NATIONAL CENTER FOR
THE MIDDLE MARKET

2Q | 2020

MIDDLE MARKET INDICATOR

In Unprecedented Times, the Middle Market Strikes a Cautious Path Forward

IN COLLABORATION WITH

THE OHIO STATE UNIVERSITY
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Executive Summary

The COVID-19 pandemic has produced conditions never before seen in the eight-year history of the Middle Market Indicator (MMI). Fewer companies than ever say their past-year performance has improved: 37%, compared to the historical MMI average of 63%. Twenty-five percent say performance has deteriorated, nearly double the worst rate on record, reached during the 2012 Greek bailout and fiscal cliff debate. The proportion of executives expressing confidence in the local economy fell to a record low. Similarly, the proportion confident in the national economy has fallen to a level not observed since 2013.

Average past-year revenues declined by 3.7%, the first time the middle market has reported a negative number for year-over-year growth, and more than 10 percentage points below the historical average growth rate of 6.6%. About two out of five firms (42%) reported lower revenues, compared to 13% for the year ending 4Q 2019. The employment growth rate was also negative, dropping to -4.4%, meaning the middle market shed jobs like the rest of the economy. This also is the first time the middle market has failed to add jobs. Three-quarters of executives say their workforce size either decreased (32%) or remained the same (43%) in the 12 months ending 2Q 2020.

Many companies have put investment plans on hold. Asked what they would do with an extra dollar in 4Q 2019, 70% said they would put the money immediately to work, with the rest saying they would put it aside either as a cushion or to fund future investments. Today that number has fallen to 52%, the second lowest figure ever. Two-thirds of these savers would hold it as cash, in a rainy-day fund, while just one-third would hold it for future investments. For those who would put the money to work for their business, the top investment destination is information technology. The proportion forging ahead with expansion plans has dropped. In the next 12 months 37% say they will enter new markets, compared to 50% in 4Q 2019. Thirteen percent expect to build a new facility, versus 24% at the end of 2019.

Despite the changing business climate, there have been only minor shifts in the middle market's core challenges. The pursuit of growth and the need for talent continue to act as the most pressing issues for executives. The economy is a growing challenge, jumping ahead of costs and competition in this report. The proportion of executives who rate cost as a top near-term external challenge fell by 11 percentage points, to 6%.

All that said, the middle market sees better times ahead. Executives overwhelmingly believe sales in the next three months will increase from their June levels. This has lifted the Short Term Index[1] —which had plummeted in March—back to its December 2019 level, although the magnitude of the expected rebound is unclear. Looking ahead a full 12 months, revenue and employment growth projections are far below what they were when last year ended. The middle market anticipates 2.0% revenue growth, the lowest forecast on record and substantially below average actual revenue growth of 6.6% since 2012. In December, companies predicted 4.9% revenue growth. Executives expect employment to shrink by 0.2% in the 12 months ahead, the MMI's first negative employment projection; but if it holds true, it means that the middle market expects to stanch the job losses caused by the COVID-19 pandemic.

It is worth noting that the data in this survey were collected in the first two weeks of June 2020. At that time, American states had begun to reopen for business, some widely, some more cautiously. New COVID-19 cases had fallen in the hard-hit Northeast, but the surge in cases in the South and West had not yet become evident. Considerable uncertainty remains. Companies' plans and performance will depend on how the pandemic evolves, and on the ability of society and science to contain it. Successful prevention, mitigation, or treatment would support growth and employment, but even under the best circumstances it will take time for the middle market to recover.

[1] The Short Term Middle Market Index reflects leaders' expectations for sales, demand, and overall business conditions for the three months 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 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 48 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 survey is designed and managed by the National Center for the Middle Market. This quarter's survey was fielded between June 1-12, 2020.

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Revenue Growth

Executives predict modest growth

Middle market revenues have declined sharply since the pandemic began. Following year-over-year growth of 7.5% in 4Q 2019, revenues shrank by 3.7% in 2Q 2020. This 11.2 percentage-point change in the growth rate is the largest since the MMI was launched. More companies report a revenue drop (42%) than a rise (38%), another first. In 4Q 2019, revenues rose for 72% and fell for 13%. The smallest firms (revenues of $10 million to $50 million) experienced the steepest contraction, at -5.9%, compared to 8% growth in 4Q 2019. Core firms (revenues of $50MM to $100MM) produced 0.7% growth. Revenues for the largest companies (revenues of $100MM to $1B) shrank by 1.8%.

