PitchBook

Q3 2022

US

PE Middle Market Report

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Executive summary

The middle market is a highly informative microcosm and broad indicator of the PE industry at large. We define the space as companies of a certain size that have received PE backing of between $25 million and $1 billion. By that measure, the middle market represents 67.9% of total US PE deal value over the last five years. Not every PE deal is a buyout, but it is the core deal type that differentiates PE as a strategy. For that reason, this report captures control transactions only, which comprised 74.0% of total middle-market deal value as of Q3 2022. This nets to the broad middle that drives a very large ecosystem of service providers, fund managers, and investors. In M&A advisory, for example, there are 598 active investment banks in the US, of which perhaps 30 can hope to participate in mega buyouts and IPO exits, but all of whom can and do participate in middle-market deals.

During Q3 2022, deal activity for US middle-market companies stopped going down and stabilized well above pre-COVID-19 pandemic levels, but half of peak levels reached in Q4 2021. The same macro headwinds at work in the larger PE deal space have buffeted the middle market, with diminished access to low-cost debt capital for leveraged buyouts (LBOs), in particular, weighing down deal flow. While this has caused larger PE funds to reach down to the middle market for deal sizes that are more easily financed and completed, the same is happening within the middle market with deals migrating to the sub-$25 million bucket.

With ample dry powder on hand, PE firms are well-equipped to continue to seek out deals in a market that has become cheaper by the quarter thanks to falling prices and lower public valuations. While take-privates have not featured prominently in middle-market deal flow, the take-public frenzy of 2020 to 2021 has created a plethora of public companies having sub-$1 billion market caps, and likely to change the calculus for PE middle-market buyers moving forward.

While the middle market is generally less reliant on, and therefore less impacted by, the drought in new public listings and IPOs this year, Q3 exit value was still down by half from the Q4 2021 peak. Portfolio company sales to other sponsors consistently exceeds sales to corporate sponsors, and the near-record level of PE dry powder is a key reason why; although, how it trends from here bears watching. Meanwhile, fundraising remains challenging as large-scale players and funds continue to dominate, crowding out middle-market funds and smaller funds, and will likely require strong outperformance by middle-market funds versus mega-funds—funds with $5 billion or more—to turn the tables. It's too early, however, to conclude that is the case from returns that have been reported so far.

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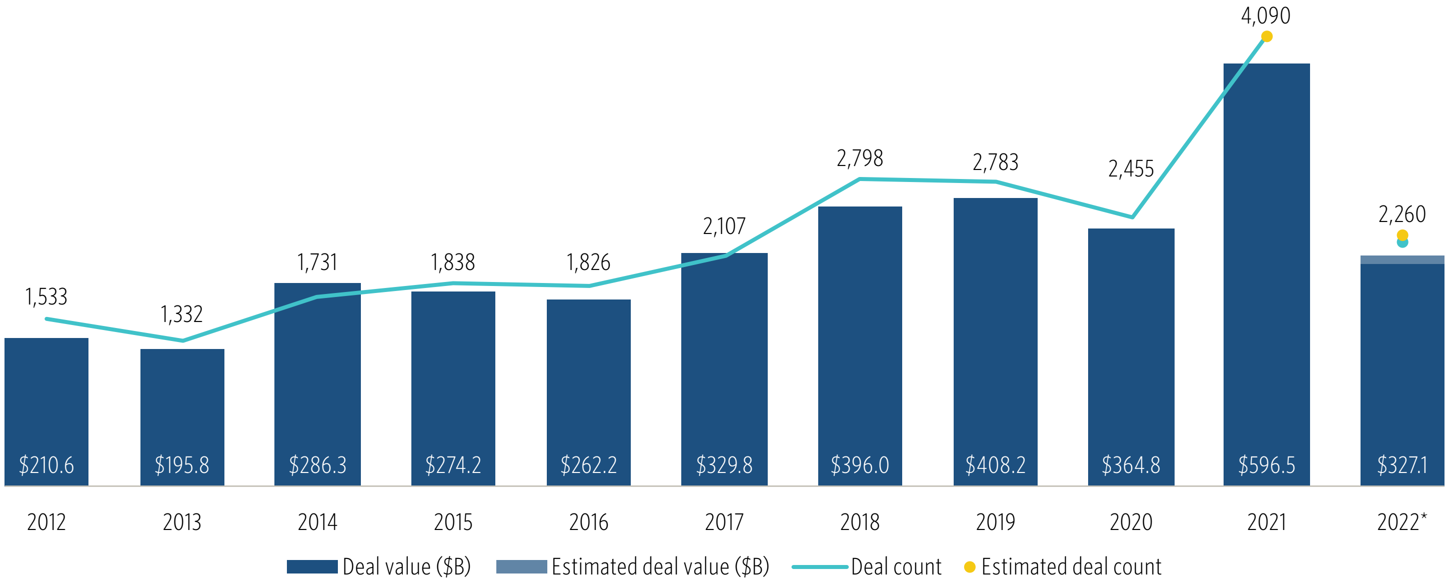
Deals

PE middle-market deal activity



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

Overview

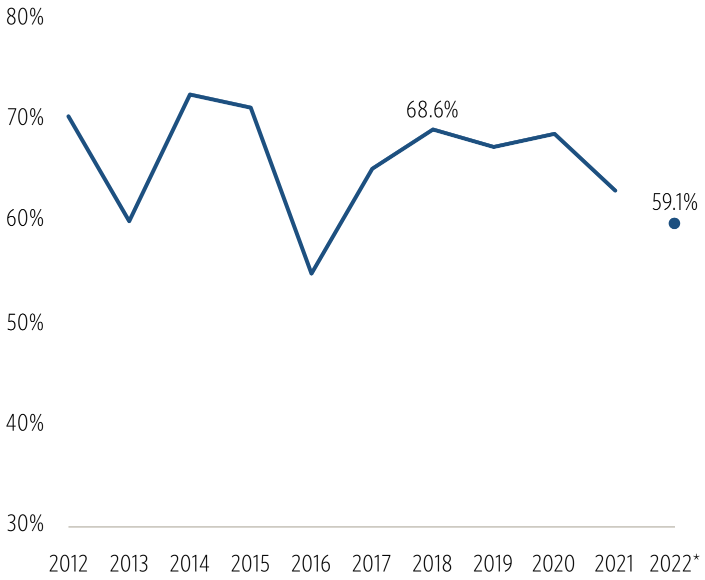
In Q3, US middle-market PE buy-side activity rebounded modestly from Q2 levels, with PE firms closing 734 middle-market buyout deals for a total of $116.5 billion. This is solidly ahead of the quarterly average for the three years prior to the global pandemic—up 24.7% by value and 18.3% by deal count. Deal volume in Q3 has fallen by 48.0% from the record level reached in Q4 2021, and year-to-date volume is down by 15.7% from the first nine months of 2021.

Since recently peaking at 68.6% in 2018, the middle market's share of total PE buyout value has drifted lower and presently stands at 59.1% year to date. This erosion in share reflects the explosive growth in mega-funds, which have swelled from 31.3% of new funds raised to 53.1% during the same four-year span, all at the expense of middle-market funds and smaller funds. The massive amounts these mega-funds have needed to deploy has crowded out deal value in the same way they have crowded out fundraising. With buyout funds now approaching $30 billion in size at the extreme upper end, they refocused on large public companies to have any hope of spending down committed capital within a reasonable time frame. This strategy has become highly popular, leading to the busiest two-year period of PE-led take-private transactions since the massive debt-fueled spending spree of 2006 and 2007. A total of 169 take-privates were announced in 2021 and 2022 in the US and Europe for $407 billion in aggregate deal value. Middle markets have taken a backseat during this surge in mega buyouts by mega-funds. However, this may be on the verge of changing.

Deal fatigue setting in on large deals

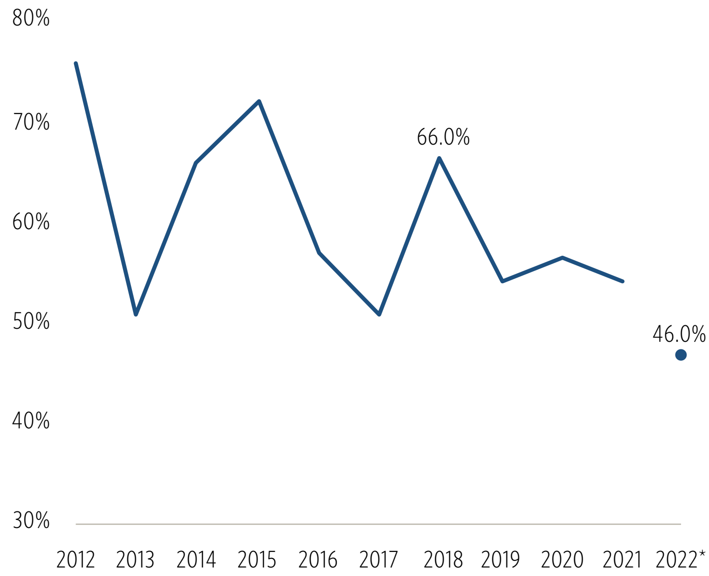
The same macro headwinds that have slowed PE deal activity across the board have impacted the middle-market space, although to a slightly lesser degree. Mega buyouts of more than $1 billion in size are becoming increasingly difficult to finance with debt capital. We can see this in the very recent trends affecting take-privates, which tend to be the largest buyout deals in any given year and where deal fatigue appears to be setting in. There have been 75 take-private deals announced in the US and Europe through October of this year at an average size of $3.4 billion and average frequency of 7.5 deals per month. Many of these were funded by the traditional syndicated loan bank channel in Q1 and Q2, and when that source shut down, it came from private credit funds and all-equity structures in Q3 and beyond. However, not a single take-private deal has been announced in the month of November, the chances of which are almost nil

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



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

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



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

looking at the observed activity of the last 17 years and 203 months. We have tracked take-private announcements in the US and Europe going all the way back to 2006 and outside of January 2019, not a single month has gone by without at least one deal announcement, and the typical flow has been eight to nine deals monthly until now. This strongly suggests that the non-bank channel has joined the bank channel in discontinuing new loan commitments to large LBOs, or that PE firms themselves have put the highly popular $3.0 billion-plus take-private strategy on hold for the time being.

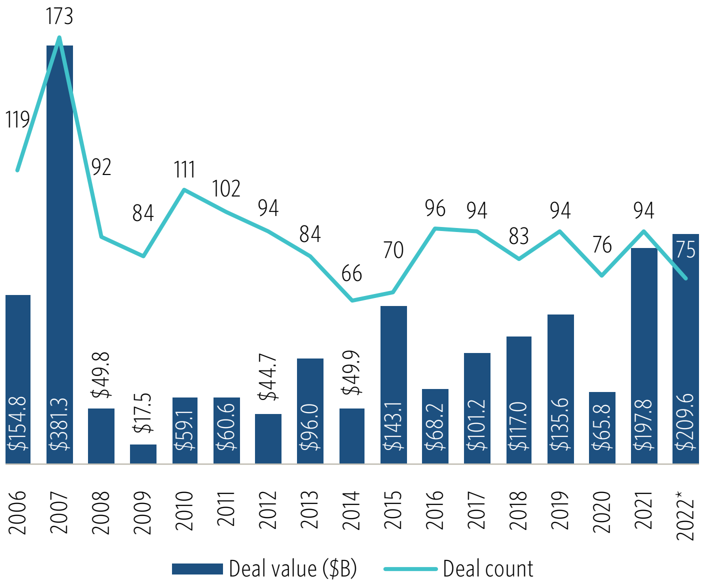
Will take-privates migrate to middle markets?

With funding for large deals growing more scarce or prohibitively expensive, deal sizes are becoming smaller and more digestible. We can see this in the data on closed deals already. Compared to 30.3% last year, small deals under $25 million ballooned to 39.3% of all deals made in Q3, continuing a trend that has played out all year. For the time being, this has cut into the middle-market segment, which declined in Q3 to 59.8% of all deals, down from 68.8% last year. However, at less than 2.2% of the market in dollar terms, this is not an attractive market to chase for service providers or PE managers with large amounts of uninvested capital. We can also see the trend toward smaller deals in add-on activity, which has grown to 72.3% of all PE middle-market buyouts.

