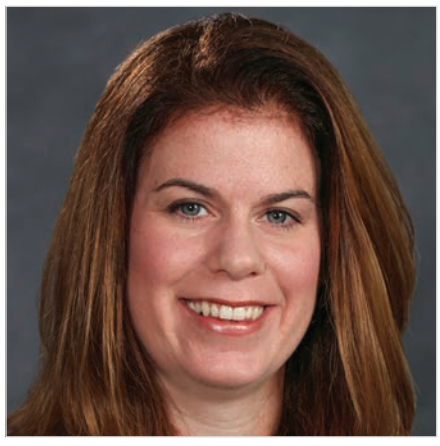
Navigating Change and Uncertainty in the Middle Market



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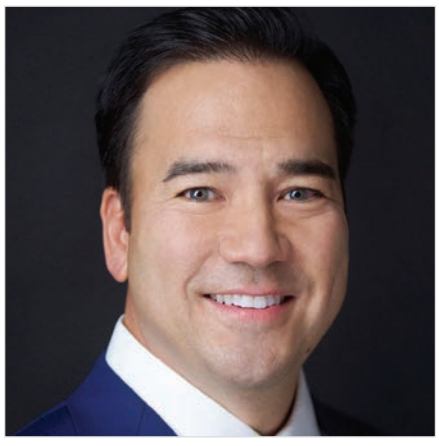

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Right now, many factors are in flux in the business world. The United States' unresolved trade relationship with China has disrupted supply chains; commercial real estate values are dropping; and a looming presidential election could create an abrupt change of course in terms of taxes, regulation and trade. These dynamics create unique challenges for New York's middle-market businesses, which must weather the changes while continuing to compete with large corporations for customers, talent and capital resources.

To get a read on how middle-market businesses in the New York area are responding to change and uncertainty, **Crain's Content Studio** posed questions to three experts in the middle-market space:

- Pamela Cianciotta, partner, commercial business group, Marks Paneth
- Andrew Bregenzer, regional president, New York metropolitan area, TD Bank
- Michael J. Clain, partner, Windels Marx

Crain's: How are global trade tensions and economic factors affecting the middle market?

Michael Clain: They are making everyone jittery. Even the signing of the phase-one trade deal with China and the fact that the United States-Mexico-Canada Agreement (USMCA) is getting closer to ratification have not quelled concerns. Most middle-market companies don't have the manpower or capital necessary to rejigger supply chains, so their only options are to increase prices, reduce costs or accept a reduction in profits. The ability to increase prices without affecting demand depends on the industry, of course, but I haven't spoken with anyone who is confident that they can pass along the bulk of their cost increases without affecting demand. So, they're tightening their belts and trying to ride it out.

Pamela Cianciotta: The U.S.-China trade war in particular has significantly affected middle-market businesses that are subject to the new tariffs. Many of the strategies available to large businesses to deal with the problem were unavailable to middle-market companies. Middle-market companies did not have enough in reserve to stay the course. They also were not able to pass on the added cost of the tariffs to their customers. In an attempt to circumvent the tariffs, many businesses started sourcing their products outside of China. However, the competition for reliable factories that had enough capacity outside of China was fierce, and many middle-market companies could not compete effectively. Those with healthy balance sheets and good lines of credit purchased as much inventory as possible before the tariffs hit.

Andrew Bregenzer: There was a fair amount of global volatility this past year, with trade tension and macroeconomic factors having varying degrees of impact on middle-market firms. The firms that did experience higher prices due to the China tariffs were able to adjust and absorb those costs, for the most part, without diluting earnings too materially. The exception would be the manufacturing sector, which did experience a sharp increase in the price of raw materials. We witnessed that effect throughout the New York area.

The most tangible effect of global friction was a decline in U.S. business confidence throughout much of 2019. If the trend continues through 2020, private middle-market firms could face greater impact due to tightening credit standards and a shrinking risk appetite among financial institutions and alternative lenders, where most middle-market firms look for short- and long-term funding.

Crain's: How are companies handling the political uncertainties of this election cycle?

