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US PE Middle Market

2017 Annual

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Key takeaways from the analyst

- Private equity (PE) firms invested in 2,306 middle market (MM) deals totaling $324.1 billion in 2017. Deal value was up 14% year-over-year, largely attributable to a shift in activity toward the upper middle market (UMM), which saw a 46% increase in deal value and a 62% increase in volume.
- A slowdown in strategic acquisitions had ramifications for the PE exit market in 2017 with strategic acquisition accounting for just 421 exits of PE-sponsored MM companies, totaling $49.0 billion in value.
- US MM fundraising continued to be strong in 2017, with $121.9 billion raised across 174 funds. 4Q was a particularly strong quarter with $40.1 billion in commitments closed during the final three months of the year.

$324.1B
US PE MM deal value
14% YoY

421
2017 strategic acquisitions
11% YoY

$121.9B
amount raised in 2017 for US PE MM funds

Nico Cordeiro, Analyst

Wins in Washington bode well for deal flow

This year promises to be another strong one for PE, as PitchBook's 2018 PE Crystal Ball Report illustrates. That's likely due in part to the landmark tax reform package passed at the end of 2017. As the voice of the middle market, ACG Global is pleased that many key provisions for its members were maintained in the bill, but that doesn't mean our work is finished. Having joined the association as president and CEO in December, I look forward to continuing ACG's work to advance the interests of the middle market.

Midsize businesses and investors will undoubtedly benefit from the tax bill's reduced corporate rate, the preservation of partial interest deductibility, favorable tax treatment of pass-through entities, and full and immediate business expensing.

To build on these accomplishments in 2018, ACG is ramping up its efforts to attract new members to the Congressional Caucus for Middle Market Growth, a bipartisan group of lawmakers dedicated to helping American midsize companies remain competitive. GrowthEconomy.org, a project that draws from PitchBook's data and a database maintained by researchers at the University of Wisconsin-Extension, shows the impact of private capital on jobs and sales growth at national, state and congressional district levels, enabling citizens and lawmakers to see how investment-friendly policies yield economic benefits.

On the regulatory front, ACG is prioritizing the issue of broker-dealer registration. Through its Private Equity Regulatory Task Force, or PERT, the association will continue its dialogue with leaders of the Securities and Exchange Commission to appropriately tailor the reporting requirements placed on middle-market PE investors. PERT last year released its groundbreaking PE Regulatory and Compliance Principles, which it will continue to update to keep firms apprised of best practices for SEC compliance.

We expect our legislative and regulatory efforts will have a positive impact on fostering deal flow, as will ACG Global's signature networking and education events—InterGrowth and EuroGrowth.

Held this year in San Diego on May 2-4, InterGrowth will bring together more than 2,000 deal-makers, a group that represents two-thirds of U.S. PE deals, according to PitchBook. For those engaged in cross-border M&A, ACG's EuroGrowth conference presents an opportunity to network with deal professionals from across the world and to hear from global business leaders in Amsterdam on June 19-20.

I wish you all a strong year for deal flow, and I look forward to seeing many of you at our events in the coming months.

Pat Morris
President & CEO
ACG Global

This intro letter represents the authors' views only and doesn't necessarily represent the views of PitchBook.

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Private equity sponsors choose Madison Capital Funding for the relationships we build—and keep. We have invested $28.1 billion of net funded commitments in over 1,050 transactions with over 285 different private equity sponsors across multiple industries.

Company	Amount	Role	Transaction	Sponsor	Date
Integrity Marketing Group	Undisclosed	Joint Lead Arranger and Syndication Agent	Add-on Acquisition	HGGC	January 2018
LGD	Undisclosed	Joint Lead Arranger and Syndication Agent	Control Recapitalization	Parthenon Capital Partners	January 2018
U-C Coatings	Undisclosed	Administrative Agent and Syndication Agent	Leveraged Buyout	highroad Capital Partners	January 2018
corsearch	Undisclosed	Joint Lead Arranger and Administrative Agent	Leveraged Buyout	Audax Group	January 2018
DELPHON	Undisclosed	Sole Lead Arranger and Administrative Agent	Leveraged Buyout	P/W/P Growth Equity	January 2018
Queen's Products	Undisclosed	Joint Lead Arranger	Leveraged Buyout	TENEX Capital Management	January 2018
CenterSquare Investment Management	$40,000,000	Sole Lead Arranger and Administrative Agent	Leveraged Management Buyout	LMP Lovell Minnick Partners	January 2018
Pearl Holding Group	Undisclosed	Sole Lead Arranger and Administrative Agent	Recapitalization	HGGC	December 2017
IAS	Undisclosed	Joint Lead Arranger and Administrative Agent	Add-on Acquisition	Genstar Capital	December 2017
THIBAUT	Undisclosed	Joint Lead Arranger and Administrative Agent	Leveraged Buyout	Harbour Group	December 2017
Alera Group	Undisclosed	Joint Lead Arranger and Co-Bookrunner	Growth Capital	Genstar Capital	December 2017
GraphPad Software	Undisclosed	Joint Lead Arranger and Co-Bookrunner	Leveraged Buyout	Insight Venture Partners	December 2017
PAG	$61,000,000	Sole Lead Arranger and Administrative Agent	Senior Credit Facility Dividend Recapitalization	PNC Riverarch Capital	December 2017
Health Connect America	$45,000,000	Administrative Agent	Recapitalization	Harren Equity Partners	December 2017
Gurobi Optimization	Undisclosed	Sole Lead Arranger and Administrative Agent	Recapitalization	Thompson Street Capital Partners	December 2017

