AMERICAN INVESTMENT COUNCIL

Data provided by PitchBook

Private Equity and Main Street: An Outlook on the Middle Market

SEPTEMBER 18, 2024

A message from Drew Maloney

Main Streets across our country weathered much in the past few years. From pandemic pressures to fierce competition for the best talent to capitalizing on new opportunities to revitalize business lines in key sectors, middle-market leaders have contended with many challenges—and have come out ahead. PE firms were critical partners in helping Main Street businesses surmount those challenges. Armed with record sums of dry powder, PE firms struck partnerships with small to midsized businesses, aiding them in upgrading expensive equipment or technology to better prepare for the longer term, or shifting to different types of organizational structures as the companies scaled.

Per a recent survey from Bank of America, 90% of midsized businesses are still experiencing the ripple effects of inflation.[1] Middle-market business leaders can ally with PE firms to obtain capital and expertise to navigate such challenges and still invest in longer-term initiatives. Hence the popularity of buyouts in the US middle market, which still account for nearly two-thirds of all US PE buyouts. It's also where PE firms tend to do their best work, with middle-market fund returns performing well at 12.7% since Q2 2022, by rolling one-year IRR as of September 30, 2023.[2]

Midway through 2024, even as overall PE dealmaking remains subdued, dealmaking levels in the middle market are staying stable in terms of both value and volume. Pockets of the middle market, such as deals from $50 million to $100 million, are even seeing slight increases.

In this report, we unpack these trends in rigorous, data-driven detail, assessing how they may unroll throughout the rest of the year and beyond. We also summarize the size and impact of the US middle market with some of the latest statistics about that critical, huge population of companies that forms the backbone of the US economy. Furthermore, as in the prior editions of our research reports, we include a highly specific duo of case studies to showcase the convergence of multiple market and sector trends, spotlighting how businesses and PE funds have partnered to achieve new goals.

As always, we hope you find the following analysis and trove of datasets both informative and insightful.

Drew Maloney
President & CEO,
American Investment Council

In this report, AIC analyzes two custom middle-market segments: 1) the core middle market, defined as deals at or under $500 million, and 2) the lower middle market, defined as deals of $100 million or less.

1: "Q1 2024 US PE Middle Market Report," PitchBook, Tim Clarke, et al., June 13, 2024.
2: "2024 Business Owner Report," Bank of America, May 2024.

