High note at end of 2021 muted by inflation, supply chain, and labor challenges

It appears that 2021 is ending better than it started – or that's how it feels for most middle market executives. However, it's not as simple as it seems on the surface. A complicated business environment defined by supply chain disruption and rising inflation has put a damper on the unhampered highs executives were feeling at midyear.

In our third 2021 survey, KeyBank asked 400 owners and executives of middle market businesses – defined as those in the $10 million to $2 billion range[1] – how macroeconomic conditions and government policies have impacted their businesses. While the negative impact of the COVID-19 pandemic is receding, new worries have entered the picture – including the availability and rising costs of raw materials and challenges in hiring and retaining talent.

> "Most of our clients are doing well, profitable, and operating efficiently, but revenues aren't as high as they thought they were going to be because of labor and supply chain costs. Still, even if their topline revenue and volumes have contracted, companies tend to be profitable because managing through COVID taught them to be very efficient."
>
> **– James Barger, market president for Connecticut and Massachusetts, KeyBank**

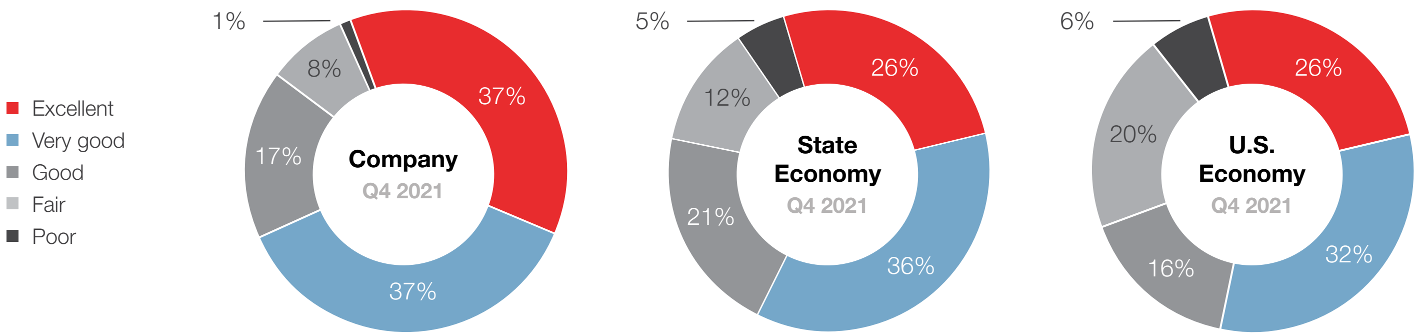
Optimism dips, but business still feels better than in January

Since the beginning of the year, pandemic surges, political volatility and rising material costs have all affected how middle market leaders view the future for their business and the economy. The survey reveals that while outlooks remain somewhat optimistic at the company, state, and U.S. economy level, they have declined compared to second quarter results – while still remaining above the tumultuous start of the year.

[1] Business Owners/Executives – This sample group represents the opinions of respondents who are specifically business owners, C-suite professionals, or have the title of SVP, VP, controller or treasurer ($10M to under $2B revenues).

Company outlook continues to exhibit the most optimism, and overall company outlooks correlated positively with perceived business health. At the company level, a robust 74% of executives had an excellent or very good outlook, compared to 81% in Q2 and 68% in Q1. Regarding outlook for the U.S. economy, very good and excellent responses decreased slightly from 61% in Q2 to 57%. Digging into the figures, higher-revenue businesses have a more optimistic outlook across all levels compared to others. As a result, the bigger your business, the more optimistic you're likely to feel.

