PitchBook

Q3 2023

US PE Middle Market Report

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PitchBook Data, Inc.

John Gabbert Founder, CEO

Nizar Tarhuni Vice President, Institutional Research and Editorial

Dylan Cox, CFA Head of Private Markets Research

Institutional Research Group

Analysis

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

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

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

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

Data

Alyssa Williams
Senior Data Analyst

pbinstitutionalresearch@pitchbook.com

Publishing

Report designed by **Drew Sanders**

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Executive summary

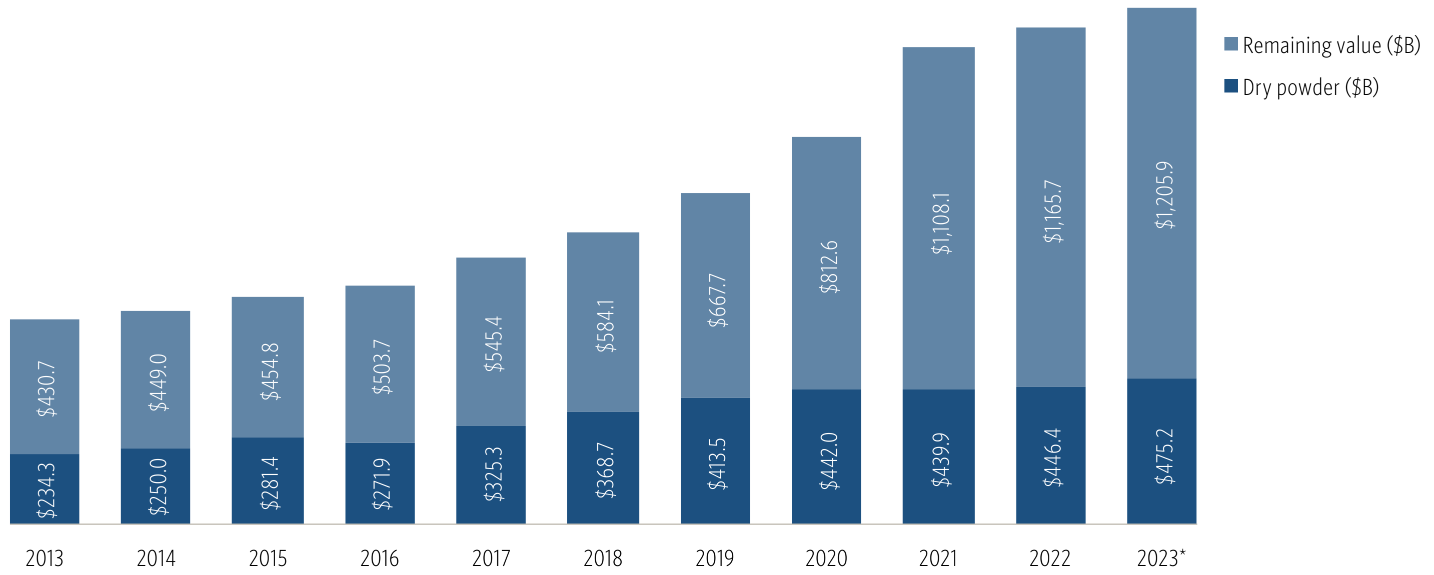
The malaise in big deal activity finally caught up with the small and midsized deal market. Unlike megadeals, where the main culprit has been limited access to debt, lending to middle markets is in ample supply. The problem has been more about getting deals to lenders in the first place. A nearly full percentage point rise in interest rates, this time on the long end, caused buyers to pause and assets to reprice—private equity assets included. Middle-market deals that did manage to close did so at lower multiples on EBITDA, although some firming was evident on revenue multiples and in the technology sector.

Middle-market share of all PE buyouts is still on track for its best year yet. Still, it could not buck the overall trend which saw a sharp downturn in deal activity in Q3 both on the buy and sell side. Exits of middle-market companies stepped down by more than 25% during the quarter. Meanwhile, PE-led, middle-market buyouts, which had shown persistent signs of stabilizing, also pushed lower in Q3 in search of a new bottom. Nonbacked founder-owned businesses continue to comprise most of the feedstock for middle-market deal flow, as companies with backing are being held for longer.

Fundraising has been a bright spot for middle markets this year. While megafunds have struggled with their fundraising for most of the year, middle-market funds made inroads with investors in search of differentiated return strategies with less dependency on leverage. Total capital raised for middle-market funds will likely close flat with 2022's total, which is not a bad result given the challenging environment and negative comparisons everywhere else in private-markets fundraising. The middle-market share of all PE buyout funds closed this year is tracking at close to 40%, the high end of its 10-year range.

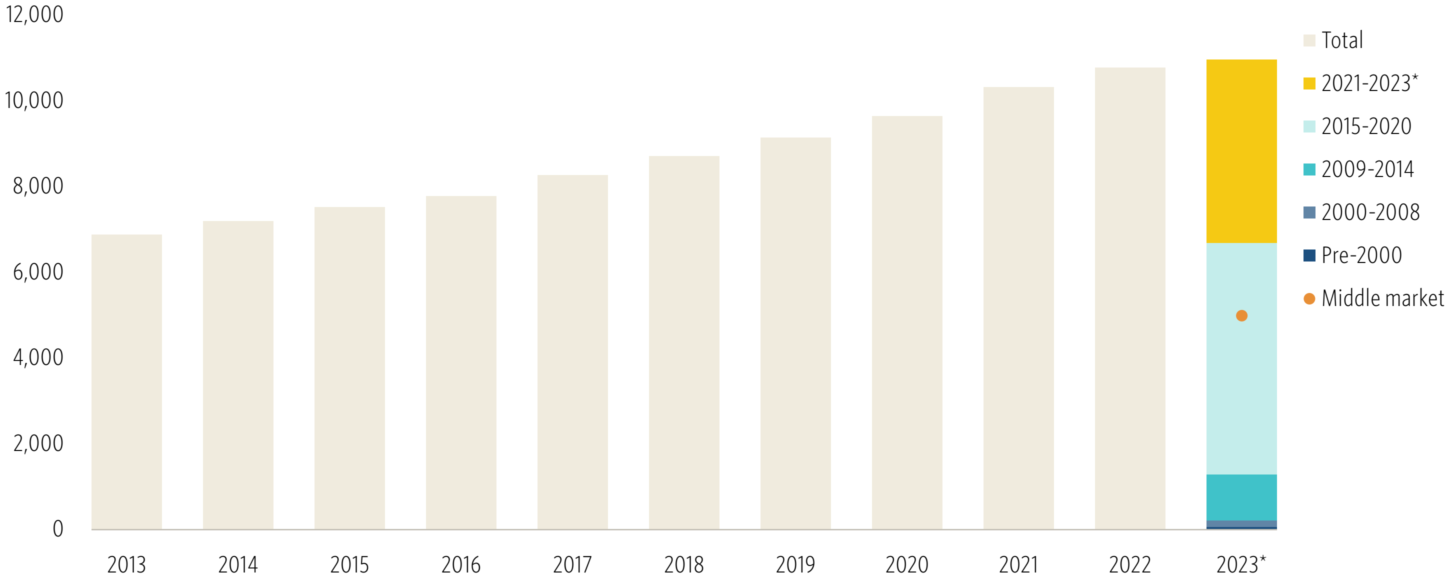
Part of what fueled middle-market fundraising was superior performance by its funds relative to megafunds, a gap that peaked in Q4 2022. As if on cue, middle-market outperformance has begun to wane one year after it started. Still, middle-market funds hung onto most of its gains versus megafunds in Q2 2023, the most recent quarter we have data for, on a trailing 12-month basis.

PE middle market AUM ($B)



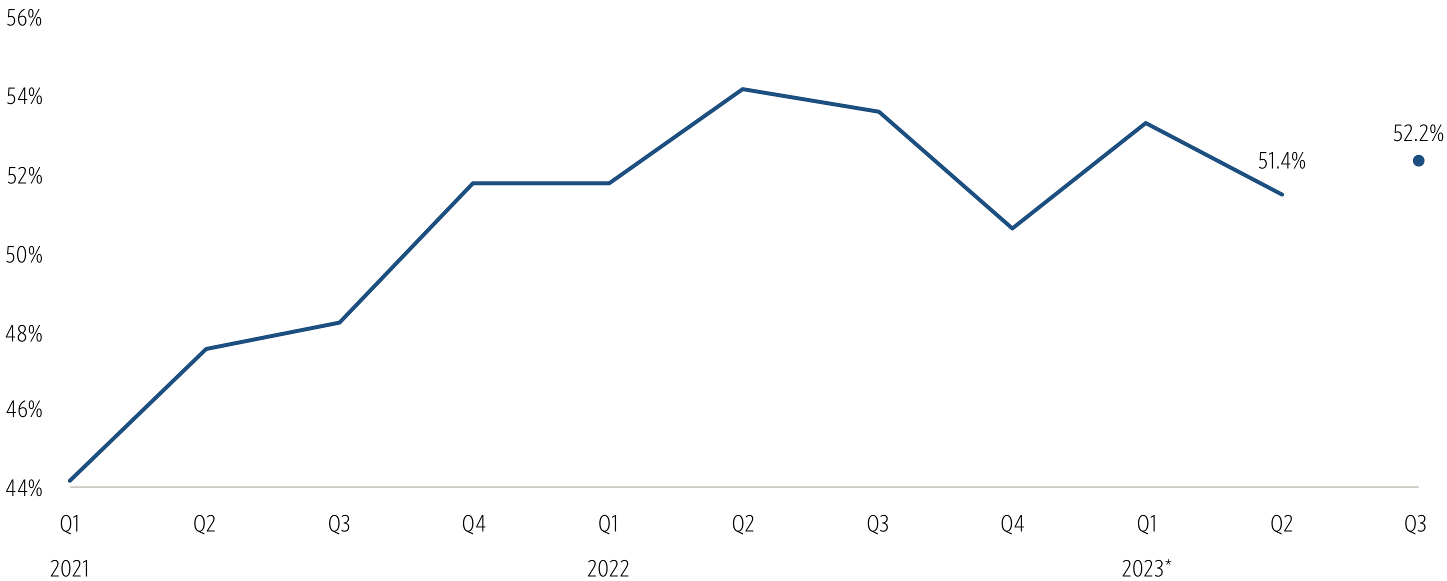
Source: PitchBook • **Geography:** US
*As of March 31, 2023

PE-backed company count by investment vintage



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

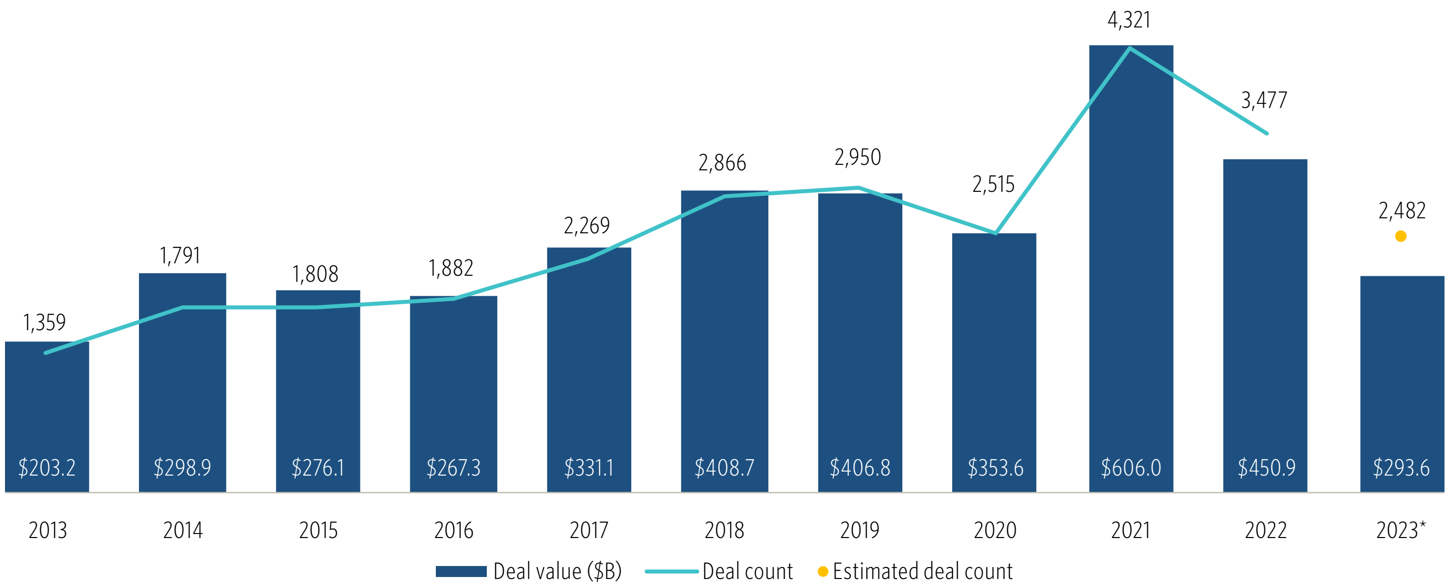
PE targets with no backing as a share of all PE middle-market buyouts by quarter



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

Deals

PE middle-market deal activity



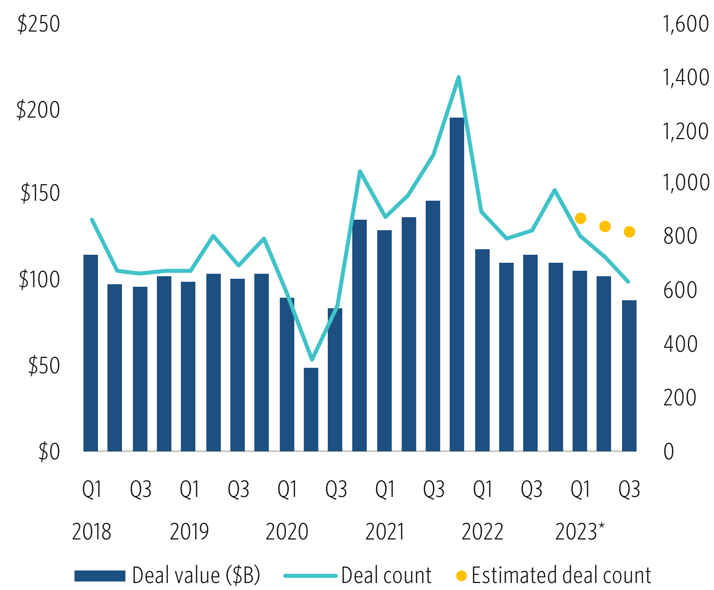
Source: PitchBook • **Geography:** US
*As of September 30, 2023

Overview

US PE middle-market buyout activity slipped to a six-year low in Q3 2023, breaking below the narrow band it had been churning in over the past seven quarters. Total value plummeted by 13.4% from the prior quarter while deal count declined by 2.5%. The peak-to-trough decline now measures 47.9% by value from the Q4 2021 peak. The middle market took its lumps early relative to the overall buyout market. Deal count and value both collapsed by roughly 35% to 40% in the quarter following the peak and seemed to have found its footing since then. However, Q3 was a definite setback. Much like the overall M&A deal environment, the middle market has yet to make a definitive bottom.

