

US PE Middle Market Report

Q3 2021

Trends in the middle market remain dynamic. A steady approach is the best path forward.

Even in the best of years there are ups and downs. Fresh COVID challenges, rising valuations and inflation risk are just some of the factors impacting today's M&A market. In this issue's Q&A, Tim Lyne, COO, shares his perspective on why a consistent approach is important to Antares, as we strive to deliver favorable risk adjusted returns.

Read the full Q&A in this issue.

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Contents

Introduction	3
Overview	4-10
Q&A: Antares	11-12
Deals by size and sector	13
Spotlight: Understanding US PE Healthcare Provider Transactions	15-16
Q&A: Canton & Company	18-19
Exits	20-22
Fundraising & performance	23-27
Q&A: LBMC	29-30
Lending league tables	31

Introduction

Middle-market private equity (PE) firms sustained the feverish pace of dealmaking activity set earlier this year: 2021's three-quarter total has already surpassed that of the previous record year in both deal count and value. The frenzy is being driven by PE firms' desire to capitalize on booming economic growth and low interest rates before the macroeconomic tide turns. Investors are watchful of inflationary risks, while elevated deal multiples are underscoring the need to drive significant earnings growth for portfolio companies. Finally, middle-market GPs are adding value to portfolio companies through ESG-related operational improvements, especially in industries such as manufacturing.

US middle-market exits also continued at a remarkable pace in Q3. Despite a slight cooling off of economic growth in Q3 due to the spread of the COVID-19 Delta variant, middle-market portfolio companies have benefited from revenue and earnings growth over the past year, resulting in favorable exit opportunities. The logistics and software industries faced particularly favorable exit environments as supply chain disruptions highlight the need for technological improvements and middle-market businesses pursue digitization.

Although fundraising has been positive, the middle market has not kept pace with the unprecedented capital raising of mega-funds. As a result, both mega-fund managers and established middle-market firms are pursuing new strategy launches. Middle-market emerging managers have fared better this year than last, and independent sponsors are carving out a growing presence at the smaller end of the market. Turning to performance, middle-market PE firms posted impressive performance figures in Q1, the most recent quarter for which data is available. A benign macroeconomic environment should continue to support healthy performance and, in turn, fundraising in the year ahead.



Rebecca Springer, Ph.D.
Analyst, PE



Jinny Choi
Analyst, PE



Anikka Villegas
Analyst, Fund Strategies and Performance

PitchBook Data, Inc.

John Gabbert Founder, CEO
Nizar Tarhuni Senior Director,
Institutional Research & Editorial
Dylan Cox, CFA Head of Private Markets
Research

Institutional Research Group

Analysis

Rebecca Springer, Ph.D. Analyst, PE
rebecca.springer@pitchbook.com

Jinny Choi Analyst, PE
jinny.choi@pitchbook.com

Anikka Villegas Analyst, Fund Strategies
and Performance
anikka.villegas@pitchbook.com

pbinstitutionalresearch@pitchbook.com

Data

Charlie Farber Data Analyst

Publishing

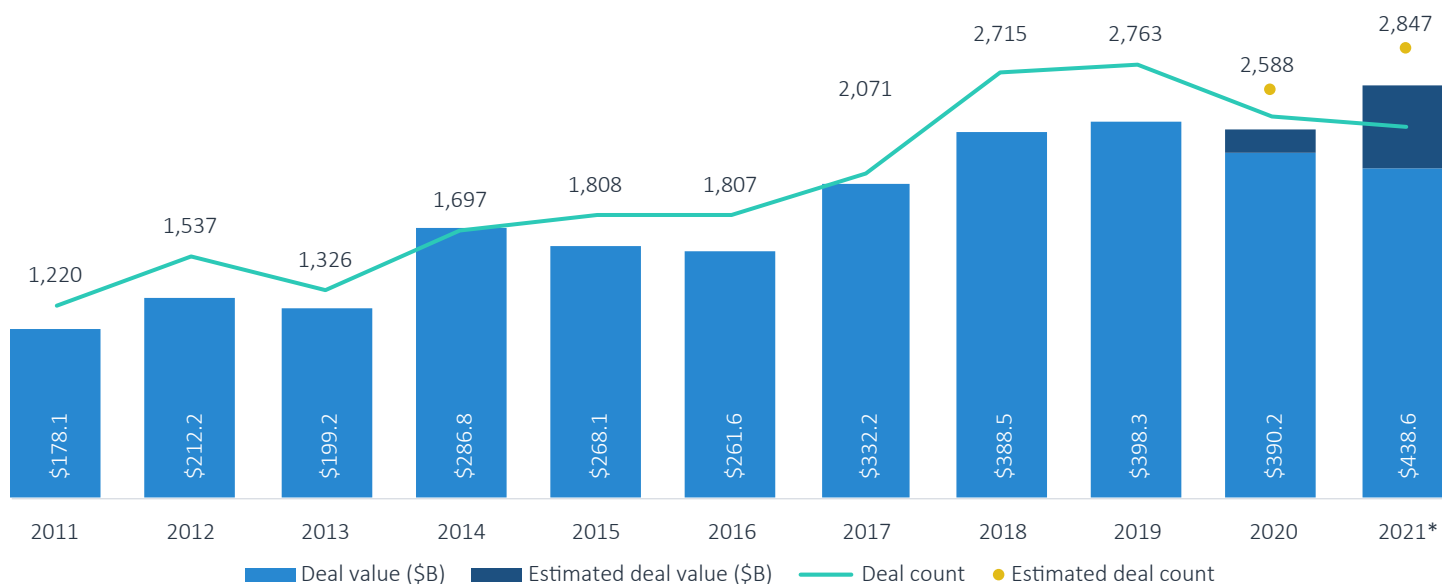
Designed by **Drew Sanders**

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[Click here](#) for PitchBook's report methodologies.

Overview

PE middle-market deal activity

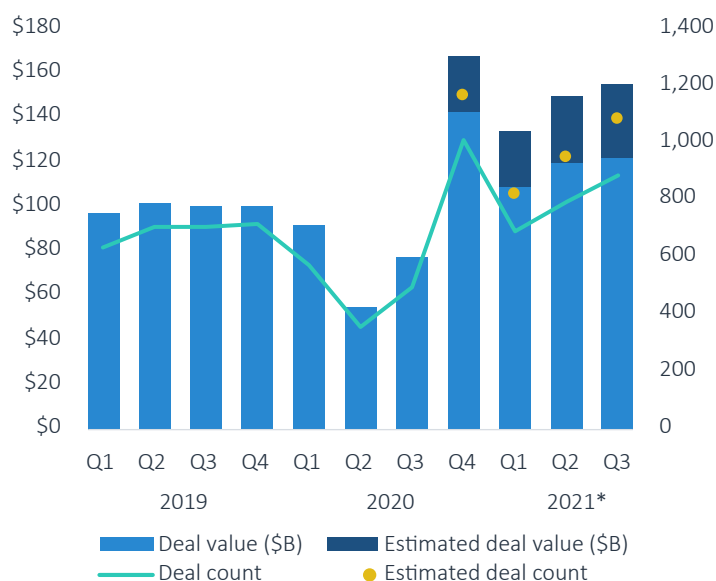


Source: PitchBook | Geography: US
*As of September 30, 2021

Middle-market PE firms sustained the feverish pace of dealmaking activity set earlier in the year, closing 2,847 middle-market buyouts in Q3 2021 for a combined \$438.6 billion. The three-quarter total for 2021 has already surpassed that of 2019, the previous record year, in both deal count and value, while trailing-12-month (TTM) cumulative deal value is 50% higher than the next best four-quarter period, which was Q3 2018 through Q2 2019.

The current frenzy in deal activity is being driven by PE firms' desire to capitalize on booming economic growth and low interest rates before the macroeconomic tide turns. With cheap financing for leveraged buyouts (LBOs) and expanding LP allocations, many firms are looking to deploy capital quickly so that they can raise additional funds. These firms are willing to compete for assets at high valuations because it is a sellers' market. The affordability of debt allows middle-market shops to stretch their equity checks further amid robust demand for assets from other sponsors and strategics. Anecdotal reports abound of auction processes with 20 or 30 bidders, businesses trading at previously unheard-of valuation multiples, and firms promising to close deals on truncated timelines—as short as a week or less—in order to sweeten their offers to sellers.

PE middle-market quarterly deal activity



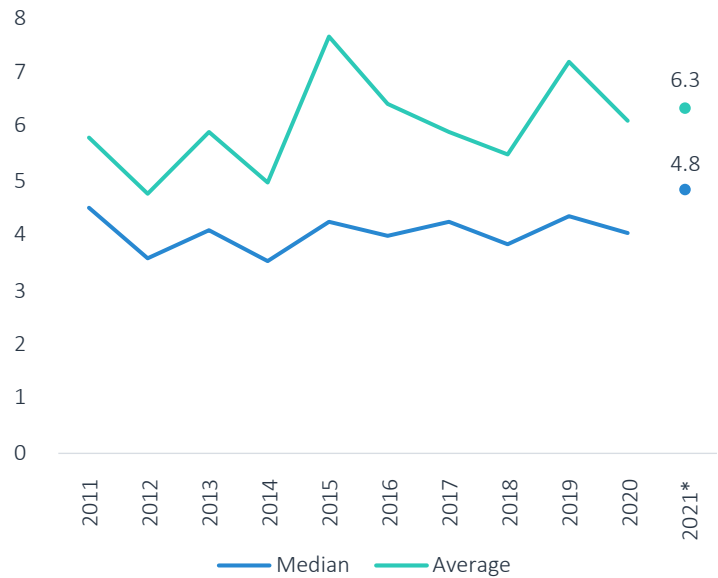
Source: PitchBook | Geography: US
*As of September 30, 2021

Overview

In these cases, middle-market firms are sometimes doing deals using unitranche loans that will be refinanced within the next one to two years because of difficulty in securing junior and mezzanine-level debt in time for closing. Our data currently shows that the median time required to close middle-market PE deals is roughly comparable to what we saw in 2020, a little over six months. However, this may reflect some accelerated processes being balanced out by more complex due diligence for other deals due to the idiosyncratic effects of the pandemic on businesses, especially in the earlier part of this year. We expect that next year's data may show accelerated deal closing times.

Tax policy has also had some effect on middle-market dealmaking. Following the election of President Biden, business owners who were contemplating a sale felt compelled to accelerate their timelines to avoid a possible capital gains tax hike. However, that impetus will diminish going forward as firms and investment banks work through their current deal pipelines because the version of the Build Back Better Act passed by the House on November 19 dropped the long-discussed capital gains tax revisions altogether.

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



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

Consumer Price Index, 12-month percent change



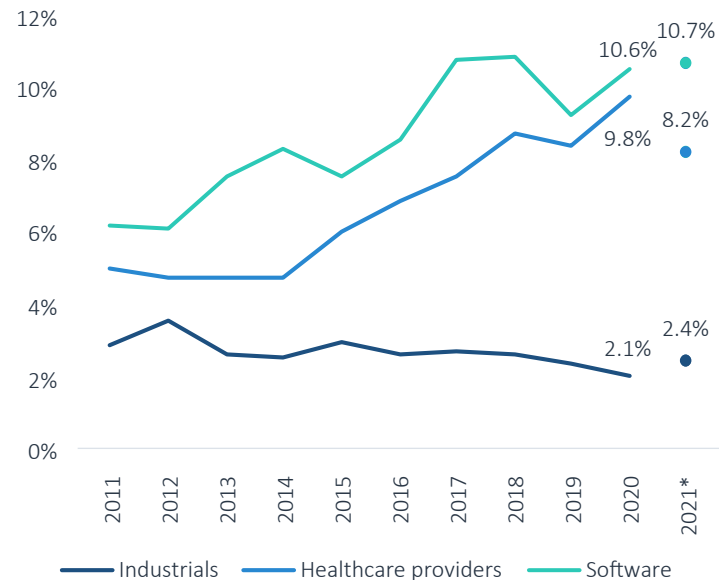
Source: FRED, Bureau of Labor Statistics | Geography: US
*As of Oct 31, 2021

Overview

Effects of inflation

Inflation is top of mind for middle-market firms. YoY Consumer Price Index (CPI) gains have remained above 5% for the past six months, and observers are still divided on how long the current inflationary environment will endure. Federal Reserve System Chair Jerome Powell recently decided to cease using the word “transitory” when describing inflation. Regardless of one’s school of thought, many middle-market companies are experiencing elevated labor, energy, logistics, and raw materials costs. Due diligence processes are focusing on these risks, especially in industries such as industrials and healthcare services, but the effects on dealmaking have been different based on specific industry dynamics. Industrials dealmaking has remained relatively flat as a proportion of PE middle-market activity over the past decade, including in 2021: Although many manufacturers have successfully passed on increased input costs to customers, this trend is not guaranteed to continue should inflation remain high over the coming quarters. Moreover, labor shortages and supply chain backlogs have prevented some companies from ramping up production to take advantage of the economic recovery. Industrials companies in the Golub Capital Altman Index (GCAI), which tracks PE-backed middle-market companies, reported 13.5% YoY revenue growth in Q3 2021, but only 0.2% YoY earnings growth, pointing to rising input costs.¹

Deals for healthcare providers have also accounted for a smaller share of middle-market deal activity in 2021, reaching the lowest proportion since 2017, despite a flurry of activity in several high-demand subsectors. One possible reason for this is that healthcare providers derive most of their revenue from long-term reimbursement contracts with insurance companies. These contracts typically have built-in annual price inflators, but often these are not linked to the CPI. Therefore, some healthcare providers may struggle to pass on elevated labor, supply, and equipment costs. GCAI healthcare companies posted slower YoY revenue and earnings growth, 9.2% and 4.9%, respectively, than the GCAI overall.² Inflation-related risks, combined with elevated purchase multiples, have caused firms to exercise more

Select industries as a share of PE middle-market deals

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

discipline in pursuing healthcare provider deals. Middle-market investors are also tracking the potential effects of inflation on high-growth industries, especially technology. In the medium to long term, if inflation persists and the Fed significantly raises interest rates in response, the valuation multiples of technology companies could fall because these companies tend to be priced based on future earnings, which would be discounted at a higher rate. However, many investors believe that secular growth prospects in the technology industry and the resiliency of the software-as-a-service (SaaS) business model outweigh this risk. Thoma Bravo founder Orlando Bravo has repeatedly said he believes software can function as an inflationary hedge because software provides so much productivity-enhancing value to customers that software companies will likely be able to pass on cost increases to customers—especially during a labor shortage.³ Software deals accounted for 10.7% of deal activity in the first three quarters of 2021 and continue to account for a growing share of US middle-market deal activity.

