Are tariffs hurting the middle market?

Over the course of 2018, tariffs and their economic impact dominated business headlines. What began as a handful of U.S.-imposed tariffs soon precipitated retaliatory tariffs from other countries. By the end of the third quarter, these combined tariffs had encompassed 10,000+ products and $300+ billion dollars' worth of goods.[1]

What does this mean for middle market businesses? To find out, KeyBank surveyed 300 middle market business owners and executives to understand the impact tariffs are having on their businesses.

How are the new tariffs impacting middle market companies?

The recent changes in tariffs, which involve steep increases on goods from the European Union (EU), Canada, Mexico, and China—who are in turn doing the same for United States (U.S.)-based products—**are indeed already impacting middle market companies.**

As a result, there are economic winners and losers as different types of companies experience different impacts.

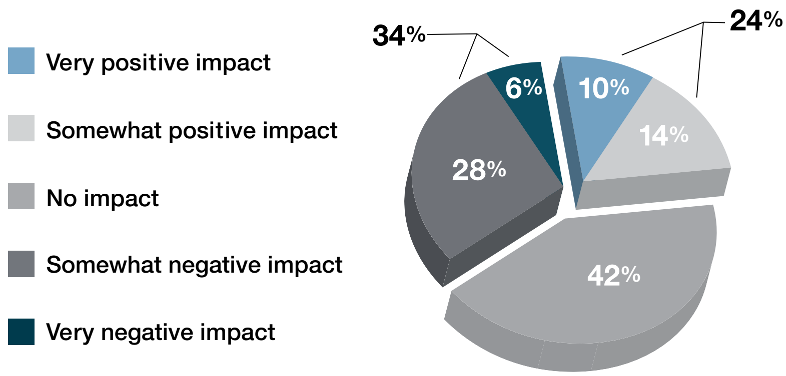
> ”
>
> *From an economic standpoint, [tariffs] have less effect on the economy as a whole…*
> *but they have a great deal of effect in terms of the winners and losers within the economy.*
>
> **–Bruce McCain, Chief Investment Strategist, Key Private Bank**

About 60 percent of the middle market companies surveyed are experiencing some type of impact, suggesting a buildup of inflationary pressure as a result of price increases. For some companies, price increases will be passed on to the end customer. For others, fierce competition prohibits increasing prices.

Regarding the type of impact companies are feeling at this point, about one third of respondents indicate a **negative impact**, compared to one quarter of respondents who indicate a **positive impact**. Those experiencing a negative impact might be more inclined to look at alternative suppliers for materials/components in the long term.

[1]*The New York Times,* 7/11/18 and 9/17/18.

Tariffs impact†



Disparate effects: two industries in focus

Negative impacts mainly relate to an increase in the cost of raw materials. This aligns with the prices of steel and other imported metal being driven up by about 25 percent; the U.S. imports a wealth of steel from Canada and the EU. Because of these tariffs, U.S. steel makers will benefit from being able to raise their prices/margins, but other companies using these imported metals will, in the short term, face higher costs and potentially lower profits. In the long term, these same firms may need to investigate alternative sourcing if the tariffs remain in effect, but their costs will likely remain higher than those of the pre-tariff period. If this occurs, these firms may need to look for other ways to reduce their costs.

Negative tariff impacts†

68%
Increased cost of raw materials/component parts

29%
Less demand for export of product(s)

26%
Longer order fulfillment times for raw materials/component parts

Those in the agricultural business are also feeling a negative impact, as foreign markets are retaliating with their own tariffs. This is lowering demand for these products, forcing U.S. suppliers to seek alternative buyers at reduced prices/margins.

"The agricultural guys are definitely getting hit hard because China has moved away from buying some of the crops and livestock from the United States, it appears." –Phil Gibbs, Equity Research Analyst, KeyBanc Capital Markets, Inc.

"We are seeing pretty significant impact overall in the industry with the recent tariffs and it has affected most commodity groups. The biggest impact is lower prices and in some cases lost or delayed sales, and that impact is reducing cash flows. Some commodities have been hit harder—the ones that have higher export volume to China like soybeans and pork."
–Mike McKay, KeyBank Agribusiness

While there is some sense—especially in the steel industry—that the level of these tariffs is unsustainable and that trade deals should help stabilize the industry, the question is: When? In the meantime, the tariffs have created a tangible feeling of discomfort.

