Transaction **Trends**

Transaction Trends provides private equity sponsors and investors with middle-market transaction information and insights compiled by the BMO Sponsor Finance group—information that helps sponsors and investors better understand the current financing climate in the middle market.

Trickling down

Private debt fundraising and the impact on PE.

"Relative value" was the buzzword in 2022; fixed income investors with broad mandates looked outside of middle market private credit due to the market dislocation. As these crossover investors moved elsewhere, PE firms found less available capital including from long-term financing relationships.

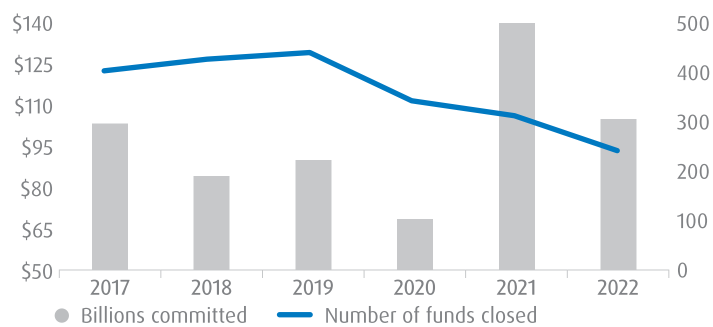
As a result, hold sizes came down in the second half of 2022; also driven in part by the CLO market. AAA spreads (>60% of the capital structure) widened to >250bps from ~150bps in 2021 which created issues with the remaining tranches returns resulting in a ~46% decline in issuance. This trend pushed PE firms to include a larger number of lenders within club transactions to ensure adequate "dry powder".

The buzzword now is "overallocation". As the liquid portions of investor portfolios have been marked down, private debt has become a larger percentage of the overall allocation. Despite these challenges, 89% of investors are expected to either keep flat or invest more capital in private debt going forward.[1] We believe the current loan origination vintage will be attractive with lenders prioritizing discipline around financial covenants, EBITDA addbacks, and economics. However, it remains to be seen if this will be enough to calm investors given uncertain macroeconomic outlook, unstable political climate, depressed publicly traded assets, and relatively attractive short-term yields.

BMO continued to demonstrate its commitment to the middle market through all cycles by deploying $4.5Bn in 2022 across 173 transactions (73 new borrowers).

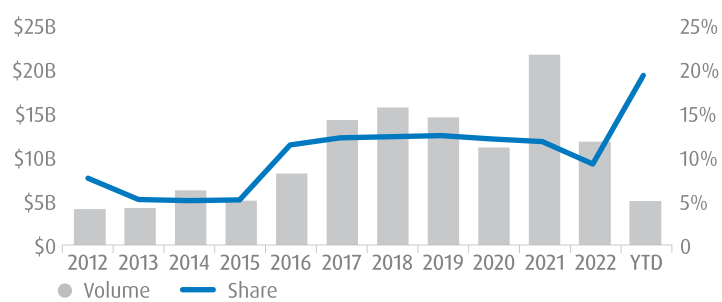
As direct lenders continue to raise larger debt funds, alignment of interest with sponsors, borrowers and investors becomes increasingly important. BMO has successfully scaled its direct lending platform to approx. $17B by investing alongside our investors and acting as lead or co-lead agent in 95% of transactions. This strategy has positioned us as a trusted partner for those seeking to invest in direct lending strategies.

Annual Fundraising Across Senior Debt



Source: Leveraged Commentary & Data (LCD)

U.S. MM CLO Issuance and Share of Volume



Data through March 13, 2023. *Source: Leveraged Commentary & Data (LCD)*

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Multiple perspectives

Big tech waves make way to the middle market.

The broader technology market has generally experienced outsized growth since early 2021 after hitting a brief pause in the early days of COVID. Public and private companies alike have invested heavily in staff and technology as the workplace environment evolved to a more hybrid state, coupled with greater emphasis on data security and digital transformation. Although broader technology spending has continued through the first quarter of this year, recent economic conditions are impacting the pace of revenue growth as well as leading to increasing softness in the labor market.

Since the beginning of 2023, there have been nearly 150,000 layoffs in the U.S. tech market, almost eclipsing the entire figure for 2022. Larger companies continue to announce new cuts in response to rising inflation and a rocky stock market; additionally, concerns around future growth would imply further volatility in the tech industry. Despite this sudden rise in layoffs and evolving expectations around technology investments, there are some key sectors within Technology Services demonstrating resilience among their peers.

