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US PE Middle Market Report

2021 Annual

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Introduction

In 2021, the US PE middle market experienced the most active dealmaking period in its history, rebounding fervently from the slight dip in activity during the economic shock of COVID-19 in 2020. The stellar deal activity was driven by ample stimulus capital coupled with cheap and easy debt funding. Secular growth trends in various industries and ESG-related companies presented attractive investment opportunities for middle-market GPs. Going forward, numerous interest rate hikes are expected to combat the current inflationary environment, and the sudden geopolitical conflict of Russia's invasion of Ukraine throws a wrench into financial markets.

Middle-market exit activity also rocketed to new highs in 2021. The strong monetization environment was propelled by rising multiples, which caused many portfolio companies to hit price targets ahead of schedule and in return generate early exits. Cash-rich buyers acquired a plethora of PE-backed companies, and delayed exit activity from a tumultuous 2020 spilled into 2021. Industrials witnessed steady exit activity as the pandemic pressured manufacturing companies and supply chains, boosting the value for many industrials companies.

Fundraising continued apace in the middle market. Fundraising figures fell just shy of 2020's annual figure in both capital raised and fund count, showing slower signs of recovery than the rest of the PE fundraising landscape. Unprecedented dealmaking activity is allowing firms to deploy capital and return to fundraising at a rapid pace, and funds are being raised faster than before with robust appetite from LPs. Turning to performance, middle-market PE firms posted stellar returns in Q2, the most recent quarter for which data is available. The return figures are likely to diminish heading into the back half of 2021 as we saw with return figures from large publicly traded PE firms, and an environment of higher rates and inflation could dampen returns across the size spectrum.

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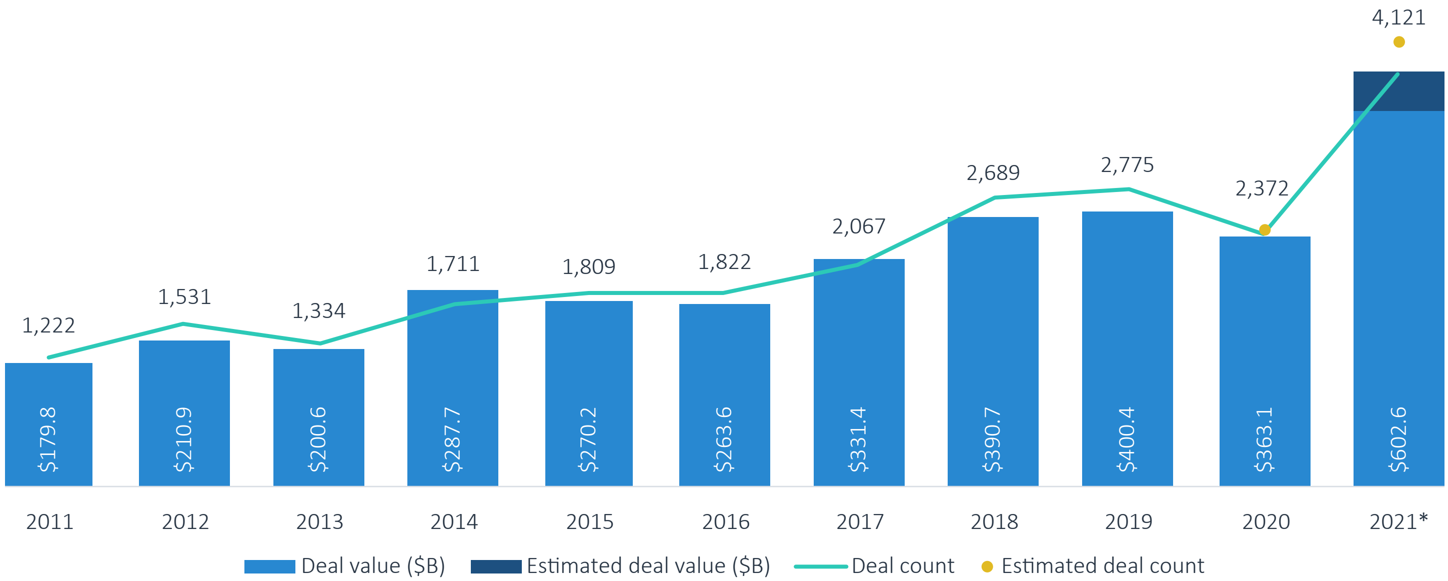
Overview

PE middle-market deal activity

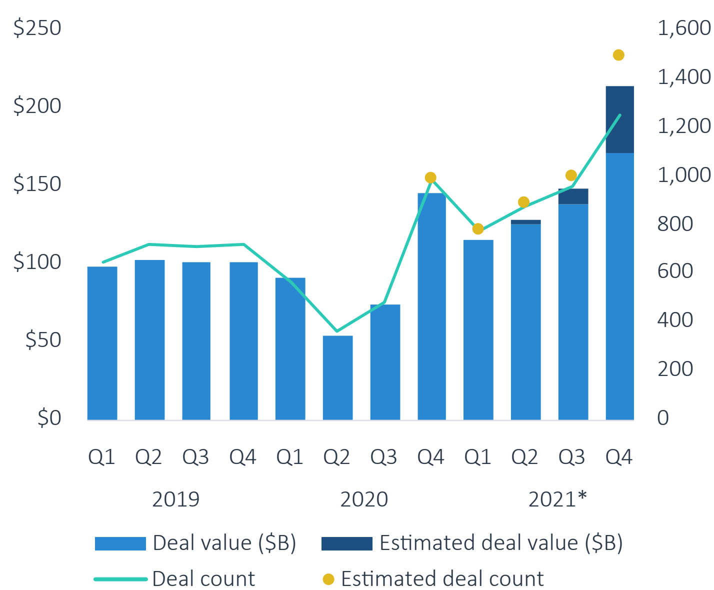


Source: PitchBook | **Geography**: US
*As of December 31, 2021

US middle-market private equity (PE) firms experienced a tremendous year, pushing forth a feverish pace of dealmaking activity that far surpassed historical records. In 2021, PE firms closed 4,121 middle-market deals for a combined $602.6 billion—around 50% above the previous annual records for deal count and value set in 2019. Dealmaking not only rebounded from the slight dip in activity during the economic shock of COVID-19 in 2020—when it lost around 9% in deal value from 2019—but the frenzied dealmaking period led to the most active time in US middle-market history.

The stellar deal activity was driven by a widespread recovery from the pandemic, aided by ample stimulus capital and easy debt funding from low interest rates. PE firms sought to capitalize on robust economic growth and were armed with excess capital after years of healthy fundraising. Sponsors did not shy away from competing for assets, which elevated valuations and helped drum up the cumulative deal value for the year. We have heard reports of auction processes for deals having 20 or 30 bidders, and firms trying to appease sellers by closing deals on shorter timelines. Our data currently shows that the median time required to close middle-market PE deals is slightly longer than that of 2020; however, this may reflect some accelerated processes being balanced out by more complex due diligence for other deals, due to the idiosyncratic effects of the pandemic on

PE middle-market deal activity by quarter



Source: PitchBook | **Geography**: US
*As of December 31, 2021

businesses and the easing of deal pacing after a potential capital gains tax revision was dropped in Q4 2021.

The impressive deal climate was supported by both the zeal with which investors chased deals and the availability of attractive assets. Businesses that successfully

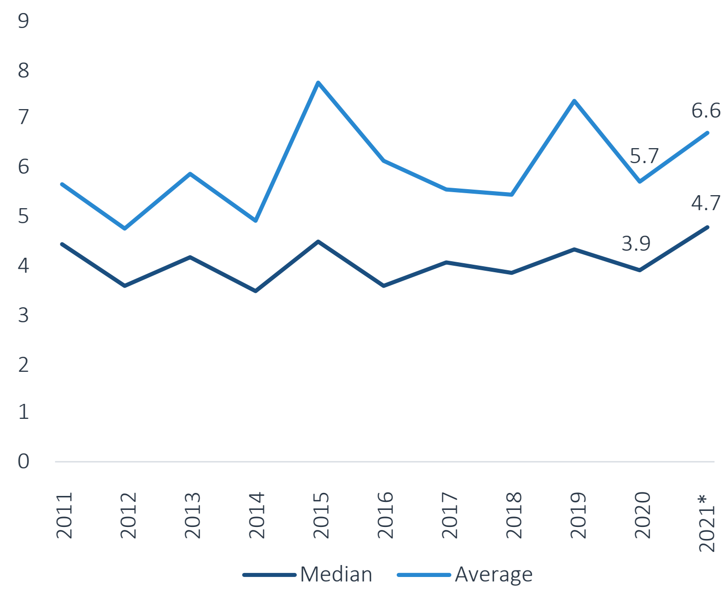
Overview

weathered the pandemic storm and demonstrated compelling industry growth trajectories saw robust demand from investors looking for opportunities that could generate long-term growth. Middle-market companies also presented opportunities to create synergies with other portfolio companies in a buy-and-build play to mitigate high platform prices through multiple arbitrage while adding supplementary business products and services. At the same time, a wave of sellers came to market to avoid anticipated tax hikes. Additionally, baby boomer business owners nearing retirement age took advantage of the pricing environment and sold to PE firms, which some have dubbed a “supercycle of business transition.”[1]

Tax policy also had some impact on middle-market dealmaking during the end of 2020 and the first three quarters of 2021. Following the election of President Biden, many business owners contemplating a sale accelerated their timelines to avoid an anticipated capital gains tax hike. Concerns over diminished returns in 2022 fueled an end-of-year rush to lock in deals—and profits—at the current rate; by Q3 2021, investment banks’ deal pipelines were full for the remainder of the year. When the Build Back Better Act was passed by the House in November, however, it did not include the capital gains rate increase many braced for, and any additional attempts are unlikely to gain traction amid a partisan gridlock. We may see the pace of dealmaking slow somewhat in the first half of 2022 as firms and banks work through the deal pipelines they had lined up in an effort to escape higher taxes, but other factors such as ample capital availability and general market sentiment are likely to have a positive effect on dealmaking activity.

Russia’s invasion of Ukraine has thrown the world into disorder and left investors grappling with the sudden escalation and its financial fallouts. As the US and Europe ramp up sanctions on Russia, price pressures are hitting consumers when the US inflation rate is already at its highest since the 1980s. Energy price and supply chain volatility continue and have been amplified, and concerns about inflation raise additional questions about how the Federal Reserve (the Fed) will respond. With the conflict seemingly nowhere near over, many buyers are hitting pause on processes. We have heard anecdotal reports from bankers that nearly all activity has ceased, and they expect this to continue for several more weeks. The invasion and sanctions have created significant uncertainty and volatility in the financial markets and could seriously hinder deal activity in the new year.

Median and average time to close (months) a PE middle-market deal



Source: PitchBook | **Geography**: US
*As of December 31, 2021

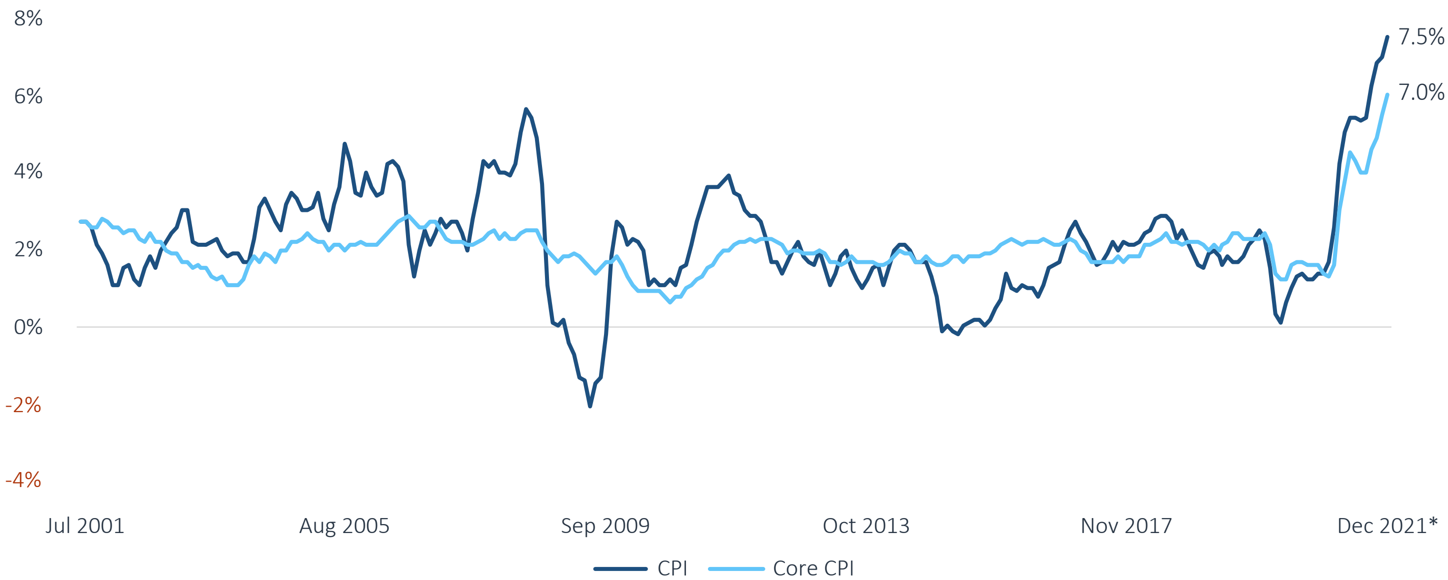
Inflation

Inflation is top of mind for middle-market firms as YoY Consumer Price Index (CPI) gains have remained above 5% since the second half of 2021 and steadily climbed beyond 7% in 2022. The broader US economy suffered from global supply chain disruptions caused by widespread pandemic-related disruptions and struggled with severe labor shortages in many industries, despite the national unemployment rate dropping to 3.9% by the end of 2021. Many middle-market companies experienced elevated labor, energy, logistics, and raw materials costs; due diligence processes focused on these risks, especially in industries such as manufacturing, hospitality, retail, and healthcare services.

