Holding their own: Middle market business leaders manage through inflation

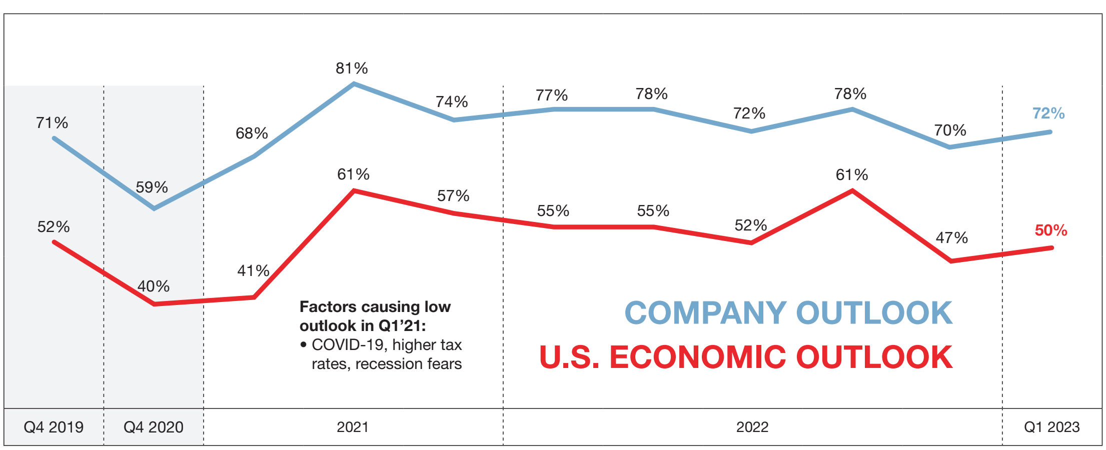
**The Q2 Middle Market Sentiment survey was fielded before and during the Silicon Valley Bank and Signature Bank closings in March 2023.*

At the end of 2022, the economic outlook among middle market business owners reached its lowest point since the first quarter of 2021. By March of 2023, they were feeling slightly more positive, as disruptions from supply chain issues and COVID-19 have mostly faded. KeyBank's March survey of 400 owners and executives of businesses with $10 million to $2 billion in revenues revealed that while some concerns have lifted, inflation and higher operating costs remain stubborn challenges for many middle market businesses—and most of those surveyed anticipate an economic downturn before the end of the year.

Confidence rebounds for some more than others

The outlook in the middle market is looking up—but only slightly. Following a drop of eight percentage points to 70% in December, 72% of middle market business leaders reported having a very good or excellent company outlook in March. That said, perspectives varied considerably by industry: construction companies reported an above-average boost in positive sentiment, from 78% in December to 88% in March. Meanwhile, the number of respondents in the healthcare field with an optimistic company outlook fell from 70% to 63%.

Looking at the broader U.S. economy, middle market sentiment continued to lag individual company outlook, in keeping with the trend over the past three years. But it also ticked up slightly, from 47% reporting a very good or excellent outlook for the U.S. economy at the end of 2022 to 50% in the first quarter of 2023. Within sectors, the number of business owners and executives in retail who felt optimistic about the economy increased nine percentage points in Q1, while the number of manufacturing leaders expressing economic optimism decreased from 57% to 51%. Across the middle market, positive sentiment about the U.S. economy remains 11 percentage points lower than it was six months ago, reflecting concerns about a variety of ongoing challenges to middle market businesses.



Inflation remains business owners and executives' top concern, with 43% reporting that it is currently having a negative impact on their businesses. Increased costs for labor (35%), raw materials (34%), energy, oil and gas (32%) are also challenging the middle market. On the bright side, fewer than one-third of respondents reported that they were currently experiencing negative effects of supply chain issues—the lowest number in more than a year. Concerns around cash flow and healthcare costs also abated after rising in December.

Top factors currently having a negative impact

	Q1 2022	Q2 2022	Q3 2022	Q4 2022	Q1 2023
Inflation	38%	44%	37%	44%	43%
Higher labor costs	39%	32%	27%	35%	35%
Higher raw material costs	37%	35%	30%	37%	34%
Higher oil/gas prices		45%	30%	33%	32%
Higher energy prices	29%	38%	35%	40%	32%
Supply chain disruptions	39%	35%	30%	40%	29%

As business leaders look ahead to the remainder of 2023, concerns about the costs of raw materials, energy, oil and gas persist. However, there are bright spots. In giving reasons for their optimism, the nearly three-quarters who reported a positive outlook for their own companies cited a variety of factors, from improved efficiency in business operations (53%) and technology improvements (43%), to their ability to attract and retain talent (39%) and the ability to raise prices (39%).

In addition, 41% of those companies who reported a positive outlook are anticipating significant revenue increases over the next 12 months. Many of these businesses are planning for growth: more than half (56%) will expand their use of technology/automation, 55% will introduce new products and 47% will add employees. These optimistic business executives are collectively less concerned about cash flow, supply chain disruptions and higher energy costs than companies with a more negative outlook.

