NATIONAL CENTER FOR
THE MIDDLE MARKET

1Q | 2018

MIDDLE MARKET INDICATOR

New Thresholds of Growth

IN COLLABORATION WITH

The Ohio State University
Fisher College of Business

SunTrust

Grant Thornton

Cisco

Executive Summary

The middle market is firing on all cylinders for the first quarter of 2018. Nearly three-quarters (72%) of companies say that overall company performance has improved compared to one year ago—a new record for the Middle Market Indicator. Additionally, the proportion of companies reporting year-over-year revenue growth and year-over-year employment growth—77% and 55% respectively—are both at the highest levels recorded in MMI history. The rate of growth for both revenues and employment is near peak levels, and nearly every industry reports faster growth than in the quarter before, with the exception of the services industry, where growth is flat this quarter. Global and local confidence levels have reached record highs, and investment plans have strengthened accordingly, with a larger-than-ever majority of leaders saying they plan to increase investment rather than hold cash in reserve.

As middle market companies continue to flourish, talent remains the number one challenge for the year ahead. In a tight labor market, finding and keeping people is becoming increasingly difficult. Middle market companies are considering increasing salaries, offering additional compensation, and investing in training and development to improve retention. These actions will increase costs. That, combined with healthcare, may be driving the growing concern over costs in the short term, and companies say they expect to see an increase in their cost structure in the 12 months ahead. Leaders, however, are relaxing their concerns related to government rules, regulations, and taxes.

Going forward, companies expect both revenue and employment growth rates to remain strong. Two-thirds of middle market businesses anticipate increases in revenue over the next 12 months, and 46% say they will add workers, many indicating that they will make hires in the coming quarter. Almost half (49%) of businesses plan to introduce a new product or service in the next 12 months and more than a quarter (27%) anticipate adding a new plant or facility. Plans for expansion are particularly robust among upper middle market firms. These largest middle market companies are most likely to predict increases in short-term sales and demand.

The construction and financial services industries continue to report impressive gains in revenue and employment. Growth in the business services industry appears to have flattened, albeit at a high 8.2% annual rate. Manufacturing and healthcare report modest gains in revenue growth, but employment in both areas has jumped. Across industries, upper middle market firms report the strongest growth this quarter.

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

Revenue growth escalates

Since mid 2017, the rate of year-over-year middle market revenue growth has climbed steadily, reaching 8.4% for 1Q 2018, the second highest rate recorded in MMI history. The number represents a substantial increase from the previous quarter and is well above the average annual growth rate of 6.7% for the past six years. Upper and core middle market firms account for the largest share of growth, and companies across nearly every industry segment report increases, with the most notable gains occurring in construction and financial services.

Companies of all sizes anticipate strong growth will continue over the next 12 months. Two-thirds of businesses say revenue will increase, and leaders predict a 5.9% growth rate for the year ahead. Core and upper middle market firms are more aggressive in their growth projections than their smaller peers. Across revenue segments, only 5% of companies believe that the rate of revenue growth will slow during the year ahead.

1Q'18 **77%** of middle market companies reported positive revenue growth. 1Q'17 74%

MIDDLE MARKET

	PAST 12 MO.	NEXT 12 MO.
1Q'18	8.4%	5.9%
4Q'17	7.6%	5.4%
1Q'17	9.2%	8.8%

S&P 500

	PAST 12 MO.
1Q'18	7.4%*
4Q'17	6.9%
1Q'17	5.8%

Employment Growth

Hiring is strong

To start 2018, middle market companies report that their headcount is 6.3% larger than it was one year ago, near record levels and well above the six-year average employment growth rate of 4.0%. Upper middle market businesses, which were largely responsible for the slower employment growth reported last quarter, have come back into the labor market and once again lead the middle market in job creation. As with revenue growth, employment is up across nearly all industries.

Projections for future employment growth are aggressive as well. Nearly half of middle market businesses expect to add jobs over the next 12 months at a rate of 4.6%, and most of those companies anticipate increases during the next quarter. Just 3% of firms expect to decrease the size of their workforce during this time period. Companies are primarily looking for full-time operations people to add to their staffs. Upper middle market companies have plans to onboard IT professionals.

1Q'18 **46%** of middle market companies expect to add jobs. 1Q'17 42%

MIDDLE MARKET

	PAST 12 MO.	NEXT 12 MO.
1Q'18	6.3%	4.6%
4Q'17	5.2%	4.7%
1Q'17	7.5%	6.0%

ADP *(Past 12 Mo.)*

	LARGE CORP.	SMALL BUS.
1Q'18	2.4%	1.9%
4Q'17	2.6%	1.4%
1Q'17	1.6%	1.4%

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

Economic Confidence

Local and global confidence peak

At 94%, middle market leaders' confidence in their local economies reaches an all-time high in 1Q 2018. Global confidence levels, too, peak at 82%. National confidence has risen slightly to 87%, just below its high of 90%, recorded in 1Q 2017.

Compared to mid 2012, when fewer than half of leaders felt sure of the national situation and fewer than a quarter were confident about the global state of affairs, today's numbers show a transformation in perception that is helping to drive growth rates. Overall confidence levels mask some revealing differences by region and industry. (See Perspectives.)

1Q'18

GLOBAL ECONOMY	NATIONAL ECONOMY	LOCAL ECONOMY
82%	87%	94%
CONFIDENT / SOMEWHAT CONFIDENT	CONFIDENT / SOMEWHAT CONFIDENT	CONFIDENT / SOMEWHAT CONFIDENT
4Q'17 75% 1Q'17 77%	4Q'17 86% 1Q'17 90%	4Q'17 88% 1Q'17 88%

Short Term Index

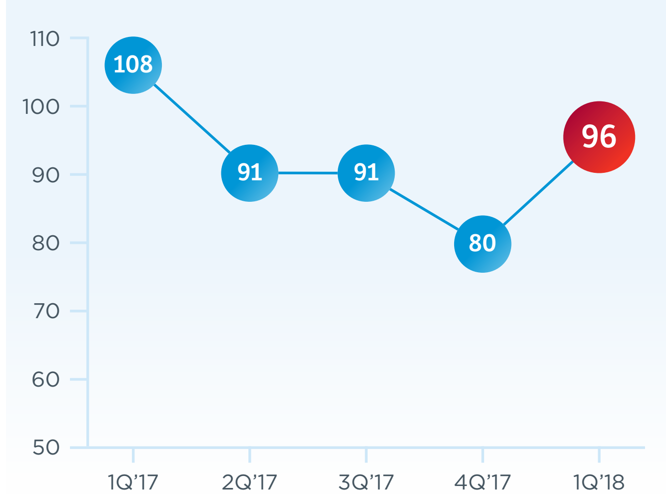
Companies expect a strong second quarter

After declining throughout 2017, the Short Term Middle Market Index has risen this quarter, jumping from 80 to 96. With the exception of 1Q 2017, this represents the highest Short Term Middle Market Index level since the Center began tracking the metric in 2015. The Short Term Index reflects middle market leaders' expectations for sales, demand, and business climate over the next three months. During the second quarter, a majority of executives are anticipating increased demand and sales; however the majority expect the business climate to largely remain the same.

Specifically, 51% of companies—primarily upper middle market companies—say that sales will increase during 2Q 2018. The largest middle market businesses are also the most likely to expect an increase in demand for their products and services in the short term.

Core middle market companies are somewhat less optimistic about the next three months than their smaller and larger peers. Among this segment, just 15% expect a more favorable business climate next quarter. However, very few middle market businesses of any size are forecasting deteriorating conditions or decreases in demand or sales.

PAST 12 MONTHS



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

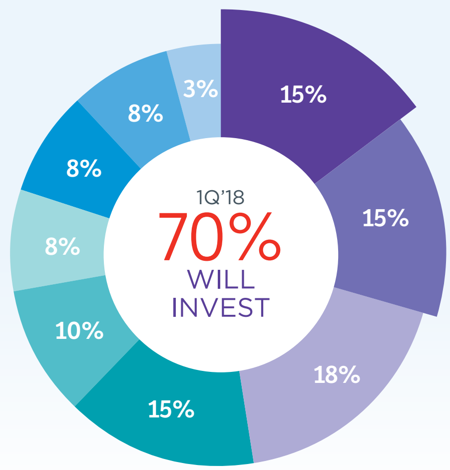
FOR COMPLETE TRENDING, INDUSTRY, & REGIONAL DATA, VISIT MIDDLEMARKETCENTER.ORG

Capital Investment

Fewer companies will save cash

Investment appetites in the middle market have steadily grown over the past six years. At the close of 1Q 2018, 70% of leaders say they would invest an extra dollar, compared to 51% who said the same in mid 2012. This quarter, information technology edges out new plant and equipment as the most likely area for investment. Of the 30% who would put money aside, fewer than half—14% of the total—say they would hold more cash in reserve,the lowest percentage recorded by the MMI. The remaining savers are holding cash to build up their funds in order to finance future investments. Companies adding to cash reserves tend to be lower or emerging middle market businesses; this is something we have seen before andprobably reflects the fact that smaller companies have less access to outside rainy-day capital.