The effects of an inflationary environment on dealmaking vary by industry. The Golub Capital Altman Index (GCAI), which tracks PE-backed middle-market companies, reported -4.6% and -6.3% YoY earnings growth in Q4 2021 for healthcare and industrials sectors, respectively. This is despite positive YoY revenue growth for both sectors, illustrating the heavy impact of rising input costs.[2] The ability to pass on increased input costs to customers is critical for preventing margin compression. In industrials, the sector is challenged by labor shortages and supply chain backlogs that have prevented

1: “Why Private Equity Is Going Big on the Middle Market,” *WSJ*, Accessed on March 3, 2022.
2: “Golub Capital Middle Market Report,” Golub Capital, Q4 2021.

Consumer Price Index, 12-month percent change



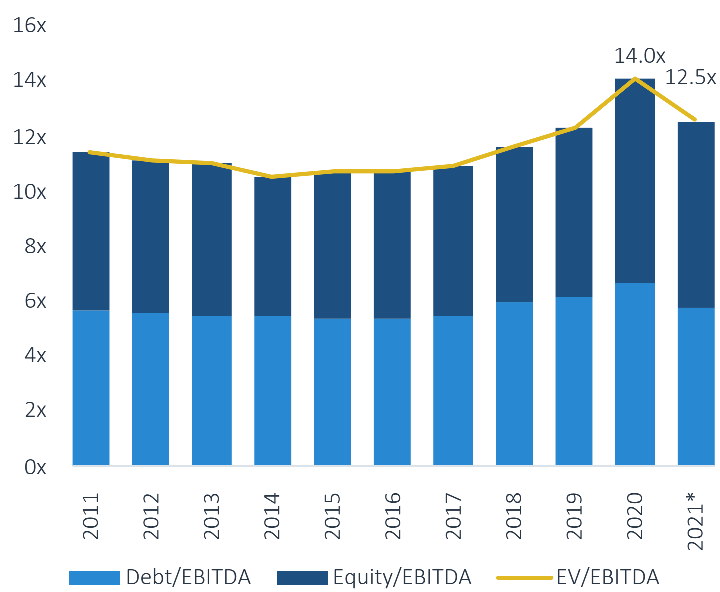
Source: FRED, Bureau of Labor Statistics | **Geography**: US
*As of December 31, 2021

some companies from ramping up production to take advantage of the economic recovery. Additionally, some manufacturing verticals have a more difficult time passing on increased input costs to customers. Healthcare providers can also struggle to pass on elevated labor, supply, and equipment costs due to the fact that they derive most of their revenue from long-term reimbursement contracts with insurance companies, which are often not linked to the CPI.

Middle-market investors are also split on the potential effects of inflation on high-growth industries such as technology. Technology companies tend to be priced based on future earnings, which means that their valuations are more sensitive to a higher interest rate environment. If the Fed significantly raises interest rates, the valuation multiples of technology companies could fall, as tech companies that are marked to market against public comps get discounted at a higher rate. We have seen this take place in public markets with the more speculative, low-profit, high-growth names. On the other hand, many argue that the resiliency of software companies and growth prospects in the tech industry mean that the sector will likely be able to pass on inflationary costs to its customers.

Persistent inflation is provoking the Fed to tighten monetary policy. Federal Reserve Chair Jerome Powell hastened the withdrawal of pandemic support and has been signaling for increased interest rates in an effort to extinguish red-hot inflation and control price pressures. Some firms, including Goldman Sachs, now

Rolling three-year median PE middle-market buyout multiples



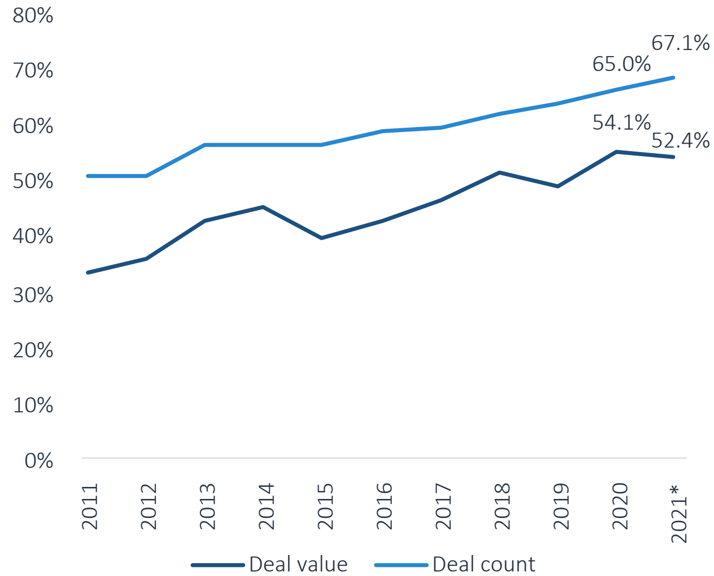
Source: PitchBook | **Geography**: US
*As of December 31. 2021

believe the Fed will hike rates seven times in 2022.[3] With the first of many interest rate hikes expected in March, concerns about the impact on economic growth sent jitters through the stock market, which has seen elevated levels of volatility since late December. Higher rates, and therefore higher borrowing costs, could impede PE firms that rely on cheap capital for dealmaking. The low rate environment lowered the cost of capital not only for buyouts, but also for amend-and-extend deals, debt refinancing, and dividend recapitalizations. These transactions also flourished in 2021 and focused primarily on planning for future growth, providing liquidity to LPs, and locking in favorable rates before the tide changes. Despite any rate hikes, capital should remain available to PE firms. This is because PE dealmaking has increasingly turned to private lenders, especially in the middle market, in part because of the flexibility they provide in times of economic dislocation. However, some PE firms may have to rein in their use of leverage and employ some valuation adjustment in the face of higher interest rates.

Add-ons

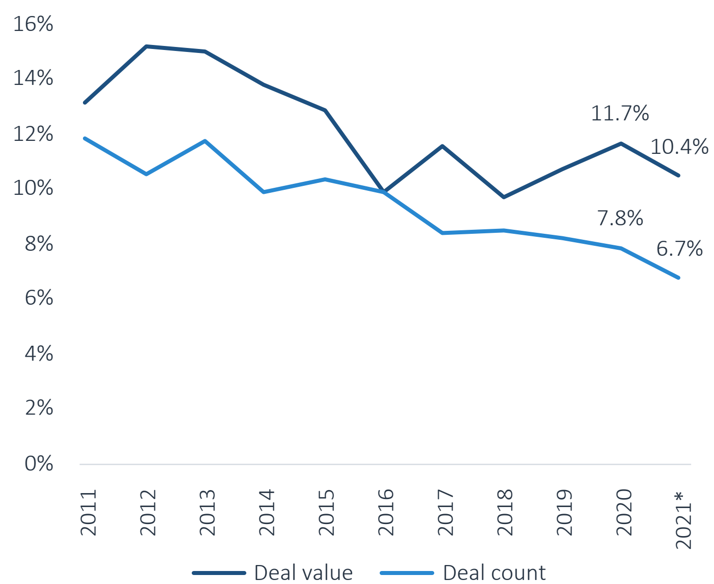
Middle-market firms continued to employ buy-and-build strategies to accelerate the growth of platform investments. Add-on activity in the middle market soared during the year, with the number of add-on deals reaching an all-time high of 67.1% of all middle-market deal activity. This strategy has been an attractive path to value creation with elevated deal multiples and competitive auctions. PE firms can acquire smaller companies for lower multiples and average down the portfolio company's total multiple. The potential to realize additional value from synergies that reduce costs and/or add revenue from extra sources adds to the strategy's draw. The middle market in particular offers myriad opportunities to scale, as the market is more fragmented and the companies are often nimbler, which makes for a smoother integration after acquisition. Add-on activity transpired across industries, with higher proportions in financial services, healthcare, and information technology (IT). Add-ons dominated deal activity for middle-market financial services, as the sector continues to rapidly transform through technology, consolidation in asset and wealth management businesses, and increased interest in the insurance market. Capital is expected to continually flow into financial services to acquire a range of targets, as investors seek to optimize cost structures, grow the top line, and further innovate.

Add-ons as a share of all PE middle-market deal activity



Source: PitchBook | **Geography**: US
*As of December 31, 2021

Carveouts and divestitures as a share of all PE middle-market deal activity



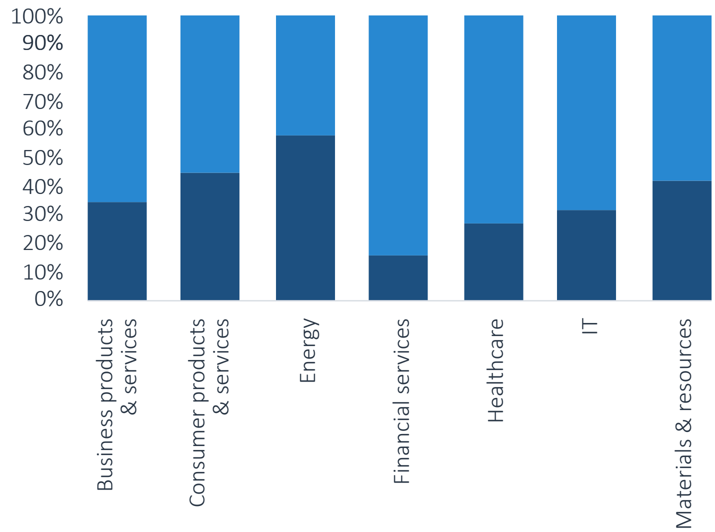
Source: PitchBook | **Geography**: US
*As of December 31, 2021

3: "Goldman Sees Fed Hiking Seven Times in 2022 Instead of Five," *Bloomberg*, Edna Curran, February 10, 2022.

Carveouts

Carveouts and divestitures increased in 2021 as PE firms readily took up the noncore assets spun off from companies refocused for recovery. In the aftermath of the pandemic, many companies reassessed their core business models and nonperforming or tangential assets. In an attempt to achieve a variety of corporate objectives such as capital raising and optimizing a corporate portfolio, many corporate leaders turned to carveouts and found favorable market conditions to sell into. These assets were easily absorbed by cash-rich sponsors. Manufacturing and industrials companies shed noncore assets in assessing their long-term growth strategies amid global supply chain disruptions. For example, Compressor Products International was sold by its parent company EnPro Industries (NYSE: NPO), a diversified industrial technology company, in December 2021 for $195.0 million. The company was acquired by Howden Group via its financial sponsor KPS Capital Partners and is expected to grow from additional technological support and access to Howden's global distribution and services network. Oil and gas companies also contributed to middle-market carveout activity as the energy sector struggled from price volatility and environmental, social, and governance (ESG) pressures.

Share of PE middle-market add-on deal count by sector



Source: PitchBook | **Geography**: US
*As of December 31, 2021

IT

IT's deal activity continued its strong trajectory, setting new records in both deal count and value in 2021. IT deals surpassed $80 billion for the first time, and the number of deals grew 57.7% from 2020 as the need for technological innovation and efficiency continued to be front and center in the global shift to remote work and the digital transformation in many other industries. Dealmaking in the middle market is driven by opportunities in business and productivity technology, as well as new software developed for less tech-enabled industries. For enterprise software, midsized companies often do not have the budget to pay for sweeping software systems or develop an in-house IT team, instead preferring similarly sized vendors and workplace productivity companies that help improve specific work functions over expensive enterprise solutions. In November, workplace productivity platform Formstack secured a $425.0 million growth investment from Silversmith Capital Partners and returning investor Providence Strategic Growth.[4] The company has seen rapid global adoption of its no-code workplace productivity platform that empowers anyone to digitize and automate both simple tasks and complex processes without code. Similarly, Renna Partners, which provides IT advisory services to middle-market investors and their portfolio businesses, was acquired by PE-backed Crosslake Technologies in December.

Companies that provide the technological services much needed for changing workplace dynamics and increasing digitalization are also attracting investors that seek to partake in this major opportunity. With the whole world scrambling amid the rapid adoption of remote work during the prolonged pandemic, PE firms are jumping to secure deals involved in this enormous disruption to how companies and employees interact. In January 2022, Vista Equity Partners invested $150.0 million development capital in OfficeSpace Software to help expand its position in helping organizations navigate workplace disruptions and evolve their workplace strategies. As organizations embrace and transition to hybrid work, OfficeSpace's cloud-based platform allows users to simplify how employees utilize their workspace, manage desk and room booking, and maintain social distancing.

With more organizations than ever relying on technological solutions, PE firms have been aggressive

4: Growth investments are not included in the middle-market deal data, even if they are appropriately sized.

in finding opportunities as the sector experiences tremendous growth and expansion into areas previously not crowded with tech companies. Supply chain technology was a significant area of attention in 2021, as the pandemic caused major disruptions to the global supply chain and revealed an acute need for transformation and innovation to strengthen operations and build long-term resilience. In June, Trucker Tools was acquired by Alpine SG through Alpine Investors for $65.0 million. Trucker Tools is a digital freight management platform that provides predictive freight matching, automated booking, real-time location tracking, and capacity management for the transportation industry. With continued vulnerabilities in supply chains, investors are ready to spend more capital in the logistics space to increase data and analytics capabilities that would improve work process optimization and monitoring. Other industries are also poised for increasing tech adoption, which will provide PE firms with additional target companies in tech-related deal opportunities. For example, ServiceCore, a provider of business management software for liquid waste and roll-off industries, announced a $54.0 million investment from Mainsail Partners in early 2022. The increased usage of software and digital services by additional consumers will expand the IT market and likely increase deal activity for the already-strong sector.