1: “Golub Capital Middle Market Report Q3 2021,” Golub Capital, October 2021.

2: Ibid.

3: Orlando Bravo: Finding, Retaining Talent More of a Concern Than Inflation,” *Buyouts*, Aaron Weitzman, September 30, 2021.

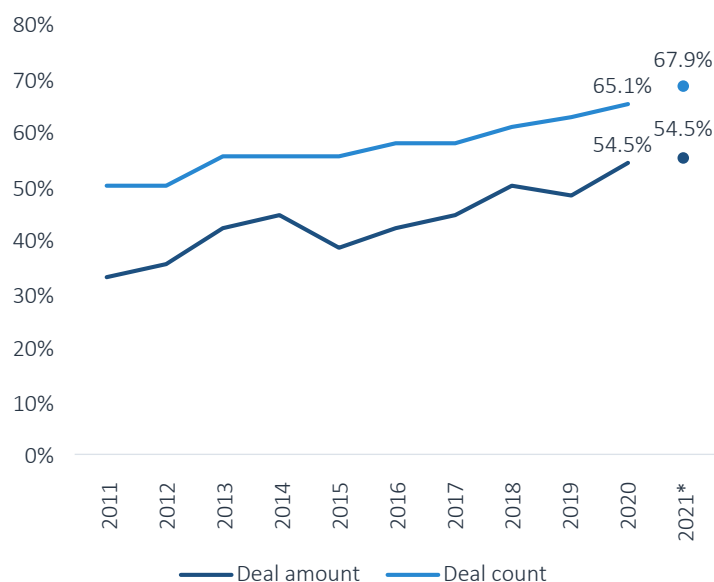
Growth strategies in a high-multiple environment

With deal multiples elevated and inflationary pressures potentially continuing, many middle-market industry participants are asking: How can firms ensure healthy returns for funds currently deploying capital? Many believe that multiples cannot rise much higher—although similar statements were made in 2018 and 2019—and many firms are underwriting current investments for zero future multiple expansion, if not multiple contraction. As a result, many middle-market investors are increasingly focused on buying companies that they believe are well positioned to leverage clear long-term demographic and consumer demand trends to drive revenue-sustained growth. For example, businesses related to pet ownership—including retail, services such as grooming and training, and veterinary clinics—are seeing intense interest from investors due to significant growth in pet ownership during the pandemic and a steady trend toward increased consumer spending on their pets' wellbeing.

Dealmaking in the pet products and services space also exemplifies another key deal trend: Firms are placing a premium on companies across sectors that have significant annual recurring revenue (ARR), mimicking the desirable SaaS business model that promises predictable cash flows and higher customer retention. As a result, many veterinary businesses are now selling subscription pet healthcare plans, which allow pet owners to access routine services for a set annual fee. One example is Cedar Animal Hospital, a single-location practice in Georgia that Southern Veterinary Partners, Shore Capital's rapidly growing veterinary medicine platform, acquired in August. The practice bundles routine examinations and vaccinations into annual plans based on pet species and age.

Buy-and-build strategies, which have the advantage of mitigating high platform prices through multiple arbitrage, continue to be an important strategy for middle-market firms deploying capital in a highly competitive environment. Add-ons as a proportion of middle-market

Add-ons as a proportion of PE middle-market deal flow



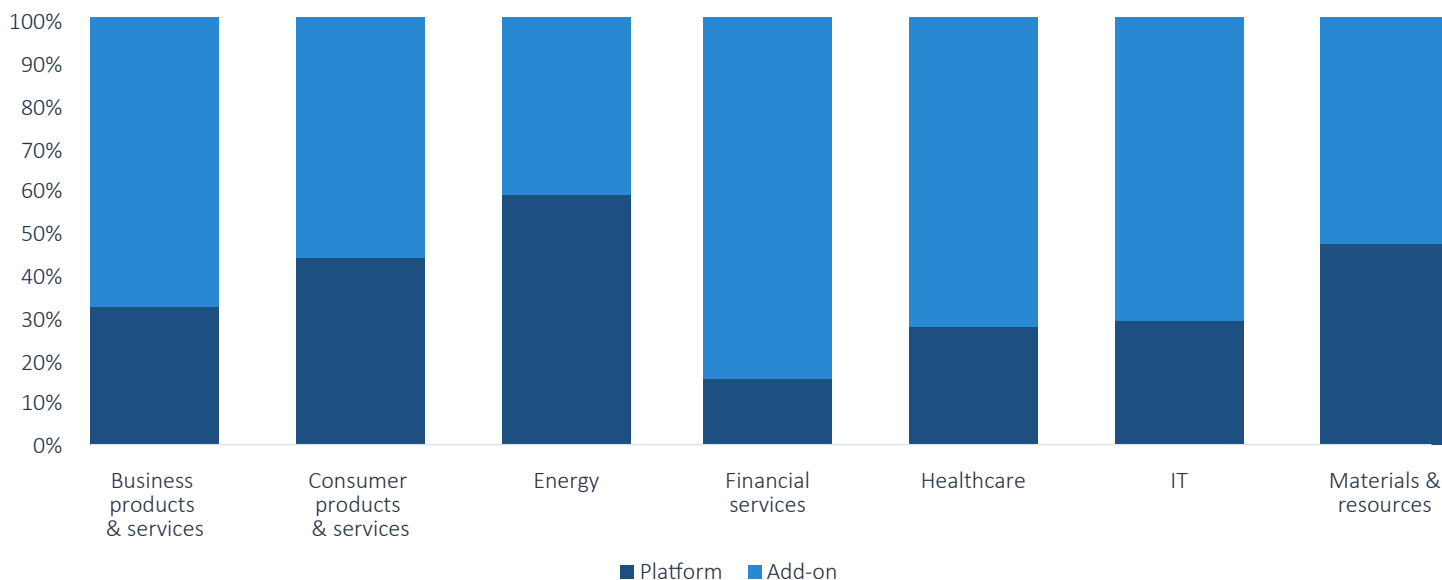
Source: PitchBook | Geography: US
*As of September 30, 2021

deal flow have reached an all-time high this year at 67.9%. In healthcare, technology, and especially financial services, the proportion is even higher. Firms are adding onto their platform companies throughout the lifespan of the investment, especially if they expect to exit via a sponsor-to-sponsor transaction, since PE firms are more tolerant than strategics of needing to continue the work of integrating recent acquisitions.

We have heard multiple reports of platforms being valued on EBITDA multiples that include the earnings from add-on acquisitions still under letter of intent (LOI). This means that many middle-market investors are pursuing aggressive inorganic growth plans even for platforms they acquired more than five years ago. For example, Risk Strategies Company, a specialty insurance brokerage that HarbourVest Partners and Kelso Private Equity acquired in October 2015, has completed three add-on acquisitions in the past month.

Overview

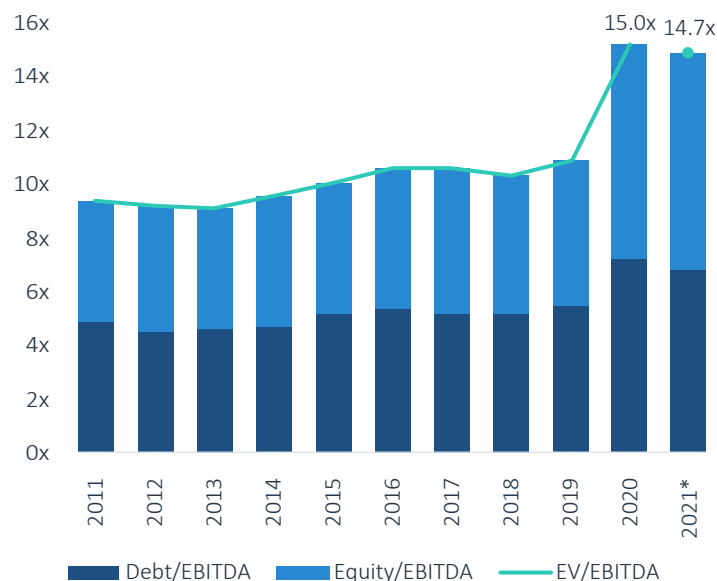
Share of PE middle-market buyout count by acquisition type, TTM



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

In other industries, firms are looking to organic growth for their multisite platforms as an alternative or supplement to add-on acquisitions. The market for applied behavioral analysis (ABA) providers, which treat autism spectrum disorder (ASD), is a prime example. Pediatric ASD diagnoses have increased steadily since 2000,⁴ creating extensive unmet demand, and margins for ABA services are attractive due to legislative reforms that have expanded insurance coverage and reimbursement rates beginning with the 2008 Mental Health Parity and Addiction Equity Act and the 2010 Affordable Care Act. As more PE firms look to buy and grow multisite businesses in the ABA space, the amount of capital chasing deals has outstripped the supply of potential targets, driving up purchase multiples for both platforms and add-ons, as well as reducing multiple arbitrage opportunities. As a result, firms are pursuing de novo growth strategies wherever possible. For instance, Acorn Health, an ABA platform that Ontario Teachers' Pension Plan bought from MBF Healthcare Partners in August, announced the opening of six new de novo clinics for H2 2021 in states where it already has a presence and is currently seeking additional therapists and technicians for further expansion—compared with just one small acquisition in the same period. Although opening a new clinic does not provide the near-instantaneous EBITDA growth of an acquisition, it often provides a superior return on investment (ROI) over a multiyear period and facilitates consistency in branding and back-office operations.

Rolling three-year median PE middle-market multiples



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

4: "Data & Statistics on Autism Spectrum Disorder," Centers for Disease Control and Prevention, September 25, 2020.

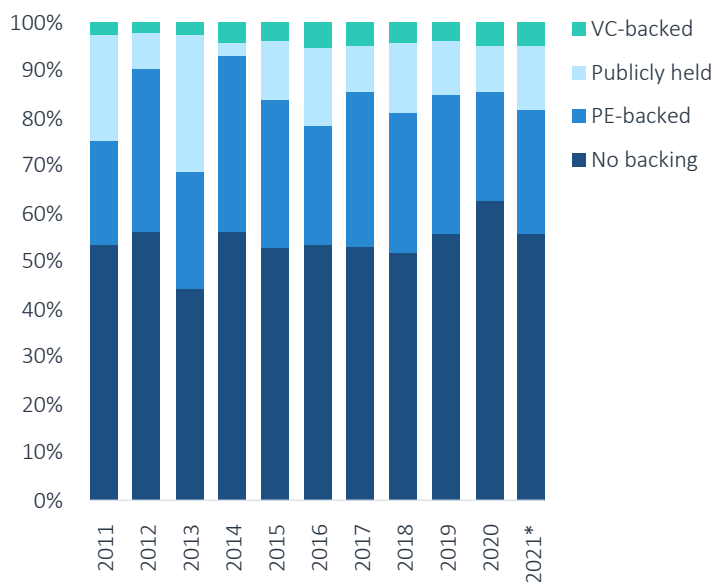
Opportunities in ESG operational improvements

Additionally, middle-market firms can add value by improving the environmental, social, and governance (ESG) profiles of portfolio companies. Although most firms do not expect to see their portfolio companies fetch artificial “ESG premiums” as a result of these enhancements, they are increasingly incorporating ESG-related improvements into their operational plans at the portfolio company level as a way to mitigate risks or reduce costs, improving the long-term sustainability and growth potential of the company. This is especially popular with companies in industries including manufacturing where social risks, such as employee health and safety and employee turnover, and environmental risks, such as spills or other contamination events, are prevalent—or where improvements lend themselves to substantial cost-saving opportunities, such as through energy consumption reductions. Middle-market firms are now more frequently building ESG assessments into the due diligence process or their initial 100-day operational plans and tracking improvements over the life of an investment.

Action items from these assessments may include working with management to implement a more robust environmental, health, and safety (EHS) program at a manufacturer with poor-to-moderate EHS performance. EHS program improvements may involve hazard identification procedures, annual employee trainings, or incident response procedures with root cause analysis, as such measures have been demonstrated to result in favorable financial outcomes through a variety of channels, some of which stem from one another. Primary financial impacts result from decreased costs associated with lost-time injuries and reduced regulatory penalties associated with avoidable injuries or illnesses. Subsequent cost impacts may include reduced recruiting costs due to improved employee retention associated with lower perceived work-related risk.