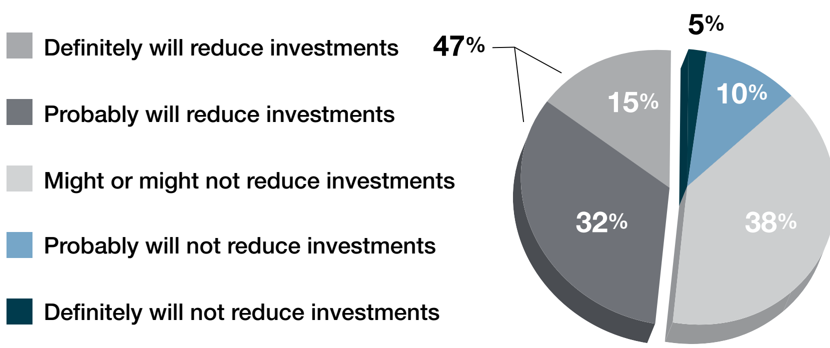
How are middle market businesses responding?

To combat the increased cost of raw materials, half of the middle market companies negatively impacted by the tariffs intend to **raise prices on their end products** over the next six months. Similarly, about half of those negatively impacted are likely going to **reduce their business investments**.

Negative tariff reactions†

Raise prices	Reduce profit margins	Find alternative suppliers
50%	36%	33%

Negative tariff impact on investments†



On the flip side, the smaller portion of middle market companies indicating a positive impact from the tariffs mainly points to higher revenues/profits on a per-unit basis, driven by their increased prices. There is a fraction of companies that see the bright side of the tariffs motivating them to expand their product sales into different markets.

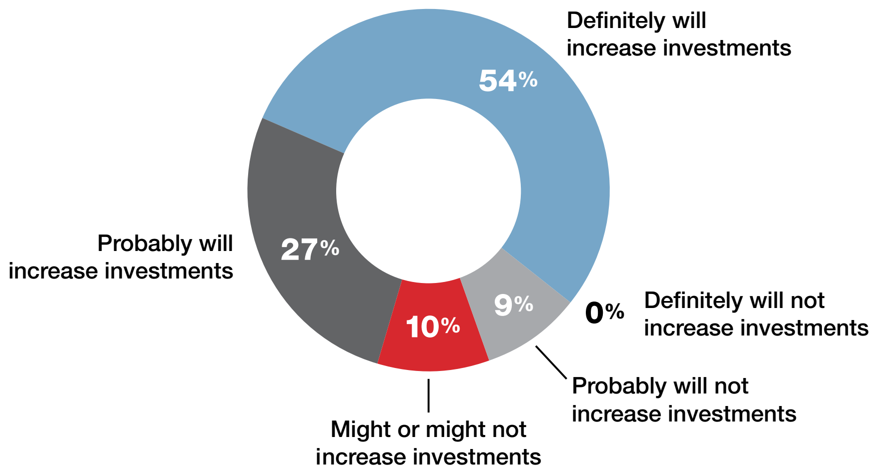
"It has created some new markets, and while we might not see an immediate impact today, I think long-term there is going to be more positive benefit because it is forcing companies to look at alternative markets for future growth and reduced concentration risk." –Mike McKay, KeyBank Agribusiness

While U.S. steel producers benefit from the higher tariffs, it's also worth noting that favorable overall economic conditions prior to the new tariffs have helped them more fully leverage this opportunity.

> Steel is a heavily cyclical and economically sensitive industry, and a good economy has just as much of a positive impact as the tariffs."
>
> **–Eric Klenz, Head of Metals and Mining, KeyBanc Capital Markets, Inc.**

As one might expect, over half of middle market companies that indicate a positive impact from the tariffs also indicate a definite intention to **increase capital/growth investments** as a direct result.

