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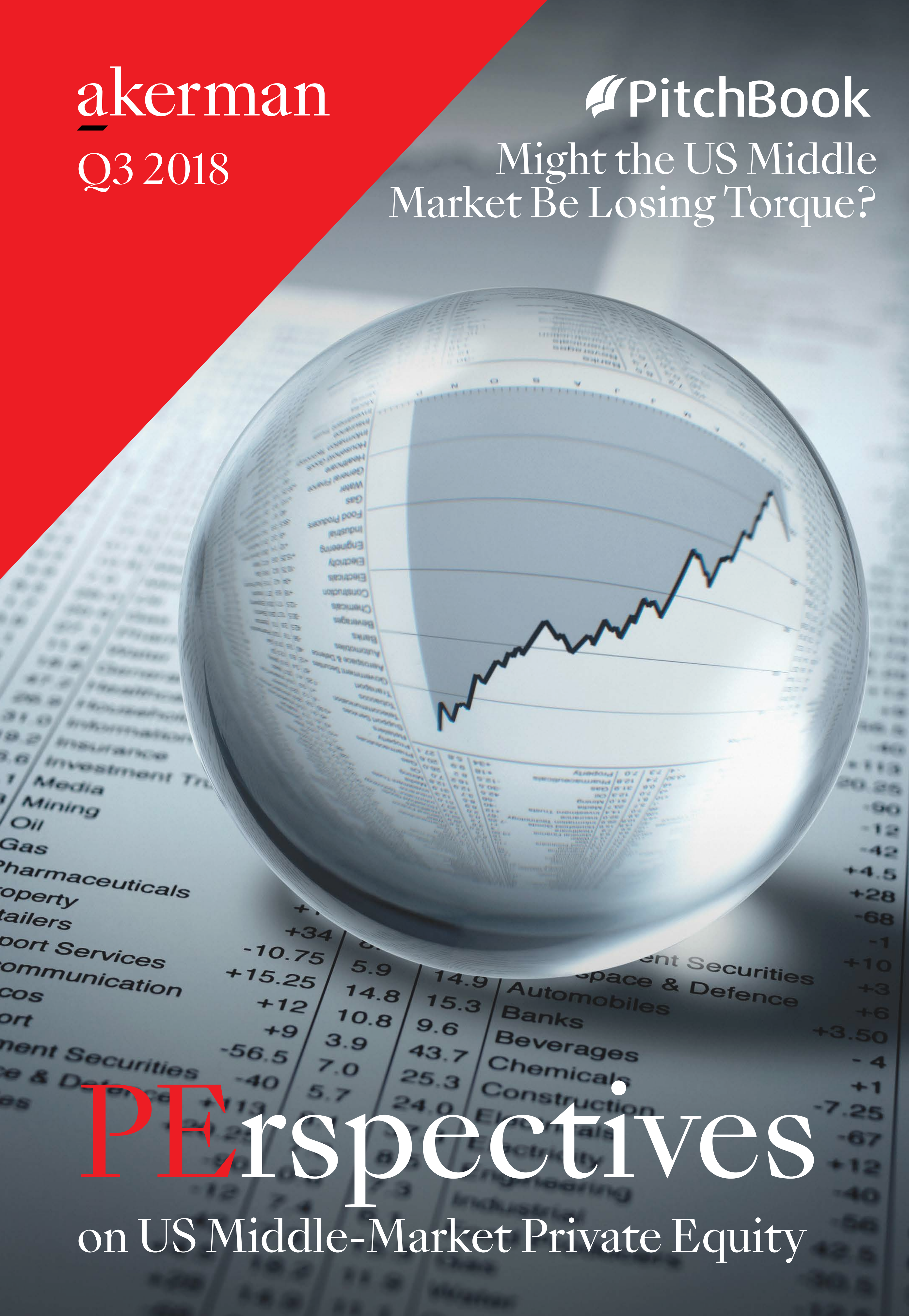
Q3 2018

PitchBook

Might the US Middle Market Be Losing Torque?



PErspectives

on US Middle-Market Private Equity

Introduction

While 2018 may be another record year for middle market buyouts, a marginal decline in third quarter activity may be indicative that the engine that has powered a decade-long run of deal activity may be losing torque.

PErspectives on U.S. Middle-Market Private Equity offers a quarterly analysis of deal activity, exit volume, valuation and fundraising trends for U.S. sub-$1B buyout funds relative to the broader U.S. buyout middle market. This quarterly publication also addresses other key drivers of shareholder value, including prudent risk mitigation strategies, for these sub-$1B buyout funds.

