Katten

2023 KATTEN MIDDLE-MARKET PRIVATE EQUITY REPORT

Aimed at middle-market private equity investors, this report outlines how funds can unlock value amid global economic headwinds and identifies growth opportunities in key industries.

JANUARY 2023 | katten.com

Dealmakers Diverge on PE Outlook Amid Market Uncertainty

Middle-market private equity (PE) firms have mixed expectations for the U.S. mergers and acquisitions (M&A) market in 2023, citing high inflation and concern that interest rates will keep climbing—but dealmakers are maintaining cautious optimism in key sectors. Though many investors expect to make additional acquisitions, some are bracing for a challenging regulatory environment, while others are prioritizing alternative deal types to mitigate impacts from macroeconomic volatility.

That split outlook is reflected in this report, which is based on a survey of 100 U.S. middle-market PE dealmakers engaged in a diverse array of industries, including financial services, education, health care, insurance, manufacturing and industrial, media and entertainment, real estate and technology. Nearly three-quarters of investors expect deal activity in 2023 to either remain at the same level as last year or increase (40 percent and 33 percent, respectively), while over a quarter (26 percent) expect a slowdown.

The amount of dry powder that PE firms have on hand could be driving this disconnect—especially as an overheated economy, domestic policymaking and geopolitical tensions come to a boil. With debt markets tightening and financing harder to procure, liquidity has become crucial to snapping up deals. Though some dealmakers have struggled, others have taken advantage of lower valuations to expand on investments in technology and finance. With the darkening clouds of a potential recession on the horizon—and a clearer picture of what a post-COVID-19 economy will look like—it should come as no surprise that while the majority of market players don't anticipate a deal slowdown in 2023, they are not overwhelmingly bullish either.

When it comes to individual sectors, some dealmakers remain optimistic despite recent media reports of tech and financial sector layoffs, falling stock prices and signs of slowdowns in key industries. More than half of PE firms (58 percent) are investing in financial services, the leading sector, followed by real estate at 48 percent and technology at 43 percent. Further, respondents see ample opportunity in technology and finance, with dealmakers seeing the potential to leverage falling valuations in the tech industry as well as transformational opportunities in the finance sector in the coming months.

Those factors have spurred a series of swift and varied strategies from investors, many of whom have pivoted toward all-equity backstopped deals to gain an upper hand in the bidding process. This deal structure requires that private equity firms agree to fund the full purchase price of a company upfront if they are unable to get debt financing in place prior to the closing date. All-equity deals are viewed by some as particularly aggressive in today's debt-constricted market; however, they ranked as the most important element in successful deal creation in 2023, and a majority of respondents anticipate an uptick in all-equity transactions moving forward.

Whether the current political and economic turbulence will dampen M&A or spur additional activity, it's clear that 2023 presents a wide range of opportunities for dealmakers — even if that means adopting new acquisition strategies to adapt, and thrive, in the face of global market disruption.

M&A Market Remains Buoyant in the Face of Economic Uncertainty and Rate Hikes

WHAT IS YOUR FIRM'S CURRENT STATUS WHEN IT COMES TO THE DEALS IN THE FOLLOWING INDUSTRIES?

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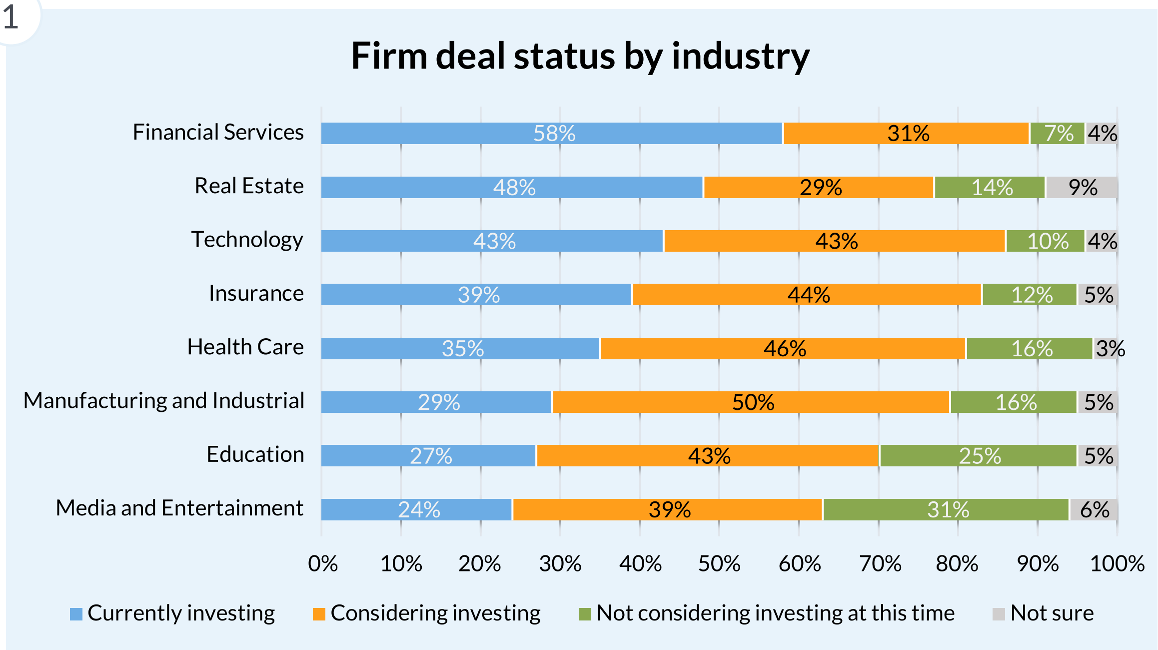

HOW DO YOU SEE THE OUTLOOK FOR M&A OVER THE NEXT 12 MONTHS?

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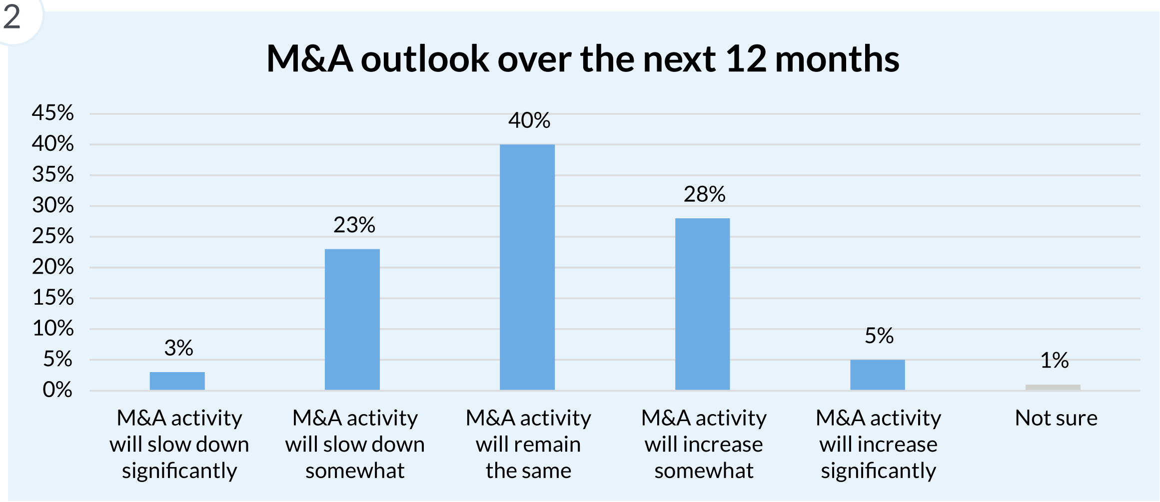