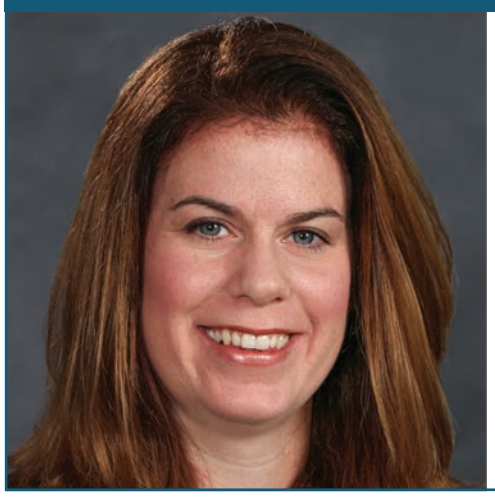
Bregenzer: Uncertainty is typical in any major election year and it usually hinges on regulations that may be scaled back, introduced or overturned. Middle-market executives need to begin planning for different scenarios and forecast how they could impact capital spending, cash flow and credit availability in 2021 and beyond.

Clain: Obviously, Warren's vision for America is very different from Biden's, Yang's or Trump's. But business owners are realists. They know that visions are aspirational and diminish greatly once they smash against the wall of Congress. So they're not making plans to switch to a single-payer system, putting money aside to fund universal basic income or switching from money-center banks for fear they might be broken up.

What they're doing instead is hunkering down. They generally expect taxes, wages and interest rates to go up, the stock market to go down and tariffs to remain in effect. So, they work to reduce their debt and their workforce, automate business processes, make investments in productivity and put off acquisitions and expansions.

Cianciotta: The two areas that I hear most concern about are the corporate tax rate and the gift-tax exemption. Business owners are reluctant to change their entity structure to take advantage of more beneficial tax rates for their operating business as well as for controlled foreign corporations. Wealthy New Yorkers with estates in excess of $11.58 million are struggling to decide if they need to accelerate their estate planning since the exemption amount may decrease significantly. This type of uncertainty is a distraction from the operation of the business.

Partner at Marks Paneth



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***Crain's:* Besides private equity firms, where can middle-market business owners go for capital?**

Cianciotta: Aside from restructuring and bringing in private equity firms, companies have used angel investors to raise capital. Companies have also used preferred stock or units, depending on their company structure, to entice passive investors to put up capital and, in exchange, get a preferred return on their investment. With interest rates remaining low, traditional bank financing is still an attractive way to raise funds, especially when the company has assets to borrow against (such as accounts receivable or inventory).

Bregenzer: Traditional bank term loans and lines of credit are excellent sources of financing for middle-market companies. Financial institutions can also offer specialized lending for equipment leasing or financing and asset-based lending. The advantage of financing with a bank vs. a private equity firm is that the business owners retain full control of the company with a bank loan, while an investment firm typically requires a share of the company or profit in return for their capital.

Clain: In my experience, most businesses (other than technology startups) will consider strategic investors—companies in the same or a related business that are looking for product or market fit, not just financial returns—before they will consider private equity. It's not surprising, since they're likely more familiar with industry players than with fund managers. They're also more trusting of people with operating experience in their industry.

Family offices—pools of money from ultra-high-net-worth individuals that are managed centrally by a professional staff—are another potential source of capital for middle-market businesses. They tend to be better partners than private equity funds (more patient and generally not interested in running businesses), but they're more difficult to identify and engage with since they don't typically employ business-development professionals.

***Crain's:* What cost-saving measures have middle-market companies adopted as their growth in revenue has slowed?**

Clain: Companies always start by eliminating what they consider luxuries and nonessential expenses. First the soy milk goes, then subscriptions and memberships, then training. If they rented extra space during boom times, they try to sublet it. But eventually, companies always get around to payroll, which typically represents upwards of 80% of expenses. Before layoffs and bonus reductions (which invariably result in employee anxiety, productivity loss and increased turnover), they try reducing head count through attrition and asking more of the remaining staff. Our savviest clients are counter-cyclical—they use the opportunity to replace nonperforming staff and may actually increase sales and marketing expenses to counteract the slowdown.

Bregenzer: Where to find cost savings really depends on the stage of the business—is it growing, looking for mergers and acquisitions or sustaining operations? Growth companies have had to spend more to attract talent in this highly competitive environment, while those seeking M&A are more likely to preserve cash on hand and forgo major capital investments. When sales are down, all businesses should drive efficiencies in their accounts receivable and accounts payable operations to stretch the time between when payments come in and when they go out. This seems like common sense, but when you're in a growth phase or business is booming it can be easy to become lax in these policies.

