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US PE Middle Market Report

2020 Annual

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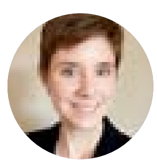
Click here for PitchBook's report methodologies.

Introduction

The US middle market ended a tempestuous year by recording $480.9 billion in deal value—by a slim margin the highest annual number on record. After the near halt of deal activity in the wake of COVID-19 in Q2 2020, convergent trends drove the middle-market recovery in Q3 and a dealmaking frenzy in Q4. In 2020, deals priced under $500 million accounted for the greatest share of middle-market deals since the global financial crisis (GFC), as some PE firms acted opportunistically to acquire assets at a discount, while others snapped up small companies with growth potential buoyed by the pandemic. At the upper end of the market, a flight to quality drove elevated valuations in the technology, healthcare, and financial services sectors.

In 2020, US middle-market exits fell for the second year in a row as many GPs delayed Q2 exits amid market turmoil. However, by the end of the year, GPs were making up for lost time in earnest, driving Q4 exit activity above pre-pandemic levels—a trend that will likely continue into 2021. Although sponsor-to-sponsor exits declined YoY, they remained the most common exit type for middle-market portfolio companies. Looking ahead, special purpose acquisition company (SPAC) mergers may facilitate more public exits for middle-market companies.

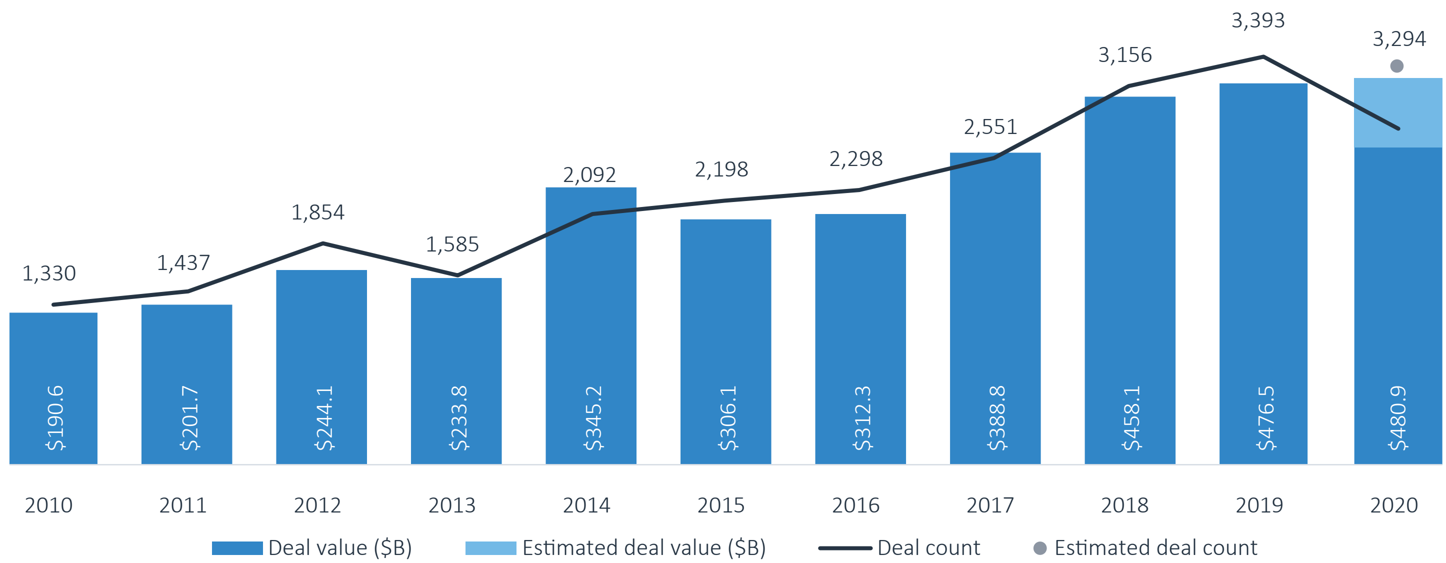
Although the amount of capital raised dipped by approximately one third YoY, 2020's US middle-market fundraising proved resilient all things considered. GPs raised 127 middle-market funds for a combined $101.1 billion—a far cry from 2019's record-breaking heights but roughly on par with fundraising levels in 2016-2018. As a result of 2020's disruptions, LPs flocked to middle-market funds raised by the largest PE firms, especially funds focused on technology and healthcare.



Rebecca Springer, Ph.D.
PE Analyst

Overview

PE middle-market deal activity

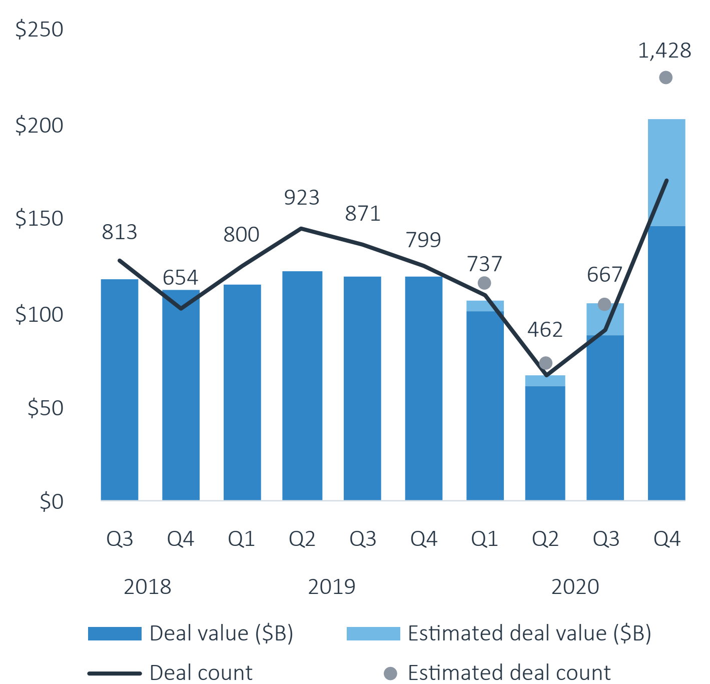


Source: PitchBook | **Geography**: US

US middle-market dealmaking in 2020 came in roughly flat with 2019's numbers. In 2020, middle-market PE firms closed 3,294 deals—just 2.9% under 2019's deal count—for a combined $480.9 billion, making it the highest annual deal value on record, albeit marginally. The fact that middle-market dealmakers not only weathered the unprecedented effects of the pandemic but also eked out a record-breaking year points to the resiliency and adaptability of PE middle-market strategies. By contrast, US PE as a whole declined 7.3% in deal volume and 3.4% in deal count YoY. Of course, these numbers obscure a more tumultuous story. In 2020, the US middle market posted both its worst quarter since 2013 with 462 deals for $67.3 billion in Q2, and its best quarter on record with 1,428 deals for $202.1 billion in Q4.

The narrative of Q2's dealmaking collapse followed by Q3's quicker-than-expected resumption and Q4's furious rebound of activity hardly needs repeating. The middle market was particularly hard hit in the early months of the pandemic: The default rate for companies with $25 million to $50 million in EBITDA leapt from 5.2% in Q1 to 6.7% in Q2.[1] Employment at US firms with between 50 and 999 employees—a rough approximation for the middle market—plummeted by 15.6% in April, dwarfing the effects of the GFC in 2008-2009 in both scale and immediacy.[2]

PE middle-market deal activity by quarter



Source: PitchBook | **Geography**: US

1: "Proskauer Releases Q4 Private Credit Default Index," Proskauer, February 8, 2021.
2: "ADP National Employment Report," ADP Research Institute," January 2021.

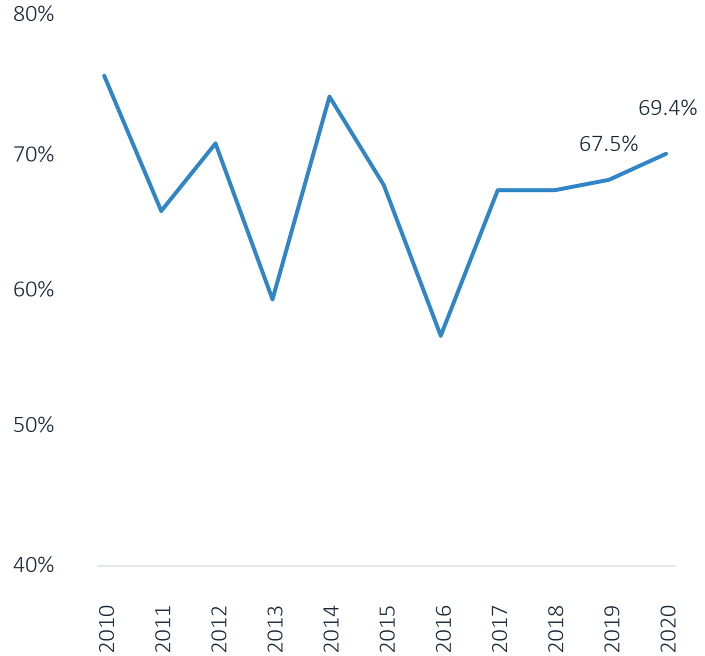
Overview

Congress and the Federal Reserve responded with unprecedented stimulus actions, which totaled around $3.9 trillion at the federal level, or around 18% of US' Q4 2020 GDP.[3,4] These interventions drove the macroeconomic recovery by pumping liquidity into the markets and boosting investor confidence. However, many PE middle-market portfolio companies were shut out of both congressional and Federal Reserve small-business loan programs. Congress' Paycheck Protection Program was available to companies with 500 employees or fewer, but the legislation counted the employees of a firm's majority-owned portfolio companies against that limit.[5] The Fed's small-business loan program was more inclusive, but it prohibited loans to companies leveraged over 4x EBITDA.[6]

Despite these challenges, the wave of restructurings that characterized the GFC did not materialize. GPs found alternative ways to shore up portfolio company balance sheets, including net asset value loans. PE firms worked closely with lenders—many of which are sponsors rather than banks—to prevent their portfolio companies from declaring bankruptcy. PE portfolio companies also benefited from guidance in cutting costs, moving product offerings online, and pivoting to take advantage of shifting consumer demand due to the pandemic lockdowns. Although revenue was hit hard in many verticals, rapid adaptation and the swift macroeconomic recovery meant that the economic impact of the pandemic was less than initially anticipated. In Q2, PE-owned middle-market companies projected an average 23.4% EBITDA decline for 2020; in Q3, they revised this projection to a decline of 13.1%. Finally, even if PE portfolio companies could not directly gain access to federal rescue loans, the Fed's overall program of debt purchasing and lowering interest rates fostered an environment of easy access to capital that facilitated the resumption of dealmaking during H2.