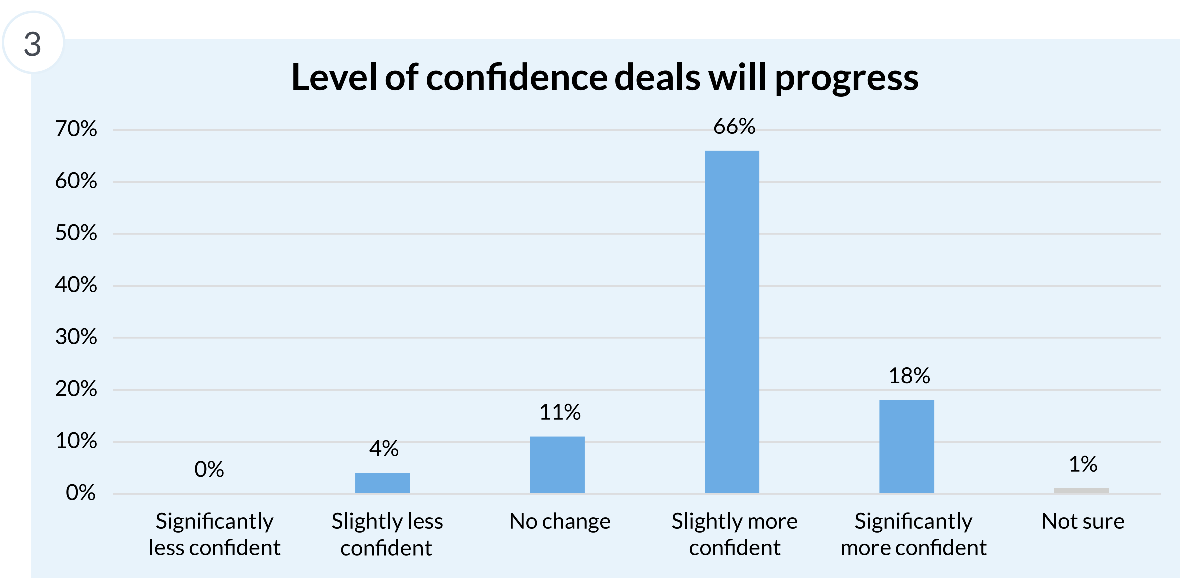
M&A Hurdles Tethered to General Economic Conditions

When asked to name the biggest hurdles to M&A in 2023, dealmakers cite a common set of obstacles connected to macroeconomic trends, and policymaking implemented to combat those trends: the availability of capital (37 percent), inflation (36 percent) and interest rate hikes (33 percent). Since these three factors are closely tied to debt—e.g., persistent inflation prompted the Federal Reserve to raise interest rates, which subsequently made deal financing more expensive—it tracks that dealmakers would rank them in a cluster, with only a 4 percentage point difference between the first and third biggest hurdles.

However, respondents remain largely optimistic that deals will progress as planned: two in three dealmakers say they are slightly more confident that deals will close, and surprisingly, 18 percent are significantly more confident compared to a year ago. In fact, the same macroeconomic obstacles that have dogged dealmakers over the past year could also help deal completion—many buyers know their sellers are less likely to back out of a deal, since finding another ready buyer is more difficult now than when the M&A market was booming.

In contrast, investors say they are more likely to abandon a transaction due to regulatory compliance matters, working capital concerns, and unforeseen diligence results than they were a year ago. Heightened scrutiny from Washington and evolving criteria regarding deals and investments are likely driving concerns about compliance. Most recently, the Securities and Exchange Commission (SEC) has begun firming up rules that will govern the fees charged by PE firms and hedge funds, while the Federal Trade Commission is taking a more aggressive stance toward antitrust and raising concerns about PE deals, including roll-ups targeting businesses in the same sector. Working capital concerns, on the other hand, may be more prevalent due to softer earnings, increased expenses and the limited availability of liquidity. This is further complicated by the higher cost of debt capital, which requires PE funds to take a more conservative stance.

WHEN SIGNING A LETTER OF INTENT (LOI) TODAY, WHAT IS YOUR GENERAL LEVEL OF CONFIDENCE THAT THE DEAL WILL PROGRESS AS PLANNED AND CLOSE, VERSUS THIS POINT ONE YEAR AGO?



FOR YOU AS A BUYER, AND WHEN COMPARED TO THIS PERIOD ONE YEAR AGO, HOW MUCH MORE OR LESS LIKELY ARE THE FOLLOWING MATTERS TO CAUSE YOU TO ABANDON A TRANSACTION?

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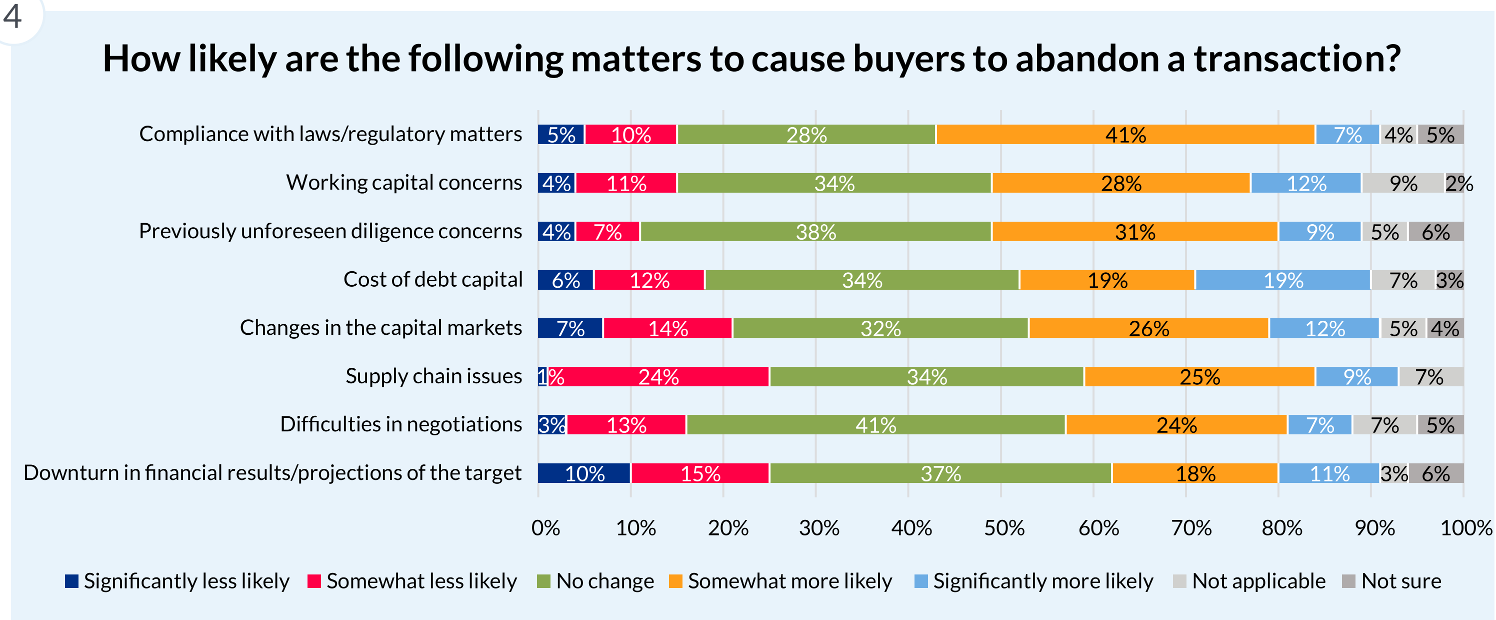

