PitchBook

Sponsored by

Antares Capital

US PE Middle Market

2Q 2018

Consistency is business as usual.

Predictable outcomes. Certainty of execution. Market leadership. Through 20+ years and changing market cycles, being consistent is how we do business.

Antares.com

Antares Capital

PitchBook

Sponsored by Antares Capital

Contents

Key takeaways	3
A note from Antares Capital	4
Overview	5-6
Spotlight: Tax reform	7
Antares Capital: Q&A	8-9
Exits	10-11
Fundraising	12-13
2Q 2018 US PE Middle-Market Lender League Tables	14

Credits & Contact

PitchBook Data, Inc.

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

Content

Wylie Fernyhough Analyst, PE
Darren Klees Data Analyst

Contact PitchBook

Research
reports@pitchbook.com

Editorial
editorial@pitchbook.com

Sales
sales@pitchbook.com

Cover design by Caroline Suttie

Click here for PitchBook's report methodologies.

Key takeaways from the analysts

- The dealmaking environment remains healthy. 654 US middle-market PE transactions closed in 2Q with a total value of $87.6 billion, 7.0% and 3.6% decreases over 1Q, respectively. The MM has seen robust activity, accounting for 68% of US PE-backed deals, compared to 58% in full-year 2017.
- The initial public offering (IPO) market stayed hot in 2Q. However, this represented only 2.9% of exit value in the quarter, compared to 3.5% in 1Q. Secondary buyouts (SBOs) continue to proliferate, accounting for 51% of all US MM PE-backed exits, marking their second straight year above 50%.
- Fundraising activity continues to skew toward larger funds. General partners (GPs) held a final close on 73 MM funds raising $61.4 billion in the first half of 2018, representing decreases of 4% and 30%, respectively, from 1H 2017. The average MM fund size came in at $841 million, a 26% increase over the $669 million average totaled in full-year 2017.

$87.6B
in deal value across 654 MM PE transactions in 2Q 2018

$14.8B
in exit value from 183 PE-backed MM sales in 2Q 2018

$32.4B
raised between 35 MM funds in 2Q 2018

Antares Capital

Optimism mixed with growing caution

US economic expansion/company earnings picking up steam

Prospects continue to look good for the US economy, with GDP growth forecast to have accelerated to perhaps 4%+ in 2Q 2018, vindicating the heightened optimism voiced in our "dealmaker" survey in late April. Earnings growth (even pretax) has likewise accelerated, with trailing twelve-month (TTM) EBITDA across the Antares portfolio of 400+ companies up 10.2% at the end of 2Q 2018 versus 8.4% at the end of in 2Q 2017 and 8.5% at year end 2017.[1,2] "We're seeing very strong company performance and a tremendous amount of capital available, whether it be debt or equity," according to Dave Brackett, Antares managing partner and co-CEO. "As a result, we're seeing more companies coming to market."

Loan market activity pacing record levels

Leveraged loan issuance was up 8% YoY in 2Q 2018 to just below previous record levels in 1Q 2017. Earlier in the year, repricing and refinancing activity was driving loan volume. More recently, there has been a meaningful pickup in M&A activity, with high LBO volume and a strengthened pipeline suggesting that 2018 is about on pace to match 2017's post-financial crisis record high. The increase in new-issue volume has, for the most part, been readily absorbed by the market in the context of booming collateralized loan obligation (CLO) issuance and robust inflows into retail funds. That said, a recent spike in new issue activity was greeted with some pushback, causing some deals to see terms tighten and spreads flex wider. Looking forward, in its 3Q 2018 Lender Outlook Survey, Thomson Reuters indicates that 83% of lenders expect sponsored, MM, "new money" loan volume to range from flat to up in 2018 versus 2017.

Trade war could end record expansion

While positive economic momentum continues, the concerns about potential trade-war-related headwinds evident in our April survey appear to have also intensified. Steel and aluminum tariffs have been enacted, and there is concern that the scope of tariffs, both in terms of products and countries, will be broadened. In the EU, recent political turbulence in the UK, Germany, Spain and Italy has amplified headwinds already exacerbated by escalating trade tensions, further affecting dealmakers' confidence.

The current US economic expansion just celebrated its ninth birthday and appears to be about one year away from surpassing the 1990s expansion as the longest period of uninterrupted growth in US history. According to the Wall Street Journal recession probability index, as of June 2018, the odds of recession during the next 12 months remain a low 16%—the same low reading as in June 2017. Most economists don't expect a recession to arrive until 2020 or 2021.

Nevertheless, while odds are the expansion continues, the hour is late, and as a lender it's important to remain vigilant.

1: EBITDA generally PF'd for acquisition and divestitures activity. Timing and/or complexity of financial statements may cause exceptions, impacting reflected YoY numbers.
2: We excluded new borrowers where PF financials for trailing 24 months were not available.

Antares Capital

With more than $20 billion of capital under management and administration, Antares is a private debt credit manager and leading provider of financing solutions for middle-market private equity-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, 2nd lien term loans, unitranche facilities and equity investments. Antares 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., collectively ("Antares").