ADDITIONAL INVESTMENT ALLOCATION



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

Key Challenges

Talent challenges escalate

As middle market companies continue to grow and increase the size of their staffs, and the labor pool continues to tighten, talent management, including finding and retaining people with the right skill sets and developing the current workforce, continues to be the number one internal long-term challenge. More than half (54%) of companies say that talent issues will potentially present problems for their businesses over the next 12 months. Externally, executives are primarily focused on core business growth issues, such as sales, acquiring new customers, and innovation.

Concerns over government rules and regulations, however, continue to subside, and just 3% of middle market business leaders say that taxes are an issue. Over the next three months, maintaining growth is the most pressing challenge, but talent management concerns continue to mount in the short term, and worries over costs are rising as well. Only about one out of 10 leaders express short-term concerns related to the economy.

SHORT TERM CHALLENGES *(Next 3 months)*

INTERNAL CHALLENGES	
1. BUSINESS	70%
2. TALENT MANAGEMENT	63%
3. COSTS	28%
EXTERNAL CHALLENGES	
1. BUSINESS	45%
2. COMPETITION	26%
3. GOVERNMENT	23%
4. COSTS	18%
5. ECONOMY	11%

LONG TERM CHALLENGES *(Next 12 months)*

INTERNAL CHALLENGES	
1. TALENT MANAGEMENT	54%
2. BUSINESS	48%
3. COSTS	20%
EXTERNAL CHALLENGES	
1. BUSINESS	35%
2. COMPETITION	23%
3. GOVERNMENT	19%
4. COSTS	17%
5. ECONOMY	14%

Spotlight

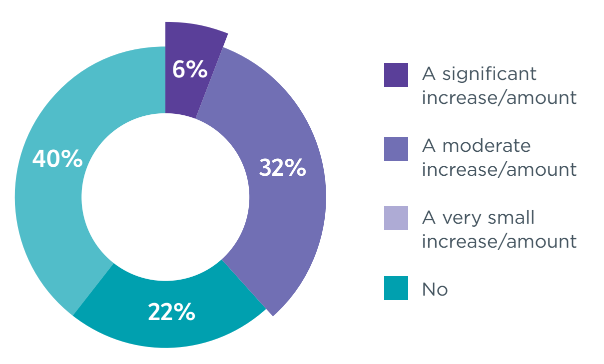
Will Tax Law Changes Increase Capital Investment?

Reduced corporate tax rates, changes in the accounting treatment of capital expenses, and other provisions of the tax bill signed into law in December were partly intended to accelerate investment by U.S. businesses. More than three out of five middle market executives say they intend to increase capital spending plans as a result. Most of these changes will be modest, but a handful of companies (6%) say they will accelerate or increase capital spending to a significant degree.

Bigger companies are more likely to be aware of tax-law changes and more likely to change capex—67% compared to 61% for the middle market as a whole. Part of this difference is due to simple awareness: Just 57% of lower middle market companies say they are aware of tax-law effects on capital spending, compared to 67% among companies with revenues between $100 million and $1 billion. Further, the Center has seen in previous studies* that larger companies are generally more knowledgeable about and responsive to the cost of capital than smaller firms.

Information technology will be the biggest beneficiary of accelerated capital investment. For every dollar executives plan to put into real estate, they will put $1.50 into plant and equipment and $2.00 into IT. Bigger middle market companies expect to invest more aggressively across the board.

Companies Planning to Increase or Accelerate Capital Spending as a Result of Tax Law Changes



*NCMM and the Milken Institute, *Access to Capital: How Small and Mid-Sized Businesses Are Funding Their Futures*, 2015

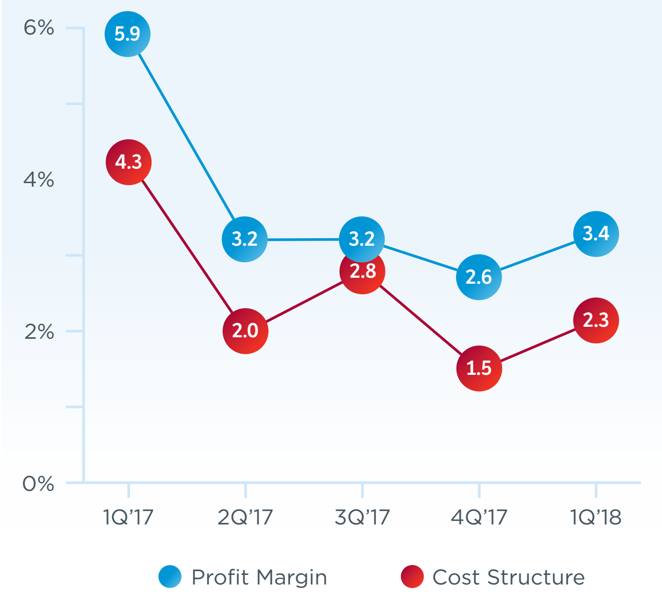
Profit Margins & Cost Structure

Profit margins and costs will increase

Over the next 12 months, middle market leaders expect to see an increase in profit margins of 3.4%. This number fell at the end of 2017, but it currently matches the predictions made at the end of 2016. To help fuel these gains, 45% of companies say they will increase the prices of their products and services. Just 5% of businesses expect to lower prices over the next 12 months.

Throughout 2017, expectations for increases in cost structure fluctuated. At the end of the year, leaders were predicting a 1.5% increase in costs for 2018. With the first quarter of the new year under their belts, companies have upped that number, saying that costs will increase by 2.3% over the next 12 months. The cost of healthcare continues to be a greater concern for companies than the cost of energy, and four out of five companies indicate that healthcare costs will have an impact on their businesses going forward.

PAST 12 MONTHS



Perspectives

Testing Limits

Average annual revenue growth for middle market companies has risen four quarters in a row—reaching 8.4% in this report. That's more than two and a half points higher than the Middle Market Indicator's historical average. On its face, growth that fast appears to be unsustainable over time: A company that grows at 8.4% a year doubles in size in fewer than nine years. Yet the expansion experienced by the middle market is echoed by growth in the broader economy.

The data in this MMI were collected in the first two weeks of March 2018, so the annualized numbers executives report is for the period that began in March 2017. Public-company data during that period tell a similar growth story for the last year, if not quite such a powerful one. The NASDAQ Index rose from 4861 to 7560, a 29% increase. The Dow rose just a little less. The S&P index increased 17% and revenues of S&P component companies increased 7.4%. While the middle market led the way, it doesn't seem to have been sprinting ahead unconnected to the rest of the economy. Moreover, as we noted last quarter, just about every company has been participating in the middle market's growth. In the first quarter a record high 72% of middle market leaders said their company's performance improved in the last year, while only 3%—a record low—said it deteriorated. That is a 24:1 ratio of winners to losers.

Whether this is sustainable growth or the final acceleration of an expansion that is about to slow, middle market companies continue to play the role we've seen and documented for seven years: turning in the strongest performance and providing the fastest job creation in the American economy.

Looking Confident

Given the excellent results of the middle market across the board, it is not surprising that executives express high confidence in the state of the economy. The data on page 4 show the sum of the top three boxes on a seven-point scale: extremely confident, very confident, or somewhat confident.

A more complex story emerges if we look at only the top two boxes, which include executives who say they are "extremely" or "very" confident about economic conditions.

+ The global number drops quite a lot, to 29%. And there are regional differences, with companies in the West and Northeast more confident about the world economy than companies in the Midwest or South.

+ High confidence in the national economy comes in at 50%. Again, the West is most bullish, with 55% of companies saying they are extremely or very confident.

+ Local conditions vary most. Overall, 53% of middle market companies are extremely or very confident about local conditions. But in the South, local confidence comes in at 57%; in the Midwest, 55%; the West, 53%; and the Northeast, just 42%.

Company size also plays a role in executive confidence. Across the board, leaders of larger middle market companies (with revenues between $100 million and $1 billion) are more confident than their smaller kindred; for example, 57% of upper middle market companies are extremely or very confident about the U.S. economy, vs. 48% of the core middle market ($50-$100 million in sales) and 46% of those with revenues between $10 million and $50 million.

The most striking difference by industry is the ebullience of people in wholesale trade, 60% of whom express high confidence in the U.S. economy. (We should note that the wholesale trade sample size is small and therefore prone to volatility: Three months ago, 42% of wholesalers were similarly confident.) It's notable that local-economy confidence is high among construction and business and financial services, which arguably have more intimate knowledge of demand in their region than, say, manufacturers. Retailers fall into the middle of the range.

Going Boldly

Confidence is both the begetter and the progeny of growth investments. Given an extra dollar of revenue, the typical middle market company would bank 14 cents as a cushion and put 86 cents to work immediately or soon. For very or highly confident companies, 91 cents would go to work. Those confident executives would put 28 cents into new capital spending (vs. 23 cents for the typical company) and 12 cents into new hiring (vs. a dime).

Interestingly, confidence doesn't seem to affect IT spending. The highly confident would put 18 cents of that extra dollar into more information technology, a penny less than the middle market as a whole. Tax treatment affects IT spending more—see Spotlight, page 6. It may be that a majority of companies still view IT primarily as a cost of operating or defending their business rather than as a tool for transformation and growth.