WHAT DO YOU SEE AS CHALLENGES FOR M&A TRANSACTIONS IN 2023?

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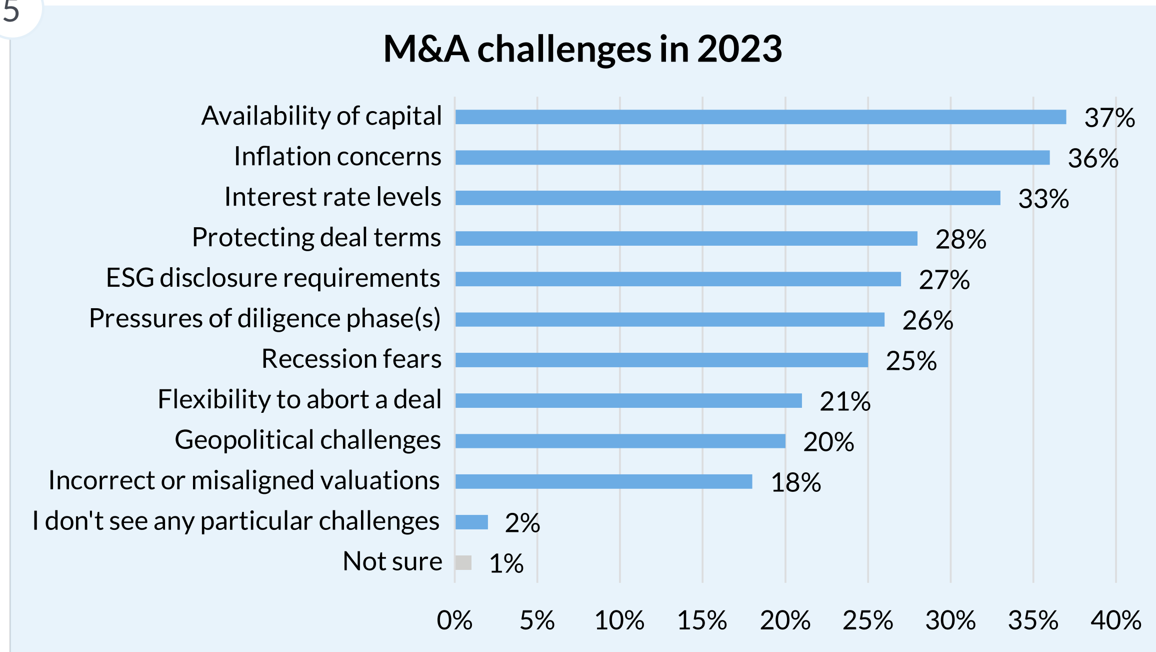

Resilience in Ability to Push Deals Across the Finish Line

When it came to deal completion, 2022 was largely business as usual for middle-market PE firms despite broader market volatility. When asked about key deal provisions — including restrictive and interim covenants, regulatory consents, material adverse change or material adverse effect clauses, closing conditions and more — a sizable majority of dealmakers reported that those provisions have not become more favorable to buyers or sellers over the past 12 months, which tracks closely with Katten's experience over the past year. In addition, the level of due diligence PE firms perform has only changed moderately in the past year—and only 15 percent say they experienced a significant change in the level of due diligence. Looking ahead, dealmakers expect more of the same — four in 10 respondents anticipate similar depth and breadth of due diligence compared to the last 12 months.

RWI aside, 35 percent of dealmakers report increased reliance on buy-side quality of earnings (QofE) assessments and 31 percent are seeing deeper assessments of environmental impact compared to last year. This subtle shift may indicate growing reliance on such tools in areas where an added level of certainty is appropriate. Such reassurances can become more important as the debt markets tighten and lenders continue to lean on strict debt covenants. Dealmakers also anticipate the implementation of transparency requirements for environmental, social and governance (ESG)-focused funds, which the SEC proposed in 2022.

"Due diligence has been largely driven by the representations and warranties insurance (RWI) carriers. Since covering deals with RWI is now standard practice—and many RWI carriers are covering a robust package of reps—most dealmakers are simply trying to meet policy requirements. And while diligence has increased with the rise of RWI, for the most part, buyers are only doing what the carrier requires for underwriting a particular policy."
— **J. David Washburn**, Partner and Co-Chair of Katten's Mergers and Acquisitions and Private Equity Practice

HOW HAS THE LEVEL OF DUE DILIGENCE CHANGED OVER THE PAST YEAR?

