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US PE Middle Market Report

2Q 2019

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Contents

A note on methodology: Beginning with this edition, the US PE Middle Market Report will be published later in each quarter in order to allow for more data collection before we complete our analysis. We have also updated our methodology regarding unknown deal sizes in order to more accurately reflect market trends. Please contact reports@pitchbook.com with any questions.

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Click here for PitchBook's report methodologies.

Introduction

Through the first half of 2019, US PE MM dealmaking is matching 2018's record-setting pace. This activity has been driven by an accumulation of dry powder, a low interest rate environment and continued economic expansion. In 2Q, manufacturing deals played an outsized role in MM activity, with four of the top 10 deals coming from the vertical. Corporate divestitures and carveouts were also overrepresented in the top MM deals, as an increasing number of companies are divesting assets. Across all sectors, MM GPs are continuing to use add-ons to blend down acquisition multiples and gain from multiple arbitrage while hopefully improving operations and growth.

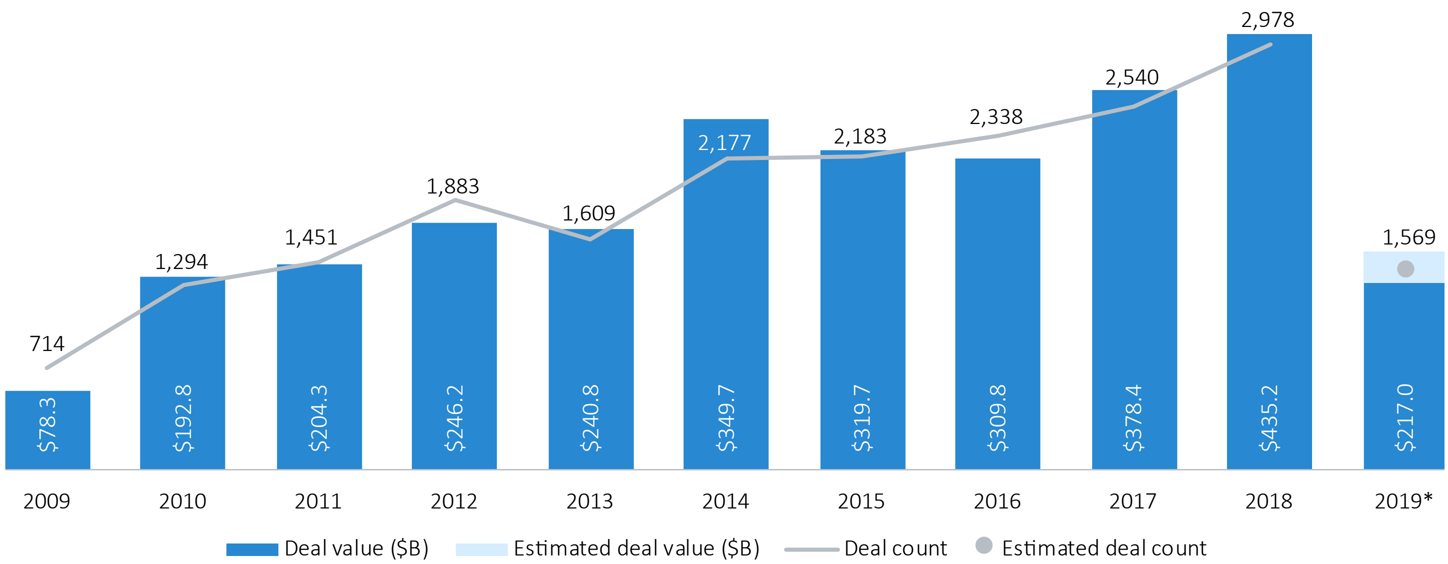
In contrast with healthy dealmaking activity, MM exit activity continued its downward trend. This is partially due to the continued proliferation of add-ons leading to an increase in platform sizes above the MM threshold. Following strong 1H performances from public indices, IPOs made a resurgence in 2Q after 1Q was devoid of any MM PE-backed public listings. SBOs also continued to grow in prominence—a trend we do not see abating anytime soon.

MM fundraising figures were down in 2Q 2019; however, the average and median MM fund size are on pace to reach the highest levels on record. The number of first-time funds in the MM is also on the decline, falling sharply from 2018 highs. Although fundraising was down, LPs were busy allocating to fund strategies that perform well in challenging economic times. Several mezzanine funds, which typically have a hybrid of equity and debt exposure, were raised in the quarter.

Stephen-George Davis
Analyst, PE

Overview

PE MM deal activity



Source: PitchBook | Geography: US
*As of June 30, 2019

MM deal activity in the first half of 2019 is on pace to approximate 2018's record-setting figures in terms of both deal count and value. In 2Q 2019, buyout shops closed 866 deals for a total of $124.2 billion, representing YoY increases of 12.9% and 15.8%, respectively. This put 1H 2019 figures at an estimated 1,569 deals valued at $217.0 billion, including debt and equity. The robust activity can be partially attributed to vast sums of dry powder raised in recent years, as well as continued economic expansion and a low interest rate environment. This strength in dealmaking is also occurring against a dimming economic backdrop in the US. The Federal Reserve is signaling its intention to make its second rate cut this year, a move that indicates the fragility of the current economic recovery.

Through 2Q 2019, the MM continued to grow in prominence. MM PE deal activity (deal sizes between $25 million and $1 billion) comprised 82.4% of all buyouts in the US, marking five consecutive years in which the MM has grown as a percentage of overall PE deal count, if current figures hold. The MM also made up 69.2% of PE deal value in 1H, higher than any full-year figure since 2014. The MM's importance has grown in part due to the prevalence of add-ons, which tend to be smaller than their corresponding platform companies. Additionally, the median deal size within the MM halfway through the year has increased to $200 million from 2018's full-year figure of $180 million, coinciding with heftier funds being raised across the PE landscape, which in turn necessitate that capital be deployed into larger companies. Though these figures could change by year end, we expect the longer-term trend of rising deal sizes is here to stay.

Due in part to an overall decline in relative performance vis-à-vis public equities, GPs have continued to utilize add-ons as a technique to enhance returns in a highly competitive and richly priced environment. In 1H 2019, add-ons comprised 59.5% of deal value as well as 68.8% of the number of deals closed in the MM, higher than any other full-year figures on record for both categories. Meanwhile, US PE buyout multiples surpassed the 12.3x mark in 2Q 2019. The buy-and-build strategy allows for a GP to blend down the acquisition multiple and capture the associated multiple arbitrage, while ideally also improving operations and growth in the process. As we stated in a recent note, this strategy has become the norm for many GPs now that "the use of leverage, financial engineering and multiple expansion are no longer adequate to deliver strong returns." We believe the use of add-ons will continue to be an increasingly prevalent strategy of GPs moving forward.

