



US PE Middle Market Report

2018 Annual

Introduction

In 2018, the US PE middle market (MM) saw:

- \$427.9 billion total deal value across 2,971 deals (increases of 14.8% and 15.1% YoY, respectively)
- \$187.6 billion total exit value across 876 exits (decreases of 10.5% and 14.8% YoY, respectively)
- \$110.8 billion capital raised across 131 funds (decreases of 4.4% and 21.1% YoY, respectively)

Overall deal activity in the US MM recorded several milestones in 2018.

Coming into the year, the MM had not registered a single quarter in which deal value exceeded \$100 billion—it happened each quarter in 2018. Consequently, 2018 was also the first year where MM deal value exceeded \$400 billion. A sustained market appetite for high-yield bonds and leveraged loans led to an easy financing environment in which dealmakers were able to attain attractive pricing for deal financing. However, attitudes began to change in the fourth quarter as the leveraged loan market—which has swollen in size since the financial crisis—saw downward swings in pricing.

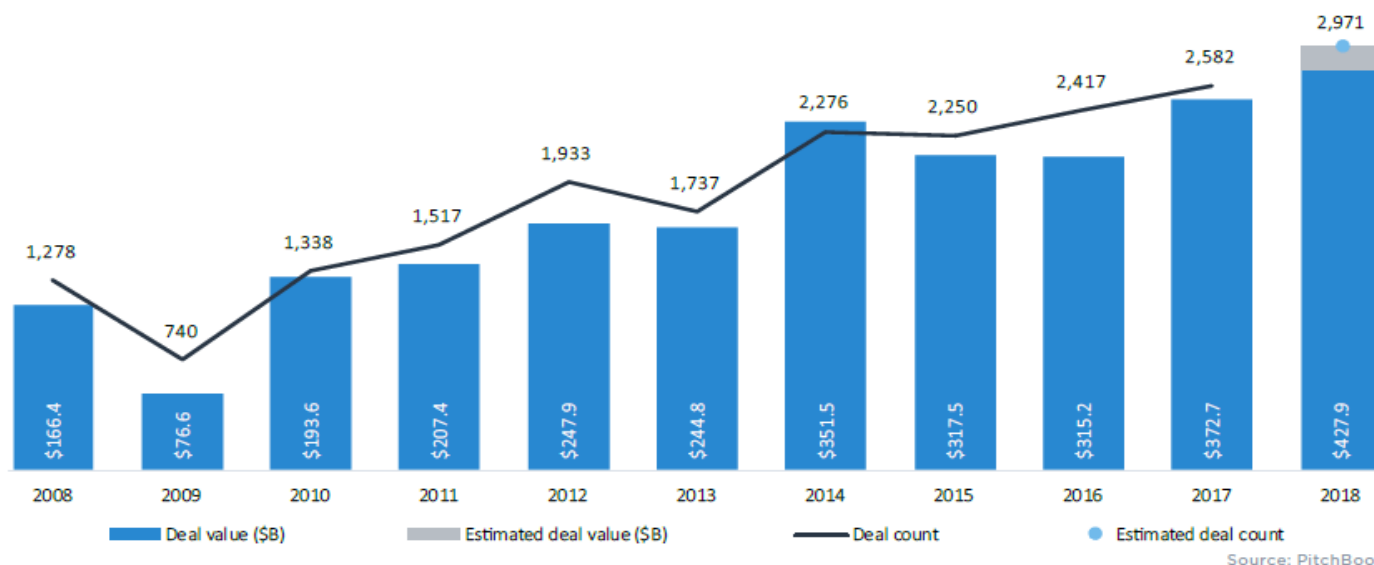
Exit activity in 2018 failed to match the pace of deal activity in the year. Since exit count and value peaked in 2014, total exit value has remained relatively steady, while exit count continues to fall. This is taking place despite the median time to exit plateauing at just over five years since 2015. Additionally, secondary buyouts (SBOs), despite accounting for over half of all exits, accounted for just 31.4% of total exit value.

Fundraising has remained relatively flat over the past five years, though we saw several mega-fund (\$5 billion+) managers return with MM funds in 2018.

Nonetheless, fund sizes within the MM continue to inch up over time, and the average MM buyout fund is now approaching \$1 billion. Furthermore, competition for placement within funds across the size spectrum looks to remain healthy as LPs expect to further increase PE allocations.

Overview

Record MM deal value and transaction volume US PE MM deal activity



2018’s record-setting pace extended through the fourth quarter as the US PE MM recorded four successive quarters with more than \$100 billion in total deal value for the first time on record. Prior to 2018, the US MM had never tallied a single quarter exceeding this amount. Overall, the MM saw 2,971 deals close totaling \$427.9 billion—15.1% and 14.8% YoY increases, respectively. While 2018 set records for deal count and value, 2018’s median deal size of \$175.0 million was a slight drop from the prior year’s \$177.8 million.

