PitchBook

US PE Middle Market

3Q 2018

PitchBook

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Antares Capital

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Key takeaways from the analysts

Dealmakers in the US middle market (MM) are on pace to surpass $400 billion in total deal value for the first time, having closed 2,171 deals with a total value of $311.7 billion YTD. In 3Q, PE dealmaking totaled $102.8 billion across 708 deals. While MM buyout EV/EBITDA multiples remained elevated at 12.3x, the median deal size has fallen marginally to $177.0 million from $182.5 million in full-year 2017.

SBOs continued to garner share of exit activity, now accounting for 53.8% of all exits as general partners (GPs)—flush with cash from record-setting fundraising years—have been keen to source deals from other financial sponsors. Through 3Q 2018, GPs completed 609 MM exits totaling $134.4 billion. Large deal sizes and fervent M&A activity have helped push up the median exit size to $274.0 million from $200.0 million in full-year 2017.

Through 3Q 2018, GPs closed 23 fewer funds than the corresponding 2017 timeframe, but the total amount raised represented a 19.6% increase. 99 MM funds closed on $88.1 billion through 3Q 2018 compared with $73.7 billion raised in the first three quarters of 2017. Activity in the largest MM size bucket ($1 billion-$5 billion) has been noteworthy; YTD, this size bucket has accounted for a plurality of MM fund closes for the first time.

$311.7B
total deal value across 2,171 deals through 3Q 2018

$134.4B
total exit value across 609 exits through 3Q 2018

$88.1B
total capital raised across 99 funds through 3Q 2018

Antares Capital: The global financial crisis... 10 years on

10 years after the collapse of Lehman Brothers and the global financial crisis (GFC), the duration of US economic expansion is in record territory with healthy momentum coming into the 2018 homestretch. Looking forward, the odds of a recession over the next 12 months remain relatively low at 18% on average based on an October 2018 The Wall Street Journal survey of economists.

Meanwhile, borrowers in the Antares portfolio are experiencing accelerating EBITDA and revenue growth, with 72% surveyed in August seeing modest margin expansion and 28% seeing significant margin expansion over the next 12 months. This view appears congruent with healthy 2019 Wall Street analyst EBITDA growth forecasts for public middle market (MM) comparables in the Russell 2000 index.

On the loan front, US institutional leveraged loans outstanding have about doubled since the GFC, recently breaching the $1 trillion mark for the first time—a level now on par with the high-yield bond market. While leveraged loan issuance is down 12% YTD from peak levels a year ago, activity generally remains relatively robust. Also, direct lending activity (i.e. private club/unitranche deals), which is primarily tied to the sponsored MM, has boomed since the GFC, and this growth isn't generally reflected in syndicated leveraged lending stats. Sponsored MM loan volume, including private/club deals, rose almost 30% YTD 3Q 2018 according to LPC. While much of this growth reflects refinancing/repricing activity in 1H 2018, "new money" M&A-related activity has also grown and saw an increased share of total volume in 3Q 2018.

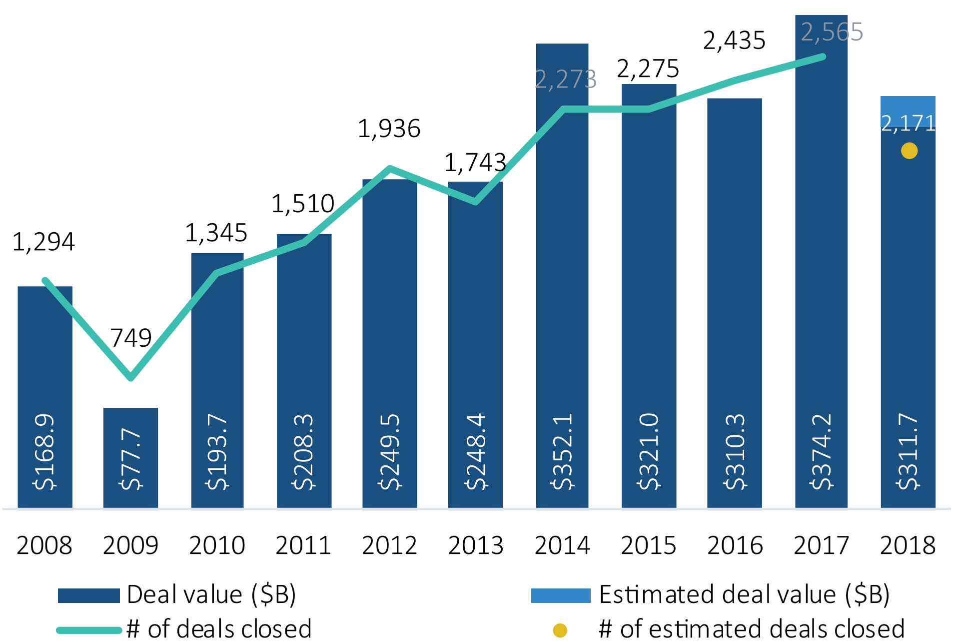
While the good times continue to roll, there remains no shortage of worries for lenders. The market has seen some modest widening of spreads and firming of terms for more "storied" credits as of late, but for the most part, loan terms remain loose. Meanwhile, rising interest rates, trade war tensions, stock market volatility and myriad other potential risks continue to loom. Credit discipline remains critical.