As the third quarter of 2018 marked the 10-year anniversary of the bankruptcy of Lehman Brothers, the continuation of the second-longest U.S. post-war economic expansion, increasing wage pressures and geopolitical tensions, the slowing growth of U.S. leading economic indicators, what may be the end of a 30-year trend of decreasing interest rates, continuing easy credit conditions, near-record valuation metrics, and an all-time record for committed capital and cash on corporate balance sheets available to be deployed in acquisitions, the unavoidable question is, how close is the U.S. buyout middle market to an inflection point?

Coming quarters will determine whether the marginal decline in Q3 transaction activity—during a year which is likely to set an all-time record—indicates that the market is pausing to catch its breath or that something more cyclical is occurring. Sponsors and investors will also be closely following whether the marginal decline in exit activity (which is less pronounced in this subsector of the market) and fundraising activity (which is more pronounced) indicates a cyclical shift in the market. While the opportunity for multiple expansion still exists at this end of the middle market and valuations remain at historically elevated levels, only time will tell whether the expected YoY decline in multiples is an indicator that animal spirits may be beginning to wane.

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Akerman LLP is a top 100 U.S. law firm recognized by *Financial Times* as among the most forward thinking firms in the industry. Its more than 700 lawyers and business professionals collaborate with the world's most successful enterprises and entrepreneurs to navigate change, seize opportunities, and overcome barriers to innovation and growth. Akerman is known for its results in middle market M&A and complex disputes, and for helping clients achieve their most important business objectives in the financial services, real estate, and other dynamic sectors across the United States and Latin America.

The Akerman Corporate Practice Group advises public and private companies, including private equity funds, on M&A, capital markets, financings, and other transactional matters, with a strong focus on the middle market. Akerman is top-ranked nationally for mergers, acquisitions and buyouts: middle market by *The Legal 500* and is recognized as a leading U.S. law firm by *U.S. News - Best Lawyers* for corporate, M&A, private equity, securities/capital markets, securities regulation, and banking and finance law, and is listed in PitchBook league tables as among the most active law firms in the United States for M&A deals.

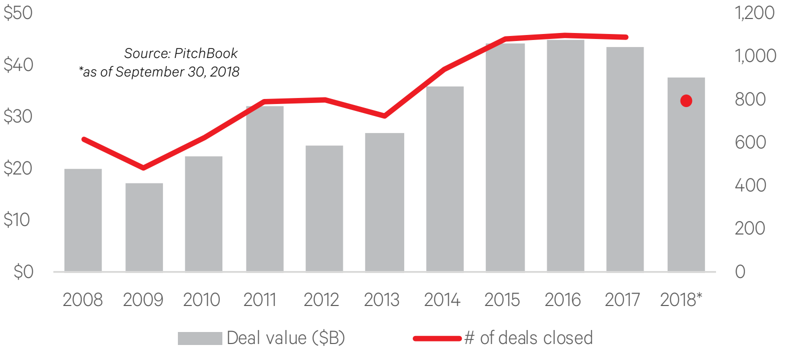
PErspectives Editor/Producer: Carl D. Roston, Co-Chair of Akerman's Corporate Practice Group

Deals

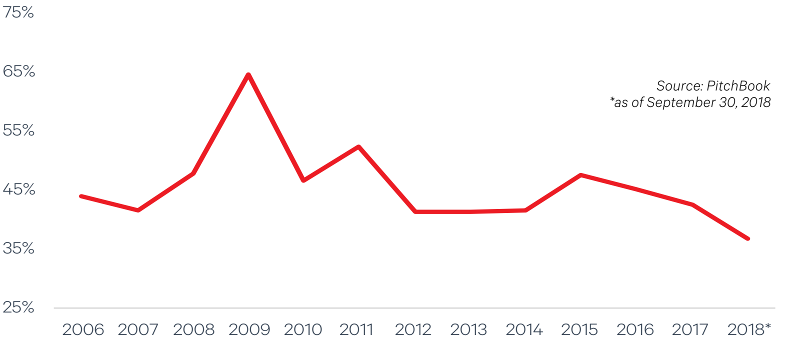
Buyout activity in this segment of the middle market and the broader middle market is set for another record year. At this pace, deals with enterprise values of less than $200M are set to increase by 15%, while overall value is on pace for an 11% bump over 2017 levels. Tracking activity at the fund level, however, shows a considerably bigger increase in value. Sub-$1B buyout funds are on pace for a significant increase in value over last year, the third consecutive strong year in the market. While those trends have continued for the broader middle market through Q3, marginal declines in transaction value and volume for this end of the middle market during Q3 raises the question of the extent to which this historically long deal bull run may be getting long in the tooth.