One deal to note is the \$500.0 million leveraged buyout (LBO) of Tuft & Needle, a direct-to-consumer mattress company, in an add-on by Serta Simmons Bedding backed by Advent International, Ares Private Equity Group, and others. The mattress industry has become highly competitive with the old guard of companies fighting a new wave of direct-to-consumer brands. The largest of these, Casper Sleep, is VC-backed, having raised a \$170.0 million Series C round in August 2017 at a

\$920.0 million post-money valuation. The company had reportedly been in talks to be acquired by Target for \$1.0 billion earlier in 2017.

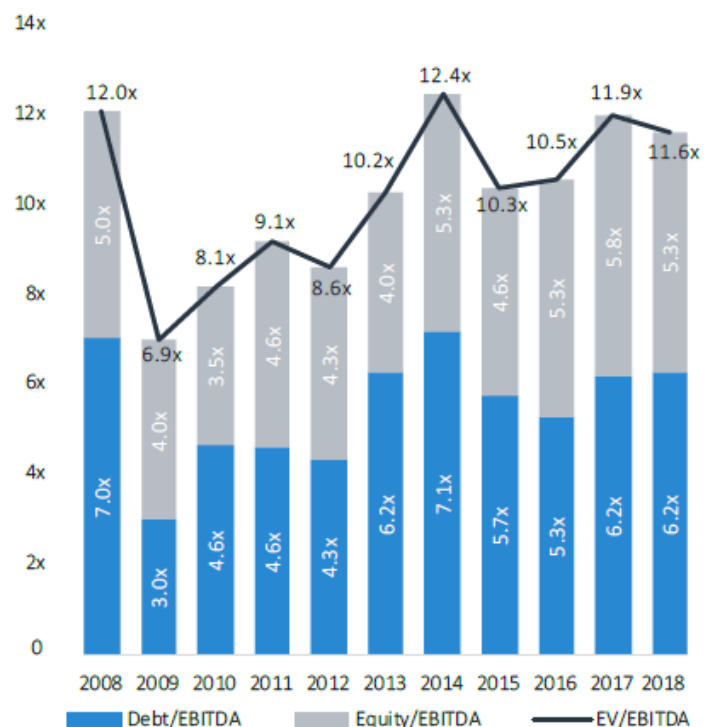
During much of the year, PE firms enjoyed continued easy access to affordable acquisition financing with favorable terms thanks to the ravenous appetite for high-yield bonds and leveraged loans, which were supported by collateralized loan obligations (CLOs). Leveraged loans have become a preferred option for financing LBOs in recent years, leading to total capital in the leveraged loan market growing at a much quicker pace than high-yield bonds after the financial crisis. Loans—which sit higher on the capital stack and are generally callable from day one—give lenders and borrowers certain advantages over high-yield bonds, which are subordinated and typically only callable several years after issuance. The floating-rate nature of leveraged loans is also attractive in a rising interest rate environment.

However, recent months have seen a dramatic turnaround with outflows in leveraged loan funds occurring at the fastest pace ever. Prices of leveraged loans dipped markedly in the last quarter of the year, and the demand from CLOs appears to be slowing. Moreover, leveraged loans are riskier now than in years past. Companies have higher debt to asset ratios, making recoveries from a bankruptcy less likely. Additionally, intangible assets— which may pose valuation and liquidity challenges—make up a higher proportion of the underlying asset value than in the pre-crisis years. Liquidity is also a concern because loans are less liquid than bonds and take longer to settle. Going forward, if investors demand pricing and covenant changes in credit markets, dealmakers may have to reprice or even forego deals, dampening overall dealmaking.

Even though the leveraged loan market came under pressure during the last few months of the year, EV/EBITDA multiples remained elevated. Fierce competition and GPs inking a record dealmaking year kept prices aloft, even as US public market indices saw multiples contract due to their worst performance since the financial crisis. Some of this change may be due to a shifting composition of companies targeted by PE firms. As many GPs begin favoring software and other high- growth sectors, these high-multiple deals are likely to boost the industry’s median multiple.

Though the US MM enjoyed a record-setting year in terms of deal value, the MM accounted for only 53.3% of overall US PE deal value in 2018, the second-lowest value post-crisis. An increasing number of buyouts are closing above the \$1 billion mark (the cutoff for the MM) as GPs look to spend down dry powder from some of the largest funds on record. 2018 recorded 73 buyouts above \$1 billion. Going forward, analysts expect this trend to continue as the sizes of buyouts and funds rise in unison.

