Middle market leaders express confidence through year-end, but anticipate downturn in 2023

The final months of the calendar year is crunch time for many businesses. As winter holidays usher in a surge of consumer activity in the retail, travel and hospitality sectors, companies across the economy engage in forecasting and budgeting for the year ahead. In the U.S. middle market, an increasing number of leaders report renewed confidence in their own enterprises and in the U.S. economy at large, according to KeyBank's September survey of 400 owners and executives of businesses with $10 million to $2 billion in revenues.

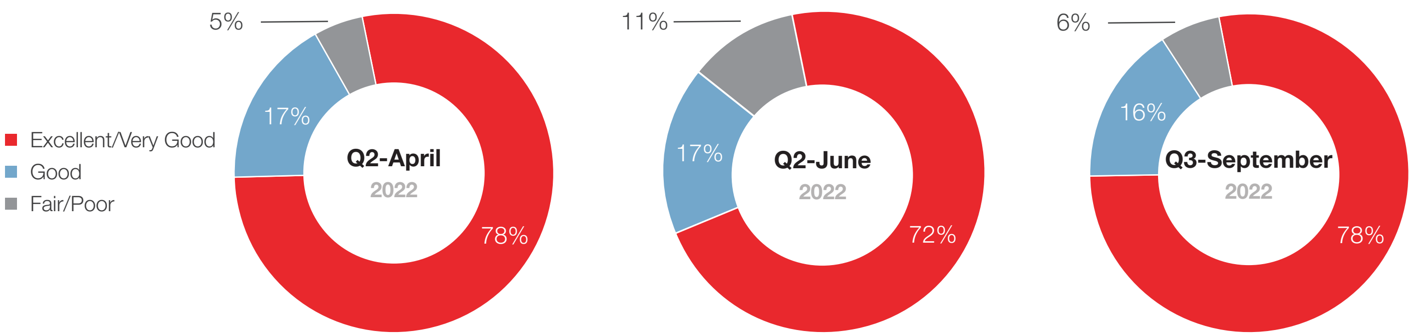
As the fourth quarter of 2022 approached, middle market business owners were still contending with a challenging labor market, elevated inflation and rising interest rates. But the number of respondents anticipating an economic downturn before the end of 2022 decreased significantly since June, and some owners seem to be breathing a sigh of relief as they look forward to the conclusion of a tumultuous year.

> "Customers we talk to are optimistic about their companies and the economy through the end of the year. Looking ahead to next year, there's a lot of uncertainty. They're worried about policy outcomes of the midterm elections, continued inflation, staffing issues and supply chain issues."
>
> **– Tim Burke, Central region sales executive, KeyBank commercial banking**

Outlook for companies and U.S. economy trend upward as 2022 winds down

Between June and September of 2022, the number of middle market business owners and executives who characterized the outlook for their own companies as excellent or very good improved by 6 percentage points. Leaders of publicly owned businesses and those in the construction industry were especially optimistic, with 85% and 87%, respectively, reporting an excellent or very good outlook for their next 12 months. The number of respondents who reported having an excellent or very good outlook on the overall U.S. economy increased by 9 percentage points to its highest level so far this year (61%).

Company outlook next 12 months



Middle market business owners were also less worried than earlier in the year about the possibility of an abrupt economic downturn during 2022. In June, more than 40% anticipated a downturn by the end of the year. As of September, that number had fallen to 29%; however, among the 22% of respondents with a lower company outlook, almost half still expect a downturn to occur before the end of 2022. The main causes for apprehension among those less optimistic business leaders are higher rates of overall inflation, potential economic recession and higher costs for labor and raw materials.

As they look ahead to 2023, many middle market businesses are exploring opportunities to expand their operations. Almost half (48%) of leaders surveyed indicated plans to hire new full-time, part-time or contract employees over the next six months, while 46% plan to expand their use of technology and automation. Forty-three percent anticipate implementing process improvements, and 42% will introduce new products.

> "When business owners are optimistic about the future, they're more likely to make bold plans, investments and strategic decisions, which creates opportunities for their organizations, employees and communities."
>
> **– Joe Markey, East region sales executive, KeyBank commercial banking**

Economic downturn predictions pushed to 2023

While middle market business leaders are less worried about navigating an economic downturn this year, most still see a potential recession on the horizon and anticipate negative implications for their businesses. Less than a third of September survey respondents still believe a downturn will occur before the end of 2022, but nearly half (47%) expect to see one during the first half of 2023, and 8% foresee it happening in the second half of 2023. Of all those who predict a downturn sometime before 2024, 76% are bracing for negative effects on their companies.

