PitchBook

Q2 2023

US PE Middle Market Report

Sponsored by

Antares Capital

bakertilly

Sponsored by

Antares Capital

bakertilly

Contents

PitchBook Data, Inc.

John Gabbert Founder, CEO

Nizar Tarhuni Vice President, Institutional Research and Editorial

Dylan Cox, CFA Head of Private Markets Research

Institutional Research Group

Analysis

Tim Clarke
Lead Analyst, Private Equity
tim.clarke@pitchbook.com

Garrett Hinds
Senior Analyst, Private Equity
garrett.hinds@pitchbook.com

Jinny Choi
Analyst, Private Equity
jinny.choi@pitchbook.com

Kyle Walters
Associate Analyst, Private Equity
kyle.walters@pitchbook.com

Data

Alyssa Williams
Senior Data Analyst

pbinstitutionalresearch@pitchbook.com

Publishing

Report designed by **Megan Woodard**

Published on September 14, 2023

Click here for PitchBook's report methodologies.

Executive summary

The middle market continues to fire on most cylinders within the broader US PE buyout market. US middle-market funds, which we define as between $100 million and $5 billion in size, outperformed megafunds (funds of $5 billion or more) for three consecutive quarters heading into 2023, with the gap expanding to 965 basis points as measured by median one-year horizon returns. This was the widest gap in favor of the middle market since 2016 and a stark contrast to Q4 2021, when megafunds trounced all other funds by a much wider margin. The middle market's performance advantage contracted in Q1 2023 based on preliminary return data but is still solidly ahead, at 522 basis points.

Also encouraging is the middle market's share of all PE buyouts, which is on track for its best year ever and presently stands at 75.6% year to date. This is all relative, of course. Dealmaking in middle markets is still down dramatically from its late-2021 peak, just less so than the overall decline in PE buyout volumes. The middle market took its lumps early in the correction process and has leveled off for six straight quarters, while the rest of the buyout market continues to push lower in search of a bottom.

Diminished access to debt packages for big leveraged buyouts (LBOs) and cheaper price tags for smaller buyouts are encouraging PE firms to reach down market for deals that are more easily financed and satisfy return targets. Even take-privates, usually the domain of megadeals, have migrated to the middle market. Here, too, sub-$1 billion companies are offering more compelling valuations and digestible deal sizes in a public market that is getting expensive again.

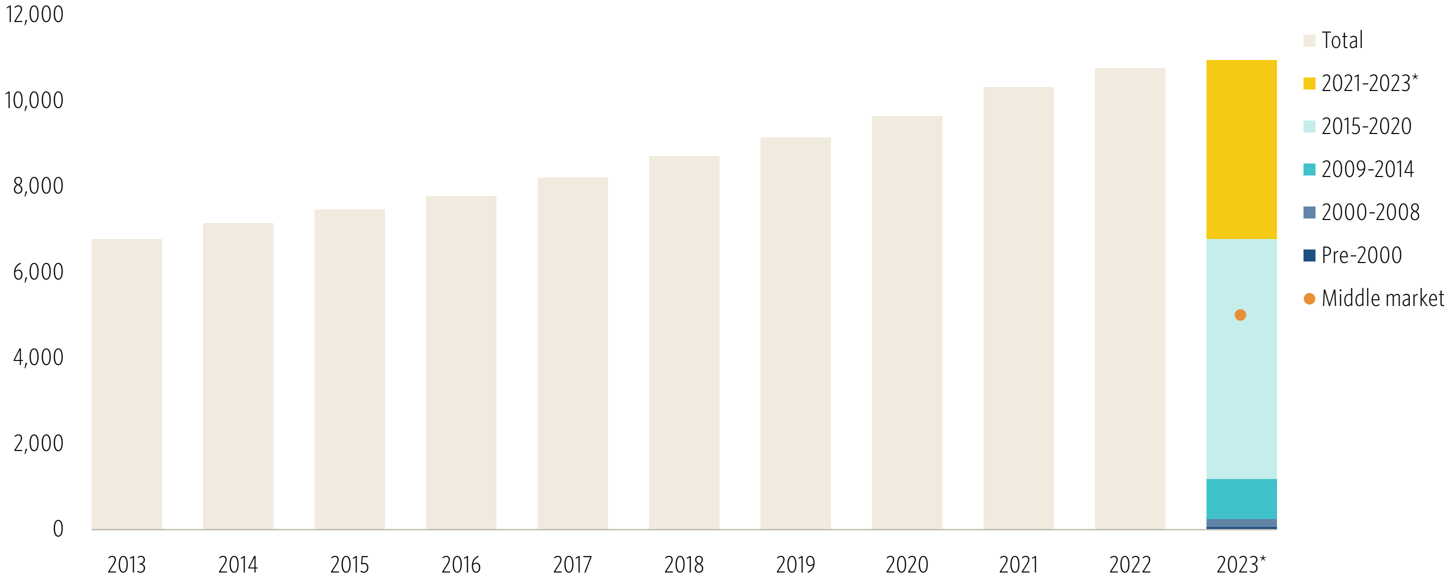
The one cylinder that is not firing is exits. In Q2 2023, middle-market exit activity slumped to its weakest quarter since 2010 outside of the pandemic-related lockdown. Even though the middle market is less dependent on new public listings as an exit route, quarterly volumes were just as depressed at one-third of the 2021 peak. Middle-market fund managers, similar to all sponsors, are postponing portfolio company sales and holding out for better prices. The most active sellers appear to be nonbacked founder-owned businesses, virtually all middle market in size, having surged to 55.0% of all PE buyouts.

Against this backdrop, fundraising for US middle-market PE was surprisingly strong in the first half of the year. 18 months ago, megabuyout funds dominated the market, which encouraged a new wave of flagships targeting $15 billion or more. However, LPs have shown signs of megafund fatigue and have taken a shine to smaller buyout funds buying smaller companies instead. Smaller funds can also mean smaller commitments, allowing LPs to stay exposed to the strategy without pressuring PE allocations. Lastly, LPs in search of a more specialized approach and differentiated alpha in an otherwise lackluster return environment are more likely to find those managers and variety within the middle market.

As a result, US PE middle-market fundraising is well ahead of last year—up roughly 25%—en route to what will probably be a record year. Reflecting that strength, the middle-market share of all US PE buyout funds closed this year has swelled to more than 60% on a dollar basis, its highest since 2015.

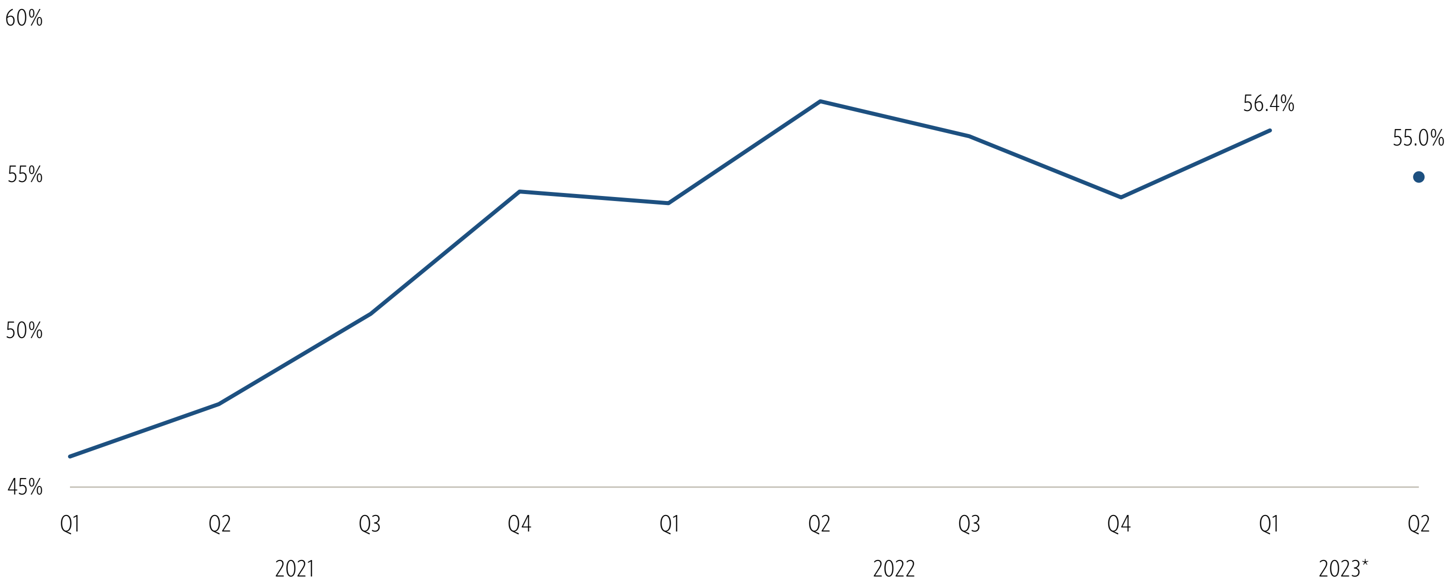
Prior periods of outperformance by middle-market funds have lasted anywhere from one to three years, and we have closed in on the low end of that range. An unexpected lurch downward in interest rates and continued movement upward in public markets would fully dispatch the denominator effect and make big buyout funds attractive again. Barring that, conditions favor the middle market in the short term, and it will no doubt continue to enjoy its moment.

PE-backed company count by investment vintage



Source: PitchBook • **Geography:** US
*As of June 30, 2023

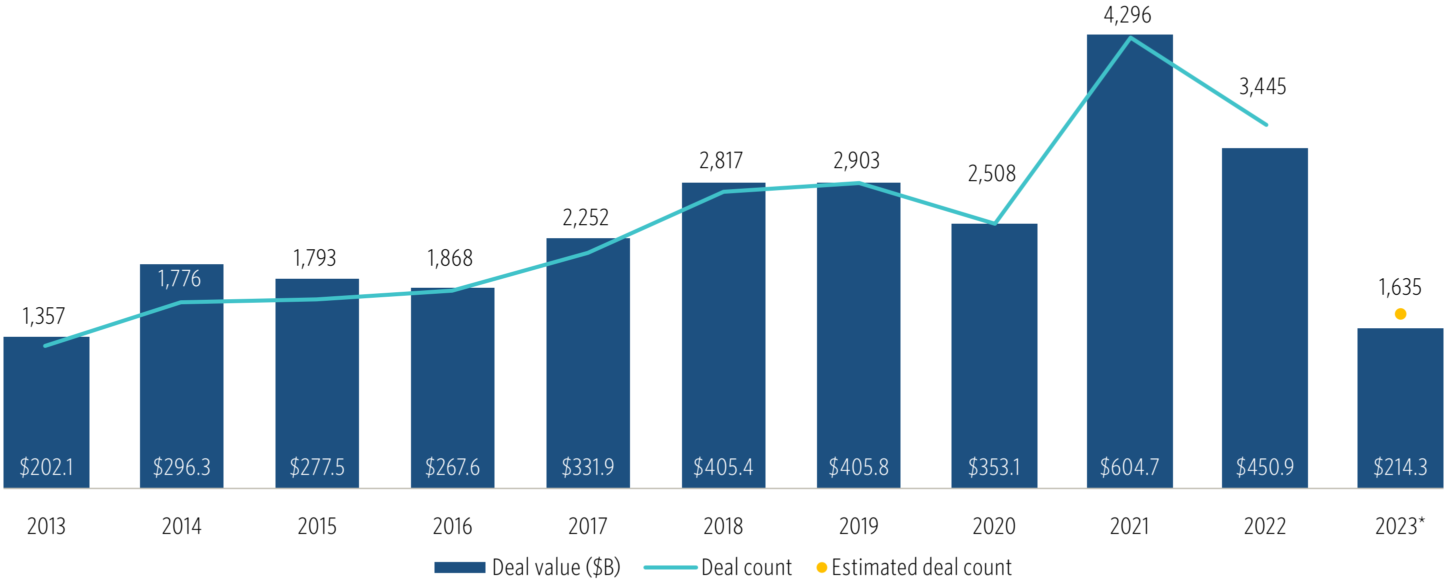
PE targets with no backing as a share of all PE buyouts by quarter



Source: PitchBook • **Geography:** Global
*As of June 15, 2023

Deals

PE middle-market deal activity

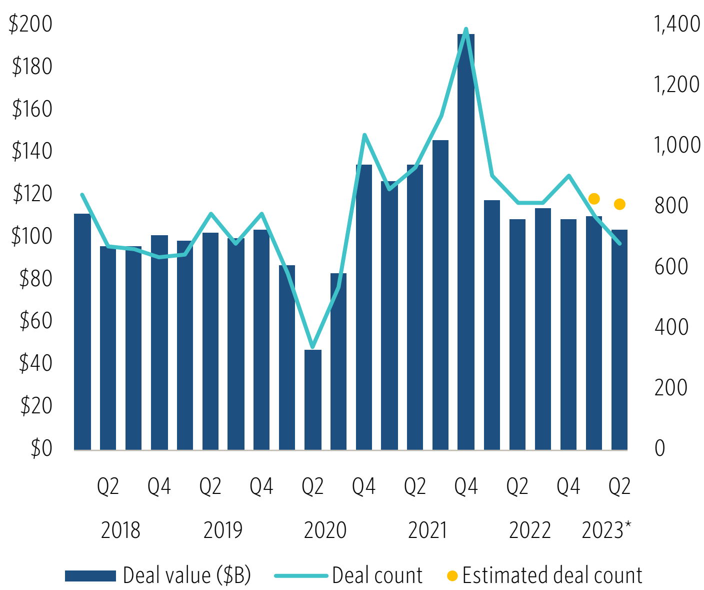


Source: PitchBook • **Geography:** US
*As of June 30, 2023

In Q2 2023, US PE middle-market buyout activity continued to move sideways in the same narrow band that has persisted over the last six quarters. The middle market took its lumps early relative to the overall buyout market. Deal count and value both collapsed by roughly 35% to 40% in the quarter following the Q4 2021 peak and have leveled out at those reduced volumes ever since, give or take 10%. Meanwhile, the larger buyout market continues to drift lower in search of a definitive bottom.