One recent transaction that exemplifies the use of add-ons is the buyout of Anvil International, a New Hampshire-based manufacturer of pipe fittings and piping components. Anvil was originally bought out in

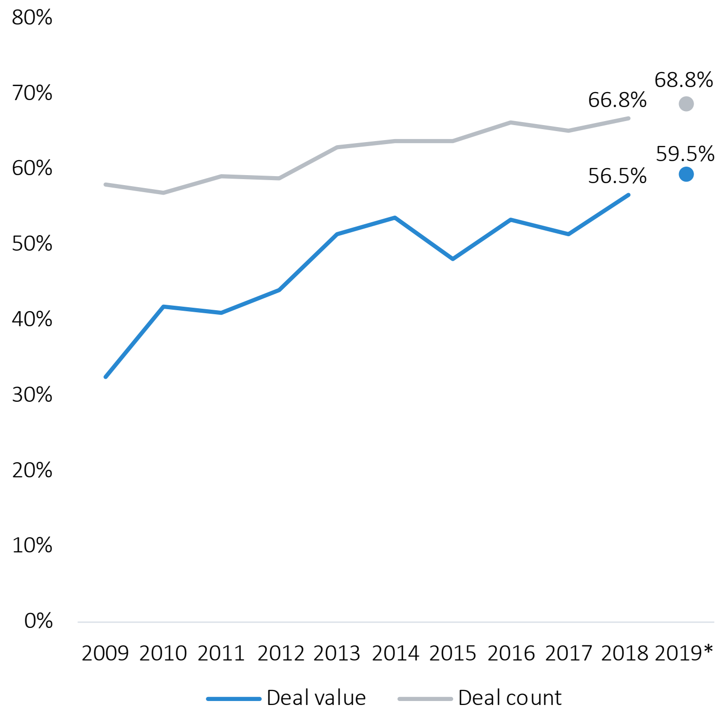
2017 by One Equity Partners for $315 million. Between the original buyout and One Equity Partners' exit of the company in May 2019, Anvil International horizontally integrated five companies to its platform in order to boost revenues. A consortium including Babson Capital Management, CDIB Capital International and Tailwind Capital purchased Anvil International through a secondary buyout (SBO) in 2Q for $765 million, making it one of the largest manufacturing deals of the quarter. The acquisition of Anvil itself was an add-on as the company was tacked on to portfolio company Smith-Cooper International.

The manufacturing vertical helped drive MM activity in 2Q, with four of the 10 largest deals falling into the category. Another manufacturing deal to close in the quarter was the acquisition of Formica by Broadview Holdings via its financial sponsor HAL Investments. The buyout of Formica, an Ohio-based manufacturer and distributor of countertops and other laminate products, was the largest manufacturing deal of 2Q 2019. With an $840 million price tag, it was also the third largest MM deal to close in the quarter. Formica was initially bought in 2007 for $750 million by Fletcher Building (NZE: FBU), a construction conglomerate based in Auckland, New Zealand. Fletcher Building decided to sell the company as part of a larger strategy to divest from non-core businesses. A near-record number of companies are planning on making a divestiture in the next two years, according to a recent Ernst & Young survey.[1] This strategy could provide additional targets for MM GPs sitting on record-setting capital levels.

Carveouts and divestitures accounted for four of the 10 largest deals in 1H 2019. Along with Formica, other notable corporate divestiture deals to close included Blackboard's Transact business unit, Bolthouse Farms (formerly of Campbell's Soup), Newell Brands' Process Solutions and Life Fitness (formerly of Brunswick). While there has been some recent debate about the suitability of PE's involvement in divestitures, the fact remains that an increasing number of companies are divesting assets.[2] These divestitures are usually done for reasons other than business failure, which leads to several viable investment opportunities for GPs down the line.[3]

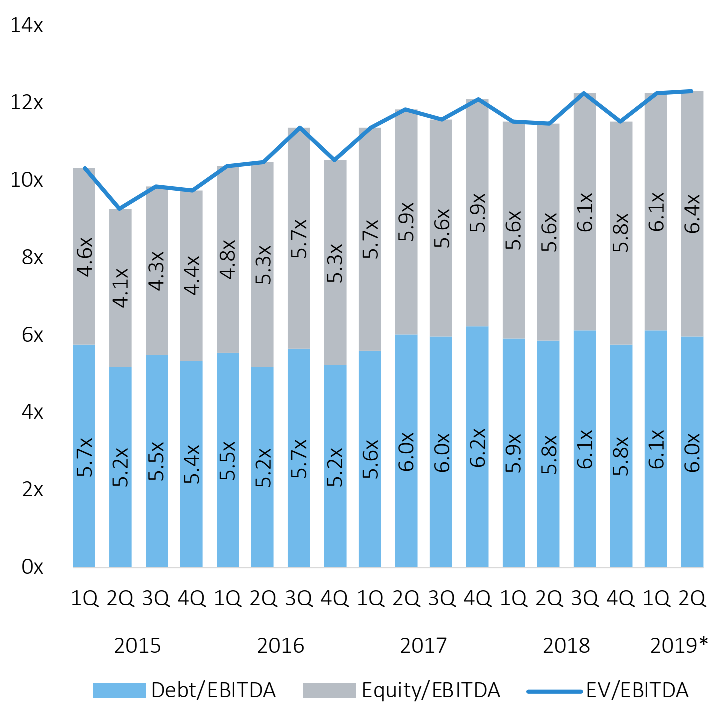
1: "Global Corporate Divestment Study 2019," Ernst & Young, 2019 as quoted in "Why So Many Companies are Divesting," Carsten Kniephoff, et. al., EY, February 12, 2019
2: "Private Equity Buyers as Divestiture Buyers: U.S. and EU Perspectives," Marc Williamson, Lindsey Champlin and Tomas Nilsson, The Threshold, vol. XIX, no. 2, Spring 2019
3: "Why So Many Companies are Divesting," Carsten Kniephoff, et. al., EY, February 12, 2019

Add-ons as proportion of overall PE MM deals



Source: PitchBook | Geography: US
*As of June 30, 2019

Four-quarter rolling median PE EV/EBITDA buyout multiples



Source: PitchBook | Geography: US
*As of June 30, 2019
Note: This chart includes data from all PE deal types

Antares Q&A: Daniel Barry

Daniel Barry

Senior Managing Director
Antares Capital

Daniel is responsible for leading the company's sponsor coverage activities in the Midwest. One of the founding partners of Antares Capital, he previously served as senior managing director for GE Antares. Prior to forming Antares Capital, Daniel worked in a variety of roles in the corporate finance group at Heller Financial. Daniel began his career at Arthur Andersen. Daniel is a certified public accountant. He graduated with a bachelor's degree in accounting from the University of Illinois.

Before we delve into sectors, let's take the pulse of PE activity in the broader US middle market. How is Antares' pipeline performing? Are there any shifts in activity you're seeing versus earlier in the year?

2019 kicked off with subdued deal activity following the sharp stock market sell-off in late 2018. Then, optimism started to lift by the end of 1Q 2019 following the Federal Reserve's signaling of a pivot towards interest rate cuts. By April, we started to see a real spike in incoming deal opportunities. However, even with the lift seen in 2Q, Refinitiv LPC reported a 33% YoY decline in US-sponsored middle-market loan dollar volume in 1H 2019. Most of this drop was due to lower reprice/refinancing activity, however, M&A-related loan volume was also down 12% YoY. So far in 3Q, we've seen a decent level of activity with our open pipeline actually up approximately 10% YoY as of September 8, 2019.

Which areas of the market, on a sector basis, have been particularly active? PitchBook data illustrates a still strong concentration of deal volume in healthcare and technology; what has Antares been seeing?

Both healthcare and technology remain among the largest and most active industry sectors we serve. In healthcare, Antares has seen a nearly 20% increase in unique opportunities and has closed more than 35 transactions through August 2019. As a result, our total healthcare commitments have risen to more than $3.5 billion across 84 borrowers owned by more than 50 PE sponsors.

Looking at healthcare, it's clear that powerful macro drivers are helping incentivize dealmaking—for example, its growing share of GDP and demographics. What other drivers does Antares see making an impact in the market?

There are several factors we see driving PE investment and consolidation in the healthcare sector. For one, legacy ownership and employment models are changing. Retiring practitioners across numerous subsectors are seeing limited ability and/or interest from the next generation to buy them out. This void in traditional successors creates attractive opportunities for established PE-owned platforms to acquire smaller providers and groups.

