



PRIVATE EQUITY REPORT

MIDDLE MARKET

3Q 2023

Carleton McKenna & Co

INTRODUCTION

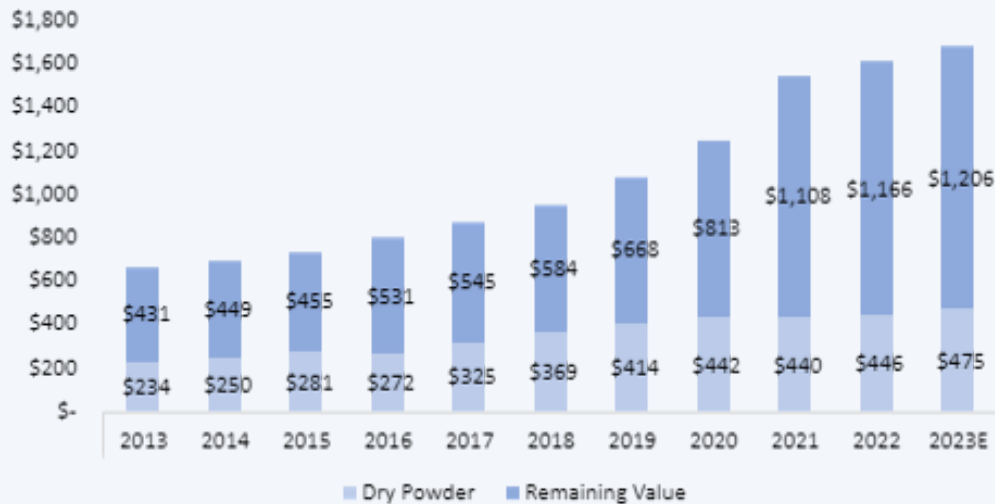
The following report will discuss Private Equity (“PE”) transactions in the Middle Market; these transactions range from \$10 million to \$1 billion in size. For reference, the Middle Market can be broken into three distinct segments: the Lower Middle Market (“LMM”) with deal sizes ranging from \$10 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 struggles of the larger acquisition universe have finally trickled down into the Middle Market M&A space through 3Q 2023. In the larger buyout market, bottlenecks have arisen from limited access to debt. While in the Middle Market, finding lenders open to transacting remains an issue. Through 3Q 2023, the US Market experienced a full point increase in interest rates, leading to limited buyout activity and the repricing of assets. Middle Market PE deals that did manage to close, often did so at lower multiples and valuations. While Middle Market PE buyout activity is still on pace for its strongest year to date, the downturn in deal activity was evident on both the buy- and sell-sides of the equation. Overall buyouts slipped down by more than 25% in 3Q 2023. PE Middle Market buyouts also fell despite showing signs of stabilization through the first half of 2023.

The bright spots in the Middle Market PE space have been found with founder-owned and operated businesses, as they have made up most of the deal flow in the Middle Market, as PE backed businesses are being held for longer, awaiting the release of valuation constraints in the US. In addition, Middle Market fundraising has been well-off in 2023. As mega-funds have struggled with fundraising for most of 2023, Middle Market fundraisers have been successful in finding investors with differentiated return strategies that are less dependent upon leverage. A large tailwind for the Middle Market’s outperformance on fundraising has been its success fundraising compared to mega funds.

PE Middle Market AUM (\$B, USD)

