PitchBook

Q2 2022

US PE Middle Market Report

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Executive summary

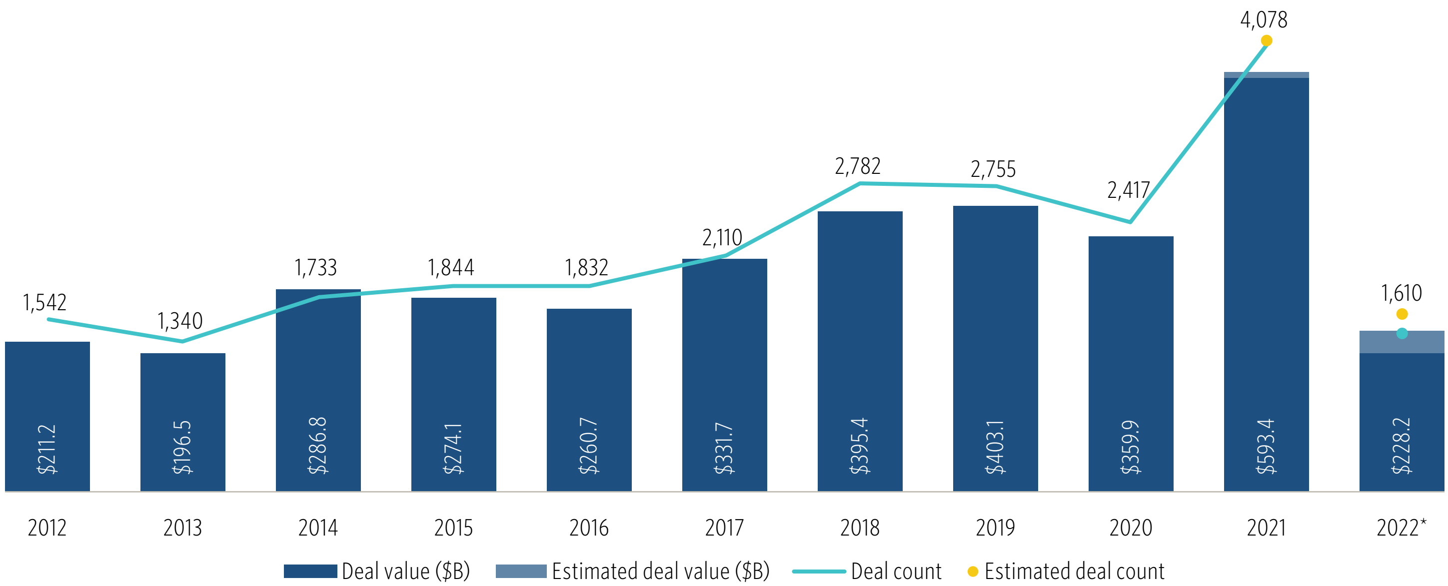
During Q2 2022, deal activity for US middle-market private equity (PE) firms remained modest amid a complex macroeconomic and geopolitical backdrop. Raging inflation continues to loom, and continued interest rate hikes fuel market volatility without alleviating supply chain disruptions. Dealmaking in the middle market experienced a sharp drop compared with the record-breaking activity seen in 2021, but it remains on pace for a healthy year by historic standards. With ample dry powder on hand, PE firms are well-equipped to continue to look for deals in a market that has become cheaper thanks to falling prices and lower valuations trickling into private assets. Large GPs are also likely to search for deals in the middle market as they become less willing to make massive bets and instead turn to smaller, tuck-in investment opportunities.

US middle-market exit activity experienced a more notable decline in H1 2022. Exits declined for the second consecutive quarter as the current market volatility posed significant challenges for GPs. No public listings occurred in Q2, demonstrating that IPOs are now an even less viable option for the middle market than before. Exits continued through sales to other sponsors and corporations, with middle-market firms able to find buyers looking to scale businesses or add strategic capabilities.

Fundraising slowed in the middle market as firms grappled with an increasingly crowded fundraising landscape. Intense demand for capital pushed LPs to their allocation limits, while a decline in exit activity also reduced capital flow back to investors to recycle into new fundraises. The current environment is likely to most negatively affect middle-market firms as institutional investors tend to prioritize larger and more-established managers during times of limited capital. As a result, middle-market GPs must adopt flexible fundraising playbooks or look in new places for capital. In performance, fund investors are bracing themselves for markdowns, but so far, many middle-market companies are producing healthy revenue and earnings growth.

Overview

PE middle-market deal activity



Source: PitchBook | **Geography:** US
*As of June 30, 2022

In Q2, US middle-market PE deal activity slowed relative to the record-breaking dealmaking pace set in 2021, but it remains on pace for a healthy year by historic standards. During H1 2022, PE firms closed 1,610 middle-market deals for a combined $228.2 billion. Deal count and value in Q2 increased slightly from the previous quarter, but most of this is likely due to the three- to six-month lag between deal agreements and closings, with many deals negotiated before the current macroeconomic backdrop turned so bearish. However, deal activity remains healthy as many investors view the market volatility as a buying opportunity. Additionally, deals can pick back up as investors adjust to the harsh macroeconomic headwinds that caused investment activity to plunge from the frenzied deal pace seen at the end of 2021.

Sponsors are facing a much different investment landscape than the one experienced last year. PE firms, capitalizing on easy access to debt financing thanks to low interest rates to compete for assets armed with record levels of dry powder, drove the impressive deal activity in 2021. The current global economic backdrop, however, poses several challenges for dealmaking. Prolonged inflation continues to loom over the broader market. After YoY Consumer Price Index (CPI) gains hit 8.5% in July, many investors are bracing for continued pressure on companies' exposure to inflation and rising

PE middle-market deal activity by quarter

Source: PitchBook | **Geography:** US
*As of June 30, 2022

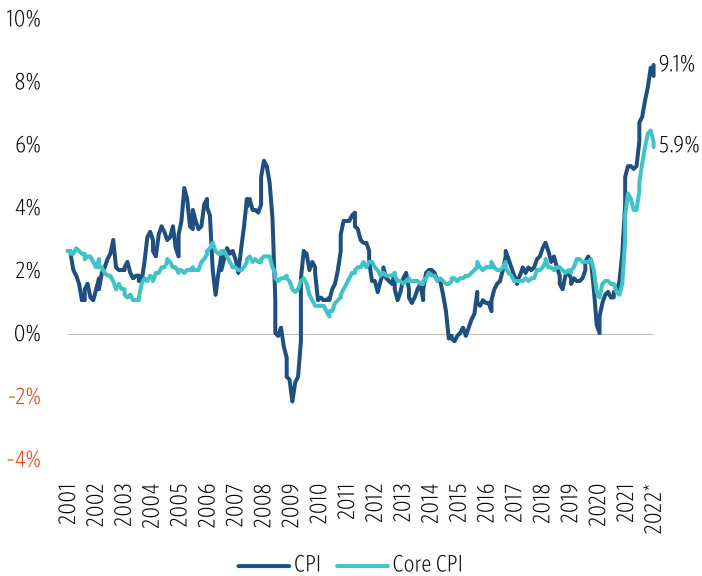
rates to create challenging dealmaking conditions. Profit margins are shrinking as input and labor costs rise, and this is expected to persist throughout the year as businesses adjust to higher inflation. The ability to pass on higher costs to consumers is critical for preventing margin compression. For example, according to the Golub Capital Altman Index (GCAI), which tracks PE-backed middle-market companies, the healthcare sector suffered an 11.6% YoY earnings decline in Q2 as labor costs weighed on profitability.[1] The Federal Reserve (Fed) has been aggressively using interest rate hikes to try to curb the highest rate of inflation since the 1980s. In July, the Fed lifted interest rates by 75 basis points for the second consecutive month, bringing the total number of interest rate increases this year to four. Higher interest rates tend to lead to lower asset prices, and the pressure on valuations has battered public markets and trickled down to private markets. The cost of debt for PE firms also rises along with interest rates.

Despite this, we expect deal activity to remain healthy as PE investors look to take advantage of market volatility and seek attractively priced assets in which to drive value creation. Investment activity was stunted earlier this year as many buyers paused processes amid uncertainty. But deal activity has held up as investors looked for opportunities in a market that has become cheaper thanks to falling stock prices and lower valuations trickling into private assets. With $429.0 billion of dry powder in US middle-market PE, sponsors are still well-equipped to close deals. Large GPs are also likely to search for deals in the middle market as they become less willing to make massive bets and instead turn to smaller, tuck-in investment opportunities.

Add-ons

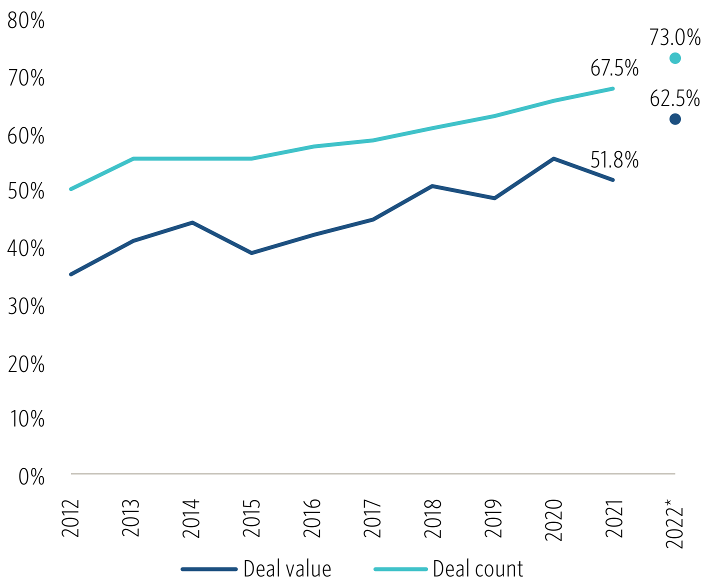
Add-on activity in the middle market continued to climb in H1 2022. Both the number and value of add-on deals as a portion of all middle-market deal activity reached all-time highs of 73.0% and 62.5%, respectively. PE firms employ add-on strategies to accelerate growth of platform investments or to create synergies that can reduce costs or add revenue. The middle market in particular offers numerous opportunities to scale, given that it is more fragmented and the companies are often nimbler than those at the larger end of the market, which makes for a smoother integration. Add-on opportunities have always been of interest to investors in the middle market, but the current downturn in public markets and adjusting private market valuations are making add-ons more attractive to GPs looking to scale their existing companies. Smaller acquisitions, which add-ons often are, tend to have less of a valuation disconnect between buyers and sellers, thus allowing sponsors to tack on to their platform companies with relative ease. Add-ons can also be attractive to investors because PE firms can acquire smaller companies for lower multiples than they would for platforms and average down the portfolio company's combined multiple.