Overview

The swift pace of dealmaking in the US MM has continued unabated. Through the first three quarters of 2018, GPs have closed 2,171 deals with a total value of $311.7 billion. During the quarter, dealmakers deployed $102.8 billion across 708 transactions, a sizable jump compared with the $92.3 billion deployed across 617 deals in 3Q 2017. After back-to-back years in which more than $100 billion was raised for new funds—a first for the MM—GPs have the firepower and incentive to spend down dry powder. In fact, 2018 is the first year in which more than $300 billion has been deployed in the first three quarters of the year, putting the industry on pace to break the $400 billion mark. This is also the first time more than 2,000 deals have closed at this point in any year. To note, 2017 set the record in terms of deal count and value with 2,565 deals valued at $374.2 billion.

MM deal flow on pace for record year

US PE MM deal activity



Source: PitchBook
*As of September 30, 2018

OVERVIEW

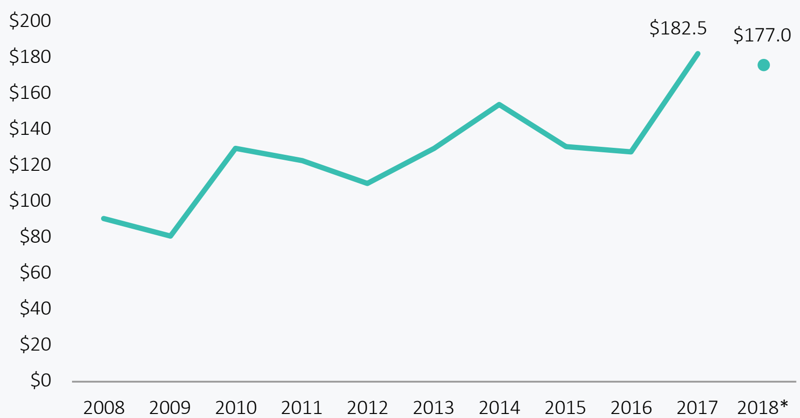
Median deal size in 2018 is $177.0 million YTD—just 3.0% off the all-time high achieved in 2017. While there has been a slight dip in 2018, deal sizes have grown 118.5% since the $81.0 million recorded in 2009, the lowest value in the past 10 years. Deal values have been climbing for years, and with fund sizes growing relentlessly, the surge in deal size shows no signs of letting up.

Another factor pulling deal sizes higher is buyout multiples, which have been and remain at elevated levels. Deal activity within the MM is on a record-setting pace, and GPs are vying for a limited number of assets, bidding up the purchase price and corresponding buyout multiples. The MM has been an area in which larger GPs traditionally looked for companies to acquire at lower multiples and add-on to their platforms, but that is becoming more difficult as MM buyout multiples have nearly doubled since 2009. Dealmakers may need to dive deeper into the MM—for instance, the lower middle market (LMM)—to find more attractive pricing, though such a move may require an evolution of the rollup strategy.

Breaking deal activity into our three MM size buckets reveals some intriguing trends. Interestingly, the upper middle market (UMM) and LMM experienced substantial activity in the healthcare sector but the core middle market (CMM) experienced less. Another sector to note, energy—where scale is important—is almost nonexistent in the CMM and LMM size buckets. In fact, energy accounted for just 3.1% of LMM deals and 1.0% of CMM deals, but 9.7% of UMM deal flow. In a similar vein, materials & resources accounted for 5.2% of CMM and 6.5% of UMM deal activity while the LMM was devoid of deals in the sector.

Deal sizes slide marginally after a record-setting 2017

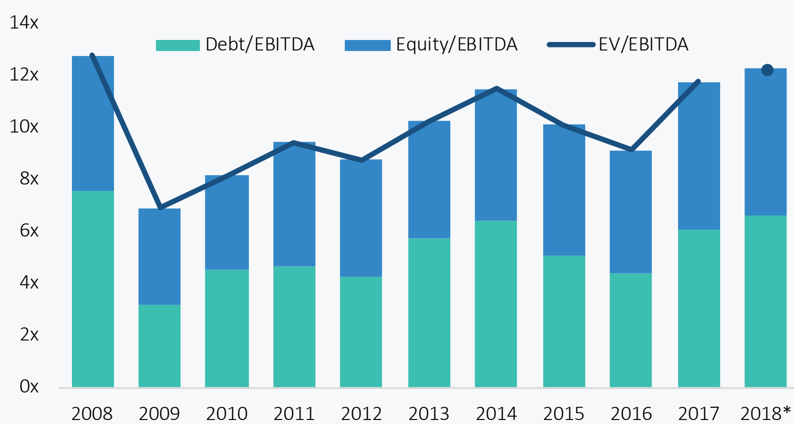
Median US PE MM deal size ($M)



Source: PitchBook
*As of September 30, 2018

MM multiples remain elevated

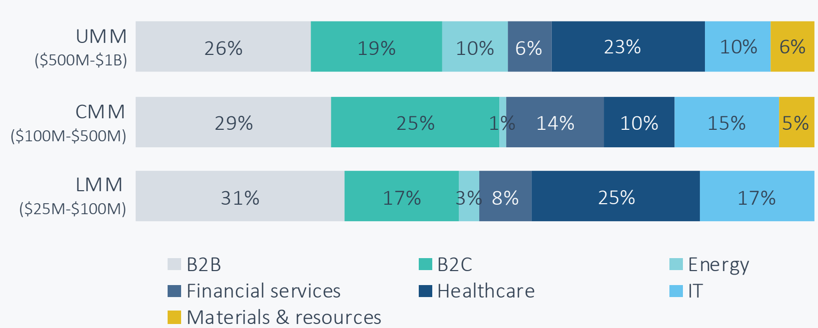
US PE MM EV/EBITDA multiples



Source: PitchBook
*As of September 30, 2018

Energy and materials & resources favored by UMM

US PE MM deals ($) by sector by size (2018 YTD)



