Sponsored by

In partnership with

ACG

Co-sponsored by

CHUBB®

US PE Middle Market

1Q 2018

We do things differently by being consistent.

Predictable outcomes through changing market cycles. And a certainty of execution that our clients have come to expect from a market leader. Through 20+ years of innovative financing, our consistency is what makes us different.

Antares.com

Antares Capital

PitchBook

Sponsored by Antares Capital

In partnership with ACG

Co-sponsored by CHUBB®

Contents

Key takeaways	3
A note from Antares Capital	4
Overview	5
Spotlight: Add-ons	7
Antares Capital: Q&A	9
Exits	12
A note from Chubb	14
Fundraising	15
1Q 2018 US PE Middle-Market Lender League Tables	16

Credits & Contact

PitchBook Data, Inc.

John Gabbert Founder, CEO
Adley Bowden Vice President, Market Development & Analysis

Content

Dylan Cox Senior Analyst, PE
Darren Klees Data Analyst

Contact PitchBook

pitchbook.com

Research
reports@pitchbook.com

Editorial
editorial@pitchbook.com

Sales
sales@pitchbook.com

Cover design by Eric Maloney

Click here for PitchBook's report methodologies.

Key takeaways from the analyst

- After a record-setting 2017 in terms of both deal value and transaction count, the US PE middle market got off to a mixed start in 1Q 2018. 619 middle-market transactions were completed, totaling $53.6 billion in deal value—a 17% increase and 40% decrease, respectively, compared to the prior year.
- US MM fundraising activity has hovered at elevated levels in recent years, and 2018 is shaping up for more of the same. PE firms closed on $29 billion across 36 funds in 1Q 2018.
- After totaling at least $20 billion each quarter for nearly two years, US PE middle-market exit value dipped to just $11.9 billion in 1Q 2018. In addition, just 165 exits were completed, representing a 26% falloff from the previous year.

$53.6B
in deal value across 619 middle-market PE transactions

$29B
amount PE firms closed across 36 MM funds in 1Q 2018

$11.9B
MM PE-backed exit value in 1Q 2018

Antares Capital

Keep a firm hand on the tiller

Optimism remains the prevailing wind, but the seas could start to get choppy.

As noted in our January Compass report, cyclical indicators coming into 2018 appeared favorable, suggesting the sustained US economic expansion still has room to run. Moreover, our recent 2nd Annual Compass survey of middle-market PE sponsors, borrowers and investors suggests that optimism over the US economy, which had already been high, has only gained steam. The vast majority of respondents see a recession in the next 12 months as unlikely or very unlikely, with loan default rates expected to remain low. Companies are forecasting strong revenue and EBITDA growth ahead and are accelerating their hiring. More recent upside surprises in March in employment and consumer confidence data would seem to lend support to the favorable outlook.

Turning to loan markets, our Compass survey indicated that most respondents expect M&A/leveraged buyout activity to continue to hold up well in 2018, with 88% of middle-market PE sponsors foreseeing a net-neutral impact of the new tax legislation on LBO activity, at least on an aggregate level. Nevertheless, strong demand from yield-hungry investors continues to outpace new loan supply. CLO issuance and middle-market fundraising are expected to remain robust, with loan mutual fund inflows continuing.

Looking forward, healthy optimism appears well-founded but can breed complacency, as evidenced by rising leverage, lower spreads and looser terms. While there may well be smooth sailing ahead, one must remember a squall can form quickly. The 2-year to 10-year T-note spread has yet to invert (a fairly reliable harbinger of recessions historically), but it has continued to narrow. The VIX—a measure of stock market volatility—has picked up since early February as worries related to potential trade tariffs (which came after our Compass survey) have rattled the market. There is no shortage of other risks that could potentially flare up. As such, credit discipline has become all the more critical. “We’re always worried,” said David Brackett, Antares co-CEO. “People ask us what inning of the baseball game we are in. As a lender, we have to presume we’re in the bottom of the ninth.”

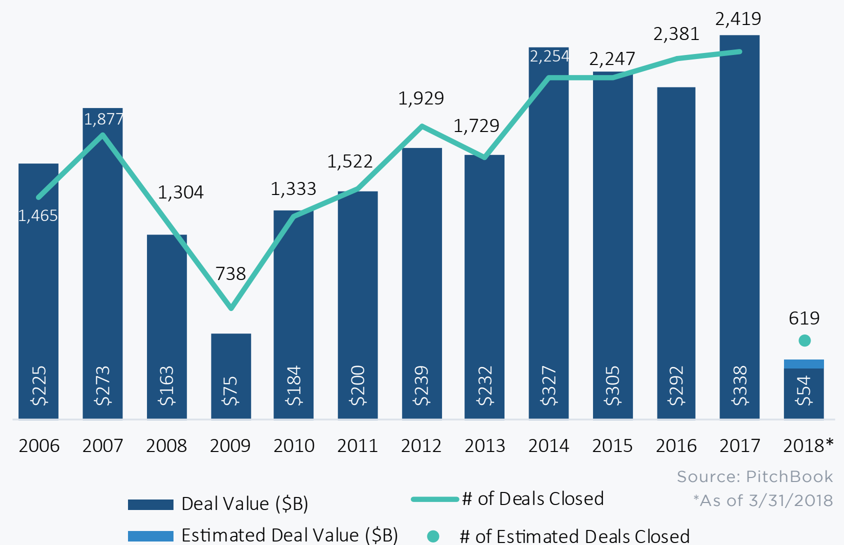
Antares Capital

With more than $20 billion of capital under management and administration, Antares Capital is a private debt credit manager and leading provider of financing solutions for middle-market PE-backed transactions. In 2017, Antares issued over $21 billion in financing commitments to borrowers through its robust suite of products including first-lien revolvers, term loans and delayed draw term loans, second-lien term loans, unitranche facilities and equity investments. Antares was the lead left arranger for approximately $17 billion of first-lien and second-lien credit facilities during 2017, and the company’s world-class capital markets experts hold relationships with over 400 banks and institutional investors allowing the firm to structure, distribute and trade syndicated loans on behalf of its customers. Since its founding in 1996, Antares has been recognized by industry organizations as a leading provider of middle-market private debt, most recently being named the 2017 Lender of the Year by ACG New York. The company maintains offices in Atlanta; Chicago; Los Angeles; New York; Norwalk, CT; and Toronto. Visit Antares at www.antares.com or follow the company on Twitter at www.twitter.com/antarescapital. Antares Capital is a subsidiary of Antares Holdings LP.

