

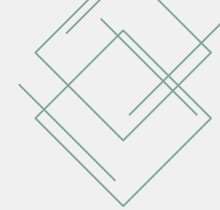
RCP Advisors

Q2 | 2017

State of the Middle Market:
Insights Into The High Valuation Environment



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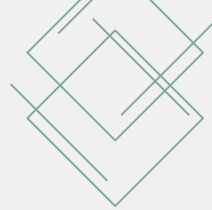
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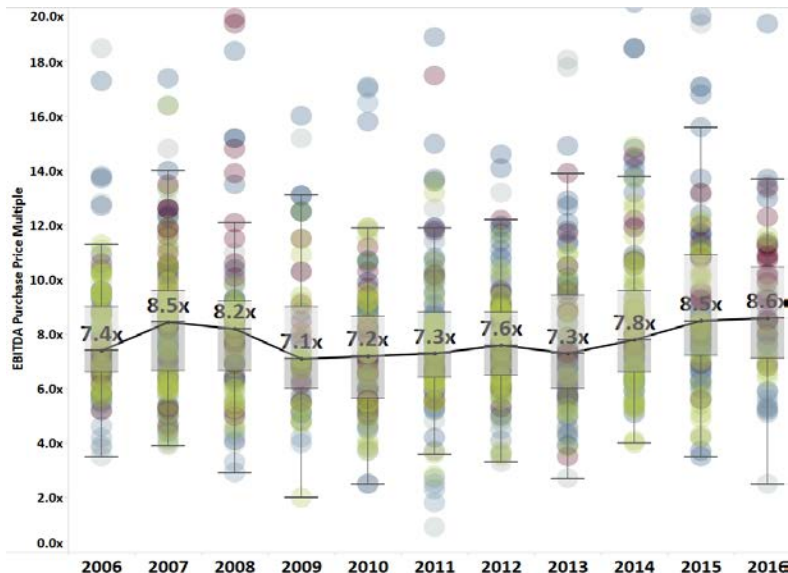


Purchase Price Multiples (by Deal Size)

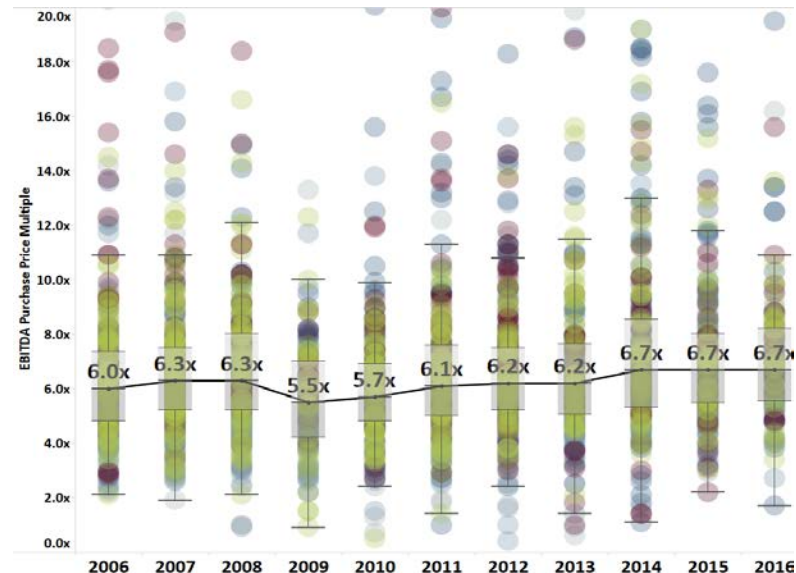


Valuation Environment Remains Elevated

>\$100M Enterprise Value



<\$100M Enterprise Value

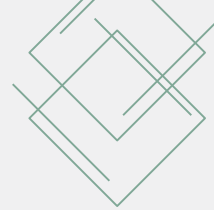


- » Entry valuations remain at pre-recession highs throughout the market
- » Recent run-up in entry valuations of smaller deals (<\$100M initial Enterprise Value) has been more muted than larger deals (>\$100M initial Enterprise Value)
 - Entry valuations for larger companies continue to increase year over year and have surpassed previous peak of 8.5x reached in 2007
 - Entry valuations for smaller companies have not increased since peak of 6.7x in 2014, but remain higher than previous peak of 6.3x reached in 2007 and 2008