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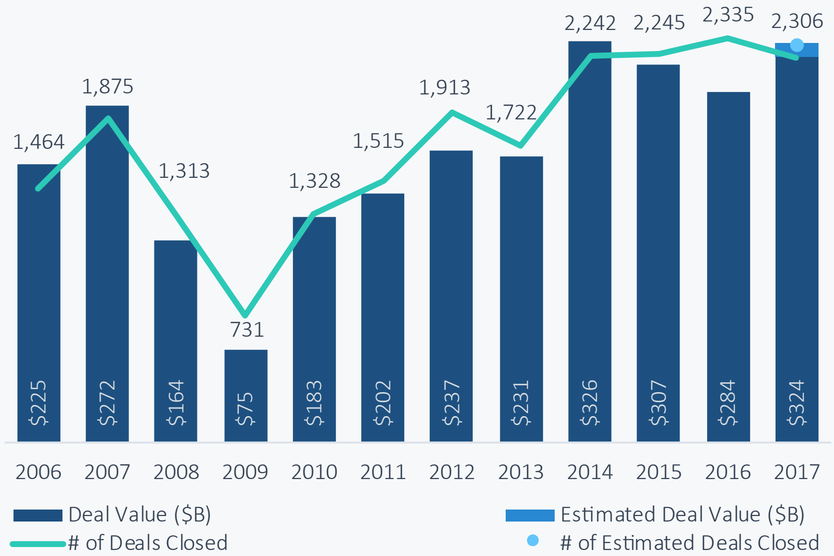
Overview

US PE middle-market dealmaking shows strength amid record fundraising

Private equity (PE) firms invested in 2,306 middle market (MM) deals totaling $324.1 billion in 2017. Given that most PE activity occurs in the MM, it is unsurprising that activity in the MM mirrors many of the same trends we see broadly across PE: Deal flow remains flat, exits are trending downward, and fundraising continues unabated. Deal value was up 14% year-over-year, largely attributable to a shift in activity toward the upper middle market (UMM), which saw a 46% increase in deal value and a 62% increase in volume. Conversely, capital invested in the lower middle market (LMM) and core middle market (CMM) dropped by 23% and 15%, respectively.