Business leaders still bracing for an economic downturn

While their overall outlook has improved slightly, most middle market business leaders still expect an economic downturn before the end of 2023. Forty percent of those surveyed believe a downturn will happen during the first half of the year, and 41% expect it to hit in the third or fourth quarter. Among those who anticipate a downturn this year, 71% believe it will have a negative effect on their businesses.

As they anticipate a downturn, businesses report taking steps to prepare. The top four actions they cite taking to safeguard against a recession are improving operational efficiencies and productivity (43%), identifying new markets, products or services to increase revenues (35%), searching for lower cost suppliers (34%) and increasing business savings and liquidity (30%). Notably, fewer are looking to adjust their workforce by freezing new hires (26%), cutting staff (23%), increasing their use of part-time or contract employees (22%) or reducing employee benefits and pay (18% and 17%, respectively).

> “The best companies have been preparing for a potential downturn for quite some time. They’ve identified opportunities to reduce expenses, increase revenue and invest in other areas of the business, like adopting financial automation software. They’re not just reacting in real-time—they’re prepared.”
>
> **– Brandon Nowac, executive vice president, commercial payments, KeyBank**

Inflation persists, but some see silver linings

More than one-third of middle market business owners and executives surveyed expect inflation to have a negative impact on their businesses over the next 12 months. Looking at the top five concerns across the middle market this year, supply chain disruptions have fallen off the list, and all of the top five have to do with elevated costs.

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

Base: Total business owners/executives

Anticipated future negative impact on business in next 12 months

	Q3 2022	Q4 2022	Q1 2023
Overall increase in inflation	37%	39%	36%
Higher labor costs	31%	36%	35%
Higher costs of raw materials/commodities	28%	33%	31%
Higher energy costs	30%	36%	31%
Higher oil/gas prices	28%	30%	30%

When it comes to inflation, business leaders experience both negative and positive effects. More than a third (35%) of business owners and executives report that inflation’s negative effects on their companies over the past six months outweighed the positive, while just under a third (31%) said that for their enterprises, the positive effects of inflation outweighed the negative ones. For the group that experienced more negative effects, the most detrimental of these included higher overhead costs (58%), increased costs of raw materials (54%) and increased costs of energy, oil and gas (54%). Among respondents in the healthcare sector, half said that inflation had negatively impacted their businesses in recent months. The leaders who characterized inflation as a net benefit cited the ability to raise prices (52% overall, and 64% in the retail sector), increased incentives for the business to spend or invest (46%) and increased customer spending—e.g., building up inventories and buying ahead (45%).

Beyond the middle market, companies across the U.S. economy and around the globe have successfully boosted their margins by raising prices in recent months.[1] Coca Cola, Nestle and McDonald’s all reported strong first-quarter earnings due in part to price increases.[2] But as some executives noted, the consumer won’t bear rising costs indefinitely, and some experts believe an inflection point is already upon us.

[1] Wall Street Journal, “Why Is Inflation So Sticky? It Could Be Corporate Profits.” May 2, 2023. https://www.wsj.com/articles/why-is-inflation-so-sticky-it-could-be-corporate-profits-b78d90b7

[2] Reuters, “Price hikes boost profits at global consumer giants; will spending last?” April 25, 2023. https://www.reuters.com/markets/what-recession-global-consumer-giants-boosted-by-spending-higher-prices-2023-04-25/

> “The consumer is definitely more focused on value in recent months, and that will likely continue to be the case moving forward. It will be a challenge for retailers and restaurants to manage their margin profiles and inflated costs when they can’t pass all of it through to the consumer.”
>
> **– Ryan Hartzell, director, consumer & retail investment banking, KeyBanc Capital Markets**

In managing inflation and higher costs, business owners’ approaches vary according to their company outlook. Over the next six months, those with a more positive outlook are more likely to focus on increasing sales and marketing efforts to generate more customers and revenue (41%) and improving processes or creating more operational efficiencies (37%). Meanwhile, business leaders with a more negative view of their companies’ financial prospects this year are more inclined to identify alternative suppliers or sources of raw materials and commodities (38%) and pass increased costs onto customers through higher prices (38%).

These findings suggest that for middle market businesses expecting to do well in 2023, inflation may pose a challenge, but leadership is taking a growth-minded approach to managing through it. For companies where the outlook is less bright, executives may be looking for ways to protect precarious balance sheets by reducing their costs while increasing their prices.

Credit and liquidity concerns remain low despite turmoil in the banking system

In spring of 2023, the collapse of three regional banks (Silicon Valley Bank, Signature Bank and First Republic) temporarily roiled the U.S. banking system.[3] However, regional bank failures do not appear to have materially affected middle market businesses in the short term.

Middle market executives surveyed around the same time as the bank failures occurred reported being more focused on the implications of ongoing inflation and a potential economic downturn than on banking issues or cash flow challenges. Only 16% of survey respondents expect cash flow concerns to have a negative impact on their businesses over the next 12 months, down from 21% the previous quarter.

