



NATIONAL CENTER FOR  
THE MIDDLE MARKET

# 2Q | 2019

## MIDDLE MARKET INDICATOR

### Mixed Messages Continue: Strong Growth; Cautious Outlook

IN COLLABORATION WITH



THE OHIO STATE UNIVERSITY  
FISHER COLLEGE OF BUSINESS



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# Executive Summary

Halfway through 2019, growth in the middle market is decidedly strong. Year-over-year revenue growth remains high at an 8.5% rate, with more than three-quarters of firms (77%) reporting gains over the past 12 months. Nearly two out of five firms (38%) are growing aggressively, reporting revenue growth rates of 10% or more. The employment growth rate picked up to 6.4%, following a slight slowdown over the past two quarters, with 55% of all middle market companies saying they expanded their headcount and 30% of firms saying their workforce grew by 10% or more compared to one year ago. For nearly all companies, the new order pipeline looks the same as or better than it did one year ago and fewer than one out of 10 firms expect sales or demand to deteriorate, at least in the short-term. The majority of middle market leaders say they have access to sufficient working and investment capital.

The sentiment numbers, however, paint a somewhat different picture. After rising steadily since mid 2017, the proportion of leaders saying overall company performance is better today compared to one year ago dropped notably last quarter to 67% and remained fairly consistent this quarter at 68%. Confidence in the economy is off the highs recorded in early 2018. Leaders appear particularly apprehensive about the next three months: Fewer companies expect the business climate to improve next quarter, driving the Short Term Middle Market Index down significantly. In addition, the percentage of leaders saying they would save an extra dollar as a cushion, perhaps to weather a future economic downturn, continues to increase.

Despite these cautious attitudes, it appears that, at least for the time being, key growth behaviors will not change. Similar proportions of companies continue to say they will launch a new product or service or expand into a new domestic market in the next 12 months. And most companies expect continued revenue growth over the next 12 months, albeit at slightly slower rates than they projected during most of 2018. Projections for the rate of future employment growth jumped more than one full point, from 3.4% last quarter to 4.8% with two out of five firms saying they will add people over the next year.

In line with historical trends, the largest middle market companies with revenues between \$100 million and \$1 billion are growing the fastest, with acquisitions accounting for a large part of the difference in growth. (See Spotlight, p. 6.) From an industry perspective, construction boasted a year-over-year revenue growth rate of 11.5%, up from 10.8% last quarter, along with an employment growth rate of 10.6%, up from 7.6% last quarter. These numbers may be driven by the busy building season. Manufacturing, business services, and financial services firms also reported strong growth numbers this quarter.

As companies start the second half of 2019, talent issues will remain a key challenge, especially with many companies looking to add to their staffs. With unemployment already very low, fewer companies expect continued tightening in the labor market, but middle market firms say they will still struggle with hiring and recruiting, skills gap issues, and retaining staff. Regulations continue to have a negative impact on most middle market firms and many companies are still in the process of preparing for changing tax laws and regulatory requirements. Companies also see risk increasing, and managing that risk can be a challenge, especially when it comes to cybersecurity. Compared to three months ago, more companies are placing greater importance on risk management, especially firms at the higher end of the revenue spectrum.

Whether or not an economic slowdown is indeed on the horizon, it appears that some middle market leaders are at least considering the possibility, particularly in the short-term. For now, however, it is business as usual with the majority of companies planning on continued growth and preparing to tackle the challenges that will come with it.

## 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](http://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 remains stable at high levels*

After declining slightly last quarter, the proportion of middle market companies reporting year-over-year revenue growth rebounded to 77%, on par with numbers seen throughout 2018. About two out of five (38%) of these companies reported growth of 10% or more for the past 12 months. Overall, the middle market growth rate remains strong at 8.5%, with upper middle market companies growing the fastest. Construction companies reported the strongest bump in growth rate. Middle market manufacturers also reported an increase in the rate of growth while services and healthcare companies continue to report strong numbers.

With the exception of two quarters over the past seven years, middle market executives have consistently underestimated and overdelivered when it comes to future growth projections. More than half (52%) of middle market businesses believe growth will continue over the next year, while just 8% see it declining. Compared to last quarter, estimates for the rate of growth have remained consistent at 5.4%. Upper middle market companies report the strongest future growth rate projections at 6.2%.

2Q'19  
**77%**

of middle market companies reported positive revenue growth.

2Q'18  
**75%**

PAST 12 MO.

MIDDLE MARKET

2Q'19

**8.5%**

1Q'19 **8.7%** 2Q'18 **7.4%**

NEXT 12 MO.

2Q'19

**5.4%**

1Q'19 **5.4%** 2Q'18 **5.9%**

PAST 12 MO.