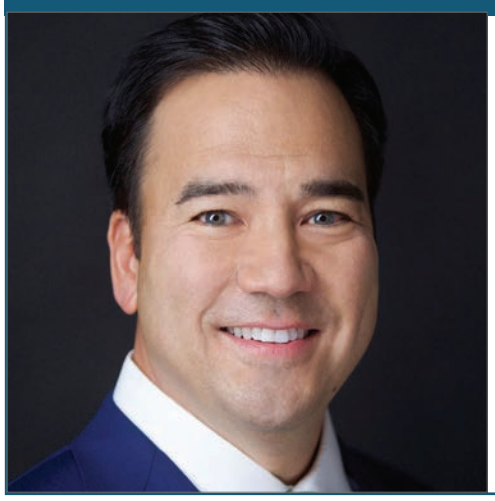
Cianciotta: Middle-market companies have adopted many different cost-saving measures as their growth in revenue has slowed, including reducing staff and hiring new staff at a slower pace. They are also putting off making necessary updates to their office and warehouse space. Instead of investing in new equipment, they are making repairs to existing equipment. Lastly, middle-market companies are raising their prices and cutting their gross profit margins to offset the downturn in the pace of revenue growth.

***Crain's:* Given the low-interest-rate environment, under what circumstances does refinancing or restructuring a firm's current working capital debt make sense?**

Bregenzer: Refinancing has merit when there is still some significant term remaining on the loan or if the new rate will save the company a meaningful amount of money over the life of the loan. Businesses just need to pay attention to the associated fees and terms regarding refinancing. Appraisal, legal, recording, origination and other fees may offset any savings due to a reduced rate.

Clain: Much of the debt refinancing and restructuring we've seen this year has had nothing to do with interest rates. Successful companies asked their lenders to eliminate financial covenants, reduce reporting requirements and, in some instances, terminate

Regional president at TD Bank



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guarantees and release collateral. Struggling companies asked their lenders for waivers, looser covenants and time to recover. Last year was a vivid reminder of the importance of having a supportive lender.

Cianciotta: Comparing your borrowing rate to what is available at your credit point is the only logical way to determine whether refinancing incurred debt makes sense. Whether you have obligations encumbering certain assets or have obtained unsecured lending, reviewing your borrowing rate for the type of debt you have incurred is the first step. Although certain rates may be low, your business may not qualify for that rate. Creditworthiness and collateral affect your available borrowing power, and ultimately your spending power. Finally, depending on your principal, a change of 10 basis points may result in significant savings on par, but it may not be worth the time or effort when refinancing fees and other advisory and servicing fees come into play.

***Crain's:* What adjustments have middle-market companies had to make in order to comply with ASC 606, the new revenue recognition standard?**

Cianciotta: All clients are required to follow a five-step model of revenue recognition. For some middle-market companies, this new standard will have minimal impact other than increased disclosure requirements in their financial statement. For others, particularly those with multiple performance obligations—e.g., contracts with multiple elements, sales of tangible property with service contracts, software arrangements—careful analysis will need to be done as to when the performance obligation has been satisfied and revenue can be recognized. Clients need to review their contracts to determine whether the terms are consistent with the anticipated revenue recognition.

***Crain's:* Real estate is losing value in the market and commercial real estate vacancies continue. How is this trend affecting middle-market companies' growth potential?**

Cianciotta: Middle-market companies that rent may be able to take advantage of the higher commercial real estate vacancies by negotiating rent concessions with their landlords, or making adjustments to their lease terms as their current leases expire. These changes will help their growth potential by increasing their monthly cash flow. Middle-market companies that own their own space may find themselves more highly leveraged, with less access to capital if they were to refinance. The decrease in real estate values may be putting additional pressure on them.

Bregenzer: We're currently seeing a market correction within commercial real estate in the New York area, with Manhattan real estate prices declining on a year-over-year basis by more than 5%, according to TD's research arm, TD Economics. This is creating a new reality for many landlords who previously could rent space at a premium.

With today's digital workforce, though, geography and holding major real estate has less importance for middle-market businesses than it did in the 20th century. This decentralized trend is accelerating opportunity for nimble firms with work-from-home flexibility and often, a global presence. In the long run, this dip in CRE prices will lead to healthier outcomes across the region, where we see investment equalizing away from the traditional convergence in Manhattan and some of the other in-demand areas like Long Island City and Downtown Brooklyn. There's still room for growth everywhere, but the real demand is lifestyle-driven.

***Crain's:* What are some of the challenges middle-market companies are currently facing in obtaining and keeping talent?**

Clain: The current labor shortage has created significant challenges for middle-market firms. Attracting and keeping talent requires that firms offer compensation, training and opportunities for advancement that are competitive with larger enterprises. And larger companies are actively marketing themselves to younger workers in a range of ways, from emphasizing sustainability and governance to offering youth-oriented office amenities.