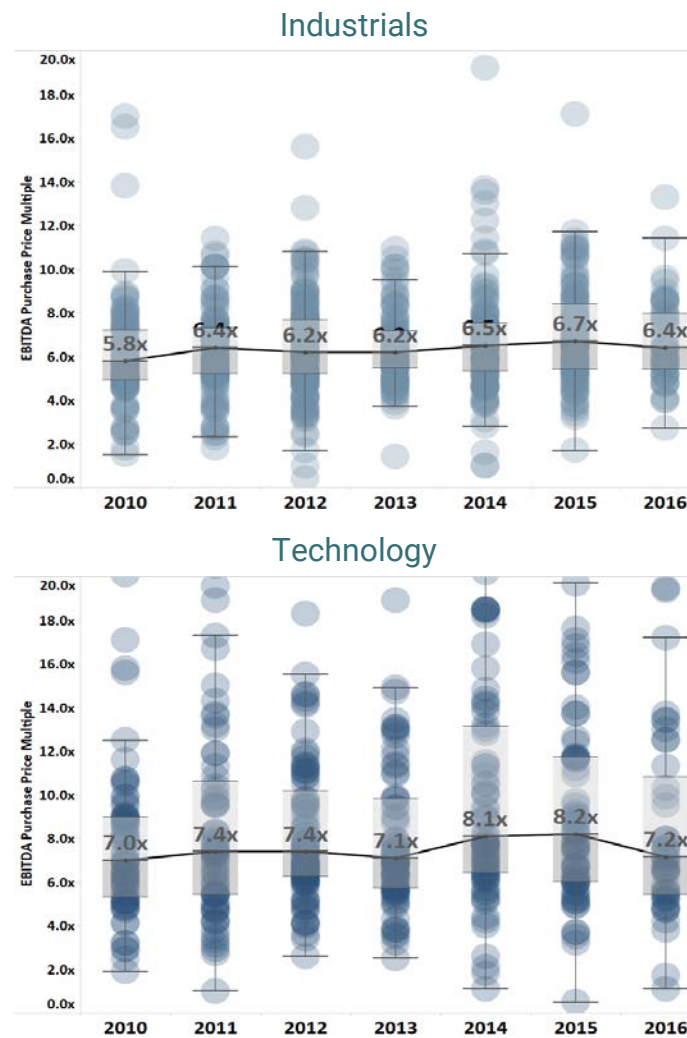
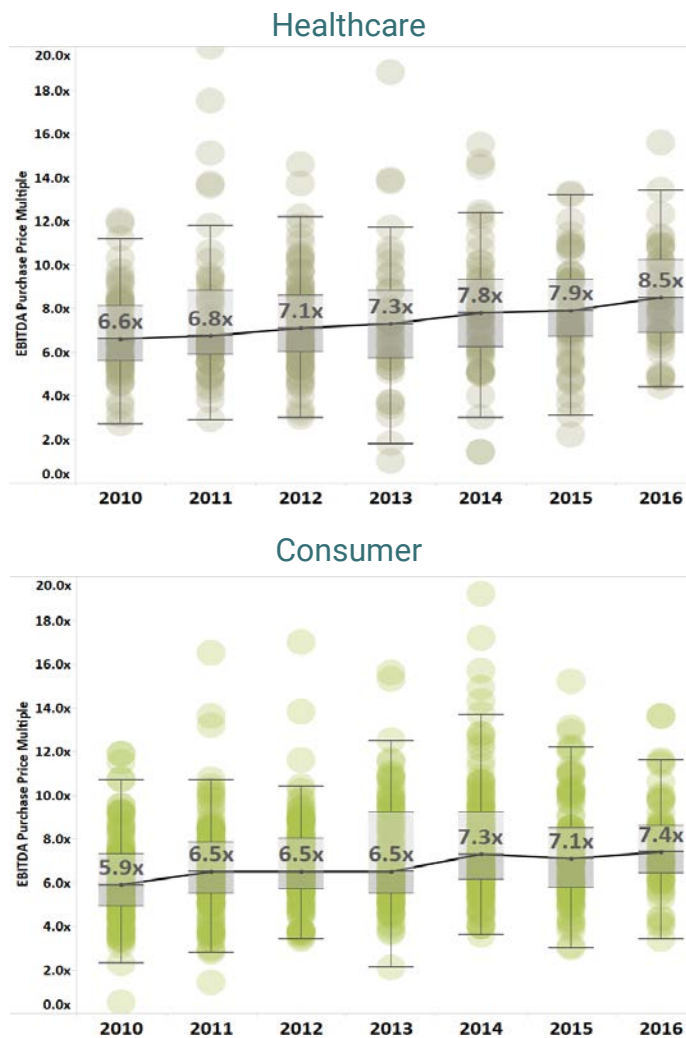
Source: RCP Database.



