NATIONAL CENTER FOR
THE MIDDLE MARKET

4Q | 2019

MIDDLE MARKET INDICATOR

Performance Improves, But the Caution Bell Still Tolls

IN COLLABORATION WITH

THE OHIO STATE UNIVERSITY
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Executive Summary

Throughout 2019, middle market leaders have been decidedly cautious. While most companies grew, the rates of both revenue and employment growth declined over the first three quarters of the year. Economic confidence, investment appetites, and both short- and long-term projections fell in tandem. The Q4 numbers, however, paint a different picture. All of these indicators reversed course—some more notably than others—to close out the year on a much more positive note. But, while the rebound is clearly evident, it is far from complete. Compared to one year ago, actual growth numbers as well as future projections are at considerably lower levels. While the Short Term Index rose over 20 points from last quarter, it remains well off its high mark. Still, with confidence, investment appetites, and expansion plans recovering much more robustly, the middle market may well be poised to begin 2020 on a strong note.

Overall, two-thirds (67%) of middle market companies report improved company performance compared to one year ago, up from 60% who said the same last quarter, but down from 73% at the end of 2018. Just 8% say performance deteriorated over the course of 2019. While sentiment is pointing up, and 73% of companies saw revenue growth this year, the rate of year-over-year revenue growth (7.5%) is lower than it was during most of 2018 and the first half of 2019. In addition, the proportion of middle market companies reporting no growth or decreasing revenues rose from 21% one year ago to 27% today. In 2019, fewer than half (48%) of middle market companies grew the size of their workforce, and that rate of growth (5%) has declined since 2018 as well.

Looking ahead, revenue and employment growth projections, while up notably from Q3, also remain below those forecasted over the past several years. Overall, a majority of companies (55%) say revenues will increase in 2020 and 42% say they will experience employment growth, albeit at more modest rates (4.9% for revenues; 3.5% for employment). Interestingly, upper middle market firms (with revenues between $100 million and $1 billion) report lower actual and projected revenue growth numbers than their smaller peers. (See Spotlight, p. 6, for additional insights.)

Despite lower overall projections for the year ahead, many middle market companies appear to be anticipating good things for the first quarter of 2020. For the first time in six months, the Short Term Middle Market Index is up, and strongly so. Many companies are anticipating a more favorable business climate, nearly half of firms expect sales to increase, and 37% expect to increase the size of the workforce over the next three months. However, another 10% say they will cut jobs.

Perhaps the strongest signs of a potential return to strong growth are confidence levels and investment appetites. Both indicators have rebounded to near their all-time highs. Almost half of middle market companies have plans to introduce a new product or service in 2020 and almost as many expect to expand into new domestic markets. Companies also show an increased interest in putting extra money toward information technology, and, as we've seen in several recent studies, companies that embrace IT and digital transformation grow faster than their peers.

Many core business challenges will persist in 2020. Talent management and maintaining growth, as always, are headwinds to performance goals. These challenges are particularly pronounced for the 27% of middle market companies that report no revenue growth or declining revenues in 2019. Costs, especially those related to import and export tariffs, are a problem for these firms as well. While economy-related concerns have diminished since last quarter, government challenges have increased as middle market executives contend with political and interest rate uncertainty and begin to consider the potential impact of the next U.S. presidential election.

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

Growth rates recover

After a sharp decline last quarter, the rate of year-over-year revenue growth climbed back to 7.5%. While the increase is notable, the number remains below rates reported during most of 2018 and 2019. Additionally, the proportion of firms reporting revenue increases is essentially unchanged at 73% and is below the 79% of firms that reported revenue increases one year ago. This quarter's jump in growth rate is driven not by more companies taking in more money, but by a significant increase in the proportion of firms growing at a rate of 10% or more. Retailers and wholesalers, perhaps benefiting from the holiday buying season, are fueling that number, along with core and lower middle market companies and those in the financial services and healthcare industries.

Looking ahead, companies continue to have muted expectations for future revenue growth. A slight majority (55%) expect to see gains in 2020. The anticipated rate of growth inched up slightly since Q3. However, the estimates are significantly lower than those given throughout 2018 and most of 2019.