PE firms’ potential to improve business outcomes by implementing ESG-related enhancements can be demonstrated by looking at a historical example. Innocor, a middle-market foam products manufacturer, was purchased by Bain Capital in February 2017 and exited in October 2019. Bain Capital integrates ESG risk and value creation

Share of PE middle-market deal value by backing status



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

considerations into its investment process and seeks to drive performance improvement through management of ESG issues. When making control investments, such as that of Innocor, Bain Capital commits to providing occupational health and safety to employees of portfolio companies.⁵

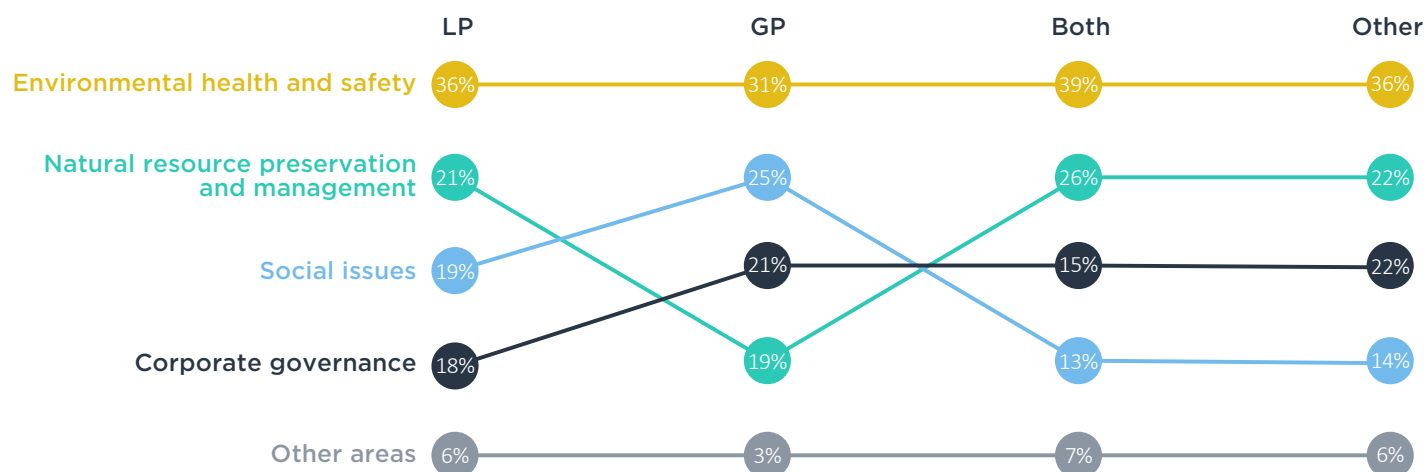
During the holding period, Innocor saw a noticeable decline in the number and severity of Occupational Safety and Health Administration (OSHA) violations, although the penalty amount fluctuated slightly due to an incident in 2018. In the 12 months prior to acquisition, Innocor experienced eight OSHA violations, all of which were designated “serious” by OSHA, resulting in a total penalty amount of \$18,760. In the 12 months leading up to Bain Capital’s exit, it received zero violations.⁶ The improvement is significant because although direct OSHA costs can be small, repeated violations are associated with broader financial ramifications including decreased productivity, higher workers’ compensation costs, increased staff turnover and hiring costs, and litigation risk.

5: “Lasting Impact Through Responsible Business,” Bain Capital.

6: “Establishment Search Results - Innocor,” Occupational Safety and Health Administration, November 29, 2021.

Overview

On what areas are you most focused when it comes to sustainability in an investment context?



Source: PitchBook | Geography: Global

Note: Sustainable Investment Survey respondents included LPs, GPs, funds of funds, and other industry participants across alternative assets and were not limited to the middle market. Respondents ranked available answers, with 1 being highest priority and 5 being lowest. This chart shows the percentage of respondents who ranked a given answer as 1.

As GPs come under increasing pressure to articulate and measure ESG management contributions regarding their portfolio companies, we expect to see more deals, especially in industrials, which allow firms to place ESG-related improvements front and center in their value creation strategies. Two deals that occurred in the second half of 2021 involved companies that may benefit from the aforementioned types of EHS improvement, based on OSHA records and GP commitments to ESG. The first is USNR, a wood processing equipment manufacturer acquired by One Equity Partners in October 2021. The second is Hubbell, an industrial and commercial lighting products manufacturer acquired by American Industrial Partners in October 2021. Both companies have experienced historical OSHA violations in recent years and have been acquired by GPs that publicly highlight employee health and safety as a key ESG consideration in their investments. In the current highly competitive environment, we expect middle-market firms will increasingly work to differentiate their deal and operational strategies by integrating robust ESG improvement practices.

Roaring like the '20s but hints of the '70s loom

Antares Capital Keynote

As 2021 comes to a close, earnings growth and M&A activity continue to boom. Consensus forecasts show real GDP growth reaccelerating from more tepid growth in Q3 2021 to a 4% to 5% range in Q4 2021. Also, profit growth trends have continued to outpace expectations—82% of the 95% of S&P 500 companies that have reported thus far in Q3 2021 have seen earnings per share upside surprises, with 75% seeing upside revenue surprises, according to FactSet. Meanwhile, middle-market M&A activity continues to surge with LBO and add-on loan volume up 82% YTD Q3 2021 from the same period in 2020 and up 15% from the same pre-COVID-19 period in 2019. According to Refinitiv LPC's Q321 Sponsored Middle Market Private Deals Analysis and the LPC Loan Connector Daily Analytic, total US LBO loan volume YTD November 2021 has already well surpassed the previous annual record high of \$208 billion in 2007.

Looking forward, despite risks and headwinds looming, consensus 2022 forecasts remain healthy, at 3.6% for US real GDP growth and at 8% for S&P 500 earnings per share, aided by trillions of dollars of increased money supply, new infrastructure spending, and low interest rates. However, the persistence of high inflation has dented consumer confidence and fueled concerns that the Fed may be behind the curve and that some companies could increasingly face margin pressure. While there are some signs of easing bottlenecks, new COVID-19 waves, perhaps including the more pernicious Omicron variant that hit the news as of this writing, could lead to more lockdowns and continue to plague supply chains through the winter months and well into 2022. Meanwhile, signs of stickier inflation have also been developing on the wage front, with some worried John Deere's new United Auto Workers (UAW) labor contract with sharp wage/benefit increases and cost of living adjustments (COLA) that are reminiscent of the 1970s could be a harbinger of things to come.



Tim Lyne

Chief Operating Officer
Antares Capital

Tim is a founding partner of Antares. He is responsible for leading the company's sponsor coverage and capital markets activities, operations and technology functions, as well as marketing and enterprise risk. Tim is a member of Antares' Investment Committee. He has been appointed to succeed David Brackett as Antares Capital's CEO in January 2022.

With the 10-year treasury bond yield near 1.5%, markets appear to remain sanguine about inflation prospects—at least in the longer term. Nevertheless, markets could see further turbulence ahead as the tides of monetary policy turn, especially if COVID-19, geopolitical risks, or other risks come to the fore. As a lender, prudence necessitates that economics remains a dismal science.

Q&A with Tim Lyne, COO

What are your expectations for middle-market PE M&A activity? What are you hearing from your borrowers and sponsors?

Strong economic and profit growth, abundant liquidity, and record PE dry powder remain potent forces that are likely to drive continued high levels of M&A activity into 2022. However, factors on the negative side include high valuation multiples, inflation and labor shortage concerns, potential new COVID-19 waves, and rising tax rates. On balance, we expect LBO and add-on activity to remain robust. Interestingly, based on an informal survey of our borrowers at a recent Antares-hosted event, 62% expect M&A to be more active in 2022 than in 2021, with only 10% expecting M&A to be less active. This perspective also appears to be consistent with other recent M&A outlook surveys we've seen. Still, there was also acknowledgement that auctions are getting very competitive with outsized multiples, making integration excellence and lower multiple add-ons all the more critical in achieving target returns.

Q&A: Antares Capital

With purchase price multiples reaching new heights, how are lenders and fund managers responding tactically to the risks associated with high valuations?

First, as a lender, to the degree that higher purchase price multiples are funded with higher equity contributions, this lowers loan-to-value ratios and is favorable to lenders in that it implies more “cushion” below the debt in the capital structure. It’s really higher debt leverage levels that are more the concern, though these haven’t risen as much. Refinitiv LPC’s data shows sponsored middle-market purchase price multiples (PPMs)—for institutional and private deals combined—climbing to a new high of 12.5x in Q3 2021 and comprised of a total debt multiple at 5.3x and an equity multiple at 7.2x. By comparison, if you look at the pre-COVID-19 Q3 2019, the PPM was 11.5x, the total debt multiple was 5.2x, and the equity multiple was 5.9x. So as you can see, leverage hasn’t risen all that much relative to the equity multiple over the last two years. If you go back several years, debt leverage is up about a turn, but the equity multiple is up three turns. Of course, it is important in today’s market to be sure in underwriting deals that true debt leverage is not too severely understated by questionable EBITDA add-backs.

Secondly, while the 12.5x middle-market LBO PPM in Q3 2021 may be a new high, it compares to a 16.9x total enterprise value to EBITDA multiple for the S&P 500 in Q3 2021—a multiple that has likewise been rising to new heights over the last several years. Of course, one can debate whether markets generally are in an asset bubble and whether the Fed tightening and raising interest rates will cause multiple compression (versus rising earnings, which could be a source of favorable multiple compression), but such questions are not specific to private debt as an asset class. In fact, if rates do rise, and valuations fall, being in a first lien position with floating interest rates is probably not a bad place to be, at least on a relative basis.

Thus far, how has inflation been impacting borrowers in your portfolio, and how as a lender do you mitigate inflation risk?

Our portfolio management team actively monitors and assesses risks such as those related to COVID-19 and supply chain/inflation. Across our portfolio, labor shortages and wage inflation are the most prevalent

concerns, followed by increased raw material costs/shortages and supply chain disruptions. About a quarter of borrowers expect some gross margin compression over the next six months, but the majority expect it to be temporary, based on their ability to pass through costs, albeit with lag. Also, some borrowers actually expect to see a positive impact from inflation. As of late October, less than 5% of our total portfolio by count was assessed as having high supply chain/inflation-related risk, with these borrowers sprinkled across industries such as automotive, aerospace and defense, chemicals, manufacturing, and capital equipment, as well as retail and consumer goods & services, food & beverage and restaurants, and containers & packaging.

As to the question of how a lender mitigates inflation risk, this entails underwriting borrowers with 1) leading positions and pricing power, 2) supply chain diversity to avoid bottlenecks and promote competition, and 3) favorable labor force dynamics—such as the ability to hire from a diverse set of prospects and improve productivity.

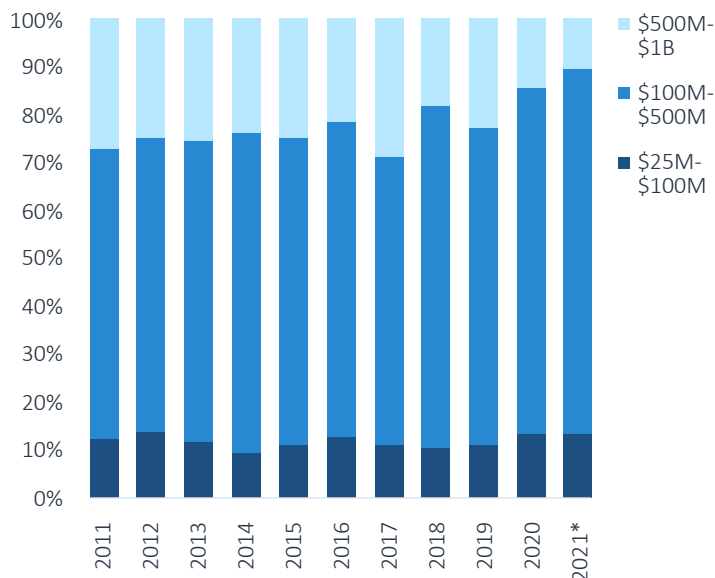
What other challenges and opportunities do you see ahead for the middle market? Do you expect defaults to rise?

COVID-19 fallout—perhaps rekindled by Omicron or other new variants—labor shortages (recruitment and retention), supply chain disruptions, and raw material cost inflation are the top challenges, but cybersecurity is another. The unfortunate reality is that cyber attackers are getting more sophisticated in their approach and companies need to continually monitor and update hardware and software to help combat attacks. In our informal borrower offsite survey, cybersecurity ranked highest among environmental, social, and governance (ESG) risk-related topics of interest.

Clearly, middle-market companies face many challenges and there will be winners and losers, but we expect them to continue to prove themselves to be an agile and a dynamic engine of the US economy, especially with strong sponsor support. Default rates may tick up a bit, given how low they are at present (0.29% in November for the S&P/LSTA Leveraged Loan Index); however, we expect them to remain low, and to the degree they do rise, spreads may also rise and/or terms tighten, which might not be a bad thing for lenders and private debt investors.