Consumer Price Index, 12-month percent change



Source: FRED, Bureau of Labor Statistics | **Geography:** US
*As of June 30, 2022

Add-ons as a share of all PE middle-market deals



Source: PitchBook | **Geography:** US
*As of June 30, 2022

1: "Golub Capital Middle Market Report," Golub Capital, n.d., accessed August 10, 2022.

In Q2, add-on activity transpired across industries, with higher proportions in financial services, healthcare, and information technology (IT). Add-on activity dominated financial services in particular as the sector continues to rapidly transform through technology, consolidation in asset- and wealth-management businesses, and increased interest in the insurance market. For example, WA Asset Management (WAAM), via its financial sponsors HGGC and Wealth Partners Capital Group, acquired BT Wealth Management in June for an undisclosed amount. The acquisition is a strategic expansion of WAAM's geographic footprint and will enhance the collective team's client offerings in financial planning and wealth management solutions.[2]

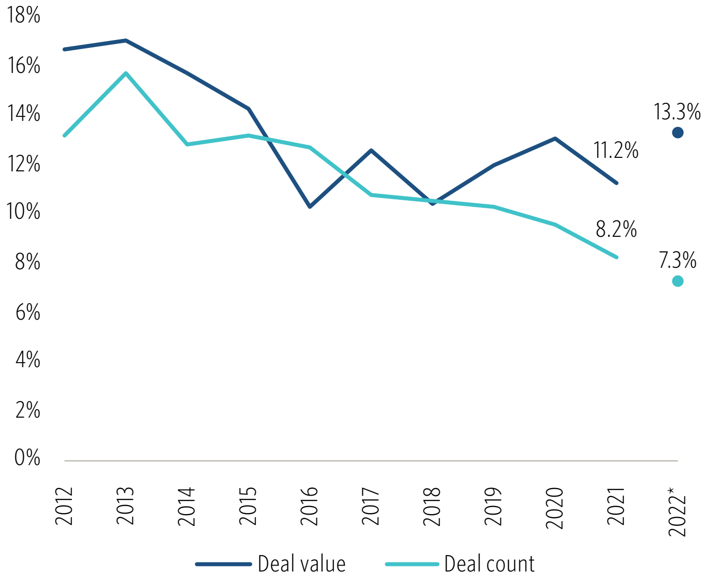
Carveouts

In Q2, carveouts and divestitures again increased their proportion of middle-market deal value. Many companies are reassessing their core business models and nonperforming or tangential assets as they continue to tighten their belts, with economic uncertainty and a potential recession on the horizon. With the goal of optimizing corporate portfolios, many corporate leaders are turning to carveouts to sell off these nonperforming assets. As corporations spin off these noncore assets, PE firms are there to answer the call. With the current volatility in the markets, we can expect more noncore assets to be spun off from companies refocused for recovery and to be absorbed by cash-rich sponsors. PE firms show interest in these often-underinvested carveouts as they can acquire carveouts more cheaply than other types of deals. PE firms can drive more value within these businesses as they have access to more capital and can more effectively focus on the business to leverage value creation and growth. For example, One Equity Partners, a middle-market PE firm, purchased PGW Auto Glass from LKQ Corporation (NASDAQ: LKQ) for $346.2 million. LKQ sold PGW Auto Glass to reinforce its ongoing commitment to review its business portfolio, rationalize its asset base, and divest noncore assets.[3] This divestiture allows LKQ to better optimize its portfolio to focus on its key growth drivers.

Energy

The energy sector has continued to amass attention as inflation and continuous supply and demand mismatch stemming from Russia's invasion of Ukraine cause swings in oil prices. Despite increased volatility, deal activity is still occurring in the energy sector, as oil prices have shot up,

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



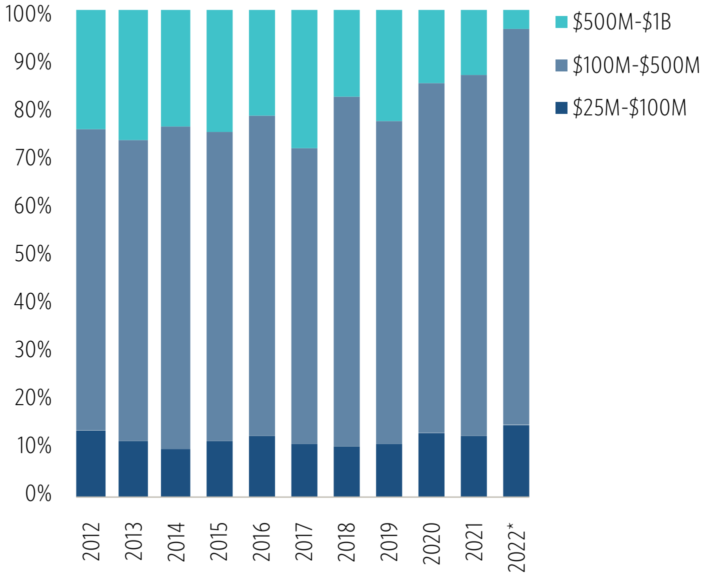
Source: PitchBook | **Geography:** US
*As of June 30, 2022

as have valuations for many companies. This in turn leads investors to be optimistic for the future of the energy sector and search for more deals. Energy was the only sector that produced positive returns in the public markets in H1 2022.[4] This performance in the public markets could draw investors looking for deals to capitalize on in the private space. With a mismatch in demand and supply leading to high energy prices, investors look to take advantage as this offers an opportunity to boost production and profit from higher prices. In the past several years, investors in the energy sector had started to pull away from traditional oil & gas assets. However, the volatility and rising prices created renewed interest in the sector. For example, in May, middle-market firm North Hudson Resource Partners acquired oil & gas production company LOGOS Resources II for $402 million. LOGOS will be increasing net production by year's end as North Hudson allocates resources for LOGOS to expand its resource base and drive value creation. While traditional oil & gas assets have seen renewed interest, renewable energy sources are still seen as the future and continue to garner the attention of investors. Q2 saw the continuation of these deals take place for solar-based energy and other renewable sources—despite the uptick in natural gas activity, such as the acquisition of BlueWave Solar by investment management firm Axium Infrastructure in May.

2: "WA Asset Management Acquires BT Wealth Management," *Business Wire*, July 6, 2022.
3: "LKQ Corporation Agrees to Sell PGW Auto Glass Business to One Equity Partners," *GlobeNewswire*, March 14, 2022.
4: "Energy Is Only Sector to Deliver Positive Returns in First Half," Nasdaq, July 1, 2022.

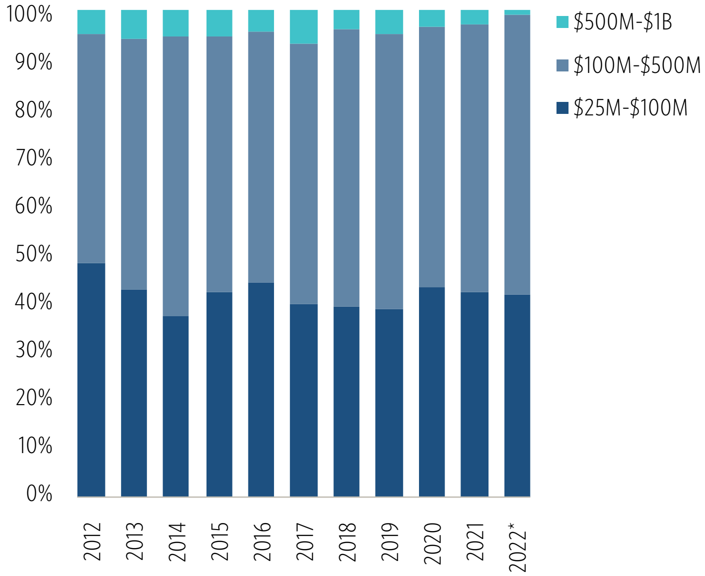
Deals by size and sector

Share of PE middle-market deal value by size bucket



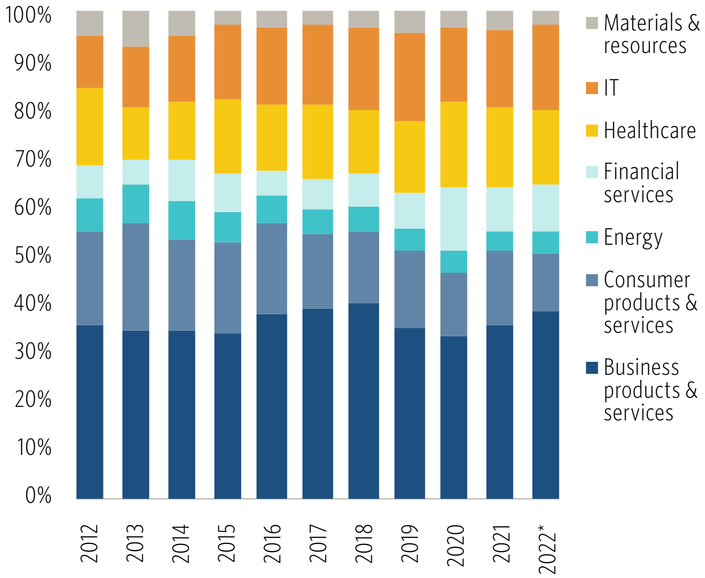
Source: PitchBook | **Geography:** US
*As of June 30, 2022

Share of PE middle-market deal count by size bucket



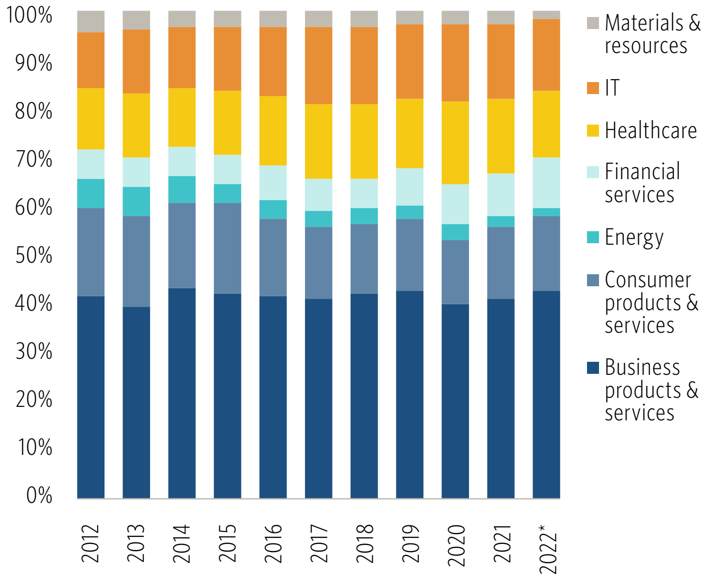
Source: PitchBook | **Geography:** US
*As of June 30, 2022

Share of PE middle-market deal value by sector



Source: PitchBook | **Geography:** US
*As of June 30, 2022

Share of PE middle-market deal count by sector



Source: PitchBook | **Geography:** US
*As of June 30, 2022

A WORD FROM ANTARES CAPITAL

On an even keel in choppy waters

Direct lending displays relative stability in H1 2022

The first half of 2022 saw a surge in volatility in the wake of geopolitical strife, a lingering pandemic, supply chain disruptions, high inflation, rising interest rates, and a hawkish Federal Reserve. Economists surveyed by the Wall Street Journal boosted their estimates of the odds of a recession in the next 12 months from just 18% in January to 49% in July.[5] Along the way, the S&P 500 fell into a bear market, dropping about 25% from a peak at the end of 2021 to a trough in May 2022.

