

Exploring the New Paradigm Shift

MIDDLE MARKET PRIVATE
EQUITY RESEARCH

FEBRUARY 2023



Apogem Capital
A NEW YORK LIFE INVESTMENTS COMPANY

Coalition Greenwich
A division of **CRISIL**



Introduction

Amid heightened geopolitical tensions, volatile public markets, and a cloudy economic outlook, middle market private equity sponsors are positioning themselves to weather market turbulence and take advantage of market dislocations.

After a record-breaking 2021 for private markets and a volatile and uncertain 2022, private equity sponsors are retrenching in an environment of higher rates and persistently elevated inflation. For skilled private equity managers, risks and opportunities can often be two sides of the same coin. While managers are cognizant of the gathering headwinds, private equity's long-term horizon combined with active management can enable managers to successfully navigate volatile conditions.

To better understand how middle market private equity sponsors are preparing for what is expected to be a challenging 2023, Apogem Capital LLC ("Apogem") partnered with Coalition Greenwich to conduct over 100 in-depth interviews with senior investment decision-makers at US middle market private equity sponsors.

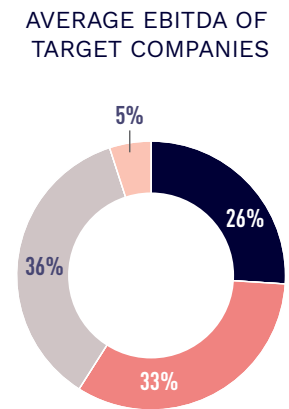
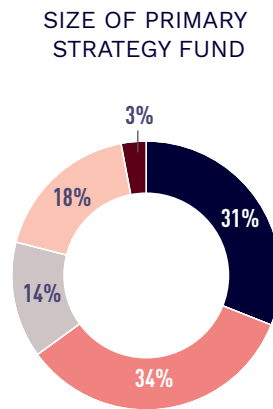
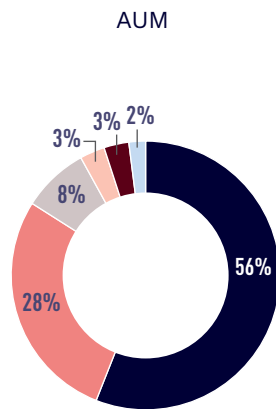
Our findings indicate that private equity sponsors are keenly monitoring new sources of risk that are presenting themselves in this evolving investment landscape, and some are well positioned to benefit, seeing these risks as unique investment opportunities in the middle market.

In this report, we analyze these and other key research findings in detail, and identify five strategies middle market private equity sponsors are implementing to optimize investment and business performance in a volatile environment.

Methodology

In the third quarter of 2022, Coalition Greenwich, in partnership with Apogem, interviewed 102 managing directors and partners at middle market private equity sponsors in the United States. These in-depth phone conversations centered on market conditions in 2022, as well as investment trends, exit strategies, funding sources, and emerging challenges and opportunities.

Exhibit 1—Participant Profile¹



- < \$1B
- \$1B—\$4.99B
- \$5B—\$9.99B
- \$10B—\$19.99B
- \$20B—\$49.99B
- \$50B+

- < \$250M
- \$250M—\$499M
- \$500M—\$999M
- \$1B—\$2.99B
- \$3B—\$4.99B

- < \$5M
- \$5M—\$9.99M
- \$10M—\$49.99M
- \$50M+

1. Based on information provided by interviewees, which has not been independently verified. Figures are approximate and represent the most recent figures available to the interviewee at the time

Navigating a More Challenging Environment

FINDING VALUE AMID RECORD-HIGH VALUATIONS

In 2021, private equity was bolstered by the combination of government stimulus, historically low interest rates, and soaring public markets, fueling a boom that led to historic levels of both deal and exit activity. As a result of these forces, managers participating in the study cite competition for assets and high valuations as top concerns in 2022. As shown in Exhibit 2, more than half of study participants rank high valuations/competition for assets as one of their top two challenges.

“During 2021, there was an overabundance of capital, and valuations got overheated,” says one middle market private equity sponsor. Another study participant agrees, labeling valuations as “unsustainable” in the current environment. This challenge extended into 2022, as the record fundraising in recent years collides with slower deal activity, resulting in even higher valuations than those experienced in 2021.

Despite high valuations, managers are diligently finding new opportunities. In the middle market, private equity sponsors deployed 80% of capital into new deals in the past 12 months, 30% higher than 2021. With record-high valuations, managers are focusing on proprietary and off-the-run opportunities, with over 70% citing their proprietary network as the most common source for new deals. By focusing on off-the-run deals, managers can avoid the aggressive bidding and high valuations typical of more competitive processes and deal sources, such as brokers and auctions.