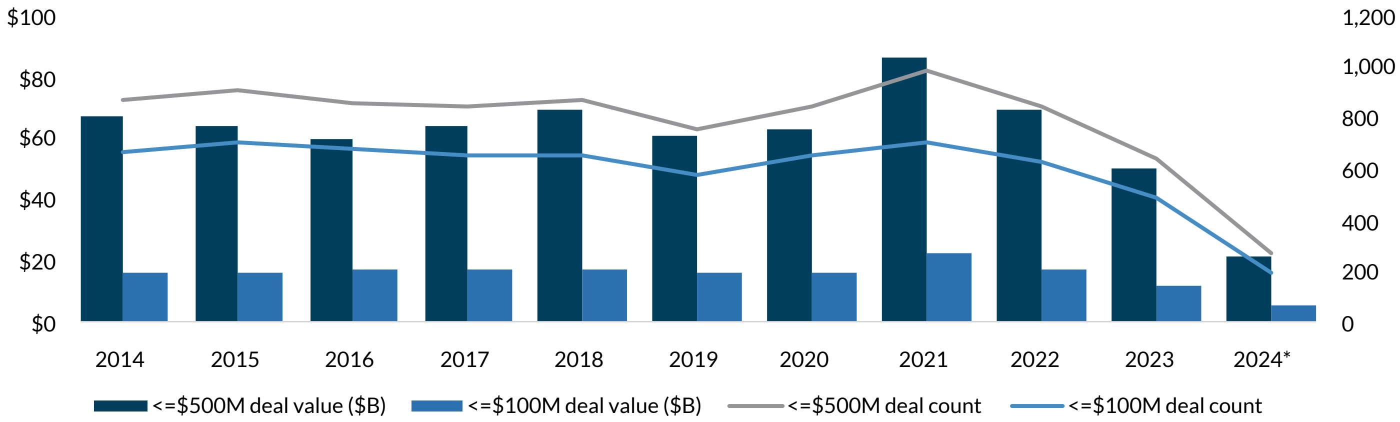
Main Street by the numbers

64.0%	US middle-market buyouts still account for most US buyouts by count, especially as leverage has become more costly and PE firms focus even more on value creation at founder-owned companies.
21%	Estimates range to a degree but it is most recently approximated that middle-market companies, and just those sized between 50 to 250 employees, account for 21% of commercial spending, or $24.2 trillion in 2022 alone.
$13.0T	The US middle market comprises an estimated 300,000 businesses generating about $13 trillion in annual revenue, according to a report from Next Street Financial and JPMorgan Chase & Co.[3] In that report, midsize businesses are defined as those with revenue ranging from $11 million to $500 million.
40.0M	All those businesses employ over 40 million people—or about 30% of all private sector employment in the country.[4]
	The Q1 2024 Middle Market Business Index, produced by RSM and the US Chamber of Commerce, noted that a majority of senior executives at middle-market firms anticipated an improvement in economic conditions throughout the remainder of 2024, accompanied by improving net earnings and revenues.[5]
12.4%	According to the National Center for the Middle Market, 2023 closed with a record rate for year-over-year revenue growth among middle-market businesses, at 12.4%.
8.7%	According to the Middle Market Center's year-end report for 2023, employment growth rates for middle-market companies were projected to hit 8.7% by end of 2024, softening a little since the end of 2022.[6]

3: "The Middle Matters: Exploring the Diverse Middle Market Business Landscape," JPMorgan Chase & Co., November 9, 2023.
4: Ibid.
5: "Q2 2024 RSM US Middle Market Business Index," RSM, June 20, 2024.
6: "Year-End 2023 Middle Market Indicator," National Center for the Middle Market, January 25, 2024.

The state of PE in the MM

PE lower- and core-middle-market deal activity

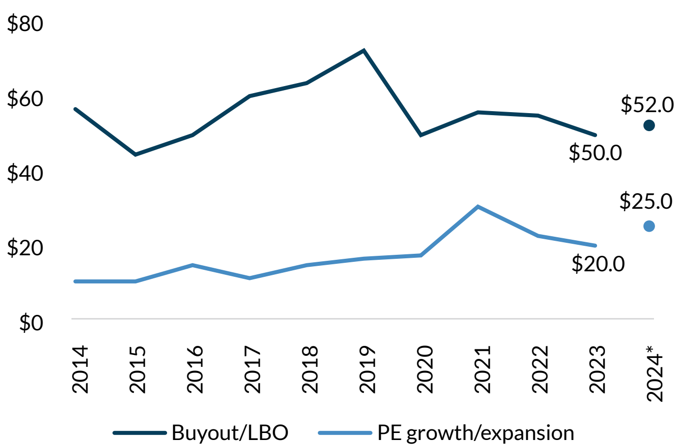


Source: PitchBook • Geography: US
*Data through June 11, 2024

Dealmaking in the US middle market is quieter, but still chugging along. PE dealmakers historically have concentrated buyouts within the US middle market, but especially in recent years, as leverage grew more expensive, dealmaking in smaller size ranges proved more resilient. Add-ons in particular have become even more popular as fund managers aid regional chains in expansion across multiple sectors to form larger platforms that can better compete against megacap, publicly traded companies. Transactions at or under $100 million are proceeding at a pace slightly lower than that of 2023, while those at or under $500 million are further off.