Multiples remain elevated
US PE buyout multiples



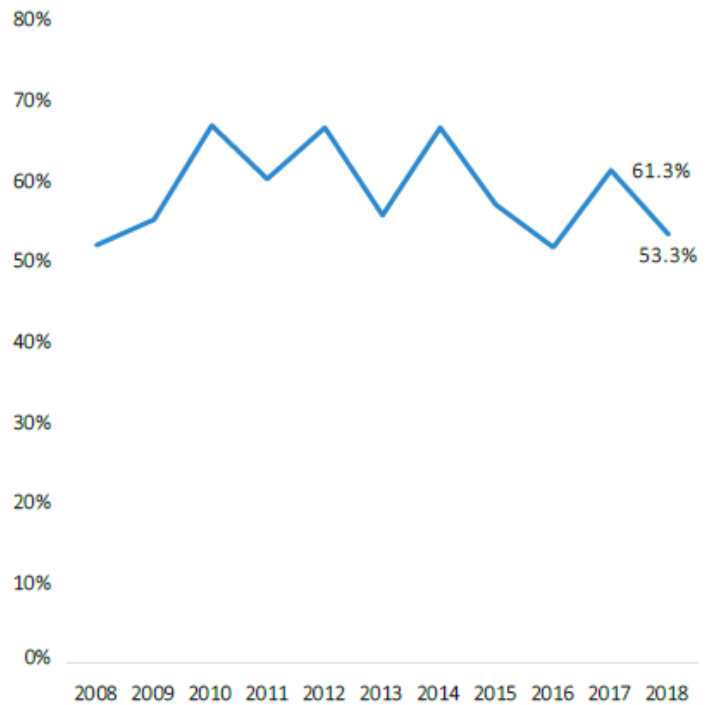
Source: PitchBook

Trends within the MM are mirroring what we see across the broader PE landscape. The sizes of deals, exits, and funds are all rising simultaneously. However, one interesting break from trend has been activity within the IT sector. Growth in the sector’s total deal value has lagged the broader market. In fact, since 2010, the sector’s deal value as a percentage of overall MM dealmaking fell to 14.8% in 2018 from 15.9% in 2010. With an explosion in VC funding and higher EV/ EBITDA multiples, many IT companies have achieved \$1 billion+ valuations, placing these tech companies above the MM threshold. As multiples seem set to persist and these companies continue growing rapidly, more IT companies could advance out of reach for MM dealmakers.

Another trend analysts expect to continue is the prevalence of add-ons within the MM. Dealmakers see the value in growing inorganically as well as organically. Furthermore, PitchBook research on the effects of add-on investing on fund performance showed a clear trend of outperformance by firms that used higher rates of add-ons. Analysts expect add-ons to further surge into the upper MM in the coming years and account for a higher proportion of MM deal value. Recent years have seen the average add-on deal size grow more quickly than the average non-add-on. In fact, 2018 saw add-ons increase their share of MM deal value by 5.3 percentage points while increasing deal count by only 2.1 percentage points, meaning the average size of add-ons was growing more quickly than non-add-ons.

MM makes up lower percentage of overall deal value as deal sizes swell

US MM as proportion of all PE (\$)



Source: PitchBook

Antares is a private debt credit manager and leading provider of financing solutions for middle-market private equity-backed transactions. In 2018, Antares issued more than \$24 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. 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.

A banner year for the PE loan markets ends on a soft note

In 2018, the US saw GDP growth accelerate in the 10th year of its record-long economic expansion. This helped foster higher earnings growth, robust M&A activity and continued low default rates. LBO-related loan issuance hit record levels as did CLO issuance (demand) which was fueled in part by investor demand for floating-rate exposure in a rising-rate environment. PitchBook data indicates that 2018 closed at an all-time high for PE investment in the US middle market.

However, as 2018 progressed, skittishness over signs of economic weakness abroad and the fallout of trade tension, rising interest rates and higher stock market volatility began to take their toll. By October, net retail dollar flows into loan funds began to turn negative, with net outflows surging dramatically by December. In 4Q 2018, loan pricing in the secondary market began to come under pressure with the SMi 100 falling below 95 by year-end. Spreads likewise began to flex upward in the primary market by year-end. Syndicated institutional loan supply hit its lowest level in 4Q 2018 since 1Q 2016, with December's level particularly weak. Direct lending volume fared much better (as is typical in times of high volatility), but overall sponsored middle-market volume still fell in 4Q 2018 versus a 2Q18 peak.

A pause that refreshes or end of the cycle?

As we enter 2019, conditions seem somewhat reminiscent of 4Q 2015-1Q 2016. Weakening economic growth abroad, sharply falling oil prices (and related credit concerns) and Brexit worries led to frosty capital market conditions and a similar drop in secondary loan pricing. It remains to be seen whether the current market swoon proves to be a healthy correction (i.e. a pause that results in more attractive valuations but still low defaults) as it did three years ago or whether the market is beginning to discount for a more full-blown end-of-cycle recession (with earnings contracting and defaults rising more sharply). There is reason for optimism that the US economy can avert recession assuming trade tensions begin to resolve, fed signals become more dovish and volatility subsides as the market digests more subdued but still healthy earnings growth expectations. However, recession odds are clearly on the rise.