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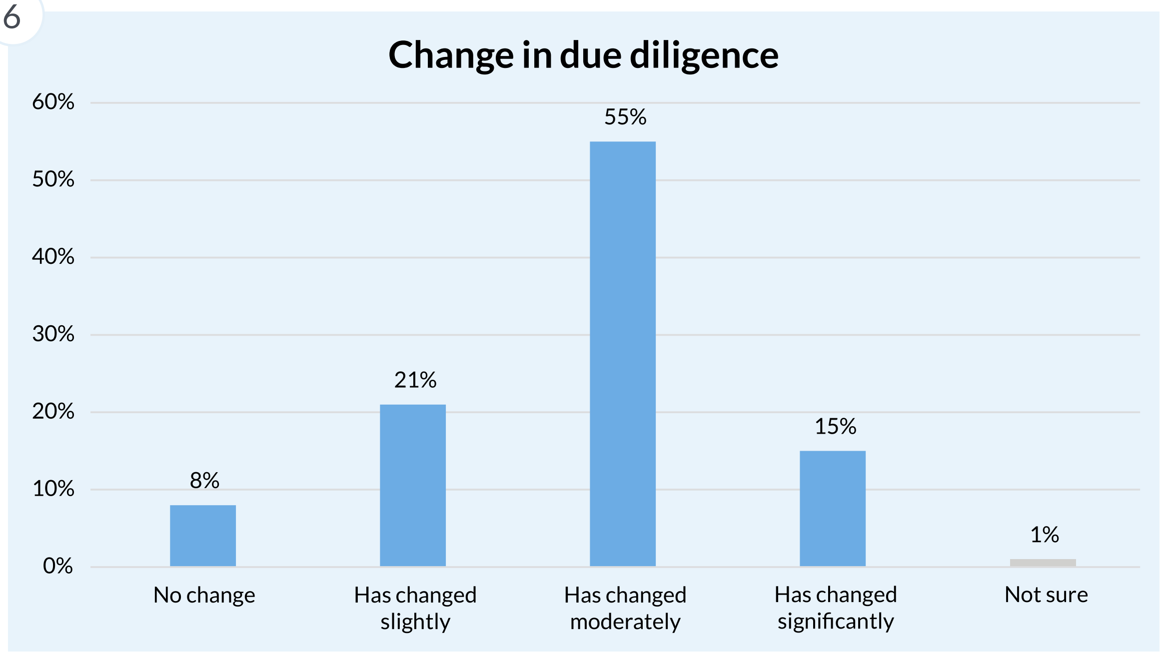

WHAT ARE YOUR EXPECTATIONS FOR THE BREADTH AND DEPTH OF DUE DILIGENCE AT YOUR FIRM COMPARED TO A YEAR AGO?

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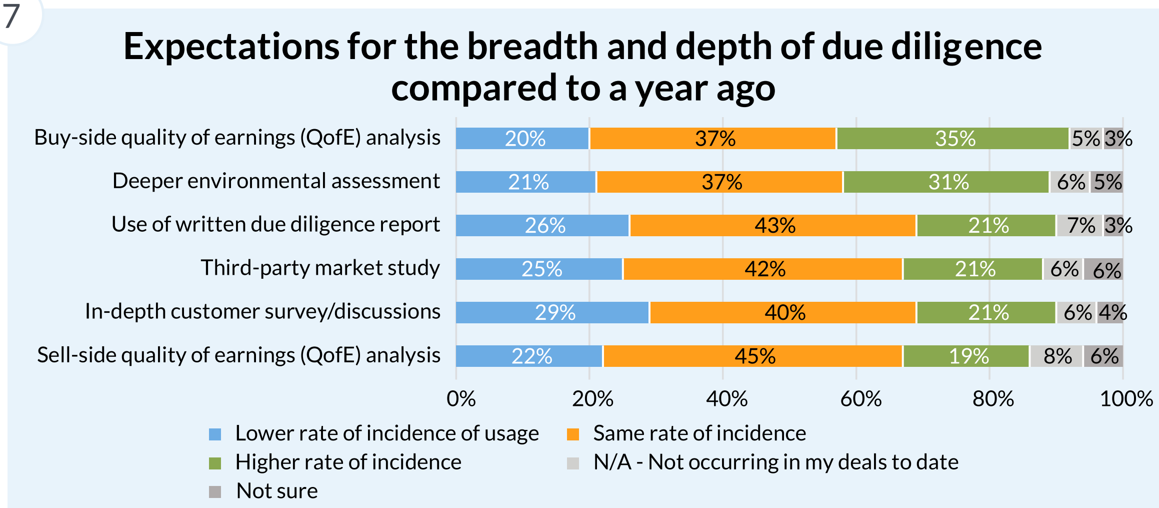

HOW HAVE THE FOLLOWING PROVISIONS CHANGED IN FAVORABILITY OVER THE PAST 12 MONTHS?

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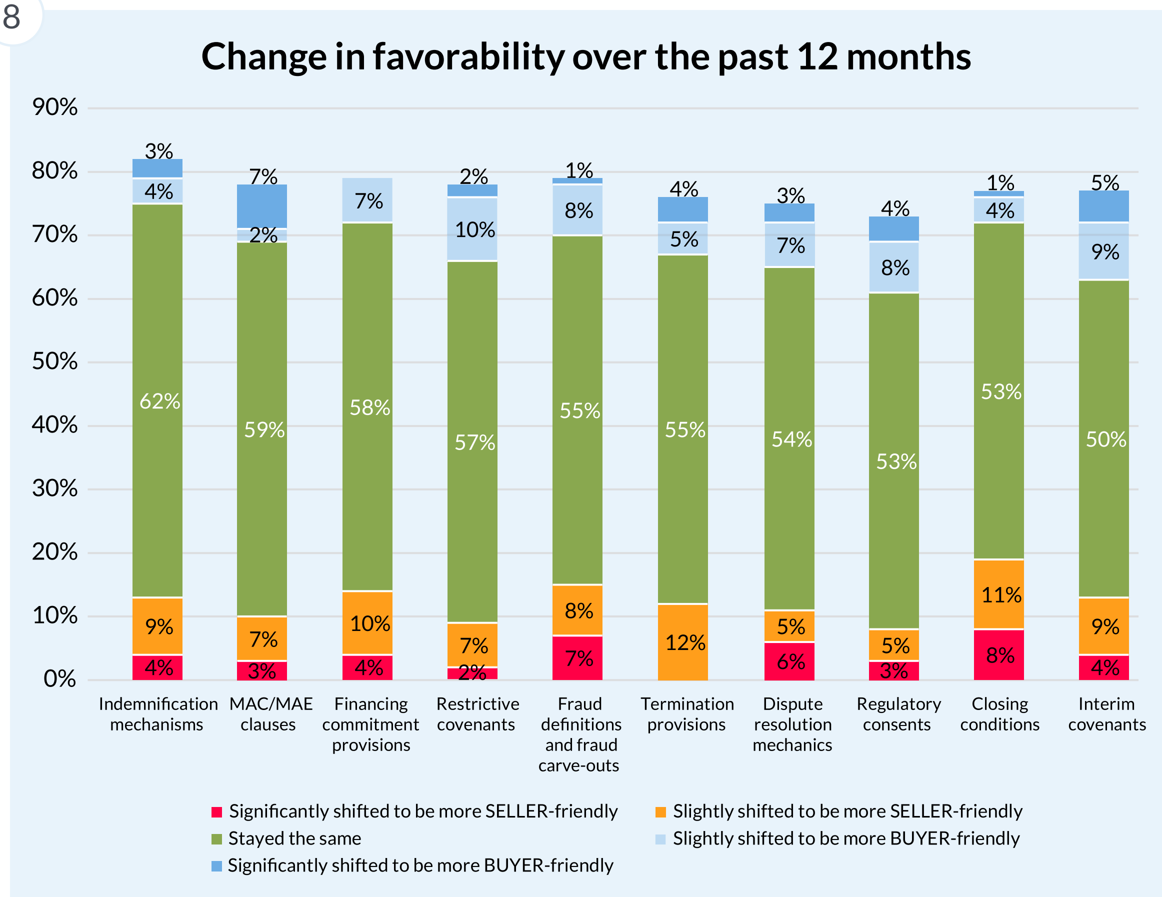

Despite Obstacles, Dealmakers See Opportunities in Finance, Tech and Real Estate

The majority of PE firms report that they are currently invested in financial services (58 percent), followed by real estate (48 percent) and technology (43 percent). Perhaps in a bid to mitigate market fluctuations affecting specific sectors, dealmakers are considering a diversified array of investments across industries like manufacturing (50 percent), health care (46 percent) and insurance (44 percent). As PE professionals look ahead, they expect financial services (54 percent), technology (47 percent), insurance (34 percent) and real estate (32 percent) will present the best opportunities for dealmaking.

