Q3 2021 U.S. Middle Market Business Owners Survey

CEO Confidence Tapers, Revenue Growth Slows Amid COVID-19 Variants

Contents

Survey Methodology

Capstone Partners is pleased to share the results of its second Middle Market Business Owners Study, providing insight into the health and recovery of small and medium sized businesses in the COVID-19 era. As we continue this research, Capstone will track the performance of the middle market, recent challenges and recovery tactics, value drivers, and the changing sentiments of businesses owners on their respective industries and the state of the U.S. economy.

Middle market businesses are vital to the health and expansion of the U.S. economy and represent nearly one-third of gross domestic product (GDP). While information on public companies can be readily accessed, insight into privately-owned middle market companies is difficult to procure. Our proprietary research seeks to provide greater insight into this crucial group, by gathering quarterly data via an online survey on how the current economic environment is impacting the operations and strategy of privately held middle market businesses.

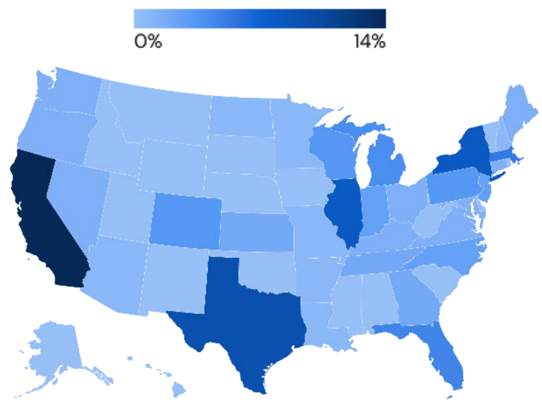
We see this as important work, and we need your help. If you wish to volunteer for future studies, please **register here**.

About This Report

This report combines Capstone's in-depth middle market expertise with proprietary insights obtained from 148 participating owners of privately owned, middle market companies. Survey responses were collected between October 12, 2021 and November 12, 2021.

Geographic Location

Respondents to our October 2021 study were heavily headquartered in California, followed by Texas, New York, and Illinois.



Industry Breakdown

Business owners in the Industrials industry comprised the largest share of responses in our October 2021 study.

Industries Surveyed	Share of Total Responses
Industrial & Manufacturing	28.4%
Consumer & Retail	20.3%
Business Services	12.8%
Healthcare	8.1%
Aerospace, Defense, Government & Security	6.1%
Technology, Media & Telecom	6.1%
Building Products & Construction Services	4.7%
Energy & Power	4.7%
*Other**	*8.7%*

**Other industries made up <3% respectively and included Transportation & Logistics, Education & Training, Financial Services, Industrial Technology, and Real Estate.*
Source: Capstone Partners Research

Executive Summary

Despite the rollout of vaccines, accompanying booster shots, and additional medication to treat COVID-19 symptoms, the emergence of Delta and Omicron variants has exacerbated challenges for many middle market companies in Q3. Supply chain disruptions worsened over the past quarter, afflicting 15.2% more businesses in Q3 compared to Q2. The impact of which has been most severe in the Consumer & Retail industry, as seasonal demand preceding the holiday period placed additional pressure on already stressed supply chains.

In Q3, 97.3% of owners experienced at least one challenge compared to 94.2% in Q2, exemplifying the need for further recovery. Owners have continued to focus on the immediate recovery of business, prioritizing resources that align with their most prominent challenges. Owners have also increasingly cited inflation as a core challenge to business operations. Among CEOs that experienced supply chain issues, nearly 80% identified rising input prices as a leading challenge, 20% higher than in Q2. In response, the number of businesses that identified logistics support as a key recovery tactic rose 13% quarter-over-quarter (QoQ) in Q3.

Although business owners suffering from workforce shortages namely pointed to a limited talent pool (90.3%) as the foremost hurdle, 16.3% more owners struggled with employee retention in Q3 compared to Q2. Exactly half of CEOs believe an enhanced labor pool remains the best method for recovery from workforce shortages, although some noted raising pay for workers to boost employee retention rates.

Looking ahead to Q4, business owners' top priority is fortifying growth strategies, both organic and inorganic, to enter new markets, expand offerings, and bolster operational efficiency. Driven by the prospect of capital gains tax increases and the accommodative borrowing environment, 20.5% of business owners plan to engage in acquisitions in Q4. As a result, Capstone expects a continuation of the robust merger and acquisition (M&A) activity witnessed in Q2, which increased 31% year-over-year (YOY), according to Capstone's Q2 Capital Markets Update. In addition, nearly one-fourth of CEOs plan to secure financing in Q4 to ensure sufficient net working capital to fulfill their growth ambitions in 2022.