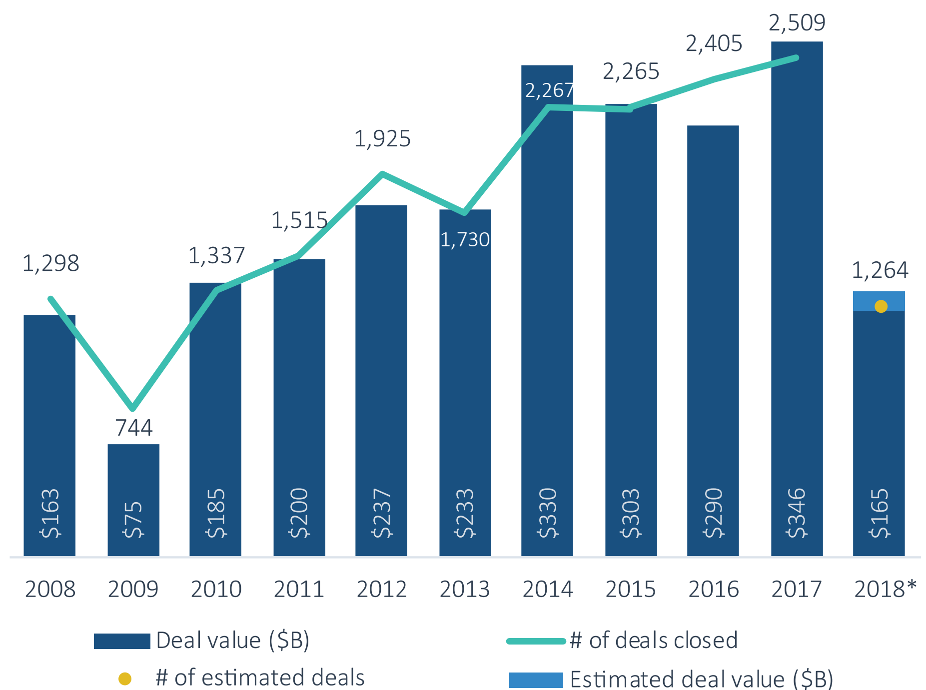
Overview

2018 has enjoyed an even better first half of the year than 2017, which set records in terms of deal value and transaction count. Through the first half of 2018, PE firms invested in 1,357 MM deals worth a combined $178.5 billion—increases of 16% and 5%, respectively, over the first half of 2017. As the PE industry continues to grow and attract more capital, the number of PE-backed MM companies has continued to swell. The maturation of the industry can also be seen in the growth of total capital investment, which has eclipsed $300 billion in three out of the past four years and is on pace to do so in 2018. This compares with the 2007 figure of $273.1 billion, which represented the peak in MM dealmaking prior to the global financial crisis.

The MM has accounted for nearly 70% of all capital invested in PE year-to-date. However, with many multibillion-dollar deals announced but not yet closed, we expect to see the MM decrease as

Strong quarter puts deal activity on pace to match last year's record figures

US PE MM deal flow



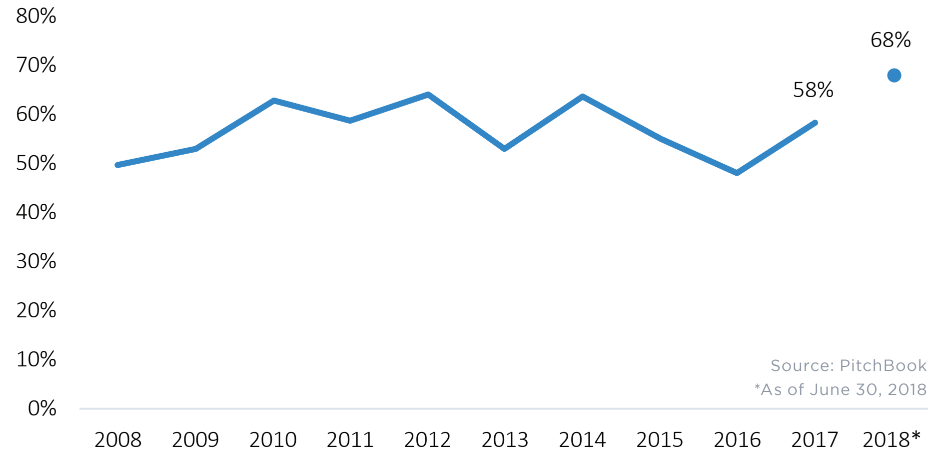
Source: PitchBook
*As of June 30, 2018

a percentage of PE deals through the back half of 2018. Many of the trends observed in the broader PE industry are happening within the MM as well. Funds, deals and exits are all increasing in size while purchase-price multiples remain elevated. We expect the trend of increasing PE deal sizes to continue and that the MM will represent a larger portion of total PE deal flow because proportionally fewer sub-middle-market deals (deal sizes below $25 million) are completed.

The median MM buyout size rose to $177.5 million in 1H, a slight increase over the $182.5 million median for full-year 2017. A first glance at the data may lead to questions about how that is possible given there were fewer upper-middle-market (UMM) deals as a proportion of total MM deals in 1H. The answer is an underlying shift toward larger deals in the core middle market (CMM), which accounted for 47% of all MM deals so far. The year-to-date median CMM deal size was $245.0 million, a 18% increase over the $207.6 million seen in full-year 2017.

