



NATIONAL CENTER FOR
THE MIDDLE MARKET

2Q 2016

MIDDLE MARKET INDICATOR

GROWTH REBOUNDS; OUTLOOK REMAINS BRIGHT

IN COLLABORATION WITH



THE OHIO STATE UNIVERSITY
FISHER COLLEGE OF BUSINESS



Grant Thornton



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.

ABOUT THE NATIONAL CENTER FOR THE MIDDLE MARKET

The National Center for the Middle Market is a collaboration between The Ohio State University's Fisher College of Business, SunTrust Banks Inc., Grant Thornton LLP, and Cisco Systems. It exists for a single purpose: to ensure that the vitality and robustness of middle market companies are fully realized as fundamental to our nation's economic outlook and prosperity. The Center is the leading source of knowledge, leadership, and innovative research on the middle market economy, providing critical data analysis, insights, and perspectives for companies, policymakers, and other key stakeholders, to help accelerate growth, increase competitiveness and create jobs in this sector. To learn more visit: www.middlemarketcenter.org.

U.S. MIDDLE MARKET DEFINED

ANNUAL REVENUE
RANGING FROM
\$10MM - \$1B



NEARLY
200,000
BUSINESSES

3RD
LARGEST
GLOBAL ECONOMY



United States \$17.97T



China \$11.38T



U.S. Middle Market \$5.9T*



Japan \$4.1T



Germany \$3.3T

Source: 2015 CIA World Fact Book (not adjusted for purchasing power parity),
*National Center for the Middle Market (estimate)

Executive Summary

For the second consecutive quarter, year-over-year revenue growth rates among middle market companies are up. Following suit, year-over-year employment growth rates increased for Q2 after remaining flat for the previous six months. The smallest middle market businesses have maintained the improvements reported last quarter while the largest companies are now showing signs of accelerating growth. Along with these performance improvements, middle market leaders report a healthier outlook for their businesses along with solid confidence in the economy as a whole. Although organizations continue to face staffing and growth challenges as well as election year uncertainty, middle market companies across all revenue segments appear poised to enjoy another period of robust growth.

Significantly more middle market businesses have seen improvements in their past year company performance this quarter than last. Nearly two-thirds of businesses (64%) say company performance improved over the past 12 months, compared to 58% of companies that reported the same last quarter. The largest middle market companies (with revenues between \$100 million and \$1 billion) show the most notable improvements in performance. On the other end of the revenue spectrum, the smallest middle market businesses (with revenues between \$10 million and \$50 million) have maintained the increases reported last quarter. Significantly more construction companies feel performance has improved, and performance has rebounded in the retail trade and healthcare industries, as well.

Looking at the income statement, nearly three-quarters (72%) of middle market firms say revenues increased over the past 12 months. Revenue growth averaged 7.2%, nearing the highs reported in late 2014 and early 2015. The current growth rate is well above the Middle Market Indicator historical average of 6.4%. Revenue growth is coming from both ends of the middle market size spectrum; with the largest middle market businesses reporting particularly strong increases in the rate of growth. To fuel the expansion, companies across the middle market are increasing sales, developing new product lines, and entering new markets. More than a quarter of companies have intensified their marketing efforts—a jump from what we saw last quarter.

At 4.4%, the rate of year-over-year employment growth increased for the first time in the past nine months. The current rate of growth exceeds the Middle Market Indicator's historical average of 3.2% and comes primarily from larger middle market businesses.

From an industry perspective, construction and retail trade report the greatest performance improvements. More businesses within these sectors are growing, and they are growing at a faster rate than reported three months ago. Construction businesses in particular are growing their revenues as well as the size of their workforces.

The short-term business outlook in the middle market improved noticeably last quarter and remains robust. While most companies continue to expect the business climate and demand to remain unchanged, fewer companies expect the situation to worsen. In fact, about two in 10 companies expect a more favorable business climate while fewer than one in 10 expect conditions to decline. A third anticipate an increase in demand and approximately four in 10 businesses expect to see an increase in sales in the short term. While middle market leaders see their revenues and payrolls increasing in the next three months, they do not currently appear worried about costs rising faster than they can manage them.

Expectations for 12-month revenue growth increased significantly last quarter and remain at those elevated levels today. Construction firms and service sector businesses especially anticipate a faster rate of growth in the year ahead. The vast majority of middle market companies continue to believe the workforce is appropriately sized. They forecast modest increases in employment in the next 12 months. Following cues from revenue growth, construction and service businesses anticipate the greatest hiring increases.

In addition to ongoing challenges related to staffing, competition, and regulations, middle market leaders express uncertainty over the upcoming U.S. presidential election and its impact on the business environment. Regulations and taxes remain key areas of concern.



