NATIONAL CENTER FOR
THE MIDDLE MARKET

3Q | 2019

MIDDLE MARKET INDICATOR

Growth Slows; Plans Become More Conservative

IN COLLABORATION WITH

THE OHIO STATE UNIVERSITY
FISHER COLLEGE OF BUSINESS

CHUBB

Executive Summary

In the wake of two quarters of softening growth projections and waning economic confidence, all key performance indicators for middle market companies declined this quarter with both revenue growth rates and employment growth rates dipping below historical averages. While solid revenue growth continues for most middle market businesses, the growth rate has cooled considerably. At 5.8%, it fell nearly three points from three months ago. The proportion of firms growing at 10% or more declined by 10 full points, from 38% in Q2 to 28% in Q3. The rate of employment growth has slowed significantly as well, from 6.4% to 4.1%. As with revenue growth, there are fewer companies adding people at a fast pace (10% or more), down from 30% three months ago to 23%. Companies across all middle market revenue segments and in all industries are feeling the chill, and projections for both the short and long term remain weak as economic confidence continues to weaken. Global economic confidence, in particular, has fallen well below the five-year average.

Nevertheless, a majority of middle market executives say that their company's overall performance is better today than it was one year ago. However, this number is declining, too, from 68% last quarter to 60% currently. The all-time high of 73% was recorded less than one year ago at the close of 2018.

Looking forward, the situation could become more challenging before it improves. The Short Term Index, which is calculated based on business climate perceptions and expected sales and demand for the three months ahead, has been on a downward trajectory since mid 2018, a trend not seen before in the Middle Market Indicator (MMI). The index now sits at its all-time low at 49. Companies' new order pipelines are less full than at any point in the last year and a half. Fewer firms are expecting to hire in the short term, with three-quarters (74%) of middle market companies saying the workforce is now the right size for market conditions. The proportion of leaders who expect further tightening of the labor market continues to drift downward.

Longer-term projections are weak as well with expectations for the 12-month rate of growth for both revenue and employment down significantly from the second quarter. A slight majority of businesses do expect continued top-line growth in the year ahead, however just 35% expect to add people. Those that do hire say they will do so at the significantly slower rate of 2.5%, the lowest projection since 2014. While middle market leaders tend to under-promise and over-deliver when it comes to future growth, the gap between projected revenue growth and actual performance closed notably this quarter, and the actual hiring rate fell below what had been projected a year ago for only the second time in MMI history.

There is some evidence that companies are dialing back on planned growth activities as well. A slightly smaller proportion of firms say they expect to introduce a new product or service, enter a new domestic or foreign market, add a plant or facility, or engage in M&A in the 12 months ahead. At the same time, a significantly larger proportion of firms indicate they would save extra cash as a cushion as opposed to putting it to work immediately or building it up for a future investment.

Still, bright spots persist. The middle market continues to grow and most companies expect future growth, albeit at slower rates. The vast majority of leaders remain confident in their local economies—the ones in which, generally, middle market companies do the most business. Executives continue to be focused on talent issues and how to retain the best and brightest people to drive their businesses forward. Overall, leaders appear to be taking appropriate steps and hedging their bets for the time being, perhaps responding to growing national and global economic uncertainty. As attitudes and behaviors shift toward conservatism, many leaders are focusing internally on ways to cut costs and drive efficiency to ensure they are prepared for whatever the coming months bring.

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.

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Revenue Growth
Growth rates slow significantly

Year-over-year middle market revenue growth slowed sharply this quarter to 5.8% from 8.5% at the midpoint of the year. This represents the slowest rate of growth recorded over the past five and a half years and is well below the historic MMI average of 6.9%. While 71% of companies are still growing, middle market firms of all sizes and across all industries report declines in the rate of growth. The proportion of companies reporting robust year-over-year revenue growth of 10% or more fell 10 points this quarter from 38% to 28%. Simultaneously, the proportion of companies saying revenue declined in the last year jumped from 9% to 13%.

Middle market leaders believe slower growth rates will persist into 2020. The projected rate of revenue growth for the next 12 months fell compared to last quarter, from 5.4% to 4.7%. Still, a majority (55%) of middle market companies do anticipate growth in the year ahead. And fewer than one out of 10 middle market leaders believe revenues will decline between now and the middle of next year.