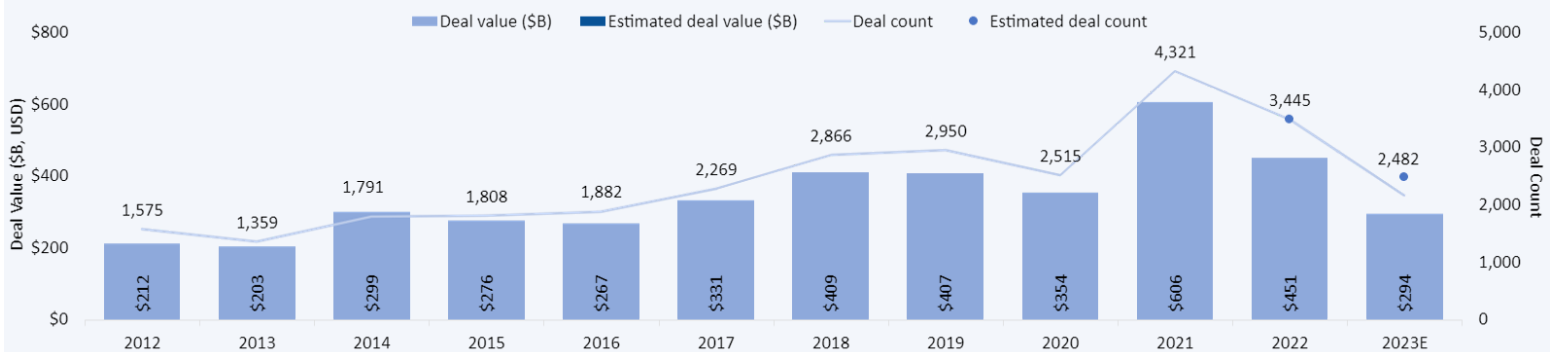


DEAL ACTIVITY²

PE Middle Market activity in the US fell to a six-year low in 3Q 2023. Total deal value and counts slipped 13.4% and 2.5% respectively. The peak-to-trough decline measures 47.9% from the 4Q 2021 peak. Similar to the broad M&A environment, the Middle Market has yet to bottom-out. Eight hundred and three deals were announced by PE firms at a total value of \$87.7B in 3Q 2023. The YTD deal count and values declined 13.9% and 1.0% respectively. While there is a substantial contraction in the Middle Market, the Middle Market is still better off than the overall US buyout space, which has experienced a decline in deal value and counts of 29.3% and 6.0%, respectively.

As a result of the more substantial decline in the broader buyout market, the Middle Market's share of all buyout activity has expanded to 73.6% on a YTD basis from a five-year average of 68.6%. If the Middle Market maintains pace, it would be the highest share historically, as the Middle Market has never experienced a share exceeding 72% for a full year period. This increase for the Middle Market would mark a sharp reversal from a previously mega fund and deal dominated buyout market.

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



The bottleneck driving the slowdown in megadeal activity has been the “ceiling” on debt packages at the \$2B level for LBOs, which the Middle Market fails to reach. As the Middle Market has not been faced with debt starvation like the broad buyout market, the Middle Market has been actively partnering with private credit lenders. Pitchbook estimates that there are more than 1,300 private credit vehicles focused on lending to small and Middle Market businesses in the US alone. The AUM of private credit vehicles has grown substantially over the previous three years, reaching \$869B, or 62.0% of the overall leveraged loan market in the US.

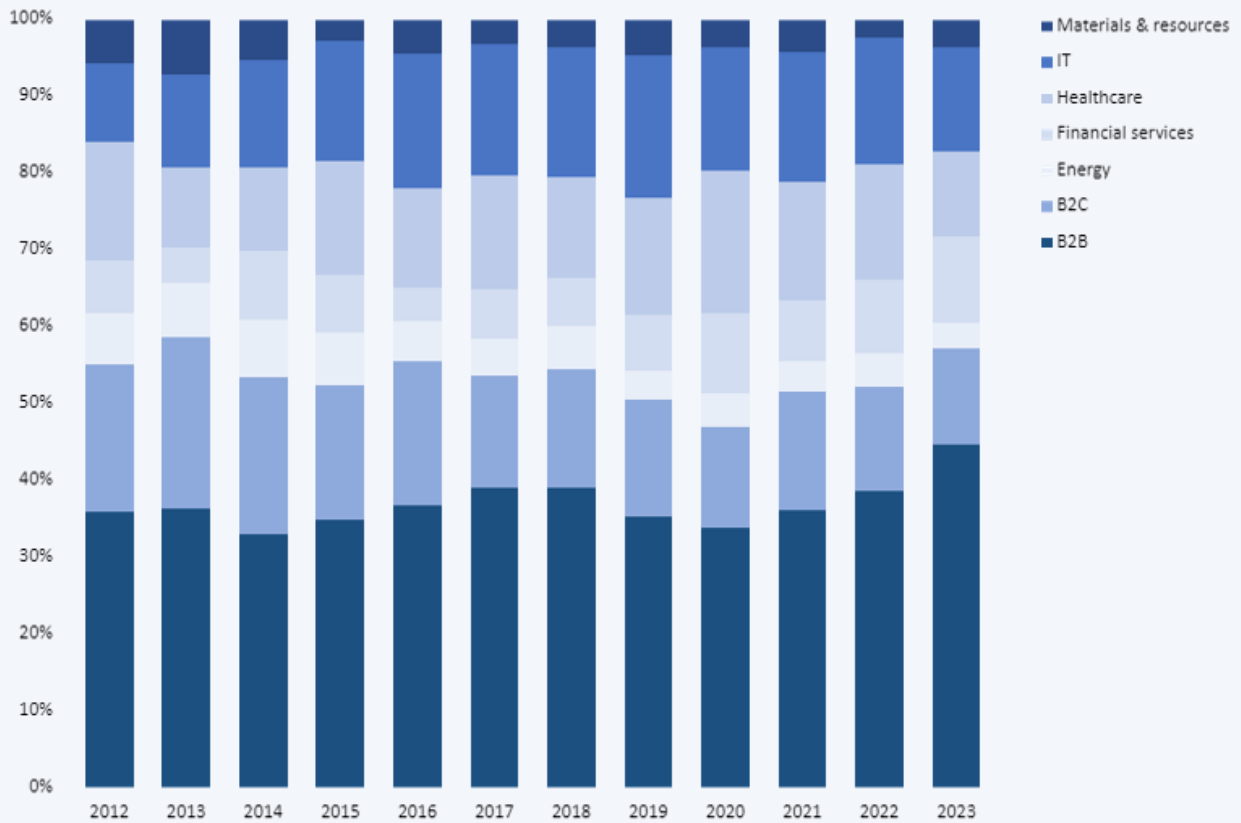
As previously introduced, the struggles in the Middle Market have been oriented around finding lenders to partner with for potential deals. While historically there has been an ample supply of lenders willing to play in the Middle Market, the supply of willing lenders, buyers and sellers all contracted in 3Q 2023.

