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US Private Equity (PE) Middle Market Report

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Summary

Could the middle market in Private Equity (PE) be experiencing a resurgence? Funds falling within the $100 million to $5 billion range have shown positive performance trends in the last two consecutive quarters, a shift from the dominance of mega-funds observed in Q4 2021. This marks a notable change since 2020 and is particularly encouraging given the middle market's share of all PE buyouts in Q4 2022, which rebounded to its highest quarterly level in five years.

In 2022, the US PE middle market saw a slowdown from its previously active deal making period, which had set historical records. The challenges of high inflation, aggressive interest rate hikes, and valuation volatility impacted deal activity, resulting in a 25.6% decrease from the peak set in 2021. However, despite the slowdown, deal making remained robust compared to pre-pandemic levels, as the middle market continued to offer numerous investment opportunities and buyout targets.

With access to low-cost debt capital for leveraged buyouts (LBOs) diminishing and a gap in buyer-seller valuations, PE firms turned their attention to the middle market. Add-on deals reached their highest-ever share of both middle-market and overall US PE deal activity, emerging as an attractive option for sponsors compared to larger platform acquisitions. Public-to-private deals, traditionally associated with larger transactions, also extended into the middle market as public valuations declined significantly.

Exit activity in the middle market slowed in 2022, dipping below pre-COVID levels. The macroeconomic challenges led potential sellers to wait for more favorable prices. With the IPO market effectively closed, PE exits relied on sponsor-to-sponsor exits and exits to corporates. These two transaction types sustained exit flow, with sponsor-to-sponsor exits slightly dominating middle-market exit activity.

Fundraising in the middle market remained steady, with the total number of funds falling just short of the 2021 figure. The trend of increasing fund sizes across the PE landscape was evident in the middle market as well, with the median middle-market fund size growing by almost 40% since 2021. The top 30 funds raised during the year attracted over half of all capital raised in the middle market. However, rapid fundraising faced a challenge as investors had largely allocated their annual PE budgets by H1 2022 or early H2 2022. Looking ahead, both deployment and fundraising cycles are anticipated to revert to more sustainable norms, slowing down from the recent rapid pace.

Deal Activity

The middle-market private equity (PE) sector in the United States witnessed a less active year in 2022 compared to the record-setting pace of deal making in the previous year. In 2021, PE firms finalized or announced 4,219 middle-market deals, totaling $596.1 billion, surpassing the previous annual records for both deal count and value set in 2019 by approximately 50%. However, in 2022, PE activity saw a decline, with 3,314 middle-market deals amounting to $443.8 billion. This represented a 25.6% decrease in deal value and a 21.5% drop in deal count year-over-year, as various macroeconomic challenges, such as the highest inflation in four decades, aggressive interest rate hikes, and geopolitical conflicts, persisted throughout the year.

