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US PE Middle Market Report

Q3 2020

Contents

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Introduction

After a sluggish Q2, mid-market PE deal activity rebounded as expected in Q3. Strong demand for new debt issuance and a modest economic thawing encouraged dealmakers to pursue buyouts once again. The use of add-on deals—a trend already underway pre-pandemic—became particularly popular. These deals tend to be smaller and are often viewed as less risky since the platform investment is already in place. Looking ahead to 2021, we expect the risk-on atmosphere resulting from central bank stimulus and exemplified by tightening credit spreads to promote further recovery in PE dealmaking.

Middle-market exit activity lagged in the first three quarters of 2020. PE firms are still waiting for a more amenable exit environment in which to sell portfolio companies. For the first time since 2009, there has been a substantial reduction in sponsor-to-sponsor exit activity, while middle-market exits via IPO have been almost nonexistent in 2020. One silver lining in the exit market has been the rise of SPACs (special purpose acquisition companies, sometimes called blank check companies), which we expect to become a meaningful liquidity path for PE-backed companies next year.

Middle-market fundraising continues to trail 2019's record-setting pace. First-time and sophomore funds have struggled, while more established managers are finding success through remote fundraising. However, for middle-market GPs of all types, hope is on the horizon. Lower interest rates signify that many pensions and other institutional investors will likely be unable to meet return targets with traditional fixed income, providing incentive for the move toward higher-yielding alternatives, including PE.

Dylan Cox
Lead Analyst, PE

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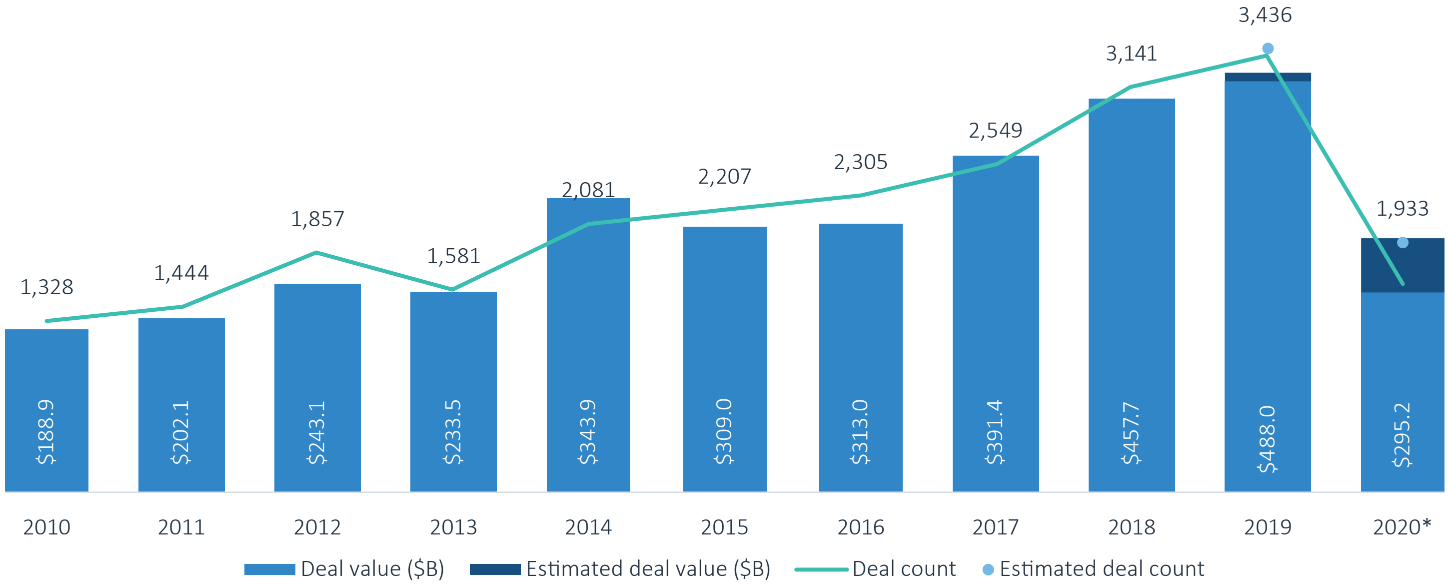
Overview

Middle market PE deal activity



Source: PitchBook | **Geography:** US
*As of September 30, 2020

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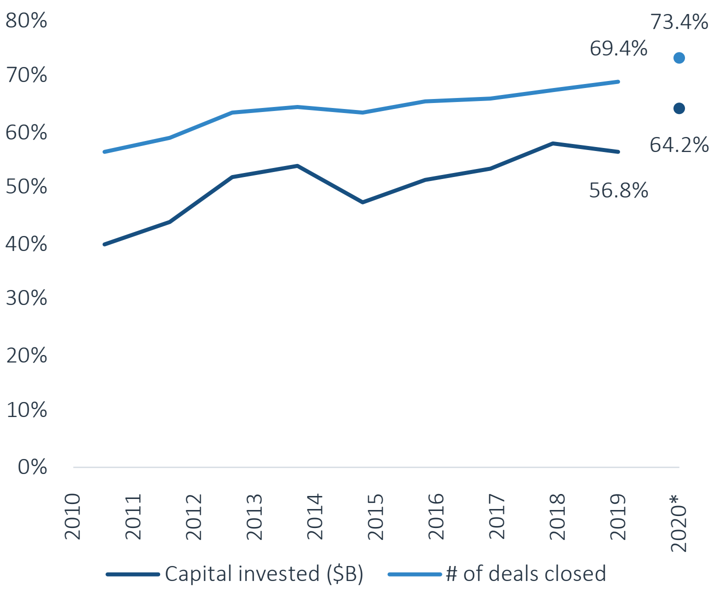
Following its slowest quarter in years, middle-market PE deal activity rebounded modestly in Q3 2020. Despite the spotty economic reopening, an insatiable appetite for credit coupled with the realization that the deals can be completed remotely encouraged dealmakers during the COVID-19 pandemic. US PE middle-market activity totaled $295.2 billion across 1,933 transactions through Q3 2020. In terms of both capital invested and total number of deals, this data puts the year almost on pace with 2017's figures. However, these numbers are well above what many had forecast amid the depths of the widespread market sell-offs in March and April. Looking ahead to the final quarter of the year, we expect deal activity to be further propelled by booming public equity markets and recently lowered interest rates, which have already triggered a risk-on sentiment felt not just in PE but also across asset classes and strategies.

One of the effects of this risk-on environment is that high-yield credit spreads have compressed to their lowest levels since February, before the pandemic took hold of global markets. This compression reflects a reach for yield that makes it not only easier for companies to issue debt for much-needed capital during this slowdown, but also for sponsors to finance new acquisitions. High-yield bonds and broadly syndicated loans, which are the bread and butter of LBO debt financing, have seen record issuance this year. Direct lending funds—which cater more to smaller and middle-market transactions—have benefited from a similar reach for yield over the last decade. All of these factors, along with continued Fed stimulus, will grease the wheels of PE dealmaking, but it is likely to be a quarter or two before most of these transactions close and appear in our data.

In addition to easily available credit, one of the main ways in which PE deal flow rebounded in Q3 was through acquiring middle-market companies as add-ons. These deals tend to be smaller and are often viewed as less risky since the platform investment is already in place. In certain cases, sponsors used the pandemic-induced volatility to take over a smaller competitor. In others—such as in the healthcare sector where add-ons are most popular—pre-pandemic rollup plans proceeded as usual. Middle-market add-ons have accounted for nearly half of all US PE deals through Q3 2020, which has resulted in smaller deal sizes across the board. The median mid-market deal size is just $157.0 million through Q3 2020, lower than any year since 2016. We expect add-ons' relative importance to ebb once the economy fully recovers post-pandemic, but when that will happen is anyone's guess.

Overview

Middle market add-ons as % of PE deal flow



Source: PitchBook | **Geography:** US
*As of September 30, 2020

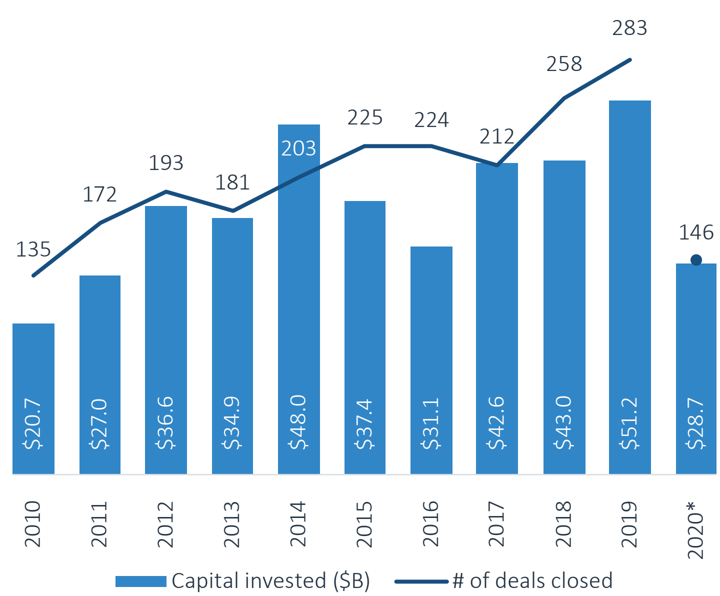
High-yield credit spreads

Source: Ice Data Indices, LLC, ICE BofA US High Yield Index Option-Adjusted Spread | **Geography:** US
*As of December 4, 2020

One of the larger middle-market deals of the quarter reflects two major trends in M&A this year: pandemic-caused economic carnage and heightened trade tensions between the US and China. Harbin Pharmaceutical Group—majority owned by Hong-Kong based CITIC capital—agreed in June to purchase vitamin retailer GNC out of bankruptcy. Harbin was already GNC's largest shareholder, but the takeover bid drew scrutiny from US Senator Marco Rubio, who called on CFIUS[1] to examine the deal (although it was ultimately approved). The deal also reflects the tough economic environment for retail businesses. GNC struggled amid the lockdowns this year and filed for chapter 11 bankruptcy, which forced a sale. Although bankruptcies have not been as widespread this year as many expected, we are likely to see more buyouts via bankruptcy proceedings if the pandemic lingers without further governmental stimulus.