3Q'19 **71%** of middle market companies reported positive revenue growth. 3Q'18 **77%**

MIDDLE MARKET

	PAST 12 MO.	NEXT 12 MO.
3Q'19	5.8%	4.7%
2Q'19	8.5%	5.4%
3Q'18	8.6%	5.3%

S&P 500

	PAST 12 MO.
3Q'19	2.1%*
2Q'19	5.2%
3Q'18	8.0%

Employment Growth
Fewer companies are hiring

Year-over-year employment growth fell sharply from 6.4% last quarter to 4.1%. Over the past two and a half years, upwards of 50% of companies reported that they were adding jobs. This quarter, the percentage declined to 46% and 14% of firms say that the size of their workforce is smaller today than it was in the third quarter of 2018. Upper middle market businesses with annual revenues between $100 million and $1 billion are the most likely to have added people over the past 12 months. However, middle market companies of all sizes and across all industries, with the exception of manufacturing, report decreases in the rate of employment growth. Overall, the proportion of firms hiring aggressively, at a rate of 10% or more, fell from 30% to 23%.

Looking ahead, 35% of companies say they will add to their workforce over the next 12 months, down from 41% three months ago. These firms will only be making nominal increases to the size of their teams. The projected rate of employment growth is 2.5%, the lowest number seen since the end of 2014.

3Q'19 **46%** of middle market companies added jobs. 3Q'18 **57%**

MIDDLE MARKET

	PAST 12 MO.	NEXT 12 MO.
3Q'19	4.1%	2.5%
2Q'19	6.4%	4.8%
3Q'18	6.4%	4.6%

ADP *(Past 12 Mo.)*

	LARGE CORP.	SMALL BUS.
3Q'19	2.4%	0.8%
2Q'19	2.3%	1.0%
3Q'18	2.6%	1.2%

**3Q numbers include only companies who have reported 3Q earnings results. Numbers change as more businesses report financial results.*

Economic Confidence

Confidence falls below five-year averages

Since mid 2018, confidence in local, national, and global economic conditions has been on a downward trajectory. While most (85%) middle market leaders remain confident in their local economies, the proportion of executives who report at least some level of confidence in the national and global environments has dipped below the five-year averages. In both categories, the numbers are at the lowest levels recorded since the end of 2016.

Perhaps driven by news headlines and the fact that half of middle market companies are exposed to some degree of international risk, global confidence has declined most notably, with 55% of leaders expressing at least some confidence in the world economy, compared to a high of 82% recorded in the first quarter of 2018. This number is well below the five-year average of 64%. National confidence has declined significantly as well, falling to 76%, three points below the five-year average of 79%.

3Q'19

	GLOBAL ECONOMY	NATIONAL ECONOMY	LOCAL ECONOMY
CONFIDENT / SOMEWHAT CONFIDENT	55%	76%	81%
2Q'19	69%	82%	89%
3Q'18	80%	88%	93%

Short Term Index

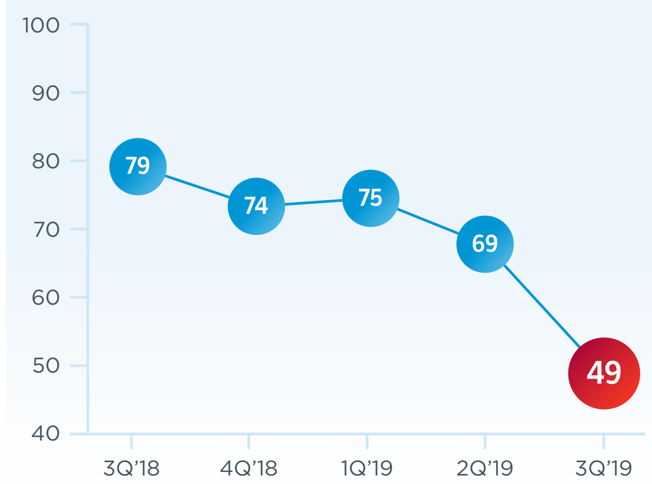
Three-month outlook is weak

For the first time since measuring the Short Term Middle Market Index—a metric that reflects leaders' expectations for sales, demand, and overall business conditions in the short term—the proportion of executives predicting a less favorable business climate over the next three months exceeded the proportion that believes the business climate will improve in the short term. Those expecting a better climate going forward fell from 23% last quarter to 16%, tying the all-time low for this metric, which was recorded in Q4 2016. Those saying the business climate will deteriorate rose from 12% to 17%, reaching the highest level recorded by the MMI.