S&P 500

2Q'19

**2.2%\***

1Q'19 **3.3%** 2Q'18 **8.3%**



## Employment Growth

*Hiring rates rebound*

Over the past 12 months, 55% of middle market companies added new jobs while just 11% decreased the size of their workforce. Year-over-year employment growth rose from 5.6% last quarter to 6.4%. Growth is being driven by more firms hiring more aggressively: The proportion of companies increasing the workforce by 10%+ rose from 26% last quarter to 30%. While upper middle market companies report the fastest rate of employment growth, companies with less than \$100 million in annual revenues showed significant gains this quarter. Construction companies report the strongest gains in employment, as one would expect given the industry's revenue growth.

After declining for three straight quarters, projections for future employment growth are up significantly. Compared to last quarter, more companies say they will hire over the next 12 months, and the 41% of firms that expect to add jobs anticipate a growth rate of 4.8%. Many of these firms will be hiring sooner rather than later: 42% of companies say the workforce will increase in the short-term.

2Q'19  
**41%**

of middle market companies expect to add jobs.

2Q'18  
**46%**

PAST 12 MO.

MIDDLE MARKET

2Q'19

**6.4%**

1Q'19 **5.6%** 2Q'18 **6.7%**

NEXT 12 MO.

2Q'19

**4.8%**

1Q'19 **3.4%** 2Q'18 **4.8%**

LARGE CORP.

ADP (Past 12 Mo.)

2Q'19

**2.3%**

1Q'19 **2.3%** 2Q'18 **2.9%**

SMALL BUS.

2Q'19

**1.0%**

1Q'19 **1.0%** 2Q'18 **1.0%**

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

## KEY FINDINGS



## Economic Confidence

*Confidence remains below all-time highs*

After declining for two quarters, middle market leaders' confidence in both the national and local economies inched back up this quarter. Global confidence levels, however, continued their downward trend, perhaps due to a combination of geopolitical tensions and trade battles. At 69%, global confidence is at the lowest level reported since the end of 2016, though it remains well above confidence levels reported between 2012 and most of 2016.

While national and local sentiment is clearly bullish (with confidence rates of 82% and 89% respectively), these numbers remain somewhat off the higher levels reported in early 2018. All three metrics (global, national, and local confidence) are still well above the average rates calculated over the seven-and-a-half-year history of the MMI.



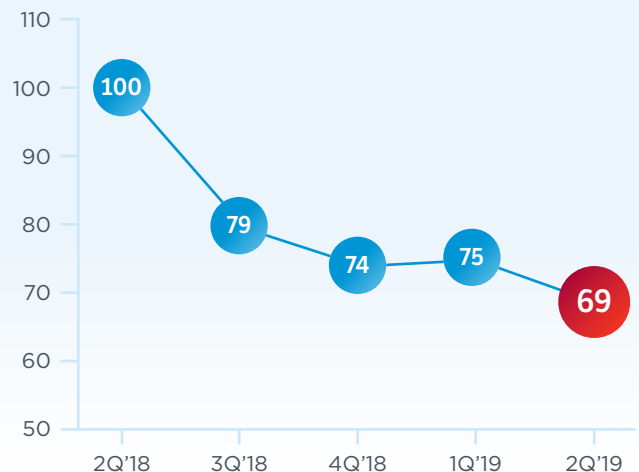
## Short Term Index

*Business climate perceptions deteriorate*

In contrast to the strong growth in both revenue and employment and healthy expectations for increased sales and demand, middle market leaders have a somewhat pessimistic view about the short-term business climate. The proportion of firms expecting a more favorable business climate over the next three months fell 2 points from last quarter to 23%, well below the high of 38% recorded at the start of 2017. At the same time, the proportion of leaders expecting a less favorable business climate jumped to 12%, the highest number recorded by the MMI.

These figures drove a decline in the Short Term Middle Market Index, down to 69 from 75 last quarter and 100 a year ago. In addition to perceived business climate forecasts, the Index score reflects leaders' expectations for sales and demand in the short-term. Interestingly, and despite growing concerns related to the overall business environment, the proportion of executives foreseeing increased sales over the next three months is up from 44% last quarter to 48%. (At the same time however, a higher-than-before number sees sales softening.) The proportion of companies expecting increased demand in the short-term rose marginally from 36% to 37%. These gains, however, were not enough to stop the Index's overall slide. While the score remains above the lowest marks recorded during the second half of 2015, the downward trajectory over the past year indicates that at least some middle market leaders see warning signs on the horizon.

