Q'18	4.7%
1Q'18	7.4%

Employment Growth

Hiring stabilizes at a slower rate

About a quarter of middle market companies are aggressively increasing the size of their workforce (10%+ year-over-year employment growth). However, fewer companies fall into this category than did throughout 2018. Additionally, the overall percentage of executives saying their workforces are larger today than one year ago dropped to 51% from 55% last quarter. At 5.6%, the average rate of year-over-year employment growth is the same as it was three months ago, but it is significantly lower than the first three quarters of 2018 when it hovered around 6.5%.

Expectations for future employment growth continue to taper off. Compared to three months ago, fewer middle market leaders say they have plans to hire more people in the next 12 months. The 37% of firms that say they will increase hiring will add people more slowly; the anticipated rate of employment growth, 3.4%, has declined for the third straight quarter. The historically low unemployment rate in the U.S. may be continuing to influence projections.

1Q'19 **51%** of middle market companies expect to add jobs. 1Q'18 55%

MIDDLE MARKET

	PAST 12 MO.	NEXT 12 MO.
1Q'19	5.6%	3.4%
4Q'18	5.4%	3.8%
1Q'18	6.3%	4.6%

ADP *(Past 12 Mo.)*

	LARGE CORP.	SMALL BUS.
1Q'19	2.3%	1.0%
4Q'18	2.5%	1.1%
1Q'18	2.4%	1.9%

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

Economic Confidence

Confidence continues to slip

The vast majority of middle market leaders remain decidedly positive about economic conditions, but local, national, and global confidence levels have all been trending down since the middle of 2018. As usual, leaders remain the most positive about the situations in their own backyards, and nearly nine out of 10 executives report a high degree of confidence in their local economies. They are least optimistic about global conditions.

The greatest decline this quarter occurred in national confidence numbers, which fell from 86% to 80%. Companies in the West region are the least confident in the national economy; these companies also report lower levels of confidence in the global and local economies compared to their peers located in other parts of the country.

	GLOBAL ECONOMY	NATIONAL ECONOMY	LOCAL ECONOMY
1Q'19 (CONFIDENT / SOMEWHAT CONFIDENT)	70%	80%	88%
4Q'18	73%	86%	89%
1Q'18	82%	87%	94%

Short Term Index

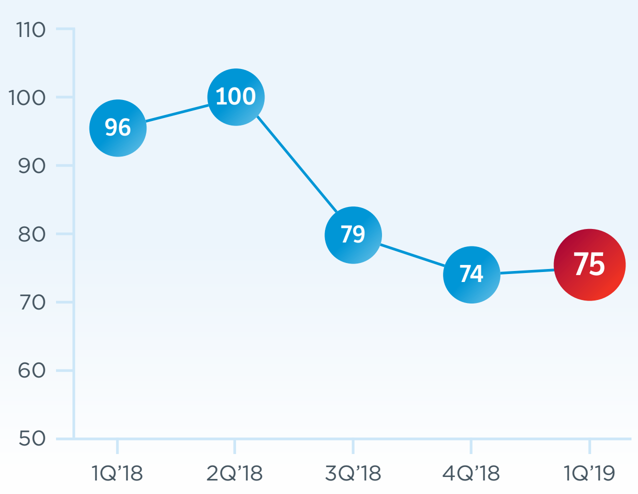
Short-term performance expectations stabilize at a lower level

The Short Term Middle Market index reflects how middle market executives perceive market conditions in the short term, or over the next three months. The score combines three different metrics: anticipated sales, anticipated demand, and overall expectations for the business climate. After falling for two straight quarters, the index has stabilized, but it is well below the levels posted throughout most of 2017 and the first two quarters of 2018.

A quarter of executives believe the business climate will be more favorable over the next three months. This represents an increase from the past two quarters, when 22% of leaders said the same, but it is well below its high point of 38% recorded at the beginning of 2017. Nevertheless, only one in 10 executives believes conditions will decline. Most believe the business climate will remain unchanged.

Interestingly, the number of executives expecting an increase in demand over the next three months rose from 32% to 36%. However, the proposition of leaders anticipating an increase in sales in the short-term fell from 46% to 44%. All in all, most middle market executives foresee little change in key business metrics, at least in the short term.

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.

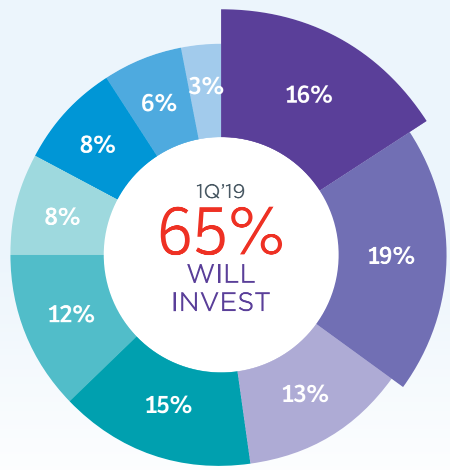
FOR COMPLETE TRENDING, INDUSTRY, & REGIONAL DATA, VISIT **MIDDLEMARKETCENTER.ORG**

Capital Investment

More companies will put money aside

For the first time in more than three years, there is a substantial increase in the proportion of middle market leaders indicating that they would save an extra dollar as opposed to investing it. While investment-minded executives continue to outnumber the savers by a ratio of nearly two to one, the shift in numbers this quarter may be reflective of overall declining economic confidence and a more cautious mindset as middle market leaders look to the future. With anticipated rates of future hiring declining, savers may potentially be holding back on investments in expanding the workforce. They also appear less inclined to put money into IT: the percentage of investors saying they would allocate an extra dollar to technology expenditures fell from 18% three months ago to 13% this quarter.