US PE middle-market activity remains robust

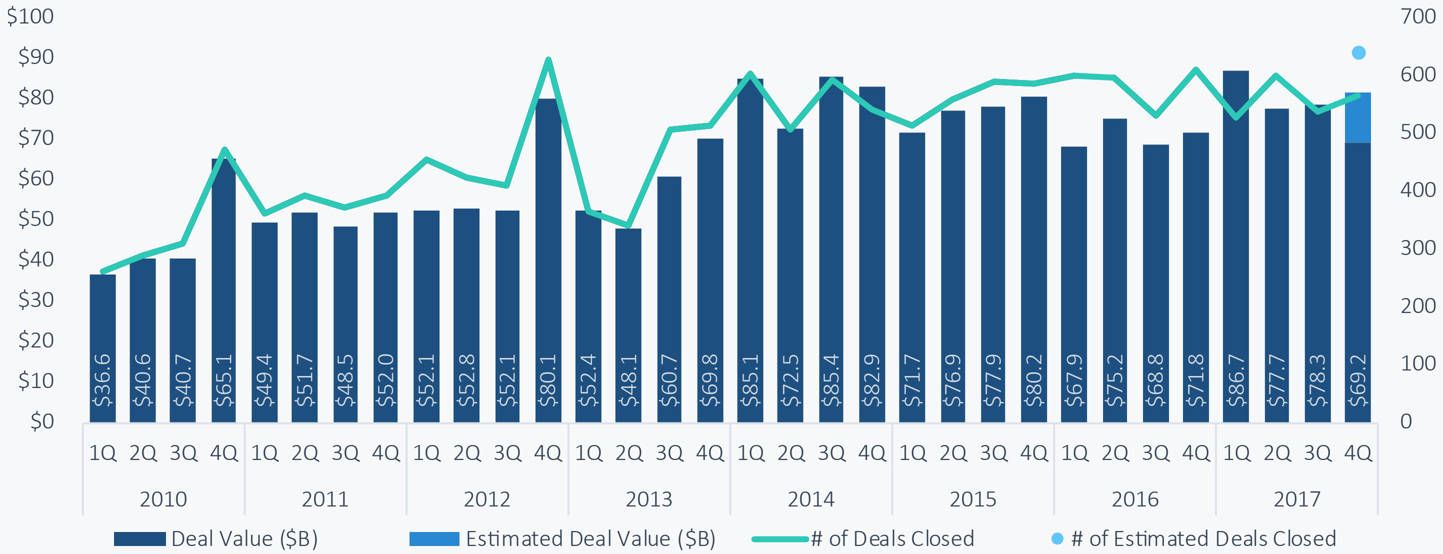
US PE middle market activity



Source: PitchBook

US MM activity finished the year on a strong note

US PE middle-market activity



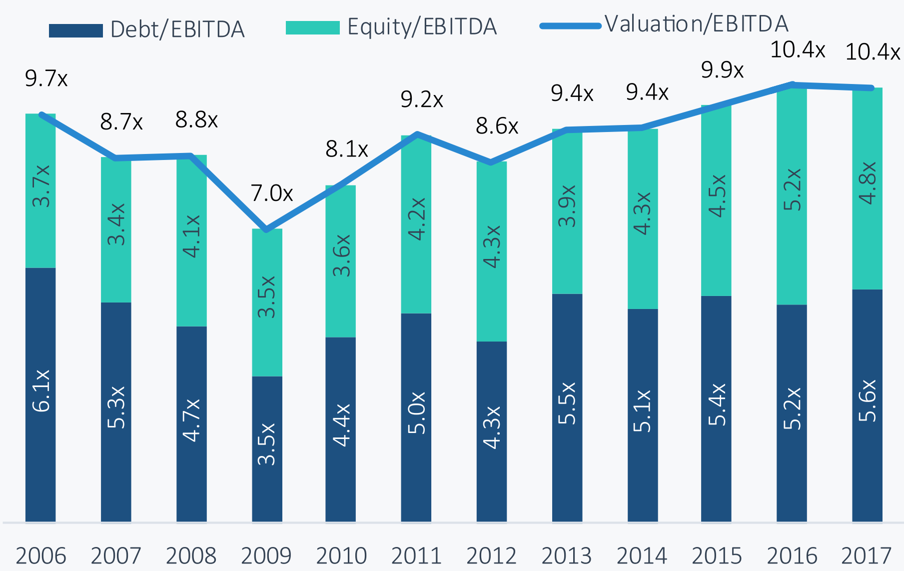
Source: PitchBook

Despite a pullback in strategic acquisitions, competitive pressures remain high. As a result, the median valuation/EBITDA multiple remains elevated at 10.4x and the median debt/EBITDA multiple has risen to a decade high of 5.6x. Competition has been stoked by increased crowding in the PE industry; US MM firms have extended an impressive fundraising streak, raising over $100 billion in capital commitments every year since 2013. These market dynamics have compressed aggregate return expectations with a clear downward trend in median returns since 2000.

The US MM company inventory continued to climb, reaching a new high of 5,932 MM PE-sponsored companies. Despite record levels of commitments to PE funds, the number of PE-sponsored companies has only grown at an average of 5% since 2009,

Purchase-price multiples remain elevated

US PE middle-market EBITDA multiples



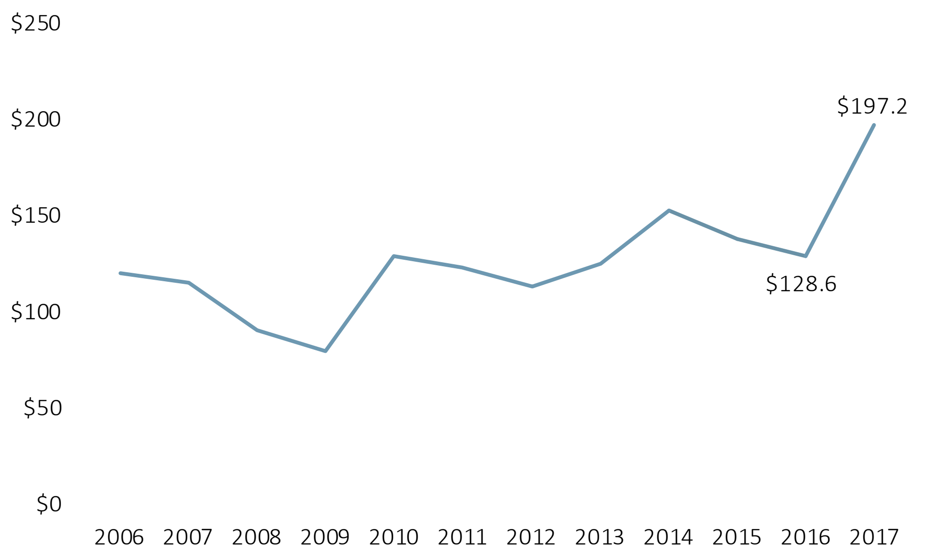
Source: PitchBook

which is well below the average annual growth rate of 15% between 2000 and 2008. Much of this discrepancy between fundraising and inventory can be explained by the 14% annual growth in add-on acquisitions as well as the shift towards larger acquisitions as valuation/equity multiples have also been on the climb.

The energy sector fell out of favor with MM investors in 2017, with a 43% decline in volume that brought activity well below both the five and 10-year averages. Conversely, technology companies continued to become a more consistent source of deal flow for PE deal makers, as the IT sector accounted for 18% of all MM PE deals. A previous iteration of this report dove into the enticing appeal of technology-based service companies to PE firms, which prize business models that feature recurring revenue models and relatively high-growth prospects.

Deal sizes continue to grow

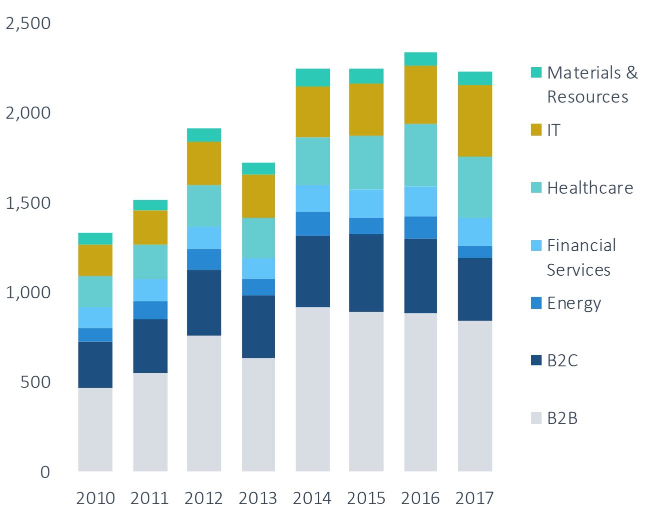
US PE middle-market median deal size ($M)