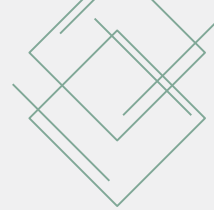
Purchase Price Multiples (by Sector)



Various Levels of Deviation From General Upward Trend Within Sectors



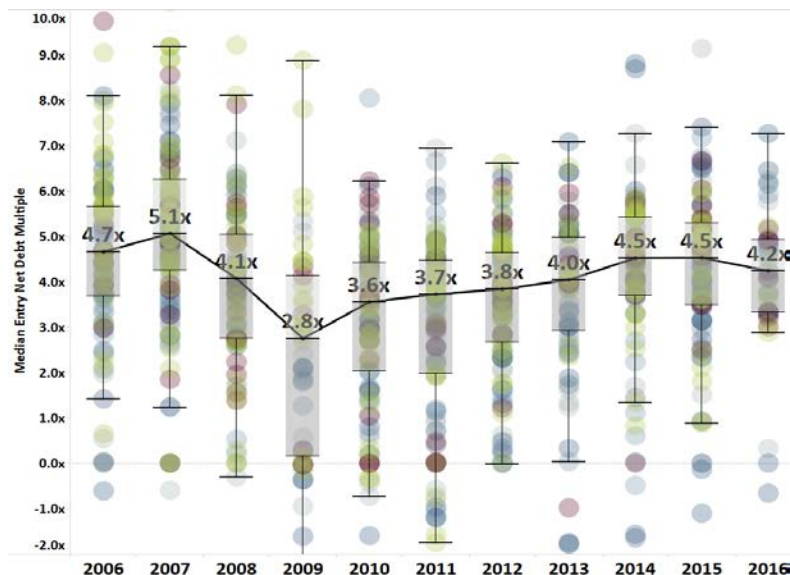
Source: RCP Database.



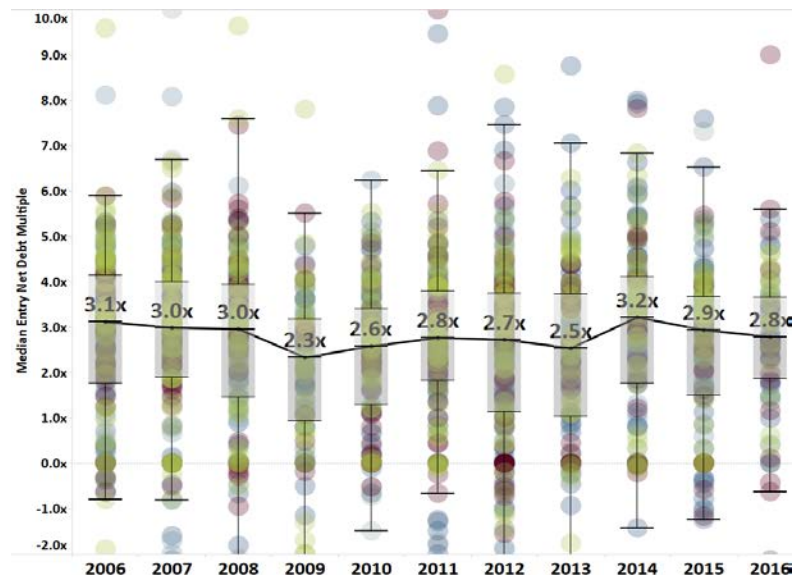
Net Debt Multiples (by Deal Size)

Recent Stability, Slight Decline in Leverage Multiples

>\$100M Enterprise Value



<\$100M Enterprise Value

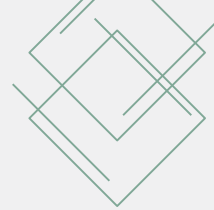


- » The last three years have been characterized by relatively stable leverage multiples with slight declines since 2014 highs
- » Leverage levels in larger deals have been more volatile
 - Significant difference (2.3 turns) between pre-recession highs (5.1x in 2007) and post-recession lows (2.8x in 2009)
 - Notably, current median net debt multiples are meaningfully below pre-recession levels
- » Leverage levels in smaller deals have exhibited more long-term stability
 - Less than a turn of difference between pre-recession highs (3.0x in 2007) and post-recession lows (2.3x in 2009)
 - Ultimately, current median net debt multiples are only slightly below pre-recession levels

Source: RCP Database.