Source: PitchBook
*As of September 30, 2018

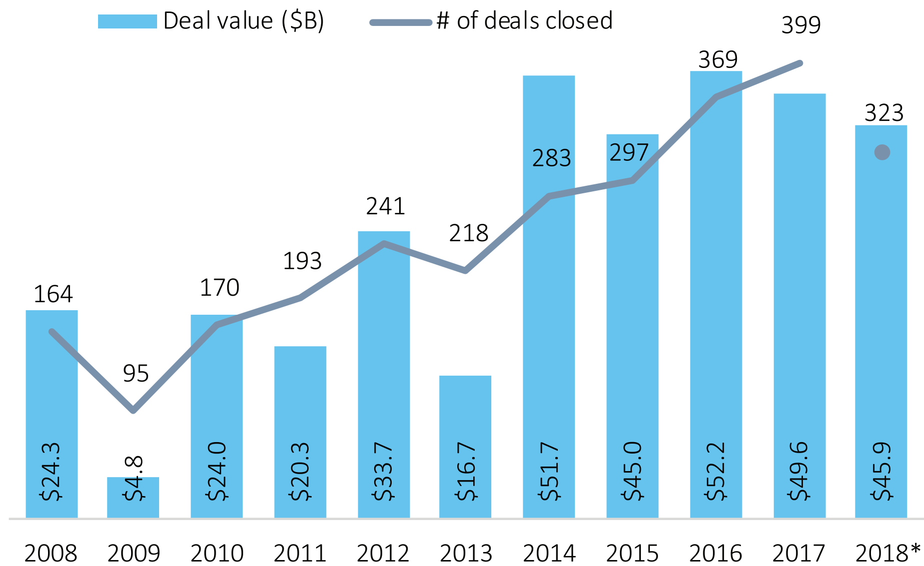
Spotlight: Healthcare

Healthcare companies have exhibited a penchant for add-ons, where they represent 59.2% of the sector's deal flow. The frequently fragmented subsectors, such as dentistry, are rife with opportunity for consolidation, and many have effectively used the rollup strategy. Heartland Dental Care has completed myriad add-ons, growing to a recent $2.8 billion valuation. KKR is purchasing a majority share (58%) of the company from Ontario Teachers' Pension Plan, which invested in Heartland in 2012; the valuation has more than doubled in that time. Acquisitions such as Western Dental Services' add-on of Smilecare Dental Associates or Smile Brands' add-on of Newbury Dental Studio are becoming more common in dentistry as money is pouring into the sector trying to own a piece of "corporate dental." However, some other larger players, such as Aspen Dental Management and Pacific Dental Services, are having success with the organic growth route—known in the industry as de novo. The entire dental subsector is undergoing change—propelled by these larger privately held companies—as corporate dentistry is scooping up practices while taking market share from the more traditional sole-practitioner dentistry practices.

A broader look at healthcare shows that it represents 22.4% of add-ons while representing only 17.0% of deals YTD, making it proportionally the second-most active sector for add-ons after energy. With an aging demographic—the "silver tsunami" as it is often called—healthcare costs are slated to rise for the foreseeable future. In fact, in-home care is another sector budding with opportunity for consolidation. The $700 million buyout of Jordan Health Services by National Home Health Care and Great Lakes Home Health Services expands on their in-home care offerings. Many compare the current rollup strategies within healthcare subsectors to how the pharmacy landscape looked 20+ years ago, before Walgreens and CVS took over much of the market.

Healthcare deal count continues to rise as deal value plateaus

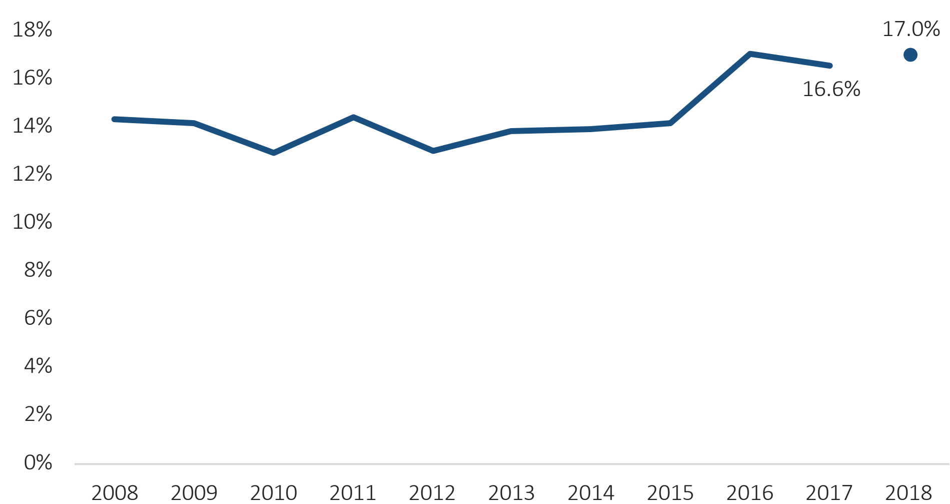
US PE MM healthcare deal activity



Source: PitchBook
*As of September 30, 2018

Healthcare continues to gain add-on share

Healthcare add-ons as proportion of total US PE MM add-ons (#)



Source: PitchBook
*As of September 30, 2018

Antares Capital: Q&A

Michael Chirillo

Mike is a senior managing director with Antares Capital. He leads the business's capital markets activities, which consist of structuring and syndicating Antares Capital's originated transactions.

Previously, Mike was senior managing director with GE Antares, serving as a member of GE Antares' Investment Council. Mike is one of the founders of Antares Capital where he served as the managing director and led its capital markets group. He served in a variety of positions within Heller Financial's corporate finance group and capital markets organization prior to forming Antares Capital.