The middle market anticipates 2.0% growth in the next 12 months. Projections were strongest for core companies (3.9%) with 50% expecting growth and 15% declining revenue. Larger companies predict 2.6% growth, with 37% foreseeing a rise and 19% a decline. Similarly, nearly twice as many smaller businesses see revenues climbing (41%) versus falling (21%), although they expect slower growth (1.1%).

2Q'20 **38%** of middle market companies reported positive revenue growth. 2Q'19 **77%**

MIDDLE MARKET

	PAST 12 MO.	NEXT 12 MO.
2Q'20	-3.7%	2.0%
4Q'19	7.5%	4.9%
2Q'19	8.5%	5.4%

S&P 500

	PAST 12 MO.
2Q'20	-13.9%*
4Q'19	4.3%
2Q'19	5.2%

Employment Growth

Employment will continue to decline, although marginally

Employment declined by 4.4% in the year ending June 2020, compared to 5.0% growth in 4Q and 4.1% in 3Q 2019. The retraction marks the worst performance in the MMI's history. In comparison, U.S. unemployment rose from 3.6% in January to 11.1% in June. Nearly a third of middle market companies reduced employment, compared to 14% in 4Q 2019. The number of companies increasing employment dropped from 48% to 24%. Those increasing employment by 10% or more fell from 27% to 12%.

Core companies report the smallest reduction (-0.6%) followed by large (-3.6%) and small companies (-5.9%). The declines have been steepest in wholesale trade (-11.6%) and retail trade (-5.5%). The only sector registering an increase is financial services (1.3%).

For the coming 12 months, 25% of firms expect employment to expand, down from 42% in 4Q 2019. Twenty-one percent expect payrolls to continue shrinking. Overall, companies believe employment will fall by 0.2% in the coming year, compared to a 4Q 2019 projection of 3.5% growth.

2Q'20 **24%** of middle market companies added jobs. 2Q'19 **55%**

MIDDLE MARKET

	PAST 12 MO.	NEXT 12 MO.
2Q'20	-4.4%	-0.2%
4Q'19	5.0%	3.5%
2Q'19	6.4%	4.8%

ADP *(Past 12 Mo.)*

	LARGE CORP.	SMALL BUS.
2Q'20	-10.0%	-9.1%
4Q'19	2.3%	0.7%
2Q'19	2.3%	1.0%

**2Q numbers include only companies who have reported 2Q earnings results. Numbers change as more businesses report financial results.*

Economic Confidence

Confidence falls sharply

During 2019, economic confidence trended downward slightly, from high levels recorded in 2018. In 2Q 2020, confidence declined the most since the launch of the MMI. Confidence in the global, national, and local economies fell at least 15 percentage points below their five-year averages. Although local confidence has been a bedrock feature of the middle market, this quarter the proportion of executives saying they are at least somewhat confident in the local economy fell by 25 percentage points, from 89% to an historic low of 64%. There appear to be few regional differences in the degree of confidence in the local economy; in fact, companies in the Northeast, where COVID-19 had hit hardest during the time of this survey, had slightly greater local-economic confidence than companies in the South, Midwest, or West.

Although confidence in the global and U.S. economies declined, these figures have not reached the lows recorded in 2012. The percentage of leaders saying that they are at least somewhat confident in the U.S. economy dropped to 57%, from 83% in 4Q 2019. For the global economy, the rate fell from 68% in 4Q 2019 to 49%. That number has been declining since the onset of the trade wars in 2018. This report marks the first time since 2015 that it has dropped below 50%.