Overall, most leaders expect the business environment to remain about the same for the next three months. However, the notable reversal in optimistic versus pessimistic mindsets has contributed to the Short Term Index plummeting from 69 last quarter to 49, an all-time low for the MMI.

Beyond sentiment, sales and demand forecasts are weak. A smaller proportion of companies are expecting increased demand and sales in the fourth quarter of the year while a larger proportion believes those performance drivers will taper off between now and the close of 2019. While many executives expect sales and demand to hold steady for the next three months, for both indicators, the proportion of leaders expecting declines in the short term rose to a high mark of 11%.

PAST 12 MONTHS



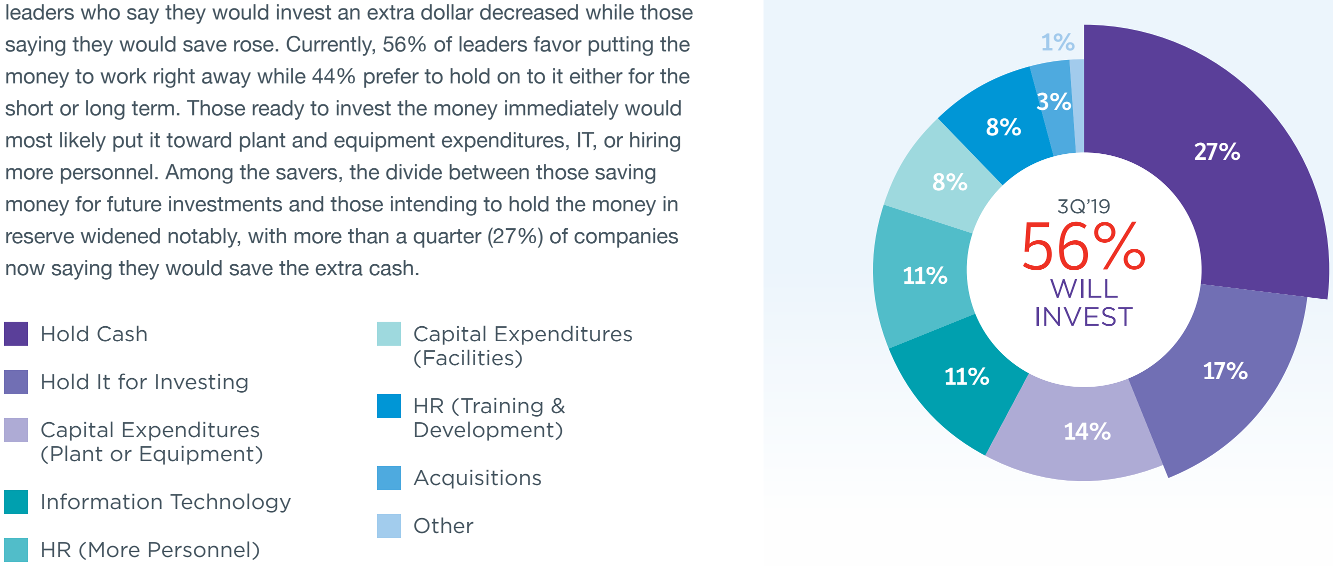
Short Term Index is calculated by taking expected net positive change in business climate plus expected net positive change in demand plus expected net positive change in sales over the next 3 months.

Capital Investment

More companies will hold cash

In line with waning confidence and weaker predictions for future growth, middle market leaders continue their shift toward more conservative investment attitudes. For the third straight quarter, the proportion of leaders who say they would invest an extra dollar decreased while those saying they would save rose. Currently, 56% of leaders favor putting the money to work right away while 44% prefer to hold on to it either for the short or long term. Those ready to invest the money immediately would most likely put it toward plant and equipment expenditures, IT, or hiring more personnel. Among the savers, the divide between those saving money for future investments and those intending to hold the money in reserve widened notably, with more than a quarter (27%) of companies now saying they would save the extra cash.

ADDITIONAL INVESTMENT ALLOCATION



Key Challenges

Economic and cost concerns escalate

Despite the fact that employment growth has slowed and fewer companies have plans to add workers over the next 12 months, talent management remains the most pressing internal challenge weighing on the minds of middle market leaders. Nearly three-quarters (74%) of companies believe the workforce is the right size to meet current market conditions; but with unemployment low and skills gaps evident, executives remain concerned with how to retain current employees and decrease turnover.