REVENUE GROWTH

Revenue growth rates rebound

After two quarters in which revenue grew at about 6.1%, the growth rate climbed to 7.2% this quarter, mirroring the high levels of growth reported during the second half of 2014 and early 2015. More than seven in 10 companies report revenue growth gains since last year. Large middle market companies in particular report a rebound, with close to 80% experiencing revenue increases at a mean rate of 8.5%. From an industry perspective, construction shows the most notable revenue gains.

Revenue growth projections increased significantly in the first quarter of 2016, and those higher projections held steady this quarter as well. More than half of middle market companies across all revenue segments and industries expect revenue to increase in the year ahead. At 4.8%, the rate of anticipated growth is nearing levels reported one year ago after dropping significantly in Q3 2015.

2Q'16
72%

of middle market
companies reported
positive revenue growth.

2Q'15
66%

MIDDLE MARKET

PAST 12 MO.

2Q'16

7.2%

1Q'16 6.3% 2Q'15 6.6%

NEXT 12 MO.

2Q'16

4.8%

1Q'16 4.6% 2Q'15 5.1%

S&P 500

PAST 12 MO.

2Q'16

1.2%*

1Q'16 -3.4% 2Q'15 -1.8%



EMPLOYMENT GROWTH

Employment growth is strong

While the percentage of middle market companies adding to their workforces has remained stable over the past year, mean total year-over-year employment growth is up this quarter to 4.4% compared to the 3.6% reported for the previous two quarters. The largest middle market firms have done the most hiring, with an average employment increase of 5.9%. Construction and manufacturing companies appear to be staffing up as well.

Expectations for future employment growth have improved. Close to four in 10 (37%) middle market firms expect to hire in the next 12 months; the average projected payroll growth is 3.3%, up from 2.7% reported the last two quarters. The largest middle market organizations and businesses in the service sector and construction sector are making the strongest growth projections for the year ahead.

2Q'16
37%

of middle market
companies
expect to add jobs.

2Q'15
38%

MIDDLE MARKET

PAST 12 MO.

2Q'16

4.4%

1Q'16 3.6% 2Q'15 3.6%

NEXT 12 MO.

2Q'16

3.3%

1Q'16 2.7% 2Q'15 2.7%

ADP [PAST 12 MO.]

LARGE CORP.

2Q'16

2.3%

1Q'16 2.2% 2Q'15 1.7%

SMALL BUS.

2Q'16

1.9%

1Q'16 2.1% 2Q'15 2.7%



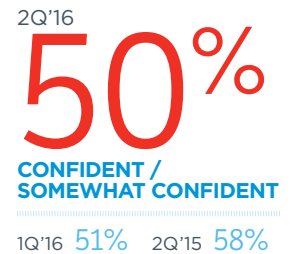
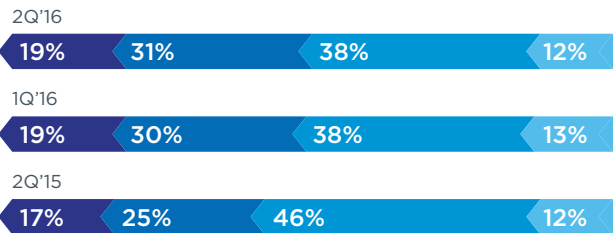
ECONOMIC CONFIDENCE

Confidence dips slightly

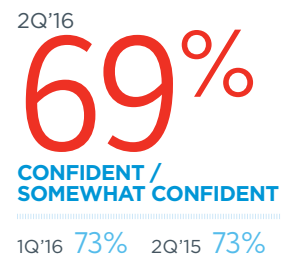
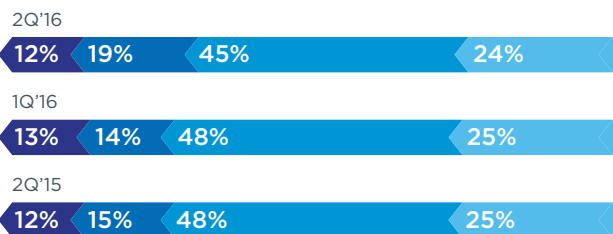
Since experiencing an uptick at the beginning of 2016, confidence in the national, state, and local economies remains relatively stable. However, the confidence levels may have peaked. As has been the trend, local confidence rates are the highest at 79% (compared to 81% last quarter). National confidence lags somewhat behind at 69% (versus 73% for Q1 2016). The global perspective continues to be the least bright, with just half of middle market leaders expressing a positive view of the global situation, down one percentage point from 51% last quarter. The UK's Brexit vote is likely to reduce that number further in the months ahead. (See Perspectives, p. 7.)

At the local and state levels, new business and employment growth and an increase in housing startups fuel confidence. For many middle market leaders, technological advancements coupled with strong worldwide demand for products and services paint a positive picture for the global economy. However, global unrest, uncertainty over the upcoming U.S. presidential election, and regulations at every level of government appear to somewhat temper confidence across the board.