Human capital management

While the Technology Services labor market has begun to cool, the overall labor market remains relatively healthy compared to historical levels. This continued hiring momentum, combined with the continued shift to a hybrid working environment, has led to increased demand for Human Capital Management ("HCM") services and products. Organizations have been forced to improve their tools and practices to attract, recruit and retain employees while also meeting compliance and regulatory standards.

Talent management and HCM investment is likely to continue regardless of the near-term or medium-term economic environment. Whether companies are contracting through layoffs or looking to grow and retain their employee base during industry specific labor shortages, workforce leaders will continue to invest in HR and HCM technologies to manage workers more efficiently. These investments could improve communication or engagement or focus on the outsourcing of specific tasks like benefits or employee recordkeeping. This dynamic is expected to drive sustained enterprise values in the low to upper teens of EBITDA in HCM Technology, while traditional HR Staffing and Services companies could experience further deterioration should the labor market decline substantially.

IT services

Managed service and general IT service providers have been in high demand over recent years in the middle market as Sponsors have focused on buy and build strategies across the fragmented space outside of the Big Four and other national providers. Hotter subsectors like networking, enterprise software implementation and cybersecurity have all increased in trading activity with valuations varying based on scale and mix of product/recurring services.

The same hybrid work environments and increasing digital sophistication seen in the HCM market pushed these businesses to staff up in recent years to meet the outsized demand for their services. However, the uncertainty in the economic environment may lead to reduced hiring and a decline in discretionary IT spending, if only temporarily, as businesses moderate their growth expectations. Enterprise valuations for offshore IT services and traditional business process outsourcing should continue to benefit as companies focus on operating margins and liquidity.

As you consider investments in the Human Capital Management or IT Services sectors, BMO Sponsor Finance and BMO Middle Market M&A are available to discuss any questions or areas of focus you may have.

We were pleased to announce late last year the additions of Chris Headrick and Dev Navare as Co-Heads of our M&A Technology and Business Services practice. Chris and Dev bring more than 40 combined years of experience in the Tech and Services space, with specific expertise in Human Capital Management, IT Services, Software and Tech infrastructure.

Please reach out to your BMO Sponsor Finance or M&A coverage contact at your convenience for an introduction to the team.

BMO spotlight

BMO flexes strength through advisory and financing execution.

- In January 2023, BMO Capital Markets advised client Savage, a global provider of supply chain infrastructure and services, on its divestiture of EnviroServe, Inc. ("EnviroServe") to One Rock Capital Partners ("One Rock"). BMO's role as sell-side advisor was the result of extensive environmental services expertise, a strong track record of middle market M&A execution and a tenured relationship with Savage.
- EnviroServe is a national provider of environmental, waste remediation and emergency response services through a network of 35 locations across the U.S. Key business merits include mission critical, non-deferable service offerings, substantial geographic footprint and resilient financial performance.
- In conjunction with One Rock's acquisition of EnviroServe, BMO's Sponsor Finance lending teams played a key role in providing significant capital commitment during a time of growing uncertainty in debt financing markets, and worked closely alongside One Rock to tailor a financing package that uniquely fit its investment thesis. This ultimately lead to BMO Sponsor Finance serving as Administrative Agent and Lead Arranger for the credit facilities.

This transaction yet again highlights the strength, capabilities and specific industry alignment of BMO's client offerings and relationships, which are particularly meaningful in an uncertain market. BMO will continue to build momentum through these types of full solution opportunities by leveraging the thousands of North American middle market business relationships across the institution, including those resulting from the recent Bank of the West acquisition.