Overview

Transaction count rises while deal value falls

After a record-setting 2017 in terms of both deal value and transaction count, the US PE middle market got off to a mixed start in 1Q 2018. 619 middle-market transactions were completed, totaling $53.6 billion in deal value—a 17% increase and 40% decrease, respectively, compared to the prior year. With more deals but less capital invested, this signals a shift toward smaller transactions. The median MM deal size was $170.0 million in 1Q 2018, down from the $188.4 million recorded during the entirety of 2017, but still comfortably higher than any other year in the dataset. The smaller median deal size seems to be driven by a lack of upper-middle-market (UMM, defined as EV between $500 million and $1 billion) deals in 1Q 2018. Just 72 UMM deals were completed in 1Q, the lowest quarterly figure in two years.



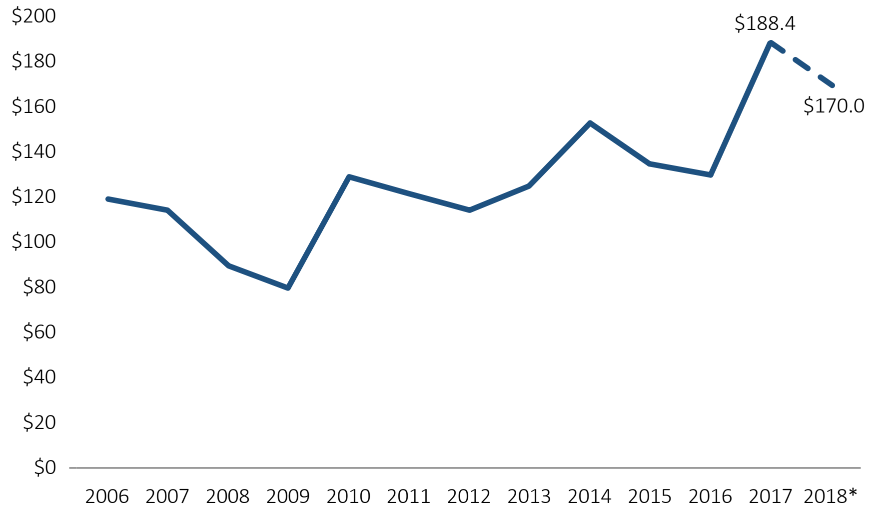
OVERVIEW

On a sector basis, B2C PE investments continue to wane, while IT and healthcare see growing interest from financial sponsors. In fact, 2017 was the first year in which there were more MM PE deals involving IT (427) than B2C (377), with 1Q seeing the same. PE investors are attracted to the recurring revenue models of many SaaS businesses, as well as the utility of add-ons in a fragmented industry such as healthcare. Conversely, traditional consumer-facing enterprises may not provide the top-line growth that firms are seeking.

Another trend taking place in PE over the last decade has been the increase in hold times of portfolio companies. Companies exited prior to the financial crisis had a median hold time of three to four years, consistent with the historical view of PE that GPs flipped in and out of companies quickly, using leverage and some financial engineering to produce speedy returns. That figure increased steadily to a peak of 5.8 years for companies exited in 2014, driven by the longer time needed to achieve expected returns at portfolio companies acquired just prior to the crash. Hold times have since stabilized around five years, a symptom of the increased emphasis on add-ons and operational improvements that have become commonplace in the industry.

Deal sizes fall, still higher than most years

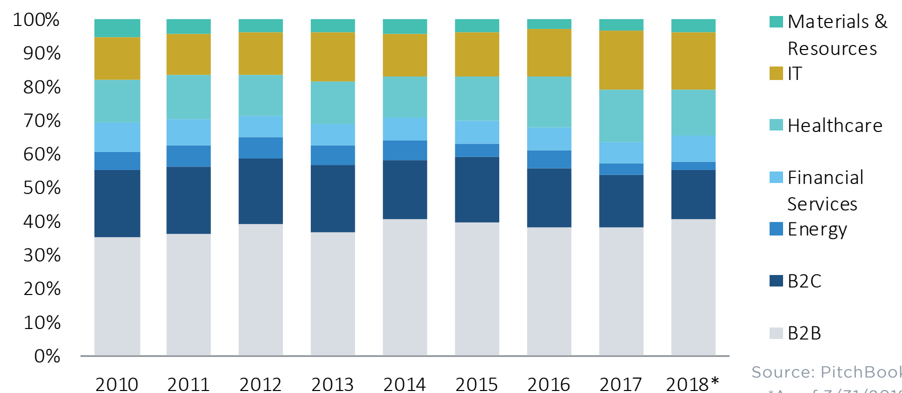
US PE MM median deal size ($M)