The tech industry has been attracting investors despite tumbling share prices and widespread layoffs, as depressed valuations hold the potential to yield high returns. The largest share of respondents believe financial services (54 percent) is an area of opportunity over the next 12 months, followed by technology (47 percent). Specifically, almost six in 10 dealmakers anticipate transformational opportunities will be the primary catalyst for deals in the tech industry over that period. Given the industry's longstanding attraction for investors, dealmakers may simply consider this a strategic moment to enter the fray.

"Deal volumes in the health care sector have remained durable in spite of rising interest rates and fears of an economic downturn. PE firms are investing in new technology and innovative assets that enhance patient care. As interest in value-based care continues to grow and the demand for digital health services increases, deal activity in this sector is likely to remain strong in 2023."
— **Kimberly T. Smith**, Partner and Global Chair of Katten's Corporate Department

As for financial services, 31 percent of respondents rank falling valuations as the main reason they expect opportunistic dealmaking within the sector over the next 12 months. For fintech in particular, global investment dipped in 2022 after topping out just above $210 billion in 2021, which was certainly impacted by last year's plunge in cryptocurrency market value. But fintech deals have experienced sky-high valuations in years prior, suggesting acquisitions of targets with lower valuations could eventually prove lucrative if the market rebounds.

Amid the backdrop of a global pandemic and housing shortage across the United States, the real estate sector is also an area where investors expect tailwinds in the coming year. Nearly a third of respondents (32 percent) believe the sector represents the greatest opportunity for dealmaking in 2023. Buildings under long-term commercial leases have been sliced into smaller segments, garnering greater revenue and higher demand. Local governments are incentivizing office-to-residential conversions in downtowns emptied out by the shift to remote work. It makes sense, then, that for this sector dealmakers see the greatest potential in deals involving government policy, tax incentives, higher rental prices and secondhand housing transactions.

Middle-Market PE Firms Remain Cautiously Optimistic in Select Industries

WHICH INDUSTRIES DO YOU THINK REPRESENT THE GREATEST OPPORTUNITIES OVER THE NEXT 12 MONTHS?

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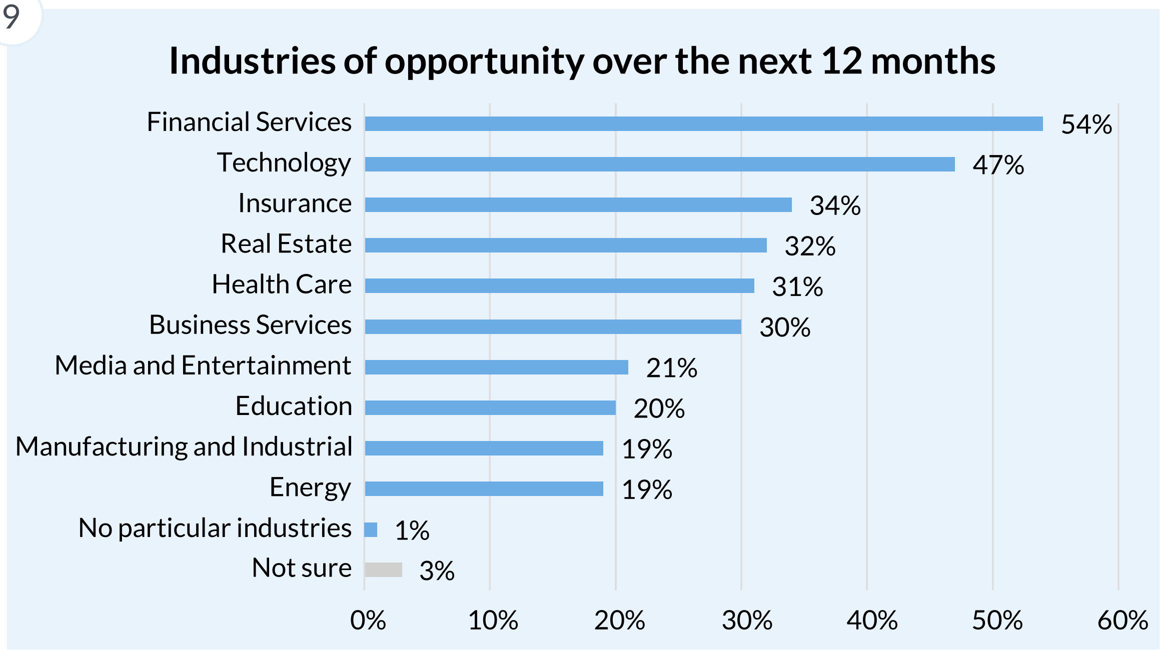

WHICH ATTRIBUTE WOULD YOU CHOOSE AS THE PRIMARY CATALYST FOR OPPORTUNITIES IN THIS INDUSTRY? *ASKED TO THOSE INDICATING AN OPPORTUNISTIC INDUSTRY.*

