



Fears of economic downturn temper optimism in the middle market

Heading into the third quarter of 2022, the economic headwinds felt strong in the middle market. U.S. inflation levels were climbing to record highs and the Federal Reserve was moving forward with a series of interest rate hikes. In its June survey of 400 owners and executives of middle market businesses, defined as those with \$10 million to \$2 billion in revenues, KeyBank found that most remain optimistic about their companies' prospects in the coming months. However, the number of those facing challenges related to broader economic concerns, rising costs and supply chain disruptions, has increased since KeyBank last conducted the survey in April 2022. The June survey also revealed that most of these businesses are bracing for an economic downturn soon.

Macroeconomic headwinds stir trepidation in the middle market

Historically, middle market business leaders have expressed greater confidence in their own companies' financial prospects than in the U.S. economy at large. This trend persists in the most recent survey, but respondents were significantly more pessimistic on both fronts.

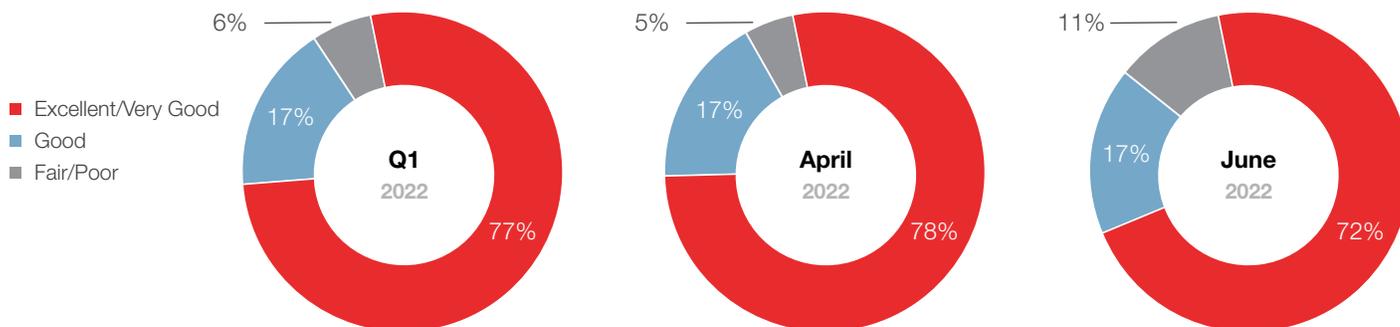
Asked to characterize their overall outlook for the U.S. economy in the next 12 months, more than one-third of middle market business owners and executives (36%) selected fair or poor, a significant increase over only 24% selecting fair or poor in April. Drivers of negative sentiment include higher rates of overall inflation and higher costs of raw materials. These concerns were especially pronounced among respondents with less-optimistic outlooks for their own businesses.

Factors causing lower US economic outlook



Given the dip in sentiment around the broader economy, it's not surprising that company outlook has also declined among some middle market business owners and executives, although most are still optimistic about their companies' financial prospects over the next 12 months. Going into the third quarter, 11% characterized their company outlook as fair or poor, an increase from 5% in April. Meanwhile, the number who describe their company outlook as excellent or very good declined from 78% in April to 72% in June.

Company outlook next 12 months



In addition, more than three-quarters of middle market business leaders anticipate an economic downturn by the first half of 2023. Among those who expect a downturn in this timeframe, 75% expect it to have a negative impact on their own business.



“The majority of our middle market customers are saying we’re already in a recessionary environment. Consumers and companies are being much more thoughtful in terms of what they’re willing to spend dollars on today. But there’s general, long-term optimism about the strength of the overall economy.”

– **Chris Picardi, senior vice president, commercial banking manager, Colorado, KeyBank**

Interestingly, a growing sense of pessimism is not universal across the entire middle market; executives with larger companies and retailers were generally more optimistic than others. Owners and executives of companies with \$500 million or more in annual revenue are more optimistic, with 85% expressing an excellent or very good company outlook for their next 12 months. Business leaders in the retail sector also report a rosier perspective, with 84% characterizing their company outlook as excellent or very good. Both groups of respondents are also more bullish on the overall U.S. economy.