Healthcare

2021 was a strong year for middle-market healthcare dealmaking as it was for most other sectors. While the US healthcare system continues to experience stress as a result of COVID-19 variants and labor shortages, hospitals have borne the brunt of these effects. By contrast, many of the healthcare businesses that middle-market GPs invest in have benefited from the broad shift to outpatient, remote, and home care and from accelerated technological and payment model disruption in the healthcare sector. Healthcare services dealmaking saw robust activity and extremely high multiples in several specialties that have experienced favorable demand dynamics since the beginning of the COVID-19 pandemic, including behavioral health, veterinary medicine, and home health. Platforms in both established physician practice management (PPM) plays, such as ophthalmology and dentistry, and emerging plays, such as cardiology and urology, also traded at elevated multiples in the last year.

One theme we are watching is the creation of new middle-market platforms that represent niche variations on common playbooks. For instance, in February, TPG's (NASDAQ: TPG) The Rise Fund announced its acquisition of Blue Cloud Pediatric Surgery Centers, a group of ambulatory surgical centers focused on pediatric dentistry that serves Medicaid and intellectually and developmentally disabled patients. The acquisition harkens back to Clairvest Group taking a 50% stake in New Jersey pediatric dentistry and primary care group ChildSmiles•FamilySmiles in early 2020. In dermatology, Hidden Harbor Capital Partners closed its acquisition of Florida-based Inspire Aesthetics in January, the latest of several recent pure-play cosmetic dermatology deals. With these deals, GPs are seeking breathing room in crowded marketplaces by moving away from a more traditional reimbursement mix, primarily Medicare and commercial, toward less-tested models—Medicaid in the case of the pediatric dentistry platforms, and out-of-pocket in the case of cosmetic dermatology.

As in healthcare services, middle-market GPs investing in healthcare technology in 2021 were faced with high multiples and fierce competition for assets related to the hottest investment themes, chief among them value-based care and electronic health record (EHR) management. While a handful of enormous deals headlined healthtech investing,[5] many GPs looked downmarket to identify value below the radar of the larger, and extremely deep-pocketed, strategics. Several GPs targeted vertical-specific EHR, risk management, and practice management solutions. For instance, in March, Carrick Capital Partners acquired Renalogic, which provides risk management software aimed at controlling costs associated with renal disease. Some firms that are committed to investing within the value-based care theme, where mature assets are scarce and highly in demand, may also be willing to move upstream to make growth investments in earlier-stage companies.

ESG

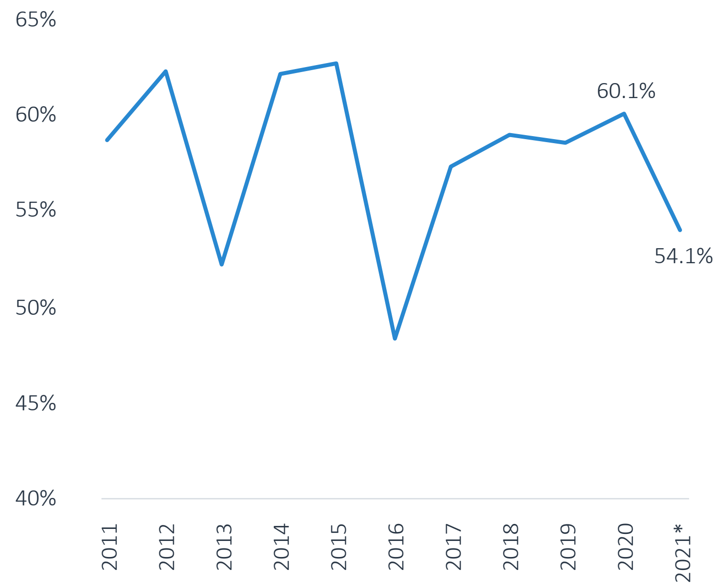
With consumers paying increasing attention to sustainable and impact-related business operations and corporate values, more PE firms are considering ESG during their due diligence of target companies. In New York Life Investments' (NYLIA) survey of middle-market PE firms in 2021, 63% of participants shared that they consider ESG factors when making investment

5: These include Microsoft's $19.7 billion acquisition of healthcare-focused AI firm Nuance Communications, Oracle's (NYSE: ORCL) $28.3 billion acquisition of EHR giant Cerner (NASDAQ: CERN), and the $17.0 billion buyout of Athenahealth by Hellman & Friedman, Bain Capital, and GIC.

decisions.[6] The middle market is still in the early stages of adopting formal procedures around ESG assessment; 37% of NYLIA's survey participants said that they have established a formal evaluation process for ESG risks and opportunities. The different schools of thought on the three ESG factors can also lead to differentiated portfolios, all focused on ESG but varying in approaches, measure of impact, and concern over greenwashing.[7] With pressure on GPs to articulate and measure these factors, we expect middle-market firms to increasingly build out more robust investment strategies that incorporate ESG in their portfolios.

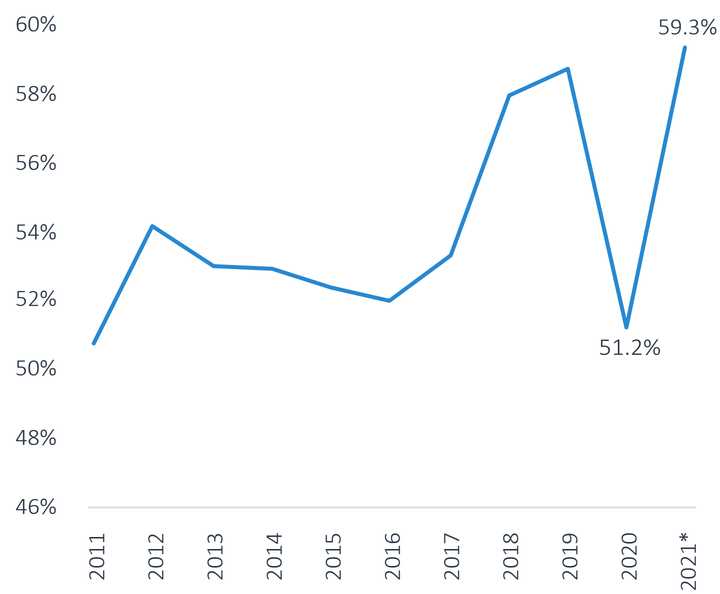
PE firms can add value by improving their portfolio companies' ESG profiles, both through risk mitigation and outperformance. ESG considerations can assess the growth potential and long-term sustainability of a company and also examine the risks or costs related to business production or operations, as well as those related to social dynamics such as workforce health, safety, and employee turnover. Entire funds dedicated to impact and sustainability are being launched in recognition of the attractive investment opportunities in businesses focused on creating positive change. In February 2022, Nuveen Investments raised $218.0 million for its inaugural global PE impact fund, which seeks to drive change in inclusive growth and resource efficiency—aligning itself with the United Nation's sustainable development goals. TPG's Rise Climate fund, a dedicated climate strategy of its global impact investing platform, launched in July 2021 with $5.4 billion. Rise Climate announced in February 2022 that it had taken a $500.0 million stake in Nextracker, which provides solar tracking and software solutions for global solar projects. With global solar installations continuing to grow, the investment could allow Nextracker to expand its market position and long-term growth with the help of TPG's experience and network in renewable energy. Increasing demand for ESG and the potential to improve business outcomes are likely to entice more PE firms into considering these factors in their dealmaking. In the current highly competitive deal environment, middle-market firms could also seek to differentiate themselves by embracing ESG in their portfolio construction.

Middle-market deal value as a share of all PE deal value



Source: PitchBook | **Geography**: US
*As of December 31, 2021

Middle-market deal count as a share of all PE deal count



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6: "Lessons Learned: Insights From the COVID-19 Crisis for Middle Market Private Equity Sponsors," New York Life Investments, Q3 2021.
7: For more information, see our recent analyst note, *ESG, Impact, and Greenwashing in PE and VC*.

Outlook remains favorable for 2022, but risks abound

Middle-market PE and private debt markets saw record deal volume in 2021 as M&A activity soared in the face of robust earnings and real GDP growth. Based on Refinitiv LPC data, sponsored middle-market loan volume rocketed to $196 billion, up 82% versus 2020 levels and up 7% from the prior 2018 peak. Accounting for 70% of the 2021 total, M&A activity was the main driver, with leveraged buyout (LBO) loan volume up 113% and add-ons up 74%. Volume was particularly strong in Q4, at a record $72 billion.

So far in 2022, PE deal activity has taken a bit of a breather following Q4 2021's frenetic pace, but recent surveys and investment banker feedback suggest activity is poised to strengthen in the months ahead. Positive drivers include expectations of continued robust—if slower—earnings and GDP growth, favorable financing conditions/liquidity, ebbing pandemic fallout, and high PE dry powder. However, inflation remains high, the Fed is increasingly hawkish, volatility is up, markets are down and geopolitical risks are running hot, with news breaking at the time of this writing regarding the invasion of Ukraine. While there is reason to be optimistic, there is also plenty of reason for concern.

Timothy Lyne

Chief Executive Officer

Antares Capital

Timothy is a founding partner of Antares. He is a member of Antares' Investment Committee and Antares' Board of Directors. Previous roles include chief operating officer and head of Asset Management for Antares.

Q&A with Timothy Lyne, CEO of Antares Capital

What are the credit implications of high inflation and Fed tightening in 2022? Are you seeing any signs of worry in your portfolio? What about the impact on M&A/PE activity?

High inflation followed by Fed tightening has been a classic precursor of past recessions, so concern is warranted. However, in most past cycles, the beginning of Fed policy tightening has actually been a sign of a firming recovery rather than imminent recession. Also, even recently raised expectations of as much as 175 basis points in hikes in 2022 look rather middling when compared to other hiking cycles since the 1960s. Of course, if inflation isn't tamed in 2022 and the yield curve inverts, the risk of a recession in 2023 or 2024 will rise.

As far as credit concerns, many existing loans have 0.75% to 1.0% LIBOR floors, so borrowers on those loans won't feel an impact until LIBOR exceeds those floors. Meanwhile, interest coverage ratios look healthy, with the S&P/LSTA leverage loan index median interest coverage at 4.76x as of Q3 2021—its highest level on record in 20 years. Thus, there appears to be significant cushion, particularly if EBITDA continues to grow as expected. Default rates, which are currently at rock bottom levels, could rise some but are expected to remain low during 2022.

Regarding our portfolio, our latest supply chain/inflation analysis indicates most credits are managing well. While almost a quarter of the portfolio anticipates some gross margin compression over the next six months, the majority expect it to be temporary. Of course, war in Ukraine could exacerbate supply chain disruptions and inflationary pressures and will warrant close monitoring in the months ahead.

Finally, regarding M&A and PE activity, the impact of inflation and rising rates is unclear. To the degree that we see some multiple compression due to higher interest rates, some may see this as a buying opportunity, while others may hold off selling in hopes of a better price later on. Of course, if inflation and interest rates rise to the point of being a harbinger of recession, deal activity would probably decline. For now, surveys and investment banker sentiment suggest reason to be optimistic about activity in the months ahead.

2021 was a record year for direct lending fundraising. Do you think it has been excessive?

According to Refinitiv LPC data, US middle-market loan fundraising rose sharply in 2021, to $180 billion, but that is still well below the year's $410 billion of US PE "buyout and generalist" fundraising. As such, it would appear that private debt fundraising isn't out of step. In fact, if you look at the dry powder of North American-focused direct lenders as measured by Preqin at the end of 2021, it is only about 20% of the total dry powder of North American-focused PE funds. Some of the discrepancy can be explained by PE funds aimed at mega-larger deals that are normally syndicated, but lately, direct lending has been increasingly penetrating deals in the "jumbo" $1 billion-plus deal size range. According to Direct Lending Deals (DLD), since September 2019, there have been over $50 billion in jumbo unitranche loans including a record sized $3.4 billion loan to Galway Insurance led by Antares Capital. About 60%, or more than $770 billion of the S&P LCD/LSTA Leveraged Loan Index, is comprised of loans in the $1 billion to $5 billion range, thus suggesting room for further growth.

How about growth prospects for PE and private debt in the middle market? Are they still favorable in the long term?

In a word, yes. The middle market remains our core focus. According to the National Center for the Middle Market (NCMM), middle-market companies saw robust revenue growth of 12.3% in 2021 and are projected to see 9.9% growth in 2022. Middle-market employment growth of 10.8% in 2021 exceeded both small businesses, at 5.2%, and large businesses, at 4.4%. While tight labor markets and supply chain disruptions continue to pose challenges, middle-market companies have proven to be agile and resilient.

The latest US census data available (2017) shows 223,000 middle-market companies in the US with revenue ranging from $10 million to $1 billion. We estimate PE penetration of companies in the $100 million to $1 billion range to be 10% to 12%, which suggests there is still plenty of room for growth. Also, new business formation surged during the pandemic and remains strong, according to findings by the National Bureau of Economic Research. Such entrepreneurial seedlings should bolster the future crop of investment opportunities for PE AUM, which is expected to more than double by 2026, according to the latest projections from Preqin.