Spotlight: Restaurants

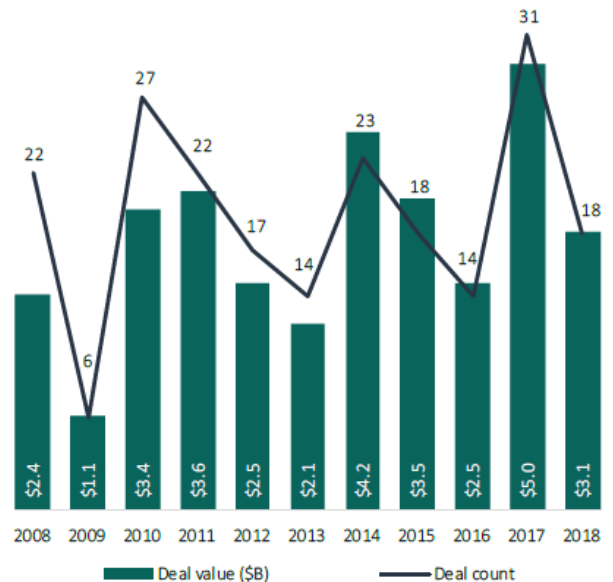
The restaurant industry has seen an uptick in activity in recent years. Consumer preferences are shifting, and the old-guard of restaurants must continuously adapt to keep up. Younger consumers are using food delivery apps and seeking out healthier options. Additionally, growth in the industry has slowed, and research by Morningstar and PitchBook points to decelerating industry growth in the years ahead. “[W]e wouldn’t be surprised to see additional small- to mid-cap restaurant chains escape public scrutiny and explore potential go private transactions. Analysts also believe conditions are favorable for a strategic or financial brand consolidator looking to add a new franchised concept,” wrote Morningstar’s Consumer Equity Strategist and Senior Restaurant Analyst R. J. Hottovy.

The restaurant industry, which saw several high-profile buyouts above the MM’s \$1 billion cutoff, experienced noteworthy activity within the MM in 2018. Overall, 18 deals closed worth \$3.1 billion. This was a decrease from the 31 deals completed in 2017, and the median deal size was smaller in 2018 as well. Many of the MM’s most prolific restaurant buyers were notably absent from the action in 2018, including Sentinel Capital Partners.

The MM saw several prominent restaurant transactions in 2018, including Rhône Group’s \$560.0 million buyout of Fogo de Chão, a Brazilian steakhouse chain, its first restaurant investment. Zoës Kitchen—a fast-casual Mediterranean chain backed by The Invus Group, among others—was purchased for \$300.0 million. Finally, Qdoba, a Mexican fast-casual chain that competes with Chipotle, was purchased by Apollo Global Management for \$305.0 million. The company had been struggling in recent quarters before parent company Jack in the Box, which had owned Qdoba since January 2003, decided to pursue strategic options, ultimately ending in a sale. Notably, all three transactions were take-privates.

Coming into 2019, TriArtisan Capital Partners is in talks to buy P.F. Chang’s for as much as \$700.0 million. Going forward, analysts believe there will be continued industry consolidation as investors seek out economies of scale to combat margin contraction from slowing (or even negative) growth.

Restaurant activity slowed in 2018
US PE MM restaurant & bar deal activity



Source: PitchBook

Select PE investors in US MM restaurants & bars

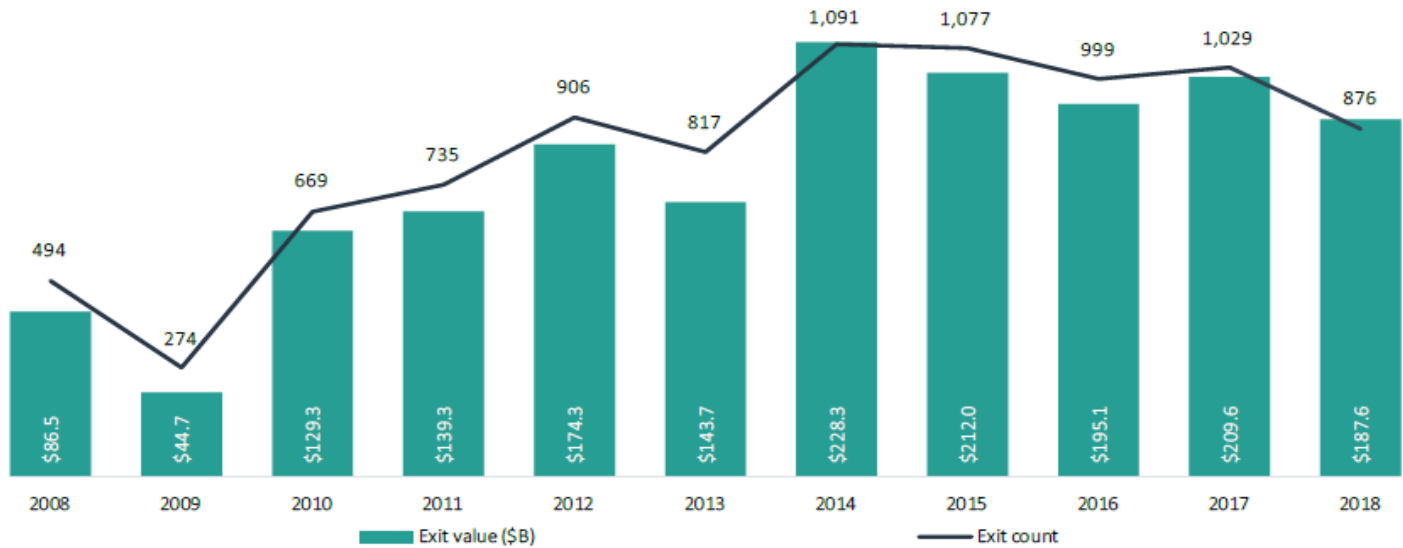
Rank	Investor	Deal count	Investor HQ state
1	Sentinel Capital Partners	6	New York
2	Olympus Partners	5	Connecticut
2	NPC International	5	Kansas
2	Kelly Companies	5	California
2	CapitalSpring	5	Tennessee
6	Boyne Capital Partners	4	Florida
7	Penta Mezzanine Fund	3	Florida
7	KBP Foods	3	Kansas
7	Sun Capital Partners	3	Florida
7	Victory Park Capital	3	Illinois
7	Partners Group	3	Switzerland
7	NRD Capital	3	Georgia
7	Hargett Hunter Capital Partners	3	North Carolina
7	TPG Growth	3	California