Another force at work is increasing administrative burdens. Practitioners are typically not well equipped to effectively a handle the increasing administrative demands related to outcome tracking and documentation for patients, payors, regulatory compliance, referral relationships, etc. As a result, meaningful economies of scale can be generated when a platform consolidates providers, executes the back-office needs efficiently and lets practitioners focus on providing patient care. Of course, as various parts of the ecosystem consolidate and become more sophisticated, it puts pressure on others to do the same. Increased scale in a particular geography can help a provider become more attractive for patients and referral sources, negotiate higher reimbursement rates, leverage marketing dollars in a region and manage staffing across multiple locations.

Finally, PE firms are well positioned to help healthcare businesses navigate the shift towards increasingly consumer-driven dynamics. As patients face higher levels of deductibles, co-pays and co-insurance amounts, they are taking more ownership in their care choices and demanding more transparency into historically murky areas. This shift is resulting in higher quality providers getting more volume from patients, traditional referral sources and pay or referrals/direction.

Relative to the other sectors across Antares' portfolio of PE-sponsored companies, how does healthcare differ in its dynamics and key factors?

Healthcare is a massive industry with a broad array of subsectors, all with unique dynamics and key considerations that warrant deep domain expertise as an underwriter.

On the pricing front, many care providers have limited control over unit-level pricing given direct or indirect origin of reimbursement rate determinations from CMS and state-level concentrations with commercial payors. It is also important to assess regulatory risks, including billing practices with government payors, Stark Law compliance (referral relationships/anti-kickbacks), HIPAA compliance and certifications when handling pharmaceuticals, just to name a few.

Of course, there are many other considerations that are not unique to healthcare—such as labor dynamics, concentrations and infrastructure/capex needs—that have dynamics specific to healthcare. For example, a large percentage of cost of goods sold for care providers is typically comprised of labor, and it can be challenging to retain physicians that are well educated with high net worth. Some care providers may have moderate-to-high levels of concentrations across variables that bear close consideration (e.g. referral sources, key practitioners, clinic locations, payors, etc.) Finally, on the cash flow front, for some legacy practitioner-owned practices, above average infrastructure needs may require investment post PE buyout for back-office functions such as finance, IT, HR, compliance and business development.

Finally, it is important to assess the ever-changing landscape given all the advancements and consolidations across the healthcare ecosystem. Providers of all kinds—whether in care, devices or services—need to be keenly focused on how care will be provided and paid for five to 10-plus years in the future and not remain content to operate within the status quo. Certain healthcare subsectors have numerous organic growth opportunities looking forward, whereas some subsectors are more mature. Sector-specific analyses are key to understanding volume growth opportunities, including the balance in geographic growth between de novo versus acquisitions, for example.

When it comes to healthcare, how does Antares' approach adapt? For example, what additional steps of diligence are taken that Antares views as critical depending on the business in question?

Firstly, we're selective about the providers we support. We believe long-term, sustainable providers are those that are not only high quality in what they do (across care, services, device manufacturing, distribution, etc.), but also do it in a cost-effective manner that helps provide both quality and value throughout the healthcare ecosystem. A provider may have been able to generate outsized margins and get away with sub-par quality metrics historically; however, we believe that the high quality and cost-efficient providers will prove to be the long-term winners as transparency and accountability continues to improve across all areas.

Then, of course, it's important to focus our diligence on the prospective borrower's compliance/regulatory history, procedures/controls, etc. for both new platform investments and acquisitions. To aid in this, we aim to have a solid foundation on the key focus areas going into the diligence process for a new opportunity through our proactive communication with PE clients, borrowers, third party advisors and relationships out in the field with practitioners and payors.

Finally, there is the need to understand the human element. Given that healthcare is so personal, we pay careful attention to the historical and forward-looking behaviors, choices and incentives/motivations for all parties involved including patients, practitioners and referral sources.

Having a keen understanding of the challenges and opportunities transforming the industry from a business model, technological and cultural perspective is critical for us to evaluate transactions and commit quickly, ultimately delivering the liquidity and flexibility our borrowers rely on to meet their growth objectives.

Spotlight: Sovereign wealth funds

This section appeared originally in an analyst note, written by Senior PE Analyst Wylie Fernyhough, on August 9, 2019.

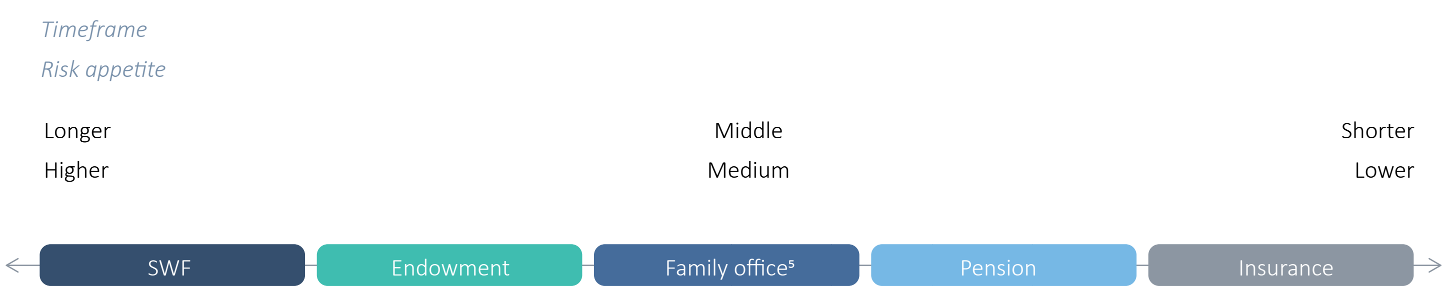
Introduction

SWFs have become major participants in today's capital markets with over $8 trillion in AUM. Many SWFs are upping private markets allocations and pouring billions of dollars into middle market funds annually. Additionally, several of these high-profile funds are managing hundreds of billions of dollars and allocating capital through in-house investment teams, with some even pursuing direct deals in the private capital markets. This means a swelling cohort of SWFs are funding middle market funds while simultaneously competing against them by pursuing direct deals. However, the overarching moniker of SWF does not reflect the nuances that differentiate them. Many SWFs are not even funded by sovereign entities and instead belong to states and cities. These entities have different AUM, goals, public disclosure requirements and levels of investment sophistication. Here, we will delineate high-level definitions to better define the SWF space and analyze the key players involved.

Goals

SWFs typically have one of three goals: stability, savings or local development. Stabilization funds are designed to reduce the effects of volatile revenues to the government and economy. These funds are set up in countries that are highly dependent on one (sometimes more) specific nonrenewable resource; capital flows into the funds when prices are high, and the government enjoys a surplus. Alternatively, when prices are lower and government finances swing to a deficit, capital flows from the SWF back to the government and economy.[4] Stabilization funds are intended for use between shorter-term cycles, such as the typical rise and fall in oil prices. Since stabilization funds are more reactionary than savings or development funds, their investment portfolio needs to hold a higher portion of liquid investments.