Purchase price multiples continue to diverge for sub-$200M enterprise value transactions and the broader middle market, as buyers are paying in excess of two turns more in the overall market (9.7x) compared to this subset of the market (7.6x). To put this in perspective, multiples were marginally higher in the years prior to the Great Recession, and this opportunity for multiples expansion is generally consistent with prior periods (although it may have narrowed somewhat compared to prior strong markets). 2018 is on pace to have the second consecutive marginal decline in multiples for the first time since the Great Recession, and while consecutive years of declines in multiples may not be a strong indicator of headwaters, one should be mindful that economic expansions are not forever.

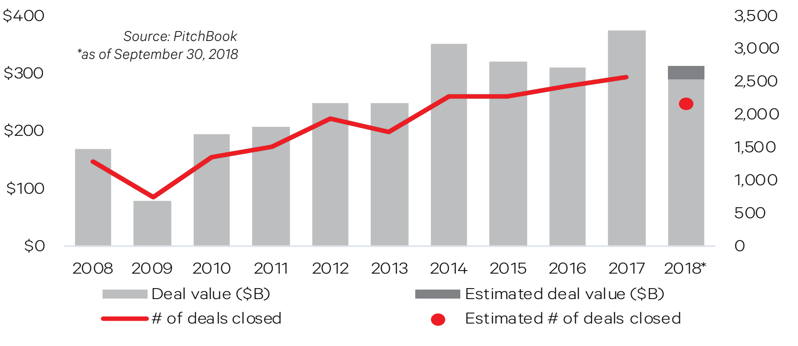
PE sub-$1B market deal flow (Akerman methodology)



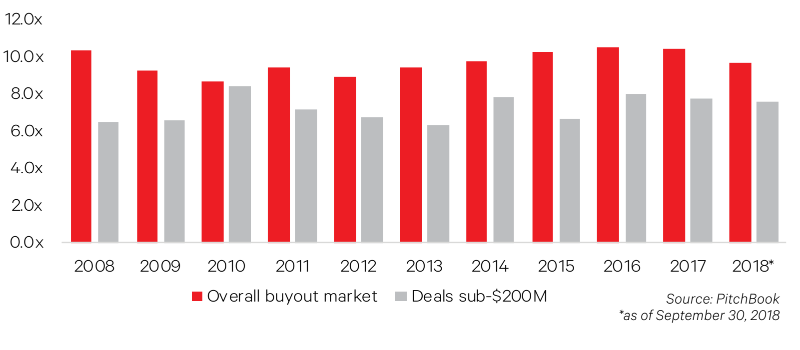
PE sub-$1B market as % of overall PE activity



PE overall deal activity



U.S. M&A multiples by year

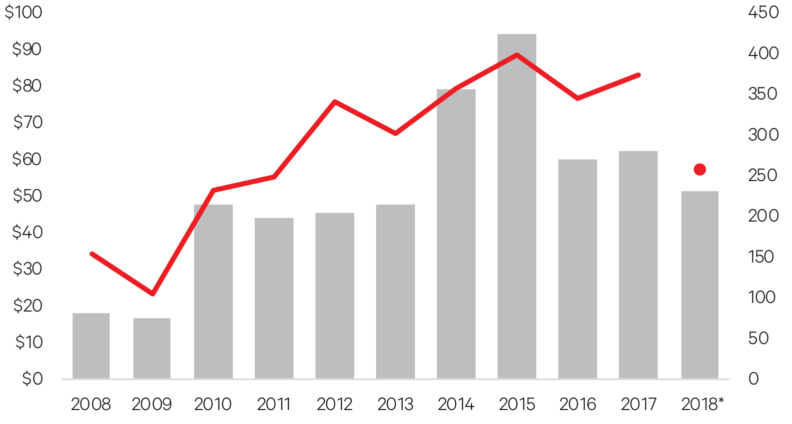


Exits

Exit activity for sub-$1B buyout funds is on track to be considerably stronger during 2018 compared to the overall middle market. At $51.5 billion through Q3, total exit value should easily exceed last year's $62 billion mark, though exit counts will likely come down YoY. As a comparison, exit activity in the broader middle market is set for a much lighter 2018. With one quarter to go, middle-market exit volume is still less than half of 2017 totals and just over a third of 2017 value. As a consequence the percentage of deals at this end of the broader middle market has risen to a record 55%, substantially exceeding the prior record high of less than 40%. So, while sub-$1B buyout funds are still in a sellers' market, their larger counterparts' decreased exit activity may be an indicator that one might consider tempering optimism about the continuation of the historic run on exits.

