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Looking ahead: Opportunity in middle market private equity

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After a decade with interest rates near zero, investors are now pivoting from a world of abundant capital to a tightening market for financing. With worries of recession, rising rates, inflation, geopolitical conflict and more, private equity managers in the U.S. middle market are bracing for continued macroeconomic uncertainty in 2023.

Our private equity teams have developed a strategy to navigate the year ahead. We anticipate greater use of equity co-investment to right-size transactions, and our teams are poised for this opportunity.

In our many discussions with U.S. middle market private equity sponsors (GPs) and fellow investors (LPs), here are the five questions that are top of mind for all:

EXECUTIVE SUMMARY

- Despite continued market volatility, underlying U.S. private equity-owned middle market companies continue to perform well, with growing top lines and resilient margins.
- We anticipate lower deal volume in the first half of 2023, with higher volume in the second half with potential for a market reset.
- We are seeing a growing flight to quality strategy and finding strong businesses operating in attractive end markets is key.
- We expect to see greater demand for equity co-investment, with LPs who are truly qualified to act quickly and decisively being well-positioned.

Five Questions for 2023:

1. SHOULD LPS CONTINUE TO SUPPORT THE U.S. MIDDLE MARKET WHEN LARGE BUYOUTS MAY SHOW LOWER DISPERSION OF RETURNS?

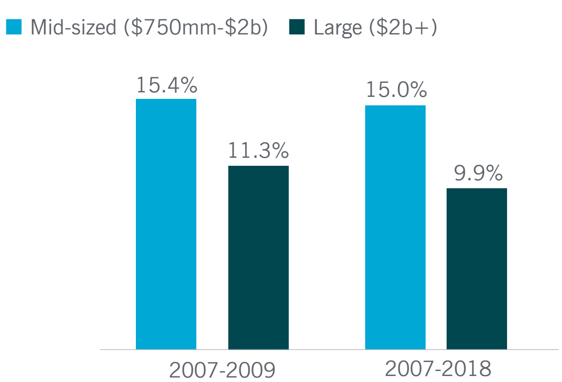
While it may be surprising, we believe that the U.S. middle market is the powerhouse of the U.S. economy—these small and medium-sized companies continue to drive growth. With 200,000 companies and over $6 trillion in revenues, the U.S. middle market is equivalent to the third-largest economy in the world when measured by gross domestic product (GDP). Yet investors sometimes overlook this segment of the market in favor of larger, more well-known companies.

Resilience in volatile markets

While both public markets and private capital segments have their attractions, the U.S. middle market has historically been more resilient in times of volatility. The average annualized returns of middle market buyout funds during the 2008 Global Financial Crisis (GFC) were higher than their large cap counterparts, and subsequent vintages have also performed strongly in comparison.

Middle market fund outperformance during the GFC and in subsequent years

Average annualized returns for stated time periods



Source: Burgiss Universe – U.S. Buyout Funds.

This resilience is likely due to several factors:

Flexibility: Due to their size, middle market companies have proven their ability to be flexible and to adapt quickly in tumultuous market conditions. With more nimble governance, middle market businesses can quickly pivot to address changing external factors.

Multiple Value Creation Levers: Middle market businesses have achieved critical scale but are small enough that untapped growth opportunities exist. Often, middle market businesses have never benefited from institutional ownership nor access to capital. According to Preqin, more than 75% of middle market portfolio companies are acquired from founders and other strategic sellers (as compared to only 28% for large cap buyouts). Given the size profile of middle market businesses, private equity sponsors can more easily add value through active growth strategies such as professionalization, operational improvements and investments in organic revenue growth initiatives.

Scale: Middle market companies have the ability to scale more quickly through mergers and acquisitions due to relative platform size and fragmentation in their competitive set.

Attractive Transaction Dynamics: Transaction terms are more favorable and capital structures more conservative for middle market companies relative to larger buyouts. LTM EBITDA multiples for middle market buyouts were 17% lower those of large caps from 2017–2021. Additionally, middle market buyouts were purchased utilizing less leverage than large buyouts (i.e., 4–6x EBITDA or less than 50% of enterprise value). Finally, middle market companies have multiple exit avenues to realize value and are less reliant on public markets for exits creating consistent and competitive liquidity options.

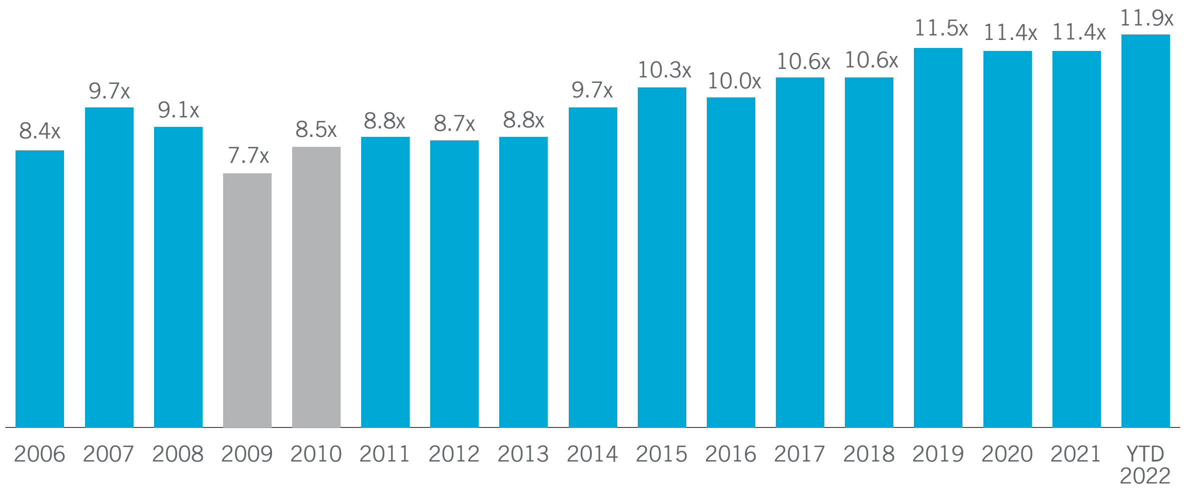
2. WHAT ARE YOUR EXPECTATIONS FOR THE DEALMAKING ENVIRONMENT IN 2023?