We also expect the pandemic to cause a resurgence of carveouts and divestitures, especially from publicly traded companies looking to generate cash—although that hasn't yet materialized in 2020. 146 mid-market carveouts have been completed through Q3, putting 2020 on track for the slowest year since 2013. While these types of transactions tend to be more common above the middle market, there are other reasons for their infrequent occurrence this year. The previously mentioned piping hot public equity and credit markets are giving companies plenty of other avenues through which to raise capital for the time

Carveout and divestiture activity



Source: PitchBook | **Geography:** US
*As of September 30, 2020

being. But companies taking on too much debt now will eventually see the bill come due, which is precisely the time PE firms will be expected to step in. In September the DOJ introduced new guidance that names PE firms as potential buyers of units divested from transactions involving antitrust concerns. This bodes well for sponsors hoping to buy out individual arms of larger conglomerates next year.

1: The Committee on Foreign Investment in the United States

Antares: Keynote and Q&A

Light at the end of the tunnel…

Markets and the economy continued to heal in Q3 2020 as US real GDP growth rebounded more sharply than most expected, rising 33.1% after having plummeted 31.4% in Q2. The S&P 500 followed suit with EPS surging 75% and the index rising 9% vs. Q2 2020. Loan markets likewise continued their ascent, with the S&P/LSTA Leverage Loan Index rising 3% during Q3.

Of course, the real light at the end of the tunnel has come with the November news of no less than three new COVID-19 vaccines developed by Pfizer, Moderna, and AstraZeneca—at least two of which claim efficacy rates above 90%.

… but winter is coming

While vaccine development is clearly wonderful news, vaccines don't prevent virus spread—vaccinations do—and we still need to get from here to there. It will take some time for approvals, production, and distribution to ramp up, with widespread availability not expected until perhaps April. In the meantime, COVID-19 cases, hospitalization rates, and business shutdowns have been resurging in the face of a pullback in emergency loan support by the U.S. Treasury and potential gridlock over other stimulus efforts.

Life after COVID… preparing for the next virus

Hopefully, we can all bask in the warmth of better times by the summer of 2021, but as a lender, we always prepare for the worst. While the Fed appears likely to be successful in bridging markets to a post-COVID-19 world, an increased populace of "zombie" companies on the other side are likely to remain vulnerable to unforeseen shocks. Defaults could remain above average for some time. Maintaining financial strength, diversification, seniority in the capital structure, meticulous underwriting, ESG mindfulness, and an alignment with strong PE sponsors and management teams will prove to be as critical as ever.

As a lender, we look forward to working closely with all stakeholders in helping finance a recovery and sustainable long-term growth—whatever other twists and turns the future may bring.

David M. Brackett

CEO, Antares Capital

Dave is a member of Antares' Investment Committee as well as Antares' Board of Directors. Previously, Dave served as president and CEO for GE Antares. He was a founding partner when Antares was formed in 1996. Prior to starting Antares, Dave was a senior executive with Heller Financial.

Q&A

How has Antares and direct lending generally weathered the pandemic thus far?

We have been very pleased at how our teams, borrowers, and PE sponsors have delivered through the crisis thus far, and I would say direct lending as an asset class also seems to have performed well. As of September 30, 2020, approximately 1% of our borrowers were in payment default, and year-to-date specific loan impairments net of recoveries were less than 0.5% of our average loan portfolio outstanding. Looking at leveraged loans more broadly, the S&P/LSTA Index trailing 12 months (TTM) default rate appears to have stabilized in recent months at near 4% as measured by LCD. On the public BDC front, results have varied, but on average non-accruals actually declined slightly in Q3 2020 vs Q2 to about 5.5%. Of course, we are not out of the woods yet, but these results are encouraging.

Has the pandemic changed your thinking at all about how you assess borrower risk? What implications has COVID-19 had for adoption of environment, social, and governance (ESG) criteria from a private debt perspective?

COVID-19 has been a "stress test" like no other in modern history—an event of great human tragedy that shut down large swaths of the economy seemingly in an instant. While the virus' epitaph has yet to be written, we feel the experience thus far has vindicated our preference for lending to sponsor backed companies, being highly diversified across borrowers and industries, and being senior secured first-lien focused.

Clearly, we didn't get all of our underwriting assumptions right. Nobody did. Lenders generally can't underwrite to such sweeping "black swan" events, or they will quickly find themselves out of business for lack of deal flow. That is why we take great comfort in having high-quality sponsors beneath us in the capital structure that are adept at managing through challenging situations and contributing equity when needed. In hindsight, we were also well served by avoiding significant direct exposure to certain highly cyclical segments such as retail, restaurants, hotels, and oil & gas—although, admittedly, this had little to do with us foreseeing the fallout of a global pandemic.

Looking forward, we continue to view rigorous underwriting as a critical driver of superior performance as a lender, and here, ESG plays an important role. Consideration of material ESG risks are really nothing new in one sense. It goes without saying that risks like environmental mismanagement, fraud, workplace safety issues, product liability issues, or cyber security breaches are all garden variety risks a lender will look to mitigate or avoid altogether. However, what has become increasingly apparent and underscored during the COVID-19 pandemic is that companies that are focused on managing ESG tend to be more resilient, well-managed companies. Happily, it turns out that doing well as a PE investor and a lender is well aligned with doing good! As such, we have become increasingly mindful of ESG throughout our investment process. This is another reason we value our sponsor relationships since we can piggyback on their ESG-related due diligence and their influence as equity owners aimed at creating long term value. Lenders have limitations as to how much they can influence management.

Of course, there are also aspirational aims for PE firms and lenders in terms of how we manage ourselves. For example, it's no secret that financial services lags behind other industries around diversity, equity, and inclusion. At Antares, we believe that a more diverse company with disparate voices, where we explore different options and hear different things, is a better company, a more profitable company. We're making strides—with good diversity on our board and a D&I Council that I chair with our CHRO. In addition, we have six affinity groups to represent our employees' voices. Ultimately, we're looking to create a strong culture of inclusion and belonging because we think it's the right thing to do from a societal perspective and will lead to long-term success.

What are your expectations for what lies ahead?

With the recent announcement of very high efficacy vaccines and the resolution of election-related uncertainty of late, it is clear the markets have been justified in looking over the valley to more normal times ahead—perhaps by H2 2021. We have seen a surge in our deal pipeline, which is up over 20% YoY as of the end of November. Much of this is add-on activity, but LBO activity has also picked up sharply.

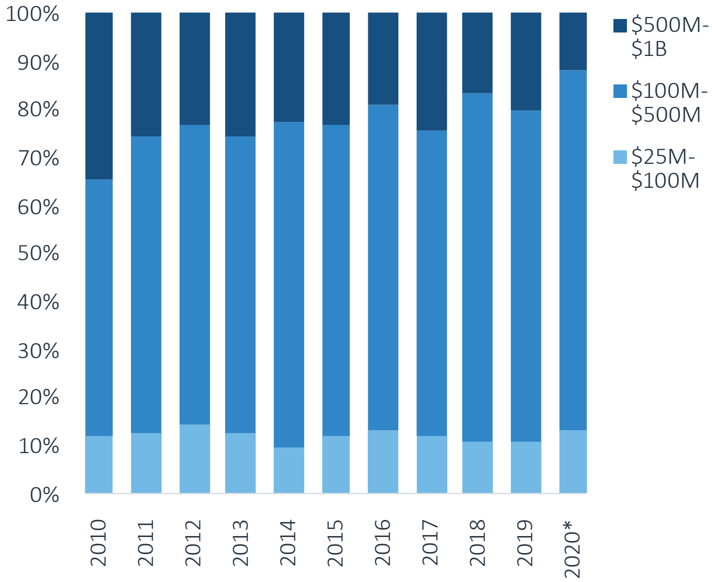
Of course, in the near term, the COVID-19 resurgence remains a threat. Already, the pace of retail sales growth appears to be losing steam (up only 0.3% MoM in October), consumer confidence is waning (down slightly in October), and jobs growth is slowing. Indeed, defaults probably haven't peaked yet, with LCD's late Q3 survey of US leverage loan portfolio managers suggesting the TTM U.S. leverage loan default rate will peak at 6.6% in 2021. However, it should be noted that this peak rate forecast—along with other credit rating agency forecasts—is down roughly 1% from expectations only a few months ago. Also, while loan markets continue to be bifurcated between COVID-19-sensitive and COVID-19-remote sectors, as time passes, the gap will probably continue to narrow as the end of the pandemic gets closer—at which point we could actually see quite a pent up resurgence in travel and other such activity.