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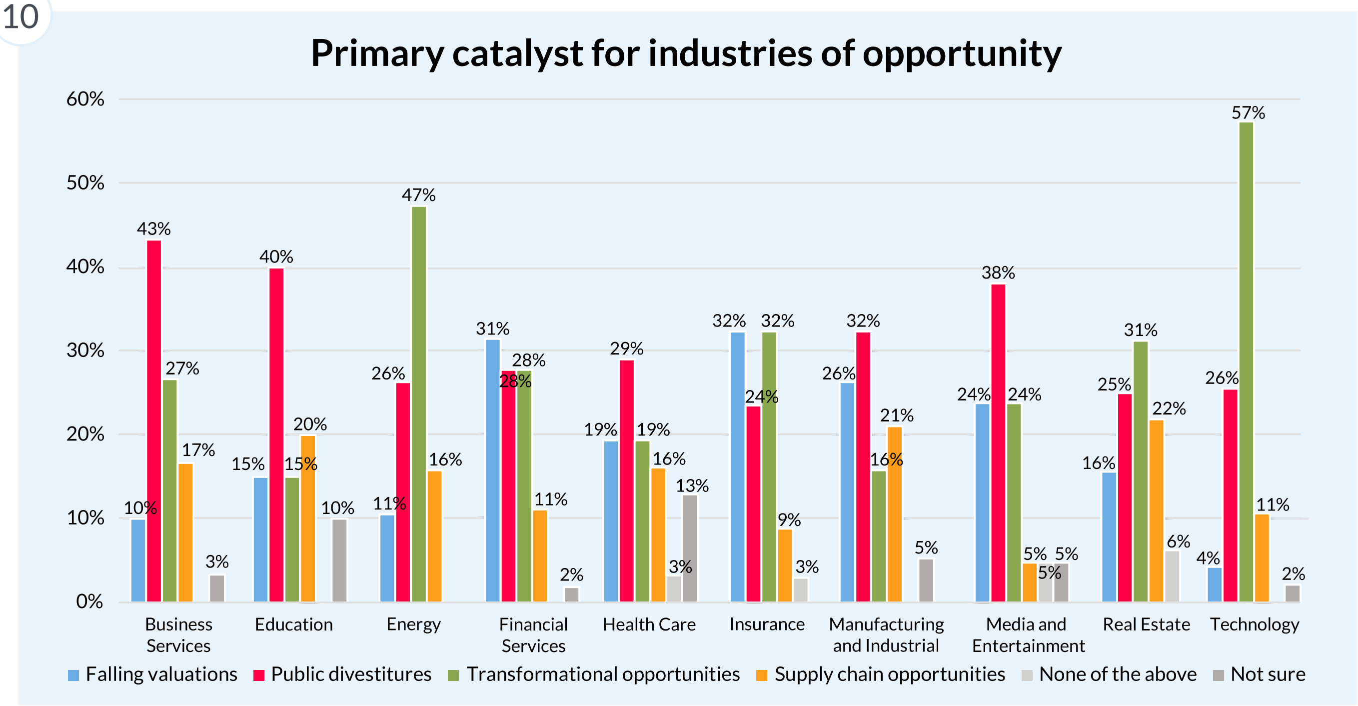

All-Equity Deals Rise, Acquisitions Outlook Uncertain

A competitive M&A landscape appears to be fueling a rapid shift to all-equity deals, which require buyers to fund the full purchase price of a company if the debt is not available by the closing date. This approach allows PE firms to move quickly and provides sellers greater certainty of closing. The result has been a series of high-profile all-equity deals in 2022.

Middle-market PE dealmakers are clearly taking notice. Forty-one percent of respondents believe all-equity deals will be an important contributor to winning deals in 2023. Changes in fund terms (39 percent) and greater protection between signing and closing (39 percent) follow close behind. Furthermore, three-quarters of respondents expect an uptick in all-equity deals in 2023, and a majority of respondents engaged in them more than half the time over the past year.

As more investors begin to adopt this strategy, its status as a market differentiator in the bidding process will only subside. Respondents recognize that all-equity deals lean high-reward, low-risk today—but an element of risk is always involved in all-equity deals, and they stand to get riskier given recent changes in the debt markets.

"Dealmakers' trepidation may stem from debt market uncertainties. Ideally, a platform acquisition involves an industry leader with established market share and a highly capable management team. These deals often demand higher purchase prices and, consequently, favorable debt terms to produce the requisite ROI. And while PE firms typically expect to make tuck-ins and bolt-on acquisitions reasonably quickly and confidently, today's uncertain debt markets create risk in implementing that strategy. As a consequence, we very well may see fewer platforms in 2023."
— **J. David Washburn**, Partner and Co-Chair of Katten's Mergers and Acquisitions and Private Equity Practice

"With a multitude of economic factors weighing on dealmakers this year, a prudent approach and tempered outlook is understandable — but it is telling that many investors still see pockets of opportunity in this market and that our clients are still fighting extremely hard on the buy-side to win deals. Dealmakers are looking to gain an upper hand in today's debt-constricted market through any means possible. In years past, buyers tried to differentiate their bids with rep and warranty insurance to reduce post-closing exposure for sellers. Now that nearly everyone is doing that, the focus seems to be more on providing certainty of a quick and uneventful closing — especially as the waters get choppier."
— **Christopher S. Atkinson**, Partner and Co-Chair of Katten's Mergers and Acquisitions and Private Equity Practice

As for acquisitions in general: Almost three in four dealmakers expect to make additional platform acquisitions in 2023 — a robust number, but in a typical year of dealmaking, that figure would likely be higher. These tempered expectations are, in part, driven by falling valuations which inevitably bring fewer assets to market.

In addition, as investors look for short-term value — perhaps recognizing that under current market conditions they are not going to get the same multiples upon an exit that they have previously — dealmakers are turning to bolt-on acquisitions. In fact, more than half of respondents plan to opportunistically use bolt-on acquisitions in 2023.

Dealmakers Bullish on All-Equity Deals

WHICH FACTORS DO YOU THINK ARE KEY TO SUCCESSFUL DEAL CREATION IN 2023?

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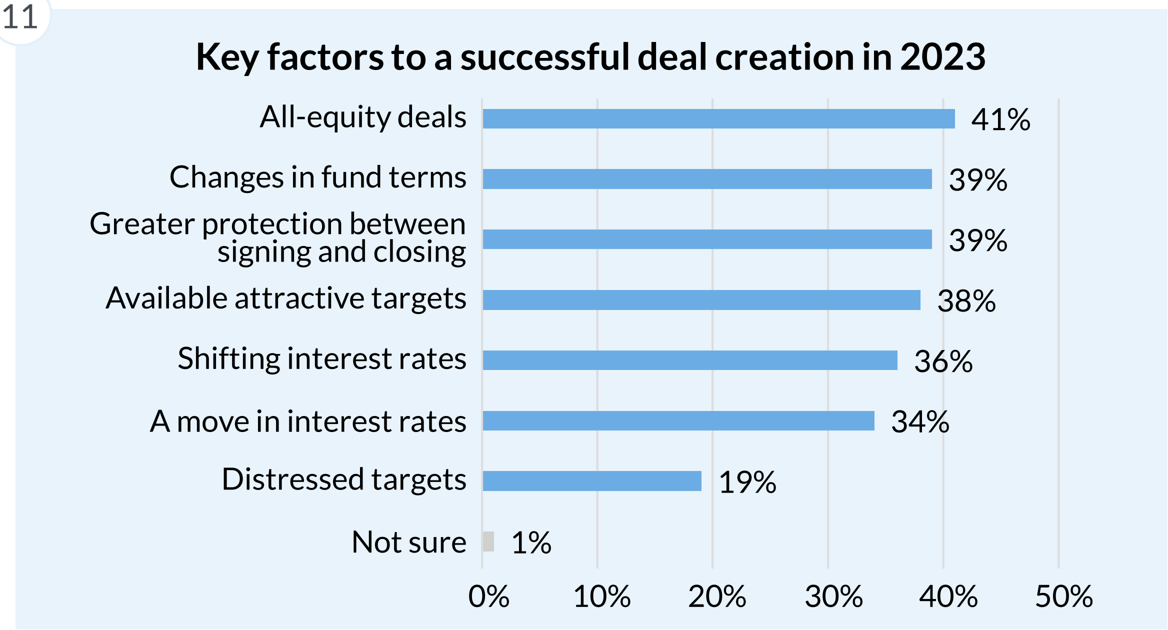

IN THE PAST YEAR, WHAT PERCENTAGE OF YOUR DEALS WERE ALL-EQUITY TRANSACTIONS, EITHER AS A BUYER OR A SELLER?