How has the LIBOR transition to SOFR gone?

Over the last two years, we have diligently prepared to arrange and lend in SOFR, and today, all our new direct originations—or new deals—are being quoted in SOFR. For existing borrowers with incremental debt needs, Antares will initially quote terms in SOFR, but we will work with the borrower and PE sponsor to determine the most appropriate base rate for each situation.

What role does ESG play in private debt versus PE, and how do you see things developing?

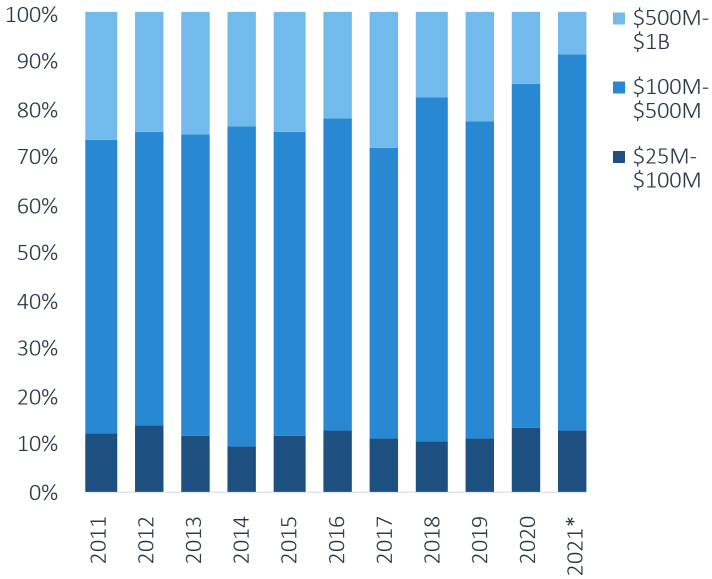
To date, PE investors have been more deeply involved in driving ESG adoption at companies, given their ownership and control positions. However, private debt providers are a critical source of capital, too, and have an important and developing role to play.

As a lender, we believe many aspects of ESG are simply fundamental to proper due diligence. We believe it's critical to get things right up front and that investing in borrowers with lower ESG risk factors will ultimately lead to better outcomes for our investments and stakeholders. Key to development of the lenders' role in driving ESG will be further progress in ESG-related transparency and standardization.

On the climate change transparency and standardization fronts, our parent company, CPP Investments—a founding PRI signatory and the first pension fund to issue a green bond—recently published "The Future of Climate Change Transition Reporting" and "Investing in the Path to Net Zero." For more information on Antares Capital's ESG policy and approach: https://www.antares.com/responsibility

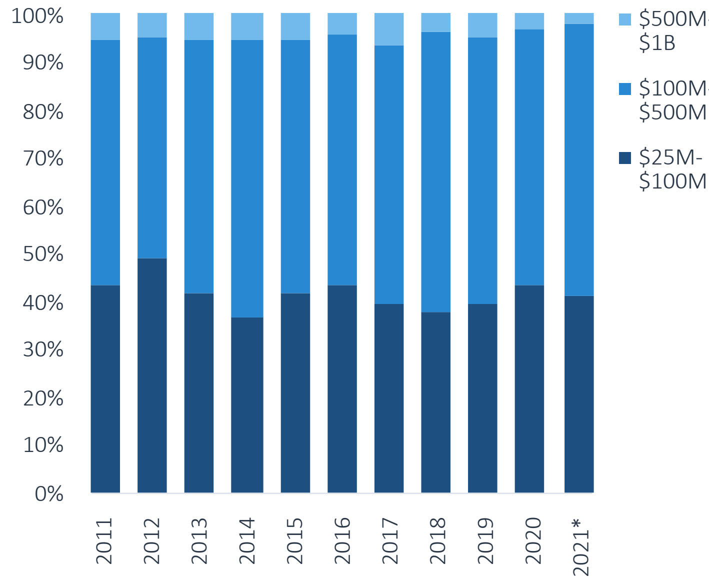
Deals by size and sector

Share of PE middle-market deal value by size



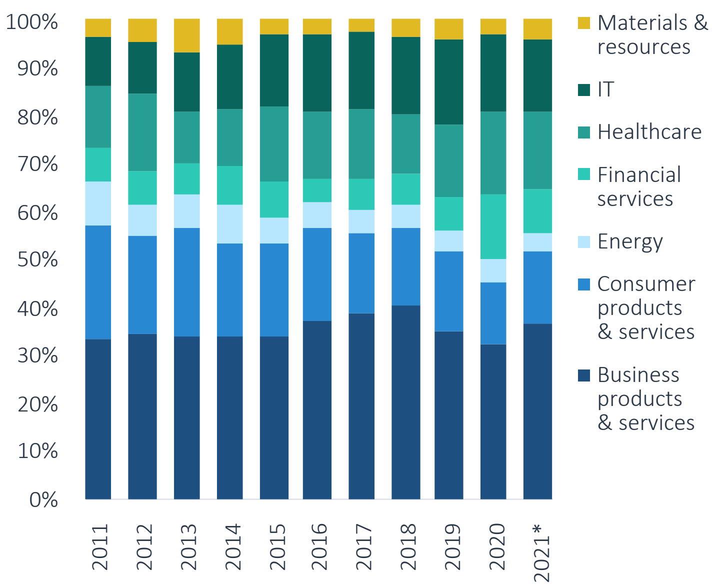
Source: PitchBook | **Geography:** US
*As of December 31, 2021

Share of PE middle-market deal count by size



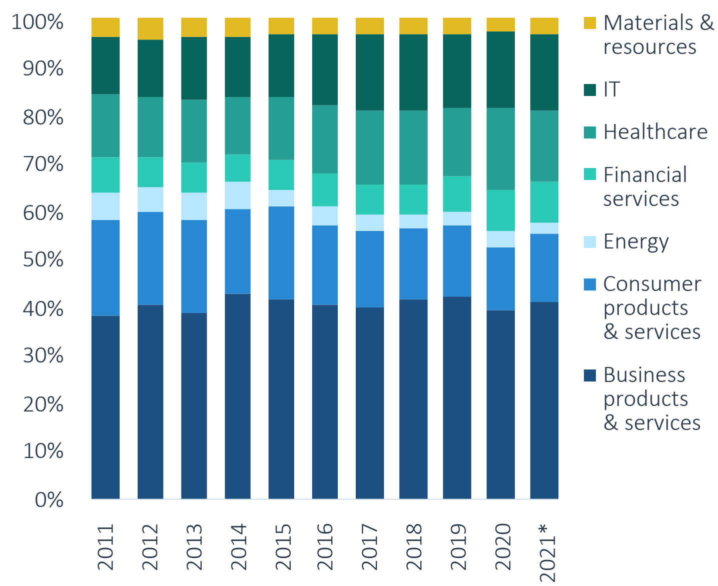
Source: PitchBook | **Geography:** US
*As of December 31, 2021

Share of PE middle-market deal value by sector



Source: PitchBook | **Geography:** US
*As of December 31, 2021

Share of PE middle-market deal count by sector



Source: PitchBook | **Geography:** US
*As of December 31, 2021

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PitchBook

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Current trends in valuing complex financial instruments

Q&A with Stout

Justin Burchett

Managing Director, Complex Securities & Financial Instruments

Stout

Justin leads Stout's Financial Services Industry practice and delivers valuation opinions and related advisory services to hedge funds, PE funds, asset managers, banks, insurance companies, real estate investment trusts, specialty finance companies, and government agencies.

Jamie Spaman

Managing Director, Valuation Advisory

Stout

Jamie leads Stout's Portfolio Valuation practice and has over 15 years of experience providing fair value services to business development companies, private debt, PE, and other portfolio managers of illiquid debt and equity investments. He also has extensive experience providing valuation services and financial opinions to PE, venture capital, and corporate institutions.

What challenges do current market conditions present in valuing complex financial instruments and alternative assets?

Justin: The current market portends challenges for performing company valuations that account for significant market variables. The sharp increase in inflation measures, expectations for a Fed rate tightening cycle, and increase in geopolitical uncertainty have caused a repricing of many financial assets and corresponding volatility in the capital markets. Abrupt changes in these market factors make estimating company forecasts, market multiples, and required rates of return more difficult. These challenges are compounded when practitioners are asked to price hard-to-value positions including complex financial instruments and other illiquid investments.

Complex financial instruments and other alternative asset values tend to exhibit more sensitivity to changes in primary inputs, due to structural features of the instrument. Similarly, complex instruments are frequently priced using second-order market variables that react more strongly to changes in market factors. As an illustrative example, the valuation of common shares in a private company involves market inputs for the discount rates applied in an income approach and market multiples derived from public companies and prior transactions. Valuing an option instrument for the same firm will require the selection of additional assumptions for volatility. This relationship means that complex instrument valuation becomes more challenging when multiple model inputs exhibit higher variability or are difficult to measure.

The Fed has forecasted several rate hikes next year. How do your clients expect to navigate a rising rate environment, and how might this affect valuations within the financial services industry?

Justin: For commercial banks, the prospect of rising interest rates can benefit the profitability of the business. Because these firms operate in a spread lending model, increasing rates are generally expected to increase the net interest margin, or the difference between interest income received on loans and interest expense costs. In the textbook scenario, rising rates are also expected to coincide with a benign economic environment with strong growth and lower default risk. It remains to be seen whether the Fed's tightening cycle will benefit banks and other financial services firms, as the anticipated rate hikes will occur following a sharp rise in inflation caused in part by government economic intervention as a reaction to the COVID-19 pandemic.

Nonbank consumer lenders are an example of a credit-sensitive business model that could be tested in an inflation-driven rising rate environment. With the slowdown of government payments, nonprime consumers may be tested, as real wages decline due to increases in the cost of living. Fintech-enabled consumer lenders have grown new lending products—point-of-sale loan portfolios in a benign default environment that did not provide a test of credit underwriting models and loan pricing. A more volatile interest rate and credit spread could stress leveraged consumer credit underwriting models to sort out the platforms that will be most successful across market cycles.

What trends are you seeing as it relates to portfolio companies?

Jamie: First, we have noticed that leverage on private credit transactions has continued to rise—notably, the share of transactions with leverage at 7x or higher is on the rise.

Overall, the market seems borrower friendly. Loose-covenant structures continue to be the norm, as borrowers can take advantage of the large amount of money available to lend. A newer trend in lending is annual recurring revenue (ARR)-based loans for primarily tech companies that have little to no EBITDA as they focus on the race for growth.

Supply chain issues, labor needs, and inflation all present themselves as issues to watch going forward. Supply chain issues are more prevalent in our analyses due to transportation costs surging, though this increase in costs is often able to be passed to customers. Trends through the pandemic put many companies in a lean workforce situation—recruiting people to return or replacing them has been a challenge.

The overall mood remains optimistic, with revenues growing in a reopening environment and the ability to pass along cost increases. Many companies are budgeting to get back to pre-pandemic levels by 2022 or 2023, and many expect the supply chain and labor shortage issues to clear up in the near term.

What do you anticipate in the SPAC market in the near and long term?

Justin: The SPAC market has taken a beating in the last two quarters. The performance of de-SPAC merged companies has declined sharply, numerous announced SPAC mergers have been canceled or delayed, and a long list of SPAC vehicles have completed a SPAC IPO and are searching for a merger partner. However, SPACs were not the only financial product to suffer in the recent market turmoil—companies that went public through a traditional IPO also experienced significant markdowns.

Market observers are tracking the proportion of SPAC shares that redeem prior to a merger. While earlier deals saw 10% redemptions, recent deals have incurred redemptions of 50% to 60%. To mitigate the effects of redeeming SPAC equity investors, sponsors have responded by forfeiting sponsor-promote shares and offering additional protections, such as convertible debt features, to PIPE investors in order to consummate a merger. We expect this trend to continue as SPAC sponsors are highly incented to close a transaction to avoid the complete loss of the sponsor economics.

Finally, we note that there will be closer scrutiny of SPAC investment terms and the valuation assumptions used to price de-SPAC merger transactions. The performance of public companies formed through de-SPAC mergers will be linked to the acquisition price and the various rights and privileges of the securities that are created as part of the deal.