Clearly, there are still risks on the horizon, some of which seem to be ever-present, but we are cautiously optimistic that 2021 will be a year of further recovery and repair despite the near-term headwinds.

The information in this report is for informational purposes only, is current as of the date noted and should not be used or taken as finance, legal, or other advice. The information presented should not be deemed as a recommendation to purchase or sell any securities or investments. Although Antares Capital LP believes that the information contained herein has been obtained from sources believed to be reliable, Antares Capital LP does not guarantee its accuracy, and it may be incomplete or condensed. Nothing within this publication should be deemed to be a research report. Past performance is not indicative of future results.

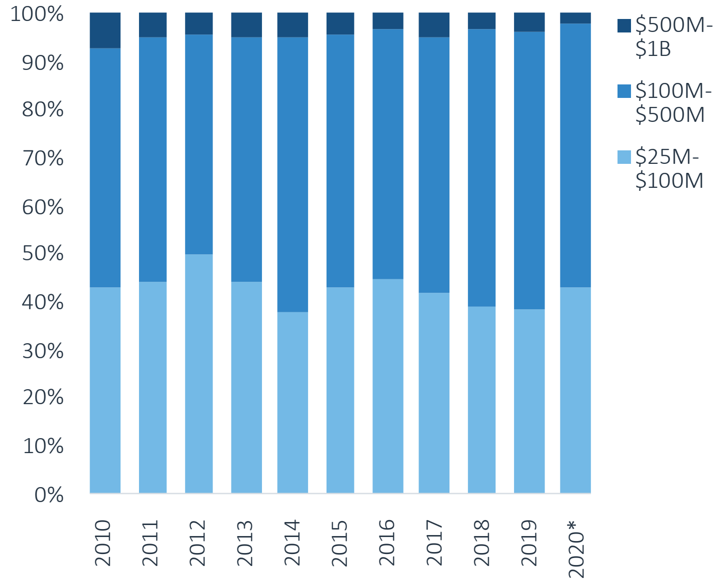
Deals by size and sector

PE MM deals ($) by size



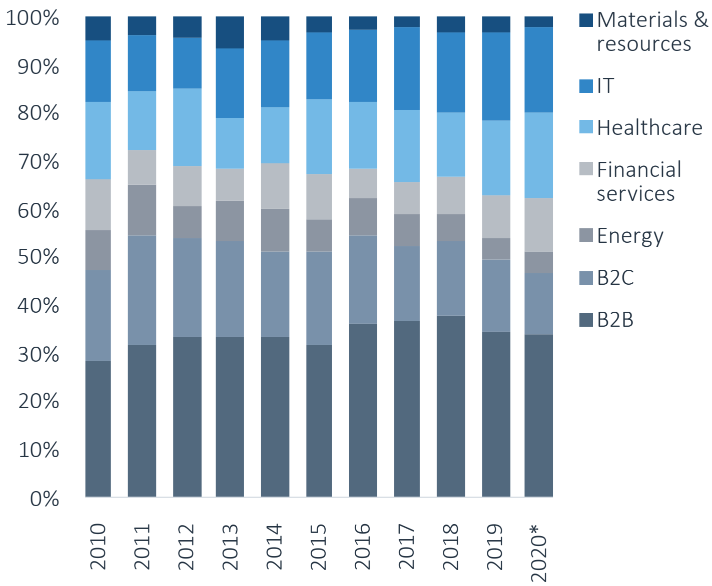
Source: PitchBook | **Geography:** US
*As of September 30, 2020

PE MM deals (#) by size



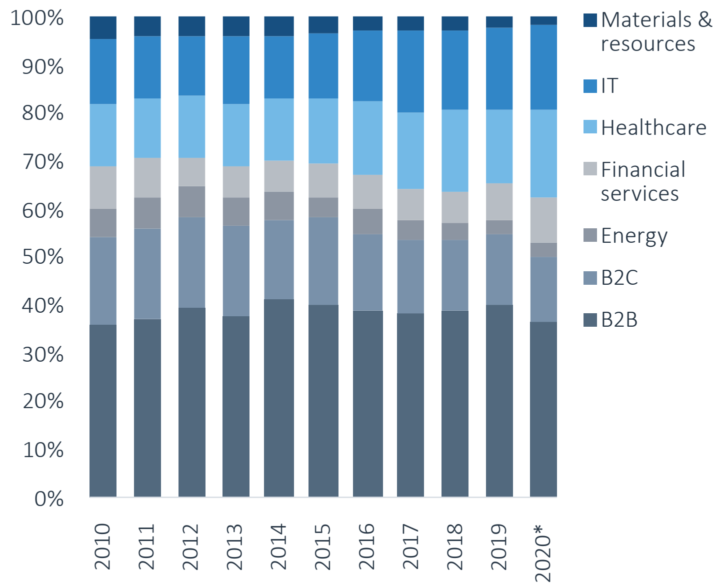
Source: PitchBook | **Geography:** US
*As of September 30, 2020

PE MM deals ($) by sector



Source: PitchBook | **Geography:** US
*As of September 30, 2020

PE MM deals (#) by sector



Source: PitchBook | **Geography:** US
*As of September 30, 2020

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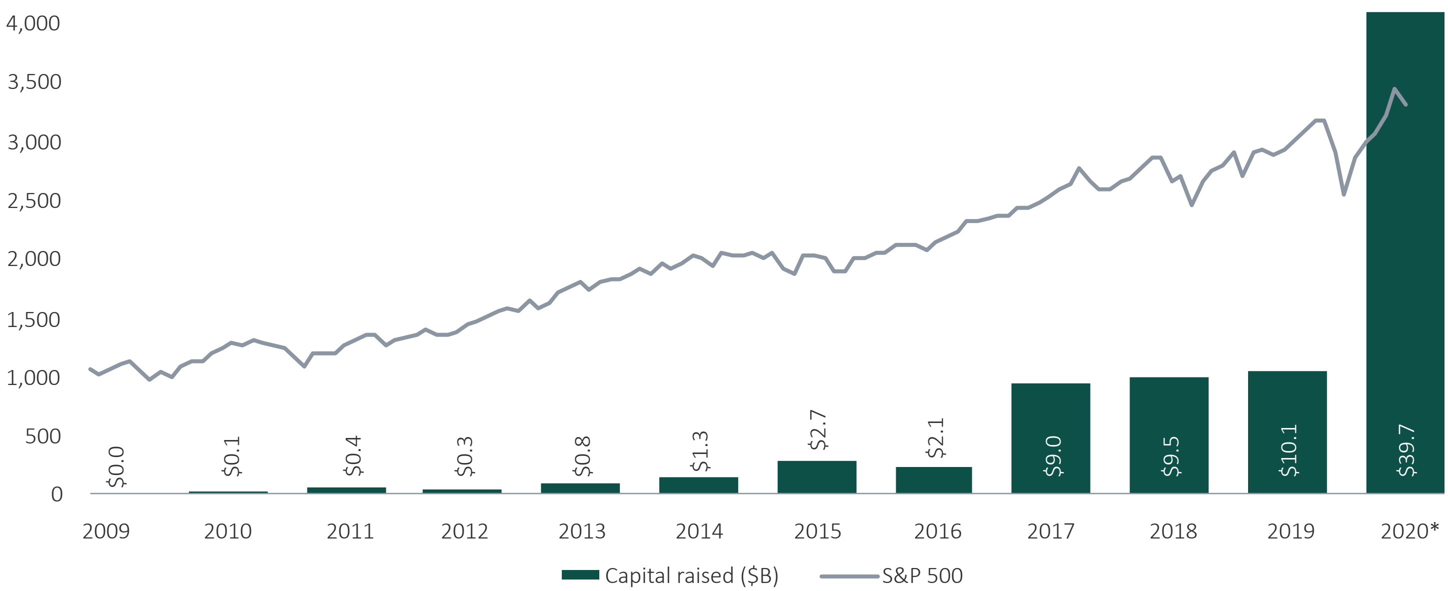
Spotlight: The 2020 SPAC frenzy

SPAC proceeds and public market performance



Source: PitchBook | **Geography**: US
*As of September 30, 2020

Note: This spotlight was abridged from an analyst note on SPACs. For a more detailed analysis of the subject, which also covers institutional investors, SPAC targets, and sector spotlights, please read our report on the 2020 SPAC frenzy.