### PAST 12 MONTHS



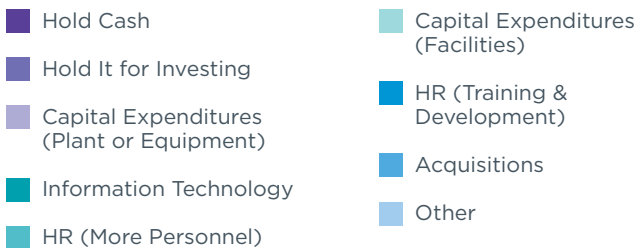
*Short Term Index is calculated by taking expected net positive change in business climate plus expected net positive change in demand plus expected net positive change in sales over the next 3 months.*



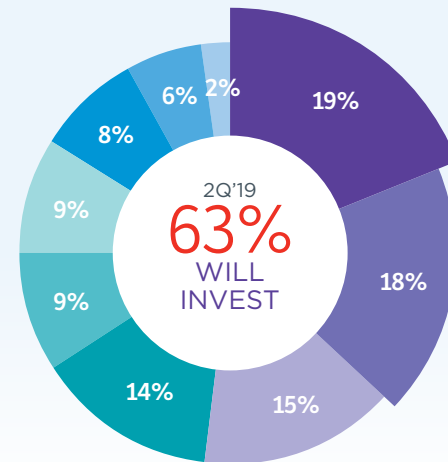
## Capital Investment

*Saving is on the rise*

Compared to the end of 2018, significantly more middle market leaders say they would save an extra dollar as opposed to investing it. Last quarter we saw the first significant increase in this metric since mid 2015. This quarter, the proportion of savers jumped once again, from 35% three months ago to 37% today. Perhaps more telling, the percentage of savers saying they would put the cash into a war chest for future investments declined, while those intending to hold onto the money as a cushion rose. That said, a clear majority of middle market companies (63%) remain investment oriented and willing to put extra dollars back into the business right away. The leading areas for investment continue to be plant and equipment expenditures, followed closely by IT.



### ADDITIONAL INVESTMENT ALLOCATION



## Key Challenges

*Talent and growth challenges persist*

With expectations for future hiring up significantly this quarter and a greater percentage of companies adding jobs at a rate of 10% or more, it's not surprising that talent issues remain a top internal challenge for middle market leaders in both the short and long term. Retention and turnover are the number one concerns, as companies seek to hold on to the staff they have rather than try to hire in a tight labor market. There are fewer unemployed candidates and this, in turn, may lead to more aggressive poaching as companies look for ways to woo qualified employees, including those who may not be actively looking.

Externally, companies continue to be most concerned with core business issues and sales growth in particular. To help drive that growth, nearly half of companies (48%) have plans to introduce a new product or service over the next 12 months and 44% say they will expand into new domestic markets. Concerns related to costs appear to be tapering off. Compared to the last several quarters, similar proportions of companies continue to mention the government, competition, and the economy as long-term external challenges.

### SHORT TERM CHALLENGES (Next 3 months)

#### INTERNAL CHALLENGES

- 1. BUSINESS 60%
- 2. TALENT MANAGEMENT 60%
- 3. COSTS 19%

#### EXTERNAL CHALLENGES

- 1. BUSINESS 34%
- 2. GOVERNMENT 25%
- 3. COMPETITION 22%
- 4. COSTS 16%
- 5. ECONOMY 11%

### LONG TERM CHALLENGES (Next 12 months)

#### INTERNAL CHALLENGES

- 1. TALENT MANAGEMENT 45%
- 2. BUSINESS 38%
- 3. COSTS 14%

#### EXTERNAL CHALLENGES

- 1. BUSINESS 32%
- 2. GOVERNMENT 20%
- 3. COMPETITION 17%
- 4. COSTS 14%
- 5. ECONOMY 10%

## Spotlight

### Organic and inorganic growth

Over the past few years, one of the most consistent observations is that larger middle market companies grow faster than smaller ones. Since the beginning of 2015, for example, the annual growth rate for the upper middle market (companies with revenues between \$100 million and \$1 billion) has been 8.4%, vs. 6.8% for the lower middle market (companies with revenues between \$10 million and \$50 million). How much of this difference might be explained by mergers and acquisitions? Quite a lot, it turns out.

We isolated companies that had not engaged in M&A in the previous year and compared their growth during that period to that of the total sample. Nearly half the growth difference evaporates when we look at organic growth alone. In the total sample, the upper middle market grew 23.5% faster than the lower; among the only-organic growers, the difference is 12.7%.

M&A is a tool that is more available to big companies than small ones. They have greater means, both monetary and managerial—easier access to the capital needed for deal making, larger executive teams, and more sophisticated outside advisors. The upper middle market may also have more motive, being at a stage where moving into new markets or adding new offerings is more easily done inorganically. In addition, they have more opportunity, since smaller companies by definition are less likely to find targets smaller than they themselves are.

Note, however, that M&A doesn't explain all the difference in growth—a little more than half must be laid at different doorsteps. One likely candidate: digital transformation. Data from the Center shows that digital transformation is accelerating growth in the middle market, and upper middle market companies say they are more advanced digitally than smaller ones.