NATIONAL CENTER FOR
THE MIDDLE MARKET

The National Center for the Middle Market is the leading source of knowledge, leadership, and innovative research focused on the U.S. Middle Market economy. The Center provides critical data, analysis, insights, and perspectives to help accelerate growth, increase competitiveness, and create jobs for companies, policymakers, and other key stakeholders in this sector. Stay connected to the Center by contacting middlemarketcenter@fisher.osu.edu.

THE OHIO STATE UNIVERSITY
FISHER COLLEGE OF BUSINESS

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SUNTRUST

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Grant Thornton

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NATIONAL CENTER FOR
THE MIDDLE MARKET

2Q | 2018

MIDDLE MARKET INDICATOR

Strong Performance; Mounting Concerns

IN COLLABORATION WITH

The Ohio State University
Fisher College of Business
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Cisco

Executive Summary

Business conditions in the middle market remain decidedly positive. A solid majority (72%) of companies continue to say their overall performance is stronger today than it was one year ago. Middle market leaders are predicting a strong third quarter and they expect to continue growing at a healthy clip for the next 12 months. While the rate of revenue growth has slowed somewhat from last quarter, middle market businesses continue to add jobs at an aggressive pace. Even in industries where revenue has increased least (wholesale and retail trade), hiring remains strong. Nearly half (46%) of all middle market companies expect to increase the size of their workforce in the 12 months ahead.

Companies will not achieve growth without surmounting challenges, of course. Talent issues continue to be a top concern as companies look for more people in a tightening labor market. Leaders are paying more attention to costs as well, particularly the costs of healthcare, wages, and energy. Apprehensions over tariffs and other costs associated with doing business abroad have risen considerably, especially among wholesale trade and manufacturing leaders, pushing costs nearer to the top of executives' list of concerns. The tariff issue may account for the decrease seen this quarter in executives' confidence in the global economy. Overall, however, the vast majority of middle market leaders remain positive about economic conditions at home and around the world.

Mounting concerns do not appear to be cooling leaders' expectations for growth, especially in the short term. For 43% of businesses, the new order pipeline is stronger today than it was one year ago. The Short Term Middle Market Index is up, too, indicating that leaders expect sales, demand, and overall business conditions to be favorable in the third quarter. Expectations for continued future growth are likely driving executives' increased willingness to invest in their businesses, to continue innovating new products and services, and to expand into new markets. Upper middle market businesses in particular have strong expansion plans for the 12 months ahead, which include investing in new plants and facilities and opening new international markets for about a third of the largest middle market firms.

Nearly every industry is performing well, with construction companies boasting the fastest rates of both revenue and employment growth. Manufacturing businesses show increases in the rate of growth in both areas as well. Retail and wholesale trade are the only two segments showing marked decreases in the rate of revenue growth. From a size perspective, upper and core middle market companies have performed the best, but lower and emerging middle market businesses show signs of catching up with their larger peers.

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Revenue Growth

Revenue growth slows

The rate of year-over-year revenue growth reported by middle market companies dipped for the first time since mid 2017. However, at 7.4%, the growth rate remains strong and well above both the average revenue growth rate recorded by the MMI (6.8%) and the growth rate reported by companies surveyed one year ago (6.7%). Upper middle market firms and businesses operating in the wholesale and retail industries report the sharpest declines in the rate of growth while companies in the manufacturing, healthcare, and services industries continue to experience increased growth.

Projections for future revenue growth remain strong and on par with last quarter's predictions, with 62% of companies anticipating increases in revenue over the next 12 months. While core and upper middle market businesses grew the fastest over the past year, it is the lower middle market firms that are most optimistic about the year ahead. This group says it will grow at an average rate of 6.5%.

2Q'18 **75%** of middle market companies reported positive revenue growth. 2Q'17 72%

MIDDLE MARKET

	PAST 12 MO.	NEXT 12 MO.
2Q'18	7.4%	6.7%
1Q'18	8.4%	5.9%
2Q'17	6.7%	5.3%

S&P 500

	PAST 12 MO.
2Q'18	8.25%*
1Q'18	7.4%
2Q'17	4.8%

Employment Growth

Companies continue to staff up

Following a significant bump last quarter, the rate of year-over-over employment growth is up again. Nearly six out of 10 companies (57%) say their workforce is larger today than it was one year ago, and companies say they've grown their headcount by 6.7% since mid-2017. Employment growth continues to remain the strongest for upper middle market businesses; however, companies in the lower middle market have made significant increases in the size of their workforce since the close of 2017. Construction, retail trade, financial services, and manufacturing businesses have staffed up most notably over the past 12 months.

Companies don't anticipate a hiring slowdown anytime soon. Over the next 12 months, they anticipate an increase in work force of 4.8%, up slightly from expectations last quarter. Close to half (46%) of middle market businesses say they will build the size of their staff in the year ahead, and 41% say they will make additional hires over the next three months. Upper middle market businesses are estimating the most aggressive hiring.

2Q'18 **46%** of middle market companies expect to add jobs. 2Q'17 42%

MIDDLE MARKET

	PAST 12 MO.	NEXT 12 MO.
2Q'18	6.7%	4.8%
1Q'18	6.3%	4.6%
2Q'17	5.7%	4.7%

ADP *(Past 12 Mo.)*

	LARGE CORP.	SMALL BUS.
2Q'18	2.9%	1.0%
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2Q'17	2.5%	1.3%

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

Economic Confidence

Confidence eases back

Confidence among middle market executives remains extremely high and well above the averages recorded by the MMI over the past six and half years. However, confidence has fallen from the record high recorded last quarter. This is particularly true of confidence in the global economy. The percentage of executives expressing positive sentiments about global economic conditions fell from 82% to 75% this quarter.

The global confidence rate is still above its mark from one year ago. Additionally, the vast majority of leaders continue to remain very positive about local and national conditions, and these rates, too, are both marginally higher than the 2Q 2017 numbers.

2Q'18

	GLOBAL ECONOMY	NATIONAL ECONOMY	LOCAL ECONOMY
2Q'18 CONFIDENT / SOMEWHAT CONFIDENT	75%	86%	90%
1Q'18	82%	87%	94%
2Q'17	70%	84%	87%

Short Term Index

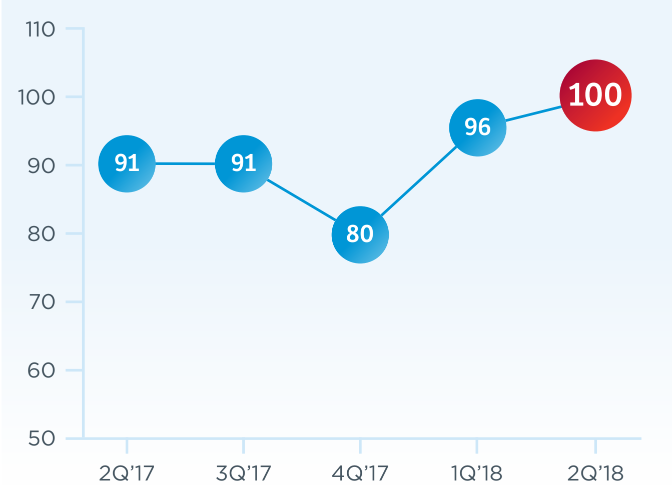
The outlook continues to improve

For the second straight quarter, the Short Term Middle Market Index is up, rising from 96 to 100, which represents a 20 point improvement since the close of 2017. The Short Term Middle Market Index provides insight into executives' expectations for the three months ahead in terms of sales, demand, and business climate.

For the third quarter of 2018, 55% of middle market companies believe their sales will increase compared to last quarter. This percentage has been on the rise since the end of 2017 and represents the highest percentage recorded for this metric since the Center began tracking the Short Term Index in 2015. Compared to last quarter, slightly more leaders expect increased demand and a more favorable business climate in the short term as well. But the majority of executives believe demand and climate will remain largely unchanged over the next three months.

While the Short Term Index as a whole is up, it is interesting to note that the proportions of companies expecting decreases in demand, decreases in sales, and less favorable conditions are each up as well, though only marginally so.

PAST 12 MONTHS



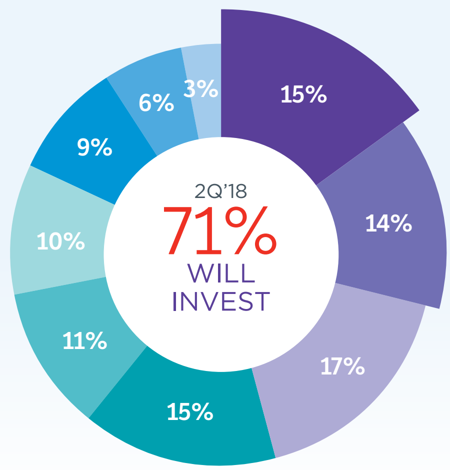
Short Term Index is calculated by taking expected net positive change in business climate plus expected net positive change in demand plus expected net positive change in sales over the next 3 months.

Capital Investment

Companies are investing in the future

At 71%, the proportion of companies willing to invest an extra dollar as opposed to save it is at an all-time high. For the second straight quarter, information technology is the most popular area for these investments, and planned expenditures on plants and equipment is a close second. Indeed, a third of upper middle market firms have plans to add a new plant or facility over the next 12 months. Among those businesses that prefer to hold onto cash, about half indicate they are saving for future financial investments. Lower or emerging middle market companies are by far the most inclined to hold cash in reserve.