ENVIROSERVE

Portfolio company of

ONE ROCK CAPITAL PARTNERS

Senior Credit Facilities

Administrative Agent
Joint Lead Arranger
Joint Book Runner

ENVIROSERVE

Segment of

SAVAGE

Sale to

ONE ROCK CAPITAL PARTNERS

Exclusive
Financial Advisor

We are the experts

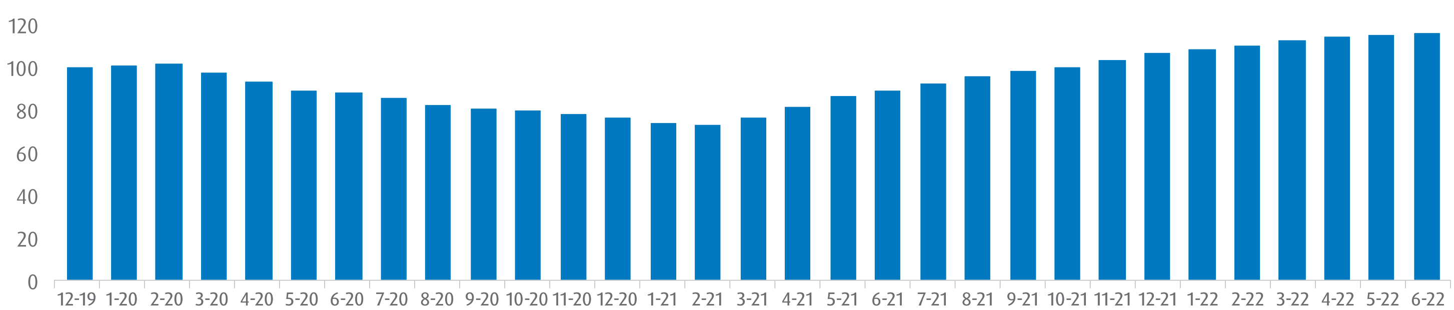
Produce distribution.

- Produce distribution has been a highly active M&A sub-sector over the last ~12 months attracting significant interest from both strategic and private equity buyers.
- Historically, foodservice (and produce distribution) has been recession resilient with several favorable macro trends driving growth including increased dining away from home, better-for-you eating, desire for experienced-based dining with new flavors, and increased demand for delivery/take-out.
- In addition to stable demand drivers, the sector has several strong attributes including a high degree of market fragmentation, strong business diversity and niche value proposition to traditional broadline distributors. Private equity has been able to leverage integration experience to acquire add-ons for their platforms to improve route density as well as expand the geographic footprint.
- In evaluating produce distribution platforms, BMO tends to focus on reputable local and regional players that have strong business diversity and an established track record of differentiation from broadliners, typically based on high-touch service levels, including frequent and flexible delivery schedules, minimum order flexibility, breadth of products/specialty items, and value-added capabilities (e.g. pre-cut offering). Those that maintain operational discipline and demonstrate differentiation, typically don't compete on price and maintain strong customer tenure and retention metrics. As such, these strong platforms are typically insulated from broadliners that are more focused on high volume SKUs with standardized delivery schedules for large, national accounts.

Historically, foodservice (and produce distribution) has been recession resilient.

- While produce distributors focused on serving the foodservice channel were some of the most heavily impacted companies at the onset of COVID (due to social distancing and mandated in-house dining closures), borrowers within BMO Sponsor Finance's portfolio and new opportunities reviewed have demonstrated very strong post-COVID recoveries in FY21 and FY22, with sales volumes now near or above pre-COVID levels (as shown below), with additional volume gains still to be realized with the normalization of event and corporate office channels.
- Further, many produce distributors have seemed to have benefitted from the strong inflationary environment of food costs in FY21/FY22 by expanding gross profit per pound (a key profitability metric BMO evaluates) above pre-COVID levels given the nature of the cost-plus pricing arrangements. Most produce distributors are able to pass product costs on quickly (typically weekly or bi-weekly) with the markup typically being either a fixed dollar amount or a percentage markup. A key question is evaluating the sustainability of profitability in the event there was deflation of food costs from current levels.
- It is common to see EBITDA margin profiles within the segment vary (from ~3-12%), and BMO has seen strong platforms on both ends of the spectrum. Key areas of focus in understanding the variation are the types of channels/customers being served, level of route density, how flexible/customized delivery schedules and order quantities are, what value-added capabilities are being provided, and the nature of the competitive landscape within the region.
- Produce distribution continues to be a sector that commands strong lender appetite given the stable fundamentals of the sector and strong EV support. The rise in interest rates has been the primary governor on leverage these businesses can support to ensure cash flows/coverage ratios remain sufficient.

LTM Volume Index



Data based on monthly volume information to scale from 2019 levels (2019 volume equals 100.0) for deals reviewed by BMO Sponsor Finance. *Source: BMO Proprietary Data*