Source: PitchBook
*As of 3/31/2018

IT investment grows, while B2C activity falls

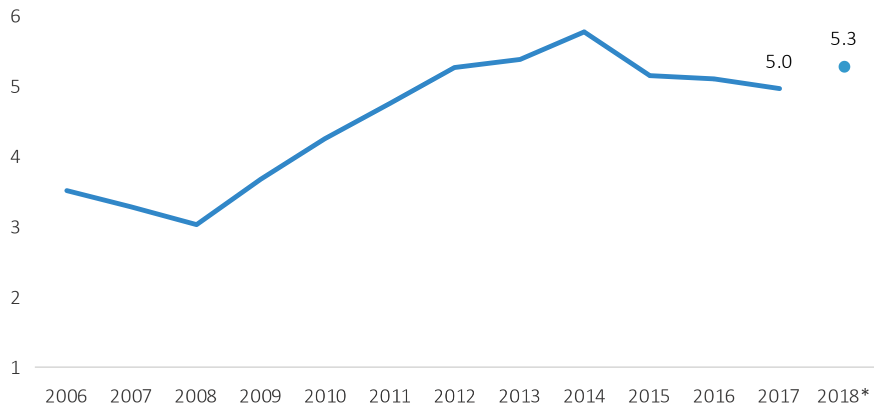
US PE MM deal flow (#) by sector



Source: PitchBook
*As of 3/31/2018

Hold periods stabilize around 5 years

US PE MM median hold period (years)



Source: PitchBook
*As of 3/31/2018

Spotlight

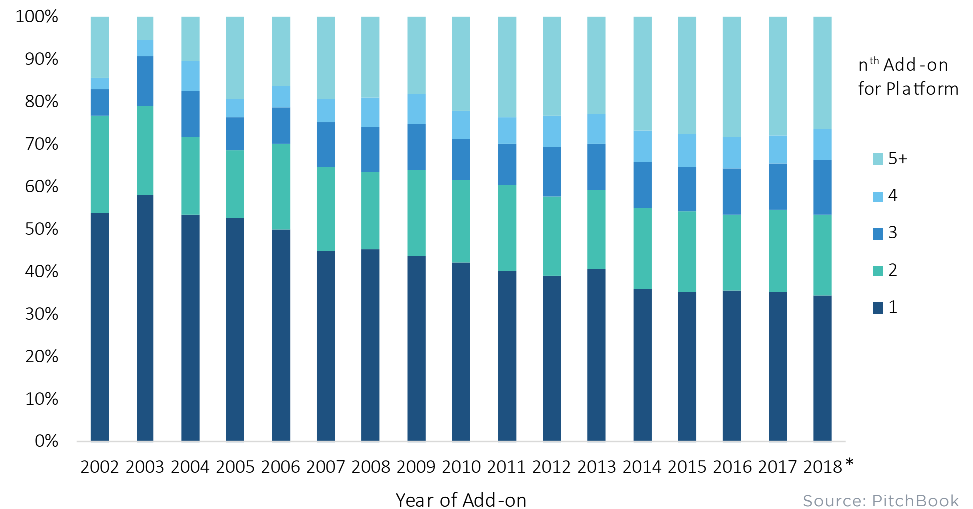
Add-ons' increasing popularity

Now representing more than half of all buyout activity, add-ons have become a ubiquitous facet of the PE industry. Indeed, add-ons represented the lion's share of transactions for each firm at the top of the 2017 Annual Global League Tables, and some PE firms even tout their prowess when it comes to executing add-ons. But while there has been much discussion about the headline level of add-on activity, little research has been done to understand how this fundamental change to the PE playbook is impacting the industry. In a recent analyst note, we found that nearly 30% of PE-backed companies now undertake at least one add-on acquisition, compared to less than 20% that did so in the early 2000s. At the same time, however, the median number of add-ons per platform has been relatively flat. To that end, it is a relatively small number of buyers that is propelling the add-on activity to unprecedented levels.

Another interesting development is that it is now takes about two years, on average, between a platform deal and an add-on, compared to fewer than 1.5 years prior to the financial crisis. Additionally, the buy-and-build deals predictably take longer to bring to fruition than standalone platform companies, given the time it takes to source, execute and integrate add-ons. To that end, we find that it typically takes about one year longer for platforms with add-ons to reach the exit.

Most completed add-ons are not the first for that platform

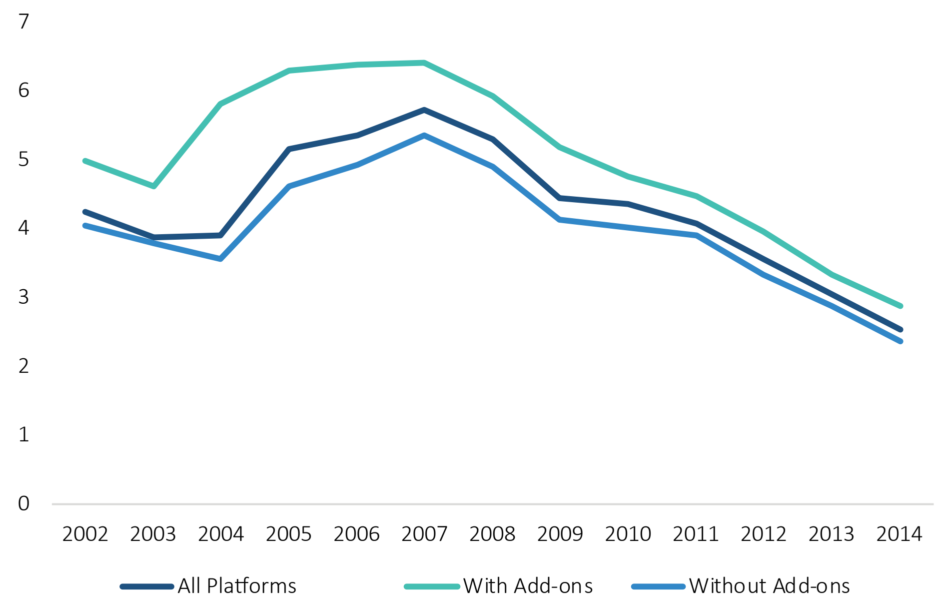
Global add-on deals (#) by sequence in platform lifecycle



Source: PitchBook
*As of 3/31/2018

PE platforms with add-ons take longer to exit

Global median time to exit (years)



Source: PitchBook
*As of 3/31/2018

What is Craftsmanship℠?