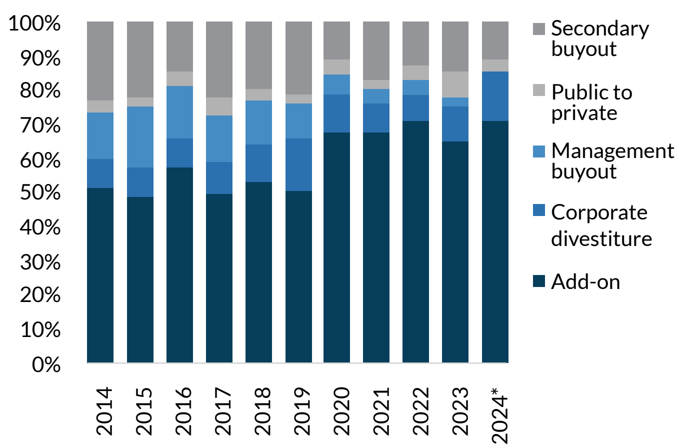
Moreover, median financing metrics are holding steady relative to the past few years. Growth deals have increased in size, as fund managers regained greater confidence in backing middle-market tech companies in particular. The prevalence of add-ons and the healthy volume of deals worth $100 million or less further reinforce that PE dealmakers are striking numerous partnerships with small and medium-size companies that are looking to reach greater scale via roll-ups.

Median core-middle-market PE deal value ($M) by type



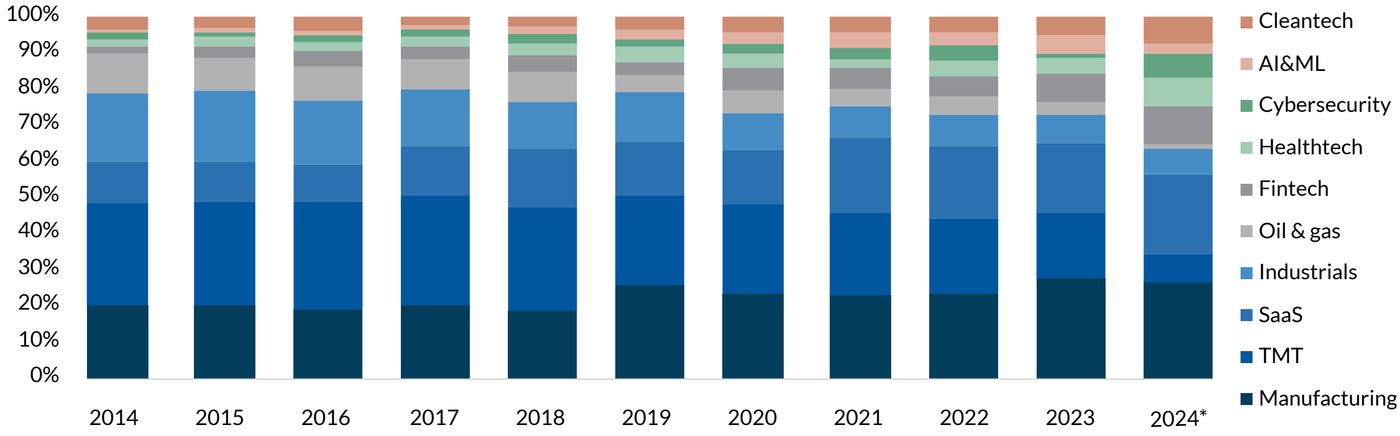
Source: PitchBook • Geography: US
*Data through June 11, 2024

Share of core-middle-market PE deal count by major deal types



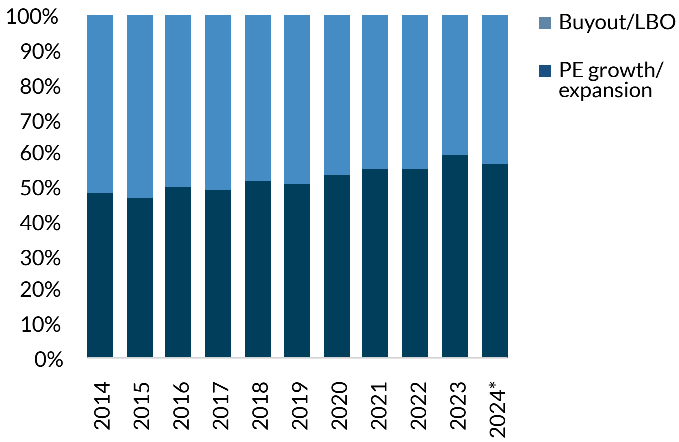
Source: PitchBook • Geography: US
*Data through June 11, 2024