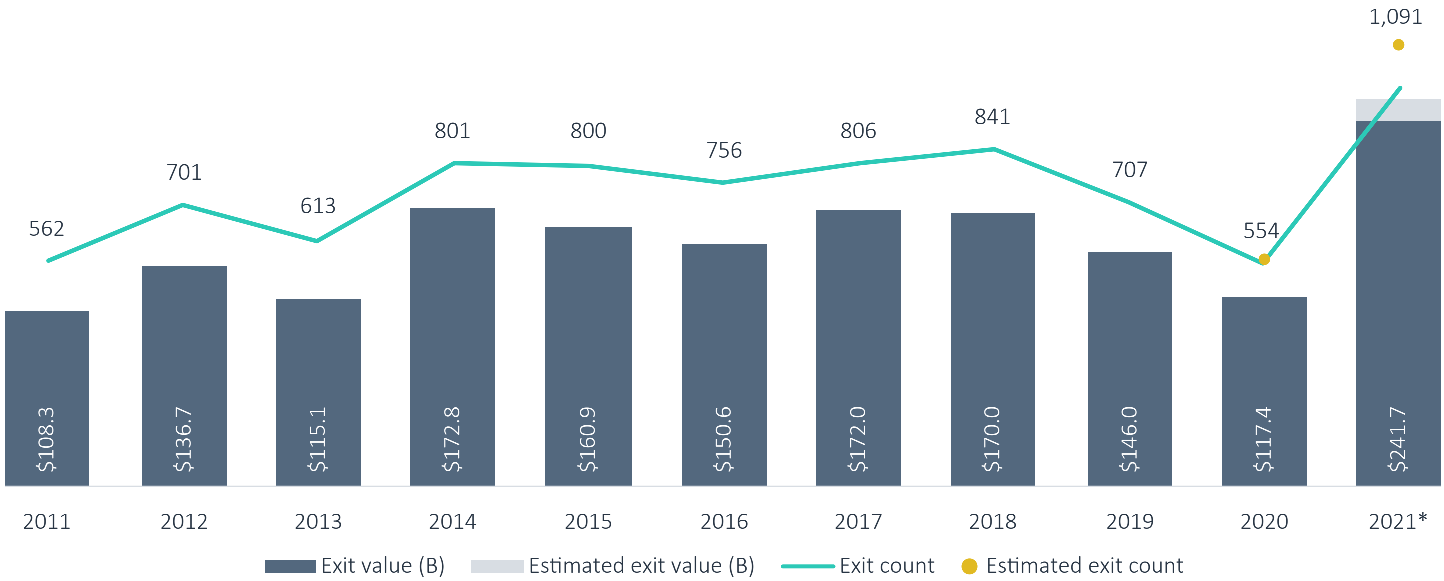
Given the transition from LIBOR, what are you anticipating in terms of the valuation of transitioning LIBOR loans?

Jamie: So far, the transition away from LIBOR has been smooth. There was some speculation as to how lenders and borrowers would incorporate alternative rates and if they would use a credit spread adjustment (CSA) in their pricing. While SOFR has been the clear leader as a replacement rate, there has been some variety in implementing a CSA. Examples include a $3.6 billion financing to fund the acquisition of software company Quest Software by Clearlake Capital, which added a separate CSA on top of SOFR, plus margin terms. Other borrowers, however, have chosen not to add a separate cushion, including a $1.15 billion term loan for the spin-off of diabetes care business Embecta from Becton, Dickinson and Co. We think negotiation will continue among borrowers and lenders on how to adjust spread when changing to a SOFR-based rate versus LIBOR.

The results of those negotiations will determine where valuations land. Even though SOFR and LIBOR typically trend in the same direction, the key difference is that LIBOR has a credit risk component, while SOFR is a risk-free index. As a result, if a loan has the same spread as it transitions from LIBOR to SOFR, there will be lower interest payments leading to a lower price. However, the use of a CSA or selecting a higher margin on the SOFR-based loan will compensate for this difference, leaving the price of the loan unchanged, all else equal.

Exits

PE middle-market exit activity

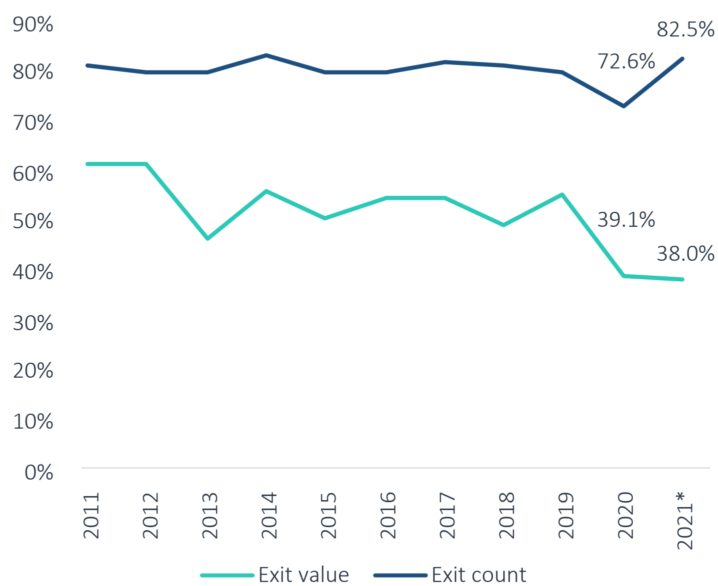


Source: PitchBook | **Geography**: US
*As of December 31, 2021

US middle-market exit activity rocketed to new highs in 2021. More than 1,000 PE-backed middle-market companies were exited during the year, setting a new high-water mark. Similarly, cumulative middle-market exit value surpassed $240 billion, also setting a record. The fervent monetization environment was propelled by several factors; some of the activity can be accredited to sponsors pushing back exits after a tumultuous and unpredictable 2020, adding to the count in 2021. Moreover, rising multiples stemming from robust economic recovery caused many portfolio companies to hit price targets a year or more ahead of schedule, incenting some firms to exit their holdings early. Furthermore, a surfeit of dry powder and cash on corporate balance sheets encouraged these entities to buy even more PE-backed companies with ease.

The first couple of months of 2022 may prevent the year from being another stellar one for monetizing portfolio companies. Inflation remains a key concern, which could cause some corporates to experience lower margins and become less acquisitive. Additionally, the prospect of prolonged higher inflation may cause interest rates to rise, boosting the cost of borrowing and pressuring company multiples. This has already taken place in public markets, with numerous high-growth companies seeing their trading price cut in half or more in a short period. The volatility effectively takes public listings off the table—though these are far less critical to the middle-market exit environment than to the top end of the market. Lastly, Russia's invasion of Ukraine has the potential to spread to neighboring countries, causing a considerable number of human casualties and economic uncertainty.

Middle-market exit activity as a share of all PE exit activity



Source: PitchBook | **Geography**: US
*As of December 31, 2021

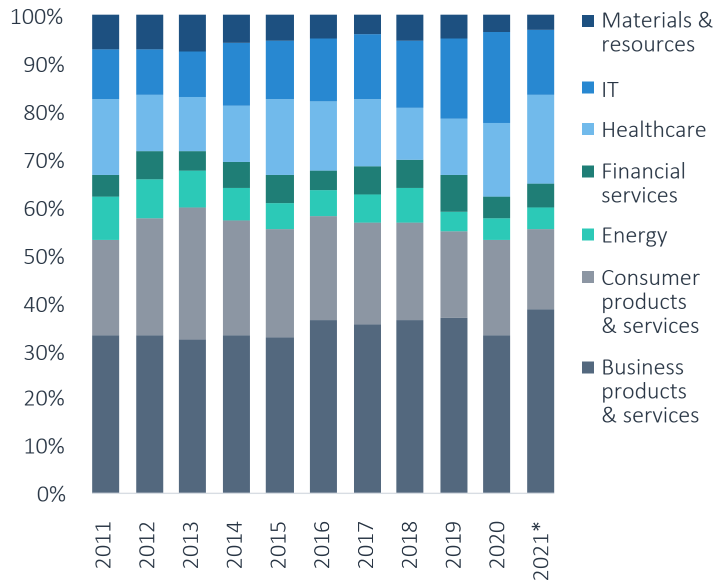
Industrials

Industrials, a mainstay of middle-market PE, witnessed steady exit activity throughout the year. The pandemic pressured manufacturing companies and global supply chains, pushing many US-based companies and the US government to launch concerted efforts to reshore manufacturing capabilities. This will likely lead to a substantial increase in the need for physical goods, boosting the value for many industrials companies. Moreover, the capital-intensive effort to decarbonize the US economy is leading many industrials companies to project higher top-line growth into the future. Sales to corporates and other PE firms were readily available to sponsors seeking to monetize their positions. Trivest Partners' $114.0 million sale of Columbus Recycling to Schnitzer Steel Industries (NASDAQ: SCHN) is illustrative of much of the exit activity to sponsors during the year. Schnitzer is seeking to leverage economies of scale by combining the company's nine facilities in Georgia, Alabama, and Tennessee with Columbus Recycling's eight locations throughout Mississippi, Kentucky, and Tennessee. Exits such as these demonstrate the secular growth trends in industrials that are helping PE firms find buyers that are interested in strengthening their market positions for anticipated growth.

Sponsor-to-sponsor industrials transactions were also prevalent in 2021, as other PE firms bought into the sector's long-term growth thesis. One exit that exemplifies many of the trends within the industry is MSouth Equity Partners' sale of Southern HVAC to Gryphon Investors. The company provides residential HVAC, plumbing, and electrical services, and represents Gryphon's second HVAC services acquisition in under one year. Long-term growth in the housing market, especially in the Southern US, drew in significant capital in 2021 and likely boosted the company's value. Additionally, many investors appreciated and paid up for the recurring nature of numerous types of services revenues. Although they are not valued as highly as the recurring revenues of software-as-a-service (SaaS) businesses, services companies saw notably higher multiples in 2021.

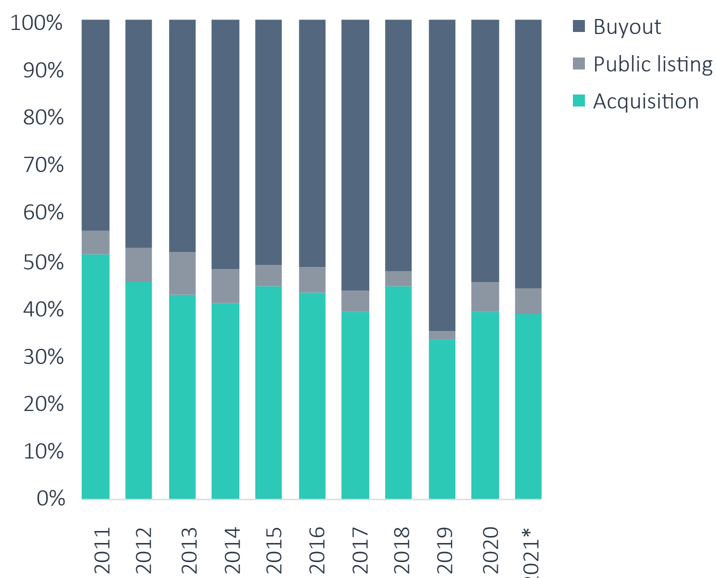
Wind Point Partners' sale of RailWorks to Bernhard Capital Partners in November 2021 is another exit that speaks to several trends driving interest in the industrials space. RailWorks constructs and provides maintenance services to rail tracks. The services company has an infrastructure bend, which is timely, given the $1 trillion infrastructure bill that was signed the same month the transaction closed. Going forward, rail will remain critical for moving freight throughout the country, as many companies build out manufacturing capacity to combat global supply chain issues.

Share of PE middle-market exit value by sector



Source: PitchBook | **Geography**: US
*As of December 31, 2021

Share of PE middle-market exit value by type



Source: PitchBook | **Geography**: US
*As of December 31, 2021

Heading into 2022, exit activity within the industrials space may lessen as several external factors put pressure on the space. Inflation is leading to heightened input costs, and climbing wages could further dampen margins that are already slimmer than in many other sectors. In the first couple of months in 2022, industrials companies have traded down more than the broader market, indicating that public market investors are taking a similar view of the sector's future. However, rising rate environments have tended to be a boon for value—rather than growth—company returns. This could buoy PE exit activity in the industrials sector in the coming quarters.

Software

IT exit activity finished the year strong, setting annual records in aggregate value and count, at $31.3 billion and 170, respectively. Buyouts represented most of the exit activity for middle-market tech companies, as PE firms actively searched for companies with additional value-creation opportunities in the next stage of investment to generate synergies with their larger platforms. Corporate acquisitions also contributed significantly to tech exits during the year, with opportunities for tech acquisitions emerging in areas previously not relying on digital capabilities. For example, New Mountain Capital sold DRB Tunnel Solutions, a point of sale (POS) software developer for the conveyorized car wash industry, to Vontier (NSE: VNT) for $955.5 million in September. DRB provides technology and software solutions to enhance consumer experience and the operational efficiency of a car wash, which in turn improves the revenue profile and profitability of the business. Increasing digitalization was a major driver of exit activity, with business and productivity software accounting for a significant portion of exits during the year. PE firms that had invested in companies related to workplace software are finding attractive markets to exit their portfolio companies into, as the shift to remote work has been a major disruptor over the last two years. TA Associates' sale of Confluence Technologies, a business process automation and data solutions provider for the investment management industry, to Clearlake Capital for $900.0 million in August was one of the many successful exits in workplace software. The accelerated tech adoption across industries and numerous organizational transformations will continue to spur more exit opportunities for PE firms investing in tech companies.

Cybersecurity, which began to see a flurry of deal activity over the last couple of years, is already seeing exits as the increased use of digital systems, coupled with rising cybercrimes, heightens the acute need for greater online protection. This trend can be seen in the middle market as well, with the cybersecurity market expanding to cover various objectives and verticals that make way for smaller companies to grow. In December, Audax Private Equity exited Acuant, an identity verification and compliance provider, to GB Group for $736.0 million. In the same month, the Wicks Group of Companies sold identity and fraud protection software developer Sontiq to TransUnion (NYSE: TRU) for $638.0 million. Rapid growth in cybersecurity strategies along with the industry's still-decentralized and segmented nature provide ample opportunities in the middle market to exit to both sponsors and corporations looking to build up market share or enhance their digital security capabilities.