Introduction

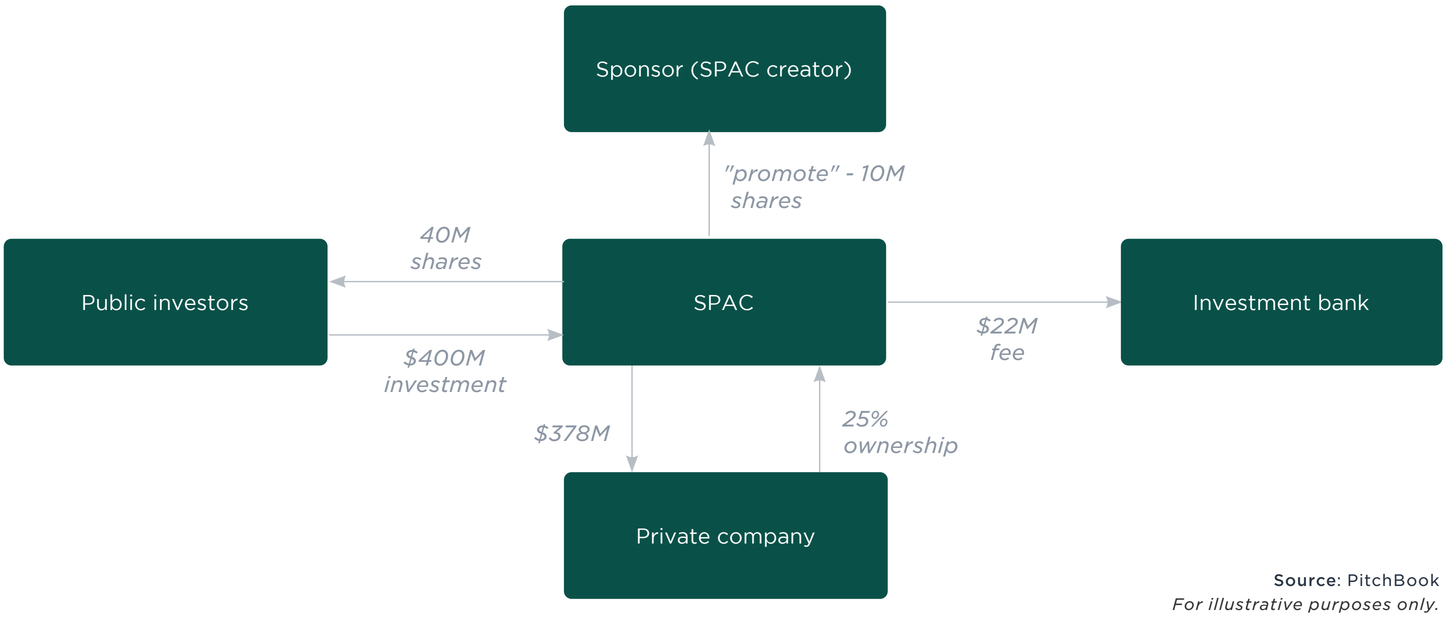
If there is one corner of the financial markets that has benefited from the pandemic, it is special purpose acquisition companies (SPACs). This atypical pathway to the public markets was once a niche strategy for small investment firms. These early embracers saw SPACs as a way to extract fees from adding structure to a reverse merger. The strategy has now become the hottest financial topic of 2020 after a massive uptick in the volume of these blank-check vehicles and as the stature of the investment professionals involved legitimized the space. The surge in IPO activity from SPACs has been covered by research providers ad nauseam, with PitchBook producing a few reports on the topic as well.

Despite extensive coverage by the industry, many misconceptions are still widely reported, and details that add nuance to the debate are commonly omitted from discussion. This analyst note aims to highlight some of these missing pieces for people in the investment community who are looking to change the way private companies become public companies and might be considering SPACs as an option.

Why SPACs? And why now?

This time last year, direct listings were the newest and shiniest toy for VCs when they were evaluating potential public market exits for their portfolio companies. Then came the pandemic, which plagued markets with economic uncertainty, especially public markets. The sustained volatility and the distinct price declines earlier in 2020 made IPOs and direct listings impractical options for the majority of private companies, which is where SPACs have found an opportunity. Unlike SPACs, direct listings do not allow private companies to raise any new capital during their transition to the public markets, which presents a problem for many startups given the elongated economic ambiguity driven by the pandemic. This is poised to change given NYSE's recent approval of adding primary shares into the opening auction, which would level the playing field of each public market pathway. Furthermore, direct listings and IPOs involve selling shares via an auction process, which can be messy in a volatile market.

Hypothetical SPAC funding



Source: PitchBook
For illustrative purposes only.

Since a SPAC is essentially just a large box of money, the listing of a SPAC necessitates a much lower level of diligence than a similarly sized IPO of an operating entity since there are no financial statements to scrutinize. For a sponsor, one could say, raising a SPAC is more akin to raising a closed-end fund, allowing for a shorter and more comfortable timeline during the fundraise. The simplified process of raising a SPAC IPO has allowed these listings to go forward since SPACs usually trade near the NAV, and the reverse merger represents the true test for SPACs when a new operating company actually becomes public and investors then evaluate and trade shares accordingly.

Sponsors

We start with the creators of the SPAC: the sponsors. For these players, incentives tend to be clear, since the sponsor acquires a special class of shares that equates to 20% of the shares in the SPAC for a nominal cash consideration, known as the "promote." These sponsors also reap other benefits in leading the SPAC, such as the option to organize a PIPE deal concurrently with the acquisition and the chance to offer some input on the strategy of the acquired business, often times through a position on the board. This strategic decision-making aspect is why former operators and executives often lead SPACs, using their expertise to identify attractive targets and help guide them to success. Sponsors do receive a lot of economic interest in the business for essentially finding the deal; that said, there are signs, such as the reduction or elimination of the promote or warrant allocations, that the SPAC structure is becoming less of a fee grab on subpar deals and instead more of a company-friendly vehicle with potential to create value. A shift in the makeup of SPAC sponsors toward institutional and reputable market participants has also begun to further legitimize the future of SPACs.

Since traditional IPOs of operating companies have been relatively scarce, SPACs have seen a huge boost in demand so far in 2020. Typical IPO investors have rushed to participate in these deferred listings in the hopes of backing the next great growth story. The high demand has allowed many SPACs to upsize the amount raised in their IPOs; both serial SPAC sponsors and new entrants alike have taken it as an opportunity to raise capital while the strategy remains in good favor. From the sponsor's point of view, raising a SPAC is just another fundraise with a slightly different LP base.

Sponsors are also potentially assuming that the market dynamics driven by the pandemic will create a host of targets at attractive valuations, suggesting the explosion may have stemmed from opportunism rather than deeper analysis around particular investment theses. This frenzy in new SPAC listings could hinder performance for these vehicles as competition heightens, which could inflate some valuations. It will be a couple of years before we can tell whether or not this was a truly sound strategy for the sponsors, but for now it seems better to accumulate assets while the iron's hot.

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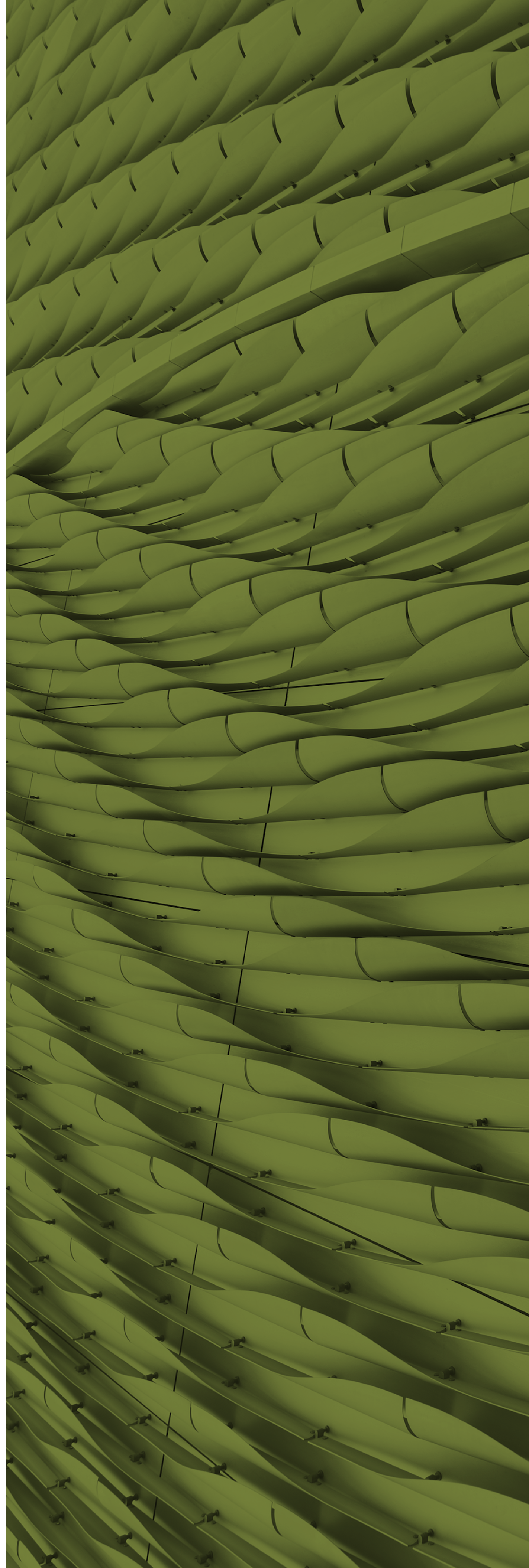

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Is there an expert in the room?

When it comes to due diligence, there should be

A successful middle market deal no longer depends solely on the size of your checkbook. When private equity was a nascent industry, company founders looking for a full or partial exit had limited options for financial sponsors to back their next phase of growth, particularly if public markets were not an option. Today, competition is fierce, and management teams can afford to be pickier than their predecessors.