Share of core-middle-market PE deal count by top vertical



Source: PitchBook • Geography: US
*Data through June 11, 2024

Share of core-middle-market PE deal count by deal type



Source: PitchBook • Geography: US
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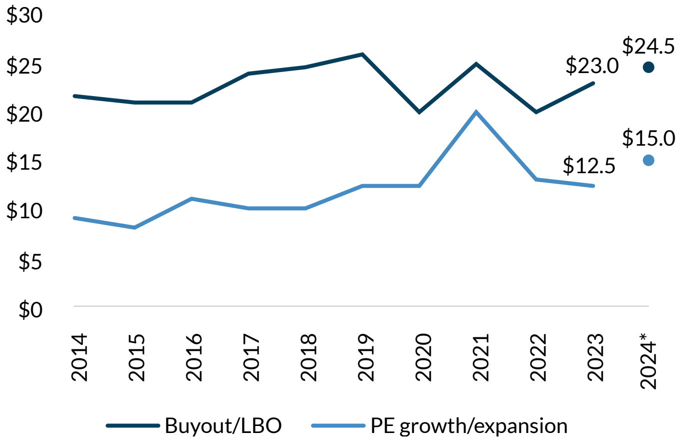
Zooming into the core and lower middle markets (defined as $500 million and under and $100 million and under, respectively), showcases a steady, inexorable rise in the proportion of minority/growth transactions over the past few years, with an unmistakable bump in 2023. In fact, growth investments' proportion of overall PE deal value in the US middle market in 2024 is at an all-time high—well over 40%—at $9.9 billion. Although always deployed by PE firms in multiple types of opportunistic dealmaking, such growth investments may also be more popular now due to the complexity of the dealmaking environment and cost of leverage. Because they are simpler infusions of direct capital, not debt, they also can help fuel growth and investment swiftly, as well as aid in navigating more expensive debt given higher interest rates. It is possible that a rate cut does occur later this year, which could make flexibility with leverage more achievable, but in the interim, PE firms' ample supplies and provision of capital can aid any companies facing shorter-term financing challenges.

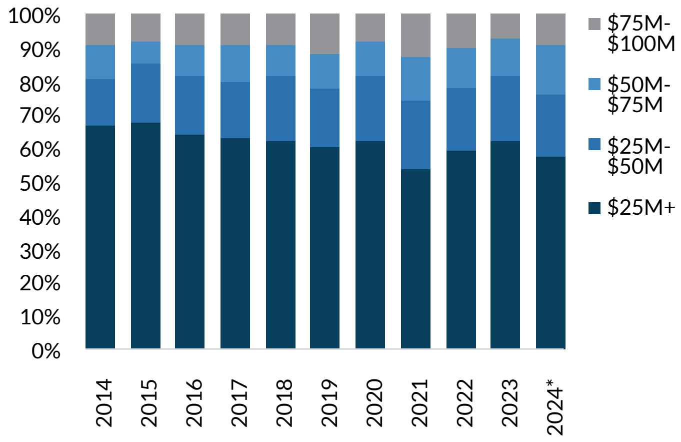
From a sector perspective, PE firms are focusing on middle-market companies spanning software, including software as a service, healthtech, fintech, and cleantech, to a greater degree than ever before. Those segments are not only benefiting from overall digitalization but also can better navigate cost-conscious environments of uncertain economic growth due to lower operating costs or stronger growth drivers. For instance, significant fiscal stimulus and stronger environmental regulations are encouraging greater adoption of energy usage monitoring systems, which can boost customer volume for cleantech software companies and installation providers. In another example, healthtech deal volume has grown as PE firms have targeted software enterprises that provide the tools for hospital chains to improve their recordkeeping, financials and more. Given the pressures of the healthcare industry's specific financial challenges, there are ripe opportunities for companies and PE firms to aid care providers in improving their operations.