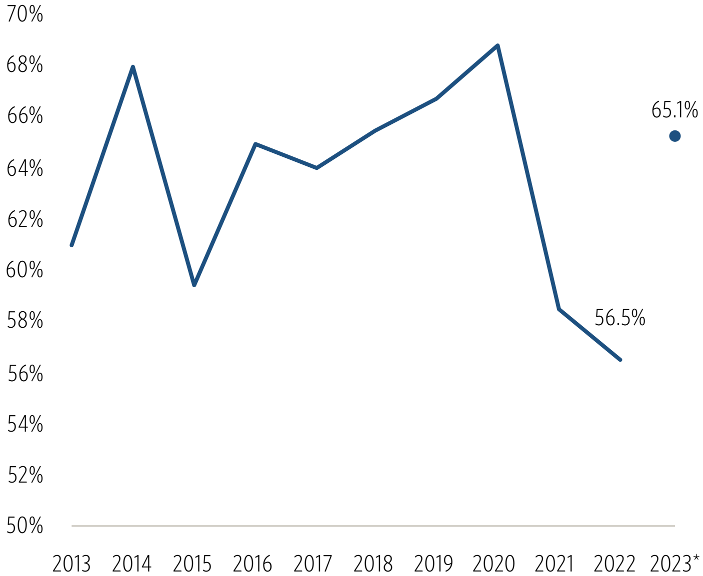
PE firms announced or closed 803 US middle-market buyout deals for a total of $87.7 billion in deal value in Q3. YTD, deal value and count have declined by 13.9% and 1.0%, respectively. While disappointing, the contraction in middle-market deal flow has been less severe than the overall US buyout market, which is down in YTD deal value and count, 29.3% and 6.0%, respectively. As a result, the middle-market share of all buyout deals has expanded to 73.6% YTD from a five-year average of 68.6%. If maintained, this would be the highest reading ever having never exceeded 72% for a full year. It would also mark a sharp reversal from a market previously dominated by megafunds and megadeals. As recently as Q2 2022, the middle-market share of deal value hit a more than six-year low of 42.3% before rebounding to 62.0% in Q3 2023.

PE middle-market deal activity by quarter



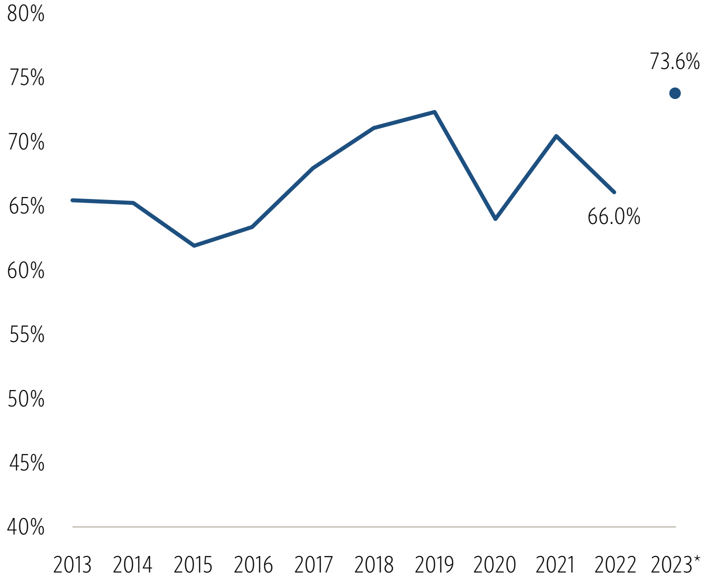
Source: PitchBook • **Geography:** US
*As of September 30, 2023

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



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

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



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

The forces driving the slowdown in megadeal activity have been well documented, with the most powerful being reduced access to debt. For most of 2023, a glass ceiling stayed in place at the $2 billion level for large leveraged buyout (LBO) financings, although that began to weaken in the past two quarters with the announcement of several multibillion-dollar debt packages. Even tech has broken through, with the $2.6 billion commitment to the New Relic LBO by a club of private credit lenders. Still, looking at announced PE buyouts of large public or private companies so far in 2023, just five have received $2 billion or more in debt financing as compared with 15 during the same span in 2022.

Middle-market dealmaking operates well below the $2 billion glass ceiling. Far from being starved for debt, the sector is being actively courted by the vast and growing complex of private credit lenders. Between private debt funds backed by institutions, listed business-development companies (BDCs) backed by public investors, and a new breed of nontraded BDCs and interval funds backed by retail investors, we estimate that there are more than 1,300 private credit vehicles in the US alone, and virtually all have the expressed purpose of lending to small and middle-market businesses. The aggregate AUM in these vehicles has grown rapidly in the past three years to reach $869.3 billion, or 62.0% the size of the US leveraged loan market, which lends to the world's largest companies but has barely grown during the same span.

The downturn in Q3 middle-market activity had less to do with restrictive access to debt as much as getting deals to lenders to begin with. While there are willing lenders abound, the supply of willing buyers and sellers shrank during Q3. Another interest-rate shock was administered during the quarter, this time on the long end, with the 10-year treasury yield rising by nearly a full percentage point to a 15-year high. Granted that middle-market deals are far from the flame of public markets, they are not totally immune to the capital markets pricing model. A 25% rise in the risk-free rate alters the price at which buyers are willing to pay for long-duration assets and discounted cash flows. This caused deal deliberations to stall during the quarter and deal value to step down to a new post-COVID-19 low.

We believe that the preconditions are still in place for a sustained recovery in middle-market PE deal activity, but Q3 was a definite setback that delayed the rebound by a quarter or more.

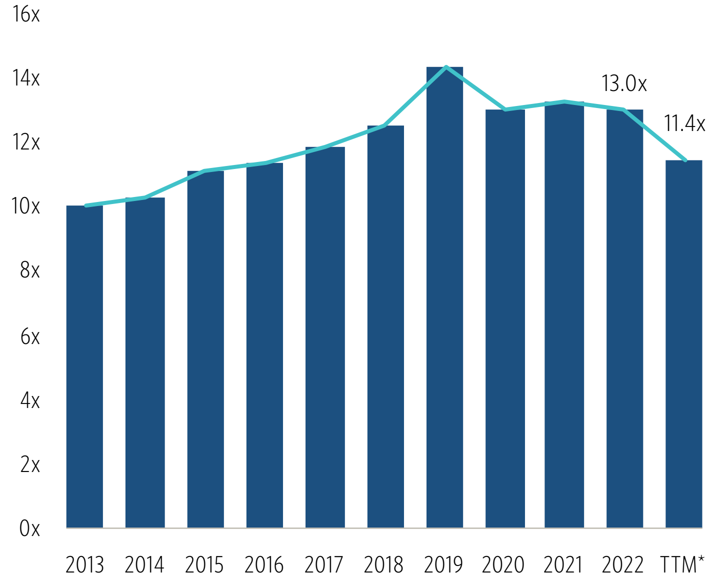
Valuations

Deal multiples on middle-market buyouts were mixed for the 12 months ending Q3 2023. Whereas enterprise value/EBITDA (EV/EBITDA) multiples continued to slide, EV/revenue multiples showed signs of firming. Of the two measures, we view revenue multiples as a more reliable and less volatile indicator. The sample size of deals having disclosed revenues is much higher than those with disclosed EBITDA—by a factor of two for middle-market-sized deals. Revenue multiples also tend to be a better yardstick for technology deals, many of which lack fully disclosed or meaningful EBITDA numbers.

The EV/EBITDA and EV/revenue multiples now stand at 11.4x and 2.4x, respectively. We combine North America and Europe in order to expand our sample size, as low disclosure rates in the US in particular can produce highly misleading medians and trends, and the regions are well correlated. On an EBITDA basis, 2019 was the peak year for PE middle markets at 14.3x. On a revenue basis, the middle markets peaked in 2021 at 3.2x, coinciding with the peak in tech and the broader market. From that 2021 peak, revenue multiples have since corrected by 26.1% through Q3 2023.

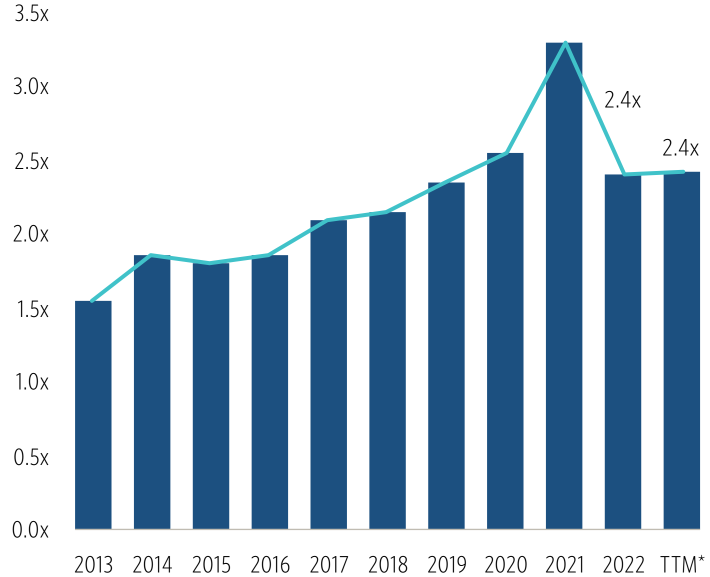
We attribute the latest multiples decline to a further dislocation in bid-ask spreads in favor of buyers. Prior dislocations in the PE market have taken 12 to 24 months to work themselves out, and the same appears to be happening now. Many of the top public PE firms have stated in their Q3 earnings calls that they have deliberately postponed running sale processes for their portfolio companies, a sentiment repeated by our conversations with other PE sponsors.

Median PE middle-market EV/EBITDA multiples



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

Median PE middle-market EV/revenue multiples



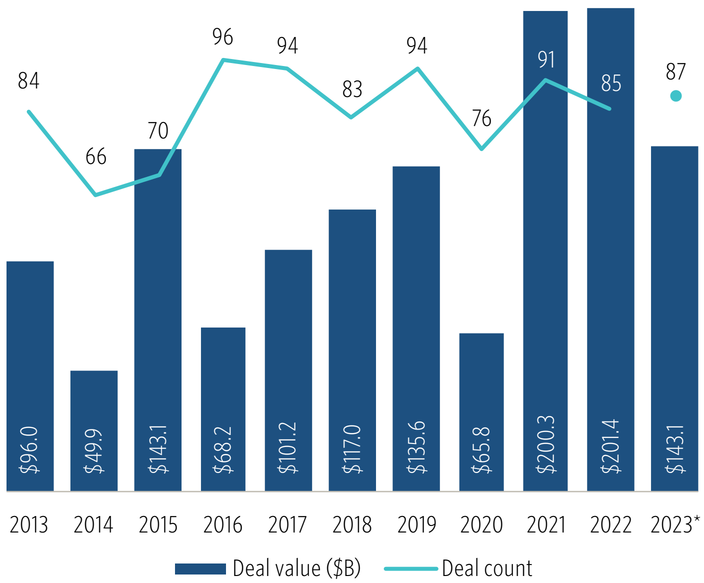
Source: PitchBook • **Geography:** North America and Europe
*As of September 30, 2023

Take-privates

The volume of take-private deals moderated somewhat in Q3 but is still running well ahead of H2 2022, when public shares spent more of the time declining and buyers scrambled to line up new sources of financing. In all, PE buyers announced 23 take-privates in in North America and Europe during Q3, unchanged from Q2. Examining the data reveals a continued trend of take-privates getting smaller and migrating to the middle market. A total of 15 deals, or approximately two-thirds of Q3's total, involved companies valued at less than $1 billion, up from a 55.0% five-year average in prior years. The median size of all take-privates in Q3 was just $469.0 million, down from $682.0 million in the five years prior.

Fewer recent listings fell into Q3's deal list, or what we call the "boomerang" stocks—companies that went public only to go private again. Over 1,000 unicorns were taken public in the frenzy between 2020 and 2021, with two-thirds sinking below the $1 billion mark as share prices collapsed. Two of the 15 take-privates under $1 billion fit that description in Q3,

PE take-private deal activity



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

PE take-private deals under $1 billion in Q3 2023*

Announced date (2023)	Company	Acquirer	Deal value ($M)	Country
September 20	Finsbury Food Group	DBAY Advisors	$187.0	UK
September 20	Self Storage Group	TIAA-CREF Asset Management	$458.0	Norway
September 18	HS GovTech Solutions	Banneker Partners	$33.3	US
September 8	Round Hill Music	Great Mountain Partners	$469.0	US
September 4	Ergomed	Permira	$890.0	UK
August 30	Instem	ArchiMed	$257.9	UK
August 30	Osirium	Barton Technology Ventures	$8.3	UK
August 14	Glantus	Accel-KKR, Basware, Briarwood Capital, Long Path Partners	$19.7	Ireland
August 9	Computer Task Group	Cegeka, Gimv, Noshaq	$170.0	US
August 7	Tabula Rasa Healthcare	AlpInvest Partners	$570.0	US
August 2	Blancco Technology Group	Francisco Partners	$225.5	UK
July 17	Gresham House	Searchlight Capital Partners	$601.3	UK
July 10	Beter Bed	De Engh B.V., Navitas Capital, Teslin Capital Management, Torqx Capital Partners	$183.2	Netherlands
July 10	STM Group	Pension SuperFund Capital	$51.9	UK
July 4	Digizuite	GRO Capital	$42.4	Denmark
Median			**$187.0**	

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

down from four in Q2 and six in Q1. PE buyers have steered clear of boomerang candidates for now, opting instead for more seasoned companies with pristine balance sheets. Both Ergomed and Bianco Technology Group were net cash positive prior to their announced take-privates in Q3. This helped Ergomed to line up $350 million in private credit financing for its $890 million buyout by Permira and Bianco Technology to net $150 million in debt financing, also private credit, for its $225 million buyout by Francisco Partners.

