



PRIVATE EQUITY REPORT

MIDDLE MARKET

Q2

Carleton McKenna & Co

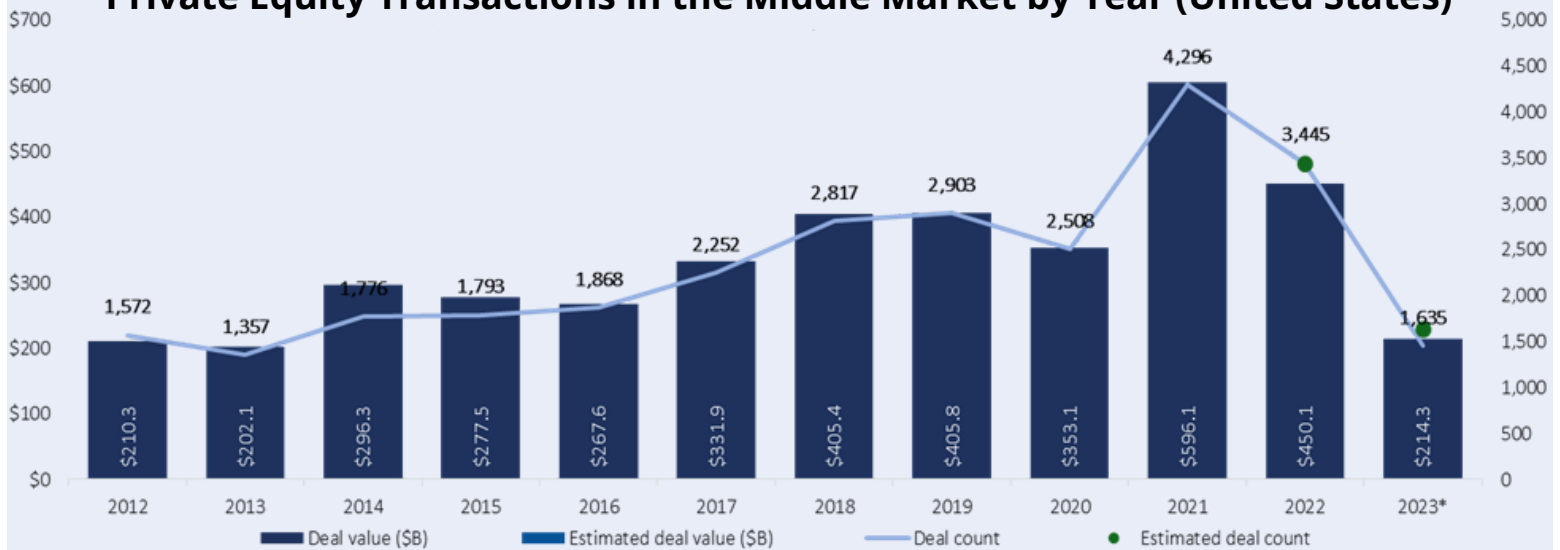
INTRODUCTION

The following report will discuss Private Equity ("PE") transactions in the Middle-Market. Middle-Market transactions range from \$10 million to \$1 billion in deal size. The Middle-Market can be broken into three distinct segments: the Lower Middle-Market ("LMM") with deal sizes ranging from \$10 million to \$100 million, the Core Middle-Market ("CMM") with deal sizes ranging from \$100 million to \$500 million, and the Upper Middle-Market ("UMM") with deal sizes ranging from \$500 million to \$1 billion.

EXECUTIVE SUMMARY¹

The Middle-Market continues to fire on most cylinders within the broader United States ("US") PE buyout market. US Middle-Market funds, which Pitchbook defines as between \$100 million and \$5 billion in size, outperformed mega funds (funds of \$5 billion or more) for three consecutive quarters heading into 2023, with the gap expanding to 9.7% as measured by median one-year horizon returns. This was the widest gap in favor of the Middle-Market since 2016 and a stark contrast to Q4 2021, when mega funds trounced all other funds by an impressive margin. The Middle-Market's performance advantage contracted in Q1 2023 based on preliminary return data but is still solidly ahead, at 5.2%.