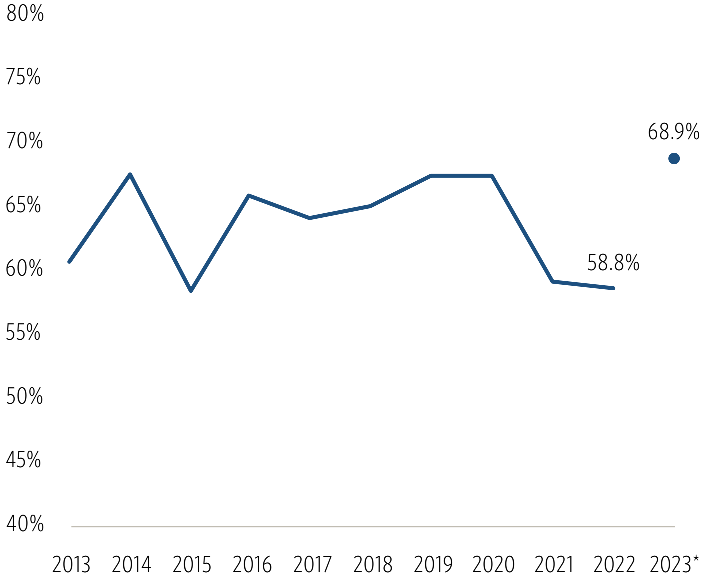
PE firms announced or closed 811 US middle-market buyout deals for a total of $103.8 billion in deal value in Q2. Deal count was largely unchanged from Q1, while value declined by 6.1%. These declines were not as steep as those in the buyout market overall, and as a result, the middle-market share of all buyout deals has expanded to 75.6% YTD from a five-year average of 68.2%. If maintained, this would be the highest reading ever having never exceeded 72% for a full year. It would also mark a sharp reversal from a market previously dominated by megafunds and megadeals. As recently as Q2 2022, the middle-market share of deal value hit a more than six-year low of 44.1% before rebounding to 70.0% in Q2 2023.

PE middle-market deal activity by quarter



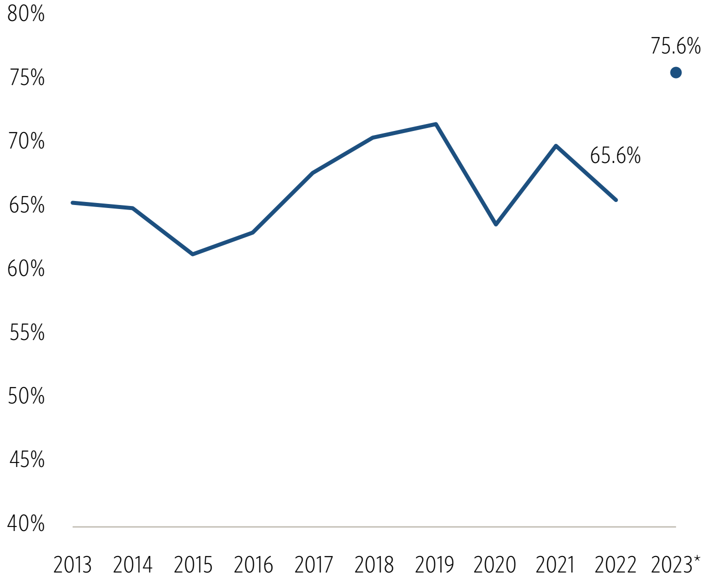
Source: PitchBook • **Geography:** US
*As of June 30, 2023

PE middle-market buyout value as a share of all PE buyout value



Source: PitchBook • **Geography:** US
*As of June 30, 2023

PE middle-market buyout count as a share of all PE buyouts



Source: PitchBook • **Geography:** US
*As of June 30, 2023

The forces driving the slowdown in megadeal activity have been well documented, with the most powerful being reduced access to large leveraged loans. For most of 2023, a glass ceiling had formed at the $2 billion level for debt packages backing LBOs, although that is beginning to fade as the recent $9.6 billion buyout of Subway and $7.1 billion deal for Syneos Health demonstrate. These transactions received debt commitments worth $5.0 billion and $4.2 billion, respectively, both from bank syndicates. Even tech has broken through, as evidenced by New Relic's $6.5 billion LBO, which netted $2.65 billion in debt from Blue Owl and other private credit lenders. Still, looking at announced PE deals for large public companies so far this year, just four have received $2 billion or more in debt financing as compared to 13 during the same span last year.

As for middle-market companies, not only are they well below the $2 billion glass ceiling, but they are being actively courted by the vast and growing complex of private credit lenders.

Between private debt funds backed by institutions, listed business-development companies (BDCs) backed by public investors, and a new breed of nontraded BDCs and interval funds backed by retail investors, we estimate that there are more than 1,300 private credit vehicles in the US alone, and virtually all have the expressed purpose of lending to small and middle-market businesses. The aggregate AUM in these vehicles has grown rapidly in the last three years to reach $842.7 billion,[1, 2] or 60.2% of the size of the leveraged loan market, which lends to the world's largest companies but has barely grown during the same span.

Given this ample supply of willing lenders and the constraints hemming in big loans for big buyouts, the path of least resistance for PE dealmakers continues to favor the middle market.

1: "Active Interval Funds," Interval Fund Tracker, n.d., accessed August 20, 2023.
2: "Business Development Company (BDC) Universe," Closed-End Fund Advisors, August 30, 2023.

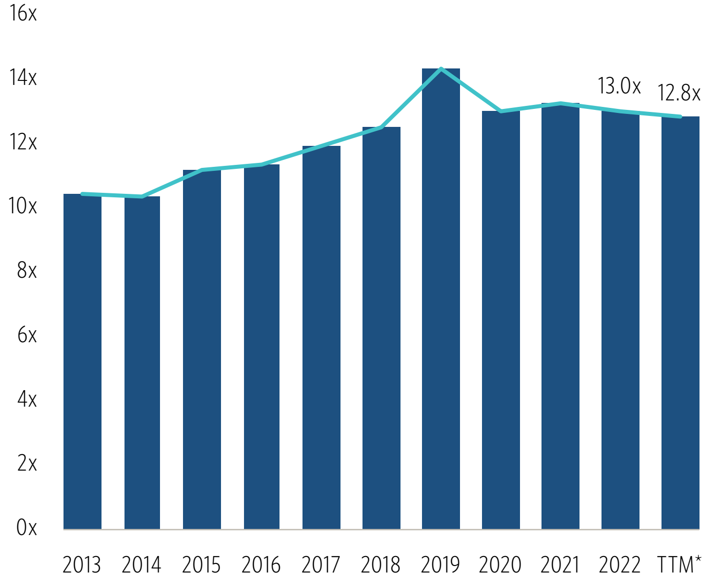
Valuations

Middle-market buyout multiples continue to slide. While down only 2% to 3% on a trailing 12-month (TTM) basis, the rate of decline has accelerated over the last six months to double digits. The enterprise value (EV)/EBITDA and EV/revenue multiples now stand at 12.8x and 2.3x, respectively, on a TTM basis and 10.3x and 2.1x on a YTD basis. We combine North America and Europe in order to expand our sample size, as low disclosure rates in the US in particular can produce highly misleading medians and trends, and the regions are well correlated. On an EBITDA basis, 2019 was the peak year for PE middle markets at 14.3x. On a revenue basis, the middle markets peaked in 2021 at 3.2x, coinciding with the peak in tech and the broader market. Revenue multiples are a better gauge of tech valuations due to the sector's lack of meaningful EBITDA numbers. From that 2021 peak, revenue multiples have since corrected by 26.9% through Q2 2023.

We attribute the latest multiples decline to a narrowing in bid-ask spreads in favor of buyers. Prior dislocations in the PE market have taken 12 to 24 months to work themselves out, and the same appears to be happening now. This is supported by statements by the top seven public PE firms in Q2 earnings reports. TPG, an active player in middle markets through its growth equity strategy, stated that sellers have been "more willing to adjust valuation expectations," a trend that it sees continuing in the second half of the year.[3] At the same time, it has deliberately postponed selling its portfolio companies, a sentiment repeated by the other public PE firms across the board.

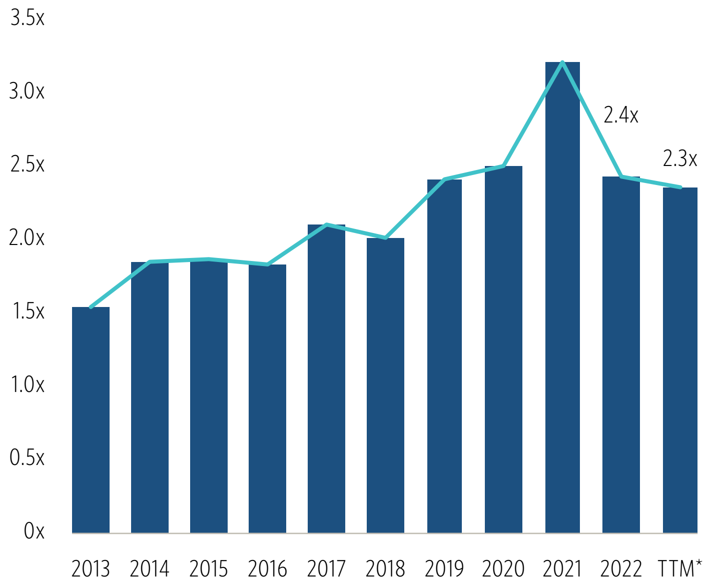
As PE firms have moved to the sidelines as sellers, they have been forced to look beyond their own ranks for deal sourcing purposes. Increasingly, this has led them to target public companies at depressed valuations, divestitures from large companies seeking to raise cash, and nonbacked founder-owned businesses seeking to sell for personal reasons. This final group, in particular, has grown to become a major source of deal flow for the broader M&A market. Nonbacked founder-owned businesses reached 61.5% of all global deals in Q1, a 15-year record high, as discussed in our recent analyst note, Founder-Owned Businesses Are Attractive M&A Targets. Within the US PE middle markets, nonbacked businesses accounted for 55.0% of all buyouts in Q2, up from a low of 46.0% in Q1 2021.

Median PE middle-market EV/EBITDA multiples



Source: PitchBook • **Geography:** North America and Europe
*As of June 30, 2023

Median PE middle-market EV/revenue multiples



Source: PitchBook • **Geography:** North America and Europe
*As of June 30, 2023

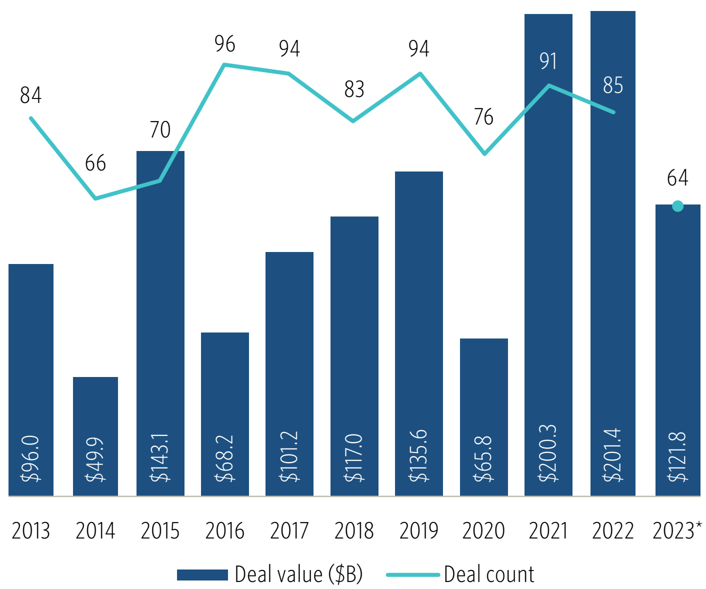
3: "TPG (Q2 2023 Earnings Call)," TPG, August 8, 2023.

Take-privates

The volume of take-private deals moderated somewhat in Q2 but is still running well ahead of H2 2022, when public shares spent more of the time declining and buyers scrambled to line up new sources of financing. In all, PE buyers announced 22 take-privates in Q2, six fewer than Q1. Examining the data reveals a continued trend of take-privates getting smaller and migrating to the middle market. A total of 14 deals, or 63.6% of Q2's total, involved sub-$1 billion companies, up from 46.4% in Q1. The median size of all take-privates in Q2 was just $385 million, down from $581 million in Q1. Fewer recent listings fell into Q2's deal list, or what we call the "boomerang" stocks: companies that went public during 2020 to 2022 only to go private again years later. Four of the sub-$1 billion take-privates fit that description in Q2, down from six in Q1, and there are plenty more where that came from. Over 1,000 unicorns were taken public in the last take-public wave, with two-thirds having been rendered sub-$1 billion companies as a result of the 70% to 80% price declines.

Private equity firms are well suited to acquire public companies after suffering a valuation reset and becoming ripe for a transformational overhaul under new ownership, particularly in the middle market. Often, public companies under $1 billion in market capitalization lack the scale to benefit from being publicly traded. Instead, they are burdened with complex reporting requirements and extra overhead with little to show for it. This is due to limited float, trading volume, and research

PE take-private deal activity



Source: PitchBook • **Geography:** North America and Europe
*As of August 15, 2023

PE take-private deals under $1 billion in Q2 2023*

Announced date (2023)	Company	Acquirer	Deal value ($M)	% from 52-week high
June 29	IRRAS	Legacy Capital Ventures	$143.0	-4.2%
June 20	Best of the Best	Globe Invest	$40.5	-92.0%
June 20	Quotient Technology	Charlesbank Capital Partners	$430.0	-5.9%
June 13	RoodMicrotec	Xenon Private Equity	$31.2	3.9%
June 12	Opdenergy	Antin Infrastructure Partners	$932.5	1.5%
May 31	Reunion Neuroscience	MPM Capital	$13.1	-77.9%
May 30	GreenLight Biosciences	Fall Line Capital	$45.5	-96.4%
May 25	Wireless Telecom Group	Artemis Capital Partners	$45.8	2.9%
April 24	Medica Group	IK Partners	$340.8	-57.7%
April 17	SignUp Software	Insight Partners	$229.4	-6.8%
April 12	Consolidated Communications	Searchlight Capital, BCI	$296.0	-42.9%
April 11	Tessco Technologies	Lee Equity Partners, Twin Point Capital	$161.4	2.4%
April 6	Xpediator	BaltCap	$76.1	4.3%
Median			**$143.0**	**-5.9%**

Source: PitchBook • **Geography:** North America and Europe
*As of June 30, 2023

coverage. Also, such companies are often below the minimum size threshold of many institutional equity funds. Without adequate analyst coverage assigned to them, the volatility of the shares is often higher, as there are more surprises, and this increases the stock's beta, leading to a higher discount rate and investors demanding a higher rate of return for their capital, and, ultimately, a lower valuation. Private ownership offers the opportunity to escape this value trap and experience less volatility in company value, and the flexibility to pursue longer-horizon investments and strategy.