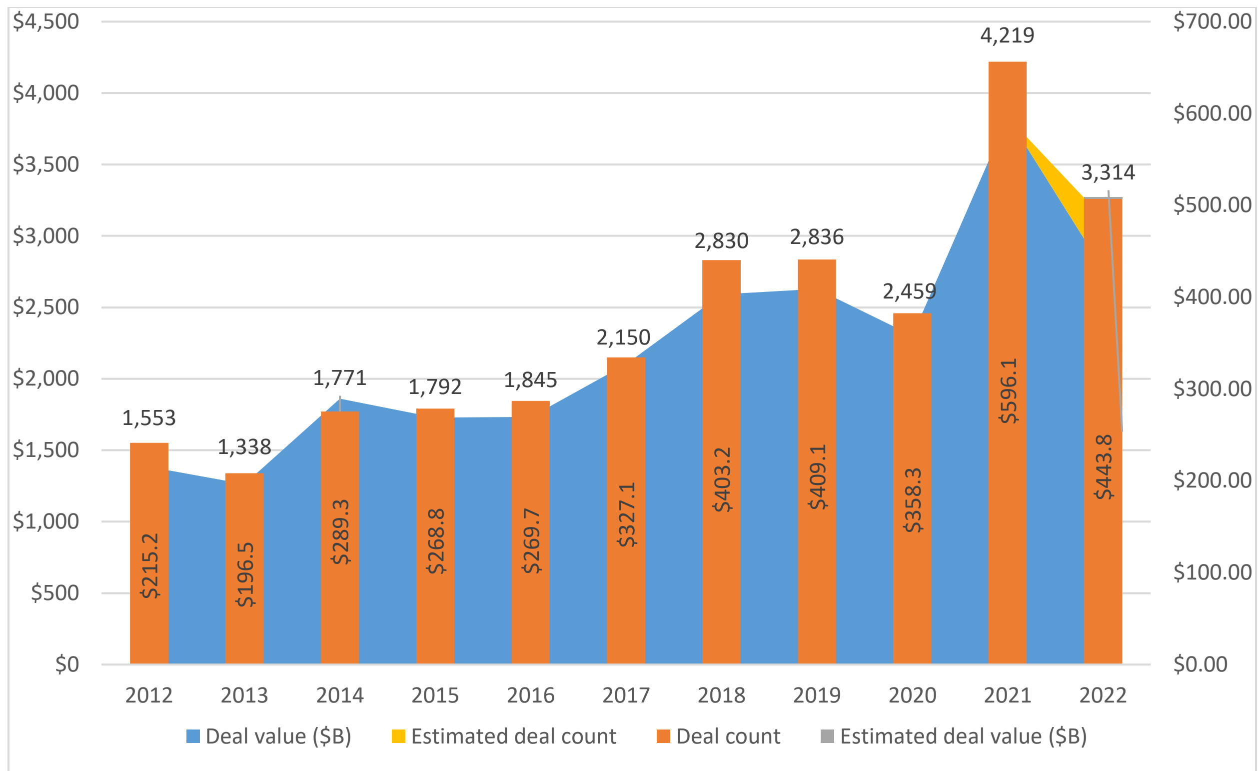

Figure 1: Private Equity Middle Market Deal Activity Data

The first quarter of 2022 experienced a significant decrease in deal making, with a decline of over 40% compared to the peak seen in the fourth quarter of 2021. Throughout the year, quarterly activity remained relatively flat, ranging from 800 to 900 deals totaling around $110 billion per quarter. Although deal activity in 2022 demonstrated stabilization compared to the frenetic levels observed in 2021, it remained robust, surpassing pre-COVID levels, with deal value and deal count higher by 16.9% and 27.2%, respectively.

Despite the impact of macroeconomic challenges on the broader PE deal space, the middle-market segment exhibited signs of improvement and a potentially easing environment. The Golub Capital Altman Index (GCAI), tracking PE-backed middle-market companies, reported a 10.8% increase in revenue and a 9.2% increase in earnings year-over-year for the first two months of Q4 2022.[1] In contrast, the S&P 500 reported a 5.4% increase in revenue and a 4.8% decrease in earnings over the same period.[2] These results indicate a stronger economic recovery, showcasing companies' ability to adapt to changing conditions with the support of their PE sponsors.

The GCAI's analysis of the four main sectors showed positive revenue and earnings growth for the quarter, with industrials and technology leading with low double-digit growth. The ability to pass increased input costs onto consumers is crucial for preventing margin compression and varies by industry. Healthcare,

[1] https://golubcapital.com/middle-market-report/q4-2022/
[2] https://advantage.factset.com/hubfs/Website/Resources%20Section/Research%20Desk/Earnings%20Insight/EarningsInsight_022423.pdf

however, faced a 1.3% increase in earnings against a 10.3% increase in revenue, highlighting the challenges posed by rising labor costs in the sector.

Over the past decade, the share of total PE buyout value in the middle market has decreased from its peak of 69.3% in 2012 to 58.1% by the end of 2022. The middle market's share of total PE deal value fell below 60% for the first time since 2015. This decline is attributed to the significant growth of mega-funds (funds of $5 billion or greater) in recent years, which have overshadowed middle-market and smaller funds in fundraising and deal value. Mega-deals (deals of $1 billion or greater) accounted for 34.4% of all PE deal value in 2022.

The middle market's share of all US PE value experienced a dip in Q2 2022, constituting only 44.9% of PE deals in the quarter due to a surge in take-privates, some of which were the largest buyouts of the year. However, it rebounded to 69.9% by Q4 2022. Middle-market deal count as a share of all PE deals reached the highest quarterly level in five years at 76.5% in Q4 2022. The annual deal count for 2022 settled at 66.8%, below its five-year average. This recovery in the middle market's share of PE deal count may indicate deal fatigue in larger deals. As financing big buyout deals becomes more challenging, PE firms are increasingly turning to add-on investments or growth equity deals instead of large leveraged buyouts. Specifically, the median buyout deal size in the middle market decreased to its lowest level since 2016, dropping to $147.0 million in 2022 from its peak of $200.0 million in 2019. Both the median and average deal sizes mirrored those observed during the pandemic-related slowdown.

Valuation Dynamics

The impact of rising interest rates on public company valuations was most pronounced for high-growth companies, leading to significant declines. Valuations in private markets were not immune to adjustments, as the present value of future cash flows decreased with higher discount rates. While the middle market faced fewer challenges, heightened borrowing and leverage costs had a dampening effect on deal activity and influenced multiples for transactions that were completed. Median EV-to-EBITDA deal multiples in the middle market contracted from 14.6x in 2021 to 12.9x by the close of 2022. The peak for middle-market EBITDA multiples occurred in 2019 at 16.0x, while the broader market reached its zenith in 2021 during a period of record-breaking deal activity. With public market valuations on the decline, sponsors are increasingly drawn to take-privates and carveouts of middle-market companies, seizing opportunities at appealing prices. Tight lending conditions necessitate middle-market PE buyers to inject more equity capital into deals, heightening their sensitivity to pricing.

Add-On Strategies

The conclusion of 2022 marked a pinnacle for add-on activity, comprising 72.3% of all US PE middle-market deal count and contributing to 58.7% of total middle-market deal value—a record-setting level. The upper middle market, dealing with transactions ranging from $500 million to $1 billion, experienced a surge, partly attributed to diminishing deal sizes in the mega-deal category as financing complexities increased throughout the year. PE firms strategically employed add-on strategies to attain inorganic growth, expedite platform investments, and create synergies that reduce costs or enhance revenue. The middle market's intrinsic smaller and more fragmented nature offers abundant opportunities for scaling, with middle-market companies showcasing greater agility for smoother integration. As public markets contend with macroeconomic challenges and private market valuations adjust accordingly, add-ons become increasingly attractive for private equity firms seeking to scale existing portfolio companies. The smaller deal sizes in add-ons mitigate the valuation discrepancies between buyers and sellers, facilitating a more

seamless integration. The financial services and healthcare sectors experienced heightened add-on activity in 2022, contributing significantly to deal counts in these industries.