To compete, middle-market firms are focusing on older workers, who are often the victims of corporate reorganizations. Bringing on trained, experienced employees who are looking for stability and a supportive work environment can be quite beneficial to a middle-market firm that doesn't have the capital or manpower necessary to deal with turnover and employee training.

Bregenzer: The current unemployment rate of 3.6% is making sourcing talent for companies of all sizes much more difficult. The bigger challenge, though, is talent retention, which is becoming a vital issue due to the aging workforce in the region. The state and the city are growing older and the young residents who we would expect to "back fill" the talent gap are moving to other parts of the country because they're priced out of the market or want a steadier lifestyle. Younger workers have shifting expectations in terms of salary, benefits and a sense of job security that has emboldened job hoppers. The middle-market's challenge is to cultivate in-house talent and accommodate the evolving workplace, but that may mean spending more on salaries and benefits to attract and keep

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the right talent.

Cianciotta: I've seen companies institute a variety of ways to obtain and keep talent, including allowing flexible work schedules, working from home or remotely, or other better work-life balance initiatives. Depending on the company structure, I've also seen companies give profit interest units (or phantom equity) to key employees or potential employees, to attract or retain them. This approach gives employees and potential employees a greater incentive to stay since they feel they have ownership in the company.

Companies are also redesigning the way people work in the office by breaking down walls and creating more collaborative work areas, making spaces more like cafés with comfortable seating and areas where employees work together and share ideas more fluidly. Also, advances in technology and the ability to work from anywhere have expanded the talent pool. Companies no longer have to look in their own geographical location, but can find the most qualified people from across the country.

***Crain's:* How would New York's legalization of cannabis for recreational use affect middle-market companies?**

Cianciotta: Legalization would increase tax revenue and reduce the unemployment rate. It would also create a new industry that would require talent in various traditional roles, in areas such as operations, finance, human resources, marketing, customer service and others. Middle-market companies would have to compete with companies in this new industry to retain talent. In addition, the potential future economic benefits that arise out of a burgeoning new industry, such as stock options, could attract top talent from existing middle-market companies.

Clain: As you'd expect, the effects would likely be mixed. Evidence from the 11 states that have legalized recreational use so far suggests that sales of THC and CBD products would grow significantly, benefitting a number of business sectors, including farming, transportation, retail, food and beverage and, of course, real estate.

There are downsides, however. We've heard plenty of concerns about the effects of marijuana availability on productivity and absenteeism.

And, on a business level, we've heard concerns that cultivation facilities will crowd out other businesses and result in increased warehouse rents, that increased truck traffic will cause congestion and that the look of dispensaries and the long lines they often generate would negatively impact nearby retail facilities.

***Crain's:* How are advances in technology such as blockchain, AI and automation affecting middle-market companies?**

Bregenzer: Automation and machine learning are affecting every industry, but companies are telling us that they're not yet adopting these technologies at a pace that is keeping up with the perceived benefits or demand. For instance, TD Bank just conducted a survey of more than 300 corporate-finance professionals at the Association of Financial Professionals Annual Conference. In that group, 92% of respondents named at least one positive benefit of blockchain technology in payments, but said investment is a low priority. Only 6% of professionals considered blockchain for payments their most opportunistic area of investment for 2020, but around one-third of respondents said that legacy technology and the organization's ability to adopt this higher-level technology was an obstacle.

Clain: Despite the hype, I haven't seen blockchain technologies put to practical use in the middle-market space. Plenty of startups claim to have created applications that will revolutionize this or that industry, but there is very little substance behind those claims.

Automation is a different story. All of our clients are looking for ways to streamline business processes and squeeze out costs—and slowly, but surely, they are. Capital constraints have slowed down progress, but, as cloud-based solutions have gotten cheaper and easier to use, we've seen significant adoption in the middle market.

AI, the ultimate form of automation, is still in the future. Given the high cost of training AI before it can do anything useful, I think it will be a decade or more before we see any practical applications for middle-market companies.

Cianciotta: Middle-market businesses must be smart in finding the right components that work for them. A combination of software, automation and AI with outsourcing is the reality for most middle-market businesses. Identifying what functions should be kept, which can be automated and which can be outsourced is an exercise no middle-market participant can ignore. Finding service providers in your budget range is crucial in evaluating your options. ■