Healthcare

Like other growth sectors, healthcare saw robust exit activity in 2021 as GPs moved up exit timelines to take advantage of favorable market conditions for companies that had seen faster-than-expected revenue growth. In healthcare services, the last wave of provider roll-up investments, which crested between 2016 and 2018, began maturing in 2021. Noteworthy exits included Audax's $950.0 million sale of Gastro Health to OMERS, RiverGlade Capital and Thurston Groups' $725.0 million exit of U.S. Oral Surgery Management to Oak Hill Capital, and MBF Healthcare Partners' sale of Acorn Health to Ontario Teachers' Pension Plan. Looking ahead, industry participants see a strong pipeline of PPM platforms either in the market or waiting for the right opportunity to enter the market in the next one to two years. In fact, with so much activity expected, GPs and their bankers are focused on timing sale processes to minimize overlap with processes for similar platforms. We have also heard that platforms that have begun to develop value-based care contracting arrangements with payers are commanding a premium above current EBITDA multiples.

While the vast majority of middle-market PPM platform exits will continue to be sponsor-to-sponsor buyouts or, in some cases, acquisitions by larger sponsor-backed platforms, some provider groups that fall within the categories of primary and preventative care—which can drive referrals for specialist services—are attracting attention from health systems and other strategics. For instance, Brentwood Associates sold MD Now Urgent Care to HCA Management Services (NYSE: HCA) in December. Additionally, investments in healthcare technology and pharmaceutical services drew significant exits to strategics looking to quickly position themselves at the cutting edge of a rapidly changing industry. For example, in January 2021, Francisco Partners sold Capsule Technologies—a maker of software that aggregates, analyzes, and shares medical device data—to Philips (NYSE: PHG) for $635.0 million.

The evolution and challenges of today's PE dealmaking environment

Q&A with Baker Tilly

Given how busy the dealmaking environment has been, have you seen proportionally larger growth rates in dealmaking within the US middle market relative to the general company population?

Certainly, 2021 was a high-water mark in terms of the number and value of deals across all markets, including the middle market. Deals increased across the spectrum—PE, strategics, and SPAC transactions. Deal volume was up more than 50% over the five-year average by some measures. Some of this deal volume related to pent-up demand, after deals dried up at the beginning of the COVID-19 pandemic. Many middle-market deals resulted in a rush to close before year-end because of concerns over possible federal tax policy changes on capital gains.

The middle market includes a class of companies that are attractive assets for buyers. Many are founder-led firms that have been around for 50 to 60 years, have experienced significant growth in recent years, and can reasonably be seen as growth engines for a better-resourced owner. So, you have a convergence of demographics—owners acknowledging it is a good time to exit and well-resourced buyers executing on deals.

How have the concerns your middle-market clients brought to you before considering a transaction evolved throughout the year?

One thing that has not changed is that clients are often surprised by how long a transaction takes to close. Because so many deals hit the market at the same time last year, it became more difficult to secure qualified assistance from advisors such as accountants, transaction attorneys, and investment bankers. Sellers that didn't close in 2021 are thinking about what their horizon might be and are taking a more clinical view on how to prepare to come to market. So, speed has become more of a concern for our clients. While the window is very much open for deals to get done at attractive valuations, when you look at all the potential headwinds—political uncertainties, fiscal and monetary policy, and concerns about the overall equity markets—there is a fear that the window will shut.

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Frank leads Baker Tilly's national CFO Advisory practice, which supports clients along their business and transaction lifecycles in the areas of transactions, technical accounting, interim management, and other business advisory solutions. With more than 25 years of public accounting, industry (CFO), and consulting experience, Frank specializes his practice in M&A and has directly led or advised on transactions valued in the tens of billions.

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Partner, Private Equity Practice Leader

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Brian takes pride in helping drive fund and portfolio company growth, leveraging his experiences along with the advisory, tax, and assurance services Baker Tilly has to offer. Brian's clients have come to rely on his guidance and recommendations as they assess business and accounting issues experienced throughout the PE transaction lifecycle.

On the buy side, our clients' valuation expectations have begrudgingly changed. Although there was a good supply of sellers, demand was just as robust, particularly for quality assets. Prices and multiples for quality businesses are much higher than they were pre-pandemic. Even PE funds that would, historically, pay somewhere between seven and nine times their earnings are commonly paying much higher multiples. A lot of money is chasing the same opportunities, and that should always be a concern over the long term.

The SPAC market was still hot in early 2021, but it has started to cool for various reasons. One is the level of effort it takes to be a public company, not to mention the increased regulatory scrutiny SPACs are facing. Still, a significant number of SPACs have yet to complete an acquisition, but we should expect to see more completed SPAC deals in 2022.

On the buy side, how are fund managers tackling the twofold challenges of pricing and subsequent operational improvements, particularly for middle-market enterprises? What about the sell side's perspective?

As some deals are priced to perfection, buyers can't financially engineer their way into acceptable returns. To mitigate higher valuations, sponsors are very disciplined about what they're pursuing, ensuring they have a clear edge in a particular industry to make an acquisition successful. Sponsors are also increasing due diligence, focusing not only on financials but also on operations. They're going to earn the return by growing and improving the business, making their operating partners and value-creation teams much more central to the transaction. In the middle market, these changes often manifest in areas such as business systems, digital transformation, financial planning and analysis, and procurement, as well as areas where operating leverage can be realized.

On the sell side, while there's competition for quality companies, some of our clients are surprised that more buyers aren't interested in their businesses. But if a buyer does not see a profitable angle for a particular business, it is quick to pass. What we do see is sellers being surprised by unexpected buyers. A seller may expect that its buyer will be a company looking for a strategic add-on or perhaps a main competitor. Because so many new PE players are in the market, however, we have seen deals where a PE investor, not previously known in a particular market, will buy the number one and number two players in a niche market because it had a thesis about how they were going to enter the market.

We assisted clients with a number of nine-figure transactions last year. All of these clients had been considering a deal for some time but finally decided to pull the trigger. In most of these deals, the seller was willing to roll a portion of its equity into the new business, as it had high conviction on the new owner's ability to grow the business, which is good to see.

What are the unique challenges that middle-market clients are navigating, and are they different than they were pre-COVID-19?

Many middle-market businesses are differentiated by their ability to run operations under a single roof or benefit from the presence of the founder. As the forced adoption of remote work ensued, some businesses did better than others navigating the new world. A lot of middle-market companies may be less vertically integrated and more reliant on external suppliers than larger companies; we have certainly seen more pervasive supply chain issues, compared with larger companies. Perhaps the biggest challenge for middle-market businesses, however, is the rising cost of labor coupled with an inability to fully pass on that cost to their customers.

Given the evolving status of the pandemic, how have middle-market businesses' concerns changed heading into 2022?

The concerns of 2021—the uncertainty of the pandemic and potential tax policy changes—are still with us in 2022. Think of the amount of money disbursed by the federal government, which has helped to fuel inflation. Ongoing issues with global supply chains are also fueling inflation. Expanded unemployment benefits likely have kept people out of the workforce, and other dynamics caused some to decide on early retirement, contributing to the talent shortage affecting all sectors of the economy.

All that being said, we try to keep our clients balanced. It is best to focus on continuing to run a good business and be deliberate about preparing to go to market.

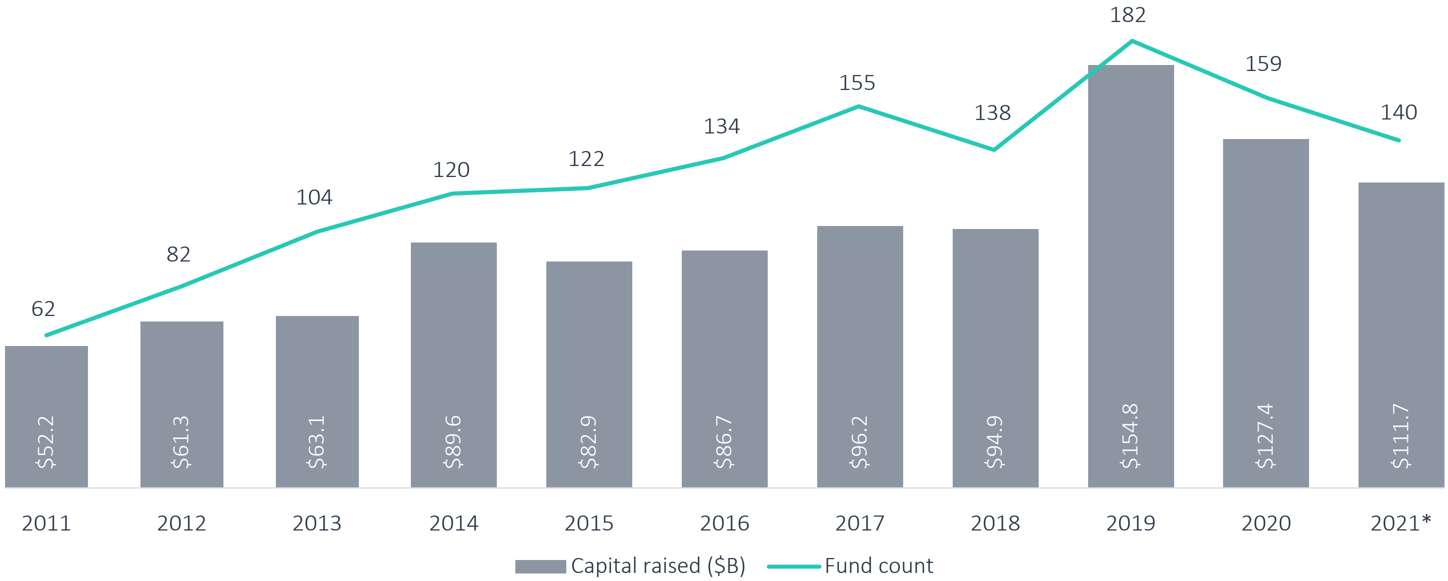
What are the least-discussed challenges and/or concerns that middle-market companies face, in your opinion? What should PE players in this space be aware of that you do not see discussed much?

The speed of change and the separation of fad from the future. All-encompassing change is everywhere—for example, digital technologies and artificial intelligence (AI), ESG, information security, hybrid working, supply chains and, of course, digital currencies. The velocity of this change today makes it difficult to distinguish between the future and the flavor of the day. There is an incredible amount of brainpower in PE, and its investment returns are why the asset class continues to attract capital. There probably isn't much that PE firms aren't aware of regarding the challenges they may face—high valuations, credit market changes, and the typical topics discussed.

A big differentiator we hear about more frequently from our clients is soft skills, usually either criticism or praise of a particular PE firm in terms of matching personality and values, as well as overall relatability with the founders. So, despite all the change, one thing remains the same—the people.

Fundraising & performance

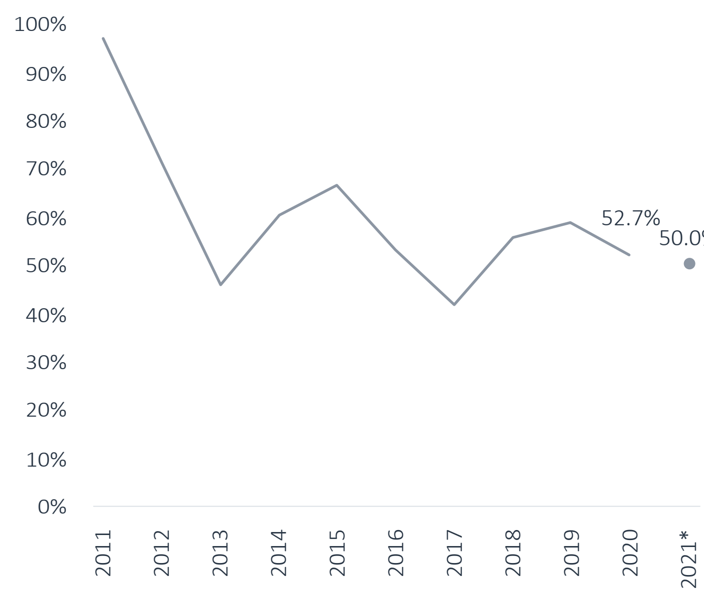
PE middle-market fundraising activity



Source: PitchBook | **Geography**: US
*As of December 31, 2021

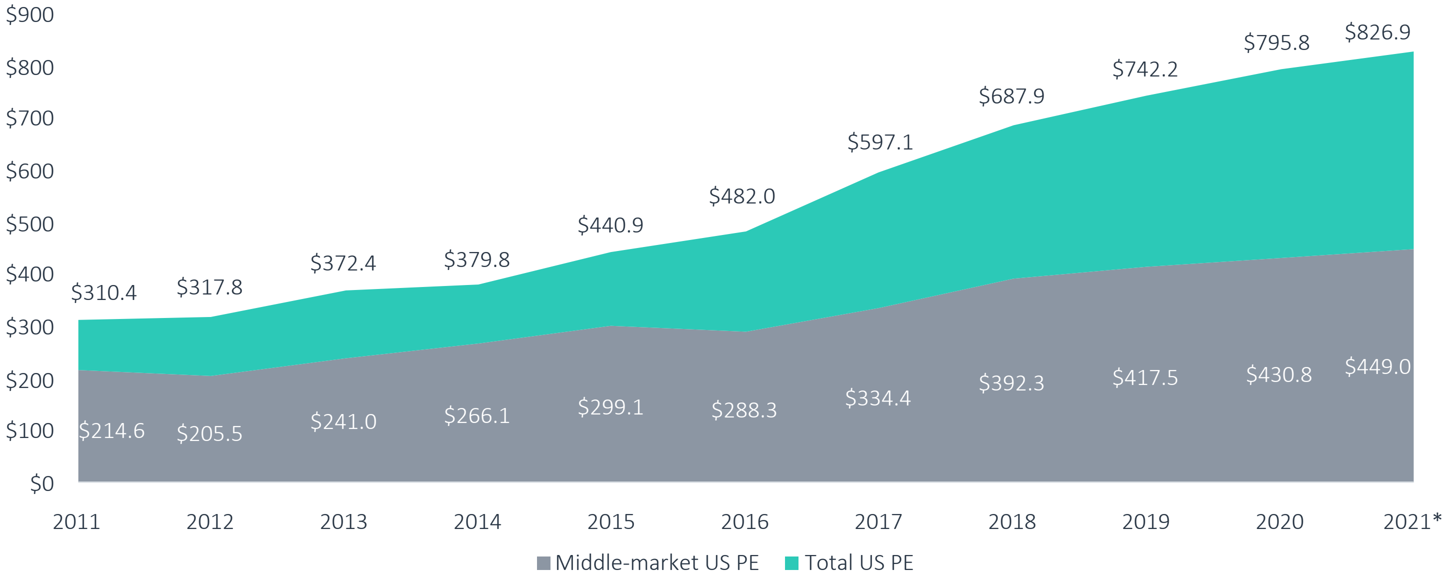
US middle-market fundraising continued apace in 2021, with 140 funds closing on a combined $111.7 billion. Fundraising figures fell just shy of 2020's annual figure in both capital raised and fund count, showing slower signs of recovery than the rest of the PE fundraising landscape. Middle-market funds accounted for 50.0% of all US PE fundraising during the year, which continued the middle market's slowly diminishing proportion of overall PE capital raised. With more than 20 US mega-funds (vehicles with $5 billion or more) currently in market or expected to launch in the coming months, even more capital will likely be poured into the top end of the market. Despite shrinking in proportion to the top end of the market, the strong fundraising activity saw the time between funds drop to 3.7 years, the shortest time in over a decade. Unprecedented dealmaking activity is allowing firms to deploy capital and return to fundraising at a rapid pace, and funds are being raised faster than before with robust appetite from LPs.

