NATIONAL CENTER FOR
THE MIDDLE MARKET

4Q 2018

MIDDLE MARKET INDICATOR

Growth Slows
Short-Term Expectations Decline

IN COLLABORATION WITH

The Ohio State University
Fisher College of Business

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Executive Summary

For several years, U.S. middle market companies have been leading the relatively long period of economic expansion and both revenue and employment growth has consistently trended up. As the overall economy begins to slow down, these companies are not immune from or unaware of the changes around them. Indeed, to close out 2018, both revenue and employment growth rates have fallen notably from last quarter, especially in the services and financial services industries. Short-term expectations have diminished significantly, and confidence has slipped slightly.

Despite these negative trends, the proportion of middle market companies reporting improved year-over-year company performance is at an all-time high at 73%, with few businesses reporting deteriorating conditions. More companies than ever before in MMI history also report increases in revenue growth compared to one year ago. The outlook for continued revenue growth in 2019 also remains strong for the majority of businesses. With economic tailwinds slowing, middle market leaders may need to look inward at the factors within their control—such as market expansion, investment and innovation, talent management best practices, growth strategy, and cost controls and efficiencies—in order to attain the growth they anticipate.

This may be especially important over the first quarter of 2019. The number of executives who expect to see improvements in the overall business climate or in demand for their wares has fallen significantly in each of the last two quarters. Hopes for improved sales are unchanged from last quarter, but below what they were in the first half of 2018.

Muted short-term expectations aside, most companies (60%) project healthy revenue growth for the full year ahead. At 5.9%, these expectations are consistent with what they were earlier in the year. This growth will probably be driven by innovation and market expansion: 49% of middle market companies expect to introduce a new product or service this year and 43% report plans for expansion into a new domestic market. Most companies also remain willing to invest an additional dollar to fuel business growth.

The long-term outlook for employment growth is less rosy. Expectations for the rate of employment growth in 2019 have fallen from 4.6% to 3.8%. The lower hiring forecast may reflect a shortage of available talent, for middle market leaders continue to say talent management issues are a top concern as they look for ways to acquire and retain the best people to continue moving their businesses forward. Cost concerns appear to be rising, too, especially related to imports, exports, and tariffs. However, companies believe that their profit margins will remain unchanged in the year ahead.

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.

FOR COMPLETE TRENDING, INDUSTRY, & REGIONAL DATA, VISIT **MIDDLEMARKETCENTER.ORG**

Revenue Growth

More companies are growing, but at a slower rate

Nearly four out of five middle market companies (79%) report increases in revenue growth compared to one year ago, the highest percentage recorded by the MMI. However, the rate of growth has slowed to 7.9% from 8.6% last quarter. The decline is driven by upper middle market companies and by businesses in the services and financial services sectors. The retail trade and construction industries report notable increases in the rate of revenue growth this quarter, and manufacturing continues to report strong growth. Despite the overall drop, revenue growth is higher than one year ago and remains a full point above the MMI average revenue growth rate of 6.9%

Looking toward 2019, most companies (60%) expect revenue to continue growing. Indeed, the expected rate of future growth has risen from 5.3% last quarter to 5.9%. Upper middle market firms have somewhat lower expectations for the year ahead; these businesses anticipate a growth rate of 5.5% in 2019.

4Q'18 **79%** of middle market companies reported positive revenue growth. 4Q'17 **75%**

MIDDLE MARKET

	PAST 12 MO.	NEXT 12 MO.
4Q'18	7.9%	5.9%
3Q'18	8.6%	5.3%
4Q'17	7.6%	5.5%

S&P 500

	PAST 12 MO.
4Q'18	4.7%*
3Q'18	8.0%
4Q'17	6.9%

Employment Growth

Hiring slows

The proportion of firms reporting year-over-year employment growth (55%) has remained fairly consistent all year long. However, the rate of employment growth has declined for the second straight quarter, slowing considerably among middle market companies of all sizes from 6.4% in Q3 to 5.4% to end the year. Current employment growth rates are similar to those seen at both the close of 2017 and the close of 2016. While the data suggest that the rate of employment growth may have peaked for the time being, middle market companies are still hiring: Only one in 10 firms reports a decrease in headcount compared to last year.