Source: PitchBook

Energy falls out of favor in 2017

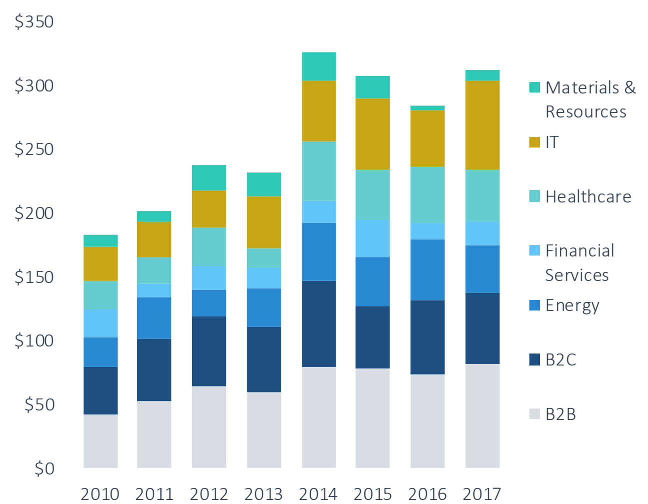
US PE middle-market deal activity (#) by sector



Source: PitchBook

IT continues recent gains in deal value

US PE middle-market activity ($M) by sector



Source: PitchBook

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Spotlight

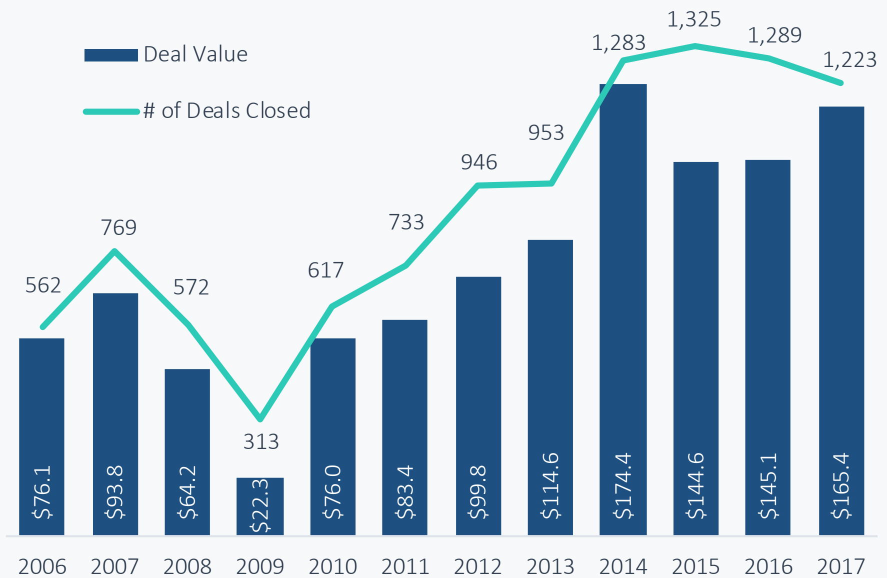
Add-ons have become a preferred modus operandi in the US middle market

The majority of acquisitions in the MM in recent years has been add-ons to existing companies in PE firms' portfolios, with these deals constituting at least 50% of MM PE deal flow since 2013. This proportion peaked at 59% in 2015 during the global M&A boom and has since trended downward to 55% in 2017 but is likely to remain the dominant proportion of MM buyouts. Add-ons serve as a way for PE firms to boost revenue and earnings growth in a low-growth environment. Furthermore, previous research found that add-on deals generally transact at lower multiples than platform companies. As such, in this elevated pricing environment, add-ons provide a means of averaging down the overall acquisition multiple a PE firm's total cost for a platform companies. Given these dynamics, it is likely add-ons will remain the dominant activity by PE firms in the MM.

This is another trend towards the institutionalization of the private markets in the US, where an ever-growing proportion of private assets are owned by institutional capital. As PE activity continues to grow, it is increasingly important for small to medium-sized business owners to understand the changing nature of the competitive landscape.

Add-ons remain popular throughout middle market

US PE middle-market add-on activity



Source: PitchBook

53%

of US PE middle market deal value was accounted for by add-ons in 2017

Add-ons have consistently represented the majority of middle-market deal flow for five consecutive years

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Revenue recognition & PE: Why should you care?

For PE portfolio companies, the new revenue recognition standards issued by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) could change several key financial metrics and ratios, including revenue and EBITDA. But it's also likely to have broader implications—for example, in M&A transactions, there may be impacts pre-transaction, post-transaction, and with ongoing fair value measurements. Corporate processes, controls and IT systems will likely feel the effects, too. The combined impact makes this a serious topic for consideration by private equity investors.

But first…

A little background is in order. In 2014, after 12 years of work, the FASB and IASB issued new standards for recognizing revenue from contracts with customers. Contained in FASB's Accounting Standard Codification (ASC) 606 and IASB's International Financial Reporting Standard (IFRS) 15, the guidelines take effect for public companies in 2018 and private companies in 2019. The goal was to create a single, comprehensive revenue recognition model across all industries and capital markets. ASC 606 and IFRS 15 achieve that goal by focusing on a core principle to recognize revenue to depict the transfer of promised goods or services in an amount that reflects the consideration the entity expects to be entitled to in exchange for those goods or services.