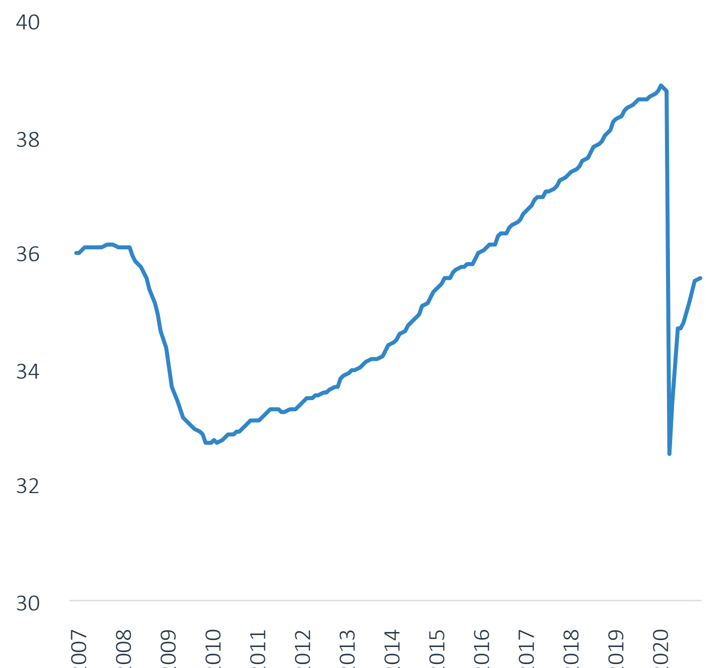
In the second half of 2020, progress in vaccine development and distribution provided a light at the end of the tunnel for many industries. In November and December, anticipation of a second large stimulus bill under the Biden administration pushed the Russell 2000 to new heights to close the year up 18.8%. Gains in the Lincoln Middle Market Index (LMMI), comprised of majority-PE-owned companies with a median EBITDA of around $30 million, look modest only by comparison: The LMMI finished 2020 up 7.3% after a record Q4, with average EV/EBITDA multiples at around 11x—above the pre-pandemic multiple.[7]

PE middle-market deals ($) as proportion of PE deal flow



Source: PitchBook | **Geography**: US

Employment by US firms with 50-999 employees (millions)



Source: ADP® National Employment Report™

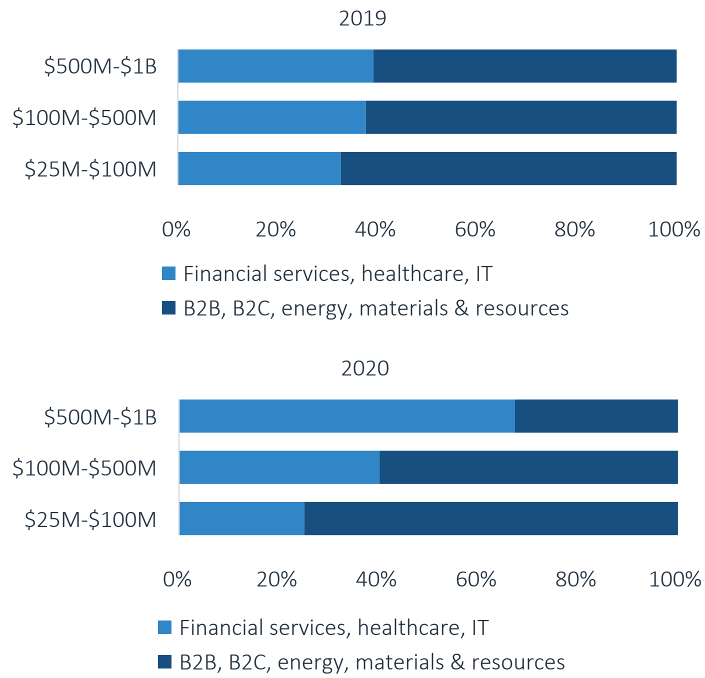
3: "Policy Responses to COVID-19," International Monetary Fund, March 4, 2021.
4: "Gross Domestic Product, Fourth Quarter and Year 2020 (Second Estimate)," Bureau of Economic Analysis, February 25, 2021.
5: "H.R.7010 - Paycheck Protection Program Flexibility Act of 2020," Congress.gov, June 5, 2020.
6: "Main Street Lending Program," Federal Reserve, March 11, 2021.
7: "Q4 2020 Lincoln Middle Market Index," Lincoln International, February 2021.

Looking ahead, many of the transactions that were initiated as confidence soared late in 2020 will close in Q1 and Q2 2021. Further, expanding vaccine distribution and recent employment gains suggest that the worst of the pandemic may be over. For these reasons, we anticipate elevated middle-market PE activity will continue in early 2021.

With these macroeconomic factors in the backdrop, convergent trends drove 2020's middle-market recovery. The median middle-market deal size declined sharply, from $200.0 million in 2019 to $165.5 million in 2020. Deals priced under $500 million accounted for the greatest share of middle-market deals since the GFC, with sectors that were more exposed to the effects of COVID-19—B2B, B2C, energy, and materials & resources—disproportionately represented. Some PE firms acted opportunistically to acquire assets at steep discounts to their fundamentals. For example, in August 2020, MiddleGround Capital bought a majority stake in DURA Automotive Systems, an automotive components manufacturer that had reportedly drawn buyout offers over $400 million in 2018, for just $65.0 million. DURA's bankruptcy administration had been complicated by COVID-19, which enabled MiddleGround to enter as a buyer.[8] Another noteworthy example of opportunistic dealmaking was Retail Ecommerce Ventures' (REV) purchase of intellectual property and e-commerce assets from several distressed consumer brands, including RadioShack and Pier 1 Imports. A fundless sponsor that partners with high-net-worth individuals (HNWIs), REV has found a wealth of targets since its 2019 inception.

Other GPs sought healthy companies with growth potential buoyed by the pandemic. Often, founder-owners of smaller companies decide to sell based on both personal and financial motivations. Faced with both H2 2020's continued market uncertainty and, in many cases, nearing retirement age, many small-business owners became more receptive to acquisitions. The specter of corporate and individual tax rate hikes by a Democratic-controlled Congress also spurred some to consider selling. Mechanisms such as earn-outs and seller rollover investments—deal terms that were already growing in popularity prior to the pandemic—were incorporated into deals and enabled parties to bridge pricing expectation gaps even in the market trough. In a deal that encapsulates several aspects of 2020's middle-market climate, Brand Velocity Partners led a $140.0 million buyout of BBQGuys, a company that sells outdoor grilling and kitchen equipment and had nearly doubled its revenue in 2020. BBQGuys' founder sold in order to spend time with his family after recovering from COVID-19.[9]

PE middle-market deals ($) by sector group and segment



Source: PitchBook | **Geography**: US

At the upper end of the market, a flight to quality drove elevated valuations in the technology, healthcare, and financial services sectors. Deals in these three sectors together accounted for around two thirds of upper-middle-market buyout deal value in 2020, compared with less than half in 2019. Healthcare, a longstanding haven for investors during downturns, was joined by technology as the pandemic bolstered demand for digital solutions and software-as-a-service (SaaS) business models proved their potential to generate sticky revenue. Bolt-on deals allowed PE-backed technology companies to add market share in key growth industries. For example, Ivanti Software, an enterprise security software company backed by Clearlake Capital Group and TA Associates, paid $872.0 million for MobileIron and an undisclosed amount for Pulse Secure, both software providers that secure employee mobile devices in remote work environments.

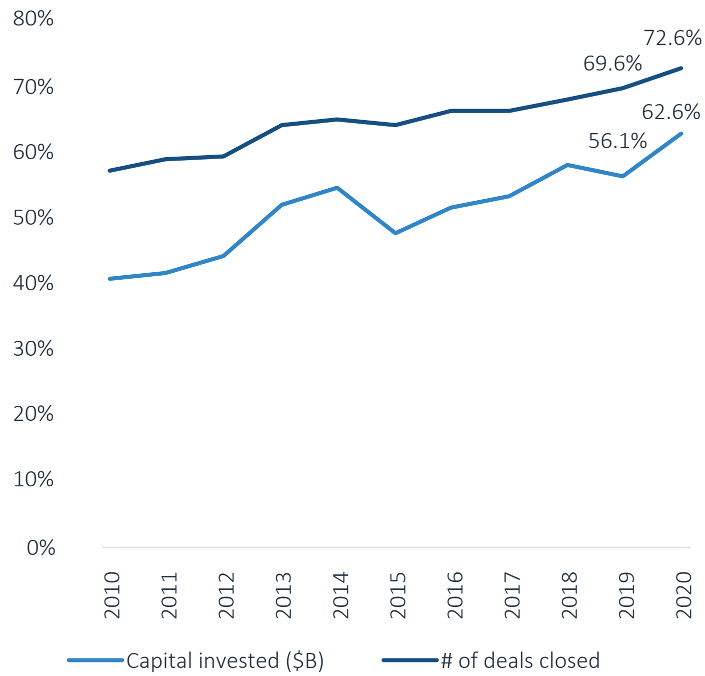
8: "Four Auto Trends Ripe for PE Investment," Buyouts Podcast, Chase Collum, November 30, 2020.
9: "How a Brush With COVID-19 Spurred the Sale of an Outdoor Grill Maker," *Barron's*, Luisa Beltran, September 29, 2020.

Overview

The financial services sector benefited from both 2020's flight to technology and the continued popularity of roll-ups. Insurers have increasingly looked to technology providers to modernize processes and cut costs. In September 2020, Thoma Bravo took Majesco private for $729.0 million, and in November, Clearlake Capital Group purchased Zywave, an automation SaaS platform for the insurance distribution industry, for $900.0 million—becoming the third private equity group to buy out the company.

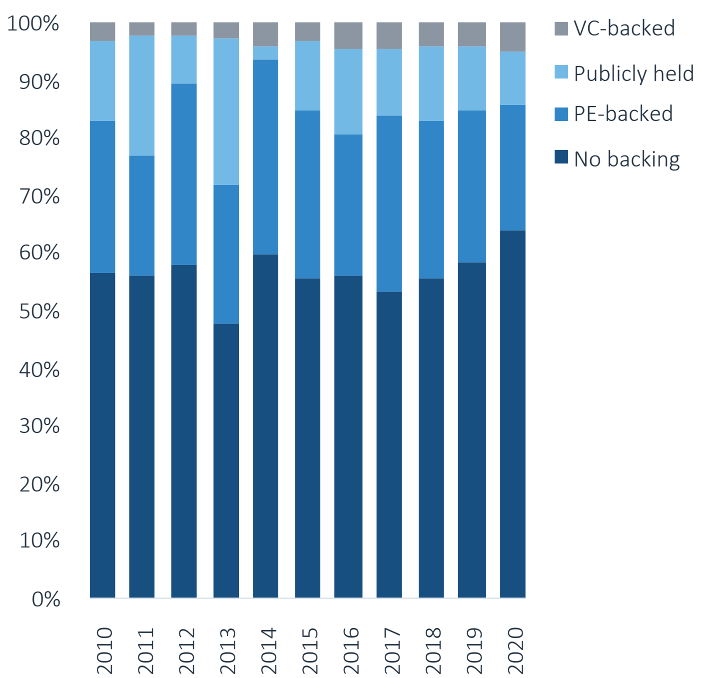
At the same time, in the highly fragmented insurance brokerage space—a favorite playground for PE firms that specialize in roll-ups—the economic downturn put temporary pressure on top-line revenues for insurance distribution. Because middle-market insurance brokers typically sell to small enterprises, the knock-on effects of exposure to verticals such as retail and hospitality may have contributed to the supply of business owners willing to sell. While some acquisitive insurance brokerage platforms such as Madison Dearborn Partners' NFP paused add-ons midyear before accelerating in Q4, others, such as GTCR and HarbourVest Partners' AssuredPartners, continued to roll up small brokerages even during the darkest months of the pandemic. Add-ons accounted for just under 85% of middle-market financial services deals in 2020, which is roughly on par with 2019's figures.