PE firms are well suited to acquire midsized companies following a valuation reset in public markets. They are able to conduct a transformational overhaul without the intense distractions and costs associated with public ownership. Companies below $1 billion in market cap are especially hard-pressed to reap the benefits of being publicly listed on a major exchange due the very limited trading volume and research coverage that they are likely to attract, making them prime take-private candidates.

Founder-owned businesses

Companies with no backing, meaning they have never before taken institutional money, have historically represented a meaningful portion of deal activity. Since the beginning of 2021, there has been a further increase in the percentage of total deals accounted for by these nonbacked companies. These businesses, typically characterized by founder ownership, tend to be appealing targets for PE buyers for reasons that are explored in our Q2 2023 Analyst Note: Founder-Owned Businesses Are Attractive M&A Targets.

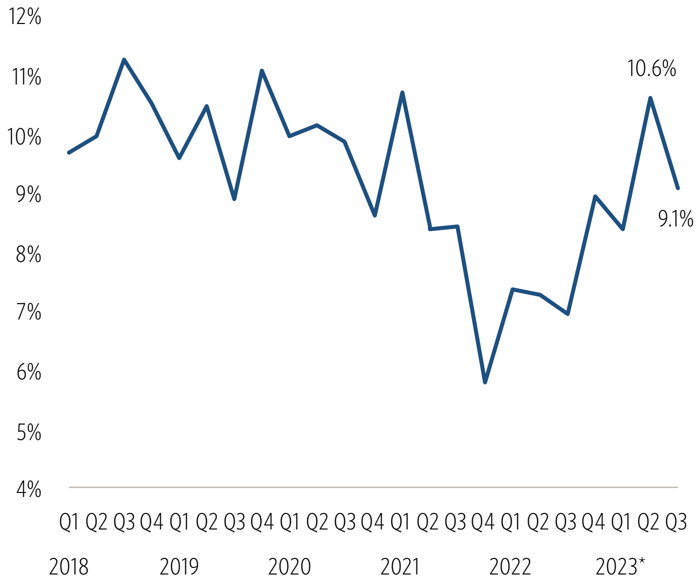
In Q3, nonbacked companies accounted for 52.2% of all middle-market buyouts in the US, a notable increase from 44.0% in Q1 2021. However, this is well off 2019 highs when nonbacked companies peaked at 59.4% of all PE middle-market buyouts, capping a nine-year uptrend. The COVID-19 pandemic caused PE interest in nonbacked companies to nosedive during that span as they were less equipped to absorb the financial shock. So, in many respects, the recent rise in nonbacked companies is about regaining lost ground, but it also reflects the inertia that has prevailed with other seller types. Those that can afford to wait out the current adverse interest-rate cycle are doing so, and that includes many financial sponsors and would-be PE sellers. Nonbacked companies, such as those that are founder owned, are motivated by other considerations, not the least of which are demographic, as key members of the management team reach the end of their working life.

Founder-owned businesses are often found in the lower end of the market, and can offer more appealing purchase price multiples. The majority of deals in this category fall within the range of $25 million to $100 million, as well as below $25 million. These transactions typically come with a significant discount compared with larger deals backed by sponsors, as businesses acquired for under $100 million tend to have lower EBITDA and revenue multiples. In the middle market, the median TTM EV/EBITDA multiple is 11.4x, which drops to 6.8x for deals under $100 million. Similarly, EV/revenue multiples decrease from 2.4x to 1.1x in the same size range.

Carveouts

Carveouts have seen a rise in their share of the overall deal mix. These transactions offer sellers an opportunity to generate cash and enable buyers to potentially reduce their check size, which is particularly pertinent in a high-interest-rate environment. As such, carveouts and divestitures have witnessed an increase in their proportion of all middle-market deals for the first time since 2015. During the first three quarters of 2023, carveouts accounted for 8.7% of all middle-market deals, up from 7.6% in 2022. On a quarterly basis, the percentage of carveouts in all middle-market deal activity has been on an upward trajectory since Q4 2021, starting at 5.8% and reaching 9.1% in Q3 of 2023. Although the Q3 percentage represents a decline from Q2, it remains higher than the 8.4% recorded in Q1 and demonstrates an upward trend.

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



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

In the short term, we expect carveouts to continue to push higher in the current environment. Carveouts typically involve the assets of a public company and serve as a cost-effective alternative to taking an entire public company private. These assets are often well-established and come with readily available historical financial data. This enables more effective due diligence for both acquirers and lenders, potentially attracting a larger pool of bidders and allowing the seller to make a more objective assessment of the fair market value of a business unit now deemed noncore to the future strategy of the business. In a time of wide bid-ask spreads, carveouts can foster better alignment between buyers and sellers.

Notable carveouts in the quarter include Duke Energy, which, in July, announced it would divest its commercial distributed generation business to ArcLight Capital Partners for $364.0 million. Duke Energy reached a sale agreement for its utility-scale renewable business platform in the month prior and will use the proceeds of the sale to strengthen the company's balance sheet and avoid additional holding company debt issuances associated with these assets. As for ArcLight, the acquisition will build on the firm's strategy of acquiring operating assets and establishing standalone renewable energy platforms.[1] Also in July, Fiserv announced it would sell its frontier reconciliation business to Trintech, a portfolio company of Summit Partners, for $230.0 million. With this acquisition, Trintech will further expand its portfolio of capabilities by incorporating two reconciliation solutions and broadening the range of services it offers to clients.[2]

Technology

Technology deal activity shifted downmarket in Q3 to smaller deals relative to the prior quarter and recent years. IT's Q3 deal count was a modest 1.1% lower than Q2, with 91 deals completed. On the basis of deal value, Q3 was down 13.1% sequentially with $11.6 billion of activity. This places the volume of deals in the first nine months of 2023 at a total of 292, down 20.9% YoY, and down 9.6% versus the 2017 to 2019 nine-month average. Deal value declined by a greater magnitude in the first nine months of 2023, down 30.1% YoY and down 20.8% versus the average from 2017 to 2019. All in all, technology deals with PE buyers are shifting downmarket to more digestible sizes. IT gained modestly in terms of mix versus other sectors, now reflecting 13.5% of all deals, and up from 13.2% in Q2, yet this reading is well below the five-year average of 15.9%.

At the outset of Q3, many market participants had expected an uptick in IT deal activity amid signs of moderating inflation. However, these hopes faded as the macroeconomic and geopolitical backdrop turned negative. In recent conversations with industry participants, we find the most significant issue hindering a resumption in deal activity is the wide gap in valuation expectations between buyers and sellers. While there are many transactions being shopped and evaluated, the deals getting done tend to be the cream-of-the-crop assets where buyers are willing to stretch to meet the higher valuation expectations of sellers. This is also contributing to the strange phenomenon where we see deal multiples actually increasing in our data despite the sharp rise in long-term interest rates. This is in part due to the shift to sellers parting with higher-quality assets only. Those that have the financial flexibility will attempt to wait out the current interest-rate cycle. But investors and asset owners can only wait so long. Eventually, things will unseize and transactions will flow, and we expect that technology will lead the way.

Notable transactions in the quarter included a majority growth investment in a software company and a take-private of an IT services firm. VBA Software, a Milwaukee-based, vertical SaaS company focused on healthcare, took a majority growth investment from Spectrum Equity and Arthur Ventures in August. The company received a sizable $156 million capital infusion to support its growth, valuing the company at $220 million.[3] VBA offers a cloud-based benefits administration software serving the entire healthcare payer ecosystem. The solution improves data management and interoperability to streamline administration of healthcare plans, an increasingly important value proposition as the healthcare industry's rapid evolution is straining outdated legacy systems.

Computer Task Group (CTG), an IT services provider helping its clients achieve IT and business outcomes by accelerating digital transformation, agreed to a take-private transaction on August 9, 2023. Based near Buffalo, New York, CTG will be acquired in an all-cash transaction led by Belgium-based PE firm Cegeka. The company is valued at approximately $170 million,[4] based on the offer of $10.50 per share of common stock in cash and representing a 44.8% premium to the trailing 90-day volume weighted average stock price prior to August 7, 2023. CTG had $306 million on TTM revenue, equating to an EV/revenue multiple of 0.55x. Cegeka views the transaction as complimentary to its existing portfolio, and expects it will enhance its capabilities and industry expertise.

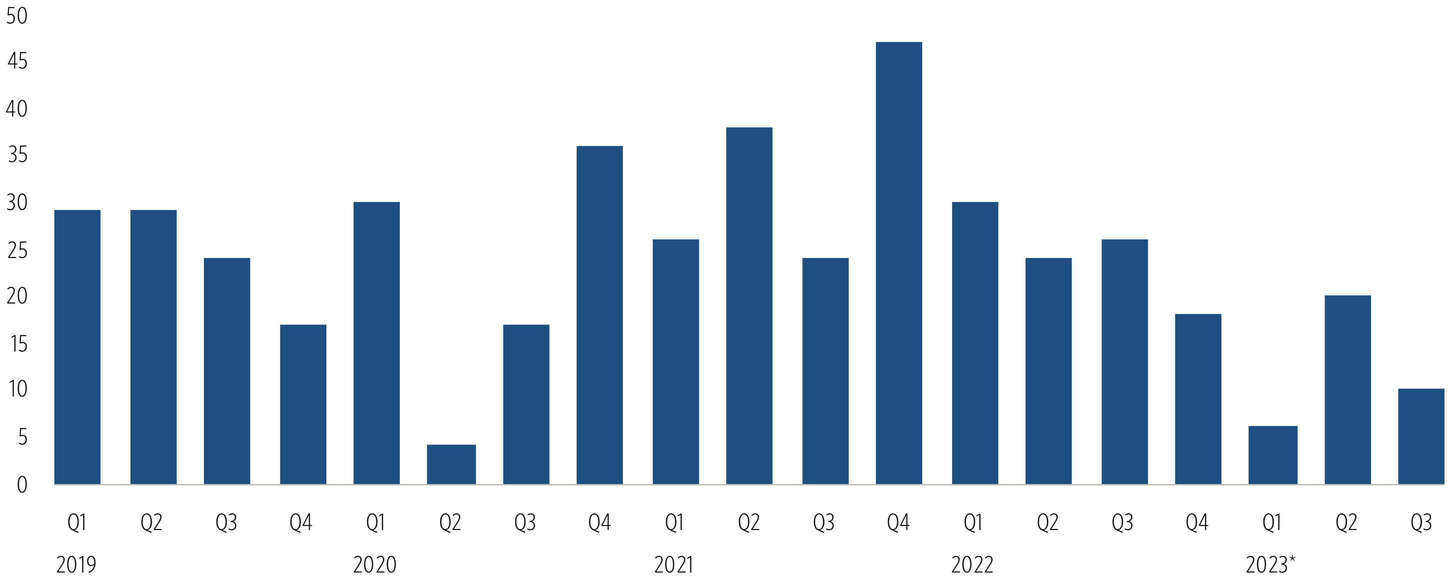
1: "Duke Energy to Sell Commercial Distributed Generation Business to ArcLight for $364 million," Duke Energy, July 5, 2023
2: "Trintech Acquires Financial Reconciliation Business From Fiserv," Fiserv, July 25, 2023.
3: "VBA Secures Growth Funding With $156 Million Led by Spectrum Equity," Spectrum Equity, August 2023.
4: "Cegeka to Acquire CTG for $10.50 Per Share, Enhancing Value to Customers Across North America and Europe," CTG, August 9, 2023.

Healthcare

Healthcare deal activity continued to experience a downturn in Q3. The quarter saw just 83 deals for $10.8 billion, marking the third consecutive quarter of decline in deal count and the fourth consecutive quarter for deal value. While quarterly share of middle-market activity has fluctuated, on average, healthcare's share of quarterly deal activity has been 200 to 350 basis points below levels seen before the COVID-19 pandemic (2017-2019). YTD, there has been 267 deals for an aggregate of $32.9 billion, which is more than 50% below last year's deal value and 44.4% lower in deal count. Although there is one quarter left of 2023, deal activity is not expected to rebound until after the new year, dissimilar to the usually observed trend of deal activity popping up in Q4 of each year. The sector is currently short of its five-year average share of middle-market activity by between 2 to 4 percentage points.

Persistent financing challenges and macroeconomic volatility continue to drive a risk-off environment among dealmakers. Some sponsors are moving downmarket to buy smaller companies due to limited financing and asset availability. For example, healthcare was no exception in the widespread trend of take-privates getting smaller and migrating to the middle market. In October, L Catterton closed its $680.0 million take-private of Thorne HealthTech. Some sponsors are turning toward add-on deals for their platform companies to optimize their existing footprint. In October, Laborie Medical Technologies acquired Urotronic, a medical device company for interventional urology treatments, for $600.0 million. Laborie Medical Technologies, which is backed by Patricia Industries, manufactures and supplies diagnostic and therapeutic equipment for urology, urogynecology, and gastroenterology. Laborie is also making a $5 million strategic equity investment in GIE Medical, which is a gastrointestinal medical technology company spinout from Urotronic, as it continues to strengthen its market position in the space.

Healthcare services PE platform buyouts by quarter



Source: PitchBook • **Geography:** US and Canada
*As of September 30, 2023

A WORD FROM ANTARES

The (Fed) pause that refreshes?

Moderating inflation amid resilient US economic growth and a Federal Reserve (Fed) pause in interest rate hikes has boosted optimism in the plausibility of a soft-landing scenario in 2024. On October 26, the Bureau of Economic Analysis reported robust real US GDP growth of 4.9% in Q2—the strongest pace since Q4 2021,[5] when the economy was still rebounding from COVID-19. Meanwhile, inflation has continued to ebb, with headline Consumer Price Index (CPI) falling to 3.2% in October and core CPI rising at a three-month annualized basis pace of just 3.4% in October—a level not too far above the Fed's 2.0% to 2.5% official target (a target some would argue should be lifted closer to 3%). Looking forward, most economists project real GDP growth to slow to a 0% to 2% range in the quarters ahead, but an outright recession is no longer the consensus forecast over the next 12 months.

