NATIONAL CENTER FOR
THE MIDDLE MARKET

3Q 2017

MIDDLE MARKET INDICATOR

STRONG GROWTH PERSISTS

IN COLLABORATION WITH

The Ohio State University
Fisher College of Business

SunTrust

Grant Thornton

Cisco

Middle Market Indicator
from the National Center for the Middle Market

EXECUTIVE SUMMARY

Thus far, 2017 is shaping up to be a record year for the middle market. In the first quarter, middle market companies reported an impressive surge in year-over-year revenue and employment growth rates, and those rates continue to remain above average in the third quarter. While revenue growth appears to be stabilizing at 7%, employment growth continues to escalate. Finding enough qualified employees to fill open positions may, however, be a challenge for executives given the tightening labor market. Some companies are looking at adding new and more unique benefits, such as financial, physical, and emotional well-being packages, to gain an edge when it comes to attracting talent.

More than two-thirds of middle market leaders report that overall company performance has improved in the past 12 months, while just 5% say that conditions have deteriorated. Seven out of 10 firms say revenues grew during this time period, and 41% say that their new-order pipelines have increased compared to one year ago, reporting an average bump of 13.2%. Around half of companies report increases in employment, and the current rate of year-over-year employment growth is nearly double the average rate since the MMI began.

Core and lower middle market companies (with annual revenues of $100 million or less), report faster revenue growth rates and a more positive future outlook than their larger counterparts this quarter. Despite a decrease in the rate of revenue growth for upper middle market companies (with $100 million to $1 billion in annual revenue), these firms are doing, and expect to continue to do, the majority of the hiring. From an industry perspective, business services, financial services, and healthcare companies are growing the fastest, while retail employment growth has tapered off significantly.

Leaders continue to report strong confidence in the economy. This confidence, coupled with anticipated future growth, is likely propelling increased willingness to invest. Investment dollars are more likely to be geared toward IT, new plants, and equipment than toward training and development for employees despite the fact that talent concerns continue to mount. The ability to recruit and retain people will be a top challenge for companies in the year ahead.

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 stabilizes

Following a rapid surge in the first quarter, year-over-year revenue growth rates settled back to average in Q2. This quarter, growth rates accelerated slightly and appear to be stabilizing at a healthy 7.0%. Core middle market companies report the largest jump; at 9.2%, their revenue growth rate surpassed that of upper middle market companies for the first time since Q3 2016. For their part, the middle market firms at the high end of the revenue spectrum reported declining growth rates for the second straight quarter.

A majority of middle market firms expect the rate of revenue growth to increase in the year ahead, particularly core and lower middle market firms. Across the middle market, companies anticipate 6.0% growth, up from 5.3% last quarter. However, upper middle market companies are more conservative, anticipating growth rates of just 4.5%. A mere 5% of companies expect the rate of revenue growth to decline over the next 12 months.

3Q'17 **70%** of middle market companies reported positive revenue growth. 3Q'16 **63%**

MIDDLE MARKET

PAST 12 MO.

3Q'17 **7.0%**

2Q'17 6.7% 3Q'16 6.3%

NEXT 12 MO.

3Q'17 **6.0%**

2Q'17 5.3% 3Q'16 4.9%

S&P 500

PAST 12 MO.

3Q'17 **4.4%***

2Q'17 5.8% 3Q'16 2.5%

EMPLOYMENT GROWTH
Hiring stays strong

Nearly half (48%) of middle market companies say their workforce is larger today than it was one year ago. Companies have increased headcount by 6.4% since Q3 2016, representing the second highest year-over-year employment growth rate in MMI history. While upper middle market firms are growing more slowly, they continue to be the most aggressive hirers, posting an 8.4% year-over-year employment growth rate. Core middle market companies also contribute significantly to the uptick in employment this quarter.

Expectations for future employment growth remain stable and healthy at 4.7%. More than four in 10 companies (42%) anticipate adding workers over the next year, and upper middle market firms are the most likely to anticipate increases in headcount. About a third of firms have plans to hire in the next three months. Most of the new jobs will be full-time positions and will primarily be in operations, marketing, and sales.

3Q'17 **42%** of middle market companies expect to add jobs. 3Q'16 **37%**

MIDDLE MARKET

PAST 12 MO.

3Q'17 **6.4%**

2Q'17 5.7% 3Q'16 4.9%

NEXT 12 MO.

3Q'17 **4.7%**

2Q'17 4.7% 3Q'16 4.0%

ADP [PAST 12 MO.]

LARGE CORP.

3Q'17 **2.8%**

2Q'17 1.6% 3Q'16 2.3%

SMALL BUS.