MM activity increases to highest proportion of PE deal flow in more than a decade

US PE MM deal value as proportion of all US PE

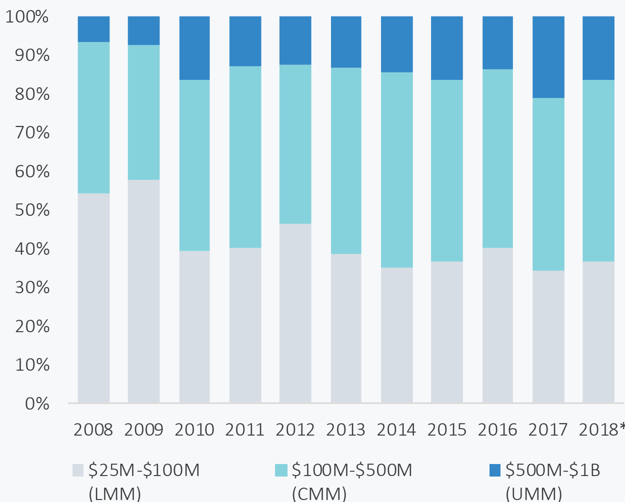


Source: PitchBook
*As of June 30, 2018

Today's lower-growth environment has pushed companies to turn to inorganic growth, and those that are able to successfully undertake the strategy can reap outsized benefits. Large platform companies scour the MM for add-on acquisitions because MM companies are large enough to move the needle, yet small enough to be digestible and potentially fly under competitors' radars. To date, add-ons have accounted for 53% of MM deals. A recent example of the buy-and-build strategy is Laborie Medical Technologies' $214.0 million take-private add-on acquisition of Cogentix Medical, their 10th add-on since 2013. This also showcases the growing size of MM add-ons, which have a median size of $172.5 million.

CMM sees higher activity

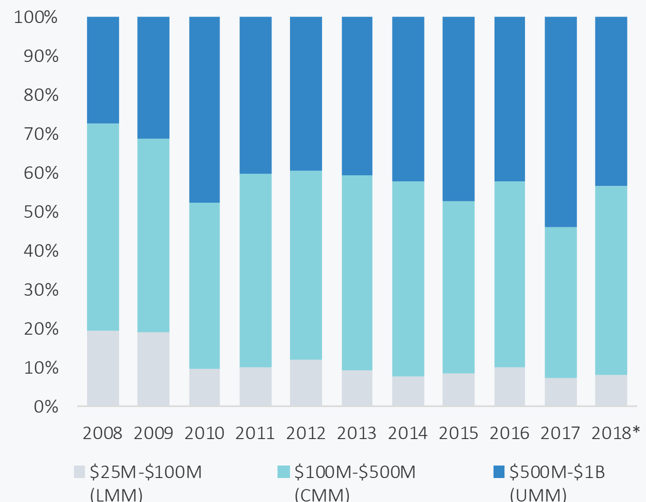
US PE MM deal flow (#) by size



Source: PitchBook
*As of June 30, 2018

CMM accounts for nearly half of all deal value

US PE MM deal flow ($) by size



Source: PitchBook
*As of June 30, 2018

Sponsored by Antares Capital

Spotlight: Tax reform

The Tax Cuts and Jobs Act (TCJA) of 2017 was the largest overhaul of the US tax code in decades. While the drop in the headline tax rate was the most notable change in the bill, PE portfolio companies will also feel widespread and disparate effects from the less-discussed changes: capital expenditure (capex) deductions and interest deductibility.

Companies can now realize bonus depreciation up to 100% of capex purchases, including used equipment acquired via asset deals, whereas the prior law allowed bonus depreciation up to 50% only on new equipment. The change is designed to incentivize companies to spend on capital equipment and realize tax savings sooner. However, beginning in 2023, the bonus depreciation drops to 80% of purchase cost and then declines by 20 percentage points each subsequent year before eventually falling to zero in 2028.

The new rules limit interest deductions to 30% of EBITDA; the deduction is further lowered to 30% of EBIT in 2022. Under the prior tax law, companies could deduct interest income up to 100% of their taxable income. For PE, which uses heavy debt loads for leveraged buyouts (LBOs) and recaps, this change is likely the largest negative from the tax plan. Previously, many highly levered companies avoided paying taxes altogether. Now these same companies could end up paying more taxes under the new bill. According to our analysis, a company's breakeven point in net taxes occurs at approximately 6x-7x leverage (though it may vary depending on the interest paid on the debt).

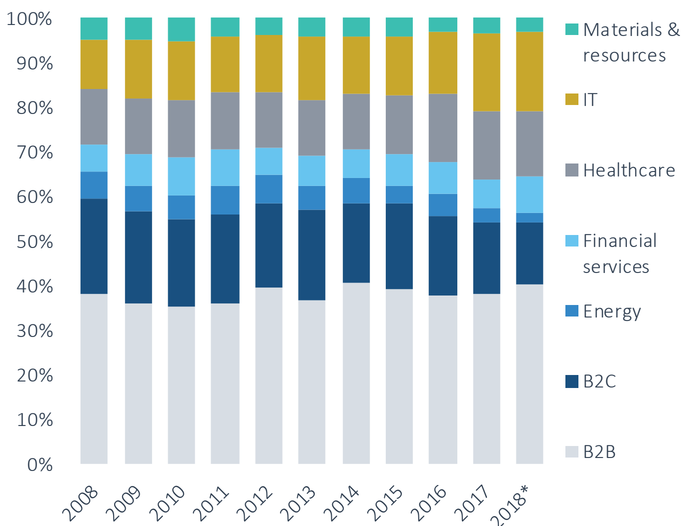
The materials & resources and energy sectors will be affected most by these tax changes because they typically are the most levered sectors, have the highest capex expenses, and have the highest average depreciation and amortization charges. The decrease in interest deductibility from 30% of EBITDA to 30% of EBIT will be especially painful, causing many of these companies to see their allowable interest deduction drop by half or more.