Positive tariff impact on investments†



Nevertheless, the impact of tariffs is something to keep an eye on as their effects settle in—and as more tariffs are potentially put in place. For instance, further levies could be placed on $200 billion worth of products from China.[2]

Retaliatory effects from China and other countries could soon be felt in a strong way, as the "trade wars" could escalate to the point of forcing more and more companies to raise their prices, thus further hurting consumers' pocketbooks as well as escalating inflationary effects. The key question remains: How likely it is that the trade wars will escalate before new stable trade agreements are reached?

Most recently, in North America, the United States-Mexico-Canada Agreement (USMCA) is being agreed upon. While there are again winners and losers here (e.g., the car industry is a winner while Canada dairy farmers have to make some sacrifices),[3] such an agreement is what companies will wait for to help relax the escalating tariffs and trade wars with other countries.

[2] "Trade wars, Trump tariffs and protectionism explained," *BBC News*, 7/26/18.
[3] "USMCA trade deal: Who gets what from 'new Nafta'?" *BBC News*, 10/1/18.

Economic outlook among middle market executives

Overall sentiment for the U.S. economy remains very positive. Despite a decline in the number of middle market companies expressing an excellent outlook, over 60 percent still have at least a very good outlook. Middle market businesses in the $500 million-$4 billion revenue range have an even more positive overall sentiment.

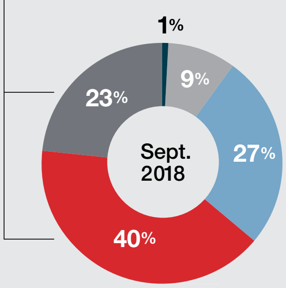
The outlook for individual companies is also still positive—especially in the western United States—and nearly 70 percent of companies are looking to expand the scope of their operations as they were in the early summer. Most want to do so by hiring more employees and through capital expenditures. Major equipment purchases, additional facilities/locations, and the expansion/renovation of current facilities are also very much in play. Lastly, half of the companies we surveyed indicated a strong likelihood to complete an acquisition in the next six months.

Economic snapshot versus June 2018†

U.S. economic outlook

Excellent · Very good · Good · Fair · Poor

Optimism ↓ 5 points

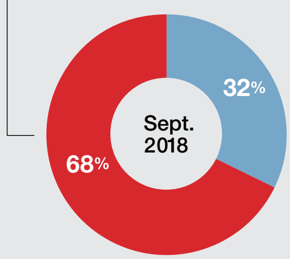


Respondent optimism has decreased since last quarter, but still remains overly positive, with 63% expecting the national economy to be "excellent" or "very good."

Expansion considerations (next 6 months)

Plan to expand · No expansion plans

Plans to expand = flat

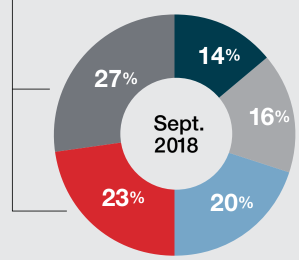


Plans for expansion within the next six months have remained flat. Of those looking to expand, more are planning to add employees compared to June.

Likelihood to complete an acquisition (next 6 months)

Extremely likely · Very likely · Somewhat likely · Very unlikely · Extremely unlikely

Plans to acquire ↓ 3 points



The number of companies likely to complete an acquisition in the next six months dropped slightly, but 50% still indicate a strong likelihood to do so.

KeyBank can help your company adjust to the tariffs.

Need to improve your cash flow? We offer lines of credit to help increase your working capital. KeyBank can also help your business improve operating efficiencies through its AP/AR automation solutions as well as lend its sector expertise to help you navigate through the cycle.

Want to take advantage of market opportunities? Should your company be looking to expand the scope of its operations, we can help by providing bank and institutional financing alternatives as well as equipment leasing options to help fund business expansions and acquisitions. To protect your company from fluctuations in interest rates, currencies, and commodity prices, KeyBank offers a full suite of risk management solutions.

No matter your plans, KeyBank makes it a point to understand your business, your goals, and your industry to provide you with value-added strategic ideas, insight, and products/services to help your business adjust to changing economic conditions and regulations.

Visit the Business Expertise Center to learn more about how we can help develop a plan to manage the potential impact of tariffs and the unique needs of your business.

KeyBank
Use the red key.

†"KeyBank Middle Market Business Sentiment Survey" September 2018.