Private Equity Transactions in the Middle Market by Year (United States)



While PE activity has yet to reach heights like the 2021 peak, the Middle-Market's share of PE buyouts is on pace for its strongest year ever and stood at 75.6% as of July 2023.

However, it's not all blue skies ahead for PE players in the Middle-Market. Middle-Market exit activity experienced its weakest quarter since 2010 in 2Q23, as fund managers are positioning portfolio company, sales and demanding better prices.

To win in this clouded economic environment, PE firms must adapt to changing market conditions coupled with long-term trends that have become increasingly important in the US, including workforce trends, digital & cloud transformation, and Environmental Social Governance ("ESG").

ECONOMIC ENVIRONMENT^{2 3}

The United States economy, expanded between 2.0-2.4% (real GDP) on an annualized pace through the first half of 2023. Consumer spending, which drives ~65% of GDP historically, has been resilient and is expected to remain strong through the end of 2023. In addition, the Fed's dramatic rate hike cycle has slowed, however indications remain that rates will remain high for the foreseeable future.

Inflation has begun to subside in 2023, however has shown more persistence than initially expected through the first half of the year. Falling energy prices have been one of the main deflation drivers. Core goods and core services inflation dropped from 12% to 0.8% and 7.3% to 6.1%, respectively, in 2Q23. Consensus expects to see gradual inflation improvement through 2023, however is noted that the Fed's target 2% level may be unattainable until late 2024.

The first half of 2023 played out in similar fashion to the second half of 2022 in the US PE space. PE firms continue to operate in a high interest rate environment, experiencing increased costs of borrowing, leading to more expensive debt, which often creates hurdles to closing transactions in a timely and efficient manner.

While the PE space remained relatively unharmed because of the bank failures in early 2023, it created a more risk-averse environment for lenders, which makes it more difficult for PE firms to get deals done quickly and efficiently.

While some aspects of the distressed economic environment have carried from 2022 into 2023, there are some differences. First being the rebounding of public markets, as of June 2023 the S&P 500 was up 15.3% on a YoY basis, where the prior FY (2022) carried a negative return of 18.1% just six months prior. As of September 22, 2023, the S&P 500 was up 13.27% YTD⁴.

PRIVATE EQUITY HEADLINES⁵

Take-private activity, which dominated the PE market in the first half of 2023, has begun to show signs of slowdown heading into the back half of 2023.

PE firms have remained focused on investing opportunistically in high quality assets in markets with long-term secular tailwinds.

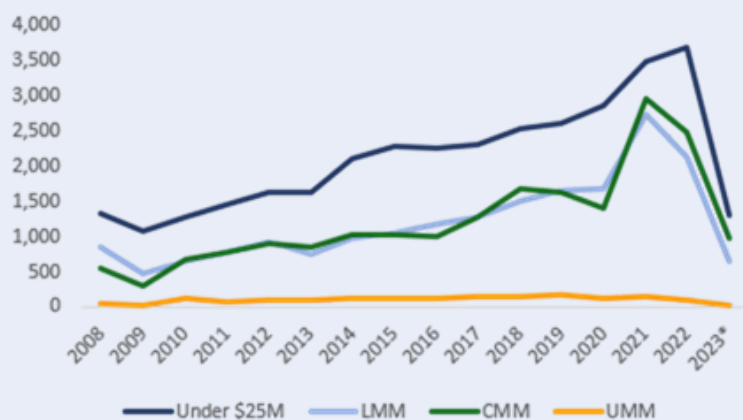
Limited access to debt packages used for leveraged buyouts (LBOs) coupled with cheaper prices for smaller buyouts has encouraged PE firms to move down-market, as these deals are more easily financed and hit return targets at a marginalized level of risk compared to deals upmarket.