Source: PitchBook

This table includes refranchising deals and non-US investors participating in US deals.

Exits

Exit activity falls shy of recent years US PE MM exit activity



Source: PitchBook

In 2018, US PE MM firms exited 876 investments for a combined deal value of \$187.6 billion. Overall exit value was down 10.5% compared with 2017 (\$209.6 billion) while exit count fell an even larger 14.8% compared with the year prior (1,029). Exit activity has generally been trending downward after peaking in 2014. Analysts believe much of the drop can be attributed to the fervent add-on activity the MM is experiencing on the deals side. For example, Curo Health Services was bought by AlInvest Partners and Thomas H. Lee Partners for \$730.0 million in August 2014. The company completed an add-on of New Century Hospice for \$120.0 million in January 2016, meaning the original buyout and the add-on were MM deals, but the July 2018 exit valued the company at \$1.4 billion. Despite its effect on MM exit figures, it should be noted that this change in EV is a key part of the buy-and-build strategy and is generally a positive for PE investors. Another example is TriTech Software Systems, which was bought for \$300.0 million by Insight Venture Partners in November 2014. In June 2018, the company was

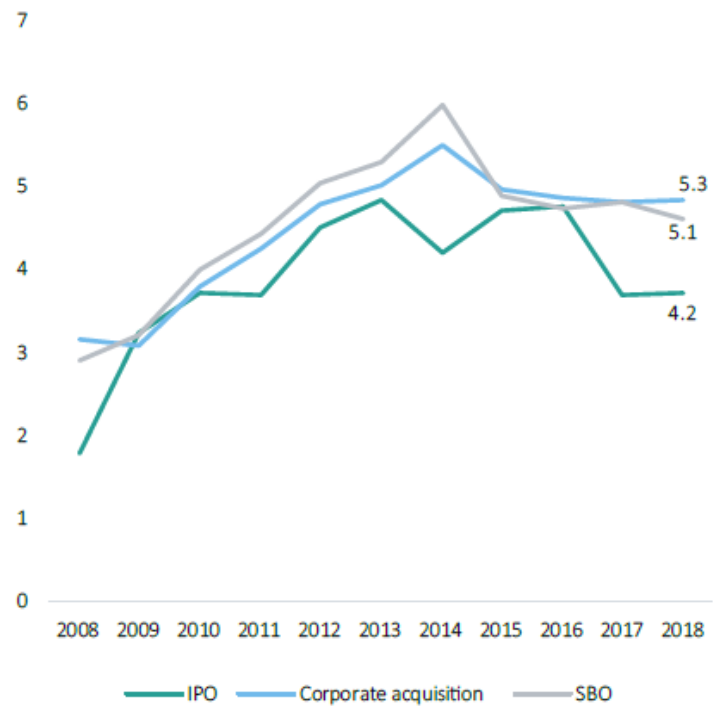
purchased by Bain Capital for \$1.1 billion. The company undertook five add-ons in that timeframe, although the sizes of the deals were not disclosed.

Some interesting sector-related trends emerged throughout the year. For example, IT lifted its share of exit count each year since 2014, rising from 12.0% to 17.3% of all exits. During that time, however, its proportion of deal value remained mostly flat, going from 12.2% to 13.3%. On the other hand, healthcare did the opposite, dropping to 12.6% of overall exit value from 16.6%. Both sectors account for a higher percentage of deal count and value than exit count and value, a trend which has persisted for several years. Analysts believe this is occurring because these two sectors tend to be dominated by add-ons and are higher-growth sectors, which means they are more likely than other sectors to exit outside the scope of the MM. This divergence appears set to persist into the future as dealmakers continue sourcing add-ons from these sectors.