In recent years, these sectors have fallen out of favor with PE, and 2018 has seen materials & resources and energy make up the lowest proportion of deals in the past decade, compared to full-year figures. Going forward, tax reform's combined negative impacts from eventually decreasing capex bonus depreciation and limiting interest deductions will negatively pressure deal activity and prices in the materials & resources and energy sectors, providing an additional headwind to the sluggish dealmaking environment of the past few years.

A more detailed analysis of the TCJA's impact on PE is available in a recent PitchBook analyst note.

Materials & resources and energy account for the lowest proportion of deals in the past decade

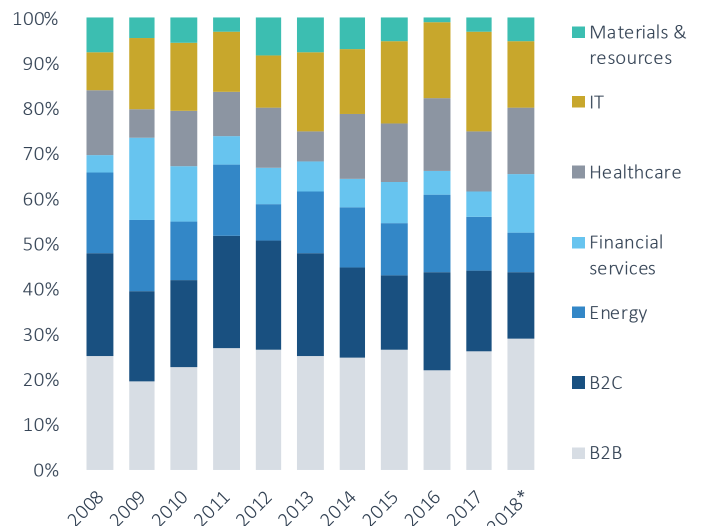
US PE MM deal flow (#) by sector



Source: PitchBook
*As of June 30, 2018

Relative slide in energy capital investment continues while financial services sees uptick

US PE MM deal flow ($) by sector



Source: PitchBook
*As of June 30, 2018

Antares Q&A: Lending in the US middle market

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.

Let's go more in-depth on current tensions within the market. Per the Antares Capital survey, it was intriguing to note the disparity between the pessimism of lenders and PE sponsors or borrowers. What do you think drove that divergence?

It may just reflect a difference in perspective that perhaps tends to get accentuated late in cycle. Lenders are largely in the business of worrying about what can go wrong, while equity investors are in the business of dreaming about what can go right. Equity investors tend to participate directly in the earnings upside from strengthening GDP growth and easy access to loans with ever looser terms. Lenders like to see strong earnings growth, too, but only insofar as it mitigates risk (and perhaps leads to more deal flow). Lenders don't participate in the upside from earnings growth. Also, more favorable loan terms for PE borrowers (e.g. lower spreads and looser terms) are generally less favorable from a lender's perspective, particularly late in cycle.

Has any further clarity emerged around the potential impact of ongoing trade tensions, especially considering the recent announcements by the administration and talk of retaliation by major trading partners?

Most of our MM borrowers are service-oriented and US-customer-centric, so the direct fallout of trade tariffs on our

> *Lenders are largely in the business of worrying about what can go wrong, while equity investors are in the business of dreaming about what can go right.*

portfolio has been limited. However, it's clearly a developing situation and the worry is that trade conflict escalates to a level where the impact becomes much more widespread and macroeconomic in nature. Obviously, if the worst comes to pass, the impact on the world economy could be significantly detrimental. Arguments have been made (hopefully rhetorically) that we can win a trade war—but there are no winners in a trade war unless one defines "winning" as perhaps not being hurt quite as badly as the other side.

It's important to heavily scrutinize EBITDA add backs and add forwards in the current environment.

What are best practices for lenders from a portfolio management perspective in the current environment?

Obviously, understanding the potential impact of tariffs for certain industries comes to mind given recent developments. However, more broadly, it's important to heavily scrutinize EBITDA add backs and add forwards in the current environment. This is particularly true in SBOs where the low-hanging fruit has likely been picked by the previous sponsor(s). As a lender, it's also important to be selective and maintain discipline around where and how far to stretch to compete on terms and pricing. Seeing virtually all the deal flow in our space is important to allow for selectivity—a key benefit of a sizable originations team with deep sponsor relationships built over 20+ years in the business.

We've spoken for some time now of the influx of new entrants as well as the incidence of potential new strategies formed around senior and/or distressed opportunities. What's your take on the best opportunities in the current market?

We continue to favor our core market of senior loans issued to well-managed companies with EBITDA in the $10 million to $125 million range that are backed by seasoned PE sponsors we know well. Clearly, it is important to be selective in the current environment in view of aggressive behavior by relatively new entrants. Whenever the next downturn comes, we believe we will be well-positioned to capitalize on opportunities to acquire loans at "stressed" pricing from undercapitalized lenders. In the meantime, having one of the largest portfolios of US-sponsored MM companies in the space is a critical advantage, with over 70% of our deal count coming from existing platforms in our portfolio over the TTM ending on June 30, 2018.