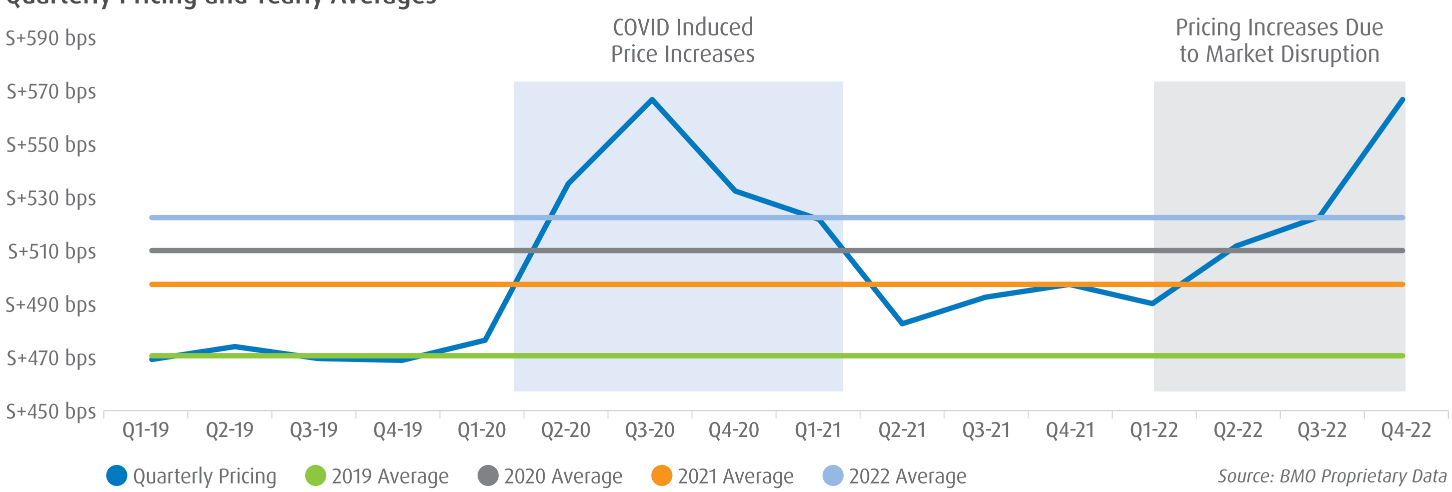
A peek behind the curtain

A snapshot of BMO's proprietary portfolio and transaction data.

Pricing trends—all transactions

- As illustrated in the chart below, spreads on new transactions (inclusive of LBOs, refinances, add-ons) began to widen in Q2'22 as market disruptions earlier in the year began to have downstream impacts on the middle market.
- Spreads continued to widen in Q3 and Q4 as growing macro economic headwinds and increased tightening by the Federal Reserve has pushed pricing upwards.
- Existing platforms that have executed a transaction in the last ~9 months (i.e. incremental for add-on) and previously had favorable rates have likely seen pricing adjusted to support incremental debt raise needs.
- BMO has seen spreads continue to increase during Q1'23; however, levels have begun to level off. However, the total impact of the "banking crisis", escalating geopolitical tensions, and recession risks remain to be seen.

