United States Private Equity (PE) Middle Market Report

2023 ANNUAL

IMBERIUM INC.

Contents

Summary

In the fourth quarter of 2023, there was a notable resurgence in middle-market private equity (PE) deal making in the United States. This marked only the second upturn in eight quarters since reaching its peak two years prior. Unlike previous instances of temporary rebounds, this increase in activity was observed on both the buying and selling sides, with growth in both deal value and deal count—a positive development. However, alongside this surge, there were concerning trends emerging.

Some of the heightened deal activity involved less favorable transactions, including buy-side deals requiring rescue capital and restructurings, as well as exits facilitated by continuation funds on the sell side. Additionally, there were indications of distress in the valuation realm, particularly evident in enterprise value (EV)/revenue multiples, which showed significant weakness during Q4. To provide insight from a debt perspective, this quarter's analysis focuses on innovative solutions from private credit lenders aimed at helping PE sponsors navigate challenges and maintain resilience.

Despite these challenges, the middle market continued to play a dominant role in PE buyouts, reaching a record share of 74.1% in 2023, surpassing previous highs. Nonetheless, it couldn't entirely counteract the prevailing downward trend. Middle-market buyout value decreased by 18.9% in 2023, albeit less severe than the broader PE buyout market, which experienced a 32.7% decline. Consequently, the middle market's share of the buyout market based on deal value increased alongside its record share of deal count.

Exit value for middle-market companies also experienced a decline, dropping by 22.0% in 2023, comparable to or worse than the overall PE market performance. Despite this, middle-market funds demonstrated efficiency in distributing returns to investors, with generally shorter holding periods compared to the broader average, indicating smoother exit processes.

A notable aspect of middle-market exits gaining traction is the use of continuation funds, a trend discussed further in our analysis. Fundraising in the middle market fared well in 2023, enjoying its strongest year since 2019, driven by robust fund returns relative to larger funds. However, the performance parity between middle-market and megafunds in Q3 2023, after a period of middle-market outperformance, suggests a potential shift in investor preferences, especially if anticipated Federal Reserve rate cuts materialize in 2024.

Deal Activity

The US private equity (PE) middle-market deal making concluded the year with figures resembling its outset. However, the journey in between was marked by a notably sluggish quarter, reminiscent of the softest performance in six years, excluding the pandemic-induced slowdown in Q2 2020. The last quarter of 2023 witnessed a rebound from the preceding sluggish period, yet the aggregate deal value harked back to levels akin to 2017. Analysts widely perceive Q3 as the nadir in overall mergers and acquisitions (M&A), which is anticipated to positively influence PE buyout activities. Despite this optimism, concerns linger regarding the persistently low exit activity, potentially hindering the industry's full recovery.

Among all types of PE deals, buyouts experienced significant downturns. In 2023, the US buyout market saw a notable 32.7% decrease in deal value. However, middle-market buyouts, ranging between $100 million and $1 billion, displayed more resilience with an 18.9% decline in value and a 4.0% increase in deal count. It's worth noting that this report focuses solely on control transactions in PE middle markets, excluding growth equity deals, which often spill into larger corporate and fund domains.

The slowdown in mega-deal activity can be attributed to various factors, notably reduced access to debt. The average debt-to-value ratio for new large loans supporting leveraged buyouts (LBOs), financed in the broadly syndicated market, significantly declined in 2023 compared to 2022. This shift favored middle markets due to their smaller deal sizes and the availability of debt from the burgeoning private credit sector. Consequently, the middle market's share of all PE buyouts surged to a record high of 74.1% in 2023.

In Q4, middle-market buyout value saw a notable 10.0% increase from the preceding weak quarter. Throughout the year, PE firms announced or concluded 3,689 middle-market buyout deals in the US, totaling $298.0 billion in deal value. Despite an 18.9% decline in deal value compared to the previous year, the 4.0% increase in deal count reversed the decline seen in 2022. While middle-market buyout value lagged behind pre-pandemic levels by 6.3%, deal count significantly surpassed the "old normal" averages of 2017 to 2019, indicating a preference for smaller deals amid the current market conditions.