Recent volatility has created a ripe environment for take-privates. While equity indexes have recovered significantly from recent lows set in mid-2022, the broader Russell 2000 (R2K) Index, which is composed primarily of small-capitalization companies, has lagged the large-cap S&P 500 (SPX) Index significantly. Since the 52-week low, R2K is up 12.9%, while SPX is up 24.0%. Similarly, when compared to the two-year high, the R2K is down 23.4%, while the SPX is down only 7.5%. The Russell 2000 Index constituents have a median market cap of under $1 billion, suggesting a sizable universe for PE buyers to sift through—especially following the lagging performance versus larger capitalization companies.

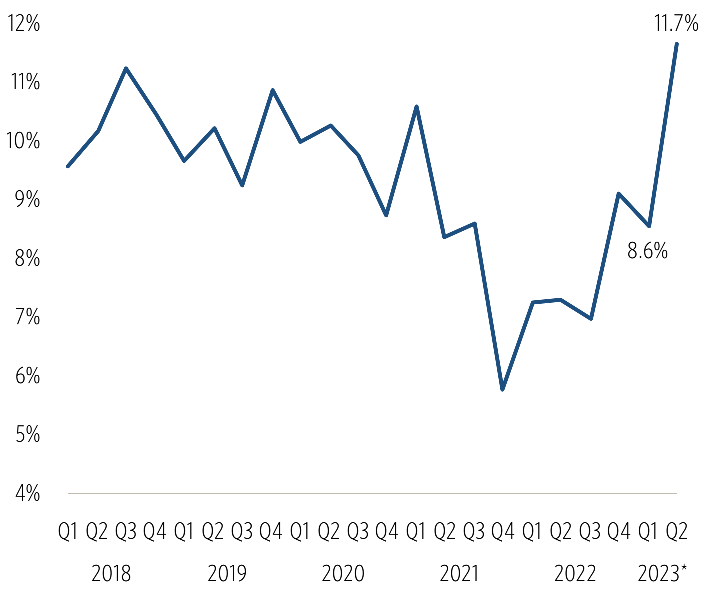
Carveouts

Carveouts continued to increase their share of the total deal mix, as these transactions allow sellers to raise cash and buyers to reduce check size, which is evermore important in a rising-interest-rate environment. During Q2 2023, carveouts comprised 11.7% of all middle-market PE deals, up from 8.6% in Q1. On the basis of capital invested, H1 2023 carveouts comprised 10.5% of deal value, up from 9.9% in 2022 and closing in on the pre-pandemic average of 11.6%.

We expect carveout deals to continue push higher in the current environment. As they often involve assets of a public company, they are a less costly alternative to a take-private of an entire public company. In many instances, the assets have been well managed, and historical financial data is readily available. This enables more efficient due diligence for both acquirers and lenders—potentially drawing a larger pool of bidders—and helps the seller arrive at a more objective assessment of the opportunity cost and fair value in shedding a business that has been held for many years but has been deemed noncore to its future strategic focus. In this era of wide bid-ask spreads, carveouts can facilitate alignment between buyers and sellers.

Notable sub-$1 billion deals in the quarter ran the gamut of platform deals, add-on deals, and turnarounds. In June, Carlisle Companies agreed to sell its fluid technologies (CFT) division to Lone Star Funds through a $520 million LBO. CFT achieved a 2022 revenue of $297 million and adjusted EBITDA of $56.3 million,[4] equating to an EV/revenue and EV/EBITDA multiple of 1.7x and 9.2x, respectively. CFT provides fluid handling and finishing equipment to aerospace and industrial clients. In May, Walmart agreed to sell online retailer Eloquii Design to Oaktree's FullBeauty Brands for $100 million.[5] Oaktree gained control of the FullBeauty as a debtor-in-possession following its bankruptcy in 2019 and has since completed three add-on deals including Eloquii. The company has scaled to become a leader in the size-inclusive fashion sector. Lastly, Qurate Retail Group, formerly known as Liberty Interactive and owner of the QVC and HSN shopping networks, agreed to divest Zulily, an online flash sales platform. The business was acquired by Regent, a Los Angeles-based PE firm with global holdings in consumer brands and other industries. While terms were undisclosed, Zulily was once a high-flying IPO in 2013 before fetching $2.4 billion in a 2015 deal with Liberty. The business has struggled, and sales have since halved to $906 million.[6] The divestiture will allow Qurate to better focus on its core video commerce assets.

Carveouts/divestitures as a share of all PE middle-market buyouts by quarter



Source: PitchBook • **Geography:** US
*As of June 30, 2023

4: "Carlisle Companies to Sell Carlisle Fluid Technologies," Carlisle, June 15, 2023.
5: "FullBeauty Brands, Proudly Inclusive Since 1901, To Acquire ELOQUII, Where Fashion Doesn't Stop at Size 12," Business Wire, April 21, 2023.
6: "Qurate Retail, Inc. Reports Fourth Quarter and Year End 2022 Financial Results," Qurate Retail Inc., March 1, 2023.

Technology

Technology deal activity fell sequentially as turmoil in the banking sector and higher interest rates hindered dealmaking. IT's Q2 deal count was 17.1% lower than Q1, putting H1 2023 down 23.8% YoY at 192 total deals. Deal value dropped by a similar 23.2% in the first six months to $29.8 billion. This equates to 7.8% below the pre-pandemic H1 mean of $32.4 billion (H1 2017 to 2019). The tech sector fared relatively worse than other sectors and fell to 13.2% of Q2 deal volume, down 86 basis points from last year. This is the lowest portion since 2014, and well below the five-year average of 15.6%.

While higher rates are a headwind for tech deals, we generally see this sector as having lower debt levels overall. We believe the turmoil in the banking sector, particularly around the Silicon Valley Bank collapse and the concerns about near-term liquidity in the greater Silicon Valley technology community during Q2, created a very disruptive situation that inhibited dealmaking in the middle-market space. Many companies were struggling to ensure near-term liquidity needs were met and didn't have the bandwidth to run a sale process. Many buyers were opportunistically hoping to find deals and expecting forced sellers willing to offer sizable discounts for attractive assets. Ultimately, many companies managed through any near-term funding disruptions and were averse to selling amid a volatile environment or entertaining the prospect of a heavily discounted sale.

Notable transactions in the quarter included a software-as-a-service (SaaS) sponsor-to-sponsor sale and a human resources (HR) tech strategic acquisition. Fusion Risk Management, offering a cloud-native operational risk management platform, was acquired by Great Hill Partners in April.[7] The investment will enable Fusion to invest in go-to-market capacity and product innovation while bolstering financial flexibility to pursue organic and inorganic growth vectors. Existing shareholder Vista Equity Partners will remain as a significant minority shareholder, in addition to Catalyst Investors and Level Equity Management. While financial details were undisclosed, PitchBook estimates the deal value at $500 million. Modern Hire, developer of a digital hiring platform with screening, assessment, interview, and workflow automation tools, agreed to be acquired by HireVue for $375 million.[8] The acquisition enhances HireVue's market position in the HR tech space, adding scale and expertise in science-based hiring solutions, according to management.[9] The $375 million private debt financing package was led by AB Private Credit Investors BDC.

Healthcare

Healthcare deal activity fell again as higher interest rates sting. Healthcare's Q2 deal count was 13.4% lower than an already soft Q1, putting H1 2023 down 29.6% YoY at 181 total deals. Deal value fell 3.7% sequentially to place H1 down 45.6% YoY to an anemic $21 billion. This equates to a large 22.2% shortfall relative to the pre-pandemic H1 mean of $27.0 billion. Relative to other sectors, healthcare posted one of the steepest declines in deal activity during H1 2023 and now accounts for only 12.5% of deal volume, the lowest since 2014 and below its five-year average of 14.9%.

Higher rates combined with high leverage are the primary headwinds in the healthcare sector as PE platform companies struggle with growing debt service costs while simultaneously facing limits of fund maturities. These factors have contributed to the sharp reduction in dealmaking activity, as large platforms in market segments well suited to roll-up strategies shift to optimizing their existing footprint, rather than expanding. These include physician practice management (PPM), dental, vision, and veterinary.

Notable healthcare deals in the quarter included continuation fund investment and a take-private. ImageFIRST Healthcare Laundry Specialists, a provider of garment rental and laundry services for healthcare operations, was rolled into a continuation fund, Calera Capital Image Holdings, in a $750 million deal announced in April.[10] The seller was Calera Capital Partners V, a 2017 vintage fund. The transaction will provide significant additional capital to repay existing debt and support the continued execution of the company's organic expansion strategy. In June, the board of Paratek Pharmaceuticals, a Boston-based commercial-stage biopharmaceutical company, agreed to a take-private sale to Gurnet Point Capital and Novo Holdings.[11] Gurnet Point sees an opportunity to accelerate the commercialization of Paratek's NUZYRA, a novel antibiotic that is approved to treat pneumonia and skin infections. The transaction is valued at $462 million, including $175 million in debt financing and earnouts tied to achieving certain commercial milestones. The transaction is expected to close in Q3 2023.

7: "Our Companies," Great Hill Partners, n.d., accessed August 20, 2023.
8: "Acquisition Solidifies Hirevue's Position as The Industry Leader in Modern Hiring Solutions Powered by Ethical AI," Modern Hire, May 9, 2023.
9: Ibid.
10: "Calera Capital Closes $750 Million Single-Asset Continuation Fund for ImageFIRST," Business Wire, June 14, 2023.
11: "Paratek Pharmaceuticals to be Acquired by Gurnet Point Capital and Novo Holdings," Novo Holdings, June 6, 2023.

A WORD FROM ANTARES CAPITAL

Private credit: Your all-weather friend

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. His previous roles include Chief Operating Officer and Head of Asset Management for Antares.

A dream come true?

Thus far, the US economy has proven to be remarkably resilient in the face of the fastest pace of interest rate hikes seen in about four decades. Real GDP growth of 2.4% in Q2 2023 surprised on the upside—in part encouragingly driven by a remarkable 3.7% seasonally adjusted annual rate jump QoQ in nonfarm productivity. Q3 2023 is looking potentially even more vibrant, based on the Atlanta Federal Reserve's (Fed's) most recent GDPNow real GDP growth estimate of over 4%. Meanwhile, inflation continues to wane, with the Consumer Price Index (CPI) down to a lower-than-expected 3.2% reading in July. Is such vibrant growth and subdued inflation an unlikely soft or no landing dream come true or just a fleeting head fake?

Beware the lag

While the recent stream of generally positive economic data is certainly heartening, it's probably premature to jump on the "no recession" bandwagon. The steep rise in interest rates to a 22-year high and recent bank credit tightening will take time to flow through the economy. Historically, a recession has typically followed a prolonged inversion of the US 2-year to 10-year Treasury yield curve by roughly 18 months. With inversion having started in earnest in July 2022, that would put arrival time for a recession in early Q1 2024. Recessions have also tended to follow the last in a series of Fed rate hikes by three to six months, and July's hike to a 22-year high may well be its last. Finally, fiscal-stimulus-induced excess household savings—which peaked at over $2 trillion in mid-2021—has been dwindling and is expected to be depleted by early 2024.

On the positive side, credit tightening following the regional bank failures, productivity gains, recession in Europe, and a slowdown in China are all deflationary forces that should help alleviate the need for further interest rate hikes and pave the way for eventual rate cuts. Currently, the forward interest rate curve would suggest that rates have peaked and are on a smooth glide path toward more normal levels by 2025. Of course, there could yet be foul weather ahead reflecting further regional banking and/or commercial real estate woes, a rekindling of inflation due to strong growth, or supply side shocks and/or geopolitical strife. While it's fine for equity investors to dream of the upside, you may find better all-weather friends among lenders that worry about the downside.

Q&A with Timothy Lyne, Antares CEO

What is your latest read on PE investment activity? Are the stronger-than-expected growth and diminished odds of recession helping?

US middle-market leveraged buyout (LBO) loan volume remained depressed in Q2 2023 at only about $6 billion—down 26% versus Q1 2023 and down 60% versus Q2 2022;[12] however, add-ons have been a relative bright spot, rising 10% in Q2 2023 versus Q1 2023 and slightly exceeding LBO volume for the first time since Q3 2020. The pickup in add-on activity plays well to our strengths and incumbency advantage as PE investors look to average down their LBO platform acquisition multiples and create value via synergies. We have one of the largest middle-market portfolios in the business, with over 70% of our deal flow coming from our portfolio.

Looking forward, it's a bit tricky to try and read the tea leaves on the direction of PE investment activity—especially during the seasonal summer doldrums of August; however, to your question, the resilience of the US economy and growing consensus that the Fed may be finished hiking rates no doubt

12: "Refinitiv LPC's 2Q23 Private Deals Analysis," Refinitiv, July 2023.

helps improve investor sentiment. A recent survey by Grant Thornton of M&A professionals and PE investors showed 99% of respondents expecting deal volume to increase in H2 2023, although only 11% forecast a "significant" increase.[13] In another survey conducted by Lincoln International in Q2 2023, 82% of private market investment professionals indicated they expect transaction activity to return to "normal" levels by H1 2024.[14] We also hear from investment banks of a significant backlog of deals, and PE dry powder levels remain high. On the institutional demand side, syndicated market activity has continued to pick up, with higher secondary loan pricing, a recent pickup in collateralized loan obligation (CLO) issuance, and improved fund flow helping drive interest in new issuance.