2Q'20

	GLOBAL ECONOMY	NATIONAL ECONOMY	LOCAL ECONOMY
2Q'20: CONFIDENT / SOMEWHAT CONFIDENT	49%	57%	64%
4Q'19	68%	83%	89%
2Q'19	69%	82%	89%

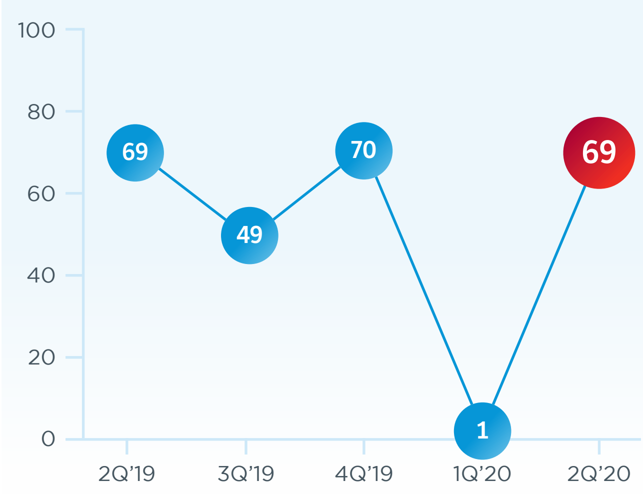
Short Term Index

Three-month outlook improves

The Short Term Index gauges leaders' expectations for sales, demand, and overall business conditions for the three months ahead. Currently, the Index is at 69, close to its level in 4Q 2019 (70) and above 3Q 2019 (49). This quarter's score is supported primarily by expectations for improved demand and sales in the quarter ahead. Nearly three times as many respondents expect both stronger demand (46%, versus 16% who expect it to be weaker) and increased sales (47% versus 17%). Executives anticipating a better business climate (39%) outstripped those who foresee a less favorable one (22%) by nearly two-to-one.

In "COVID-19 and the Middle Market," a survey of 260 executives conducted in March 2020, the Short Term Index declined to 1, the lowest level ever. The rise this quarter means executives expect better conditions in 3Q than in 2Q, when lockdowns severely restricted business. However, the Index does not measure the magnitude of any increase (or any decline); it simply shows the direction in which sales, demand, and overall conditions will move.

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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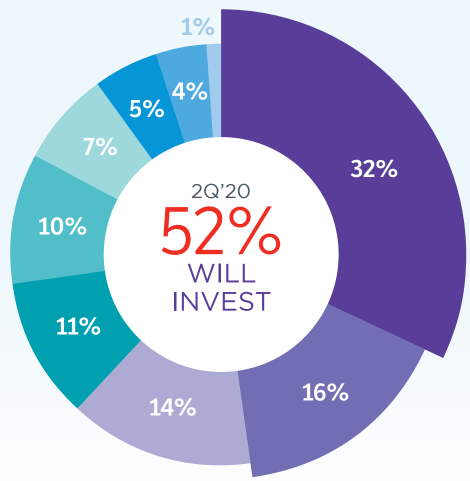
Capital Investment
Caution remains high

Middle market executives are increasingly cautious, preferring to hold cash versus investing it back into the business. If given an extra dollar, 70% of middle market executives in 4Q 2019 said they would put it to work for their business, just one percentage point below the 2018 all-time high. This quarter, amid high uncertainty, only 52% are willing to put that money to work immediately, one percentage point from the low recorded in 2Q 2012. The top destination for such investment is information technology, followed by new plant or equipment. Of the 48% who said they would save the money, two-thirds would hold more cash while the other third would hold it in anticipation of future investments.

ADDITIONAL INVESTMENT ALLOCATION

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



Key Challenges
Economic concerns rise as cost worries fall

The top short-term internal challenges for the middle market continue to be core business issues, such as boosting sales and revenue. The proportion of executives citing these has remained largely flat since early 2019. Talent follows at 54%, a three-percentage point drop since 4Q 2019. For the longer term, talent has been the most frequently cited top challenge since 2017, and it remains so today.

The proportion of executives concerned about costs fell to an all-time low for both the short (13%) and longer term (11%). Forty-one percent say COVID-19 is among the top three challenges in the short term, but only 24% believe it will rank that high over the next 12 months.

For external challenges over the next quarter and year, other than COVID-19, business and government issues remain the most common concerns. The state of the economy moved ahead of both costs and competition on the list of challenges. This is the first time since 2017 that the economy has not ranked lowest among short-term concerns.