1Q 2015 - 2Q 2019	Total Middle Market	Lower MM \$10-\$50MM	Core MM \$50-\$100MM	Upper MM \$100MM-\$1B
Average Growth Rate All Companies	7.4%	6.8%	7.6%	8.4%
Average Growth Rate, Companies with No M&A in Previous 12 Months	6.6%	6.3%	6.6%	7.1%



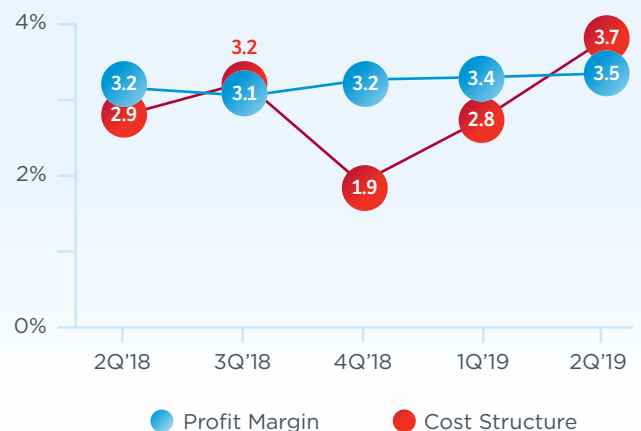
## Profit Margins & Cost Structure

*Costs will rise more quickly than profit margins*

Fewer than one out of five middle market leaders cite costs when asked to name their top business challenges. However, when directly asked about their company's cost structure, nearly half (49%) say they expect it to increase over the next 12 months. This percentage has been rising over the past several quarters. Additionally, the expected percentage change in costs jumped notably this quarter, to 3.7% from 2.8% three months ago. Indeed, expected cost structure increases are greater than the expected increases in profit margins, the latter of which inched up from 3.4% to 3.5% over the past three months.

One reason why increasing costs do not appear to be causing great alarm is that many companies plan to pass on those costs in the form of price increases: 55% say they are planning to raise prices within the next three months. Additionally, the majority of middle market leaders (52%) say their firms are very good or excellent at containing costs through operational efficiency.

### PAST 12 MONTHS





# Perspectives

## *Uncertainty ... or doubt?*

President Harry Truman supposedly joked that he wanted to find a one-handed economist, because “All my economists say, ‘On the one hand,’ then ‘but on the other.’” People looking for clear economic signals from the middle market are likely to be as frustrated as Truman was.

On the one hand: American middle market companies have reported back-to-back quarters of bang-up revenue growth: 8.5% (annualized) this quarter following 8.7% in the one before. Of the four highest-growth quarters in the MMI’s seven-and-a-half-year history, three have come in the last 12 months. Nearly four out of 10 companies grew more than 10%. Similarly, the employment growth rate, 6.4%, is tied for the third-highest in MMI history. Even manufacturing—a soft spot in the overall economy—is strong in the middle market, with revenue up 10.1% year-over-year. If you look at hard numbers, this long economic expansion still shows plenty of life, at least among middle market companies.

On the other: The short-term index, a predictor of performance in the next three months, has fallen 10 points in the last year. The percentage of executives who foresee a less favorable business climate has doubled in the last 18 months. While just one in 12 sees weaker sales, that’s up from one in 20 a year ago. And while 77% saw their revenue growth rate increase compared to a year ago, just 52% foresee faster growth in the year ahead. Increasingly, middle market leaders say they want to sock extra cash into a rainy-day fund, rather than use it to fill a war chest for future expansion.

## *Watch what they do, not what they say*

Overall, the middle market is financially conservative. Family businesses, sole proprietorships, and partnerships—more than half the middle market—like to pay as they go. Generally leery of debt and reluctant to dilute equity, they prefer to fund their own growth. Consequently, the flux of the capital markets and the overall economy has less impact on their investment decisions compared to public companies, which need to hit the numbers Wall Street wants to see.

### ***With that in mind, consider these data points:***

- Last year, **47%** of middle market companies introduced a new product or service; in the year ahead, **48%** plan to do the same
- Last year, **22%** acquired another company; in the year ahead, **27%** expect to acquire one
- Last year, **19%** added a new plant or facility; looking forward, **28%** plan to add one
- Last year, **36%** opened new domestic markets; **44%** expect to do so in the next year
- Last year, **15%** moved into new international markets; looking forward, **25%** plan to do so

That is, asked about their own company’s specific investment plans, executives are much more bullish than they are when asked about the state of the economy or what they would do with a hypothetical extra dollar. Now, these plans might not be baked into budgets. They might take more than a year to come to fruition. They might be put on hold. They might be scrapped. But all of these predictions and past actions are almost exactly in line with the numbers we saw in the second quarter of 2018. Judging by deeds, in other words, the middle market is forging ahead.



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