The reported revenue gains among middle market companies in Q3 fell below initial projections, further damaging business owners' optimism towards the U.S. economy and their respective industries. As a result, the share of CEOs expecting a multi-year recovery of business conditions increased by 9% QoQ.

Capstone's Research Team

Sarah Doherty, Director of Research, Aerospace, Defense, Government & Security
sdoherty@capstonepartners.com

Connor McLeod, Research Manager, Building Products & Construction Services, Consumer & Retail, Healthcare
cmcleod@capstonepartners.com

Max Morrissey, Research Associate, Technology, Media & Telcom, Education & Training, Business Services
mmorrissey@capstonepartners.com

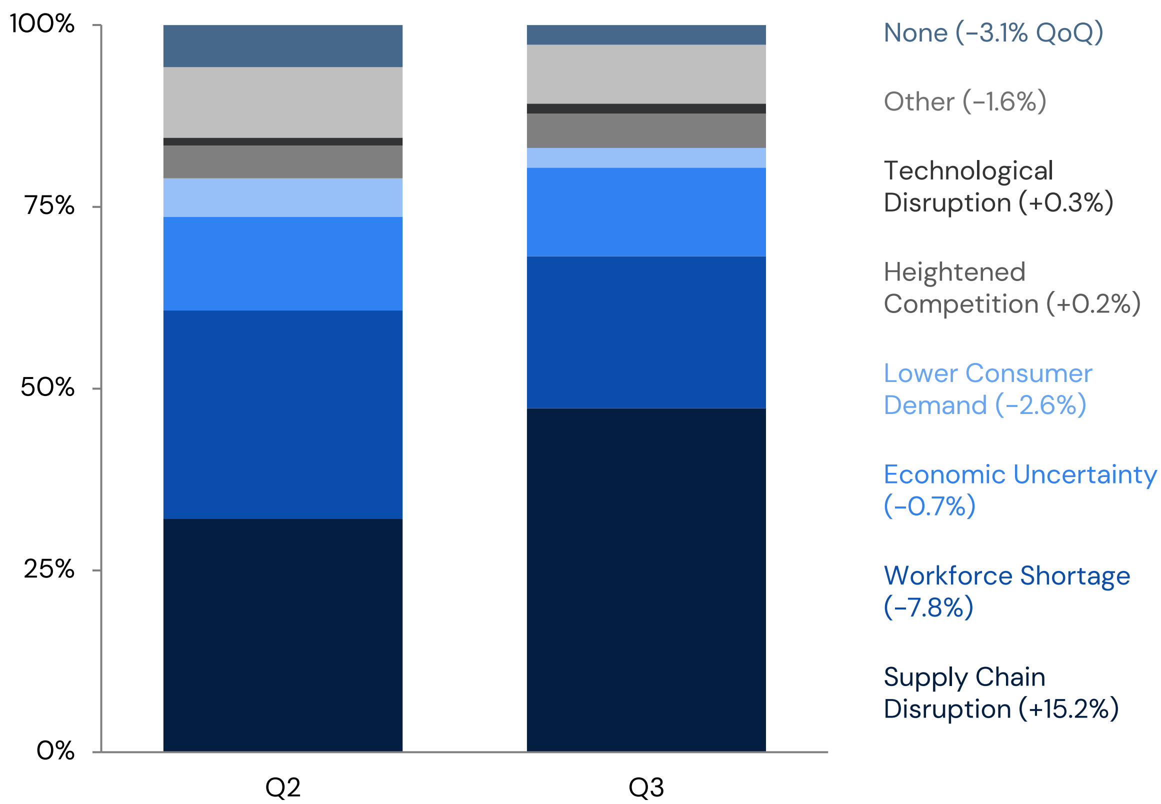
Lucas LaCroce, Research Analyst, Business Services, Industrials
llacroce@capstonepartners.com

01. Current Business Challenges

Supply Chain Challenges Worsen in Q3

Supply chain disruptions continued to be the foremost issue faced by business owners in Q3 (47.3%), with the number of owners adversely affected rising 15.2% QoQ. CEOs in the Consumer & Retail industry represented the greatest QoQ increase in supply chain hurdles (43.3%), as seasonal demand preceding the holiday period placed additional pressure on already stressed supply chains.