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

Cost concerns are on the rise

While talent management and core business issues, such as maintaining growth and managing capital, remain top concerns for companies in both the short and long term, apprehensions related to costs are beginning to rise. Half of middle market companies indicate that their costs have increased in the past 12 months. Internally, executives worry over the costs of talent and healthcare. Externally, they are particularly focused on the impact of tariffs and costs associated with imports and exports.

Since last quarter, concern over the tariff issue has jumped by six percentage points, pushing costs to the number two spot on executives' list of long-term external challenges, surpassing worries related to competition and the government. In response to increasing costs and cost concerns, many middle market companies are focusing on accelerating topline sales and driving cost efficiencies through improved processes and upgraded equipment.

SHORT TERM CHALLENGES *(Next 3 months)*

INTERNAL CHALLENGES	
1. BUSINESS	**72%**
2. TALENT MANAGEMENT	**63%**
3. COSTS	**29%**
EXTERNAL CHALLENGES	
1. BUSINESS	**46%**
2. COMPETITION	**25%**
3. COSTS	**25%**
4. GOVERNMENT	**21%**
5. ECONOMY	**9%**

LONG TERM CHALLENGES *(Next 12 months)*

INTERNAL CHALLENGES	
1. TALENT MANAGEMENT	**54%**
2. BUSINESS	**50%**
3. COSTS	**26%**
EXTERNAL CHALLENGES	
1. BUSINESS	**37%**
2. COSTS	**26%**
3. GOVERNMENT	**20%**
4. COMPETITION	**19%**
5. ECONOMY	**10%**

Spotlight
Change at the Top

In the last three years, 30% of middle market companies experienced some kind of major transition. An almost equal number, 28%, expect a major change in the next three years. Just under half of those were a change at the top—a new CEO. For the others, a major transition came in the form of an acquisition big enough to be transformative or the sale of all or a significant part of the shop.

These data come from a set of business-transition questions included in this quarter's Middle Market Indicator survey. Overall, the data show middle market companies trying to seize the benefits of change without letting go of the value of continuity. For example:

+ Normal transition due to age or retirement is the biggest reason for a CEO's departure, ranked No. 1 by 32%; but a nearly equal number, 31%, say a CEO change was provoked by a scale-up (17%) or a "need to change leadership" (14%)
+ "Maintaining the continuity of business operations" during a transition is the top concern of executives, cited by 49%; but the second-biggest, at 44%, is "taking the company to the next level of performance."

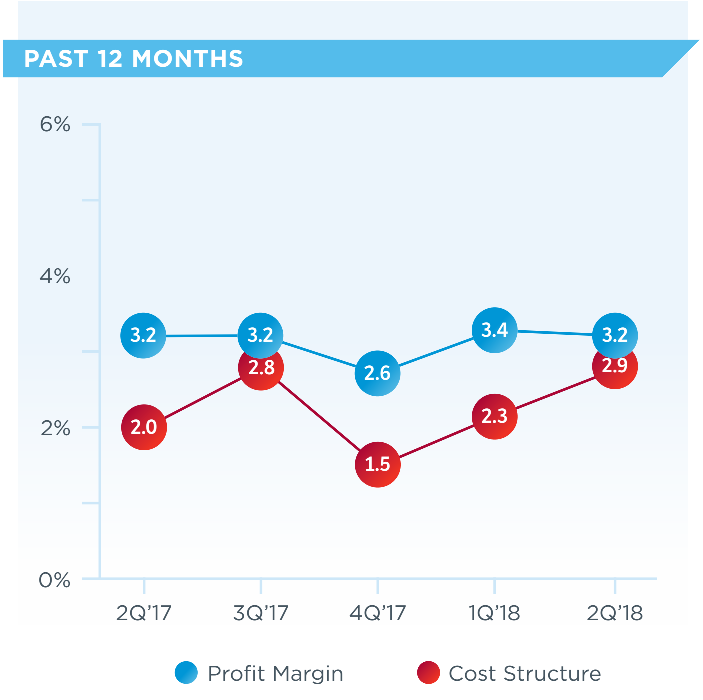
Major transitions come most often to publicly traded companies—41% in the last three years. Within that group, 62% switched CEOs, which is substantially higher than the percentage for any other type of company. Private-equity-owned companies come next. Sole proprietorships, partnerships, and family firms are much less likely to replace CEOs.

Companies younger than 15 years are only 75% as likely to undergo a major transition than older ones. Beyond 15 years of age, the rate of change flattens out.

Profit Margins & Cost Structure
Costs will climb but profit margins will hold steady

Middle market companies expect their cost structures to increase by 2.9% over the next 12 months. This percentage has been rising since the end of 2017 and is now at the second highest level recorded by the MMI. Healthcare costs drive this number; however, an increasing proportion of firms are saying energy costs will also have an impact on company performance in the year ahead.

As a result, nearly half (49%) of middle market businesses intend to raise their prices over the next 12 months. This represents an increase of seven points compared to companies that indicated the same one year ago. These increases will help companies maintain their profit margins despite rising costs. Companies believe profit margins will grow by 3.2% over the next 12-month period.



Perspectives

The Short and the Long of It

Business is excellent for most companies in the middle market, but amid the resounding boom of the present can also be heard an ominous rumble of thunder.

Before getting to the thunder—or before it gets to us—we should look at how well middle market companies are performing. Annualized revenue growth rates have been 7% or higher four quarters in a row—something we have not seen since the MMI began in 2012. Projected revenue growth for the year ahead is running just under its historical high (apart from an anomalous spike in the first quarter of 2017). Seventy-two percent of companies report improved overall year-on-year performance, which ties the record set three months ago. In the background, meanwhile, the U.S. economy as a whole has expanded for eight years and 11 months, only 13 months shy of the longest expansion in its history.

For now, middle market executives are reporting strong sales order activity. Forty-three percent say their new order pipeline has increased since a year ago, and among those companies the average increase in orders is 12.3%. Both are the highest numbers ever recorded. The NCMM's short-term index stands at 100, the highest since that standout first quarter of 2017. The index combines positive and negative opinions about three things: the business climate, overall demand for the products or services a company sells, and how much of that demand executives think their company will book as sales. Of those three elements, sales (the most concrete) is up the most, followed by demand; business climate (the most subjective) is more or less unchanged.

And therein—in subjective sentiments—lies the rub. The MMI measures executives' confidence in global, national, and local economic conditions. All three declined this quarter, with confidence in the global economy dropping most. At 75% (global), 86% (U.S), and 90% (local), all remain higher than they were a year ago, and one quarter's decline doesn't necessarily constitute a turning point. But a dip in confidence is of more than psychological importance: New and related research from the Center, derived from analysis of five years of MMI data, shows that economic confidence accounts for more than 30% of overall company growth.[1]

It is not hard to find a cause for the anxiety: Ten percent of middle market executives are concerned about the cost implications of tariffs. That is five times the average of the previous three years.

The sentiments reported in this MMI were gathered during the first two weeks of June 2018, at the beginning of what it appears will be a U.S-instigated global trade war. Just before the survey went out, the U.S. imposed tariffs on steel and aluminum from Canada, Mexico, and the EU; they reciprocated with tariffs on baskets of U.S. goods. A month later, in early July, the U.S. hit China with $34 billion in tariffs, which struck back in retaliation.

Not surprisingly, wholesalers are most anxious about trade conflict, since they will have to deal with tariffs on both exports and imports—33% of wholesalers worry about the impact of tariffs. Manufacturers come next: Twelve percent are concerned. Manufacturers, too, might be taxed both coming (raw materials and components) and going (intermediate or finished goods). The cost of raw materials is an issue as well: Twice as many executives cite raw material costs as a major issue as did a year ago. Those, too, may be affected by trade policy.

We have noted before that the middle market is primarily domestic, but that internationally-minded middle market companies outperform their peers,[2] which means that their fate in a trade war will disproportionately affect the overall growth of the middle market. It is worth adding that globally-minded mid-sized companies are much less likely than big firms to have production facilities abroad, which makes them less able than large multinationals to skirt trade barriers by relocating operations from one country to another.

Overall, 26% of executives listed a cost issue among their three biggest long-term challenges, which is a big jump from the 17% who cited costs a year ago. The biggest driver is wages and benefits, as companies offer better packages to attract and keep employees in what has become a seller's market for talent.

And how are they going to cope with cost increases? Far and away the most popular plan among executives is to sell more products and services—which means they'd better hope the economy stays strong.

[1] NCMM, *The DNA of Middle Market Growth*, 2018
[2] NCMM and The Brookings Institution, *Accelerating Exports in the Middle Market*, 2014

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NATIONAL CENTER FOR
THE MIDDLE MARKET

3Q | 2018

MIDDLE MARKET INDICATOR

Strong Growth Continues
Cost Concerns Mount

IN COLLABORATION WITH

The Ohio State University
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Executive Summary

Performance, growth, confidence, and investment appetites remain strong in the middle market, but company leaders have pulled back some on their expectations for the future. Growth in the middle market may be stabilizing, albeit at rates that are considerably higher than the historical average. Executives' perceptions of performance remain near all-time highs: 71% say their company's overall performance today has improved compared to one year ago, while a nominal 5% say performance has deteriorated. The rate of revenue growth, which has fluctuated this year, currently sits at the second highest level recorded by the Middle Market Indicator. Employment growth remains steady and strong.