Add-ons (#) as a proportion of PE middle-market deals



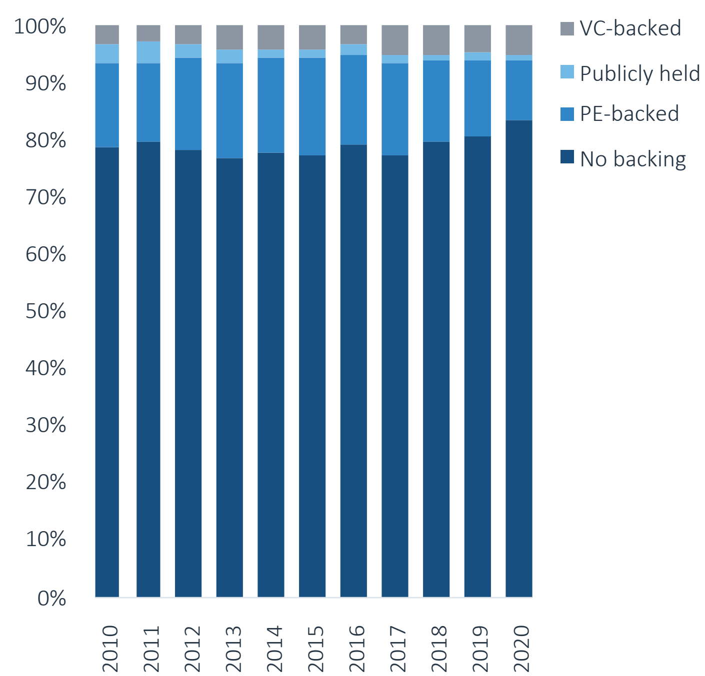
Source: PitchBook | **Geography**: US

PE middle-market deals ($) by backing status



Source: PitchBook | **Geography**: US

PE middle-market deals (#) by backing status



Source: PitchBook | **Geography**: US

Overview

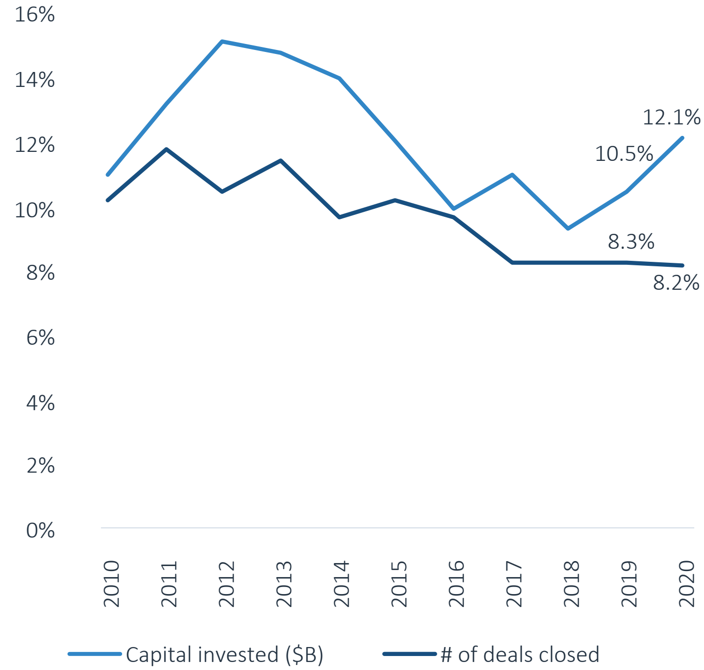
Add-ons continued to propel middle-market activity in 2020, topping 70% of middle-market deals for the first time. Although the strategy has grown in popularity over the past two decades regardless of macroeconomic trends, it is worth noting that add-ons can be particularly attractive to PE as a recessionary hedge. Volatility and depressed valuations in some sectors caused GPs to delay exits in 2020. In the face of elongated hold periods and the resulting drag on IRR, completing an add-on acquisition can help accelerate growth.

In a related trend, sponsor-to-sponsor buyouts sharply declined as a proportion of middle-market deals, ultimately hitting 20.0%—the lowest reading since 2009. Opportunistic sponsors were on the hunt for COVID-19 discounts to valuations, particularly for smaller companies, while PE sellers held on to portfolio companies with strong fundamentals in hopes of exiting at better prices as the pandemic subsides. Coupled with the attractiveness of smaller add-on targets—which are less likely to be institutionally backed—this misalignment pushed buyouts of private companies with no institutional backing to 64.0% of middle-market buyouts by deal size and 83.2% by deal count, the highest reading since 2009.

Meanwhile, venture-backed companies—especially enterprise SaaS companies—continued to account for a growing proportion of middle-market buyouts. On the heels of raising three buyout funds, Thoma Bravo was particularly active in this space. The firm acquired Exostar, a cloud-based identity management provider, in a $100.0 million buyout. It also bolted Conga, a cloud-based commercial operations platform, on to its portfolio company Apttus for $715.0 million.

Although median middle-market deal size declined in 2020, corporate divestitures continued to augment. Carveouts represented just 8.2% of PE middle-market deals by count—but 12.1% by value. Large carveouts allowed diversified companies to refocus on their core businesses with added liquidity. For example, in December 2020, Kainos Capital acquired Nutrisystem, a weight loss meal program, from Tivity Health (NASDAQ: TVTY), which manages senior healthcare and wellness brands. Expected synergies between Tivity and Nutrisystem had not materialized, and the sale price of $575.0 million was less than half of the $1.3 billion that Tivity Health had paid for Nutrisystem just 15 months earlier.

Carveouts and divestitures as a proportion of PE middle-market deals



Source: PitchBook | **Geography**: US

Q&A: Antares Capital

Optimism serves as a highly effective vaccine for the economy...

Lately, middle-market PE deal activity has cooled from Q4 2020's record pace, but the outlook nevertheless remains favorable for 2021. Based on our recent Fifth Annual Compass Survey of PE sponsors, borrowers, and investors, confidence in the US economy is high. In fact, it is up from the already high reading from our early 2020 pre-pandemic survey—and up even more for the global economy. Previous worries of a possible COVID-19 next-wave-induced downturn seem to have evaporated, and default rate expectations have declined with most 2021 US GDP growth estimates near 5%. Given this reassuring backdrop, most of our survey respondents expect M&A activity will rise over the next 12 months—especially given the specter of higher capital gains tax rates looming in 2022.

...but beware of side effects.

Anxiety over inflation may seem undue with the 10-year treasury note yield at 1.4% at time of writing—and some transitory inflation and a steepening yield curve would be welcome tell-tails of an entrenching recovery. However, stretched valuations could become vulnerable to a "taper tantrum" narrative from those lamenting froth (e.g. green bubbles, SPAC bubbles) from too much stimulus as inoculated consumers emerge from their winter dens, ready to take vacations with stimulus checks in hand. Even if inflation proves to be as tamable and transient as hoped, supply chain constraints and rising input costs could squeeze margins for certain borrowers short on pricing power. As the pandemic determined winners and losers in the downturn of 2020, so it may in differing ways in the upturn of 2021.

The private debt market appears to have passed 2020's stress test with flying colors, but another shock, such as virus mutations or Sunburst hack fallout, could come at any time. As a lender, it's okay to be optimistic, but it's never a good time to be complacent.

Q&A with Dave Brackett

With 2020 in hindsight, how do you feel private debt performed? Any key learnings to take moving forward?

Dave Brackett

Chief Executive Officer
Antares Capital

Dave is a member of Antares' Investment Committee as well as Antares' Board of Directors. Previously, Dave served as president and CEO for GE Antares. He was a founding partner when Antares was formed in 1996. Prior to starting Antares, Dave was a senior executive with Heller Financial.

There was variance among lenders, but in general, private debt as an asset class appears to have performed quite well through the COVID-19 stress test. Credit rating agencies have been cutting their default rate forecasts from initially dire levels that were near those of the global financial crisis to more benign levels. Public business development company nonaccruals have been trending down since their peak in Q2 2020. For our part, given such a challenging year, we are happy that losses net of recoveries were consistent with our low historical average.

In terms of lessons learned, the experience certainly reinforced our preference for sponsor-backed companies and our biases on industry exposure. Our sponsors were very agile in supporting their companies and infusing equity when needed. Also, certain environmental, social, and corporate governance-related (ESG) considerations such as increased focus on employee health and safety and supply chain sustainability came to the forefront. The period also underscored that strong governance and controls over ESG factors are indicative of a more mindful management team that can better monitor potential risk factors to drive business resilience.

What is the outlook for 2021? Can you share some of your findings from your recent Compass Survey?

The outlook for 2021 looks bright. Based on our Fifth Annual Compass Survey completed in February 2021, 75% of sponsors, 65% of borrowers, and 79% of investors are confident in the US economy over the next 12 months. These readings were generally above last year's pre-pandemic survey results, with a higher percentage of the mix now very confident. Confidence in the global economy rose more sharply YoY, though it is still below the levels of confidence in the US economy. On the flip side, compared with 2020's survey, a greater majority see a recession as unlikely or very unlikely in 2021. The earnings outlook also looks bullish, with 87%+ of borrowers expecting to see moderate to strong revenue and EBITDA growth over the next 12 months. Given such favorable trends, it is unsurprising that most—53%—of investors surveyed expect default rates to end 2021 below 4%—with 85% expecting them to fall below 5%.

On the deal activity front, 74% of investors expect leveraged loan volume to increase this year versus only 19% in our early 2020 survey. Most—42%—expect an increase in the range of 3%-10%, with 32% predicting a rise of over 10%. This no doubt reflects expectations of higher M&A activity, with 65% of sponsors and 53% of investors expecting a pickup in M&A versus readings of only 17% and 21%, respectively, in the survey one year ago.

Coverage of the pandemic's impact on portfolios has been expansive. Are you seeing any second- and third-order impacts that may be underappreciated?

Since the pandemic hit, we have been closely tracking COVID-19's impact on our borrowers with heat maps that aggregate our borrowers up to the industry level. There are all kinds of secondary and tertiary impacts at the industry level—good or bad depending on which side of the K-shaped recovery you are on—such as restaurant shutdowns affecting food distributors and packaging companies, among others. Most of these impacts have been dissipating; our watch list counts are way down.