Discussed in more detail later in this paper, middle market sponsors are leaning on their lending relationships to successfully close investments. As activity in the leveraged loan market has fallen sharply in 2022, PE sponsors with the ability to finance transactions through direct lenders may be better positioned to continue transacting in a challenged market.

Exhibits 2 and 3—Deteriorating Conditions: Challenges and Strategies

EXHIBIT 2—GREATEST CHALLENGES TO INVESTING IN CURRENT ENVIRONMENT

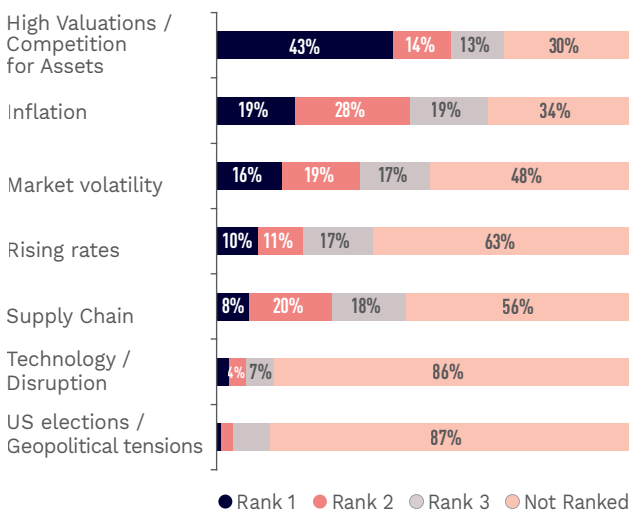
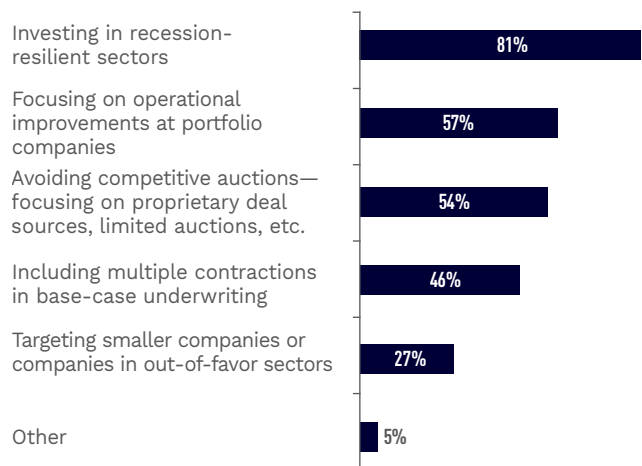


EXHIBIT 3—IMPACT OF CURRENT ENVIRONMENT ON INVESTMENT STRATEGY AND EXECUTION



Exhibits 4 and 5—Deteriorating Conditions: Challenges and Strategies

EXHIBIT 4—CAPITAL DEPLOYMENT—PAST 12 MONTHS

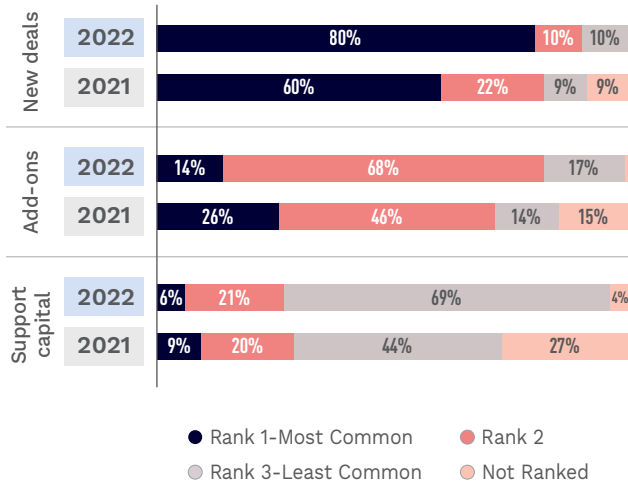
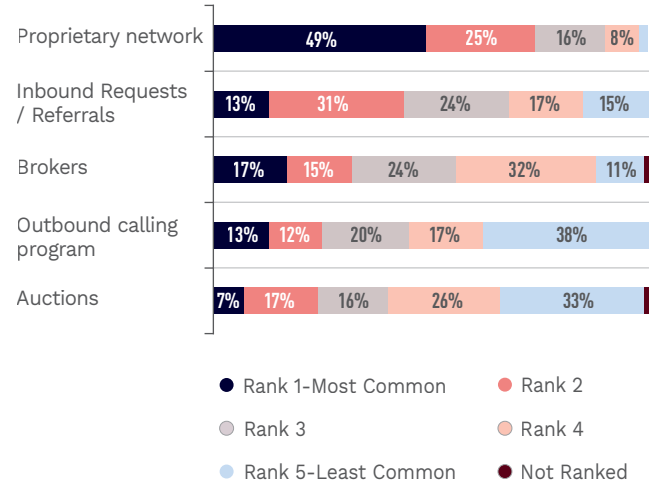