All industries report increases in the rate of revenue growth, with the exceptions of retail and construction, which continued to grow, but at a slower rate than they reported three months ago. Both of these industries reported increases in the rate of employment growth last quarter and could now be returning to the mean. The services industry reports the most notable gains in year-over-year revenue and employment this quarter while growth in manufacturing, healthcare, and financial services appears stable overall.

Nevertheless, expectations for future growth are somewhat diminished from the second quarter. The Short Term Middle Market Index is down for the first time in 2018. While most leaders expect the business climate (one element of the short-term index) to remain unchanged, fewer than half predict increases in demand or sales in the next three months—the two other components of the index.

The longer term perspective is better. Over the next 12 months, 48% of companies expect to add a new product or service and 41% say they will expand into new domestic markets—both strong numbers. Additionally, most companies anticipate growing revenues over the next 12 months, but at a slightly slower rate than they were calling for earlier in the year. Two out of five expect to have a larger workforce a year from now, but as with revenue, they expect to add employees at a slightly slower rate.

Despite near record-high confidence levels in the global, national, and local economies and a sustained willingness to invest, some leaders are voicing concern related to government issues, the political environment, and the current administration's policies, especially related to tariffs. Talent management issues continue to be a major concern for middle market leaders as companies continue to explore the best ways to find and keep qualified talent in a tight labor market.

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
Revenue growth rebounds

After falling by one full point last quarter, the rate of year-over-year revenue growth for middle market companies has surged back to 8.6%, the second highest rate of revenue growth recorded by the MMI. And this growth is widespread, with more than three-quarters (77%) of companies reporting gains. With the exception of construction and retail trade, all industries report increases in the rate of revenue growth. Upper middle market companies, which largely drove the dip seen last quarter, made a strong rebound, posting a year-over-year growth rate of 11%, up from 7.7% in 2Q.

Three out of five middle market companies say they will continue to experience revenue growth over the next 12 months. Companies expect to grow revenue at a rate of 5.3%. While this growth forecast is slightly below predictions made in the previous two quarters, it remains a healthy long-term number. The upper middle market is most optimistic about the year ahead while core firms appear the most cautious.

3Q'18 **77%** of middle market companies reported positive revenue growth. 3Q'17 **70%**

MIDDLE MARKET	PAST 12 MO.	NEXT 12 MO.
3Q'18	8.6%	5.3%
2Q'18	7.4%	5.9%
3Q'17	7.0%	6.0%

S&P 500	PAST 12 MO.
3Q'18	8.02%*
2Q'18	8.25%
3Q'17	4.4%

Employment Growth
Hiring stabilizes at a high level

While 57% of middle market companies continue to report increases in year-over-year employment, the rate of growth (currently 6.4%) has tapered slightly since 2Q. Prior to this quarter's decline, the employment growth rate increased steadily since the end of 2017. It now appears to be stabilizing, but at a rate well above the historical average of 4.2%. As with revenue growth, employment growth is increasing most rapidly among upper middle market firms. Companies in the service industry post the most notable increases in the rate of employment growth over the past 12 months.

Most firms (79%) continue to believe their workforces are correctly sized for current market conditions; however, 17% of companies say they are insufficiently staffed. Compared to the last two quarters, slightly fewer firms say they have plans to hire in the short term and over the next 12 months. The 40% of companies that do plan to add staff expect to do so at a rate of 4.6%, a prediction that has remained stable throughout 2018. Upper middle market firms expect the greatest gains in employment.

3Q'18 **40%** of middle market companies expect to add jobs. 3Q'17 **42%**

MIDDLE MARKET	PAST 12 MO.	NEXT 12 MO.
3Q'18	6.4%	4.6%
2Q'18	6.7%	4.8%
3Q'17	6.4%	4.7%

ADP *(Past 12 Mo.)*	LARGE CORP.	SMALL BUS.
3Q'18	2.6%	1.2%
2Q'18	2.9%	1.0%
3Q'17	2.8%	1.2%

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

Economic Confidence

Confidence boost

After dipping slightly in 2Q, the confidence levels of middle market leaders have returned to the high rates seen at the beginning of the year. Global confidence experienced the most notable decline last quarter, potentially due to tariff-related headlines. But the metric is now back up to 80%, hovering near its all-time high of 82% reported in 1Q.

Local and national confidence remain more stable, and nearly all middle market leaders continue to express positive perceptions of the state of the economy in the country and within the communities where they operate.

3Q'18

	GLOBAL ECONOMY	NATIONAL ECONOMY	LOCAL ECONOMY
3Q'18 – CONFIDENT / SOMEWHAT CONFIDENT	80%	88%	93%
2Q'18	75%	86%	90%
3Q'17	74%	83%	88%

Short Term Index

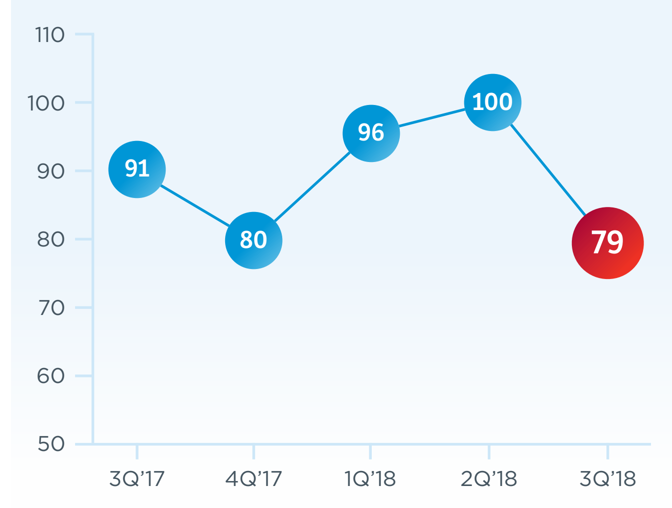
Short-term performance expectations fall

Despite solid predictions for the year ahead, middle market leaders express some concerns for the short term—defined as the next three months. Following a notable leap in 1Q and another slight bump last quarter, the Short Term Middle Market Index fell to 79% in 3Q.

The Short Term Middle Market Index gauges executives' expectations related to sales, demand, and business climate for the three months ahead. All three of these metrics tapered off this quarter. The most notable change is the proportion of companies expecting an increase in sales in the short term, which has dropped from 55% to 46%. Across the middle market, fewer than a quarter (22%) of leaders anticipate a more favorable business climate over the next three months.

It is important to note that middle market leaders do not necessarily expect decreases in demand or sales or a less favorable business climate going forward. Indeed, fewer than one in 10 leaders is calling for a drop in any of these metrics in the short term. The majority of leaders simply expect business conditions to hold steady for the time being.

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 remain high

The proportion of companies that would invest an extra dollar, rather than put it aside, remains at the all-time high rate of 71% for the second straight quarter. Information technology and capital expenditures on plant and equipment remain the most popular areas for investment, especially for upper middle market companies. From a historical perceptive, the desire to hold more cash has diminished significantly since 2012. Lower middle market companies remain most likely to save cash for a rainy day. However, core middle market businesses are the least likely of all three groups to invest. One in five core middle market leaders is currently setting aside cash not as a cushion, but rather to fund a future investment.

ADDITIONAL INVESTMENT ALLOCATION

Key Challenges

Government concerns increase

Government-related concerns, which eased off over the past few quarters, re-emerged in 3Q as both a long and short term external challenge. A general uncertainty about government activity is one concern; the imposition of tariffs is a specific worry. (See Spotlight, p.6.) Company leaders continue to focus on core business issues, including reaching new prospects and growing the customer base, as well as on protecting their market share and staying ahead of the competition. Only about one in 10 executives voices economic concerns; but those that do mention the tariff issue as a potential threat to the economy.

From an internal perspective, talent management remains the most pressing challenge for the 12 months ahead. Even though the rate of hiring appears to be holding steady, leaders continue to worry over how to recruit, acquire, and retain the people they need to run their businesses as the labor market continues to tighten. For the next three months, leaders' greatest internal challenge will revolve around core business issues and maintaining healthy growth.

