NATIONAL CENTER FOR
THE MIDDLE MARKET

3Q | 2018

MIDDLE MARKET INDICATOR

Strong Growth Continues
Cost Concerns Mount

IN COLLABORATION WITH

The Ohio State University
FISHER COLLEGE OF BUSINESS

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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.

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

Short Term Index

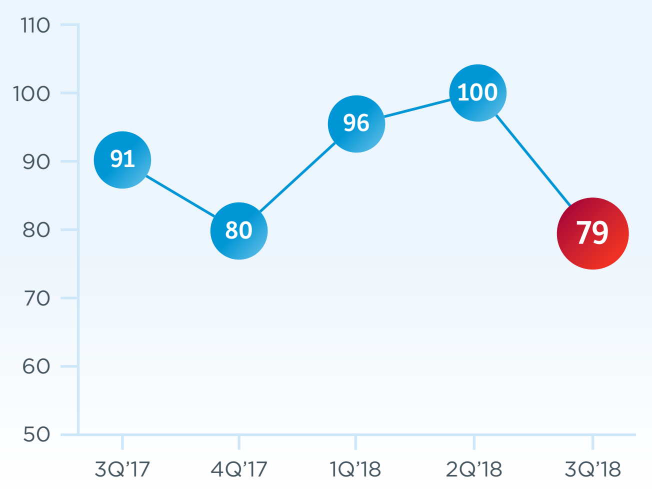
Short-term performance expectations fall

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.

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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%

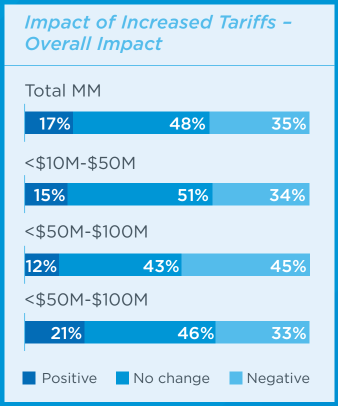
KEY FINDINGS

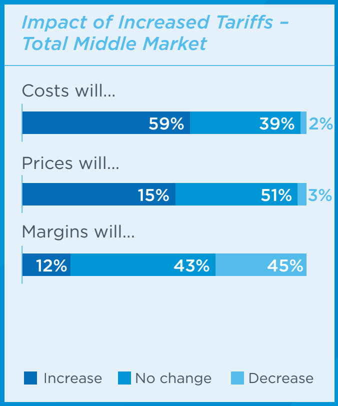
Spotlight

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.)



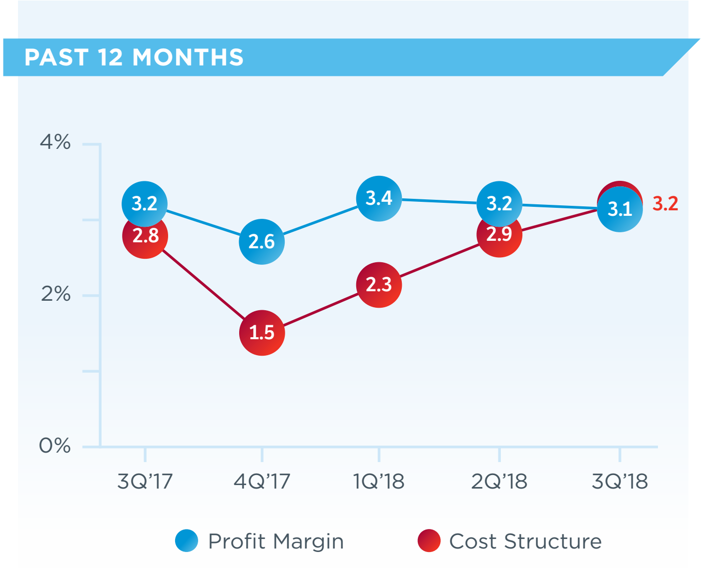


Profit Margins & Cost Structure

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

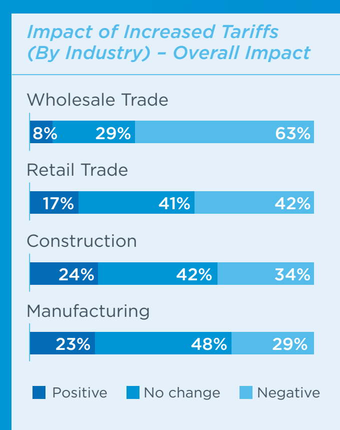
Government is weighing on executive minds for reasons other than trade policy; in this quarter, 25% named government among their top challenges, not counting those who are concerned about trade. Uncertainty and the general sense of political disorder seem to be the culprit, as one executive told us,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

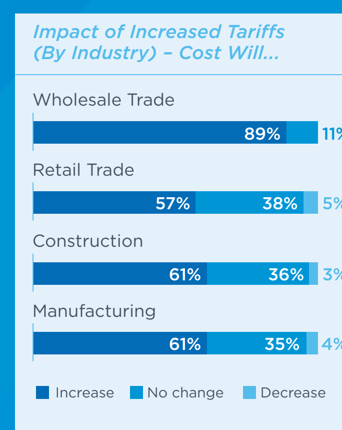
Costs

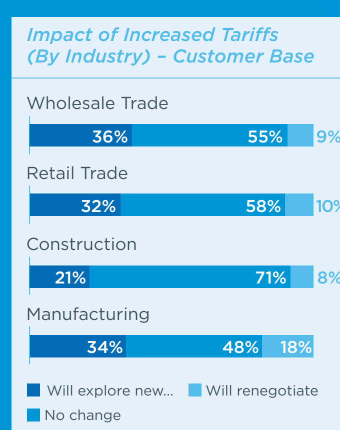
The number of executives who listed costs as a top challenge dropped last quarter from 26% to 19%, but is still up from 14% a year ago. In particular, health care costs are cited as a primary concern. Energy and interest costs are up. Full employment and increases in minimum wages by big companies might 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.

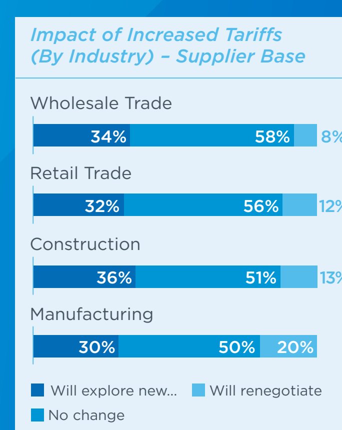
Of course, costs are just the subtrahend of the equation. The minuend is revenue, and the difference is profit. We have been doing that math for years. For the last year, the difference has been narrowing, and this quarter—for the first time in more than five years—executives say costs will go up more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









NATIONAL CENTER FOR THE MIDDLE MARKET

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Grant Thornton

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