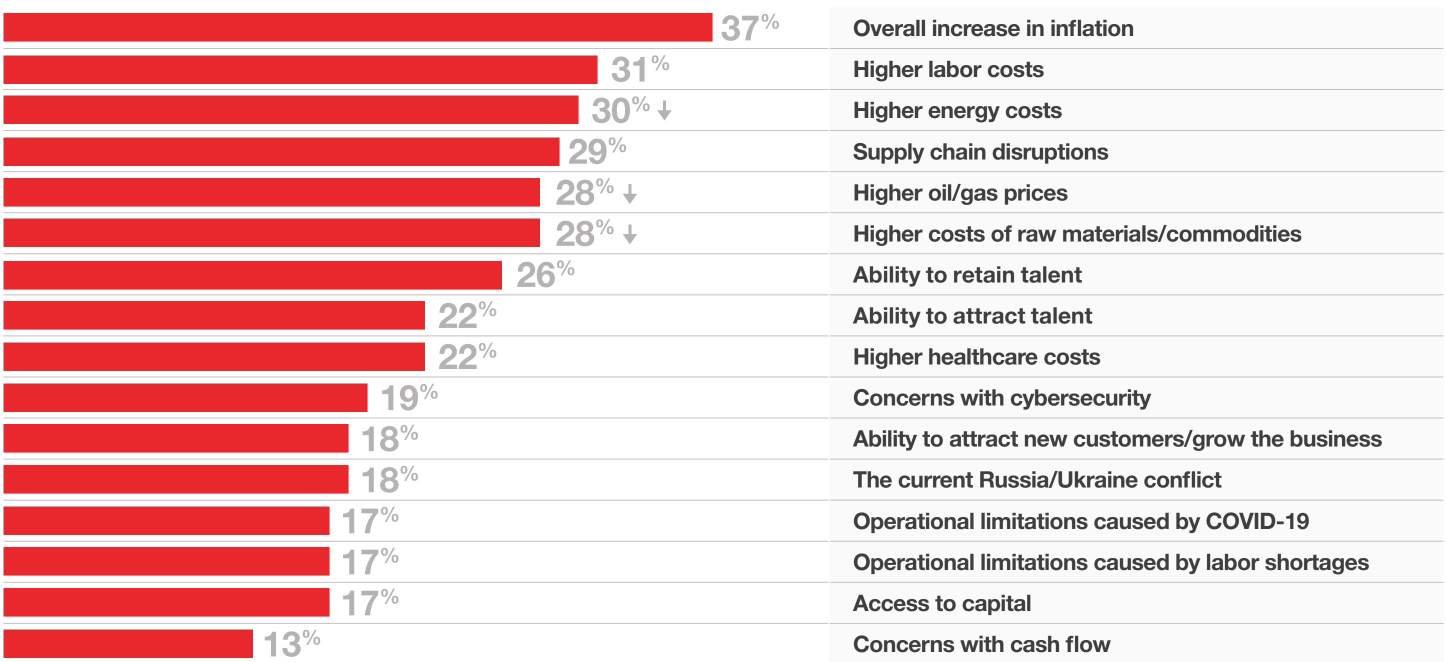
> “We are hearing quite a few companies scaling back their 2023 projections in anticipation of an economic slowdown. They’re guarded, but most feel it’s not going to be a deep recession.”
>
> **– Joe Markey, East region sales executive,**
> **KeyBank commercial banking**

To cushion the impending blow, middle market businesses are taking similar measures as they reported in June: 41% are working on improving operational efficiencies and productivity, 34% are seeking alternate or lower-cost suppliers for raw materials and component parts and 31% are identifying new markets, products and/or services to increase revenues. Thirty-one percent are also increasing savings and liquidity in anticipation of a coming downturn.

A potential recession is not the only obstacle the middle market will face in the coming months. Business owners and executives are still experiencing and anticipating negative effects on their operations from inflation, higher energy costs and oil and gas prices, higher costs of raw materials and commodities, ongoing supply chain disruptions and higher labor costs. That said, fewer survey respondents expect these issues to affect their businesses over the next 12 months than did in June.

Factors currently having or anticipated to have negative impact on business in next 12 months

Q3 2022



The survey data reveal broad topical trends, but middle market companies are by no means a monolith. Segmenting results by company size, region, industry or outlook uncovers significant variation in respondents’ experiences and sentiment. This holds especially true when it comes to the implications of inflation and rising costs.

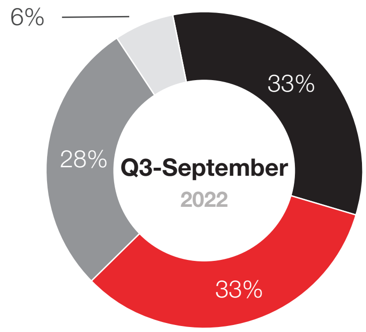
Effects of inflation are mixed, but cost pressures persist

On the topic of how inflation affects their business, middle market leaders were split almost evenly into three camps: 28% said the negative impacts of inflation outweighed the positive; 33% reported a similar amount of negative and positive impacts; and 33% said the positive impacts of inflation outweighed the negative ones.