Carveouts

The year 2022 witnessed large corporations grappling with margin compression, compelling them to reassess core and noncore assets, and consider divestitures. A total of 251 carveouts occurred in the middle market, amounting to $50.0 billion—a slight decrease from pre-pandemic levels, but in alignment with capital invested. Despite a slight dip from 2021 levels, middle-market carveouts constituted 53.7% of all US PE carveouts in 2022. Carveouts present an opportune avenue for PE firms to infuse fresh capital, revitalize underinvested assets, and stimulate growth. This strategic approach involves acquiring smaller segments of large companies and rejuvenating them or augmenting their growth prospects. Notably, TreeHouse Foods divested Winland Foods to Investindustrial for $950 million, streamlining its business[3], while Cinven acquired TaxAct from Blucora for $720.0 million to create a comprehensive tax solutions provider.[4] These carveouts empower companies to refocus on core strengths and spur innovation within their respective sectors.[5]

Take Privates

In 2022, a total of 79 take-privates above $100 million were either announced or completed. Among these, 34 were PE-led and below $1 billion in size, highlighting a trend where sponsors capitalized on the opportunity to take companies private as their market caps entered middle-market territory.

Take-privates stand out as a proven strategy for PE firms, particularly when public markets undergo significant corrections, and private markets anticipate higher prices. This reflects the current scenario, where sponsors can acquire attractive public companies at substantial discounts compared to their valuations just a year ago in 2021. Furthermore, public targets bring a well-established and transparent track record of operating results, making them more reliable in today's challenging lending environment.

Traditionally, take-privates are known for being the largest buyouts of the year, often exceeding $1 billion in deal size. This was evident in the first half of 2022, with the median deal size for announced take-privates reaching $1.7 billion. However, this figure dwindled to $316.0 million in the second half of the year, accompanied by a decrease in the frequency of deals from 48 announcements in H1 to 31 in H2 2022. The final two months of the year were particularly sluggish, with only three announced deals, including none in November. This slowdown in deal flow is attributed to sponsors facing challenges in sourcing loans for larger deals, solidifying a trend toward smaller transactions of less than $1 billion.

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[3] https://advantage.factset.com/hubfs/Website/Resources%20Section/Research%20Desk/Earnings%20Insight/EarningsInsight_022423.pdf

[4] https://www.cinven.com/media/news/cinven-to-acquire-taxact/

[5] https://www.globenewswire.com/news-release/2022/12/19/2576674/0/en/Blucora-Announces-Closing-of-TaxAct-Sale.html#:~:text=(%E2%80%9CBlucora%E2%80%9D%20or%20the%20%E2%80%9C,proceeds%20of%20approximately%20%24620%20million.