Workforce shortages, accounting for the second most prominent challenge, decreased 7.8% QoQ among owners in Q3 as many businesses implemented higher pay for workers in an effort to bolster employee retention. This tactic has proved only mildly successful as employee retention rates remain top of mind for owners across industries (see page eight for more details).



Question: What was the most notable challenge your company faced over the past three months?
QoQ = quarter-over-quarter from Q2 to Q3
Source: Capstone Partners' Middle Market Business Owner Survey, Total Sample Size (N): 380, 148

Price Hikes Account for New Leading Supply Chain Issue

Among those CEOs that experienced supply chain disruptions in Q3, **78.6% noted that rising input prices were the leading issue**, followed by materials availability (74.3%), port congestion (61.4%), and trucking bottlenecks (57.1%). The number of CEOs that experienced rising input prices increased 20% compared to Q2 as inflation has persisted, driving elevated commodity costs.

Container shortages, although not among the top challenges, also increased 20% QoQ among business owners in Q3. Heavy port congestion and trucking bottlenecks have led to shipping containers stranded on cargo vessels for up to months at a time, especially in frequently trafficked West Coast sites such as ports in the cities of Los Angeles, Long Beach, Oakland, and San Diego.

79% Rising input Prices

Nearly 80% of business owners with supply chain issues experienced rising input prices, up 20% QoQ as costs for lumber, crude petroleum, and natural gas surged in 2021.

74% Materials Availability

Materials availability represented the leading supply chain challenge in Q2, now the second leading challenge (-6% QoQ) as prices continued to spike.

61% Port Congestion

Port congestion emerged as a supply chain headwind especially for West Coast sites, with more than 60% of business owners (+9% QoQ) identifying it as a supply chain issue.

57% Trucking Bottlenecks

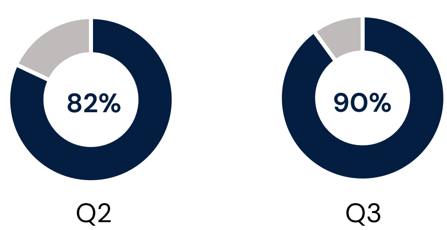
Shipping delays have stressed transportation networks with trucking bottlenecks extending fulfillment timelines for 57% of owners, up 12% QoQ.

Question: What supply chain disruptions has your company faced over the past three months? Select all that apply.
QoQ = quarter-over-quarter from Q2 to Q3
Source: Capstone Partners' Middle Market Business Owner Survey, Sample Size (N): 70

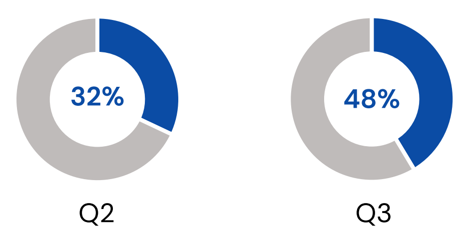
Employee Retention Increasingly Afflicts Owners

Business owners suffering from workforce shortages namely pointed to a limited talent pool (90.3%) as the foremost hurdle faced in the past three months. Despite record-setting job requisitions in the U.S., organizations found it difficult to fill entry level positions as workers sought lifestyle changes amid the pandemic and devoted time to searching for upskilled roles. Known as the Great Resignation, this trend has severely damaged employee retention rates, with **48.4% of CEO’s having identified employee retention as a leading workforce challenge in Q3 (+16.3% QoQ).** Meanwhile, the number of owners that have experienced difficulty with remote workforce engagement declined by 13.3% in Q3 as COVID-19 vaccine and testing requirements allowed employees to return to in-person work.