3Q'17 **1.2%**

2Q'17 1.4% 3Q'16 1.8%

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

ECONOMIC CONFIDENCE
Leaders remain confident

Middle market leaders continue to report solid confidence in the economy close to home as well abroad. Local and global confidence levels are particularly strong this quarter. At 88%, local confidence matches its peak level and is especially strong in the western and southern regions of the country, although it has dipped slightly in the Northeast. Global confidence, at 74%, is at the second highest level reported by the MMI. National confidence also remains well above average, although it has dipped just slightly for the second straight quarter.

Still, with 83% of middle market business leaders reporting positive perceptions about the U.S. economy, it is clear that the middle market feels decidedly upbeat regarding business conditions across the nation, especially companies in the Midwest. High confidence levels are likely helping to bolster increases in anticipated revenue and employment growth rates for many middle market companies.

GLOBAL ECONOMY

3Q'17
74%
CONFIDENT / SOMEWHAT CONFIDENT
2Q'17 70% 3Q'16 56%

NATIONAL ECONOMY

3Q'17
83%
CONFIDENT / SOMEWHAT CONFIDENT
2Q'17 84% 3Q'16 71%

LOCAL ECONOMY

3Q'17
88%
CONFIDENT / SOMEWHAT CONFIDENT
2Q'17 87% 3Q'16 80%

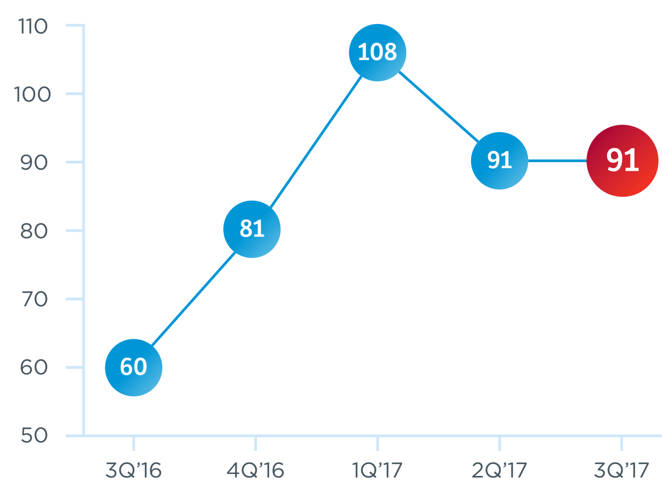
SHORT TERM INDEX
Short term index holds steady

The Short Term Index is calculated based on expected net positive change in business climate, expected net positive change in demand, and expected next positive change in sales for the next three months. The index rose rapidly during the second half of 2016 and peaked in Q1 2017. It fell slightly last quarter, and this quarter it remains steady and strong at 91.

Over a quarter (27%) of middle market business leaders anticipate a more favorable business climate in the next three months and nearly half (49%) say sales will increase in the short term. More than four in 10 expect an increase in demand for their products or services as the year finishes out, a percentage that has remained steady all year long.

Fewer than one in 10 leaders expect the business climate to deteriorate in the last quarter of 2017. Just 5% of business leaders forecast a decrease in demand or a decrease in sales as we head into the fourth quarter. Lower middle market firms are less optimistic about the three months ahead than their larger peers, and most of these companies expect the business climate, sales, and demand to hold steady throughout the remainder of the year.

PAST 12 MONTHS

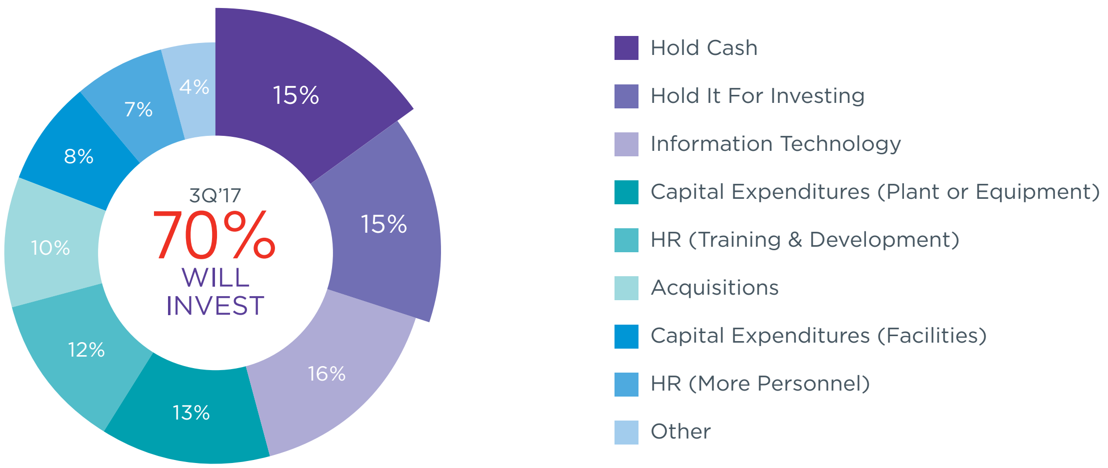


Short Term Index is calculated by taking expected net positive change in business climate plus expected net positive change in demand plus expected net positive change in sales over the next 3 months.