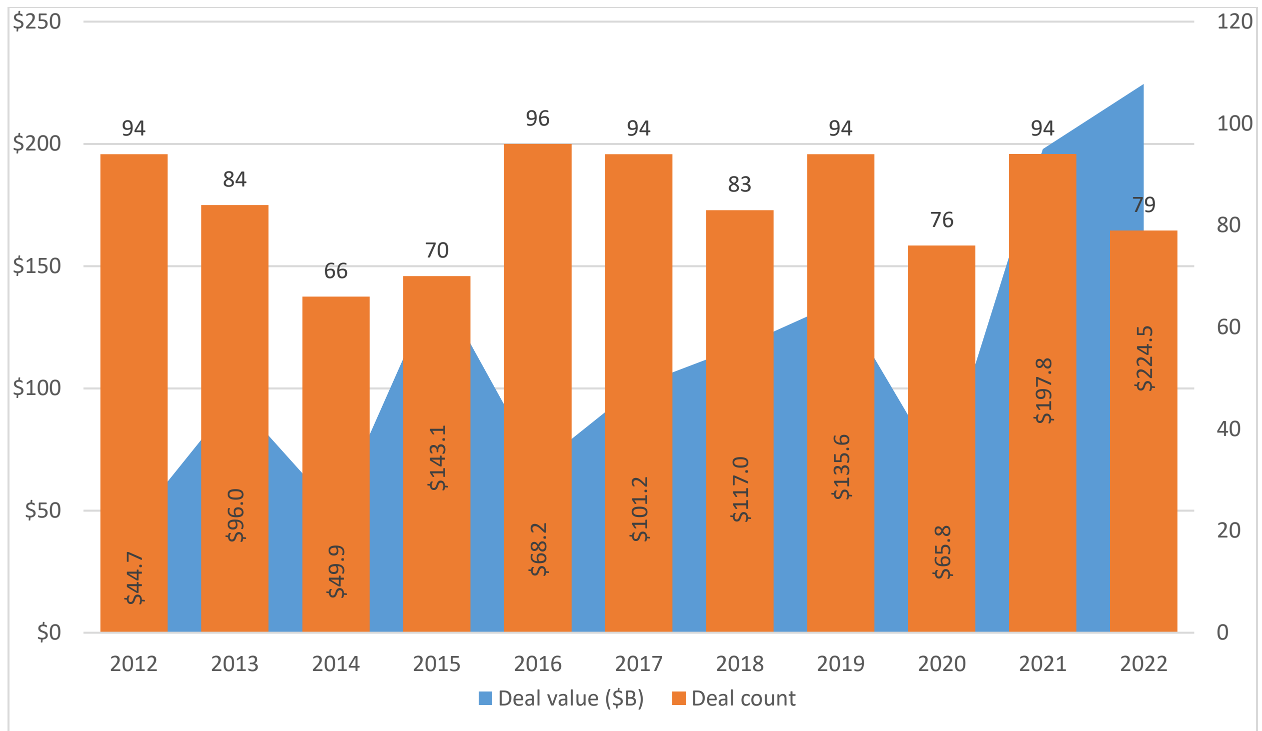

Figure 2: Public to Private LBO Private Equity Deal Activity Data

Company	Acquirer(s)	Deal Value ($M)	Date (2022)
SOC Telemed	Patient Square Capital	$302.5	February 2
Volt Information Sciences	ACS Group	$132.9	February 14
IntriCon	Altaris Capital Partners	$241.0	February 24
Stagecoach Group	DWS	$912.2	March 9
Virtus Health	BGH Capital	$698.0	March 14
Manning & Napier	Callodine Group	$249.0	April 1
Tufin	Turn/River Capital	$570.0	April 6
Blueknight Energy Partners	Ergon	$812.7	April 21
GTY Technology Holdings	GI Partners	$372.0	April 29
Ocean Outdoor UK	Atairos	$580.0	May 3
Hemisphere Media Group	InterMedia Partners	$283.8	May 6
Cary Group	CVC, Nordic Capita	$824.1	June 28
Maca	Elliott Management, Hochtief, Thiess	$239.4	July 26
Nearmap Australia	Thoma Bravo	$734.8	August 21
Elmo Software	K1 Investment Management	$307.7	October 26
Pushpay	BGH Capital, Sixth Street Partners	$902.2	October 28
Trean Insurance Group	Altaris Capital Partners	$316.0	October 15

Table 1: Take private Deals under $1 Billion in 2022

B2B

Despite fluctuations in deal activity, B2B (business-to-business) deal activity demonstrated resilience, marking one of the two sectors with positive growth in its share of total middle-market deal activity, alongside financial services. In 2022, there were 1,423 B2B deals totaling $173.4 billion. While YoY deal activity experienced a dip, the sector's share of middle-market deal count increased by 2.5%, and its share of deal value saw a 3.7% jump. B2B's share of middle-market deal making remained above its five-year average, highlighting the sector's relative strength during periods of market volatility.

The B2B sector encompasses a diverse range of primarily non-tech and service-oriented businesses, spanning manufacturing, professional services, and transportation. B2B offers opportunities for efficiency improvements against rising labor costs, particularly in the middle market, where it presents a highly fragmented market with chances to consolidate market share and scale businesses. Industrials, a significant vertical within the B2B space, includes manufacturers of heavy equipment, building materials, electrical components, transportation vehicles, and infrastructure, as well as services related to these manufacturing processes.

Despite challenges posed by rising input costs, sponsors are likely to seek opportunities in the middle market to strategically expand their platform companies and acquire noncore assets through divestitures. As an example, in November, HIG Capital acquired the distribution business of Avient Corporation for $950.0 million, renaming it Formerra with plans to accelerate its growth as an independent leader in polymer distribution. The ongoing focus on strengthening the supply chain continues to drive deal activity in the B2B sector, and the growing interest in nearshoring operations could further enhance investor attention in this space.

The Role of Placement Agents in GP Fundraising

Placement agents play a crucial role in efficiently connecting General Partners (GPs) with Limited Partners (LPs) who are likely to invest in their funds. Their primary objective is to guide GPs through the fundraising process, ensuring a smooth and expeditious experience. While often perceived as introduction services, placement agents offer a comprehensive range of services, assisting GPs at every stage of fundraising. This includes tasks such as document preparation, data room setup, relationship management, meeting coordination, and support for LPs until the fund's final close.

In general, placement agents assist fund managers in two key ways. Firstly, they aid in the creation of marketing and due diligence materials, preparing GPs for extensive LP due diligence processes. Secondly, they introduce GPs to a targeted list of potential LPs through premarketing meetings and roadshows, collaborating with GPs to secure investor commitments for the fund. These objectives evolve throughout different stages of a GP's fundraising process.

Boutique Placement Agents

Boutique placement agents, despite having global capabilities, operate with smaller teams. Their focus is on limiting the number of funds they represent each year, usually between five and ten, allowing them to devote substantial time and attention to each client. Due to their smaller size, team members in boutique placement agencies often take on multiple roles, managing both project-related tasks and sales and distribution efforts. These agents typically target funds ranging from $150 million to $5 billion, working within a more focused range compared to larger placement agents.

Reasons for GPs to Work with Placement Agents

Many GPs may wonder whether to engage a placement agent. While the majority of funds in the market do not retain placement agents, approximately 12.5% of the 2,760 funds that closed through Q4 2022 used a placement agent. Notably, between 2017 and 2021, only 10.3% of funds employed a placement agent to close. Fundraising without an agent is indeed possible but can be an enormous undertaking. GPs, whose expertise lies in deal-making, portfolio improvement, and exits, might find fundraising to be a distracting and time-consuming task without a robust internal investor relations (IR) team. Working with a placement agent offers benefits such as guidance on marketing laws in different geographies, targeted introductions, informed feedback on fund propositions, and constructive criticism from LPs.