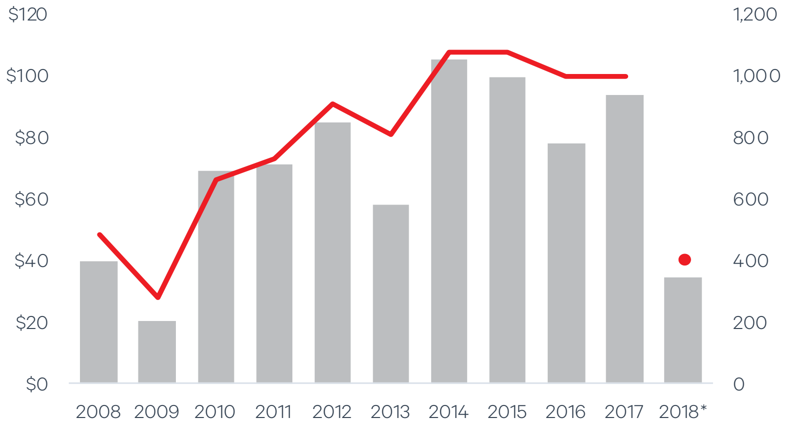
While sponsors and strategics have record firepower to continue to fuel the exit machine, activity levels will undoubtedly continue to be highly correlated with the friendliness of the debt markets and the health of the overall domestic economy.

Sub-$1B PE exit activity (Akerman methodology)



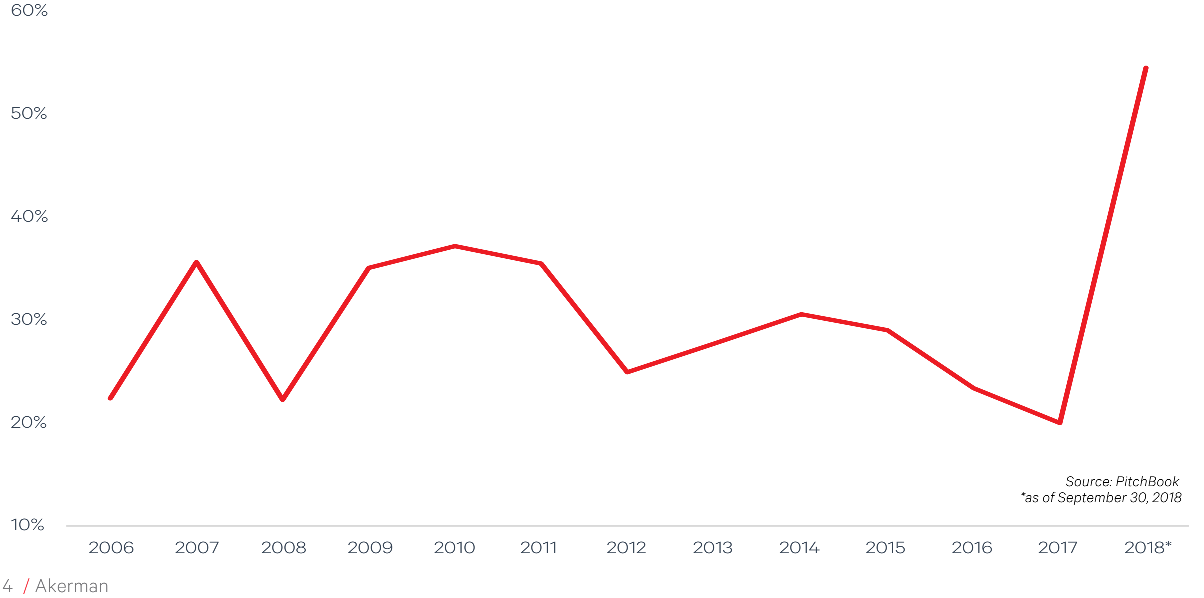
Source: PitchBook
*as of September 30, 2018

Sub-$1B PE exit activity (overall)