4Q'19 **73%** of middle market companies reported positive revenue growth. 4Q'18 **79%**

MIDDLE MARKET

	PAST 12 MO.	NEXT 12 MO.
4Q'19	7.5%	4.9%
3Q'19	5.8%	4.7%
4Q'18	7.9%	5.9%

S&P 500

	PAST 12 MO.
4Q'19	4.3%*
3Q'19	2.1%
4Q'18	4.7%

Employment Growth

Employment numbers inch back

In tandem with revenue, employment growth numbers fell sharply in Q3. This indicator has recovered to finish the year, but numbers remain off the higher rates seen over the past two-and-a-half years. Fewer than half (48%) of middle market companies increased the size of their workforce in 2019 while 14% say headcount shrank. Those that did hire report a rate of year-over-year employment growth of 5%, up from 4.1% last quarter, but still the second lowest rate recorded since mid-2016. Almost all industries, with the exception of manufacturing, report modest increases in the rate of the employment growth while retailers and wholesalers hired the most aggressively.

Looking ahead, 42% of firms say they expect employment increases in 2020, up from 35% in Q3. The expected rate of employment growth over the next 12 months is 3.5%, on par with forecasts made earlier in 2019. While this represents a solid increase from last quarter's 2.5% projection, it remains below the more optimistic projections recorded in 2017 and 2018.

4Q'19 **48%** of middle market companies added jobs. 4Q'18 **55%**

MIDDLE MARKET

	PAST 12 MO.	NEXT 12 MO.
4Q'19	5.0%	3.5%
3Q'19	4.1%	2.5%
4Q'18	5.4%	3.8%

ADP *(Past 12 Mo.)*

	LARGE CORP.	SMALL BUS.
4Q'19	2.3%	0.7%
3Q'19	2.4%	0.8%
4Q'18	2.5%	1.1%

**4Q numbers include only companies who have reported 4Q earnings results. Numbers change as more businesses report financial results.*

Economic Confidence
Confidence rebounds

During the previous four quarters, confidence in the global, national, and local economies was on a downward trend, plummeting significantly in Q3. At the end of 2019, that trend reversed. All three numbers rose substantially, nearing levels seen at the end of 2018 and rising above the five-year MMI averages. But each number still remains below its all-time high.

Currently, more than four out of five middle market leaders say they are at least somewhat confident in the state of economic affairs in the United States and in their own local economies. The proportion of firms expressing at least some confidence in worldwide economic conditions increased most, from 55% last quarter up to 68%. Of the three metrics, however, this number remains the furthest from its high of 82% recorded in Q1 2018.

GLOBAL ECONOMY

4Q'19

68%

CONFIDENT / SOMEWHAT CONFIDENT

3Q'19 55% 4Q'18 73%

NATIONAL ECONOMY

83%

CONFIDENT / SOMEWHAT CONFIDENT

3Q'19 76% 4Q'18 86%

LOCAL ECONOMY

89%

CONFIDENT / SOMEWHAT CONFIDENT

3Q'19 81% 4Q'18 89%

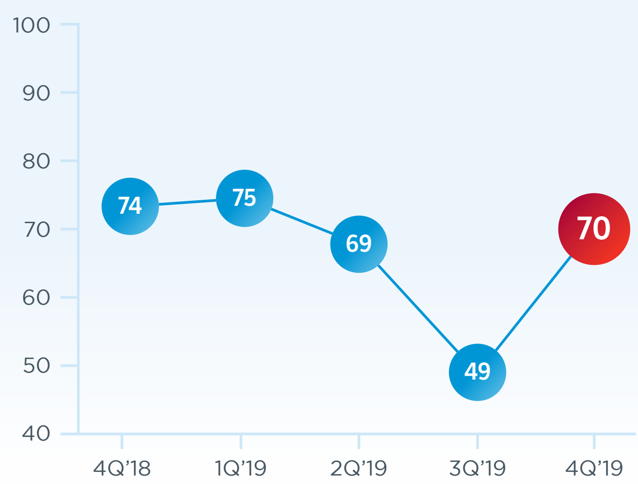
Short Term Index
Three-month outlook improves

The Short Term Middle Market Index reflects leaders' expectations for sales, demand, and overall business conditions for the three months ahead. Throughout much of 2019, the Index declined. And last quarter in particular, it fell sharply, largely driven by sentiment around the overall business climate. In Q4 2019, the Index bounced back notably, from 49 to 70. While it remains below the scores recorded in 2017 and 2018, the improved Index score, coupled with rebounding confidence and more willingness to invest, signals that leaders are more optimistic about the future—at least the first quarter of 2020—than they have been over the past six months.