As the pandemic ebbs and demand rebounds, supply chain issues and rising raw material and labor costs are areas that may come into increasing focus. Prices for raw materials such as copper, silver, lumber, and other key inputs have already risen sharply. Some areas have been starved of capital, and many supply chains remain unsettled and face bottleneck issues. For example, a well-publicized shortage of semiconductor chips has already caused auto production cuts, which can ripple through to other areas. In our Compass Survey, supply chain management and rising costs were among the top of the list of external challenges anticipated in the year ahead.

How is the competitive landscape shaping up for private debt?

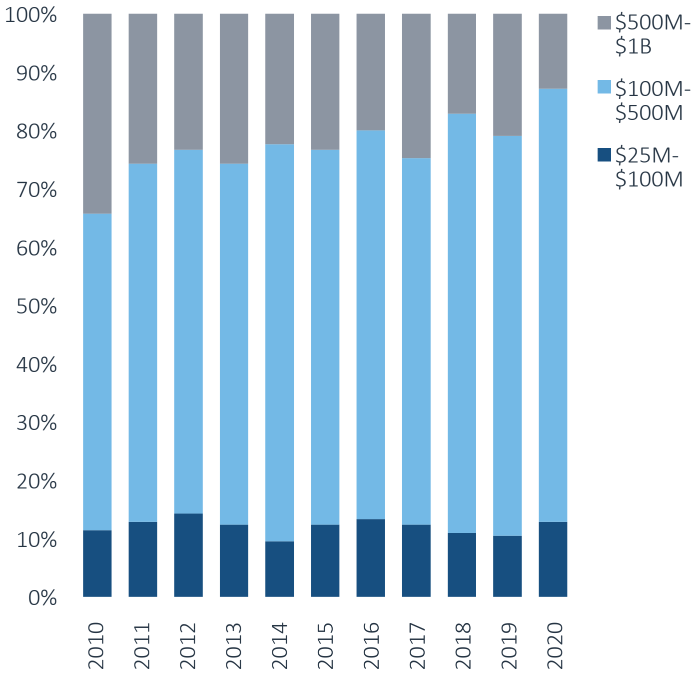
The pandemic played well to the strengths of the larger, established direct lenders. Investors sought comfort in allocating to experienced players with long track records, strong relationships, and the ability to mine add-on deal flow from their large, well-diversified portfolios of known credits. Q4 2020 was a particularly attractive period for deal flow for those able to go on offense, with high-quality companies issuing at attractive terms and spreads.

In Q1 2021, loan markets have become more issuer friendly as loan demand surged and new issue supply slackened. On the demand side, loan ETF and mutual fund net flows turned significantly positive in January 2021 for the first time since September 2018, with collateralized loan obligation (CLO) issuance continuing its rise. This has led to spread pressure, which has been most acute in broadly syndicated loans. This pressure has been rippling down into the upper middle market, but lately, core-middle-market spreads have been stable.

Looking forward, a slight majority—53%—of investors polled in our Compass Survey expect middle-market spreads to decline by 50-100 basis points over the next 12 months, while 47% expect middle-market spreads to hold flat at around 50 basis points. Recent spread pressure may abate in H2 2021 if M&A-related new issuance activity picks up as expected.

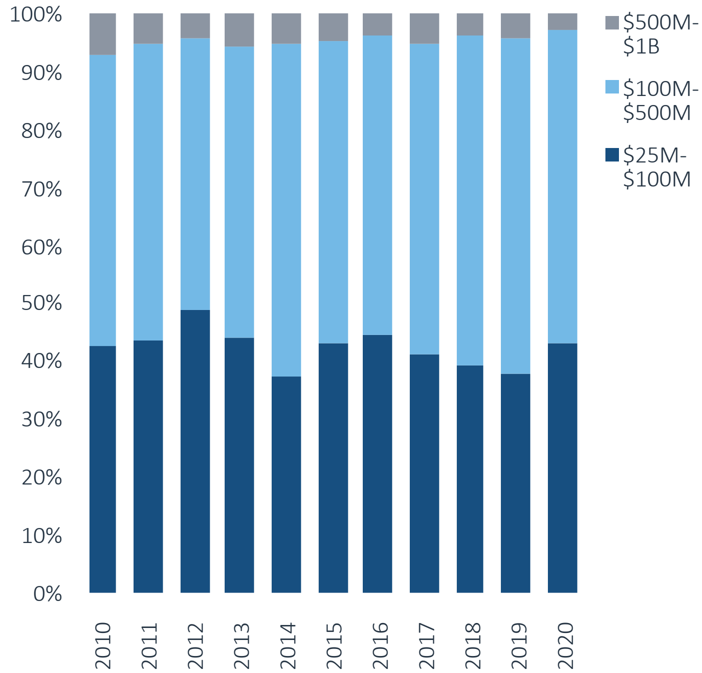
Deals by size and sector

PE middle-market deals ($) by size



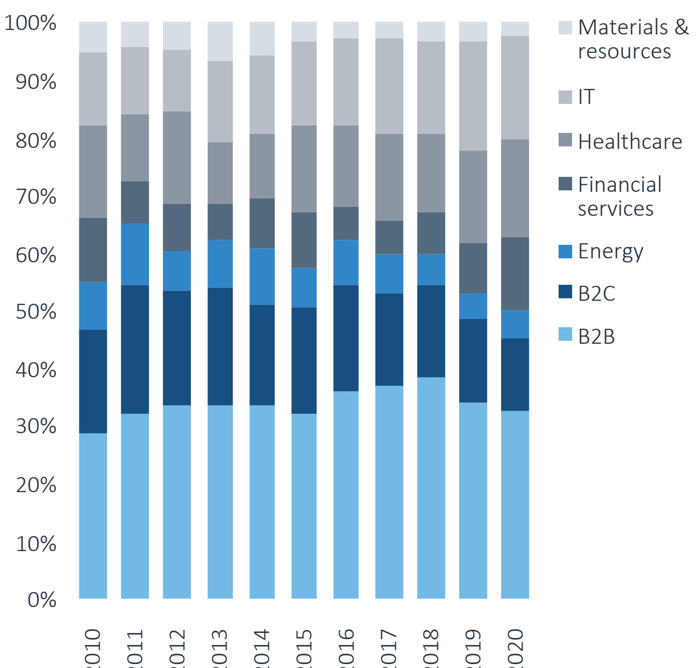
Source: PitchBook | **Geography**: US

PE middle-market deals (#) by size



Source: PitchBook | **Geography**: US

PE middle-market deals ($) by sector



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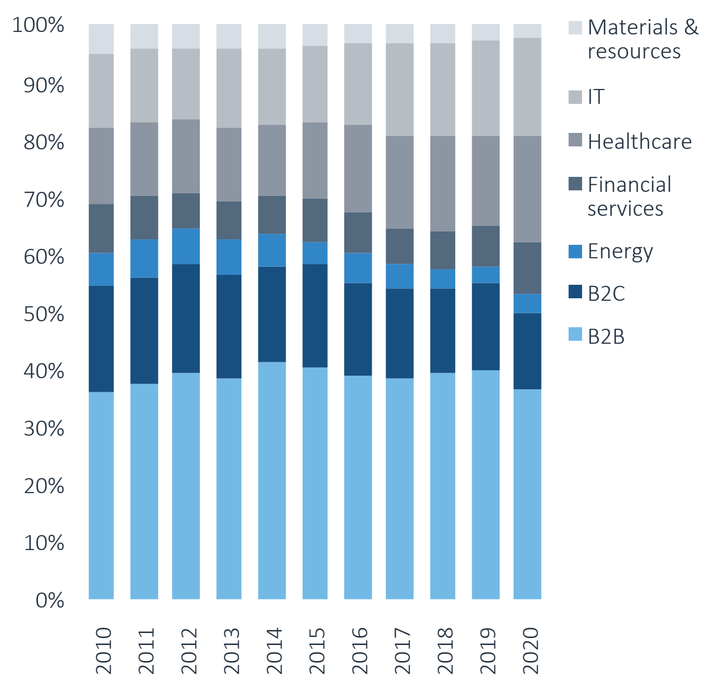
PE middle-market deals (#) by sector



Source: PitchBook | **Geography**: US


Evaluating opportunities should never be a gamble.
Let our experts help you improve the odds.

Q&A: Corporate Resolutions, Inc.

With deal flow at record highs, investors continue to seek unique opportunities to deploy capital. According to PitchBook, more than one third of all PE and VC deals closed in 2020 took place in the fourth quarter. Whether sticking with traditional structures or joining the special purpose acquisition company (SPAC) excitement, we know that the success of any investment relies on the quality of the management team. It takes only one bad actor to destroy earnest intentions and bruise a company's reputation.

20 years ago, conducting a background investigation before committing capital was tantamount to subterfuge. The subtext was that the investor was wary of the company, suspect of its management team, or just paranoid. Fast forward to today: Hiring a background check company has become as rote as engaging legal teams—albeit far less expensive.

Now, a target company's management teams expect to be checked out. Investors who follow strict protocols on requiring all teams to be vetted have stellar reputations: They take their deals seriously, believe in their investments, and suffer no fools. Also, most LPs demand this level of scrutiny.

Not all background checks are created equal. A comprehensive background investigation is a qualitative endeavor requiring multiple ingredients to formulate a thorough review on which investors can rely. CRI offers experience, intelligence, access, and resourcefulness. Without each of these components, the information can be erroneous, misleading, or give a false sense of security.

As any scrupulous investor knows, the use of intelligent intelligence is boundless. The question is never why it should be commissioned but rather how it is exercised. In a competitive deal environment, it is even more important to have a trusted due diligence partner who can quickly assess opportunities and highlight key risks before writing a check.

To evaluate service providers in this space, experience and expertise, along with a balance of technology and human analysis, are priorities. When it all comes together, our clients' capital and reputation are preserved.

Joelle Scott
Chief Operating Officer
Corporate Resolutions, Inc.

With 20+ years of experience helping alternative investors mitigate risk, Joelle Scott oversees all aspects of research operations and client management at CRI. She is co-author of Digging for Disclosure: Tactics for Protecting Your Firm's Assets from Swindlers, Scammers, and Imposters. She earned her BA from Colgate University and her MS in journalism from Columbia University, where she also served as television executive Richard Wald's assistant for ten years.

How has the internet and social media affected your industry? Why can't I just Google the person?

To quote Kurt Vonnegut, "In this world, you get what you pay for," and Google is free. While the internet grants us access to thousands more sources, people are often eager to flaunt their accomplishments through social media, blogs, and biographies, among other outlets—while often disguising their true selves. This breadth of information is a great starting point for us, but it neither hastens nor replaces the research landscape upon which we rely.

Further, for CRI, performing a Google search is more than just typing a name into a search bar. We apply customized search strings, reverse imaging, and other creative research tools to find the real information.