As a result of the decreased activity of larger, platform acquisitions in the Middle-Market, PE firms are sitting on unprecedented levels of dry powder reserves, about \$1.1 trillion in aggregate within the US. This increased presence of dry powder is a direct result of reduced outflows (investment activity) seen across the broader PE market. As a result, the market expects to see increased activity with creative means of capital deployment (ex. Minority investments, all-equity deals, private debt placement) from investors.

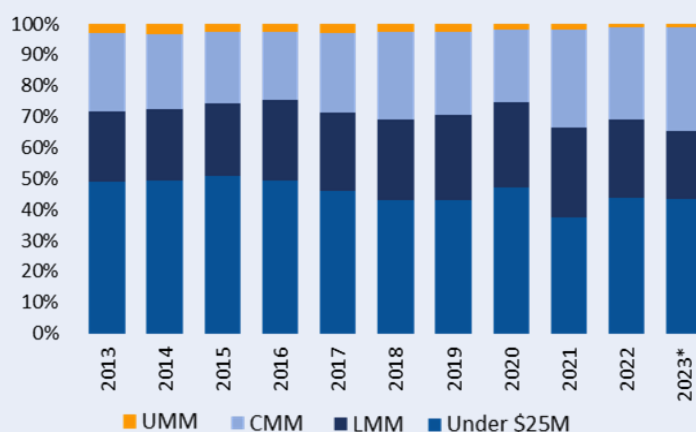
DEAL ACTIVITY

According to Pitchbook, PE firms closed 811 Middle-Market buyout deals in 2Q23, leading to a total of \$103.8 billion in deal value. These values are largely unchanged compared to 1Q23, where total deal value declined by 6.1%. The declines in volume and value in the Middle-Market are not as steep as the greater buyout market overall. The Middle-Market's share of buyout deals experienced an expansion to 75.6% YTD through Q2, up from a five-year average of 68.2%. The Middle-Market has never experienced a share of 72% or higher for a full year. If maintained, it marks a significant reversal from a market previously dominated by mega funds and their corresponding deals.

Deal Count by Middle Market Segment



Middle Market Deals by Size



Middle Market as a % of All PE Buyout Value (\$B)



The slowdown in megadeal activity has distinct identifiers, the most powerful of which is the inability to access large leveraged loans. For most of 2023, a “glass ceiling” had formed at ~\$2 billion level for packages backing LBOs.

US PE Deal Value (\$B) by EV bucket

EV Bucket	2019	2020	2021	2022	2023
Under \$25M	\$21.3	\$25.0	\$30.3	\$25.0	\$11.6
\$25M-\$100M	\$80.1	\$84.0	\$130.0	\$94.3	\$33.6
\$100M-\$500M	\$341.8	\$317.8	\$584.1	\$479.8	\$246.3
\$500M-\$1B	\$109.8	\$81.7	\$110.6	\$70.6	\$23.9
Total	\$765.3	\$689.6	\$1,288.1	\$1,018.2	\$418.3

GF Data

Looking to announced PE deals for larger, public companies in 2023, only four had surpassed \$2B in debt financing, while at the same time last year there had been thirteen. For the Middle-Market players, the \$2B glass ceiling is outside of typical investment criteria. In addition, the current economic environment has forced Middle-Market PE shops to develop relationships with complex private credit lenders. Given the increased concentration of lenders being standoffish for big buyouts, the Middle-Market continues to be the path of least resistance for PE dealmakers.

VALUATIONS⁷

In the YTD 2023 period, Middle-Market buyout multiples have experienced a continued contraction. While the TTM period has only seen buyout multiples slip between 2%-3%, the rate of decline has accelerated in the YTD period. As of June 2023, enterprise values (EV)/EBITDA and EV/Revenue multiples stood at 12.8x and 2.3x respectively on a TTM basis, and 10.3x and 2.1x on a YTD basis.