For our part, we remain very much open for business and see encouraging signs of increased activity, including a nice recent pickup in staple financings—another incumbency advantage from our large portfolio. While there has been some modest spread pressure, spread per unit of leverage remains near the highs of the past decade. We continue to view the current environment as yielding a great loan vintage, and hopefully, we'll start to be able to harvest some more grapes.

What insights can you share about how your borrowers are faring in the current environment?

We continue to see revenue growth across our portfolio, with most companies having had success in mitigating cost inflation with price increases. However, EBITDA growth has slowed and is lagging in a few areas. Industry segments facing pressure include aerospace & defense, select retail goods & services segments, and physician management practices (PPMs).

On the positive side, there are signs that cost inflation is abating with margins stabilizing. At a recent annual event we held for borrowers, an informal survey of executive attendees indicated that the impact of raw material costs and supply chain issues has shifted favorably from a "significant" to "slight" negative impact, with some even seeing a positive impact. Hiring and retaining labor remains a challenge, yet there has been some improvement versus one year ago.

Has the outlook for defaults and losses changed, and how have sponsors been dealing with troubled investments?

As you would know, the latest Q2 2023 Pitchbook-LCD Leverage Finance Survey loan default rate forecast for the next 12 months was unchanged from its prior survey at 2.5% to 3.0%, which compares to the current default rate of 1.4% as of August and the long run average of about 2.7%. Of course, forecasts differ, but base case numbers look manageable.

Resilient growth and declining inflation certainly help the default outlook, but interest costs have been rising and many companies are still facing cash flow pressures. Lincoln International's database of private companies shows average interest coverage of just 1.19x in Q3 2023 assuming a 5.5% Secured Overnight Financing Rate (SOFR) base rate with almost one-third of companies below 1.0x on a weighted average basis.

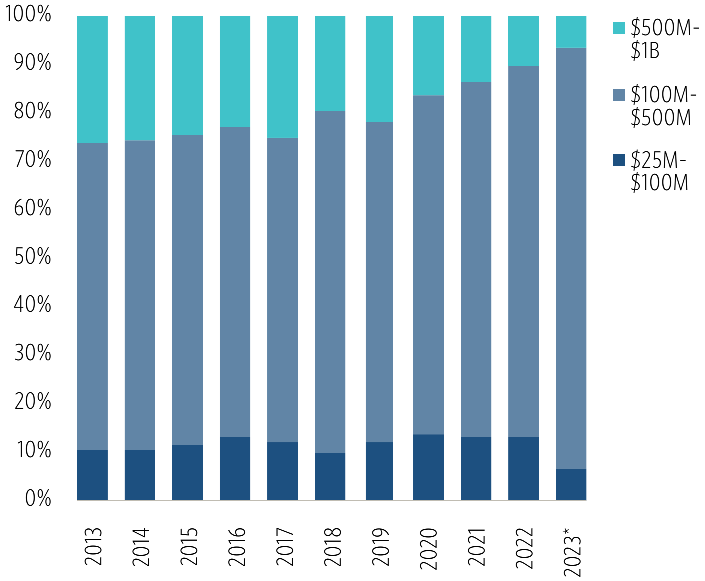
The good news is sponsors have generally been managing cash flow and liquidity well via better working capital and capital expenditure management in many cases. Sponsors and direct lenders appear to have been working well together to get ahead of the problem—particularly in instances wherein foreseeable stress has been purely related to base interest rate increases versus operating performance issues. Lenders have been accepting amendments (for example, covenant or pricing amendments and maturity extensions, among other things) in exchange for fees/better economics, with sponsors often contributing more equity when needed.

Interestingly, KBRA Direct Lending Deals has recently started tracking US direct lending defaults, and in its June report noted that it expects the sponsor-backed direct lending default rate of 2.5% by count at year-end 2023 to be less than a 4% rate for high-yield and 5.5% rate for leveraged loans.[15] Some of the reasons for this include: first, a lack of trading in direct loans that could otherwise allow investors into the fold that may have opposing agendas; and second, the willingness of a small club of buy-and-hold-oriented direct lenders to work constructively with sponsors that have substantial skin in the game. We think this underscores direct lending's appeal to both sponsors and investors.

13: "M&A Professionals Predict a Continued Jump in Deal Volume," Grant Thornton, August 11, 2023.
14: "Lincoln Private Market Index Gains Ground Amid Stable Private Company Growth," Business Wire, August 8, 2023.
15: "DLD Default Report: US Direct Lending," KBRA, August 10, 2023.

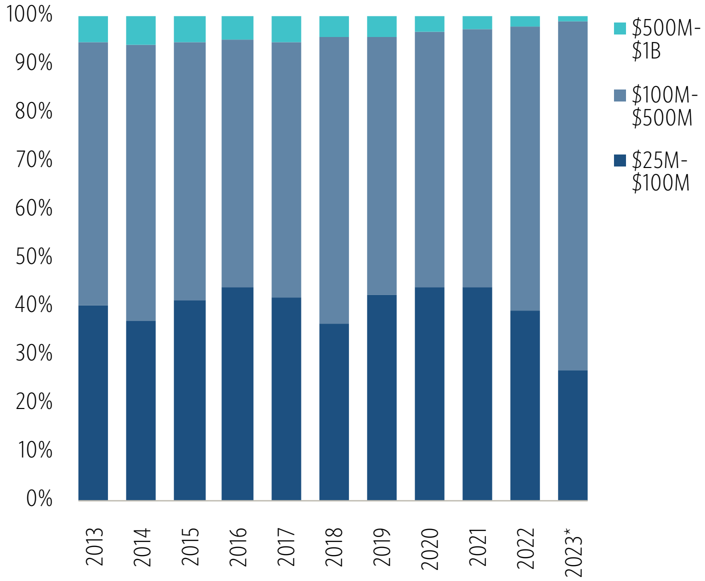
Deals by size and sector

Share of PE middle-market deal value by size bucket



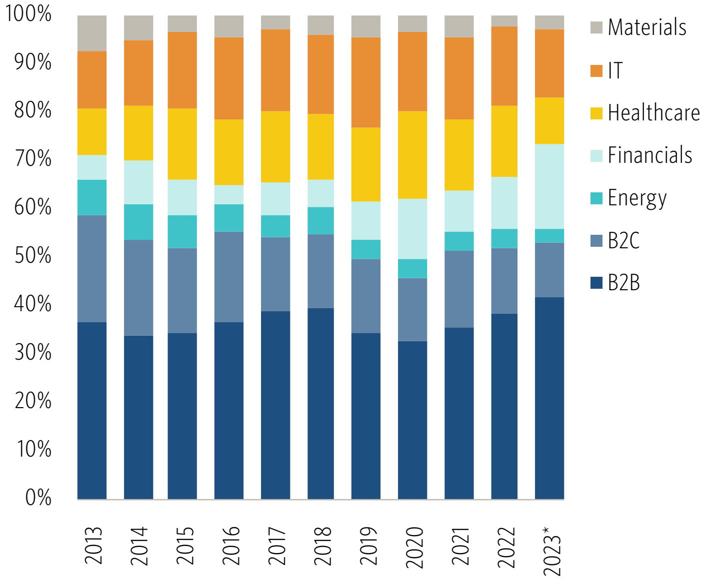
Source: PitchBook • **Geography:** US
*As of June 30, 2023

Share of PE middle-market deal count by size bucket



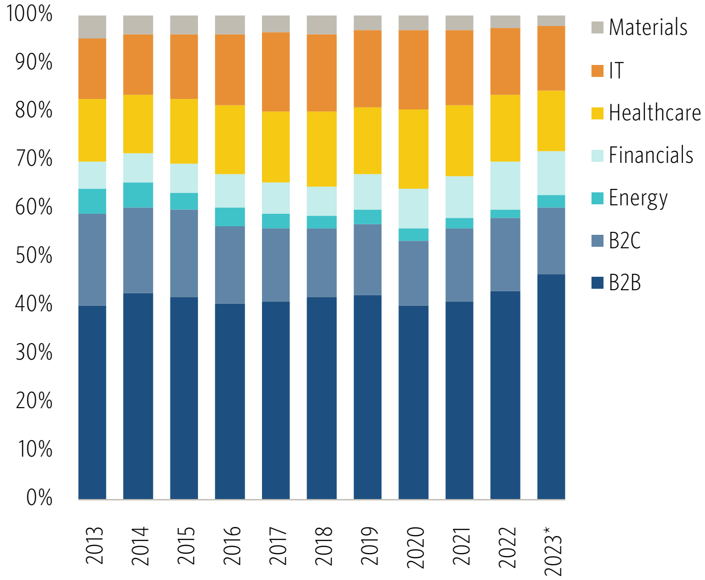
Source: PitchBook • **Geography:** US
*As of June 30, 2023

Share of PE middle-market deal value by sector



Source: PitchBook • **Geography:** US
*As of June 30, 2023

Share of PE middle-market deal count by sector

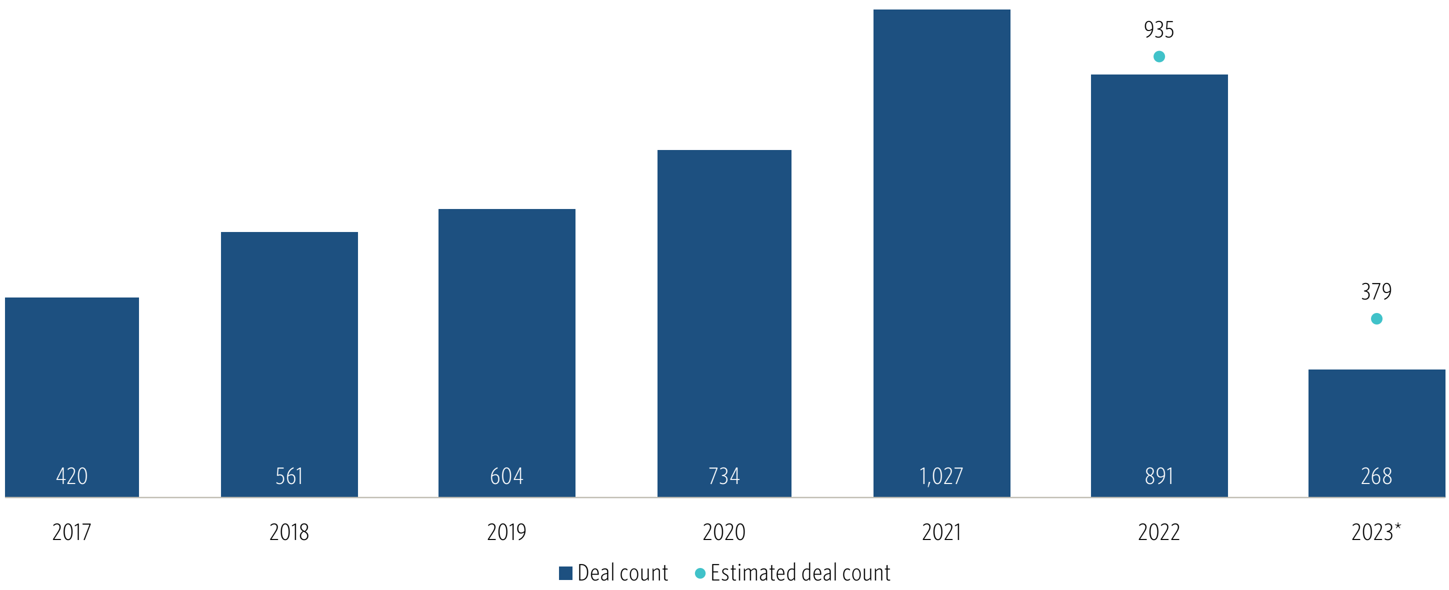


Source: PitchBook • **Geography:** US
*As of June 30, 2023

SPOTLIGHT

Q2 2023 Healthcare Services Report

Healthcare services PE deal count



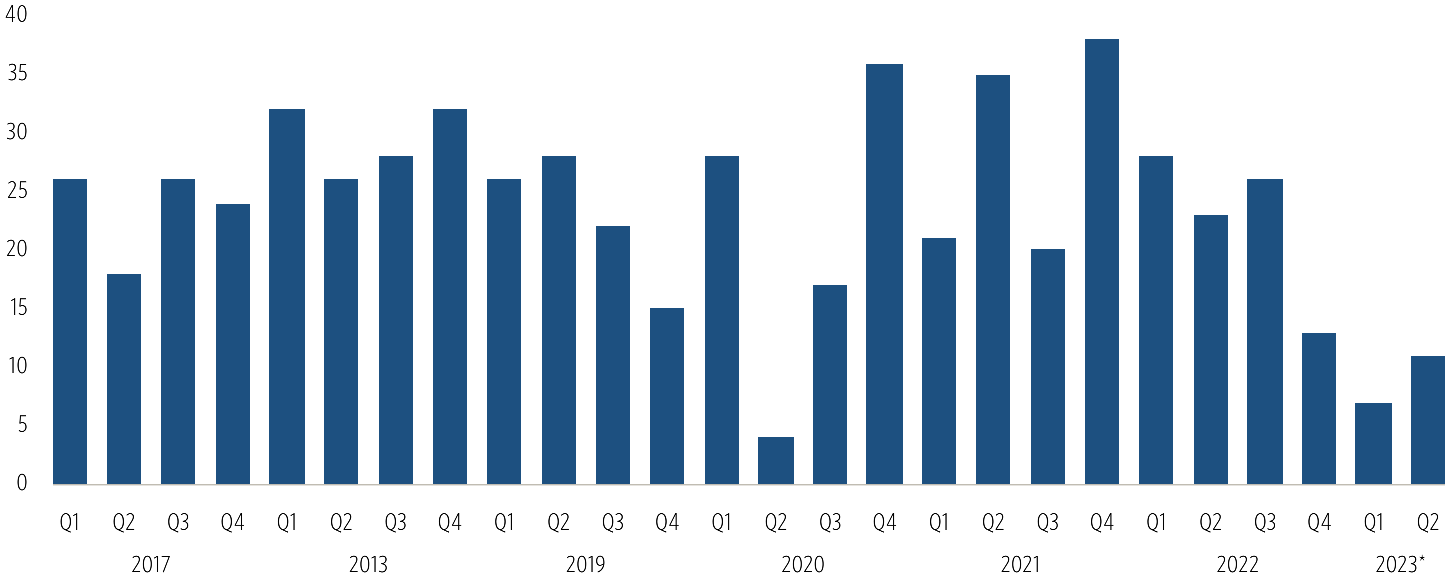
Source: PitchBook • **Geography:** US
*As of June 30, 2023

Note: This spotlight is abridged from our Q2 2023 Healthcare Services Report. Please see the full report for additional analysis about the healthcare services sector.