It’s unlikely that take-privates will stay dormant for long given its interrupted record of deal flow, even during a credit crunch. More likely, the playbook just gets tweaked. The logic is still very compelling and has been executed well, allowing PE buyers to scoop up attractive public companies at significant discounts while private market values and deal multiples remained stubbornly high. Moreover, public companies have a more seasoned and fully transparent record of operating results, which in theory should make them more bankable for lending purposes. Lastly, these large public companies permitted PE managers to deploy large sums of dry powder that had built up to record levels in a single go.

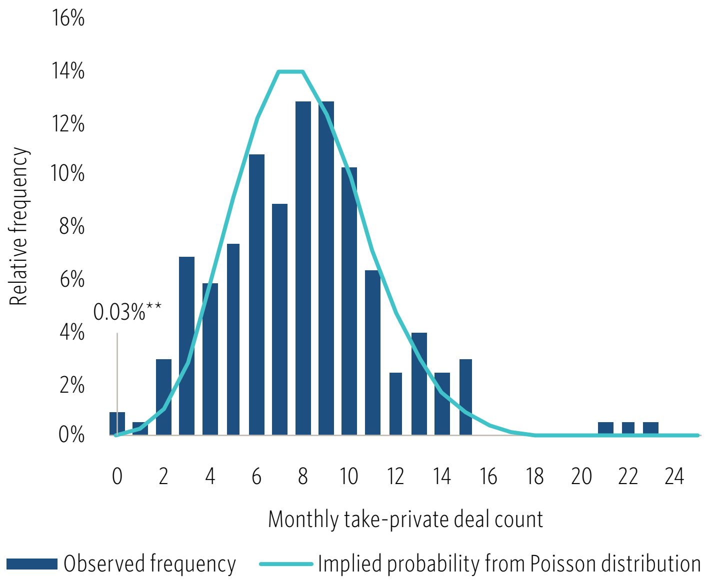
Of these, the most compelling factor was the discount opportunity. Of the 75 public-to-private acquisitions announced this year, PE firms paid an average discount of 6.7% to the target’s 52-week share price high. This was no small doing given that these stocks typically rose by 20% to 30% from their unaffected share prices prior to their deal announcements. In a normal environment, takeover announcements usually send shares of the acquired company to fresh 52-week highs, but because valuations have been beaten down so badly—down 24.5% on the S&P 500 through mid-October—this year has been the exception.

PE-led take-private deal activity



Source: PitchBook | **Geography:** North America & Europe
*As of December 1, 2022

PE-led take-private monthly count distribution curve and implied probability*

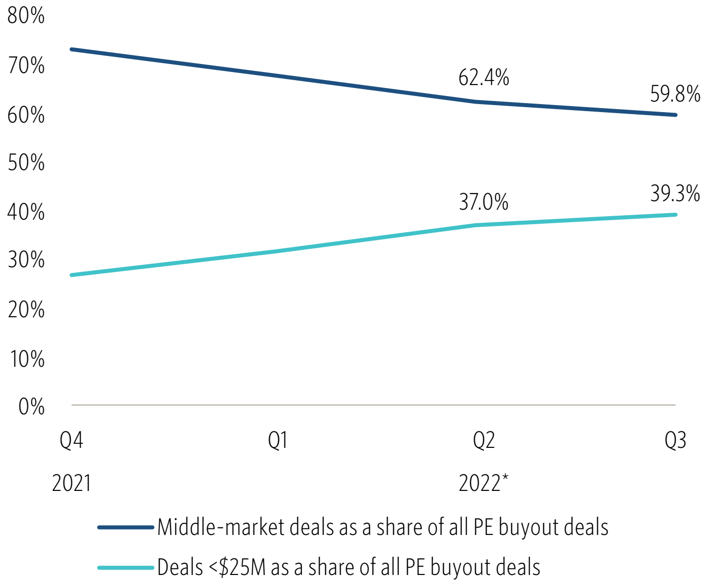


Source: PitchBook | **Geography:** North America & Europe
*As of December 1, 2022
***No deals announced in November 2022 with very slight probability of happening*

The 10.0% rally in the broader market—14.6% for the larger cap Dow 30—since mid-October is likely another culprit at work in bringing about the screeching halt in November take- privates. However, whereas the major indices and large cap stocks, in particular, have rallied sharply and, in some cases, exited the bear market, the overhang of newly minted middle-market public companies that were listed during the IPO and SPAC frenzy of 2020 and 2021 remain in deeply discounted territory.

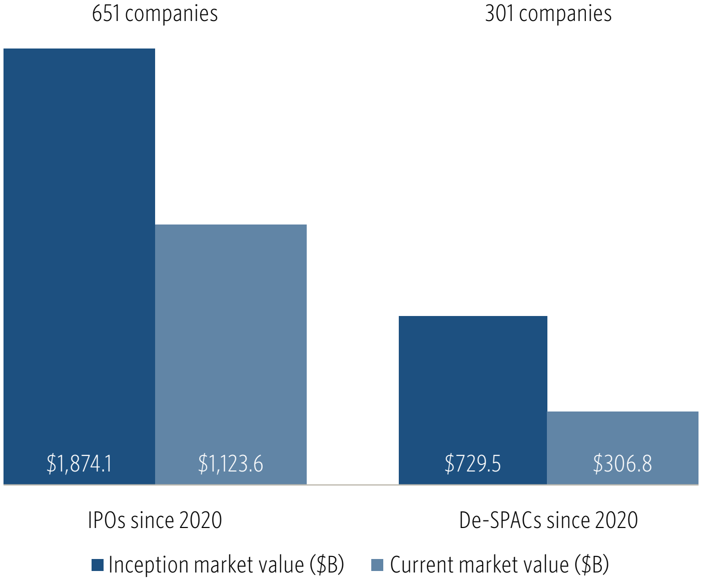
The two-year take-public episode that came to an abrupt end earlier this year resulted in 952 new listings that have traded to a 45.1% average discount from their inception value. Of these, 301 originated from SPACs that were able to successfully close on their deals and list their acquired companies ("de-SPACs"). These companies did not start out as middle-market companies, but they are now. 221 of these de-SPACed companies have a market capitalization below $1 billion.

PE middle-market deals and PE deals <$25M as a share of all PE buyout deals



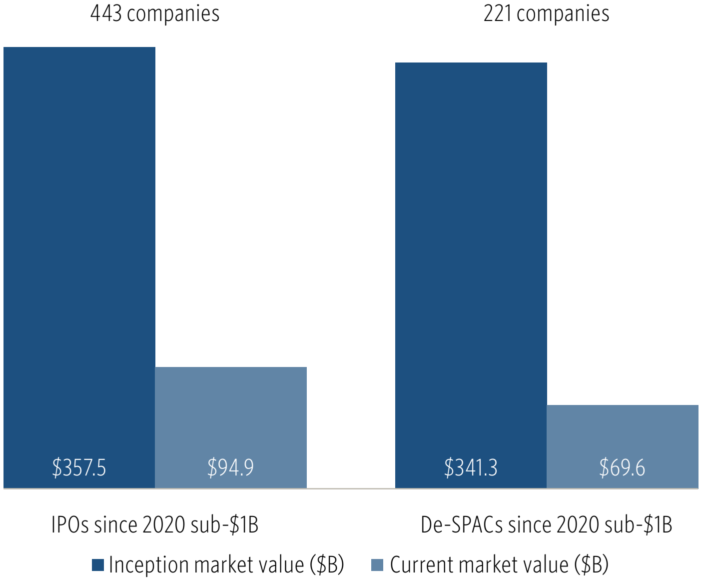
Source: PitchBook | **Geography:** US
*As of September 30, 2022

Universe of all new public listings since 2020*



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

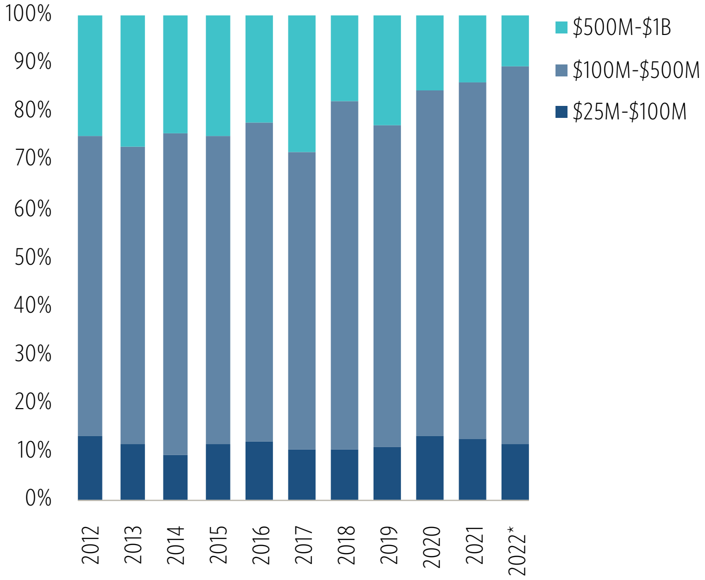
Universe of new public listings since 2020 now trading below $1 billion*



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

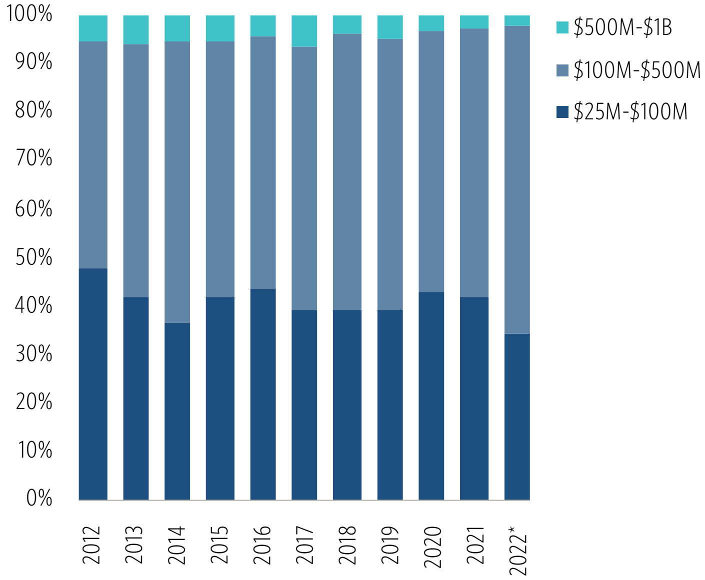
Another 651 US IPOs were completed over this two-year span, of which 443 now have market caps below $1 billion. This combined total of 664 newly listed middle-market companies may well become a new area of focus going forward as the PE take-private machine re-tools and re-directs. Many of these are not of the quality or seasoning that PE buyers will be attracted to—especially the SPAC offspring, as many are pre-revenue companies attempting to break into huge addressable markets such as electronic vehicles. Although many are high quality, they now lack the sponsorship and market cap to survive in public markets. Look for these companies to populate the ranks of take-privates, and for the buyout pendulum to swing back in favor of the middle-market segment.