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

Talent and maintaining growth remain top challenges

Middle market leaders are projecting less aggressive growth in both the short and long term. Fewer expect to hire, and those who do plan to staff up say the rate of employment growth will slow. Nevertheless, talent management will be the number one internal challenge for executives over the next 12 months. For the first time, talent issues tied core business issues as the leading challenge in the short term: more than half (58%) of executives say talent, specifically retaining current employees, could be a headwind to growth over the next three months.

Externally, core business issues, such as how to maintain growth and deal with changing market conditions, remain the most significant concern. Interestingly, fewer executives are mentioning these issues compared to three months ago. The percentage of leaders citing cost, competition, and economic concerns fell as well, and worry over governmental issues has trended down since mid- 2018. As overall growth rates begin to stabilize, executives may feel less pressure in some of the areas that have traditionally been most challenging.

SHORT TERM CHALLENGES *(Next 3 months)*

INTERNAL CHALLENGES	
1. BUSINESS	**58%**
2. TALENT MANAGEMENT	**58%**
3. COSTS	**19%**
EXTERNAL CHALLENGES	
1. BUSINESS	**37%**
2. GOVERNMENT	**22%**
3. COMPETITION	**20%**
4. COSTS	**18%**
5. ECONOMY	**14%**

LONG TERM CHALLENGES *(Next 12 months)*

INTERNAL CHALLENGES	
1. TALENT MANAGEMENT	**45%**
2. BUSINESS	**39%**
3. COSTS	**20%**
EXTERNAL CHALLENGES	
1. BUSINESS	**29%**
2. GOVERNMENT	**19%**
3. COSTS	**19%**
4. COMPETITION	**17%**
5. ECONOMY	**11%**

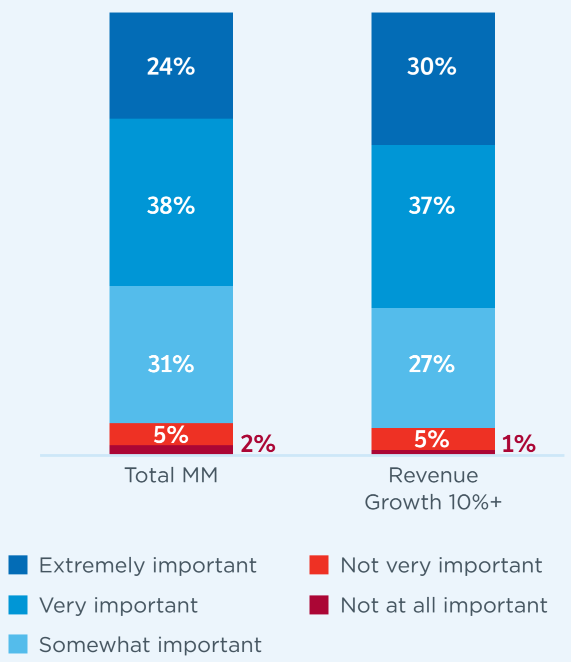
Spotlight
Digital Pictures, Big and Small

The Q4 2018 MMI survey was used to explore digital transformation among middle market companies. Companies that are more advanced in digital transformation, we learned, grow substantially faster on average than laggards. This quarter, we learned that a strategic vision for digital transformation supports superior growth. (See Perspectives, p. 7.)

But we also learned that the details of digitalization can drive growth as powerfully as the strategic vision, by asking a series of questions about analytics. The headline: Companies whose executives consider analytics to be extremely important are 25% more likely to have achieved double-digit growth last year than the average middle market company. Three out of ten of these companies grew 10% or more.

The use of analytics appears to be part of a trend in which spending on IT is increasingly focused on customer-facing activities, including understanding who's-buying-what with more precision and detail than was possible before. That is not to say that back-office digital capabilities are being neglected. Indeed, security systems are the most critical technologies, executives say—but salesforce management and analytics are not far behind. It appears that the largest middle market companies (annual revenues $100 million to $1 billion) are leading the charge. The biggest firms are almost twice as likely to say analytics is an extremely or very important technology capability than smaller middle market companies are.