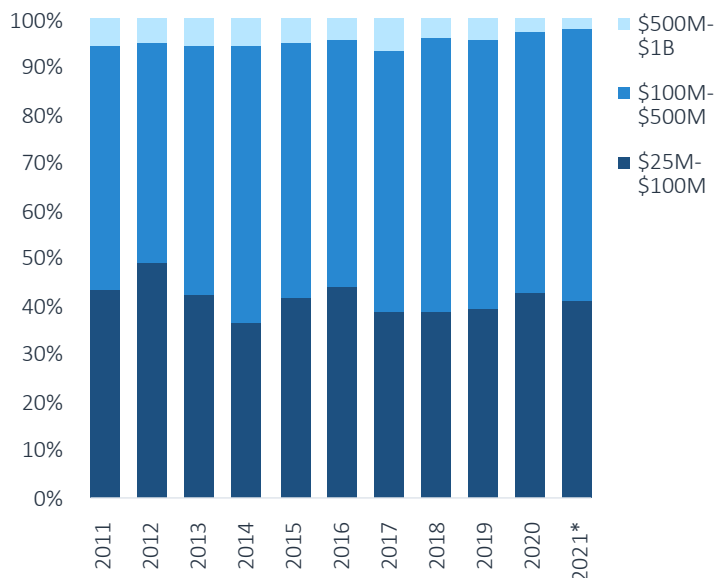
Deals by size and sector

Share of PE middle-market deal value by size



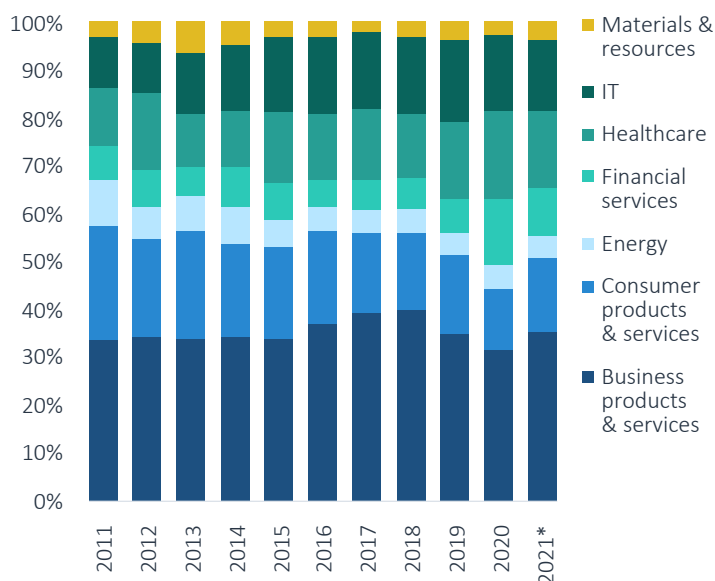
Source: PitchBook | Geography: US
*As of September 30, 2021

Share of PE middle-market deal count by size



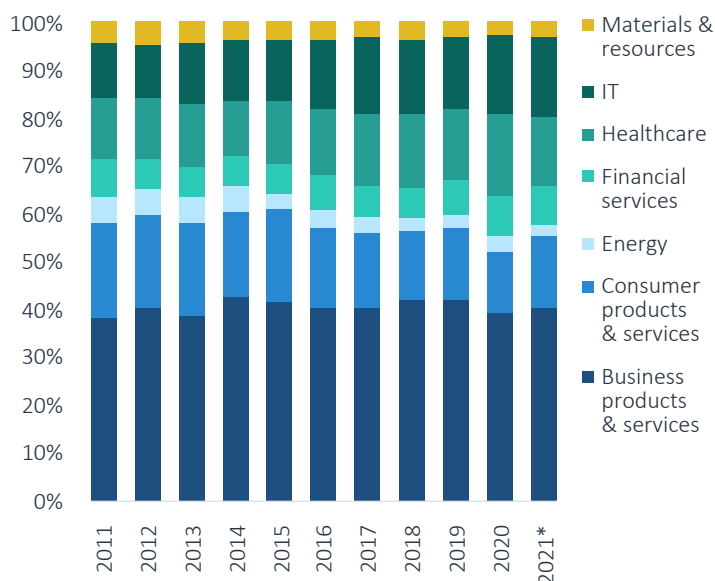
Source: PitchBook | Geography: US
*As of September 30, 2021

Share of PE middle-market deal value by sector



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

Share of PE middle-market deal count by sector



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

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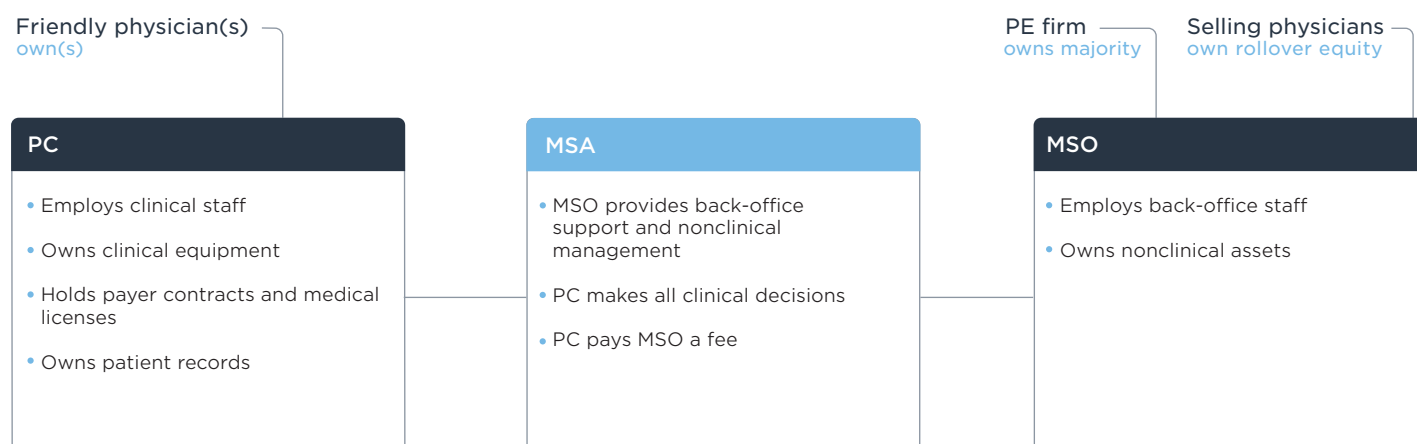
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Spotlight: Understanding US PE Healthcare Provider Transactions

Note: This spotlight is excerpted from our Analyst Note: Understanding US Private Equity Healthcare Provider Transactions. Please see the full note for additional analysis, including anti-fraud and abuse regulations, payer contracts, and more.

MSO structure



Over the past decade or so, healthcare provider practices have grown to be one of the most prominent PE investment areas. In the past five years, healthcare services deals, the majority of which are provider deals, accounted for over 70% of all US PE healthcare buyouts and over 10% of all US PE buyouts (including add-ons). Like other key PE buy-and-build playgrounds ranging from registered investment advisors (RIAs) to auto repair shops, the healthcare provider landscape is highly fragmented, with thousands of small, privately owned businesses. This creates attractive opportunities to employ the PE playbook, leveraging multiple arbitrage and economies of scale to generate returns. However, the complex regulatory and reimbursement frameworks in which healthcare services businesses operate mean that PE healthcare services transactions are unique among other PE deals in many important ways. Understanding these transaction considerations is essential for strategic decision making in growing a PE-backed healthcare services business, because

they can have a profound impact on risk, revenue, and geographic expansion.

Corporate practice of medicine

The most important regulatory issue governing US PE healthcare services transactions is a body of law known as “corporate practice of medicine,” or CPOM, laws. These are enacted—or derived from case law—and enforced at the state level. “Corporate practice” means ownership of a medical practice, employment of physicians, or influence—formal or de facto—over clinical decision making. Clinical decision making includes physician (and often clinical staff) hiring, diagnosis, and treatment decisions, but depending on the state, it can also include other factors such as equipment and supply purchases. Put simply, a state that prohibits CPOM generally requires that medical practices be solely physician owned and forbids any corporate structure that would allow non-physicians (laypeople or entities) to influence clinical decision making.

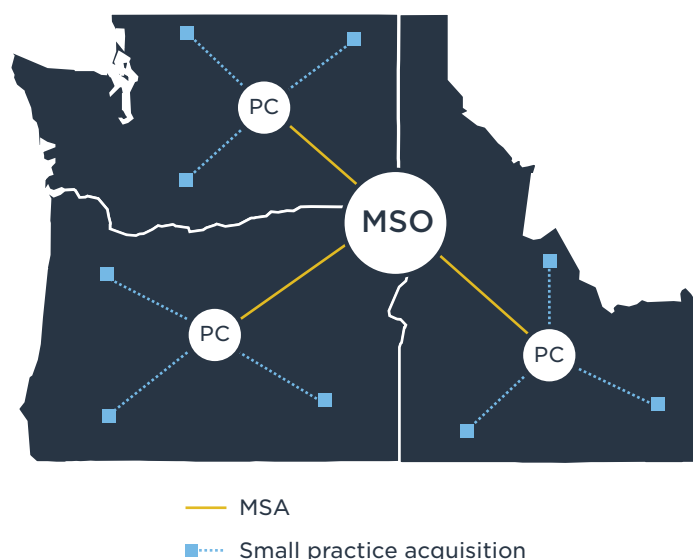
Spotlight

The majority of states prohibit CPOM, although how narrowly or widely “corporate practice” is defined and the ways restrictions are enforced varies. New York, New Jersey, Washington, Texas, and California are among the states with the strictest CPOM prohibition regimes. By contrast, states such as Ohio and Virginia permit the corporate practice of medicine, and several other states, such as Kentucky, have a CPOM prohibition law but do not regularly enforce it. There are equivalent laws relating to dentistry and optometry, and some states also prohibit the corporate practice of physical therapy and/or psychology. Additionally, CPOM laws in many states apply to veterinary medicine. In the analysis that follows, we focus on human medicine, but the same general principles apply to other practice types.

Because of CPOM restrictions, in most cases, PE firms cannot purchase medical practices directly. Instead, they must form a management services organization (MSO) that is separate from the professional corporation or limited liability company (PC). That is, they split all the administrative and back-office operations of the practice into a separate, nonclinical entity (the MSO), while all clinical functions remain with the physician-owned PC. Generally, the PC must be fully physician owned and employ the selling physicians, thus incurring their compensation, benefits, and malpractice costs. Entity-level licenses needed to operate the medical practice, payer contracts and associated liabilities, and patient records also reside with the PC. The MSO is the entity that the PE firm will own. It acquires the practice’s nonclinical assets, employs all nonclinical support staff, and provides back-office support such as information technology (IT) services, human resources and payroll, and administration. The MSO’s economic value is created by a fee paid by the PC to the MSO.⁷ This fee and the corresponding services that the MSO will provide to the PC are set out in a management service agreement (MSA).

Even though some states allow CPOM, most PE purchases of a healthcare provider platform, regardless of location, involve the creation of an MSO. This is because growth strategies for these platforms usually involve regional, if not national, expansion. It is also possible to combine a directly owned practice in a state

Hypothetical regional MSO structure



that allows CPOM with an MSO structure under a single entity, although this can sometimes become unwieldy. Once a firm has established an MSO platform, it will look to acquire additional practices via the MSO. According to J. Matthew Owens, Partner at Arnold & Porter, practice roll-ups can be structured as a hub-and-spoke model, wherein a single MSO contracts with many PCs, or as a series of affiliated “sister” MSOs established on a state-by-state or regional basis, each with several PCs.⁸ In smaller asset purchase deals that do not cross state lines, selling physicians can be absorbed as employees into an existing PC affiliated with the MSO.

Working with experienced lawyers and transaction service providers to carefully perform due diligence on potential corporate practice, fraud and abuse, payer contract, transaction structure, and physician compensation issues is essential to avoid unforeseen costs or revenue loss and to strategically plan geographical expansion. Moreover, this landscape is fluid, as changes to federal and state regulations can have a significant effect on PE strategy, especially in areas such as Medicare reimbursement and VBC. We will continue to track these important transaction considerations as they evolve.

7: Some practices also choose to form a physician-owned MSO independent of a PE sponsor or other nonphysician corporate owner. This can provide an attractive way for independent practices to combine into a single enterprise, thereby fueling growth while centralizing back-office operations.

8: J. Matthew Owens, telephone interview with Rebecca Springer, September 21, 2021.



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Canton & Company: Q&A

Q&A With Don McDaniel, CEO

A contrarian voice in the \$3.8 trillion healthcare industry, Don McDaniel founded Canton & Company on the premise that market principles can unlock innovation that leads to a more rational, sustainable system. McDaniel has launched several businesses and knows firsthand where to find value within healthcare's complex new economy.

Canton's growth-acceleration services combine proprietary data, a network of established industry relationships, and hands-on healthcare experience. With a team of leading authorities, Canton crafts the strategy and delivers the execution investors need at all points in the investment lifecycle, from deal sourcing to portfolio exits.

What are the key challenges for your clients in the current market environment?

Most PE-backed firms we talk to have growth issues. There are insurgent disrupters in the market—the Amazons, Walmarts, and Best Buys of the world—that leverage their consumer success and apply it to healthcare. Meanwhile, healthcare's incumbents are trying to innovate either to maintain revenue or to slice business away from their competitors. In the case of hospital institutions, they're doing so while carrying the burden of massive capital expenditures.

It's difficult to grow with this kind of competition, especially with the current shift regarding the place of service. The higher-cost institutions cannot sustain their margins, especially in light of the pandemic's effects, and care is moving farther into the community. That means more office-based and outpatient services, including virtual care at home. Upwards of 30% or more of services provided in acute-care institutions can be provided elsewhere. So, service providers need to determine how to provide high-quality care that meets patient expectations, all while dramatically reducing overhead.