Share of PE middle-market deal value by size bucket



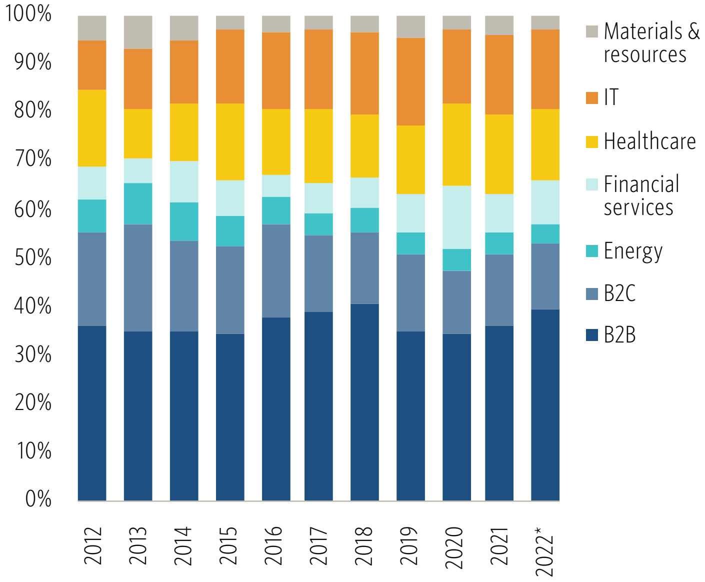
Source: PitchBook | **Geography:** US
*As of September 30, 2022

Share of PE middle-market deal count by size bucket



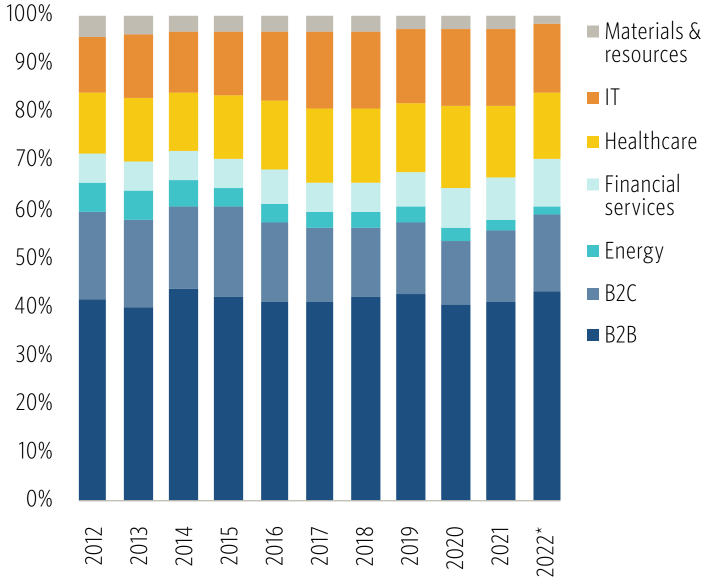
Source: PitchBook | **Geography:** US
*As of September 30, 2022

Share of PE middle-market deal value by sector



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

Share of PE middle-market deal count by sector



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

A WORD FROM ANTARES

Uncertainty yields opportunity

Timothy Lyne

Chief Executive Officer
Antares Capital

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

No recession...yet; inflation starts to cool

As we enter the homestretch of 2022, key US macroeconomic indicators have been relatively constructive or at least less troublesome than some had feared. The US real GDP growth of 2.6% in Q3 2022 was higher than consensus expectations and dispelled any notion that the US economy might be in a recession. In September, the Consumer Price Index continued to cool to 7.7% (6.3% core), which was below consensus expectations of 7.9% and down from 8.2% (6.6% core) in August and a peak of 9.0% in June. Labor markets—a sticky source of inflation—remain healthy but have seen some welcome modest cooling with wage growth slowing in Q3 2022 and the unemployment rate rising from 3.5% in September to 3.7% in October.

Challenges and opportunities ahead

Markets have celebrated recent economic news with the S&P 500 up about 12% from its early October lows as of this writing; however, the economy is by no means out of the woods, and geopolitical risks continue to loom large. In a world so acclimated to a near-zero interest rate environment, the lagging impact of the fastest pace of interest rate hikes from the Federal Reserve (the Fed) in decades may yield unwelcome surprises. Also, although inflation may have peaked, the Fed still has plenty of work to do with core inflation of more than 6% still well above target. Meanwhile, economic and market stress continues abroad with Europe facing a recession and with the recent UK pension fund fiasco a possible sign of things to come. Clearly, challenges remain. However, with uncertainty and volatility in liquid markets comes opportunity. Although defaults seem likely to rise, 2022 and 2023 could prove to be great vintage years for well-managed direct lenders given double-digit first lien yields, lower leverage, and tighter terms.

Q&A with Timothy Lyne, CEO of Antares Capital

How has sponsor-backed private debt been faring in the current environment?

Direct lending has been faring well in an otherwise down market. Although sponsored middle-market loan volume fell 14% YoY in Q3 2022, the direct lending segment's volume was up 1% while the syndicated volume was down 46%, according to Refinitiv LPC. Direct lending was up 16% and syndicated was down 30% YTD. Economic uncertainty that caused a sell-off in the secondary market for broadly syndicated loans forced banks to take billions in write-downs and has constrained their appetite for underwriting. As a result, direct lending's share of the US sponsored middle market surged to 80% in Q3 2022—up from 65% in Q2 2022 and 50% in Q2 2021. Direct lenders have also seen their share of the large corporate segment of the market rise to 23% with $42 billion in volume in Q3 2022, up 12% from Q2 2022. Looking ahead, with more than $40 billion in hung debt still on bank balance sheets, it will likely take some time for syndicated markets to recover—perhaps starting sometime in early 2023.

Meanwhile, direct lending investors are enjoying better pricing and terms, with first lien yields now in the 10%-plus zone and with leverage down modestly. It's really a very attractive market, but you need to be highly selective in picking deals, as defaults are expected to rise.

Are you seeing any signs of stress yet in your portfolio or the middle market more generally?

Looking at the broader market, about 70% of the companies in the S&P 500 have reported Q3 2022 revenue and earnings-per-share upside surprises thus far; however, earnings growth has decelerated to only about 2%, which is the slowest rate seen since Q3 2020, with the energy sector accounting for the bulk of the growth. Some of the headwinds to S&P 500 earnings stem from the strong impact of the US dollar on company earnings abroad, but this tends to be less of an issue for more domestically focused US middle-market companies.

In terms of defaults, the Morningstar LSTA US Leveraged Loan Index default rate of 0.83% in October is up from ultralow levels of less than 0.3% over much of the trailing 12 months, but it is still a low level. The percentage of distressed priced loans (priced below 80), however, has risen to 7% as of October, up from an average of about 3% in Q2 2022.

We continue to see favorable revenue and EBITDA growth across most of our portfolio with a net loss rate of nearly zero YTD as of September 2022. Performance for many industries continues to be favorable, particularly for nondiscretionary and highly defensible industries, such as nonelective healthcare platforms, insurance, business services, and mission-critical software and technologies, which represent our leading areas of exposure. We continue to monitor our portfolio for the impact of key headwinds, including cost inflation/supply chain issues, rising interest rates, and recessionary pressures, and are keeping a close eye on areas of lesser exposure that are more dependent on cyclical end markets and discretionary spending. We remain focused on prudent deployment, selectively investing into noncyclical transactions and relying on our incumbent deal flow where we have conviction and know the credits well.

What is your current outlook for 2023, and has it changed following recent economic news?

On the economic front, we still believe a mild recession in 2023 is probably the most likely scenario but a soft landing is still a possibility. Of course, no one has a crystal ball, and a hard landing is also a distinct prospect. For a lender and risk manager, hope is not a strategy, and it is important to stress-test your portfolio and be prepared for any scenario.

On the positive side, as of this writing in mid-November, the Federal Reserve Bank of Atlanta's GDPNow forecast for Q4 2022 is near 4%. This is sharply higher than the "blue chip" consensus forecast of about 0.4%, suggesting Q4 may bring another upside surprise for GDP growth heading into 2023. Also, the Services Purchasing Managers' Index (PMI)—though trending down—remained expansionary in October with the New Orders Index at 56.5%. The Institute for Supply Management's October report says, "The past relationship between the Services PMI and the overall economy indicates that the Services PMI for October (54.4%) corresponds to a 1.5% increase in real gross domestic product (GDP) on an annualized basis." This is an important indicator, as much of our portfolio tends to be services-oriented. (Note: This is in contrast to the Manufacturing PMI, where new orders have started to contract.)

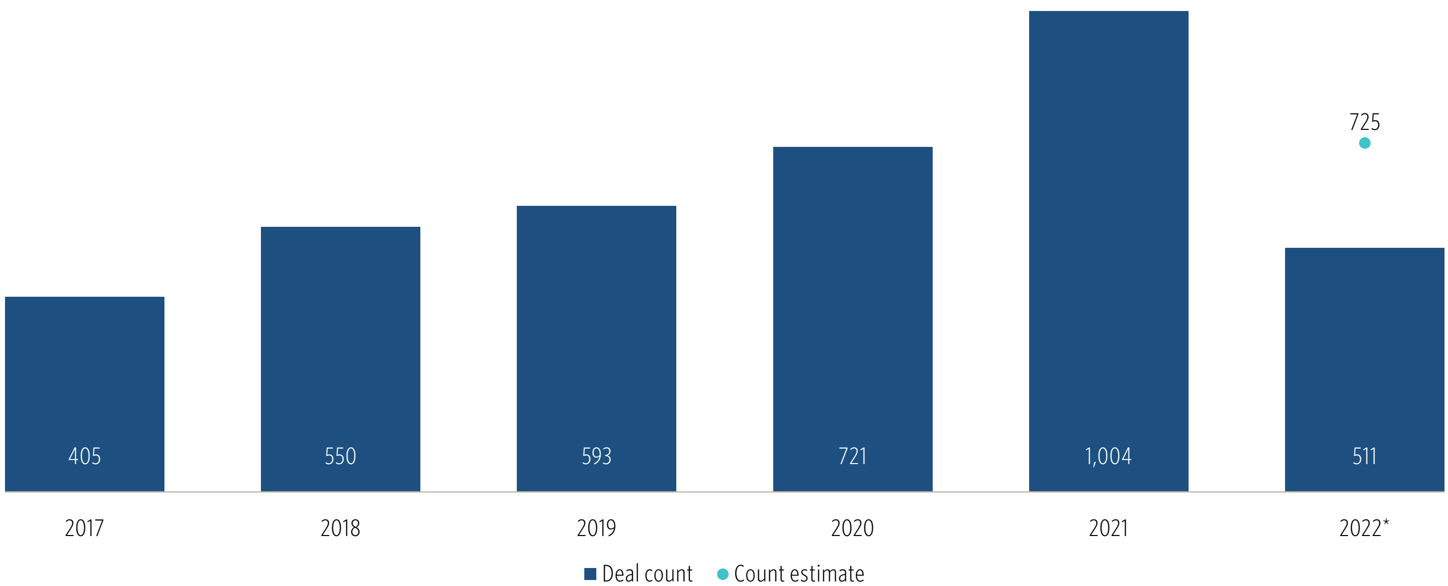
On the deal activity front, US sponsored middle-market M&A-related loan volume in Q3 2022 was down 20% YoY and down 10% YTD, reflecting the headwinds of economic uncertainty, an increased mismatch in buyer and seller pricing expectations, and a less favorable financing market. These factors may continue to constrain deal activity in the near term. However, we believe PE deal activity will see a resurgence once inflation is tamed given the levels of PE dry powder and lower, more attractive company valuations.

Finally, on the default front, clearly the outlook depends on whether a recession is in the cards and, if it is, how deep it might be. However, it is worth noting that first lien yields, which have averaged in the 6% to 7% range over most of the last decade, are now more than 10%. A roughly 4% pickup in yield seems highly likely to more than offset any default-related losses after recoveries in all but the most pessimistic of scenarios.

SPOTLIGHT

Healthcare services report

Healthcare services PE deal count



Source: PitchBook | **Geography:** US & Canada
*As of September 30, 2022

Note: This spotlight is abridged from our "Q3 2022 Healthcare Services Report." Please see the full report for additional analysis on the healthcare services industry.

Healthcare services is the largest vertical within PE healthcare investing, accounting for roughly 10% of PE buyout and growth deals overall in the US in 2022. The vertical includes traditional healthcare providers that offer medical treatment in hospitals, clinics, residential facilities, and homes.