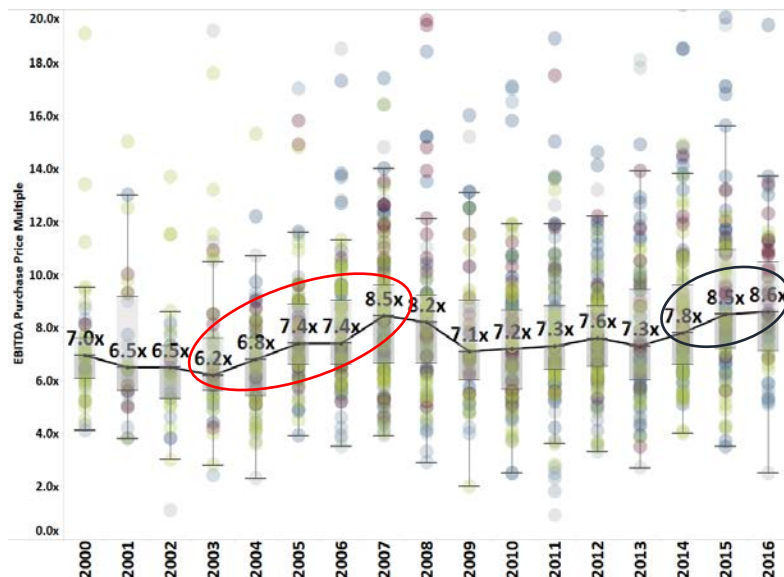


Valuations and Leverage: Transactions >\$100M EV

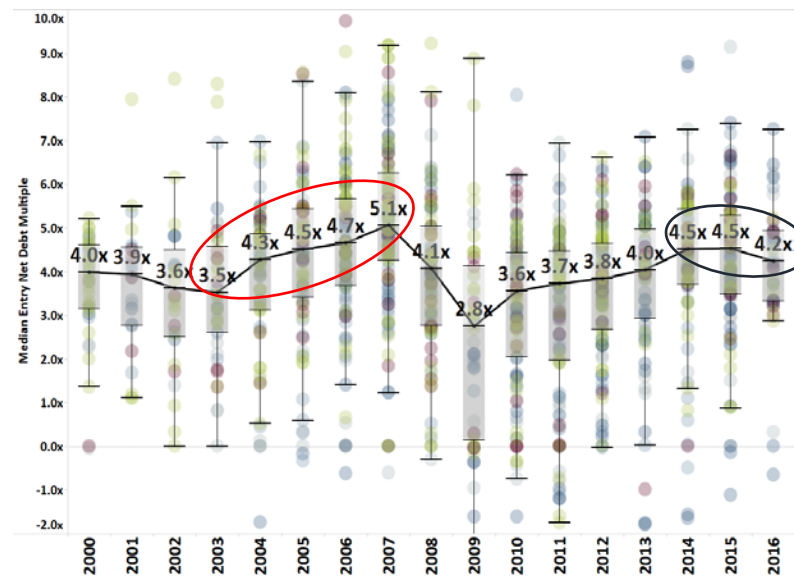


Simultaneous Run Up in 2003 – 2007 in Larger Deals

Purchase Price Multiples



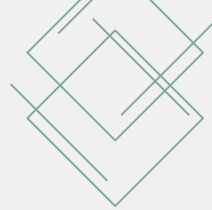
Net Debt Multiples



- » Period leading up to the GFC (2003 – 2007):
 - Purchase multiples increased by 2.3 turns and net debt multiples increased by 1.6 turns
 - Increased borrowing likely a large contributor to pre-recession high valuation environment
- » Today's environment (2014 – 2016):
 - Purchase multiples have increased by 0.8 turns and net debt multiples have decreased by 0.3 turns
 - Previously observed positive relationship between valuations and net debt levels is not sustained