Reasons against Working with Placement Agents

One of the primary reasons GPs engage placement agents is to expedite the fundraising timeline. Historically, funds working with placement agents closed in less time than those without. However, since 2020, this trend has shifted, and funds with placement agents are spending more time in the market on average. The pandemic has contributed to this shift, with LPs becoming more comfortable with online due diligence, leveling the playing field between funds with and without placement agents.

Middle-Market Exit Activity in the US

In contrast to the vibrant monetization environment witnessed in 2021, middle-market exit activity in the US faced a significant downturn throughout 2022. The robust economic recovery post-2020, escalating multiples, and the abundance of private equity (PE) dry powder and corporate cash on balance sheets fueled a fervent monetization climate in the previous year. However, the landscape changed early in 2022 as several macroeconomic challenges emerged. Inflation and rising interest rates exerted pressure on company multiples, leading to market price dislocation, while access to capital constricted. Sellers awaited more favorable prices, and potential buyers exhibited decreased acquisitiveness, resulting in a slowdown in exit activity.

During 2022, a total of 748 PE-backed middle-market companies were exited or announced to be exited, amounting to $141.0 billion. This marked a substantial 34.6% decline in exit count and a 47.2% decline in exit value from the preceding year. Exit activity not only fell below the levels of 2021 but also dipped below pre-COVID levels (2017 to 2019), with exit count and value down 14.6% and 19.4%, respectively. Despite the usual surge in Q4 exit activity, Q4 2022 recorded the slowest quarterly exit activity of the year, with just 162 exits (announced and closed) totaling $29.8 billion. This represented a 57.4% drop in exit count and a 65.3% drop in exit value from the peak in Q4 2021.

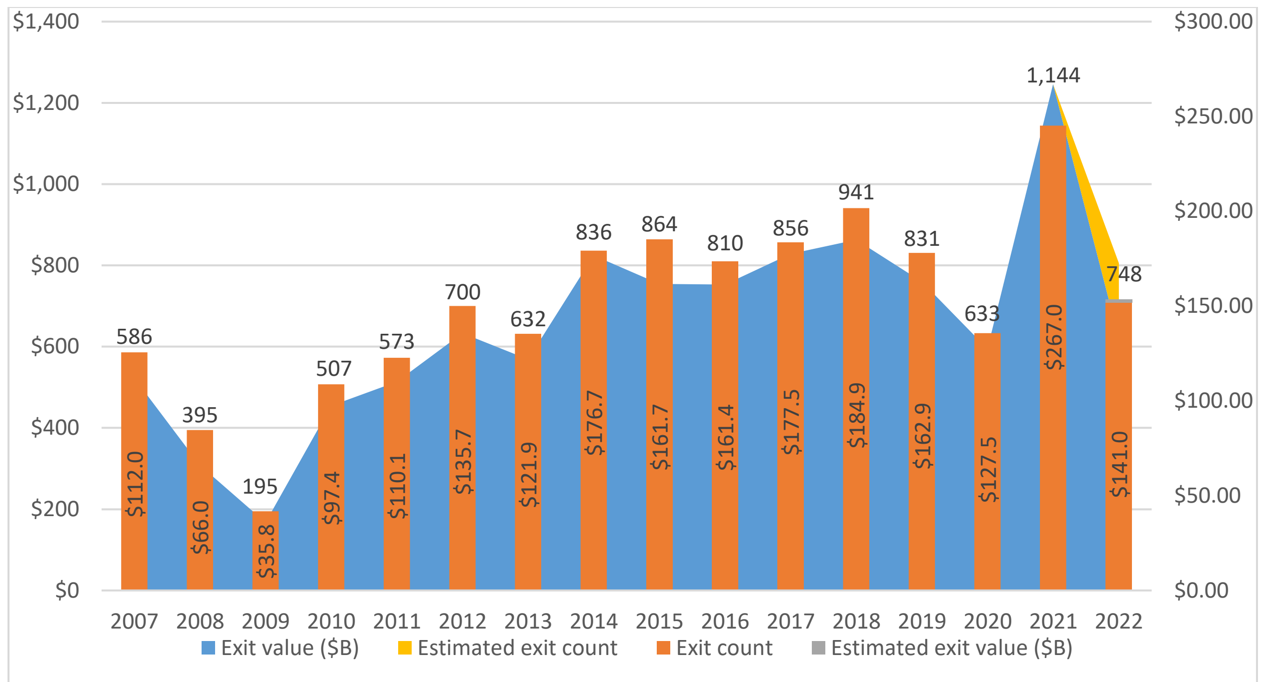

Figure 3: Private Equity Middle Market Exit Activity Data

Sponsor-to-sponsor

A notable facet of exit dynamics, experienced a decline in 2022. General Partners (GPs) exited 387 companies to other sponsors, amounting to $73.0 billion. Although this marked a decrease from the record numbers in 2021, where 644 deals were exited for $147.4 billion, sponsor-to-sponsor exits still constituted 54.9% of middle-market exit value. This proportion remained similar to pre-pandemic levels. Even when excluding public listings, sponsor-to-sponsor exits represented 55.1% of middle-market exit value, slightly lower than the 2021 figure. This trend aligns with the 10-year average of 53.7%. The preference for sponsor-to-sponsor exits over exits to corporates has been consistent over the past decade, driven by the expansion of PE managers and relatively stable numbers of corporate buyers. Robust fundraising by sponsors in recent years has further facilitated attractive exit opportunities, allowing them to pursue deals and acquire portfolio companies from other PE funds even during economic downturns.

