NATIONAL CENTER FOR
THE MIDDLE MARKET

# 4Q 2017

## MIDDLE MARKET INDICATOR

## REVENUE GROWTH ACCELERATES, EMPLOYMENT GROWTH SLOWS

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

For the middle market, 2017 can be summed up as a year of strong growth in both revenue and employment. The proportion of middle market businesses reporting improved year-over-year company performance is at its highest level (71%) in the six years of the MMI. Companies ended the year with a year-over-year revenue growth rate of 7.6%—second only to the rate reported in 1Q'17. While the employment growth rate fluctuated throughout the year, leaders report a 5.2% increase in headcount for 2017, and over half of firms added people to their rosters. Overall, the year was the strongest year for middle market employment growth in MMI history. Confidence levels are at near record highs to close the year, and a large majority of leaders prefer investing extra cash as opposed to saving it.

Yet middle market leaders are no strangers to challenges and headwinds. They are increasingly concerned about how to maintain the growth they have experienced in recent years and how to keep up with changing market conditions. In particular, half of firms say they struggle to find and retain the talent they need to achieve the growth they seek. And they are becoming more and more sensitive to the cost of doing business, particularly as it relates to healthcare and the expenses associated with finding and keeping the right people on board.

As leaders look ahead to 2018, they are optimistic. In the short term, sales and demand expectations have eroded slightly. However, more leaders expect to find a more favorable business climate in the next three months, and nearly a third plan to expand their workforces in the first quarter of 2018. Over the course of the year, companies project a healthy 5.4% rate of revenue growth. Employment is anticipated to grow more slowly: 43% of businesses expect to add workers this year and expect growing their workforces by 3.7%. These somewhat muted expectations may be a result of the shrinking size of the labor pool as the economy nears full employment: a solid majority (81%) say their workforce is just about the right size for current market conditions.

While all industry segments experienced growth in 2017, business services, construction, and financial services firms have grown the most rapidly. With the exception of construction, all industries have slowed the rate of hiring slightly. Upper middle market companies, with revenues between $100 million and $1 billion, have slowed their employment growth rates the most notably this quarter. However, after two consecutive quarters of reporting decreases in year-over-year revenue growth, the largest middle market businesses once again report the fastest rates of revenue growth for 4Q'17.

**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 climbs

Three-quarters of middle market firms report increases in revenue over the past 12 months. After falling from an all-time high at the beginning of the year, the rate of revenue growth has accelerated the past two quarters. To close out 2017, companies report a year-over-year revenue growth rate of 7.6%, up from 6.9% at the end of 2016 and almost a full point above the six-year average revenue growth rate of 6.7%. Middle market companies of all sizes are growing their revenues faster than the historical average.

In 2018, most middle market companies (62%) expect revenue to continue to grow. They anticipate a healthy revenue growth rate of 5.4%—a percentage that has fluctuated somewhat this year, but that is consistent with what companies anticipated at the close of 2016. Middle market companies with annual revenue of $50 million or more are more optimistic than the lower middle market regarding growth in the year ahead.

4Q'17 **75%** of middle market companies reported positive revenue growth. 4Q'16 70%

**MIDDLE MARKET**

**PAST 12 MO.**
4Q'17 7.6%
3Q'17 7.0% 4Q'16 6.9%

**NEXT 12 MO.**
4Q'17 5.4%
3Q'17 6.0% 4Q'16 5.5%

**S&P 500**

**PAST 12 MO.**
4Q'17 6.9%*
3Q'17 4.4% 4Q'16 4.4%

## EMPLOYMENT GROWTH
### Hiring rates slow

A majority (52%) of middle market companies increased the size of their workforce in 2017. The rate of employment growth fluctuated throughout the year. Companies report 5.2% year-over-year growth for 4Q, down from 6.4% last quarter, but on par with the 5.4% growth rate reported at the close of 2016. Overall, the rate of employment growth has cooled off this year. However, hiring in the middle market remains decidedly strong and well above the average employment growth rate of 3.9% as measured by the MMI.

Expectations for future employment growth have also declined over the course of the year. More than four out of 10 businesses (43%) do expect to hire in 2018, and about a third of companies (32%) say they will make workforce increases in the first quarter of the year. But the anticipated rate of employment growth for the year ahead is down to 3.7%. Companies will continue to add full-time workers primarily in operations, marketing and sales, and IT.