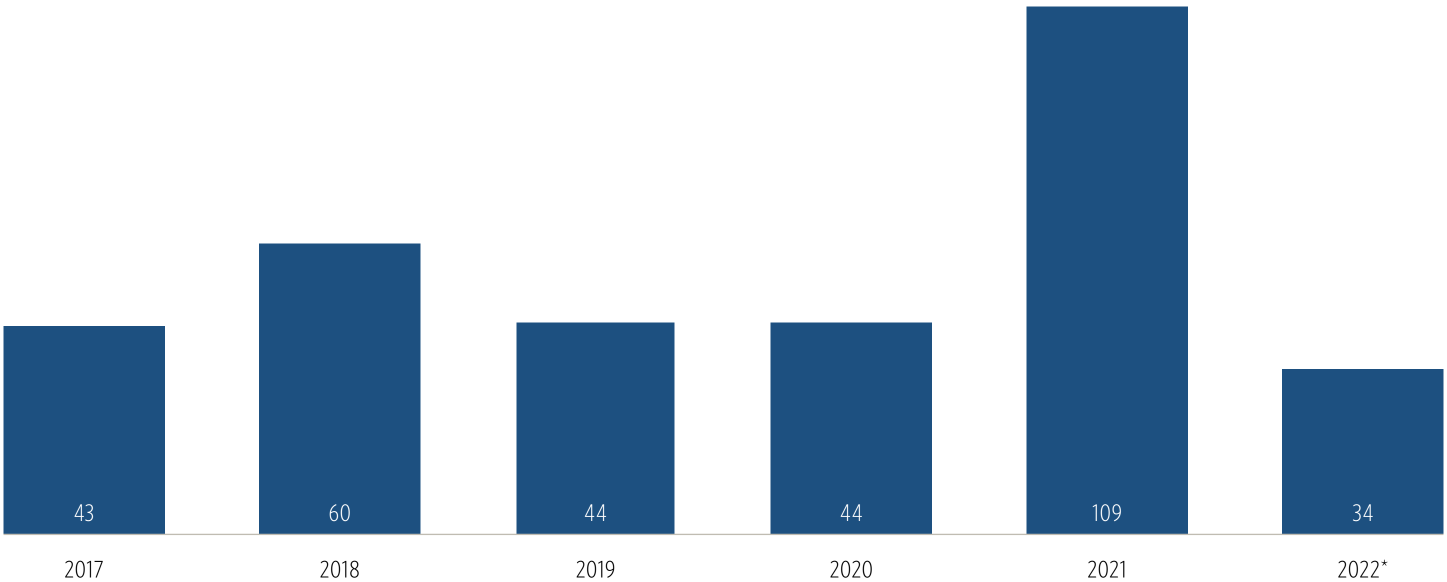
As one of the oldest PE buy-and-build plays, healthcare services continues to attract investor interest due to its favorable demographic trends, acyclical characteristics, and consolidation opportunities. According to Centers for Medicare & Medicaid Services data, US healthcare services care expenditures reached $2.9 trillion in 2020 and is projected to exceed $4 trillion by 2027. This figure includes government and commercial payer reimbursement and out-of-pocket spending on care categories excluding retail prescriptions and medical products.[1] We estimate that US PE firms currently have $62.0 billion in dry powder available to deploy in healthcare services, which translates to roughly $150 billion in cumulative company enterprise value.

PE strategy

Traditionally, PE investment in healthcare services focused on consolidating medical specialties such as dentistry, dermatology, and vision, with returns driven primarily by multiple arbitrage, financial leverage, and the development of ancillary business lines. Firms have also looked for opportunities to finance de novo expansion in provider categories with favorable supply-demand dynamics, such as behavioral health. Across provider categories, scale enables not only fixed cost efficiencies but market power. By increasing market share in a given metropolitan, state, or regional geography, a platform can position itself to negotiate more favorable payer contracts. For categories that are not referral based, scale also helps to increase brand awareness, thereby driving patient volume.

1: "National Health Expenditure Data," CMS.gov, n.d., accessed October 20, 2022.

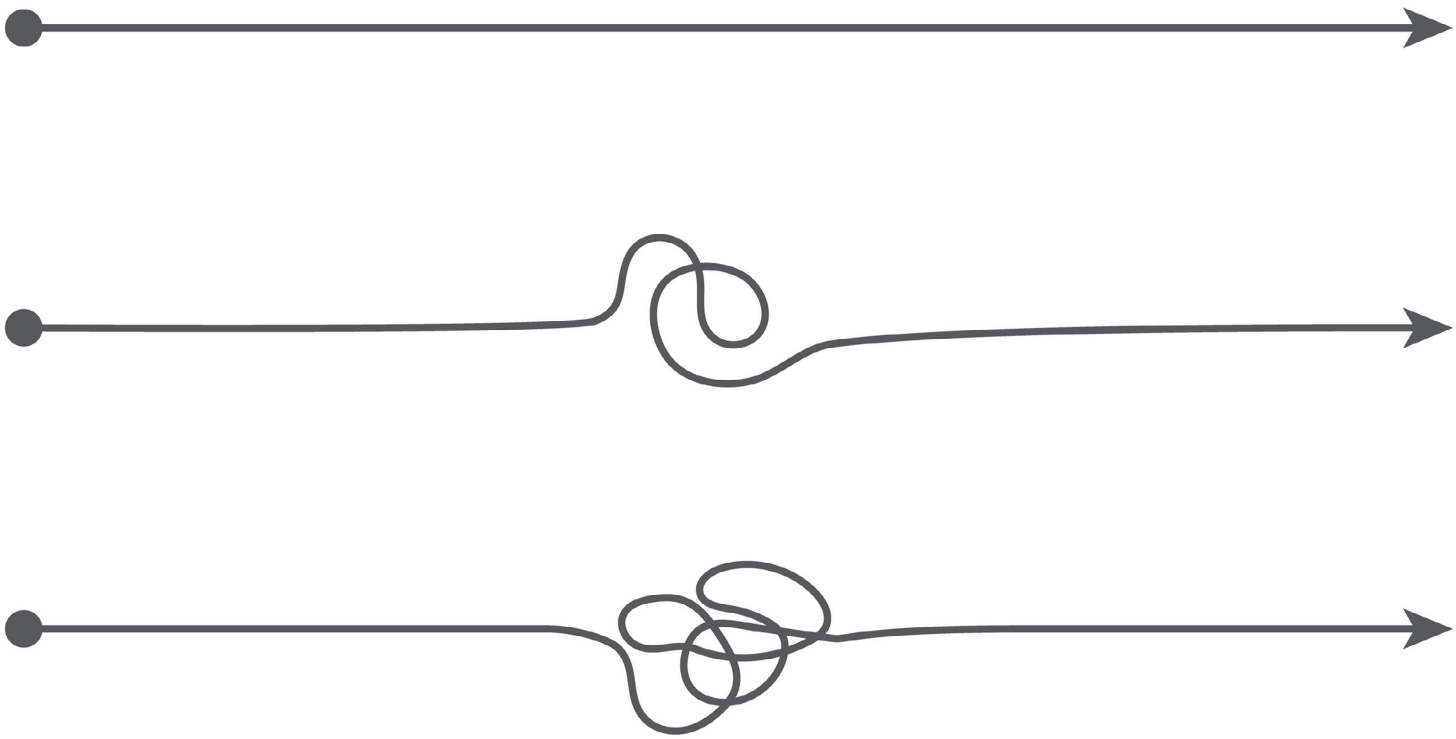
Healthcare services PE exit count



Source: PitchBook | **Geography:** US & Canada
*As of September 30, 2022

PE activity

Amid macroeconomic turmoil, healthcare services PE deal activity has shown resiliency so far in 2022, especially in the lower middle market. Our estimated deal count for Q1 to Q3 2022 already exceeds 2020's full-year number. However, the industry faces growing headwinds. Staffing shortages are squeezing virtually every type of healthcare services organization, increasing costs and inhibiting growth. The financial strain is most acute for hospitals, which have significant fixed costs due to facility overhead, and which had little time to regroup financially after the worst of the pandemic abated. Also heavily affected are healthcare organizations that rely on low- or moderately-skilled care providers and operate on lower per-visit margins, such as home care agencies, applied behavior analysis therapy clinics, and group homes for people with intellectual and developmental disabilities.



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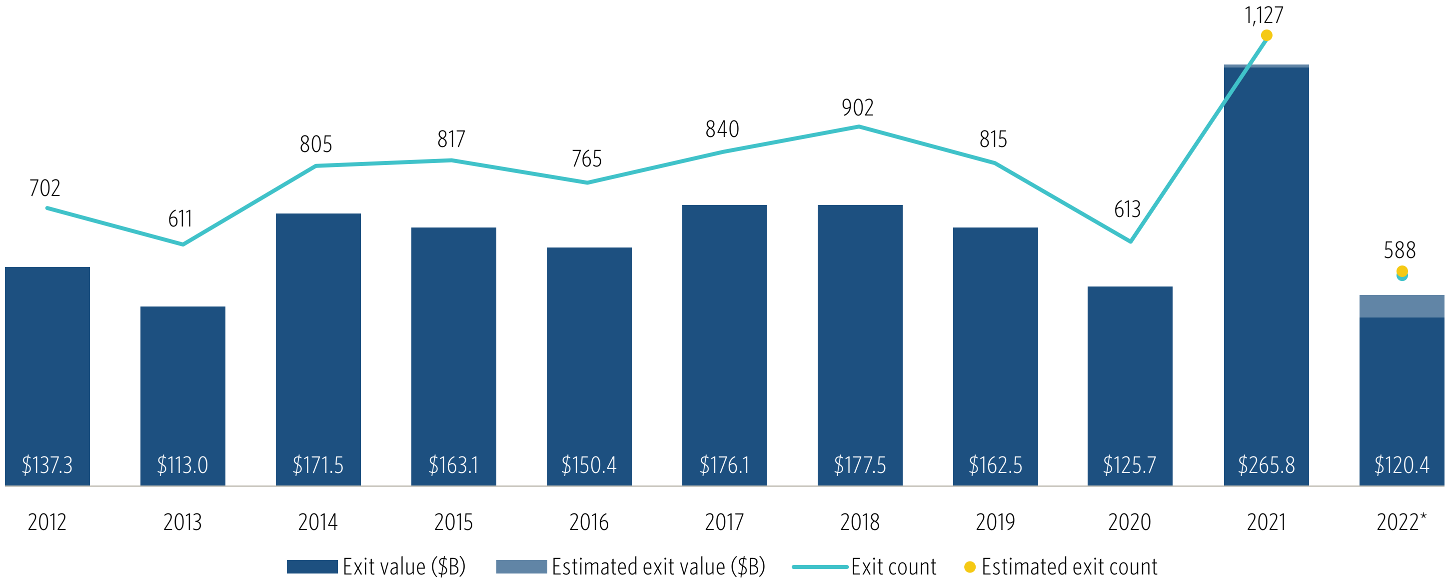
Exits

PE middle-market exit activity



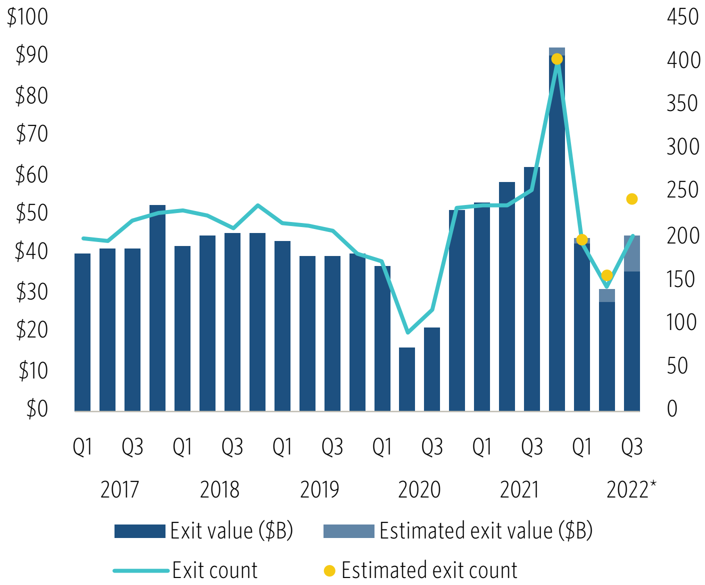
Source: PitchBook | **Geography:** US
*As of September 30, 2022

Overview

US middle-market exit activity ticked back up in Q3 after falling sequentially in the first two quarters of 2022. Sponsors exited 240 portfolio companies during this quarter, with a cumulative exit value of $44.8 billion. That is markedly higher than the 154 exits and $31.3 billion amassed in Q2. Exit value has fallen 51.5% from the peak recorded in Q4 of 2021 and is down 30.5% year to date. That said, at an average of $40.2 billion in value realized per quarter across 196 deals, this year's exit activity is nearly identical to the pace it maintained prior to the bust-then-boom of 2020 and 2021. We expect exit activity to stay muted over the next several quarters as monetary conditions and access to capital continue to tighten.