Most sectors witnessed a decline in sponsor-to-sponsor exit trends, with healthcare experiencing the most significant drop at a 65.6% decline year-over-year (YoY). The healthcare sector faced challenges such as a challenging macro environment, staffing shortages, and rising costs, limiting exit opportunities. While healthcare's share of total middle-market exit value dropped by 4.6%, and its share of total exit count decreased by 1.9%, a rebound in sponsor-to-sponsor exits is anticipated. Factors such as PE dry powder fueling sponsors' ability to acquire PE-backed assets and lower valuations motivating PE-backed platforms to acquire opportunistic assets are expected to contribute to this rebound. An example of this is Spectrum Equity and Health Enterprise Partners' sale of Payer Compass, a healthcare solutions provider, to Zelis Healthcare for $180.0 million in September.

On the other hand, PE exits to corporates experienced a steady decline throughout 2022. Starting the year with 102 exits totaling $19.9 billion in Q1, it concluded with 47 exits for $7.4 billion in Q4. Exits to

corporates accounted for 44.9% of total middle-market exit value when excluding public listings. This represented a YoY decline in exit count and value of 31.2% and 44.0%, respectively. Despite this decline, PE firms capitalized on exiting investments to corporations seeking strategic acquisitions with strong fit and growth opportunities. Noteworthy was KKR's sale of Minnesota Rubber and Plastic (MRP) to Trelleborg Group for $950 million in H2 2022, reflecting the ongoing strategic moves in the market.

While the corporate landscape experienced some caution due to recessionary fears, PE firms found opportunities to exit investments to companies actively pursuing strategic acquisitions. Energy was the only sector that recorded growth in exit value during the year, with 24 exits to corporates totaling $6.5 billion. Energy achieved its highest exit value since 2011, driven by notable exits like Warburg Pincus' $865.0 million sale of RimRock Oil & Gas to Devon Energy and Energy Capital Partners' $631.2 million sale of Sendero Midstream to Crestwood Equity Partners.

Energy Sector

The year 2022 brought a confluence of factors, including high commodity prices, geopolitical tensions, and the ongoing trends toward renewables and decarbonization, creating diverse exit opportunities within the energy sector. Despite facing challenges, energy exhibited the smallest decline in exit value among all sectors, experiencing a modest 10.1% drop from $10.7 billion in 2021 to $9.6 billion in 2022. Energy's share of total middle-market exit value expanded by 3.2% year-over-year (YoY), with exit count showing a marginal increase of 0.4%, totaling 34 exits with an aggregate value of $9.6 billion.

The surge in commodity prices bolstered the balance sheets of traditional oil & gas companies, providing General Partners (GPs) with opportunities to exit their investments. Notably, Earthstone Energy, an oil & natural gas exploration and production (E&P) company, capitalized on this trend by acquiring three PE-backed companies in 2022, enhancing its net production and footprint in the Permian Basin. Ongoing market uncertainties, fueled by price volatility and geopolitical risks, have inclined middle-market sellers towards smaller add-on deals, which offer more stability than larger acquisitions.

Simultaneously, the sector's shift toward renewables has opened up additional exit avenues. Large E&P companies, driven by the desire to focus on core operations, may divest noncore assets, attracting interest from other sponsors and corporations for their short-term value. Assets in renewable energy are gaining increased attention for their long-term growth potential. An exemplar of this shift is Pfingsten Partners, which sold clean energy systems manufacturer Dynapower to Sensata Technologies for $577.7 million in July.

Regulatory pressures, such as those stemming from the Inflation Reduction Act, are anticipated to channel more capital into renewables and decarbonization assets. This regulatory push aligns with the broader industry trend towards environmental sustainability.

Materials & Resources Sector

In contrast to broader market trends, the materials & resources sector emerged as a source of surprising strength for exit activity in 2022. This sector, alongside B2B, saw an increase in both exit count and value, with a notable uptick of 170 basis points in both metrics year-over-year.

With 39 exits totaling $7.0 billion, the materials & resources sector experienced a modest 9.3% slowdown in exit count since 2021. Exit value, while dropping by 26.8%, remained on the lower end of the decline

observed across other sectors. The exits spanned various subsectors, including chemical & gas companies, containers and packaging, and agriculture companies.

Environmental, social & governance (ESG) considerations played a role in generating exit opportunities within the sector. For instance, Genera Energy, a PE-backed entity, was sold to Ara Partners for $200.0 million in June. Ara Partners, specializing in industrial decarbonization investments, aims to expand Genera Energy's production capabilities to capitalize on the growing sustainable packaging market and provide eco-friendly solutions to the global plastic pollution problem.[6]

Despite the positive momentum in exits in 2022, the materials & resources sector is anticipated to remain a relatively smaller part of overall PE middle-market exit activity. Historically, this sector has represented around 5% of total exit count and value. Challenges such as rising capital costs and geopolitical uncertainties persist, influencing buyer preferences to steer away from cyclical businesses during economic downturns. Continued ESG pressures may also make potential buyers cautious about investing capital amid periods of change and uncertainty. However, companies with robust balance sheets and a focus on ESG exposure may find lucrative exit opportunities as market volatility subsides, and valuations become more attractive.