4Q'17 **43%** of middle market companies expect to add jobs. 4Q'16 33%

**MIDDLE MARKET**

**PAST 12 MO.**
4Q'17 5.2%
3Q'17 6.4% 4Q'16 5.4%

**NEXT 12 MO.**
4Q'17 3.7%
3Q'17 4.7% 4Q'16 3.4%

**ADP** [PAST 12 MO.]

**LARGE CORP.**
4Q'17 2.6%
3Q'17 2.8% 4Q'16 2.4%

**SMALL BUS.**
4Q'17 1.4%
3Q'17 1.2% 4Q'16 1.4%

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

## ECONOMIC CONFIDENCE
### Confidence stays strong

Middle market leaders remain optimistic about economic conditions both at home and abroad. Local economy confidence closed out the year at 88%, just off its all time high and a couple of points above the 4Q'16 number. After a slight dip in 2Q17, global economic confidence has climbed back to 75%. Eighty-six percent of middle market executives are very or highly confidence in the U.S. economy, a near-record percentage. Across the board, economic confidence levels are well above the average levels measured by the MMI. Compared to mid 2012, when fewer than half of leaders reported confidence in the U.S. economy and fewer than a quarter had positive perceptions about the global state of affairs, there has been a dramatic shift in attitudes. Today, leaders appear steadfast in their belief that economic conditions are healthy and strong everywhere their businesses operate.

#### GLOBAL ECONOMY

4Q'17
**75%**
CONFIDENT / SOMEWHAT CONFIDENT

3Q'17 74% 4Q'16 65%

#### NATIONAL ECONOMY

4Q'17
**86%**
CONFIDENT / SOMEWHAT CONFIDENT

3Q'17 83% 4Q'16 81%

#### LOCAL ECONOMY

4Q'17
**88%**
CONFIDENT / SOMEWHAT CONFIDENT

3Q'17 88% 4Q'16 86%

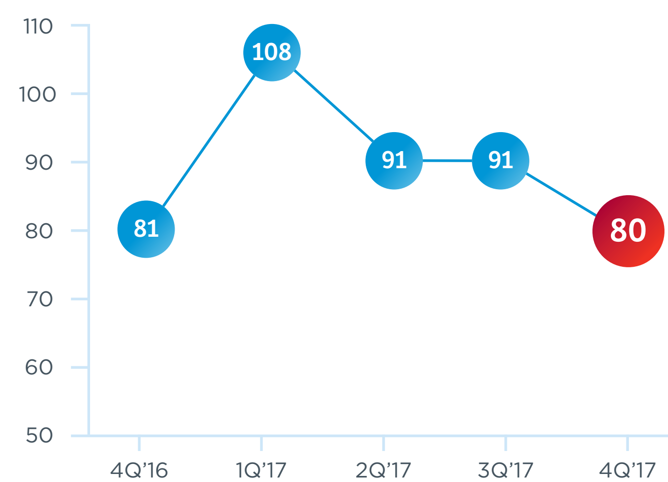
## SHORT TERM INDEX
### Short term expectations cool

Since climbing to peak levels in the first quarter of 2017, the Short Term Middle Market Index has tapered off throughout the year. The index is created by combining leaders' expectations regarding the business climate, demand, and sales for the three months ahead. At 80, the index is at the lowest level recorded since the close of 2016. Nonetheless, it remains higher than average since the National Center for the Middle Market began calculating this measure in 2015.

The percentage of business leaders saying they anticipate increases in demand and sales in the short term is down compared to three months ago, which accounts for the dip in the index this quarter. For the most part, executives believe these numbers will hold steady for the first quarter of 2018. Fewer than one in 10 leaders expect sales and demand to decline over the next three months.

Interestingly, the proportion of firms expecting a more favorable business climate in the next three months is slightly higher than in 3Q, with 30% saying conditions should improve in the short term. Upper middle market companies are a bit less optimistic than their smaller peers about the outlook for the business climate over the next three months.

