2Q 2014

MIDDLE MARKET INDICATOR

NATIONAL CENTER FOR
THE MIDDLE MARKET

In Collaboration With

THE OHIO STATE UNIVERSITY
FISHER COLLEGE OF BUSINESS

GE Capital

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 45.6 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 upper and lower 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

Founded in 2011 in partnership with GE Capital, and located at The Ohio State University Fisher College of Business, The National Center for the Middle Market is the leading source of knowledge, leadership, and innovative research 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. The Center's website, which offers a range of tools and resources for middle market companies, can be visited at www.middlemarketcenter.org.

U.S. MIDDLE MARKET DEFINED

ANNUAL REVENUE
RANGING FROM
$10MM – $1B

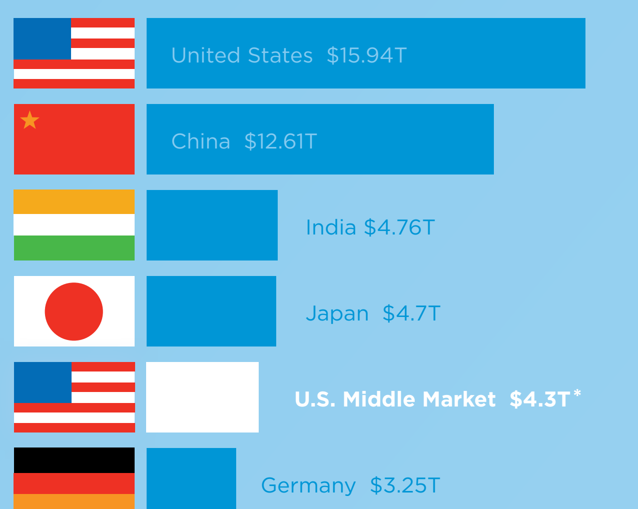
$ LOWER MIDDLE MARKET
$10MM - $50MM

$ $ CORE MIDDLE MARKET
$50MM - $100MM

$ $ $ UPPER MIDDLE MARKET
$100MM - $1B

NEARLY
200,000
BUSINESSES

5TH LARGEST
GLOBAL ECONOMY



*Source: CIA World Fact Book, *National Center for the Middle Market (estimate)*

Executive Summary

The second quarter of 2014 marked the second consecutive quarter of solid revenue growth for U.S. middle market firms. Virtually every industry segment reported revenue increases, with the manufacturing and healthcare sectors reporting significant year-over-year growth. In addition, firms maintained hiring increases that were reported in the first quarter of the year.

This unabated growth through the second quarter, coupled with continued economic confidence, strongly suggests that the middle market has put the recessionary period firmly behind it. Middle market leaders in general, and particularly lower middle market firms (annual revenue between $10 million and $50 million), are increasingly optimistic in their revenue growth projections for the next 12 months. While projections for employment growth remain stable, leaders in the core middle market (annual revenue between $50 million and $100 million) are showing more caution in hiring prospects for the coming year than both their larger and smaller counterparts. Across all revenue segments, middle market executives continue to be concerned about the cost of healthcare and the cost of doing business, the ability to grow revenue, and margin pressures; but they indicate lessening regulatory concerns for the second straight quarter.

Consistent with the past 12 months, a solid majority of middle market leaders continue to report improved overall company performance versus one year ago. For the second quarter of 2014, the proportion of companies reporting improved performance is up slightly to 63% from 60% last quarter, the highest level over the past year.

"The hardest part about going global was taking the first step. Once we did, everything else fell into place. Exports are a growing portion of annual revenues."

Chairman of the Board, Manufacturing Company, $53MM Annual Revenue, 160 Employees

Companies have sustained the rate of increase in year-over-year revenue growth as reported in the last quarter, with a mean total revenue growth of 6.6% for Q2 2014. Following the dip in revenue reported at the end of 2013, revenue growth has stabilized at higher levels with 33% of middle market firm reporting growth of 10% or more for the past 12 months. Once again, the middle market has clearly demonstrated its resiliency and its importance to the overall economy by outpacing revenue growth for the S&P 500, which was 3.4% for the same period.*

While the proportion of middle market firms experiencing revenue growth consistently outpaces the proportion that added workers in the past year, middle market firms have maintained the significant increase in hiring reported in the first quarter of 2014. For Q2 2014, more than 40% of firms report increased employment compared to one year ago.

Looking forward, almost half (47%) of middle market firms expect to add workers over the next 12 months, projecting a mean total growth of 3.3%. This represents a stabilized employment outlook, compared to the significant increase in the proportion of firms expecting to hire in the last quarter.

While employment projections remain steady, middle market leaders are much more likely to expect notable increases in revenue growth for the next 12 months. In fact, 70% of leaders say revenue will grow, which is dramatically higher than the 59% who projected an increase in yearly revenues last quarter.

