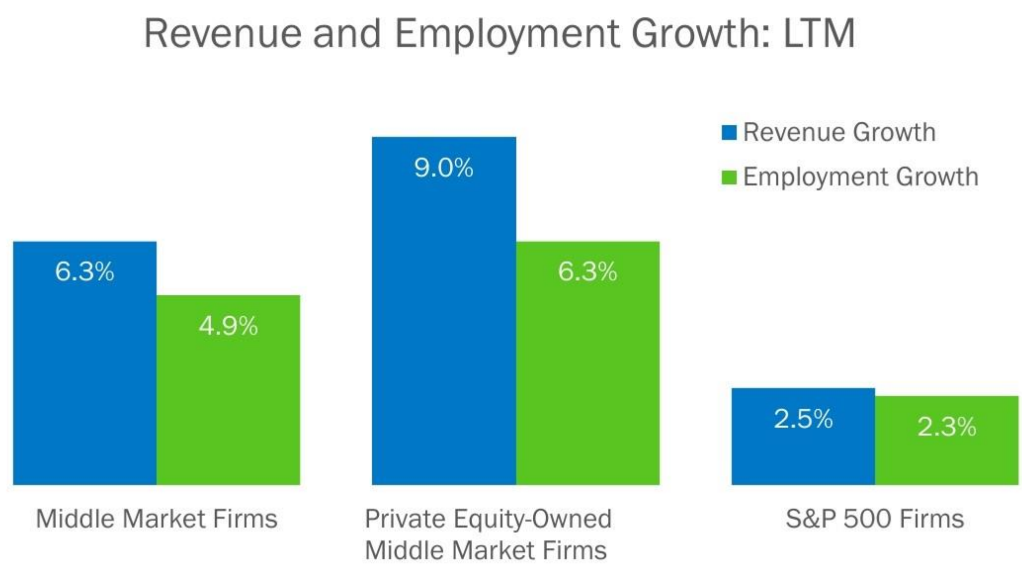
Valitas Insights: Growth in the Middle Market – Bucking the S&P Trend

Slow organic revenue growth is an issue for many companies – over the past twelve months, revenue growth for S&P 500 companies was an unimpressive 2.5%. This week, however, we are reporting on an interesting twist: **U.S. middle market companies are outpacing their larger counterparts by a strong margin, and PE owned companies are leading the pack.**

The National Center for the Middle Market (NCMM) recently released its Q3 2016 survey results. Trailing twelve-month revenue growth for middle market companies was 6.3%, with employment growth of 4.9%. Notably, private equity (PE) owned firms realized revenue growth of 9%. Contrary to public perception that PE firms cut staff to produce cost savings, PE owned companies generated employment growth of 6.3%. Over the same period, employment growth for large business and small business was, respectively, 2.3% and a mere 1.8%.



Innovation was identified as a key driver of revenue growth, impacting new products and services as well as processes. Surveyed companies reported that they were concerned about a shortage of talent in meeting their future hiring needs, forecast at 4% and 5.6% for non-PE owned and PE owned firms respectively.

These survey results are consistent with findings we've discussed previously linkng business courage to higher revenue growth. We know courageous businesses invest more in innovation and hire employees at higher levels than their non-courageous peers.

Perhaps we can speculate that middle market companies are, on average, more courageous than their smaller and larger counterparts. But why are PE owned firms outpacing the rest of the pack? The NCMM report suggests several possibilities[1]:

1. Selection bias: PE firms select acquisition targets with the best prospects;

2. Portfolio leverage: Acquired companies may yield economies of scale/synergies as PE firms target add-ons to existing platforms;

3. Infusion of outside capital: Viable projects that could not be funded pre-acquisition are now being funded. To quote the presenter of the NCMM report: "Pour water on the desert and bingo, the desert starts to bloom"; and

4. Professionalization of Management: Add-on acquisitions benefit from management expertise at the platform level. Additionally, post-acquisition, management issues are addressed and interests aligned with business goals.

The outlook for middle market companies remains positive for 2017, with revenue growth and hiring forecasts ahead of larger and smaller peers, reflecting a sustained, strong confidence in the economy. We've all heard the saying that "small business is the engine that drives the economy". Perhaps this should be reframed to include mid-size business as well.

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[1] Read more about the value-creation principles employed by PE firms in our October 28 Insight Article