Valuations are down and there continues to be a dislocation in prices, making willing sellers harder to find. This comes at a time when only two of the three exit routes remain open, as the IPO market has been closed for most of the year. This has impacted the broader PE and VC world more than PE middle markets, which historically has derived just 5% of realized value from IPO exits. Selling to other PE sponsors and corporate strategic buyer has been the key to middle-market exits, and that remains the case today.

PE middle-market exit activity by quarter



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

While macro headwinds continue to depress exit opportunities, PE sponsors are still awash in dry powder, representing an important counterweight. Dry powder in US PE funds stood at $787.5 billion at the end of Q3, of which 55.1%, or $433.6 billion, was in middle-market funds—funds between $100 million and $5 billion in size. While some of this dry powder was deployed earlier in the year, leading to a dip in cumulative value for the first time since the Global Financial Crisis, we are still close to record levels in absolute dollar terms—although, as a percentage of AUM, it has reached a new low. This source of liquidity will remain a key support factor going forward for PE-backed middle-market exits.

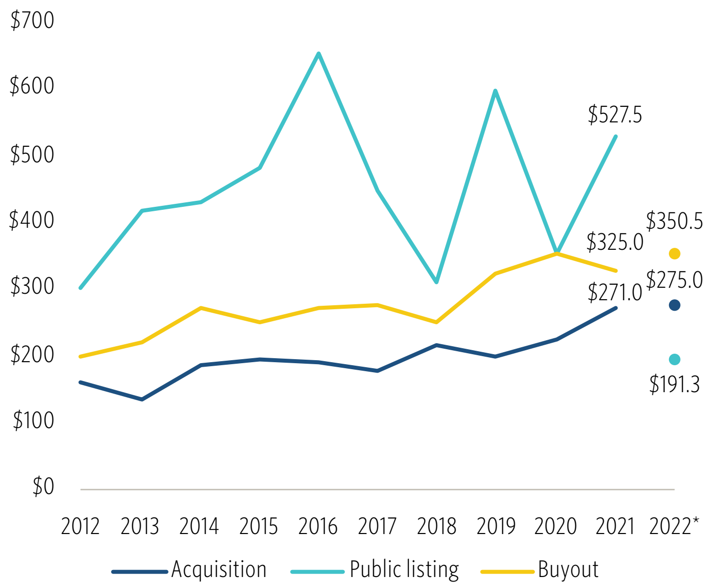
Median exit sizes for both sponsor-to-sponsor exits and corporate acquisitions through the first three quarters of the year pushed through to record highs of $350.5 million and $275.0 million, respectively. The continued increase in median exit size suggests that middle-market sponsors can still successfully close a number of sizeable exits despite a difficult macro environment. As headwinds persist, corporations may choose to hunker down and focus instead on shoring up their own balance sheet while putting acquisitions on hold. This has yet to happen as strategic buyers accounted for a healthy 38.8% of all middle-market PE exits in Q3, in line with prior quarters in recent years. However, this bears watching moving forward, especially with the PE exits engine now firing on just two of its three cylinders.

Sponsor-to-sponsor exits

Looking at just core exits, excluding the highly cyclical IPO market, sponsor-to-sponsor exits ticked down from a record high of 58.1% of all deals in 2021 to 55.6% year to date. This is still relatively high and above its ten-year average of 53.1%. The proportion of sales to other PE sponsors has drifted higher over the years as the universe of PE managers—middle-market fund managers in particular—has steadily expanded while the number of corporate buyers has remained relatively unchanged.

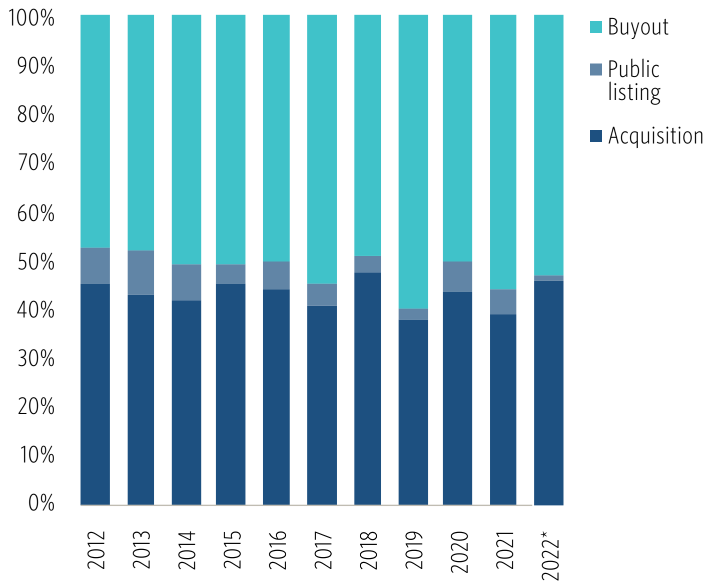
Sponsors have continued to find opportunities to exit portfolio companies to the next PE firm that is looking to create additional value. PE firms can sell to other firms with expertise in specific sectors or different growth stages to continue to build value through strategies such as buy-and-build, operational expansion, or cost synergies. A good example of this in the middle-market space is Behrman Capital's sale in July of The Emmes Company to affiliates of New Mountain Capital for $800.0 million. The Emmes Company

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



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

Share of PE middle-market exit value by type



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

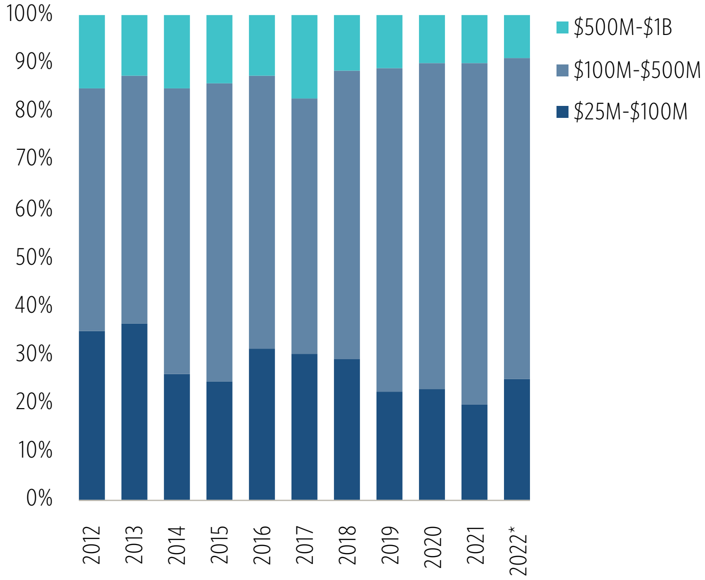
is a contract research organization that provides its clients with the technologies and dedicated service required to manage clinical research studies with the highest standards of quality.[2] New Mountain Capital is a growth-oriented investment firm that will look to help The Emmes Company through its next stage of growth. Healthcare has continued to see strong demand from other PEs because of its potential for high growth and expansion; several of the largest sponsor-to-sponsor exits throughout 2022 have taken place in the healthcare industry.

Exits to corporates

Despite continued headwinds, strategic buyers absorbed PE-backed middle-market companies at a strong rate through the first three quarters of the year, accounting for 44.4% of all exits excluding IPOs, up from 41.9% in 2021. Exits to corporates in 2022 have seen consistently solid numbers sequentially. However, they have fallen short of the quarterly averages seen over the past five years, emphasizing once again the growing importance and size of the PE ecosystem as a buyer at the margin. Corporates will not hesitate to buy PE-backed companies with a strong strategic logic and fit; however, they could be passing on prices that PE sellers are demanding. Corporate acquisitions are typically driven by high levels of balance sheet cash and C-suite bullish sentiment, both of which have taken a hit as higher interest costs consume cash flow and the risk of a recession grows. Significant deterioration in these factors could further shrink M&A appetites and dampen PE exits to corporations.

In Q3, middle-market firms were still able to capitalize by exiting investments to companies seeking strategic acquisitions to position themselves for continued growth, such as leading South American retailer Cencosud's August acquisition of The Fresh Market from Apollo funds for $676.0 million. The Fresh Market is a premium specialty retailer competing in the food retail industry in the US and will help Cencosud expand its geographic diversification into the US, a market that is traditionally more defensive and a currency that is more stable for a non-US buyer.[3] Consolidation plays also created exit opportunities for strategic buyers. In September, Tailwater Capital sold NorTex Midstream Partners to Williams Field Services Group, a subsidiary of The Williams Companies, for $423.0 million. The acquisition will help Williams consolidate its share of the storage market

Share of PE middle-market exit count by size bucket



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

for Permian gas and meet the growing demand for liquified natural gas in the Gulf region.[4] The energy and renewables sector in general saw the biggest pick up in middle-market PE exits of any industry group this year, accounting for 7.9% of all value (+330 basis points) and was dominated by big sales to corporates. Other notable exits in the sector include Warburg's $865.0 million sale of RimRock Oil & Gas to Devon Energy, and NGP's $627.0 million sale of Titus Oil & Gas to Earthstone Energy.

Information technology

Through the first three quarters of 2022, information technology (IT) saw exits step down from the record pace witnessed in 2021, but exit activity remains in line with the pace seen in the years prior to the global pandemic. IT saw 28 exits take place in Q3 in the middle-market space, worth an aggregate value of $4.0 billion. Even though middle-market companies are far less likely to seek public listings due to their size, the sharp down draft in public tech stocks and valuations has spilled over nonetheless to dampen sentiment and buyer demand for small and mid-sized PE-backed technology companies. As a result, many PE firms are either

2: "Behrman Capital Sells Portfolio Company Emmes to Affiliates of New Mountain Capital," Cision PR Newswire, June 21, 2022.
3: "Cencosud to Acquire Majority Stake in The Fresh Market Holdings from Apollo Funds," Cision PR Newswire, May 11, 2022.
4: "Williams Concludes $423m Acquisition of NorTex Midstream," Offshore Technology, September 9, 2022.

exiting companies at lower valuations than they may have garnered a year ago or holding on to their portfolio companies longer to grow into their old valuations. However, IT exits have accounted for 15.5% of all middle-market exits this year, second only to the B2B sector, demonstrating its resilience and attractiveness longer term.

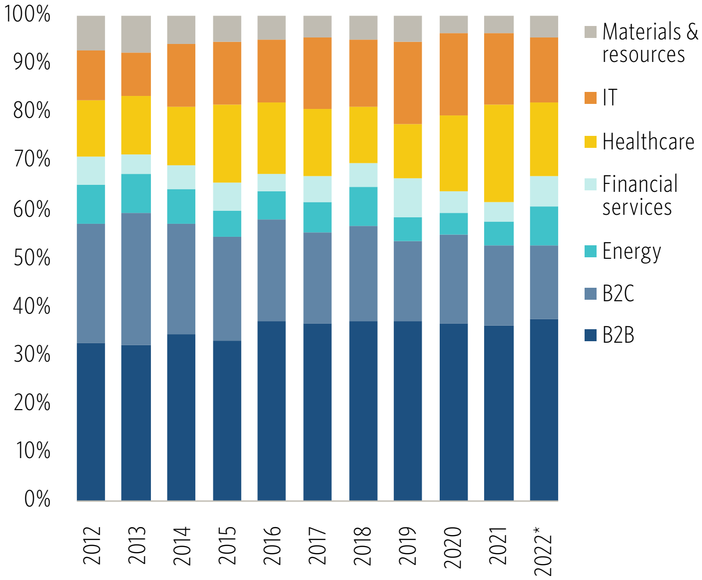
Corporate acquisitions helped contribute to tech exits as increasing digitalization across industries spurred exit opportunities for PE firms investing in tech companies. In August, Siris Capital Group exited their investment in Stratus Technologies to SMART Global Holding for $275.0 million. Stratus is a global leader in simplified, protected, and autonomous computing solutions. SMART Global believes that the acquisition will further strengthen its high-availability and fault-tolerant capabilities in its edge and cloud computing offerings.[5]

Sponsor-to-sponsor exits for middle-market tech companies were quite common in Q3 as new PE ownership and structures attempt to accelerate value creation and reinvigorate growth. A good example of this is Carousel Capital's sale of its majority share in APEX Analytix, a provider of supply chain risk management software and services, to KKR. The company believes that the addition of KKR will allow APEX to accelerate growth and meet customer needs with greater agility.[6] In September, Centerbridge Partners exited AHEAD, a leading provider of enterprise cloud services, to Berkshire Partners, which has upped its investment to take a majority stake in the company.[7] Secular trends in tech, such as the increasing demand for digital transformation capabilities and efforts to scale them into market share leaders, will continue to spur more exit opportunities for middle-market PE firms investing in IT.