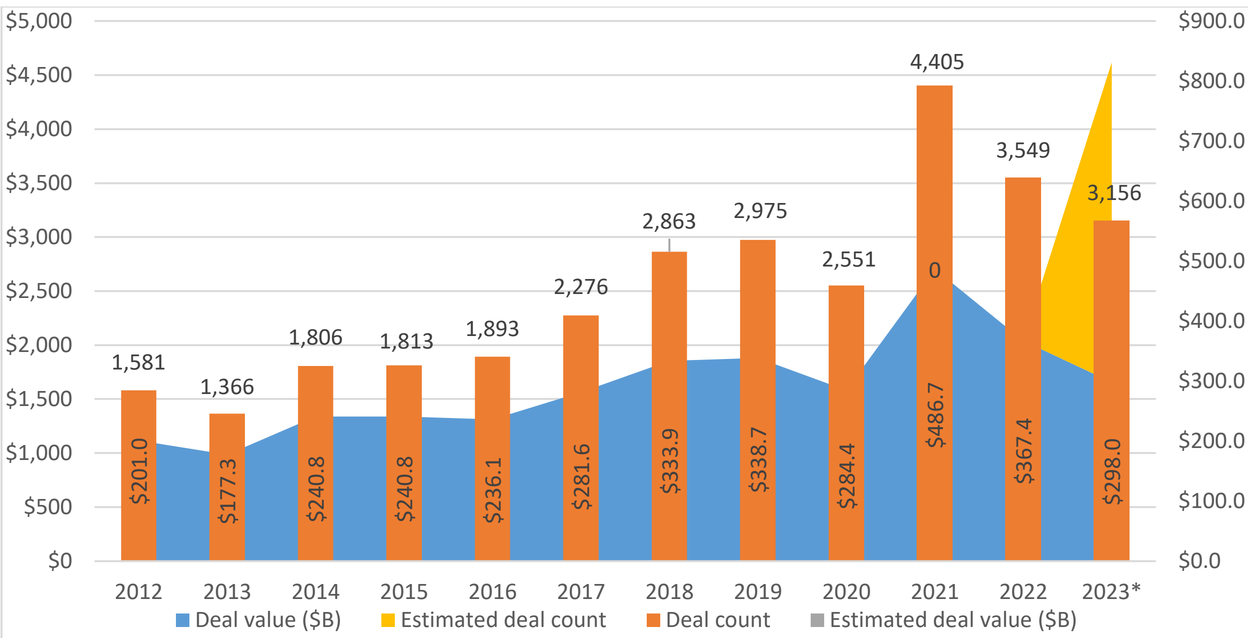

Figure 1: Private Equity Middle Market Deal Activity Data

Valuations

In middle-market private equity (PE) transactions have followed a downward trajectory since their peak in 2021, showing no signs of stabilizing. Both EV/EBITDA and EV/revenue multiples have experienced significant declines, ranging from 25.0% to 40.6% from their highest points. This decline has been particularly pronounced in the past year.

In 2023, EV/revenue multiples for middle-market PE deals stood at 2.0x, marking a 23.1% decrease from 2022, while EV/EBITDA multiples finished at 11.0x, down by 15.5%. These figures indicate a regression to 2017 valuation levels in the middle-market segment.

EV/revenue multiples are especially pertinent in assessing valuation trends, particularly in sectors like technology where EBITDA metrics may not be as informative. The rapid ascent to the peak in 2021 was followed by an equally swift decline, with signs of distressed selling becoming more apparent. For instance, the trailing 12-month (TTM) median multiple dropped from 2.4x revenue in Q3 to 2.0x for the entire year of 2023.

In Q4, the median EV/revenue multiples for middle-market deals plummeted to 1.5x, based on 37 transactions. While caution is advised in extrapolating short-term trends due to data volatility, such a sudden shift in the TTM average cannot be overlooked.

Take-Privates

In the fourth quarter, there was a sequential decrease in the number of middle-market take-private transactions, but a notable increase compared to the previous year. This uptick was supported by reduced market volatility and improved financing availability. Specifically, private equity (PE) buyers announced or finalized eight take-private deals under $1 billion in North America and Europe during the quarter. While this marked a significant drop from the 19 transactions in the prior quarter, it represented a notable improvement over the five deals in the same period of 2022. Throughout the entire year of 2023, there were 53 take-private deals under $1 billion, surpassing the 41 transactions recorded in 2022.

Notably, none of the transactions in Q4 involved "boomerang" stocks, referring to companies that swiftly return to private ownership after going public. The trend of public-to-private transitions has slowed, particularly among the numerous unicorns that went public during the surge of 2020 to 2021. Many of these companies experienced a decline in valuation below the $1 billion mark as their stock prices fell. This shift indicates a strategic pivot by PE firms towards more stable companies with robust financial bases, avoiding the recent volatility associated with boomerang stocks.

A broader analysis of the public stock market suggests favorable conditions for take-private deals in the sub-$1 billion segment. This is highlighted by the underperformance of the Russell 2000 Index relative to the S&P 500, with returns of 15.8% and 24.7%, respectively, in 2023. Additionally, expectations of moderating inflation and anticipated interest rate cuts in 2024 further bolster the attractiveness of targeting companies within this valuation range for PE firms. These firms are well-positioned to rejuvenate middle-market companies that are too small for public markets and burdened by the high costs associated with maintaining public status. Private equity investors can efficiently implement transformative improvements without the scrutiny faced in public markets. Companies with market capitalizations below $1 billion are particularly enticing targets for take-private transactions due to their limited trading volume and analyst coverage, which often offset the benefits of being publicly listed.

Company	Acquirer(s)	Deal Value ($M)	Date (2023)
P&F Industries	ShoreView Industries	$41.2	October 13
Spark Power	American Pacific Group	$140.0	October 13
Logistec	Blue Wolf Capital Partners, Investissement Québec, Stonepeak	$866.1	October 16
Q4	Sumeru Equity Partners	$124.9	November 13
EQS Group	Thoma Bravo	$414.1	November 15
DX Group	H.I.G. Capital	$338.8	November 16

Impellam Group	HeadFirst, IceLake Capital, Kartesia	$473.4	December 13
Permascand	Altor Equity Partners	$105.6	December 16

Table 1: Private Equity Take Private Deals under $1 Billion in Quarter 4 2023

Founder-Owned Businesses

Businesses led by their founders, operating without institutional support, have historically been significant participants in private equity (PE) deal-making. Since the beginning of 2021, there has been a noticeable increase in their share of total transactions, a trend explored in our 2024 US Private Equity Outlook. In 2023, non-backed companies accounted for 52.0% of all US middle-market PE buyouts, marking a rise from 47.5% in 2021 and continuing a trend that emerged in 2020. This shift contrasts with the previous nine-year cycle, which favored larger-scale and sponsor-backed transactions. The recent surge in deals involving non-backed entities indicates both a market rebound and a broader sense of caution. Amid current macroeconomic conditions, many sellers, including financial sponsors and potential PE sellers, are delaying deals, anticipating a more favorable interest rate environment.

Non-backed sellers, often constrained by higher financing costs or founder retirement plans, may find it challenging to postpone exit strategies. Unlike their backed counterparts, which may wait for better market conditions, non-backed entities are often compelled to sell due to immediate competitive pressures, financial constraints, or personal circumstances. This highlights a unique dynamic in the middle-market transaction landscape.