#### PAST 12 MONTHS

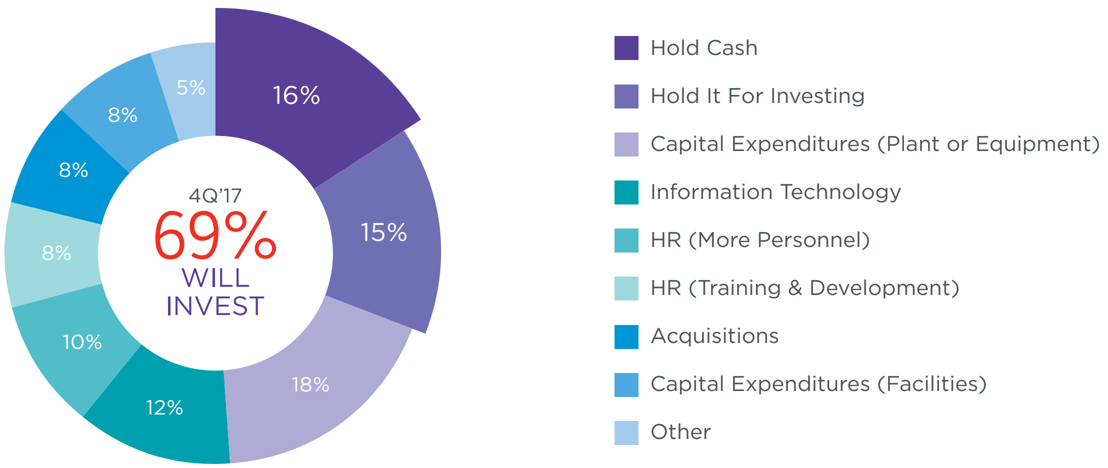



*Short Term Index is calculated by taking expected net positive change in business climate plus expected net positive change in demand plus expected net positive change in sales over the next 3 months.*

## CAPITAL INVESTMENT
### Companies will invest in growth

The proportion of firms that would invest extra money as opposed to hold it remains near peak levels. The percentage has risen slowly but surely since mid-2012 when the investors and savers were nearly equally split. Today, 69% of companies say they would put an extra dollar of revenue to work immediately via investment, primarily through new plants and equipment or IT improvements or upgrades. In 2018, 22% of companies say they are highly likely to add a new plant or facility. Among the 31% of companies indicating that they would hold on to cash, about half say they are saving for future investments. Just 16% of middle market businesses would hold additional revenue in a cash reserve.

### ADDITIONAL INVESTMENT ALLOCATION




## KEY CHALLENGES
### Cost and competition concerns heat up

Talent management concerns, including those related to retention and recruitment, remain the top internal long-term challenge for middle market business leaders, as they have been throughout 2017. Half of business leaders claim that talent is an issue for their companies. However, cost concerns have risen throughout the year, with close to a quarter (22%) of executives now citing costs as a long-term challenge. (See spotlight on the next page). Managing healthcare costs remains an issue. Companies are also feeling salary pressure and may need to increase their recruiting and labor expenses due in part to a tightening labor market. Externally, leaders are most likely to lose sleep over how to maintain the growth they are experiencing and how to keep up with changing market conditions. Competition is on the rise, especially from larger companies that may have more flexibility to reduce prices, and external cost concerns are up, too. However, worries related to government and regulations continue to ease.

### SHORT TERM CHALLENGES (Next 3 months)

**INTERNAL CHALLENGES:**

| | |
|---|---|
| 1. BUSINESS | 71% |
| 2. TALENT MANAGEMENT | 56% |
| 3. COSTS | 23% |

**EXTERNAL CHALLENGES:**

| | |
|---|---|
| 1. BUSINESS | 40% |
| 2. COMPETITION | 28% |
| 3. GOVERNMENT | 23% |
| 4. COSTS | 15% |
| 5. ECONOMY | 12% |

### LONG TERM CHALLENGES (Next 12 months)

**INTERNAL CHALLENGES:**

| | |
|---|---|
| 1. TALENT MANAGEMENT | 50% |
| 2. BUSINESS | 47% |
| 3. COSTS | 22% |

**EXTERNAL CHALLENGES:**

| | |
|---|---|
| 1. BUSINESS | 37% |
| 2. COMPETITION | 23% |
| 3. GOVERNMENT | 21% |
| 4. COSTS | 19% |
| 5. ECONOMY | 13% |

## SPOTLIGHT

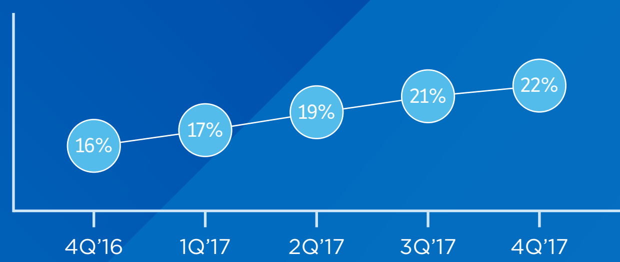
### PIPELINES, PRICES, AND PLANNING FOR CONTINUED GROWTH

The Q4 MMI—and every quarter of 2017—has been rosy. But a couple of dark spots are embedded in it. One is a softening in the new order pipeline: Companies reporting increases in their pipelines dropped from 41% in 3Q to 35% in 4Q. That remains a strong number (it compares to 31% in 4Q 2016) but it was enough to pull down the short-term index. Of more concern: Among those with larger new order pipelines, the average amount of the increase fell all year, from 18.4% to 12.1%.