These days, investors' challenges are more tactical—especially surrounding talent. It's hard to find talent—not just at the executive level but also for clinical and allied-health staff. You can have a great service offering, but without the labor force to deliver it, your growth will be limited.

Consumers have played a relatively small economic role in the system, thus resulting in dissonance between the ultimate consumer of care and those providing care.



Don McDaniel
CEO

Don McDaniel leads a team of healthcare experts to accelerate growth for innovators in the new health economy. A serial entrepreneur with decades of experience, he is a former hospital, health services, technology, and insurance executive, and operating partner for a venture capital firm.

But that's changing thanks to high-deductible health plans and the direct-to-consumer virtual care models that promise patients a path of less resistance between themselves and their care providers.

Don't want to drive 20 miles to your doctor's office? Can't get an appointment today? Great, here's an online portal that will evaluate your sore throat and provide a prescription if needed. Candidly, in what other industry does the supplier typically expect consumers to inconvenience themselves as a function of the service?

Any healthcare investment must have sightlines into consumer preferences, whether your portfolio company is in the direct care business or not. It's going to permeate every interaction.

Which key policy, regulatory and tax issues are you watching most closely, and why?

The key regulatory activities are almost always related to payment. Care providers and tech vendors alike solve for revenue issues first—asking whether they can get paid to do certain things. But the warnings are clear: If you start poking at the loopholes, lawmakers will notice.

For example, a persistent problem exists related to patient data and interoperability of health records. Recent regulations around data blocking are the result of companies trying to hold patient data hostage as intellectual property. The rules that went into effect this year prohibit interference with the access, exchange, or use of electronic health information.

Policies are essentially acknowledging that data must be democratized to allow not just providers to have access,

Q&A: Canton & Company

but also to allow patients that access as well. When consumers can easily get their hands on their own health data, they have a better opportunity to shop for care and manage their out-of-pocket costs.

There's no doubt healthcare's complexity is directly related to the large number of regulations that this ecosystem must comply with. Many of them are myopic and directly affect growth potential. Investors must have consistent insight into where the regulatory environment is headed and how that can overlay their decisions because a single change to reimbursement policy, for example, could suppress growth for your entire healthcare portfolio.

Are there any unique concerns or challenges for middle-market-sized healthcare entities and the PE funds that look to partner with them?

Too many to list. Healthcare is painfully dysfunctional and doesn't act like other markets. The usual suspects include: cost and quality variation, lack of cost transparency, and irrational pricing. Furthermore, consumers are neither enabled, inspired, nor encouraged to shop around, which dulls their market influence. If consumers aren't affected by their spending, we are missing the fuel for innovation. Most of the issues related to variation, pricing, and so forth are related to this.

Obviously, no one wants to see healthcare services become commoditized. But a chasm exists between where we are today in terms of variability and anything even close to commoditization.

As a result, the value levers are opaque. Investors need market data to help identify opportunities that actually work—as opposed to what sounds good on paper. Frequently, we're working alongside clients, refining their strategies in the execution phase and adjusting when we foresee some peculiar market hurdle that could slow their growth.

What are the most difficult parts of forecasting healthcare entities' financial targets, and how can prospective investors best prepare?

Financial risk abounds in healthcare. As much as Medicare and commercial insurers would like to drop more risk in the providers' laps, they're finding that scenario isn't producing cost savings.

Not to be deterred, the latest iteration on risk will have providers budgeting with population-based payments. That means the risk comes in with sicker patient populations who need more management and whose future needs aren't at all easy to predict.

Investors must be cautious about how their health services portfolio companies calculate such risk. Health tech investors should take a long view on how their assets are enabling the risk-sharing environment, and anyone investing in commercial payers such as Medicare Advantage must keep their eyes open about quantifying risk with the appropriate documentation to back it up.

In September, the largest government oversight office began questioning whether insurers are overstating risk and thus benefiting financially. Examining 2016 data, the office found \$9.2 billion in overpayments, and officials recommended tighter oversight, especially considering the recent growth of these private market plans.

Finally, like the rest of the US, healthcare is also experiencing worker shortages, which limits growth. In the hospital space, one of the country's best-known not-for-profit hospital systems is paying nurses \$400 bonuses per day on top of overtime pay to incentivize them and keep all the shifts covered. Acquire all the assets you want—without the staff to deliver net-new services, your organic growth will fall short of expectations.

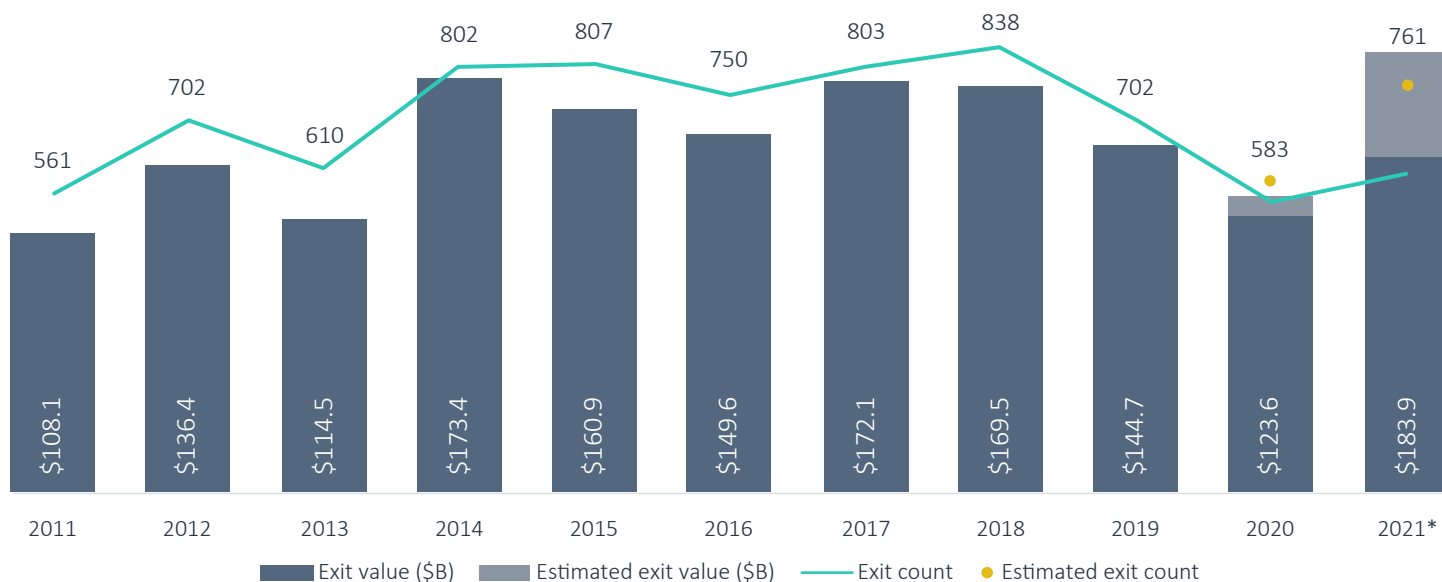
Please feel free to expand on any of the issues broached above or address those that have not yet been mentioned.

Canton & Company is a value accelerator across the complete lifecycle. We meet our clients where they are and advance their abilities to grow in the nuanced healthcare industry. We've worked with some of the biggest businesses in healthcare—including the disrupters—and we've launched new companies from the ground up.

Healthcare is all we do. Engagements are not off-the-shelf strategy plans that we leave at the curb for you to unpack. We're hands-on doers who leverage our data resources, relationships, and frontline industry experience. Our network extends both broadly and deeply, so our clients have exactly the expertise they need to solve challenges and realize the futures they envision.

Exits

PE middle-market exit activity

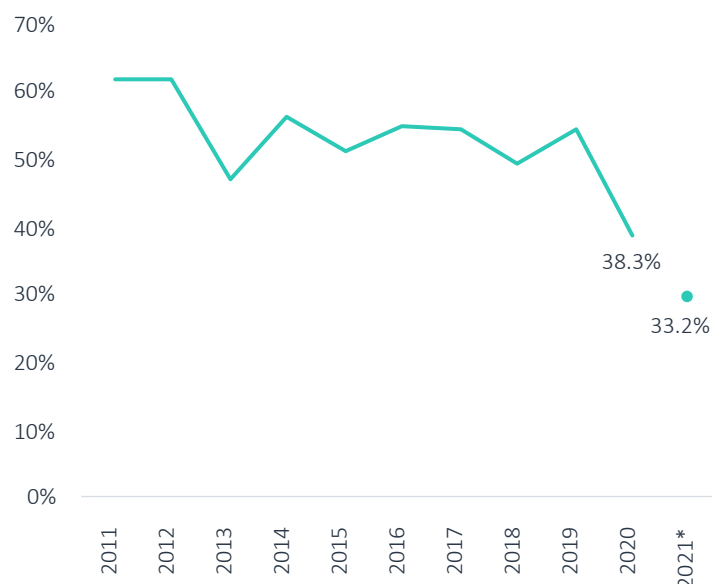


Source: PitchBook | Geography: US
*As of September 30, 2021

US middle-market exits continued at a remarkable pace in Q3, with the annual exit value already surpassing the previous annual record. Firms exited 761 investments with a total combined enterprise value of \$183.9 billion through Q3 2021. Despite a slight cooling off of economic growth in Q3 due to the spread of the COVID-19 Delta variant—US GDP grew at an annualized rate of 8.1%, compared with 13.4% in Q2—middle-market portfolio companies have benefited from revenue and earnings growth over the past year, resulting in favorable exit opportunities. The GCAI shows 20.8% revenue and 13.4% earnings growth YoY for PE-backed middle-market companies. Highly motivated buyers are also facilitating middle-market exits. Financial buyers are deploying plentiful dry powder, and healthy private debt fundraising is adding to their dealmaking abilities. Strategic buyers are also benefiting from improved balance sheets due to the economic recovery. Although public listings represent a minuscule proportion of middle-market exits, elevated stock prices have also increased the buying power of publicly traded strategics.

With the TTM financials of companies now starting at Q3 2020, the worst of the pandemic effects are being aged out of the financial statements used in company valuations. This is pushing up TTM revenues and earnings for most companies beyond the growth enjoyed during the current bullish market.

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



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

Exits

However, some industries are still recovering from the downturn or are reconfiguring business models to adapt to post-pandemic needs, possibly pushing back exit timeframes. Other investors are choosing to hold their portfolio companies longer, believing that the market will remain favorable and their portfolio companies will continue to grow. We expect exits to remain strong as market recovery becomes more widespread and financial sponsors and strategics, flush with cash, look to scoop up opportunities in the middle market.

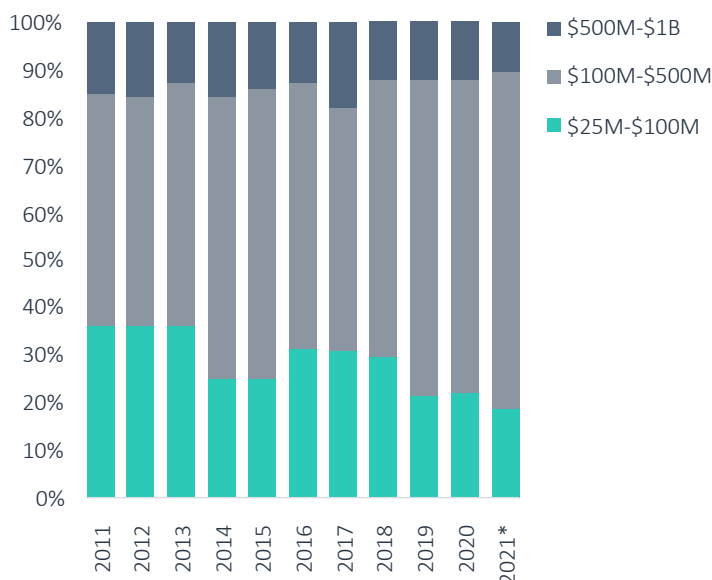
Sponsor-to-sponsor exits

Sales to other sponsors continue to account for a growing proportion of middle-market exits as healthy fundraising and record levels of dry powder push firms to deploy capital quickly. Through Q3, sponsor-to-sponsor exits represented 62.7% of all middle-market exit count and 56.0% of exit value. Because middle-market PE firms have substantial dry powder and debt financing is readily available, sponsors looking to exit portfolio companies can seek out other financial buyers that are pursuing opportunities such as add-on acquisitions to further grow existing investments. While numerous large exits occurred in industries such as healthcare that are seeking to build up large platforms, many lower-middle-market companies were also sold to financial sponsors. For instance, Hamilton Robinson Capital Partners sold Horizon Bradco, a commercial refrigeration and HVAC equipment solutions provider for supermarkets and convenience store customers, to Smart Care Equipment Solutions for \$35.8 million in August. Smart Care is backed by Audax Private Equity and has pursued nine add-on acquisitions under the sponsor to expand its platform in a fragmented commercial kitchen repair and maintenance service market. Horizon Bradco adds new geographic footprints and creates deeper service penetration for Audax Private Equity's growth strategy.