CAPITAL INVESTMENT
Investment appetites increase

For the first time in MMI history, the proportion of middle market leaders who say they would invest extra cash instead of save it has risen to 70%. Additionally, among the 30% of leaders who prefer to save cash, a majority say they are saving for future investments as opposed to simply putting money aside. Information technology is the most likely area for future investment, followed by capital expenditures for plant and equipment. Upper middle market companies are slightly more likely to invest, especially in the area of plant and equipment. Overall, 26% of middle market firms anticipate adding a new plant or facility in the next 12 months; that percentage has trended slowly up for the last five years.

ADDITIONAL INVESTMENT ALLOCATION



KEY CHALLENGES
Talent concerns are high and rising

Concerns over talent retention and recruitment are on the rise for the second straight quarter. Talent issues will be a challenge for a majority of middle market firms (51%), especially as many firms anticipate hiring more aggressively and the labor market continues to tighten. Accordingly, middle market companies are three times more likely to add to their benefits packages than to reduce them (see Spotlight, page 6). More companies voice concerns over core business issues, including maintaining growth and managing capital.

Competition is mounting, and some companies express worry related to the increase in acquisitions in their industries. Our data suggest most believe costs are under control. However, concern about costs has been inching higher over the last three years, and this quarter marks the first time that more than 20% of executives put costs on their list of top challenges. The concerns are across the board: healthcare, wages, materials, construction. Worries related to government regulations have eased.

SHORT TERM CHALLENGES (Next 3 months)

INTERNAL CHALLENGES:

1. BUSINESS	**65%**
2. STAFF/EMPLOYEES	**59%**
3. COSTS	**22%**

EXTERNAL CHALLENGES:

1. BUSINESS	**41%**
2. COMPETITION	**25%**
3. GOVERNMENT	**25%**
4. ECONOMY	**18%**
5. COSTS	**18%**

LONG TERM CHALLENGES (Next 12 months)

INTERNAL CHALLENGES:

1. STAFF/EMPLOYEES	**51%**
2. BUSINESS	**48%**
3. COSTS	**21%**

EXTERNAL CHALLENGES:

1. BUSINESS	**34%**
2. GOVERNMENT	**22%**
3. COMPETITION	**22%**
4. ECONOMY	**16%**
5. COSTS	**14%**

SPOTLIGHT

EMPLOYEE VALUE PROPOSITIONS: A TOOL FOR ATTRACTING TALENT

Given recent high rates of year-over-year employment growth, it's not surprising that middle market companies cite talent issues as a top challenge. Companies need qualified people to help support growth, and those people can be difficult to find.

One way companies can attract the best talent is by enhancing their employee value propositions, or the complete package of benefits and opportunities that employees receive in exchange for working for a firm. Middle market companies appear equally split between three approaches to benefits: *Minimizers* offer only what's expected. *Competitors* offer expanded services to keep up with peers. And *Differentiators* use benefits as a strategic tool for attracting the best talent. In terms of ownership structures, partnerships tend to be more strategic than companies with other ownership types, while public firms and non-profits are much more likely to match the competition. Interestingly, Competitors show the fastest revenue growth and Minimizers are posting the highest employment growth rates and expect the greatest increases in headcount in the year to come.

From an industry perspective, the fastest-growing segments, including business services, financial services, and healthcare, offer the most diverse benefits packages. It's not surprising that slower-growing industries, namely retail and wholesale, offer less comprehensive benefits. Yet, executives in these industries appear to be no less satisfied with the benefits they offer than their peers whose packages are more robust, presumably because their bar is lower.

Retailers, however, are most concerned about the financial well-being of their employees, probably because pay tends to be lower in this industry. But they are not alone. Most leaders across all industries are at least somewhat concerned about employees' financial health. And some are doing something about it: Indeed, financial wellness packages, along with physical and emotional wellness, are emerging benefit areas that some companies, upper middle market firms in particular, are considering adding to attract more employees.