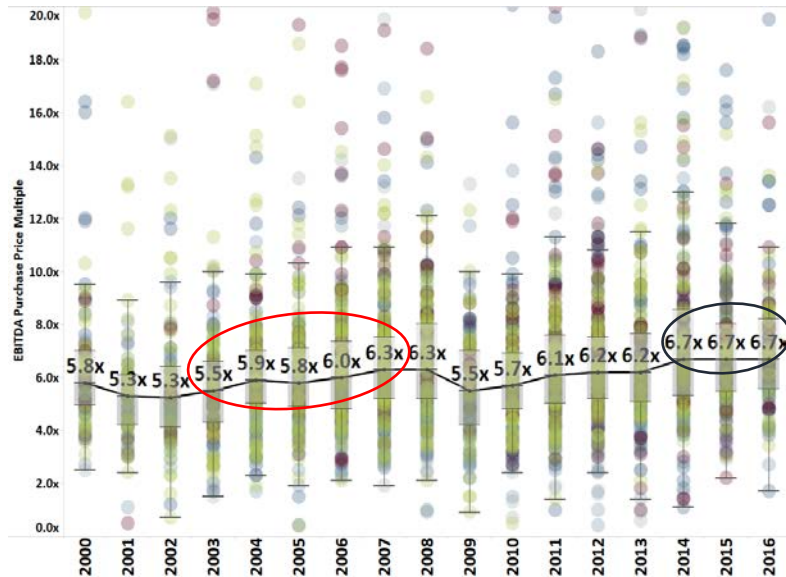


Valuations and Leverage: Transactions <\$100M EV

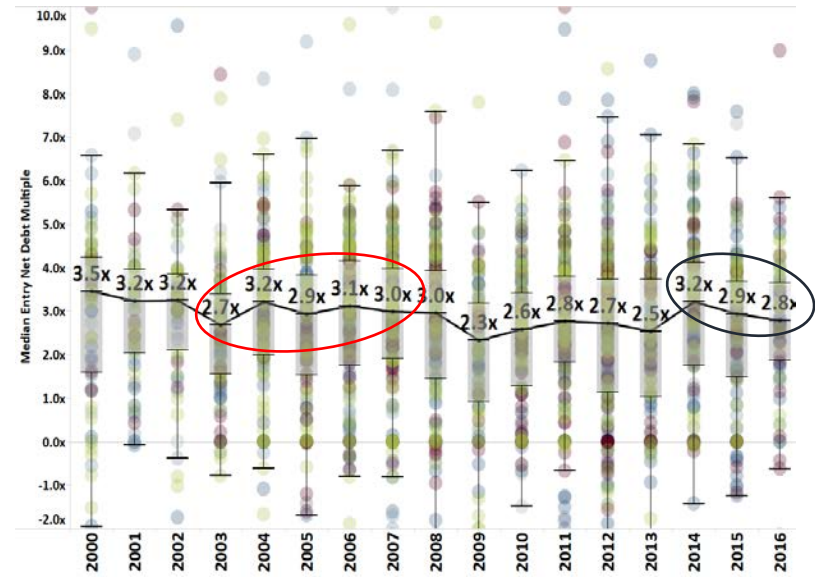


More Long-Term Stability in Smaller Deals

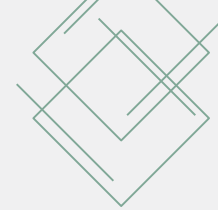
Purchase Price Multiples



Net Debt Multiples

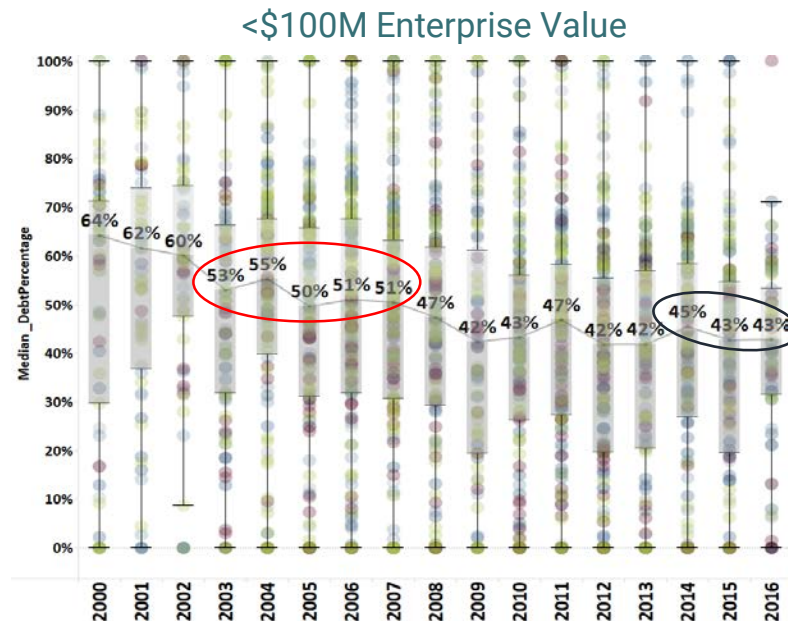
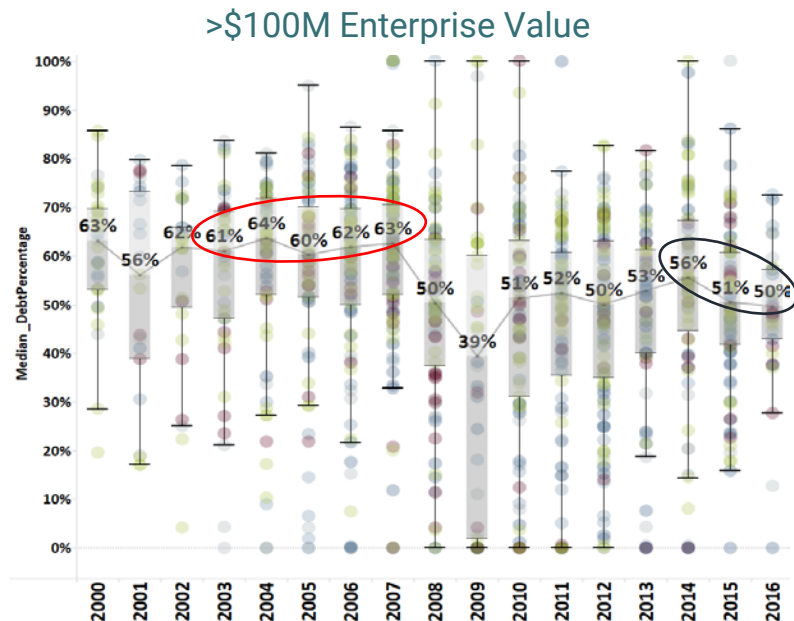