Exits to strategic buyers

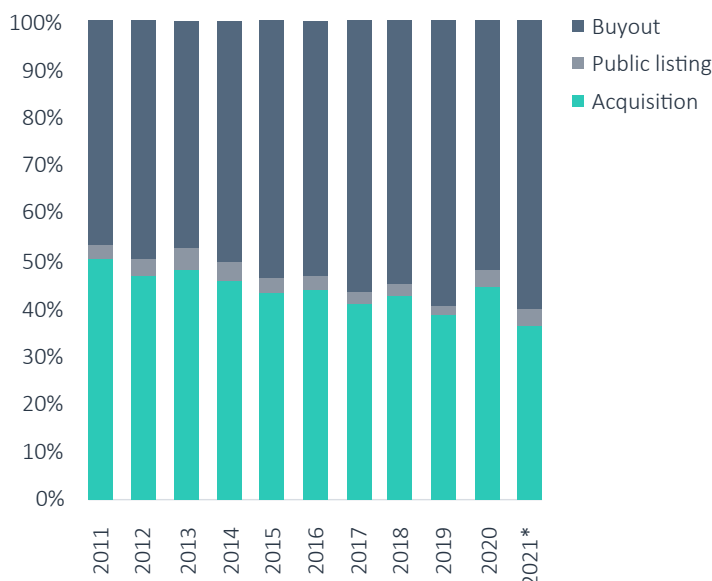
Middle-market PE exits to corporate acquirers remained steady in Q3 2021. Although the numbers are healthy, smaller strategics are likely slower to bounce back as active buyers than large companies after a period of lost revenue and labor shortages. With new trends stemming from the pandemic causing many industries to adapt in order to stay competitive in the post-pandemic environment, the middle market can capitalize by exiting its investments to companies that seek to implement changes and new synergies. During

Share of PE middle-market exit count by size



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

Share of PE middle-market exit count by exit type



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

Q3, Endicott Group and Susquehanna Growth Equity sold Real Capital Analytics, a global commercial real estate data and analytics provider, to MSCI (NYSE: MSCI) for \$950.0 million.

Exits

The sale comes at an opportune time as commercial real estate continues to transform with shifting consumer behaviors in work, lifestyle, and travel driven by the pandemic, and as companies seek to consolidate businesses and look to bring in proprietary data. In some cases, strategic buyers are willing to pay a premium for companies because they are better placed to realize synergistic benefits through cost savings, access to new customers and geographical footprints, and other revenue opportunities through economies of scale; in the current environment, some sponsors have begun to pursue synergistic M&A as well and are willing to pay equally high multiples.

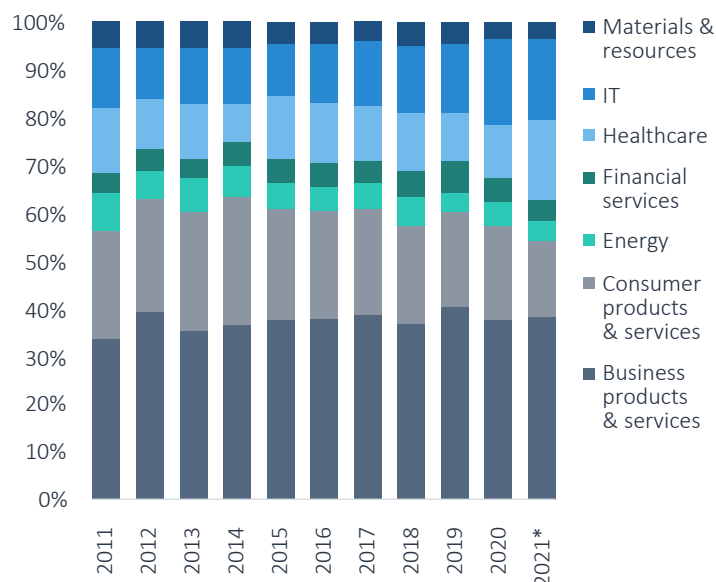
Opportunities in supply chain and logistics

As global supply chain disruptions highlight the need for operational and technological improvements in the supply chain industry, middle-market PE firms are realizing favorable exits for their logistics-related portfolio companies. Some have found strategic buyers, such as in One Equity Partners' sale of PS Logistics, the US' largest flatbed transportation and full-service logistics provider, to Gamut Capital Management and British Columbia Investment Management in June. Most middle-market supply chain companies, however, are currently being sold to industrials companies that are seeking to bolster their current operations and unlock synergies. In October, Riverside Partners announced its sale of R&D Altanova to Advantest (TYO: 6857), which is seeking to incorporate the consumable test interface board supplier to expand its test and measurement solutions across the semiconductor value chain. And in November, Trive Capital announced its sale of NXEdge, a semiconductor supply chain business, for \$850.0 million to EnPro Industries (NYSE: NPO) to accelerate its growth in industrial technology-related markets. The ongoing global chip shortage has exposed major vulnerabilities in the semiconductor supply chain, causing disruptions for consumers and suppliers across numerous industries. With both governments and companies rushing to strengthen this critical supply chain, it is no surprise that middle-market firms are finding plenty of opportunities to sell their relevant and timely portfolio companies.

Demand for middle-market-focused software providers

IT continues to see robust exit activity as the pandemic has accelerated the growing need for digital transformation. Midsized companies often do

Share of PE middle-market exit count by sector

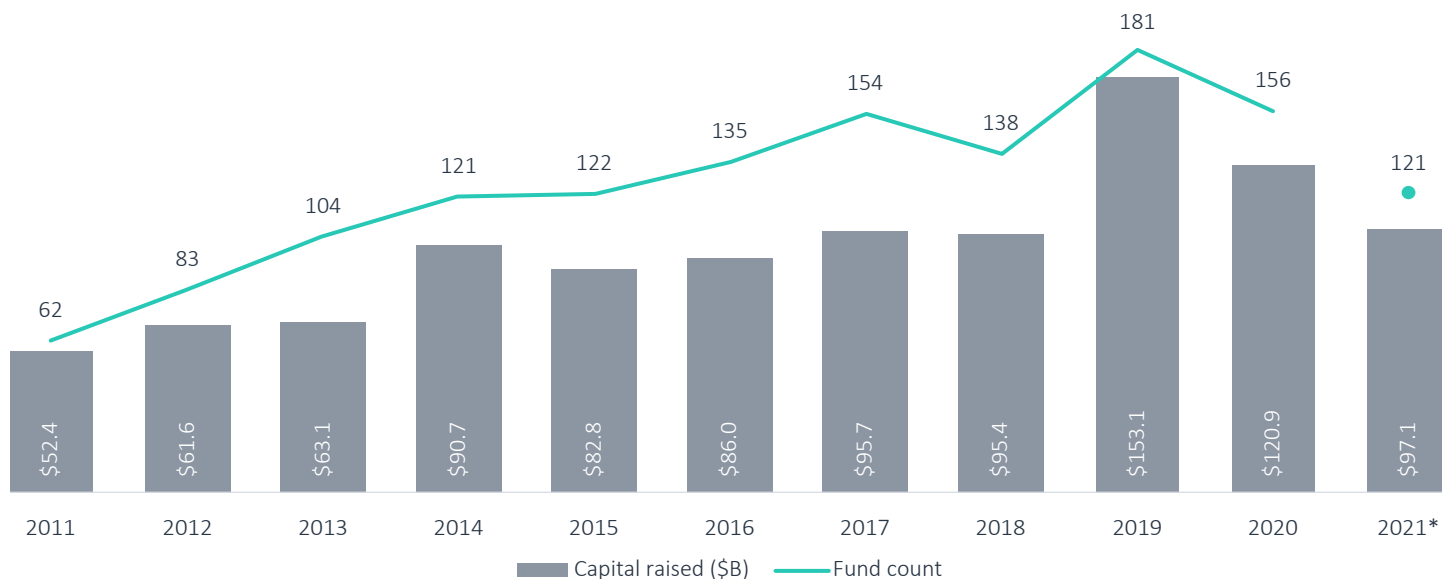


Source: PitchBook | Geography: US
*As of September 30, 2021

not have the budget to pay for sweeping software systems, instead preferring similarly sized vendors and cloud applications that help integrate data siloes over expensive enterprise solutions. PE firms that recognize this opportunity are securing favorable realizations as middle-market investors increasingly seek out ways to implement digital strategies in their operations. In October, Level Equity Management sold HVR Software, a leading software platform for real-time data integration and replication, to Fivetran for \$700.0 million. HVR Software allows enterprises to connect and use data across on-premises and cloud environments, part of a data integration effort that is key to larger digital transformation initiatives. Similarly, PE-backed e-commerce company Ecwid was sold to Lightspeed (TSE: LSPD) for \$500.0 million in October to fold into its omnichannel commerce platform. Ecwid, which allows small business merchants to set up global online stores in minutes, will be integrated with Lightspeed to provide additional selling flexibility across platforms such as TikTok, with which Lightspeed has a partnership. Companies that provide data integration and multichannel services much needed in the middle market are experiencing a favorable exit environment as other investors seek to drive additional growth with the next stage of investment.

Fundraising & performance

PE middle-market fundraising activity



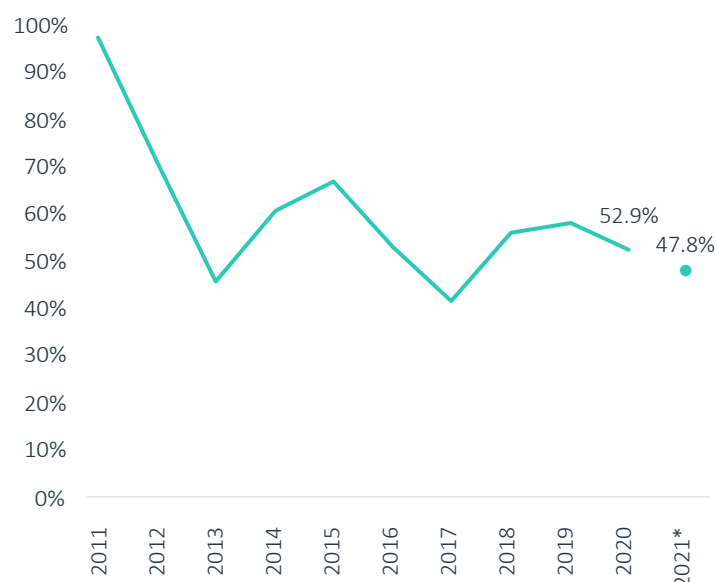
Source: PitchBook | Geography: US
*As of September 30, 2021

US middle-market fundraising held firm in Q3, with 121 funds closing for a combined \$97.1 billion. YTD fundraising figures are on track to approximately meet 2020's annual figure by the end of the year but likely will not reach the high-water mark set in 2019.

Step-ups and strategy expansion

Although the fundraising environment is positive by historical standards, the middle market has not kept pace with the unprecedented capital raising activity we are seeing from mega-funds (\$5 billion and over), which are currently propelling the industry overall toward a record-breaking fundraising year. The current low interest rate environment has made the higher returns promised by PE more attractive to LPs, many of which are continuing to lift their PE allocations. However, many public pensions, endowments, and foundations are understaffed, making them keen to consolidate manager relationships wherever possible. This trend strongly favors larger funds over smaller ones. We are seeing some upper-middle-market managers grow their fund sizes aggressively in light of this. For example, in September, both Nautic Partners and Alpine Investors closed funds at their hard caps just two years after their last fundraises: \$3.0 billion for Nautic Partners X, a nearly 2x step-up from the previous fund, and \$2.25 billion for Alpine Investors VIII, a 2.25x step-up.

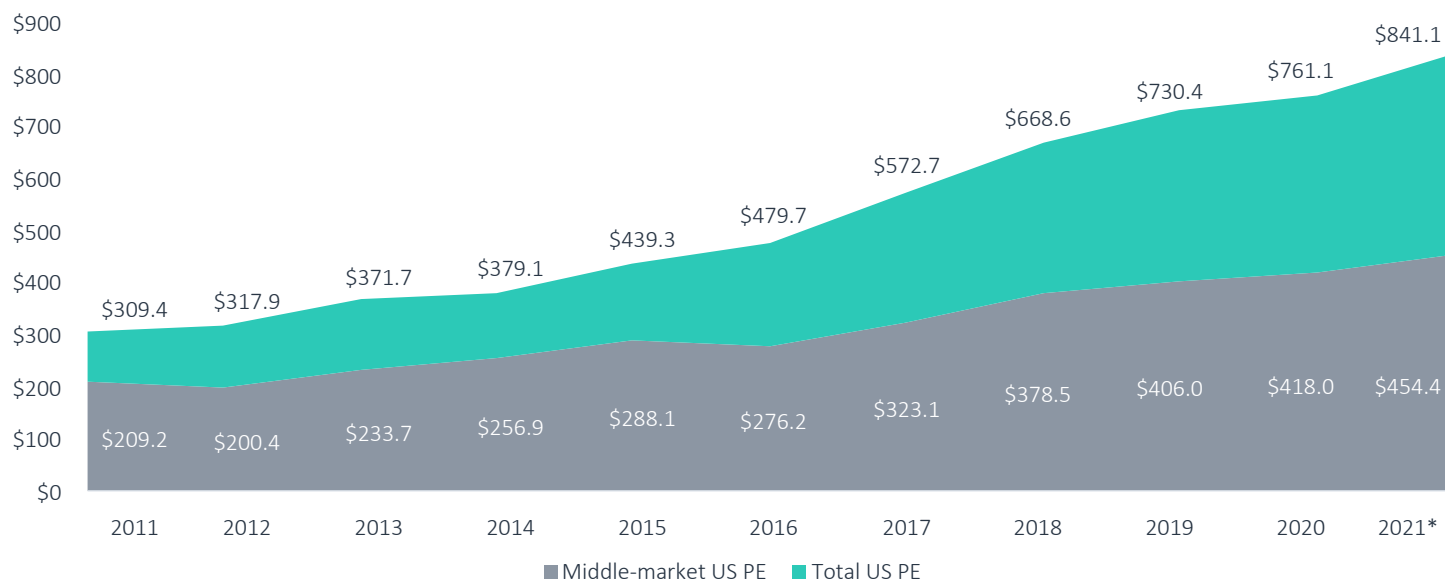
PE middle-market funds as a share of all PE capital raised