Tyler Lindblad

Tyler is a senior managing director and Chief Credit Officer for Antares Capital.

Previously, he was senior credit executive—Lending for GE Capital's commercial lending business in North America with responsibilities that included leading the underwriting, account management, portfolio management and risk management processes. Before assuming this role, he was the Chief Risk Officer of specialized finance that included responsibility for Healthcare Financial Services and Franchise Finance, and Chief Credit Officer of Telecommunications, Media and Technology. Prior to joining GE Capital, he was a director and one of the founders of Antares Capital Corporation. Prior to that, he spent seven years with Heller Financial, Inc.

Mid-September of this year marked a decade since the Lehman Brothers bankruptcy. Since then, the credit markets have changed drastically in many ways. What are the overall conclusions Antares has drawn in the intervening decade as to how credit markets have transformed and what that portends for the future?

In the leveraged loan MM, the number of institutions that have established strategic relationships and holding levels today is materially different from back in 2006-2007. Holding sizes typically used to be in the $15 million-$30 million range and are now often in the $75 million zone. Of course, for some transactions, particularly unitranche transactions that didn't even exist prior to the financial crisis, holding sizes can go much higher. So direct lenders now bear more risk via increased exposure. Another big change is that EBITDA adjustments are much larger and more prevalent today. Likewise, in 2006-2008, covenant-light loans (cov-lite) were available only to larger, more liquid credits. Today, cov-lite loans are much more prevalent and comprise a fair chunk of MM issuance. An offset to this is that equity checks are bigger today, with 45%-50% of an LBO now financed with equity versus only 30%-40% back in 2006-2007. So, from a lender's perspective, it's become more critical to be selective and loan only to proven companies with strong management teams backed by sophisticated sponsors that have the financial wherewithal and know-how to be able to support the company when and if times get tough.

On the positive side, from a more systemic risk perspective, much of the investment in more highly leveraged transactions has been diverted to a more fragmented base of global institutional credit investors that aren't FDIC-insured and that have a different set of risk tolerances. While banks have experienced some relaxation of leveraged lending guidelines with the recent clarification that they are, indeed, "guidelines," banks do not appear to be rushing into holding large positions in highly leveraged loans. They remain generally constrained by "safety and soundness" requirements and the realistic repayment of all senior secured debt or at least 50% of total debt over a five-to-seven year period. Banks also are more careful about their pipeline of underwritten deals, and some of the dynamics behind the undisciplined, mark-to-market selling of loans in the post-Lehman crisis appears less likely today.

How has Antares Capital reshaped its approach to managing risk in the context of its entire portfolio?

We have been through multiple cycles over the past 20+ years we've been in business, and our scale allows us to be selective and have a very diverse portfolio with low concentration levels. Much remains the same in terms of our core underwriting and portfolio monitoring principles and requirements, although we, of course, remain on a path of continuous improvement. Our lead underwriters have an average of 15+ years of experience, and we have a rigorous credit risk training program for new talent that has been developed over decades. Since we were sold by GE Capital in August of 2015, we've made adjustments to better align our originators to longer-term lending success over the life of a credit. We have also improved our reporting dashboards and cycle times and expanded some risk metrics (e.g. ESG-related, EBITDA adjustment classifications, etc.). Finally, we have improved our diversity and permanence of funding to give us maximum flexibility to add value for our customers and take advantage of opportunities when times get tough. Our parent, CPPIB, is a key source of this permanent capital, and they approve all our transactions now within the context of their long-term-oriented risk/return objectives.

Per the ACG Growth Economy publication, US PE-backed companies, particularly in the MM, have exhibited significant outperformance in growth over the past couple of decades. From Antares' perspective, how has that factored into its strategies for exposure and overall growth plans?

We have always focused solely on PE-owned, US- and Canadian-based, MM-sized borrowers. As the growtheconomy.com stats demonstrate, these companies represent perhaps the most dynamic and fastest-growing segment of the broader MM, which itself is dynamic and fast growing. We view this as an attractive area to be lending into that will have very significant secular capital-growth needs for decades to come.

Hearkening back to the most recent edition of the US PE MM Report, what is Antares' take on the current macroeconomic landscape, and how does that landscape impact its view on MM companies' growth prospects? What seems poised to be the more transformative factors shaping US economic growth concerns for the next few years?

The outlook remains favorable for US-based companies. Business and consumer confidence remains high. Job creation and unemployment trends look good, with some signs of wage increases (e.g. Amazon boosting minimum wage). GDP growth has accelerated to near the 4% level of late. It may slow a bit in 2019-2020, but most economists see recession odds as relatively low. Companies continue to report and forecast healthy earnings growth. Most recently, trade disputes with Canada and Mexico now look closer to being resolved.

Of course, that's not to say a squall can't form quickly, and there are some signs we are late in the cycle. Interest rates have been rising since 2016 with further hikes on the way. The yield curve is getting close to inversion. Auto sales and housing starts are showing signs of plateauing. There also is potential for blowback on the US economy from financial, economic, trade-related and geopolitical issues abroad. It is no time to be complacent.

What about the growth of the private credit markets on the whole? How do you anticipate its development shaping in the year to come?

Investor allocations to private credit still appear to have plenty of room to grow. Many limited partners (LPs) are still new to the asset class and have no exposure while existing private credit investors are looking to increase their exposure. According to Preqin, around only 40% of investors surveyed had an active mandate for investing in direct lending funds coming into 2018. Looking forward, the majority of private debt investors Preqin surveyed in April 2018 said they planned to increase their allocations in the next 12-24 months. That said, it would not be surprising to see the pace of MM loan fundraising slow some in 2019 from the torrid pace seen in 2017-2018.