Accompanying the improved outlook for growth has been a recognition that interest rates may stay high for longer. Although the Fed paused hiking the federal funds rate for a second month in a row in November, rates further out in time on the curve have risen over the course of 2023. As of this writing in mid-November, the Secured Overnight Financing Rate (SOFR) is expected to remain more elevated at closer to 4% through 2025 and beyond versus expectations from only a few months ago that SOFR would fall to closer to 3% in the out years.

On balance, higher growth and higher-for-longer interest rate expectations are favorable for private credit. Less risk of recession is positive for credit, and higher-for-longer base rates should help keep yields aloft. However, the outlook is not without its caveats. Private equity deal activity may continue to face headwinds in a world of slow growth and 4% base rates, and some borrowers may continue to struggle. Also, although recession risks have waned, they remain elevated with the lagged impact of the fastest pace of rate hikes in four decades still rolling through the economy. Meanwhile, wars and geopolitical risks, political dysfunction, deficits, and election-year uncertainties continue to loom large.

"The pause that refreshes" was a slogan launched by Coca-Cola in 1929, the year that kicked off the great depression.[6]

Timothy Lyne

Chief Executive Officer
Antares Capital

Timothy is a founding partner of Antares. He is a member of Antares' Investment Committee and Antares' Board of Directors. His previous roles include Chief Operating Officer and Head of Asset Management for Antares.

While the outlook appears decidedly sunnier these days, we continue to anticipate that credit discipline, selectivity, and strong workout capabilities will remain critical to credit success in the year ahead, with performance dispersion among lenders likely to widen.

Q&A with Timothy Lyne, Antares Capital CEO

Has there been any pickup in private equity deal activity? What are the implications of a higher-for-longer interest rate environment for private equity M&A looking forward?

US sponsored middle-market M&A-related loan volume picked up sequentially in Q3, particularly for add-on volume, which was up 33% versus only a 6% rise for leveraged buyouts. Still, M&A-related loan volume remained depressed compared with one year ago; it is down over 40% both in Q3 and Q3 YTD, according to Refinitiv LPC data.[7]

Pre-Labor Day expectations for a surge in M&A activity in the normally seasonally strong Q4 have waned lately, but we still expect some improvement in Q4 versus Q3. For 2024, interest rate stability, waning recession worries, and the turn of the calendar should all help stimulate deal activity, especially given a backdrop of a strong pipeline of deals waiting to get done, high private equity dry powder, and growing LP demands for a return of capital. However, the higher cost of capital, election-year uncertainties, and other risks will remain headwinds. On balance, there will likely be at least a modest pickup in M&A activity in 2024.

5: "Gross Domestic Product, Third Quarter 2023 (Advanced Estimate)," Bureau of Economic Analysis, October 26, 2023.
6: "History of Coca-Cola Advertising Slogans," The Coca-Cola Company, n.d., accessed November 15, 2023.
7: " 3Q23 US Sponsored Middle Market Private Deal Analysis," Refinitiv LPC, n.d., accessed November 18, 2023.

What about the implications of higher-for-longer interest rates for private credit default rates and returns?

Higher-for-longer interest rates imply higher-for-longer private credit floating-rate yield, which is a plus for investment returns. On the other hand, higher-for-longer rates in and of themselves could imply higher loan loss rates insofar as they represent an incremental drain on borrowers' cash flows. However, higher-for-longer rates presumably suggest an incrementally stronger economy and more favorable earnings prospects. Also, while rates in the out years on the SOFR curve have risen, they remain down from current levels, suggesting some interest rate relief is still on the way for borrowers.

On balance, the picture continues to look favorable for private credit:

On the yield side—which some consider the "beta" component of returns—if you take the current long-term SOFR rate of near 4% in the forward curve and tack on some reasonable spread and original issue discount assumption for private credit loans, you get a working assumption on what your longer-term yield might be. In Q3, spreads on sponsored middle-market first-lien term loans dipped to 655 basis points from 669 in Q2, but they remained elevated versus an average of near 550 basis points over the last decade, according to Refinitiv LPC data.[8]

On the loss side, 2024 default rate forecasts by credit rating agencies have generally held steady in recent months at levels that are up from 2023 but still quite manageable. Fitch Ratings recently lowered its institutional leverage loan default expectations to 3.0% to 3.5% for 2023 while maintaining its 3.5% to 4.5% forecast for 2024.[9] This compares to a recent peak of 4.5% in 2020 during COVID-19—a "stress test" period through which private credit ended up performing well.

Of course, private credit default and loan loss rates—which many consider to be the "alpha" component of returns—will differ among lenders. Indeed, while two first-lien term loans might offer the same yield at underwriting, one may end up defaulting and the other, not. Furthermore, recovery rates on loans that default will also vary among lenders. This is why selectivity, diversification, credit discipline, and dedicated and experienced workout capabilities are so critical to lender performance.

How is private equity coping with liquidity stress?

Lincoln International's proprietary Q3 2023 US private company data shows 30% of private company borrowers with an average interest coverage ratio of less than 1.0x pro forma a 5.5% base rate,[10] so clearly some borrowers are facing stress. However, sponsors have a lot of skin in the game and have been managing well, with Q3 YoY last 12 months (LTM) EBITDA growth across Lincoln's private companies database stable at 4.2% QoQ.[11] Amendment activity aimed at giving borrowers more breathing room and extending PE's investment lifecycle is up, but it's important to note that such amendments typically come with fees, upward repricing, and/or sponsor equity infusions, which can help lift private credit returns on older vintages.

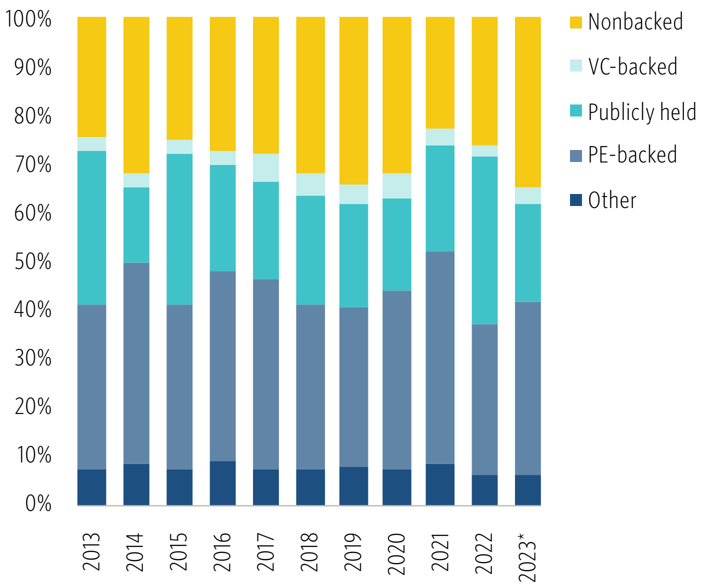
Some have been suggesting that as private credit has grown, it has become a source of systemic risk. Do you agree?

We do not believe private credit poses systemic risk. If anything, private credit plays more of a role as a shock absorber than shock creator as we saw most recently following regional bank failures. Of course, that is not to say there won't be credit default cycles—there always have been and always will be. We have had a lot of experience navigating them over our 25+ years in business. However, we believe private credit risks are well understood, diversified, and well distributed among sophisticated investors with no daily redemptions for private closed-end funds that could lead to "runs" like we saw on regional bank deposits. In fact, during the pandemic stress period, the US Government Accountability Office studied the issue and confirmed that US financial regulatory agencies had not found leveraged lending to significantly threaten financial stability.[12]

8: " 3Q23 US Sponsored Middle Market Private Deal Analysis," Refinitiv LPC, n.d., accessed November 18, 2023.
9: "Lowering 2023 U.S. LF Default Forecasts on Better Macro; 2024 Unchanged," Fitch Ratings, October 5, 2023.
10: "Supplemental Deck Valuation Assumptions," Lincoln International, Q3 2023.
11: "Lincoln Private Market Index Increases Marginally on Higher Fundamental Performance Despite Multiple Pressure," Lincoln International, November 2023.
12: "The Role of Private Credit in U.S. Capital Markets," Proskauer, March 31, 2022.

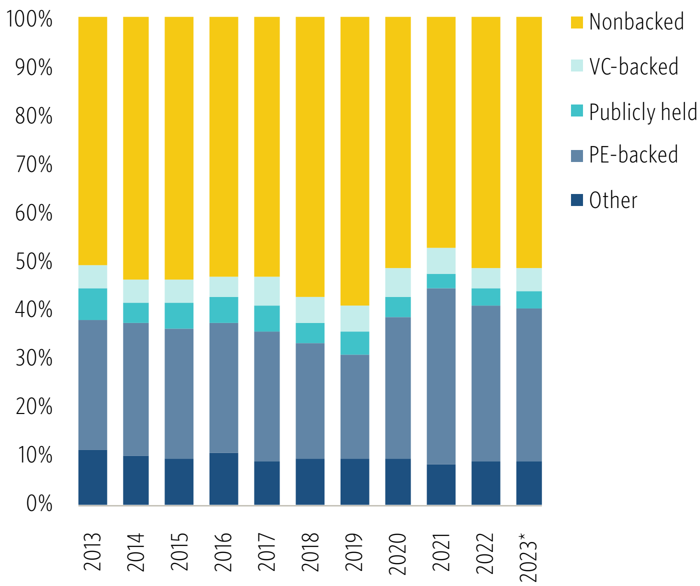
Deals by size and sector

Share of PE middle-market deal value by backing type



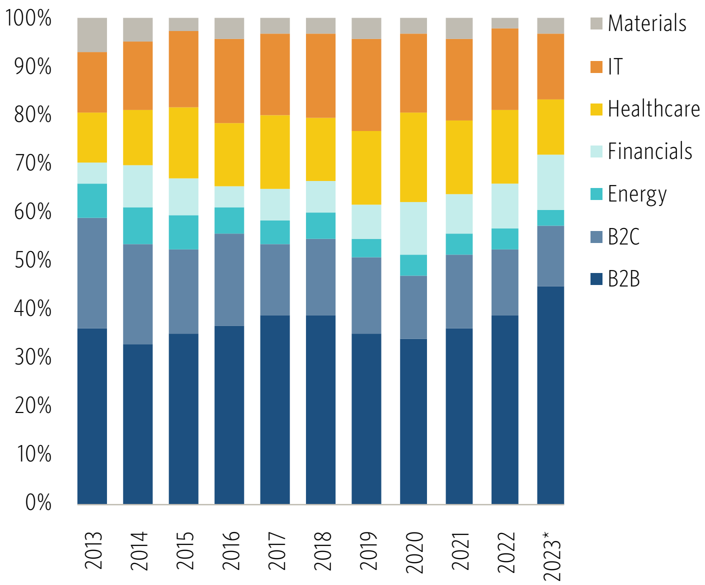
Source: PitchBook • **Geography:** US
*As of September 30, 2023

Share of PE middle-market deal count by backing type



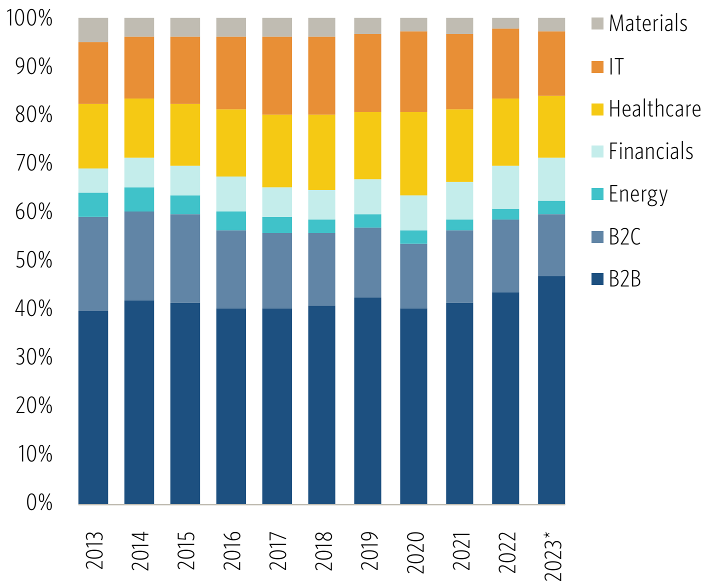
Source: PitchBook • **Geography:** US
*As of September 30, 2023

Share of PE middle-market deal value by sector



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

Share of PE middle-market deal count by sector



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

SPOTLIGHT

Private credit lenders offer flexibility, win deals via PIK interest payments

Note: This spotlight is abridged from our LCD news report, Private credit lenders offer flexibility, win deals via PIK interest payments*. Please see the full article for additional analysis on PIK interest and its impact on the private credit space.*

In the wake of rate hikes that sent borrowing costs soaring, leveraged companies are eager to find ways to conserve cash. Private credit lenders, which have been willing to provide structures and features unavailable in other parts of credit, are allowing companies to pay interest with more debt, known as payment in-kind (PIK) interest.

By now, it is clear that borrower companies have been able to structure some private credit loans with an option to switch to PIK interest, even pay PIK interest from the start, especially when credit market conditions are strong. Just this month, LCD reported that debtholders of Khoros, United Group, and Bowery Farming would receive PIK interest. Edgio said last week it placed a $79 million term loan due 2027, priced at 3.5% cash-pay interest plus 16% PIK, alongside a convertible note exchange.

To win deals in a competitive market, private credit providers have used the feature, which is less attractive to lenders than cash-pay interest would be.

It could make sense for an early-stage company in growth mode. The feature is not available in the broadly syndicated loan market due to structural requirements of collateralized loan obligations (CLOs), the largest source of demand for loans. Generally, CLOs can buy 5% or less of assets that can pay-in-kind, but they cannot buy assets that are currently paying PIK interest. Once a borrower has opted to PIK interest for some time, a CLO will treat the loan as a default.

