NATIONAL CENTER FOR
THE MIDDLE MARKET

# 1Q | 2019

## MIDDLE MARKET INDICATOR

# Growth Remains Strong; Cautions Mount

IN COLLABORATION WITH

THE OHIO STATE UNIVERSITY
FISHER COLLEGE OF BUSINESS

Grant Thornton

CISCO

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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*

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### *How is the research conducted?*

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## 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.

**1Q'19**

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

## Short Term Index

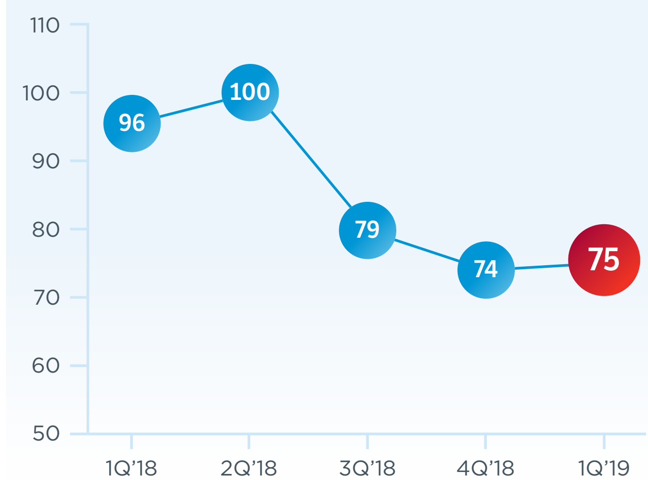
*Short-term performance expectations stabilize at a lower level*

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**



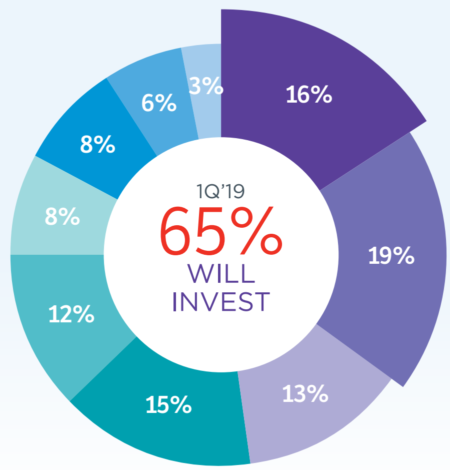

*Short Term Index is calculated by taking expected net positive change in business climate plus expected net positive change in demand plus expected net positive change in sales over the next 3 months.*

## 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

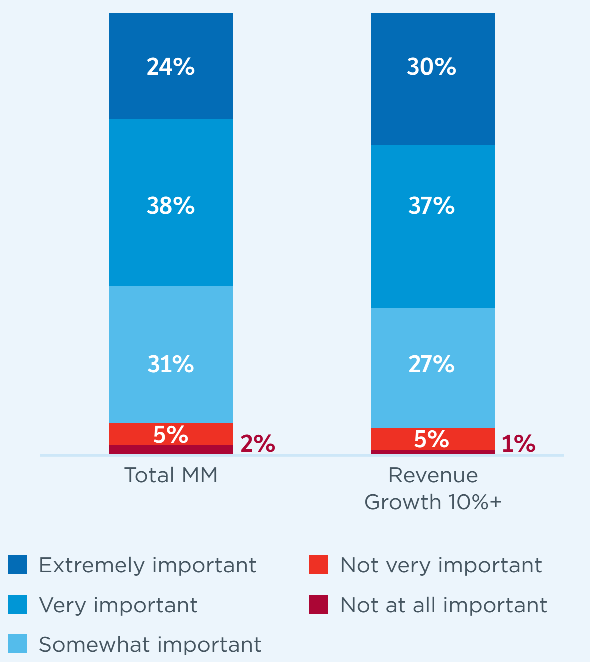
*Digital Pictures, Big and Small*

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*



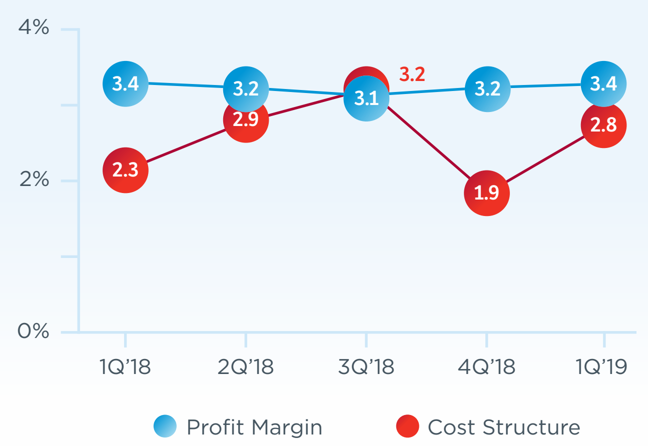

## Profit Margins & Cost Structure

*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
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NATIONAL CENTER FOR
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# 2Q | 2019

## MIDDLE MARKET INDICATOR

## Mixed Messages Continue: Strong Growth; Cautious Outlook

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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.