To implement the standard, public and private companies alike have been completely re-evaluating how they account for revenue. This is arguably the most profound new compliance change to affect corporate finance since the Sarbanes-Oxley Act of 2002. Implementation may require considerable efforts to understand the accounting issues and the broader implications for processes, controls, and systems. So, if you think this doesn't affect your PE portfolio companies, think again.

Pre-transaction considerations

New investment due diligence. You'll want to assess how prepared the potential portfolio company is for the accounting change, potential impacts to the company's cash-flow projections, and costs and resources needed to implement the standard. If new financing arrangements are contemplated, it would be prudent to consider impacts on financial metrics before negotiating debt covenants.

Exit strategies. The standard could result in potential changes to pricing and market strategy of the portfolio company.

Post-transaction considerations

Management compensation, performance bonuses, and incentive compensation. By evaluating existing compensation plans, you can determine whether the plans require modification to align accounting treatment and goals while still incentivizing employees.

Debt covenants. It will be important to monitor existing debt covenants to prevent violations stemming from any potential accounting changes.

Taxes. You will need to assess how changes in the timing of revenue recognition versus cash receipts potentially impact recognition of tax expenses, benefits, and deferrals as well as state apportionment factors, sales and property taxes, and transfer pricing.

Ongoing portfolio company fair value measurement

The adoption of ASC 606 or IFRS 15 is likely to have considerable effect on key valuation inputs and operating metrics of portfolio companies, including:

• Consistency of historical financial metrics, such as revenue and EBITDA

• Impact of implementation on peer company financial metrics used in a market approach valuation model – for example, guideline public company (GPC) or guideline transaction method (GTM).

• Consideration of the timing of when peer companies adopt ASC 606 or IFRS 15, as well as the method of adoption — i.e., retrospective vs. modified retrospective with cumulative effect adjustment at beginning of period

• Alignment of entry multiple pre- and post-adoption of ASC 606 or IFRS 15

• Impact on portfolio company cash-flow projections

• Adjustments to valuation models to account for the items noted above

Because of changes to these inputs, ASC 606 and IFRS 15 may have a variety of positive and potentially negative impacts on the overall valuation of a portfolio company. Each portfolio company, and each customer contract, may need to be evaluated to assess the impact on the valuation.

For more information

To learn more about ASC 606 or IFRS 15 and its implementation in portfolio companies, please contact:

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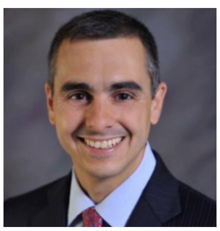

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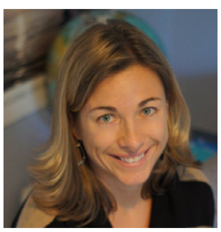

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Mindy is an audit Director in the West Coast Investment Management group with over 19 years of experience. Mindy has served large public and private clients in the asset management, banking and securities industries. Mindy has extensive experience auditing investment funds, including mutual funds, hedge funds, fund of funds, private equity funds and venture capital funds. In addition to financial statement audits, Mindy also has experience with readiness and examinations of internal controls over financial reporting under Sarbanes-Oxley 404, service auditor reports for broker-dealers and investment fund administration, and custody (SSAE16 Reports).

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Exits

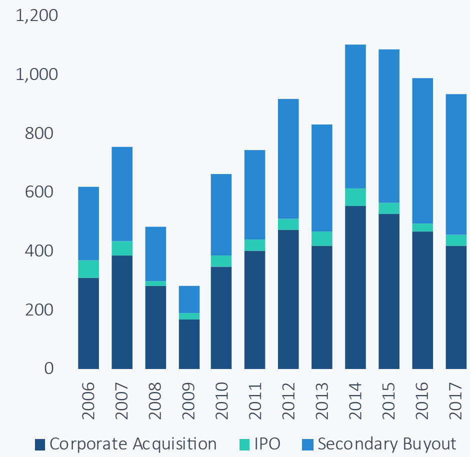
SBOs outpace strategic acquisitions

A slowdown in strategic acquisitions had ramifications for the PE exit market in 2017. PE firms exited $89.8 billion in value across 934 MM exits in 2017, YoY decreases of 11% and 6%, respectively. While strong on a longer-term historical basis, corporate acquisitions of MM PE-backed companies represented only 45% of exits in 2017; strategics acquired just 421 PE-sponsored MM companies, accounting for $49.0 billion in value. A notable exception to this pullback was in the IT sector, which saw a 25% increase in activity in corporate acquisitions.

While exits via strategic acquisitions declined, secondary buyouts (SBO) constituted 51% of all exit volume—the highest proportion recorded in the dataset. As outlined in our 2018 Private Equity Outlook, it is likely that PE-to-PE transactions will continue to grow in importance for two reasons: (i) PE firms, flush with capital, are struggling to find deal flow, and (ii) at the opposite end of the investment cycle, PE firms need to find exits as the company inventory continues to age and grow. Despite sliding exit activity, median hold times continued to fall from their post-financial-crisis high of 5.7 years in 2014, when PE firms were forced to hold portfolio companies acquired at elevated multiples until market dynamics recovered.