Whenever the next downturn comes, we believe we will be well-positioned to capitalize on opportunities to acquire loans at "stressed" pricing from undercapitalized lenders.

Have you observed any material shift in typical structures, terms or the like in response to the latest market conditions or in response to the types of borrowers lately coming to Antares?

Yes. We saw a surge in the supply of loan issuance leading up to the July 4th holiday with the number of deals in our open pipeline up over 20% YoY as of July 1st. This allowed loan buyers to be a bit more disciplined and selective. As a result, in some cases, spreads were flexed wider and terms tightened for deals to clear. Whether this marks a sustained shift in the market or is more of a temporary occurrence has yet to be determined. However, looking forward, we expect supply to wane during the traditional August slowdown. This should help augment market liquidity in advance of what we expect will be a busy market post-Labor Day.

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.

PitchBook

Sponsored by Antares Capital

Exits

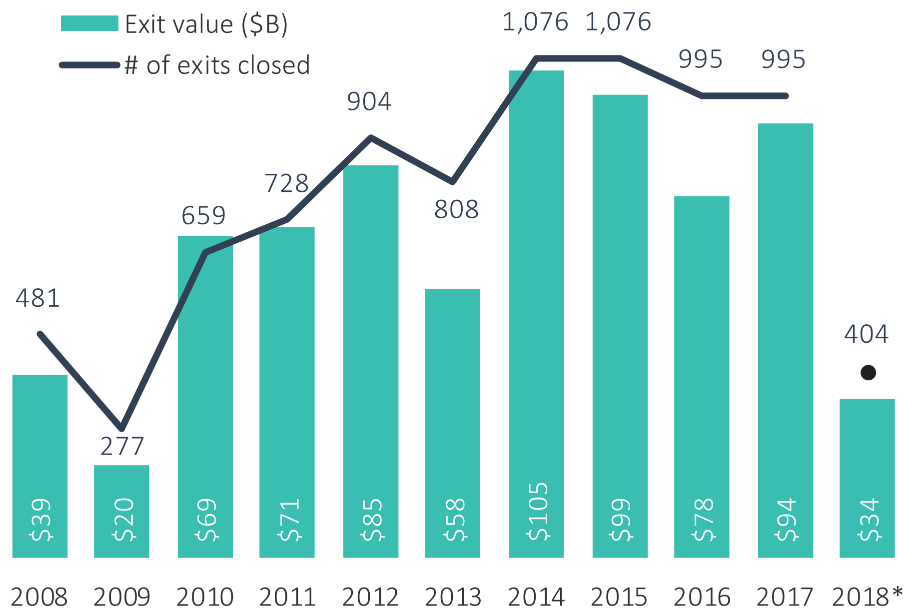
After exits got off to a slow first quarter, activity picked up in 2Q with 183 exits worth $14.8 billion. This has led 1H figures to total 393 exits worth $29.2 billion, compared with 476 totaling $43.7 billion in 1H 2017.

2018's hot IPO market has not led to a surge in PE-backed MM exits. The market conditions have caused a proliferation of multibillion-dollar PE-backed IPOs, though these exits sit firmly above the MM cutoff. As competition for deals between PE firms and corporate acquirers within the MM has increased, IPOs look less attractive—even with the currently hot IPO market. This is because IPOs are relatively expensive and take more time to complete than a sale to a corporate acquirer or another PE firm. Furthermore, IPOs often leave the PE firm still holding a stake in the investment, as opposed to the complete liquidity provided via a sale. As a result, PE-backed MM IPOs, such as Bernhard Capital Partners' exit of Charah, an environmental management and services company, are becoming more of a rarity.

While taking portfolio companies public has lost some favor with PE firms, SBOs and corporate acquisitions are gaining ground. In fact, SBOs and corporate acquisitions have accounted for 51% and 47%, respectively, of MM exit volumn to date. The proliferation of SBOs, which have long been scrutinized, has continued because PE firms are growing increasingly confident in utilizing additional value-extracting levers to ensure SBOs pencil out in ways they may not have just a decade ago. There are also more PE firms in existence today with record levels of capital, leading to an increase in potential buyers for every transaction.

Exit activity in 2018 on pace to exceed the 10-year average

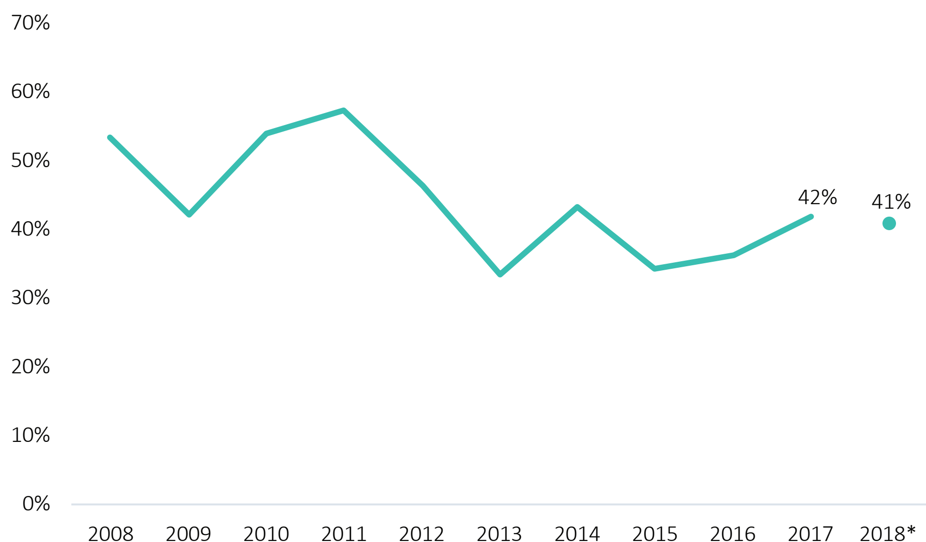
US MM PE-backed exits



Source: PitchBook
*As of June 30, 2018

As portfolio companies trend larger, MM continues to account for a smaller proportion of exit value