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## 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%

| MIDDLE MARKET | PAST 12 MO. | NEXT 12 MO. |
|---|---|---|
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| S&P 500 | PAST 12 MO. |
|---|---|
| 2Q'19 | 5.2%* |
| 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%

| MIDDLE MARKET | PAST 12 MO. | NEXT 12 MO. |
|---|---|---|
| 2Q'19 | 6.4% | 4.8% |
| 1Q'19 | 5.6% | 3.4% |
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|---|---|---|
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| 1Q'19 | 2.3% | 1.0% |
| 2Q'18 | 2.9% | 1.0% |

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

## 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.

| | GLOBAL ECONOMY | NATIONAL ECONOMY | LOCAL ECONOMY |
|---|---|---|---|
| 2Q'19 — CONFIDENT / SOMEWHAT CONFIDENT | 69% | 82% | 89% |
| 1Q'19 | 70% | 80% | 88% |
| 2Q'18 | 75% | 86% | 90% |

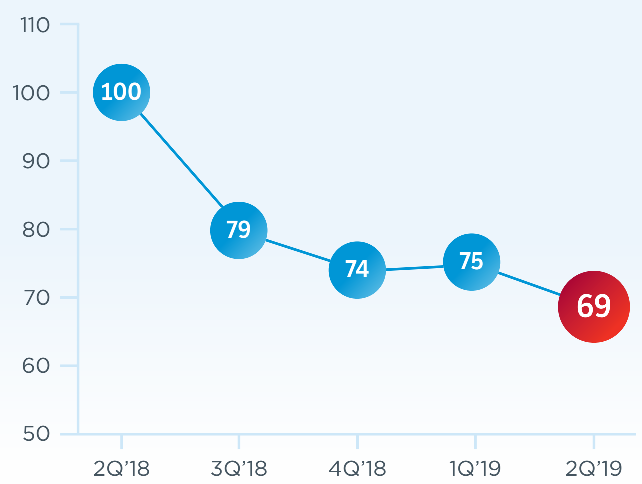
## Short Term Index

### *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



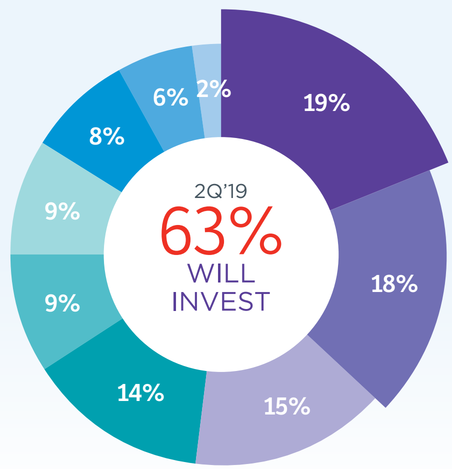

*Short Term Index is calculated by taking expected net positive change in business climate plus expected net positive change in demand plus expected net positive change in sales over the next 3 months.*

## 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**




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

## 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% |

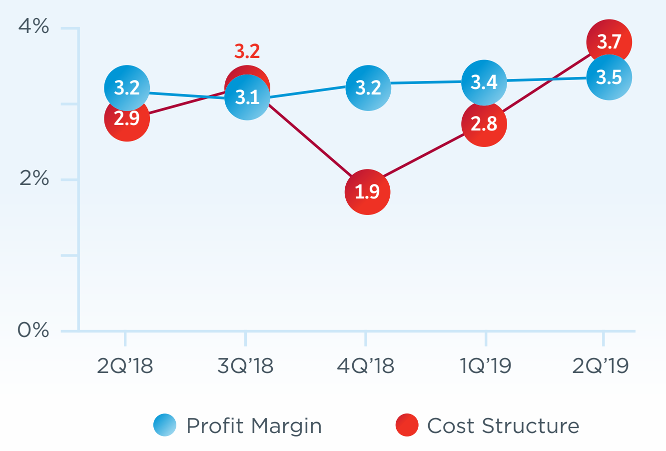
## Profit Margins & Cost Structure

*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.

NATIONAL CENTER FOR
THE MIDDLE MARKET

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THE OHIO STATE UNIVERSITY
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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.