Expectations for future employment growth have tapered off significantly. About 2 out of 5 firms (43%) say they will increase the size of their workforce in 2019, but at a much slower clip. Companies project 3.8% employment growth over the next 12 months, down a full point from the rate firms were anticipating just two quarters ago. The upper middle market intends to grow employment somewhat faster than its smaller peers. These larger companies project 5% employment growth for 2019.

4Q'18 **55%** of middle market companies expect to add jobs. 4Q'17 **52%**

MIDDLE MARKET

	PAST 12 MO.	NEXT 12 MO.
4Q'18	5.4%	3.8%
3Q'18	6.4%	4.6%
4Q'17	5.2%	3.4%

ADP *(Past 12 Mo.)*

	LARGE CORP.	SMALL BUS.
4Q'18	2.5%	1.1%
3Q'18	2.6%	1.2%
4Q'17	2.6%	1.4%

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

Economic Confidence

Local and global confidence ease back

As a group, middle market leaders remain decidedly confident about the economy at home and around the world. Throughout 2018, confidence in the national economy has consistently stayed above 85%. Local and global confidence have shown slightly more volatility this year and both are currently at their lowest levels for 2018.

Despite these dips, nearly nine out of 10 middle market leaders (89%) remain confident in the local economies where they do daily business. Global confidence has eased back most notably, falling to 73% from 80% last quarter. It now sits at the lowest level since mid 2017. However, all three metrics (local, national, and global confidence) remain well above the averages recorded by the MMI over the past seven years.

GLOBAL ECONOMY

73%

CONFIDENT / SOMEWHAT CONFIDENT

3Q'18 80% 4Q'17 75%

NATIONAL ECONOMY

86%

CONFIDENT / SOMEWHAT CONFIDENT

3Q'18 88% 4Q'17 86%

LOCAL ECONOMY

89%

CONFIDENT / SOMEWHAT CONFIDENT

3Q'18 93% 4Q'17 88%

Short Term Index

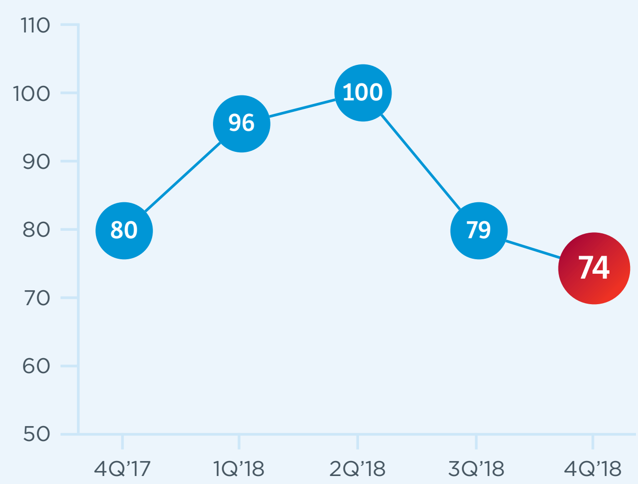
Short-term performance expectations continue to decline

The Short Term Middle Market index, which gauges middle market leaders' perceptions of the business climate and expectations for sales and demand for the next three months, is down for the second straight quarter. After a sharp decline from 100 in 2Q to 79 in 3Q, the index fell five more points to 74 to end the year. The index currently sits at the lowest level recorded since mid 2016.

Diminished expectations for demand drive the decline this quarter. Over the last three quarters, the percentage of companies expecting an increase in short-term demand has tapered off, falling from 42% in 2Q to 32% today. However, few leaders expect decreases in demand; most believe demand will hold steady for the next three months.