The loan markets were also affected but saw significant divergence between private/direct and public/syndicated market performance. The average bid on syndicated loans in the S&P/LSTA Leveraged Loan Index fell from 98.6 at the end of 2021 to 92.1 by the end of Q2 2022, with the percentage of "distressed" loans trading below 80 rising from 1.6% in December 2021 to 4.0% by July 2022. Banks, which hold underwritten buyout loans for a short period before syndicating them, were left to sell into weakness and take significant write-downs. In contrast, the more "buy and hold"-oriented direct lending market exhibited greater stability, which enabled direct lending's share of the US-sponsored middle market to grow from 56% in H1 2021 to 70% in H1 2022. In the large corporate market, jumbo unitranche direct lending deals continued to take share, with volume almost doubling to $40 billion in H1 2022 from $21 billion in H1 2021, according to Refinitiv LPC.

Fair winds and following seas?

So far in early Q3 2022, there are signs that the waters are calming, with inflation showing signs of ebbing, earnings holding up better than expected, and the stock market recovering about half its losses. However, with Fed interest rate hikes still yet to bite, it remains to be seen whether the tempest has passed or if we are just in the eye of the storm. No doubt challenges and opportunities lay ahead, but as former President Franklin D. Roosevelt once said, "A smooth sea never made a skilled sailor."

Tyler Lindblad

Chief Investment Officer
Antares Capital

Tyler is Chief Investment Officer for Antares Capital. Previously, he was senior credit executive for GE Capital's commercial lending business in North America, where he led the underwriting, account management, portfolio management, and risk management processes. Before this role, he was the CRO of specialized finance and CCO of Telecommunications, Media & Technology. Prior to GE Capital, he held roles at Heller Financial, Inc. and was a founding member of Antares.

Q&A with Tyler Lindblad, Chief Investment Officer of Antares Capital

With all the market turmoil, can you give us a view from your portfolio on how well companies are handling inflation, supply chain issues, and rising interest rates?

We have a portfolio team that diligently tracks the impact of issues on our diverse portfolio of over 475 companies, and on the whole, our portfolio has been performing quite well.

On the inflation front, as of our end-of-July reading, only 5% of our portfolio was deemed to have high inflation risk exposure—up only slightly from a 4% reading at the end of Q1 2022. Cost inflation pressures tend to overlap with supply chain issues by driving up input costs, but supply chain constraints can also limit output and revenues. Most of our portfolio companies have been able to pass through prices to cover inflation, with some actually seeing net benefits; however, some industries are facing margin headwinds. Sectors with the most exposure include food and beverage, aerospace and defense, and restaurants. In any case, given the strong cash flow profiles of our borrowers, we do not believe modest margin compression will result in any material principal risk.

5: "About the Wall Street Journal Economic Forecasting Survey," The Wall Street Journal, Anthony DeBarros, July 17, 2022.

On the interest rate side, base one-month secured overnight financing rates are currently near 2.8% and are expected to peak near 4% in early/mid-2023 based on the forward curve as of mid-September. Granted such a rise and assuming flat EBITDA, interest coverage would remain healthy for the vast majority of our borrowers, with our modeling suggesting only very slight incremental net losses. Of greater concern is what happens to EBITDA. While there may be some margin pressures in some sectors, when looking at the absolute level of EBITDA, revenues have also been growing as an offset. Our portfolio has been seeing solid double-digit revenue growth YTD, and this has been the case for most sectors within our portfolio. Looking forward, the National Center for the Middle Market's mid-year 2022 survey shows middle-market company revenue growth of 12.2% in Q2 2022 projected to be at 9.1% growth in Q2 2023.[6] Middle-market company revenue growth is thus expected to continue to outpace growth of 11% in 2022 and 4% in 2023 for the S&P 500 revenues based on a consensus of estimates as of mid-August.

All told, while default rates have started to rise, they are generally projected to remain relatively benign. According to S&P Global as of September 1, the trailing 12-month Morningstar LSTA Leveraged Loan Index default rate is expected to rise from 0.43% in July 2022 to 2.0% by June 2023 in its baseline forecast, but this remains slightly below the long-term average of 2.1%. Even its pessimistic case forecast of 4.25% remains below the late-2020 COVID-19 peak of 4.6%—a "stress test" period through which private debt generally performed well. Also, on the positive side, terms and conditions for loans have become more lender-friendly, with wider spreads, less leverage, tighter EBITDA definitions, increased call protection, and tighter baskets.

What have you been seeing in terms of deal flow, and what is the outlook? Has your deployment strategy changed in the face of higher recession risk?

We are seeing a slower pace of activity compared with near-record-high levels at this time last year, with leveraged buyout activity down. However, add-on activity remains very robust and is actually up pretty sharply for us on a volume basis YTD, in part reflecting larger average deal sizes. Being able to mine our portfolio for incumbent deal flow among credits we like and know well is an advantage that comes with having one of the largest middle-market portfolios in the business. It also allows us to remain selective when deploying capital to new borrowers. YTD July, 78% of our deals by count have come from our portfolio.

Looking forward, Refinitiv LPC's Q3 2022 direct lender survey shows 45% of lenders expecting a moderate decrease in middle-market M&A activity in H2 2022 and 32% foreseeing a moderate increase. Our crystal ball on M&A activity is a bit cloudy, but our expectation is that 2022 will be down modestly from booming 2021 levels but will still be a pretty solid year, with capital deployment opportunities remaining favorable given continued add-on acquisition activity and ongoing dislocation in the broadly syndicated market.

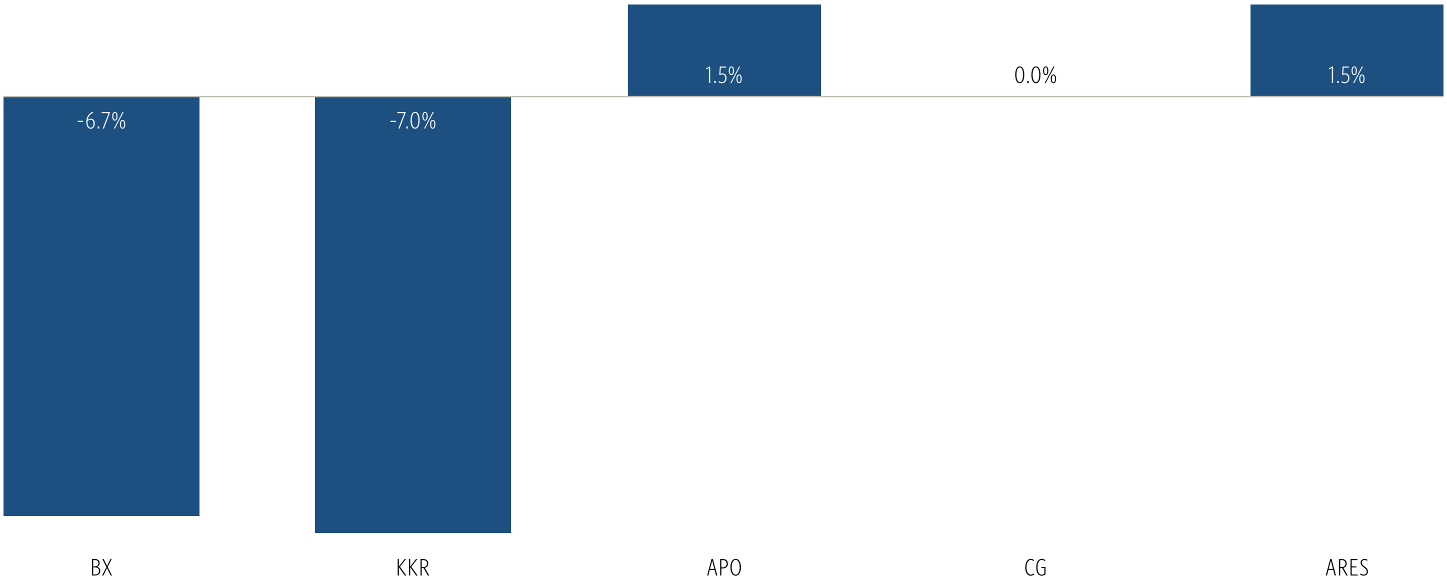
As far as our capital deployment strategy, we continue to look for leading companies with strong cash flow and pricing power and continue to favor growing, less-cyclical sectors such as software, business and financial services, and healthcare. We don't really try to time the cycle by doing sector rotation or stretching our credit box. We always underwrite to a bad case/recession scenario. Our strategy really hasn't changed much for more than 25 years, and it has served us quite well through many cycles. Upside appreciation is limited as a lender (in contrast to equity), and thus we believe alpha among lenders is generated primarily by loss avoidance. As such, we believe it is critical to have: 1) strong originations and a large, diversified portfolio of lead-managed incumbent opportunities that allows for selectivity among the best credits; 2) a first lien focus with strong private equity sponsor support; 3) strong credit discipline, portfolio management, and experience through multiple cycles; and 4) a dedicated and experienced workout team to maximize recoveries.

6: "Mid-Year 2022 Middle Market Indicator," National Center for the Middle Market, n.d., accessed September 9, 2022.

SPOTLIGHT

Key takeaways for US public PE firms

Gross PE fund performance in Q2 2022*



Source: Public filings | **Geography:** Global
*As of June 30, 2022

Note: This spotlight is abridged from our "Analyst Note: Q2 Key Takeaways and Benchmarking for Blackstone and US Public PE Firms." Please see the full note for additional analysis on the five main publicly traded private equity firms' Q2 earnings calls.

The tone of the public alternative asset managers' Q2 2022 earnings calls remained optimistic. Nearly all emphasized strong fundraising and deployment efforts. Firms acknowledged the wreckage seen in public markets but believe they have positioned themselves well for the future. Several firms stated that they have seen challenges arise in PE as the dealmaking environment starts to face economic headwinds. PE fund performance is starting to see the impact of higher rates: In Q2, Apollo (NYSE: APO) and Ares (NYSE: ARES) each saw appreciation of 1.5% for their PE portfolios, while Carlyle (NASDAQ: CG) remained flat, and Blackstone (NYSE: BX) and KKR (NYSE: KKR) marked their PE portfolios down by 6.7% and 7.0%, respectively.