SHORT TERM CHALLENGES *(Next 3 months)*

INTERNAL CHALLENGES	
1. BUSINESS	67%
2. TALENT MANAGEMENT	59%
3. COSTS	29%
EXTERNAL CHALLENGES	
1. BUSINESS	43%
2. GOVERNMENT	27%
3. COSTS	21%
4. COMPETITION	20%
5. ECONOMY	11%

LONG TERM CHALLENGES *(Next 12 months)*

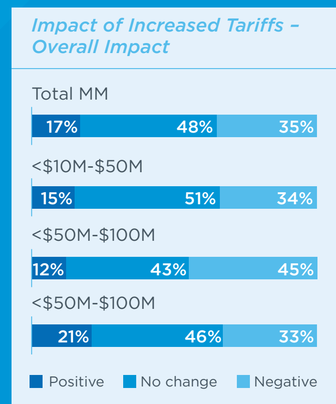
INTERNAL CHALLENGES	
1. TALENT MANAGEMENT	51%
2. BUSINESS	47%
3. COSTS	20%
EXTERNAL CHALLENGES	
1. BUSINESS	35%
2. GOVERNMENT	25%
3. COSTS	19%
4. COMPETITION	18%
5. ECONOMY	11%

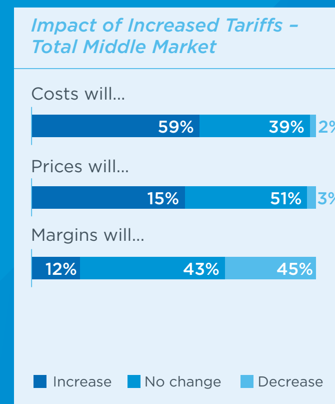
Spotlight

When will tariffs bite—and how hard?

Three months ago, the Middle Market Indicator documented a leap in concerns about the costs of trade—tariffs in particular—from data collected just after the U.S. taxed steel and aluminum imports from Canada, Mexico, and the EU. An escalating series of levies and counter-levies followed between June and early September, when we collected 3Q data. Since the survey date, the United States, Canada, and Mexico have shaken hands on a revised free-trade agreement, while the U.S. and China have shaken fists with tariff hikes on $260 billion worth of goods.

It takes about six months for tariffs to work their way from sales to shipments to shelves, according to Grant Thornton chief economist Diane Swonk, so their full effects won't be clear until well into 2019. By a two-to-one margin, middle market executives say tariffs will hurt their business. A third say profits will suffer, and more than half will raise prices. The worst affected companies are in the core middle market, with annual revenues between $50 and $100 million. These are companies big enough to participate in global markets, but in all likelihood not big enough to have overseas operations that might allow them to avoid tariffs by shifting production from one side of a border to another. (For a discussion of industry and other effects, see Perspectives, p.7.)



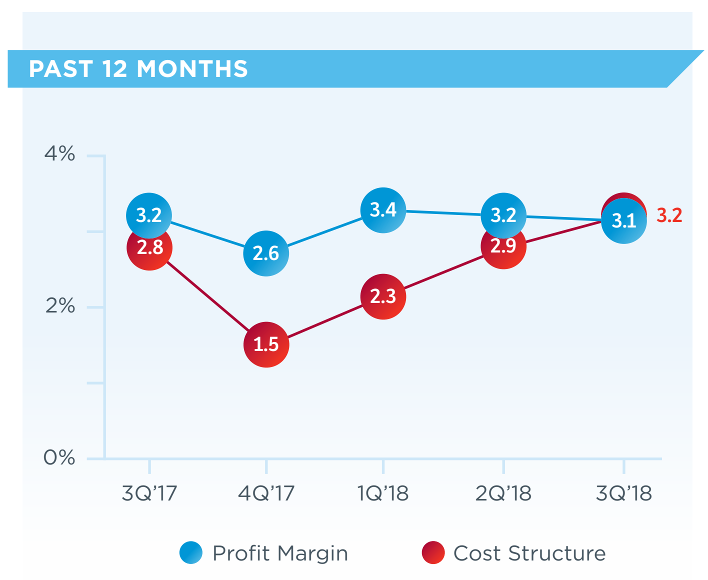


Profit Margins & Cost Structure

Costs could grow faster than margins

Since mid 2014, middle market leaders have consistently stated that profit margins will increase at a faster rate than cost structure. However, throughout 2018, expectations for cost structure increases have risen slowly but surely while expectations for the rate of profit margin increases have slowly tapered off.

This quarter, the lines flip. Leaders say costs will increase by 3.2% over the next 12 months and profit margin will lag behind slightly, growing at 3.1%. Nearly half (48%) of middle market leaders expect to raise prices over the next 12 months to help close this gap and offset the impact of healthcare, energy, and other costs for the business.



Perspectives

By every current measure, middle market business is good. Revenue is rocking, having risen 8.6% in the last year. Thirty-five percent of companies expanded into new domestic markets last year, and 41% expect to do so next year, reflecting their 88% level of confidence in the U.S. economy. Job growth is an impressive 6.4%, as the middle market continues to show that it deserves the most credit for the steadily falling U.S. unemployment rate.

There are devilish details, of course. Here are three of them:

Tariffs

Executives in all industries say tariffs will hurt their business (see Spotlight, p. 6), but some will suffer more than others. Protecting U.S. manufacturers is the ostensible purpose of border taxes, but more of them say they will be hurt than helped. Some subsectors, like steel, stand to benefit from protectionism, but more, like manufacturers that use steel, are likely to suffer. Majorities in many industries forecast rising costs: 89% among wholesalers, 62% of construction companies, the same percentage of manufacturers, and 56% of retailers. They will impose price increases in almost the exact same measure.

Costs aren't the only bite. Executives also predict substantial disruption of commercial relationships—in those four industries, between 42% and 50% will seek new suppliers or renegotiate terms. Among wholesalers, retailers, and manufacturers, similar percentages say they will pursue new customers or strike new terms. For some companies, these disruptions may be more significant than the costs themselves. Relationships ruptured may not all come back; for example, American soybean growers fear customers they have lost in China will be gone forever, as buyers find supplies in Brazil and elsewhere.

Government

Government is weighing on executive minds for reasons other than trade policy; in this quarter, 25% named government among their top challenges, not counting those who are concerned about trade. Uncertainty and the general sense of political disorder seem to be the culprit, as one executive told us, "The political environment is a major distraction that makes planning difficult."

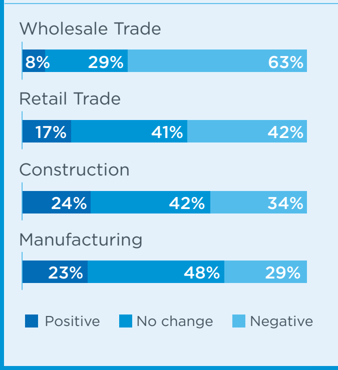
Costs

The number of executives who listed costs as a top challenge dropped last quarter from 26% to 19%, but is still up from 14% a year ago. In particular, health care costs are cited as a primary concern. Energy and interest costs are up. Full employment and increases in minimum wages by big companies might put pressure on labor costs. Indeed, 48% of executives say they will offer more pay to retain people—up from 38% at this time last year.

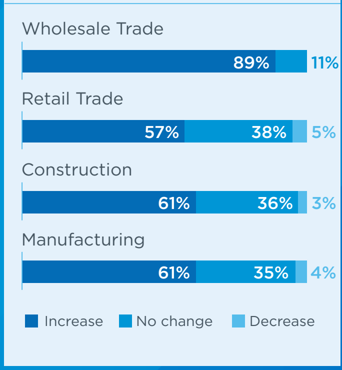
Of course, costs are just the subtrahend of the equation. The minuend is revenue, and the difference is profit. We have been doing that math for years. For the last year, the difference has been narrowing, and this quarter—for the first time in more than five years—executives say costs will go up more than margins.

Amid all this, however, middle market executives say that their biggest challenges are the core business issues of maintaining growth and beating competitors. And the numbers show that when it comes to meeting those challenges, they rock.

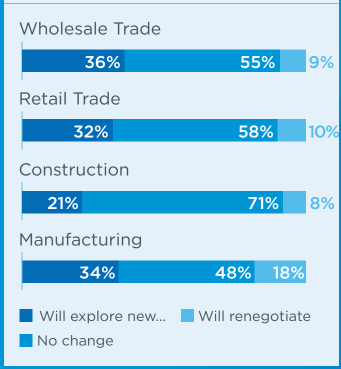
Impact of Increased Tariffs (By Industry) – Overall Impact



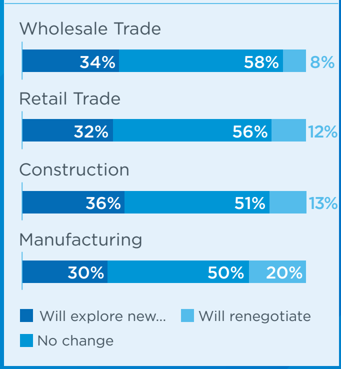
Impact of Increased Tariffs (By Industry) – Cost Will...



Impact of Increased Tariffs (By Industry) – Customer Base



Impact of Increased Tariffs (By Industry) – Supplier Base



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NATIONAL CENTER FOR
THE MIDDLE MARKET

4Q | 2018

MIDDLE MARKET INDICATOR

Growth Slows
Short-Term Expectations Decline

IN COLLABORATION WITH

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Executive Summary

For several years, U.S. middle market companies have been leading the relatively long period of economic expansion and both revenue and employment growth has consistently trended up. As the overall economy begins to slow down, these companies are not immune from or unaware of the changes around them. Indeed, to close out 2018, both revenue and employment growth rates have fallen notably from last quarter, especially in the services and financial services industries. Short-term expectations have diminished significantly, and confidence has slipped slightly.