The decline in exits is primarily due to diminishing M&A

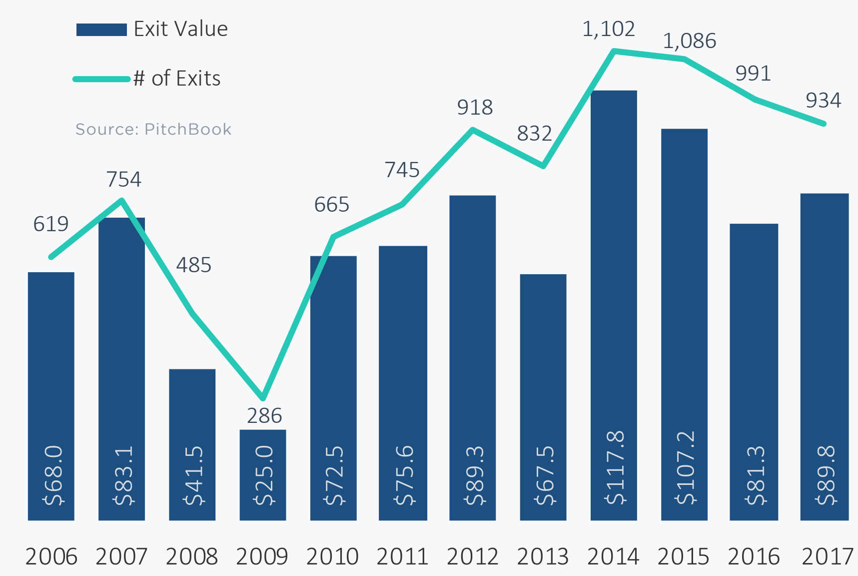
US middle market exits (#) by type



Source: PitchBook

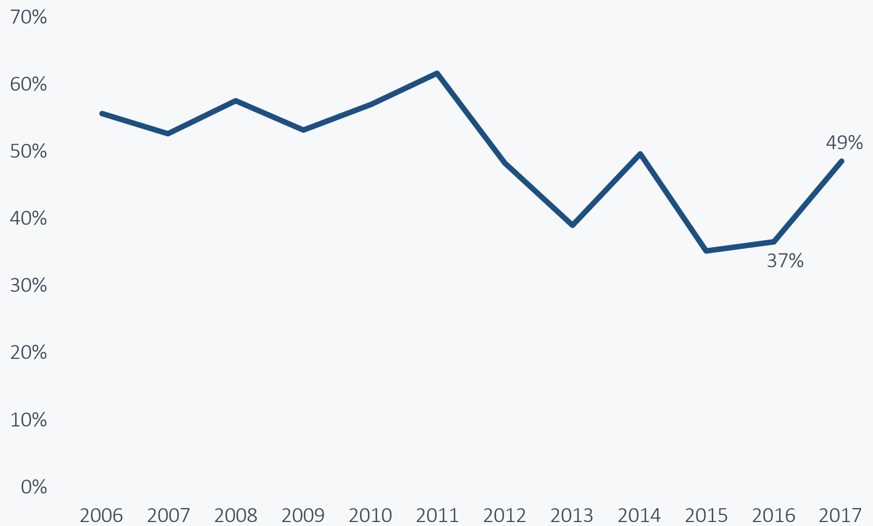
Exits decline below long-term trend

US PE-backed exits



MM accounts for half of PE capital exited

US middle market exit value as percentage of total PE



Source: PitchBook

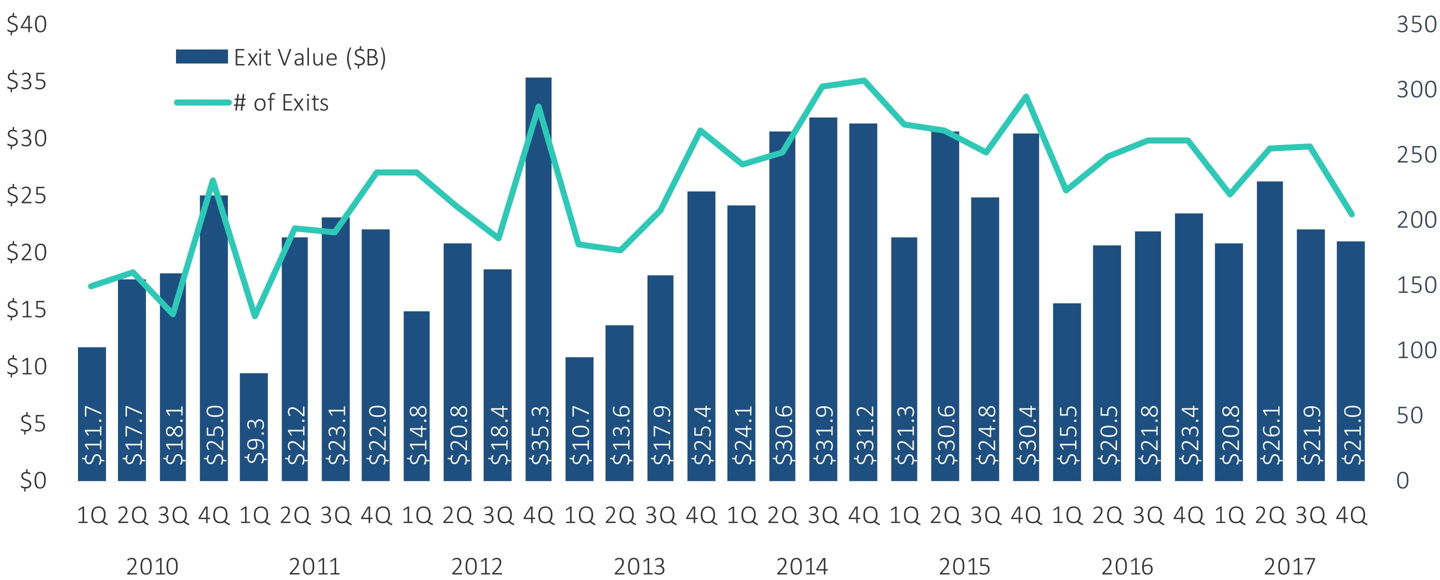
In 2017, tech reached the second-highest middle-market exit value that the sector has achieved