What matters most? It varies, but management teams now see industry expertise as critical to the continued growth and strength of their business. Is the financial sponsor willing to invest in new products, services, or markets? Do they have a track record of scaling businesses in similar industries? Is their vision for the future in line? What unique access can the PE sponsor provide to target customers, potential M&A opportunities, or other valuable connections in the industry?

While PE firms can try to front-run or altogether avoid a competitive process, most deals today come to market via a banker-led auction and 20-30+ sponsors receive teasers. Although this narrows to a handful of interested parties as diligence progresses, standing out from the crowd is critical.

An expert on the right side of the table

Many middle market companies play in niche segments and receive less attention from prominent analysts. These companies require richer analysis and deeper insights to develop a strong understanding of the opportunity and value. This often means adding a seasoned industry professional who has "been there, done that" to the team. An expert strengthens the diligence process—helping to more quickly cement the conviction that the opportunity is an attractive one. Also, the firm that does this positions itself as a preferred partner to the management team because it understands their business needs and industry dynamics upfront.

Darin Clemente

Darin is the Head of Private Equity in the Americas at GLG. Prior to assuming his current role in 2019, he served as Managing Director, Head of Regional Business Development & Private Equity / Venture Capital (PE/VC) Practice. Before joining GLG in 2011, Darin held leadership roles at iPipeline, InfoNgen, Pyxis Mobile, and Thomson Financial. Darin holds a BA from Boston College.

Differentiating during due diligence

An expert who knows the space can easily identify where the proverbial skeletons are buried and where to dig. These professionals also offer connections in the space who can help paint an unbiased view of the strengths and weaknesses of the target relative to its competition.

Positioning as preferred partner

PE sponsors can cast themselves in a more favorable light in a variety of ways:

1. Demonstrating robust operating experience in a similar/parallel company viewed as highly strategic or impactful
2. Evidencing connections to untapped or in-pipeline potential new customers
3. Showcasing a strong network among other companies in the space who may serve as attractive M&A targets
4. Flexing a robust rolodex that can support the team's ability to engage/hire the best talent.

The gold standard is someone with all of the above, who is viewed as a "legend" in the space for the impact they've had on the industry.

Finding the right expert

About five years ago, GLG launched a suite of solutions geared towards giving sponsors the edge they need to build conviction quickly and differentiate themselves in auction processes. Our focus is on building flexible, agile solutions that support key phases of the diligence process through value creation within portfolio companies.

We now regularly identify and secure elite professionals to work on an extended basis alongside deal teams as they review targets, meet with management teams, and analyze data. Such specialists can serve as invaluable resources who support every phase of diligence to ensure that ultimately a sponsor bids a reasonable, appropriate price for the business.

Many GLG clients have walked away from deals because the target company's management team was telling a great story, but our specialists helped uncover significant concerns with their technology, the strength of their customer base, or the industry at large that ultimately tainted the deal. Of course, we have also seen firms working with GLG develop strong conviction around a winning bid as a result of more nuanced synergies and opportunities that their deal specialist helped uncover.

If the sponsor secures the deal, we often see the same deal specialist stay on to serve in operating or independent board roles post-close, where they go on to help the portfolio company generate significant value via key customer introductions, strategic M&A, leadership team coaching, new market entry, new product launches, prioritizing growth initiatives, or cost reduction strategies. Such support can often make the difference between a good deal and a great deal.

Finding the type of expertise I've described isn't easy, and getting the right fit for the sponsor as well as the target is critical. GLG maintains relationships with more than 43,000 recent C-Level executives able to serve in these types of roles, which means we have the resources to find the right fit for any firm.

Two sides of the same coin: finding the perfect match

Today's competitive deal environment creates opportunities for sponsors to differentiate themselves on many more elements than just the size of their bid. Targets seek partners who will provide the resources and expertise needed to support their growth—and it's critical for these sponsors in turn to develop a deep, robust understanding of these niche businesses and their associated risks and opportunities. These are really two sides of the same coin that—in the end—reflect the earnest intent to create significant value for all parties in an investment by finding that perfect match.

As the world's insight network, GLG connects our clients with top professionals from around the globe. Drawing from the experience of more than 700,000 Council Members, GLG supports private equity professionals at every stage of the deal lifecycle. We understand the complexities of the current deal environment and help clients compete for new deals while minimizing risk and maximizing efficiency in their investment processes. Learn more about how we can help you.

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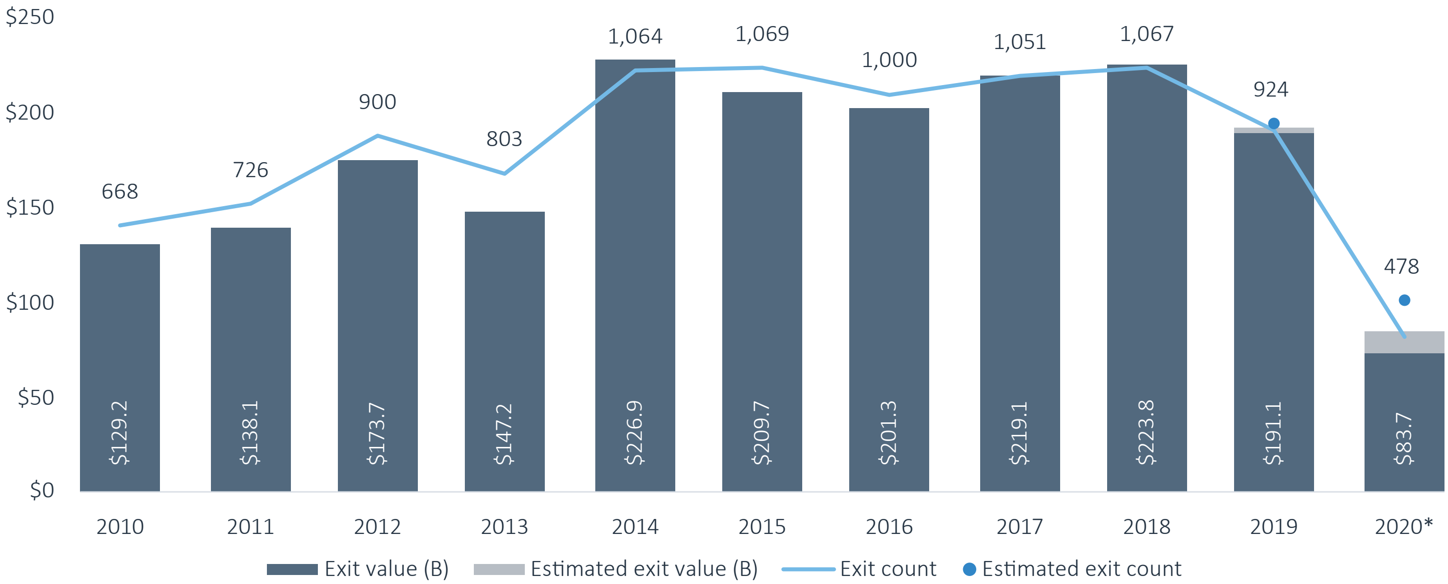
Exits

Middle market PE exit activity



Source: PitchBook | **Geography:** US
*As of September 30, 2020

Wylie Fernyhough Senior Analyst, PE
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Middle-market exit activity has been sluggish through the first three quarters of 2020. There have been just 478 exits representing $83.7 billion, with exit count on pace for a 30%+ YoY drop and exit value looking at a 40%+ YoY reduction. The declines seen in middle-market exit activity are even more profound than in middle-market deal activity, which is also on a downward trajectory. This is because PE firms are not forced sellers and have the luxury of waiting for an easier selling environment, although they do feel some pressure to deploy dry powder.

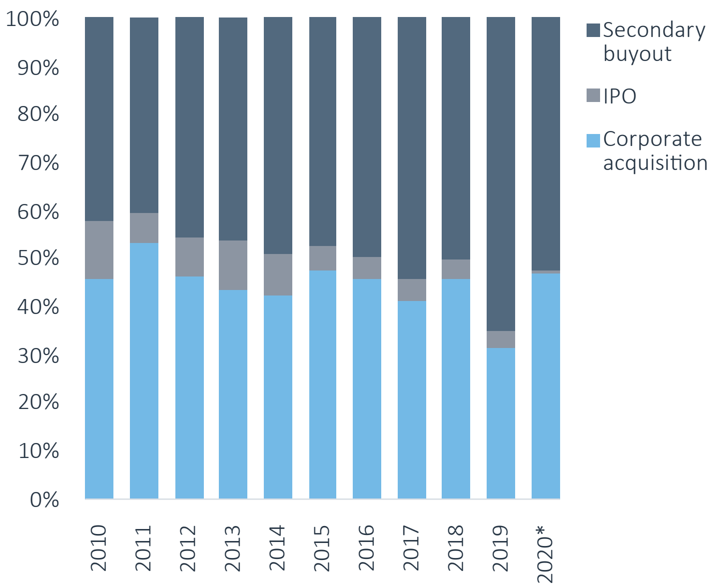
The story from last quarter still rings true in that PE firms are waiting for a more amenable exit environment in which to sell portfolio companies. This timetable reset has had several knock-on effects, namely longer holding periods and diminished returns for some funds, especially if portfolio marks never fully recover. The median time to exit has ticked up modestly through 2020 and is likely to continue to do so for the remainder of the year. Holding periods are up, but until recently recap activity had gone in the opposite direction. With PE firms holding onto portfolio companies longer, some firms have looked to recaps to bring forward cash flows and boost their IRR. Through the initial months of the pandemic, credit conditions were unsuitable for these financings, but with the Fed backstopping the credit market, capital is flowing more freely. Nearly 24% of the capital raised in the US loan market funded dividends through the first half of September, compared to less than 4% on average over the past two years, according to S&P Global Market Intelligence data.[2] The stalled exit market has also caused a proliferation of GP-led secondaries deals. These transactions, whereby a PE firm rolls some or all remaining holdings into a new special purpose vehicle (SPV), often give the PE firm another three-to-five years to reach a liquidity event. Industry sources have seen a notable pickup in recent months and expect this flurry of GP-led deals to continue with exit time frames pushed out.