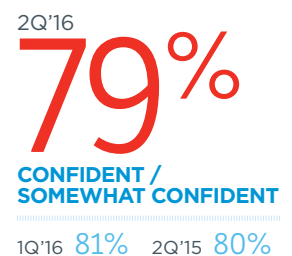
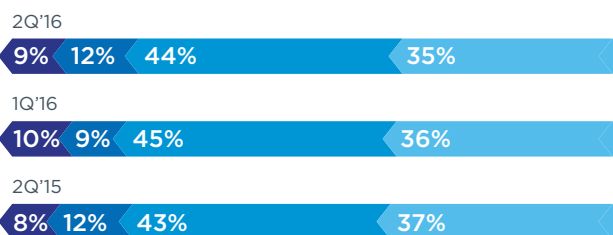
GLOBAL ECONOMY



NATIONAL ECONOMY



LOCAL ECONOMY





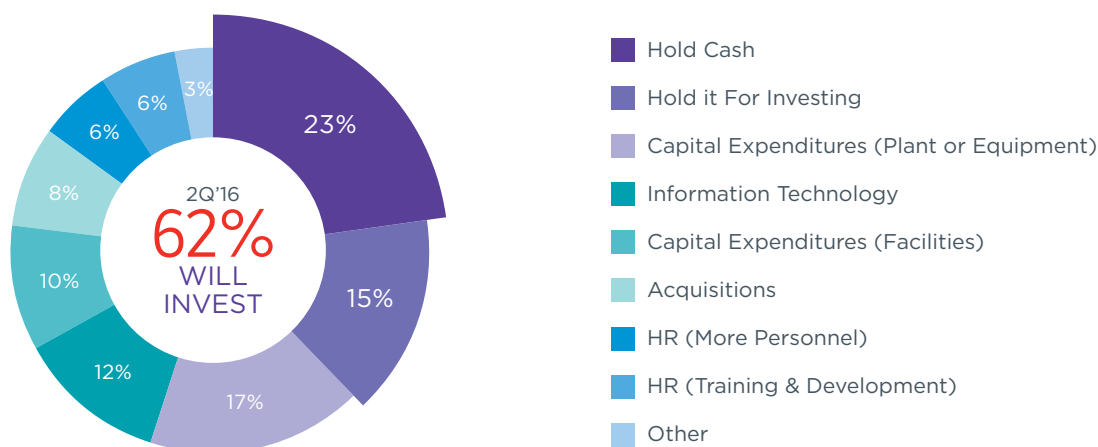
CAPITAL INVESTMENT

Investment plans are restrained

The middle market's appetite for investment has not fluctuated much over the past four and a half years. Asked what they would do with an extra dollar of profit, a majority of businesses—currently 62%—express a desire to invest the money while fewer than four in 10 firms (38%) prefer to hold onto it as cash. This is at the low end of the historical range. For the most part, plans for expansion remain stable. Almost a quarter (24%) of

companies are considering new plant or facility additions in the next 12 months, while 39% expect to expand domestically and 42% say they will introduce a new product or service. After jumping significantly last quarter, the proportion of core middle market businesses planning on launching new offerings has returned to around a third. As noted earlier, marketing spending appears to be trending upward.

ADDITIONAL INVESTMENT ALLOCATION



KEY CHALLENGES

Election year uncertainty joins the list of top challenges

Middle market organizations continue to contend with hiring and retaining qualified employees, business growth, development issues, and how to keep pace with their competitors. In the short term, companies worry about health insurance and transportation costs. Looking further out, the ability to sustain competitiveness, find new customers, and successfully introduce

new products remain key concerns. On top of these ongoing challenges, political uncertainty, given the election year, will be an issue both short and long term. The outcome of the election and its impact on policies and taxes is, not surprisingly, top of mind for many middle market business leaders today.

SHORT TERM CHALLENGES (Next 3 months)

INTERNAL CHALLENGES:

- | | |
|--------------------|-----|
| 1. BUSINESS | 63% |
| 2. STAFF/EMPLOYEES | 51% |
| 3. COSTS | 23% |
| 4. GOVERNMENT | 13% |

EXTERNAL CHALLENGES:

- | | |
|----------------|-----|
| 1. BUSINESS | 35% |
| 2. GOVERNMENT | 23% |
| 3. COMPETITION | 19% |
| 4. ECONOMY | 15% |
| 5. COSTS | 14% |

LONG TERM CHALLENGES (Next 12 months)

INTERNAL CHALLENGES:

- | | |
|--------------------|-----|
| 1. STAFF/EMPLOYEES | 41% |
| 2. BUSINESS | 39% |
| 3. COSTS | 18% |
| 4. GOVERNMENT | 6% |

EXTERNAL CHALLENGES:

- | | |
|----------------|-----|
| 1. BUSINESS | 26% |
| 2. GOVERNMENT | 18% |
| 3. COMPETITION | 14% |
| 4. ECONOMY | 13% |
| 5. COSTS | 13% |

Perspectives

GROWING AND GROWING AND GROWING

Seven full years into the economic expansion that began in July 2009, the middle market has been picking up the pace when one might expect it to be gasping for breath. Middle market revenues and payrolls grew faster in the second quarter of 2016 than in the first—spiking nearly a full percentage point on the top line, and 0.8% for payrolls. Both revenue and payroll growth are higher than they were in the second quarter a year ago. And, though executives' forecasts of future growth lag last year's, they have risen for four quarters in a row, a trend of rising expectations that we have seen only once before in the MMI's history (starting in the third quarter of 2012).

Growth was fastest among the larger middle market companies (annual revenues between \$100 million and \$1 billion), whose sales increased 8.5% on average in the last 12 months. For the last two years, this has been the norm: In all but two of those eight quarters, the larger segment of the middle market has outpaced companies in the core (\$50-100 million) or smaller (\$10-50 million) segments—though it is worth noting that smaller firms project faster growth than their larger cousins do.

At the halfway point of the year, 2016 is shaping up well. Confidence in global, national, and local economies has dipped a tad, but only 8% of middle market executives expect the business climate to worsen, while 19% expect it to improve. The ratio of optimists to pessimists is currently 2.4 to one—the highest in over a year. Among companies that expect to grow, the mean anticipated revenue increase is an impressive 10.8%.

Now, these data were collected in the first half of June, before Great Britain's shock vote to leave the European Union. We returned to our surveyed companies a week after the Brexit vote to ask about it. Forty-nine percent say Brexit will have at least a somewhat significant impact, and 13%—one in eight—say it will be extremely significant. Investments in the UK will be hit—28% of middle market companies say those will decline, and 21% say they will reduce investments to the rest of the EU. Instead, 26% say, they will redirect investments home to the U.S.

LEVERS OF GROWTH AND PERFORMANCE

When a company outperforms its industry or the economy, its leaders must be doing something right. Using factor and regression analyses, we have ranked activities that appear to have the greatest leverage on top-line growth. Foremost is expanding into new markets (especially domestic), which contributes 43% to middle market company growth. Innovation comes second, contributing 29%. Talent investments are third, with an 11% contribution. These are not mutually exclusive; CEOs know and our studies document that lack of talent is a major obstacle to global expansion, for example.¹

Growth is an important element of overall performance, but the full value of an enterprise also depends on its competitive position, efficiency, profitability, risk management, and other factors. Accordingly, the gearbox that drives overall performance is different. For example, salesforce effectiveness and retaining profitable customers rank high as levers of performance, whereas market expansion and finding new customers matter more for revenue. There is a strong link between planning and both growth and performance, but for overall performance the emphasis is on strategy and long-term plans.

TOP DRIVERS OF GROWTH	TOP DRIVERS OF OVERALL PERFORMANCE
Expansion into new domestic markets	Overall salesforce effectiveness
Percentage of annual revenue spent on R&D	Having a long-term, 3-5 year growth strategy in place
Attracting new customers	Retaining profitable accounts
Setting formal annual growth targets	Maintaining margins
Overall salesforce effectiveness	Innovating new products and services

PUBLIC SERVICES

Former Illinois governor Adlai Stevenson famously quipped, “Your public servants serve you right.” This quarter we asked a set of questions to elicit how government services help, hold, or hinder middle market companies, at federal, state, and local levels.

The headline: local governments do pretty well in executives' estimation, whether in basic services like infrastructure and policing, regulations and incentives, or value-added services like trade promotion or workforce training. States are viewed less favorably, and the federal government trails for everything from infrastructure to taxes. A few federal programs score high, especially energy efficiency and Commerce Department programs. Unsurprisingly, satisfaction varies greatly by industry, state, and region.² Overall, the regulatory burden is not egregious: 35% say it is just right, 51% say it is high but manageable, and just 13% say it is unmanageably high.

System complexity appears to hurt middle market companies. Big enough to operate across boundaries but lean in their compliance staffing and expertise, they struggle with overlapping taxes and rules. Asked if they could choose either tax reduction or tax simplification, but not both, they pick simplification, 50% to 42%. (Eight percent don't have a problem either way.) Nearly a third (31%) say regulatory overlap creates major hurdles to getting work done.

¹ See NCMM and the Brookings Metropolitan Policy Program, *Accelerating Exports in the Middle Market: Global Opportunities for U.S. Firms and Metro Areas*, 2014. ² For more detailed government-satisfaction data, see: *Middle Market Perspectives on Government Services*, 2016 URL TO COME



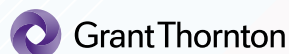
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