From an external perspective, growth remains top of mind. However, the economy and costs are both growing areas of concern. The proportion of companies citing economic-related challenges in the long term rose sharply this quarter, up eight points from three months ago. This is in line with the declining economic confidence leaders have been reporting for several quarters. Short-term economic concerns also jumped significantly. A larger proportion of leaders indicate they are worried about costs, especially as a headwind to growth in the long term, with tariffs the number-one cost issue cited.

SHORT TERM CHALLENGES *(Next 3 months)*

INTERNAL CHALLENGES	
1. BUSINESS	**59%**
2. TALENT MANAGEMENT	**55%**
3. COSTS	**21%**
EXTERNAL CHALLENGES	
1. BUSINESS	**38%**
2. GOVERNMENT	**24%**
3. COMPETITION	**18%**
4. COSTS	**18%**
5. ECONOMY	**17%**

LONG TERM CHALLENGES *(Next 12 months)*

INTERNAL CHALLENGES	
1. TALENT MANAGEMENT	**46%**
2. BUSINESS	**39%**
3. COSTS	**19%**
EXTERNAL CHALLENGES	
1. BUSINESS	**31%**
2. GOVERNMENT	**20%**
3. ECONOMY	**18%**
4. COSTS	**17%**
5. COMPETITION	**14%**

Spotlight
Smaller raises?

Middle market executives are cost hawks. Lacking deep pockets and as leery of taking on debt as they are of selling off equity, they are a pay-as-you-go crowd. An examination of MMI data over the years as well as other research by the Center shows that, as a group, middle market leaders hold back on hiring until they are sure they need new hands, and refrain from capital expenditures till they are stretched.

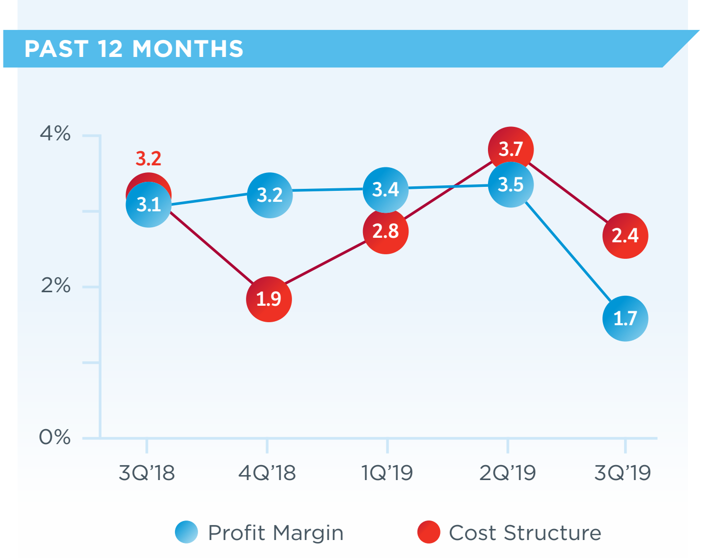
But if they are slow to pull the trigger on expansion, are they quick to react to slower growth?

This quarter we asked executives whether they had accelerated cost-cutting and efficiency efforts in the last six months. Forty-six percent said they had; 11% said they had increased cost-cutting significantly. (A nearly equal number, 47%, said their cost-consciousness was unchanged, and 7% loosened the reins.) Those efforts appear to include trying to hold the line on salary increases, despite a shortage of talent: Six months ago 46% of executives said they planned to raise pay to keep people and that number is down to 42%. Along with a projected decrease in hiring and increases in healthcare costs, this suggests that bosses may be more Scrooge than Santa when merit increase time rolls around.

Profit Margins & Cost Structure
The gap between cost and profit expectations widens

Nearly half (49%) of middle market business leaders expect costs to rise over the next 12 months. Compared to last quarter, the rate of that expected increase is lower with companies forecasting a 2.4% increase in costs, down from 3.7% projected three months ago. However, costs appear to be increasingly on the minds of middle market leaders, and increased expenses could be eating into profit margins for many companies.

Throughout 2018 and most of 2019, companies projected profit margins would increase more than 3%. Those expectations fell this quarter with middle market companies now saying their profit margin growth over the next year will be just 1.7%. The expectation for costs to grow faster than margins may be driving the mounting cost-related concerns as well as the more conservative investment attitudes we continue to see in the MMI.