Going forward, signs point to a healthier exit market. Portfolio marks, which already began to rebound sharply in Q2, are looking to continue that momentum into Q3. This bodes well for future exit activity. Preliminary marks from some non-public PEs, as well as the publicly traded goliaths, are pointing to healthy performance figures that should put many funds back in the black for 2020. As some funds exit clawback and others finally hit carry, PE firms will be looking to lock in gains as the economy recovers. We have heard several anecdotes of sales processes that

2: "Private Equity Owners Pile on Leverage to Pay Themselves Dividends," Financial Times, Joe Rennison, September 16, 2020.

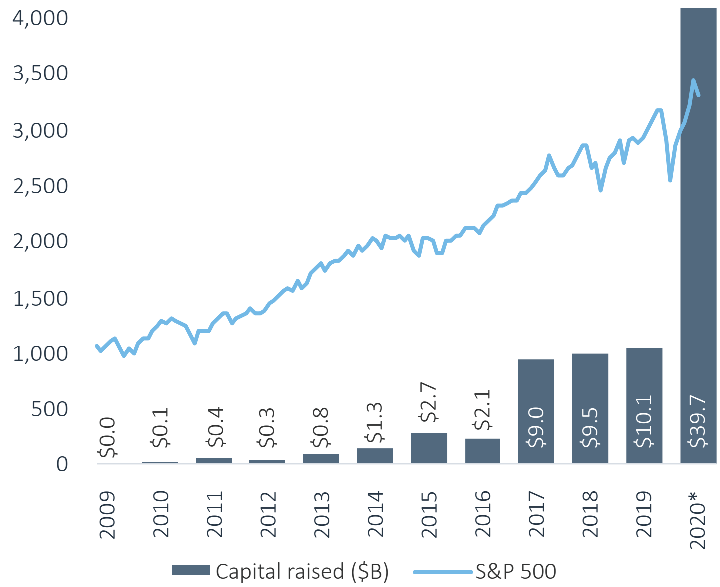
Exits

Middle market exit activity ($) by type



Source: PitchBook | **Geography:** US
*As of September 30, 2020

SPAC fundraising activity



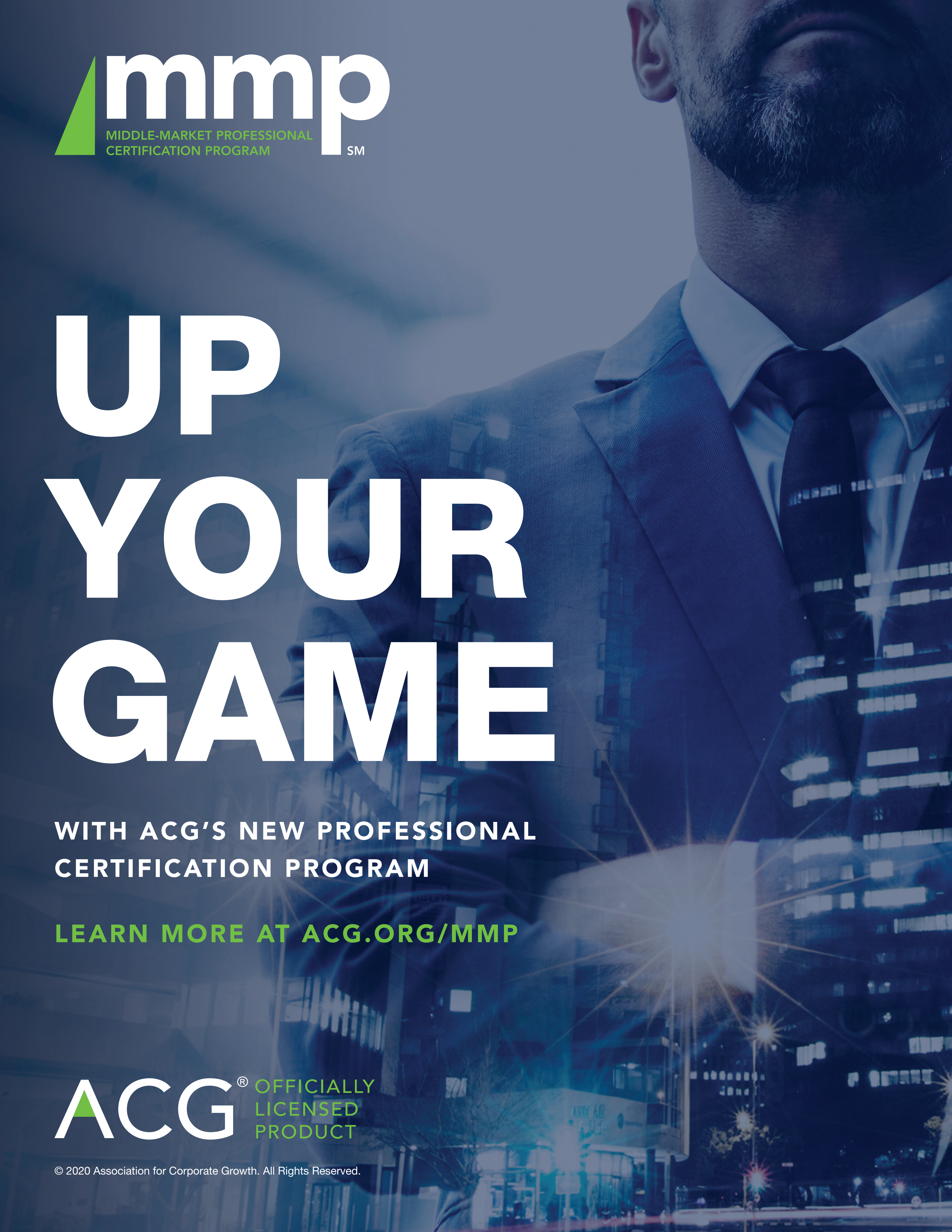
Source: PitchBook | **Geography:** US
*As of September 30, 2020

had been paused in March coming back to life in Q3 and Q4. Although the freeze on exit activity may be thawing, these sales take time. With the need to go through auction processes and typical closing minutiae, PE firms that decide to exit a portfolio company today may not close on the transaction for another six months, or more. This means that while 2020 exit activity is likely to remain depressed, numbers in 2021 may tick up by a healthy amount—as long as the virus is controlled.

Not only has exit activity abated in 2020, but the composition has shifted as well. For the first time since 2009, there has been a meaningful reduction in sponsor-to-sponsor (also called secondary buyouts, or SBOs) exit activity. During the pandemic it appears that PE firms had perhaps been seeking steeper discounts on deals than other buyout shops were willing to grant, pushing more exits to strategics. With the healthy fundraising activity that has occurred to date, many PE firms are now sitting on even more dry powder than at the beginning of the year, meaning the flow of future exits may tilt back in favor of selling to other sponsors. The IPO market has also been nearly untenable for mid-market exits, with just three portfolio companies exiting PE ownership through this route in 2020. IPOs, and the cumbersome laws that govern public companies, have dissuaded all but the multi-billion-dollar companies from going public. However, the SEC has announced some planned changes that would lessen this regulatory burden, which may persuade more middle-market firms to exit portfolio companies via IPO in years to come.

The rise and glut of SPACs may also alter the exit landscape in the coming years. 2020 has been the year of the SPAC, with these companies raising more capital in the first three quarters of the year than in the prior 10 years combined. Despite some concerns about the incentives at play in SPACs, they can move more quickly than the traditional IPO roadshow and can deliver price certainty, both attractive options to PE firms. Further, SPACs allow the target company to show revenue and profit projections in the offering, something disallowed for the traditional IPO. This option may help investors visualize the future of a quickly growing technology company or one that is currently saddled with debt from an LBO. Founder share issuance usually means SPAC sponsors are compensated handsomely, often prompting SPACs to prioritize making a deal above the price paid. Partially due to their zealousness to complete deals, SPACs have tended to produce price returns far lower than comparable IPOs,[3] which may cause some PE firms to steer away. Although the PE-backed exits to SPACs, such as H&F exiting GCM Grosvenor to CF Finance Acquisition Corp, have been in multi-billion-dollar transactions, a flood of $100.0 million SPACs could target companies with portfolio values between $500 million and $1 billion.