## 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%.

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

## Short Term Index

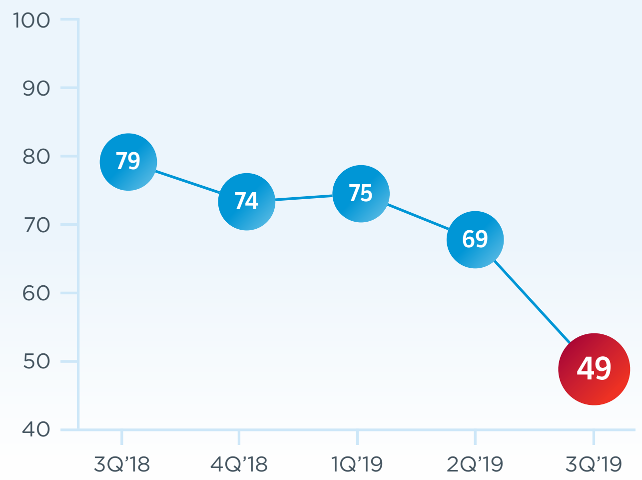
*Three-month outlook is weak*

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



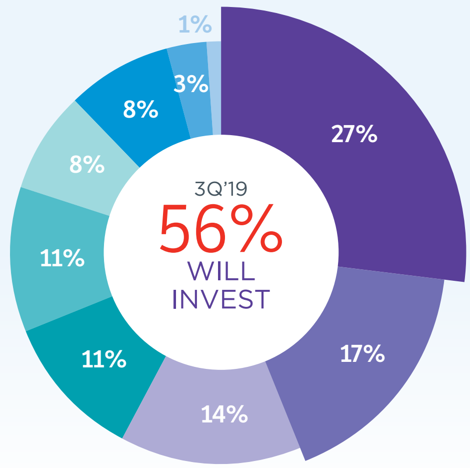

*Short Term Index is calculated by taking expected net positive change in business climate plus expected net positive change in demand plus expected net positive change in sales over the next 3 months.*

## 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**




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

## 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?

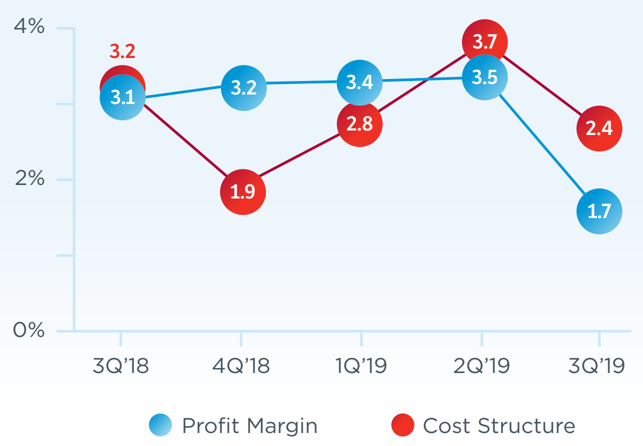
This quarter we asked executives whether they had accelerated cost-cutting and efficiency efforts in the last six months. Forty-six percent said they had; 11% said they had increased cost-cutting significantly. (A nearly equal number, 47%, said their cost-consciousness was unchanged, and 7% loosened 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.

PAST 12 MONTHS



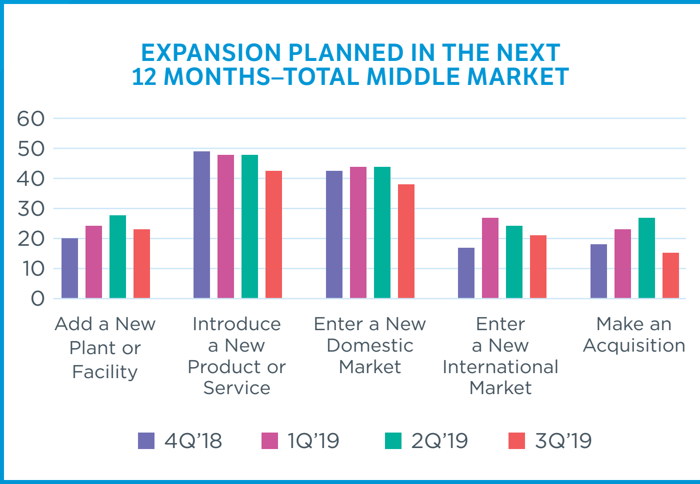
# Perspectives

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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NATIONAL CENTER FOR
THE MIDDLE MARKET

# 4Q | 2019

## MIDDLE MARKET INDICATOR

## Performance Improves, But the Caution Bell Still Tolls

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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.

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## 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.