B2B

B2B continued to see a strong exit count in Q3 with 87 deals and $14.3 billion in value, right in line with the strong activity seen in Q1 to start the year growing. Year to date, the sector has grown its share of all exits to 42.1% (+250 basis points), the largest of any sector by far. The sector

Share of PE middle-market exit value by sector



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

comprises a broad mix of primarily non-tech and service-oriented businesses, spanning everything from manufacturing to professional services to transportation. B2B offers ways to improve efficiency, given its high labor intensity. The industry also tends to be highly fragmented with many opportunities for strategic acquisitions to consolidate market share in attractive sub-segments that serve the business customer. Considered major verticals within the B2B space, industrial includes manufacturers of heavy equipment, building materials, electrical components, transportation vehicles, and infrastructure, as well as services related to these manufacturing processes. In September, Aurora Capital Partners exited their investment in National Technical Systems (NTS) to Element Materials Technology for $700.0 million. NTS is a provider of qualification testing, inspection, and certification services in North America that serves a wide range of end markets. The acquisition of NTS is expected to further Element's capability to be a partner throughout the product lifecycle for its customers.[8]

5: "SGH to Acquire Stratus Technologies," Business Wire, June 29, 2022.
6: "KKR Invests in Apexanalytix," Business Wire, June 6, 2022.
7: "Berkshire Partners Acquires Majority Stake in AHEAD from Centerbridge," Business Wire, September 26, 2022.
8: "Element Materials Technology Acquires National Technical Systems," Business Wire, September 27, 2022.

A WORD FROM LBMC

PE landscape challenges: LBMC experts' perspective

In this challenging environment, buy-side doing diligence early and often

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 less than $10 million to greater than $7 billion in size across a number of industries, with deep expertise in healthcare.

Brad Bonde

Shareholder, Transaction Advisory Services

Brad has more than 18 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.

John Mark McDougal

Shareholder, Practice Leader, Accounting and Assurance

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.

What are the challenges your clients have been bringing to you most recently? Which of them surprised you the most?

Lisa Nix: In this current environment, pressure on valuations is real with sellers proposing more run-rate and pro forma adjustments that make up a significant portion of adjusted earnings. As a result, more of the financial due diligence effort is being focused on pro forma earnings utilizing historical trending to inform forecasts and run-rate revenue and expense adjustments. To mitigate or address the potential valuation gap, buy-side clients are requesting increased assistance with not only stress testing seller pro forma adjustments, but surprisingly with performing analysis and scenario modeling on their own synergy and forecast adjustments, which are integral to their investment decision. Since the 2021 deal frenzy, clients have become more selective and more disciplined earlier in the deal process, requesting additional buy-side due diligence assistance in the pre-Letter of Intent (LOI) or pre-exclusivity phase of a transaction. With the economic uncertainties weighing on deal valuations and the continuance of compressed deal timelines, it is important now more than ever for a buyer to utilize external advisor(s) to assist in their evaluation of a seller.

For the US middle market in particular, what are the most underrated concerns you are flagging in PE transactions, and how do they differ between the buy side (and the sell side, if applicable)?

LN: From a buy-side perspective, one of the most underrated and often underestimated concerns is the cost and effort that will be required for financial transformation with some middle-market selling companies. The lack of investment in financial systems, controls, data analytics and processes is common in the middle market and becomes an operational challenge early after the deal closing. Timely and accurate financial reporting, albeit critically important, goes much beyond a company producing financial statements in accordance with US GAAP. The development of a scalable, cloud-based data architecture—if one does not exist—that lays the groundwork for comprehensive financial and operational reporting and analysis, becomes necessary for a buyer to deploy successful integration strategies and realize pre-closing deal synergies. Continuing to assimilate and integrate new or disparate data sources as the company evolves, developing data driven reporting to support real-time financial and operational decision-making, and extending capabilities for future acquisitions will also become business-critical priorities. Clients are requesting data analytics and analyses employed during the due-diligence process to extend post-close as they develop and build out these capabilities internally. Conversely, sellers are typically not highlighting deficiencies in their financial systems, and the burden rests with buyers to make this assessment during the diligence process.

What innovations in the use of third parties or other relatively novel types of services are you seeing in the US middle-market ecosystem, especially as it pertains to PE dealmaking?

John Mark McDougal: Everyone is stretching right now, with a compressed labor market and supply chain woes, to find new ways to solve old problems. Most of the problems themselves have not changed that much, only the severity of their near-term impact, particularly in cases such as the labor market and supply chain. Having "blue ribbon" technology, reporting, and processes in these crunch times where significant decisions are needed quickly increases an organization's probability of success. Companies should focus on maximizing areas of strength to address both expected and unexpected challenges.

The year thus far has been characterized by marked volatility. What are the key macro factors you are watching most closely?

JMM: This question has a lot of differentiation based on industries and even geographies, but a few things are clear—all eyes are on interest rates, adjusted inflation numbers, and jobs reports. In speaking with clients the last few months, our business-to-consumer clients are monitoring order levels and discretionary spending very closely. The consumer is spending based on a variety of factors, one of them being their personal outlook based on the news they see. While earnings have been holding up in many sectors, continual economic headwinds eventually make people want to halt some spending, or at least defer it, and that's when you'll see the "pullback." The auto industry continues to be plagued by supply chain disruption as well as labor issues. Last, but not least, healthcare is what you would expect—a continued stable force in uncertain times.

What impact has the current economic environment had on negotiations during transactions, post-acquisition planning, or due diligence?

Brad Bonde: Given the recent substantial shift in interest rates and potential for a recession on the horizon, many PE groups have narrowed their assumptions as part of underwriting and projections, the exception being premium assets with proven management teams and high cash flows that still command strong valuations. The second tier of assets, which have managed costs and grown revenues but have some volatility in their earnings profile, is experiencing more negotiation throughout diligence. Investors are taking a longer look at potential complications to ensure they have sufficient risk mitigation structures in place. Valuations have stabilized or decreased in many sectors, and investors are attempting to factor in continued talent challenges and inflationary risks in their assessment of investments.

We are not seeing investors frequently stretch or be willing to pay for synergy and optimization for companies with significant levels of addbacks and pro-forma growth projections in their value proposition. We have observed more clients trying to bridge financial results between what was reflected during quality of earnings and the results that are being identified subsequent to closing. This is primarily driven in situations where investors may have stretched in their valuations during the breakneck pace of the past two years.

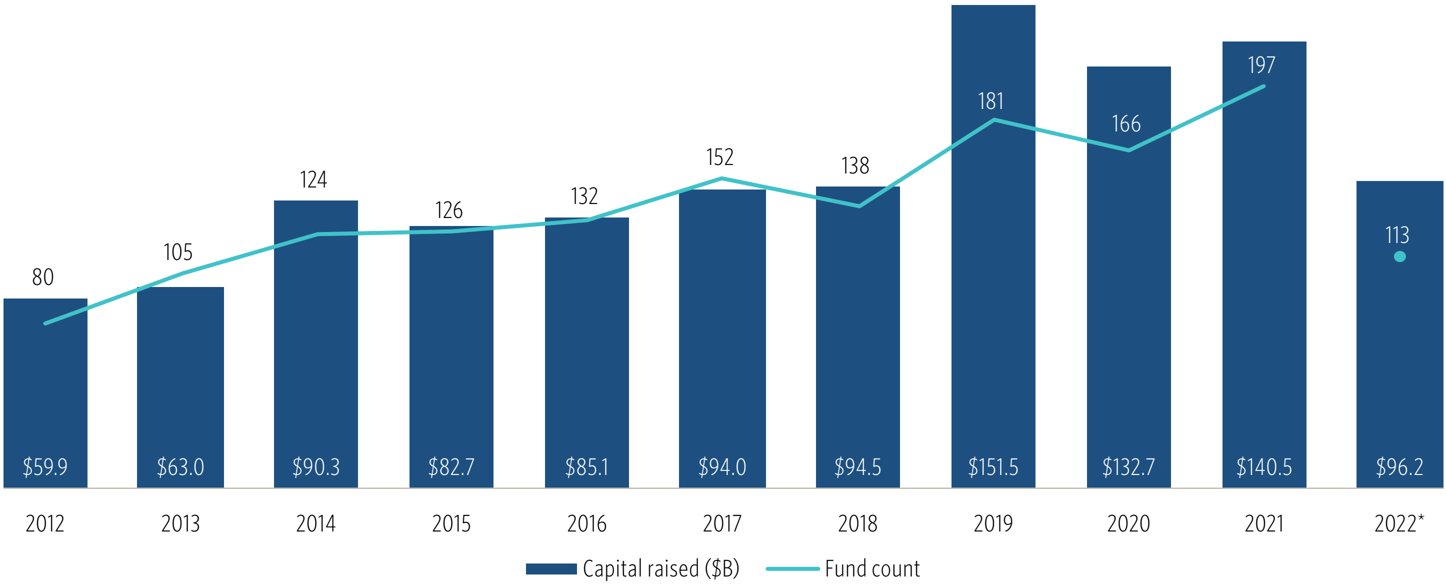
With PE dry powder still at elevated levels, what other factors might play into the decision-making process for both the sellers and the buyers?

BB: When everyone has capital to put to work, other factors may come into play in a seller's decision-making process. When investors are reluctant to pay a premium that just a short time ago would have been attained, sellers may be more willing to roll equity to participate in additional upside or hope to capture additional return in an improved economic market while still taking some chips off the table. Sellers may also consider feedback that bankers and peers may offer in relation to their experiences during diligence while making a decision. Investors that may have a reputation for lengthy and onerous diligence and propose significant changes to LOIs may be at a disadvantage.

Investors should plan to budget more growth funding into their acquisitions shortly after closing. These short-term nonrecurring costs may help drive returns to offset higher costs of capital. In addition, when operating in an environment with economic uncertainty, key differentiators in driving returns include the ability to optimize processes and accelerate the time it takes to generate financial insights. When companies have immature financial teams, processes, and systems, higher emphasis on the post-closing steps throughout diligence becomes more important to a successful acquisition. These steps are necessary to consider when holding periods may extend longer than originally anticipated in the current market.

Fundraising and performance

PE middle-market fundraising activity

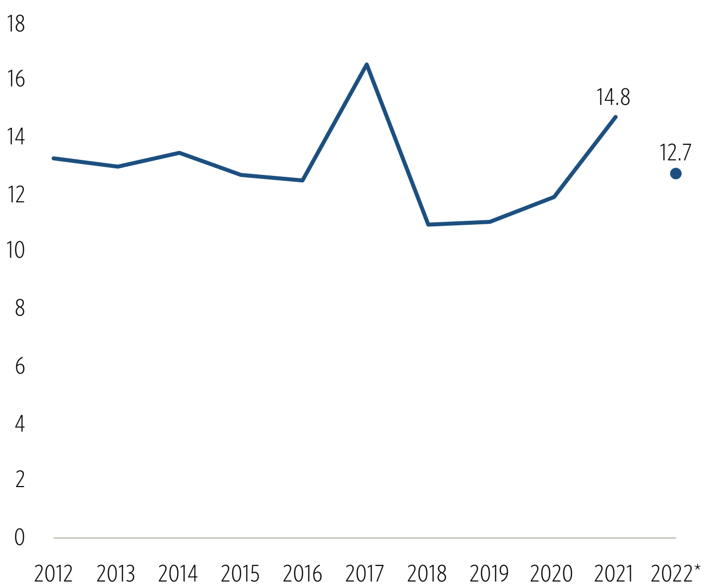


Source: PitchBook | **Geography:** US
*As of September 30, 2022

US middle-market fundraising remained steady through Q3, with a total of 113 funds closed with an aggregate of $96.2 billion. The fundraising pace barely slowed this year compared to the strong figures seen in the last three years as GPs returned to market at a rapid pace after unprecedented dealmaking activity in 2021. However, whereas 2021 ended with 71 funds closed in the final quarter—36% of the full-year total—we do not expect that year-end bump to repeat in 2022, as many LPs are wrapped up for the year heading into Q4. It has been a tough environment for smaller scale players and funds, with the top 35 vehicles capturing 75.1% of all LP capital raised this year by US PE funds, as compared to 40.4% last year. Middle-market funds that are not part of a larger fundraising platform have struggled as a result.