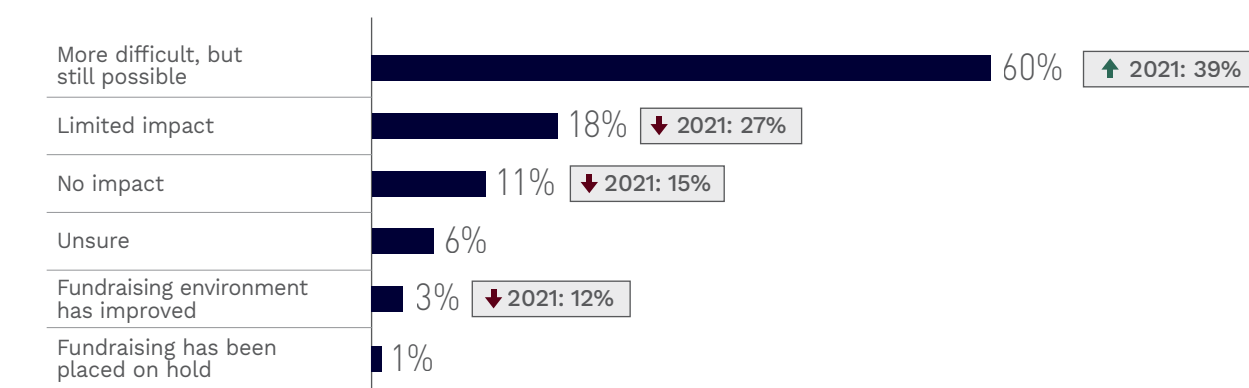
EXHIBIT 5—SOURCES OF NEW OPPORTUNITIES



MORE ATTRACTIVE ENTRY POINTS ON THE HORIZON?

While valuations continued to rise in 2022, the peak may be on the horizon. High valuations have been driven in part by record fundraising in 2021 and early 2022, particularly by large and mega funds.² The effect has been increasing competition for assets and the price private equity buyers are willing to pay to put their investors' capital to work. However, while macroeconomic challenges have not tempered valuations yet, they have impacted the private equity fundraising environment, which has deteriorated in the second half of 2022, with 60% of managers saying fundraising is more challenged, up from 39% in 2021.

Exhibit 6—Fundraising is Becoming More Challenging



When discussing challenges sponsors face while financing in this environment, “It’s either feast—with 10+ lenders interested—or famine.”

Sourcing debt capital for new investments has also become more challenging, which could ultimately impact the overall price that can be paid for an asset. One participant says sponsors face a “risk-off market environment” when it comes to financing. “It’s either feast—with 10+ lenders interested—or famine.”

As the availability of both debt and equity capital becomes more limited, competition for assets may become more subdued, creating more attractive entry points in the future. As a comparison, valuations decreased by approximately 25% from peak to trough during the Global Financial Crisis, according to data from PitchBook.

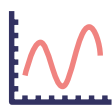
With capital becoming increasingly scarce and the risk of recession rising, sponsors are focusing on investing in recession-resilient sectors, effecting operational improvements at portfolio companies, leaning into ESG and diversity & inclusion initiatives (“D&I”), and reinforcing existing relationships.

2. Source: PitchBook, “US Annual Private Equity Breakdown, Q2 2022.”

PE Sponsors Shift Focus

WHAT IS A RECESSION-RESILIENT SECTOR? IN THE MIDDLE MARKET, DEFINITIONS DIFFER

More than 80% of middle market private equity sponsors have started to focus their investments on recession-resilient sectors. In general, the sponsors in the study are defining recession resiliency in two ways:



Non-cyclical industries with the potential to weather economic downturns. At the top of that list are business services and healthcare services, which have demonstrated recession resiliency historically and, critically, present attractive opportunities for digital transformation.