SHORT TERM CHALLENGES *(Next 3 months)*

INTERNAL CHALLENGES	
1. BUSINESS	59%
2. TALENT MANAGEMENT	54%
3. COVID-19	41%
EXTERNAL CHALLENGES	
1. COVID-19	38%
2. BUSINESS	37%
3. GOVERNMENT	21%
4. ECONOMY	17%
5. COMPETITION	13%

LONG TERM CHALLENGES *(Next 12 months)*

INTERNAL CHALLENGES	
1. TALENT MANAGEMENT	52%
2. BUSINESS	42%
3. COSTS	11%
EXTERNAL CHALLENGES	
1. BUSINESS	35%
2. COVID-19	24%
3. GOVERNMENT	22%
4. ECONOMY	15%
5. TALENT MANAGEMENT	12%

Spotlight
Caring for the Caregivers

No industry has been more essential in the last six months than healthcare, a category that includes hospitals, medical practices, pharmaceuticals, and other life-sciences companies.

While essential, middle market healthcare businesses have been very negatively affected by the pandemic. Revenue fell more sharply for retailers and wholesalers, unsurprisingly due to lockdowns; but healthcare came in next worst and its drop was steeper than retail's. For healthcare, the past year revenue growth rate plummeted 11.5 points, from 7.9% in December to -3.6%. (Retail fell 10.6 points.) The industry forecasts growth of 1.4% over the next 12 months, below the overall middle market's 2.0% prediction.

Above and beyond the revenue challenges, healthcare companies face daunting management and strategic issues. By a substantial margin, healthcare executives are most likely to predict needing to make substantial and long-lasting changes in how they operate and run their businesses for the safety of employees and customers. And pretty much across the board, healthcare executives are most likely to say that the next six months will bring problems like delayed investments, staff cuts, general disruption, supply shortages, cash crunches, and the need to impose and endure significant restructuring.

Likelihood of Business Impact over the Next Six Months
Percentage of companies responding that impact is extremely or very likely

	TOTAL MIDDLE MARKET	BUSINESS SERVICES	MANU-FACTURING	WHOLE-SALE TRADE	RETAIL TRADE	CONSTRUC-TION	FINANCIAL SERVICES	TECH-NOLOGY*	HEALTH-CARE
DELAYING PLANNED INVESTMENTS	39%	43%	29%	27%	44%	30%	37%	27%	54%
DISRUPTION OF WORK	38%	45%	26%	45%	34%	20%	32%	40%	48%
LAYOFFS	32%	34%	23%	31%	32%	22%	27%	27%	42%
RAW MATERIALS/ SUPPLIES SHORTAGES	25%	21%	28%	36%	19%	20%	11%	25%	34%
CORPORATE RESTRUCTURING	22%	23%	15%	26%	22%	17%	16%	21%	30%
CASH PROBLEMS	21%	23%	18%	16%	20%	14%	12%	21%	35%

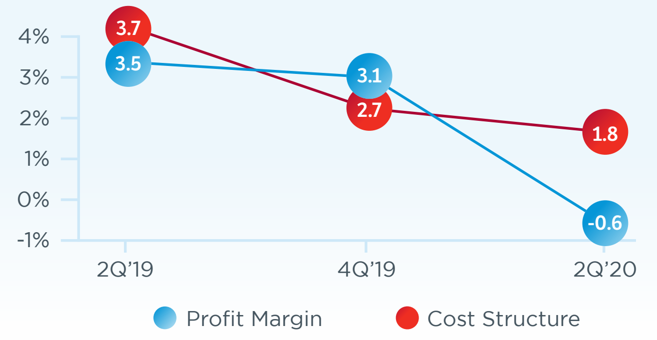
**Includes companies also represented in other industries, e.g., computer manufacturers, IT services, healthtech, fintech.*

Profit Margins & Cost Structure
Margins dip despite lower costs

Over the next 12 months, an equal percentage of companies (42%) believe that their costs will rise or stay the same. The average increase is 1.8%, down from 2.7% in 4Q 2019. This increase, the lowest since 2017, is consistent with the middle market's declining concern over costs.