Exits

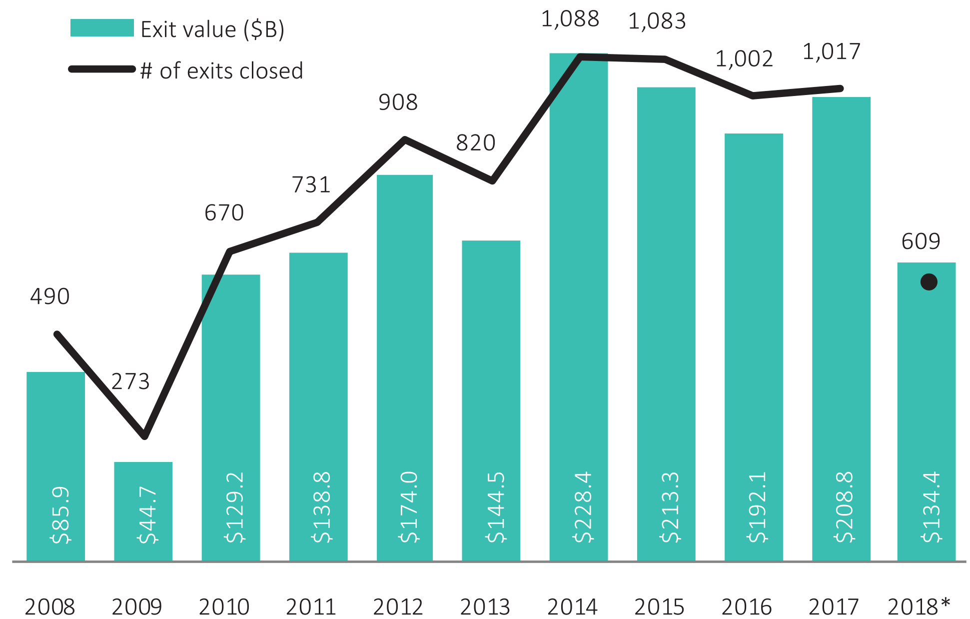
Please note previous versions of this report used size of offering as an IPO's deal value. However, in this and subsequent reports, we will use the pre-money valuation at IPO. Additionally, unknown exit values have now been extrapolated using a similar methodology to our deal value extrapolation. Please see our methodology page for more information.

Through the first three quarters of 2018, GPs have completed 609 MM exits totaling $134.4 billion. While dealmaking is on pace to break records in terms of count and value, the pace of exits is likely to approximate recent years and fall short of 2014's record of 1,088 exits totaling $228.4 billion. YoY, exit value declined at a slower rate than exit count while median exit size rose to $274.0 million—a 37.0% increase over the full-year 2017 median of $200.0 million. However, the MM still represents the lion's share of PE with MM exits accounting for 80.9% of the total PE exit count YTD.

As total exit count falters, SBOs have continued to gain share. GPs, raising larger sums of cash, have been apt to outbid strategics more recently. In fact, last year marked the first time SBOs accounted for more than half of exit activity. 2018's figures maintain this trend. As a proportion of exits, SBOs have lifted their share each year since 2013, rising from 44.5% of exits to 53.8% of exits through 3Q 2018. This trend is strongest within the MM; for deals valued more than $1 billion—above the MM threshold—SBOs represent only 30.6% of the exit count. As SBOs have gained share, IPOs have become more prevalent, too. Strong public market performance has spurred dealmakers to choose IPOs more often than any point in the last four years. IPOs represented 3.9% of MM PE-backed exits through 3Q 2018—a 1.2 percentage point increase over 2017 figures—which is near the 3.7% averaged between 2008 and 2017.