Median lower-middle-market PE deal value ($M) by type



Source: PitchBook • Geography: US
*Data through June 11, 2024

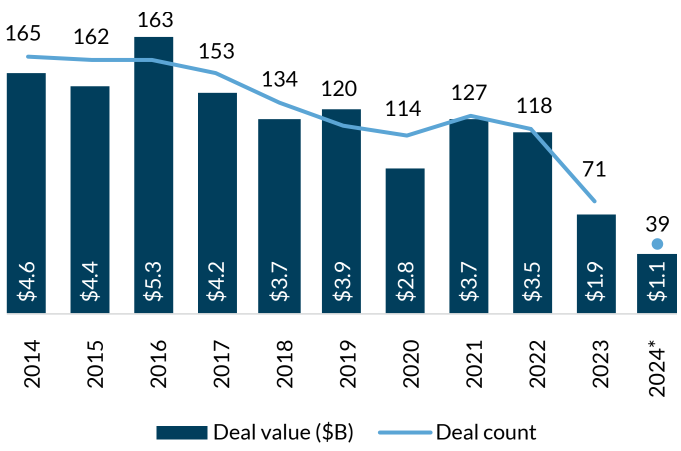
Share of lower-middle-market PE deal count by size bucket



Source: PitchBook • Geography: US
*Data through June 11, 2024

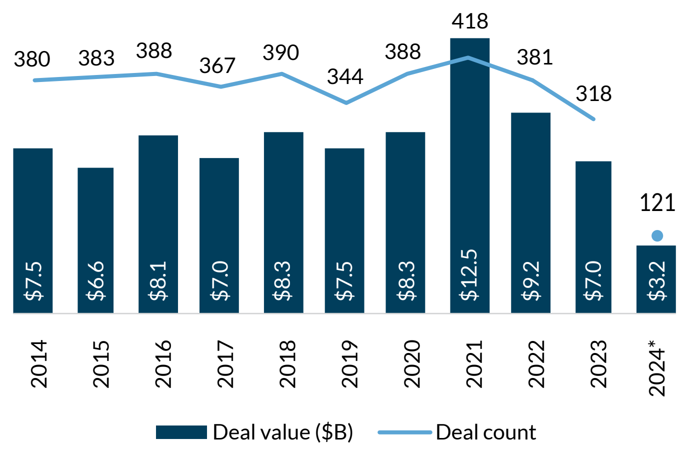
Resilience in median financing metrics among the dealmaking market segment of $100 million or less, paired with middle-market executives' optimism about growth prospects, does suggest that both PE dealmakers and company leadership are increasingly finding common ground in negotiations. Especially as first-time lower-middle-market buyouts may tick up this year, executives are finding value in partnering with PE firms for the first time. In such inaugural deals, there can be more levers for executives and PE operating partners to pull to help revamp or expand businesses. Growing appetite for such deals shows in financing metrics. PE fund managers are willing to deploy more equity as leverage remains somewhat more expensive; business owners are more sanguine and are enjoying a tick upward in median buyout size year over year in the segment of deals worth $100 million or less.