For every bit of quality information online or through open sources comes an equal amount of bad: illegitimate sites, false social media profiles, and countless conspiracy theories that use the same names as well-respected businesspeople. Going to the primary source is critical. From the courthouse to the archive room, the original source determines the information's validity. After we identify these principle sources, we analyze the data to ensure our clients get an accurate picture rather than a pixelated one. Without these methods, we would've been unable to uncover the VP who tried to mask his predilection for inappropriate selfies or unveil the truth about the CEO who was accused of having connections to ethically questionable groups.

Q&A: Corporate Resolutions, Inc.

You have worked with private capital investors of all shapes and sizes. Do their needs and risk tolerance vary, and how do you address that in your research?

For 30 years, we have sought to protect the reputation and capital of each of our 300+ alternative investment clients. Our goal is not to make the ultimate decision on the deal—that is up to the investor. We provide firms with as much information as possible so that the decisions are easy to make. This ethos applies to every one of our clients.

Every investor has a different appetite for risk. One person's killed deal is another person's opportunity. We always hope that the management team we investigate will have a clean result—boring is never a bad thing for our clients. Often, however, that is not the case. When we find damaging information, a client's response varies. Some clients have walked away from a deal because of drunk driving incidents, while others have invested in a manager with a history of criminal behavior. Each investor's goal dictates the ways they respond to unsavory findings in a background check.

Some clients prefer a deep dive into every executive at a target company, while others need only a quick red flag review to close the deal. No matter the scope, the quest for risk mitigation applies to all of our clients. We have maintained—and expanded—an impressive client roster because of our ability to make our research bespoke enough to be valuable and standardized enough to be reliable.

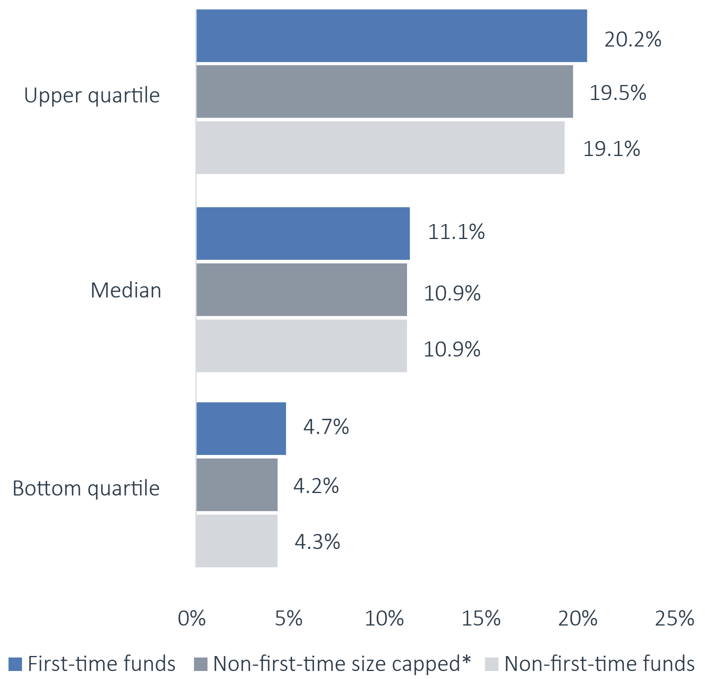
PE always has a "flavor of the month"—healthcare and technology are hot while manufacturing has been set aside. Do you specialize in a target industry? How do you address those needs?

The only industry in which we specialize is background investigations. We apply our creative methodology to every project. For instance, healthcare deals are more complex than investigating a company that manufactures auto parts. The healthcare sector requires us to independently gain access to the state licensing departments, federal agencies, and ancillary organizations that most medical professionals either belong to, are accredited by, or maintain licensure with. These departments are not interwoven; the records of one are not reflected in another. Without this knowledge, a background investigation in healthcare is rendered meaningless. From a research perspective, every industry has a distinctive set of criteria.

Like a newsroom, our team of analysts has differing perspectives and skill sets that are applied to specific projects. There is the young technophile who spends hours locating veiled social media profiles and reverse imaging geometric symbols; the land document specialist who loves investigating the real estate developer with hundreds of LLCs and property records; and the analyst who can recite the public record availability and sourcing of more than 76 countries. It is not the firm that needs to be specialized but rather the team that needs to be diverse.

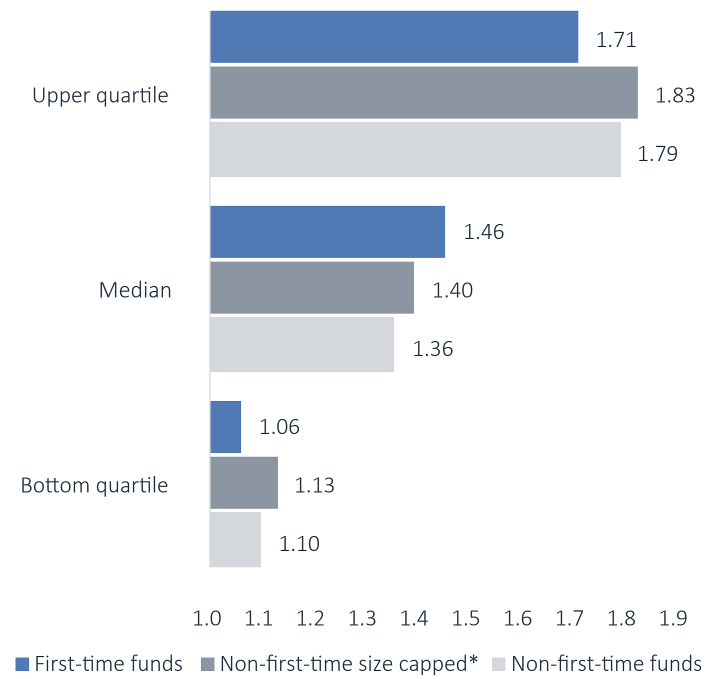
Spotlight: First-time PE funds

IRR quartiles by PE fund type



Source: PitchBook | Geography: US
*Fund size capped at the size of the largest first-time fund in each group.

TVPI quartiles by PE fund type



Source: PitchBook | Geography: US
*Fund size capped at the size of the largest first-time fund in each group.

Note: This spotlight was abridged from an analyst note on first-time PE funds. Please see this note for more detailed analysis.

There are several competing narratives around investing in first-time managers. Some LPs are attracted by the concept of the hungry emerging manager whose existence as a GP depends on the first fund's performance, while others commit to first-time funds precisely because they are pure strategy plays, with managers who left large generalists to focus on a niche. Still other LPs focus on building relationships with the next generation of great managers, which gives them preferential access to the GP's larger funds as the firm matures. Finally, a growing number of LPs, including several of the largest pension funds, operate emerging manager platforms that often explicitly aim to invest with diverse managers—either women- and/or minority-owned.

Fund performance

Despite the narrative around first-time funds outperforming their more-established peers, our data suggests outperformance levels are minimal in aggregate and sporadic in timing. Comparing first-time funds with more established funds reveals that first-time funds outperform by approximately 1 percentage point or less for IRRs across the bottom quartile, median, and top quartile—though first-time funds do hold the performance edge in each IRR quartile, even compared with other funds of a similar size. Looking at cash multiple returns, the results are clearer. But again, the difference between first-time, non-first-time, and size-capped non-first-time funds is negligible across the bottom quartile, median, and top quartile. This lends nuance to the notion of significant first-time fund outperformance and emphasizes the importance of picking top-quartile managers, regardless of the fund number from which the manager is investing.

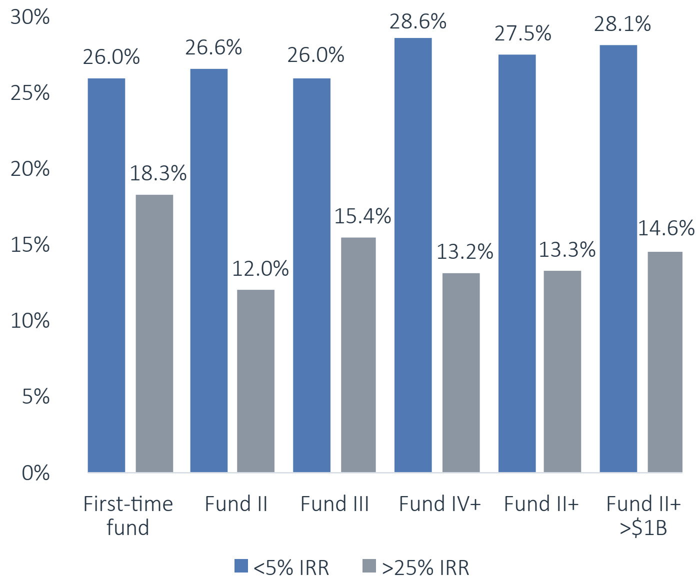
The data reveals that first-time funds have a comparable level of downside risk to more-established vehicles. First-time funds have just over a 25% chance of achieving an IRR of less than 5%, which is marginally lower than second, third, and other funds. The bull case, however, does appear more promising, with first-time funds delivering IRRs of more than 25% most frequently—at 18.3% of the time. Similarly, although first-time funds often post lower IRRs than more-established funds despite equal cash multiples, first-time funds have a quicker payback period.

Fundraising trends

The run-up to the GFC was the heyday of first-time fundraising. During this period, the private equity industry was less developed, which resulted in more opportunities for new managers to prove themselves. Since the GFC, however, LPs have been more conservative in their allocations to first-time funds. The unprecedented buildup of dry powder in recent years has been driven not by new entrants to the PE manager landscape but by investors' appetite for mega-funds—as well as established managers launching new strategies and entering new geographies.

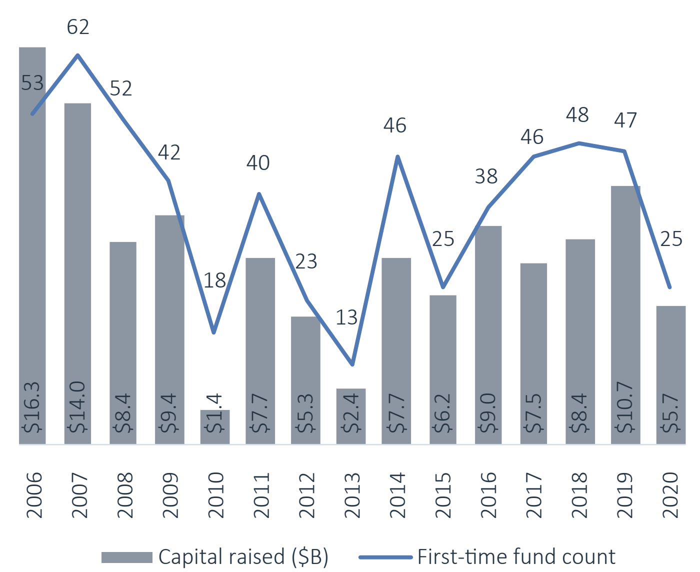
Meanwhile, first-time fundraising as a percentage of funds raised overall has held relatively steady since the mid-2010s. This includes 2020, a year that many observed anecdotally to have been particularly challenging for first-time fundraisers because of the problems posed by conducting due diligence without in-person meetings. Although the number of first-time funds raised nearly halved from 2019 to 2020, the drop-off was commensurate with overall declines in PE fundraising. This may be because funds that closed in early 2020 had already completed most of their fundraising before the pandemic hit. The pandemic may have even provided a tailwind for firms that specialize in resilient, fast-growing sectors such as technology and biotechnology. It remains to be seen whether there will be a lagged decline in the proportion of first-time funds raised in 2021, but our PE outlooks predict the best numbers in more than a decade.