PIK interest is not a new trend, with borrowers turning to PIK debt for most of 2023. It appeared in the early 2000s, generally as part of mezzanine loans, with debt typically structured as 10% cash-pay and 2% PIK interest. High-yield bond issuers have allowed PIK historically during accommodating market conditions, last observed two years ago. The PIK trend is also taking hold in Europe.

Troubles? Switch to PIK

PIK interest is commonly used in the current market to help manage stressed situations, such as via an amendment due to a borrower's inability to pay cash interest. A private credit lender may be willing to switch to PIK interest proactively when a borrower faces challenges, thus allowing the lender to avoid a default or nonaccrual status of a loan in an investment portfolio, which is a less-than-ideal scenario for a lender.

Private credit providers have also been known to issue PIK-from-the-start loans to finance a borrower's interest payment, and even to pay fees owed to lenders. Some borrowers have managed to renegotiate their loans to a far lower spread, but with a larger share of PIK interest, resulting in an overall higher yield for a lender.

Whatever the reason, companies are taking full advantage of the feature in the current market.

BDC holdings that converted at least 50% of their first-lien term loan interest to PIK*

Borrower	Maturity date (2023)	Sector	Spread (basis points)	PIK (basis points)	Spread (basis points)**
Alert Media, Inc.	April 27	IT	775	675	500
Bluestem Brands, Inc.	August 25	B2C	750	650	750
Captive Resources Midco, LLC	July 29	Financial services	575	288	263
Confine Visual Bidco	February 29	IT	575	300	575
Engage Debtco Limited	July 29	Healthcare	590	590	590
HM Dunn Co Inc	June 26	B2B	600	600	600
Impel Pharmaceuticals Inc.	March 27	Healthcare	1075	1075	875
Long Term Care Group, Inc.	September	B2B	700	600	600
OTG Management, LLC	September 25	B2C	1000	1000	1000
PCP CW Aggregator Holdings II (CardWorks)	February 27	Financial services	925	925	725
Petvisor Holdings, LLC (PetDesk)	June 28	IT	650	650	550
Project Essential Bidco, Inc. (ARCOS)	April 28	IT	625	325	625
Thrasio, LLC	December 26	Financial services	700	700	700
Vobev, LLC and Vobev Holdings, LLC	April 28	B2B	775	400	700

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

To check just how much, LCD combed through 15 BDC filings for a dozen of the largest BDC managers that filed Q3 2023 results. We found 30 borrowers that added a PIK component to interest on their first-lien term loans during the third quarter. This analysis focuses on first-lien term loans that added a PIK component as of September 30 while keeping the same maturity date, and excluded any loan marked as a nonaccrual. In total, 32 loan investments showed a PIK component that was not recorded on the same loan in Q2 filings.

The 32 loans that added PIK interest last quarter had an average total spread of 712 basis points at the end of the Q2, including 378 basis points of PIK. In other words, noncash interest accounted for 53% of their interest, on average.

In all, 14 out of 32 term loans in LCD's analysis converted more than half of their interest to PIK. On the other end of the spectrum, nine borrowers paid at least 70% of their interest in cash.

In terms of maturities, 21 out of 32 term loans mature in 2027 or later, and only three fall due in 2025.

BDC holdings that converted at less than 50% of their first-lien term loan interest to PIK*

Borrower	Maturity date (2023)	Sector	Spread (basis points)	PIK (basis points)	Spread (basis points)**
Captive Resources Midco, LLC	July 29	Financial services	575	288	263
Innocoll Pharmaceuticals Limited	January 27	Healthcare	575	275	575
Turing Holdco, Inc.	September 28	IT	600	250	600
Cyara AcquisitionCo, LLC	June 29	IT	675	275	675
Laboratories Bidco LLC	July 27	B2B	675	275	575
Comprehensive EyeCare Partners, LLC	February 25	Healthcare	650	250	650
Tennessee Bidco Limited (Davies Group)	July 28	Financial services	700	250	700
Tennessee Bidco Limited (Davies Group)	August 28	Financial services	700	250	700
Lightspeed Solution, LLC	March 28	IT	650	217	650
Accuride Corp	May 26	B2B	525	160	525
Sensor Technology Topco, Inc. (Humanetics)	May 26	B2B	700	200	650
L&S Mechanical Acquisition, LLC	September 27	B2B	775	200	775
Gotham Greens Holdings, PBC	December 26	Materials & resources	888	150	738
Adams Publishing Group, LLC	March 27	B2C	700	100	700
NWN Corporation	May 26	IT	900	100	800
RumbleOn, Inc.	August 26	B2C	825	50	825
Pacific BidCo Inc. (Rodman Media)	August 29	B2B	600	25	575
US Infra Svcs Buyer, LLC	April 26	B2B	650	25	675

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

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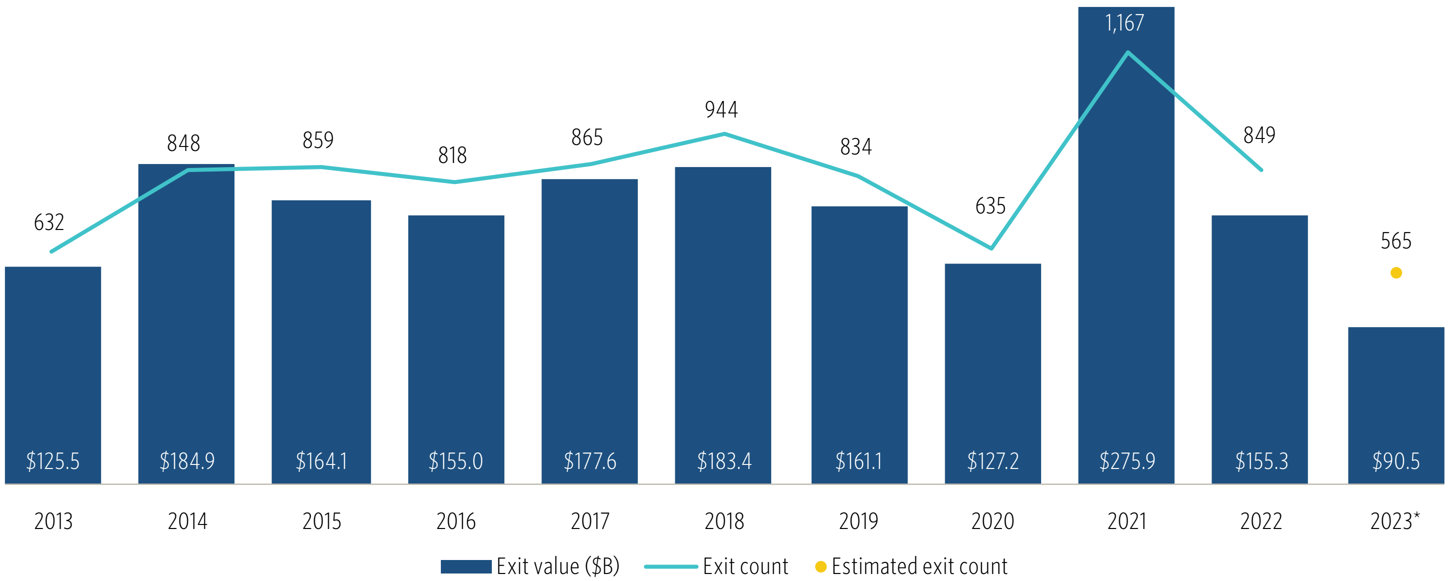
Exits

PE middle-market exit activity

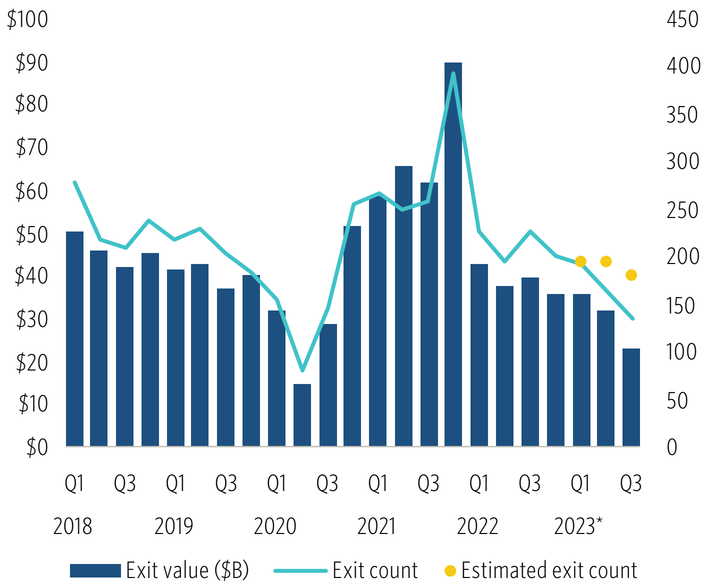


Source: PitchBook • **Geography:** US
*As of September 30, 2023

Overview

Exit activity in the US PE middle market deteriorated further in Q3 2023, marking a new low since the global financial crisis, excluding just one quarter during the COVID-19 pandemic. An estimated 179 PE-backed middle-market companies were exited or announced to be exited during the quarter for an aggregate exit value of a mere $23.2 billion. Both exit value and count decreased QoQ, declining by 26.6% and 7.1%, respectively. Exit flow continued to slump throughout the year as the depressed exit environment refused to abate. Exit value was down 41.5% and exit count dropped by 20.8% YoY, while compared with the peak in Q4 2021, activity was down a solemn 74.1% and 54.5%, respectively. Exits fell below half of the average activity seen in the pre-COVID-19 years between 2017 and 2019, which saw an average of 220 exits for $43.5 billion every quarter. 2023 is likely to end short of last year's exit levels given the lackluster activity YTD and the likelihood that a recovery in exit markets will not materialize until well into next year.

PE middle-market exit activity by quarter



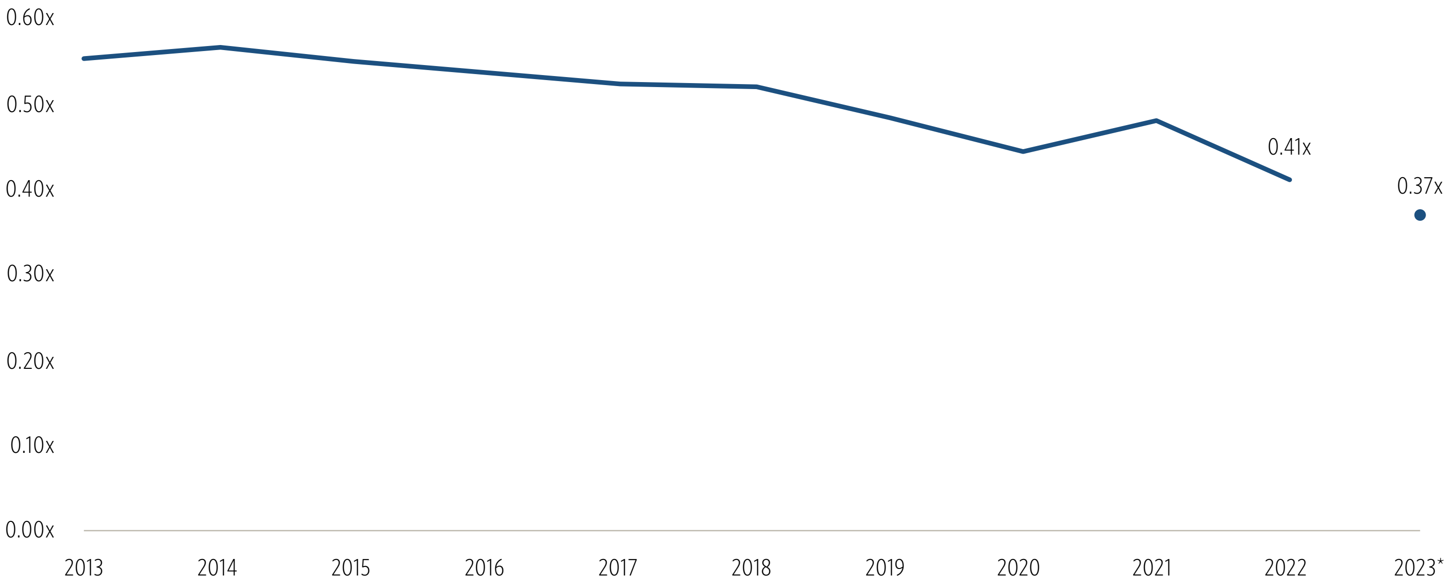
Source: PitchBook • **Geography:** US
*As of September 30, 2023

PE firms typically avoid being forced sellers, leading to the current landscape of sponsors holding onto promising assets for longer until exit conditions improve. For the broader US PE market, the exit-to-investment ratio hit a historically low mark in Q3, sliding down to 0.37x from 0.48x in 2021 and 0.41x in 2022. Slower exits are already showing up in longer holding periods for PE-backed companies. The median holding period for PE exited companies ticked up to 6.3 years by the end of Q3 2023, crossing the six-year mark for the first time since 2014. Comparatively, the median holding period was 5.0 years in 2021 and 5.7 years in 2022.

There could be some good news on the horizon for the exit landscape. While Q3 showed sustained weakness in exit activity, investors are optimistic that underlying demand for deals will lead to exit opportunities as interest rates settle and that ample dry powder will pave the way for improved sponsor-to-sponsor activity. The Golub Capital Altman Index, which serves as a good proxy of operating trends in the US middle-market space, reported that revenue and earnings growth was the strongest it has been in two years,[13] suggesting that there is a sufficient pipeline of quality companies ready to be picked up once deal activity bounces back.

For the middle market, there are some advantages when it comes to exit opportunities. Although the smaller size of a typical middle-market portfolio company limits public listings from being a meaningful exit option, it opens multiple other paths to exit. For example, middle-market companies can grow to be platform acquisitions for larger PE firms or stay small enough to roll into other platform companies as add-on deals. Lower-middle-market companies also tend to be less leveraged, and no or lower amounts of debt allow for easier exits in the current macroeconomic backdrop.