To be crafted is to meet exacting standards.

It's the human touch that combines art and science to create something unique.

We tend to think about craftsmanship in terms of physical things: fine wine, classic cars, custom furniture and iconic structures.

But what about the underwriting of insurance to craft protection for your unique and valuable things? And the service behind that coverage when you need it most – like claims and loss prevention?

For your business.

Your employees.

Your home.

The people you love.

Things that need a particular kind of protection and service.

The kind Chubb provides.

Not just coverage. Craftsmanship.℠

Not just insured.

Chubb. Insured.℠

chubb.com

CHUBB®

©2018 Chubb. Coverages underwritten by one or more subsidiary companies. Not all coverages available in all jurisdictions.
Chubb®, its logo, Not just coverage. Craftsmanship.℠ and Chubb. Insured.℠ are protected trademarks of Chubb.

Q&A: Antares Capital's David Brackett & John Martin

David Brackett

Dave is a managing partner and co-CEO of Antares Capital. He is a member of Antares' Investment Committee as well as Antares' Board of Directors.

Previously, Dave served as president and CEO for GE Antares. He was a founding partner when Antares was formed in 1996. Prior to starting Antares, Dave was a senior executive with Heller Financial.

He began his career at Continental Illinois National Bank. Dave graduated from the University of Denver, and earned an MBA from Northwestern University's Kellogg Graduate School of Management.

John Martin

John is a managing partner and co-CEO of Antares Capital. John is a member of Antares' Investment Committee as well as Antares' Board of Directors. He was a founding partner when Antares was formed in 1996.

Previously, John was the leader of GE's Global Capital Markets. He also served as president and CEO for GE Antares. Prior to forming Antares, John was a senior executive with Heller Financial.

He began his career with Continental Illinois National Bank. John earned his BBA in finance from the University of Notre Dame.

Amid an active yet pricey dealmaking environment for PE firms, what key trends in the lending market for US middle-market companies will be most impactful in 2018?

The capital markets for loans remain wide open for business with favorable pricing and terms. This is perhaps a mixed blessing for middle-market PE firms looking to do deals. On the positive side, favorable capital markets foster deal flow and allow PE firms to bid competitively against strategic competitors who are increasingly flush with cash. We are seeing increased repricing/refi activity, which had already boomed early last year in the broadly syndicated market, but has become more prevalent of late in the middle market. Meanwhile, terms continue to loosen and spreads to narrow. Of course, on the negative side, easy access to capital has also contributed to the rise in LBO purchase price multiples that are making it increasingly difficult for PE investors to hit their return targets. Consequently, PE firms have been increasingly turning to add-on acquisitions as a means of averaging down their purchase price multiples and/or increasing platform value creation opportunities.

While our working assumption is that capital market conditions will remain favorable, as history has demonstrated, the window can close quickly if markets get spooked for any number of reasons. This is why we, as a lender, feel it is critical to be able to offer our sponsor clients multiple financing solutions that allow for the best execution in any market condition whether that entails leveraging our deep capital markets distribution capabilities, private club deal networks or unitranche execution capabilities (e.g., Antares Bain Capital Complete Financing Solution (ABCS)).

One of the broader macro trends we've seen in PE dealmaking has been the popularity of secondary buyouts. With regard to helping finance these transactions, what's Antares' perspective on their benefits and challenges?

Sponsor-to-sponsor activity has picked up over the last few years, reflecting pressures to put dry powder to work on the buy side and desire for sponsors to exit aging investments on the sell side.

Sponsors have increasingly been fishing for deals in each other's portfolios because they know potentially promising companies will come up for sale in three or more years. This allows them to focus early due diligence efforts and potentially improve their bidding position when auction time comes—or perhaps even preempt the auction process. In fact, often sponsors that lost out in the initial auction may bid again the next time the company comes up for sale, having already done the initial due diligence and found the business attractive. We even see cases where the sponsor owned the company before and is buying it again.

PitchBook stats show over 50% of middle-market exit volume being secondary buyouts, which appears to be directionally in line with what we see. Also, a large proportion of our SBO volume is related to companies already in our portfolio, which underscores the competitive advantage that comes with having one of the largest sponsored middle-market loan portfolios in the industry.

From a lender perspective, while every deal is unique, as a generalization, SBOs are viewed favorably since the credit is usually seasoned and well-understood with a track record of revenue & EBITDA growth. However, one must scrutinize EBITDA add-backs and add-forwards in the context of the next sponsor owner's phase 2 or 3 of value creation, as much of the low-hanging fruit has likely already been picked by the original sponsor owner.

Recently, it appears that cov-lite incidence varies widely across different segments of the market. What trends in covenants are you seeing across the US middle market? What other important trends in structuring are you tracking?

Covenant-lite structures, which have traditionally been common in the large corporate/broadly syndicated loan market, have increasingly penetrated into the sponsored middle market, rising from 9% of sponsored middle-market issuance in 2016 to 26% in 2017 and to 37% in 4Q 2017. Traditionally cov-lite was rare for companies in the sub-$50 million EBITDA range, but now it is more common in the $40 million-$50 million zone.

While covenants are important to lenders to help mitigate potential losses, historically, lender success has been more reliant on picking solid credits than enforcing convenants. In our case, the vast majority of cov-lite deals we've done in the last year or so have been with portfolio companies whose credits we know well.

Of course, EBITDA add-backs and add-forwards and loosening of other terms (e.g., around restricted payments and incremental debt capacity) are other important areas of challenge for lenders in the current environment.

As Antares' most recent Compass Report details, leverage levels remain a significant area of concern for many. How are these concerns best mitigated in the current environment by firms such as Antares?