Performance outcome by fund number



Source: PitchBook | **Geography**: US

US PE first-time fundraising activity

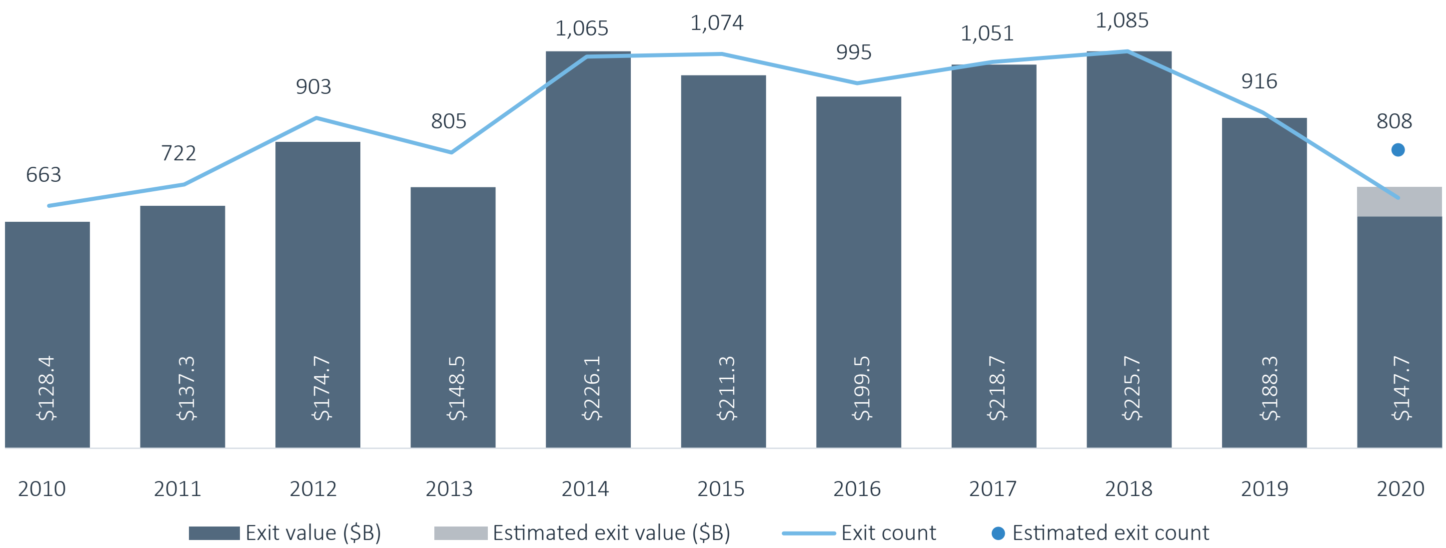


Source: PitchBook | **Geography**: US

Raising a first-time fund is difficult and labor intensive for both LPs and GPs. The due diligence process is notoriously arduous, and first-time managers may have to fund company expenses out of their own pockets. Because first-time fund managers often lack fully attributable track records, prospective LPs lean heavily on references to determine which role the manager has played in dealmaking—from sourcing through execution—and portfolio company management at their prior firm. However, the playbook for raising a first-time fund has more options now than before the GFC, including developing a track record as an independent sponsor before raising an institutional fund, seeking backing from a seeding platform, and securing an anchor commitment.

Exits

PE middle-market exit activity

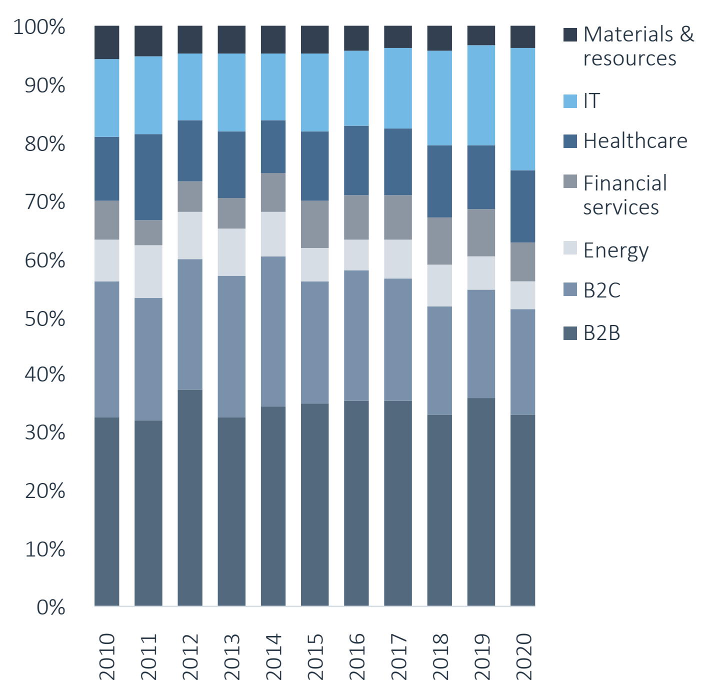


Source: PitchBook | **Geography**: US

In 2020, US middle-market exits fell for the second year in a row, with 808 exits for a combined $147.7 billion—11.8% and 21.6% YoY declines, respectively. Many GPs delayed exits in order to avoid crystallizing the deleterious effects of COVID-19 on portfolio company valuations. (Although the median middle-market hold time fell to just over five years, the drop in exit counts portends an uptick in hold times beginning in 2021.) Beginning midyear, GPs worked to make up for lost time, eventually driving Q4 exit activity above 2019's levels.

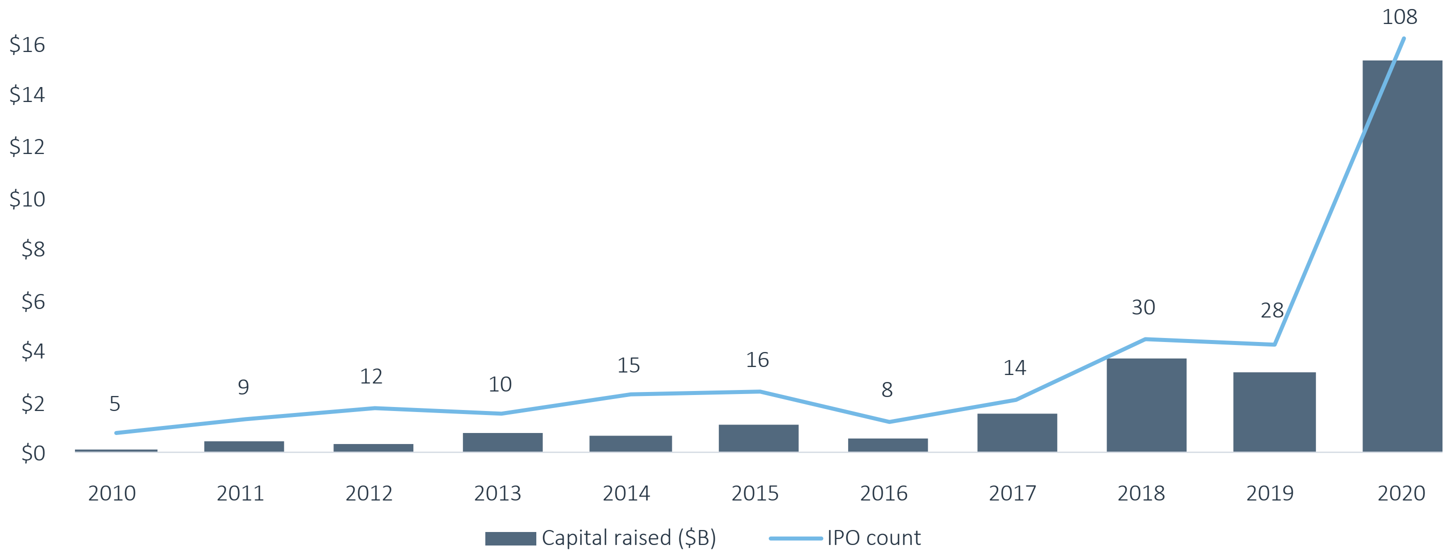
The proportion of middle-market deals exited through sponsor-to-sponsor exits declined from 57.0% in 2019 to 53.8% in 2020, likely because many GPs paused buyouts in the middle of the year. Even so, 2020 was the fourth year in a row that more middle-market portfolio companies were exited through sponsor-to-sponsor deals than through strategic acquisitions. We expect the longstanding trend toward more sponsor-to-sponsor exits will resume in 2021. While some LPs still look askance on sponsor-to-sponsor deals, dubious of another sponsor's ability to make improvements—and sometimes find themselves contributing transaction fees on both sides of a purchase, many middle-market firms have expertise in specific company growth stages. This expertise allows subsequent PE buyers to add significant value as companies graduate from the lower to upper middle market and beyond. For example, Cove Hill Partners, a Bain spinout, will seek to grow online safety training

PE middle-market sponsor-to-sponsor exits (#) by sector



Source: PitchBook | **Geography**: US

PE middle-market SPAC IPOs under $200 million



Source: PitchBook | **Geography**: US

provider Kalkomey Enterprises following its $157.0 million buyout of the company from lower-middle-market-focused Inverness Graham and Riviera Investment Group.

In 2020, middle-market companies in the materials & resources, healthcare, and technology sectors were the most likely to be sold through sponsor-to-sponsor deals, while financial services and B2C were the least likely. Technology has accounted for a growing proportion of sponsor-to-sponsor exits as PE firms increasingly covet—and are willing to pay top dollar for—the resiliency and scalability of software business models.

Although public listings represent a small proportion of middle-market exits—just 2.4% of exit value in 2020—the recent explosion of SPAC public listings may facilitate a greater proportion of public exits for middle-market companies going forward. SPAC reverse mergers can be an attractive exit option for middle-market companies approaching the $1 billion threshold because they offer simplified negotiations, less onerous due diligence, a compressed timeline, and the potential to raise more capital than might be available through a traditional IPO. In 2020, 108 US SPACs completed IPOs under $200 million, more than the previous five years combined.[10] Although no SPAC mergers of majority-PE-owned middle-market companies were completed in 2020, the large number of SPACs now searching for targets will render the SPAC merger an increasingly likely exit route for middle-market PE buyout firms over the next two years.

10: The $200 million threshold was selected because larger SPACs will likely seek firms above the middle-market cutoff.

Q&A: ACG

What's new at ACG?

Thomas M. Bohn, CAE, MBA

President and CEO
ACG

Thomas M. Bohn, CAE, MBA, joined ACG as president and CEO in 2019 after overseeing unprecedented growth at the North American Veterinary Community (NAVC). At NAVC, Tom fostered operational change and organizational growth by bolstering staff resources and revenue returns, including several acquisitions. Within six years, he grew revenue from $11 million to $26 million and fundamentally improved the relevance of the organization.