- » Period leading up to the GFC (2003 – 2007):
 - Purchase multiples increased by 0.7 turns and net debt multiples increased by 0.3 turns
 - More muted valuation increases seem only slightly connected with increased leverage levels
- » Today's environment (2014 – 2016):
 - Purchase multiples have remained flat while leverage has decreased by 0.4 turns
 - Leverage does not seem to be an underlying driver of valuation environment

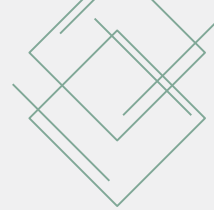


% of Debt in Transactions (by Deal Size)

More Conservative Use of Leverage in Today's Market

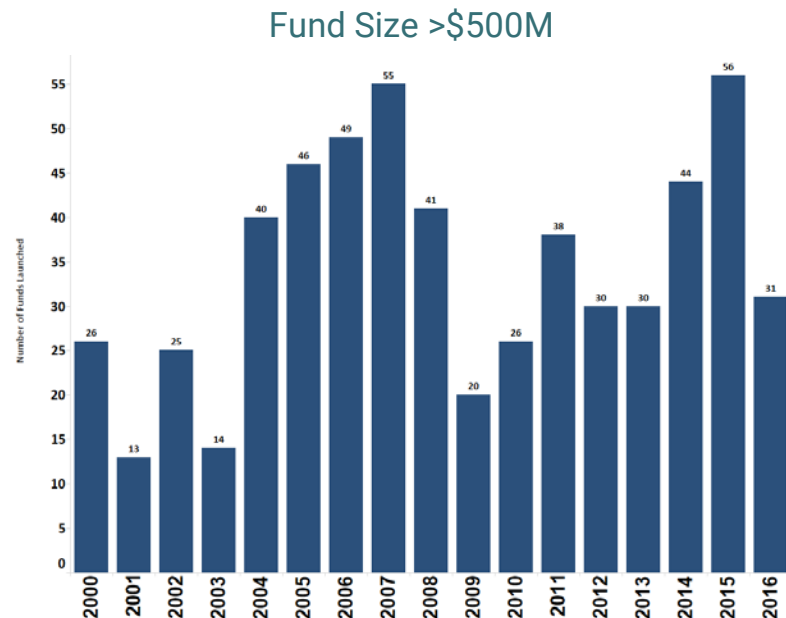
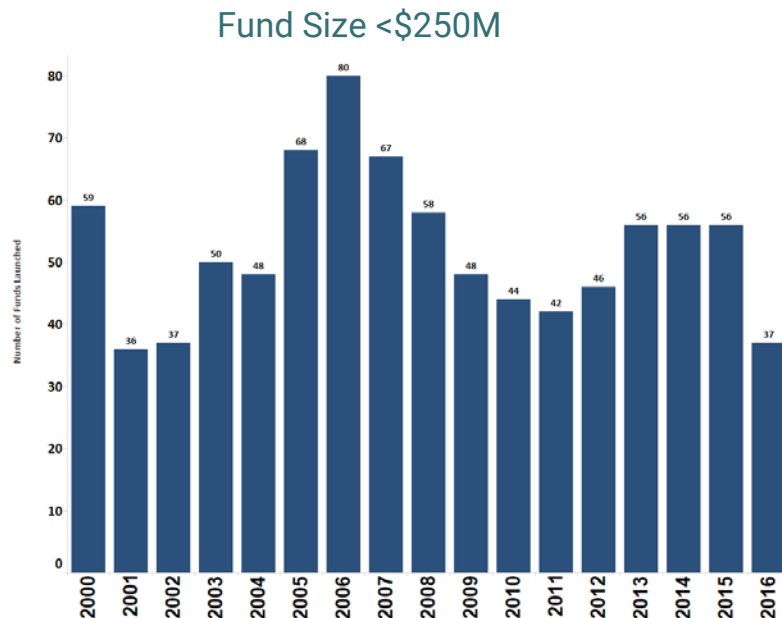


- » Across all deal sizes, percentage of debt in transactions has trended down since GFC
- » Both larger and smaller have decreased use of leverage measured as a % of enterprise value by ~900 bps
- » Continued trend of smaller deals utilizing a lower % of debt than larger deals



What's Driving the Current Shifts?

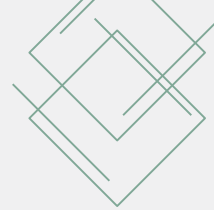
Significant Number of Private Equity Funds Raised Recently (despite 2016 drop)



Funds are arranged by initial launch date of the fund vehicle rather than more common convention of close date or vintage. Statistics above reflect both open funds (assume to raise target size in summation of dollars raised) and closed funds (final commitment amounts).