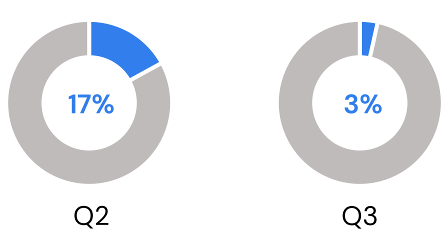
Limited Talent Pool



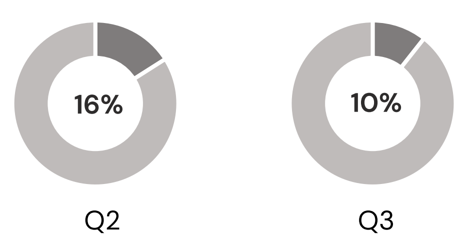
Employee Retention



Engagement with Remote Workforce



Other

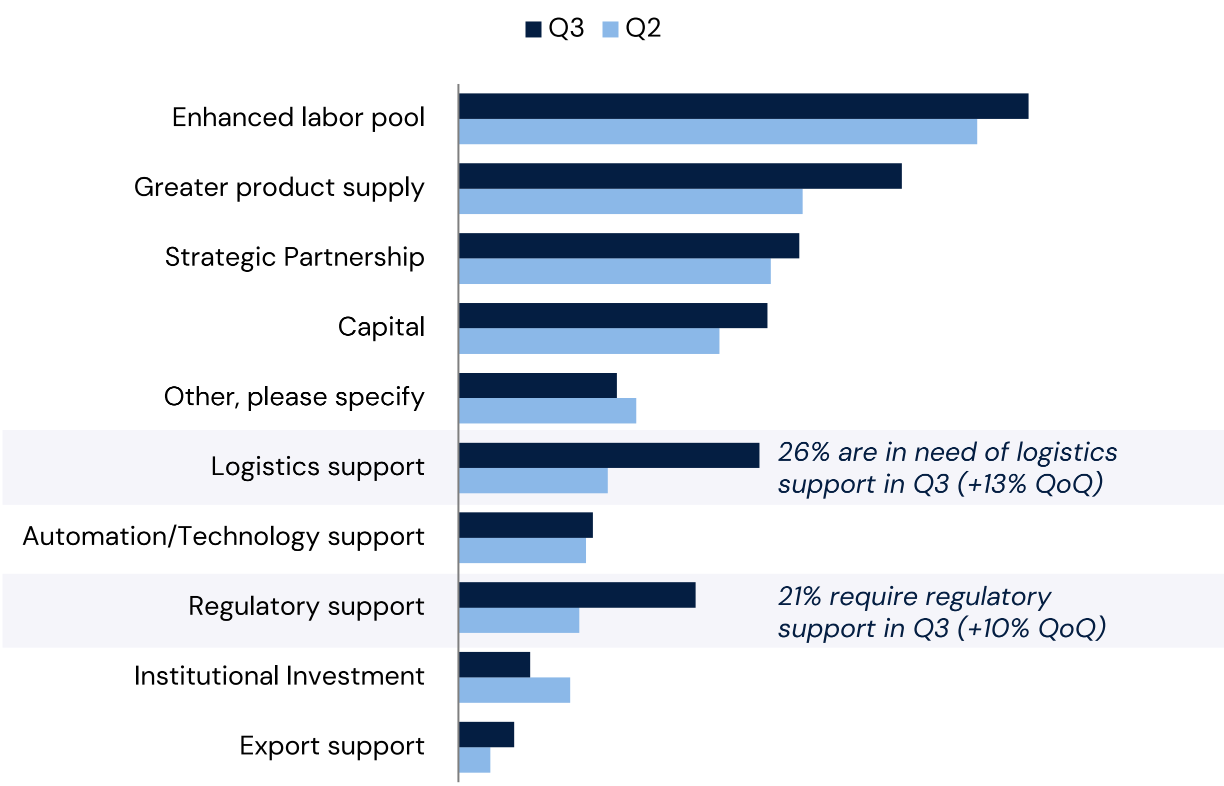


Question: What workforce challenges has your company faced over the past three months? Select all that apply.
Source: Capstone Partners’ Middle Market Business Owner Survey, Sample Size (N): 109, 31

02. Strategies & Initiatives

Continued Disruption Further Necessitates Recovery Tactics

In response to the recent challenges companies have faced, owners ranked recovery tactics to offset their leading issue, prompting the immediate recovery of their business. **With workforce shortages impacting most industries, 50.0% of owners stated that an enhanced labor pool would be the most helpful recovery tactic, up 4.5% from Q2.** Logistics support and regulatory support represented the largest QoQ increase at 26.4% and 20.8% in Q3, respectively. Strenuous supply chains prompted the spike in logistics support requests as businesses attempt to manage inventory levels for year end and 2022. Regulatory support as a recovery tactic increased 10% QoQ in Q3, as owners pointed to monetary inflation, international trade policy disruptions, domestic oil and gas policy issues, and government interference with businesses as the top challenges to be resolved.