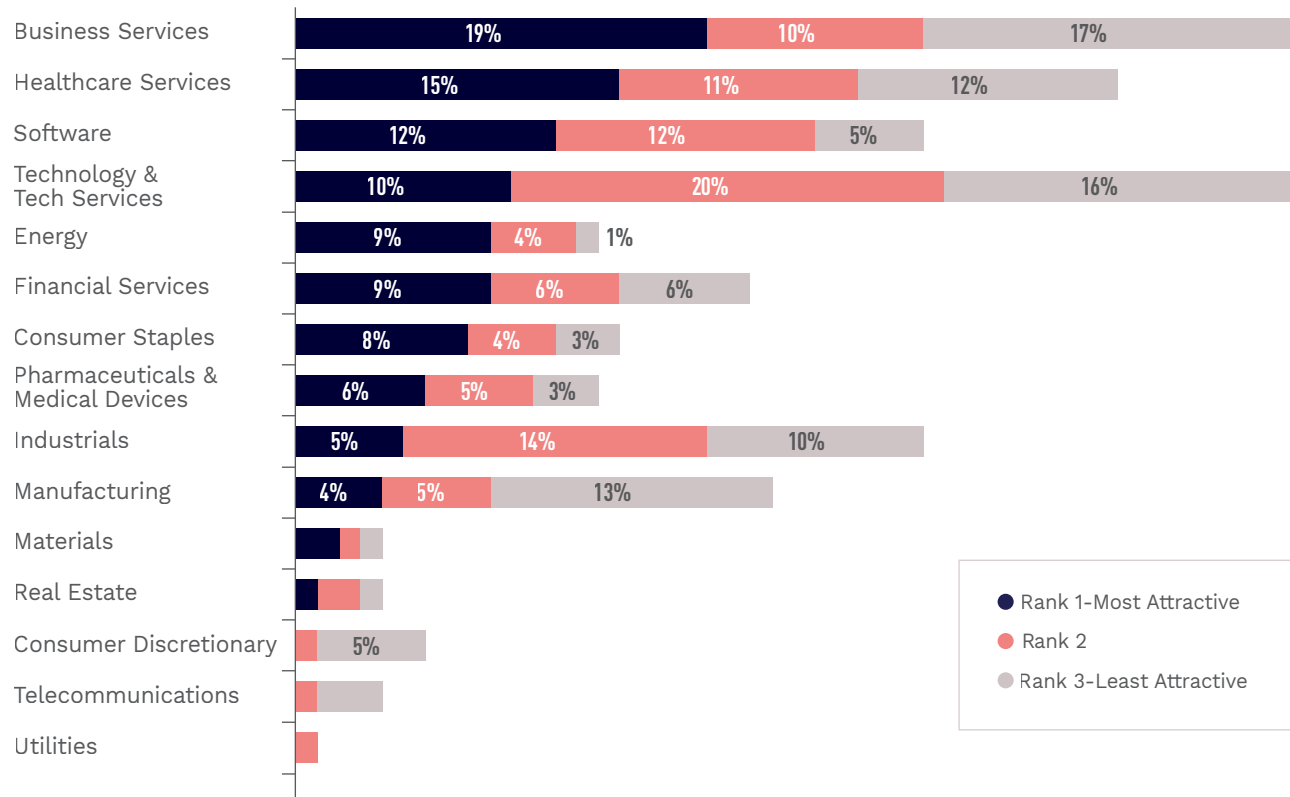


Asymmetric opportunities in industries traditionally considered more cyclical. These opportunities are sectors in which sponsors see valuations as having fallen far enough to present attractive opportunities to capitalize on long-term tailwinds. For example, in energy, sponsors cite a decade of underinvestment, durable and growing demand, and the opportunity in renewables. “Energy transition has long tailwinds,” says one sponsor. In software, technology, and tech services, sponsors say crashing valuations are “making buying opportunities” relevant again. As one sponsor put it, in any economic environment, “innovation never gets old.”

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The wide variation illustrates the value of portfolio diversification as a means of lowering overall risk and enhancing risk-adjusted portfolio returns. This is particularly relevant in challenging markets where public market volatility and shifting sentiment can create varied opportunities and challenges for investors in different sectors.