Leaders also expect to grow at a greater rate—5.8% versus the 4.5% growth rate projected last quarter. A more positive outlook in a broad range of sectors—including services, manufacturing, construction, financial services, and healthcare—is driving these increases in projected revenue growth. In addition, lower middle market firms are particularly optimistic about future revenue growth, with mean revenue growth of 6.1% expected.

*Based on sales/share data for the S&P 500

REVENUE GROWTH

Revenue growth is stable and predicted to surge

Nearly seven in 10 middle market firms (69%) reported an increase in gross revenues over the past 12 months with a mean total revenue growth of 6.6%. These numbers represent a slight increase over last quarter's figures (6.5%), indicating that firms are maintaining the significant year-over-year growth that occurred in Q1 2014.

Projections for future revenue growth and growth rates are the highest they have been in over a year. This quarter, 70% of middle market leaders say they expect revenue to increase in the next 12 months, up significantly from 59% last quarter. The rate of expected growth also increased significantly to 5.8% from 4.5% last quarter. Specifically, lower middle market firms are much more optimistic about their prospects for revenue growth then they were at the end of 2013 and early 2014 (4.2%).

2Q'14 **69%** of middle market companies reported positive revenue growth. 2Q'13 65%

MIDDLE MARKET

	PAST 12 MO.	NEXT 12 MO.
2Q'14	6.6%	5.8%
1Q'14	6.5%	4.5%
2Q'13	5.8%	5.1%

S&P 500

	PAST 12 MO.
2Q'14	3.4%
1Q'14	0.5%
2Q'13	1.3%

EMPLOYMENT GROWTH

Companies maintain hiring increases

Middle market firms have maintained the significant gains in employment reported in Q1 2014, with 44% of companies indicating that their workforce is larger today than it was one year ago. While mean total employment growth for the past 12 months dropped slightly, year-over-year workforce increases are still stronger than in any quarter of 2013.

Following a significant jump in future employment expectations reported last quarter, the outlook has stabilized. Nearly half (47%) of middle market executives expect to hire over the next 12 months with a mean total expected growth rate of 3.3%. However, core middle market firms are more cautious: only about four in 10 (39%) say they plan to increase their workforce, down significantly from 53% last quarter.

2Q'14 **47%** of middle market companies expect to add jobs. 2Q'13 43%

MIDDLE MARKET

	PAST 12 MO.	NEXT 12 MO.
2Q'14	3.2%	3.3%
1Q'14	3.7%	3.2%
2Q'13	2.6%	2.5%

ADP [PAST 12 MO.]

	LARGE CORP.	SMALL BUS.
2Q'14	2.6%	2.1%
1Q'14	2.6%	2.1%
2Q'13	2.2%	1.6%

ECONOMIC CONFIDENCE

Confidence remains high

Middle market leaders from all revenue segments continue to express higher levels of confidence in the global, U.S., and local economies. This quarter, over half (55%) expressed at least some confidence in the global economy, while an impressive 68%—just over two-thirds—reported being at least somewhat confident in the U.S. economy. The percentage of respondents expressing some level of confidence in the local and regional economy is an impressive 77%.

Leaders in the manufacturing segment in particular have shown a significant surge in confidence in both the global and U.S. economies. Consistent with these findings, the percentage of middle market leaders expecting the global, U.S., and local economies to grow is up significantly from last quarter. However, leaders in core middle market firms are less likely to expect domestic economic growth than they were last quarter.

GLOBAL ECONOMY

	Not confident	Somewhat not confident	Somewhat confident	Confident
2Q'14	17%	28%	43%	12%
1Q'14	15%	28%	43%	14%
2Q'13	24%	28%	42%	6%

2Q'14 **55%** CONFIDENT / SOMEWHAT CONFIDENT

1Q'14 57% 2Q'13 48%

NATIONAL ECONOMY

	Not confident	Somewhat not confident	Somewhat confident	Confident
2Q'14	16%	16%	48%	20%
1Q'14	16%	20%	41%	23%
2Q'13	18%	19%	44%	19%

2Q'14 **68%** CONFIDENT / SOMEWHAT CONFIDENT

1Q'14 64% 2Q'13 64%

LOCAL ECONOMY

	Not confident	Somewhat not confident	Somewhat confident	Confident
2Q'14	10%	13%	43%	34%
1Q'14	9%	10%	41%	40%
2Q'13	9%	13%	43%	35%