Founder-owned companies, typically operating at the lower end of the market, offer more attractive purchase price multiples. Most deals in this segment fall within the $25 million to $100 million valuation range, with some even below $25 million. Transactions in this bracket usually occur at a discount relative to larger, sponsor-backed deals, reflecting lower EBITDA and revenue multiples. In the middle market, the median trailing twelve-month (TTM) EV/EBITDA multiple stands at 11.1x, decreasing to 4.8x for deals under $100 million. Similarly, EV/revenue multiples decrease from 2.0x to 1.1x within this valuation range, making non-backed businesses particularly appealing to PE investors, especially amid demographic shifts and management team retirements.

Carveouts

The share of carveouts in the deal landscape reached its peak in Q4, accounting for 10.7% of the overall deal mix—the highest level since Q1 2021. Throughout full-year 2023, carveouts represented 9.0% of all middle-market transactions, up from 7.6% in 2022. We anticipate this trend of expansion to continue, given the historical average of 12.1% from 2010 to 2020. This upward trajectory underscores the significance of carveouts as a vital segment within the deal universe, particularly in the current market environment characterized by a wide bid-ask spread.

Carveouts offer sellers a unique opportunity to generate cash and enhance strategic flexibility, crucial for paying down debt or reallocating capital. The process benefits from the transparency of well-established assets with comprehensive historical financial data, facilitating effective due diligence for acquirers and lenders. Despite hesitancy in offloading non-core assets amidst the volatility of 2023, the outlook for 2024 appears more optimistic.

In Q4, notable middle-market carveout transactions were announced in the B2B and financial sectors. L3Harris Technologies agreed to sell its Commercial Aviation Solutions (CAS) division to The Jordan

Company (TJC) for $800 million, representing an LTM EV/EBITDA multiple of approximately 15.0x.[1] This divestiture will enable L3Harris to repay debt. Additionally, Computershare Limited agreed to sell its US mortgage and Specialized Loan Servicing units to Rithm Capital for $720.0 million, allowing Computershare to focus on core businesses with more consistent recurring revenue and lower capital intensity.[2]

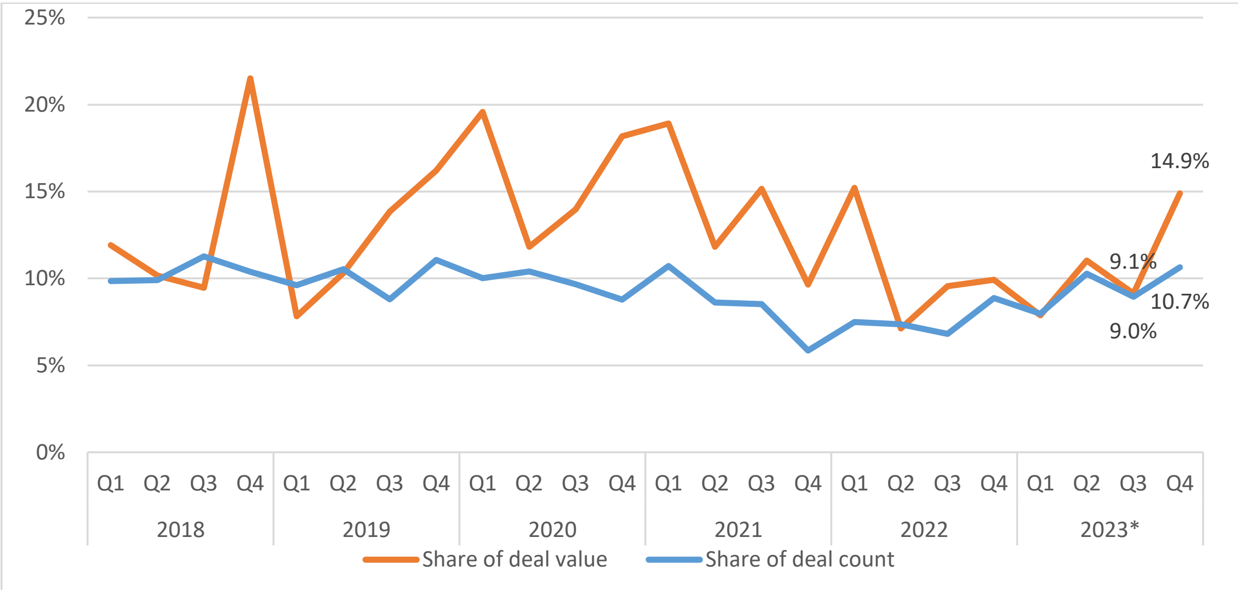

Figure 2: Carveouts and Divestitures as a Share of all United States Private Equity Middle Market Deal Activity by Quarter

Technology Sector

In the fourth quarter, the technology sector experienced a slight increase in deal activity, thanks to reduced market volatility which helped bridge the valuation gap between buyers and sellers. There were a total of 103 transactions during the quarter, marking a 2.0% sequential increase, though witnessing a 22.0% decline year-on-year (YoY). The total deal value for the quarter amounted to $10.1 billion, reflecting a 9.0% sequential increase but a 25.5% YoY decrease. Looking at the entire year of 2023, there were 419 deals, down 18.0% YoY and 4.6% from the annual average of 2017 to 2019. The total deal value for 2023 was $41.7 billion, showing a steeper decline of 29.9% YoY and 21.3% compared to the 2017 to 2019 average.

Notably, technology deals involving private equity (PE) buyers tended to be smaller in size, and the information technology (IT) sector's share of the deal mix decreased to 13.3%, down 110 basis points YoY and 260 basis points below the five-year average of 15.9%. The distribution of technology deals in the quarter expanded beyond software to encompass a more diverse range of IT investments at rational valuations, indicating a closer alignment in valuation expectations among market participants.