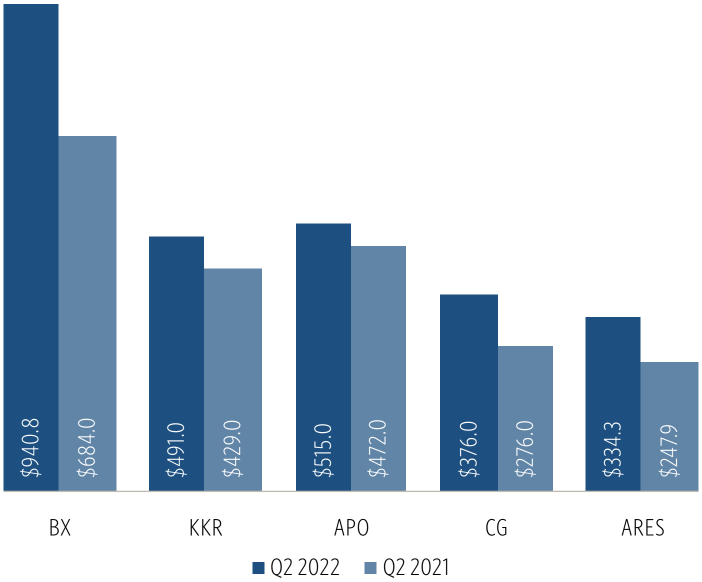
Fundraising and deployment

On their Q2 earnings calls, several firms reaffirmed concerns in the fundraising market, though sentiment remains bullish for flagship vehicles. The landscape continues to become more crowded, and many believe this environment favors the largest players, as the more prominent LPs tend to re-up with the well-established alternative asset managers that have name-brand funds. Managers, including KKR and Ares, believe that record dry powder provides them with significant opportunities to deploy in an increasingly attractive investing environment. Overall, both AUM and fee-generating AUM (FGAUM) climbed across the board as these firms continue to diversify across strategies and geographies. The trend is expected to persist.[7]

With several firms having dry powder at record levels, deployment exceeded expectations in Q2 as opportunities

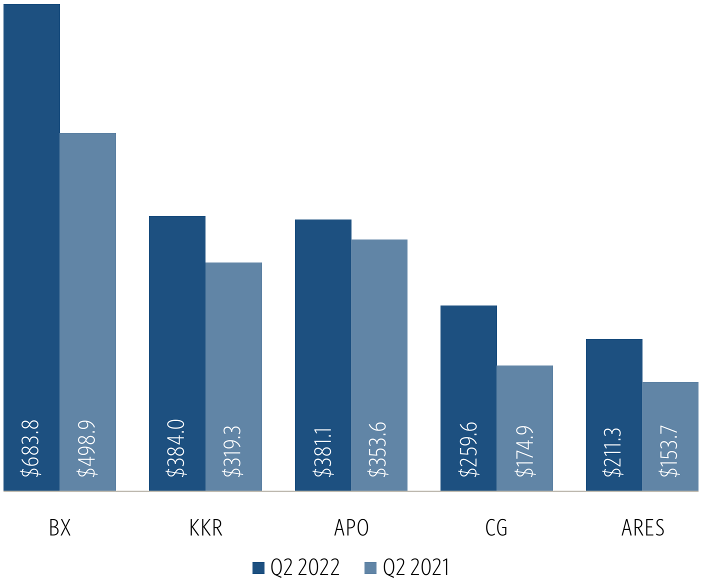
7: AUM refers to total market value of the assets an entity handles on behalf of investors, while FGAUM refers to the total market value of assets an entity handles where management fees, monitoring fees, or other investment-related fees are earned.

AUM ($B) by manager*



Source: Public filings | **Geography:** Global
*As of June 30, 2022

FGAUM ($B) by manager*



Source: Public filings | **Geography:** Global
*As of June 30, 2022

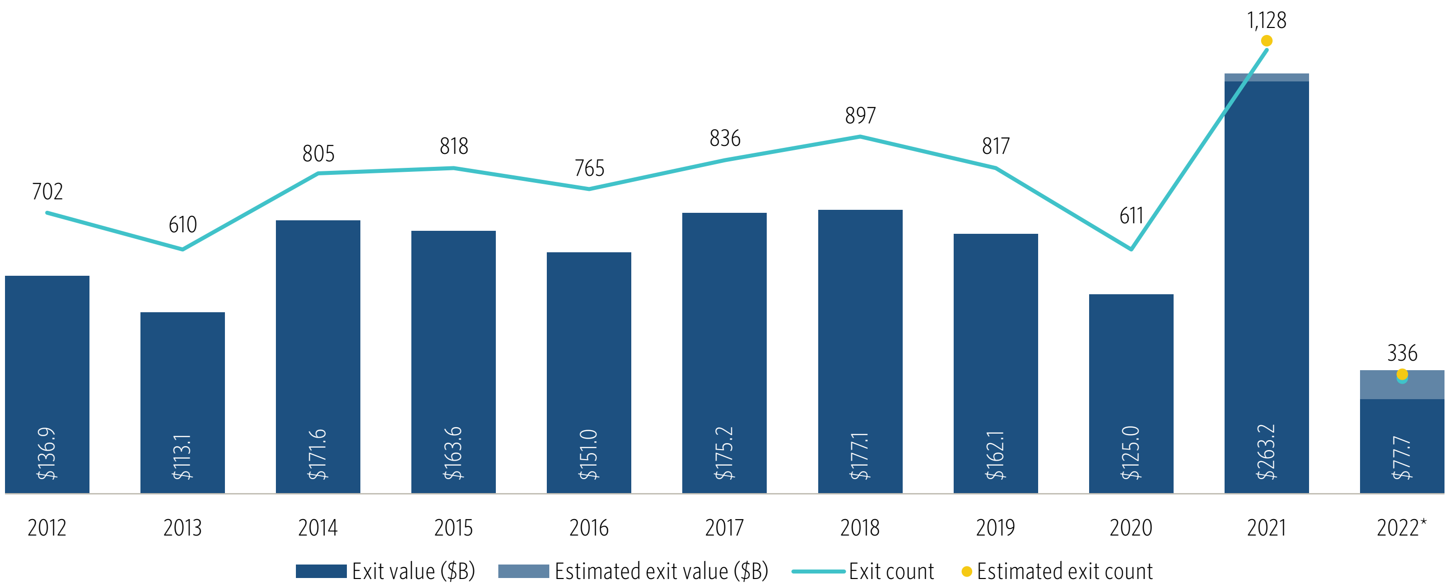
arose due to lower valuations caused by market headwinds. Blackstone, Ares, and KKR deployed $47.8 billion, $24.1 billion, and $19 billion, respectively. Apollo deployed $40 billion in gross capital as deal activity remained robust, and it was able to take advantage of market dislocation. Often when there is market dislocation, deals slow because it takes time for sellers to accept that their value has fallen. However, in public markets, valuation changes happen more instantly, so PE firms are finding more ability to deploy at lower valuations in public markets than in private markets. This has allowed take-privates to see a rise in activity through H1. Ares noted volume slowdown in private credit and PE, though this was its second-highest quarter as it, too, was able to take advantage of the current market environment. Carlyle and Ares remain optimistic about deploying capital in the coming months, given record dry powder and lower valuations that present buying opportunities.

Financials

All public PE firms except KKR saw QoQ growth in distributable earnings (DE), while all firms saw strong growth in DE over the TTM when compared with the prior 12-month period. Over the past several quarters, DE has seen record growth. However, these significant climbs will be less likely to continue if the current economic backdrop persists. Seeing profitable realizations on their investments is what leads to these managers collecting incentive fees. Should realizations slow due to the economic backdrop, DE will face headwinds in the coming quarters as public market volatility pressures valuations in the private markets. These headwinds could be more significant for the public PE firms and their incentive fees, as larger managers tend to do deals at larger valuations, with exits often coming from public listings. With the exit market slowing significantly in H1 and expectations that it will continue to slow in H2, lower DE could be on the horizon.

Exits

PE middle-market exit activity

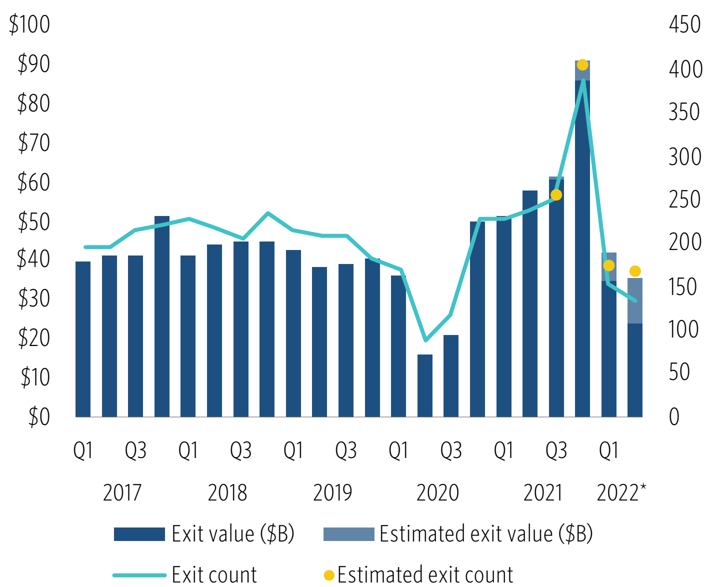


Source: PitchBook | **Geography:** US
*As of June 30, 2022

US middle-market exit activity continued to drop for the second consecutive quarter. Sponsors exited 164 portfolio companies during Q2, with a cumulative value of $35.6 billion. This lackluster exit activity is below the average of the exit values and counts of the five years pre-pandemic. While quarterly comparisons are usually less meaningful due to the shorter timeframes, the slight decline from recent exit trends signals that the economic and geopolitical headwinds and subsequent market volatility are significant challenges for the middle market. Looking at the historic long-term middle-market exit trend, the slowed exit activity seen in H1 2022 is still on pace to come close to the average exit counts and values, although it is a sharp drop compared with the record-breaking exit activity seen in 2021.