$14.7B

exit value of PE-held technology portfolio companies in 2017

The 4Q exit count fell to a four-year low

US PE-backed middle market exits



Source: PitchBook

Fundraising

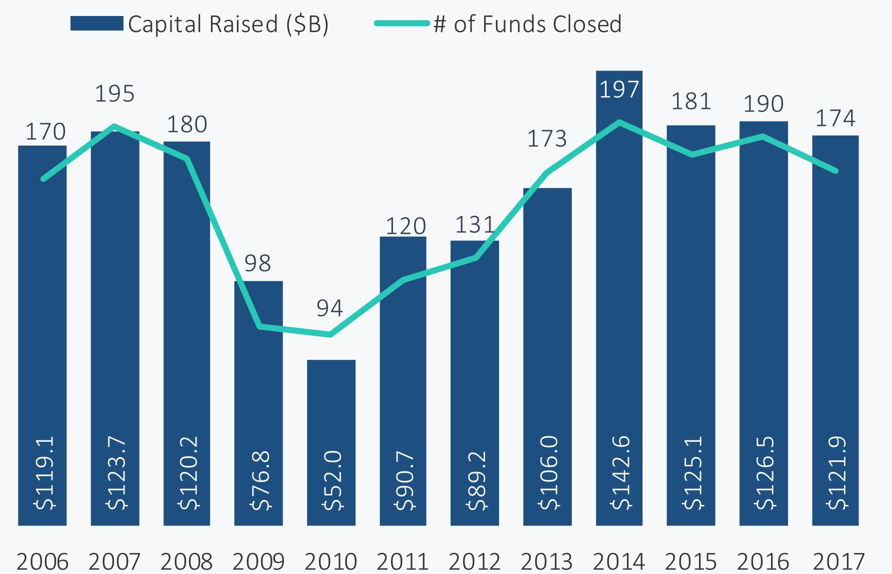
$120B+ raised for fourth consecutive year

US MM fundraising continued to be strong in 2017, with $121.9 billion raised across 174 funds. 4Q was a particularly strong quarter with $41 billion in commitments closed during the final three months of the year. As LPs consolidate their PE commitments amongst fewer managers to simplify due diligence and reporting costs, the proportion of funds of $100 million to $250 million fell to just 28%, well below the historical average of 35%. Another motivating factor behind the shift towards larger commitments to fewer GPs is that it gives greater negotiating power to LPs, who have made a concerted effort to lower the fees associated with PE investing.

Two data points signify the fundraising fervor that has failed to slow over the last few years. First, median MM buyout fund size rose to $413.5 million, an 18% increase since 2013. Second, the median time to close a MM PE fund dropped from 15.0 months to 7.5 months from 2016 to 2017, a 50% YoY decrease and the fastest time to close recorded in the dataset. This enthusiasm for the asset class is unsurprising given PE's historical outperformance of public equities, proposed diversification benefits of alternatives, and the low-growth environment that has pushed a greater proportion of LPs into a search for higher yield.