While leverage levels have crept upward on middle-market LBOs in terms of debt to EBITDA, they remain below broadly syndicated deal levels, particularly in the private/club deal market. Also, equity contributions to middle-market LBOs have risen meaningfully along with enterprise valuations. Finally, debt service measures remain favorable given low interest rates. Of course, if interest rates were to spike, that could change, but in general leverage levels do not seem unreasonably high. Also, there may well be exceptions where unrealistic EBITDA add-backs/add-forwards mask true debt leverage. The best way to mitigate the issue of rising debt leverage is credit discipline gleaned over decades of experience through various cycles. Its also critical to long-term performance to have solid work-out capabilities to mitigate losses whenever the downcycle does come—a capability many new lending entrants lack.

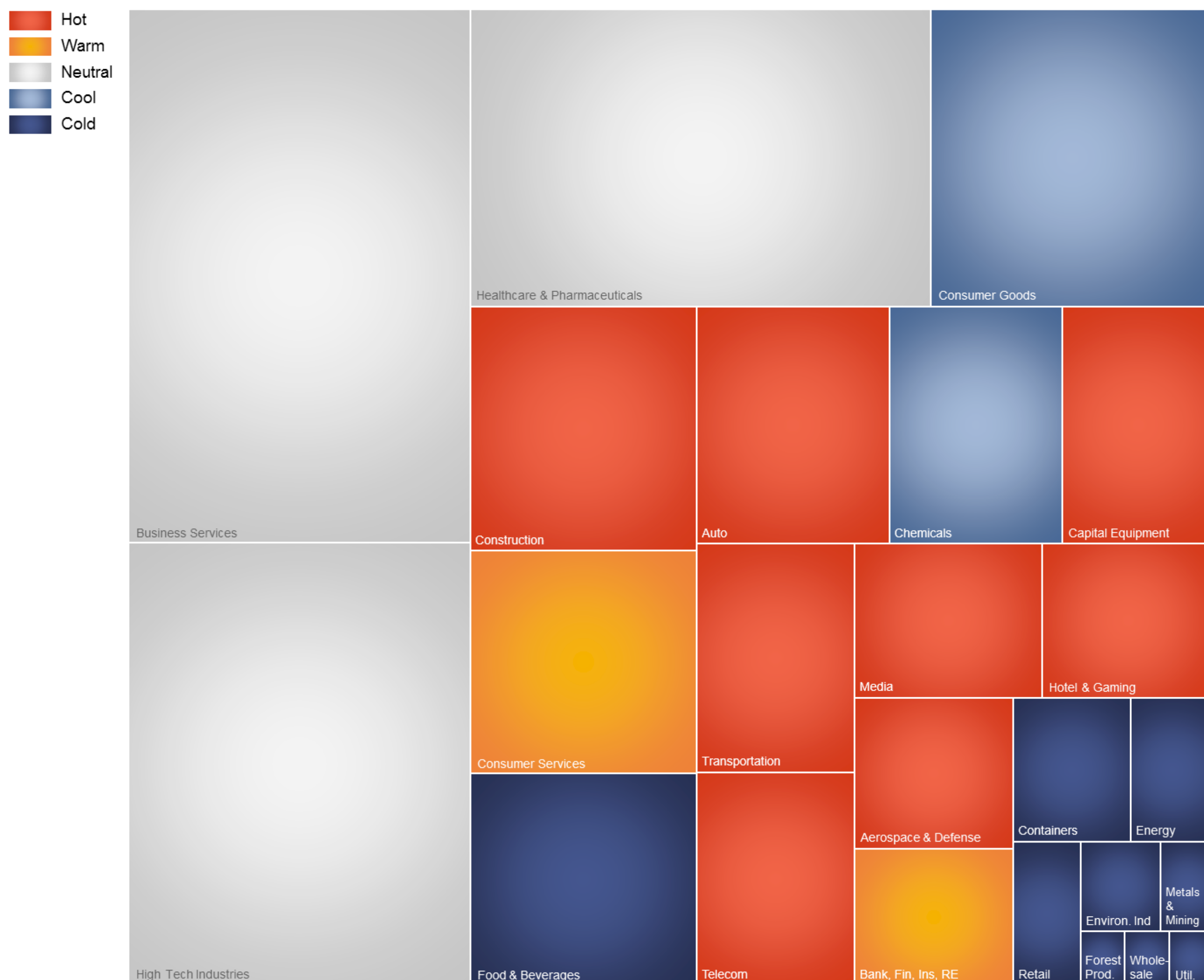
With regard to recent evolution in adjustments of earnings and other similar measures, how significantly are such changes affecting overall leverage levels?

EBITDA add-backs and add-forwards have become increasingly prevalent and can have a material impact on leverage measures. Some claim that regulated lenders have used such add-backs as a way to be able to get around leveraged lending guidelines (LLG). There are various firms (e.g., Covenant Review; Proskauer) that report on EBITDA adjustment measures. For example, in its 2017 report, Proskauer shows an upward migration in deals toward the high end of the cap range for run-rate synergies. Specifically, 85% of the deals it tracked in 2H 2017 had a cap on run-rate synergy expenses of between 20%-29.9% (the higher end of the cap range) versus 58% of deals in 1H 2017. Likewise, the cap on non-recurring expense has also been trending higher, as has been the percentage of deals with no cap.

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

M&A Heatmap: Antares Capital's M&A loan activity deal count by industry trend[1]

M&A activity cooled modestly the last four months through March 2018 versus the prior four months through November 2017, largely reflecting sluggish activity in January and February 2018; however, activity picked up sharply in March, and the open pipeline in April (not reflected in heatmap) is also up year over year, with high-tech industries (including software and services) heating up recently.