First-time lower-middle-market PE deal activity



Source: PitchBook • Geography: US
*Data through June 11, 2024

Lower-middle-market PE growth deal activity



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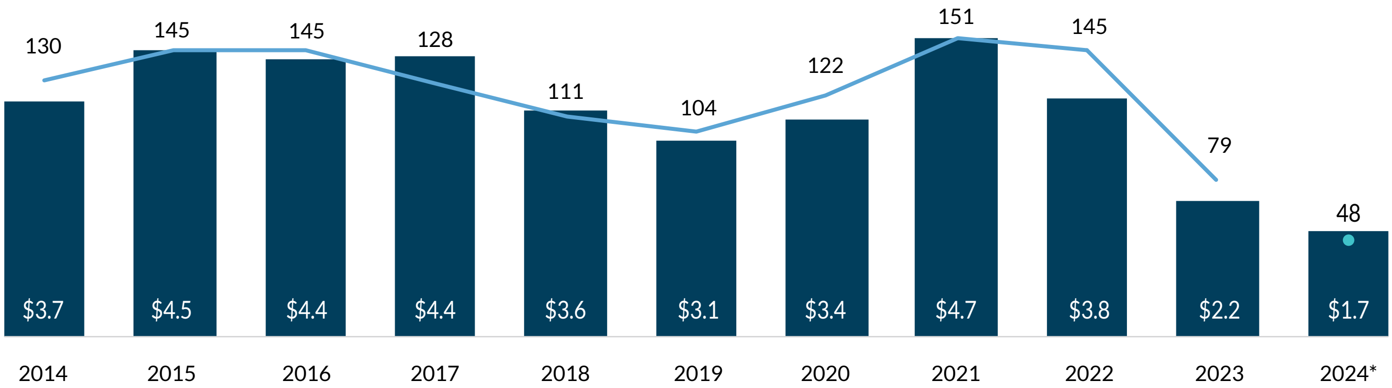
Lower-middle-market PE add-on activity



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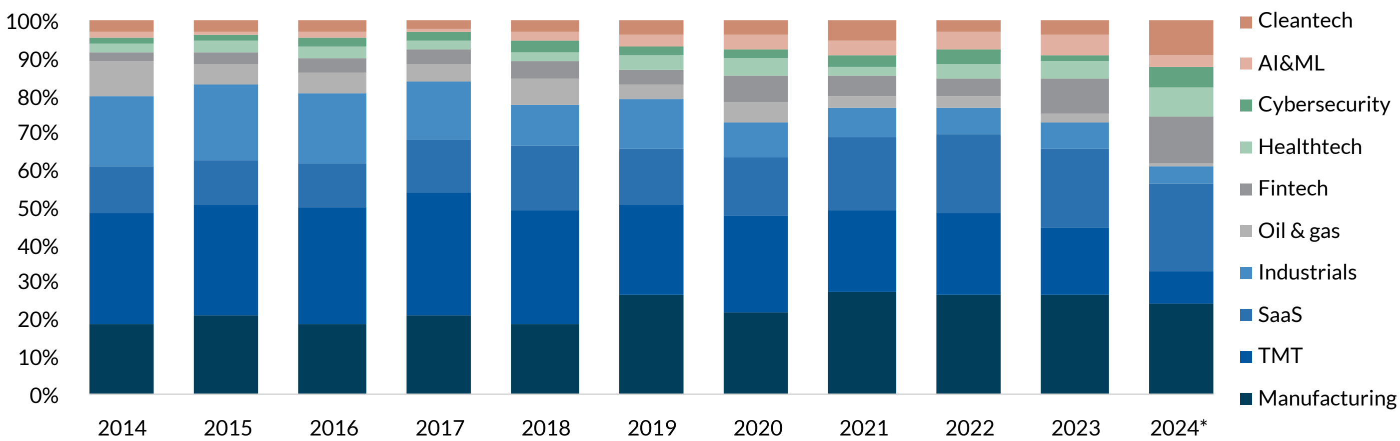
*Data through June 11, 2024

In a related sign of more optimistic attitudes—if not outright ebullience—add-ons of $100 million or less are on pace to significantly rebound in volume after a sluggish 2023. As noted above, growth transactions remain resilient as well, especially in this size segment. Rather than a clear shift to favor either type of deal, it is likely fund managers are going to keep prioritizing such accretive, smaller add-ons as well as minority growth capital infusions, to help improve fundamental financial resilience, weather ongoing challenges from inflation, and more, as noted in macroeconomic data above. Significant challenges in specific parts of the economy remain, including hiring challenges for particular job functions, digital infrastructure implementation, and cybersecurity investment. However, as seen in the following case studies, investment opportunities arise from those same challenges, whether in PE firms partnering with cybersecurity businesses to help them accelerate growth or in capital infusions to expand domestic manufacturers as they look to capitalize on growing demand for locally made goods. It is important to note that anecdotally, PE firms seem more determined than ever to focus on the lower middle market, supporting smaller companies to better expand and contend with megacap chains and conglomerates.