Exit activity slows in 2018

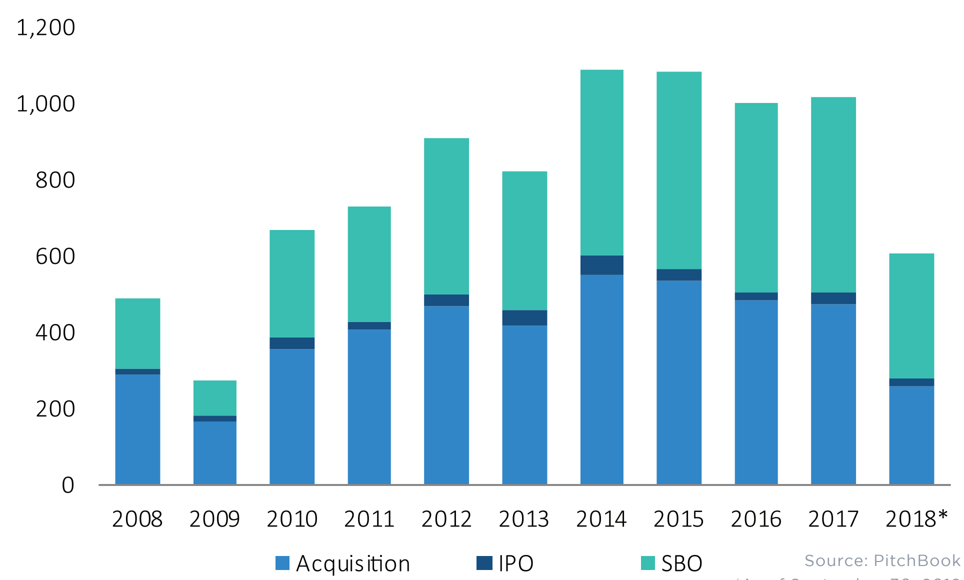
US PE MM exit activity



Source: PitchBook
*As of September 30, 2018

SBOs continue to be most prevalent exit method

US PE MM exits (#) by type



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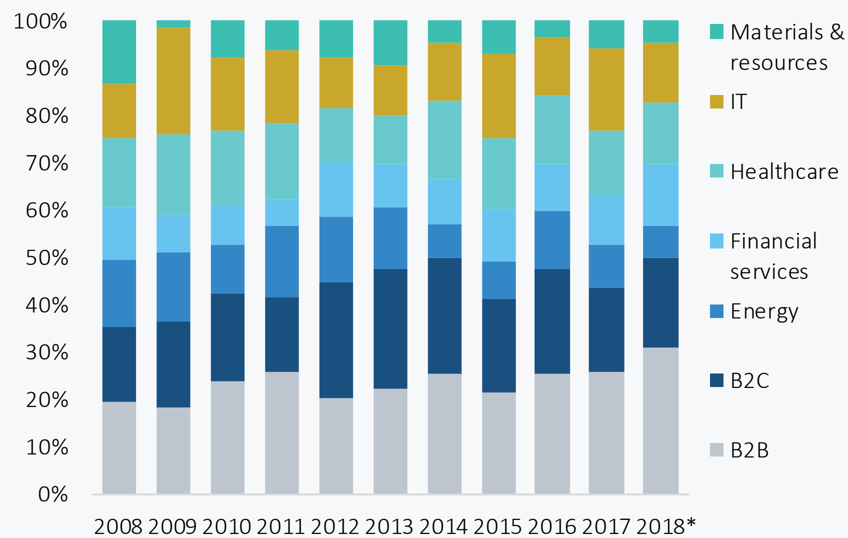
*As of September 30, 2018

On a sector basis, IT has represented a lower proportion of exit value YTD compared with full-year 2017, which is unexpected because the sector has generally been gaining share of overall deal value. Total exit value in the energy sector has also proportionally dipped YoY—despite the recent rise in oil prices and GPs' heavy usage of add-ons to augment platform companies' top-line growth. However, while IT, healthcare and energy ceded share proportionally, B2B gained. The sector represented 31.0% of total exit value, eclipsing the pre-recession high of 30.8%. During the quarter, the MM saw several sizable exits in B2B close, including United Rentals' $715.0 million acquisition of BakerCorp from Permira and Goldman Sachs, and VINCI Airports' $800.0 million acquisition of Airports Worldwide from OMERS (Ontario Municipal Employees Retirement System) Infrastructure Management.

Though there are changes to how GPs are choosing to exit, the median holding time held steady at 5.5 years. However, within the figure, there is a sizable difference between the time to exit depending on the exit type. For instance, the median time to exit via IPO is 4.5 years compared to 5.9 years for corporate M&A. One possible reason for this is the amount of time it takes to fully exit an investment via IPO. Even though we track the IPO date as an exit, GPs often retain a sizable piece of the company to be sold off over time—exposing returns to market gyrations. IPOs may take an additional 12-24 months to fully exit, putting the full exit figure more on pace with corporate M&A and SBO (5.2 years). Additionally, GPs often know well in advance which companies are likely to exit via IPO, and therefore begin laying the groundwork far ahead of time. Though holding times are lower today than the peak of 6.2 years in 2014, the lift over the 3.3 years seen in 2008—the lowest figure in over a decade—is substantial.

B2B sees proportionally highest activity in a decade while energy sees proportionally lowest

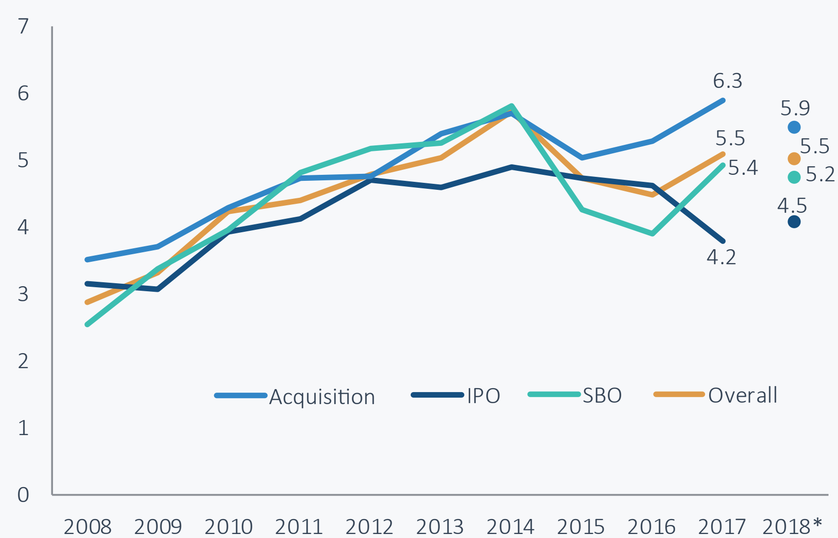
US PE MM exits ($) by sector



Source: PitchBook
*As of September 30, 2018

Corporate M&A exits come quicker while IPOs take longer as all three exit types converge