2Q'14 **77%** CONFIDENT / SOMEWHAT CONFIDENT

1Q'14 81% 2Q'13 79%

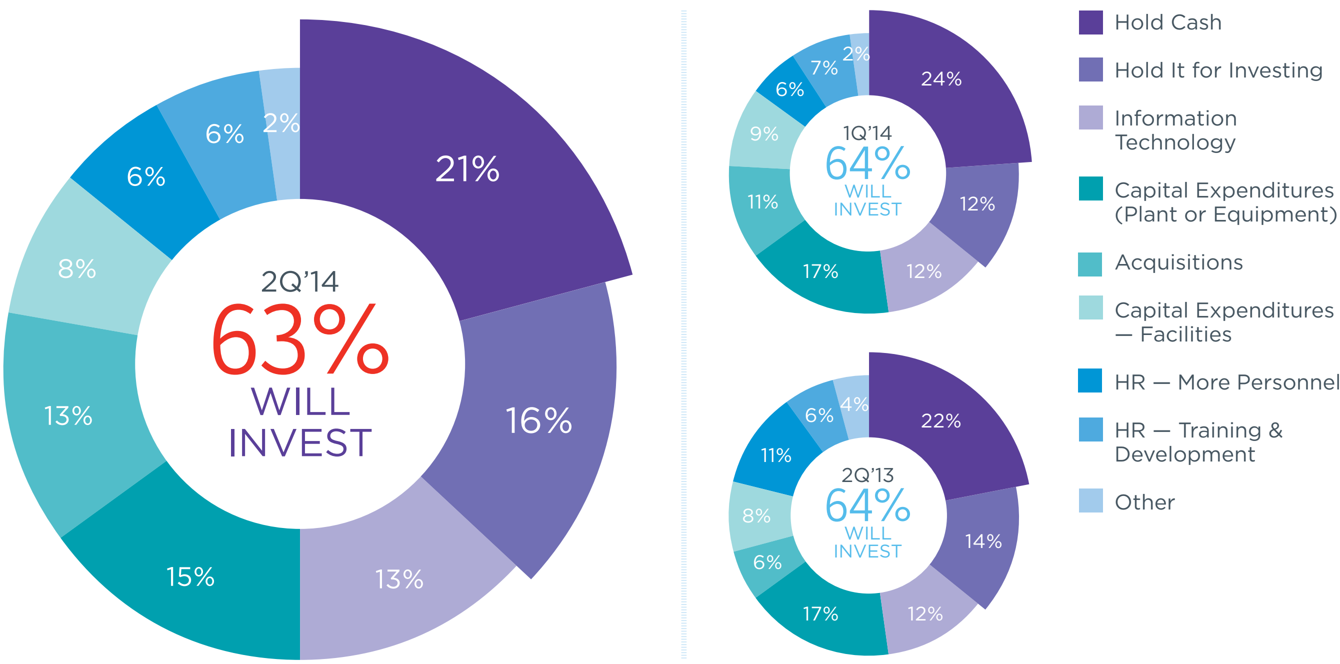
Not confident · Somewhat not confident · Somewhat confident · Confident

CAPITAL INVESTMENT

Capital investment plans remain the same

Over the past year, middle market leaders have not altered their capital investment plans. The number of firms likely to invest additional dollars today is 63%, just one percent off from the 64% that indicated they were likely to invest in Q2 2013. Correspondingly, the 37% of middle market firms currently planning to hold cash is nearly identical to the 36% of firms that said they planned to save one year ago. Not surprisingly, saving and spending patterns have remained relatively stable in each industry. Lower middle market firms are more inclined to hold cash than their larger counterparts, which are more likely to spend on plants, equipment, or IT.

ADDITIONAL INVESTMENT ALLOCATION



KEY CHALLENGES

Concerns about the regulatory environment continue to subside

Top challenges for middle market firms have remained consistent this past year. Healthcare costs still top the list, with other margin pressures following closely behind. While uncertainty about government actions remains a key challenge, the significant decrease in middle market leaders who consider this issue "highly challenging" has sustained since last quarter. Just 35% of leaders listed regulatory concerns as highly challenging this quarter, versus a yearly high of 47% in Q3 2013. Lessening concerns over external factors appear to be giving way to growing concerns about business execution: the ability to attract, train, and retain talent now ties government uncertainty for the number five spot on the list of top challenges.

TOP CHALLENGES

1.	THE COST OF HEALTHCARE	**87%**
2.	ABILITY TO GROW REVENUE	**84%**
3.	THE COST OF DOING BUSINESS	**82%**
4.	ABILITY TO MAINTAIN MARGINS	**82%**
5.	THE UNCERTAINTY OF HOW GOVERNMENT ACTIONS WILL IMPACT MY BUSINESS	**77%**

Perspectives

THE MIDDLE MARKET MARCHES AHEAD

If the U.S. economy has turned the corner, it's clear that the middle market led the way. We now have two consecutive quarters of six-and-a-half percent year-over-year revenue growth in the middle market and large gains in confidence: Confidence in their own performance, with 70% saying they expect revenue to grow in the year to come, vs. 59% just three months ago; confidence in their local economies, and, at last, much increased confidence in national and global conditions. Once again, the middle market is outperforming the S&P 500, too: Middle market companies report 6.6% revenue growth, compared to 3.4% for the big firms. It's therefore no surprise that executives appear to be laying plans to continue to push the top line aggressively.