Exhibit 7—Sectors Representing Attractive Investment Opportunities

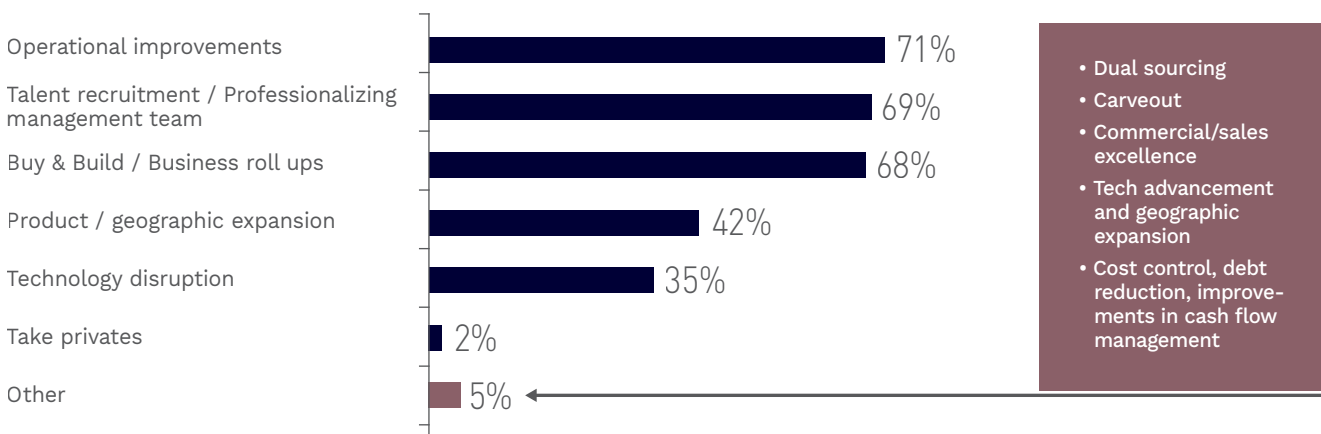


BACK TO BASICS: EMPHASIS ON OPERATIONAL IMPROVEMENTS

In an increasingly challenging economic environment, middle market private equity sponsors are focusing on key value-creation levers. More than 70% of study participants say current market and economic conditions have prompted them to focus on operational improvements at portfolio companies as a primary means of creating value. Talent recruitment/professionalizing management teams and business rollup/buy & build strategies are other primary value-creation strategies cited by managers.

For many sponsors, driving operational improvements has become a cornerstone of the value-creation process, allowing companies to weather economic headwinds and grow their way out of potential valuation compression that may accompany an economic downturn. The long-term time horizon of private equity funds can be an advantage in these environments: sponsors can be patient, focus on value creation, and wait for the right opportunity to exit an investment.

Exhibit 8—Greatest Opportunities for Value Creation at Portfolio Companies



SUPPLY CHAIN CHALLENGES

In addition to the traditional operational improvements cited previously, sponsors are also lending their experience and resources to support management teams facing new challenges. For example, sponsors are working with management teams to address persistent supply chain disruptions and create competitive advantages through more sophisticated and effective supply chain management. Sponsors are helping companies find alternative sourcing options, explore reshoring and onshoring strategies, and integrate local suppliers and manufacturers into their supply chains. Participants in the study say lingering global supply chain issues are also creating opportunities to build efficiencies and create advantages through enhanced inventory management.

HIRING IN A TIGHT LABOR MARKET

Private equity sponsors participating in the study say their portfolio companies continue to experience staffing pressures. “A tight labor market continues to starve good companies of talent,” says one middle market private equity sponsor. Private equity sponsors are applying their skills and resources to help portfolio companies hire and retain top talent, both at the fund and portfolio company-level, by optimizing compensation and benefits and rolling out new, flexible work arrangements.

Despite a challenging labor market and economic outlook, approximately 75% of managers said the vast majority of their portfolio companies added jobs during the hold period.

Further, managers are increasingly hiring with a focus on enhancing the diversity of their employee base. Respondents indicating they have adopted diversity and inclusion (“D&I”) standards and goals within their own firms, management teams, boards, and even in their portfolio companies have increased markedly from the 2021 survey, as presented in Exhibit 10. As one sponsor notes, “In hiring, we have a huge focus on D&I, including women on investment teams, as well as significant initiatives around veterans and many other areas.” Another agrees, adding, “Our hiring practices are targeting diversity through gender, education, ethnicity, and experience, all in an effort to have a collaborative investment team with different perspectives among team members.”

One study participant explained the D&I initiative her firm has adopted for portfolio company management teams: “We work with management to promote the best D&I practices, including annual monitoring, D&I surveys, and a portfolio company roundtable to share best practices,” she says. Finally, multiple sponsors detailed steps they are taking to increase diversity on their boards, including actively recruiting women and partnering with organizations that can help bring in women and minority candidates.

Exhibit 9— Share of Portfolio Companies Adding Jobs

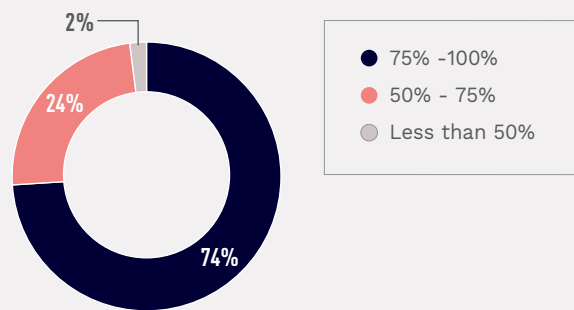
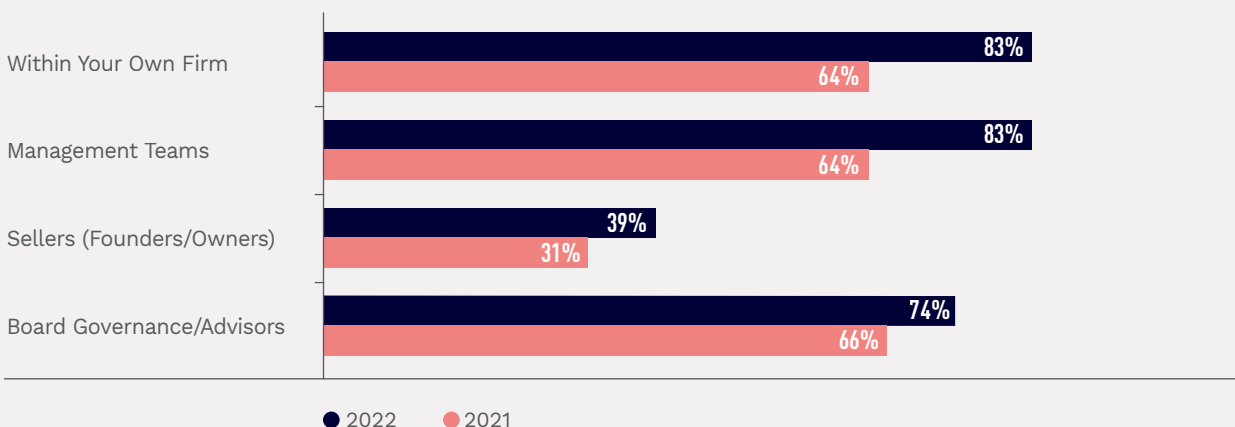