Institutional investor categorization

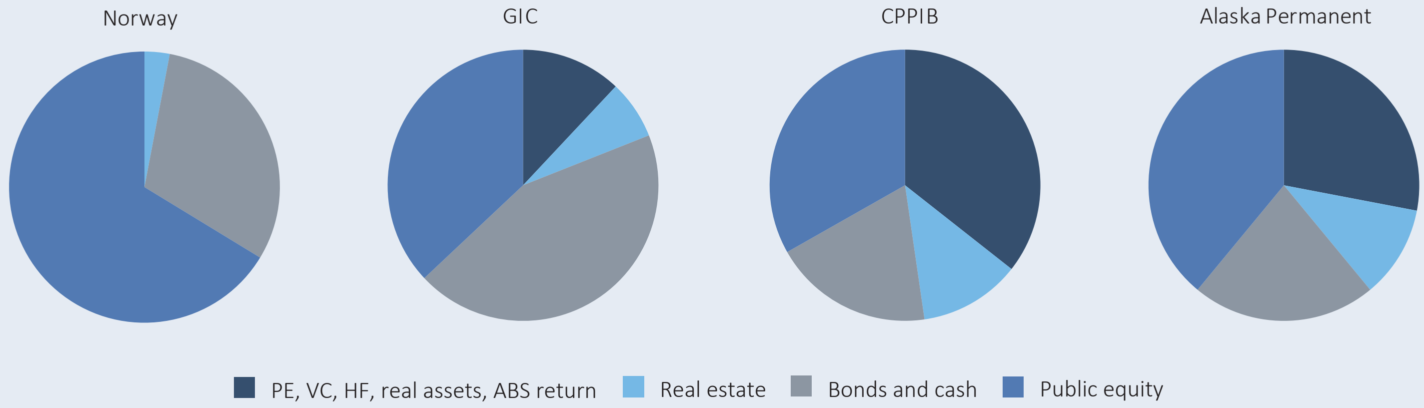


This chart is meant to help visualize the differences in time horizon and investment risk tolerance between major institutional investor types. SWFs on the left typically have the longest time horizons and thus can take on the highest levels of investment risk. On the right, insurance companies must be ready for substantial payouts at any time and keep a significant portion of assets liquid, forcing them to have shorter time horizons and take less risk. However, risk tolerance and investment horizon can vary greatly within each of these categories.

Source: PitchBook | Geography: US
*As of June 30, 2019

4: "Stabilization and Savings Funds for Nonrenewable Resources: Experience and Fiscal Policy Implications" International Monetary Fund, Jeffrey Davis, et. al., April 13, 2001
5: This investor type has the most variety and is difficult to summarize. Many family offices have multigenerational outlooks and resemble SWFs, though many others are hyper focused on short-term investing and hold huge portions of wealth in cash.

Asset allocation by LP[6]



Source: Norway as of 2018; GIC as of March 2019; Alaska Permanent as of 2018; CPPIB as of June 6, 2019

Savings funds, which make up the bulk of funds and AUM, are designed to provide an economic boost to the local economy. Natural resource-financed funds are intended to bridge the gap from reliance on a nonrenewable resource to the time when the country or region depletes its natural resource base. Though most of these funds are financed by revenue from fossil fuels, minerals revenue is also a source of capital for several funds. Another subset of funds is financed by excess government assets. Whereas stabilization funds are more focused on the short-term, savings funds are intended to have a multigenerational time horizon and will be the SWFs of most interest to private market practitioners. Though their investment scope is generally much longer, savings funds can have different timeframes depending on resource depletion levels. Many savings funds, such as the Alaska Permanent Fund, deploy some of their yearly gains, though the bulk of savings funds are not expected to begin fully paying out for several decades. Many of the largest funds, including Norway Government Pension Fund Global and Abu Dhabi Investment Authority (ADIA), are more fixated on growing assets today than on distributions.[7]

Another classification of SWF, known as development funds, has a strategy beyond just investing for multigenerational gains. Development funds are also tasked with promoting the economic growth within the home country. Many of these funds invest in the domestic economy with the goal of catalyzing homegrown markets through infrastructure investing and direct investments in local companies. These investors hope to be a force that proves the viability of local capital markets while reaping the long-term benefits of being a first mover. Often, countries with SWFs will have development funds as well as savings funds, such as Abu Dhabi with ADIA and Mubadala or Singapore with GIC and Temasek.

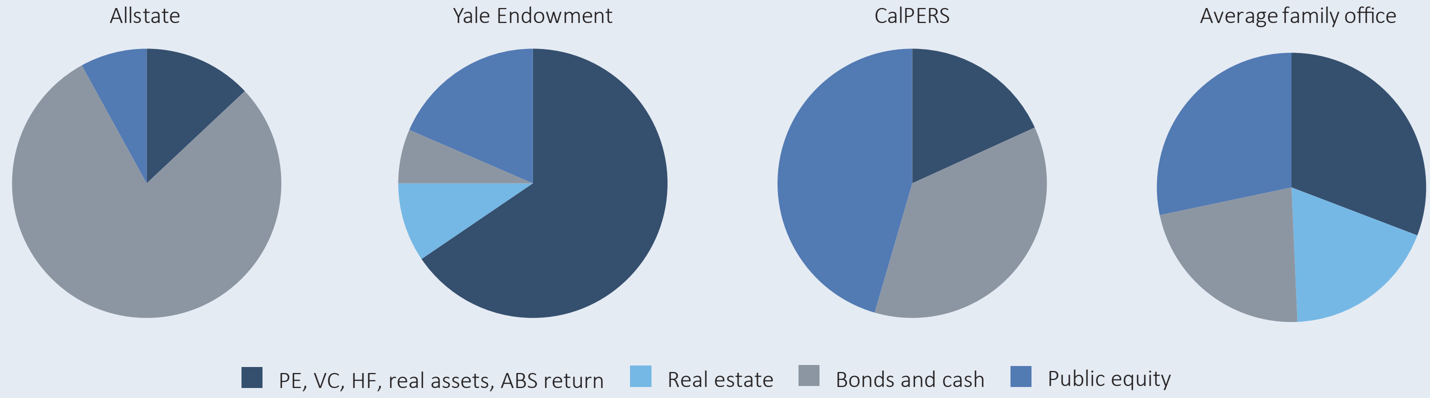
The funds with longer-term horizons are more focused on growth and are better suited for illiquid investments, allowing them to pursue higher allocations to equity as opposed to cash or fixed income. To supplement our understanding of these investors, we have categorized five of the main institutional investor types—SWFs, endowments, family offices, pensions and insurance companies—by their timeframes and risk appetites.

Investment sophistication

A SWF's investment sophistication can run the gamut. The simplest asset allocators tend to allot only to publicly traded equities, real estate and bonds. Additionally, they lack inhouse allocation teams and often exclusively rely on outside consultants and fund managers. On the other end of the spectrum, sophisticated allocators typically assign a higher portion of AUM to in-house strategies and private markets and

6: Due to reporting inconsistencies, real estate's weighting may not accurately reflect underlying portfolio assets as some managers categorize the asset class within real assets or other alternatives.
7: For political reasons, many of these funds distribute some capital today, though the distributions are likely to rise in future years as oil revenues decline. For example, Norway's fund distributes 3% of its capital per year to supplement the government's social services budget but will likely distribute a larger portion once oil revenues cease. "Factbox: Norway's $960 billion Sovereign Wealth Fund," Reuters, Gwaldys Fouche, ed. Dale Hudson, June 2, 2017

Asset allocation by LP



Source: CalPERS as of June 30, 2018; Allstate as of 2018; Yale Endowment as of 2019; family office as of 2017

often take a further step by co-investing in funds and even directly sourcing deals. Many go so far as to have entire in-house public equity, PE and/or real estate teams running internal funds. Though the medium-sized SWFs may not be able to pursue this strategy as effectively as larger SWFs, some, such as Alaska Permanent and GIC, display a sophisticated investment approach that we believe outclasses their peers. Alaska Permanent and GIC's novel approaches to private and public markets exhibit a level of execution that many similarly sized funds lack. The sophistication goes beyond simply allocating to private markets, as this can be done poorly even at scale, as evidenced by CalPERS' many woes in private markets.