Projections for short-term sales and a more favorable business climate are also lower than they were mid-year. Less than half (46%) of leaders expect increases in sales over the next three months. Fewer than a quarter of companies (22%) say the business climate will improve in the first quarter of 2019. As with demand, only a handful of leaders expect declines in these areas; for the most part, leaders believe business will stay the course.

PAST 12 MONTHS



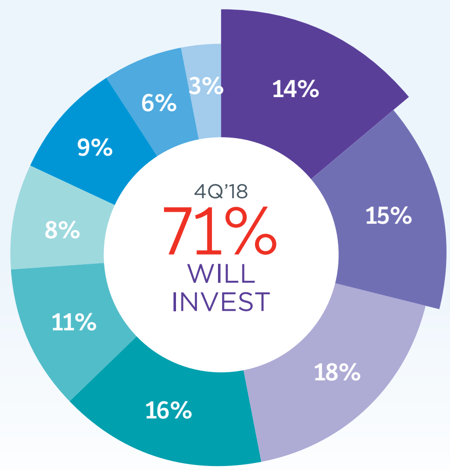
Short Term Index is calculated by taking expected net positive change in business climate plus expected net positive change in demand plus expected net positive change in sales over the next 3 months.

Capital Investment

Companies remain willing to invest

For the third straight quarter, 71% of middle market companies say they would invest an extra dollar rather than save it for a rainy day or future investments. These companies are most willing to put their dollars toward information technology improvements or to invest in capital expenditures on plant and equipment. Some companies, and lower middle market businesses in particular, indicate a desire to use extra funds to add personnel, while larger businesses are more likely to invest in training and development programs for current employees. Core middle market firms are the most likely to hold onto their additional dollars although, by a two to one ratio, these savers say they would set the money aside for future financial investments rather than cash reserves.

ADDITIONAL INVESTMENT ALLOCATION



- Hold Cash
- Hold It for Investing
- Information Technology
- Capital Expenditures (Plant or Equipment)
- HR (More Personnel)
- HR (Training & Development)
- Capital Expenditures (Facilities)
- Acquisitions
- Other

Key Challenges

Talent issues and costs may be headwinds to growth

Long-term, middle market leaders are most concerned with maintaining growth. To that end, their talent management concerns continue to rise. (They have been increasing steadily over the past several years.) Executives worry about how to attract and retain the best people. Costs, both internal and external are weighing more heavily on leaders' minds than they were a few years ago. Companies are increasingly concerned about the cost of healthcare as well as costs associated with IT, tariffs, and higher interest rates. They appear to be somewhat less concerned with governmental issues, rules, and regulations apart from tariffs.

Indeed, over the next three months, costs associated with imports, exports, and tariffs are the primary cost-related concern as companies contend with how to maintain their growth, keep up with changing market conditions, and manage their capital. Short-term talent concerns are near their all-time high, with 62% of middle market leaders expressing some level of worry over how to find and keep the people they need to meet the current demands of the business.

SHORT TERM CHALLENGES *(Next 3 months)*

INTERNAL CHALLENGES	
1. BUSINESS	69%
2. TALENT MANAGEMENT	62%
3. COSTS	27%
EXTERNAL CHALLENGES	
1. BUSINESS	43%
2. GOVERNMENT	26%
3. COMPETITION	25%
4. COSTS	25%
5. ECONOMY	15%

LONG TERM CHALLENGES *(Next 12 months)*

INTERNAL CHALLENGES	
1. TALENT MANAGEMENT	54%
2. BUSINESS	45%
3. COSTS	23%
EXTERNAL CHALLENGES	
1. BUSINESS	39%
2. COMPETITION	22%
3. COSTS	22%
4. GOVERNMENT	18%
5. ECONOMY	13%