Share of lower-middle-market PE deal count by top vertical



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*Data through June 11, 2024

Case studies

L.S. Starrett

Public-to-private buyout - $195 million

In late May 2024, AIC member MiddleGround Capital acquired a majority ownership stake in L.S. Starrett, a maker of industrial, professional, and consumer measuring and cutting tools and related products. Although a public-to-private buyout, this transaction showcases different trends defining the junction of PE and the US middle market. L.S. Starrett was originally founded in 1880. Growing steadily over the years, the company expanded into multiple precision tool markets. It finally went public nearly a century later in 1973. Now, the company manufactures more than 5,000 types of precision tools for a wide variety of end users, employing just over 1,500 people. Its partnership with MiddleGround Capital via the $195 million take-private will enable a closer focus on core markets, especially as a wide-ranging push to revitalize domestic manufacturing in the US gets further underway. Multiple government programs and bills across bipartisan party lines are flowing in to support the renaissance of key aspects of US manufacturing, which could provide significant tailwinds to many US middle-market manufacturers that have navigated difficult conditions in the 21st century thus far. PE capital and subject-matter expertise can provide financial and strategic assistance in capitalizing on these favorable opportunities.

ZeroFox

Public-to-private buyout by Haveli Investments - $350 million

The take-private of cybersecurity company ZeroFox by Haveli Investments for approximately $350 million in spring 2024 is a fascinating example of multiple market, PE, and sector trends in the US middle market. Throughout the 2010s, the surge of venture investment in the US produced a crop of multiple highly valued fast-growing businesses that eventually went public. However, some of those businesses either discovered that public markets are not their ideal operating domain or struggled due to macroeconomic and industry pressures. As a result, PE firms, armed with near-record sums of capital overhang, have engaged in selective take-private partnerships as of late, deploying specific industry expertise and often drawing in operating partners.

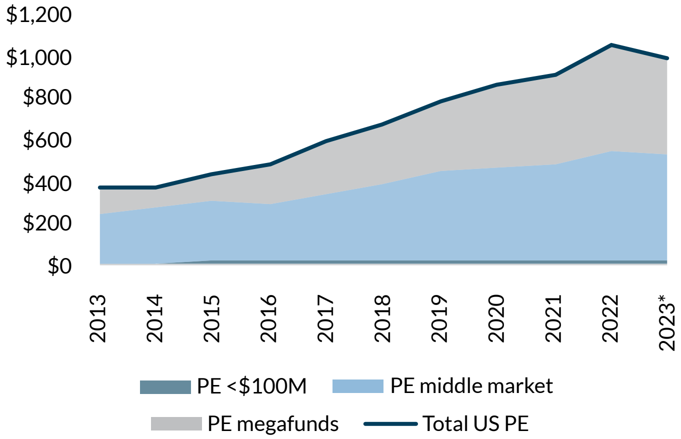
ZeroFox, which provides threat intelligence and protection for a variety of end users such as brands and individuals, is a prime example: It went from seed funding in 2013 to a reverse merger with a special purpose acquisition company in 2022, growing steadily throughout that near-decade. However, its tenure in public markets was marked by challenges in improving margins, so eventually Austin-based PE firm Haveli Investments approached the company with a proposal to take it private. That buyout concluded in May 2024, with Haveli taking a majority ownership position and ZeroFox delisting from the Nasdaq. This type of transaction could likely to see an uptick, even in the core- and upper-middle-market enterprise size ranges, as PE firms look to navigate a challenging dealmaking environment.

The last major trend this deal exemplifies is the growing focus on cybersecurity concerns by middle-market businesses. As noted in the aforementioned RSM Middle Market Business Index's recent special report, cybersecurity is a growing concern for many middle-market executives—37% plan to increase revenue portions dedicated to those departments/teams.[7]

7: "RSM US Middle Market Business Index Special Report: Cybersecurity 2024," RSM, May 29, 2024.