Healthcare services PE deal activity dipped unexpectedly in Q2 2023. An estimated 164 deals were recorded or announced, the lowest mark since Q2 2020 and less than half the deal count of Q4 2021, the market peak. The Q2 deal count represents a quarter-over-quarter decline of 23.7% and the sixth straight quarter of deal count declines. However, it is still 12.3% higher than the average quarterly deal count in 2018 and 2019.

Leverage has become the central story and the primary cause of declining deal activity. Heavily leveraged platforms are straining under growing debt service costs and impending maturity walls. This has led to a significant deceleration in add-on M&A by many of the largest groups, especially in PPM roll-up categories such as dental, vision, and veterinary. Three of the 36 healthcare provider companies that are constituents of the Morningstar LSTA US Leveraged Loan Index—Duly (DuPage), Aspen Dental, and Radiology Partners—were downgraded by S&P in Q2 2023, while Moody's downgraded US Renal Care to Caa3 in July. Staffing firm Envision Healthcare and oncology provider GenesisCare, both backed by KKR, filed for bankruptcy in May and June, respectively. Additionally, we are continuing to see a steady trickle of minority equity infusions for late-in-hold platforms, at least some of which are related to restructuring.

Healthcare services platform LBOs by quarter



Source: PitchBook • **Geography:** US
*As of June 30, 2023

This dynamic is exacerbated by the continued absence of large platform deals from the healthcare services market. We recorded seven platform buyouts in Q1 2023 and 11 in Q2 2023—both lower than any quarter since 2017, other than Q2 2020. Established PPM categories—which drive the majority of the sector's overall deal flow—tend to exhibit cyclical deal dynamics in which deal activity accelerates as a cohort of platforms are created or traded and then declines as those platforms reach the late stages of their investment periods. Dermatology provides a good example: Deal activity declined in 2019 and 2020 as larger platforms aged, but it has since accelerated following a handful of key platform trades.

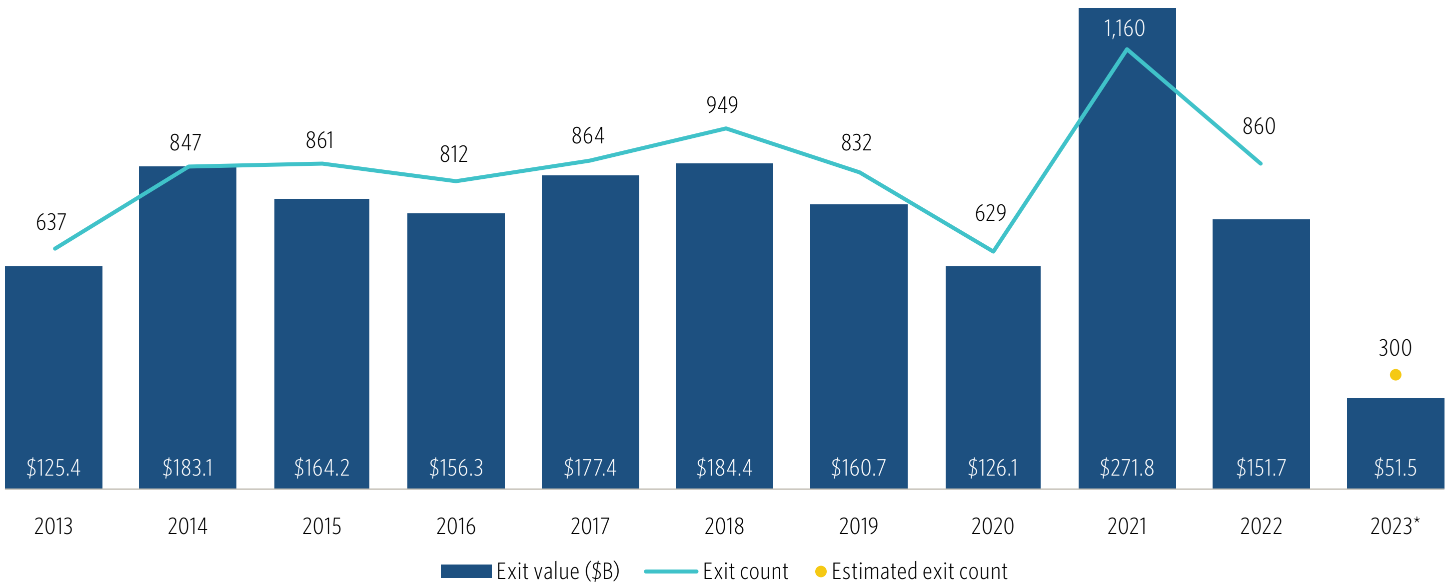
On the positive side, margin pressure due to labor cost inflation is finally beginning to ease—although by no means disappear—as labor force participation rates finally edge past the pre-pandemic mark.[16] Additionally, macroeconomic uncertainty and the slowdown in dealmaking have afforded management teams and investors the opportunity to closely attend to operational efficiencies, including better workforce utilization, retention, and upskilling strategies.

Looking ahead, we believe a gradual reversal is in sight. At a macroeconomic level, recession is no longer the base case in the eyes of most economists, and inflation is steadily retreating.[17] Healthcare specialist managers also have a growing arsenal of dry powder to deploy. According to our H1 2023 Healthcare Funds Report, fundraising by healthcare specialist PE firms skyrocketed in 2021 and has remained elevated through the first half of 2023 despite depressed fundraising for the asset class as a whole. All told, we maintain our expectation that deal activity will stay flat or be slightly elevated for the remainder of the year. Although it remains difficult to predict when the floodgates of on-hold sale processes will open, the growing sense of economic stability and gradual debt market recovery will likely give more sponsors the courage to bring their healthier assets to market by the end of the year. Heavily leveraged platforms, meanwhile, will likely need to hang on until interest rates ease materially.

16: "Labor Force Participation Rate - 25-54 Yrs.," Federal Reserve Bank of St. Louis, July 27, 2023.
17: "Fed Staff Drop US Recession Forecast, Powell Says," Reuters, David Lawder and Dan Burns, July 26, 2023.

Exits

PE middle-market exit activity

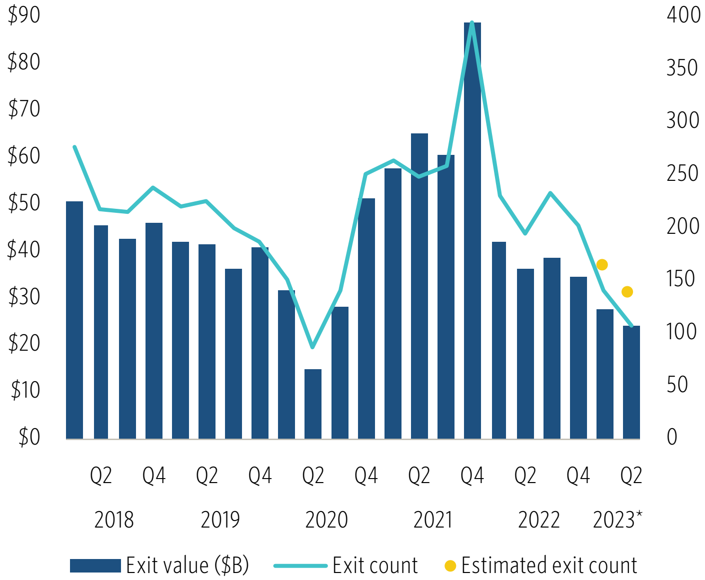


Source: PitchBook • **Geography:** US
*As of June 30, 2023

Overview

Exit activity in the US PE middle market was extremely weak in Q2 2023, falling to its lowest level since the aftermath of the global financial crisis (GFC), excluding a single quarter during the COVID-19 pandemic. An estimated 138 PE-backed middle-market companies were exited or announced to be exited during Q2 for a cumulative exit value of $24.0 billion. Both exit count and value decreased for the third consecutive quarter, dropping by 15.1% and 12.8%, respectively, demonstrating the continued depressed exit environment. YoY, exit count was down 29.1% while exit value dropped 34.2%, and exit value has fallen by a whopping 72.9% from the peak in Q4 2021. Exits have retreated to just above half of the average activity recorded in the pre-COVID-19 years of 2017 to 2019. The broader PE market fared better than the middle market in Q2, as a few mega-sized exits buoyed US PE exit activity and created a modest bounce back in quarterly exit value. We believe the sharp downturn in Q2 middle-market exits could be related to a sudden downshift in growth of middle-market companies during the quarter, giving pause to potential buyers. The Golub Capital Altman Index, which serves as a good proxy of operating trends in the US middle-market

PE middle-market exit activity by quarter



Source: PitchBook • **Geography:** US
*As of June 30, 2023

space, reported that revenue and earnings growth slumped to 4.3% and 4.5%, respectively, down from 10% or more in the prior two quarters.[18]

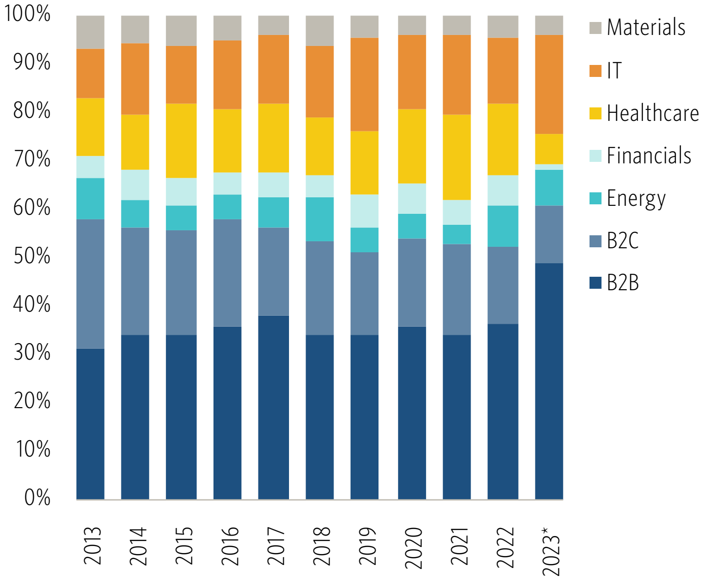
Challenges remain ahead for the exit market. We have heard anecdotally from some banks that many planned sales in the middle-market space have ended up as hung deals. This can be for various reasons: buyers can withdraw bids if they perceive fundamentals to have changed, distressed prices can deter sellers from accepting them and proceeding to a close, and volatility in debt markets can create changes in lender terms that increase the cost of leverage. Prolonged weakness in exits means that a "maturity wall" is fast approaching for the PE funds nearing the end of their term life to distribute capital back to investors through exits. With a new normal of slow exit activity likely to continue for the foreseeable future, PE owners will soon face the prospect of a large overhang of investments that need to be sold or held for longer than expected. The pressure is building for GPs to quickly find solutions to a rising liquidity concern.[19]

Nevertheless, investors are optimistic about conditions improving in the final quarter of 2023. This sentiment was echoed by the giant public PE firms during their Q2 earnings calls.[20] For the middle market, there are some advantages when it comes to exit opportunities. The smaller size of portfolio companies allows PE firms to pursue multiple paths to exit: They can grow under the middle-market sponsor to be a platform acquisition for other PE firms or stay small enough to roll into other platform companies as add-on deals. Lower-middle-market companies tend to be less leveraged, and no or lower amounts of debt paves the way for easier exits. Lastly, with PE fundraising having ballooned over the last two years, there is increased appetite for sponsor-to-sponsor exits. US middle-market PE firms held $420.5 billion of dry powder as of Q4 2022, which is near its record-high supply of capital.

Public listings

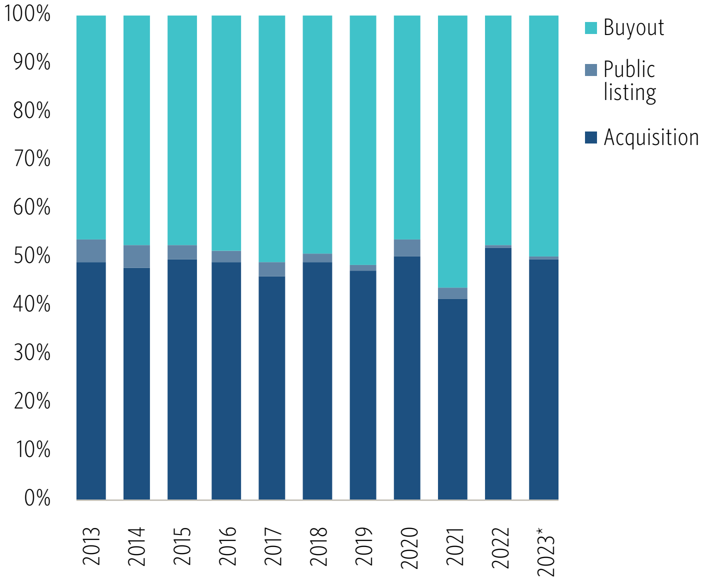
While public listings tend not to be a meaningful exit option for the middle market given the typical company's size, the recent market volatility has wiped out what little IPO activity there has been, resulting in an average share of less than 1% of exit value in the last year, down from its 10-year average of 5.1%. There was one public listing in the middle market so far this year: Kodiak Gas Services, which raised $256.0 million for its IPO in June. While not spectacular, this

Share of PE middle-market exit value by sector



Source: PitchBook • **Geography:** US
*As of June 30, 2023

Share of PE middle-market exit count by type



Source: PitchBook • **Geography:** US
*As of June 30, 2023

18: "US Middle Market Remains Resilient," Golub Capital, Q2 2023.
19: For more analysis, please refer to the Q2 2023 Analyst Note: PE Exit Timelines and the Impending Maturity Wall.
20: For more analysis, please refer to the Q2 2023 US Public PE and GP Deal Roundup.

amount was enough to push the IPO share of exit value to 3.9% in Q2. There are signs of a long-awaited recovery in the IPO market, with filings ticking up, including VC-backed Instacart, corporate venture capital (CVC)-backed ARM, and PE-backed Klaviyo—though these are far from being middle-market companies. That said, a reboot of equity and debt underwriting markets is a key driver of investor sentiment and precursor to a more active exit environment, starting with better bids for M&A deals.