Despite these negative trends, the proportion of middle market companies reporting improved year-over-year company performance is at an all-time high at 73%, with few businesses reporting deteriorating conditions. More companies than ever before in MMI history also report increases in revenue growth compared to one year ago. The outlook for continued revenue growth in 2019 also remains strong for the majority of businesses. With economic tailwinds slowing, middle market leaders may need to look inward at the factors within their control—such as market expansion, investment and innovation, talent management best practices, growth strategy, and cost controls and efficiencies—in order to attain the growth they anticipate.

This may be especially important over the first quarter of 2019. The number of executives who expect to see improvements in the overall business climate or in demand for their wares has fallen significantly in each of the last two quarters. Hopes for improved sales are unchanged from last quarter, but below what they were in the first half of 2018.

Muted short-term expectations aside, most companies (60%) project healthy revenue growth for the full year ahead. At 5.9%, these expectations are consistent with what they were earlier in the year. This growth will probably be driven by innovation and market expansion: 49% of middle market companies expect to introduce a new product or service this year and 43% report plans for expansion into a new domestic market. Most companies also remain willing to invest an additional dollar to fuel business growth.

The long-term outlook for employment growth is less rosy. Expectations for the rate of employment growth in 2019 have fallen from 4.6% to 3.8%. The lower hiring forecast may reflect a shortage of available talent, for middle market leaders continue to say talent management issues are a top concern as they look for ways to acquire and retain the best people to continue moving their businesses forward. Cost concerns appear to be rising, too, especially related to imports, exports, and tariffs. However, companies believe that their profit margins will remain unchanged in the year ahead.

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

More companies are growing, but at a slower rate

Nearly four out of five middle market companies (79%) report increases in revenue growth compared to one year ago, the highest percentage recorded by the MMI. However, the rate of growth has slowed to 7.9% from 8.6% last quarter. The decline is driven by upper middle market companies and by businesses in the services and financial services sectors. The retail trade and construction industries report notable increases in the rate of revenue growth this quarter, and manufacturing continues to report strong growth. Despite the overall drop, revenue growth is higher than one year ago and remains a full point above the MMI average revenue growth rate of 6.9%

Looking toward 2019, most companies (60%) expect revenue to continue growing. Indeed, the expected rate of future growth has risen from 5.3% last quarter to 5.9%. Upper middle market firms have somewhat lower expectations for the year ahead; these businesses anticipate a growth rate of 5.5% in 2019.

4Q'18 **79%** of middle market companies reported positive revenue growth. 4Q'17 **75%**

MIDDLE MARKET

	PAST 12 MO.	NEXT 12 MO.
4Q'18	7.9%	5.9%
3Q'18	8.6%	5.3%
4Q'17	7.6%	5.5%

S&P 500

	PAST 12 MO.
4Q'18	4.7%*
3Q'18	8.0%
4Q'17	6.9%

Employment Growth

Hiring slows

The proportion of firms reporting year-over-year employment growth (55%) has remained fairly consistent all year long. However, the rate of employment growth has declined for the second straight quarter, slowing considerably among middle market companies of all sizes from 6.4% in Q3 to 5.4% to end the year. Current employment growth rates are similar to those seen at both the close of 2017 and the close of 2016. While the data suggest that the rate of employment growth may have peaked for the time being, middle market companies are still hiring: Only one in 10 firms reports a decrease in headcount compared to last year.

Expectations for future employment growth have tapered off significantly. About 2 out of 5 firms (43%) say they will increase the size of their workforce in 2019, but at a much slower clip. Companies project 3.8% employment growth over the next 12 months, down a full point from the rate firms were anticipating just two quarters ago. The upper middle market intends to grow employment somewhat faster than its smaller peers. These larger companies project 5% employment growth for 2019.

4Q'18 **55%** of middle market companies expect to add jobs. 4Q'17 **52%**

MIDDLE MARKET

	PAST 12 MO.	NEXT 12 MO.
4Q'18	5.4%	3.8%
3Q'18	6.4%	4.6%
4Q'17	5.2%	3.4%

ADP *(Past 12 Mo.)*

	LARGE CORP.	SMALL BUS.
4Q'18	2.5%	1.1%
3Q'18	2.6%	1.2%
4Q'17	2.6%	1.4%

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

Economic Confidence

Local and global confidence ease back

As a group, middle market leaders remain decidedly confident about the economy at home and around the world. Throughout 2018, confidence in the national economy has consistently stayed above 85%. Local and global confidence have shown slightly more volatility this year and both are currently at their lowest levels for 2018.

Despite these dips, nearly nine out of 10 middle market leaders (89%) remain confident in the local economies where they do daily business. Global confidence has eased back most notably, falling to 73% from 80% last quarter. It now sits at the lowest level since mid 2017. However, all three metrics (local, national, and global confidence) remain well above the averages recorded by the MMI over the past seven years.

	GLOBAL ECONOMY	NATIONAL ECONOMY	LOCAL ECONOMY
4Q'18	73% CONFIDENT / SOMEWHAT CONFIDENT	86% CONFIDENT / SOMEWHAT CONFIDENT	89% CONFIDENT / SOMEWHAT CONFIDENT
3Q'18	80%	88%	93%
4Q'17	75%	86%	88%

Short Term Index

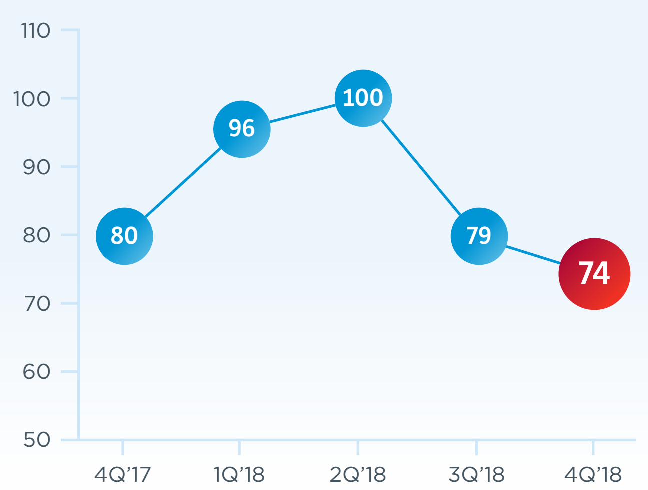
Short-term performance expectations continue to decline

The Short Term Middle Market index, which gauges middle market leaders' perceptions of the business climate and expectations for sales and demand for the next three months, is down for the second straight quarter. After a sharp decline from 100 in 2Q to 79 in 3Q, the index fell five more points to 74 to end the year. The index currently sits at the lowest level recorded since mid 2016.

Diminished expectations for demand drive the decline this quarter. Over the last three quarters, the percentage of companies expecting an increase in short-term demand has tapered off, falling from 42% in 2Q to 32% today. However, few leaders expect decreases in demand; most believe demand will hold steady for the next three months.

Projections for short-term sales and a more favorable business climate are also lower than they were mid-year. Less than half (46%) of leaders expect increases in sales over the next three months. Fewer than a quarter of companies (22%) say the business climate will improve in the first quarter of 2019. As with demand, only a handful of leaders expect declines in these areas; for the most part, leaders believe business will stay the course.

PAST 12 MONTHS



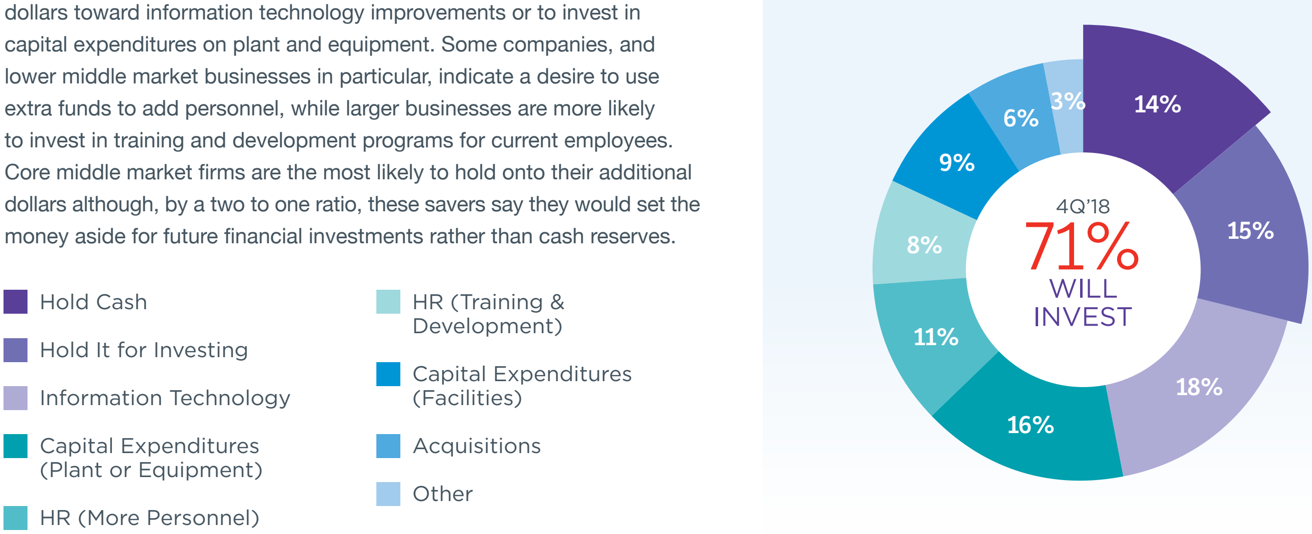
Short Term Index is calculated by taking expected net positive change in business climate plus expected net positive change in demand plus expected net positive change in sales over the next 3 months.