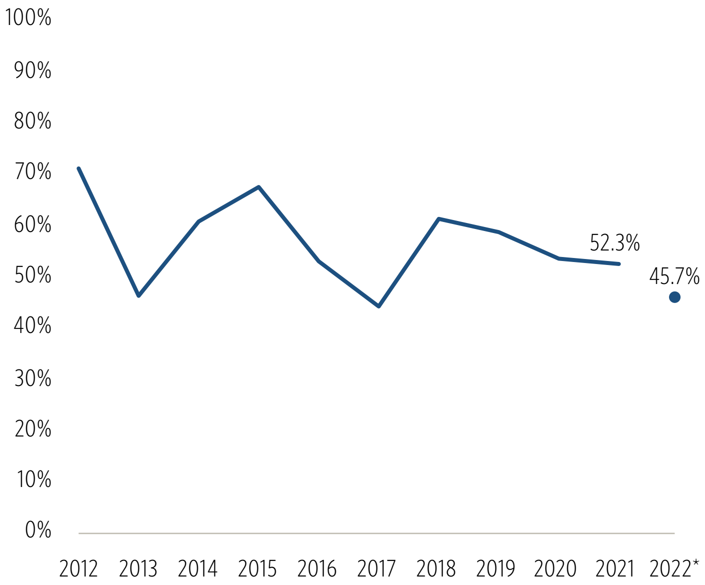
For middle-market funds that closed in 2022, average time to close dropped from 14.8 months to 12.7 months, reflecting the quickening pace of fundraising this year. LPs struggled to match the high demand for capital, and many investors reached their yearly allocation limits early in H1 amid a highly competitive fundraising environment. Market volatility and reduced exit activity during the year slowed the flow of capital back to LPs, further constraining LP ability to fund new commitments. We expect fundraising activity to see little change through Q4, with most LPs done allocating capital

Average time (months) to close for PE middle-market funds



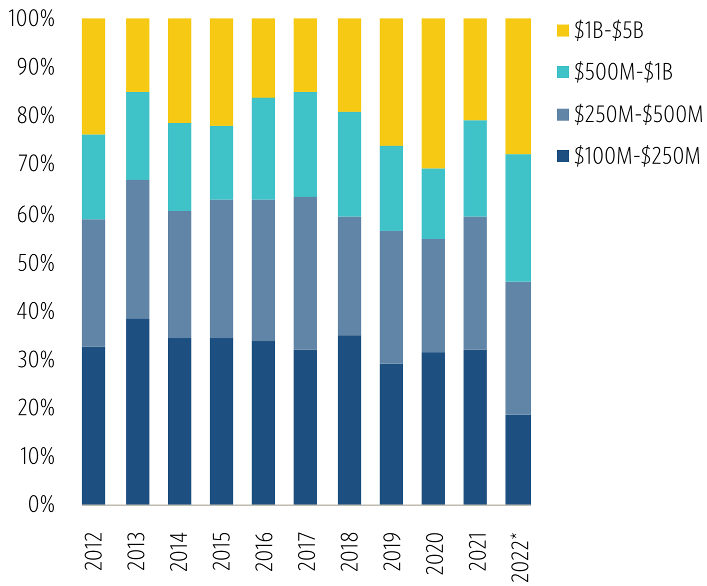
Source: PitchBook | **Geography:** US
*As of September 30, 2022

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



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

Share of PE middle-market fund count by size bucket

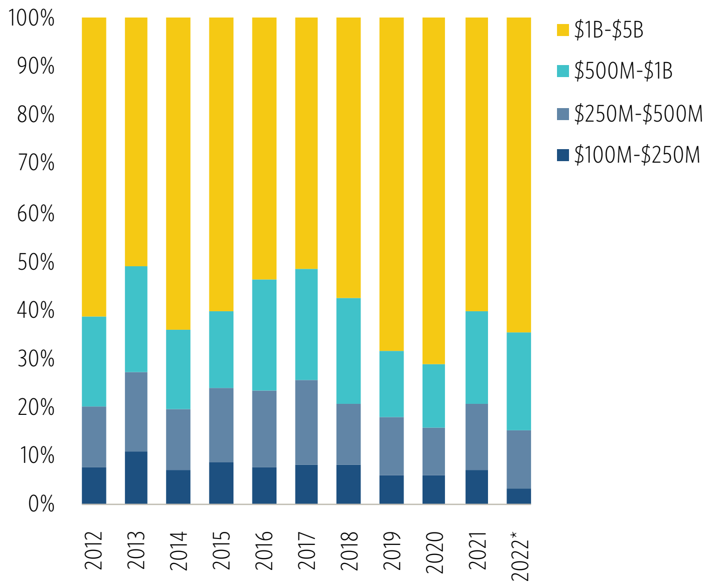


Source: PitchBook | **Geography:** US
*As of September 30, 2022

for the year. While the middle market is likely to fall short of the pace set since 2019—$130 billion raised each year across nearly 200 funds—fundraising activity is still healthy when compared to a longer time frame.

Going forward, deployment and fundraising cycles will likely revert to their historical norm as the recent pace is unsustainable for both GPs and LPs. With most LPs struggling against rapid re-ups, LPs are more comfortable pushing back on GPs to slow down fundraising to a more manageable cadence. The denominator effect is also causing LPs to slow their fundraising pace as PE portfolios have swelled relative to depressed public holdings. For example, the investment council of Oregon's Public Employee Retirement Fund announced plans to reduce its PE allocation, specifically citing the denominator effect as causing PE to become its largest asset class.[9] Teacher Retirement System of Texas also anticipates a reduction in its PE commitment pacing while balancing the ability to be active when valuations become more attractive.[10] With a more constrained capital base, less managers will meet the bar for commitments during diligence. However, still-impressive returns from PE strategies will continue to attract investor capital. A survey from Royal Bank of Canada and Campden Wealth found that nearly half of North American family offices intend to increase their PE

Share of PE middle-market capital raised by size bucket



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

9: "Oregon Looks to Reduce its Massive Allocation to Private Equity," **Buyouts**, Gregg Gethard, September 7, 2022.
10: "Scott Ramsower, PE Chief at Texas Teachers, on Navigating PE in Dislocated Markets," **Buyouts**, Chris Witkowsky, November 16, 2022.

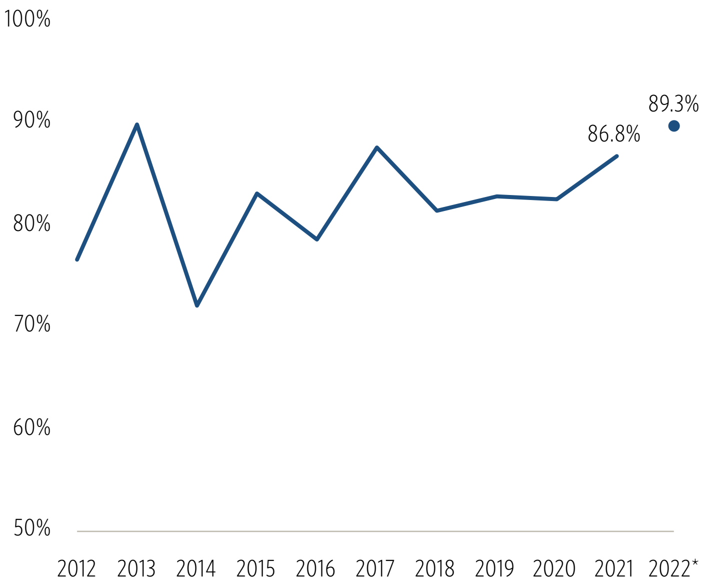
bets in 2023 after enjoying double-digit returns last year.[11] Kansas Public Employees Retirement System is also planning to ask its state legislature to increase its allocation cap to alternative assets after being constrained by the denominator effect and risking losing access to good managers and attractive returns.[12, 13]

The middle-market specialist funds and managers are more negatively affected as fundraising tightens across PE. During periods of high competition for capital, institutional investors prioritize more seasoned relationships, meaning that larger and more-established managers fare better in their fundraising efforts. Middle-market funds decreased as a proportion of overall PE fundraising, accounting for 45.7% of capital raised so far this year, compared to 52.3% in 2021, as mega-funds continue to take more market share of fundraising. The preference for larger funds is playing out within the middle market as well, with the lower middle market—$100 million to $500 million—getting squeezed out by both fund count and value compared to the core—$500 million to $1 billion—and upper middle market—$1 billion to $5 billion. Small, niche managers can still be successful in fundraising efforts, since they require much smaller checks and provide a diversification strategy for many large LPs. Some LPs do leave room in their annual budgets to allocate to new relationships, but GPs will have to lean on connections, a strong track record, relationship building, and/or flexible fundraising playbooks to hit their fundraising targets.

Step-ups

By the end of Q3, 89.3% of middle-market funds closed with more capital than their predecessors, demonstrating the pervasive trend of step-ups throughout the PE industry. Median step-up size remained stable, but the average step-up shot up to 216.4% as some GPs grew their funds at a rapid pace. Motive Partners, for example, had a final close of $2.5 billion for its second flagship fund in July, marking a 5.4x step-up from its first fund raised in 2019. The fund secured capital from a significant group of new investors that are geographically diverse and ranging from pensions, sovereign wealth funds, family offices, and high-net-worth-individuals.[14] A large portion of step-up activity in the middle market could be from funds that have started fundraising before the intense demand for LP capital hit against funding capacity.

Share of PE funds larger than previous fund in fund family



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

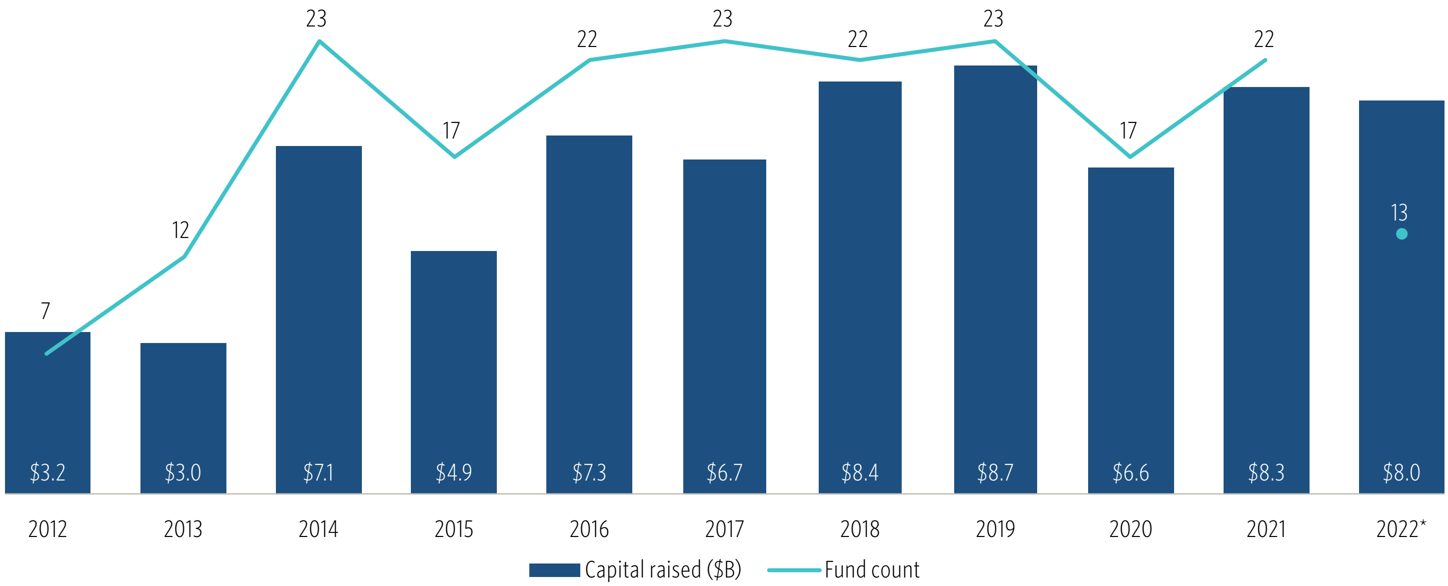
Continued high demand for capital in a crowded fundraising environment may pressure the quantity and magnitude of step-ups for middle-market managers going forward. Step-up activity could continue, however, as GPs increasingly turn toward the middle market to search for attractive deals with valuations coming down and market volatility creating opportunities for distressed companies. Kohlberg & Company recently announced that it is targeting $5 billion for its latest mid-market buyout fund, which would be 47% larger than its previous fund. Expected to close in H2 2023, the fund's strategy is focused on North American companies with EBITDA of $25 million to $150 million operating in healthcare services, infrastructure services, business services, and financial sectors.