Median US PE MM holding time (years) by exit type



Source: PitchBook
*As of September 30, 2018

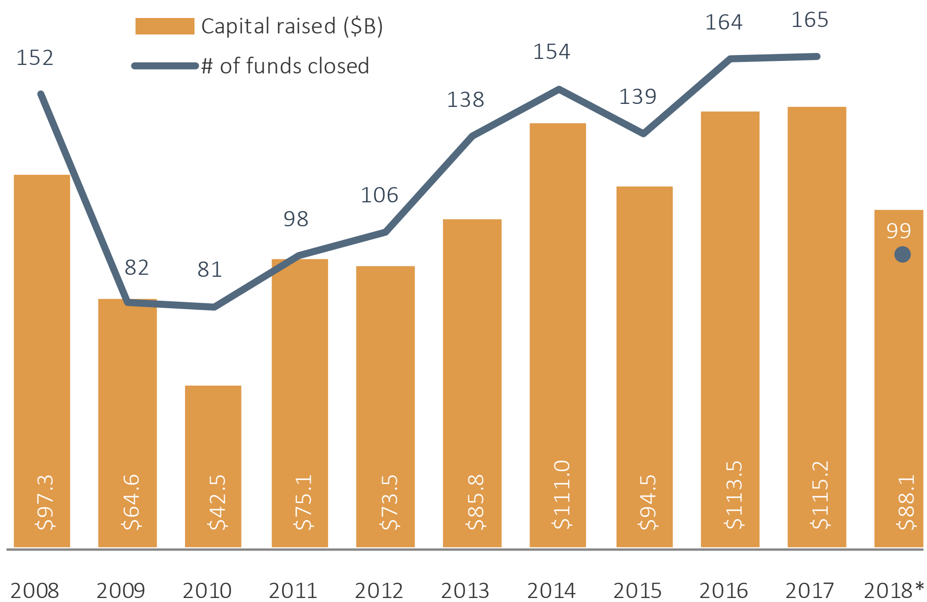
Fundraising

Please note previous versions of this report included energy and co-investment funds in overall fundraising figures. In this and subsequent reports, those categories will no longer be included in our PE fundraising numbers.

Through 3Q 2018, PE firms have raised $88.1 billion across 99 MM funds. Compared to the first three quarters of 2017, the sum of capital raised is up 19.6% YTD while the fund count is down 18.9%. Fund size has risen, with the average fund ballooning from $604.2 million (1Q-3Q 2017) to $890.2 million YTD 2018—a 47.3% increase. The top-end of the MM saw rich fundraising activity in 3Q as several well-known GPs held a final close on funds in the largest MM size bucket ($1 billion-$5 billion), including: Audax Group (Audax Private Equity Fund VI at $3.5 billion); Platinum Equity (Platinum Equity Small Cap Fund at $1.5 billion); and Sycamore Partners (Sycamore Partners III at $4.8 billion). This trend of growing fund sizes is occurring across the wider PE environment and broader private markets in general, though the jump in average fund size is more pronounced within the MM.

Fundraising on pace to match last year's record

US PE MM fundraising activity

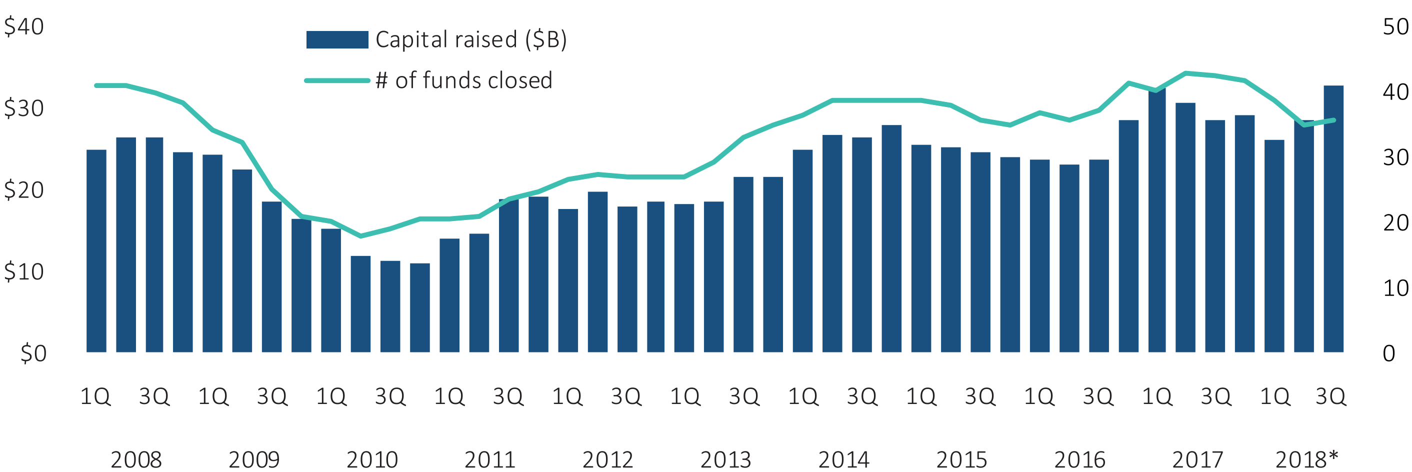


Source: PitchBook
*As of September 30, 2018

Even though funds are trending larger, some managers are retaining smaller, MM-focused offerings. One example is Platinum Equity's Small Cap Fund. The proven buyout manager had previously closed four funds, each successive fund larger than the last. Platinum's Fund I closed in 2004 at $700.0 million, Fund II closed in 2008 at $3.0 billion (including co-investment funds), Fund III closed in 2012 at $4.0 billion (including co-investment funds) and Fund IV closed in 2017 at $6.5 billion—their first fund above the MM cutoff threshold—and