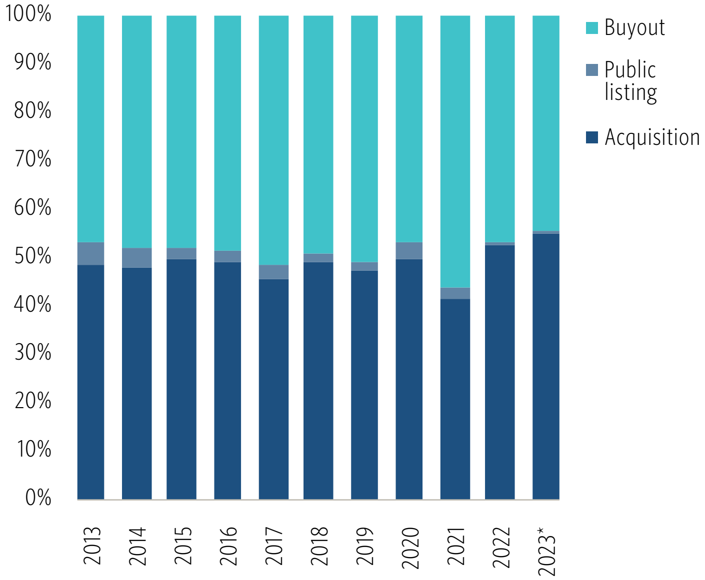
PE exit/investment ratio



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

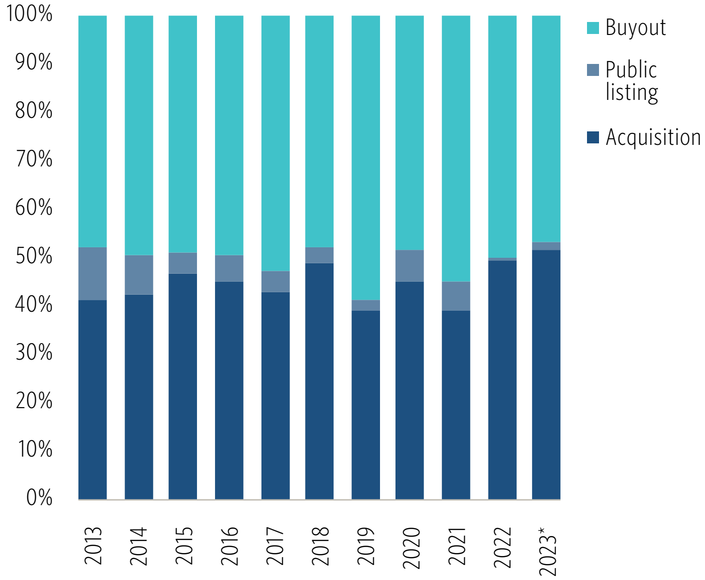
13: "U.S. Middle Market Shows Strongest Earnings Growth in Two Years," Golub Capital, October 10, 2023.

Share of PE middle-market exit count by type



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

Share of PE middle-market exit value by type



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

Exits to sponsors

Middle-market exits to sponsors and exits to corporations were more balanced in Q3, accounting for 52.5% and 47.5% of exit value, respectively, compared with 53.3% and 43.4% in Q2. With public listings nearly out of the picture, middle-market exits have often been evenly split between PE and corporate strategic buyers since the beginning of 2022. From Q1 2022 to Q2 2023, exit to sponsors accounted for an average of 48.2% of exit value while exits to corporates accounted for an average of 50.7%. For the past two consecutive quarters, the split between the two types of exits flipped as sponsor-to-sponsor exit value was lifted by a few transactions in the upper middle market. For example, Littlejohn & Co. announced its sale of The Cook & Boardman Group to Platinum Equity for $863.0 million in November, marking the largest middle-market exit so far in 2023. Cook & Boardman is a specialty distributor of commercial door and security integration solutions and is expected to grow both organically and through additional M&A in a fragmented industry.[14] Also in Q3, Madison Dearborn Partners and The Tornante Company exited Bazooka Candy Brands to Apax Partners for $700.0 million. Apax Partners will leverage its expertise in the consumer goods space to support the company's next stage of growth.[15]

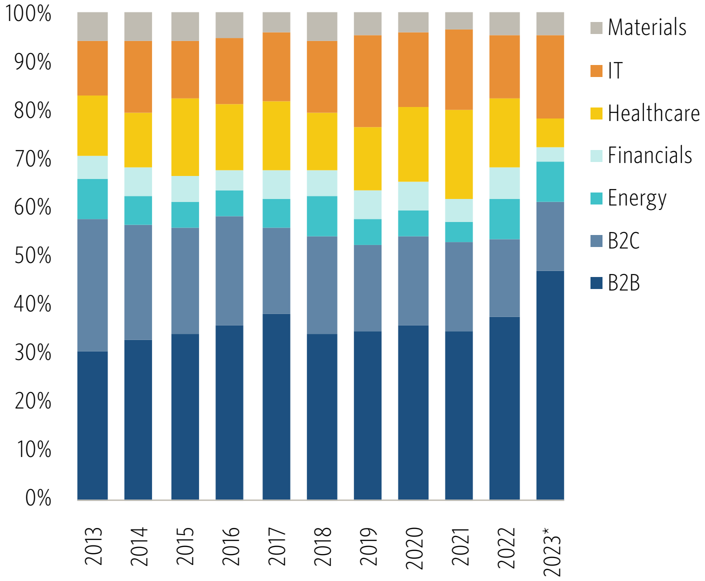
On an absolute basis, both sponsor-to-sponsor exit count and value fell QoQ to just 68 exits for a total of $12.2 billion. We do anticipate activity to bounce back, with the overall rebound in M&A activity and deal underwriting, as sponsor-to-sponsor exits currently sit below their historic averages along with the broader market. The industry remains hopeful that the large amount of dry powder that PE firms raised over the last two years will be put to work soon while those still bogged down by higher borrowing costs will increasingly turn to smaller transactions in the middle market.

Exit to corporates

Exits to corporates took up a greater share of middle-market exit value, accounting for 47.5% of middle-market exit value when excluding public listings, compared with 44.9% in Q2. On an absolute basis, both exit count and value dropped from 77 exits for an aggregate of $13.7 billion in Q2 to 67 exits for $11.0 billion in Q3. The third quarter marked the worst ever for both quarterly exit count and value since the height of the pandemic in Q2 2020. With exit activity expected to stay depressed for the rest of the year, annual value of exits to corporations is likely to hover near levels seen in 2020. YTD exit value is tracking 18.4% below that of 2020 and 39.0% short of exit value in 2022.

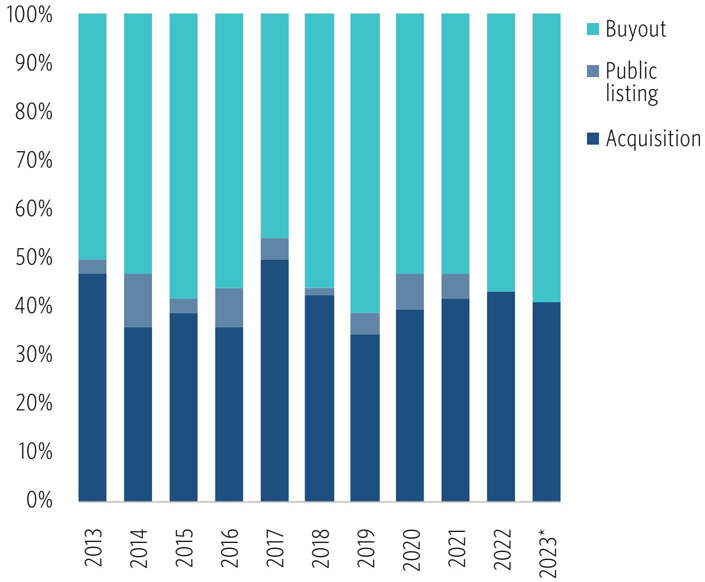
14: "Platinum Equity to Acquire Majority Interest in the Cook & Boardman Group From Littlejohn," Platinum Equity, September 29, 2023.
15: "Apax Partners Acquires Bazooka Candy Brands for $700m," Private Equity Insights, October 11, 2023.

Share of PE middle-market exit value by sector



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

Share of technology PE middle-market exit value by type



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

Despite the abysmal state of exits, exits to corporations have been buoyed by strategic buyers pursuing larger transactions when able. The median size of exits to corporations is $340.0 million YTD, which is a current record since our data starting in 2007. Although the median is calculated from a smaller number of exits closed this year compared with those in previous years, the median size of exits to sponsors sits at $287.3 million and below its five-year average, illustrating corporate appetite for large PE-backed deals. For example, Incline Equity Partners' announced exit of Specialty Products and Insulation to TopBuild for $960.0 million is the largest exit in the middle market so far this year. The acquisition is expected to expand TopBuild's position in specialty distribution of insulation and building material and reduce the company's cyclicality by significantly increasing its revenue stream.[16] Energy companies continued to account for some of the largest exits to corporates this quarter. In September, KKR-backed Energy Transfer Canada closed its $885.0 million divestiture of Meritage Midstream to Western Midstream. The deal allows Western Midstream to expand its existing footprint in the Powder River Basin and diversify its customer base.[17]

Technology

IT continues to be a relatively strong sector for exit activity. With 73 exits for an aggregate of $15.6 billion, IT accounts for 14.8% of middle-market exit count and 17.2% of exit value YTD, which is an increase of 80 basis points and 420 basis points, respectively, since Q4 2022. This suggests, on the exit side, that PE firms selling IT companies are shifting upmarket and selling higher value companies. Still, the technology sector is not immune to the overall weak level of transaction activity. In 2023 YTD, middle-market IT exit activity, totaling 73 deals, is tracking for a decline in volume of 31.8% YoY. This is the same magnitude, a drop of 31.8%, when compared with the 2017 to 2019 average (both comparisons equate to 107 deals). Aggregate deal value is up 1.5% YoY and down 23.4% relative to the 2017 to 2019 average. This further supports our view that disciplined PE asset owners with financial flexibility are selling the higher-priced, better-quality assets and holding back on selling if they can wait out the present volatility.

16: "TopBuild to Acquire Specialty Products & Insulation in All-Cash Transaction Valued at $960 Million," TopBuild, July 27, 2023.
17: "Western Midstream Announces Closing of Meritage Midstream Acquisition," Western Midstream, October 13, 2023.

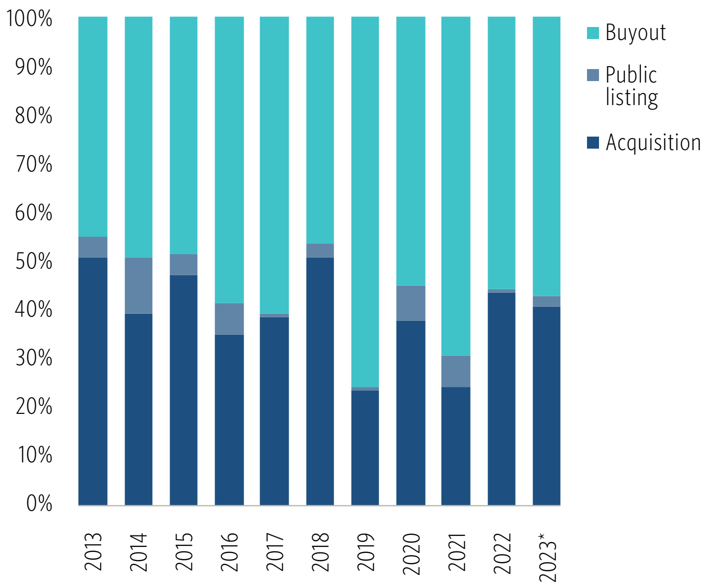
Notable exits in the quarter included two sponsor-to-sponsor sales of industrial technology companies. DMC Power, a provider of proprietary connector systems for high-voltage power infrastructure, was acquired by Golden Gate Capital through a $350 million LBO on July 13, 2023.[18] The deal was supported by $140 million of debt financing in the form of a secured-term loan and revolving credit from Antares Capital and Churchill Asset Management. DMC operates manufacturing facilities in Carson, California and Olive Branch, Mississippi, along with multiple distribution facilities across North America, with a team of over 200 employees. Bridgepoint, a global PE firm, was the seller.[19] Additionally, Industrial Physics, a provider of test and measurement instrumentation, was acquired by KKR on July 28, 2023 from Union Park Capital.[20] PitchBook estimates the deal value at $102.5 million, and notes support from $70.8 million of mezzanine financing. KKR will support the company pursuing a strategy of organic growth, supplemented by add-on acquisitions.

Healthcare

Healthcare exit activity remained lackluster, with just 42 exits for an aggregate value of $5.3 billion YTD. Although there is one quarter left in 2023, exit value is 76.1% below that of last year's while exit count is 59.6% lower. The sector accounted for 8.5% of middle-market exit count and 5.8% of exit value YTD, falling steeply from the mid-to-high teens share it held just a couple years ago. As with the broader PE market, sponsors are continuing to hold on to their portfolio companies in a less favorable pricing environment, slowing down exit flow. At the same time, buyers are more cautious and targeting smaller deals at slower paces or turning toward minority deals, which are not captured in our middle-market data. We anticipate that exits will pick back up in the second half of 2024 thanks to robust fundraising by healthcare-focused PE firms and a more stable macroeconomic outlook. More sponsors should feel pushed to exit substantial portions of their portfolios to return capital to LPs as they focus on raising subsequent funds in a favorable fundraising environment. And as inflation, interest rates, and the debt market continue to stabilize, more sponsors are likely to bring their assets to market to the interest of freshly capitalized healthcare PE firms.

There were still various exit plays in the healthcare sector in Q3. In August, PE-backed Keystone Dental agreed to acquire Check-Cap through a reverse merger that would create a combined public company focused on advancing Keystone Dental's portfolio of tooth-replacement solutions. The $225.0 million exit is expected to close in Q4. Also in August, Hadley Capital and Medallion Capital closed their sale of QDx Pathology Services to LabGenomics for $60.0 million. The acquisition of the diagnostic service company is expected to expand LabGenomics' market reach to North America and provide a broader range of diagnostic tests and services to customers.[21]

Share of healthcare PE middle-market exit value by type



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

18: "Golden Gate Capital to Acquire DMC Power from Bridgepoint," Business Wire, June 30, 2023.
19: "Bridgepoint Sells DMC Power to Golden Gate Capital," Bridgepoint, July 1, 2023.
20: "KKR Completes Acquisition of Industrial Physics, Welcomes Barry Lyon as Chief Executive Officer and Lance Reisman as Chairman," Industrial Physics, July 28, 2023.
21: "LabGenomics USA LLC acquires QDx Pathology in a Strategic Move to Expand Its Diagnostic Lab Services and IVD Diagnostic Products Business Into The US Market," Business Wire, September 5, 2023.