No public listings occurred in Q2, as PE firms held on to their portfolio companies amid falling stock markets and valuation adjustments. Although IPOs have never been a major portion of middle-market exit activity, the lack of activity demonstrates GPs' current lack of confidence in public listings as a viable exit option. Exits instead continued through sales to other sponsors or corporates. Median exit sizes for both sponsor-to-sponsor exits and corporate acquisitions in H1 2022 recorded highs of $319.8 million and $358.8 million, respectively. The increase suggests that middle-market

PE middle-market exit activity by quarter



Source: PitchBook | **Geography:** US
*As of June 30, 2022

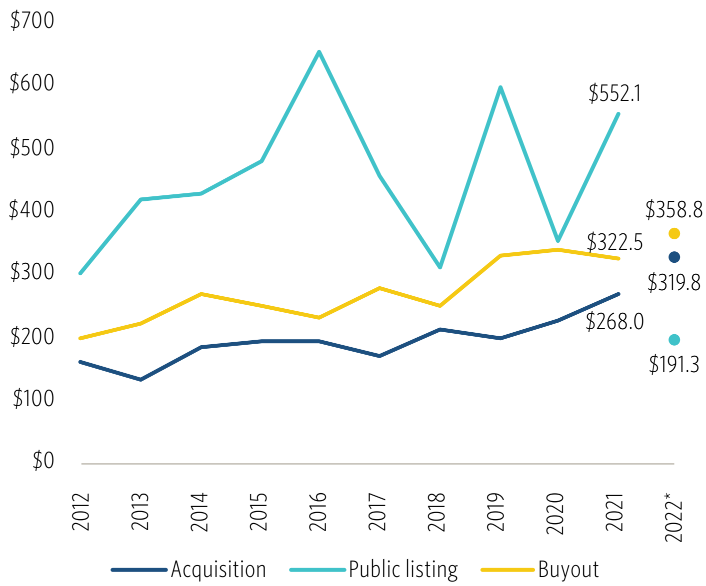
sponsors can still successfully close a number of sizable exits despite the challenges in the exit landscape.

While uncertainty looms in the broader PE market and depresses exit opportunities, not all hope is lost for the middle market. PE sponsors still have plenty of dry powder on hand to deploy and remain as a consistent exit route for middle-market GPs. While corporations may be increasingly hesitant buyers of PE-backed companies and instead turn to protect their balance sheets, lower valuations can prompt them to make strategic acquisitions. As some lofty valuations come down, investors could scoop up opportunities in the middle market that had previously been too expensive.

Sponsor-to-sponsor exits

Sponsor-to-sponsor exits continued to lead middle-market exits, representing 63.4% of exit count and 61.7% of exit value. Sales to other sponsors have increased compared with Q2 2021 as exits via public listing have come to a halt—totaling zero exits in Q2, the exit route's lowest quarterly results since Q1 2009. Sponsors continue to find opportunities to exit portfolio companies to the next PE firm that is looking to create additional value. PE firms often have expertise in certain sectors and industries, thus allowing them to step in and provide additional value in a business by creating synergies and improving performance. Additionally, high levels of dry powder, coupled with lower company valuations, have allowed other PE firms to easily step in as buyers. In April, Riverside Partners sold Revecore to GrowthCurve Capital for an undisclosed amount. Revecore is a leader in the revenue and reimbursement solutions space and is well-positioned to accelerate growth as it serves over 1,200 hospitals across the US, offering technology and insight into areas of revenue cycle and ensuring hospitals are appropriately reimbursed for the care they provide.[8] GrowthCurve Capital seeks to add value by leveraging its expertise in artificial intelligence (AI) and data to expand Revecore's offerings. Technological implementation in healthcare is seeing tremendous growth and expansion, which is drawing in other PE firms looking to capitalize by expanding current investments and scaling up platforms.

Median PE middle-market exit value ($M) by type



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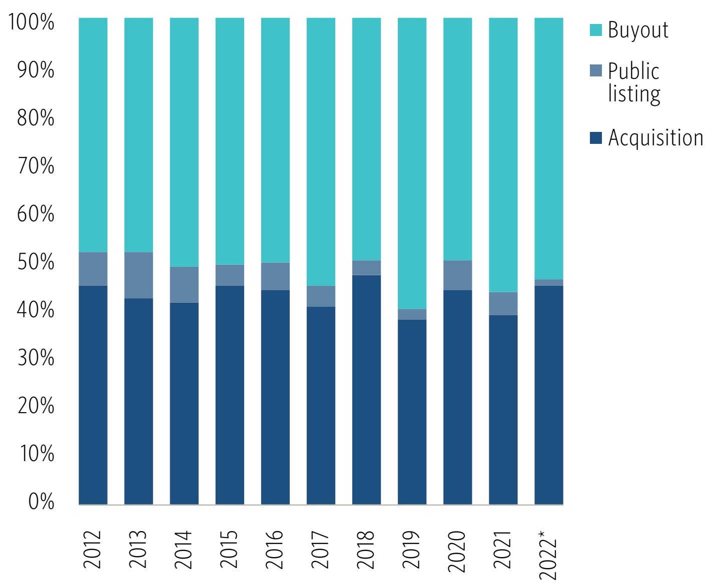
Share of PE middle-market exit value by type



Source: PitchBook | **Geography:** US
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Exits to corporates

Strategics also continued to absorb PE-backed companies—albeit at a much lower count and value than just one quarter prior. In Q2, middle-market firms exited 49 companies at an aggregate value of $9.2 billion to strategic buyers. High levels of balance sheet cash for corporations and executive bullishness drive corporate acquisitions, so continued turbulence in the markets and concern for a potential recession could dampen exits to strategics as corporations

8: "GrowthCurve Capital Completes Acquisition of Revecore to Support Continued Growth and Innovation," *Business Wire*, April 5, 2022.

become more cautious about transactions. In Q2, middle-market buyout firms were still able to capitalize by exiting investments to companies seeking strategic acquisitions to grow and expand their businesses. For example, Charles River Laboratories (NYSE: CRL) acquired Explora BioLabs from a group of PE firms including Seabright Fund and Housatonic Partners for $295.0 million in April. Explora BioLabs is a contract vivarium research firm and will complement and expand Charles River's business in the turnkey vivarium rental space. The combined company will add at least 25 vivarium facilities by the end of the year and give former Explora BioLabs clients access to the Charles River's discovery and nonclinical development expertise.[9]

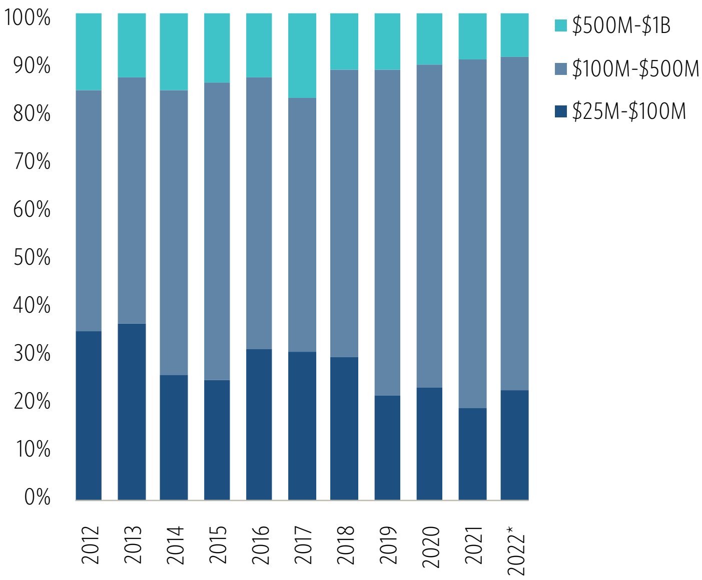
Consolidation plays also created exit opportunities to strategic buyers. In June, Arden Leisure Group (ASX: ALG) and RedBird Capital Partners sold Main Event Entertainment Group to Dave & Buster's Entertainment (NASDAQ: PLAY) for $835.0 million. Main Event is one of the fastest-growing family entertainment brands in the US and seeks to draw in mostly families with young children, while Dave & Buster's targets young adults. The acquisition will merge two strong brands with different demographics to offer a wider breadth of offerings and experiences to each brand's guests while creating cost savings from store support center consolidation and supply chain efficiencies.[10]

Industrials

Industrials, a mainstay of middle-market PE, has witnessed somewhat steady exit activity in H1. With global supply chain and manufacturing capacity capabilities issues persisting, many companies have launched concerted efforts to strengthen capabilities and seek supply chain solutions as disruptions to the supply chain have caused higher prices and wavering supply. At the same time, many middle-market PE firms have been able to exit relevant portfolio companies in the space in a timely manner. Many middle-market logistics and supply chain companies are being sold to industrial companies seeking to bolster their current operations and unlock synergies to increase efficiencies and drive growth. In Q2, ID Logistics acquired Kane Logistics for $240.0 million to provide stronger logistics capabilities for customers across the US, Europe, Asia, and Africa.[11] Kane Logistics was sold by Harkness Capital Partners, which purchased the company in 2019. Pressures on both supply chains and manufacturing companies continue to highlight the need for operational improvements and expansion; with this, middle-market PE firms are realizing favorable exits for companies that can help address these issues. For example, in early April, Comvest Partners sold Encompass Supply Chain Solutions to Parts Town in a move that will offer growth opportunities to expand Parts Town's operations as it adds the rapidly growing Encompass Supply Chain Solutions, which delivers nearly $200 million in annual revenue.[12]

With companies focusing on strengthening supply chains and manufacturing capacity, middle-market firms are likely to find plenty of opportunities to sell their relevant and timely portfolio companies. Diminishing returns derived from higher input and labor costs could hinder exit activity. However, rising interest rate environments tend to favor returns for value companies over growth-oriented ones. There has been elevated demand for many delivery and freight service companies, as many transport and logistics companies are seeking to better control costs and expand their capacity to combat global supply chain issues, in what has been a volatile supply chain environment since the start of the COVID-19 pandemic. This will allow middle-market firms to continue to find exit opportunities for their relevant portfolio companies.

Share of PE middle-market exit count by size bucket



Source: PitchBook | **Geography:** US
*As of June 30, 2022

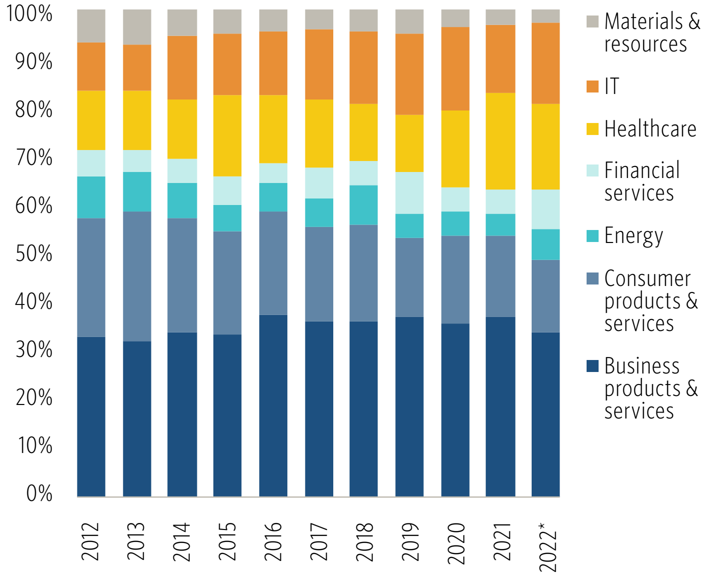
9: "Charles River Laboratories Acquires Explora BioLabs," Charles River, April 6, 2022.
10: "Dave & Buster's Completes Its Main Event Acquisition," Restaurant Business, Heather Lalley, June 29, 2022.
11: "ID Logistics Completes Acquisition of Kane Logistics in the U.S.," Supply Chain Dive, April 8, 2022.
12: "Parts Town Acquires Encompass Supply Chain Solutions," *Business Wire*, April 5, 2022.