We believe most SWFs want to be sophisticated investment managers, eventually handling investments in-house, forging relationships and conducting investments outside the traditional fund structure and expanding private market allocations over time. ADIA has doubled its direct PE investments over the past three years according to the fund's annual filing, clearly illustrating its investment prowess and asserting itself near the head of the pack in terms of sophistication.[8] Not only should raising allocations to private markets lift long-term returns, but maximizing co-investments and direct deals may further enhance returns by reducing fee drag. In-house teams also allow SWFs an opportunity to markedly deviate from a globally cap-weighted index in public equities and fixed-income, potentially delivering alpha. However, doing so comes with added risk. While there are relatively few SWFs on the cutting-edge end of the investment spectrum, we believe most SWFs will increase their allocations to private markets and focus on direct investments and in-house management teams over the medium-to-long term. As a supplement to understanding investment sophistication and risk tolerance, we have included the allocations for some major LPs across each of the major asset classes, including for three SWFs.

For more on SWFs—including a spotlight on several select funds—please read PitchBook's Sovereign Wealth Fund Overview.

8: "2018 Review: Prudent Global Growth," Abu Dhabi Investment Authority, 2018

ACG Q&A: Andrew McCabe

Andrew McCabe headlined ACG Seattle's Northwest Middle Market Growth Conference this summer and recently spoke with Kathryn Mulligan, editor-in-chief of the Association for Corporate Growth's Middle Market Growth magazine. This Q&A is an edited excerpt of that interview, which will be featured in an upcoming MMG podcast episode. You can find it by searching for "Middle Market Growth Conversations" in Apple Podcasts or Google Play.

Mulligan: In your role as acting director of the FBI, you were instrumental in ensuring that the investigation into Russian interference in the 2016 election moved forward, and in the appointment of the special counsel. Were you satisfied with the findings of the Mueller report?

McCabe: I have the highest respect for Director Mueller, and the folks he worked with. The report is an amazing piece of work. I was both impressed by the report and maybe a little bit disappointed. It provides overwhelming facts and details and is remarkably revealing, particularly regarding the information about Russian meddling in the 2016 election. It's a great thing for every American to read because it's unlikely you will get another view of this type of intelligence work anytime soon.

Like many Americans, I walked away from the obstruction side of the report and wished it was more specific about the team's thoughts about whether the behavior that the president engaged in, which is laid out extensively, would constitute indictable conduct if it were done by someone other than the president of the United States. Like any 400-page report, there are some things that I think any of us would do differently, if we could.

Mulligan: Have you seen the country make any progress toward recognizing the threat that Russia and other state actors pose to our cybersecurity, or is that conversation still too clouded by partisan politics?

McCabe: We haven't had nearly the level of success that we need. Senior leaders in the intelligence and law enforcement community have been talking about this for a long time. I and others testified about this under oath back in 2017. The Mueller report details how intensely the Russians targeted our democratic process and how they engaged in cyberwarfare against our elections. Despite consistent information and consistent assessments about the Russian threat, I don't see that we have really taken major steps to do things differently. I think the folks in the agencies are doing what they can, but it's a big mistake that we haven't taken any federal legislative steps.

Former top FBI official points to cyberthreats for US businesses

Andrew McCabe

Former Acting Director of the FBI

He chronicles much of his time with the FBI in his new book, The Threat: How the FBI Protects America in the Age of Terror and Trump. McCabe spent 22 years at the FBI where he began his career as an agent in the New York Field Office. He worked high-profile cases including the 2013 Boston Marathon bombing, the Clinton email investigation and the investigation into Russian interference in the 2016 election. He assumed the role of Acting Director of the FBI in May 2017. Most recently, he was the keynote speaker at ACG Seattle's Northwest Middle Market Growth Conference.

Mulligan: In addition to threatening the integrity of our political system, cybersecurity poses a serious threat to American businesses. What are the most attractive assets for criminals, and have you seen that change over time?

McCabe: I'm not sure that anyone in the government or private sector can easily answer that question. When we first started to track cyberattacks from Russia and China on our businesses and commercial infrastructure, we were honestly surprised by some of the targeting that we saw. For example, we were curious about the persistent targeting of health care companies, which included massive thefts of data with no obvious effort to weaponize the data or extort the company.

Today, there is a broader and more aggressive targeting effort. We used to see the major banks and financial institutions targeted. Now it's malicious activity directed at small to midlevel businesses in which ransomware is used to lock up or destroy computer infrastructure or data.

Every day, hospitals, municipalities and small to midsized businesses around the country are receiving requests for ransom to restore stolen data. They are easier to victimize because they lack the sophisticated security and prevention steps. And because they don't have the resources to recreate the data, the victims are more likely to pay the ransom in an effort to reclaim their data.

The adversaries are getting much smarter about what to target, whom to target and how to use that information to extract the most money that they can.

Mulligan: Recently, you described how Russia has long been focused on intelligence and influencing politics, while China has largely targeted intellectual property. Have those different motivations influenced how the FBI allocates resources, or its strategy in dealing with threats from each country?

McCabe: It is always challenging to decide how to allocate limited resources. For instance, Chinese actors were aggressively targeting private sector entities. This required coordinating people with all the applicable skills, from field offices across the country, who can respond to the affected entities as soon as possible. From there, we try to build those cooperative relationships to find a path forward. With Russia, its cyber efforts are part of ongoing, never-ending, incredibly aggressive intelligence collection activities. So that threat never goes away, and is constantly changing in terms of techniques and methods.

Much like in the private sector, you use your limited resources strategically. There are many things that impact how the FBI assigns and deploys its cybercrime investigative resources [...] We need to be strategic and use the best resources for the greatest threats.

Mulligan: There seems to be consensus that intellectual property theft is a real problem, but much of the business community believes tariffs aren't the right response, that they're too blunt of a tool. In your view, what's the best way to deal with China and protect US companies?

McCabe: Prior administrations pursued an engagement strategy to deal with these threats. By some indicators that strategy worked because we did see a significant decline in Chinese activity for some time.

Was the process perfect? Probably not, but we did make progress. I'm not part of government now, and I don't know what they are seeing in response to the tariffs, but it is hard to imagine that you'll convince our adversaries to operate differently by using the tools of business to injure each other through a trade war. It might seem obvious to say, but when things are getting worse, they are likely to get worse.

We need a better path forward with the Chinese. I think our chances of finding that are better through productive engagement than with tariff wars.

Mulligan: Since the trade conflict with China has escalated, do you expect to see more cyberattacks now that the relationship between the two countries has become more adversarial?

McCabe: When you are on defense, you must be on your game and successful all the time. The cybercriminals and all the foreign intelligence agencies that conduct cyberwarfare only have to get it right once. They can send out thousands of spearfishing efforts and they only need one person to click on the wrong link. That is a very tough game for the government to play. It's an even harder one for a private entity to play because in many cases they don't have the resources to engage in a sophisticated cyber defense.

Mulligan: I've spoken with leaders of US companies who are considering moving to suppliers outside of China in response to the tariffs. If a manufacturer is quickly shifting to a new supplier in Thailand or Vietnam, for example, will this create a new set of vulnerabilities from a security standpoint?

McCabe: As you change locations, you raise the threat of a new set of cyber actors, whether criminal or state-supported. You are entering an entirely new environment, where you will encounter a new set of cyber actors who will present new challenges to your defenses. The threat will be different, but it will not disappear.