Capital Investment

Companies remain willing to invest

For the third straight quarter, 71% of middle market companies say they would invest an extra dollar rather than save it for a rainy day or future investments. These companies are most willing to put their dollars toward information technology improvements or to invest in capital expenditures on plant and equipment. Some companies, and lower middle market businesses in particular, indicate a desire to use extra funds to add personnel, while larger businesses are more likely to invest in training and development programs for current employees. Core middle market firms are the most likely to hold onto their additional dollars although, by a two to one ratio, these savers say they would set the money aside for future financial investments rather than cash reserves.

ADDITIONAL INVESTMENT ALLOCATION



Key Challenges

Talent issues and costs may be headwinds to growth

Long-term, middle market leaders are most concerned with maintaining growth. To that end, their talent management concerns continue to rise. (They have been increasing steadily over the past several years.) Executives worry about how to attract and retain the best people. Costs, both internal and external are weighing more heavily on leaders' minds than they were a few years ago. Companies are increasingly concerned about the cost of healthcare as well as costs associated with IT, tariffs, and higher interest rates. They appear to be somewhat less concerned with governmental issues, rules, and regulations apart from tariffs.

Indeed, over the next three months, costs associated with imports, exports, and tariffs are the primary cost-related concern as companies contend with how to maintain their growth, keep up with changing market conditions, and manage their capital. Short-term talent concerns are near their all-time high, with 62% of middle market leaders expressing some level of worry over how to find and keep the people they need to meet the current demands of the business.

SHORT TERM CHALLENGES *(Next 3 months)*

INTERNAL CHALLENGES	
1. BUSINESS	69%
2. TALENT MANAGEMENT	62%
3. COSTS	27%
EXTERNAL CHALLENGES	
1. BUSINESS	43%
2. GOVERNMENT	26%
3. COMPETITION	25%
4. COSTS	25%
5. ECONOMY	15%

LONG TERM CHALLENGES *(Next 12 months)*

INTERNAL CHALLENGES	
1. TALENT MANAGEMENT	54%
2. BUSINESS	45%
3. COSTS	23%
EXTERNAL CHALLENGES	
1. BUSINESS	39%
2. COMPETITION	22%
3. COSTS	22%
4. GOVERNMENT	18%
5. ECONOMY	13%

Spotlight
The Long Road to Digital Transformation

Give middle market executives extra money to invest, and they will direct more of it to information technology than anything else: 18¢ on the dollar—24¢ if the company falls in the core middle market with revenue between $50-100 million. An increasing portion of the IT budget is going into cybersecurity, now the number-one technology priority for the middle market. But a rapidly growing portion is going toward the transformation of business by digitalization.

Transformation is more than automation; it implies moving digital from a support function to the front line of what companies offer, how they produce it, how they market, sell, and distribute it, and how they manage the business; it has profound implications for strategy, talent, and productivity.

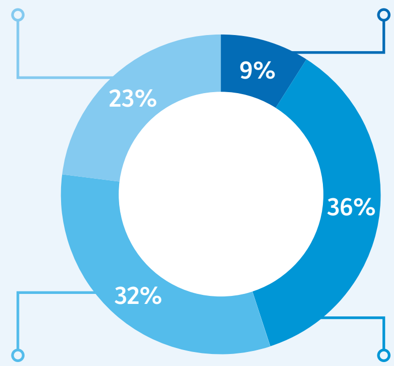
More than half—54%—of middle market companies say digital transformation is extremely or very important. In the financial and business services industries, the number approaches two-thirds. Laggards that “are using digitization to improve the company, but not to transform how we do business” account for about a quarter of the middle market. They are mostly smaller firms.

Fewer than 10% claim to be leaders. But those companies grew 10.2% in the last 12 months, nearly four full percentage points faster than the laggards. (See chart.)

Digital Transformation

LAGGING
Using digitalization to improve the company, but not to transform the business—
2018 growth 6.3%

STRATEGIC
A cornerstone of strategy; among the leaders in competitor set—
2018 growth 10.2%



DEFENSIVE
Keeping up with established best practice—
2018 growth 6.7%

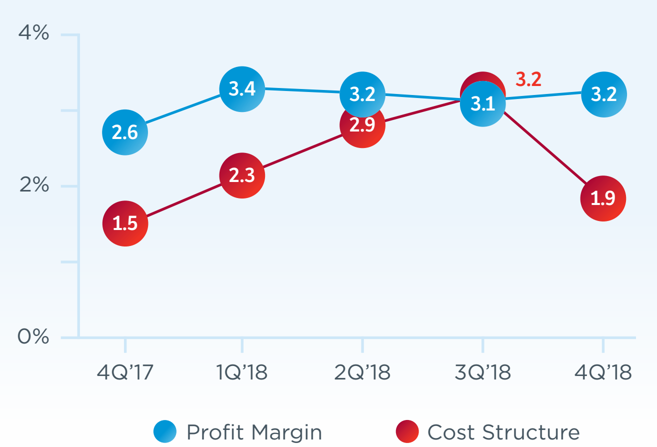
ADVANCED
Actively transforming important parts of operations & customer interaction—
2018 growth 9.3%

Profit Margins & Cost Structure
Profit margins will hold steady

Throughout 2018, middle market leaders have reported increases in their companies’ cost structure. Despite growing cost concerns, in Q4, the expected percentage of that increase fell from 3.2% to 1.9%. About half of middle market companies (47%) continue to say they will raise prices over the next 12 months, which may help to offset any expected cost increases. Additionally, most middle market leaders say their companies do well at containing costs through operational efficiency. The projected slowdown in the rate of employment growth may also help companies keep costs under control.

Expectations for profit margins held steady throughout 2018, and leaders continue to call for a profit margin of 3.2% in 2019. Overall, a slight majority (52%) of leaders say their businesses are very adept at maintaining margins.

PAST 12 MONTHS



Perspectives

What They Say, What They Do

Middle market companies have closed the books on a very satisfying 2018. But they face 2019 with ambivalence. On the one hand, confidence has slipped; challenges appear more diverse and more daunting; their short-term outlook has darkened. On the other, their appetite—the money they intend to invest in innovation, opening new markets, and building new facilities—continues to be robust. If they are seeing warning signals, they appear not to be slowing down.

Seventy-three percent of companies said their performance improved. This is the highest percentage ever recorded by the MMI. Just 5% said business deteriorated, making for a nearly 15:1 ratio of winners to losers. This despite slowly increasing headwinds from tariffs, rising interest rates, labor shortages and higher labor costs, lower growth in China, and a bad year in public equity markets. (The Russell 2000 index peaked at 1741 on August 31 and closed the year at 1349. During the two weeks that this quarter's data were collected—December 1-15—the index fell from 1549 to 1411.)

The vast majority of middle market companies are privately held, but executive jitters show up in this MMI in the form of dips in confidence and, particularly, the Short-Term Index, which dropped from 100 to 74 in the second half of the year. (See p. 4.) The Index looks at forecasts for the business climate, demand, and sales for the next three months. For each, it subtracts negative sentiment ("sales will fall") from positive ("sales will rise"). Interestingly, almost all the drop in the Index is due to declining positive sentiment. The negatives are virtually unchanged. As of now, executives don't see things getting worse; but fewer think things are getting better.

It thus makes sense that forward-looking activity hasn't changed, even though forward-looking sentiment has. Compared to a year ago, a middle market company's likelihood of introducing a new product, expanding into new domestic markets, or adding a new plant or facility is unchanged; investment appetite is slightly higher, as is the likelihood of international expansion; overall capital spending is up a bit and access to capital is unchanged. IT spending increased substantially as companies focus on cybersecurity and digital transformation. (See Spotlight, p. 6.) Forecasted hiring is the only downer—and that could be because fewer people are unemployed.

Uncertainty

A witty Danish proverb says that predictions are difficult, especially about the future. Clearly there is more risk in 2019's environment than in the last few years, and therefore more reason to manage and hedge against risk. There is also more uncertainty—that is (as the economist John Maynard Keynes said), matters for which no calculation of risk can be made, about which "we simply do not know," and about which we must nevertheless plan and act. For Keynes, the great defense against uncertainty was liquidity—money held in reserve.

We might expand his view to include agility—human capital that can be deployed in new ways, resilient and reconfigurable supply chains, the strategic nimbleness to dodge a punch or exploit an opening. In *The DNA of Middle Market Growth*,* we analyzed five years of MMI data and identified seven growth drivers that are under management's control and largely independent of economic factors. This quarter our respondents told us they are by far most confident of their abilities in one of them: 63% say they are excellent or very good at financial management. But just 41% rate themselves that highly when it comes to developing people. (The other growth drivers—innovation and investment, expansion, attracting talent, and cost efficiencies—cluster in the middle.) A good New Year's resolution might be to strengthen both liquidity and agility, and improve the capabilities that support all seven growth drivers.

**NCMM, The DNA of Middle Market Growth, 2018*

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