Numerous large closes in 3Q 2018 lead to pop in fundraising total

US PE MM rolling four-quarter fundraising activity



Source: PitchBook
*As of September 30, 2018

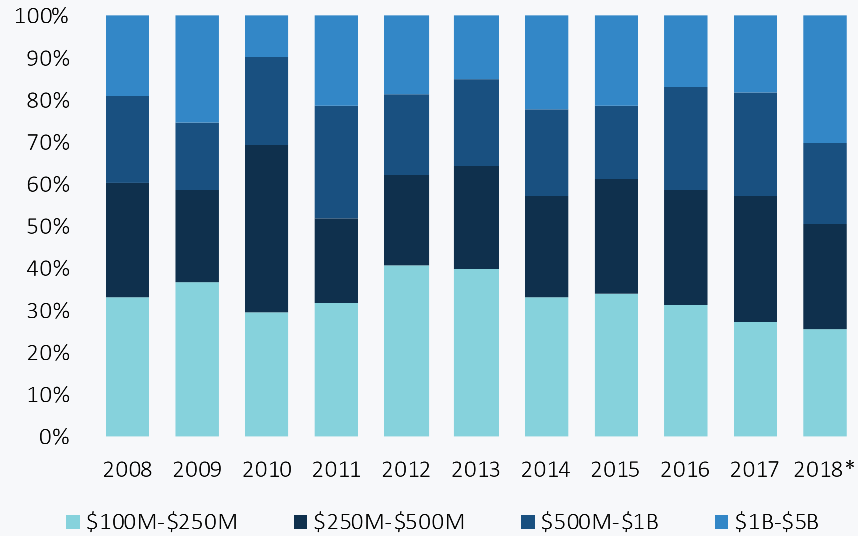
Platinum Equity is raising a fifth flagship fund targeting between $6.5 billion and $8.0 billion. However, this manager raised a fund targeting smaller MM companies in a move proving limited partners' (LPs) demand to access MM funds remains healthy.

While the mega-funds from industry stalwarts like Blackstone and The Carlyle Group garner inordinate media attention, the bulk of the PE funds raised sit within the MM. Here, the largest size bucket is seeing the most funds close. In fact, 11 funds between $1 billion and $5 billion closed in the quarter, bringing up the annual total to 30, matching the 2017 full-year figure. This is happening in a year when the total number of funds raised is in decline. On that front, the largest MM size bucket accounted for 30.3% of all funds raised, though the data may change over the coming quarter. This is also the first time more funds have closed in the $1 billion-$5 billion size bucket than any other. In stark contrast is the smallest bucket ($100 million-$250 million), where the proportion of overall fundraising has shrunk in all years but one since 2012, when it represented 40.6% of all MM funds raised. At a time when deal size and multiples are flirting with all-time highs, GPs are raising larger funds to compete for and win deals. The trend toward larger funds does not look to be stopping any time soon.

Feeding into this trend is the fact that news seems to break almost weekly about a large LP increasing its target allocation to PE. Competition to access top managers is heating up, allowing GPs to hold final closes in record time. Across all PE (including growth and mezzanine), the median time to close dropped to the lowest level on record at 12.3 months. We believe funds will continue to close more quickly than in years past as LPs race to gain access to the dwindling number of funds.

Fund sizes continue to creep up

US PE MM fundraising (#) by size



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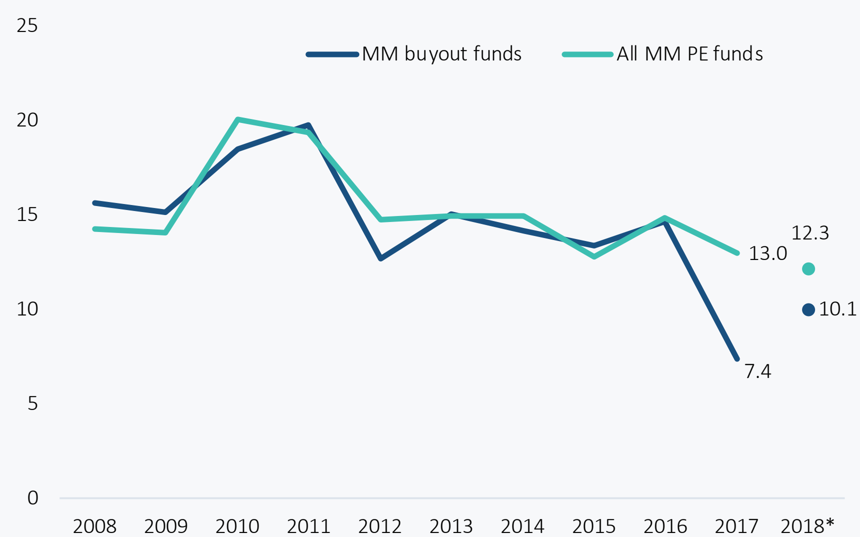
Buyout funds close more quickly than other PE funds, but the gap is shrinking

Median US PE MM fundraising time to close (months)



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*As of September 30, 2018

3Q 2018 US PE MM lending league tables

Most active lenders by deal count

1	Antares Capital	35
2	Madison Capital Funding	22
3	Twin Brook Capital Partners	17
4	NXT Capital	16
5	Golub Capital	14
6	Bank of Ireland	13
6	MidCap Financial	13
8	Jefferies Group	12
9	BMO Financial Group	11
10	Churchill Asset Management	10
11	NewStar Financial	9
11	Monroe Capital	9
13	Capital One	8
14	Ares	7
14	BBVA Bank	7
16	Citizens Bank	6
16	ING Group	6
18	Bain Capital Credit	5
18	Crescent Direct Lending	5
20	BNP Paribas	4
20	The Goldman Sachs Group	4
20	Credit Suisse	4
20	Varagon Capital Partners	4
20	Deutsche Bank	4
20	Patriot Capital	4

Source: PitchBook