[1] https://www.l3harris.com/newsroom/press-release/2023/11/l3harris-announces-definitive-agreement-commercial-aviation-solutions

[2] https://ir.rithmcap.com/investors/news/news-details/2023/Rithm-Capital-to-Acquire-Specialized-Loan-Servicing-LLC/default.aspx

Key transactions in the technology sector during Q4 included deals in digital infrastructure and IT services. Cyxtera Technologies, with over 60 global data centers, was acquired by Evoque Data Center Solutions, backed by Brookfield Infrastructure Partners, for $775 million.[3] SwyftFiber, a provider of fiber internet and TV streaming in rural areas, secured a $275.0 million equity investment from Macquarie Asset Management.[4] Trustwave, a US-based cybersecurity company, was acquired by The Chertoff Group for $205.0 million.[5]

Healthcare Sector

Deal activity in the healthcare sector was relatively subdued in Q4, with 102 deals amounting to $10.0 billion. This represented a decline of 6.4% quarter-on-quarter (QoQ) in volume and 20.9% YoY, while value decreased by 9.2% QoQ and 5.6% YoY. On a full-year basis, the sector recorded 411 deals, down 15.8% YoY, with a total deal value of $40.6 billion, down 21.7% YoY.

In addition to facing macroeconomic challenges in 2023, the healthcare sector encountered regulatory uncertainties, including limits on market concentration. New guidelines from the Justice Department suggested increased scrutiny of deals that might result in a high level of market concentration.[6] This particularly affects roll-ups of facilities in specific geographic areas, a popular strategy in the healthcare sector. The middle market, where healthcare PE buyers often seek add-on deals, is expected to be particularly impacted by this regulatory environment.

Notable healthcare sector deals in Q4 included TIDI Products, a manufacturer and distributor of medical products, which was acquired by TJC for $900.0 million.[7] Akumin, a provider of outpatient radiology and oncology solutions, agreed to be acquired by Stonepeak in a $600.0 million transaction, following a prepackaged Chapter 11 restructuring process.[8]

Exits Activity

Reflecting the trend seen in buy-side activity, exit activity in the US middle-market experienced a modest rebound in Q4 following a notably weak Q3. Approximately 190 exits were estimated during the quarter, totaling around $24.4 billion. This represented a quarterly increase of 14.5% in volume and 4.7% in value. Although this uptick suggests a potential bottoming out for PE exits, overall exit activity remains subdued. Exit value is significantly lower than pre-pandemic levels, standing at 36.8% below the quarterly average and 66.0% below the peak seen in Q4 2021. In 2023, PE firms exited a total of 771 companies with an aggregate value of $102.3 billion, marking the second consecutive year of decline compared to 2022.

[3] https://www.cyxtera.com/about-us/press-releases/evoque-data-center-solutions-closes-acquisition-of-cyxtera
[4] https://www.macquarie.com/au/en/about/news/2023/macquarie-asset-management-announces-agreement-to-invest-in-us-fiber-business-swyftfiber.html
[5] https://www.singtel.com/content/dam/singtel/investorRelations/factsheetsAndPresentation/2023/Completion%20of%20Trustwave%20strategic%20review%20-%20FINAL.pdf
[6] https://www.justice.gov/d9/2023-12/2023%20Merger%20Guidelines.pdf
[7] https://www.prnewswire.com/news-releases/roundtable-healthcare-partners-completes-sale-of-tidi-products-to-tjc-302024528.html
[8] https://akumin.com/investor-relations/press-releases/akumin-inc-reaches-agreement-with-stonepeak-to-become-a-private-company/

PE firms typically prefer to hold onto promising assets until exit conditions improve, leading to a dynamic where sponsors delay exits. This resulted in a historically low exit/investment ratio in US PE markets in 2023, dropping to 0.36x. Longer holding periods for PE-backed companies are becoming more common, with the median holding period reaching 6.1 years by the end of 2023. However, the middle-market segment maintains a lower median holding time at 4.8 years, indicating a more favorable environment for exits compared to larger deals.

As PE firms face an impending "maturity wall" for deals made five to seven years ago, they are increasingly turning to continuation funds to extend exit timelines or secure liquidity.[9] This trend is particularly prevalent in the middle market, where continuation funds are becoming a preferred option for many secondary investors. By combining smaller companies into more marketable assets, PE firms can enhance their chances of achieving favorable exits. For example, MiddleGround Capital utilized a continuation fund to extend its hold on Banner Industries and merge it with Castle Metals, resulting in a $440.0 million transaction.[10] Other continuation funds closing on middle-market targets in Q4 include partnerships between Leonard Green & Partners and Carlyle subsidiary AlpInvest, as well as AlpInvest and Kinderhook Industries.

Middle-market funds appear to be balancing distributions to contributions better than the broader PE market, potentially driven by the resilience of PE-backed companies in this segment. The Golub Capital Altman Index reported the highest year-on-year earnings growth in Q4, indicating a strong pipeline of quality companies ready for sale once M&A activity improves.[11]

[9] https://files.pitchbook.com/website/files/pdf/Q2_2023_PitchBook_Analyst_Note_PE_Exit_Timelines_and_the_Impending_Maturity_Wall.pdf

[10] https://middleground.com/news/middleground-capital-closes-440-million-continuation-vehicle-to-combine-castle-metals-and-banner-industries/