At the same time, anxiety about costs has risen for four straight quarters. While a cost issue is named as a top-three concern by just 22% of executives (vs. 50% who name a talent issue), that figure was 16% a year ago. One person's cost increase is another person's price increase, and we see that, too: 48% of companies expect to raise prices next year, which is up eight points from 4Q'16 and the highest number we have seen. Executives worry especially about managing healthcare costs (particularly at smaller firms). These data do not reflect whatever impact tax-law and other policy changes may have on costs or other aspects of business.

The picture points to growing complexity: While growth and profitability continue to be very strong, executives say the challenge of managing and sustaining them seems more difficult. The level of concern for all long-term business issues—not just costs—has risen in the last year. Not surprisingly, the two subjects that top leaders' lists as things they want to know more about are strategic planning and creating a high-performance culture—both capabilities that will help a company handle whatever curveballs the economy throws at them.

*EXECUTIVES CITING A COST ISSUE AMONG THEIR TOP THREE INTERNAL CHALLENGES*



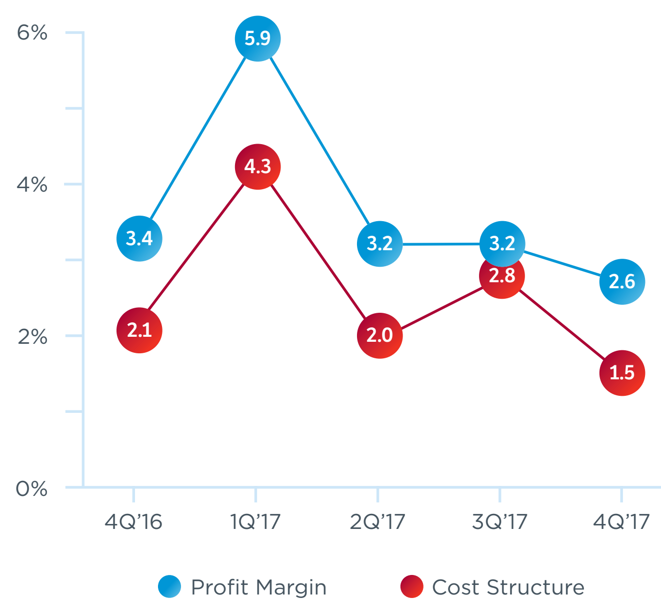

## PROFIT MARGINS & COST STRUCTURE

### Profit margins and costs will rise more slowly

Middle market companies expect their profit margins to increase in 2018, but to a lesser extent this year than last. For the most part, middle market executives believe that they will be able to manage revenues and costs in such a way that profit margins will increase. At 2.6%, the percentage of profit-margin increase is the lowest in the last year (even leaving aside the anomalously high numbers from the first quarter of 2017). For the year ahead, leaders anticipate much more modest increases of 2.6%. However, the proportion of businesses saying they will raise prices is up significantly from three years ago. In 2018, nearly half (48%) of middle market businesses say they will charge more for their products and services.

Leaders have also moderated their expectations when it comes to cost increases in 2018. They say cost structure over the next 12 months will increase by 1.5%, down from the 2.8% they speculated a quarter ago. Healthcare costs remain a major concern and companies believe the cost of healthcare will have a significantly greater impact on their bottom lines than the cost of energy.

**PAST 12 MONTHS**



# Perspectives

## *How's business?*

One question on the Middle Market Indicator survey asks executives whether their company's overall performance has improved, deteriorated, or stayed the same in the last year. This quarter, the ratio of companies saying their performance was better to those who felt it had weakened was approximately 12 to 1. When the MMI was launched in April 2012, that ratio was approximately 5 to 1; furthermore, over the six-year history of the MMI, the average ratio has been 8 to 1. By this point, the economic tide has lifted just about every boat.

Past performance is no guarantee of future results, as the saying goes; but given this long period of growth, it is no wonder that middle market leaders feel more confident about the economy than they ever have. It has been nearly a decade since they have faced headwinds from the economy. But while they are benefitting from good conditions, it is worth reflecting on some smart things middle market leaders are doing to make things even better for themselves and their companies. Although mid-size companies, especially those in the lower middle market, are susceptible to buffeting from economic conditions, we continue to see evidence of sound management bolstering performance.