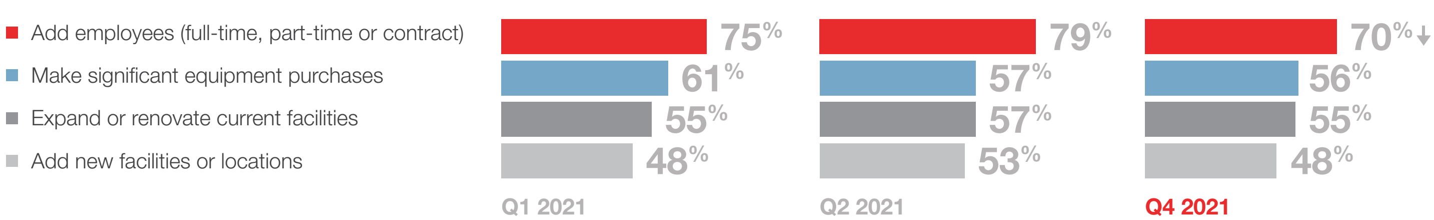
Overall outlook for the next 12 months



For companies who are doing well, the upswing is having an energizing impact on their future plans. Businesses with an optimistic overall company outlook are far more likely to anticipate expanding the scope of their operations within the next six months compared to those with a neutral or pessimistic overall company outlook. To that effect, 82% of the optimists are making expansion plans, as compared to only 44% of those with neutral or pessimistic outlooks. When taking into account the impact of the pandemic, those who are mostly operational and fully back to a pre-COVID-19 level of operation are significantly more likely to plan to expand scope of operations in the next six months.

Hiring more employees continues to be the leading method for business owners and executives who plan to expand, although that proportion has decreased to 70% from 79%. Significant equipment purchases (56%) and expanding or renovating current facilities (55%) are other common methods for expanding. Companies with higher revenues are much more likely to make large equipment purchases and add locations or facilities.

Method for expanding



In short, company leaders who are feeling upbeat about their company and the national economy have shown resilience and are ready to look ahead.

What's weighing on middle market executives

On the other side of the scale, middle market executives who show a negative outlook for their companies or the U.S. economy point to many factors for their discontent. Of the 43% who do not have a positive U.S. economic outlook, concerns with the COVID-19 pandemic continue to top the list of factors, with little change from the previous quarter. Higher rates of overall inflation and higher costs of raw materials are also top concerns for businesses, signaling the impact of supply chain disruption.

Looking at executives with a fair or poor outlook, they also identify higher labor costs (62%), potential higher tax rates (56%) and a potential economic recession (60%) in greater proportions than executives with a good outlook. Business owners who are considering how to position their companies in the face of these compounding challenges may consider M&A activity, said Barger. Some companies may use M&A to increase production ability or supply chain access, while others may try to sell and exit their privately held businesses in the event that the proposed estate tax law changes with wealth transfer implications take effect.

Factors causing low outlook for the U.S. economy

Q4 2021	
68%	**The COVID-19 pandemic**
65%	**Higher rates of overall inflation**
62%	**Higher cost of raw materials/commodities**
56% ↑	**Volatile political landscape**
52%	**Higher labor costs**
49%	**Potential higher tax rates**
46%	**Potential economic recession**
45%	**Other issues related to supply chain disruption**
43%	**Difficulties attracting and retaining talent**
41%	**Less availability/timeliness of receiving raw materials/commodities**
40%	**Higher energy costs/carbon tax**
38%	**Higher healthcare costs**
22%	**Concerns with cybersecurity**
21% ↑	**Increasing tariffs**
16%	**Increasing global competition**
14%	**Potential changes in trade agreements**
4%	**Currency wars**
3%	**Other**

Business concerns are mirrored by the general public with inflation worries causing a steep decline in consumer sentiment. The consumer sentiment index fell to a 10-year low early November, with the year-over-year figures dropping 13.1% to 66.8 from 71.7.[2] Economists point to the upward pressure on prices across the economy, including on basic consumer goods, as driving dissatisfaction with the administration's policies, but President Biden and leaders at the Federal Reserve have described this inflationary spike as temporary and still related to recovery from the pandemic.[3]

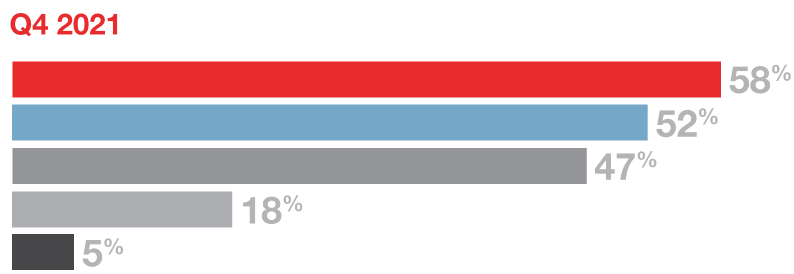
[2] U.S. News & World Report: "Consumer Sentiment Hits 10-Year Low, Reflecting Partisan Divide Over Inflation and Economic Policy," Nov. 12, 2021. https://www.usnews.com/news/economy/articles/2021-11-12/consumer-sentiment-hits-10-year-low-reflecting-partisan-divide-over-inflation-and-economic-policy