Fundraising and Performance Trends in the US Middle-Market Private Equity Landscape

The landscape of US middle-market fundraising in 2022 exhibited resilience, with 156 funds successfully closing, amounting to an aggregate value of $133.5 billion. Although 2022 witnessed a decrease of 42 funds compared to the preceding year, the overall fundraising pace remained consistent with both 2021 and 2020. However, the fourth quarter of 2022 emerged as the weakest fundraising quarter due to challenges in securing LP capital, attributed to a surge in supply from General Partners (GPs) in the first half of the year.

Across the private equity (PE) spectrum, fund sizes continued to expand, a trend mirrored in the middle markets. The top 30 middle-market vehicles raised in 2022 accounted for 53.6% of the total capital raised. Consequently, the median middle-market fund size rose to $503.0 million in 2022, up from $365.3 million in the previous year. Although larger funds and sponsors continued to dominate, the share of total capital raised by middle-market funds experienced a slight decline from 50.9% to 46.0% in 2022. Notably, the number of middle-market PE funds closed in 2022 constituted 42.6% of all funds closed, reaching a 10-year high and indicating a growing influence in the fundraising landscape.

[6] https://www.prnewswire.com/news-releases/ara-partners-acquires-genera-largest-integrated-manufacturer-of-non-wood-agricultural-pulp-and-molded-fiber-products-in-north-america-301572791.html

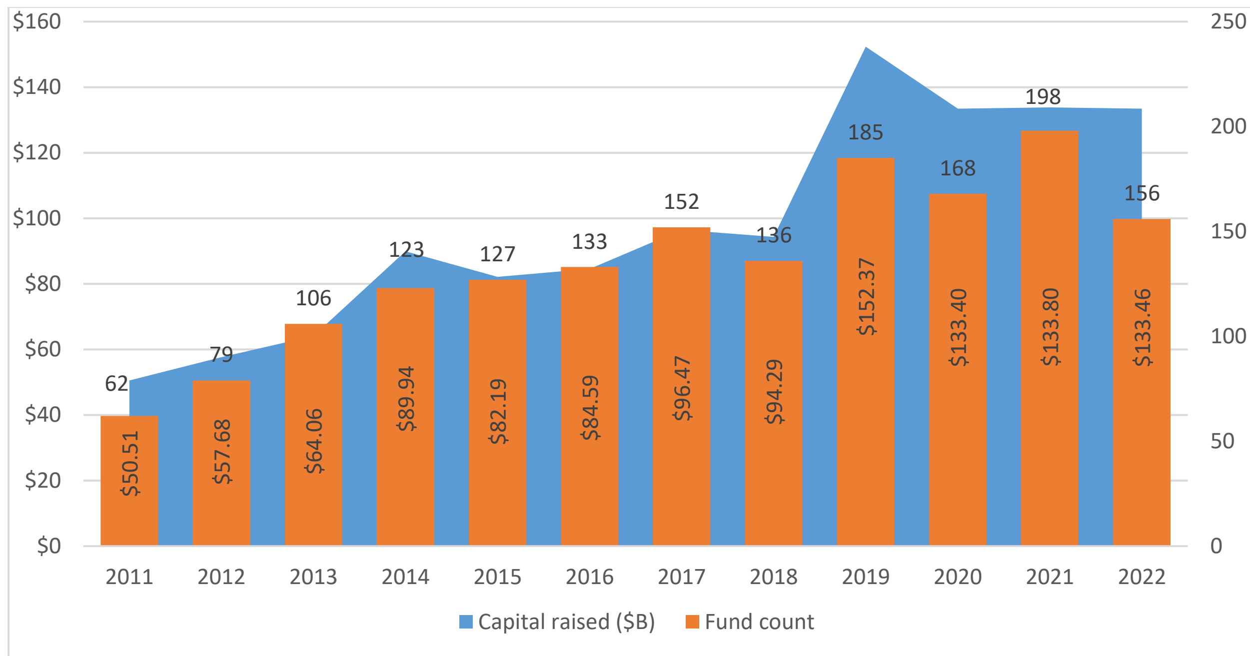

Figure 4: Private Equity Middle Market Fundraising Activity Data

Middle-market funds that concluded fundraising in 2022 exhibited an accelerated pace, with the average time to close decreasing from 15.0 to 13.1 months. This reflected the overall trend of rapid fundraising observed in the broader PE landscape throughout the year. The heightened demand for capital, coupled with market volatility and fewer exits, resulted in institutional investors reaching their yearly allocations for PE investments shortly after the first half of the year.

Looking ahead to 2023, the large public PE firms expressed confidence in an upswing in fundraising, although it remains to be seen whether this optimism extends to middle-market funds. Notably, Thoma Bravo's successful closure of two funds targeting upper-middle-market and lower-middle-market funds at substantial step-ups to their predecessor funds is seen as a positive indicator for middle-market fundraising.

In addition to quicker fund closures, the gap between funds within the same family narrowed, with the median time decreasing from 3.6 years in 2021 to 3.1 years in 2022. However, the tight link between fundraising and deployment activity, which has slowed significantly, suggests that the time between funds may elongate in the future.

A noteworthy trend in 2022 was the prevalence of step-ups in capital raised. A record-high 90.8% of middle-market funds closed with more capital than their predecessors, surpassing the industry average of 84.9%. Although the median size of these step-ups moderated from 68.9% in 2021 to 60.4% in 2022, middle-market-focused PE firms achieved considerable success in expanding the size of their flagship funds. One Equity Partners, for instance, closed One Equity Partners VIII on $2.75 billion, marking a 57.1% step-up from its predecessor fund.