Exhibit 10—Where are PE Sponsors Adopting D&I Goals and Standards

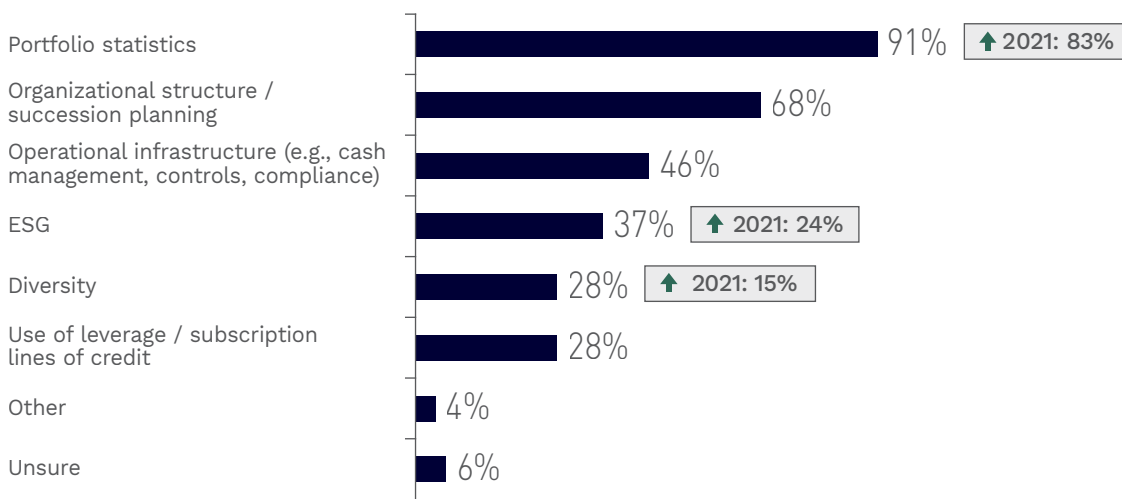


LEANING INTO ESG

Private equity sponsors looking to build relationships with limited partners (“LPs”) that endure across all stages of the market cycle should act now to incorporate environmental, social, and governance (“ESG”) and D&I into both their investment processes and business operations.

Ninety percent of the middle market private equity sponsors participating in the study say LPs are driving interest in ESG investing. That increasing emphasis on ESG is playing out in their due diligence processes. In 2021, only 15% of study participants said their LPs were using diversity as a main due diligence category. This year, that share jumped to 28%. Over the same period, the share of private equity sponsors reporting that LPs are using ESG as a key criterion in due diligence grew to 37% from less than a quarter.

Exhibit 11—Main Diligence Areas for LPs in Underwriting



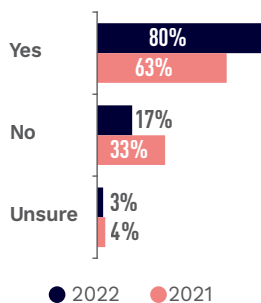


These trends, combined with the broader advance of ESG in investment markets and business, suggest that private equity investors will increasingly seek out investments and sponsors who demonstrate a commitment to sustainability and inclusion. Sponsors are actively working to ensure their values and business practices are in alignment with those of their LPs.

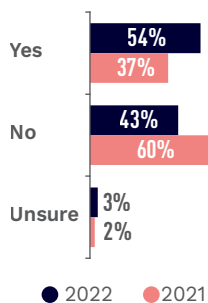
The industry is already taking strong steps in that direction. The share of middle market private equity sponsors reporting that they evaluate ESG risks and opportunities in their investments increased to 80% in 2022 from just 63% in 2021. Over the same period, the share of sponsors incorporating a formal process for evaluating ESG risks and opportunities into their investment processes increased to 54% from 37%, and the share regularly monitoring and reporting ESG factors increased from 30% to nearly 40%.