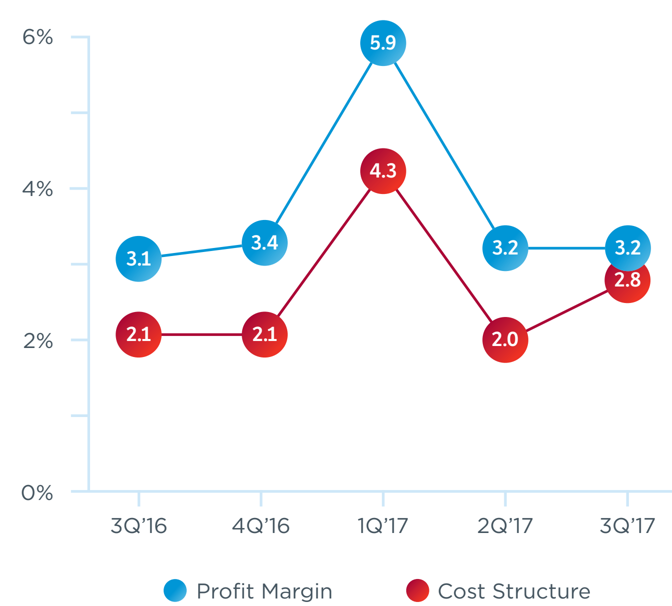
PROFIT MARGINS & COST STRUCTURE

Profits and costs will rise

Over the next 12 months, middle market leaders anticipate an increase in profit margins of just over 3%. While the majority of firms will keep their product and service prices consistent over the next year, four in 10 businesses will initiate pricing increases. Only 5% of firms expect to bring prices down.

Company cost structure is expected to increase as well, but to a slightly lesser degree—that is, companies expect their profits to increase faster than costs do. Most middle market leaders believe that the cost of healthcare will have a moderate to significant impact on their businesses in the year ahead. The majority also believe that energy costs will have an impact on company performance, but healthcare costs are clearly the more pressing concern. Inventory may also impact cost structure. Just under one third of firms say they are holding more inventory today than they were one year ago. Only one in 10 firms has decreased inventory levels.

PAST 12 MONTHS



Perspectives

As of this date—October 2017—the U.S. economy has expanded for one hundred consecutive months. That is the third-longest period of uninterrupted growth in U.S. economic history. The longest, 120 months, came in the 1990s; the expansion of the 1960s lasted 106 months. The current expansion has not been rapid; no one would call it a boom. It has not been evenly distributed across places and populations. But it has been extraordinarily long-lived.

It has also been led by middle market companies. In the last five years, non-farm employment in the United States has increased from 142 to 154 million—roughly eight percent. The middle market has added jobs at a rate of 5.5% a year. That figure includes inorganic growth, so it is not apples-to-apples with overall employment. But quarter after quarter, comparable data show middle market employment rising at least twice as fast as employment in smaller or bigger companies. The same holds for top-line growth, which for the middle market has dipped below 6% only four times in the last 20 quarters.

We have noted before how benign the economic climate has been, with negligible inflation, persistently low costs for capital, talent, and energy, and robust equity markets. (This this is the second-longest bull market in history.) Microeconomic signals are green, too. Executives expect profits to rise faster than costs. Forty-one percent of companies say their new-order pipeline has grown, a number that is 10 full percentage points higher than it was at this time in 2016. Among those with fuller pipelines, the average increase is a very robust 13.2%.

Given all this, it is no wonder that middle market executives expressed this quarter their highest-ever level of confidence in their local economies, second-highest ever confidence in the global economy, and third-highest-ever confidence in the U.S. economy. They also say that they will back that confidence with actions designed to secure and extend their growth.

COMPANY INVESTMENT PLANS, NEXT 12 MONTHS	3Q 2017	3Q 2016
Will expand into new domestic markets	44%	36%
Plan to open new foreign markets	23%	16%
Plan to open a new plant or facility	26%	19%
Plan to make an acquisition	25%	22%
Plan to take on new debt	22%	15%

These are plans, not promises; but historically middle market companies have kept close to plan. For example, a year ago 37% planned new domestic expansion, and 36% actually did it.

This worm will turn; worms always do. While the middle market does not seem to face macroeconomic headwinds, there are considerable uncertainties. Company valuations, sovereign debt, and political risk all are high. Trade agreements are being challenged. These or other factors could put an end to the good times, and they will be obvious only in retrospect, and out of executives' hands. Two major challenges are more under executives' control.

The first challenge: Talent shortages. Four out of 10 executives say a lack of talent constrains their growth. Executives cannot do much about workforce participation rates, which are affected by factors like an aging population, immigration, and labor lost to opioid addiction. But only 35% of middle market job vacancies are filled by promotion from within, which suggests companies experiencing labor shortages should rely less on the tight outside labor market and invest more in training, developing career paths for employees, and enhancing the employee value proposition to increase retention.

The second challenge: The middle market, like the rest of the economy, is not getting much in the way of labor-productivity improvement. For the last two quarters, revenue growth and employment growth have converged. In 2014, we noted that job growth was trailing revenue grow substantially—in the third quarter of 2014, the two numbers were 7.5 and 3.5, respectively. At that time we wondered if executives were being too cautious about hiring. Now it appears that they are getting fewer gains in productivity than they should—perhaps an indication that they are holding back on capital spending.

The paradox: If they could solve the productivity problem, they would also reduce the talent-shortage problem.

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.

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