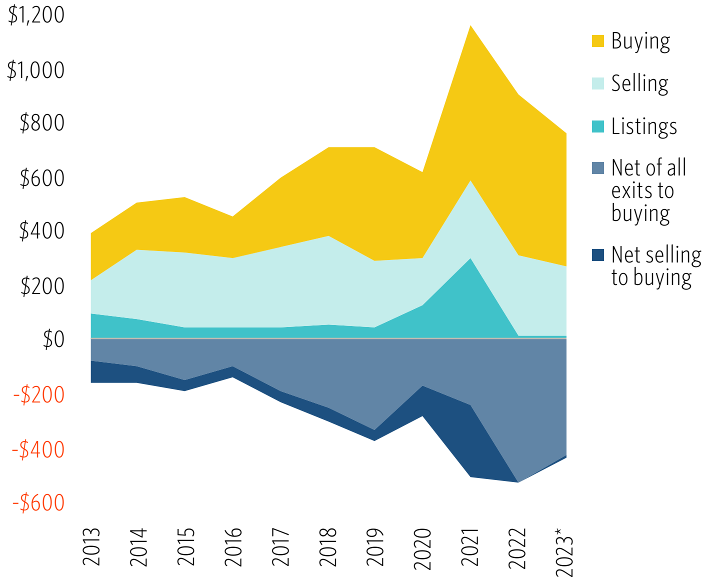
Exits to sponsors

Middle-market exits have been evenly split between PE and corporate strategic buyers since the start of 2022. From Q1 2022 to Q1 2023, corporate buyers accounted for an average of 51.4% of exit value, while exits to other sponsors accounted for an average of 48.1%. The split between sponsors and corporate buyers flipped as sponsor-to-sponsor exit value was lifted by a few transactions in the upper middle market, such as ImageFIRST for $750.0 million, MEI Rigging & Crating for $610.0 million, and Fusion Risk Management for $525.0 million. Sponsor-to-sponsor exits took up 58.3% of Q2's exit value and 59.3% of exit count, while exits to corporates took up 37.7% of exit value and 39.8% of exit count. Exclusive of new listings, sponsor-to-sponsor exit value popped from 43.2% of middle-market exits in Q1 to 60.7% in Q2. YTD, exits to other sponsors as a share of middle-market exit value (exclusive of IPOs) are up 163 basis points at 50.2% but still below the five-year average of 53.5%. Middle-market sponsors remain confident that there is appetite for sponsor-to-sponsor exits. Large PE firms have successfully fundraised over the last two years and are sitting on plenty of dry powder. At the same time, sponsors have been bogged down by higher borrowing costs and reduced access to credit to finance LBOs. This means sponsors will be motivated to execute on smaller transactions to bolt onto their larger portfolio companies or to grow into another platform.

Exit to corporates

Exits to corporates dropped during the quarter, sliding down to less than 40% of the middle-market's exit value when excluding public listings, compared to 56.8% in Q1. While it is too soon for quarterly changes to be meaningful, the turn in the steady pace shown by exits to corporates demonstrates the eclectic nature of exit opportunities to strategics. A slowed economy has been pushing many companies to

PE buying to selling and the net exit gap ($B)



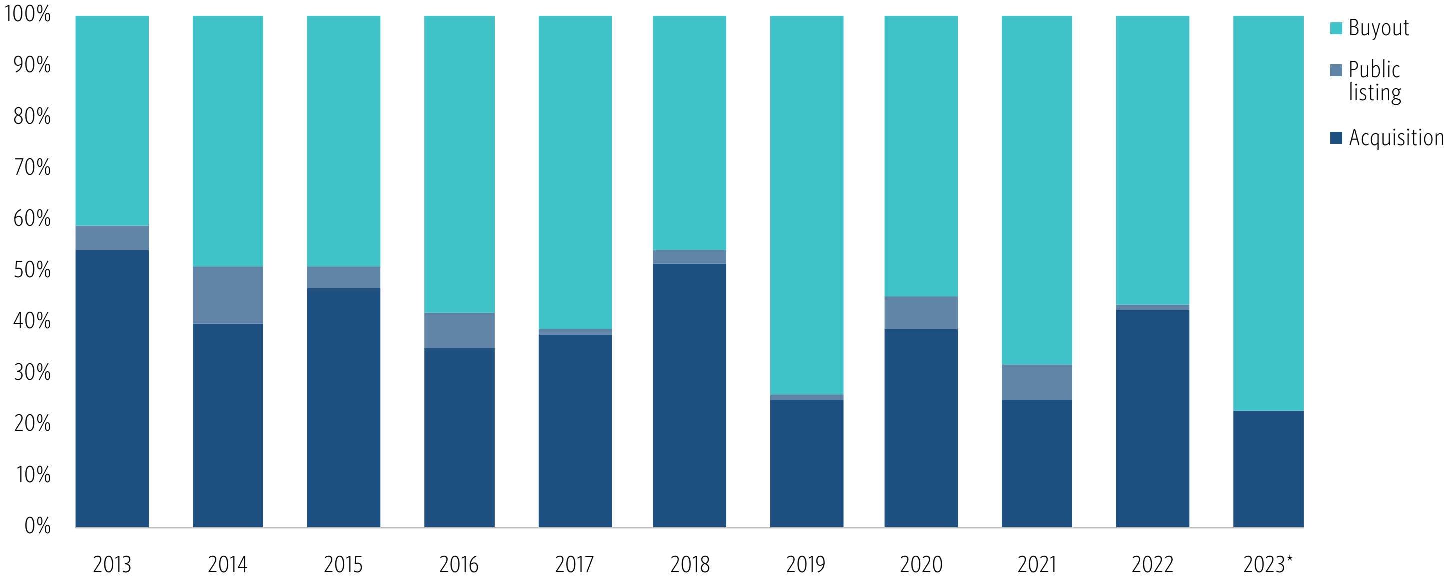
Source: PitchBook • **Geography:** US
*As of June 30, 2023

protect their balance sheets, but those with the ability to pursue acquisitions continue to absorb PE-backed companies. In fact, US companies are holding near-record amounts of cash on hand, with corporate cash holdings rising above $4.0 trillion in Q1 2023—just 3.3% shy of its all-time high.[21] Corporations with appetite for strategic investments can fund acquisitions with relative ease, and slowing growth in corporate profit increases interest in buying revenue through acquisitions. The median size of exits to corporates also remains strong at $277.5 million, which is greater than that of 2022.

Energy companies made up the two largest exits to corporates for Q2, driven by the industry's consolidation wave and push toward energy transition. In June, EnCap Investments sold Forge Energy II to Vital Energy and Northern Oil & Gas for $540.0 million. The joint acquisition of the exploration & production (E&P) company strengthens the buyers' position in the Delaware Basin and provides opportunities for further development. Similarly, in July, Carnelian Energy Capital and Old Ironsides Energy exited Percussion Petroleum II for $537.5 million to Callon Petroleum. Through the transaction, Callon Petroleum will strengthen its oil and gas inventory in the Permian basin, an area known for high productivity and undeveloped reserves.[22]

21: "Why Are US Companies Hoarding So Much Cash?" Kellogg Insight, Michael Faulkender, Kristine W. Hankins, and Mitchell A. Petersen, April 29, 2022.
22: "Callon Petroleum Buys Permian Asset for $475 Million, Exits Eagle Ford," Reuters, Sourasis Bose, May 4, 2023.

Share of healthcare PE middle-market exit value by type

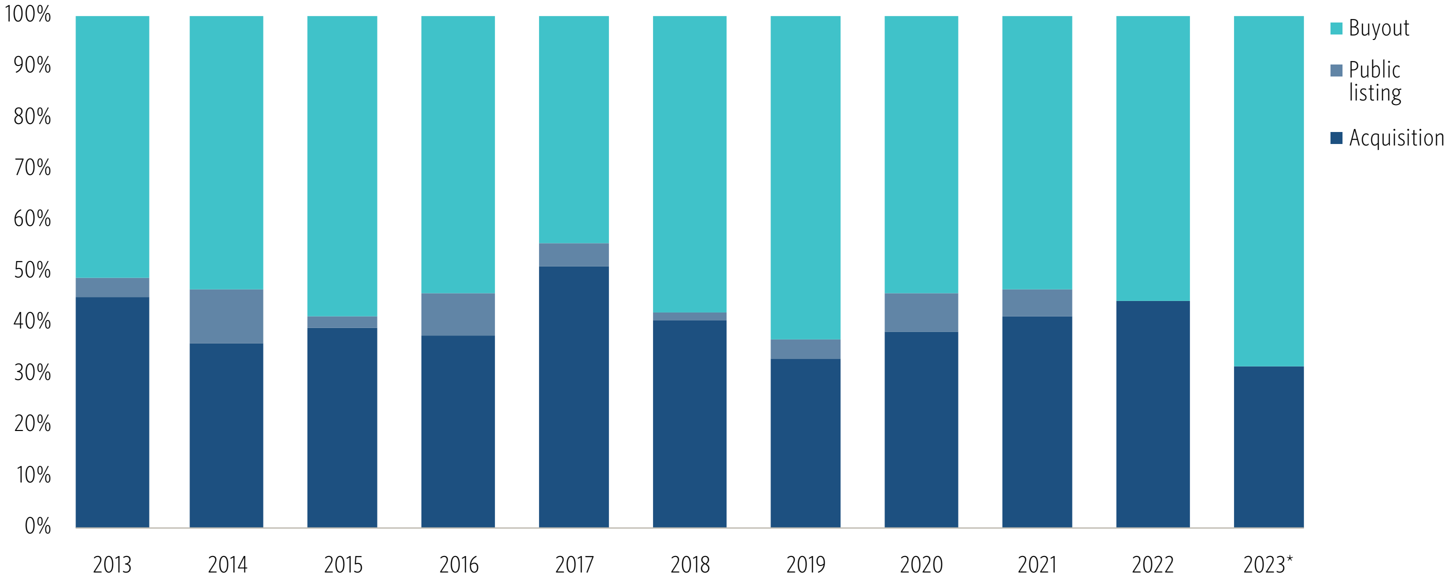


Source: PitchBook • **Geography:** US
*As of June 30, 2023

Healthcare

Relative to other sectors, healthcare continues to be a weak spot in middle-market exits, with its share of middle-market exit value down 8.6% YTD. Healthcare saw the greatest YTD decline in both exit count and exit value of all the sectors. Sponsors are slow to exit their portfolio companies as they wait for better pricing and the industry continues to face headwinds from labor costs and inflation. Sponsor-to-sponsor exits have been lackluster this year as PE firms turn their attention instead to carveouts and take-privates. Greater focus on cost cutting over growth-fueled capital allocation also drove down exit opportunities to corporates. The middle market provides targets for add-on activity for platform companies, but with interest rates set high, heavily leveraged platforms are struggling with growing debt costs and impending maturity walls and therefore have reduced appetite for acquisitions. Healthcare platforms are increasingly bringing in new minority investors to restructure or support additional growth while they delay exits. For the middle market, healthcare exit activity was skewed toward sponsor-to-sponsor transactions, with 14 exits to sponsors for an aggregate of $2.4 billion so far in 2023 compared to eight exits to strategics for an aggregate of $0.7 billion. Frazier Healthcare Partners' $323.3 million sale of United Digestive to KKR and Ares is the largest exit in the middle market YTD, save for the roll-up of ImageFirst into a continuation fund. United Digestive is one of the largest gastroenterology physician practice management firms in the US and will continue to build scale for its fully integrated platform. Much like for the broader PE environment, the buyer-seller price gaps are narrowing, which would push along exit activity as GPs begin to accept lower valuation multiples to realize their assets. We expect more sponsors to bring their well-performing assets to market by the end of the year with the growing sense of stability in inflation, interest rates, and the debt market.

Share of technology PE middle-market exit value by type



Source: PitchBook • **Geography:** US
*As of June 30, 2023

Technology

On the other hand, IT remains a strong source of PE exits relative to other sectors. With 50 exits for an aggregate of $10.7 billion, IT accounts for 16.0% of middle-market exit count and 20.7% of exit value YTD, which is an increase of 2.3% and 7.5%, respectively, since Q4 2022. Exit activity has dropped quarter-to-quarter, and H1 exit activity remains far below the halfway point of the annual averages seen before COVID-19 (2017 to 2019), but investors expect activity to pick back up as valuation gaps reduce thanks to the sector's long-term fundamentals. The megatrend of digitization persists across sectors, and enterprise software verticals are expected to experience strong growth with organizations accelerating their digital strategies.[23]

The middle market can also take advantage of macroeconomic headwinds to offload smaller tech companies to buyers. The higher cost of debt and the decline in tech valuations led to an increasing appetite for smaller transactions, which the middle market can cater to by offering companies small enough to not require lots of leverage and suitable for add-ons to accelerate growth in a slowed economy. For example, Global Leveraged Capital and Kayne Anderson Capital Partners exited Video King, a developer and manufacturer for the electronic gaming industry, to Everi for $59.0 million in May. The acquisition is expected to provide Everi, a casino gaming content and product provider, with complementary assets and an established customer base to support further scale in its gaming segment.[24] Everi has acquired several companies in the past few years to drive additional growth in product capabilities and market reach, such as its acquisition of certain strategic assets of Venuetize in Q4 2022 to expand its reach beyond casino gaming for the first time and build its mobile capabilities.[25]

The largest tech exit in Q2 was the $525.0 million sale of cloud-based risk management company Fusion Risk Management to Great Hill Partners.[26] The sellers—Vista Equity Partners, Catalyst Investors, and Level Equity—will remain as minority investors as the company enhances its go-to-market and product innovation capabilities under Great Hill Partners. The company is poised to capitalize on the evolving risk landscape with its capabilities in data-driven insights and its flexible platform.[27]

23: "IDC Forecasts a Robust Market for Enterprise Applications as Organizations Pursue Digital Era Strategies," IDC, Michael Shirer, August 1, 2023.
24: "EVERI to Acquire Assets of Video King, a Leading Integrated Electronic Bingo Gaming Device and Systems Provider," Cision PR Newswire, Everi Holdings Inc., April 11, 2023.
25: "Everi to Acquire Strategic Assets of Mobile-First, Guest Engagement Technology Innovator, Venuetize," Cision PR Newsire, Everi Holdings Inc., October 4, 2022.
26: "Fusion Risk Management Announces Strategic Growth Investment from Great Hill Partners," Business Wire, April 26, 2023.
27: Ibid.