Negative inflation impact on business

Q3 September 2022

- Positive impacts outweighed negative impacts
- Similar amount of positive and negative impacts
- Negative impacts outweighed positive impacts
- No impact

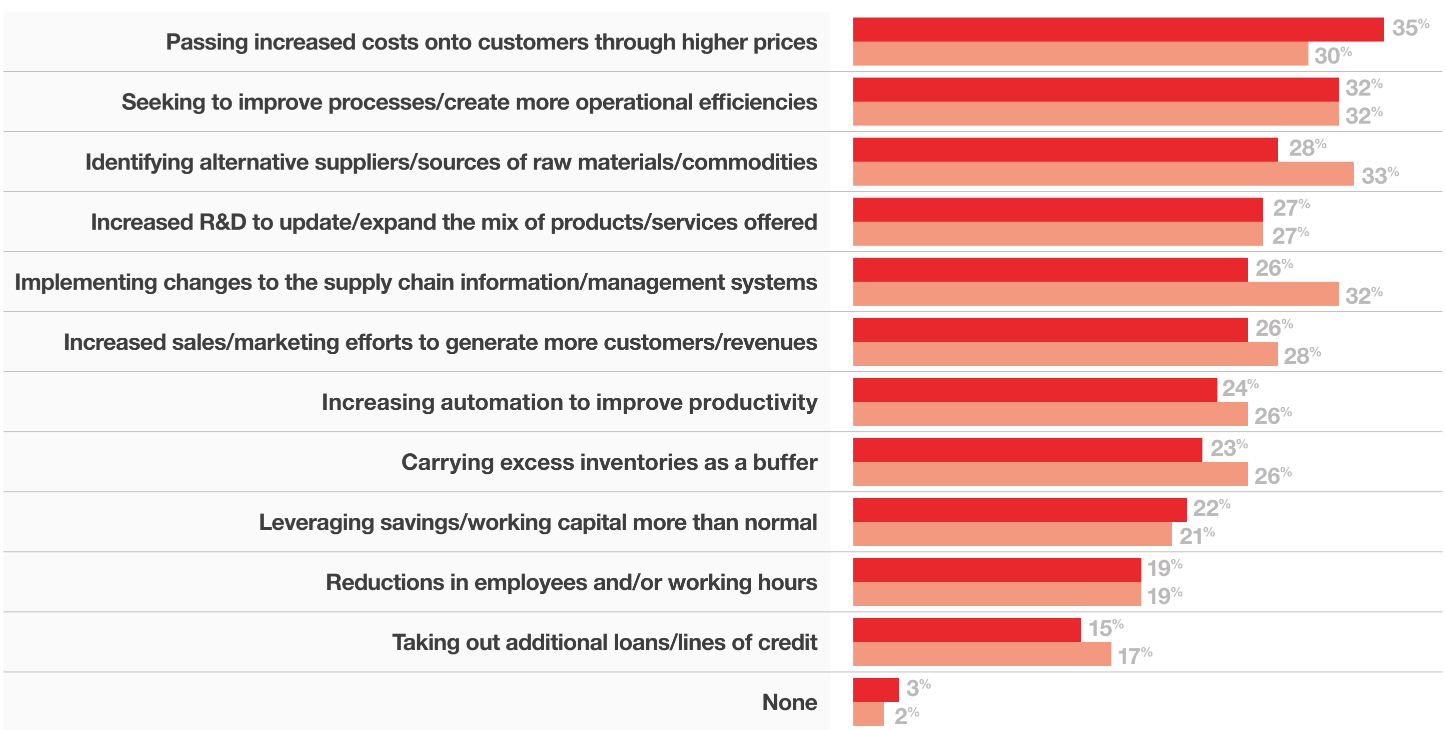


Among the businesses that reported negative impacts from inflation, increases in the cost of energy, oil and gas (53%), overhead (50%), and raw materials and supplies (45%) were the contributing factors cited by the highest numbers of respondents. At the other end of the spectrum, business owners and executives who indicated that inflation has been good for their businesses named increased productivity (44%), increased customer spending (44%) and the ability to raise prices (43%) as positive developments driven by inflation over the past six months. Within the group of survey respondents who reported positive effects of inflation, more than half of the higher-revenue companies reported productivity gains (55%), while increased customer spending gave the biggest boost to manufacturing firms (58%).

As inflation persists into the fourth quarter of 2022, middle market business leaders are taking a variety of actions in response. Over the past six months, more than a third have passed cost increases on to customers, and 30% plan to do so over the next six months. Companies are also taking steps to increase efficiency and identify alternative suppliers for raw materials.