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

Fundraising

Dry powder (\$B)

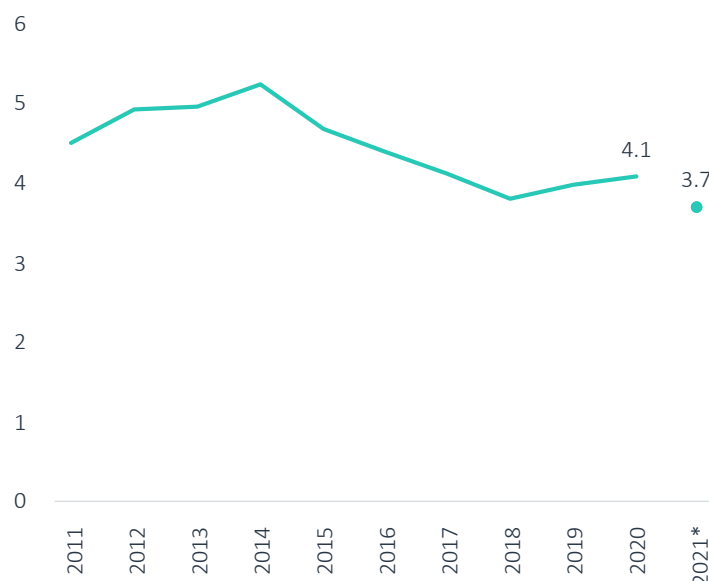


Source: PitchBook | Geography: US
*As of March 31, 2021

Mega-fund managers are also taking advantage of LPs' desire to consolidate manager relationships while increasing allocations by launching additional strategies, many of them focused on the middle market. Our data shows that large firms, defined here as those that have raised at least one \$5 billion-plus fund, have collectively launched an average of 2.5 new middle-market buyout strategies per year since 2011. Many of these strategies are now raising their second or third vintages. For example, Warburg Pincus is currently seeking \$2.5 billion for its second financial sector fund, which invests in financial services companies alongside the flagship. And Vista Equity Partners and Thoma Bravo, both of which are expected to launch their next flagship buyout funds imminently, will likely raise additional middle-market funds simultaneously.

Several established middle-market firms, such as H.I.G. Capital and The Riverside Company, have also used strategy expansion to grow AUM while keeping fund sizes under \$5 billion. H.I.G. closed its first Europe Middle Market LBO Fund at \$2.4 billion in September and is reportedly close to launching a technology-focused fund.⁹

Average years between funds



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

9: "Tech-Focused Firms Speed Up Fundraising," WSJ, Preeti Singh and Laura Cooper, December 1, 2021.

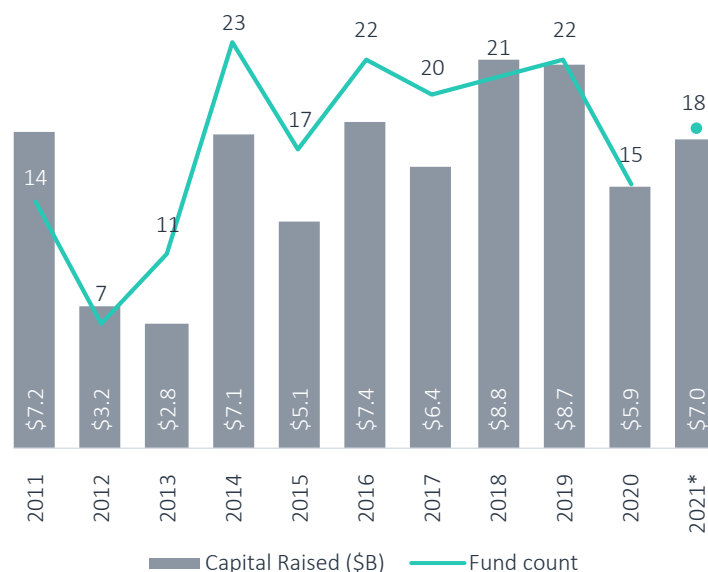
Riverside's new value-focused buyout fund opened in August. Unlike many strategy expansions by large managers, which operate as sidecars investing alongside the flagship, both H.I.G.'s upcoming tech fund and Riverside's value fund were preceded by the firms hiring veteran sector specialists to lead dedicated teams.^{10, 11} Another middle-market manager that has joined the strategy expansion trend more recently is Shore Capital Partners, which closed its first business services-focused fund in the third quarter alongside its fourth flagship healthcare fund. Shore, which has remained disciplined in its microcap focus, is a noteworthy case because the firm was a healthcare specialist for nearly a decade before it began raising funds focused on other sectors, beginning with a food & beverage fund in 2019.

Positive signs for emerging managers

Middle-market emerging managers (those raising funds I through III) have also fared better in 2021 than in 2020. Emerging managers play an important role in middle-market fundraising because virtually all new managers, whether they aspire to raise large-cap funds eventually, begin their fundraising journeys at the sub-\$5 billion level. Funds raised by emerging managers have accounted for more than 40% of middle-market funds closed and just over a quarter of capital raised YTD in 2021. One noteworthy fundraise is that of Avesi Partners, which invests in healthcare and business services companies and closed its first fund at \$875.0 million in July after less than six months in the market. Also, Tenex Capital Partners, a generalist firm, hit its \$1.2 billion hard cap with its third fund in October.

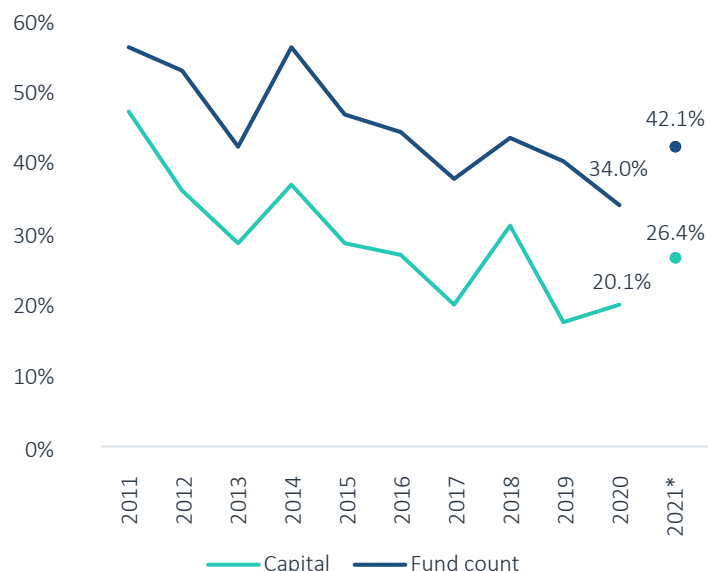
In addition to the potential for performance upside, many LPs are looking to emerging managers to access highly specialized, operationally focused small- to mid-cap strategies. Deal professionals often spin out from larger firms because they want to focus on their core area of expertise and potentially have the opportunity to work on smaller deals that their previous firm was too large to pursue. Recent fundraises by middle-market specialists include the \$650.0 million second flagship of Amulet Capital Partners, a healthcare-focused firm led by Ramsey Frank, who previously focused on healthcare as a Senior Managing Director at JLL partners, and the \$312.0 million debut fund of Clearhaven Partners, a software investor led by Michelle Noon, who also led technology deals as a General Partner at Riverside Partners. Both funds exceeded their targets.

PE middle-market first-time fundraising activity



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

PE emerging manager fundraising activity as a share of total middle-market fundraising count and capital raised



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

10: "H.I.G. Capital Hires John Woyton To Lead Dedicated Technology Buyouts Team," Business Wire, August 5, 2021.

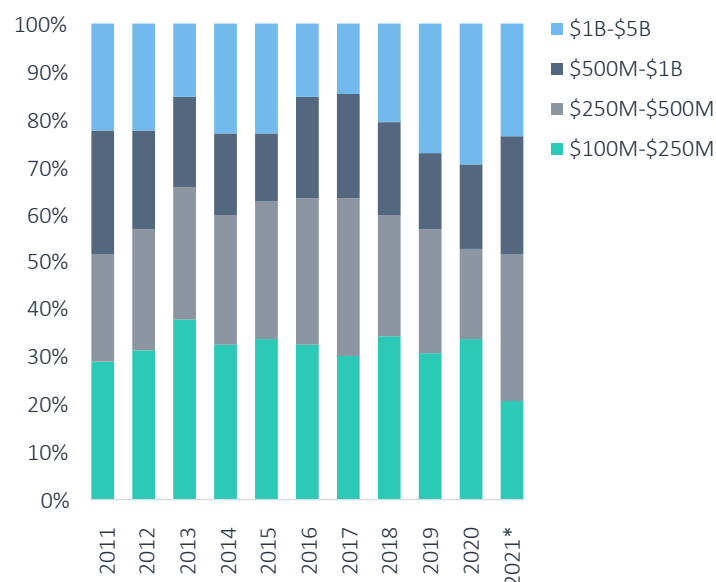
11: "Riverside Co. Adds Managing Partner To Run Value Investing Drive," Pensions & Investments, James Comtois, September 9, 2019.

Additionally, we are seeing numerous pensions expand their emerging manager programs or launch new programs, which are typically separate capital pools managed by a consultant or fund of funds. These programs allow pensions to ring-fence the additional risk that comes with emerging manager commitments while potentially building manager relationships that could mature into the pension's main portfolio. Typically, they also focus on backing women- or minority-owned managers, a growing priority for many governing boards. Nevertheless, the fundraising process remains challenging for emerging managers and particularly first-time funds, which face the chicken-and-egg problem of needing to secure a first close to bring additional LPs on board. For this reason, we are also seeing an expansion of seeding as a nascent strategy within PE. Seeding firms raise funds or invest off their balance sheets to provide first-close capital to new managers in exchange for preferred economics, typically a revenue share of around 20%. There are currently at least four seeding funds open: Gatewood Capital Partners and Stable Asset Management are both raising second funds, while Grafine Partners, a new firm, and Azimut Alternative Capital Partners, which has previously seeded off its balance sheet, are raising first funds. We also know of two additional seeding firms with Fund I launches in the works.

Growth in the independent sponsor space

While PE funds overall are trending larger, and the fundraising process remains challenging for emerging managers, independent sponsors—also known as fundless sponsors—have carved out a growing presence at the smaller end of the middle market. Two thirds of independent sponsors target companies with less than \$5 million in EBITDA, according to the 2020 Citrin Cooperman Independent Sponsor Report.¹² While capital raising activities by independent sponsors by definition do not appear within our fundraising data, they represent an important part of the middle-market capital allocation landscape, and many in the industry believe that the independent sponsor space will continue to grow. Independent sponsors generally fall into two categories: experienced dealmakers looking for the flexibility to pursue deals in their area of expertise without the encumbrances of the fund structure, and industry professionals from PE, banking, or operational backgrounds who are working to build an attributable track record that enables them to raise a fund in the future. Independent sponsors represent an additional

Share of PE middle-market fund count by size



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

commitment option for small LPs, especially family offices, that are looking for greater flexibility and control over their investments. They also offer LPs the ability to avoid paying management fees on committed but uninvested capital and to make investments that extend beyond the traditional fund lifespan, without requiring the deal sourcing, execution, and management resources associated with direct investment. Independent sponsors are increasingly partnering with traditional PE firms as well, allowing larger firms to delegate the sourcing and management of deals that would otherwise be too small for them to pursue.¹³

Fund performance

Middle-market PE firms posted impressive performance figures in Q1, the most recent quarter for which data is available, reaching around 30% net IRR over a one-year horizon. Although these figures appear to be overshadowed by the astronomical performance of \$5 billion-plus funds over the same period, mega-fund performance figures are being driven disproportionately by a wave of public exits and firms marking unrealized investments to market against public comps, which have traded up substantially.

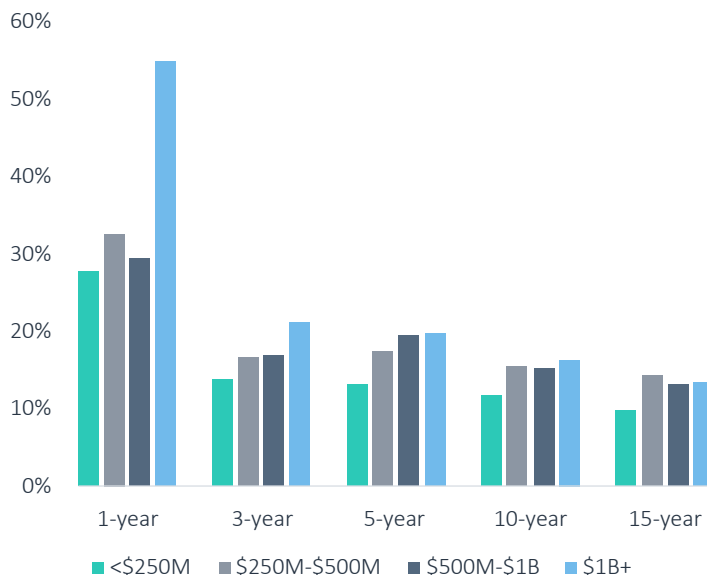
¹²: "2020 Independent Sponsor Special Report," Citrin Cooperman, 2020.