The middle-market space witnessed the growing influence of mega-fund managers, with funds spanning multiple vintages targeting middle-market companies. In April, Veritas Capital launched its Veritas Capital Vantage Fund, focusing on the middle market with $1.8 billion in committed capital. Similarly, Thoma

Bravo closed its Explore Fund II on $1.8 billion in December, emphasizing lower-middle-market investments, a significant increase from the $1.1 billion raised by Explore Fund I.

Emerging Managers and Performance Dynamics in the Middle-Market Private Equity Landscape

Emerging Managers

Within the middle-market segment, emerging managers, defined as those with three or fewer funds ever launched, including first-time managers, found a thriving space in 2022. These managers constituted 23.2% of all capital raised in the middle markets during the year. Impressively, 94.9% of the capital raised by first-time managers in 2022 was within the middle-market domain. The overall share of total fundraising by emerging managers increased, highlighting their significance in an otherwise stable market.

The average size of funds managed by emerging managers witnessed growth, reaching $516.7 million in 2022, up from $384.1 million in 2021. This shift reflects the broader trend in the private equity (PE) landscape where fewer managers are securing more substantial funding. Emerging managers often represent highly experienced teams, with many originating from larger PE establishments. Noteworthy instances include BayPine's inaugural fund closure at $2.2 billion in September, led by former executives from Blackstone and officials from the US Department of the Treasury. Additionally, Brighton Park Capital, founded in 2019 by former executives at General Atlantic and Apax Partners, closed its second fund at $1.8 billion in November.

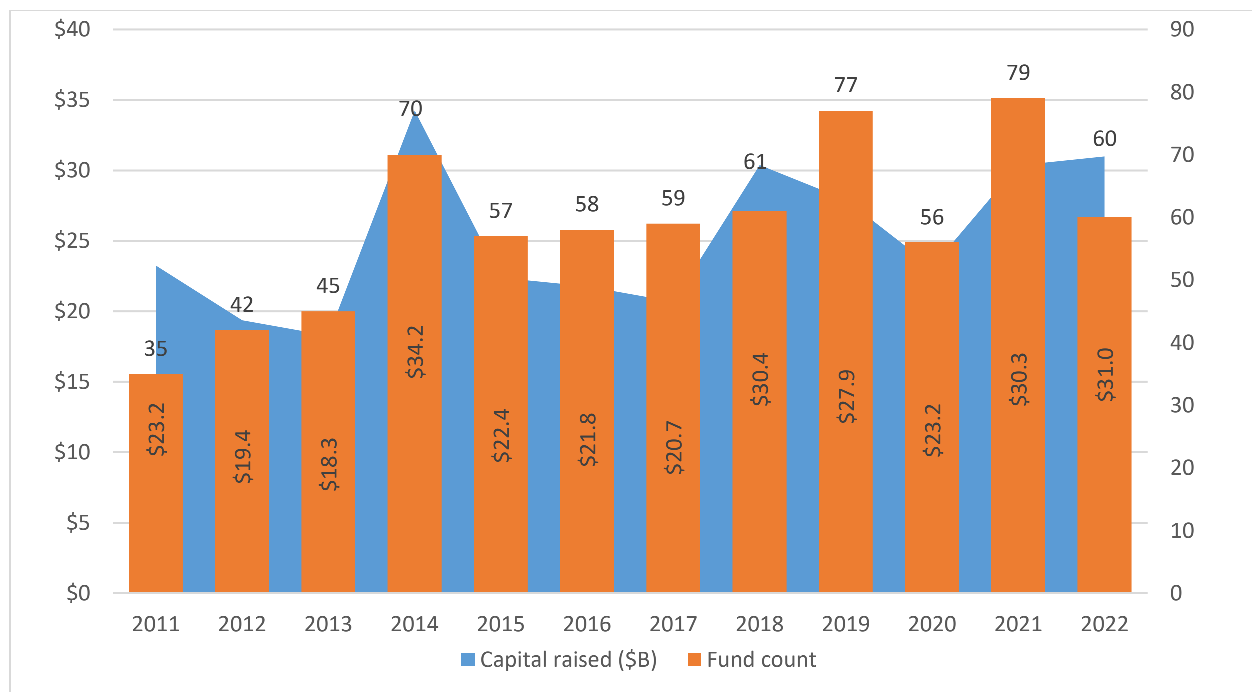

Figure 5: Private Equity Middle Market Fundraising Activity with Emerging Managers Data

Performance

In Q3 2022, middle-market funds demonstrated a noteworthy performance surge, outpacing mega-funds. The median one-year horizon return for middle-market funds stood at 9.0%, surpassing the 4.2% return for US PE funds with sizes exceeding $5 billion. This marks a significant shift from Q4 2021 when mega-

funds led by 1,391 basis points. The middle-market's ability to erase this performance gap within just six months and deliver two consecutive quarters of outperformance highlights its resilience.

This performance superiority extends across every subsector within the middle markets, with the core and lower middle market exhibiting higher returns compared to the upper middle market. This reversal of fortunes, favoring smaller entities in the PE landscape, is a noteworthy trend. While this shift is in its early stages and may take several quarters to influence allocation decisions, it challenges the prevailing psychology and fundraising trends that currently favor larger managers perceived as safe havens.

The middle market faces challenges in competing with mega-fund platforms, especially given the prevailing fundraising trends. Nevertheless, sustained superior performance remains a powerful driver to reverse the share of future fund flows, and recent results indicate a step in that direction.

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