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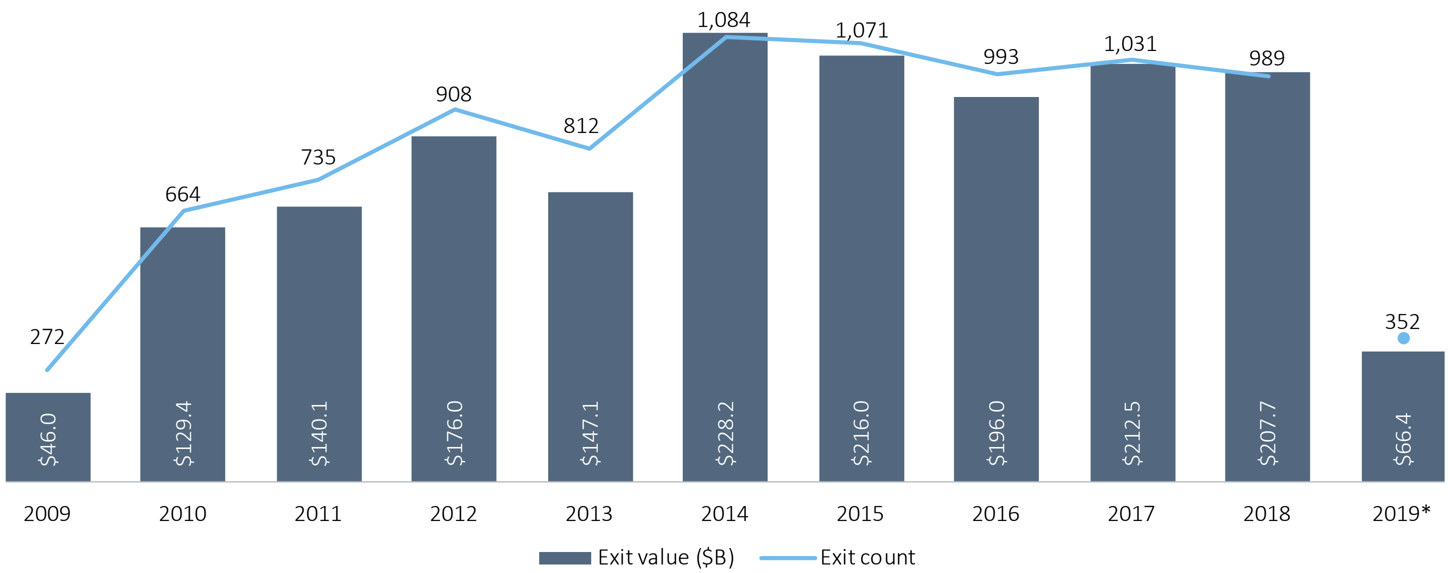
Exits

PE MM exit activity



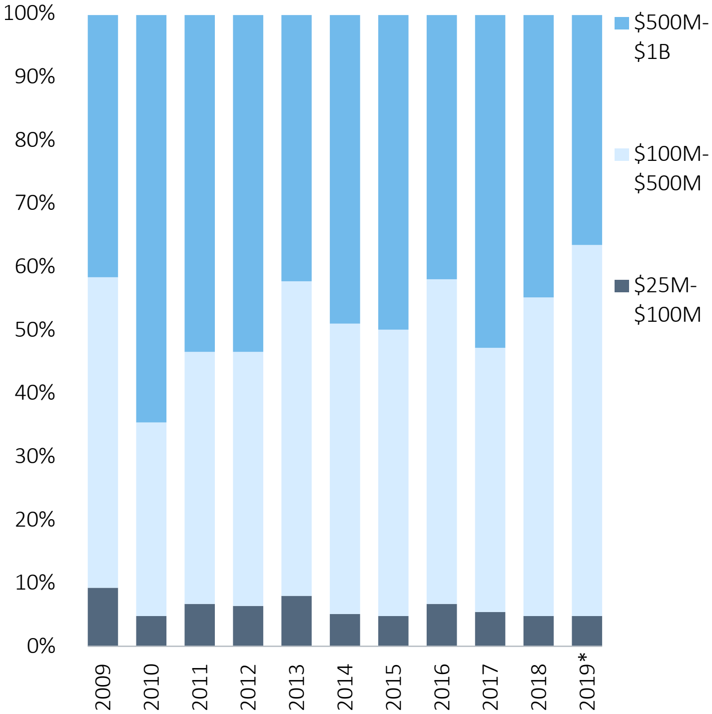
Source: PitchBook | Geography: US
*As of June 30, 2019

In 2Q 2019, MM exit activity saw GPs exit 176 companies for a combined value of $31.0 billion—a decline of 12.4% in exit value compared to 1Q 2019, even while exit count remains unchanged since the first quarter. This highlights a continuation of a downward trend that we have seen in MM exit figures. However, not all MM PE exit activity news has been negative. There was a broad resurgence of PE-backed IPOs, five of which were in the MM in 2Q 2019, compared to zero in the first quarter of the year. In fact, the largest MM exit of the quarter was Change Healthcare's (NASDAQ: CHNG) $557.1 million IPO, which had a valuation of $981.2 million excluding the new proceeds.

Change Healthcare employs a SaaS business model to offer an assortment of software services and solutions to assist healthcare payors and providers. The company was initially taken private by The Blackstone Group and Crimson Ventures in 2011. In 2016, the company was merged with McKesson's technology solutions business. McKesson received a 70% stake in the entity, and Blackstone, along with others, split the remaining 30% stake. Change Healthcare's IPO marks a return to public offerings of PE-backed companies, which had been lacking in the last few quarters largely due to market volatility in 4Q 2018 and the government shutdown, which bled into 1Q 2019. Although IPO exit value only made up 2.2% of total exit value in 1H 2019, compared with 5.9% of exit value in 1H 2018, we anticipate an uptick in IPO activity and corresponding IPO value going forward. A return of the MM PE-backed IPO as a viable exit route may also give GPs some pricing power as they leverage bids against elevated public markets multiples; however, this is only likely to affect the larger MM exits as the cost of taking smaller companies public can outweigh any pricing benefits.

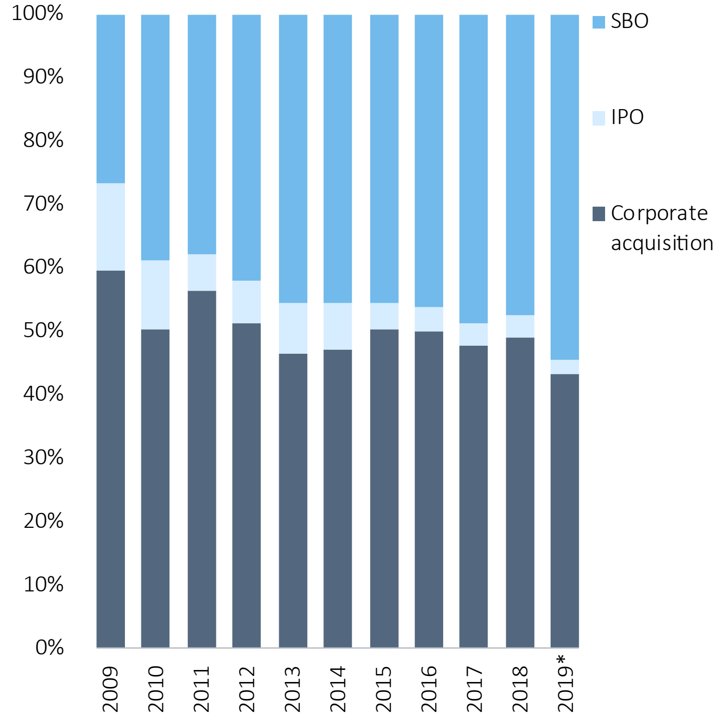
Another significant exit of a SaaS company was that of GlobalTranz, the Arizona-based developer of freight management and logistics software. This transaction is notable as it is an example of an increasingly common VC-to-PE buyout and subsequent exit, wherein previously VC-backed companies are sold to PE firms. GlobalTranz was initially purchased in an LBO in 2018 by The Jordan Company from a group of VC and PE growth investors, before being sold to Providence Equity Partners for $930 million in May 2019. This trend is mainly seen in the software space and is especially common with SaaS companies due to their recurring revenues and generally highly scalable business models.