Indeed, the proportion of executives expecting conditions to be better for business in the months ahead rose from just 16% in Q3 2019 to 26%, while those foreseeing a less favorable business climate fell from 17% to 12%. To back up this sentiment, more business leaders are anticipating increased sales to kick off 2020—up from 42% to 47%. Only one out of nine leaders (11%) expect sales to decrease over the next three months.

Interestingly, the proportion of executives who believe demand will increase (a little more than a third) has remained relatively stable throughout 2019, despite the fact that the other two Short Term Index metrics have seesawed.

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.

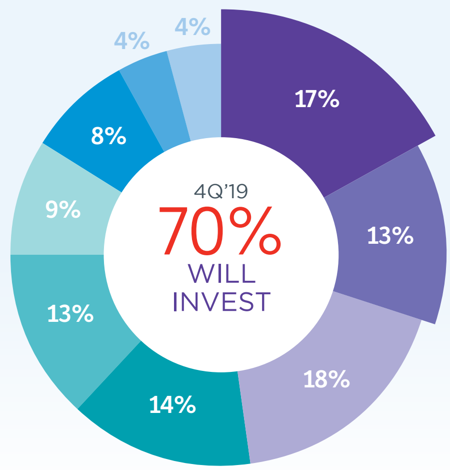
Capital Investment

Investment appetites resurge

For several quarters, we've seen middle market executives take an increasingly cautious approach to cash management. That trend reversed this quarter and the proportion of leaders willing to put an extra dollar to work in their businesses rebounded to 70%, just one percentage point off its all-time high. In addition, the number-one destination for that dollar is now information technology, which likely reflects a growing recognition of the importance of digital transformation to middle market companies, the need to invest in digital solutions in order to remain competitive, and cybersecurity concerns. Overall, increased willingness to invest is likely tied to rebounding economic confidence sentiment. However, among the 30% of firms saying they would hold onto that extra dollar, the majority would keep it in cash instead of earmarking it for future investment purposes.

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

ADDITIONAL INVESTMENT ALLOCATION



Key Challenges

Talent and growth remain top challenges

Nearly half of middle market companies continue to say that talent management is a top issue for their businesses. With employment growth numbers lower than they have been in past years and fewer leaders citing tightness in the labor market, executives worry most about how to retain their current staff. However, talent acquisition is still an issue, especially for organizations planning to expand the size of the workforce or looking for talent with specific skills, such as the IT skills needed for digital transformation.

Externally, concerns related to the economy have abated since last quarter, consistent with the increase seen in economic confidence levels overall. However, the proportion of companies citing challenges pertaining to the government has increased, particularly around government rules and regulations. Seven out of 10 middle market business leaders say that state and federal industry regulations have a negative impact on their business, but only 22% say the impact is major, while 26% say regulations have no impact or a positive one. Some leaders also cite concerns related to the upcoming U.S. presidential elections.

SHORT TERM CHALLENGES *(Next 3 months)*

INTERNAL CHALLENGES	
1. TALENT MANAGEMENT	57%
2. BUSINESS	59%
3. COSTS	20%
EXTERNAL CHALLENGES	
1. BUSINESS	35%
2. GOVERNMENT	24%
3. COMPETITION	21%
4. COSTS	17%
5. ECONOMY	13%

LONG TERM CHALLENGES *(Next 12 months)*

INTERNAL CHALLENGES	
1. TALENT MANAGEMENT	48%
2. BUSINESS	39%
3. COSTS	15%
EXTERNAL CHALLENGES	
1. BUSINESS	29%
2. GOVERNMENT	20%
3. COSTS	18%
4. COMPETITION	17%
5. ECONOMY	10%

Spotlight
Pressure on Upper Middle Market Growth?