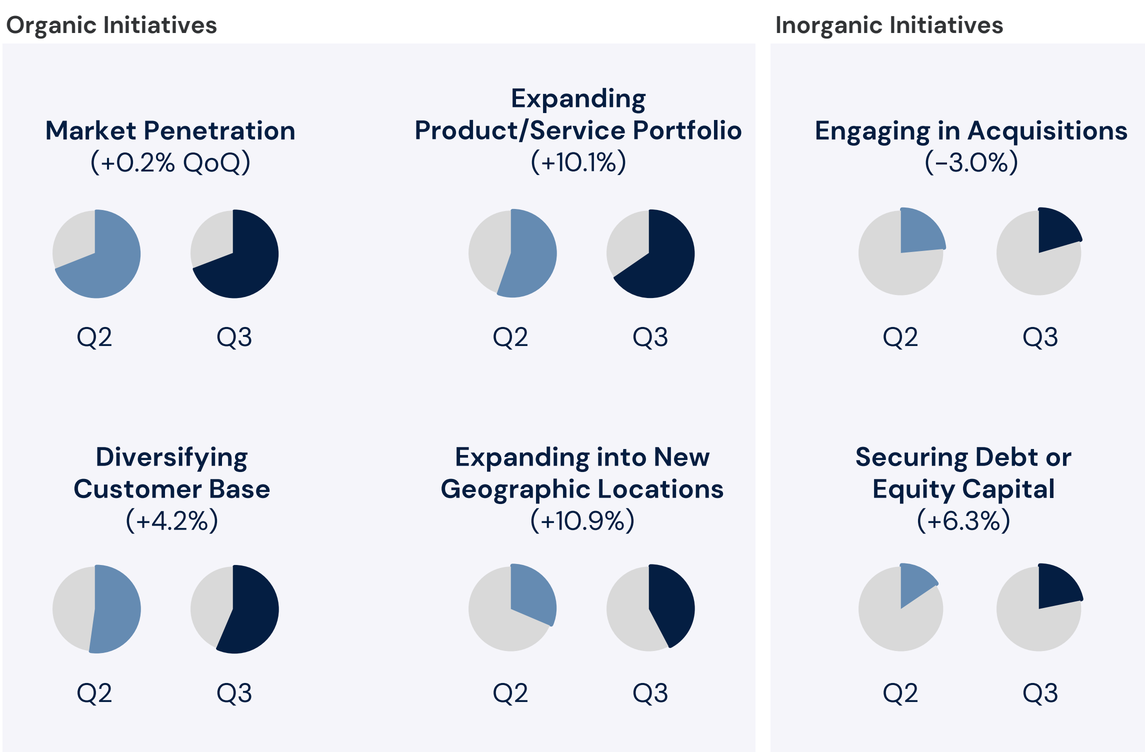


Question: Which of the following would be useful in the recovery of your business? Select all that apply.
QoQ = quarter-over-quarter from Q2 to Q3
Source: Capstone Partners' Middle Market Business Owner Survey, Sample Size (N): 358, 144

CEOs Expand Products, Services, & Geographic Reach

In the upcoming quarter, business owners are primarily focused on growth strategies (52.7%), led by organic initiatives including enhancing market penetration, expanding products and services, and diversifying customer bases to capture a larger portion of the addressable market**. Notably, business owners who plan to expand product and service offerings and geographic reach in Q4 increased 10% and 11%, respectively compared to the prior quarter.**