3: Another side of this argument is that SPACs have been the less certain way to go for PE firms; making the highest quality companies choose an IPO over a SPAC and the historically lower quality companies choose SPACs is why their share price performance has been so dismal.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ACG: Greater inclusion requires intentional actions

In the wake of George Floyd's death this year, Martin Okner, Association for Corporate Growth® (ACG) Chairman of the Board of Directors and dpHUE President and COO, convened a Diversity, Equity, and Inclusion (DEI) Task Force to create a policy and complimentary programming to help foster a more equitable and inclusive middle market. Middle Market Growth® Editor in Chief Kathryn Mulligan interviewed task force members Cornelia Cheng and Rich Grant about how their respective career experiences have informed their perspectives and aspirations as well as their recommendations for meaningful change.

Cornelia Cheng

Cornelia is a Managing Director on the Investments Team of Brightwood Capital Advisers. She focuses on the US western region and is based in Los Angeles. Prior to Brightwood, Cornelia held roles with Prudential Private Capital, CIBC World Markets, and First Interstate Bank. Cornelia is a director with the ACG Los Angeles board and chairs its DEI Committee.

Rich Grant

Rich Grant is Director of Business Development with Growth Operators. Rich has more than 15 years of sales, marketing and business development experience with an array of organizations. Rich has a successful history of building meaningful relationships in the private equity middle market community and aims to serve as a trusted partner & advisor providing value-added solutions enabling PE backed investments.

ACG recently convened a DEI Task Force to help the association effect sustainable and systemic change in its membership network. What are the goals of that task force?

Cornelia: What happened this spring required us to abandon the sidelines and take intentional actions. I think we all recognize that our industry is homogenous and remains relatively unchanged. We can't simply hope for change anymore; intentional action is required. The task force will focus on ACG internally as an organization, as well as work across the ACG chapters and across our member and member firm communities to promote diversity across our industries.

Rich: Overall, our goal is to create a truly inclusive environment to empower our fellow ACG members to be champions of DEI, with accountability attached to it. We are going to do more than just create and end with the task force. We are going to create an environment that will advocate for the underrepresented in our community. Change will come in a couple of different forms, including changing the demographics within firms that are associated with ACG and providing access to capital for businesses in the middle market.

How have your personal and professional experiences influenced your perspective on diversity and inclusion initiatives?

Rich: I am a first generation Black American, born of Jamaican parents. I went to a wonderful school in upstate New York, Colgate University. My professional experiences have consistently put me in a room where there are not a lot of other Black or Latino men and women on the sales teams I have been a part of, not to mention within the leadership ranks at organizations where I've worked.

Cornelia: My grandparents and parents were political refugees who left their home country with nothing. My parents moved to the US so I could have opportunities. If you asked me in high school what I wanted to do as a career, I would not have even thought a path to Wall Street finance was available. My first job in finance came through one of my professors, who was an East Indian woman. From there I became a fellow through the UCLA Riordan program, which helps minorities and women prepare for MBA school. I didn't attend an Ivy League undergrad school, nor did I think about going to business school. But that program gave me the confidence to apply, and Wharton opened doors to opportunities in corporate finance and private credit where I built my career.

One argument made by some organizations that say they're trying to diversify is that they can't find enough diverse candidates. Is that a real challenge, and if so, what's contributing to the lack of diversity within candidate pools?

Cornelia: A lot of firms want to plug and play experienced candidates. If you are committed to DEI, then you have to move past easy hiring and be willing and able to recruit and evaluate candidates differently and then train them. There is no STEM equivalent in schools for kids to learn about careers in finance and private equity. Kids, especially those from underprivileged communities, don't know these opportunities exist. If firms only successfully recruit from a small pool of Ivy League schools, then the students who are educated outside of that pool don't have access to these career opportunities. Consider recruiting from finance-focused DEI programs such as the Robert Toigo Foundation's MBA Fellowships.

Rich: It is a real challenge for financial services and private equity firms to recruit and hire diverse candidates. There is a lack of intentionality when approaching diversity and a refusal to leave the comfort zone. Until all companies intentionally decide to leave that comfort zone, that remains the greatest challenge. The traditional means have clearly not yielded diverse candidates. When employers find avenues to recruit diverse candidates who will add value to the firm, those employees will become future leaders whose presence will ensure that more people like them will join the firm.

Groups that work on DEI in the financial services industry have focused on different stages of a career journey. How do you and the other task force members think about where to put the emphasis in order to drive immediate change?

Cornelia: ACG is a middle-market dealmaking community. We will leverage what we do well and partner with synergistic associations where we can advance DEI and make our organizations more representative of our respective communities. That starts internally, with ACG as an organization, its board, and its committees. For example, at ACG Los Angeles, we recently partnered with two other ACG chapters for events featuring a Latina business entrepreneur and a Black tech founder. We selected and featured diverse women founders because it is important. ACG programming offered us an immediate, intentional way to reflect the communities that we represent. It's our hope that those actions carry out across the network, so we can inspire our members, membership firms, and chapters to do the same.

Rich: One consensus among the task force members is to focus on recruiting. We keep mentioning three E's: educate, engage, and empower. We have to educate the underrepresented whom we have not recruited into the middle-market community and inform them that there are rewarding careers here. Once here, we have to keep them engaged and get them involved. As an example, ACG chapters have had various DEI efforts, but when someone walks into a room and sees a sea of "vanilla," they are unlikely to return. Engagement needs to be sustained. We need to get them involved in ACG committees and speaking opportunities. Once involved, we have to empower them to go back to their own communities and continue to recruit people who look like them.

What are ways that employers can improve diversity and inclusion within their own organizations?

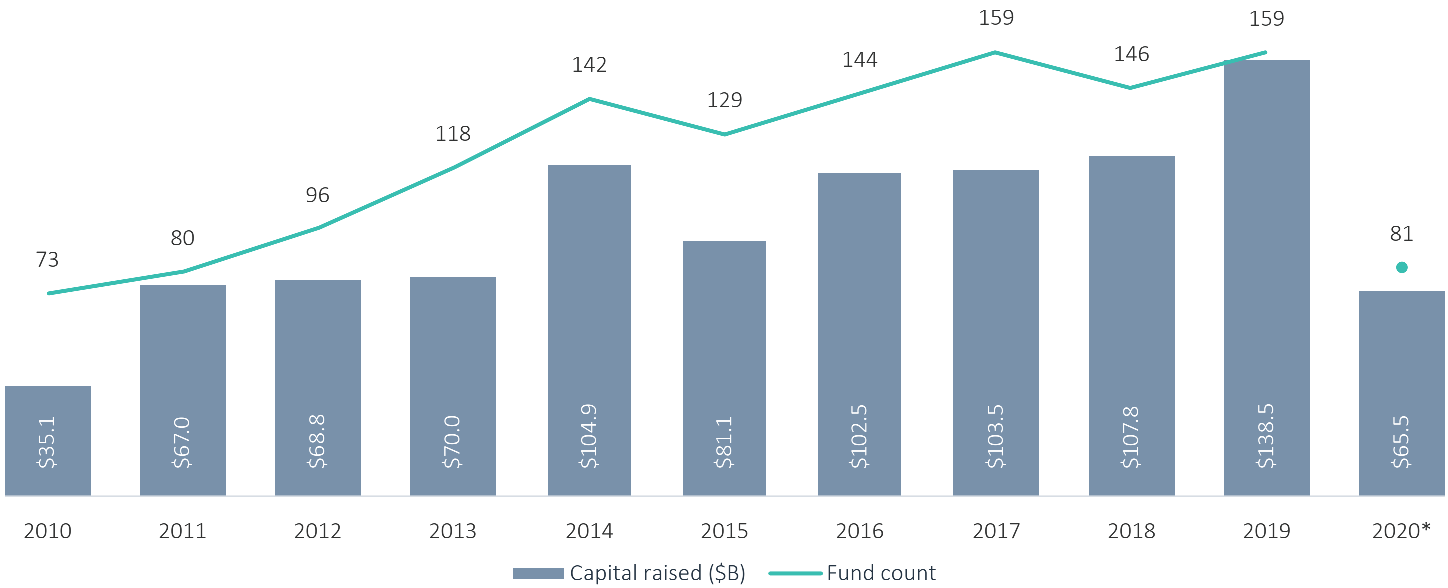
Cornelia: Change is hard. I spent most of my career with very large financial firms, and that's like steering a container ship. Now, I'm with Brightwood. Our founder is Black. We are a 100% minority-owned firm. We have 40% women and 47% ethnic diversity. One of Brightwood's funds was created to provide capital to businesses owned and operated by diverse managers. Our firm started intentionally from the ground up to increase diversity in private equity. Employers can start by re-evaluating their recruiting strategy and doing more than just creating a DEI committee. Meaningful and long-term change comes from the C-suite. Boards and business leaders need to be directly involved in adopting and actively advocating for a more diverse and inclusive workforce, and creating strategies to invest in minority-owned businesses, which will bring more opportunities to the middle market and the broader community.

Rich: Before you create a DEI role in the organization, look at the leadership and see how they can adopt the facets of that role that will guide their effort. With our firm, in terms of recruiting from a broader and more diverse talent pool, we have started to collaborate with organizations that allow us to meet and work with people who are young in their careers, as well as business owners. That collective experience informs future hiring decisions. I think that practice lends itself to a repeatable strategy.