US MM PE-backed exits as a proportion of all US PE-backed exits ($)



Source: PitchBook
*As of June 30, 2018

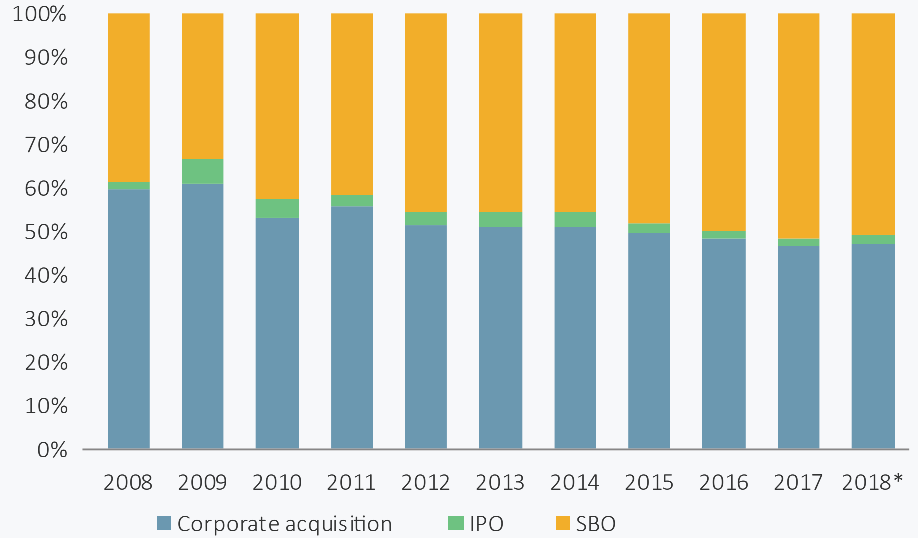
Corporate acquirers, for their part, are flush with cash following a near-decade-long recovery and a boon from tax reform; they are turning to M&A as a means of putting capital to work and to drive top-line expansion in this lower-growth environment. Many corporate acquirers have shown their willingness to pay up for larger deals. It is not surprising then that corporate acquisitions have accounted for 64% of the exit value in the MM, even though corporate acquisitions made up only 47% of the number of exits.

The proportion of MM exits to total PE exits has been relatively stable since 2010, though the MM continues to make up a lower proportion of total PE exit value because billion-dollar-plus exits have become an increasingly common occurrence in the PE landscape. In addition to target companies being bigger, the buy-and-build strategy allows PE firms to buy and combine several MM companies and achieve these larger exits.

Overall, we expect buyers of all types to remain active due to continued strength in PE fundraising paired with increasingly cash-rich corporations that have an appetite for acquisitions, which bodes well for MM PE firms looking to exit. The optionality and competition increase the likelihood of exiting deals at attractive valuations and give sellers additional leverage in this high-multiple environment.