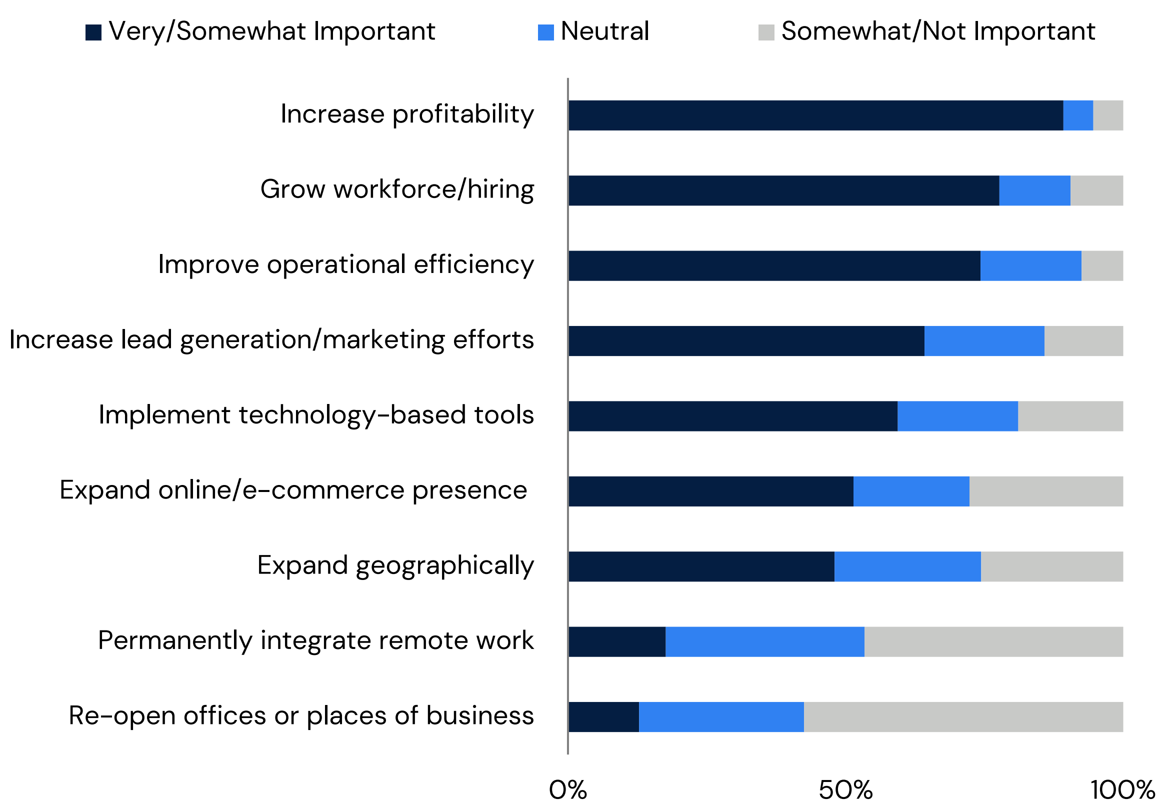
Inorganic growth strategies will also be implemented in Q4, with 20.5% of owners planning to engage in acquisitions and 21.8% securing debt or equity capital. Owners that expect to secure financing in Q4 increased 6.3% from Q3, with most businesses utilizing debt or equity capital to fund new initiatives and ensure sufficient net working capital to fulfill their growth ambitions in 2022. For more information on net working capital in the M&A process, please see Capstone's recent article.



Question: Which of the following growth strategies are most important to prioritize over the next three months?
QoQ = quarter-over-quarter from Q2 to Q3
Source: Capstone Partners' Middle Market Business Owner Survey, Sample Size (N): 226, 78

Business Owners Plan to Bolster Internal Processes

Top priorities for business owners looking ahead to Q4 include increasing profitability (89.2%), growing their workforce (77.7%), improving operational efficiency (74.3%), and increasing lead generation and marketing efforts (64.2%). **Compared to owners' viewpoints in Q3, the focus for Q4 has shifted to enhancing internal processes rather than outbound sales efforts.** Owners that have identified operational efficiency as very or somewhat important increased 2.5% QoQ and the importance of growing workforces rose 3.5% QoQ. In addition, business owners that deemed remote work and the reopening of offices very or somewhat important decreased by 7.7% and 12.4%, respectively. Many places of business have already returned to in-person work despite new variants of COVID-19, with business leaders prioritizing the redesign, reorganization, and rebuilding of office spaces to ensure compliance with new regulations and enable overall productivity for employees.