[11] https://golubcapital.com/wp-content/uploads/2024/01/23_Q4_GCMMR.pdf

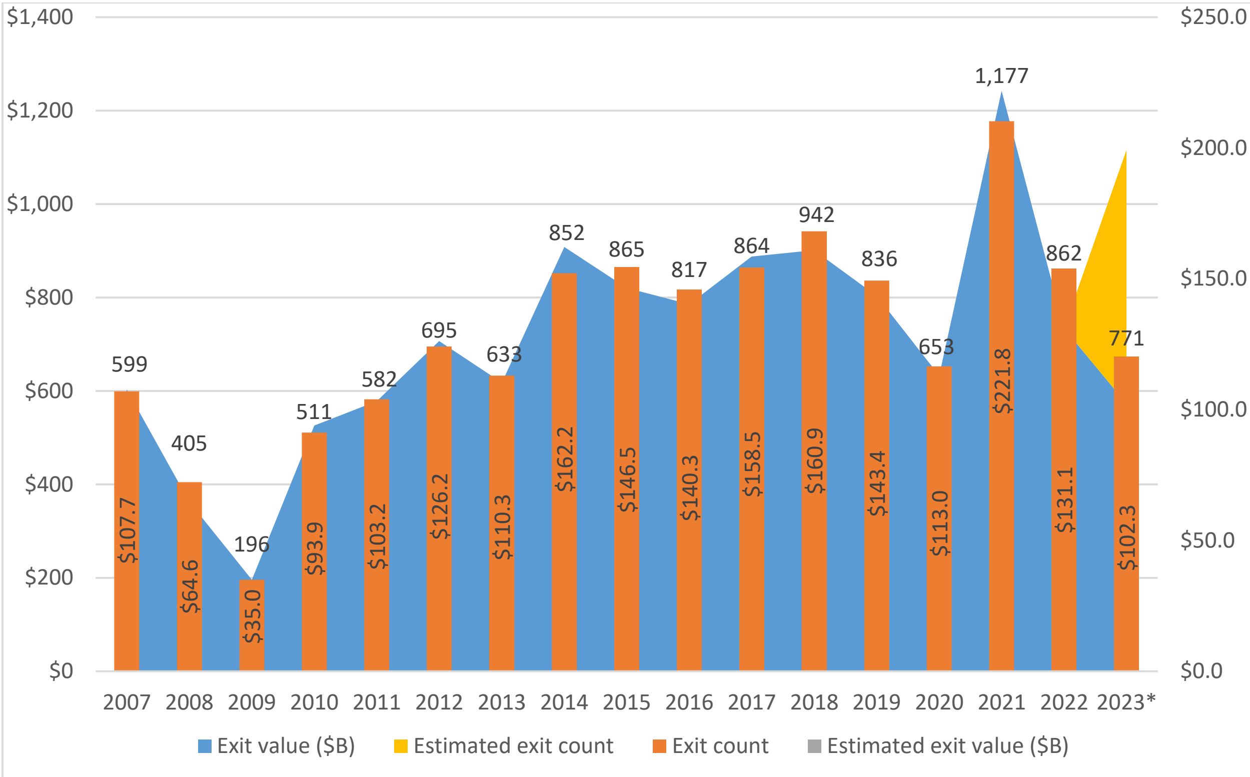

Figure 3: United States Private Equity Middle Market Exit Activity Data

Exits to Other Sponsors

In 2023, exits from private equity (PE) firms to other sponsors witnessed a decline for the second consecutive year, representing a diminishing share of overall middle-market exit activity. Due to the minimal occurrence of initial public offerings (IPOs) in the middle market, it's more significant to focus on sponsor-to-sponsor exits and exits to corporates. Excluding public listings, sponsor-to-sponsor exits decreased from comprising 47.7% of middle-market exits in 2022 to 45.5% in 2023, both in count and value. Throughout the year, an estimated 305 companies were exited to other sponsors, totaling $55.3 billion, indicating a 25.4% decrease year-over-year (YoY) in count and a 25.1% decrease YoY in value. Although Q4 saw a slight increase in sponsor-to-sponsor exits, with a 5.6% rise in count and an 8.9% increase in value compared to the previous quarter, activity remained below historical levels.

Despite an abundance of over $500 billion in dry powder available for middle-market investments, PE buyers faced challenges due to discrepancies in buyer-seller valuations. PE sellers hesitated to sell their assets at perceived undervalued prices, while market conditions such as a weakened financing environment and persistent inflationary pressures hindered overall PE deal activity. However, the median size of sponsor-to-sponsor exits increased to $315.0 million by the end of 2023, suggesting that despite the decline in absolute exits, sponsors managed to secure attractive prices for higher-quality assets amidst a cautious deal environment. With signs of a narrowing valuation gap and the middle market emerging from a robust fundraising year, an increase in sponsor-to-sponsor exits is anticipated in 2024 as more PE firms seek assets to deploy their capital.

Exits to Corporates

In 2023, exits to corporates as a share of middle-market exit value increased, accounting for 45.3% of exits when excluding public listings, compared to 43.3% in 2022. However, both exit count and value decreased from 449 exits totaling $56.4 billion in 2022 to 365 exits for $45.9 billion in 2023, representing an 18% decline from the previous year. Exit activity to corporates reached its lowest point since the height of the pandemic in Q2 2020, with Q4 experiencing particularly weak activity. This decline was attributed to adjusted valuations and corporate hesitancy to make acquisitions amidst an uncertain economic outlook. Despite the decline in median exit size to corporates from $214.0 million in 2022 to $210.0 million in 2023, corporate entities remained cautious in protecting their balance sheets.

Nevertheless, there are signs of improvement, with Q4 witnessing a slight quarter-over-quarter increase in exit value, rising from $8.8 billion in Q3 to $10.6 billion in Q4. The largest exit to corporates in Q4 was the $950.0 million sale of toy and children's products manufacturer Melissa & Doug by AEA Investors, Berkshire Partners, and Metalmark Capital to Spin Master, a global children's entertainment company.[12] This acquisition is expected to enhance Spin Master's retail and e-commerce presence by incorporating Melissa & Doug's product line. Additionally, improving corporate earnings and anticipated stability in inflation and interest rates could further bolster M&A activity from corporates.