SBOs continue to be the preferred exit type

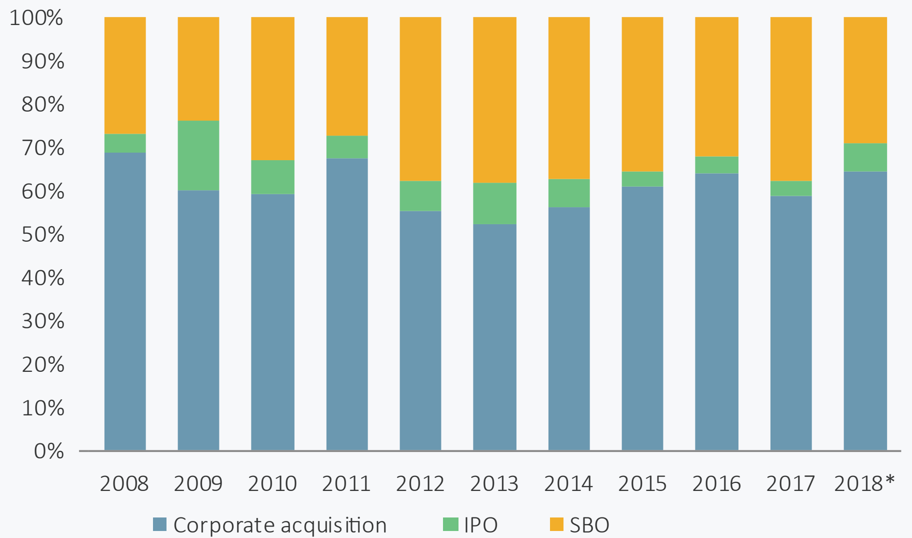
US MM PE-backed exits (#) by type



Source: PitchBook
*As of June 30, 2018

Corporate acquisitions represent nearly two-thirds of US MM PE-backed exit value

US MM PE-backed exits ($) by type



Source: PitchBook
*As of June 30, 2018

Fundraising

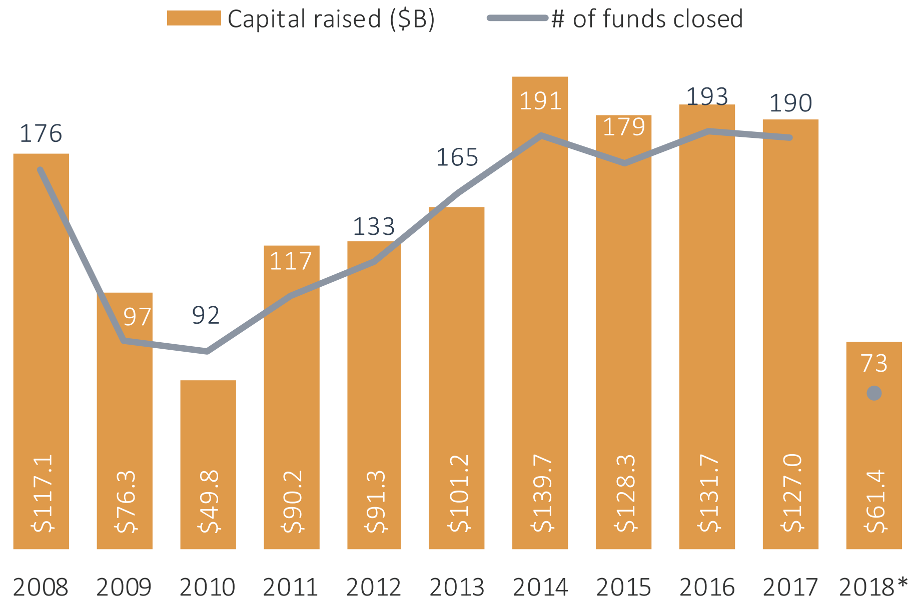
The strong MM PE fundraising environment has continued in 2018, with 73 funds raising $61.4 billion through 1H. We expect fundraising figures to remain solid through the year, with 38 open MM buyout funds currently seeking at least $1 billion. The average MM fund size came in at $841 million in 1H, a 26% increase over the $669 million average totaled in full-year 2017, with billion-dollar-plus buyout funds becoming more commonplace. Following three years of decreases, the $841 million average fund size in 1H 2018 currently exceeds the high-water mark of $786 million set in 2009.

MM deals, exits and funds have been increasing in scale over time. Larger deals and high multiples beget larger funds as GPs need to stay competitive in bidding for larger deals and want to avoid overconcentration. This trend looks to remain intact for the time being.

First-time funds have seen stable fundraising activity, accounting for 11% of funds closed and 5.3% of the capital raised. Five of the eight first-time funds closed in 2018 held a final close in the second quarter. With sizes ranging from Monogram Capital Partners' $152 million buyout fund to Argonne Capital Group's $530 million buyout fund, these smaller funds offer LPs the ability to begin allocating to the next generation of managers.

Capital raised on pace to match recent years, even though fewer funds are closing