¹³: "For Independent Sponsors, Access to Capital Is No Longer a Constraint," CohnReznick, Claudine Cohen, February 25, 2021.

Fundraising

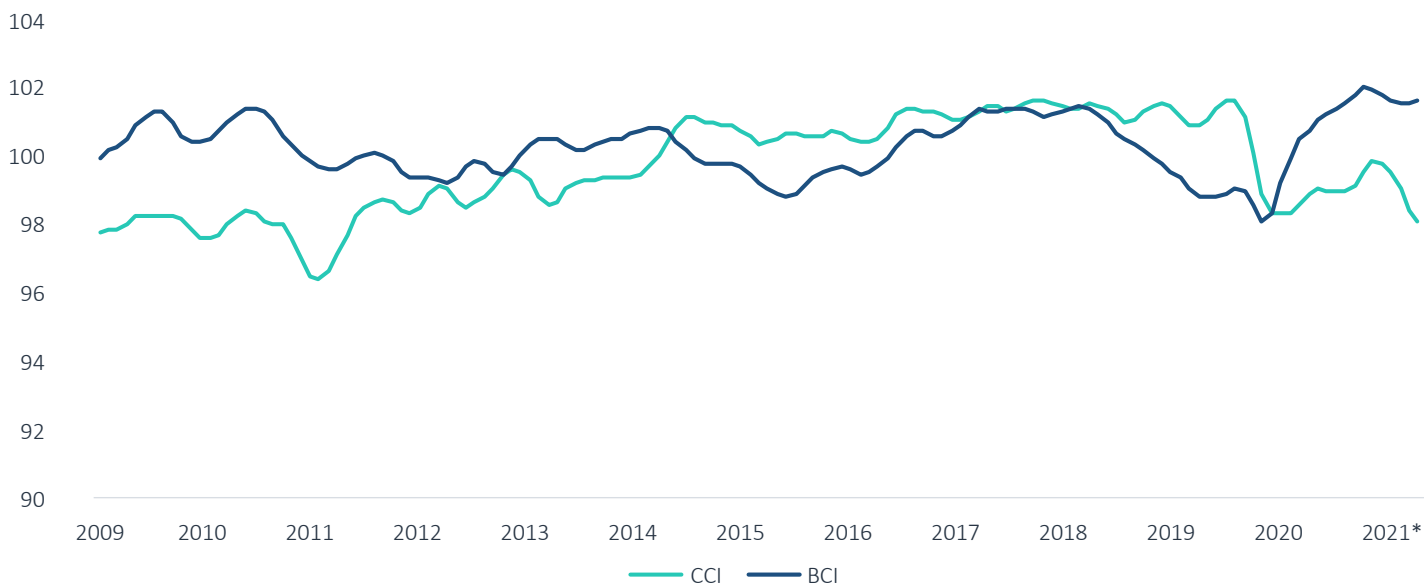
Robust middle-market fund performance in the absence of these factors signals a healthy exit market and strong underlying revenue and earnings fundamentals for portfolio companies. As additional data is recorded, we expect Q2 and Q3 2021 middle-market performance to cool slightly from Q1's levels, but remain impressive by historical standards. US consumer confidence dipped since Q1 due to the spread of the Delta and other COVID-19 variants as well as concerns about inflation, although business confidence and advance retail sales figures for October 2021 show a positive trend. Additionally, an accelerated realization pace for middle-market funds in Q2 and Q3 should bolster performance—as portfolio companies continued to recover from the worst of the pandemic downturn—and by Q3, should age its financial effects out of their TTM financials altogether. It will be worth watching how middle-market funds fare, as those investments that did not recover quickly from 2020—and therefore have had exits significantly delayed—are eventually realized in Q4 2021 and beyond. It will also be interesting to see how inflationary pressures, should they persist, will affect portfolio company valuations. However, a benign macroeconomic environment should continue to support healthy middle-market performance and, in turn, fundraising in the year ahead.

PE fund horizon IRRs by size bucket*



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

US Consumer Confidence Index and Business Confidence Index



Source: OECD | Geography: US
*As of September 30, 2021



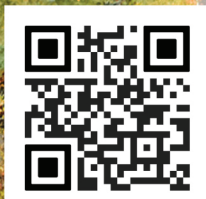
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LBMC Experts Weigh in on PE Dealmaking Landscape

Q&A with LBMC

Given how competitive the PE dealmaking landscape has been in 2021, what has helped your PE firm clients adapt in order to continue closing transactions?

Lisa Nix: The reality is that on each potential deal, other investors are also evaluating the potential investment. Sell-side age demographics, tax planning considerations, and increased valuations have helped increase the supply of willing sellers, but the demand for quality targets is still at a historical high, and earnings multiples are very rich.

With this comes pressure on early bid valuations, pressure from the sell side to execute deals quickly, and internal pressure for investors to execute. As a result, our clients are performing more robust pre-LOI due diligence in not only financial but operational, compliance, and regulatory areas. The use of more data analytics during the pre-LOI phase to strengthen valuation models as well as financial and operational diligence has been a key ingredient in lowering the execution risks of deals in the post-LOI phase of transactions.

In this season of incredibly high valuation multiples, the impacts of COVID-19 must be carefully considered within the deal model and pricing—concerning not only revenue impacts, but the post-COVID-19 impacts on the seller's cost structure. Determining the “new normal” for operational/cost structures has proven to be extremely challenging in many situations where the sellers are still dealing with the effects of COVID-19, particularly when sellers have revamped key employee compensation arrangements to address volume impacts as well as the intensely competitive labor market.

Where more of the deal issues are engaged with sellers pre-LOI, and financial and other due diligence is confirmatory, our clients are executing at record volumes. Where these issues remain to be understood and solved post-LOI, execution risk goes up as buyers are faced with either absorbing the updated financial information into their models internally or communicating and revisiting valuation with sellers and lenders.

There is a flip side to this attractive market for our clients that have more mature investments. As exit opportunities abound, more of our clients are performing financial sell-side diligence



Lisa Nix

Shareholder, Practice Leader, Transaction Advisory Services

Lisa leads LBMC's Transaction Advisory Services Practice and has over 25 years of experience, including serving as a Managing Director within a Big 4 firm's national M&A Transaction Services Group. Her experience includes transactions from <\$10m to >\$7b in size across a number of industries with deep expertise in healthcare.



John Mark McDougal

Shareholder, Practice Leader, Audit and Advisory Services

John Mark is the Practice Leader for LBMC's Accounting and Assurance Practice. He works primarily with privately owned, middle-market companies, where ownership is held by private equity groups or by families. His clients have been involved in buy-side acquisitions, as well as having been acquired themselves, and he has served as a business advisor in both capacities.



Brad Bonde

Shareholder, Transaction Advisory Services

Brad has over 17 years of experience, including time spent with a Big 4 firm, GE Healthcare, and a national public accounting firm. He serves as a technical accounting and auditing review expert for LBMC and frequently assists clients with buy-side and sell-side financial due diligence, including post-transaction accounting consulting and working capital settlements.

irrespective of whether the portfolio company has been historically audited. With compressed transaction timelines, selling management having a view of their diligence-adjusted earnings prior to launching a process will lend more credibility and sustainability to the deal value and reduce the likelihood of the contemplated transaction being retraded.

What are some of the most underrated hurdles for prospective dealmakers, and why?

Brad Bonde: If you asked 10 sponsors about their biggest

Q&A: LBMC

roadblocks for transactions, I suspect the recurring theme of responses would be how to attract talent to support growth. The companies that find unique ways to attract and retain talent will be among the winners over the next several years.

Another hurdle that is often anticipated, but might also be underrated, relates to managing sellers that are going through their first exit. With the number of mom-and-pop operators in many subsectors of healthcare, dealing with inexperienced sellers can be exacerbated when you layer in navigating the various licensing requirements between states, as well as trying to ensure potential compliance risk is identified and mitigated to an acceptable level.

As sponsors gravitate downmarket to consolidate these smaller, mom-and-pop healthcare businesses, targets generally do not have the infrastructure in place to facilitate a smooth diligence process. These sellers may also push back on various insignificant deal points and utilize advisors that do not specialize in M&A transactions. Unfortunately, with valuations continuing to climb across industries and no shortage of capital, sponsors will need to balance their “needs” in diligence and the transaction process with their “wants” in closing their deals quickly. While sellers likely won’t withdraw from an LOI, they may become more sophisticated about the market and begin to utilize this leverage to push back on sponsors. Setting the stage and building good relationships with the sellers on the front end of negotiations will usually serve as a foundation to keep these issues from becoming problematic.

What about healthcare in particular?

Lisa Nix: Specifically from a healthcare perspective, we have seen more successful attempts at deeper regulatory and compliance diligence, including provider billing and coding due diligence earlier in the deal process and sometimes prior to the finalization of the LOI—admittedly not in all cases though. Significant compliance and regulatory exposures are difficult to overcome in a transaction, and discovering those issues earlier in a deal process will likely provide for more thoughtful legal and financial considerations that lessen the risk of a dead deal.

What are the underrated risks related to the current dealmaking environment, particularly for PE funds targeting middle-market companies? What about from the sell-side perspective?

John Mark McDougal: The current environment, with deal pace being extremely high and valuations following the same path, increases the risk that target companies may have difficulty achieving desired success built into

these valuations if the business environment changes. The valuations in times such as these are generally supported using best-case scenarios in many inputs to the valuation estimates.

We see these valuations impacted in a couple of ways. One is the normal cyclical economy that expands and contracts and has peaks and valleys; it currently feels as though we are operating at or near peak level. The other place we see it is in specific industry sectors that have become popular. There are a number of those now after COVID-19’s arrival in the first quarter of 2020.

In addition to valuation, we also see increased risk factors—which are oftentimes overlooked—concerning “speed to close” and increased emphasis on getting the deal done, regardless of challenges that may show up. This doesn’t impact every deal, but in an environment like this, the risk is ever present.

Another underrated risk relates to indirect taxes. With recent law changes including the US Supreme Court’s decision in the Wayfair case, it is now easier than ever for state and local taxing jurisdictions to impose taxes on entities and transactions. As a result, these state and local jurisdictions are aggressively asserting that taxes are owed on new products and services under the existing taxing authority. Software and SaaS are prime examples. Legislative bodies are enacting new laws that extend their taxing reach even further, allowing them to assess taxes on previously untaxed entities and products, such as digital goods and their equivalents. This trend is unlikely to change in the immediate future.

LBMC provides recruiting, staffing, and human resources solutions. Managers worldwide have noted intense challenges in staffing adequately; how is this evident in your work with PE firms?

John Mark McDougal: Since the first quarter of 2020, many things have been stretched thin, from the supply chain to the labor force. Now is the time to stick with strong fundamentals and a straightforward game plan in recruiting and retaining people. The workforce, in general, desires clear lines and communication, now more than ever, to alleviate more of life’s unknown factors. As a result, PE firms and their portfolio companies experience these same issues, but the magnitude may vary depending on the industry, geography, management teams, company lifecycle, and so on. PE firms are looking at more out-of-the-box approaches to the talent shortage, such as contract staffing placement and engaging outsourced accounting groups.

Q3 2021 US PE MM

lending league tables

Overall Select roles*

1	Barings	54
2	Antares Capital	50
3	Kohlberg Kravis Roberts	47
4	Churchill	44
5	MidCap Financial	38
6	PNC	35
7	KKR Private Credit	34
7	Ares	34
9	Audax Private Debt	33
10	Madison Capital Funding	30
11	The Goldman Sachs Group	29
11	Twin Brook Capital Partners	29
13	Golub Capital	28
14	Crescent Capital	27
14	Monroe Capital	27
16	Jefferies Group	26
17	Varagon Capital Partners	25
18	J.P. Morgan	23
18	BMO Financial Group	23
20	Wells Fargo	22
20	Capital One	22
20	Owl Rock	22
23	Citizens Bank	21
23	KeyBank	21
25	Truist	17

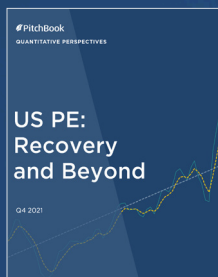
Source: PitchBook

1	Antares Capital	46
2	Churchill	33
3	PNC	28
3	Twin Brook Capital Partners	28
5	Madison Capital Funding	26
6	Ares	25
7	Varagon Capital Partners	22
8	Jefferies Group	20
8	KeyBank	20
10	Barings	19
10	BMO Financial Group	19
12	J.P. Morgan	18
12	Monroe Capital	18
14	Capital One	16
15	Truist	15
15	Citizens Bank	15
15	Fifth Third Bank	15
18	Crescent Capital	14
18	MidCap Financial	14
20	Wells Fargo	13
21	The Carlyle Group	12
22	Bank of America	11
23	The Goldman Sachs Group	10
24	NXT Capital	9
25	Credit Suisse	8

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

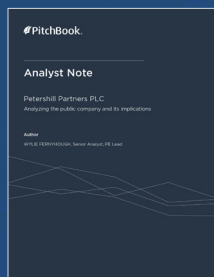
Additional research

US private equity



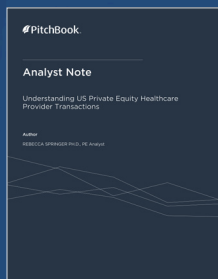
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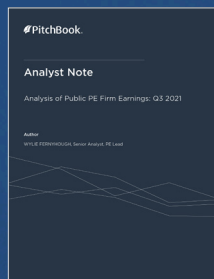
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