PE MM exits ($) by size



Source: PitchBook | Geography: US
*As of June 30, 2019

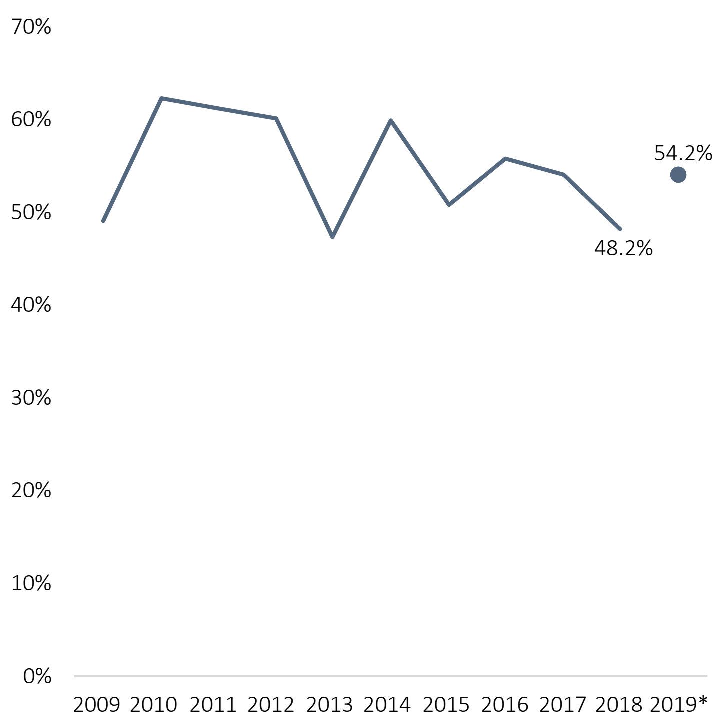
PE MM exits ($) by type



Source: PitchBook | Geography: US
*As of June 30, 2019

Additionally, SaaS is overrepresented in terms of VC funding, which may account for its high portion of VC-to-PE buyouts. In a twist of irony, Providence Equity Partners was one of the growth equity investors who had previously backed GlobalTranz in their VC rounds.[9] The deal is also an example of the enduring prominence of SBOs—which accounted for 61.4% of exits in 2Q 2019—a trend that does not appear to be running out of steam any time soon. Looking forward, we see the trend of VC-to-PE buyouts and subsequent SBOs becoming increasingly prevalent, especially in the software and tech space. With the number of VC-backed tech companies—and more specifically software companies—continuing to surge, PE firms' pool of acquisition targets will keep expanding. Moreover, as GPs such as Thoma Bravo and Vista Equity—which recently closed on a record-setting $16 billion fund—continue to find success investing in more nascent tech companies than PE shops have done in the past, we expect other GPs to imitate the strategy and further drive demand for VC-backed companies.

MM exits ($) as proportion of all PE exits

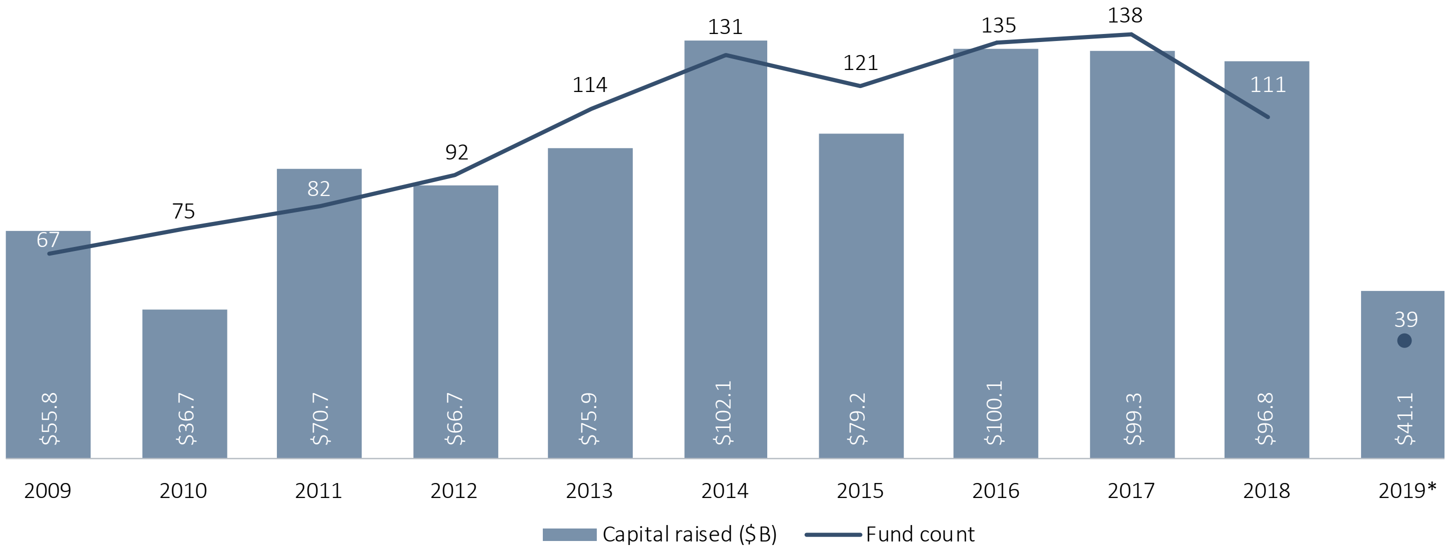


Source: PitchBook | Geography: US
*As of June 30, 2019

9: Two different Providence funds participated in the deal.