Another Federal Reserve (FED) induced interest rate hike also occurred in 3Q 2023, but this time on the long-end, as ten-year treasury yield rose nearly a full point to a fifteen-year high. While Middle Market deals do not mirror the behavior of public markets, they are not immune to all inputs of the capital markets' pricing model. A 25% hike in the risk-free rate altered the price at which buyers are willing to pay for long-duration assets and discounted cash flows, which has stalled deal deliberations in 3Q 2023, pushing deal value to a new post-covid low.

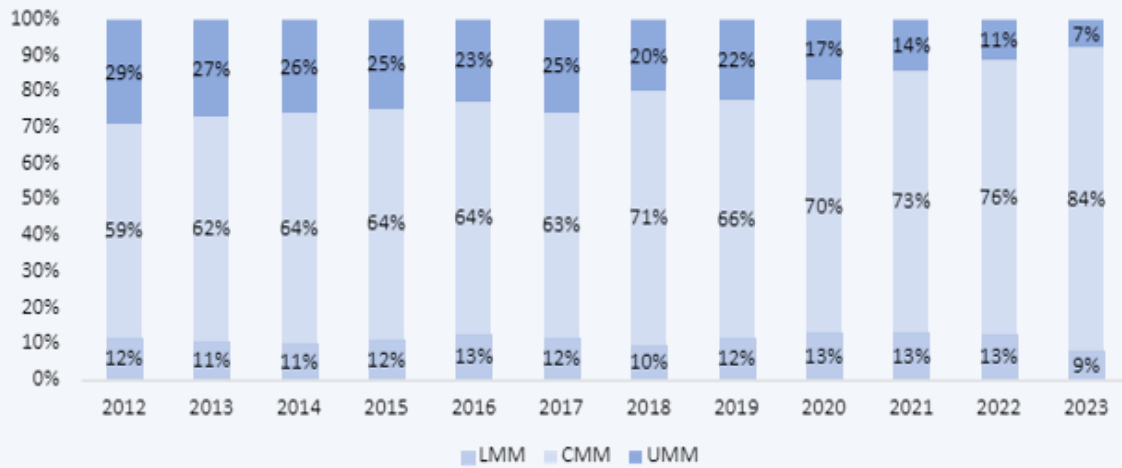
Middle Market as a % of All PE Buyout Value (\$)