But the ruddy revenue growth and rosy outlook do not seem to have changed the innate caution of the middle market. Executives continue to be close-fisted about new investment and the number who expect to add to payrolls is essentially unchanged. This looks like a productivity play: Companies seem to be determined to consolidate their gains by holding the line on investments in both capital and labor.

One telling indication of the fact that business is good: While 82% of middle market executives list "ability to maintain margins" as one of their top challenges (it's #4 on the list), the percentage who say it is highly challenging has dropped from 33% to 28%, while the percentage who say maintaining margins is only somewhat challenging jumped from 49% to 52%.

GDP DROP? WHAT GDP DROP?

What are we to make of the continued—even accelerating—growth of the middle market in comparison to the performance of the economy as a whole? In particular, what accounts for the middle market's performance in the first half of 2014 vs. the 2.9% decline in GDP during the first quarter? (Preliminary second-quarter GDP figures will appear after the MMI's release.) Part of the answer lies in the fact that MMI data capture year-on-year growth, not quarter-to-quarter data. But there is more to consider. Also, the latest national employment figures (a robust addition of 288,000 jobs in June) and strong earnings reports tell us that the GDP dip may be a localized first quarter phenomenon rather than a broad trend.

Clearly the middle market is not immune to trouble in the broader economy, but several factors explain the middle market's continued strong growth despite the GDP contraction in the first quarter. For one, the entire drop in first quarter GDP could be attributed to a decline in exports and inventory investment, according to the Council of Economic Advisors. The former affects the middle market less than the broader economy, because only 40% of middle market companies take in any revenue from outside the U.S. In the long run, this parochialism is a problem for the middle market—our research shows that companies that seek and serve global markets outperform stay-at-homes. But it insulated the middle market from the first quarter's export troubles. Like the broader economy, the middle market did show first quarter weakness in healthcare. That industry rebounded sharply this quarter, with 68% reporting year-on-year revenue growth, vs. just 52% three months ago, perhaps because people newly insured under the Affordable Care Act are starting to seek more medical care. Looking ahead, the exceptionally strong performance of middle market manufacturing companies—72% report increased year-over-year revenue growth, up from 63% in the first quarter—bodes well for the larger economy and for American competitiveness.

One piece of this generally cheerful picture bears watching, however. Companies in the core of the middle market are noticeably more cautious than their lower and upper middle market siblings. Sixty-one percent expect revenue growth, compared to 70% for lower and 73% for upper middle market companies. The percentage of this group predicting the U.S. economy will grow is down nine points from the first quarter. Thirty-nine percent expect to hire more, compared to 47% and 51% for the other groups. These numbers may reveal nothing more than an abundance of caution in the core of the middle market. Or maybe executives are just catching their breath, since 40% of them (in contrast to 34% and 28% of the lower and upper middle market firms, respectively) reported revenue growth of 10% or more in the past 12 months. Indeed, overall these core middle market executives' mean growth expectations are unchanged, for example, and the number who expect to reduce payrolls has declined since the first quarter.

MIDDLE MARKET AS A GROWTH PLATE

Perhaps most importantly, the data underscore the importance of the middle market to economic growth in America and around the world. Many small businesses—such as dry cleaners, gas stations, hairdressers, clinics, small contractors—grow within relatively narrow bands. Job creation in these sectors is more a matter of new business formation than of adding to payrolls. Above the middle market, in the S&P 500 for example, organic growth slows under the influence of the law of large numbers. Many studies have documented the gap between the organic growth rates of large companies and the growth expectations embodied in their stock prices. Management closes the gap with M&A—inorganic growth. Plenty of companies are exceptions to the rule, of course, but in aggregate it's the middle market where organic growth chiefly occurs.

For now, the middle market's performance seems to suggest it can have the best of both worlds: top line growth that is significantly faster than increases in spending on labor or capital. The conservative management philosophy that seems innate in this sector—with its large percentage of family ownership and deep roots in local economies and communities—has stood it in good stead so far. That stance may be put to the test if the economy picks up steam and global rivalries (and opportunities) become more important.

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Fisher College of Business at The Ohio State University is dedicated to training the next generation of business professionals through world-class faculty and a highly innovative curriculum elevated by close partnerships with industry leaders. The market has spoken: a recent survey of corporate recruiters conducted by The Wall Street Journal ranked Fisher second in the nation among business schools with the most sought-after graduates. Stay connected to Fisher via Twitter.

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