Middle-market capital raised as a share of all PE capital raised



Source: PitchBook | **Geography**: US
*As of December 31, 2021

PE middle-market dry powder ($B)

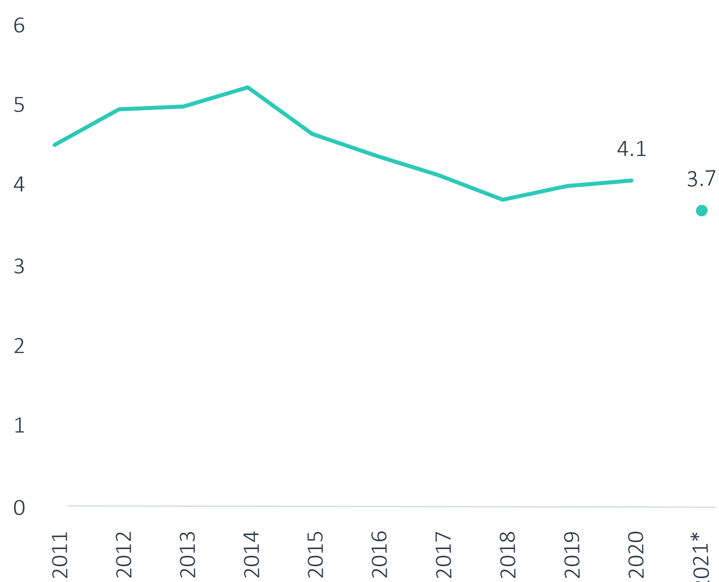


Source: PitchBook | **Geography**: US
*As of June 30, 2021

Step-ups

Middle-market GPs have not been able to keep pace with the unprecedented capital raising activity we are seeing from mega-funds, which were a driving force behind 2021's fundraising total and look to be making even more of an impact in 2022. The trends of large institutional investors remaining understaffed and seeking deeper relationships with a few large LPs, combined with LPs broadly boosting allocations to alternatives and the largest managers seeking healthy step-ups, have further concentrated capital in the 50 or so largest managers. However, large GPs are not the only ones seeking to cash in on this fundraising environment. Plenty of middle-market firms pursued sizable step-ups in 2021, with 88.0% of funds closing on more capital than their predecessors, an all-time high. Similarly, the median step-up climbed to 70.0%. Some middle-market managers are growing even more quickly. For example, in March, Atlas Holdings held a first, final, and hard-cap close of its buyout fund, Atlas Capital Resources IV, at $3.1 billion. The fund was nearly a 2x step-up from its previous fund, which had closed three years prior at $1.68 billion. Similarly, in September, Alpine Investors closed Alpine Investors VIII at $2.25 billion, a 2.25x step-up from its previous fund. While the proportion of middle-market funds in the largest size segments has decreased in the past year, this is largely due to the fact that numerous funds have expanded beyond the $5 billion size bucket and are no longer categorized as part of the middle market.

Average years between PE middle-market funds



Source: PitchBook | **Geography**: US
*As of December 31, 2021

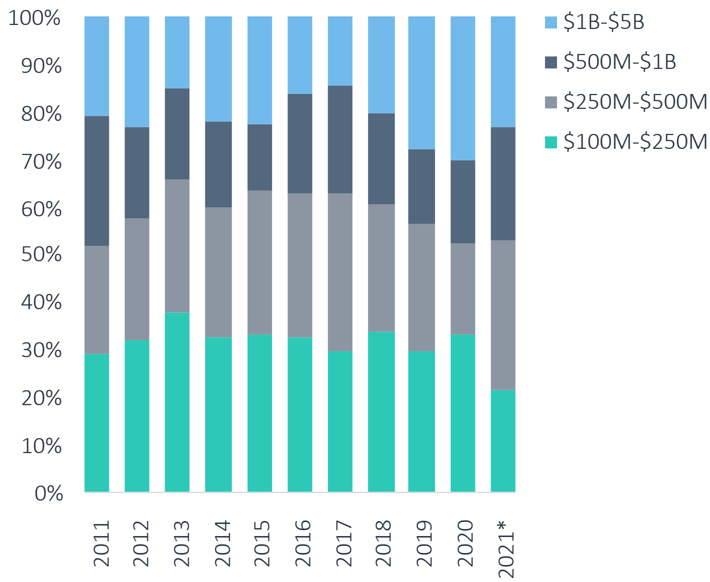
Strategy expansion

Strategy expansion has been the focus of several fund launches in the middle market. Mega-fund managers are taking advantage of LPs' desire to consolidate manager relationships while increasing allocations by launching additional strategies, including those focused on the middle market. As of Q3 2021, our data shows that large firms with at least one mega-fund have collectively launched an average of 2.5 new middle-market buyout strategies per year since 2011. For example, Thoma Bravo, a technology-focused PE firm with over $91 billion AUM as of September 2021, has two open funds with strategies focused on the middle market. The firm is currently fundraising for Discover Fund IV, which will invest in middle-market software and technology companies, and Explore Fund II, which focuses on the lower middle market. Middle-market firms are also using strategy expansion to grow AUM while remaining focused on their mid-cap target market. For example, H.I.G. Capital closed its first Europe Middle Market LBO Fund at $2.4 billion in September to expand its geographical reach. In sector expansion, Shore Capital Partners is a noteworthy example: The firm closed its first business services-focused fund in July at $213.0 million along with its fourth flagship healthcare fund at $366.0 million. Shore Capital, which has remained disciplined in its micro-cap focus, had been a healthcare specialist for nearly a decade before raising funds focused on other sectors—for example, launching a food & beverage fund in 2019.

Emerging managers

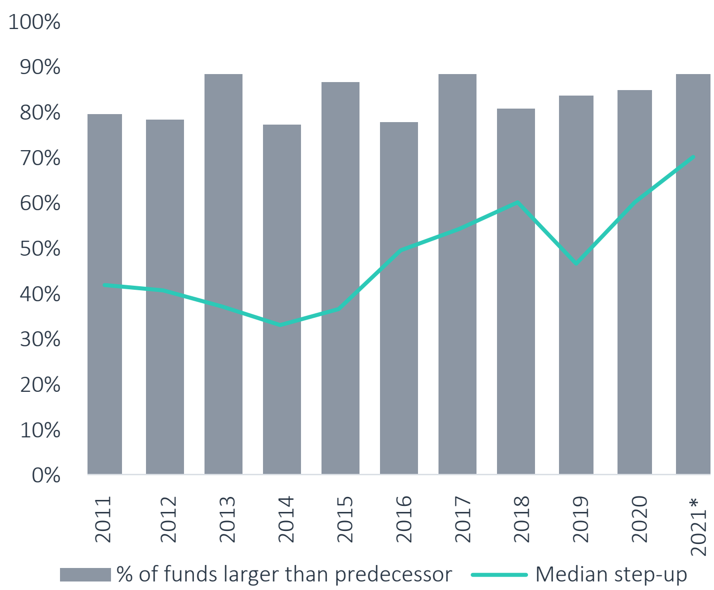
Emerging manager fundraising, defined as funds one through three, held steady in 2021. 58 funds were raised, totaling $27.6 billion and in line with the previous five-year average of around 60 funds and a combined $25 billion. Recent years have seen emerging manager fundraising remain relatively flat even as middle-market fundraising has generally risen. With each successful new manager launching and securing capital, the barriers to entry in the buyout space rise. Additionally, dozens of larger players, as well as some middle-market specialists, are raising funds beyond the traditional flagship offering. One such example was MiddleGround Capital, which is based in Lexington, Kentucky, and focuses on industrials. The firm closed its second flagship fund in 2021, collecting $800 million in commitments for its commingled vehicle. MiddleGround collected another $250 million for its first Mobility Opportunity Fund, which will invest alongside the flagship in "automotive companies with exposure to electrification of the powertrain, vehicle light weighting, connected and autonomous vehicles."[8] This type of focused offering has gained acceptance with LPs and helped many emerging managers find fundraising success.

Share of PE middle-market fund count by size



Source: PitchBook | **Geography**: US
*As of December 31, 2021

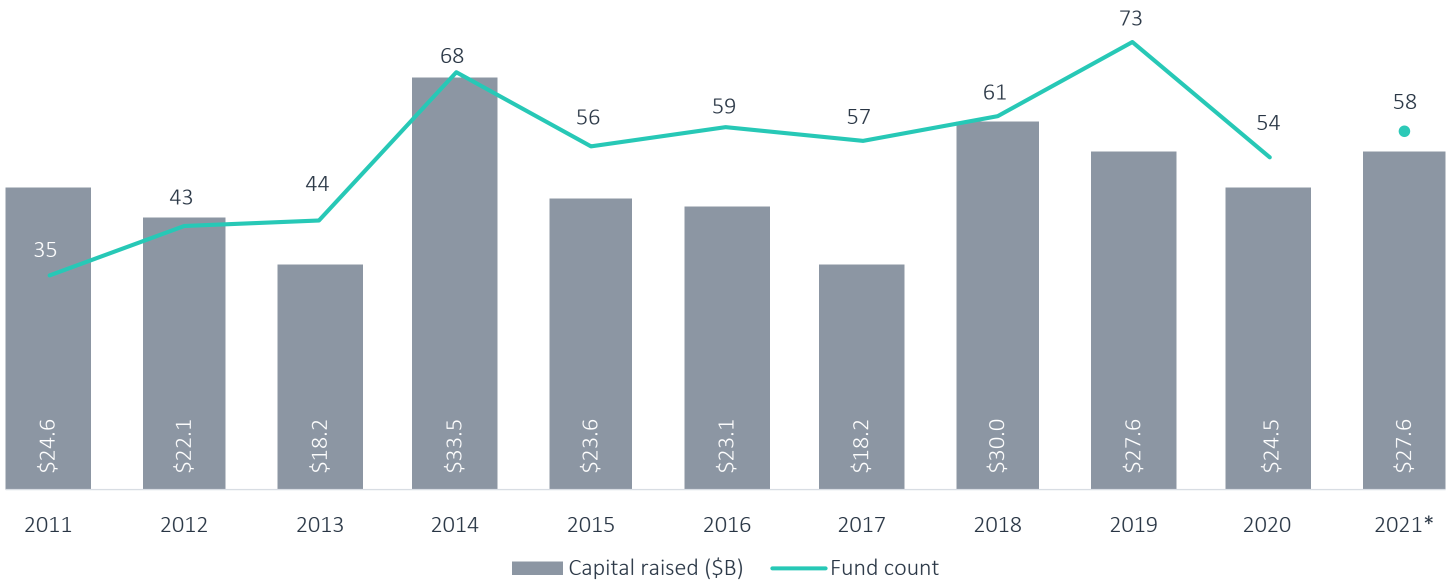
Median step-up from previous PE middle-market fund in fund family



Source: PitchBook | **Geography**: US
*As of December 31, 2021

8: "MiddleGround Capital Raises Over $1 Billion, Less Than Two Years After Raising Its $460 Million Debut Fund, Increasing AUM to $1.9 Billion," Business Wire, August 30, 2021.