Middle Market Deals by Segment %



Middle Market Deals LMM, CMM, UMM %

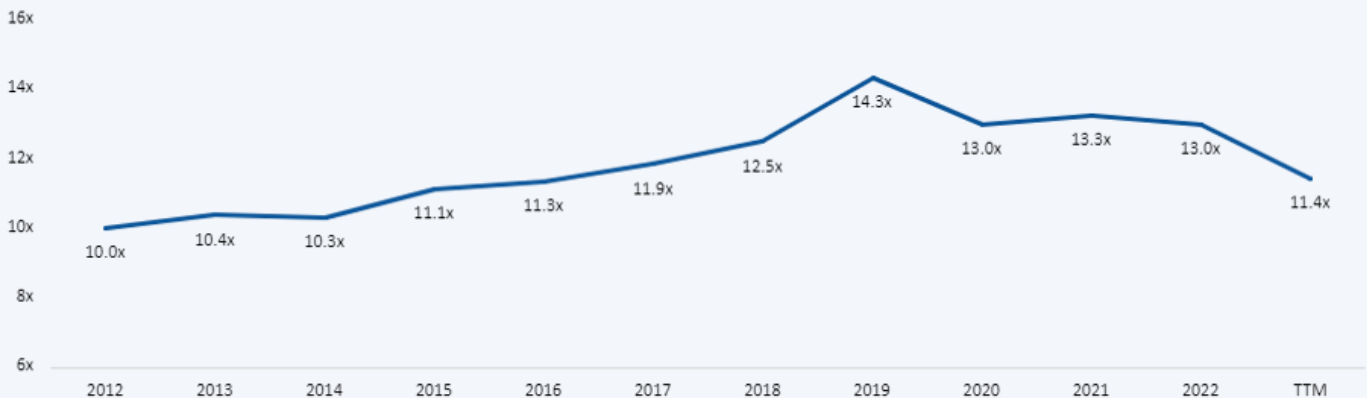


VALUATIONS³

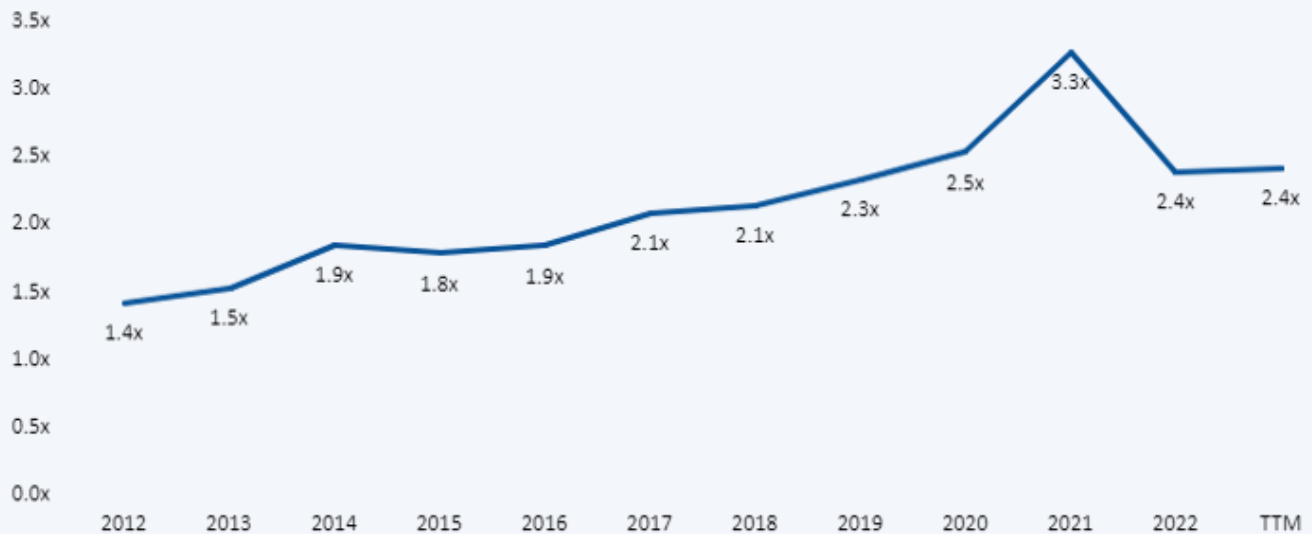
For the TTM period ending in 3Q 2023, there were mixed valuation results. EV/EBITDA val multiples continued to contract, whereas EV/revenue multiples showed signs of stabilization. EV/EBITDA multiples and EV/revenue multiples stand at 11.4x and 2.4x, respectively. On an EBITDA basis, 2019 was the latest peak year for PE Middle Market activity, where multiples stood at 14.3x. On a revenue basis, 2021 was the latest peak year, when multiples stood at 3.2x.

Since the 2021 revenue peak, multiples have contracted 26.1% through 3Q 2023. The contraction in Middle Market valuations is attributed to the widening of the bid-ask spread in favor of buyers. Historically, similar spread behaviors have taken between twelve to twenty-four months to correct, and consensus believes that the market is beginning to experience a correction period as of 3Q 2023. Public PE players have disclosed in earnings calls that they have been waiting to pursue sale processes on their portfolio companies, a sentiment that is also reflected in the broader M&A market in the US.