Actions taken or planning to take as result of inflation

Past 6 Months   Next 6 Months



Rising costs for energy, oil and gas have frequently made headlines in 2022, especially as Russia's war on Ukraine has affected global supply. Among U.S. middle market businesses who are concerned about the effect of these rising costs, 67% reported smaller profit margins over the past six months and 38% experienced a decrease in revenues. Forty-five percent said they were increasing their efforts around renewable energy sources and/or energy efficiency because of higher energy costs. But financial implications are not the only factors motivating companies to explore renewables:

> "Businesses are hearing from employees that environmental issues are very important. There is a greater sensitivity to and focus on those issues, especially in the West. Rebates and other federal, state and local incentives are also encouraging companies to invest in energy-saving technology."
>
> **– Laurie Muller-Girard, West region sales executive, KeyBank commercial banking**

Supply chain disruptions also continue to impact some middle market companies. Nearly half (47%) of business leaders indicated that supply chain issues have had a somewhat or very negative impact on their operations over the previous 12 months. Among those, respondents with a lower company outlook were significantly more likely to report issues with higher costs of raw materials, loss of some suppliers and reduced availability of raw materials and commodities. In addition, the negative impacts of inflation, including increased overhead costs, increased costs of oil and gas and decreased profits, appear to be more prominent among businesses that have experienced negative supply chain impacts. In response to supply chain difficulties, 44% of middle market businesses are passing increased costs onto customers, 35% are identifying alternative suppliers of raw materials and 34% are carrying excess inventories.

Hiring workers is getting easier, but some sectors continue to struggle

On the surface, optimism around attracting and retaining talent appears to be trending upward among owners and executives of middle market businesses. But upon examining individual industries, regions or companies, the picture becomes more nuanced.

Fifty-eight percent of survey respondents believe it will be easy or very easy to fill their company's job vacancies in the next six months, compared to 55% in June and 51% in April. Those who report a positive outlook on the U.S. economy are more confident in their ability to attract talent (79% expect it to be very easy or easy), as are higher revenue companies (68%) and those located in the West (68%). But in the Midwest region, only 48% of business leaders were confident that it would be easy to fill job openings in the coming months.

> "We hear about hiring challenges from the C-Suite and the finance office (controller, treasurer, accountants) to manufacturing and transportation workers. Everybody and their brother is looking for drivers and welders."
>
> **– Laurie Muller-Girard, West region sales executive, KeyBank commercial banking**

Retaining qualified workers also appears to be less of a challenge than it was earlier in the year: In September, only 15% of those surveyed anticipated difficulty retaining employees over the following two quarters. This amounts to a significant decrease since June, when nearly a quarter (22%) of middle market business owners and executives anticipated difficulty in keeping their companies adequately staffed. But at the industry level, 30% of middle market businesses in the retail industry and 29% of those in healthcare anticipate that their ability to retain talent will have a negative impact on their business within the next 12 months.

> “Our nurses are absolutely drained. It’s hard to attract people to that industry after all they’ve been through over the past two to three years, and it will continue to be a struggle for the foreseeable future.”
>
> **– Tim Burke, Central region sales executive, KeyBank commercial banking**

Middle market business leaders who expressed concerns about attracting qualified workers plan to implement or enhance competitive wages (55%), bonus programs (45%), flexible hours/schedule (39%) and signing bonuses (39%). Those who anticipate difficulty in retaining talent indicated they would take similar measures: competitive wages (57%), bonus programs (46%) and flexible hours (42%) rose to the top of their lists, along with PTO (40%). In both cases, the number of survey respondents who said they would use health and wellness benefits to appeal to current and prospective employees fell from more than 50% to just over one-third.

Conclusion: 2022 goes out on a high(er) note, but uncertainty looms in 2023

The end of 2022 marks the conclusion of another challenging year for middle market businesses. Since 2020, business owners and executives have shepherded their companies through a global pandemic, stomach-churning stock market volatility, the Great Resignation, record-high inflation and more. But despite their resilience and persistent positive outlook, uncertainty remains a source of trepidation:

“I’ve never seen a period of time with so many factors driving uncertainty. People don’t even know how to forecast given the number of significant variables that could impact their future planning.” – Tim Burke, Central region sales executive, KeyBank commercial banking.

Macro-level unknowns, such as extreme weather events, escalation of geopolitical conflicts or a recession, could strike at any moment. But despite these unpredictable challenges, most middle market business owners and executives are confident in their management teams’ abilities and optimistic about their companies’ futures.

In the face of uncertainty in 2023 and beyond, KeyBank middle market experts can partner with your business to provide real-time counsel and help guide decision-making. For more information on KeyBank’s middle market capabilities, contact a KeyBank Relationship Manager.

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“KeyBank Middle Market Business Sentiment Survey,” September 8 – 21, 2022.