A WORD FROM LBMC

Navigating pressures in the middle market

Jim Meade

Shareholder, CEO-elect
LBMC

Jim Meade takes on the CEO role beginning January 1, 2024. Jim has more than 25 years of experience in accounting and auditing serving clients in a variety of industries. He focuses on VC and PE firms and their portfolio companies, technology startups, growth-stage companies, and acquisition-oriented businesses.

Lisa Nix

Shareholder, Practice Leader, Transaction Advisory Services
LBMC

Lisa Nix has more than 25 years of experience in public accounting and healthcare, including leading M&A transaction services teams for both strategic and financial buyers. Her teams have served on transactions ranging from several million dollars to over $7 billion. Lisa has managed assurance and advisory services for not-for-profit entities as well as for-profit private and public entities.

Jon Hilton

Shareholder, Practice Leader, Consulting and Business Intelligence
LBMC

As a senior data leader, data strategist, and data scientist, Jon Hilton helps organizations leverage data to achieve their business goals and objectives. He is a client-facing business leader and engagement manager who leads teams of data professionals to successfully execute data projects. His leadership style pushes for action, guiding organizations from digital strategy to roadmap execution.

Among the chief pressures that middle-market businesses have faced in the past year, which do you see carrying over to next year or growing even more intense? What about for PE fund managers?

Jim Meade: We anticipate the impact of rising interest rates on variable-rate debt will become more significant in the coming year. When speaking with clients in the past several months, we've learned that increased personnel costs and costs of goods and services continue to be the norm, and certain industries are still affected by staff shortages and supply chain constraints. Clients are strategizing to reduce expenditures through outsourcing noncore functions, reducing variable-rate debt, offshoring for cost-effective labor, and utilizing technology in new processes.

While supply chain issues have improved in the past year, there is still disruption, and the continued rising cost of goods and services has placed significant pressure on gross margins. In 2024, we expect to see increased pressure on EBITDA, cash management, and debt covenant compliance.

On the PE/VC side, the rising cost of capital and market uncertainty are major concerns. As interest rates increased, it became more expensive to leverage acquisitions and investments, which could have led to lower returns on investments. Market volatility and uncertainty also makes it harder to accurately assess the value of target companies, which has resulted in delaying both acquisitions and portfolio exit plans.

There are plenty of funds available to deploy, and at some point, these funds' managers will begin to deploy them in the form of acquisitions. However, deal multiples have decreased and will continue to be down from the highs we saw in recent years. This is particularly true in later-stage capital raises.

Which are the most intriguing and/or challenging concerns that your clients are bringing to you, and why?

Jim Meade: Clients are concerned with the pause in M&A activity due to the downward pressure on deal values and cost of credit/capital. Except for the manufacturing and distribution sector, where supply chain issues still exist, growth remains strong; however, margins and bottom lines are contracting.

Technology clients (such as software-as-a-service providers) have significant cash needs to support sales growth and the continuous development of software/products. The cost of capital/debt has become, or is becoming, a significant challenge for earlier-stage technology entities.

Also, we have observed that the scarcity of quality in-house accounting staff often resulted in transaction delays or errors or changes in revenue/income which were discovered in pre-transaction diligence or audits. Making the investment in the right financial partner well before a transaction is anticipated will help ensure there are few surprises and delays when that time comes.

Which regulatory and/or tax issues are you watching most closely, and why?

Lisa Nix: The applicability of sales taxes has been recently underestimated by many buyers and sellers, particularly within the healthcare industry. There is a common misconception that healthcare is immune to the complexities of sales tax, but this assumption is far from reality. Durable medical equipment, prescription drugs, medical appliances, and healthcare diagnostic equipment often catch healthcare providers and suppliers off guard, as qualifications for sales tax exemptions in these areas are based on specific criteria that varies by state. Another common misconception in the healthcare industry is that if a product or service is reimbursed by Medicare or Medicaid, then it automatically qualifies for a sales tax exemption. However, this is not always the case. It's essential for businesses in the healthcare industry to research and understand the specific tax treatment of their offerings in each state where they operate. For healthcare industry players as well as others, addressing sales tax issues is not just about compliance; it's also about protecting your financial health. Multiple years of incorrect compliance or inattention can generate significant and unforeseen sales tax liabilities. These liabilities can directly impact EBITDA, which is a critical metric in assessing a company's financial performance.

Which risks in the current market do you think are still underrated and should prompt more heed?

Lisa Nix: As noted, the scarcity of quality accounting resources, lack of appropriate financial expertise employed during a deal process, and/or the lack of a timely investment in financial systems and processes persist as common "pain points" for many buy-side due diligence processes in the middle market. Given the current economic environment, buyers are even more cautious and disciplined during the deal process than in previous periods, when the cost of capital was much lower. Sellers that are looking to achieve a maximum valuation should not overlook the importance of being prepared for a deal process and sell-side due diligence. If buyers have tremendous difficulty in determining the quality and realizability of pro forma earnings due to lack of relevant and reliable financial data, values and deal structures become less favorable to sellers.

The availability of quality financial data that supports real-time financial and operational decision-making is a business imperative. If sellers have gaps in their data, buyers will immediately begin to question the additional cash investment needed to address these risks and exposures. Achieving data quality and data security is essential before any AI strategy can be adopted and successfully executed, which is top of mind for many buyers today.

How are you advising clients as it relates to leveraging the adoption of AI efficiently?

Jon Hilton: Between inflation, recession, workforce struggles, and hindered access to capital, businesses will sink or adapt so they can swim. A big part of adaptation will occur in the AI space. This has already affected all aspects of the PE landscape.

AI adoption is much like the adoption of any new technology or process in a company. Following a deliberate plan and taking measured steps in innovation are the key to unlocking AI's potential. A good way to think of AI adoption is to apply a three-step approach:

- Strategize: Find the area or business process that is the best place to start with AI adoption. This would likely be a highly manual process or one that involves reviewing a lot of data or forecasting the future based on historical data.

- Organize: After finding that first business process, get your data "AI ready." This means understanding how data flows through that process, who handles that data, and where it is stored. Next, the data needs to be organized and structured in the cloud to be available and accessible by AI models. As long as data remains scattered, unorganized, and stored in various systems, it will remain inaccessible to AI models. Think of data as the fuel for an AI engine.

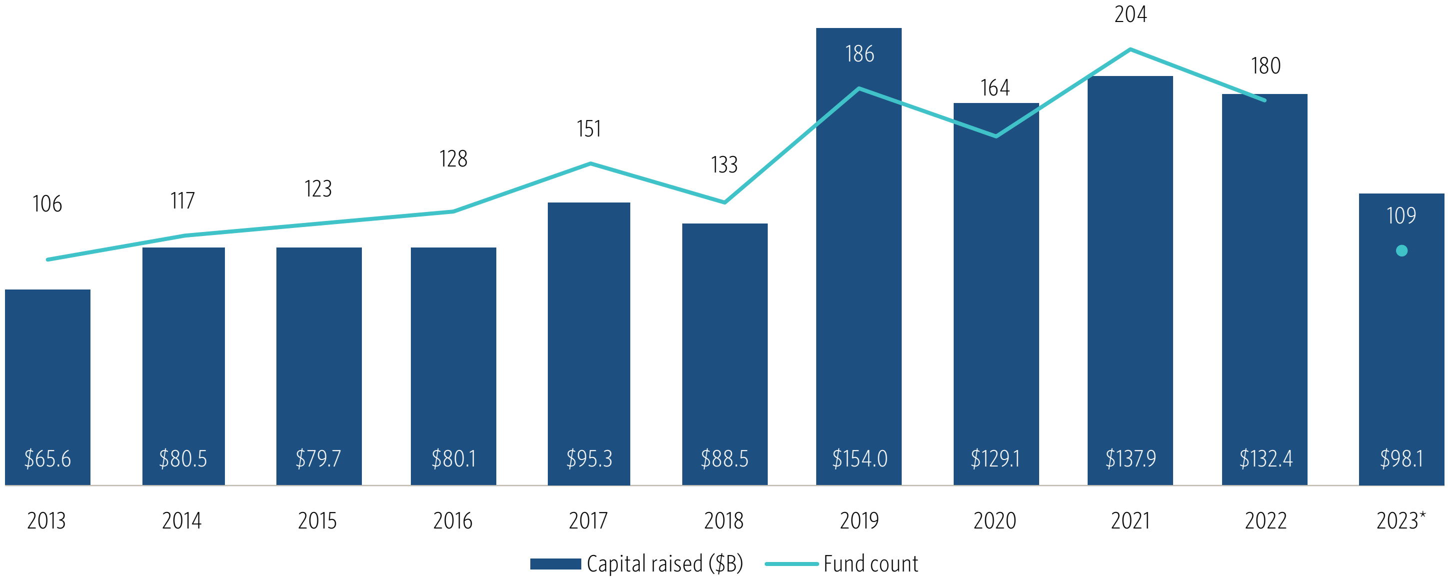
- Apply: Start experimenting with AI, even with small subsets of data. This is about learning and innovating on a small scale to move into larger-scale applications.

You can follow this framework to scale AI across your organization. An additional strategy will need to be developed to create a roadmap of which business processes and areas you will address based on business prioritizations.

Contact our experts: jim.meade@lbmc.com, lisa.nix@lbmc.com, jon.hilton@lbmc.com or learn more at https://www.lbmc.com/industries/private-equity/

Fundraising and performance

PE middle-market fundraising activity



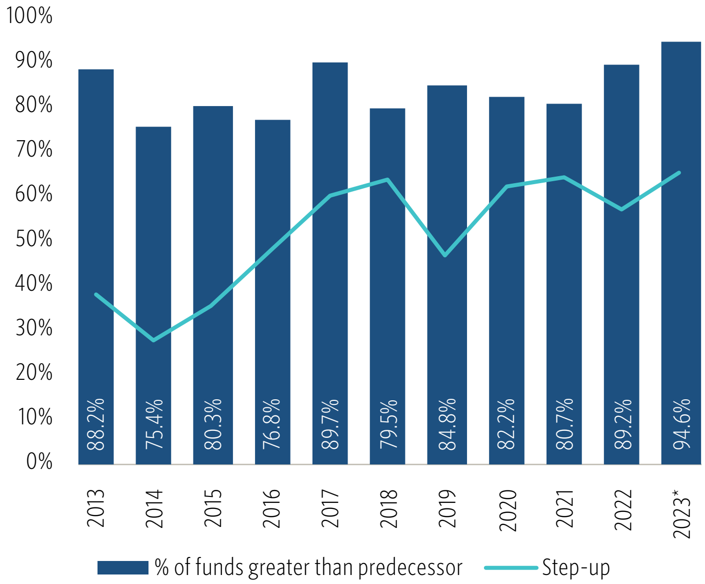
Source: PitchBook • **Geography:** US
*As of September 30, 2023

Overview

The pace of fund closings in the middle-market space cooled in Q3, as 29 funds wrapped fundraising with $22.8 billion of commitments, below the historical norm of $25 billion to $30 billion per quarter. Total value of closed funds in Q3 was down 7.3% sequentially and measured less than half of the strong volume of Q1 with over $50 billion registered in fund closings. Despite the slowdown from Q2, middle-market fundraising YTD is tracking basically in line with last year, up just 30 basis points YoY. Middle-market fund sizes are shifting higher in 2023, with the average size now $900.2 million, well ahead of 2022 at $735.8 million.

Established GPs in the middle market have been successful in increasing the size of their funds. Through the first nine months of 2023, 94.6% of middle-market funds closed at greater sizes, a record level, for a median step-up of 65.5% relative to their predecessor funds. This surpassed the industry as a whole, wherein 81.0% of all US PE funds achieved a step-up YTD and are nearly 550 basis points higher than in 2022, while 89.2% of all middle-market funds received a step-up. For example, Alpine Investors closed its Fund IX with $4.5 billion on July 12, 2023, double the size of its predecessor fund, which raised $2.3 billion with a close in September of 2021.

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



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

Analyzing fundraising on a fund-count basis, we find the middle market accounted for 39.3% of all PE funds closed in the first nine months of 2023. This is well above 2022 at 28.9% and the 10-year average of 36.5%. Middle-market funds captured a respectable share of PE-sponsored funds closed on a dollar basis in the TTM at 42.3%, but this is a large drop sequentially, down from 60.4% as of Q2, as megafunds posted sizable closing in Q3. The middle-market segment is now tracking below the 45.2% of AUM closed in 2022 and below the 10-year average of 54.6%. We continue to believe middle-market funds face an opportunistic landscape as lower deal valuations in this size range make it easier to compensate for the lack of leverage and higher borrowing costs.

Investors continue to commit capital to middle-market managers but are hindered by the denominator effect in addition to the soft exit environment which is lengthening the timeframe for capital returns from older vintage funds. As a result, the time to close funds has expanded. The median time to close has stretched to 15.5 months at YTD 2023, the longest time to close since 2011 when it was 17.5 months. While this is counterintuitive, considering the challenging fundraising environment, the time between vintages of buyout funds contracted slightly to 2.7 years from 3.2 years.

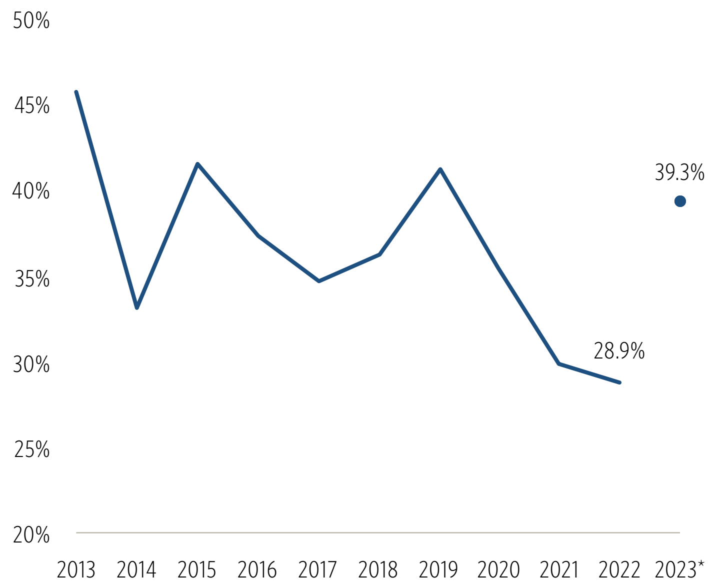
Recent closings

Q3 included a relatively normal cohort of middle-market funds closing, with 75.9% of funds between $100.0 million and $999.9 million, 20.7% of funds between $1.0 billion and $1.999 billion, and a single fund over $2.0 billion.