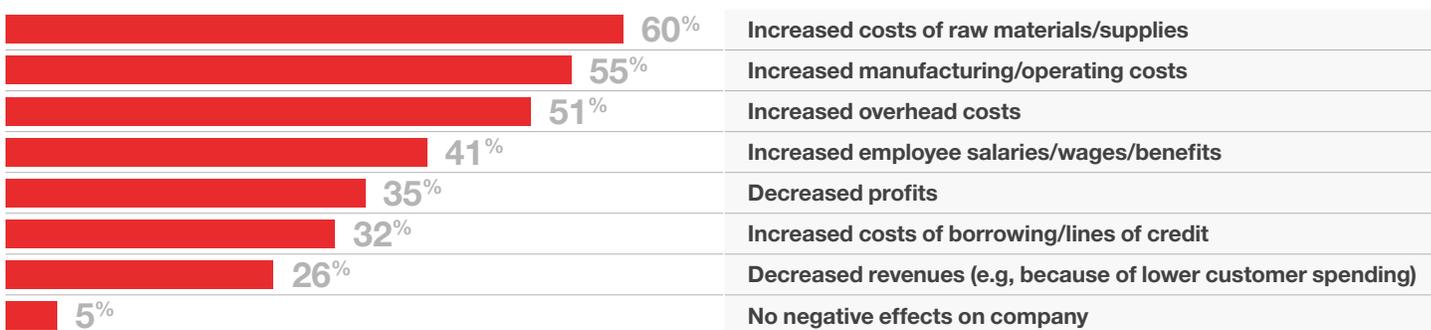
As inflation peaks, businesses face soaring costs for materials, energy

In June, U.S. inflation reached a 40-year high of 9.1%, reflecting sharp increases in the prices of food, energy and housing.¹ Middle market businesses are feeling inflation in the form of higher costs for raw materials, manufacturing and overhead. To a lesser degree, business owners and leaders also report higher employee wages, tighter margins, higher borrowing costs and decreased revenues.

¹ *Washington Post*, “June inflation soared 9.1%, a new 40-year high, amid spiking gas prices.” July 13, 2022. <https://www.washingtonpost.com/business/2022/07/13/inflation-june-cpi/>

Negative inflation effects on business

Q2 June 2022



In late June, 45% of middle market business owners and executives said that higher oil and gas prices were currently having a negative impact on their operations, an increase over 36% in April. Thirty-eight percent expect elevated oil and gas prices to continue to be a challenge over the next 12 months, and about the same number (37%) predict that high prices for raw materials and commodities will pose challenges. Even more middle market business owners and executives (43%) expect higher energy costs to have a negative impact on their operations over the next year.

Among middle market executives with a less optimistic economic outlook, higher rates of overall inflation are particularly concerning. Of those who characterize their U.S. economic outlook as fair or poor, 83% cite inflation as a contributing factor. Higher costs of raw materials and commodities (81%), a potential economic recession (77%) and higher energy costs (74%) are the other most-cited concerns among this group of respondents.



“Costs have increased for raw materials and supplies across the board, from plastic and petroleum products to paper and packaging-related items. Manufacturers are also experiencing shortages for individual components of certain products, which creates the logistical challenge of identifying alternative suppliers.”

– Dan Dower, senior vice president, commercial bank market leader,
Northwest Ohio, KeyBank

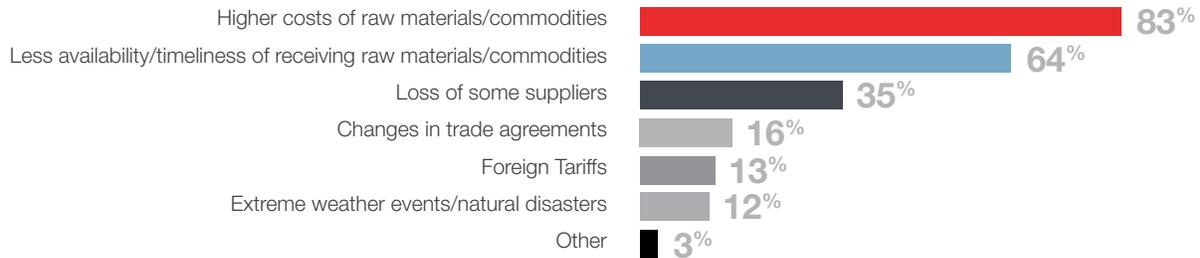
Conversely, roughly 80% saw some positive effects of inflation within the past six months. These “silver linings” include the ability to increase prices, increased consumer spending and increased productivity due to investments in automation and other process improvements. Owners and executives of middle market companies in the healthcare and retail sectors are more likely to report these positive effects, whereas manufacturing companies are less likely to report any upside as a result of inflation.