Quarterly Pricing and Yearly Averages

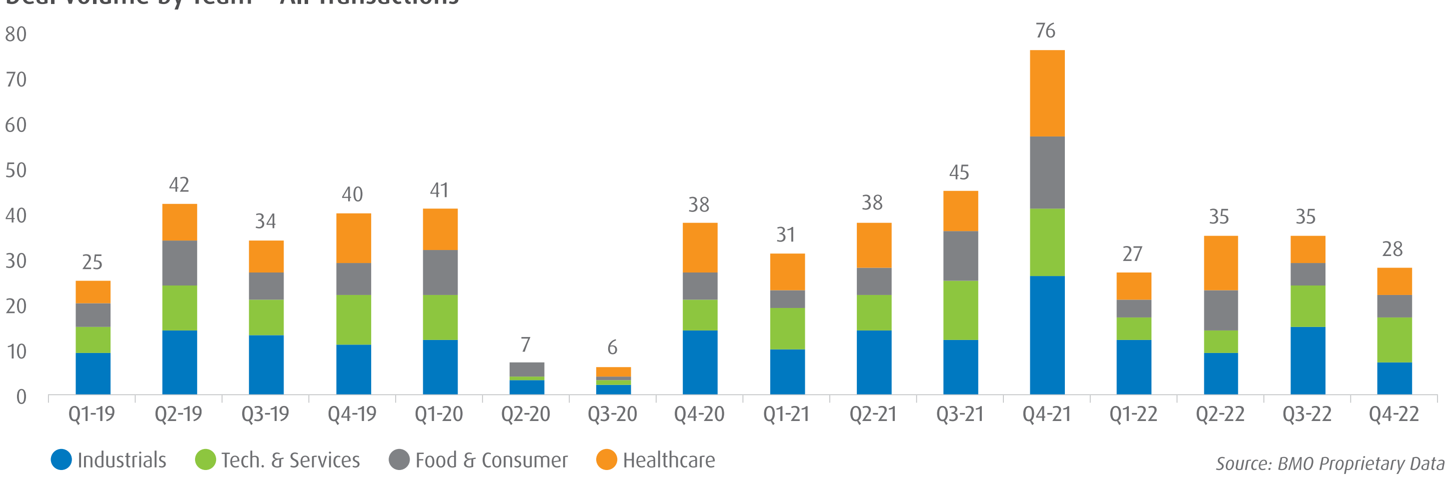


Source: BMO Proprietary Data

Quarterly transaction activity—all transactions

- New Deal activity remained lower than prior periods and year-over-year in Q4'22, which has continued into Q1'23.
- Tightening of appetite within the financing markets (paired with increasing rates) and dislocations in bid/ask valuations between buyers and sellers with the softening macro-economic environment, has slowed activity.
- While "A-List" opportunities continue to command strong buyer and lender interest, particularly with the flight to quality, "B and C-List" opportunities have recently had a strategic buyer angle.
- M&A bankers continue to indicate strong pitch activity and mandate pipelines, but many processes have been delayed for a more favorable deal making environment.
- While new platform activity has slowed of late, sponsors remain highly active in pursuing add-on activity for existing platforms.

Deal Volume by Team—All Transactions



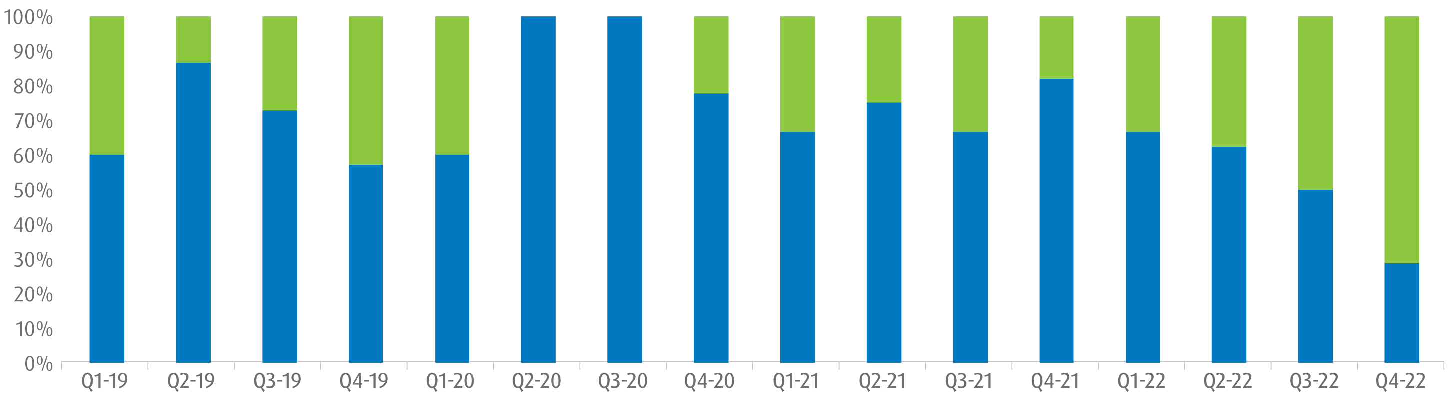
Source: BMO Proprietary Data

New transaction activity

Capital structure type—new LBOs

- While single tranche structures have been favored in recent years given large lender holds and simplicity of execution, BMO has seen increasing usage of senior/junior structures of late.
- We attribute this to a number of factors including (i) pull back in unitranche lender appetite and hold capabilities, (ii) spiking SOFR and spreads on senior floating rate debt has made fixed mezzanine paper more attractive, and (iii) mezzanine lenders increasing willingness to PIK a higher portion of their yield, which is attractive to cash flow dynamics.
- BMO has also seen increased usage of debt advisors as well as more active outreach by sell-side bankers prior to launching a process.