In *The DNA of Middle Market Growth*, published in 2018, the Center conducted an analysis of five years of *Middle Market Indicator* data. We were able to isolate seven growth drivers—market expansion, formal growth strategy, innovating and investing, attracting and retaining talent, financial management, cost efficiencies, and staff development—and weight their impact on company growth. In addition, from work we did for the 2Q 2019 MMI, we are able to isolate the effect of M&A on overall company growth. Putting those factors together, we can roughly gauge how changes in company investments will affect future growth.

The middle market's pullback from international expansion is likely to have the biggest impact. A 33% decline in the likelihood of entering new foreign markets (compared to a year ago) will take one percentage point of growth away from the middle market—a substantial decline. That is unevenly distributed, of course: Wholesalers and manufacturers, more exposed to global markets in the first place, are more likely to reduce investment overseas and to see their growth slow as a result. So are companies in the upper middle market (those with revenues between $100 million and $1 billion).

The reduction in M&A plans—about 18% from a year ago—has less impact on overall middle market growth than one might expect. About one-tenth of the middle market's 7.5% growth in the last year was inorganic. Cutting M&A by a fifth would, therefore, drop growth to about 7.3%, all else being equal. But that impact, too, falls unevenly. In the upper middle market, M&A accounts for about 15% of top-line growth.

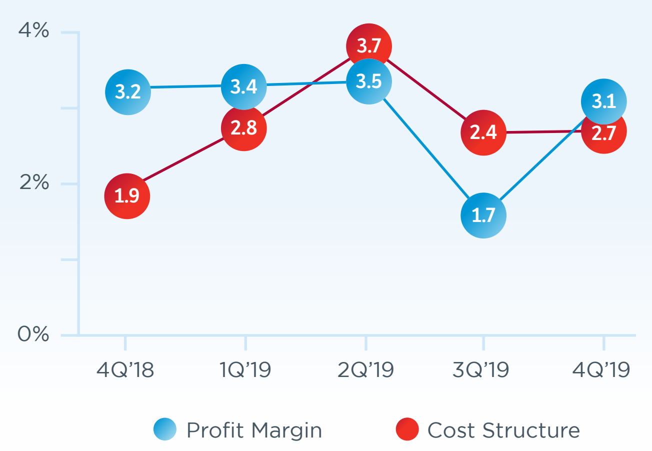
Now, the bigger a middle market company is, the more likely it is to be global and the more likely it is to make acquisitions. In all likelihood, those two factors have depressed the performance of the upper middle market in this quarter. At 6.7%, its growth is, unusually, well below the growth of the lower (8.0%) and core (8.2%) middle market. If executives stick to their plans to slow international expansion and acquire less, these decisions will continue to weigh on the results of upper middle market firms.

Profit Margins & Cost Structure
Profit margins will improve despite rising costs

Over the next 12 months, 45% of middle market companies believe their costs will rise while just 12% expect a decrease in costs. Among those anticipating higher costs, the average rate of the expected increase is up from 2.4% in Q3 to 2.7%. However, fewer business leaders (just 15%) cite costs as a long-term internal business challenge.

Even with costs increasing, companies are more confident than they were three months ago about the future health of their profit margins. These margins are expected to increase by 3.1% in 2020, offsetting cost increases and perhaps contributing to more favorable expectations for the business climate in the months ahead.

PAST 12 MONTHS



Percentages show changes in the cost structure and profit margin, not absolute percentages.

Perspectives

How Big a Bounce?

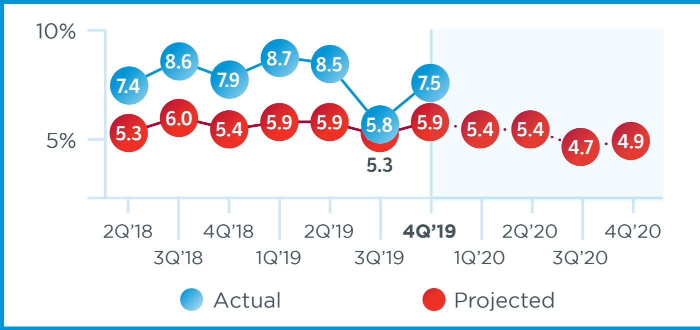
The middle market ended 2019 with a bounce back—partly back, at least—from the worrisome performance we reported in the third quarter. But is it back to business as usual? Does the middle market enter the new decade boldly or anxiously?