Exhibit 12—Considering ESG Risks and Opportunities

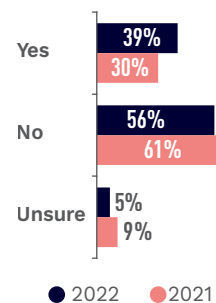
MOST PE SPONSORS CONSIDERING ESG RISKS AND OPPORTUNITIES



SPONSORS WITH FORMAL ESG PROCESSES



SPONSORS MONITORING AND REPORTING ESG RISKS AND OPPORTUNITIES



80% of respondents evaluate ESG risks and opportunities when investing, up from 63% in 2021.

Exit Environment

AS THE IPO DOOR CLOSSES, CORPORATE AND PE BUYERS CAN STEP IN

Considering economic and market conditions overall, exit activity has held up relatively well. While exit activity has fallen sharply from the 2021 record-setting level, the level of activity in 2022 was largely in line with the longer-term historical pace.³ Forty percent of managers in the study say hold periods have remained the same, with 34% saying they have lengthened and 25% saying they have shortened.

However, if the macroeconomic environment continues to deteriorate, and public market volatility persists, M&A activity will likely slow meaningfully. Based on findings from our study, middle market private equity may prove more resilient.

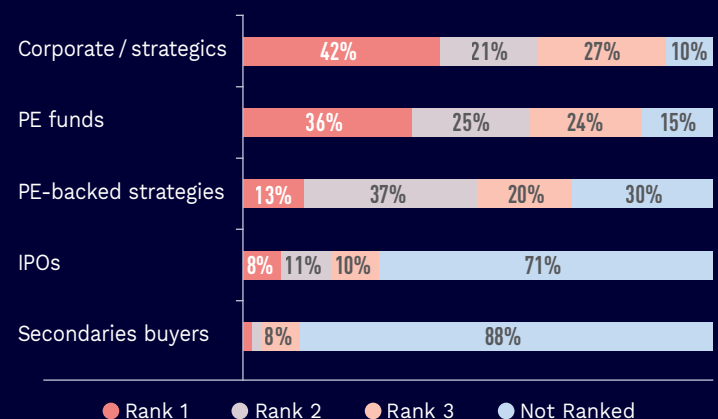
The IPO market was effectively closed in 2022. According to Ernst & Young, IPO volume fell 44% year-over-year through September 2022, with the US recording its lowest amount of aggregate IPO proceeds since 2003,⁴ primarily impacting the exit potential for large and mega private equity funds and venture capital managers. For example, in 2021, IPOs accounted for approximately 16% of exits for venture funds and over 60% of venture exit value over the past 5 years.⁵ Overall however, only 8% of middle market managers cite IPOs as a common exit path.

As shown in Exhibit 13, middle market private equity managers primarily exit their companies to corporations and larger private equity funds, which have significant and durable pools of dry powder that have grown sharply in recent years. Dry powder available to large / mega private equity funds has increased

by ~200% since 2010, while corporate cash has increased by 85% over the same period.⁶

When discussing fundraising challenges, many managers cited larger private equity managers coming back to market sooner with bigger funds. *According to Pitchbook, 46% of the capital raised by private equity firms from 2019 to 2022 went to funds of \$5 billion or more, with another 34% raised by funds in the \$1 billion to \$5 billion range.*⁷ While this has made fundraising more difficult for middle market managers, it also suggests a large pool of private equity dry powder up market that will be motivated to continue to transact, buying the portfolio companies of middle market funds, even in the event of a downturn.

Exhibit 13—Paths to Exit for Middle Market Portfolio Companies



3. Source: PitchBook, "US Annual Private Equity Breakdown, Q2 2022."

4. Source: https://www.ey.com/en_gl/ipo/trends

5. Source: PitchBook, "Q3 2022 PitchBook-NVCA Venture Monitor."

6. Source for Corporate Cash: Bloomberg. Source for Dry Powder: PitchBook. Includes US and Canada PE Funds > \$750 million. Accessed November 2022.

7. Source: PitchBook, "US Annual Private Equity Breakdown, Q2 2022."

Cultivating Relationships with Reliable Partners



As the middle market has developed in recent years, it remains a business focused on relationships and partnerships. Across strategies ranging from lending to GP stakes, sponsors surveyed identified the history and quality of a relationship as one of the top criteria for selecting partners.

Middle market private equity sponsors are shoring up ties with their most loyal financing partners to ensure continued access to capital throughout any extended market disruptions. “Financing markets have been severely impacted by market volatility that is making it difficult to execute deals,” says one study participant.

As financing risks mount, it’s no surprise to see middle market private equity sponsors turning to capital partners who have proven themselves over time. Sponsors describe trusted partners as “strong and reliable when things do not go well,” who “continually stand by us whenever a challenging situation arises,” and who “step up for hard-to-finance assets.” One sponsor adds that “our best capital partners have communicated well through volatility and uncertainty.”