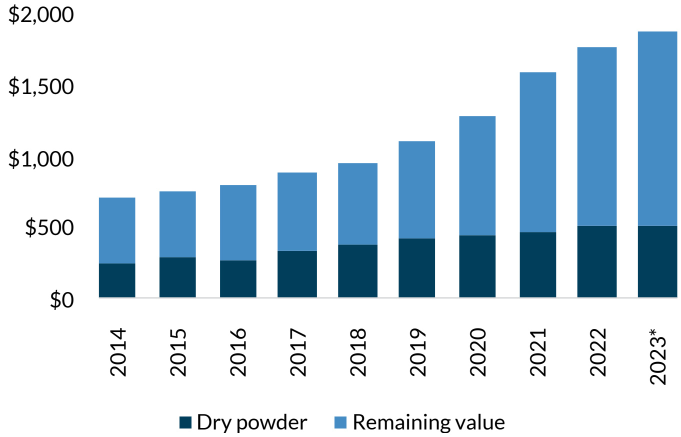
Looking forward

PE dry powder ($B) by fund size



Source: PitchBook • Geography: US
*Data through June 30, 2023

PE middle-market AUM ($B)



Source: PitchBook • Geography: US
*Data through June 30, 2023

The partnership between the US middle market and PE continues to be fruitful. Especially given the sheer size of the US middle market—PitchBook estimates around 5,000 companies comprise the PE-backed US middle-market inventory and estimates the total middle market as up to 200,000 companies—the bulk of PE firms continue to focus on backing US middle-market companies. The middle market has been the backbone of PE dealmaking in the US historically—that does not look set to change but could intensify even further.

Although concerns around economic and market variables persist, ranging from significant shifts in government policies during an election year to an uptick in geopolitical tensions, dealmakers and executives seem to be adapting to the tumult of the post-pandemic period. Consequently, dealmaking sentiment is on the upswing. In particular, family- or founder-owned businesses that are looking to transition ownership or reach a new level of growth are also attracting PE attention, especially as demographics shift. PE firms can provide the capital and expertise for a successful family-owned enterprise to scale even further, thus providing a tailwind of demand from the businesses' side.

Moreover, key datasets indicate significant potential for further dealmaking and exits. PitchBook figures show that the remaining value concentrated in middle-market PE portfolios has never been so high—closing in on $1.4 trillion. That could induce both opportunistic seizing of M&A options or secondary buyouts in order to achieve liquidity as well as encourage other increasingly common measures such as continuation funds. IPOs could also return as market volatility ebbs amid fresh highs for major indexes.

Capital overhang remains at near-record levels for middle-market funds, totaling $499.4 billion. However, this figure shows some capital deployment over the past 12 to 18 months of unsettled market conditions, evidenced by the reduction of capital overhang from close to $520 billion in 2023. Despite this investment, dry powder concentrated in PE funds that are active in the deal range of $100 million or less persists at a record high of $14.8 billion.

As a result, ample supplies of capital are primed to be invested in the US middle market as of now. However, for dealmaking, it is likely that the pace will remain more sedate due to the greater complexity of the current economic and market operating environment. Given that strategies are shifting toward deals for small to medium-sized companies, as detailed in this report, and with the relative cost of capital persisting at an elevated rate, it is even likelier that the US middle market sees the bulk of PE focus going forward.

Methodology

PitchBook's standard report methodologies, which can be found here, were utilized for this report unless otherwise noted. For this edition, American Investment Council developed bespoke deal size ranges to define dealmaking in the US PE middle market, as those deal sizes equated to expected ranges of enterprise values.

About AIC

The American Investment Council (AIC) is the leading advocacy and resource organization established to develop and provide information about the private investment industry and its contributions to the long-term growth of the U.S. economy and the retirement security of American workers. Member firms of the AIC consist of the country's leading private equity, private credit, and growth capital firms united by their successful partnerships with limited partners and American businesses. More information about the AIC can be found at www.investmentcouncil.org.