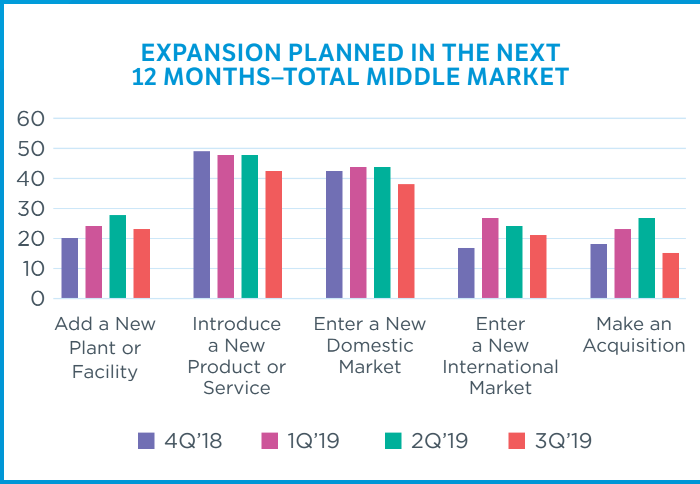
Perspectives

In late 2018, a number of elements of the Middle Market Indicator started drifting downward. Economic confidence softened, particularly confidence in the global economy. The Short Term Index fell, primarily as a consequence of declines in executives' perceptions of the business climate. Asked what they would do with an extra dollar, a growing number of executives said they would squirrel it away rather than invest immediately. But, as we pointed out three months ago, we saw little evidence that performance had weakened or that actual plans had changed.

Now we do. This quarter's report shows the biggest one-quarter drops in revenue and employment growth in the eight-year history of the MMI. One has to go back to the end of 2014 for a similarly low rate of top-line growth, and to the beginning of 2016 for similar job growth rates.

In the third quarter we also saw, for the first time in the last year, evidence that middle market executives are pulling back some planned investments and expansion. To summarize, we now see changes in performance and behavior as well as in sentiment.

The exhibit here demonstrates how middle market executives have turned down the dial on plans for expansion in the months to come.



The biggest drop, both absolutely and in percentage terms, is in plans to make an acquisition, which is the expansion activity that has the least to do with continuing operations. Plans for new facilities, new products, and new market entries—activities closer to the core business—have not been cut as much (though they have been cut).

Cloudy or stormy?

It is important not to make too much of these downward-pointing numbers. For one thing, they are just one quarter's data. It is possible to get anomalous signals, even in a sample as large as the MMI, which polls 1,000 leaders. In the first quarter of 2017, the MMI recorded a huge upward spike; revenue growth jumped from a 6.9% rate to 9.2%—then settled right down to 6.7% the quarter after. This might be a similar outlier. In addition, though the growth numbers are down, they are not bad. At 5.8%, middle market revenue growth was higher than the S&P 500 rate of 2.1%. Middle market employment growth of 4.1%—in just one year—looks robust when you consider that the total number of employed persons in the U.S. has grown by about 8% over the last five years.

A look deeper into the numbers reveals interesting nuances. Just 7% of companies reported deteriorating performance. This is up from 6% a quarter before, but it is exactly the average over the history of the MMI. Compared to last quarter, the big difference in overall performance is that fewer companies say performance has improved. More say it has stayed the same, but not many are suffering. Among growing companies, there is a substantial drop in the percentage that grew 10% or faster. Last quarter, 38% of the middle market qualified as these so-called "Growth Champions"; this quarter, only 28% made the cut. Similarly, the number of firms hiring aggressively (whose workforces increased 10% or more in the last twelve months) fell from 30% to 23%. These numbers open the possibility that the slowdown, while general, has affected the fastest-growing middle market companies more than it has the sector as a whole. That's not to say it's confined to a small group; after all, in Q2 nearly two out of five middle market companies were Growth Champions.

Looking ahead, we should watch for three things. Foremost, in three months, will we see growth and hiring continuing at a lower level, or will it rebound? Second, will investment activity drop further, and cut more deeply into core business areas? And third, what will sentiment show? The confidence numbers this quarter are the lowest we have seen since 2016. Asked to name the top three long-term challenges, 18% of middle market executives volunteered "the economy," compared to just 10% in Q2 and 11% a year ago. If those feelings don't change, it is unlikely that investment will pick up.

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