2018 saw a pair of PE-backed producers of baked goods find liquidity. Mondelez International, the snack-foods conglomerate, acquired Tate’s Bake Shop—backed by The Riverside Company—for \$500.0 million. Additionally, Olympus Partners bought Rise Baking Company—backed by Arbor Investments—for \$550.0 million. Overall, consumer-facing investments (B2C) accounted for 20.4% of all exit value and 18.5% of total exit count. Financial services, another active sector, accounted for 10.8% of exit value in the year. In a noteworthy deal, Orix USA—a financial services firm—bought NXT Capital in a \$900.0 million LBO that will expand Orix USA’s lending business in the US MM.

Exit times, for the most part, appear to be plateauing around five years. In fact, the median holding period for exits occurring in 2018 was exactly five years. Exits via corporate acquisition took slightly longer (5.3 years) than those via SBO (5.1 years). While the median time to exit via IPO is about a year shorter, at 4.2 years, there is a simple explanation. We track the IPO date as an exit; however, GPs often retain a sizable piece of the company to be sold off over time—usually in the next 12-24 months. Since it takes more time to fully exit an investment via IPO than the cash-up-front options, the overall exit timeframe for IPOs ought to more closely resemble the five-year median. Although holding times depend heavily on the market environment, analysts believe they will rise in the coming years given that GPs are raising a growing number of “long-dated funds” with investment horizons that can stretch beyond 15 years, and LPs have become more accepting of longer holding times in traditional fund structures.

Time to exit plateaus around five years
 Median US PE MM time to exit (years) by exit type



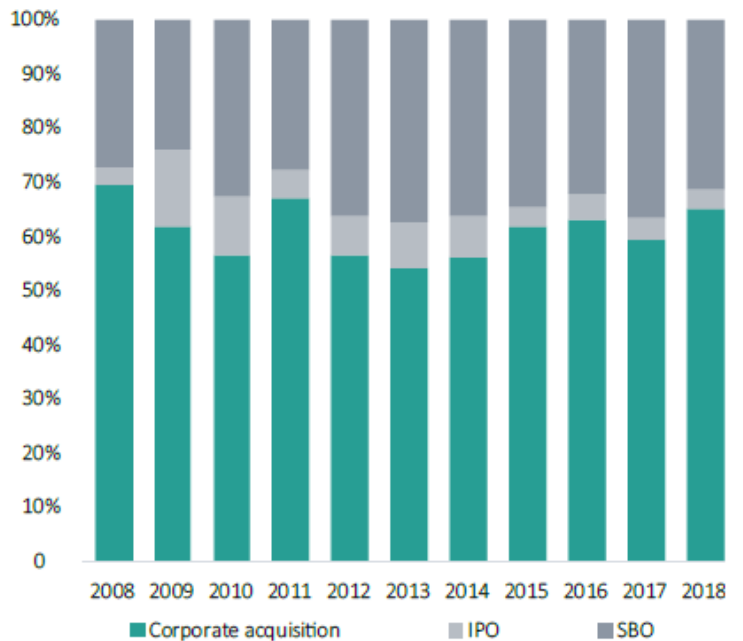
Source: PitchBook

The bifurcation between total count and capital exited via SBO and corporate acquisition continued in 2018. SBOs accounted for 54.0% of exits while accounting for just 31.4% of exit value. Corporate acquisitions, on the other hand, accounted for 42.9% of exits and 64.9% of exit value, a sign of the continuing importance of strategics at the upper end of the market. As the overall level of PE AUM has risen unabated for the past decade-plus, so too has the inventory of PE-backed companies. Although GPs are likely to continue selling portfolio companies to other financial sponsors at a rapid clip, the same cannot be said when it comes to deal sourcing. GPs sourced deals via SBO at the lowest rate in five years during 2018.

Several large PE-backed energy companies went public in the year, though most activity took place in the first quarter. Cactus Wellhead—which received a growth round from Cadent Energy Partners—went public at a \$985.9 million valuation, raising \$437.0 million. Liberty Oilfi Services—which received growth capital from Riverstone Holdings and Oakmont—listed publicly at a \$956.2 million valuation, raising \$216.4 million. These two exits represent the largest exits of the year in the MM. GPs frequently use public markets to exit energy companies as public markets tend to be more amenable to their irregular—and often times negative—cash flows. In fact, energy companies made up just 7.5% of overall MM PE-backed exits but accounted for 17.2% of MM PE-backed IPOs in 2018.