Last quarter we said we would watch three things: whether revenue growth and hiring rebound; whether investment activity increases or falls further; and whether sentiment—confidence—continues its downward path. All three have recovered. At the same time, all show continuing signs of relative weakness.

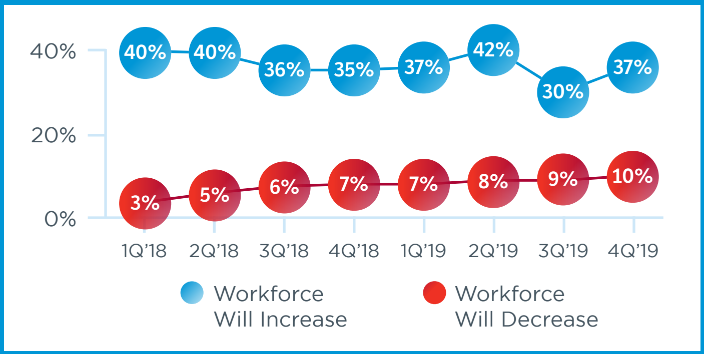
Expansion

Take growth. Year-over-year revenue growth jumped from 5.8% to 7.5%. That is below the 8% range we saw in the last couple of years, but it is well above the historical average and consistent with the thesis that last quarter was a one-time dip.

Growth projections, however, tell a less optimistic tale. Each quarter we ask executives to report on last year's growth and forecast what next year's will be. Middle market executives typically lowball these predictions. As you can see, a year ago the middle market projected 5.9% growth and delivered 7.5%. Worrisome here are not the absolute numbers in the forecasts, but their direction—as the chart shows, there's a slow downward drift. It suggests that revenue growth in the next few quarters will stay below the 8% numbers we saw in 2018 and the first half of 2019.



Employment growth projections show a similar declining trend line. Furthermore, a growing number of executives say they will reduce their workforce in the next three months. From an all-time low of 3% two years ago, that number has slowly but steadily risen to 10%.



Investment

Investment plans are more bullish. The number of companies whose plans for the year ahead included adding a new plant or facility, introducing a new product, entering a new domestic market, entering a new foreign market, and making an acquisition all dropped in the third quarter. All look much better now. In particular, domestic expansion plans are at an historic high; new product plans are near their peaks. But international expansion remains low, probably because of the extra costs and uncertainties of trade conflict. Both M&A and opening new plants, while better than last quarter, are below typical levels.

One interpretation: Leaders are holding back on expansion plans that require big, irrevocable commitments (new facilities, global markets, acquisitions) while moving strongly ahead with plans that are easier to trim or adjust (new products, new domestic markets). That interpretation is consistent with what we see in the third dimension, confidence.

Confidence

Most confidence indicators have improved, suggesting that their slide might have bottomed out in the 3rd quarter of 2019. One indicator: Last quarter, 18% of executives cited "the economy" as one of their top three long-term challenges—the highest we had seen in five years. That number is now just 10%—tied for the lowest. Twenty-six percent expect the business climate to improve, up from 17% three months ago; 11% say it will be worse, down from 16%. And, asked what they would do if they had an extra dollar, the number of executives who say they would invest it jumped back up to 70%—a high number—after four quarters in which it had declined, reaching just 56% three months ago.

But the caution bell still tolls. The most popular choice for a place to put that extra dollar is information technology, picked by 18% of leaders. The second most popular, at 17%, is to stash it as cash. That is, executives are more likely to say they would put money into a rainy day fund than into plant and equipment, new hiring, training, or facilities. It seems they are not convinced that the economy will support their growth ambitions and are holding cash in reserve in case they need it. Another sign of a cooling economy: concern about costs, which had risen steadily from 2016 to the middle of 2018, when 26% cited costs among their top three challenges; only 15% say so now—back exactly to where it was in the first quarter of 2016.

It is important not to make too much of these notes of caution. They are there; but the middle market's dominant tune continues to be optimistic, supported by a steady drumbeat of growth, hiring, innovation, investment, and (increasingly) digital transformation.

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