Transactions by Type—New LBOs

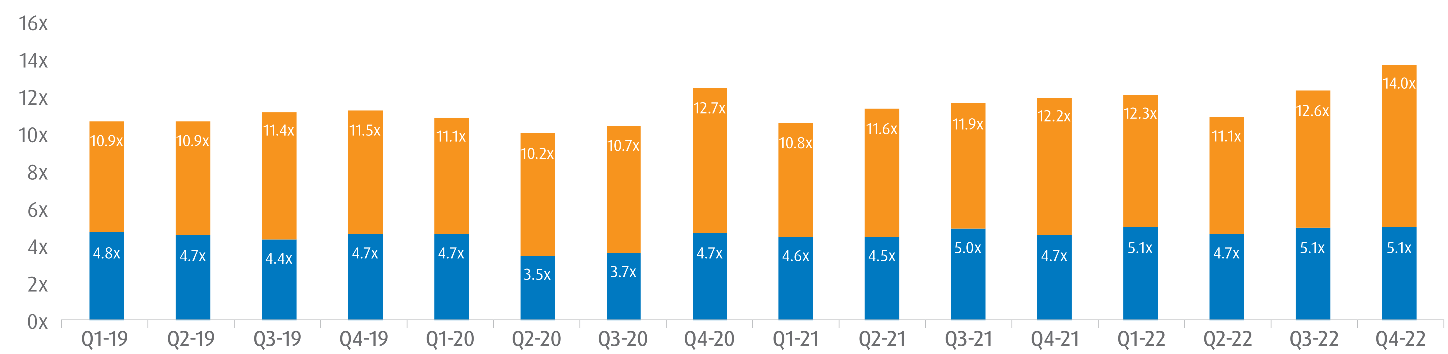


Source: BMO Proprietary Data

Average total leverage trends—new LBOs

- Despite growing macroeconomic headwinds, closing leverage of new LBOs has largely remained in-line with previous quarters over the last ~12–18 months.
- This is partially driven by a flight to quality by both sponsors and lenders, where highly attractive and non-cyclical assets continue to command strong lender interest with similar leverage and valuation multiples as in past quarters.
- We continue to see a bifurcated market split between high quality assets which have benefitted from "scarcity value"; where BMO has been active, as well as profiles that have experienced tremendous ramp in performance with questionable sustainability. Given the continued increase in SOFR and spreads, fixed charge coverage ratios have become a focal point for lenders on how much debt a business can support. As a result of increasing rates, we've seen leverage reads come in 1.0x–1.5x turns on certain businesses relative to indications ~12–18 months ago.
- Despite fixed charge coverage becoming a focus, we have yet to see it be implemented as a formal covenant within the direct lending market.

Average Total Leverage and EV—New LBOs



Source: BMO Proprietary Data

A word from our GP lending colleagues in BMO Wealth Management

Over the years, GP co-investment financing solutions have evolved from retail credit products to preferred equity financings and GP stake sales. While GPs may still use traditional solutions, many are evaluating the pros and cons of other options available in the market due to:

GP commitments getting bigger, faster…

Average years between predecessor & successor funds over the last 10 years has reduced from 5 years to 3.2 years while the median increase in size from predecessor has increased from 28% to 50%.[2]

Slowing realization through 2022 into 2023

Macroeconomic headwinds factored in a 32% year-over-year decline in private equity exits in 2022 and nearly 39% year-over-year drop in the value of private equity acquisitions.[3]

Introduction of new strategies within a firm

Sponsors raising a small cap fund alongside a flagship fund.

Increasing investment allocation to GP co-investments vs. public markets

Greater conviction for private markets over public markets creating a liquidity need.

When evaluating options, we encourage our clients to consider alternatives to Home Equity Loans and Securities Based Lending. BMO offers our Private Equity clients a range of alternative options including our GP Co-investment Loan Program which (i) leverages an underutilized asset (ii) improves personal borrowing capacity, and (iii) limits debt service costs. If interested in learning more, please contact your respective Sponsor Finance coverage team or Garrett Johnson.

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Garrett leads BMO Wealth Management's Private Equity Credit team which works with financial sponsors across the country. The teams focuses on providing liquidity solutions to General Partners for both investment & personal purposes. Garrett founded the team in 2021 after spending six years in BMO Wealth Management building a niche business focused on the financial sponsor community. Prior to Wealth Management, Garrett spent nearly eight years in BMO's Sponsor Fund Lending team where he provided fund level credit facilities to leading middle market focused financial sponsors.

BMO Sponsor Finance

Consistency, speed and surety of close are crucial when it comes to serving the needs of middle-market private equity firms. Whether it's providing capital for mergers and acquisitions, leveraged buyouts, recapitalizations or growth capital, BMO Sponsor Finance group works with you from initial review to ongoing portfolio management for reliable execution and follow-through with no handoffs.

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[1] PDI Perspectives 2023

[2] Prequin & Bain & Company Global Private Equity Report 2023.

[3] S&P Global: Slower pace of private equity-backed M&A expected to continue.

*Does not constitute tax advice, consult your tax advisor for tax related questions or advice.