Fundraising totals decline despite uptick in fund sizes

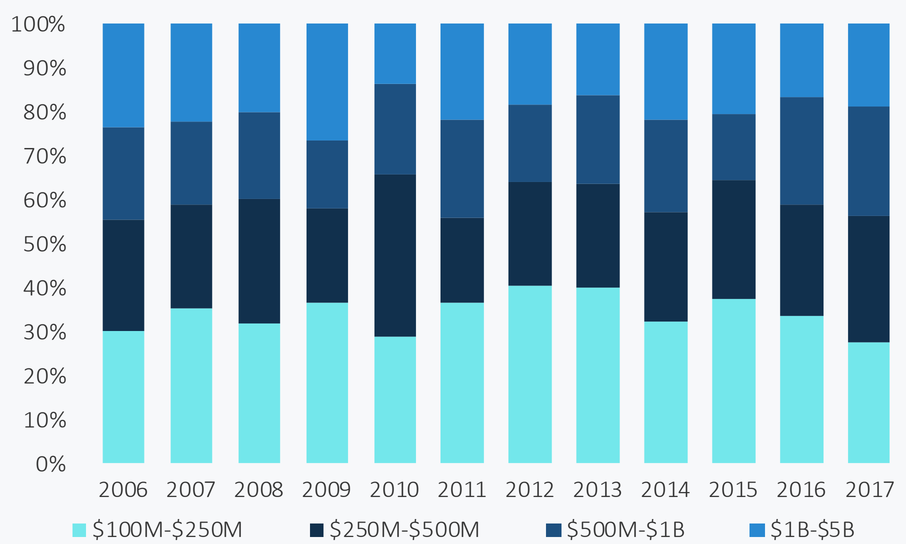
US PE middle market fundraising



Source: PitchBook

Small funds continue to fall from favor

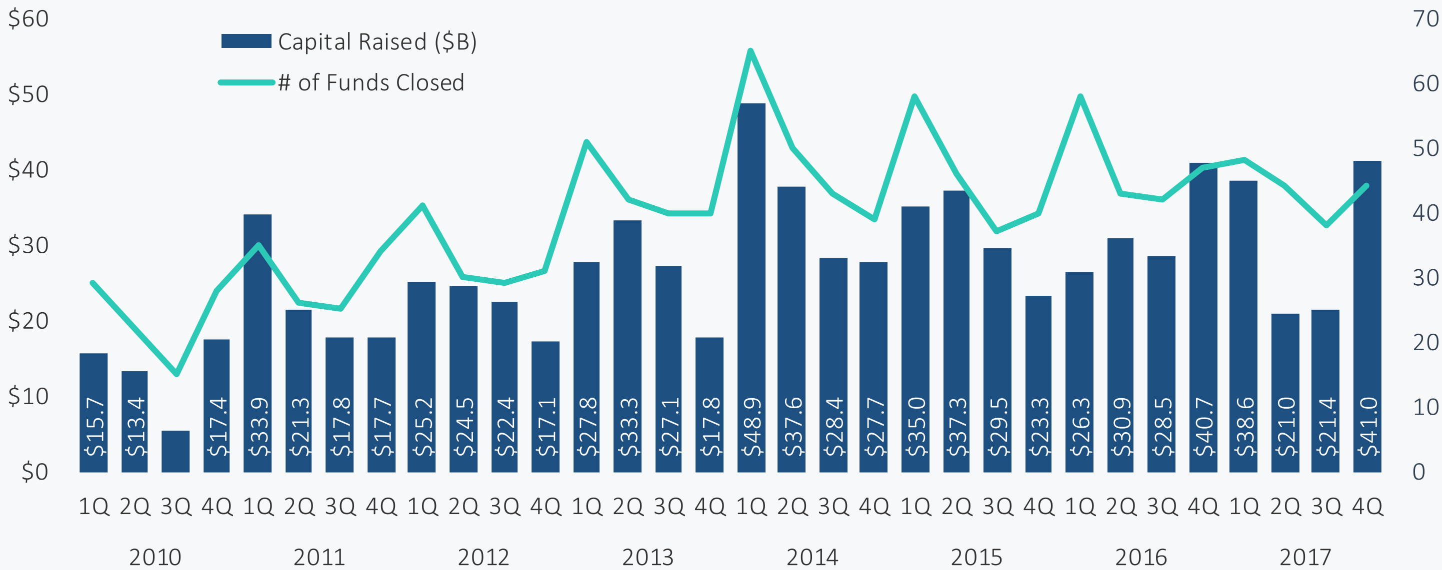
US PE middle market fundraising (#) by size



Source: PitchBook

4Q ends year on particularly strong quarter with $41B raised by middle market funds

US PE middle market fundraising



Source: PitchBook

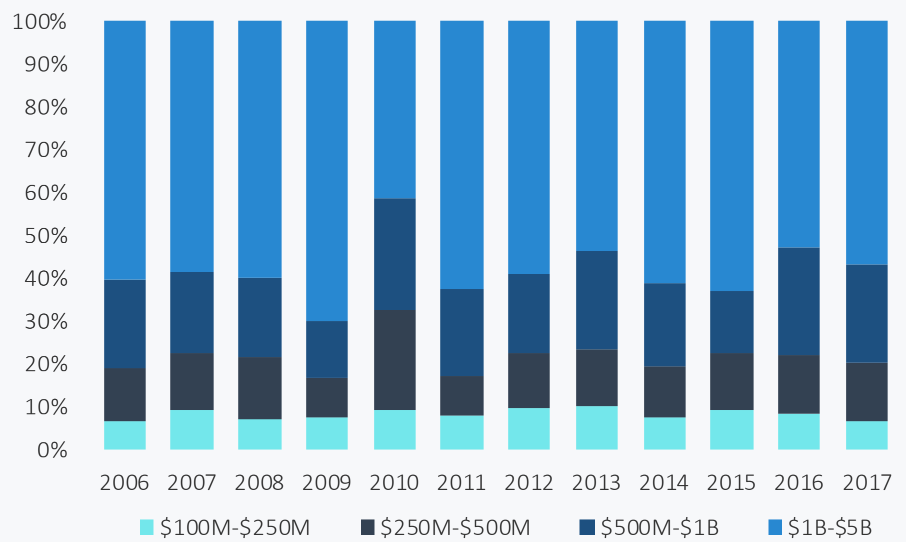
The median US middle market buyout fund size is at the highest point since 2011

$413.5M

median US PE middle market buyout fund size

Capital flows remain concentrated in large vehicles

US PE middle market fundraising ($) by size



Source: PitchBook

2017 US PE Middle-Market Lending League Tables

Most active lenders by deal count

Antares Capital	111
Ares Capital	82
Madison Capital Funding	79
Twin Brook Capital Partners	56
The Goldman Sachs Group	55
Golub Capital	41
BMO Financial Group	40
Monroe Capital	36
Bank of America	33
BBVA	29
Crescent Direct Lending	29
Credit Suisse	28
Citizens Bank	27
NXT Capital	26
Capital One	26
J.P. Morgan	24
Fifth Third Bank	23
Jefferies Group	22
Bridge Bank	22
PNC	21
Wells Fargo	21
Citigroup	21
Varagon Capital Partners	20

Source: PitchBook