Valitas Insights: The Middle Market - Full Steam Ahead in 2017

U.S. middle market companies are killing it. In a good way.

This week, the National Center for the Middle Market (NCMM) reported the results of its Q4 2016 survey. The findings: on several key indicators, U.S. middle market companies are outpacing their larger and smaller counterparts, and private equity (PE) owned middle market firms continue to lead the pack.

The NCMM surveyed 1,000 middle market executives on key performance indicators, economic confidence, and perceived business challenges. Responses were gathered during the first two weeks of December - after U.S. election results were known, but before the inauguration and rapid fire of executive orders. We expect that in the intervening period, given the surge in U.S. investor confidence, economic confidence expectations have likely remained unchanged or are shifting upwards.

Revenue Growth: Ahead of 5-year average, with PE-owned firms outpacing the pack

Revenue growth for 2016 was 6.9%, somewhat higher than the five-year average of 6.5%, and considerably outpacing the S&P 500's revenue growth of 4.4%. The strongest growth came from the construction sector at 12.6%. With the new administration's commitment to rebuilding U.S. infrastructure, we expect this to be sustained in 2017.

PE-owned middle market companies continued to outperform their peers, with revenue growth of 10%. As we've noted previously, explanations for PE firms' strong showing include:

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 a previous NCMM report: "Pour water on the desert and bingo, the desert starts to bloom"; and

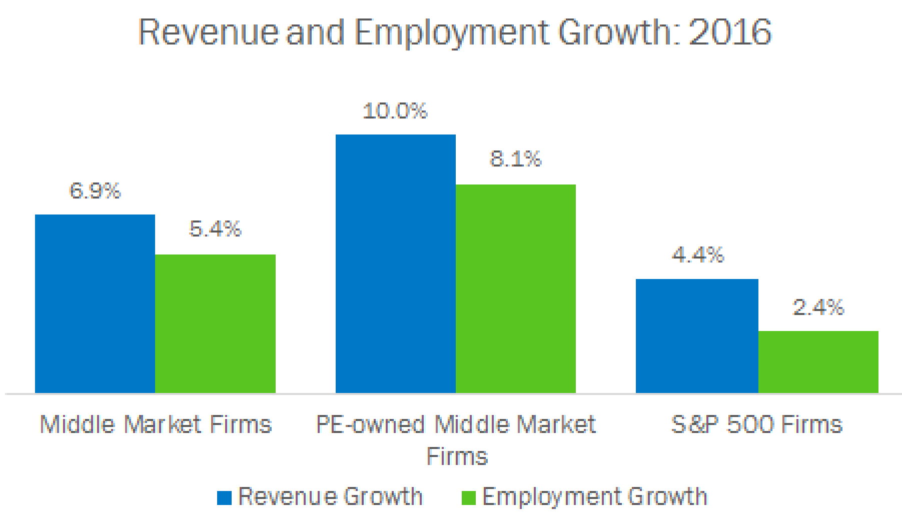
4. Professionalization of management: Add-on acquisitions benefit from management expertise at the platform level. Additionally, post-acquisition, management issues are addressed and interests aligned with business goals.

Revenue growth projections for the next twelve months were lower, at 5.5% (and 7.5% for PE-owned firms). Over the five years that the NCMM has been conducting this survey, however, revenue growth projections have typically been 1-1.5% shy of actual results.

Employment Growth: Debunking the myth that PE acquisitions result in net job loss

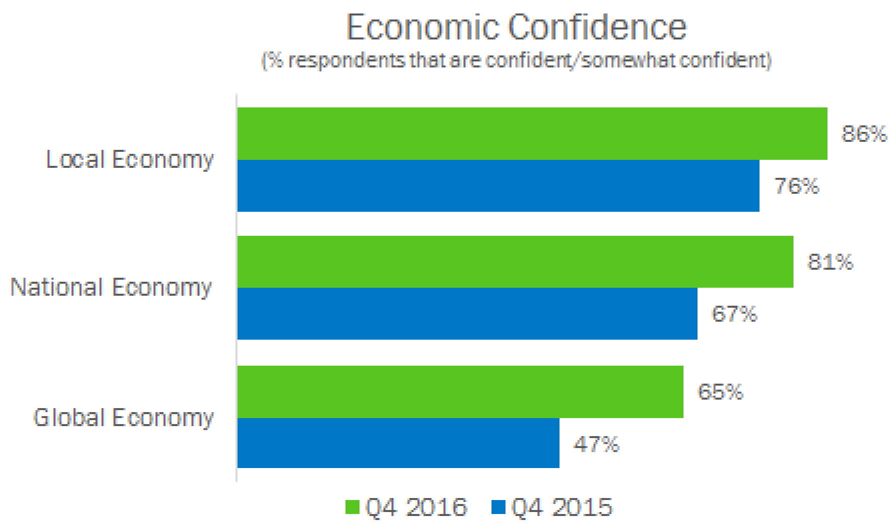
Middle market companies reported 2016 employment growth of 5.4% and have been adding jobs at an accelerating rate over the past two years relative to their peers. Once again, PE-owned firms were well ahead of the pack, with employment growth of 8.1%. Over the same period, employment growth for S&P 500 firms and small business was considerably lower at, respectively, 2.4% and 1.4%.

We can expect further employment growth in 2017, with 33% of respondents expecting to add jobs in the coming year. In fact, talent acquisition was regarded as one of the biggest constraints to growth for middle market companies; almost 40% claimed that if they could find the talent, they could grow faster.



Soaring confidence and stronger expectations for M&A

Middle market confidence levels in the global, national, and local economies reached the highest levels ever recorded in the NCMM survey. Sentiment was most positive amongst firms reporting the highest growth rates, which leaves us wondering if these respondents are extrapolating from past success to guide their economic outlook. Only time will tell whether, and to what extent, this is the case.



Companies also reported on their plans to drive growth in 2017. Organic growth drivers included the introduction of new products or services, and expansion into new markets at higher levels than 2016. In addition, respondents expressed heightened intentions to engage in deal activity, with 39% stating that some sort of M&A activity was extremely or very likely in the next twelve months.

New regime, different challenges?

Prospects appear to be rosy for the U.S. middle market. However, as the author of the NCMM report observes: "[F]or the last five years, the U.S. has enjoyed steady and moderate growth, low interest rates…negligible inflation, and little pressure from materials or wages." Shifts in these conditions will impact the challenges faced by middle market companies and we're certainly faced with changing times. It's not clear yet what the long-term picture will be, but for now, it's full steam ahead.