1: Compares Antares Capital's M&A-related funded and lost deal count in trailing four-month period ending March 31, 2018, versus four-month period ending November 30, 2017. Does not include open pipeline. Size of box is proportionate to deal count. Color indicates whether activity heated up or cooled down during periods compared to. Moody's-based industry categorization.

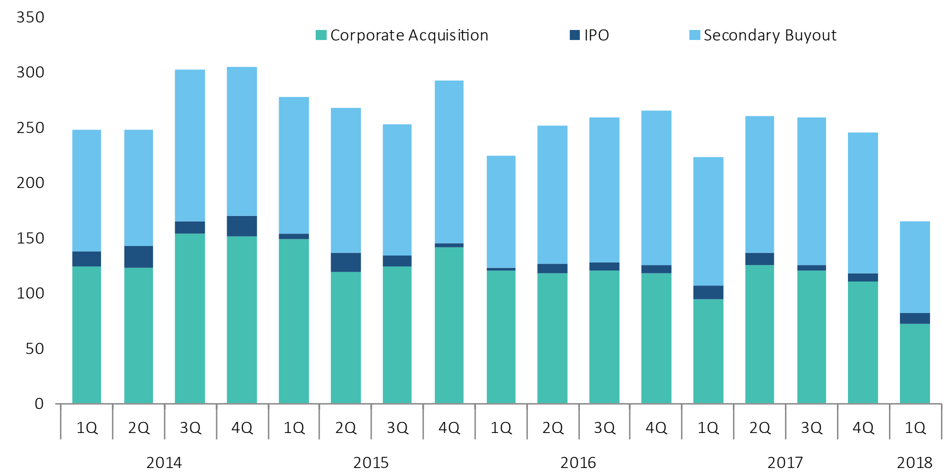
Exits

2018 off to a slow start

After totaling at least $20 billion each quarter for nearly two years, US PE middle-market exit value dipped to just $11.9 billion in 1Q 2018. In addition, just 165 exits were completed, representing a 26% falloff from the previous year. IPO activity was the one bright spot, as PE-backed IPOs followed the broader uptick in public offerings amidst public equity volatility early in the year. On a sector basis, exits have exhibited a pattern similar to deal flow; IT and healthcare now account for a larger proportion of PE-backed exits, while exits of B2C companies accounted for just 17% of exits in 1Q 2018, lower than any other year in the dataset.