**4Q'19**

| | GLOBAL ECONOMY | NATIONAL ECONOMY | LOCAL ECONOMY |
|---|---|---|---|
| CONFIDENT / SOMEWHAT CONFIDENT | 68% | 83% | 89% |
| 3Q'19 | 55% | 76% | 81% |
| 4Q'18 | 73% | 86% | 89% |

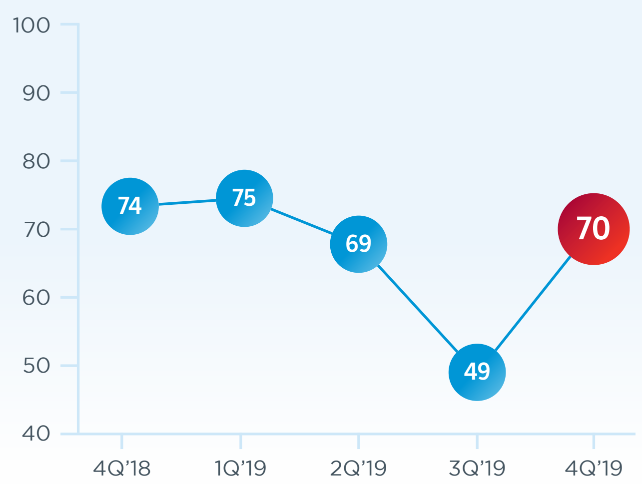
## Short Term Index
*Three-month outlook improves*

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.*

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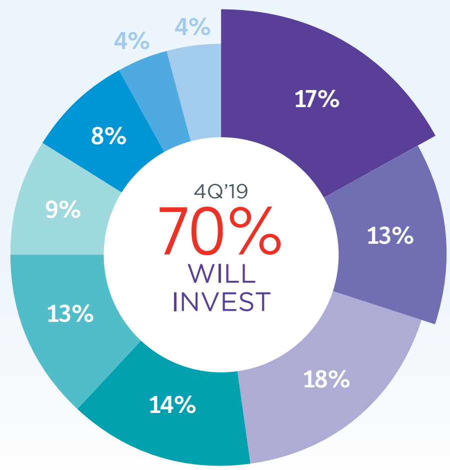
## Capital Investment

*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.

**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 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.

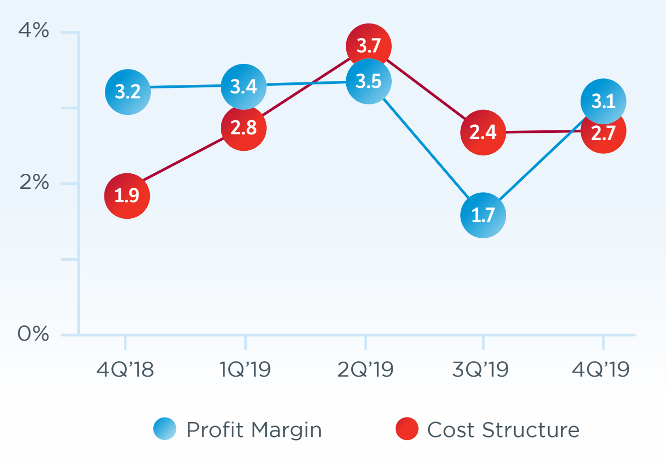
## Profit Margins & Cost Structure

*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?*

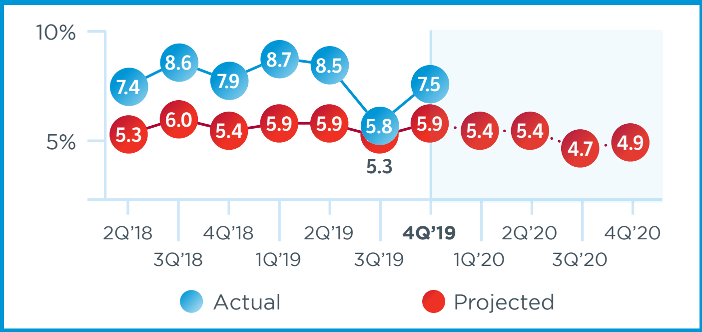
The middle market ended 2019 with a bounce back—partly back, at least—from the worrisome performance we reported in the third quarter. But is it back to business as usual? Does the middle market enter the new decade boldly or anxiously?

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.

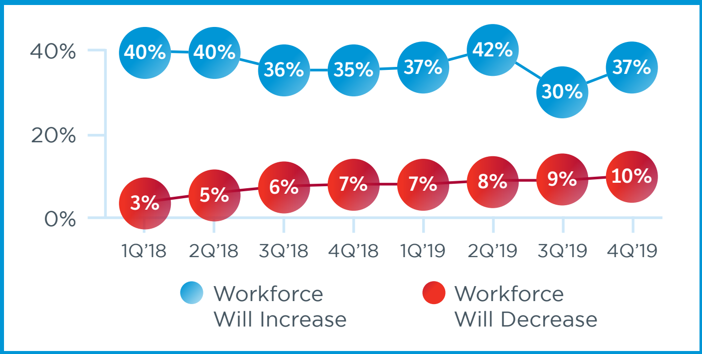
## *Expansion*

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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