Two funds stood out at the top of the Q3 fundraising leaderboard. Alpine Investors IX closed on July 12, 2023 with $4.5 billion in commitments, doubling the size of its prior vintage from September 2021. The firm noted it encountered a challenging backdrop for fundraising, as many LPs had less capital to allocate in the current environment, yet it was still able to exceed its target of $3.8 billion and was oversubscribed with a diversified base of new and returning investors from the US, Europe, Asia, and the Middle East. The fund seeks control buyouts of software and services businesses with total enterprise values of up to $1 billion, with a focus on platform investments.

Additionally, Paine Schwartz Partners closed its Food Chain Fund VI on September 26, 2023, with $1.7 billion of commitments, ahead of its target $1.5 billion and an 18.9% step-up from its predecessor vintage fund of 2019. The fund is focused on sustainable investments in the food & agribusiness sector. Two core themes will guide the investment process: productivity & sustainability, meaning businesses that enhance agricultural productivity and reduce resource consumption; and health & wellness, meaning businesses that expand access to healthier, more nutritious, and safer food. Already, 40% of the fund has been deployed.

PE middle-market fund count as a share of all US PE funds



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

Largest PE middle-market fund closings YTD*

Close date (2023)	Manager	Fund	Fund size ($M)
September 26	Paine Schwartz Partners	Paine Schwartz Food Chain VI	$1,700.0
July 12	Alpine Investors	Alpine Investors IX	$4,500.0
June 13	Altaris Capital Partners	Altaris Health Partners V	$2,350.0
May 31	Sun Capital Partners	Sun Capital Partners VIII	$1,417.0
March 30	Accel-KKR Capital	Accel-KKR Capital Partners VII	$4,400.0
March 27	Parthenon Investors	Parthenon Investors VII	$4,500.0
March 23	STG	STG VII	$4,200.0
March 21	Arcline Capital	Arcline Capital Partners III	$4,500.0
February 6	Greenbriar Equity Group	Greenbriar Equity Fund VI	$3,475.0
February 1	Patient Square Equity Partners	Patient Square Equity Partners	$3,900.0

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

Emerging managers

The middle market is the sweet spot for emerging managers, which we define as managers with three or fewer funds launched, including first-time managers. Emerging managers have accounted for 31.4% of the value of all middle-market funds closed so far in 2023, steadily rising from an all-time low of 16.0% in 2020 when investors were most skittish. This same trend is reflected in the number of first-time managers closing funds in 2023, which expanded to 15.6% of all middle-market funds closed, up from a 10.4% share in 2020. Meanwhile, the share of first-time managers of all PE buyout funds closed has declined during the same span. New and emerging managers are being given more of a shot than the last time the fundraising market was under stress. That is, so long as they can clear the $100 million bar and demonstrate a differentiated strategy and higher alpha than other more generic buyout fund offerings.

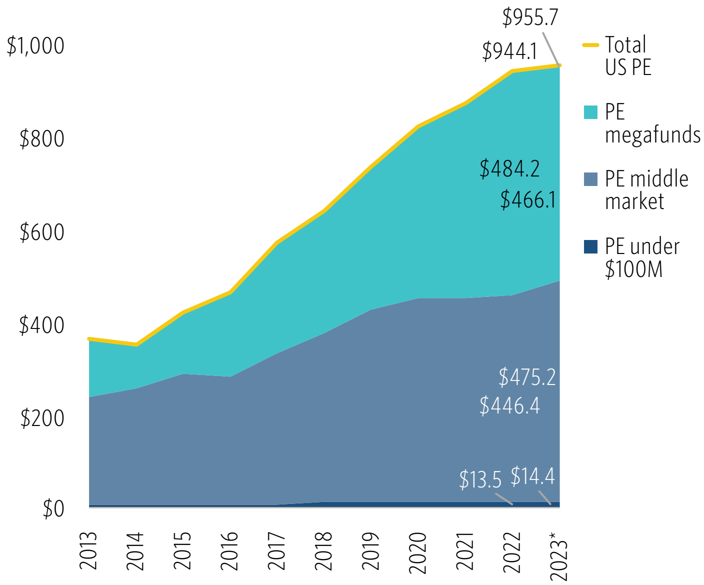
The largest fund raised by an emerging manager in the quarter belonged to a first-time manager. In July, Bansk Group, a consumer-focused buyout firm, announced the close of its inaugural fund of $800.0 million. Bansk was formed in 2019 and founded by Bart Becht, who was previously CEO of Reckitt Benckiser, a British multinational consumer goods company, for 17 years. Other backgrounds for the firm's investment team include Blackstone and TPG Growth. Many emerging managers who are seeing strong fundraises tend to have a pedigreed background, often spinning out from large and successful buyout shops. To date, the fund has already invested in four portfolio companies, spanning various consumer subsectors including consumer healthcare, beauty, and personal care brands.

Blue Sea Capital raised $618.0 million for its third fund, making it the second largest fund raised by an emerging manager in Q3. This represents a step-up of over 40% from Fund II. Consistent with the strategy of its predecessor funds, Fund III will focus on investing in subsectors of the healthcare and industrial end markets. Fund III has already allocated approximately 30% of its investments across three platform investments. These include Flagger Force, a regional provider of short-term traffic-control services, and Rhino Tool House, a distributor of intelligent fastening solutions, customized material-handling solutions, and calibration services to original equipment manufacturers in various markets. Third is Hatch Fertility, a comprehensive fertility services platform offering medical and nonmedical third-party reproductive services.

Dry powder

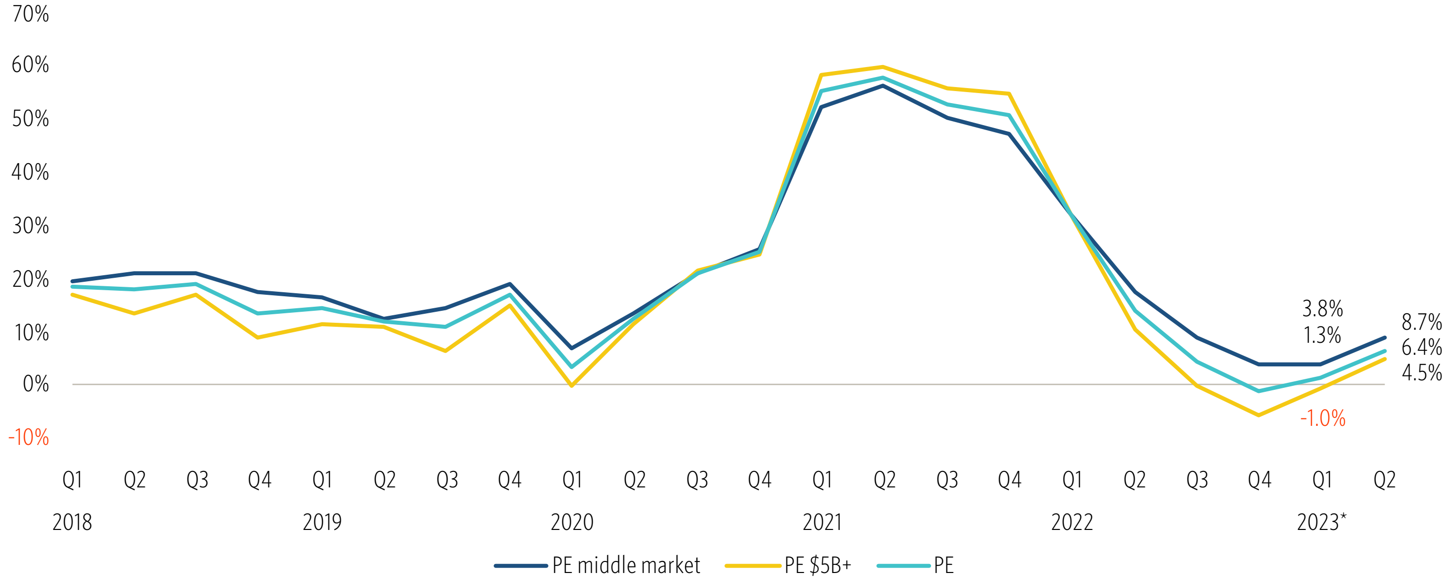
As of Q1 2023, middle-market PE funds held a record-breaking amount of dry powder at $475.2 billion, accounting for 49.7% of all dry powder in the US PE ecosystem. Middle-market share of total US PE dry powder had previously declined from 57.4% in 2018 to 47.3% in 2022, but this trend has now reversed thanks to the strong pace of fundraising seen in Q1 2023. With middle-market dry powder reaching its highest level ever, it has significantly surpassed the pre-COVID-19 (2017 to 2019) median dry powder of $368.7 billion. In terms of total AUM, middle-market dry powder has increased by 60 basis points, reaching 28.3% in 2023. With PE deployment proceeding at a slower pace, dry powder continues to accumulate.

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



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

Rolling one-year PE fund performance by size category



Source: PitchBook • **Geography:** US
*As of June 30, 2023
Note: Q2 2023 data is preliminary.

Performance

Based on our final estimate of fund returns for the period ending Q1 2023, one-year returns posted by middle-market buyout funds outperformed megafunds for the fourth consecutive quarter. Pooled one-year horizon IRRs (net of fees) equaled 3.0% for middle-market funds as of Q1 2023, more than 4 percentage points better than megafunds, which registered a median return of -1.2%. However, this outperformance gap has narrowed from the more than 8-percentage-point gap enjoyed as recently as Q4 2022, the widest since 2016. Prior periods of outperformance by middle-market funds have lasted anywhere from one to three years, and we have entered the beginning of that range.

Our preliminary data for Q2 2023 points to a continued rebound by megafunds and a narrowing underperformance gap. Megafunds posted an indicative one-year horizon return of 4.5% versus the middle market at 8.7%. In all likelihood, this reflected the strong rally in public markets, which have more of a positive knock-on effect to megafunds than middle-market funds. However, given that the public-market rally broadened out to mid- and small-cap companies in Q2, middle-market fund returns held their own for the most part.

We would expect megafunds to regain their appeal and middle-market funds to lose their relative attraction now that a down interest-rate cycle is coming back into view, as discounted by recent market action. Should this play out, it will likely lead to improved access to debt financing for large LBOs and an improved outlook for future returns and distributions.

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Q3 2023 US PE middle-market lending league tables

Overall

Rank	Company	Deal count
1	Churchill	38
2	Ares	31
3	Twin Brook Capital Partners	26
4	Golub Capital	21
5	MidCap Financial	19
6	Antares Capital	18
7	Monroe Capital	14
8	PNC	13
9	Citizens Financial Group	12
10	BMO Financial Group	10
10	Barings	10
10	Wells Fargo	10
10	T. Rowe Price OHA Select Private Credit Fund BDC	10
14	Owl Rock	9
14	KeyBank	9
14	Principal Global Investors	9
14	Jefferies Group	9
14	J.P. Morgan	9
19	Apollo Global Management	8
19	Crescent Capital	8
19	BlackRock Private Credit Fund BDC	8
19	The Goldman Sachs Group	8
23	Audax Private Debt	7
24	Goldman Sachs Middle Market Lending Corp. II BDC	6
24	First-Citizens Bank & Trust	6
24	Truist Financial	6
24	Mitsubishi Financial Group	6
24	WhiteHorse Capital	6
29	Fifth Third Bank	5
29	HPS Investment Partners	5
29	NXT Capital	5
29	Apogem Capital	5
29	Oak Hill Advisors	5
29	The Blackstone Group	5
29	Bain Capital	5
29	Canadian Imperial Bank of Commerce	5
29	Kennedy Lewis Capital Company BDC	5

Source: PitchBook

Select roles*

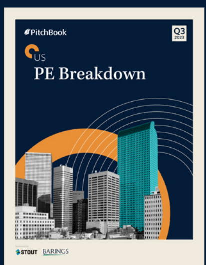
Rank	Company	Deal count
1	Churchill	31
2	Twin Brook Capital Partners	25
3	MidCap Financial	18
4	Antares Capital	16
5	Ares	15
5	Golub Capital	15
7	Citizens Financial Group	12
8	Monroe Capital	11
9	PNC	10
10	Jefferies Group	7
10	BMO Financial Group	7
10	Wells Fargo	7
13	J.P. Morgan	6
13	WhiteHorse Capital	6
15	Principal Global Investors	5
15	Audax Private Debt	5
15	KeyBank	5
15	Truist Financial	5
19	Mitsubishi Financial Group	4
19	Apogem Capital	4
19	Fifth Third Bank	4
19	NXT Capital	4
23	Texas Capital Bank	3
23	Macquarie	3
25	Owl Rock	2
25	UBS	2
25	Webster Financial	2
25	Bank of America	2
25	Sumitomo Mitsui Banking Corporation	2
25	Oak Hill Advisors	2
25	Barings	2
25	Rabobank Group	2
25	Tree Line Capital Partners	2
25	Societe Generale	2
25	Truist Securities	2

Source: PitchBook

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

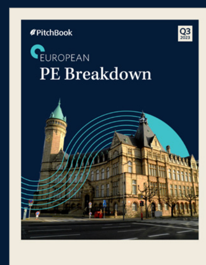
Additional research

Private markets



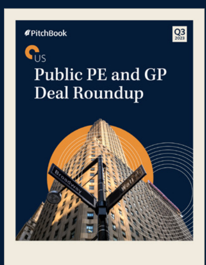
Q3 2023 US PE Breakdown

Download the report here



Q3 2023 European PE Breakdown

Download the report here



Q3 2023 US Public PE and GP Deal Roundup

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Q3 2023 Global M&A Report

Download the report here

Q1 Global Fund Performance Report (with preliminary Q2 2023 data)

Download the report here

Q2 2023 US PE Middle Market Report

Download the report here

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