Corporate acquisitions account for bulk of exit value

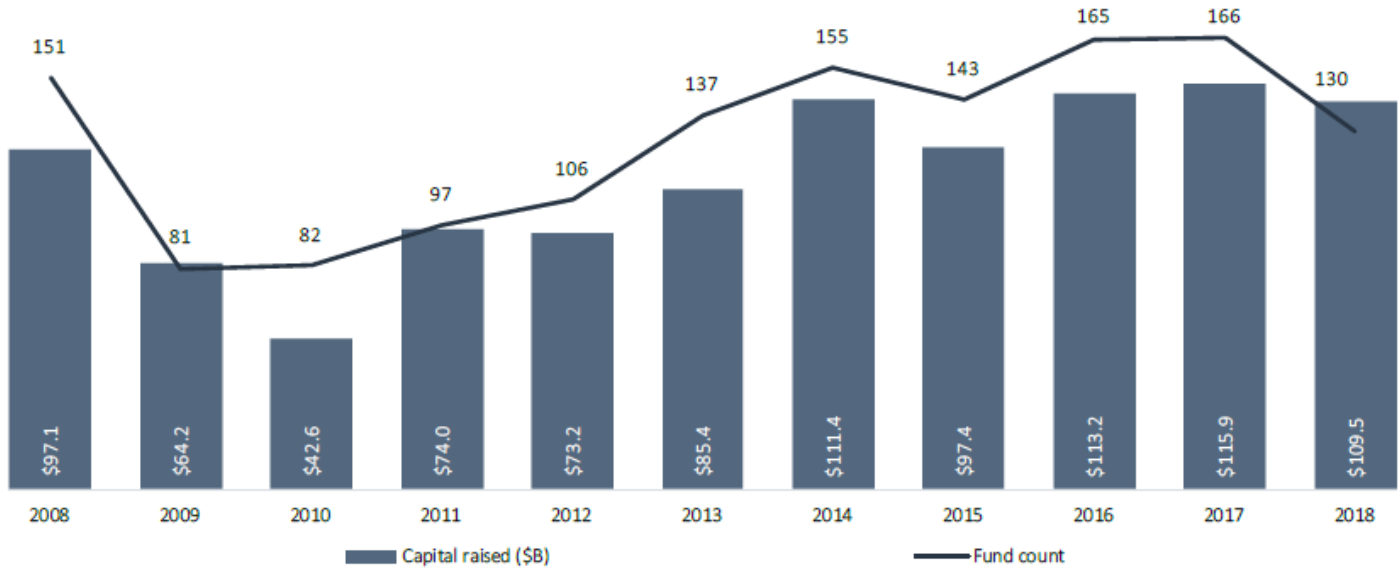
US PE MM exits (\$) by type



Source: PitchBook

Fundraising

Fundraising capital remains flat on fewer funds US PE MM fundraising activity



Source: PitchBook

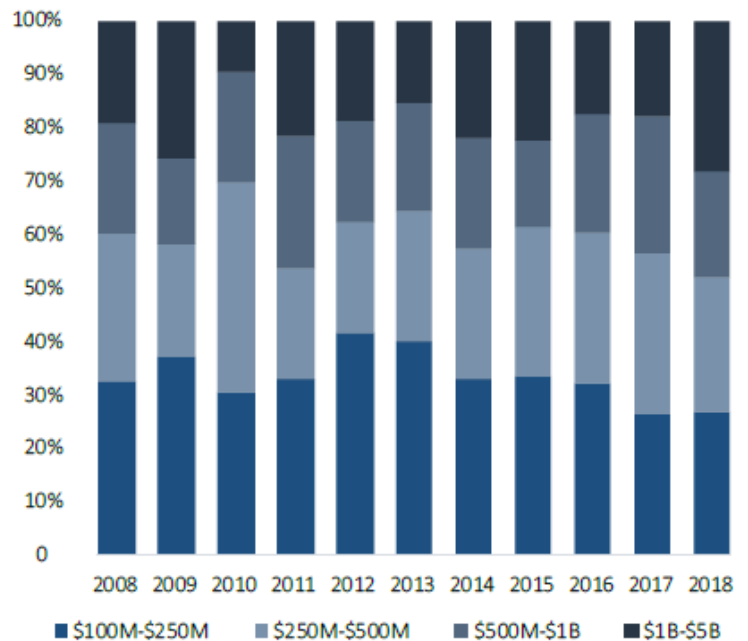
2018 was another healthy fundraising year for the US MM with total capital raised nearly matching previous years. Overall fundraising saw 130 funds close on \$109.5 billion—declines of 21.7% and 5.5% YoY, respectively. Four out of the past five years have seen the US MM raise more than \$100 billion. This robust fundraising activity has been driven by steady returns for the asset class and a continued rise in target allocations by LPs. In fact, as detailed in our 2018 Annual Institutional Investors Survey, LPs are expecting to make the largest—relative and absolute—increases to their target allocation for private market strategies. Respondents foresaw their average private markets strategy allocation rising from 30.9% to 32.5%. Much of this anticipated increase will be fueled by cutting exposure to hedge funds and fixed income. Furthermore, many LPs expect to grow their number of GP relationships, which ought to augment a healthy and competitive fundraising environment for funds outside the bulge bracket.

Exemplifying the strong market demand for exposure to MM funds, some firms closed multiple vehicles under \$5 billion in 2018. For example, H.I.G. Capital closed on three MM funds in 2018: the H.I.G. Advantage Buyout Fund at \$3.0 billion, the H.I.G. Strategic Partners Fund at \$1.3 billion, and the H.I.G. Growth Buyouts & Equity Fund III at \$970.0 million. Interestingly, the Strategic Partners Fund will act as a sort of fund-of-funds for other H.I.G. Capital funds (though this means it will not show up in our aggregate figures in this report). The fund “is targeting \$1 billion to invest in the firm’s 12 underlying funds as they return to market over the next four years, in addition to making co-investments on an opportunistic basis alongside the underlying funds.” The selling point to LPs is “the opportunity to lock in allocations to their oversubscribed fund lines, while building in diversification across their strategies,” according to a presentation by Texas Municipal Retirement System in June 2018.