Source: PitchBook
*as of September 30, 2018

Sub-$1B PE exits as % of overall PE exits



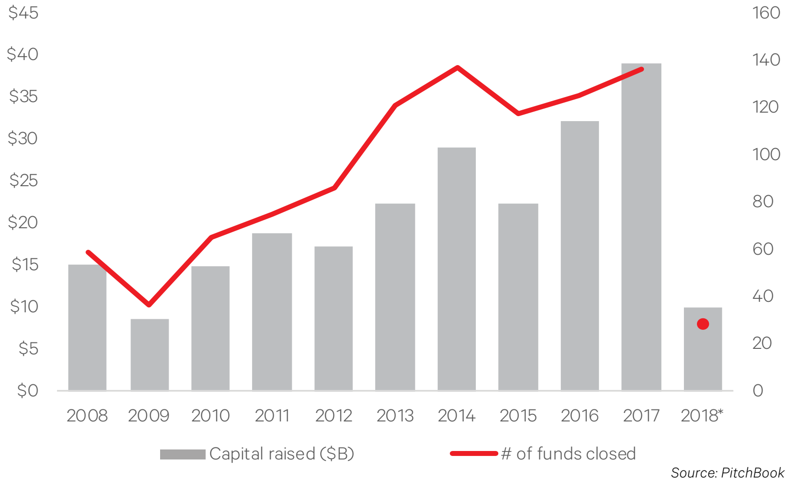
Source: PitchBook
*as of September 30, 2018

Fundraising

Middle-market buyout fundraising has enjoyed record years recently. In fact, the buyout fundraising boom has affected funds in all markets, as LPs seek to reinvest record distributions in the same asset classes in an attempt to keep their allocations intact. Fundraising should continue to benefit from LPs' recognition that, on a risk-adjusted basis, U.S. middle market buyout funds have traditionally outperformed a significant majority of other asset classes.

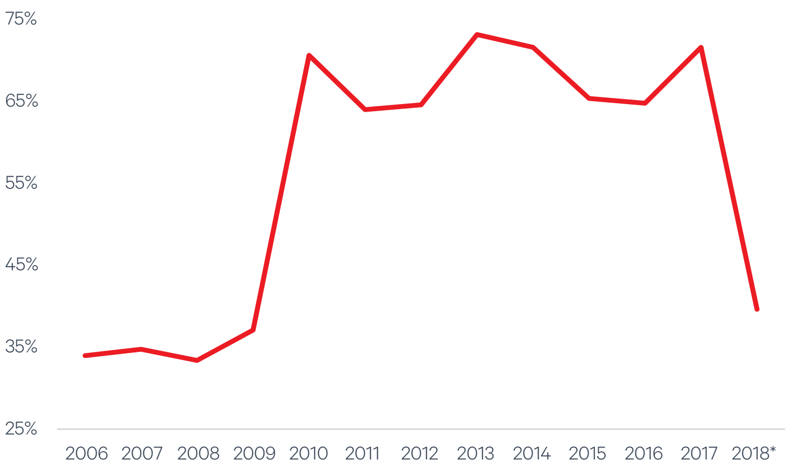
But fundraising, like all aspects of the buyout market, is cyclical, and the boom appears to be waning. The broader middle market is set for an annual decline after four consecutive years which were stronger than in any prior cycle. For sub-$1B buyout funds, after a record-setting 2017, 2018 is set for a steeper relative decline in both funds closed and capital raised. Granted, a downturn should not be altogether surprising after years of strength. Some argue that this relative decline for smaller funds is a result of family offices and other smaller LPs seeking to time the market, while larger institutional LPs are more disciplined in their asset allocation models. A slowdown in fundraising may ultimately be healthy for this end of the market, as the continuing increase in competition may be tempered somewhat. And despite this decline, GPs have record amounts of uncalled committed capital to put to use.

Sub-$1B PE fundraising (Akerman methodology)



Source: PitchBook
*as of September 30, 2018

Sub-$1B PE fundraising as % of overall PE fundraising



Source: PitchBook
*as of September 30, 2018

Methodology

PitchBook: PitchBook defines the middle market as U.S.-based companies acquired through buyout transactions between $25 million and $1 billion. Note that minority deals are not included. This methodology covers only U.S.-based middle market companies that have undergone a buyout. PitchBook defines middle market funds as PE investment vehicles with between $100 million and $5 billion in capital commitments. The methodology includes only PE funds that have held their final close. Funds-of-funds and LP secondary funds are not included.

Akerman: Akerman's analysis of the sub-$1 billion market is performed at the investor level, defined by the investor's assets under management (AUM) and most recent fund size. All investors included in Akerman's methodology must have estimated AUM of less than $2 billion in total, with their most recent fund being less than $1 billion as well. Deals must be less than $200 million in size to be included in this methodology. Fundraising figures, however, include all funds of said investors. Exits must have said investor tagged as a seller/exiter on the given transaction. Geographic scope is also U.S.

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