Rapid change is underway at the Association for Corporate Growth as the organization rolls out new programs and offerings for members and streamlines the membership experience across ACG chapters.

ACG President and CEO, Thomas M. Bohn, who joined the organization in December 2019, discusses the company's evolution and what middle-market professionals can expect during 2021 and beyond.

You joined ACG only a few months before the onset of the pandemic. How did COVID-19 affect the plans you had for your first year as CEO?

Leading ACG through a global pandemic certainly wasn't what I expected as I stepped into the role. COVID-19 exacted an unprecedented toll on ACG. Social distancing and live events don't mix, so in order to keep our members safe, we canceled events all over the country. We followed the government's guidance and began operating remotely to reduce risk of exposure.

After addressing those immediate safety concerns, we started planning for ACG's future. To ensure ACG members could continue networking, sourcing deals, and making connections, we developed brand-new software to replicate the in-person event experience. We expanded our suite of media with the introduction of a video channel called GrowthTV and launched a series of special reports that we're publishing in conjunction with our flagship magazine, *Middle Market Growth*. We've also brought on several new endorsed partners who will offer exclusive benefits for ACG members.

Perhaps the most exciting development is the progress we've made toward building an integrated ACG community worldwide. Historically, ACG chapters have operated more or less independently as they serve their local and regional membership bases. Yet we know that many of the individuals and firms engaged with ACG do business across the US—and in some cases, the world. Through our initiative One ACG, we're building an integrated organization that helps our members do business seamlessly, wherever they are.

How will the One ACG initiative improve the experience for the middle-market professionals within ACG's membership?

We are in the early stages, but by integrating the chapters and our national organization, One ACG will enable our entire organization to more effectively leverage resources. Chapters will have back-office and marketing support so that they can deliver high-quality networking events and programming for members.

The pandemic has underscored the power of technology and the importance of having the right systems. Through One ACG, investments in meeting scheduling tools, virtual event software, and more will benefit all One ACG chapters. Instead of each local ACG outpost having to design, buy, and implement its own technology, these tools can be leveraged to ensure all members benefit.

We are gearing up for collaborative events, wherein chapters within a region work together on programs and conferences. For individuals and firms doing business in multiple markets, One ACG will make it easier to attend nonlocal events. Similarly, if you're looking to market your firm through advertising and thought leadership across geographies, you'll no longer need to broker those deals chapter by chapter. The One ACG arrangement will ensure you have the options that best fit your marketing needs, whether that's a local campaign or a global one.

Chapters in Atlanta, Los Angeles, and Boston already have signed on to participate in One ACG as the first three chapters in the program—a number that will grow throughout the year. This will be a multiyear endeavor, but with every chapter that signs on, the One ACG network will only strengthen, with expanded and direct benefits for our members.

Can you talk about the ACG community itself and the types of firms or roles that benefit from the networking and thought leadership resources ACG offers?

ACG is the home for the middle market. We're the trade association for anyone involved in growing midsize companies, either organically or through M&A. For a long time, that has included private equity investors, investment bankers, lenders, attorneys, accountants, and consultants. In recent years, we've also been developing programs and offerings for private equity-backed executives, family offices, and corporate strategic acquirers. Meanwhile, the Private Equity Regulatory Task Force (PERT) offers a place for sharing best practices among chief financial officers and chief operating officers at the fund level.

Regardless of career stage, if you work in the middle market, there's a place for you within ACG. There are members who've worked within the industry for 50 years who come to our annual conference, InterGrowth, to reconnect with and strengthen existing relationships. For senior-level executives looking for a more intimate networking experience, chapters like ACG New York offer exclusive, bespoke networking events and dinners.

There are plenty of opportunities for young professionals as well. Chapters across the country offer Young ACG networking groups and programs that cater to those early in their career. In a few months, we'll be celebrating some of those up-and-coming leaders in the *Middle Market Growth* awards issue, which features profiles of the 10 Young Professional Award winners.

To help professionals of all ages improve their knowledge of the middle market, last year we launched our Middle Market Professional certification program. Known as MMP, the six-week, self-paced course provides ACG's community of high-achieving professionals the opportunity to strengthen their knowledge of—and standing within—the middle market.

Tailoring our offerings for professionals at all career stages is just one component of our efforts to achieve greater diversity within the middle-market community. Like many organizations, we heard the calls last year for more diversity, equity, and inclusion (DEI) in the workplace. That prompted ACG to form the DEI Task Force, a group that will create a DEI policy and complementary programming to foster a more equitable and inclusive middle market. We're actively working toward building a more diverse community, so expect to see more content for and about the diverse professionals in our industry.

Prior to the pandemic, ACG was known by many for its in-person networking events. What would you say to someone who's questioning the value of joining ACG in the absence of in-person events?

For a long time, live events really were the core value proposition that ACG offered to its members. Those will come back, so in-person networking will continue to be an important feature of what ACG has to offer. At the same time, we've evolved as an organization into so much more than just in-person events.

Exclusive virtual events powered by our customized, secure meeting technology give members a place to continue to network and build new relationships until we're back in person. Another digital tool is our member directory, which makes it easy to search and connect with fellow middle-market dealmakers.

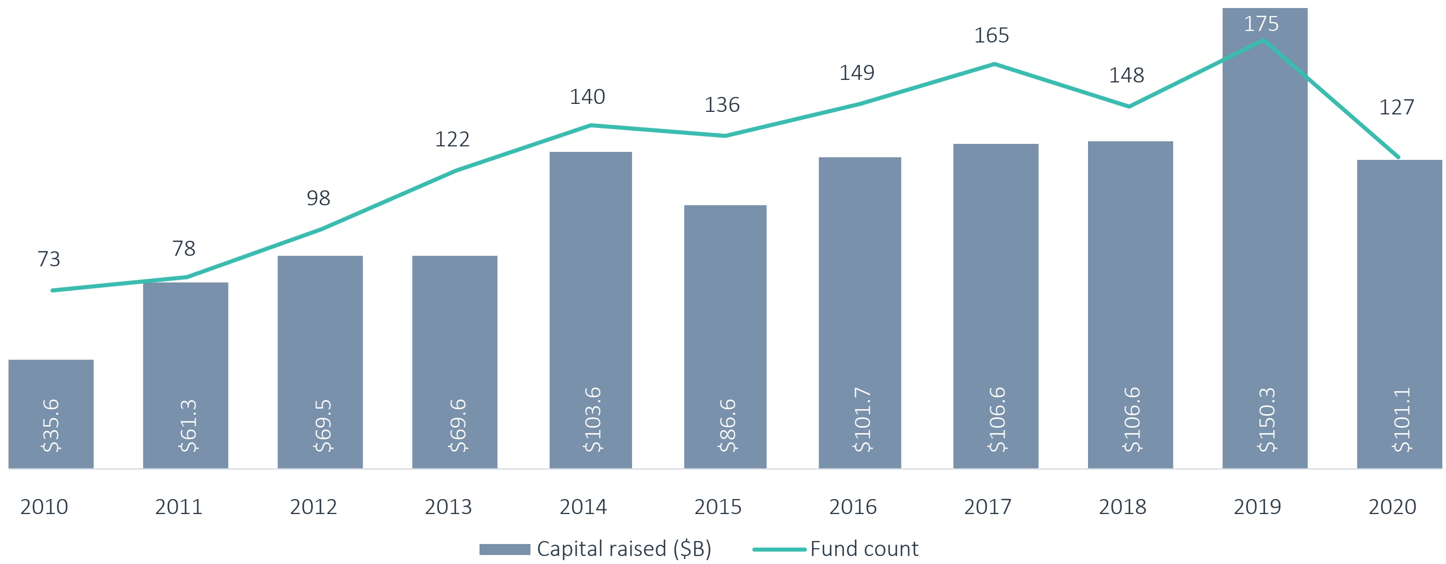
Members and middle-market professionals also have access to a wealth of expert intelligence through our media offerings, including *Middle Market Growth* and GrowthTV. In February 2021, we launched Next Target, a new members-only email produced in partnership with Grata, a middle-market company search engine platform that helps identify specific sections of industries that are primed for investment.

There are also exclusive offers from ACG's endorsed partners, including Cambridge Global Payments and Insperity, and new member benefits available through Founders Card, CLEAR, and more. I would direct prospective members to the "New Member Resources" tab on our website. As we add new offerings, we'll continue to update this page so that you have all of our member benefits at your fingertips.

Ultimately, ACG membership is about being part of the vibrant middle-market community. It's the place to meet the people you need to know before you need to know them and to access invaluable industry insights. If you're already a member, we thank you for your contributions to this powerful network. And if you haven't yet joined, we look forward to welcoming you into the fold.

Fundraising

PE middle-market fundraising activity

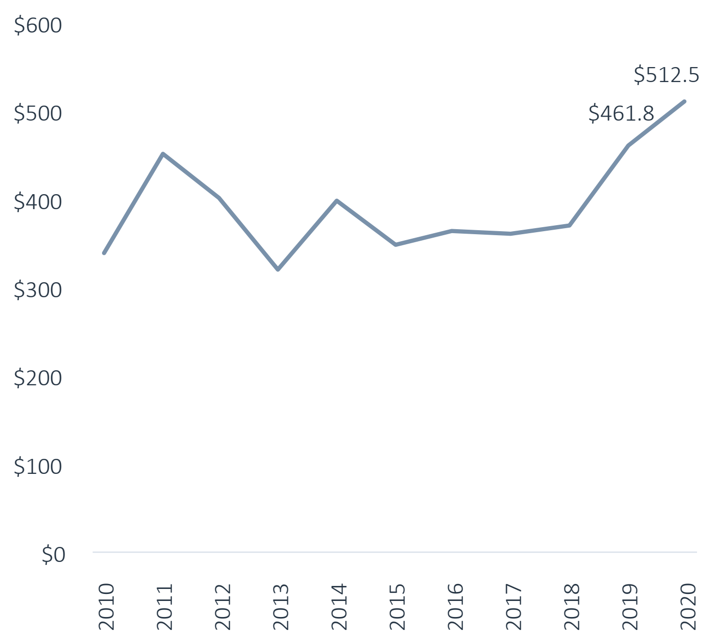


Source: PitchBook | **Geography**: US

Although the amount of capital raised dipped by approximately one third YoY, 2020's US middle-market fundraising proved resilient all things considered. GPs raised 127 middle-market funds for a combined $101.1 billion—a far cry from 2019's record-breaking heights but roughly on par with fundraising levels in 2016-2018. Since 2017, funds over $1 billion have accounted for an increasing share of middle-market fundraising, while the proportion of funds under $500 million has diminished. That trend continued in 2020 as the median middle-market buyout fund size rose above $500 million for the first time ever.