Fundraising

PE MM fundraising activity



Source: PitchBook | Geography: US
*As of June 30, 2019

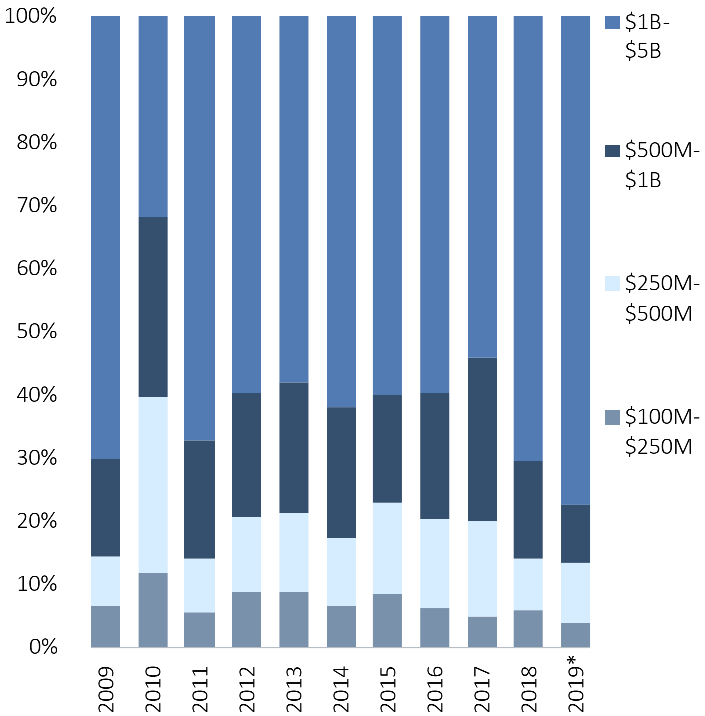
MM fundraising figures were down in 2Q 2019, with $17.2 billion raised across 19 funds. Fundraising value in 1H 2019 has declined by 19.5% from 1H 2018 and the number of funds raised has dropped by 35.0%. While the 19 funds raised in 2Q is the lowest since 3Q 2012, the average and median size of a MM fund (of any type) has reached the highest level on record. Concurrently, MM funds are a declining portion of all US PE funds in terms of value, which we view as correlated to the rise in average and median fund size as well as the ascension of mega-funds, which are not counted in the MM. Not only are we seeing a swelling count of mega-funds, but MM funds are growing in size as well. Funds between $1 billion and $5 billion (the largest bucket in MM fundraising) made up 77.3% of all MM fundraising value in 1H 2019, up from 70.4% in 2018 and 54.2% in 2017. As GPs raise ever-larger funds and crest the mega-fund threshold, we expect the MM to account for a lower portion of US PE fundraising value.

One of the drivers of fundraising activity in 2Q 2019 was the relative abundance of mezzanine funds raised in the quarter. Of the 19 MM funds raised in 2Q, four were mezzanine funds. The largest mezzanine fund of the quarter (and the second largest raised overall) was Silver Lake Management's first mezzanine fund, a $2.5 billion Silver Lake Alpine Fund, focused on making non-control (minority) "privately negotiated structured equity and credit investment in technology, technology-enabled and related growth companies."[10] This accommodates Silver Lake's overarching strategy of investing in tech companies, though the firm is now targeting a different part of the capital stack. The Alpine Fund has recently taken a minority stake in the electronic payment company EverCommerce in a deal that values the payments company at over $2 billion. Firms (especially firms that invest in high-growth sectors) are also expanding into credit strategies in order to gain both equity and income-generating exposure and take advantage of their deep, sector-specific knowledge.

On the smaller end of the spectrum, Grain Communication's Opportunity Fund II closed on $900 million this past April. The firm's second buyout fund focuses on investments in the global communications sector, concentrating on investing in "mission-critical communication assets, both domestic and abroad."[11] The fund initially targeted $750 million, though due to excess demand, the final close was higher. The strong demand for the second fund is in line with the trends of lower median time to close figures for funds in the MM, as well as the increasing size of MM funds.

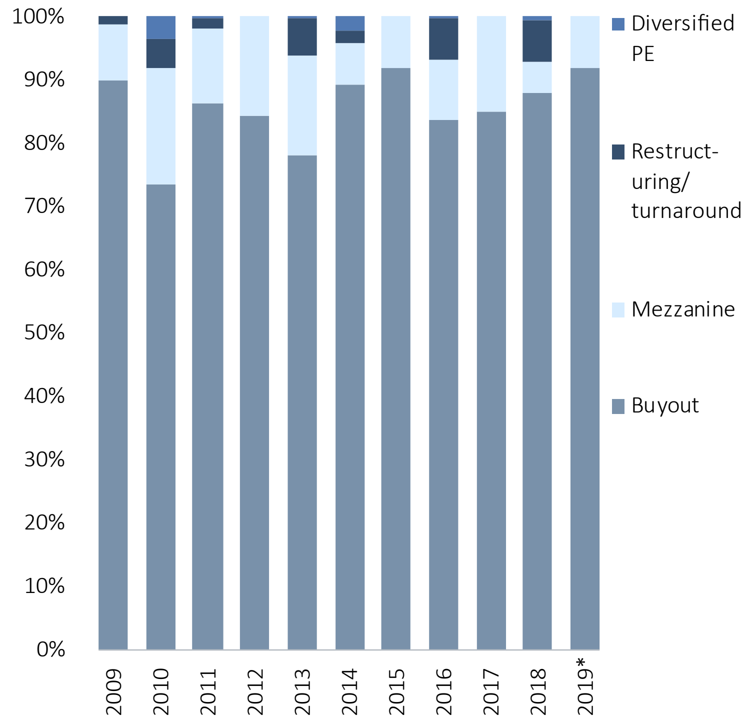
10: "Strategies: Silver Lake Alpine," Silver Lake, 2019
11: "Grain Management Closes Fourth Fund with Close to $900 Million in Commitments," Grain Management, April 25, 2019

PE MM funds ($) by size



Source: PitchBook | Geography: US
*As of June 30, 2019

PE MM funds ($) by type



Source: PitchBook | Geography: US
*As of June 30, 2019

However, it seems not all in the MM are benefitting from lower time to close and increasing fund size. The number of first-time MM funds has declined sharply from 2018's elevated figures. To date, only three first-time funds closed, and in 2Q, only one first-time fund closed—Gainline Capital Partners' Gainline Equity Fund, which held its close for $155 million in May. We believe LPs, seeing a potenital recession on the horizon, are becoming more conservative in their allocation of funds. Additionally, as many of the more established GPs raise massive funds and become one-stop-shops, LPs can sate their appetite with fewer manager relationships. Looking forward, we expect the proportion of MM activity to overall PE activity to decline as funds and deals continue to grow. However, we still expect MM fundraising to find continual success as LPs look to allocate to the MM's unique return profile.

PE MM median fund size ($M)

Source: PitchBook | Geography: US
*As of June 30, 2019

PitchBook

2Q 2019 US PE MM lending league tables

Overall

1	Antares Capital	32
2	Ares	20
3	Barings	18
3	The Carlyle Group	18
3	Churchill Asset Management	18
6	Bank of Ireland	16
6	Citizens Bank	16
8	MidCap Financial	12
8	NXT Capital	12
8	The Goldman Sachs Group	12
11	Golub Capital	11
12	Twin Brook Capital Partners	10
13	BMO Financial Group	9
13	Crescent Capital	9
15	Capital One	8
16	Monroe Capital	7
17	Owl Rock Capital Partners	6
17	Deutsche Bank	6
19	Fifth Third Bank	5
19	Jefferies Group	5
19	Bank of America	5
19	Madison Capital Funding	5
19	Varagon Capital Partners	5

Source: PitchBook

Select roles*

1	Antares Capital	25
2	Ares	15
2	Citizens Bank	15
4	MidCap Financial	10
5	Twin Brook Capital Partners	9
6	NXT Capital	8
6	Capital One	8
8	Churchill Asset Management	7
8	Bank of Ireland	7
10	Golub Capital	6
11	BMO Financial Group	5
12	The Goldman Sachs Group	4
12	Bank of America	4
12	J.P. Morgan	4
12	Deutsche Bank	4
12	Madison Capital Funding	4
17	UBS	3
17	Jefferies Group	3
17	Sumitomo Mitsui Banking Corporation	3
17	PNC	3
17	KeyBanc Capital Markets	3
17	Credit Suisse	3
17	Owl Rock Capital Partners	3
17	Varagon Capital Partners	3

Source: PitchBook. *Select roles are comprised of bookrunners, lead arrangers, mandated lead arrangers and administrative agents only.