A WORD FROM BAKER TILLY

PE dealmaking in the middle market: A surprising resilience

Which macro trends do you think are going to be most momentous for the US middle market in the remaining months of this year? Which ones are you watching most closely heading into next year?

In terms of macro trends, outside of general economic performance, we pay close attention to how the credit markets are functioning. We have had the convergence of generally tighter credit standards along with a historic increase in the cost of capital, with risk-free rates bouncing from about zero late last year to more than 5% as of August 2023. When you look at floating-rate debt, which many middle-market companies and deals are financed with, it is now not uncommon to see double-digit current pay interest rates. This is putting a fair amount of pressure on what can be accomplished in terms of traditional leveraged buyouts and, consequently, valuations. However, significant dry powder remains in terms of available private equity commitments, and private credit has stepped in where traditional banks have retreated.

In terms of next year, it will most likely be similar in terms of paying close attention to the credit markets, as they are often the canary in the coal mine, so to speak. It is currently unknown what the lag effect may be from these significant rate increases, how persistently high they will remain, and whether there is any further slack that private credit is unwilling or unable to absorb. In addition, the Treasury yield curve inversion that we are currently experiencing is often considered a harbinger for a recession, but the economy remains seemingly resilient.

One thing that investors are unlikely to forget is that vintage funds from times of economic downturns are often high performers. Although this is something that nobody could predict, we are seeing continued activity in middle-market M&A.

From the perspective of your practice, which key trends are you watching most closely at this point in the year? How have they evolved since the start of the year?

Marc Chase
Principal, Private Equity Practice Leader
marc.chase@bakertilly.com

Marc is a seasoned professional with operational and board-level proficiency in private equity investments. As the leader of Baker Tilly's national private equity practice, he offers tailored services for middle-market investors and their portfolio companies. From pre- to post-transaction, Baker Tilly provides specialized support, ensuring clients achieve growth and success throughout the entire lifecycle.

Frank Walker, CPA
Partner, Transactions and Financial Advisory Practice Leader
frank.walker@bakertilly.com

Frank leads Baker Tilly's Transactions and Financial Advisory practice. He brings to market key service offerings, including transaction advisory, strategy consulting, CFO advisory, and capital markets advisory. With more than 25 years of public accounting, consulting, and industry experience, Frank specializes in mergers & acquisitions and has directly led or advised on transactions valued in the tens of billions.

One crucial aspect we focus on is tracking the number of sell-side transactions within our investment bank or transaction advisory services group. This serves as a leading indicator for potential robust M&A activity in the future. An interesting observation we've made is the rise in the number of companies considering coming to market. Investment banks are actively considering bringing more companies to market in the fall. This trend suggests that businesses are becoming more willing to engage in transactions and are accepting the current market conditions.

The sell side serves as an indicator of activity because it is followed by the buy side, where companies are brought to market, typically within an approximately 90-day lag.

However, we must consider the impact of debt markets on this. When debt becomes more costly, it adds pressure to the purchase price, which, in turn, may force sellers to accept potentially lower sale prices or walk away in hopes of better market conditions.

Another significant trend we closely monitor is earnings. Considering macroeconomic conditions and inflation, it is hard to determine how much of the input cost increases can continue to be passed on or how much margin erosion may occur if businesses are no longer able to pass the increases on. Fortunately, when looking at the entire portfolio, aside from factors tied to the capital structure, such as interest rates, earnings seem to have held up well, demonstrating the resilience of the consumer market.

Which of your clients' current concerns are the most complex, and why?

From the perspective of our clients, the most complex concerns we are currently focused on revolve around determining their true cost structure, which presents a complicated analysis considering the speed at which changes in cost have occurred. They are grappling with questions about the extent of labor cost increases and other input costs. While certain factors may have subsided, the reality is that companies have experienced significant increases in everyday expenses, such as electric and water bills, among others. All of this raises important considerations about pricing strategies and determining what can be passed on to customers without risking potential margin erosion.

What has surprised you the most in PE dealmaking in the US middle market thus far this year?

The most surprising aspect in PE dealmaking this year is the remarkable resilience exhibited despite a significant shift in interest rates from nearly 0%. The speed at which this change occurred was unprecedented. Despite such a substantial shift, dealmaking did not come to a halt; it did slow and evolve over time. We noticed a decrease in platform deals and a notable increase in add-ons and tuck-in transactions. This outcome is unexpected because typically, models display high sensitivity to interest rate increases, leading one to expect a more significant impact in such a scenario. However, this situation underscores the remarkable resilience of our economy and this asset class as it continues to find ways to generate returns for investors. So, while we remain active working on deals, they might not be occurring at the same pace as before. Nevertheless, the market remains open for business.

To what degree do you think risks in private credit are factoring into US middle-market PE dealmaking thus far this year? From the vantage point of your practice, how is that dynamic affecting the market beyond dealmaking?

It is evident that private credit has played a significant role in the US middle market and experienced an enormous influx of capital, filling some of the void left by banks. Providers have stepped in where regulated banks could not offer certain loans, thus leading to notable shifts in covenants and credit standards and influencing the dealmaking landscape.

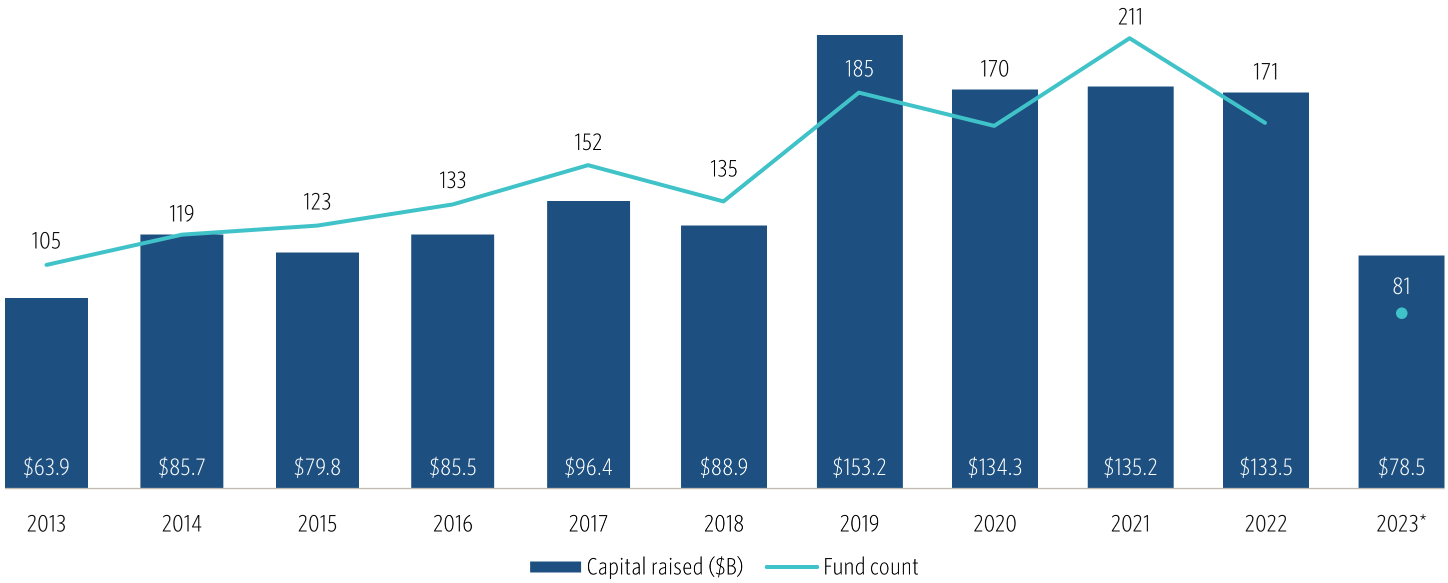
It will be interesting to see how they mature, as many providers have operated mostly in a zero-rate environment. Underwriting is becoming more difficult as rates rise, interest coverage becomes more problematic, and the ability to refinance some of these credits may be more limited.

This situation will differentiate proficient private equity groups from others. Interestingly, those adept at blending credit and equity in turnkey financing might uncover unique opportunities in this evolving landscape.

Uncertainty looms over the future implications of these dynamics, sparking curiosity about what lies ahead. Nevertheless, private credit has a significant and growing role in funding growth in dealmaking.

Fundraising and performance

PE middle-market fundraising activity



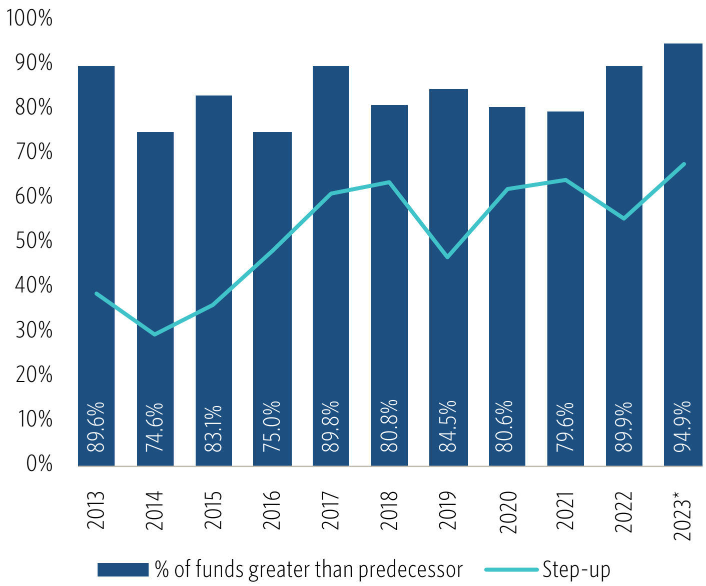
Source: PitchBook • **Geography:** US
*As of June 30, 2023

Overview

The pace of fund closings cooled somewhat in the middle-market space as 38 funds closed on $24.2 billion in Q2, reverting to the space's more historic norm of $25 billion to $30 billion raised per quarter. That's down from the torrid pace of Q1, when more than $50 billion in closings occurred. Despite the sequential slowdown from Q1, middle-market fundraising is still more than 25% ahead of last year. And at $78.5 billion raised YTD, the middle market is on track for its best fundraising year ever. The median middle-market fund size has increased sharply compared with last year, with the Q2 2023 median of $680.5 million up from $439.6 million in 2022 and $343.7 million in 2021.

GPs in the middle market have been successful in increasing the size of their funds. Through the first six months of 2023, 94.9% of middle-market funds closed at greater sizes—also a new record—for a median step-up of 67.9% relative to their predecessor funds. This surpassed the industry as a whole, wherein 79.1% of all US PE funds achieved a step-up YTD, and is nearly 500 basis points higher than in 2022, when 89.9% of all middle-market funds received a step-up. For example, Warren Equity Partners closed its fund IV on $1.4 billion in Q2, a 108.0% step-up from its predecessor fund, which raised $673.0 million.

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

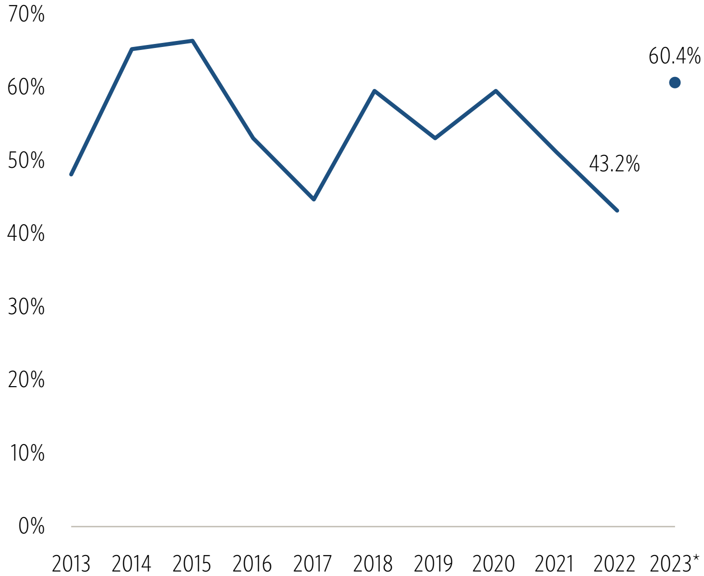


Source: PitchBook • **Geography:** US
*As of June 30, 2023

On a fund count basis, the middle market accounted for 55.6% of all buyout funds closed in the first half of 2023. This is well above 2022's 29.6% and the 10-year average of 36.1%. Furthermore, middle-market funds captured the majority of total funds closed on a dollar basis in H1, at 60.4%. This is a significant increase from the 43.2% of total capital raised in 2022 and above the 10-year average of 54.5%. This step-up indicates LPs are delaying or slowing commitments to PE megafunds, likely because of the denominator effect. Meanwhile, the middle markets have been bolstered by more compelling deal valuations in this size range, thus making it easier to compensate for the lack of leverage and higher borrowing costs. This creates greater potential upside for middle-market funds that are able to acquire companies more cheaply.