Software

Through the first half of 2022, IT exit activity struggled to hold on, with 60 exits completed at an aggregate exit value of $9.9 billion. The sector's pace of exits was slow compared with the impressive exit activity seen in 2021: H1 2022's exit count declined 35.5% from that of H1 2021, while exit value dropped 45.9%. As with the rest of the broader market, volatility in public tech stocks continued to put downward pressure on valuations of exiting PE-backed companies. As a result, many PE firms are either exiting companies at lower valuations than they may have garnered several months ago or choosing to hold on to their portfolio companies to wait for better pricing. IT exits still accounted for 16.6% of the overall middle-market PE exit value in H1 2022, demonstrating the resilience of the sector's long-term growth trends. For example, a consortium of PE firms exited mobile security platform Zimperium to Liberty Strategic Capital for $525.0 million in May. With both the usage of mobile devices and the threat of cybersecurity expected to grow, Liberty plans to accelerate Zimperium's growth, both organically and via strategic acquisitions.[13] Secular trends in tech, such as the increasing demand for cybersecurity capabilities and efforts to scale them into market share leaders, will continue to spur more exit opportunities for middle-market PE firms investing in IT.

Corporate acquisitions also contributed to tech exits as increasing digitalization across industries spurred exit opportunities for PE firms investing in tech companies providing enterprise resource planning (ERP) software support. In May, Cerberus Capital Management, LLR Partners, and One Equity Partners exited their investments in Rizing to Wipro (NYSE: WIT) for $540.0 million. Rizing provides consulting services regarding the popular SAP ERP software platform for clients in consumer industries, manufacturing, and energy services.[14] The sale expands Wipro's global footprint in SAP consulting and enhances services offered to help clients build agile businesses for an era of digitalization. In June, BV Investment Partners sold GlideFast Consulting, which provides IT consulting and development services, to ASGN (NYSE: ASGN) for $350.0 million. GlideFast provides tailored solutions for ServiceNow (NYSE: NOW) implementations, a major cloud computing system for enterprises looking to optimize their IT operations. ASGN, which provides IT services and solutions across commercial and government sectors, anticipates growth in its business pipeline and revenue synergies through the combined IT consulting offerings.[15]

Share of PE middle-market exit value by sector



Source: PitchBook | **Geography:** US
*As of June 30, 2022

13: "Zimperium Closes Acquisition by Liberty Strategic Capital and will Accelerate Mission of Strengthening Mobile Security Worldwide," *Business Wire*, May 17, 2022.
14: "Wipro Acquires SAP Consultancy Rizing for $540 Million," Consulting.us, April 28, 2022.
15: "Why ASGN (ASGN) Is Buying GlideFast Consulting For $350 Million," *Pulse 2.0*, Amit Chowdhry, June 2, 2022.

A WORD FROM BAKER TILLY

Despite inflation, middle-market firms have options to position themselves well for profitable deals

Inflation continues to roar and interest rates are poised to rise quickly to combat these pressures. How are your middle-market clients thinking about financing deals in this environment? How are they thinking about the composition of financing and the amount of debt versus equity used to fund deals?

Structures haven't seemed to change much yet, but as we look further out, and after speaking to our PE clients, they are seeing banks providing less leverage as a multiple of earnings before interest, taxes, depreciation, and amortization (EBITDA). What we're hearing is a quarter to half turn less leverage, and that may change as interest rates continue to rise. As senior debt gets more expensive, something must fill that funding gap; potentially, that could be putting more equity in, requiring or increasing an equity rollover from a seller, or asking for a seller note. So far, we have not seen larger earn-outs come back into play—the deals we've closed lately have had limited earn-out components, but that could be something PE firms could utilize to maintain total transaction value as they look at debt as a more expensive component of a deal's capital stack.

Supply chain difficulties and rising labor costs have been major components of the elevated inflation figure. What are middle-market companies doing to prevent these two areas from demonstrably diminishing profit margins over the coming quarters?

We've seen our clients do several things. Obviously, they've implemented price increases that are either larger than what some may be used to and/or more frequent than in the past. Some clients have implemented across-the-board price increases, and others are specifically focusing on certain customers buying certain products and services. Our clients are looking at what will make the largest gross margin difference strategically; it's not simply a flat percent increase across the board. Companies are being more surgical in how they look at their customers and product and service margins to determine what makes the most sense.

Lisa Van Lieshout, CPA

Managing Director, Baker Tilly Capital, LLC
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Lisa has been with Baker Tilly since 2008, focusing on originating and executing M&A transactions and capital sourcing and serving clients in a variety of industries, including manufacturing and distribution, food & beverage, and real estate. Prior to joining Baker Tilly, Lisa provided corporate finance advisory services through finance and accounting roles in private industry and public accounting.

Brian Francese, CPA

Partner – Private Equity Practice Leader, Baker Tilly
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Brian takes pride in helping drive fund and portfolio company growth, leveraging his experience along with the advisory, tax, and assurance services that 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.

Another approach we've seen our clients take is changing the minimum order/shipping quantities on products. In the past, the company may have shipped "less than a truckload" of product to a customer; now, they might require a minimum of a full truckload to manage shipping costs better.

Some clients are taking a second look at their suppliers. If a company is buying something from overseas, it might be looking for an alternate US supplier. Or, if the company was already buying domestically, they may be looking for an even closer supplier to reduce the total delivered cost.

Also, our clients' c-suite is more intentional in addressing issues by leveraging company data and looking at it differently to see what's driving up costs.

On the buy side, the past decade has seen multiple expansion account for the bulk of returns, but that seems less likely in a rising rate environment. How are PE sponsors thinking about underwriting deals and where returns will come from?

With less leverage available and higher interest rates, buyers will not initially be able to put as much bank debt on a deal as they have in the past. To maintain equity returns, PE funds could use a combination of seller financing, high seller equity rollovers, earnouts, and debt recapitalizations—for example, 2.5 years into the investment hold period—to lower the total amount of fund equity committed at closing. More importantly, sponsors will be focused on companies where there are a number of financial and operational changes that can be implemented and sustained to drive revenue growth and improve EBITDA and EBITDA margins.

With this fast-moving and complex backdrop, what are some unique opportunities you see for middle-market companies?

Not every company needs to pivot to navigate this complex environment meaningfully, but the ones that have a c-suite and management team with the right skill sets in place will utilize data to find efficiencies or take a hard look at products and services that aren't achieving revenue growth or gross margin targets. In addition, companies can implement automation (co-bots) and optimize their information technology systems to improve procurement, scheduling, labor mix, shipping costs, and customer service.

Turning to the sell side, it appears the selling frenzy of 2021 has dissipated. How are PE sponsors thinking about holding times? How, if at all, are they changing their views when it comes to exiting to public markets, corporates, or other sponsors?

When you look at deal flow and transactions that have closed this year, the actual number of transactions and the total dollar amount are down compared with 2021. However, 2021 was an unusual year based on the deals that were delayed from going to market in 2020 due to COVID-19 and business owners that were concerned that tax rates were going to change. In addition, many private business owners had grown weary of supply chain issues, labor shortages, and raw material price increases, and in response, pushed up their plans for retiring, transitioning out, or selling their business.

From a hold time perspective, it doesn't appear anything has changed yet. Depending on what happens in the next six to 12 months, PE funds may hold their portfolio companies a little longer than expected, depending on how those portfolio companies perform during and after the technical recession. In addition, when funds look to sell a portfolio company, they have to consider who the financial and strategic buyers could be. Most funds will look at public market valuations and comparable transaction data to see where EBITDA multiples could be at the time the deal is brought to market. Finally, the amount of leverage available and interest rates could affect the timing of when to sell. We could see something similar to the 2008 to 2010 period when PE held on to portfolio companies a little longer than initially anticipated.

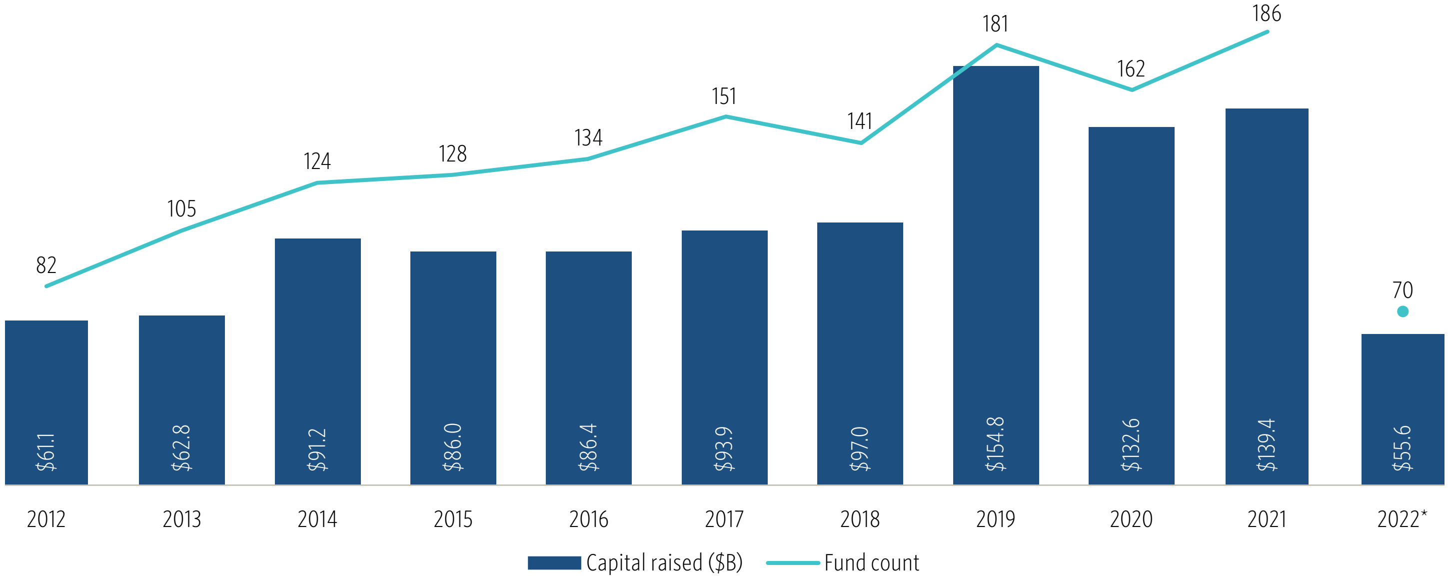
Regarding exit strategies, we anticipate a continued downtick in public market exits compared with 2021; however, we foresee corporate divestiture exits and middle-market sponsor portfolio exits being more mainstream.