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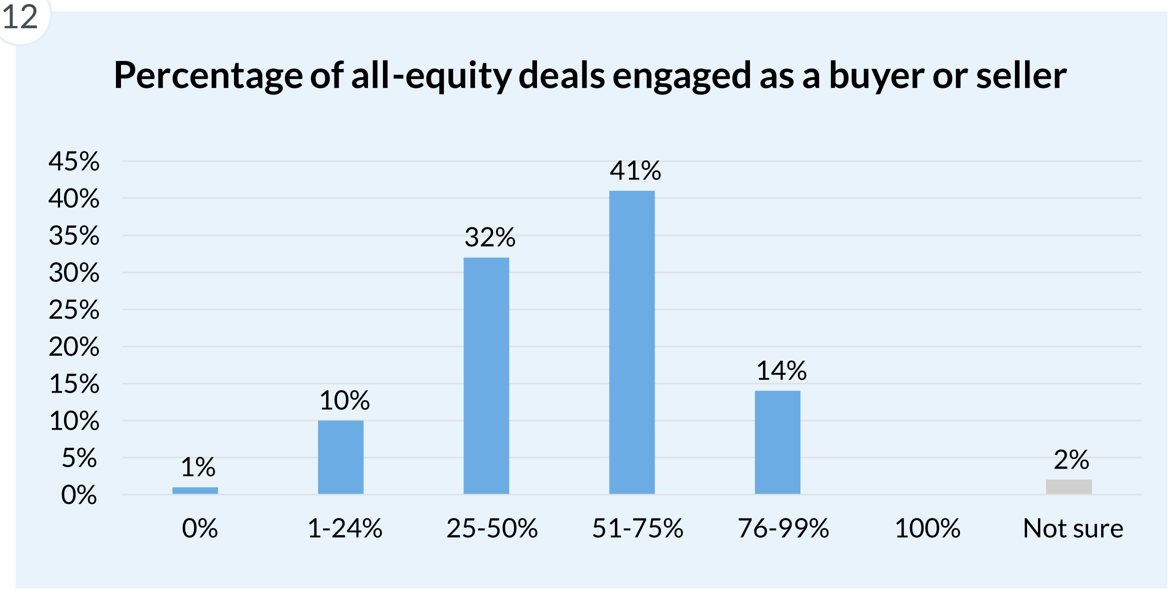

Dealmakers Bullish on All-Equity Deals *(continued)*

WHAT DO YOU THINK IS THE OUTLOOK FOR ALL-EQUITY DEALS IN 2023?