Thoma Bravo returned to the MM with the closing of its Discover Fund II in 4Q—a \$2.4 billion vehicle that will focus on MM software investments. The Chicago-based tech investor is currently fundraising for an \$11.5 billion flagship buyout fund after closing on a \$7.6 billion fund in 2016. Another tech-heavy investor, Clearlake, closed on its \$3.6 billion flagship Capital Partners V in the fourth quarter.

Funds between \$1 billion and \$5 billion made up the highest proportion of overall MM funds on record, accounting for 27.7% of all MM funds closed in the year. In fact, the 36 funds of that size are also the most the MM has ever seen, surpassing the 34 closed in 2014 and 33 closed in 2007. As larger funds make up a mounting proportion of overall fundraising, the average and median sizes of MM funds are rising as well. 2018 saw the average buyout fund hit \$929.0 million, eclipsing \$900 million for just the second time on record, the other being the \$901.3 million average in 2011.

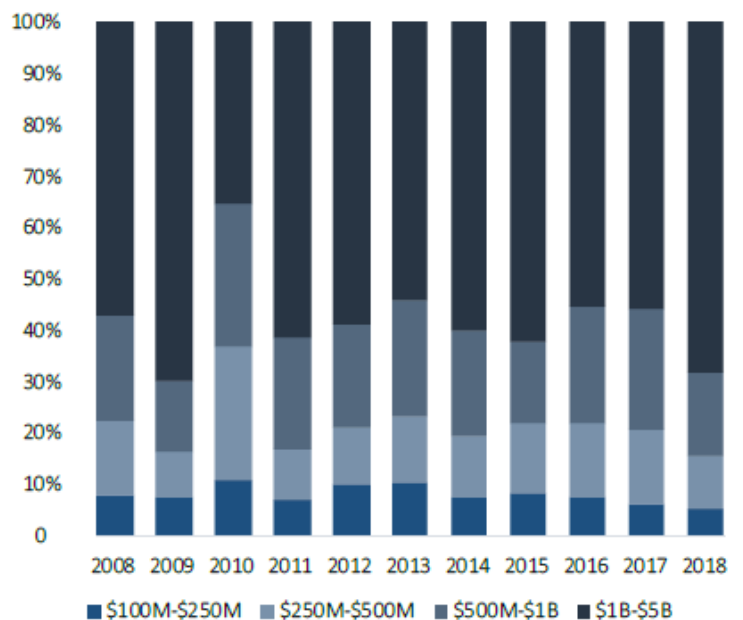
\$1B-\$5B funds make up highest proportion of MM funds in over a decade
US PE MM fundraising (#) by size



Source: PitchBook

\$1B-\$5B accounts for nearly 70% of capital raised

US PE MM fundraising (\$) by size

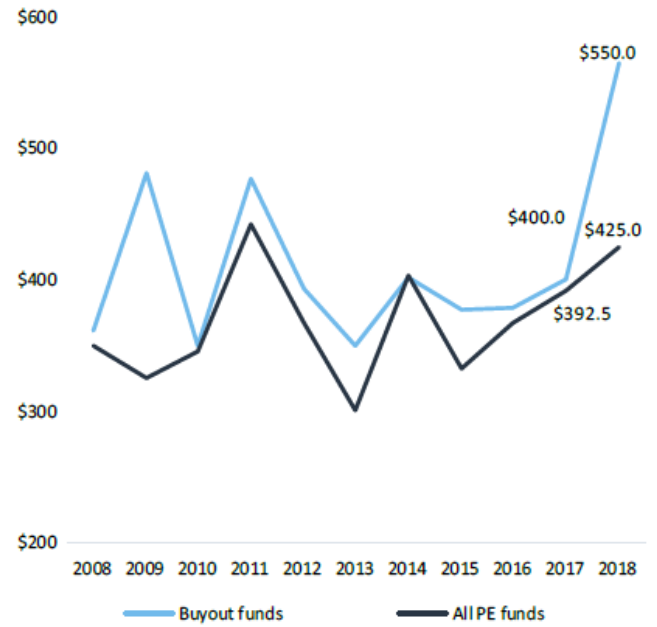


Source: PitchBook

Analysts expect MM funds to continue swelling in size and for the larger funds to make up an ever-growing percentage of overall funds and fundraising capital. In the years to come, analysts also expect established GPs that have successfully raised mega-funds will continue returning to the MM to raise funds targeting smaller companies. Thoma Bravo, Audax, and others closed these funds in 2018, and 2019 is likely to see even more as GPs look to raise additional capital and further expand strategy offerings.

Median buyout size hits highest value on record

Median US PE MM fund size (\$M)



Source: PitchBook