Anything else you are seeing in the market that is surprising or unusual?

PE firms are still looking for quality deals, and it seems like they're back to how they operated in 2019. The expectation is that there will be a number of transactions going to market late in 2022 that will close in early 2023—and the PE appetite for these appears to be oddly unaffected by inflation and recession fears. What is surprising is the limited number of distressed private portfolio companies—this is likely due to the laser focus on financial performance since early 2020.

Fundraising and performance

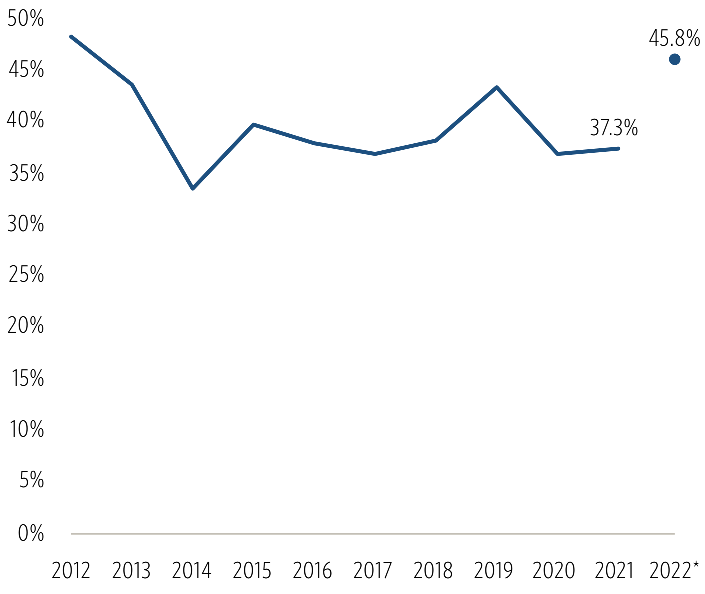
PE middle-market fundraising activity



Source: PitchBook | **Geography:** US
*As of June 30, 2022

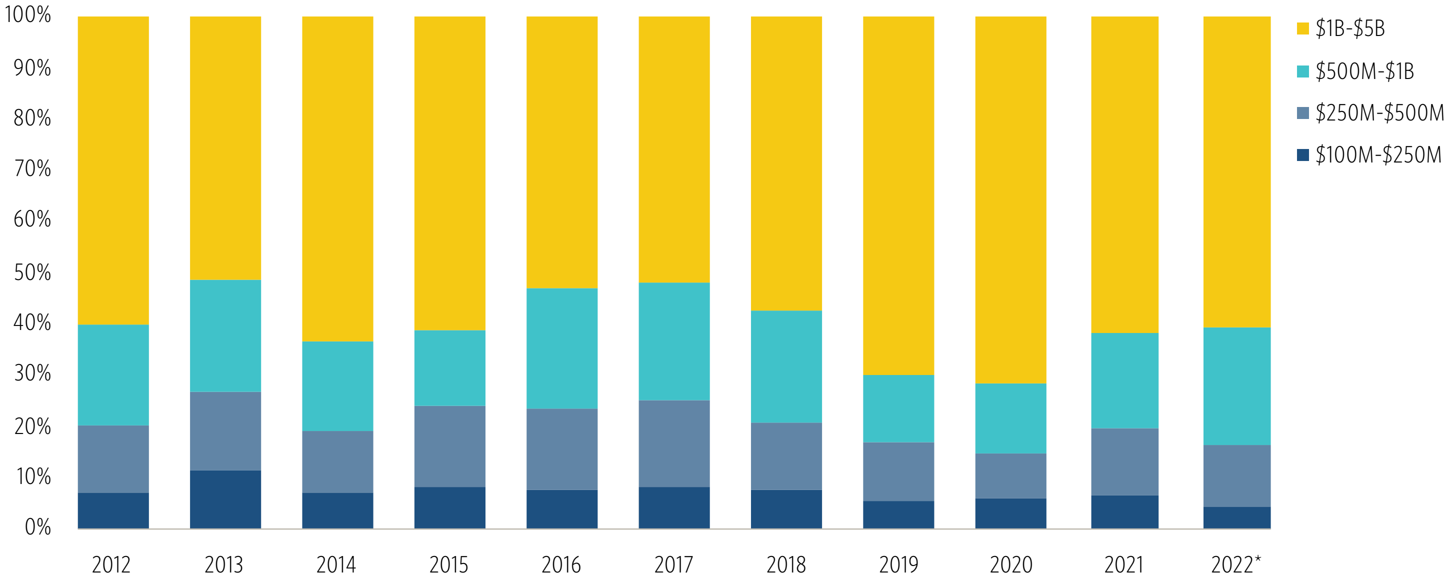
US middle-market fundraising slowed in 2022, with 70 funds closing for an aggregate $55.6 billion by the end of Q2. This is a notable drop compared with previous years. Since 2019, the middle market has raised over $130 billion across almost 200 funds each year. Fundraising figures are expected to fall short of the trajectory seen in the last three years as middle-market firms grapple with a heavily competitive environment and experience a turn in previously strong fundraising activity. Unprecedented dealmaking activity in 2021 allowed firms to deploy capital and return to market at a rapid pace, with robust appetite from LPs resulting in funds being raised faster and often at step-ups. For middle-market funds that closed in 2022, the average time to close dropped to 11.9 months from 14.6 months in 2021, reflecting the faster pace of fundraising seen across PE. The time between funds also dropped to 3.6 years, the shortest in over a decade. Intense demand for commitments, however, is pushing investors to their allocation limits, while a dearth of exit activity in the current volatile market also reduces capital flow back to LPs, thus creating additional difficulties for LPs to fund new commitments.

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



Source: PitchBook | **Geography:** US
*As of June 30, 2022

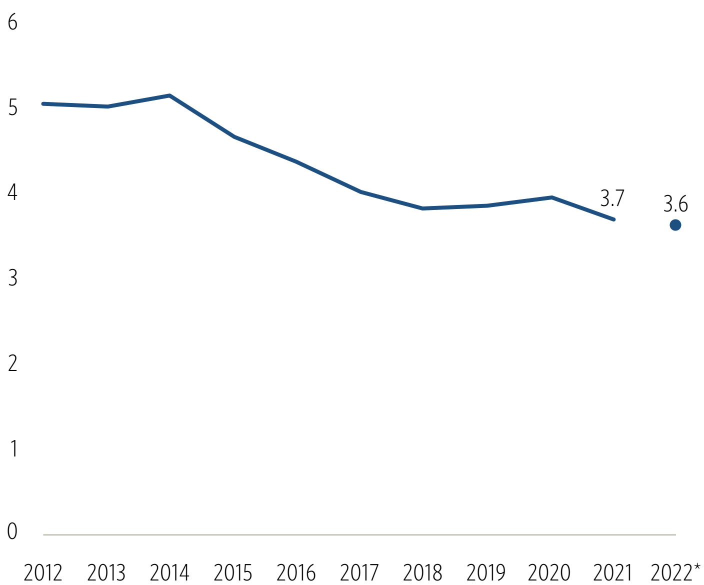
Share of PE fund count by size bucket



Source: PitchBook | **Geography:** US
*As of June 30, 2022

The middle market is likely to be most negatively affected by these challenges as institutional investors tend to prioritize their existing and longest-lasting relationships, meaning larger and more-established managers will fare better in their fundraising efforts. Middle-market managers are feeling pressure from mega-funds (funds with $5 billion+) taking more market share of fundraising from LPs, with middle-market funds accounting for 40.6% of the overall PE capital raised so far this year, compared with 52.2% in 2021. The number of middle-market funds as a portion of all US PE increased 8.4% since 2021, demonstrating that that challenging landscape's effect on the middle market has not been detrimental. Small, niche managers could find fundraising success as well, as they require much smaller checks and provide a diversification strategy for many large LPs. As a result, middle-market GPs will have to work harder or be more innovative to hit their fundraising targets. Firms with deep connections that can lean on familiar LPs will be most successful in today's environment, and firms can also adopt flexible fundraising playbooks to delay fund closings to gain access to allocations available for 2023 or find interest from other investor segments such as international LPs and family offices.

Average time (years) between PE middle-market funds



Source: PitchBook | **Geography:** US
*As of June 30, 2022

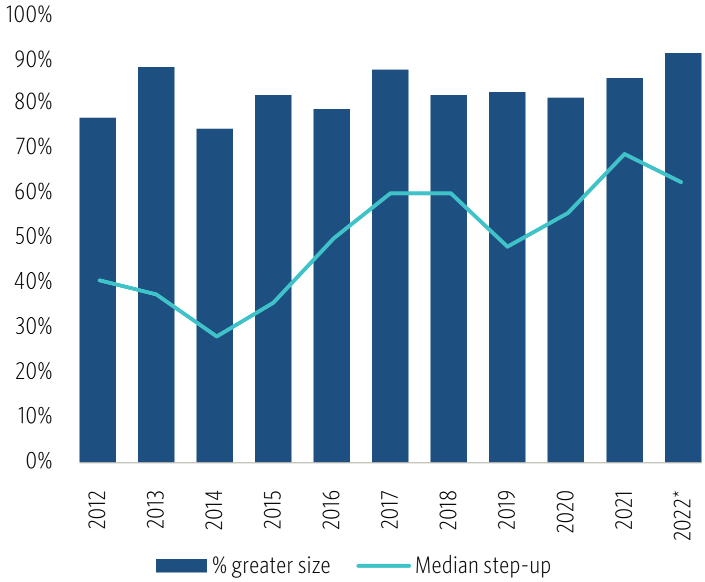
Step-ups

The trend of large institutional investors seeking deeper relationships with a concentrated portfolio of GPs, combined with the largest managers raising funds with healthy step-ups, further distributes capital to the top end of the market. However, large GPs are not the only ones seeing robust step-up activity with re-ups. By the end of Q2, 91.4% of middle-market funds closed on more capital than their predecessors, an all-time high. Median step-up size remained steady at 66.5%, but some middle-market managers are growing even more quickly. For example, Blue Wolf Capital Partners closed on a $1.1 billion fifth fund at a 2.0x step up in April. Emerging firms were also successful in raising larger funds. In May, Tyree & D'Angelo Partners closed its third fund at a 2.3x step-up of $350.0 million. Highly prevalent step-up activity in the middle market could be because many of these funds started fundraising before the intense demand for LP capital hit against funding capacity. LPs could also be prioritizing their relationships with the strongest managers, although several non-top-quartile performers closed on larger funds, as well. Continued high demand for capital in a crowded fundraising environment may pressure the quantity and magnitude of step-ups for middle-market managers going into the back half of 2022.