***They're investing in talent.*** Half of middle market leaders state talent is their company's number-one long-term challenge, and by an eight-to-one margin they say that labor market conditions will tighten over the next few months. The lower the number of people looking for jobs, the more important it is to train and retain the talent already in place. In 2015, just 26% of executives said they would increase their investment in workforce training and education. In 2016, that rose to 30%. This year, it jumped to 38%. During the same period, the number saying they would use wage increases as a retention tool is unchanged at 43%.

***They're moving into new territories.*** Until 2017, the number of executives who said their company had expanded into a new domestic market in the previous year had never exceeded 33%. But in the four MMIs of 2017, those numbers were 36%, 38%, 36%, and 36%—a meaningful increase. As for international business, while the middle market remains overwhelmingly domestic (87% of sales come from the U.S.), those with international operations report strong expansion, with 45% reporting increased sales and just 4% reporting declines.

***They're getting innovation to market.*** Middle market companies invest roughly 8% of revenue in R&D—a percentage that has remained consistent, though of course the absolute dollars increase as revenue does. There is a change at the other end of the R&D pipeline, however. This quarter, 41% of middle market executives say they expect the proportion of revenue from new products to increase next year, while 57% say it will stay the same and 2% that it will decline. But two years back, just 31% thought new products' share of revenue would increase, with 66% forecasting no change, and 3% a decline. Whatever the cause or causes might be, it is clear that the middle market is making more of its R&D investment than it did.

***They're minding the store.*** MMI data contain little evidence that executives are letting their very high confidence in the economy translate into untoward exuberance in their behavior. The trend line for companies taking on new debt is as flat as Florida. Capital spending is up only a bit. More companies are holding increased inventory than were at this time a year ago--but more companies are also holding less inventory.

The overall picture is one we have seen before: Middle market companies move quickly when they see an opportunity, but not before they feel sure of it, and prefer to pay as they go. It is a formula that has produced economy-leading results for middle market companies, and seems likely to serve them well whatever the coming year brings.

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

From business as usual to business unusual, Fisher College of Business prepares students to go beyond and make an immediate impact in their careers through top-ranked programs, distinguished faculty and a vast network of partnerships that reaches from the surrounding business community to multinationals, nonprofits and startups across the globe. Our students are uniquely prepared and highly sought, leveraging Fisher's rigorous, experiential learning environment with the resources of Ohio State, a premiere research university with 500,000 proud Buckeye alumni.

SUNTRUST

SunTrust Banks, Inc. (NYSE: STI) is a purpose-driven company dedicated to Lighting the Way to Financial Well-Being for the people, businesses, and communities it serves. Headquartered in Atlanta, the Company has two business segments: Consumer and Wholesale. Its flagship subsidiary, SunTrust Bank, operates an extensive branch and ATM network throughout the high-growth Southeast and Mid-Atlantic states, along with 24-hour digital access. Certain business lines serve consumer, commercial, corporate, and institutional clients nationally. As of December 31, 2017, SunTrust had total assets of $206 billion and total deposits of $161 billion. The Company provides deposit, credit, trust, investment, mortgage, asset management, securities brokerage, and capital market services. SunTrust leads onUp, a national movement inspiring Americans to build financial confidence. SunTrust's Internet address is suntrust.com.

Grant Thornton

Founded in Chicago in 1924, Grant Thornton LLP (Grant Thornton) is the U.S. member firm of Grant Thornton International Ltd, one of the world's leading organizations of independent audit, tax and advisory firms. Grant Thornton has revenue in excess of $1.6 billion and operates 60 offices with more than 570 partners and more than 8,500 personnel in the United States and at our Shared Services Center in Bangalore, India. Grant Thornton works with a broad range of dynamic publicly and privately held companies, government agencies, financial institutions, and civic and religious organizations. "Grant Thornton" refers to Grant Thornton LLP, the U.S. member firm of Grant Thornton International Ltd (GTIL). GTIL and the member firms are not a worldwide partnership. Services are delivered by the member firms. GTIL and its member firms are not agents of, and do not obligate, one another and are not liable for one another's acts or omissions.

CISCO

Cisco is the worldwide leader in IT that helps companies seize the opportunities of tomorrow by proving that amazing things can happen when you connect the previously unconnected. At Cisco customers come first and an integral part of our DNA is creating long-lasting customer partnerships and working with them to identify their needs and provide solutions that support their success. Learn more at cisco.com.