[3] NPR: "Inflation is surging and people are hopping mad," Nov. 13, 2021. https://www.npr.org/2021/11/13/1055315389/inflation-president-biden-groceries-gas-food-energy-prices

Material sourcing, costs and delays cause headaches

While businesses have been trying to rebound from 2020's historic crisis, continued supply chain challenges have hampered their upward trajectory. Nearly half of all middle market business feel that recent supply chain developments in the past 12 months have negatively impacted them, with retail (64%) and transportation and logistics companies (62%) unsurprisingly skewing higher. Executives are noticing raw materials and commodities are less available and timely (76%) and that costs for materials and commodities are higher (70%). This impact is being felt on their bottom line – with smaller profit margins and decreased revenues – as well as decreased production and efficiency.

Supply chain effects



Middle market businesses are not alone in feeling the pain of supply chain disruption – in fact, it's jeopardizing the recovery of the global economy. According to a Bloomberg Economics report, the problem is not just one of transportation networks, but of a swift increased demand for goods, and manufacturers struggling to produce enough to meet it: "Pulling all these pieces together, the Bloomberg Economics supply indexes show shortages just off a 20-year high in the U.S."[4]

Middle market executives told KeyBank they are responding by identifying alternative suppliers of raw materials, combating shortages by carrying excess inventories, and increasing digital and automation efforts.

> "When it comes to the supply chain, companies and industries that are vertically integrated, with access to or control of raw materials and internal distribution networks, fared well as long there was good demand for their end product. This tended to favor larger companies that are better capitalized."
>
> **– Dwayne Finney, market president for Western Pennsylvania, KeyBank**

Attracting and retaining top talent remains top of mind

In the face of record high job openings[5], many middle market companies are investing in recruiting and retention efforts. The survey found middle market executives with an optimistic overall company outlook are significantly more likely than others to find ease in both attracting and retaining talent. To compete in an exceedingly tight labor market, business owners are looking towards offering potential candidates competitive wages (56%), flexible working hours, and health and wellness benefits (42%). And for companies that expect difficulties attracting talent, those who are planning to add employees are more likely to offer options to work remotely, increased paid time off, new employee signing bonuses, and job training as ways to attract qualified talent.

[4] Bloomberg: "Supply Chain Crisis Risks Taking the Global Economy Down With It," Nov. 1, 2021. https://www.bloomberg.com/news/features/2021-11-02/supply-chain-crisis-has-central-banks-facing-stagflation-lite

[5] Wall Street Journal: "Record Quitting Fuels Tight Job Market," Nov. 12, 2021. https://www.wsj.com/articles/record-high-job-openings-persist-in-tight-labor-market-11636713002

“With the amount of people who left the workforce or changed jobs during the pandemic, we will see a run on human capital for a while, and it’s going to cause wage escalation.”

– Dwayne Finney, market president for Western Pennsylvania, KeyBank

The Employment Cost Index, reported by the Labor Department, shows that wages are indeed growing, but not fast enough to keep up with rising costs. As the *New York Times* reports[6], “In the year through September, the index’s measure of wages and salaries jumped by 4.2 percent. But an inflation gauge that tracks consumer prices rose by 5.4 percent over the same period.” It’s too early to tell whether wage increases will eventually surpass inflation as companies adjust their profit expectations, or whether the Federal Reserve will have to increase interest rates to tamp down prices. And, middle market businesses are feeling the pressure of that uncertainty.

Conclusion: Managing through highs and lows

Middle market business owners have come through 2021 with greater efficiency, strong revenues and confident plans for the future. But, major economic forces – including a tight labor market, supply chain disruption, and inflation – as well as impending tax policy changes are making recovery bumpier than they’d like.

As your company heads into 2022, you may be planning for expansion, contemplating M&A, considering the automation of payment processes, or putting in place a succession strategy. KeyBank middle market experts can provide customized insights, real-time counsel, and a broad range of relevant and tailored solutions to guide your decision-making. For more information on KeyBank’s middle market capabilities, contact a KeyBank Relationship Manager.

[6] New York Times: “Wages are rising, but can they keep up with inflation?” Nov. 5, 2021. https://www.nytimes.com/2021/11/05/business/economy/wages-inflation.html

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“KeyBank Middle Market Business Sentiment Survey” October 1, 2021 - October 18, 2021.