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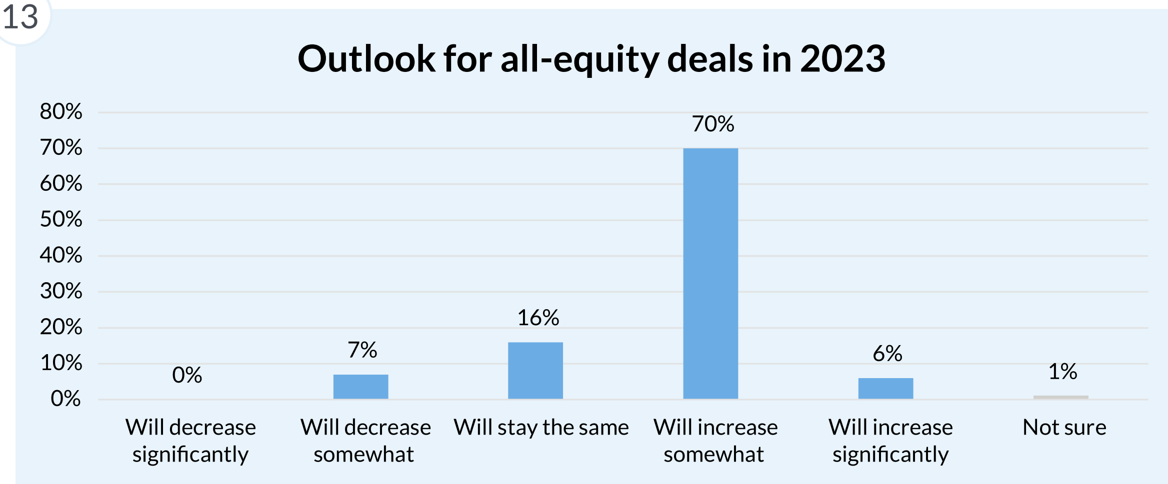
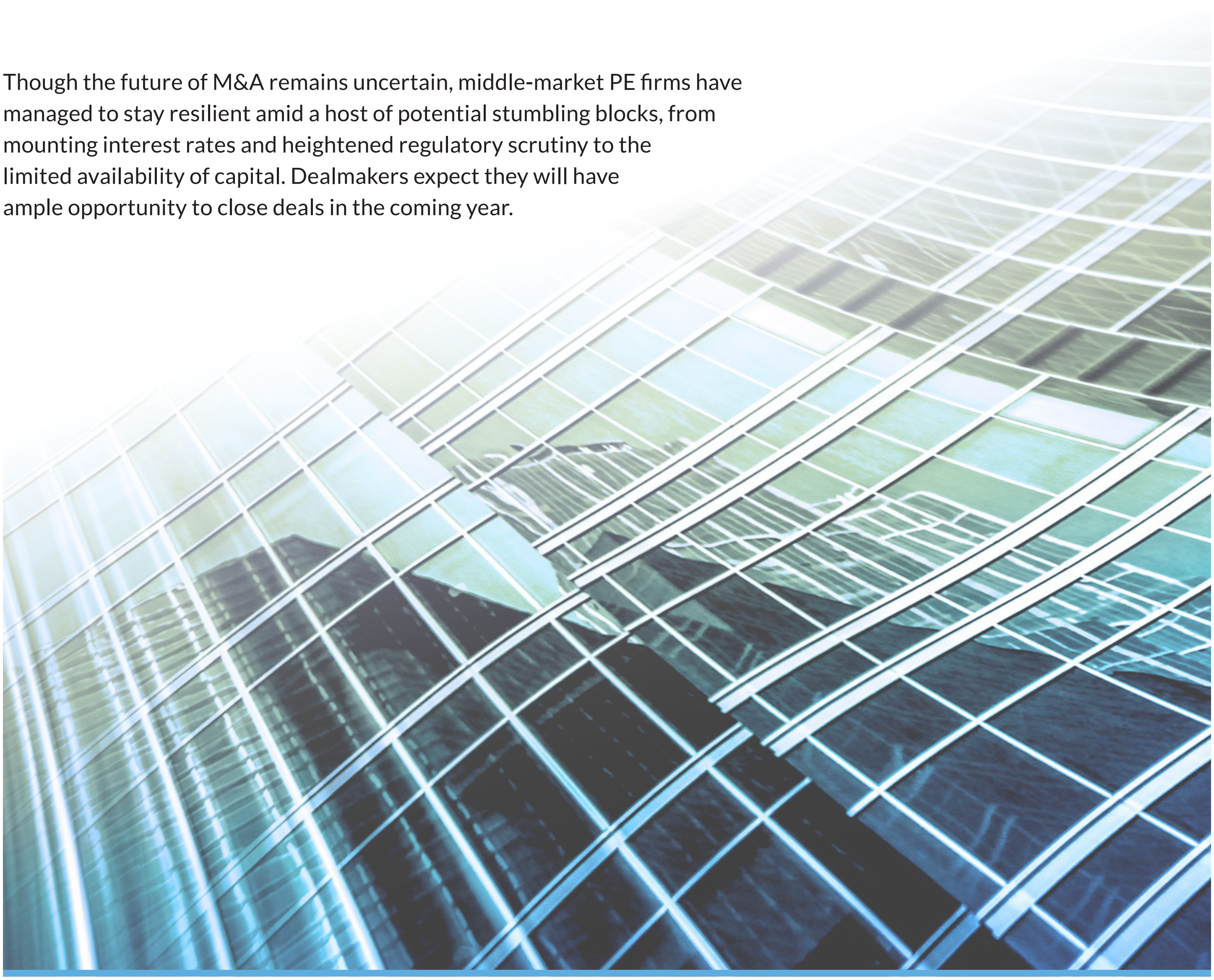
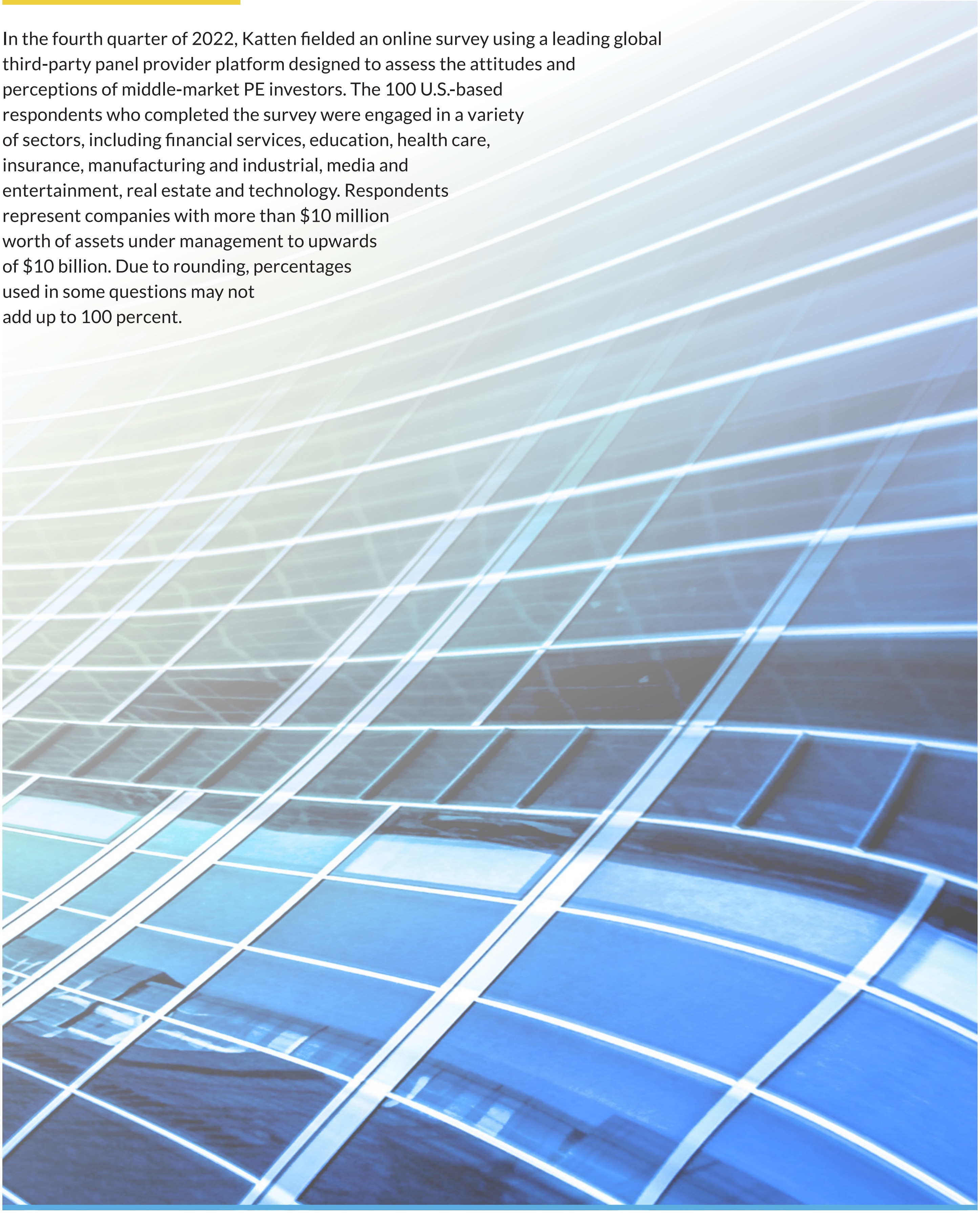


Though the future of M&A remains uncertain, middle-market PE firms have managed to stay resilient amid a host of potential stumbling blocks, from mounting interest rates and heightened regulatory scrutiny to the limited availability of capital. Dealmakers expect they will have ample opportunity to close deals in the coming year.



Methodology and Demographics

In the fourth quarter of 2022, Katten fielded an online survey using a leading global third-party panel provider platform designed to assess the attitudes and perceptions of middle-market PE investors. The 100 U.S.-based respondents who completed the survey were engaged in a variety of sectors, including financial services, education, health care, insurance, manufacturing and industrial, media and entertainment, real estate and technology. Respondents represent companies with more than $10 million worth of assets under management to upwards of $10 billion. Due to rounding, percentages used in some questions may not add up to 100 percent.



About Katten

With approximately 700 attorneys serving public and private companies, Katten is the firm of choice for clients seeking sophisticated, high-value legal services in the United States and abroad. Our collaborative, entrepreneurial culture leads to true partnerships with our clients. We understand and focus on our clients' business objectives and address their legal needs in a manner consistent with their "big picture." We have a reputation for being trusted advisors, and we demonstrate our value every day in the successful results we deliver.

About Katten's Private Equity Practice

To get good deals done, private equity investors must contend with sky-high valuations, compressed timelines and unprecedented competition. When opportunities do appear, the stakes are high and investment parameters complex. Katten cuts through the legal issues that bottleneck deal flow and provides the immediacy, intelligence and integrity private equity investors demand.

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