- » Despite drop in funds launched in 2016, fundraising environment remains robust; however, unlike pre-GFC environment, many LPs are concerned that pace of deployment is lower than expected
- » Abundance of private equity capital available and mounting pressures to put capital to work are likely more of a contributor to current valuation environment given debt levels have remained flat to down (especially larger funds – likely to invest in deals >\$100M in EV – which have recovered to pre-recession volumes)
- » Other factors to consider include: changing attitudes of lenders, proliferation of growth equity (lower leverage) and buy-and-build strategies (initial over-equitization in anticipation of add-ons), and generally higher levels of risk aversion

Source: RCP Database.

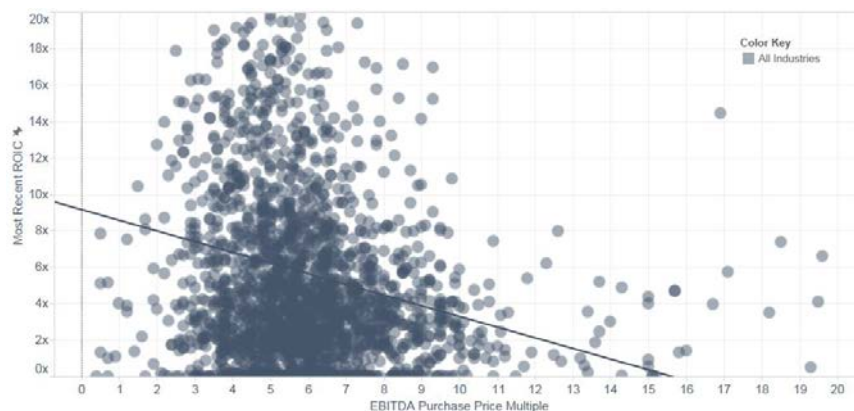


Final Thoughts

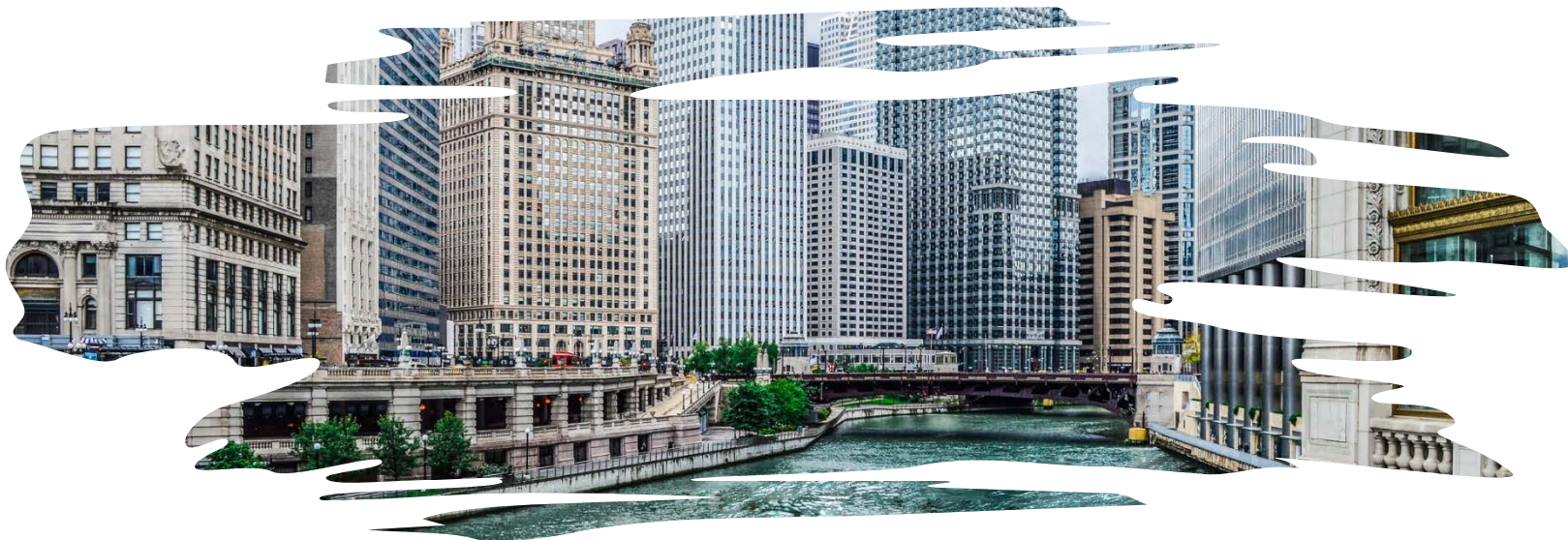
Understanding and Navigating the Current Environment

- » Valuation environment remains elevated
 - Market has shifted away from highly leveraged deals
 - Likely driven more by availability of equity rather than leverage, **especially at larger deal sizes**
- » Sub-segments of market remain relatively more insulated than others
 - Smaller transactions
 - Certain industries (e.g., Industrials vs. Healthcare)

-
- » Silver Lining: purchase prices alone do not dictate ability to generate returns (see Exhibit 1)
 - Inverse relationship between purchase multiple and ROIC is apparent
 - However, low strength of association implies purchase price alone does not determine likelihood of success as measured by ROIC
 - Within this environment, there are still avenues to generate strong returns



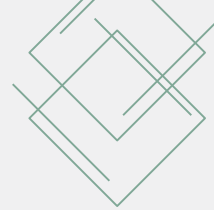
Gross ROIC as explained by initial Purchase Price Multiple. Includes all fully realized transactions with available data transacted from 1985 – Present.