The decline in buyout multiples can be attributed to narrowing bid-ask spreads in favor of buyers in the marketplace. As a result of ineffectiveness of PE sellers, firms have been forced to target public companies as buyers seeking distressed valuations, divestitures from larger companies seeking to raise capital, and non-backed founder ownership businesses seeking to sell for personal reasons. Non-backed founder-owned businesses have developed a heavier share of deal flow in the broader M&A space, representing 61.5% of all global deals in 1Q23, a 15 year high. In the US Middle-Market, non-backed businesses accounted for 55% of all buyouts in 2Q23, up from a floor of 4% in 1Q21.

TEV/EBITDA - By Industry (\$10-\$250M TEV)					
Industry	2019	2020	2021	2022	2023 YTD
Manufacturing	6.5x	6.7x	7.1x	7.3x	6.4x
Business Services	7.2x	7.1x	7.3x	7.5x	7.8x
Health Care Services	8.0x	7.6x	8.1x	8.4x	8.7x
Retail	9.3x	6.5x	8.3x	8.0x	5.7x
Distribution	7.0x	7.5x	7.2x	7.2x	6.5x
Media & Telecom	9.4x	8.3x	6.3x	9.1x	NA
Technology	10.0x	7.6x	10.3x	8.1x	7.8x
Other	6.5x	6.2x	7.3x	6.7x	7.0x

GF Data

Average valuations on Manufacturing and Distribution deals slipped in the first half of 2023 by 0.9x and 0.7x respectively. While Health Care and Business Services experienced significant gains, as investors focused on markets with recurring revenue models amidst the risk-averse lending environment of 2023⁸.

Debt Multiples					
Debt Type	2019	2020	2021	2022	2023 YTD
SUB Debt/Ebitda	0.7x	0.6x	0.7x	0.7x	0.6x
SR Debt/Ebitda	3.2x	3.1x	3.3x	3.2x	2.9x
Total Leverage	3.9x	3.7x	4.0x	3.9x	3.5x

GF Data

Average all-in leverage multiples slipped to 3.6x across all deals in the first half of 2023, down from 3.9x in the prior YoY period, and below the historical average of 3.7x. Senior debt across all deals fell to an average of 2.9x compared to 3.2x in 2022. Use of senior debt across all deals dropped in the first half of 2023 to an average contribution of 39%, while use of subordinated debt also decreased to 8.5% compared to 8.8% in 2022.

CONCLUSION

The effects of record inflation, economic uncertainty, and geopolitical tensions are showing themselves within global markets. While financial institutions across the globe are dealing with bottlenecks that create inefficiencies as it pertains to closing transactions, the US Middle-Market is better off than the broader PE market. Increased costs of borrowing, trends of risk-averse behavior, and slowdown in investment activity across the board have shifted investors to look to the Middle-Market for transactions. This has uniquely positioned the Middle-Market PE players, as they are sitting on unprecedented levels of dry powder, ready to deploy once the forward economic outlook post 2023 becomes clear.

FIRM OVERVIEW:

Carleton McKenna & Co is an independent investment banking firm providing M&A and Capital Raising advisory services. We work with middle-market closely-held family businesses, multi-generational family businesses, portfolio companies of financial sponsor firms and divisions or subsidiaries of public companies focusing in Specialty Manufacturing & Chemicals, Consumer Products, Food & Beverage and B2B Services.

Our Team is made up of finance and accounting experts, entrepreneurs and operators, C-Suite and Board professionals, lawyers, consultants and marketing professionals. These diverse experiences and skills drive extraordinary results for our clients.

We believe businesses are the economic engine of our society, and that business owners deserve and require a proactive advocate to maximize life changing transactions.

Have A Question?

Contact Brandon for additional information or any questions you may have about this report.



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Interested in Learning More About CM&Co?

Contact Emily to learn more about Carleton McKenna's services.



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