While middle market business leaders are not overly worried about their balance sheets, some are taking precautionary liquidity management measures to prepare for a possible recession. Thirty percent reported increasing business savings and liquidity, while a quarter are increasing their company’s line of credit and 21% are identifying new credit lenders.

> “The pandemic was so difficult for businesses, and many learned hard lessons despite PPP loans and other pandemic stimulus flooding the system with liquidity. Strong operators have learned that in difficult times, you need to protect the balance sheet and preserve as much cash as possible.”
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> **– Chris Doyle, senior vice president, commercial banking leader, Cleveland, Columbus and Western PA, KeyBank**

[3] AP, “Fed faults Silicon Valley Bank execs, itself in bank failure.” April 28, 2023. https://apnews.com/article/silicon-valley-fed-supervision-review-30f56061bf5d103cef7e9445d50fd759

Fewer businesses are struggling to attract and retain qualified workers

The U.S. unemployment rate hasn't been this low since 1969, and most middle market businesses have been managing through labor shortages. In December, middle market business leaders' pessimism around attracting and retaining qualified talent reached a peak. By March, those worries had begun to subside, although businesses in certain segments reported they were still struggling.

More than a quarter (27%) of those surveyed said in March that it would be difficult or very difficult to fill job openings at their companies over the next six months, compared to 34% in December. Business leaders with an optimistic company outlook were less worried about attracting and retaining talent: only 18% of those with excellent or very good company outlooks expect difficulty filling positions, compared to more than half of companies with a more negative outlook. In addition, 77% of companies with a positive outlook said it would be easy or very easy to retain employees over the same period, compared to only 24% of those with a neutral or negative outlook.

Seventy percent of business leaders in the construction industry and two-thirds of those with revenues between $250 million and $2 billion predicted that it would be easy or very easy to find talent; on the other hand, 41% of those in the transportation industry and 37% of those with revenue under $25 million predicted that it would be difficult or very difficult.

Business leaders who anticipate difficulty attracting workers recognize that wages are a key factor: more than half (55%) reported plans to enhance the competitiveness of their wages and salaries. After compensation, other incentives they are considering include flexible hours (47%), health benefits (46%), and bonuses (46%). Companies that plan to expand their workforces within the next six months and expect to encounter difficulty filling those job openings are more likely to consider all available measures for attracting and retaining qualified talent:

Measures company is considering using to attract talent by methods of expansion

Base: Those who plan to add employees in the next 6 months (business owners/executives)

March 2023

	Those expecting difficulties attracting workers	Those expecting difficulties attracting workers who plan to add employees (full-time, part-time or contract)
The competitiveness of wages/salaries	55% (+3)	68% (+8)
Flexible hours/schedule	47% (+0)	54% (+7)
Health and wellness benefits	46% (+1)	55% (+3)
Bonus programs	46% (+3)	56% (+12)
Paid time off (PTO)	42% (-3)	48% (-11)
Company match on retirement plans (e.g., 401k plans)	38% (+4)	53% (+12)
Options to work remotely	36% (-1)	39% (+1)
New employee signing bonuses	35% (+0)	43% (+2)
Job training and educational benefits (such as tuition reimbursement)	29% (+4)	39% (+7)
Creating a safe working environment at company offices and physical locations	20% (-5)	32% (-2)
Profit sharing	18% (+7)	21% (+9)
Offering child care reimbursement	13% (+3)	18% (+10)
Stock options	13% (+3)	19% (+11)
Subsidizing/reimbursing mental healthcare	12%	18%
Social impact/volunteer initiatives	9% (-1)	11% (+3)

Employee retention is a challenge in some industries. Middle market business leaders in consumer-facing companies (52%), retail (51%) and transportation (49%) were more likely to perceive retaining workers over the next six months as difficult or very difficult, compared to only 16% of businesses overall. Business leaders worried about retaining their people also focused on enhancing compensation, flexibility and benefits.

“Hiring has been a major pain point for several years. Companies are being opportunistic—if there are good people to hire, they’re going to do it.”

– T.J. Monico, managing director, industrial investment banking, KeyBanc Capital Markets

One perspective does not fit all

With the first quarter of 2023 in the rear-view mirror, middle market business leaders are carefully monitoring economic conditions as well as their own prospects. For some, inflation and higher costs continue to put pressure on the bottom line; for others, the ability to raise prices has boosted margins. Some are having an easier time hiring the workers they need, while others are struggling to attract and retain qualified talent. The middle market has never been monolithic, but in moments of uncertainty, it becomes clearer than ever that the outlook for this crucial segment of the economy is as diverse as the businesses that comprise it.

KeyBank’s experts have the insight and solutions to help your business prepare for a potential downturn, manage risk and identify opportunities in an uncertain economic environment. In addition, our payments capabilities offer integrated solutions and strategic expertise to help your business collect funds faster, reduce fraud, optimize payables and processes, and improve your bottom line through effective funds management. To learn more about KeyBank’s middle market capabilities, contact a KeyBank Relationship Manager.

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“KeyBank Middle Market Business Sentiment Survey,” March 7-16, 2023.

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