Overall Importance of Analytics to Current Business

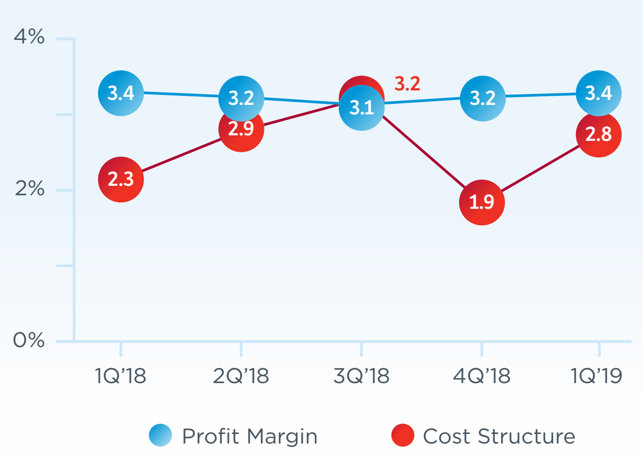


Profit Margins & Cost Structure
Costs will rise but profit margins will hold

Compared to 2018, significantly more middle market leaders are anticipating an increase in their cost structure. This quarter, close to half (45%) of executives say they expect costs to increase, up from 37% who said the same at the end of 2018. The expected percentage change in costs is also up from last quarter, from 1.9% to 2.8%. Only one in 10 companies projects that costs will decrease over the next 12 months.

Most companies are confident in their capabilities to manage costs through operating efficiencies, however managing healthcare costs can be particularly challenging, especially for upper middle market firms. Nevertheless, the majority of companies believe their profit margins will remain intact, and 39% of businesses expect to see increases in profit margins at an average rate of 3.4%

PAST 12 MONTHS



Perspectives

Roads to Growth

Middle market executives are clearly less bullish than they were a year ago. Since the first quarter of 2018, the percentage who are highly or very confident in their local economy fell from 94% to 88%; confidence in the U.S. economy dropped from 87% to 80%; and confidence in the global economy sank from 82% to 70%. From 2012 through 2018 the trend lines for confidence had gone nowhere but up. Now they are nosing down.

Not so revenues, which grew 8.7%, the second-highest recorded in 29 quarters of the MMI. And while job growth has been slowing, 5.6% is robust and remains well within the range it has occupied for the last two years. Then why the less optimistic outlook?

A look inside the Middle Market Indicator data suggests a few causes—and points the way to a few paths executives might follow to secure strong growth. Last quarter, we observed that negative outlook (as expressed in the Short Term Index) was unchanged, but positive outlook had fallen: "As of now, executives don't see things getting worse; but fewer think things are getting better." That outlook has now shown up in results, not just predictions. Asked about overall company performance, only 5% say performance deteriorated, which is the same as last quarter and the average for the last two years. But the percentage saying business improved dropped from 73% to 67% compared to three months ago. Similarly, despite the near-record average growth rate, the percentage of companies reporting higher growth fell. And the percentage of companies reporting 5% or faster growth declined from 63 to 58.

This suggests that middle market executives are beginning to experience the environment economists have forecast, in which growth slows but does not turn negative.

With less wind in their sails, executives will have to do more to propel growth on their own, a concept we explored in-depth in our DNA of Middle Market Growth report. The report identifies the most important growth drivers within management's control and shows how the fastest-growing middle market companies assemble those drivers to fuel their success. Companies cannot—or will not—achieve growth goals just by adding more muscle: With unemployment negligible and wage costs rising, middle market hiring forecasts have fallen in each of the last four quarters and are the lowest they have been in two years. Nor do the data show a surge in capital spending, which might be a way to increase output whatever the number of workers.

With some quarterly variation, the percentage of companies that say they added a new plant or facility in the previous year has long held steady, at about twenty; in fact, it declined to 17% this quarter. Instead of adding to headcount or buying equipment, executives will need to find productivity gains by developing the skills of the workforce they have and improving management processes, both of which show up in the DNA growth drivers report.

Innovation is another proven driver of growth. Indeed, investment in R&D has been trending slowly up. It reached a record high, 9.8% of revenue, in the first quarter of 2019. This compares to an average of 8.1% for the previous four years—a substantial increase. It appears that companies have shifted the mix of R&D, too, and are placing more emphasis on entirely new products and services, as opposed to improvements in existing offerings. The latter is still where executives expect to see the biggest impact from innovation spending, but it has declined quite a bit relative to the impact of new offerings.

Exploring and exploiting the opportunities of digitalization appears to be another path to growth—and an especially rewarding one. This quarter we asked executives, "Is your organization's digital vision clear and comprehensive, widely understood, and used to guide strategic decisions?" People who agreed with that statement lead companies whose average annual growth rate was 10.5% Companies whose leaders were neutral or disagreed grew 6.0%. The digitally driven added jobs more than twice as fast as the others: 7.3% vs 3.1%. The pattern holds in all industries: The road to growth is paved with 1s and 0s. As middle market executives confront what they believe will be a slowing—but still growing—economy, they are placing their bets on inventing new products and services, and harnessing technology to improve both revenue and costs.

NATIONAL CENTER FOR THE MIDDLE MARKET

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