Despite the modest rise in costs, middle market executives expect profit margins to shrink by about 0.6% in the coming year, presumably because of lower revenues. A greater proportion of core companies (37%) expect margins to increase, compared to smaller (35%) and larger (32%) firms.

PAST 12 MONTHS



Percentages show changes in the cost structure and profit margin, not absolute percentages.

Perspectives

From "What Happened?" to "Now What?"

Six months ago, as 2020 began, cautious optimism reigned in the middle market. Growth forecasts, expected hiring, and economic confidence were high, although trending slightly lower compared to the robust performance and glowing optimism of the last half of the decade that was ending. The long expansion seemed long in the tooth, but it was still expanding.

Then—boom.

When we talked to middle market executives in March, two weeks after the World Health Organization declared COVID-19 a pandemic and as much of business locked down, 25% feared a "catastrophic" impact on their business. Three out of four—76%—said "ongoing uncertainty" was one of their top three challenges, followed closely by "continuity of operations." The great economist John Maynard Keynes described uncertainty this way: "About [uncertain] matters there is no scientific basis on which to form any calculable probability whatever. We simply do not know. Nevertheless, the necessity for action and for decision compels us as practical men to do our best to overlook this awkward fact."

We simply do not know: That is where the middle market found itself in March. Like someone who had fallen into a gully, the middle market first asked, "What happened?" and moved its limbs to see if anything was broken.

Three months later, one out of eight expect catastrophe—a better number, but still a bad one. Executives still find themselves facing uncertainty (according to 66% in our June COVID-19 report) but they are turning to *the necessity for action and decision*. Executives have gone from reaction to reality. What first? What next? What then? The answer seems to be people and customers first. Get them back and feeling safe. We'll work it out from there.

A Hazy Outlook

It is too early to forecast the timing and pace of recovery, or how business will look and feel next quarter, next year, or five years from now. No sooner was this survey completed than COVID-19 cases began to surge in the West and South, where the disease had been relatively quiescent. But in the fog of the future we can discern some ways in which middle market companies—historically the most dynamic and fastest-growing part of the economy—will shape their future.

One is the overall resilience of middle market companies. Though economic confidence is at or near record-low levels, just 17% of executives expect the next quarter's sales to be down; their estimation of underlying demand for their offerings is essentially unchanged for the last year and a half. Overall, companies expect that the road out of the gully may be a long one, but it leads upward. They also, generally, have the ability to absorb a punch (more than small business) and the agility to respond quickly to an opportunity (more than big business). Tempering this optimism: Just 38% say getting access to the capital they need is somewhat or very easy, while 20% say it is somewhat or very hard, a two-to-one ratio; the corresponding numbers six months ago were 53% and 14%, nearly four-to-one.

Second, the next few months will favor those who prepared beforehand. Forty-seven percent of middle market companies saying they have easy access to capital also say that the impact of the pandemic has been low. Companies with an "excellent" or "very good" long-term growth strategy in place are almost half again as likely to have had a low impact as those less planful. Similarly, companies that give themselves high marks for retaining talented employees are much less likely to say the pandemic hit them hard than companies less attentive to their human capital. The same holds true for companies that invest sufficiently for the future. As companies grow, processes such as planning become increasingly important, a phenomenon we documented during the long expansion.

These capabilities will make for an easier road through the challenging times ahead. The middle market as a whole sees growth of 2.0% in the next 12 months. Those confident in their ability to get capital foresee growth of 6%, while companies that invest sufficiently expect 5.7% growth. The strong strategic planners see 5% growth, and talent-keepers see 4.7% growth.

Third, many executives intend to use forthcoming months not just to recover, but to change. The impact of the pandemic on digital transformation efforts has been slightly more positive than negative: 27% cite a positive impact, 25% a negative. (For companies in business services, 36% see a positive impact; in healthcare, 34%.) This contrasts to largely negative impacts in areas such as capital spending (16% positive, 42% negative) and growth initiatives (21% positive, 52% negative.) It is often said that a crisis can accelerate trends that already exist. COVID-19's effect on digital transformation appears to be an example.

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