Technology

The information technology (IT) sector remained resilient in terms of middle-market exit activity in 2023. There were a total of 113 exits amounting to $16.7 billion. Although both the count and value of exits declined year-over-year (YoY) by 17.5% and 12.8%, respectively, the IT sector's share of middle-market exits slightly increased throughout the year. It accounted for 14.7% of the total exit count and 16.3% of exit value, up from 13.9% and 14.6% in the previous year, respectively. Notably, the IT sector's share of exit value was higher than the pre-pandemic average of 15.3%, while its share of exit count remained flat compared to the pre-pandemic average of 14.7%. This indicates the relative strength of the IT sector compared to other sectors in a subdued exit environment. Moreover, the rate of decline in exit activity showed signs of improvement compared to the significant drop experienced in 2022, with a 12.8% decline in exit value in 2023 compared to a staggering 54.8% decline in 2022.

The Golub Capital Altman Index reported five consecutive quarters of year-over-year positive earnings and revenue growth in the IT sector, with a remarkable 37.0% year-over-year earnings growth for middle-market IT companies in Q4. This suggests that private equity (PE) asset owners will have high-quality assets to sell more easily as the valuation gap between buyers and sellers narrows and exit conditions improve. Exit activity in the IT sector was evenly balanced between sponsor-to-sponsor exits and exits to corporates, with buyouts accounting for slightly over half of the sector's exit activity. While Q4 saw numerous sizable exits to corporates, the largest exit was Brentwood Associates' sale of Parchment, a credential management platform, to Instructure for $835.0 million.[13] This acquisition by Instructure, a leading learning platform, is expected to expand its customer base and enhance its position in the education sector.[14]

[12] https://www.prnewswire.com/news-releases/spin-master-completes-acquisition-of-melissa--doug-a-trusted-brand-in-early-childhood-play-302024756.html
[13] https://www.brentwood.com/news/brentwood-associates-completes-sale-of-parchment/
[14] https://www.prnewswire.com/news-releases/instructure-signs-definitive-agreement-to-acquire-parchment-the-worlds-largest-academic-credential-management-platform-and-network-301971786.html

Healthcare

Exit activity in the healthcare sector experienced another year of decline in 2023, with only 72 exits totaling $10.2 billion. This marked the lowest level of activity the sector has seen in the past 14 years, reflecting the challenges faced by the industry, including high labor and input costs, cost-cutting measures by acquirers, and high interest rates. The healthcare sector's share of middle-market exit activity declined by approximately 3 percentage points YoY, representing the largest share loss of any sector, and now accounts for less than 10% of both deal value and count. Sponsor-to-sponsor exits declined significantly, with only 37 occurring during the year compared to the pre-pandemic average of 61.

Despite the slowdown in exits, PE firms willing to acquire PE-backed companies were able to do so at substantial sizes, with sponsor-to-sponsor exits accounting for more than 66% of the healthcare sector's total known exit value for 2023. For example, the largest sponsor-to-sponsor exit in Q4 was RoundTable Healthcare Partners and Dempsey Ventures' sale of medical device manufacturer TIDI Products to TJC for $900.0 million. It is anticipated that exits will improve in the second half of 2024 as firms feel pressure to provide returns to limited partners and as newly capitalized healthcare-focused PE firms seek to deploy capital. A more stable macroeconomic outlook is expected to support a rebound in exit activity, supported by strong revenue and earnings growth reported by middle-market healthcare companies according to the Golub Capital Altman Index.

Fundraising and performance

Fundraising in the US middle-market buyout space, defined as funds ranging from $100 million to $5 billion in size, surged to close the year as the second-best ever. During the fourth quarter, 42 funds concluded, amassing a total of $34.6 billion. This brought the total fundraising for the year to $141.1 billion, trailing only behind the record set in 2019 with $154.3 billion. It's anticipated that this total will increase further as all late-reporting funds are taken into account. Across all size brackets and categories, US private equity (PE) fundraising outperformed expectations and experienced growth in 2023.

A significant highlight of the middle-market rally was its increased prominence, accounting for 38.1% of total buyout funds closed and 48.0% of the total value of buyout funds closed in 2023. This was a notable increase from 28.3% and 47.3%, respectively, in 2022. The middle-market's strong performance was partly due to its advantage over megafunds for five consecutive quarters starting in Q2 2023. Although this advantage has diminished recently, investors correctly anticipated that smaller funds would have better opportunities in deal-making and performance sustainability in a higher-interest-rate environment, leading to a fundraising cycle that favored middle markets, especially in the first half of the year. This shift towards middle-market dealmakers was evident in the median size of middle-market funds, which increased from $410.2 million in 2022 to $590.0 million in 2023.

Established general partners (GPs) in the middle market have notably succeeded in expanding the size of their funds. In 2023, 92.1% of middle-market funds closed at larger sizes, the highest rate ever recorded, surpassing the industry average. Middle-market funds achieved growth of over 500 basis points higher than in 2022, with a median step-up of 60.8% compared to predecessor funds. For example, Incline Equity Partners raised its sixth buyout fund, closing at $1.9 billion in December, representing a 63.1% increase from the predecessor fund.

Investors continue to allocate capital to middle-market managers, but they face challenges due to delayed distributions caused by the challenging exit environment. Consequently, the delay in distributions has led to less capital available for recycling into the next vintage of funds. This expansion in the median time to close funds, stretching to 14.8 months in 2023 from 11.9 months in 2022, and the median time between funds also increased year-over-year, from 3.1 years to 3.6 years.