Strong quarter for IPOs amid downturn in total exits

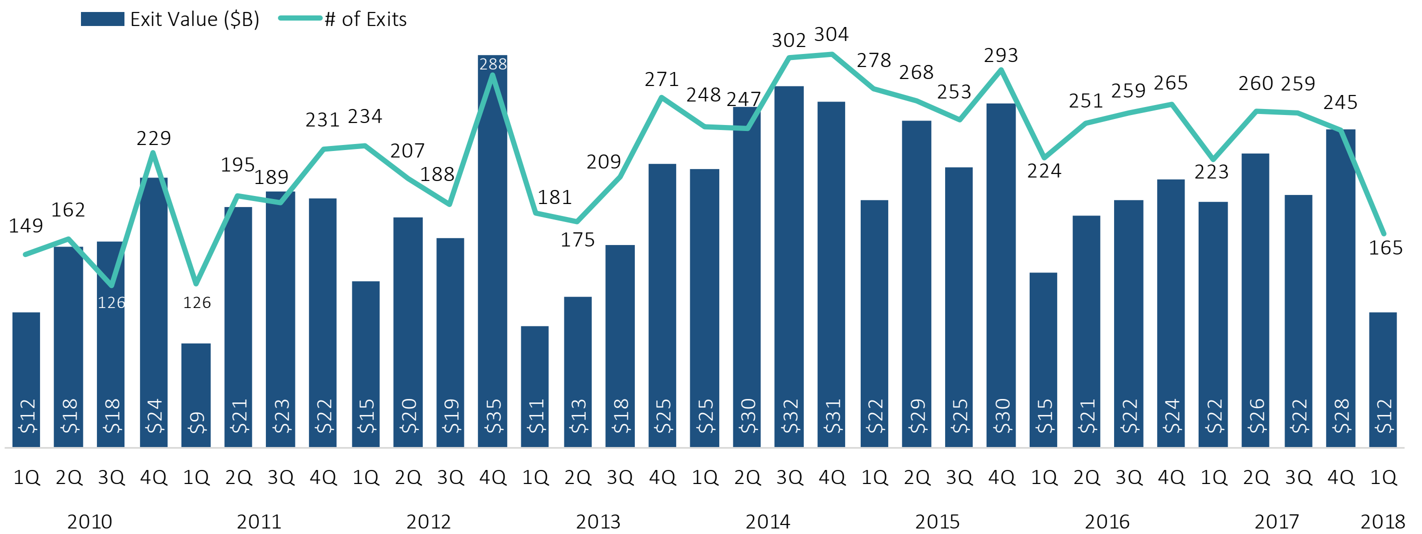
US PE-backed MM exits (#) by type



Source: PitchBook

Exit value expected to rebound later in the year

US PE-backed MM exits



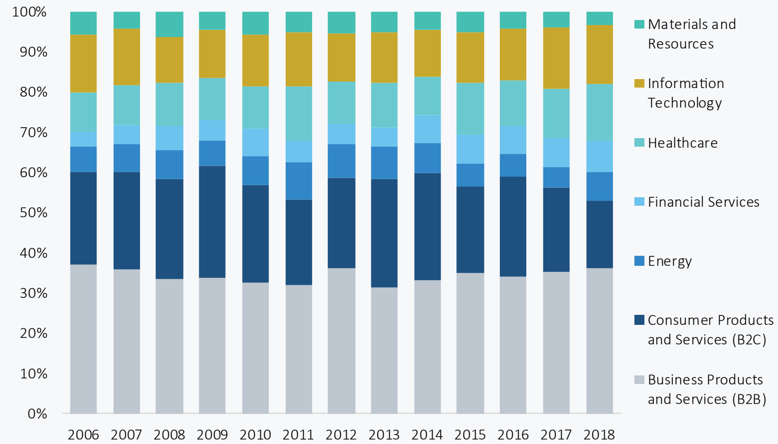
Source: PitchBook

EXITS

About one-half of MM exits came via secondary buyout in 2016 and 2017, a trend that remains unchanged in the first quarter of this year. SBOs have become more prominent due in part to the growing heft of the buyout industry. Financial sponsors are seeking liquidity for aging portfolio companies, while investors armed with ample dry powder search for target businesses that fit the PE mold. Increasingly, GPs are dealing with other institutional sponsors across the negotiating table. LPs contend there is little value-add in buying companies that have already undergone the PE regimen, but GPs counter they have specific expertise across geographies, technologies or customer segments that allow them to continue making improvements.

IT & healthcare exits see growth in transaction count

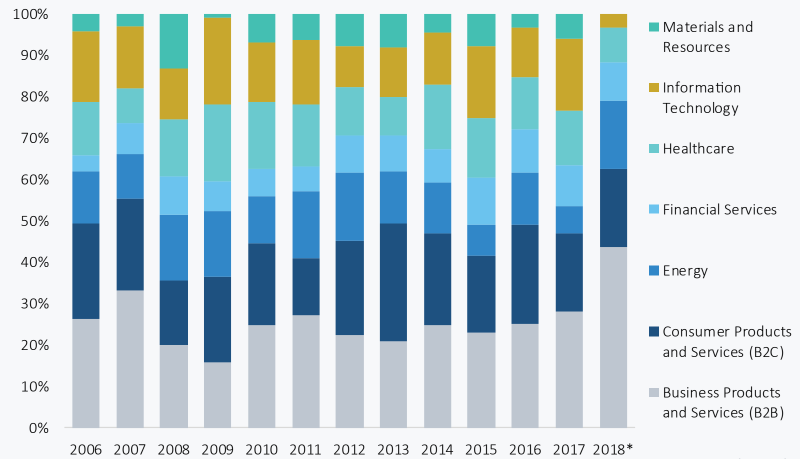
US PE-backed MM exits (#) by sector



Source: PitchBook
*As of 3/31/2018

B2B exit value surges in 1Q

US PE-backed MM exits ($) by sector



Source: PitchBook
*As of 3/31/2018

Chubb

Adaptation required

Successful cyberattacks are expected to increase in the future

PE dealmakers confront significant issues over the cyber exposures of a target acquisition. Last year was the worst on record for cyberattacks, with nearly half of all businesses held captive by ransomware incidents alone, according to a survey by Osterman Research.[1]

Companies of all sizes have experienced data breaches, from the largest enterprises to Main Street businesses. The categories of cyberattacks are also multiplying, as are the types of attackers, which include hacktivists, criminal enterprises and even possibly nation-states.

Of notable concern, successful cyberattacks are expected to increase in the future. Attackers are proving to be more sophisticated in their use of social engineering techniques, cleverly inventing new phishing scams that lure people to click on malware-infected attachments. Many companies are also rapidly embracing new technologies that broaden their exposure, including machine learning, augmented intelligence, natural language processing, big data analytics, robotics and the Internet of Things. A forensic analysis of a target acquisition's cyber risks that was performed during due diligence may no longer provide a credible assessment of the company's exposure after the deal closes.

Even as the ink on the transaction agreement dries, the merged entity's cyber exposures generally increase. As the two organizations begin the process of combining networks and multiple systems, their respective data at specific intersection points are vulnerable to an attack. The reason is the need to temporarily remove the filters at the intersection points to permit data to flow from one system to another.

Other factors can also contribute to the combined entity's enhanced cyber risk profile. Each party's cybersecurity protocols may be dissimilar, and they will need time to determine which practices will remain in place, potentially leaving the combined organization exposed to security gaps in the interim. Phishing-related data breaches post-merger also tend to rise because each company's employees are unsure over the authenticity of emails or other communications they receive. Cyber criminals are very cognizant of these post-transaction vulnerabilities.

The growing concern over cybersecurity is compelling investment managers to conduct more thorough due diligence of a potential acquisition's cyber risks to gauge the impact on post-transaction value.

Even the best due diligence may not uncover the full extent of a target acquisition's cyber risks, given the rapid growth in the number and types of sophisticated cyberattacks. One way to mitigate such risks is to seek cyber insurance from insurers that specialize in M&A transactions. These insurers typically provide a range of different cyber insurance policies to absorb a broad array of cyber risks, in addition to multiline cyber peril endorsements that address gaps in an insurance portfolio placed with multiple brokers and carriers.

Some insurers also offer a variety of valuable loss control services as part of their insurance programs. These services may include comprehensive cyber risk assessments, continuous detailed threat intelligence and analysis, and post-incident forensic and crisis management assistance. Thus, the right cyber coverage along with associated risk management services can help identify and mitigate this evolving risk.

For more information about middle-market PE, contact Ryan France at rfrance@chubb.com. For the full whitepaper, click here.

1: Osterman Research, Understanding the Depth of the Global Ransomware Problem, August 2016

CHUBB®

Chubb is the marketing name used to refer to subsidiaries of Chubb Limited providing insurance and related services. For a list of these subsidiaries, please visit www.chubb.com. Insurance is provided by US-based Chubb underwriting companies. All products may not be available in all states. Coverage is subject to the language of the policies as actually issued. Surplus lines insurance is sold only through licensed surplus lines producers. This information is advisory in nature and is for informational purposes only. No warranties or representations of any kind are made to any party and no liability is assumed by reason of the information in this presentation. The information provided should not be relied upon as legal advice. For such advice, a listener or reader should consult their own legal counsel. This presentation is copyrighted and is the property of Chubb. Any use of this presentation without Chubb's prior, written consent is prohibited.