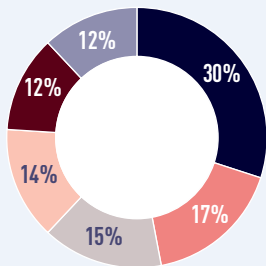
“Our best capital partners have communicated well through volatility and uncertainty.”

In terms of specific needs, private equity sponsors are asking capital providers for flexibility and speed—two attributes that can make or break transactions in a volatile environment. As challenges arise, one sponsor says he is looking for lenders to offer “flexibility regarding covenants without being punitive.” When it comes to speed, sponsors say quick actions by lenders make execution predictable and seamless, providing “certainty of closing.”

As presented in Exhibit 14, sponsors also cite the importance of relationships in investment tools ranging from established strategies (co-investments) to earlier evolution strategies (continuation vehicles, GP stakes). For many of these managers, the quality of a relationship was among the most important criteria for selecting a partner. Both continuation vehicles and GP stakes are becoming more popular strategies for both GPs and investors, with over 40% of GPs saying they have considered using a continuation vehicle to exit a company and 13% having considered taking on a GP stake investor. As these strategies grow in popularity, investors with the relationship history GPs are seeking in a partner may be well positioned to capitalize on new opportunities.

Exhibit 14—Relationship History Among the Top Priorities for GPs

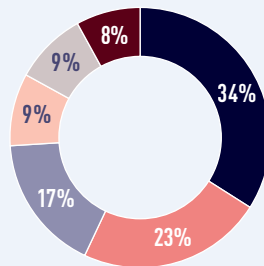
NEW FLAGSHIP FUND PROSPECTS



- History / quality of relationship
- Prospective investor / relationship building
- Time to close
- Stapled investment in fund
- Ability to add value in due diligence
- Size of Investment

Qualities in a co-invest partner Respondents ranked “1”

CONTINUATION FUNDS & SPECIAL PURPOSE VEHICLES

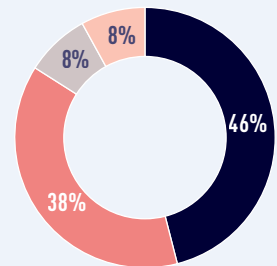


- History / quality of relationship
- Prospective investor / relationship building
- Size of Investment
- Stapled investment in fund
- Time to close
- Ability to add value in due diligence

Qualities in an SPV partner Respondents who have completed or are considering a continuation fund ranked “1”

*Note (Base: 35)

EXPLORING A GP STAKE SALE



- Price
- Strategic value of relationship (e.g., ability to assist with fundraising, deal sourcing, capital needs, etc.)
- Structure of investment (e.g., rights / controls of GP stakes investor, confidentiality)
- Other

Biggest consideration when completing at GP stake sale for Respondents that have explored or considered such.

*Note (Base: 13)

Conclusion

FIVE STRATEGIES TO NAVIGATE A VOLATILE MARKETPLACE

Our research findings reveal several key trends that are emerging as middle market private equity sponsors position themselves for a more unpredictable and volatile marketplace. Study participants describe five strategies they are adopting to maximize some of the natural advantages presented by the middle market segment during a period of challenging market conditions:

- 1 Building diversified portfolios emphasizing recession-resilient sectors
- 2 Focusing on creating value through operational improvements
- 3 Leaning into ESG and D&I
- 4 Capitalizing on fundraising by larger private equity sponsors for attractive exit opportunities
- 5 Cultivating relationships with reliable partners

In this challenging market environment, sponsors in the middle market could benefit from less competition for assets and more consistent opportunities for attractive exits relative to larger peers and sponsors operating in other segments of the market.

Middle market sponsors are positioning themselves for a challenging period—capitalizing on the advantages inherent in the middle market and adopting new strategies to mitigate the risks in the current environment.

About Apogem Capital

Apogem Capital was formed in April 2022 through the combination of PA Capital, Madison Capital Funding, and GoldPoint Partners to create a singular and unified private markets alternative investment firm.

With approximately \$39 billion in assets under management as of September 30, 2022*, Apogem has the deep relationships, data, and history in the middle market to deliver innovative solutions to both clients and sponsors. Apogem Capital offers investors access to the middle market's growth engine through investments in what we believe to be leading private companies and funds. The Firm manages a streamlined suite of capital solutions, including direct lending, junior debt, primary fund investments, secondary investments, equity-co-investments, GP stakes, and private real assets.

Apogem Capital is a wholly owned subsidiary of New York Life Insurance Company ("NYLIC"), through New York Life Investment Management Holdings, LLC ("NYLIM").

For more information visit: apogemcapital.com

* AUM is approximate, estimated, and unaudited as of September 30, 2022. AUM includes non-discretionary and co-advised assets, as well as assets managed for New York Life and certain of its subsidiaries.

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