About the Association for Corporate Growth: ACG's mission to drive middle-market growth is realized through its dealmaking network of 90,000 professionals and 60 chapters. As the most trusted and respected resource for middle-market dealmakers, business leaders rely on it to invest in and build companies. ACG's official publication, Middle Market Growth® is the hallmark of its media offerings.

Fundraising

Middle market PE fundraising activity



Source: PitchBook | **Geography:** US
*As of September 30, 2020

Wylie Fernyhough Senior Analyst, PE
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Middle-market fundraising in 2020 continues to trail 2019's record-setting value, and is on pace to fall short of $100 billion for the first time since 2015. US middle-market PE firms have closed 81 funds for a combined $65.5 billion, meaning fund count and cumulative value are approximately halfway to 2019's totals. The COVID-19 pandemic continues to cause problems for many middle-market firms as they try to raise capital without in-person due diligence. A survey by fundraising advisory firm Probitas Partners found that most institutional investors see virtual meetings as suitable only for preliminary talks rather than as a substitute for in-person due diligence. According to Probitas managing director Kelly Deponte, "The limitations on travel and meeting people have really made it much more difficult for first time funds in this environment."[4]

This difficulty raising funds from nascent managers continues to appear in our data. As the year grinds on, fewer first-time funds have been closing, and these funds have been accounting for a shrinking proportion of overall fundraising. Even sophomore funds appear to be struggling to close. Despite the headwinds, several first-time funds closed in Q3, including a pair of lower-middle-market buyout funds from Chicago. Benford Capital Partners raised $130.0 million and Longshore Capital Partners closed on $203.0 million in their debut funds. Each firm has been around for more than a decade and has a history of dealmaking, perhaps making their initial fundraising efforts more palatable to risk-averse LPs. This may suggest that first-time and sophomore funds lacking this history could struggle to find success in the interim.

While most middle-market firms are struggling, it appears allocators are adapting to this new reality, and fundraising momentum is picking up for the mega-managers. Ares Management raised the most capital ever in Q3 2020. Other massive public PE firms, including KKR, The Carlyle Group, and Blackstone also commented on their continued fundraising success in this challenging environment. Although the bulk of the capital raised by these massive firms is in mega-funds, these firms nonetheless found success with smaller, middle-market strategies in the quarter.

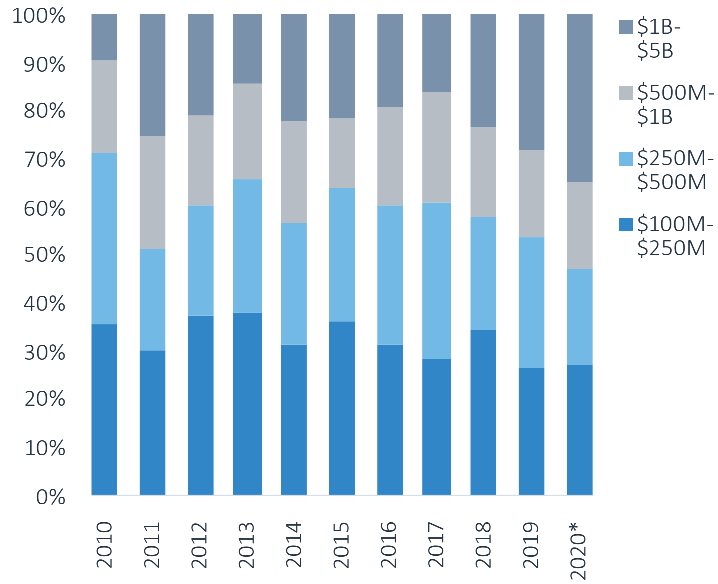
Blackstone, for example, made notable progress on three sub $5-billion funds in the quarter. The firm closed on $4.6 billion in its Blackstone Life Sciences V fund,

4: "Fledgling Private Equity Firms Falter as Virus Curbs In-Person Wooing," Reuters, Chibuike Oguh, October 13, 2020.

the first under the Blackstone banner after acquiring management team Clarus Ventures in 2018. The fund has seen healthy investor demand and has deployed capital swiftly, which would indicate the fund is likely to be fundraising again in the next year or two; even a mild step-up would propel the fund to $5 billion+, above what we consider to be middle-market. Blackstone's inaugural growth equity fund also made progress during the quarter. SEC documents filed on July 23 report that the fund has raised approximately $900 million of its $3 billion-$4 billion target. Most of the capital has been sourced from wealth management networks as opposed to Blackstone's usual route: tapping institutional capital. The firm's GP stakes fund, Blackstone Strategic Capital Holdings II, has raised $3.5 billion of its $4.0 billion goal, according to SEC documents. This fund is targeting the same amount as Petershill IV, a GP stakes fund managed by Goldman Sachs, which is also in the market fundraising. At least five other middle-market-focused GP stakes funds are also fundraising, although they are all seeking debut funds that are somewhat smaller. Bonaccord Capital Partners and Stonyrock Partners are each seeking $1.0 billion while Investcorp is targeting $750.0 million. Two other newcomers—RidgeLake Partners and Hunter Point Capital—have yet to announce their fundraising goals. However, sources say RidgeLake—which was seeded with $500.0 million for the first fund—is targeting around $1.5 billion, and Hunter Point may be seeking as much as $2.0 billion-$3.0 billion.

Fundraising for PE ought to remain strong heading into 2021. Positive vaccine news from several key players also means that in-person due diligence may be back on the table in 2021. This alone could ignite fundraising, although other factors will also buoy middle-market capital-raising efforts. The runway for low interest rates has been further extended due to the economic wreckage wrought by the pandemic. This means the gap between target returns and the risk-free rate will remain for years to come, underpinning the current rotation away from traditional fixed-income and equities into alternatives, especially PE. Elevated public market valuations and volatility are also causing some allocators to capture gains and invest in asset classes such as PE, where they believe returns over the next decade or so will be more favorable. The timing on any commitments appears advantageous. Near-term allocations are usually drawn down over the coming years and are typically funded by realizations from previous PE fund commitments. With valuations for most PE funds now above their 2019 year-end marks, exit activity is poised to bounce back and fund any increase in commitments.

Middle market fundraising activity (#) by size



Source: PitchBook | **Geography:** US
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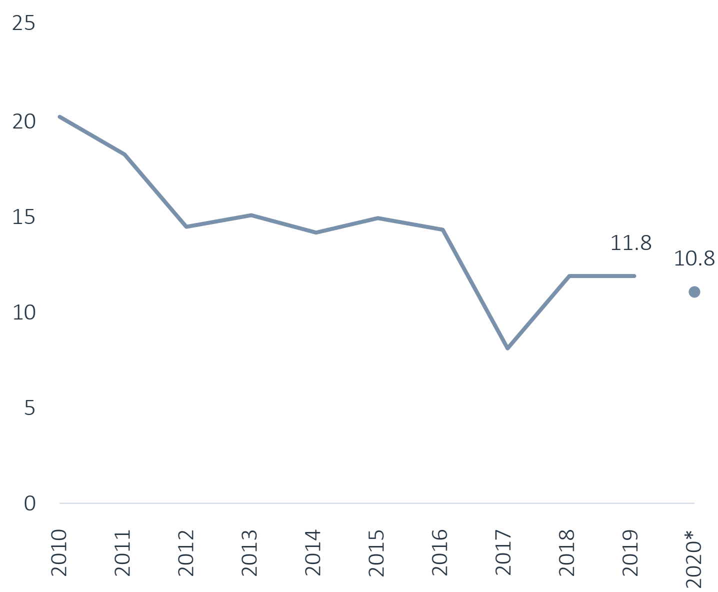
Middle market median time to close (months)



Source: PitchBook | **Geography:** US
*As of September 30, 2020

Q3 2020 US PE MM lending league tables

Overall

1	Antares Capital	26
2	Ares	21
3	Barings	20
4	Churchill	18
5	MidCap Financial	15
5	The Goldman Sachs Group	15
5	Crescent Capital	15
8	PNC	13
8	NXT Capital	13
10	Golub Capital	11
11	KeyBank	10
11	Jefferies Group	10
11	Twin Brook Capital Partners	10
14	Citizens Bank	9
14	The Carlyle Group	9
14	Madison Capital Funding	9
14	Truist	9
14	BMO Financial Group	9
19	Varagon Capital Partners	8
19	BlackRock	8
19	Main Street Capital	8
19	Fifth Third Bank	8
19	Maranon Capital	8

Source: PitchBook

Select roles*

1	Antares Capital	25
2	Ares	11
2	MidCap Financial	11
2	Crescent Capital	11
5	Madison Capital Funding	9
6	Citizens Bank	8
7	Churchill	7
7	Fifth Third Bank	7
7	BMO Financial Group	7
7	Golub Capital	7
7	Jefferies Group	7
7	Twin Brook Capital Partners	7
13	KeyBank	6
13	Maranon Capital	6
13	NXT Capital	6
13	Truist	6
17	PNC	5
17	Bank of Ireland	5
17	Varagon Capital Partners	5
20	Owl Rock Capital Corporation	4
20	Wells Fargo	4

Source: PitchBook. *Select roles comprise bookrunners, lead arrangers, mandated lead arrangers and administrative agents only.