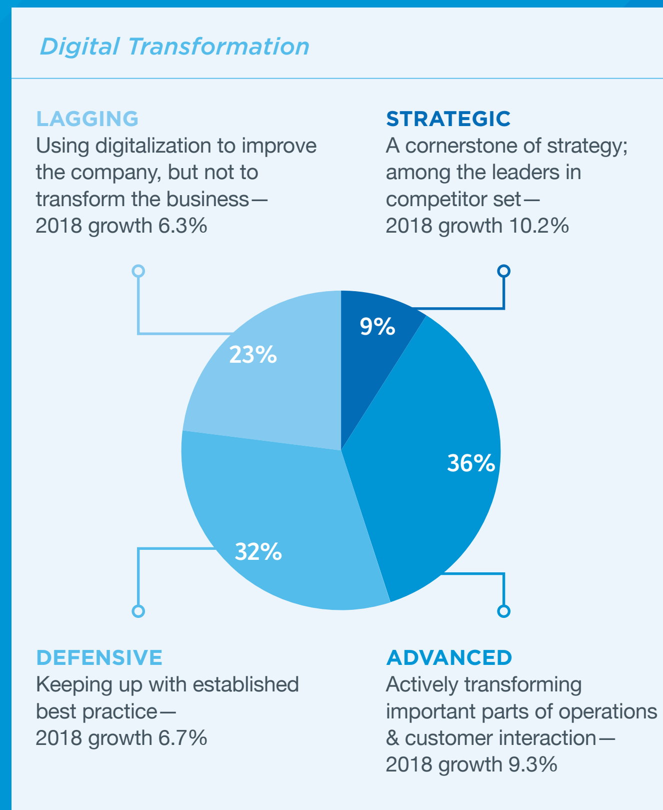
Spotlight
The Long Road to Digital Transformation

Give middle market executives extra money to invest, and they will direct more of it to information technology than anything else: 18¢ on the dollar—24¢ if the company falls in the core middle market with revenue between $50-100 million. An increasing portion of the IT budget is going into cybersecurity, now the number-one technology priority for the middle market. But a rapidly growing portion is going toward the transformation of business by digitalization.

Transformation is more than automation; it implies moving digital from a support function to the front line of what companies offer, how they produce it, how they market, sell, and distribute it, and how they manage the business; it has profound implications for strategy, talent, and productivity.

More than half—54%—of middle market companies say digital transformation is extremely or very important. In the financial and business services industries, the number approaches two-thirds. Laggards that "are using digitization to improve the company, but not to transform how we do business" account for about a quarter of the middle market. They are mostly smaller firms.

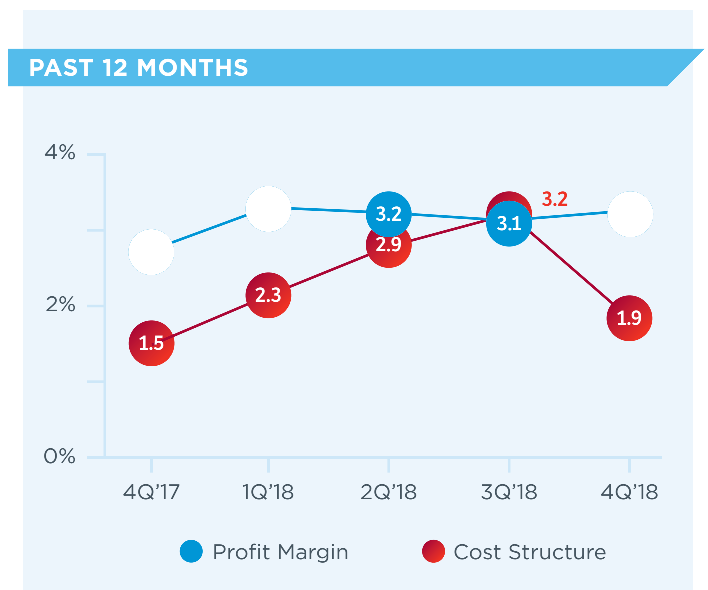
Fewer than 10% claim to be leaders. But those companies grew 10.2% in the last 12 months, nearly four full percentage points faster than the laggards. (See chart.)