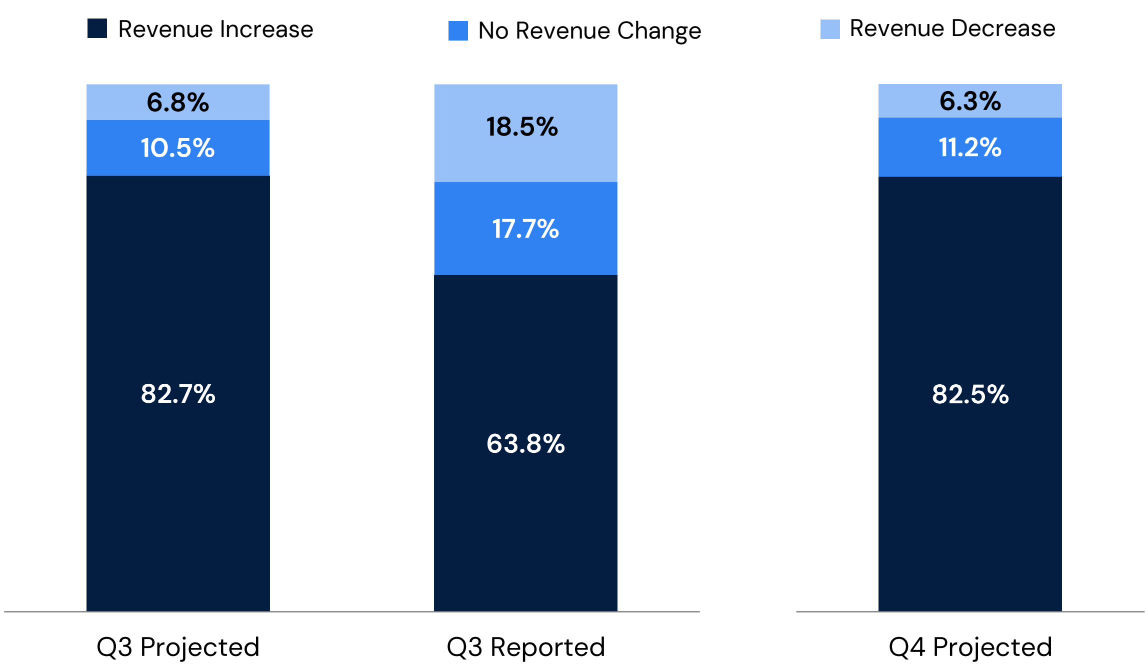
Question: How important will the following tactics be to your company over the next three months?
Source: Capstone Partners' Middle Market Business Owner Survey, Sample Size (N): 148

03. Revenue Impacts, Forecasts, & Economic Outlook

Q3 Revenue Gains Fall Below Initial Projections

In Q2, 82.7% of business owners projected they would witness a revenue increase in Q3. However, **only 63.8% of owners experienced an increase during this quarter, with just under half (48.9%) reporting elevated revenues between 1-25%.** In actuality, more than one-third (36.2%) of companies surveyed in the middle market saw no change or decreased revenues in Q3 as new COVID-19 variants spawned unforeseen hurdles.

Nearly matching Q3 projections, 82.5% of business owners surveyed predict a revenue increase for the coming quarter, as 66.4% expect an increase of 1-25% and 16.1% anticipate a rise of 26% or more. Although business owners have remained bullish on Q4 projections, we expect reported revenue in Q4 to more closely align with Q3 reported levels as CEO confidence towards the U.S. economy and their respective industries has declined.