Fundraising

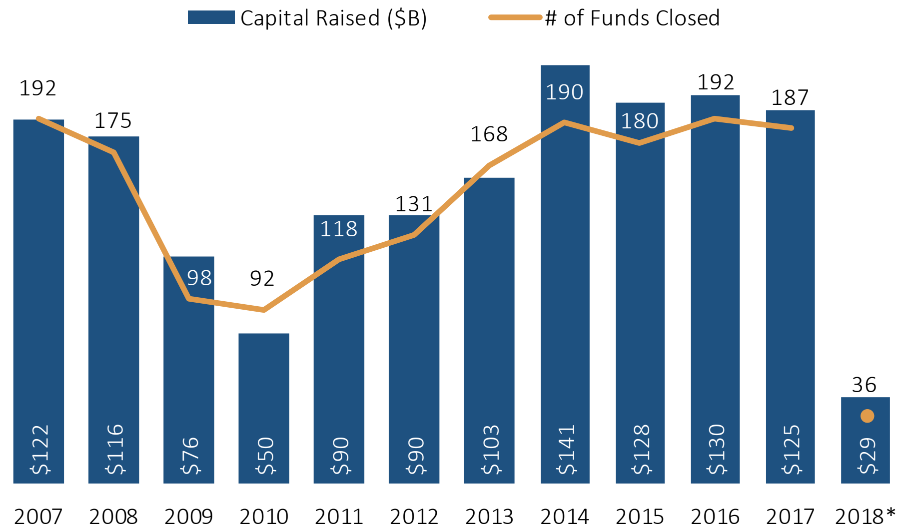
Poised to match prior years

US MM fundraising activity has hovered at elevated levels in recent years, and 2018 is shaping up for more of the same. PE firms closed on $29 billion across 36 funds in 1Q 2018. While this is in line with recent MM trends, fundraising for mega-sized vehicles of $5 billion or more hit a speed bump early in the year. As a result, 79% of the capital raised in 1Q came via MM funds, up from just 52% in 2017; however, we expect to see mean reversion in the coming quarters, with Blackstone, Oaktree and Carlyle amongst the firms actively raising sizable vehicles that appear primed to close later this year.

At the other end of the spectrum, fundraising diminished for funds in the $100 million-$250 million bucket, with just nine such funds closed in 1Q. First-time fundraising, which had shown signs of life recently, was also lackluster. But while only two first-time MM funds were raised during the quarter, they were notable for their size. Brightstar Capital Partners took in $710 million for its inaugural vehicle, while LightBay Capital soared past its initial target of $450 million to hold a final close on $615 million. One common characteristic of these teams—and many of those raising first-time funds—is the experience that they bring. The founding partners of LightBay worked together at Ares for 15 years, while the team at Brightstar boasts decades of combined experience at firms Lindsay Goldberg, Fifth Street and Goldman Sachs.

2018 fundraising off to a strong start

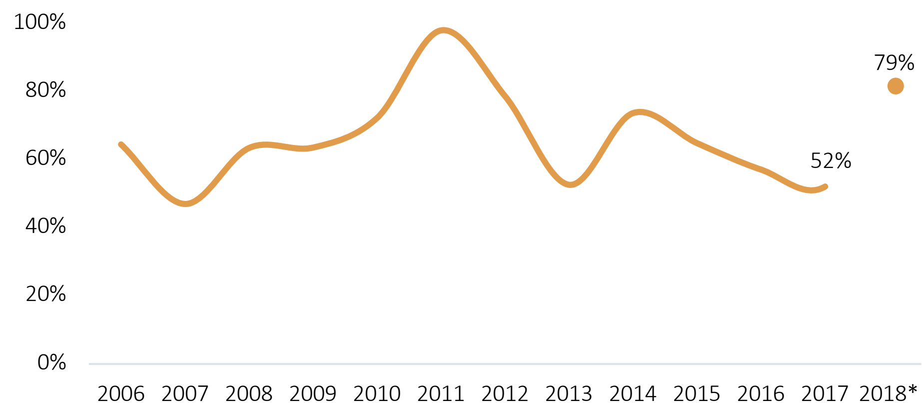
US PE MM fundraising



Source: PitchBook
*As of 3/31/2018

MM funds account for majority of capital raised in 1Q

US PE MM fundraising as a proportion of total ($)



Source: PitchBook
*As of 3/31/2018

1Q 2018 US PE Middle-Market Lending League Tables

Most active lenders by deal count

Lender	Deal count
Antares Capital	25
NXT Capital	22
Madison Capital Funding	22
NewStar Financial	15
Twin Brook Capital Partners	14
Bank of Ireland	13
Crescent Direct Lending	10
Churchill Asset Management	10
MidCap Financial	9
BMO Financial Group	9
Golub Capital	8
Capital One	8
Jefferies Group	8
Byline Sponsor Finance Group	7
Ares	7
Maranon Capital	6
SunTrust Banks	6
Guggenheim Partners	5
PNC	5
BBVA Bank	5
Credit Suisse	5
The Goldman Sachs Group	5
Barings	5

Source: PitchBook

COPYRIGHT © 2018 by PitchBook Data, Inc. All rights reserved. No part of this publication may be reproduced in any form or by any means—graphic, electronic, or mechanical, including photocopying, recording, taping, and information storage and retrieval systems—without the express written permission of PitchBook Data, Inc. Contents are based on information from sources believed to be reliable, but accuracy and completeness cannot be guaranteed. Nothing herein should be construed as any past, current or future recommendation to buy or sell any security or an offer to sell, or a solicitation of an offer to buy any security. This material does not purport to contain all of the information that a prospective investor may wish to consider and is not to be relied upon as such or used in substitution for the exercise of independent judgment.