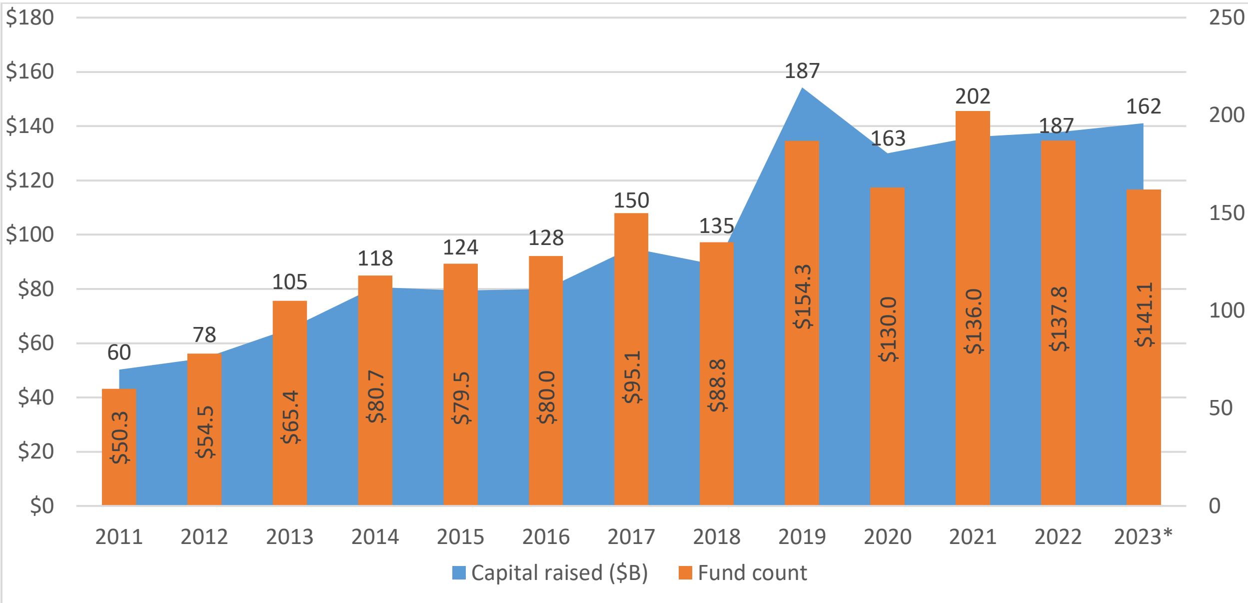

Figure 4: United States Private Equity Middle Market Fundraising Activity Data

Recent Closings

Several large middle-market funds led the rebound in Q4. Four funds between $2 billion and $5 billion in size were closed during the quarter, the highest since Q1. Arlington Capital Partners made the largest close of the quarter, closing its sixth fund at $3.8 billion. This fund will focus on investing in leading companies in the aerospace and defense, government services and technology, and healthcare sectors.[15] Kelso & Company closed its 11th flagship with $3.3 billion in total commitments, while KKR closed Global Impact Fund II at $2.8 billion, targeting companies contributing to the United Nations' Sustainable Development Goals.

Manager	**Fund**	**Fund Value ($M)**	**Close Date (2023)**
Patient Square Equity Partners	Patient Square Equity Partners	$3900.0	February 1
Greenbriar Equity Group	Greenbriar Equity Fund VI	$3475.0	February 6
Arcline Capital	Arcline Capital Partners III	$4500.0	March 21
STG	STG Fund VII	$4200.0	March 23
Parthenon Investors	Parthenon Investors VII	$4500.0	March 27
Accel-KKR Capital	Accel-KKR Capital Partners VII	$4400.0	March 30

[15] https://arlingtoncap.com/news/arlington-capital-partners-closes-latest-oversubscribed-fund-at-3-8-billion/

Altaris Capital Partners	Altaris Health Partners V	$2350.0	June 13
Alpine Investors	Alpine Investors IX	$4500.0	July 12
Kelso & Company	Kelso Investment Associates XI	$3280.0	September 29
Arlington Capital Partners	Arlington Capital Partners VI	3810.0	December 15

Table 2: Top Middle Market Private Equity Fund Closings of 2023

Emerging Managers

The middle market presents an opportunity for emerging managers, defined as those with three or fewer funds launched, including first-time managers. In 2023, emerging managers accounted for 25.8% of all middle-market capital raised, a significant increase from 15.9% in 2020. First-time managers' share of all PE buyout funds also increased during this period. Despite a weaker fourth quarter, first-time managers showcased their strength, with six of the 11 funds closed by emerging managers. For instance, Astira Capital Partners closed its inaugural fund at $675.0 million, specializing in investments in B2B services businesses. Tower Arch Capital secured the largest fund raised by an emerging manager in the quarter, closing its third fund at $750.0 million, focusing on investments across various sectors.