Supply chain concerns rebound after diminishing earlier this year

For many middle market businesses, energy and material costs are closely linked with supply chains. Nearly half of middle market business leaders (48%) in June said that supply chain developments have had a negative impact on their businesses in the past 12 months. In contrast, only 39% reported negative supply chain impacts in April. Difficulties in obtaining raw materials because of higher costs, lower availability and longer wait times are the top challenges cited among companies struggling with supply chain issues.

Supply chain difficulties

Q2 June 2022



Company outlook continues to be correlated with supply chain sentiment. Only about one-third of respondents with an excellent or very good company outlook report negative supply chain impacts. Among those with a less optimistic company outlook, however, 89% report that recent supply chain developments have negatively affected their businesses. Looking ahead, it's a positive development that just under one-third (31%) of all respondents anticipate that supply chain disruptions will have a negative impact on their business over the next 12 months.

It may be that executives are less concerned with supply chain challenges because they are taking action to be ready for them. To address current and future supply chain challenges, middle market business owners and executives have plans to identify alternative suppliers of raw materials, pass increased costs onto customers and carry excess inventories. For the most part, these are the same tactics they reported implementing previously, but the number of businesses taking action to counteract supply chain issues has risen to its highest in 2022 so far.



“Many middle market companies haven’t historically reset their pricing all that frequently, but, with the rapid and extreme escalation of their own costs in the current environment, they’re realizing they don’t have the luxury of waiting six months or a year to adjust prices. They need to be more dynamic, or they risk impaired profitability.”

– Dan Dower, senior vice president, commercial bank market leader,
Northwest Ohio, KeyBank

Hiring has gotten easier for some businesses, but not for others

Despite economic concerns, 44% of middle market companies plan to add employees in the next six months, and many are feeling confident in their ability to attract and retain talent. Just over half (55%) of middle market business owners and executives anticipate that it will be easy to find qualified workers to fill job openings through the end of 2022, while the number who say it would be very easy increased to 24% from 19% in April. Similarly, of the 62% who do not anticipate difficulty retaining employees through the end of 2022, about a quarter (26%) say it will be very easy to maintain their workforces.

Of the 45% of middle market business leaders who anticipate difficulties in recruiting and retaining talent, half of those respondents plan to implement or enhance programs designed to make workers happy. These measures include health and wellness benefits, competitive wages, bonus programs, flexible work hours and more paid time off (PTO). Compared to earlier this year, significantly more companies now are investing in competitive compensation and PTO to attract new employees.

Measures companies are considering using to attract talent

Q2 June 2022

 53%	Health and wellness benefits
 53% ↑	The competitiveness of wages/salaries
 50%	Bonus programs
 47% ↑	Paid time off (PTO)
 44%	Flexible hours/schedule
 42%	Options to work remotely
 41%	Company match on retirement plans (e.g., 401(k) plans)
 34%	New employee signing bonuses
 32%	Creating a safe working environment at company offices and physical locations
 29%	Job training and educational benefits (such as tuition reimbursement)
 16%	Profit sharing
 12%	Offering child-care reimbursement
 10%	Stock options
 8% ↓	Social impact/volunteer initiatives



“Middle market businesses are competing for entry-level, hourly workers against much larger corporations that can pay higher wages. These individuals tend to be more concerned with per-hour wages than the total benefits package and, in some markets, a big-box store might pay close to \$30 an hour for overnight shifts stocking shelves.”

– Chris Picardi, senior vice president, commercial banking manager,
Colorado, KeyBank

Conclusion: As inflation peaks, confidence in the economy has dipped—but company outlook remains positive

At the outset of the third quarter, most middle market business owners and executives are anticipating an economic downturn, with some believing one is already underway. To weather the storm, companies are enhancing operational efficiencies, identifying new ways to increase revenues and searching for alternate suppliers and materials. Despite inflation, supply chain disruptions and a potential recession, business leaders in the middle market remain optimistic about their own companies' futures. Many are investing in growth and uncovering new opportunities to strengthen their organizations.

Whether you're gearing up for an acquisition, or seeking to hedge against looming uncertainty, KeyBank middle market experts can provide customized insights and real-time counsel to guide your decision-making.

For more information on KeyBank's middle market capabilities, contact a KeyBank Relationship Manager.



"KeyBank Middle Market Business Sentiment Survey" June 9–27, 2022.

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