Profit Margins & Cost Structure
Profit margins will hold steady

Throughout 2018, middle market leaders have reported increases in their companies' cost structure. Despite growing cost concerns, in Q4, the expected percentage of that increase fell from 3.2% to 1.9%. About half of middle market companies (47%) continue to say they will raise prices over the next 12 months, which may help to offset any expected cost increases. Additionally, most middle market leaders say their companies do well at containing costs through operational efficiency. The projected slowdown in the rate of employment growth may also help companies keep costs under control.

Expectations for profit margins held steady throughout 2018, and leaders continue to call for a profit margin of 3.2% in 2019. Overall, a slight majority (52%) of leaders say their businesses are very adept at maintaining margins.



Perspectives

What They Say, What They Do

Middle market companies have closed the books on a very satisfying 2018. But they face 2019 with ambivalence. On the one hand, confidence has slipped; challenges appear more diverse and more daunting; their short-term outlook has darkened. On the other, their appetite—the money they intend to invest in innovation, opening new markets, and building new facilities—continues to be robust. If they are seeing warning signals, they appear not to be slowing down.

Seventy-three percent of companies said their performance improved. This is the highest percentage ever recorded by the MMI. Just 5% said business deteriorated, making for a nearly 15:1 ratio of winners to losers. This despite slowly increasing headwinds from tariffs, rising interest rates, labor shortages and higher labor costs, lower growth in China, and a bad year in public equity markets. (The Russell 2000 index peaked at 1741 on August 31 and closed the year at 1349. During the two weeks that this quarter's data were collected—December 1-15—the index fell from 1549 to 1411.)

The vast majority of middle market companies are privately held, but executive jitters show up in this MMI in the form of dips in confidence and, particularly, the Short-Term Index, which dropped from 100 to 74 in the second half of the year. (See p. 4.) The Index looks at forecasts for the business climate, demand, and sales for the next three months. For each, it subtracts negative sentiment ("sales will fall") from positive ("sales will rise"). Interestingly, almost all the drop in the Index is due to declining positive sentiment. The negatives are virtually unchanged. As of now, executives don't see things getting worse; but fewer think things are getting better.

It thus makes sense that forward-looking activity hasn't changed, even though forward-looking sentiment has. Compared to a year ago, a middle market company's likelihood of introducing a new product, expanding into new domestic markets, or adding a new plant or facility is unchanged; investment appetite is slightly higher, as is the likelihood of international expansion; overall capital spending is up a bit and access to capital is unchanged. IT spending increased substantially as companies focus on cybersecurity and digital transformation. (See Spotlight, p. 6.) Forecasted hiring is the only downer—and that could be because fewer people are unemployed.

Uncertainty

A witty Danish proverb says that predictions are difficult, especially about the future. Clearly there is more risk in 2019's environment than in the last few years, and therefore more reason to manage and hedge against risk. There is also more uncertainty—that is (as the economist John Maynard Keynes said), matters for which no calculation of risk can be made, about which "we simply do not know," and about which we must nevertheless plan and act. For Keynes, the great defense against uncertainty was liquidity—money held in reserve.

We might expand his view to include agility—human capital that can be deployed in new ways, resilient and reconfigurable supply chains, the strategic nimbleness to dodge a punch or exploit an opening. In *The DNA of Middle Market Growth*,* we analyzed five years of MMI data and identified seven growth drivers that are under management's control and largely independent of economic factors. This quarter our respondents told us they are by far most confident of their abilities in one of them: 63% say they are excellent or very good at financial management. But just 41% rate themselves that highly when it comes to developing people. (The other growth drivers—innovation and investment, expansion, attracting talent, and cost efficiencies—cluster in the middle.) A good New Year's resolution might be to strengthen both liquidity and agility, and improve the capabilities that support all seven growth drivers.

**NCMM, The DNA of Middle Market Growth, 2018*

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THE MIDDLE MARKET

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