COVID-19 undoubtedly made 2020 a significantly more challenging fundraising year for middle-market GPs. Although the average time to close slid below one year for the first time ever in 2020, it is likely that 2021's data will show longer fundraising periods. During the pandemic's initial wave in Q2, LPs struggled to conduct due diligence via videoconference. Some LPs scaled back commitment plans to focus on existing relationships with well-established managers, a route requiring less work when performing due diligence. Many of the funds that closed in 2020 had begun fundraising in 2019, and anecdotal reports suggest that the pandemic's disruption may have forced some of these funds to delay closing.

PE middle-market median buyout fund size ($M)



Source: PitchBook | **Geography**: US

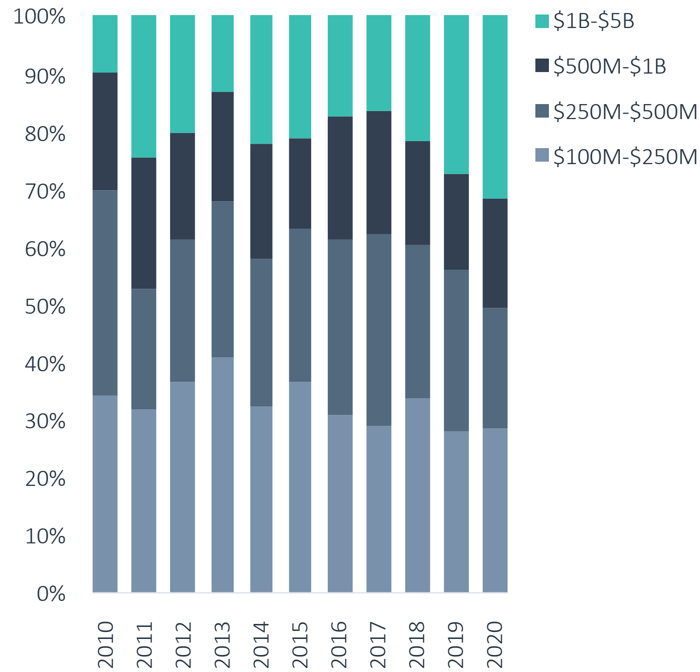
In some cases, emerging managers who were already near the end of their fundraising periods may have closed at or near their target rather than pushing for further commitments.

Despite 2020's turbulent environment, several established middle-market firms fared well. Wind Point Partners, Aquiline Capital Partners, and H.I.G. Capital, to name a few, all closed funds well over their targets. 2020 also saw successful fundraises by new GPs based in regions lacking significant private equity presence, including Breck Partners in Frisco, Texas, Rallyday Partners in Denver, and Pike Street Capital in Seattle. Although 2020 data does not show a marked increase in funds located in these nontraditional regions, it remains to be seen whether pandemic-induced migrations away from major financial centers will extend to private equity fundraising in 2021 and beyond.

Funds focused on technology and healthcare—both high-growth, haven sectors—were particularly attractive to LPs in 2020. The largest technology-focused GPs had standout fundraising years: Thoma Bravo raised $3.9 billion for its third Discover Fund and $1.1 billion for its Explore Fund, while Francisco Partners raised $1.5 billion for its second Agility Fund. Both firms raised these middle-market funds simultaneously with flagship mega-funds. In healthcare, Blackstone's Life Sciences V closed at $4.6 billion in July 2020.

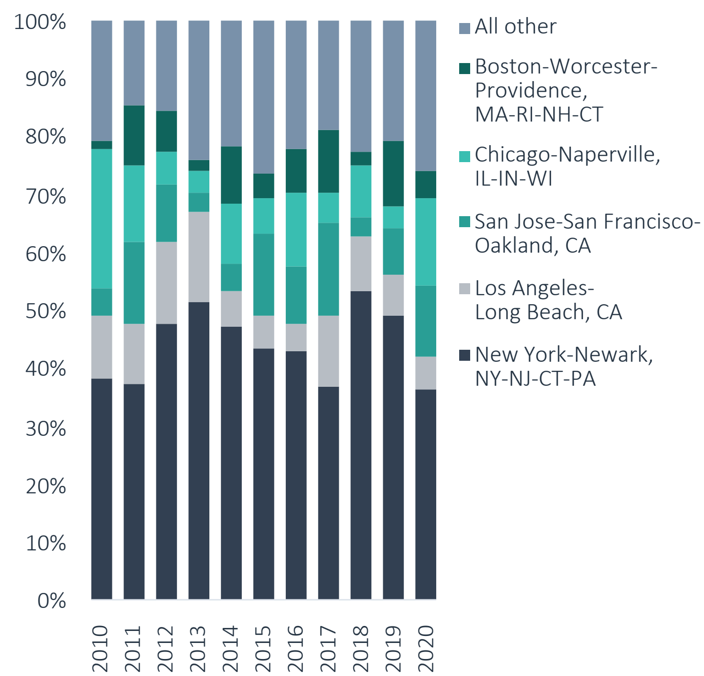
Turning to another key investing theme, two of the largest GPs closed ESG funds in 2020. KKR's $1.3 billion Global Impact Fund, which invests internationally in lower-middle-market companies that align with the UN's Sustainable Development Goals, closed in February 2020, while Bain Capital Double Impact II raised $800.0 million in November, more than double the amount raised by its predecessor fund in 2017. ESG fundraising faced headwinds in H2 from a new Department of Labor rule proposed in June and finalized in November that requires corporate pensions to select investments based on pecuniary factors only. The new rule caused widespread confusion because an earlier version had explicitly taken aim at ESG investing.[11,12] The Biden administration is reportedly reviewing the rule with a view to reversing it, and 2021 will likely produce an acceleration of middle-market ESG fundraising.

PE middle-market fundraising (#) by fund size



Source: PitchBook | **Geography**: US

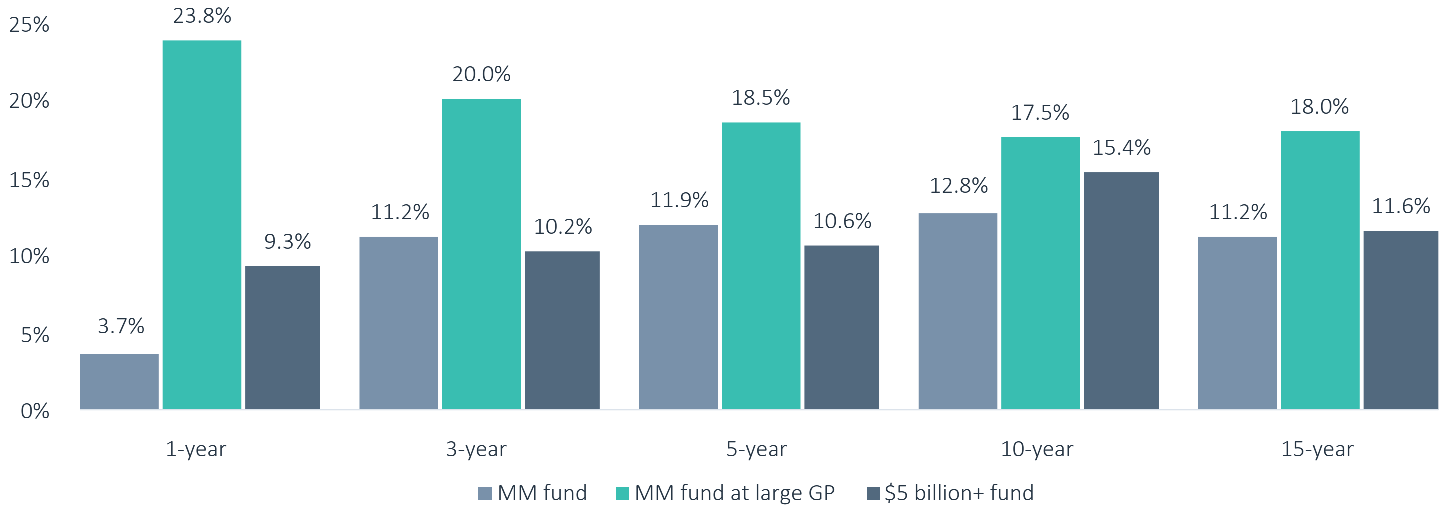
PE middle-market fundraising ($) by location



Source: PitchBook | **Geography**: US

11: "Financial Factors in Selecting Plan Investments," Federal Register, June 30, 2020.
12: "Financial Factors in Selecting Plan Investments," Federal Register, November 13, 2020.

PE middle-market fund horizon IRRs*



Source: PitchBook | **Geography**: US
*As of June 30, 2020
Note: For the purposes of this chart, we define "large GP" as a GP that has raised at least one $5 billion+ fund.

The technology-, healthcare-, and ESG-focused funds mentioned above are examples of another growing middle-market trend: GPs who manage mega-funds of $5.0 billion or more also launching middle-market strategies. Thoma Bravo, Francisco Partners, Blackstone (NYSE: BX), Bain, and KKR (NYSE: KKR) are just the latest examples. By fundraising for one or two smaller funds in tandem with the flagship fund, as with the Thoma Bravo and Francisco Partners funds, the largest firms can raise additional capital without needing to bring on the same number of staff that launching a new strategy would require. Raising middle-market funds as a mega-fund GP also removes friction for LPs, who can allocate to a different market segment without managing additional GP relationships. However, LP appetite for these funds is also performance driven: Middle-market funds managed by large firms have consistently outperformed both other middle-market funds at smaller firms and mega-funds—though it is important to note that this data likely exhibits some survivor bias, as only the most successful middle-market firms can raise $5 billion+ vehicles.

2020 US PE MM lending league tables

Overall

1	Antares Capital	175
2	Barings	113
3	Ares	112
4	Churchill	107
5	BMO Financial Group	86
6	MidCap Financial	78
7	Twin Brook Capital Partners	73
8	Crescent Capital	71
9	PNC	61
10	Golub Capital	58
10	NXT Capital	58
12	The Goldman Sachs Group	56
12	Varagon Capital Partners	56
14	Madison Capital Funding	55
15	Fifth Third Bank	49
16	Owl Rock	47
16	Citizens Bank	47
16	Capital One	47
16	KeyBank	47
20	Bank of Ireland	46
20	Jefferies Group	46
22	The Carlyle Group	45
22	Morgan Stanley	45

Source: PitchBook

Select roles*

1	Antares Capital	148
2	Twin Brook Capital Partners	57
3	MidCap Financial	53
4	BMO Financial Group	50
5	Ares	44
5	Churchill	44
7	Varagon Capital Partners	43
8	Crescent Capital	42
9	Citizens Bank	41
10	Madison Capital Funding	40
11	Fifth Third Bank	37
12	KeyBank	33
13	Jefferies Group	32
14	Capital One	31
14	NXT Capital	31
16	Golub Capital	30
17	Credit Suisse	24
18	Truist	23
19	The Carlyle Group	22
19	The Goldman Sachs Group	22
21	Bank of Ireland	20
22	Barings	18
22	Owl Rock	18

Source: PitchBook. *Select roles comprise only bookrunners, lead arrangers, mandated lead arrangers, and all types of agents that are specifically listed within PitchBook.