PE middle-market emerging manager fundraising activity

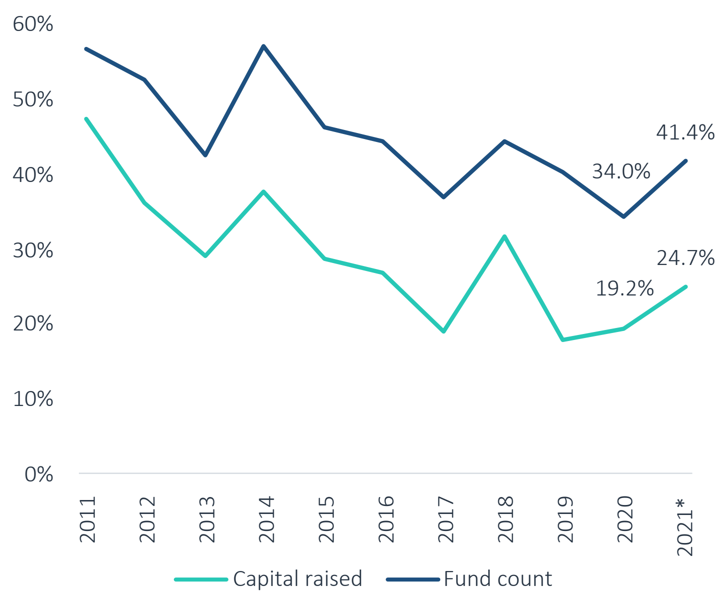


Source: PitchBook | **Geography**: US
*As of December 31, 2021

Healthcare also appears to be an area of particular interest for emerging managers, with three life sciences-focused emerging managers closing funds in Q4 2021 alone—Novalis LifeSciences, Ascend Partners, and Regal Healthcare Capital Partners.

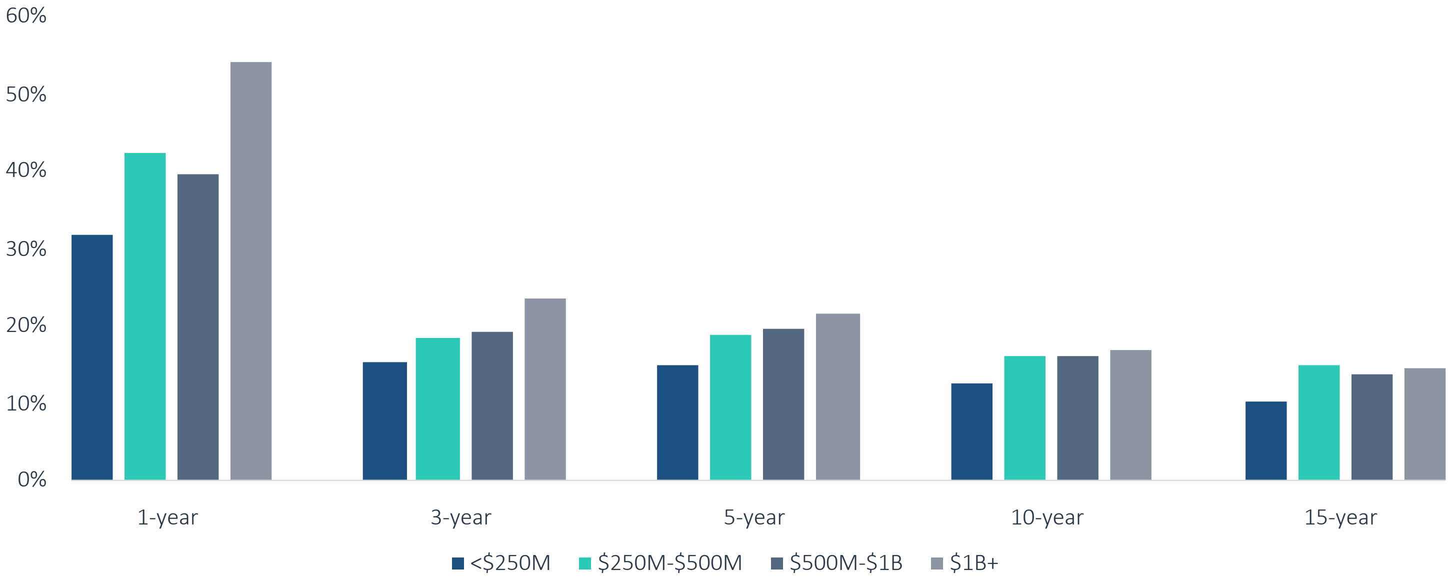
Within the broader emerging manager bucket, first-time managers had a decent year as well. Here, too, thematic investors found traction convincing LPs to bet on them. In 2021, the US' largest first-time buyout fund was Crosspoint Capital Fund I, which focuses on cybersecurity and infrastructure software. However, the firm reportedly saw a co-founder leave in early 2021, followed by their head fundraiser later in the year, even as Crosspoint was preparing to launch its next fund. The largest first-time PE fund also closed in 2021, though it is minority-stake focused and not included in the dataset. Arctos Sports Partners, a dedicated sports investing platform, raked in more than $3.0 billion including coinvestment commitments, illustrating LP willingness to back sizable first-time offerings in some cases. The movement toward more sector specialty is likely to continue, with an increasing proportion of first-time managers bringing sector-focused offerings to market. This approach lines up with the current trend of LPs preferring sector specialists because of the added control it affords them over portfolio management.

Emerging manager fundraising as a share of all PE middle-market fundraising activity



Source: PitchBook | **Geography**: US
*As of December 31, 2021

PE middle-market fund horizon IRRs by size bucket*



Source: PitchBook | **Geography**: US
*As of June 30, 2021

Middle-market performance

Performance figures, which run through Q2 2021, are stellar for middle-market funds. Funds across all size buckets were up at least 30% net over the past four quarters. However, the largest multi-billion-dollar funds have outperformed these figures as they marked sizable portfolio companies to market against high-flying public companies that soared in 2021. Though the return figures are likely to lessen for middle-market funds heading into the back half of 2021, as we saw with return figures from large publicly traded PE firms. Although these are not a perfect indication because of the size difference, public PE fund returns are posted well before we can view most middle-market fund returns and tend to act as a solid predictor of general fund movements for the broader PE industry. Looking ahead, an environment of higher rates and inflation could further depress portfolio company valuations, dampening returns across the size spectrum. Equity markets have tumbled in the first couple of months of 2022. Moreover, Russia's invasion of Ukraine could further complicate factors and lead to negative quarterly returns. Investors have a lot to be wary of in early 2022.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M&A in the middle—a PE lesson

Q&A with Datasite

Bill Myers

*Vice President, Sales - Private Equity
Datasite*

Bill Myers is Vice President of Private Equity Sales at Datasite. Prior to joining Datasite in 2016, he held several sales leadership roles in a variety of SaaS companies.

Why are PE firms interested in acquiring US middle-market companies?

Because they always have been! But why now especially? The US middle market is a prime hunting ground for assets you can grow quickly to achieve a swift exit. So, when interest rates are low and debt is easy to come by, PE firms will swoop. According to PitchBook, PE accounted for a record 20% of global M&A activity in 2021, of which the US middle-market activity made up 27.5%.

Other factors are kicking in too. There's a lot more scrutiny of deals now, for both security and antitrust reasons. That means fewer corporate mega-mergers, and when those do happen there are more divestitures and spin-offs. So, PE is picking off these tasty opportunities.

In addition, PE firms are sitting on a mountain of dry powder, feeding a trend of funding acquisitions through direct lending. We saw this in action recently in one of the largest buyouts ever: a consortium of PE firms acquiring a family-owned medical supply company.

What are the main areas of concern for PE firms?

Economic weather is always an issue—which at present means things like the changing monetary policy, shifting regulatory priorities, a greater focus on ESG risks, tax reform, inflation, supply chain challenges and labor shortages (the "Big Quit"). According to our December 2021 survey of 600 global dealmakers, the top deal-breaking risks this year are likely to be ESG factors and inflation.

Then you have the risks down at deal level. A white-hot market, scarce assets, frantic competition. Due diligence in the Americas is being raced through—an average 19% faster than last year, according to Datasite Insight. And this is with a reduced workforce. Efficiencies simply must be found, such as through technology like ours.

Now, factor in sky-high valuations. These make it tough for PE firms to create an investment thesis with robust ROI. One solution has been to focus on roll-up strategies, while another has been to dodge competitive auctions in favor of one-on-one acquisitions.

Consequently, in this part of the market, more buyers are preferring to take the wheel on due diligence. Instead of having the seller call the shots, buyers are finding it more efficient to set up and manage their own data room and have sellers upload documents into that. Our dedicated buy-side platform has been instrumental here.

Why are PE firms getting anxious about ESG risks?

We're seeing ESG transform from check-the-box compliance to a genuine source of value creation—or potential value loss. Our research shows that ESG issues now register as the highest priority for boards, and that nearly three quarters of PE dealmakers expect to see more deals sink in the coming two years because of issues surrounding climate change. With the direction of travel so clear, it's no wonder that businesses everywhere are feeling the heat.

Larger PE firms have already made ESG issues part of their due diligence processes. Middle-market firms can head off many risks by doing the same and we are increasingly seeing that become a core part of their strategy and value proposition to investors. Another good practice is to address any ESG issues in portfolio companies prior to selling, to make those businesses more attractive.

Above all, the motto is "buyer beware." An asset with hard-to-fix ESG problems could start losing value from the day of purchase. And PE firms know it. We saw unprecedented levels of deal scrutiny in 2021, with due diligence teams reviewing 34% more materials on average than in 2020.

Meanwhile, there are new openings, especially in the energy and power sector. Our research shows that green energy initiatives will represent the biggest M&A opportunity in the sector over the next five years. We're also seeing global investors place bets on clean tech, with a primary focus on agriculture, food, and mobility—these being the biggest carbon emitters. The 41% surge in technology, media, and telecom (TMT) projects in 2021 wasn't just about remote working—a big chunk of it was clean tech.

What's going on elsewhere in M&A that might influence PE activity?

The US has a housing shortage to overcome, so both home prices and the home building market are shooting through the roof. That's resulted in much PE activity in the real estate space, and also in infrastructure.

We've seen record PE activity in the past year, especially in TMT. How does the industry sustain this without burning out?

Inevitably, there are limits to dealmaking capacity. In our survey of 400 dealmakers, close to 90% told us that they were now being more selective in choosing deals to pursue. Even allowing for this selectivity, a busy year lies ahead. We expect PE firms to find efficiency gains through technology and external specialist support.

One example of this is the rapid adoption of our previously mentioned buy-side platform, Datasite Acquire. This lets buyers run an easily repeatable process while consolidating checklists and all other workflow items in one place. Now that they don't have to muddle through a new seller's data room for every new deal, they can save huge amounts of time, while getting specialist buy-side support.

There are efficiency gains to be found on the sell side too, via technologies such as AI and machine learning. These help not just with high transaction volumes, but also with automating the most time-hungry parts of M&A, such as asset marketing, deal preparation, and due diligence itself. It translates into more completed deals for the same—or less—effort.

And, of course, PE would be nowhere without funds. Technology such as Datasite Outreach can help with the whole process of investor engagement, keeping track of prospects, progress, and potential obstacles. Along the way, it creates better transparency for stakeholders so that fundraising hits fewer snags. In short, every cog in the deal machine can now move faster and more smoothly.

2021 US PE MM lending league tables

Overall

1	Barings	211
2	Antares Capital	203
3	Golub Capital	201
4	Churchill	188
5	BMO Financial Group	183
6	Ares	179
7	KKR Credit	170
8	Morgan Stanley	140
9	MidCap Financial	136
9	Twin Brook Capital Partners	136
11	Madison Capital Funding	122
12	Audax Private Debt	121
13	PNC	119
14	Monroe Capital	110
15	Crescent Capital	108
16	Capital One	106
17	Jefferies Group	103
18	Citizens Bank	97
18	The Goldman Sachs Group	97
20	Varagon Capital Partners	91
21	J.P. Morgan	90
22	Credit Suisse	86
23	Owl Rock	84

Source: PitchBook

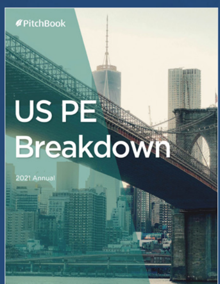
Select roles*

1	Antares Capital	191
2	Golub Capital	177
3	BMO Financial Group	149
4	Ares	136
5	Twin Brook Capital Partners	134
6	Churchill	132
7	Madison Capital Funding	110
8	Barings	94
9	Capital One	85
10	Varagon Capital Partners	84
11	PNC	81
12	Citizens Bank	77
13	Jefferies Group	71
14	Crescent Capital	70
15	Monroe Capital	68
16	MidCap Financial	66
17	J.P. Morgan	60
17	Truist	60
19	KeyBank	58
20	Morgan Stanley	57
20	NXT Capital	57
22	Bank of America	55
23	Fifth Third Bank	52

Source: PitchBook. *Select roles comprise only bookrunners, lead arrangers, mandated lead arrangers, and all types of agents that are specifically listed within PitchBook.

Additional research

Private equity



2021 Annual US PE Breakdown

Download the report here

2021 Annual Private Fund Strategies Report

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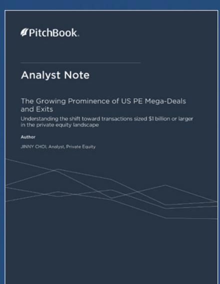

The Growing Prominence of US PE Mega-Deals and Exits

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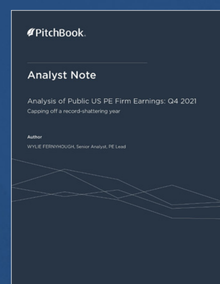

Analysis of Public US PE Firm Earnings: Q4 2021

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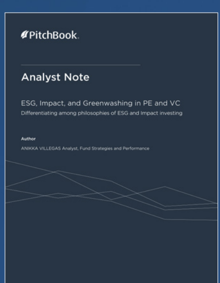

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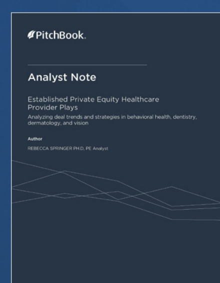

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