First-time funds

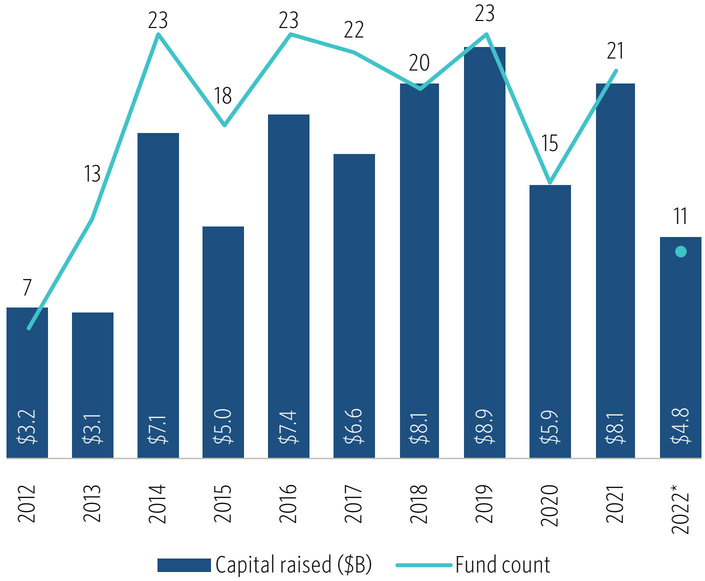
The current fundraising environment promises to be increasingly difficult for first-time managers, though it may take several quarters for data to fully reflect the dispersion. This comes as the fundraising market becomes even more crowded, with more experienced GPs increasingly returning to the market to increase their fundraising targets. As economic conditions worsen, first-time managers are likely to struggle to fundraise because they lack the connections or track records to secure investors. First-time managers with more pedigreed backgrounds or those with differentiated strategies are most likely to receive funding in an already congested fundraising environment. The largest US first-time buyout fund raised in H1 2022 was IT-focused Recognize Partners I, which raised $1.3 billion. Several first-time funds closed in Q2; these funds are the results of several quarters—if not years—of hard work on the fundraising trail leading to their close. OceanSound Partners' I, for example, closed on $780.0 million early in H1 after more than three years of fundraising. Similarly, GHK Capital Partners closed on $410.0 million after nearly two years on the fundraising trail.

Median fund step-up



Source: PitchBook | **Geography:** US
*As of June 30, 2022

First-time fundraising activity

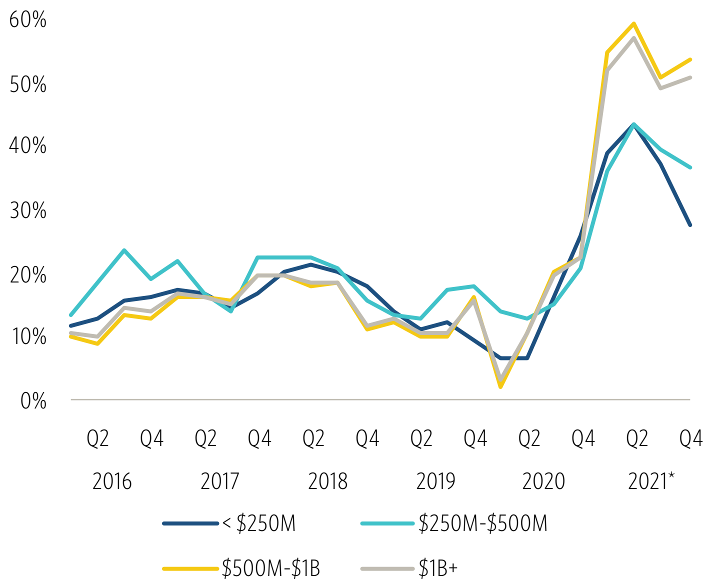


Source: PitchBook | **Geography:** US
*As of June 30, 2022

Performance

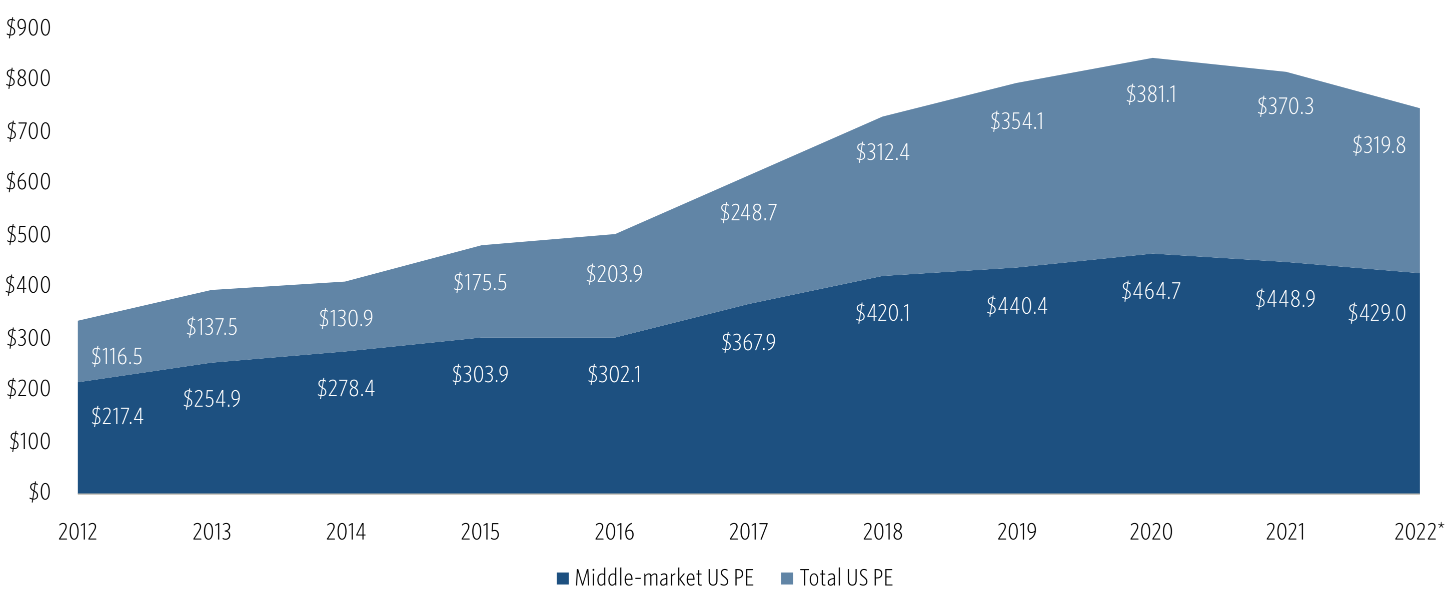
After delivering incredible performance for the past several quarters, fund investors braced themselves for markdowns in their portfolios, wary of the turn in the macroeconomic environment. However, early indications suggest that the middle market will fare better than expected, despite higher inflation and shrinking margins. According to Golub Capital, the US middle market experienced YoY growth in revenue and earnings in Q2.[16] Revenue growth in the middle market outpaced inflation, and the portfolio companies for which earnings growth outpaces multiple contraction caused by higher discount rates could even see markups during the quarter. This was the case with some of the publicly available fund returns; Apollo and Ares both saw their PE portfolios appreciate 1.5% during Q2. Meanwhile, Blackstone and KKR saw around 7% markdowns in the quarter. Preliminary performance data shows that PE did not take the hit in performance to the extent that public markets did in 2022, and because middle-market firms are less dependent on public market comparables, they may be able to post more positive marks than the rest of PE, at least for the time being. However, continued stress in the markets will likely complicate markups in Q3 2022, as Q2 YoY revenue and earnings growth declined compared with growth in Q1, according to Golub Capital. Overall, 2022 will challenge GPs of all sizes and disrupt the run of attractive returns that investors have been enjoying for the past several years.

Rolling one-year PE middle-market fund performance by size bucket



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

PE middle-market dry powder ($B)



Source: PitchBook | **Geography:** US
*As of June 30, 2022

16: "Revenue in the U.S. Middle Market Grew by 12% in the First Two Months of Q2 2022," Golub Capital, July 13, 2022.

PitchBook

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Q2 2022 US PE middle market lending league tables

Overall

Rank	Company	Deal count
1	Ares	63
2	Golub Capital	51
3	Churchill	46
4	Audax Private Debt	41
5	Antares Capital	40
6	Morgan Stanley	37
7	Barings	33
8	Twin Brook Capital Partners	32
9	BMO Financial Group	30
10	Crescent Capital	28
11	Varagon Capital Partners	23
12	Monroe Capital	20
12	Citizens Bank	20
14	MidCap Financial	18
15	Apollo Debt Solutions BDC	16
15	PNC	16
15	NXT Capital	16
18	Jefferies Group	14
18	Truist	14
18	The Goldman Sachs Group	14
18	Capital One	14
22	Owl Rock	13
22	KeyBank	13
22	Wells Fargo	13
25	The Carlyle Group	11
25	Bank of America	10

Source: PitchBook

Select roles*

Rank	Company	Deal count
1	Antares Capital	39
1	Golub Capital	39
3	Twin Brook Capital Partners	32
4	Churchill	26
5	BMO Financial Group	23
5	Varagon Capital Partners	23
7	Crescent Capital	22
8	Ares	20
8	Audax Private Debt	20
10	Citizens Bank	19
11	Morgan Stanley	17
12	Barings	15
13	MidCap Financial	14
14	Truist	12
14	Jefferies Group	12
16	NXT Capital	11
16	KeyBank	11
18	Capital One	9
19	The Goldman Sachs Group	8
19	Wells Fargo	8
19	KKR Credit	8
22	The Carlyle Group	7
22	PNC	7
22	Credit Suisse	7
22	Madison Capital Funding	7

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 markets

H1 2022 Global Real Estate Report
Download the report here

Q2 2022 Global Private Markets Fundraising Report
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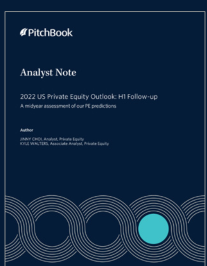

Analyst Note: 2022 US PE Outlook: H1 Follow-Up
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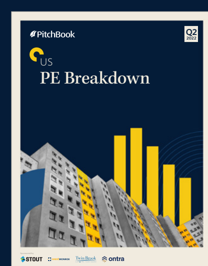

Q2 2022 US PE Breakdown
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