Emerging managers

The current fundraising environment is harder for emerging managers who lack the connections or proven track records to secure investors. Middle-market fundraising activity by first-time or emerging managers has nearly halved in number of funds raised so far this year, with 13 first-time funds closing in the middle market through Q3. However, capital raised

11: "Family Offices With $182 Billion Eye More Big Gains on PE Bets," Bloomberg, Benjamin Stupples and Amanda Albright, November 16, 2022.
12: "Kansas Wants to Hike PE Allocation Amid Soaring Exposure," Buyouts, Gregg Gethard, September 30, 2022.
13: For more on the denominator effect, read our latest, Allocator Solutions: Taking the "Demons" Out of the "Denominator Effect."
14: "Motive Partners Raises $2.5 Billion," Business Wire, July 12, 2022.

First-time fundraising activity



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

remains in line with previous years, demonstrating that managers with a more pedigreed background or spinning out of high-profile shops can secure chunkier sizes for their new strategies. In September, BayPine closed its inaugural fund at $2.1 billion, marking the largest first-time middle-market fund raised in 2022. BayPine was formed by an impressive team with backgrounds ranging from Blackstone to the US Department of the Treasury.

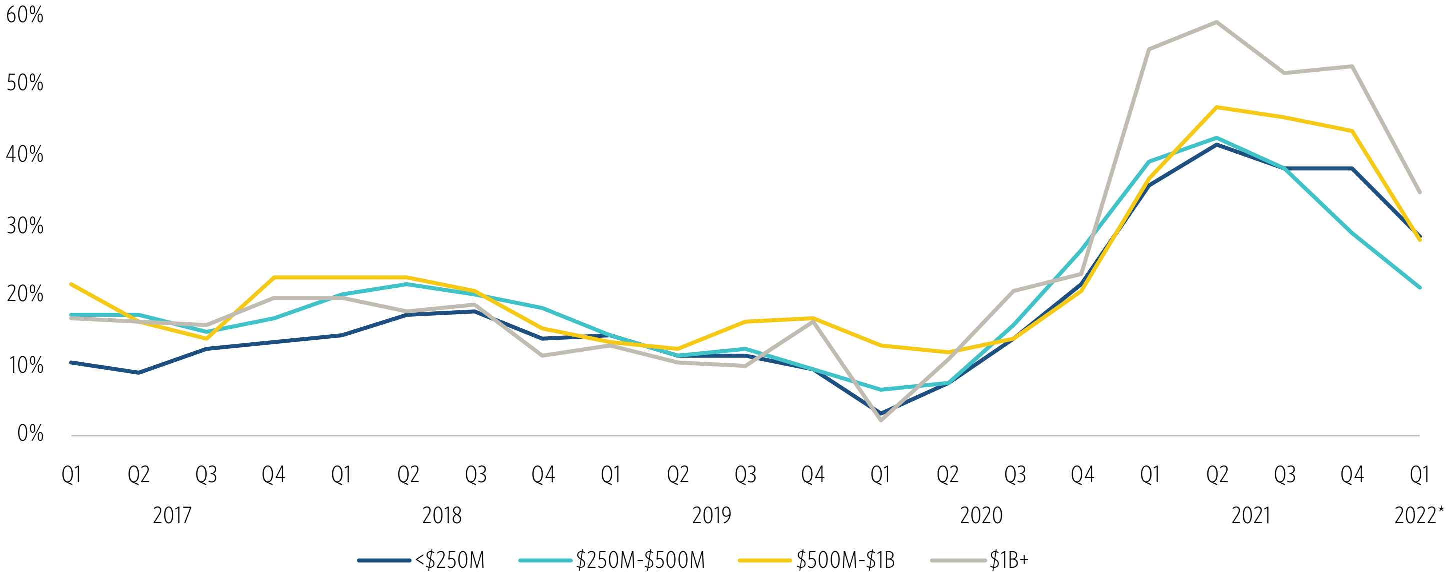
Performance

In a shifting macroeconomic environment, PE's long run of outperforming other private market strategies has officially come to an end. Global PE strategies slipped to a return of 2.1% in Q1 and preliminary estimates for Q2 point to a negative quarterly return of -3.2%, ranking last when compared to other major private market strategies. Middle-market private companies in the Golub Capital Altman Index saw a year-over-year earnings decline of 2.1% in Q3, despite 11.6% growth in revenue as uncertainty and inflation in US markets continued to put pressure on company profit margins.[15] There was increasing dispersion in performance by industry: Consumer sector earnings declined YoY by 4.5% as companies struggled to pass increased input costs to consumers, while industrials showed positive profit growth as the sector improved cost management earlier on. Earnings calls hosted by publicly traded PE firms told a similar story of solid double-digit top line growth and a much more mixed picture on the ability to pass through higher costs from inflation. Blackstone and Apollo saw gross PE fund performance of -0.3% in Q3, while KKR marked its portfolio down further at -4%. While private markets have enjoyed less volatility than public markets, continued headwinds are likely to produce another quarter or two of stunted returns.

During the upturn, smaller middle-market funds lagged behind funds of $1 billion-plus, with the latter peaking at a one-year horizon return of 58.9% in Q2 2021. Since then, middle-market funds have done slightly better than mega-funds in the downturn, although it is too early in the cycle to conclude which strategy has been more successful in protecting investor principal.

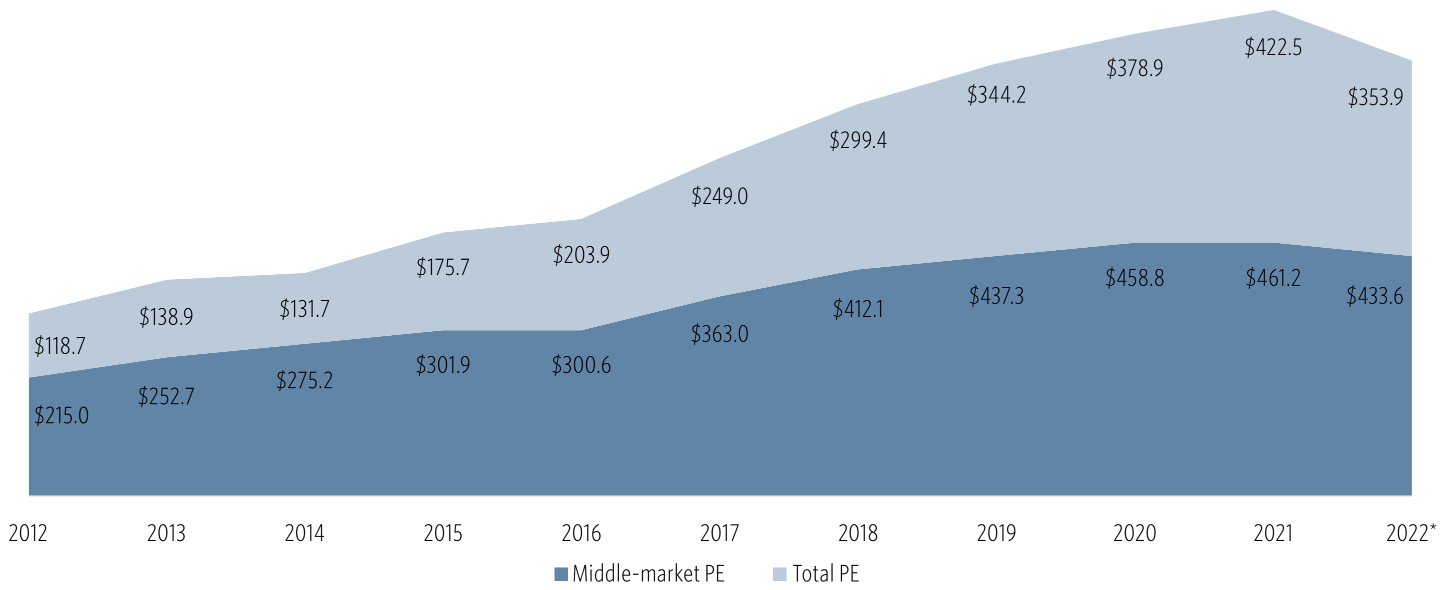
15: "Golub Capital Middle Market Report," Golub Capital, Edward I. Altman, n.d., accessed December 1, 2022.

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



Source: PitchBook | **Geography:** US
*As of March 31, 2022

PE middle-market dry powder ($B)



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

PitchBook

Sponsored by Antares Capital LBMC

Q3 2022 US PE middle market lending league tables

Overall

Rank	Company	Deal count
1	Churchill	44
2	Ares	39
3	Twin Brook Capital Partners	36
4	Antares Capital	35
5	Monroe Capital	31
6	Audax Private Debt	26
7	BMO Financial Group	25
7	Golub Capital	25
9	PNC	24
9	Barings	24
11	Varagon Capital Partners	23
12	Capital One	22
13	MidCap Financial	19
14	Crescent Capital	18
15	KeyBank	17
16	Fifth Third Bank	16
16	Owl Rock	16
16	The Carlyle Group	16
19	Citizens Bank	15
20	U.S. Bank	13
20	Truist	13
20	Jefferies Group	13
20	Principal Global Investors	13
24	The Goldman Sachs Group	12
24	HPS Corporate Lending Fund	12

Source: PitchBook

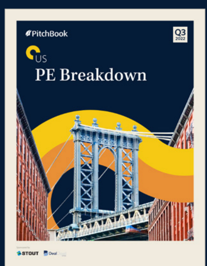
Select roles*

Rank	Company	Deal count
1	Twin Brook Capital Partners	36
2	Churchill	33
3	Antares Capital	32
4	BMO Financial Group	23
4	Varagon Capital Partners	23
6	PNC	20
7	Ares	19
7	Monroe Capital	19
7	Golub Capital	19
7	Capital One	19
11	Crescent Capital	15
12	MidCap Financial	13
12	KeyBank	13
12	Barings	13
12	Fifth Third Bank	13
12	Citizens Bank	13
17	Audax Private Debt	12
17	The Carlyle Group	12
17	Jefferies Group	12
20	U.S. Bank	11
21	Truist	9
21	NXT Capital	9
23	Wells Fargo	8
24	Regions Financial	7
24	J.P. Morgan	7

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

Additional research

Private markets



Q3 2022 US PE Breakdown

Download the report here

Q3 2022 Global Private Market Fundraising Report

Download the report here

Q4 2022 Quantitative Perspectives: When the Tide Goes Out

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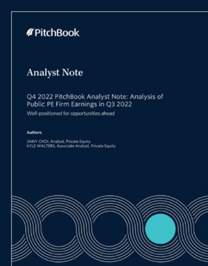

Analyst Note: Analysis of Public PE Firm Earnings in Q3 2022

Download the report here

2022 Global Fund Performance Report (as of Q1 2022 with Preliminary Q2 2022 Data)

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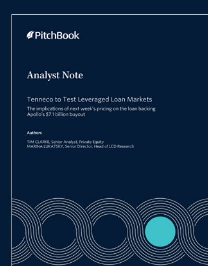

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