Median North America & Europe PE Middle Market Multiples



Median North America & Europe PE Middle Market EV/Revenue Multiples



ECONOMIC ACTIVITY⁴

In 3Q 2023, Middle Market deal flow was dominated by strategic buyers, as they accounted for 92.6% of acquisition activity. For strategic buyers, 3Q 2023 was their highest quarter of activity since 3Q 2022. On the other hand, financial sponsors shared 7.4% of deal flow activity. Financial sponsors are continuing the trend noted in 2Q 2023, as they continue to sit on their reserves of dry powder ready to deploy when the economic turmoil of the present becomes more attractive for investment.

Overall, through the economic turmoil ignited by the pandemic, the Middle Market has generally outperformed the broad market⁵.

Middle Market vs. SP500 Revenue Growth Rate %



Most inflation readings have decelerated from their peak levels, with many standard inflation indicators returning to normalized ranges. While the FED is cautiously optimistic on the economic outlook heading into 2024, they have noted that they are not satisfied with the pace of disinflation, particularly in the business services space.

MARKET SENTIMENT^{6,7}

CFO optimism has grown in the latter half of 2023 concerning 2024 outlook. Executives have a more positive view of overall business activity heading into 2024 and have greater confidence that 2024 will further refute the forecasts of a recessionary period. Financial executives believe gross domestic product (GDP) will rise north of 1.7% in 2024, an upgrade from a forecast of 1.3% in 2Q 2023.

The feeling in both public and private markets is that the FED's goal of a "soft landing" is more probable than ever, as the FED's unprecedented aggression towards combatting inflation has yet to crumble. However, nothing is certain. 2Q 2023 encompassed solid GDP growth of 2.1%, and 3Q encompassed GDP growth north of 5%. While expert economists do not expect economic growth to maintain pace above 5% heading into 2024, it is a sign that American businesses and consumers have taken stride with increased borrowing costs.

DEBT⁸

As interest rates have been on an upward climb through 2023, debt has become more expensive. While there is contraction throughout the Middle Market PE space, investors have had to develop new and more creative ways to bridge funding gaps in the M&A space. Private credit funds have been a notable access point to PE funds in accessing debt in the risk-averse economic environment of 2023.

Total Debt/EBITDA - All Industries by Deal Size

TEV	2003-2018	2019	2020	2021	2022	YTD Oct-23
\$10M-\$25M	3.3x	3.8x	2.9x	3.4x	2.9x	2.9x
\$25M-\$50M	3.5x	3.9x	2.7x	3.0x	3.0x	2.5x
\$50M-\$100M	3.9x	3.9x	2.9x	3.1x	3.4x	2.9x
\$100M-\$250M	4.4x	4.4x	4.1x	3.9x	3.4x	3.3x
\$250M-\$500M	4.9x	5.1x	4.8x	5.1x	4.2x	4.2x

MIDDLE MARKET PRIVATE EQUITY SNAPSHOT^{9,10}

In the third quarter of 2023, deal activity was focused on smaller, equity-heavy growth and add-on transactions. But overall, the Middle Market PE space made the best of the economic turmoil of 2023.

While 2022 was a great year for Middle Market fundraising, 3Q 2023 saw total fundraising capital down nearly 13%.

Five mega funds closed in 3Q 2023 most notably by European-based CVC Capital Partners, TA Associates, Permia and Warburg Pincus bringing the US 2023 total to 11. In the US, the most notable 3Q 2023 closed funds belonged to Paine Schwartz Partners (\$1.7B), Alpine Investors (\$4.5B) and Warburg Pincus (\$17.3B).

During 3Q 2023, 275 PE-backed companies were exited, accumulating to \$44.1B, the lowest quarterly figure in over ten years (excluding the pandemic). The YTD exit value is 43.7% lower than in 2022.

While Middle Market PE deal activity may be approaching its bottom, the growth potential in the second half of 2024 is meaningful. While 3Q 2023 was less than ideal for the Middle Market PE space, attitudes across the market have begun to improve.

PE firms continue to sit on unprecedented reserves of dry powder, that will be deployed into the market once the economic dust further settles, hopefully early in 2024.

END NOTES

1. <https://pitchbook.com>
2. <https://pitchbook.com>
3. <https://pitchbook.com>
4. <https://greenwichgp.com>
5. <https://www.middlemarketcenter.org>
6. <https://www.cfodive.com>
7. <https://www.forbes.com/>
8. <https://gfdata.com>
9. <https://pitchbook.com>
10. <https://www.junipersquare.com>

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, Healthcare 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.

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Interested in Learning More About CM&Co?

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