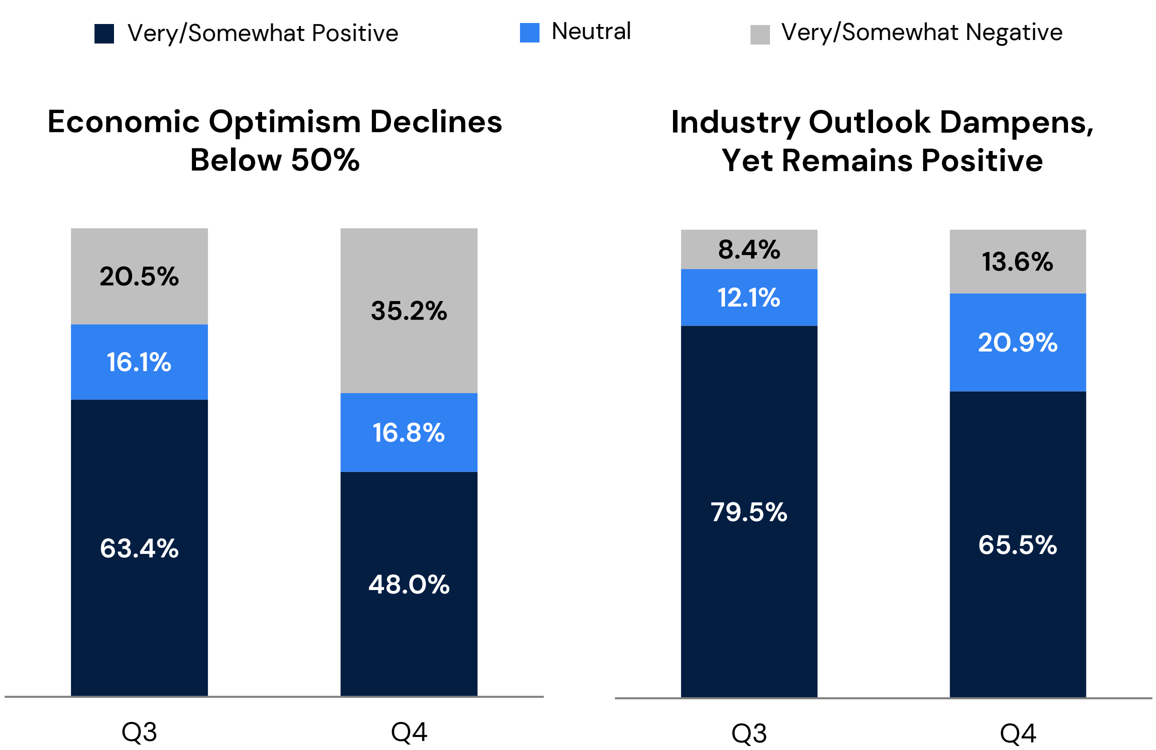


Questions: Revenue change over past three/next three months
Source: Capstone Partners' Middle Market Business Owner Survey, Total Sample Size (N): 380, 148

Economic & Industry Confidence Drop for Year End

Economic optimism for Q4 declined by 15.4% compared to Q3, with less than half (48.0%) of CEOs feeling very or somewhat positive on the future state of the U.S. economy. Driven by inflation running at a breakneck speed, rising corporate debt levels, and the labor market still millions of jobs short of the pre-pandemic peak, full economic recovery continues to be delayed by pandemic-induced issues.

The sentiment business owners have expressed regarding their respective industries skews positive across all groups, with **nearly two-thirds (65.5%) of CEOs somewhat or very positive on the outlook of their industry. However, we have witnessed a 14% decline in industry optimism compared to Q3**, likely driven by the widespread economic uncertainty faced in the previous quarter.



Question: Economic/industry outlook for the next three months?
Source: Capstone Partners' Middle Market Business Owner Survey, Total Sample Size (N): 380, 148

Share of CEOs Expecting Multi-Year Recovery Grows

Given tapering industry growth, low economic confidence, and new COVID-19 variants, middle market founders and entrepreneurs are not expecting an immediate normalization of the business environment. Notably, 29.1% of business owners expect conditions to normalize in seven to 12 months and 29.7% predict one to two years. **The forecasts for returning to "normal" business conditions have been extended compared to the prior quarter, with 37.8% of CEOs now expecting normalization to occur in no less than one to two years (+9% QoQ).** Despite the rollout of vaccines, accompanying booster shots, and additional medication to treat COVID-19 symptoms, many business owners believe the Delta and Omicron variants to only be the beginning of the virus' evolution, and that this will continue to inhibit business operations in the following years.

Question: Within your industry, when do you expect conditions to return to pre-COVID-19 performance levels?
Source: Capstone Partners' Middle Market Business Owner Survey, Sample Size (N): 148

About Capstone Partners

Capstone Partners is one of the largest and most active independently-owned investment banking firms in the United States. Over the past 20 years, thousands of business owners, investors, and creditors have trusted us to help guide their strategic decisions and maximize financial outcomes at every stage of the corporate lifecycle. For more information, please visit www.capstonepartners.com.

Built for the Middle Market

Capstone Partners has developed a full suite of corporate finance solutions, including M&A advisory, debt advisory, financial advisory, and equity capital financing to help privately owned businesses and private equity firms through each stage of the company's lifecycle, ranging from growth to an ultimate exit transaction.

Mergers & Acquisitions

- Sell-side Advisory
- Buy-side Advisory
- Recapitalizations
- Mergers & Joint Ventures

Capital Advisory

- Equity Advisory
- Debt Advisory
- Infrastructure Finance

Financial Advisory

- Transaction Advisory
- Interim Management
- Performance Improvement
- Valuation Advisory
- Litigation Support

Special Situations & Restructuring

- Special Situations
- Turnaround
- Restructuring
- Bankruptcy
- Insolvency