Appendix



Notes on the Data



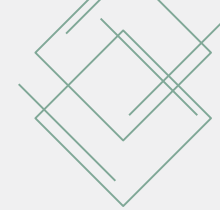
- » RCP collected information from PE Firms, third party data providers (e.g., Preqin, etc.), and public data sources for inclusion in the dataset. RCP's strategy is focused primarily on North American lower-middle market buyouts, so a majority of managers analyzed operate in this segment of the market
- » In total, RCP tracks information on more than 1,200 fund managers, as of June 1, 2017. Manager strategies include Buyout, Growth, Buyout & Growth, Distressed, and Multi-Strategy; Mezzanine and other credit strategies are largely excluded from analysis, but can be added if relevant. Venture, Real Estate, and other unrelated strategies are completely excluded. Fund strategy classifications are determined based on internal RCP assessment
- » The dataset contains Gross ROIC information for more than 13,000 deals that are either fully realized or unrealized and recently valued (based on valuation dates following "Cut Off Date", a user-controlled input, usually defaulted to exclude unrealized valuations >2 years old)
- » Gross ROIC are controlled for outliers that can meaningfully skew average calculations. Any instance of an ROIC >50x is replaced with a value of 50x ROIC to account for the outsized return without removing the data point.
- » Deals analyzed range from enterprise values of less than \$1M to greater than \$20B with an average of ~\$145M and companies are assigned various levels of industry classification based on those provided by S&P Global Market Intelligence
- » The dataset contains more than 1,500 funds with Vintage Years¹ from 1969 – present with vehicle maturities² ranging from 1 – 40 years for which relevant deal valuations are available
- » Fund sizes of these managers range from less than \$50M to \$2B with an average fund size of ~\$500M. Unless explicitly noted, attributed fund track records and 'pledge funds' (capital raised on a deal-by-deal basis) are excluded.
- » Both sector specialist and industry agnostic strategies are included. Data set includes managers that invest in Consumer, Healthcare, Business Services, Technology, and Industrials sectors (among others), or any combination of the aforementioned.
- » Because analysis is often disaggregated by manager maturity, manager strategy, company sector, etc., certain analyses may be performed on smaller sample sizes and may be biased by one or several data points.
- » Past performance is not an indication of future performance, provides no guarantee for the future, and is not constant over time

1. In this Presentation, RCP defines "Vintage Year" as the year in which a fund first draws capital, or, if unavailable, date of final close.

2. In this Presentation, "vehicle maturity" refers to the difference, in years, between the valuation dates of deals and fund's Vintage Year.



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Description of Performance Measurement Methodology

Gross ROIC: Represents the return on invested capital for an individual deal. Gross ROIC is calculated by dividing the sum of distributions and unrealized NAV as of the most recent available valuation date by invested capital. Gross performance returns do not reflect management fees, carried interest, and expenses. Actual returns will be reduced by management fees and other expenses that will be incurred in the management of a fund. Actual account performance will vary depending on each fund’s applicable fee schedule.

GFC: Great Financial Crisis.

Exhibits detailing data for portfolio companies are grouped by year of the fund’s initial investment in a company, as opposed to vintage year. Returns are gross returns.

Biases within the Report for consideration include:

- Survivorship bias:
 - Information flow will be biased towards managers successful enough to raise subsequent funds; given updated return information is primarily gathered during fundraising diligence, data reflects deals transacted by relatively more successful managers
 - Inclusion of realized deals may positively skew results as poorer performing investments often remain ‘unrealized’ for longer periods despite eventual likelihood of being ultimately written off
- Availability bias: Due to RCP’s lower middle market focus, more data is available on smaller companies vs. larger

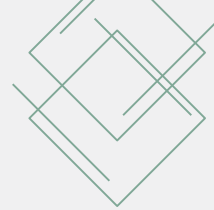
RCP Database: Provides private fund and investment-level performance data drawn from fundraising and diligence documents produced by general partners and publicly available information, as well as quarterly unaudited and audited annual financial statements produced by RCP’s underlying fund managers. As of June 1, 2017, RCP’s database contains information on more than 1,200 fund managers and more than 2,500 funds. These documents are provided to RCP by the fund managers themselves. Full discussion on the database appears on “Notes on the Data”.

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