We are starting to see early signs that seller and buyer expectations on valuations are beginning to converge. In 2022, many sellers and buyers took a pause over the spring and summer, with robust activity resuming in the fall. With a continuation of rising interest rates and persistent inflation, we expect that 2023 patterns will echo 2022. The first half of 2023 will likely see lower deal volumes through mid-year, then begin to build momentum through the second half, with valuations settling at a new normal once interest rates are put on hold. Ultimately, total volume may be slightly down from 2022, but positioned for another strong year in 2024.

Lastly, with rising rates, sponsors are very focused on structuring deals correctly. GPs that relied solely on first lien or unitranche financing under more benign macroeconomic conditions are becoming more creative around capital structure choices to counter the rising interest rate environment. Fixed cash and payment-in-kind (PIK) coupons are two solutions, along with funding more equity, which can drive heavier equity co-investment deal flow.

Private Equity Valuations

Enterprise Value/EBITDA Multiples



Source: PJT Park Hill Private Equity Market Overview 4Q 2022. Chart is representative of the average enterprise value multiples (purchase prices) of companies in U.S. leveraged buyout transactions during the stated time period.

3. ARE PRIVATE EQUITY PORTFOLIO VALUATIONS DUE FOR A DOWNGRADE?

There is a healthy debate around whether private equity valuations are in a bubble and if GPs are being slow to mark down their private equity portfolios relative to the speed of the public markets. Since March, private equity portfolios are down 3% while the S&P 500 is down 16% during the same time period. Putting aside the technical aspects of valuations (i.e., interest rate movement, hold periods, and methodology), underlying private equity portfolio companies continue to perform well, with growing top lines and resilient margins. Portfolio company health remains strong because the best GPs and investors (1) have experience navigating markets, (2) have experience driving operational improvements and (3) are focused on selecting the most resilient/high-quality companies. For these same reasons, GPs continue to underwrite new deals to the same return expectations.

 OPINION PIECE. PLEASE SEE IMPORTANT DISCLOSURES IN THE ENDNOTES.

4. THE PACE OF CHANGE HAS ACCELERATED IN ALL AREAS, FROM DEAL FLOW, TO FUNDRAISING, TO CO-INVESTMENT PROCESSES. HOW DO YOU SEE THIS DYNAMIC CREATING OPPORTUNITY?

We believe that the flywheel of fundraising is slowing down—GPs that have deployed capital quickly are returning to a fundraising environment that is more challenging. As a result, funds may be undersized and equity checks constrained.

> *The solution is greater use of equity co-investment to right-size transactions.*

Yet, deal processes remain fast, and GPs need partnership from LPs who are truly qualified to act quickly and decisively. In fact, the ability to run quickly as an LP may be the most important criteria to gaining access to co-investment deal flow. In a recent survey by PEI, closing speed was cited as the number-one factor that hinders LPs from participating in co-investments. Only the most sophisticated LPs with direct transaction-focused deal teams will be able to drive more co-investment opportunities in these market conditions.

5. WHEN INVESTORS LOOK BACK AT INDUSTRY GROWTH, TECHNOLOGY AND HEALTHCARE HAVE BEEN CLEAR WINNERS OVER TIME. LOOKING AHEAD, WHAT SECTORS WILL REMAIN ATTRACTIVE? DYNAMIC CREATING

Based on our discussions with the GP and LP community, we are seeing a growing flight to quality sentiment among investors. Fundamentally, finding strong businesses operating in attractive end markets with long-term secular growth trends is key. Is revenue growth sustainable? Are cash flow generation and EBITDA margins strong? Is the risk of disruption to the business model low? While Churchill believes that technology and healthcare will remain winning areas to place capital, there are other markets that deserve attention. One example is the logistics sector, where continuing global supply chain issues and the proliferation of e-commerce have created rising demand for third-party logistics products that can provide customers with flexible and cost-effective solutions. Another example is outsourced business services, in which companies provide outsourced non-discretionary functions that are non-core to their customers' skill sets. Our team believes that despite the economic environment there will be demand for services that help customers efficiently and cost-effectively focus on their core competencies.

> Private capital can play an important role in portfolio construction as it helps create new exposures within a traditional portfolio while also increasing overall return potential.

For more information, please visit nuveen.com.

Endnotes

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