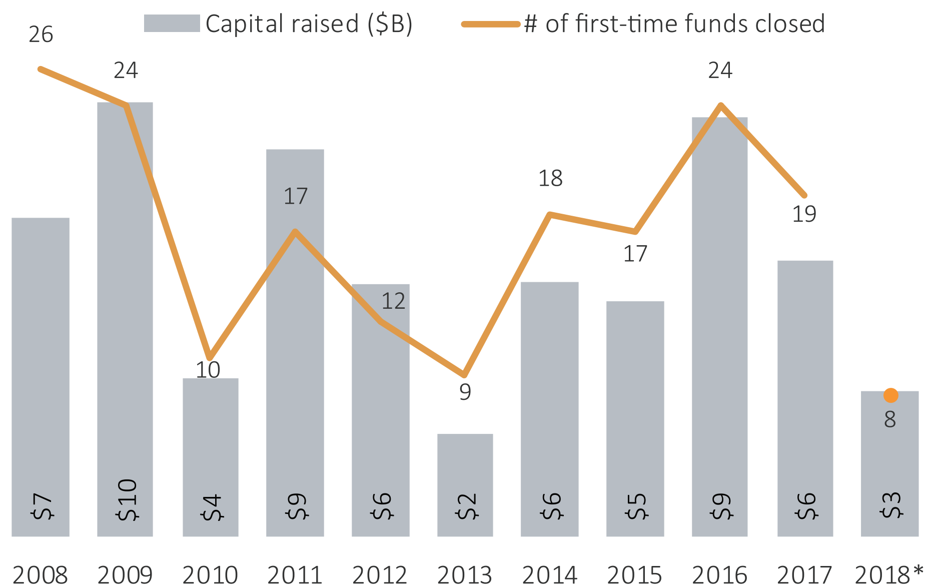
US PE MM fundraising



Source: PitchBook
*As of June 30, 2018

Stable fundraising activity for first-time funds

US PE MM first-time fundraising

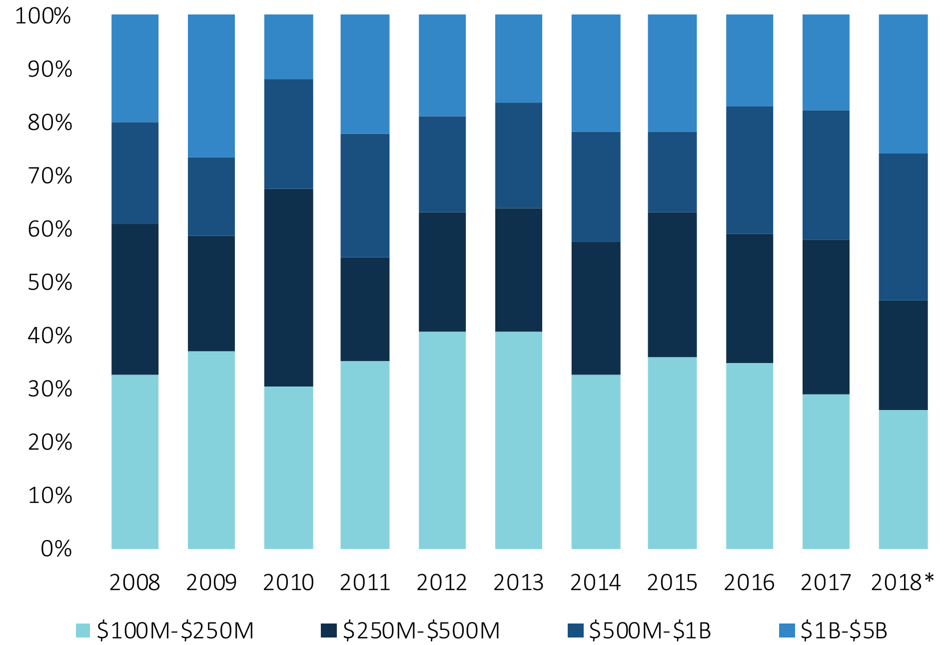


Source: PitchBook
*As of June 30, 2018

Coinciding with the lack of mega-deals closed in 2018, mega-funds have been noticeably absent from the market. As a result, MM fundraising has accounted for 88% of capital raised, the second-highest proportion in the past decade. Within the MM, the largest funds have had a banner fundraising year. As managers establish a track record of outperformance, they can raise larger funds. For example, Thoma Bravo's Fund X raised $1.27 billion in 2011, Fund XI raised $3.66 billion in 2014, and Fund XII raised $7.6 billion in 2016, placing it above MM territory. Interestingly, even though Thoma Bravo has proven its ability to raise larger vehicles, it closed a $2.4 billion MM fund in 2018, showing that LPs still have an appetite for exposure to the MM and that GPs have a desire to remain active in their area of expertise. Robust MM fundraising should have knock-on effects for deals and exits. 2018 has posted solid figures in all three areas, a trend we expect to continue as PE matures and LPs allocate and commit more capital to the asset class.

Larger MM funds gain market share

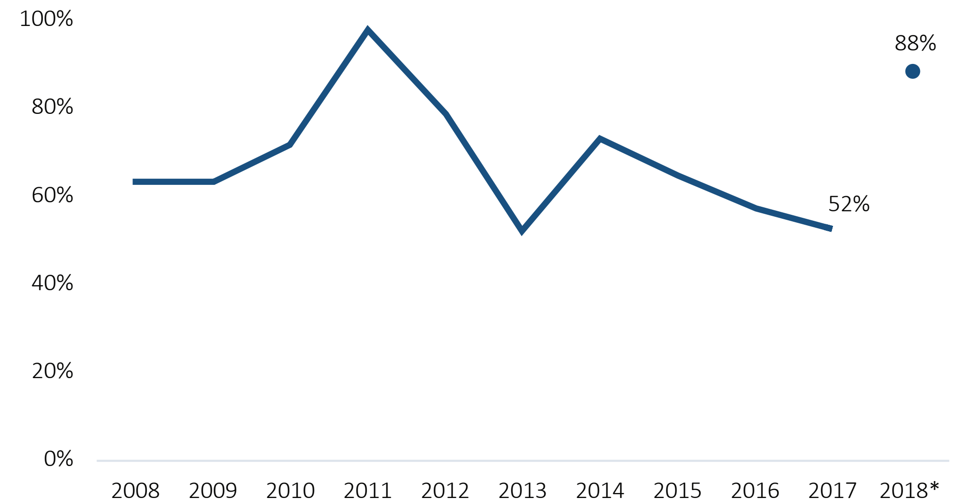
US PE MM fundraising (#) by size



Source: PitchBook
*As of June 30, 2018

US MM PE fundraising is overrepresented as only one mega-fund has closed year-to-date

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



Source: PitchBook
*As of June 30, 2018

2Q 2018 US PE Middle-Market Lending League Tables

Most active lenders by deal count

Lender	Deal count
Antares Capital	33
Madison Capital Funding	21
NXT Capital	18
Churchill Asset Management	17
Crescent Direct Lending	15
NewStar Financial	14
Twin Brook Capital Partners	13
Golub Capital	11
Bank of Ireland	11
Bank of America	10
Ares	10
Citizens Bank	10
MidCap Financial	9
Varagon Capital Partners	9
The Goldman Sachs Group	8
Jefferies Group	8
Capital One	8
SunTrust Banks	8
Audax Group	7
Monroe Capital	7
Barclays	6
BMO Financial Group	6
BBVA Bank	5
GSO Capital Partners	5
Bain Capital Credit	5
KeyBank	5
Deerpath Capital Management	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.