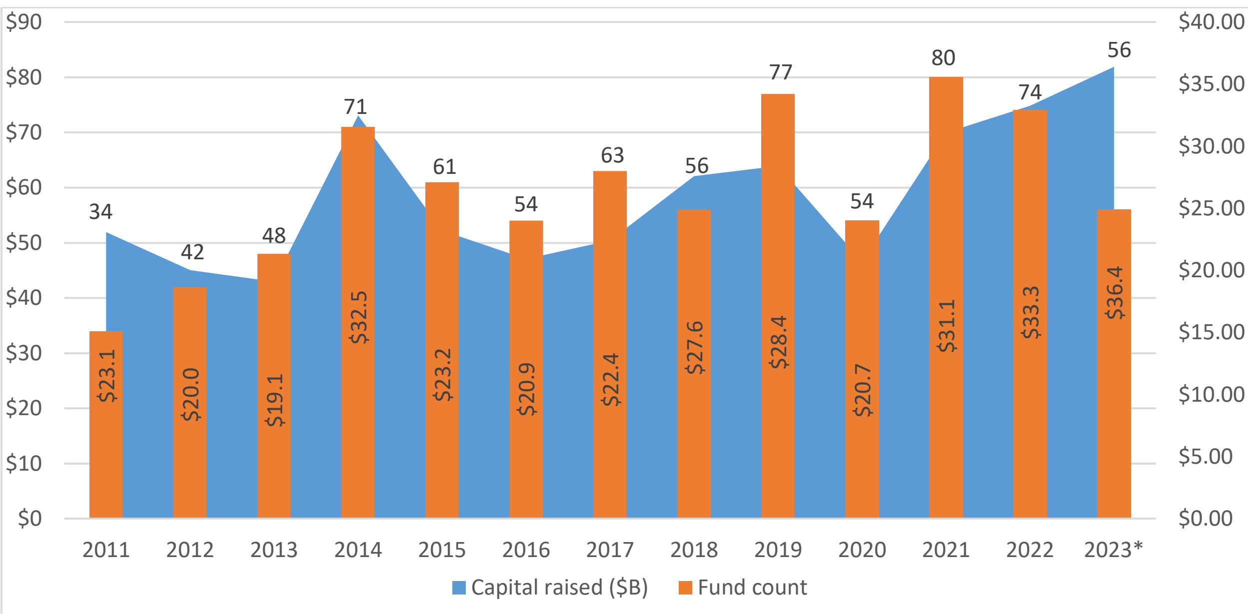

Figure 5: United States Private Equity Middle Market Fundraising Activity by Emerging Managers

Dry powder

As of the second quarter of 2023, middle-market private equity (PE) funds held a record $508.8 billion of dry powder, comprising 51.2% of the total dry powder in the US PE landscape. This share had previously declined from 57.3% in 2018 to 48.9% in 2022 but reversed course in the first quarter of 2023, continuing into the second quarter. The upswing can be attributed to robust fundraising activity observed in the middle markets during the first six months of the year. Current dry powder levels have surpassed the pre-pandemic median dry powder of $367.7 billion from 2017 to 2019. In terms of total assets under management (AUM), middle-market dry powder remained relatively stable at 28.5% in 2023, slightly down from 28.6% in 2022. The accumulation of dry powder continues as PE deployment progresses at a slower rate.

Performance

Middle-market buyout funds outperformed megafunds for over a year, spanning from Q2 2022 to Q2 2023. Typically, these leadership cycles between middle-market funds and megafunds last one to three years before reversing. Based on final estimates of fund returns for the period ending Q3 2023, one-year returns posted by megafunds outperformed middle-market buyout funds, ending the latter's five-quarter winning streak. This shift coincided with the rebound in large-cap public equities, resulting in positive marks to portfolio values.

The narrowing performance gap between the two had been occurring for the past few quarters, mirroring the robust public market rally, which affects megafunds more than middle-market funds. However, as the public market rally broadened to mid- and small-cap companies in Q2, middle-market fund returns held their ground for the most part. After five quarters of middle-market managers outperforming, megafunds have reclaimed the lead, achieving a rolling one-year horizon IRR of 7.9%, slightly edging out the 7.6% achieved by middle-market managers.

Although megafund IRRs have once again exceeded those of the middle market, the middle market remains the cash flow leader. In the first half of 2023, middle-market managers recorded $66.3 billion in contributions and $88.7 billion in distributions, resulting in a positive net inflow to investors of $22.4 billion. Conversely, megafunds saw contributions nearly double the $31.6 billion in distributions, ending the first half with a net outflow of -$30.0 billion. Middle-market funds continue to demonstrate their ability to exit portfolio companies more easily than megafund managers, which could strengthen their position in the next fundraising cycle as they continue returning capital to limited partners, even amid a challenging exit environment.

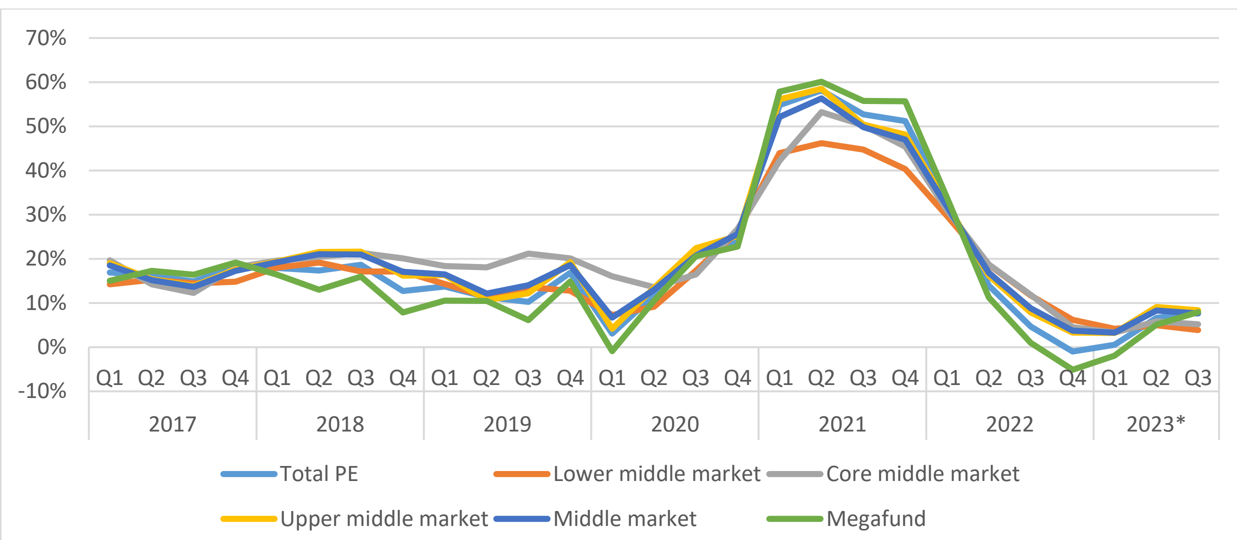

Figure 6: Quarterly Rolling One Year United States Private Equity Fund Performance by Fund Size

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