Investors continue to commit capital to middle-market managers but are fighting to keep up with the demand for capital while still battling the denominator effect. As a result, the time to close funds has expanded. The median time to close has stretched to 15.7 months so far this year, up from 11.8 months in 2022, while the time between funds contracted slightly to 2.9 years from 3.2 years.

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



Source: PitchBook • **Geography:** US
*As of June 30, 2023

Recent closings

Unlike Q1, which saw six outsized middle-market funds closing in the $3 billion-to-$5 billion range, Q2 featured a more normal flow of core middle-market fund closings, all below $2.5 billion.

In June, Altaris Capital Partners raised the largest fund of the quarter, holding the final close of its fifth healthcare flagship fund at $2.4 billion. Fund V was more than double the size of Fund IV, with the firm now targeting $3.0 billion for its Fund VI. Sun Capital Partners closed its eighth flagship fund with $1.4 billion in committed capital. The firm focuses primarily on acquiring middle-market companies in the business & consumer services sector. Warren Equity Partners closed its Warren Equity Partners Fund IV with $1.4 billion in April, exceeding its initial target of $1.2 billion to invest in industrial and other business services. Also notable was the closing of the largest continuation fund of the year. Insight Partners Continuation Fund II was closed in May with $1.3 billion of total commitments, including secondary specialists HarbourVest and Lexington Partners. The fund will target stakes in software companies across six of Insight's legacy funds. Two other continuation funds closed during the quarter in what is likely to be a growing area of fundraising moving forward: the sub-$5 billion category.

Notable recent PE middle-market funds*

Manager	Fund	Close date (2023)	Fund size ($M)
Altaris Capital Partners	Altaris Health Partners V	June 13	$2,350
GrowthCurve Capital	GrowthCurve Capital Partners I	June 13	$1,400
Sun Capital Partners	Sun Capital Partners VIII	May 31	$1,417
MidOcean Partners	MidOcean Partners VI	April 4	$1,500
Accel-KKR Capital	Accel-KKR Capital Partners VII	March 30	$4,400
Parthenon Investors	Parthenon Investors VII	March 27	$4,500
STG	STG Fund VII	March 23	$4,200
Arcline Capital	Arcline Capital Partners III	March 21	$4,500
Greenbriar Equity Group	Greenbriar Equity Fund VI	February 6	$3,475
Patient Square Equity Partners	Patient Square Equity Partners	February 1	$3,900

Source: PitchBook • **Geography:** US
*As of June 30, 2023

Emerging managers

The middle market is the sweet spot for emerging managers, which we define as managers with three or fewer funds launched, including first-time managers. Emerging managers accounted for 14.5% of fundraising in H1, rebounding from 2022's all-time low of 9.1% and above the five-year average of 11.8%.

In May, Integrum Holdings closed its inaugural fund, Integrum Capital Partners Fund, with $1.1 billion in committed capital. The fund will invest in technology-enabled service companies in the financial and business services sectors. The fund has made four investments to date, three of which were insurance-related investments, including in USI Insurance Services, Evertree Insurance, and Strategic Risk Solutions. The fourth investment was MerchantE, a developer of fintech payment platforms, which Integrum sold to a strategic acquirer in November 2022.

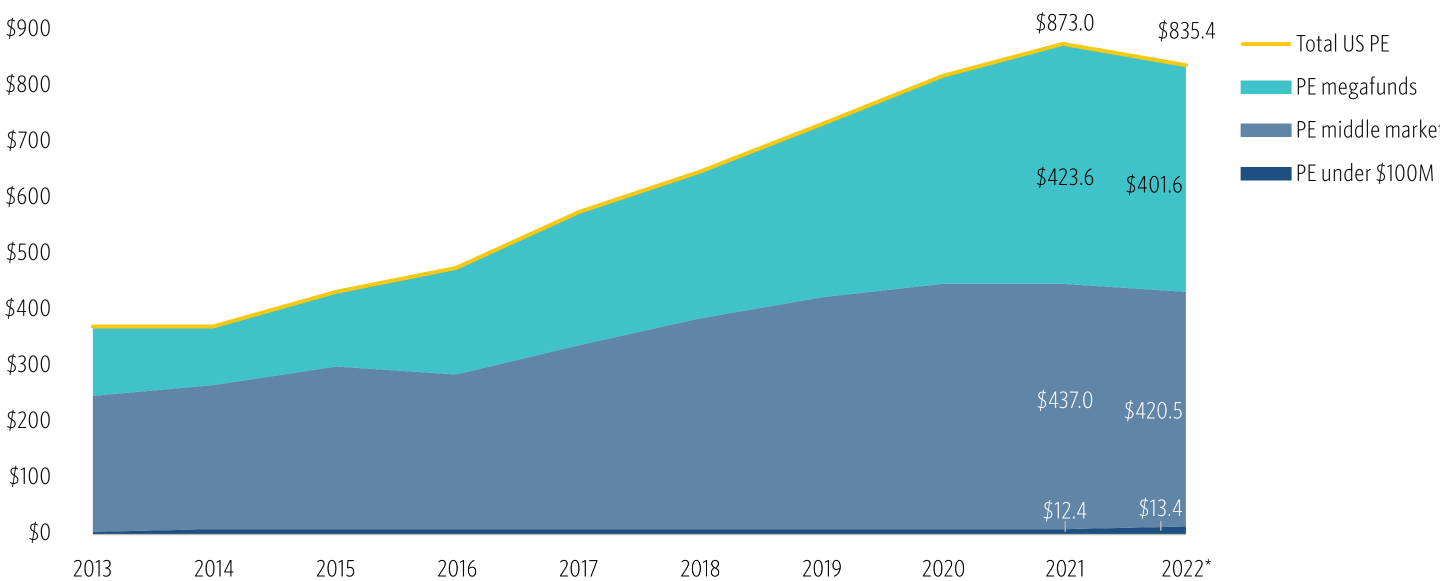
Similarly, LightBay Capital closed its second fund on $1.04 billion. The firm is led by former Ares Management executives and will invest its sophomore fund in tech-enabled services in the business, healthcare, and consumer services industries. An unusual aspect of LightBay's funds is that the firm offers a fixed amount of its management fees and carried interest to its LightBay Foundation, whose goals are to provide access to high-quality education and expand access to healthcare and other basic needs to underserved families.[28]

In June, GrowthCurve Capital announced the final close of its maiden fund with $1.4 billion in committed capital. GrowthCurve has a distinctive approach to building businesses and accelerating growth through AI and digital transformation. As of the fund's closing, it has invested approximately 50% of its capital commitments across four investments, spanning all three of the firm's focused sectors.

Dry powder

As of the end of 2022, middle-market PE funds held $420.5 billion in dry powder, equivalent to 50.3% of all dry powder across the US PE complex. While middle-market dry powder has decreased slightly since peaking in 2021, it is still well above the pre-COVID-19 (2017 to 2019) median dry powder of $370.1 billion. As a percentage of total AUM, middle-market dry powder has also declined from the 2021 peak by 190 basis points. This compares to a 147 basis-point decline in dry powder as a percentage of AUM held by megafunds. Dry powder is in runoff mode as PE managers are calling and deploying capital at a slightly faster pace than new capital is being raised.

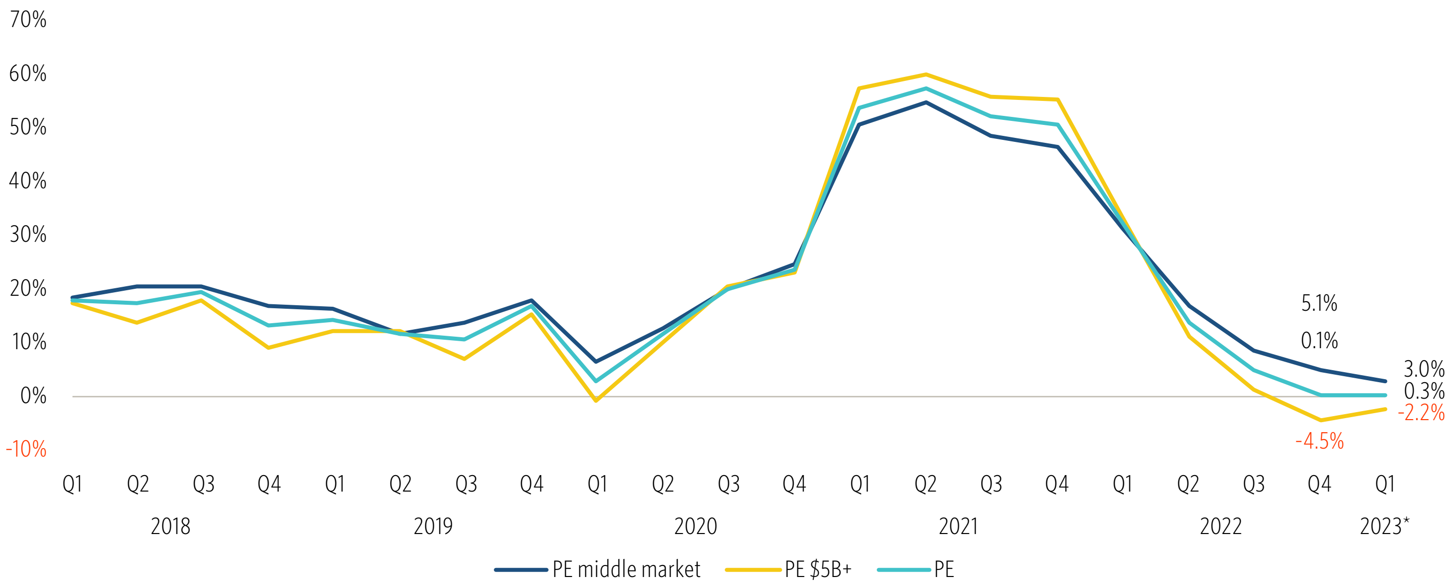
PE middle-market and overall dry powder ($B)



Source: PitchBook • **Geography:** US
*As of December 31, 2022

28: "LightBay Capital Raises Over $1 Billion for its Second Private Equity Fund," LightBay Capital, May 10, 2023.

Rolling one-year PE fund performance by size category



Source: PitchBook • **Geography:** US
*As of March 31, 2023

Performance

Based on our final return data, the median returns by middle-market buyout funds pulled away from megafunds for three consecutive quarters heading into 2023. Pooled one-year horizon IRRs equaled 5.1% for middle-market funds as of Q4 2022, well ahead of megafunds, which recorded an IRR of -4.5%. The 965 basis points of outperformance by middle-market funds was the widest gap since 2016 and marks a sharp reversal from Q4 2021, when megafunds outpaced middle-market funds by a similar margin.

Prior periods of outperformance by middle-market funds have lasted anywhere from one to three years, and we have entered the beginning of that range. Our preliminary data for Q1 2023 points to a rebound by megafunds and a narrowing of underperformance. Megafunds posted an indicative one-year horizon return of -2.2% versus the middle market at 3.0%. In all likelihood, this reflected the strong rally in public markets, which have more of a positive knock-on effect to megafunds than middle-market funds. However, given that the public market rally broadened out to mid- to small-cap companies in Q2, we expect middle-market fund returns to hold their own.

We would expect megafunds to regain their appeal and middle-market funds to lose their relative attraction if interest rates were to lurch downward. This would likely lead to improved access to debt financing for large LBOs and boost returns looking forward. Barring that, conditions favor the middle market in the short term.

Q2 2023 US PE middle-market lending league tables

Overall

Rank	Company	Deal count
1	Audax Private Debt	75
2	Ares	40
3	Churchill	31
4	MidCap Financial	28
5	Antares Capital	26
6	Twin Brook Capital Partners	24
7	Truist Financial	23
8	Monroe Capital	22
9	J.P. Morgan	20
10	Barings	19
11	Citizens Financial Group	18
11	BMO Financial Group	18
13	Golub Capital	17
14	Mitsubishi Financial Group	13
15	PNC	12
15	Morgan Stanley Private Credit	12
17	Capital One	11
17	KeyBank	11
19	Fifth Third Bank	10
19	The Goldman Sachs Group	10
19	Main Street Capital BDC	10
19	Crescent Capital	10
23	Owl Rock	9
23	Wells Fargo	9
25	NXT Capital	8
25	Apollo Global Management	8
25	First-Citizens Bank & Trust	8
25	Bank of America	8
25	MidCap Financial Investment BDC	8

Source: PitchBook

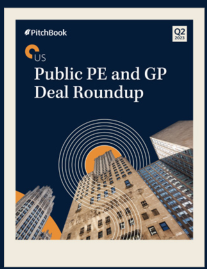
Select roles*

Rank	Company	Deal count
1	MidCap Financial	28
1	Audax Private Debt	28
3	Antares Capital	26
4	Churchill	23
4	Twin Brook Capital Partners	23
6	Truist Financial	19
7	Citizens Financial Group	18
7	Monroe Capital	18
9	J.P. Morgan	17
10	BMO Financial Group	16
11	Golub Capital	14
12	Mitsubishi Financial Group	11
13	Barings	10
13	Ares	10
15	KeyBank	9
16	NXT Capital	8
16	Capital One	8
18	PNC	7
18	Crescent Capital	7
20	Regions Financial	6
20	Varagon Capital Partners	6
20	Truist Securities	6
20	Deutsche Bank	6
20	WhiteHorse Capital	6
20	Fifth Third Bank	6
20	The Goldman Sachs Group	6
20	Barclays	6
20	Bank of America	6
20	Morgan Stanley Private Credit	6

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

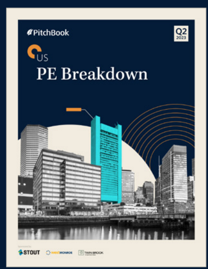
Additional research

Private markets



Q2 2023 US Public PE and GP Deal Roundup

Download the report here

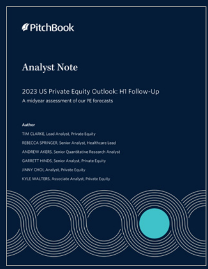


Q2 2023 US PE Breakdown

Download the report here

Q2 2023 Global M&A Report

Download the report here



2023 US Private Equity Outlook: H1 Follow-Up

Download the report here

More research available at pitchbook.com/news/reports