Staying Power

How the Middle Market Can Navigate the Paradigm Shift Facing Markets

Apogem Capital Mid-Year Private Markets Outlook

August 2022

Apogem Capital
A NEW YORK LIFE INVESTMENTS COMPANY

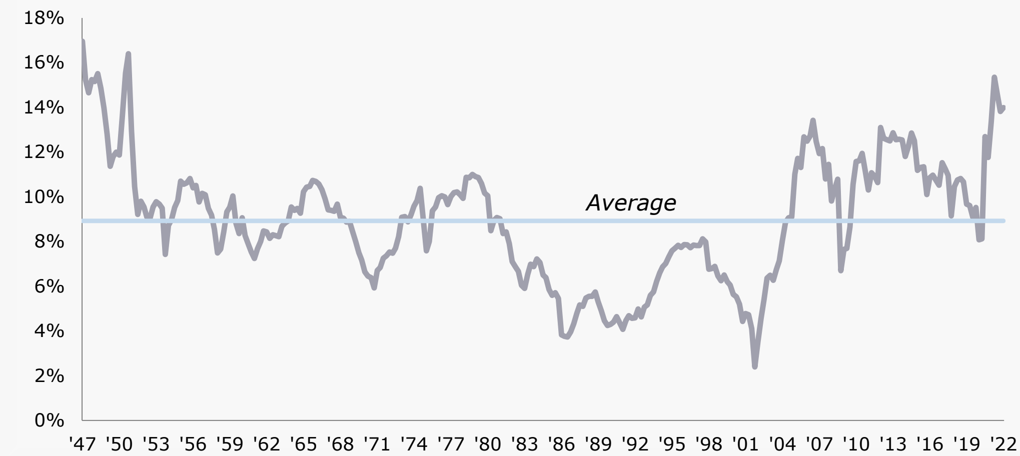
Introduction: Macroeconomic & Private Markets Update

As public markets have sold off and concerns about a global recession have grown, private markets have remained relatively resilient, falling from the near record levels of activity reached in 2021 and reverting back to longer-term levels of deal flow, exit activity, and fundraising. While private markets will not be immune from market volatility and the regime shift occurring in the economy, we believe certain segments of private equity and private credit may be better positioned to navigate a prolonged economic downturn.

Over the past decade, assets across the investment landscape have increased rapidly in value, resulting from the period's low interest rates and the infusion of liquidity by the Federal Reserve and other central banks. As presented in the chart below, these conditions have inflated valuations across asset classes, driving US financial assets to unprecedented levels, as measured relative to GDP.[2]

Profit Margins at Highest Level In 50 Years

US non-financial corporate profits as share of gross value added[1]

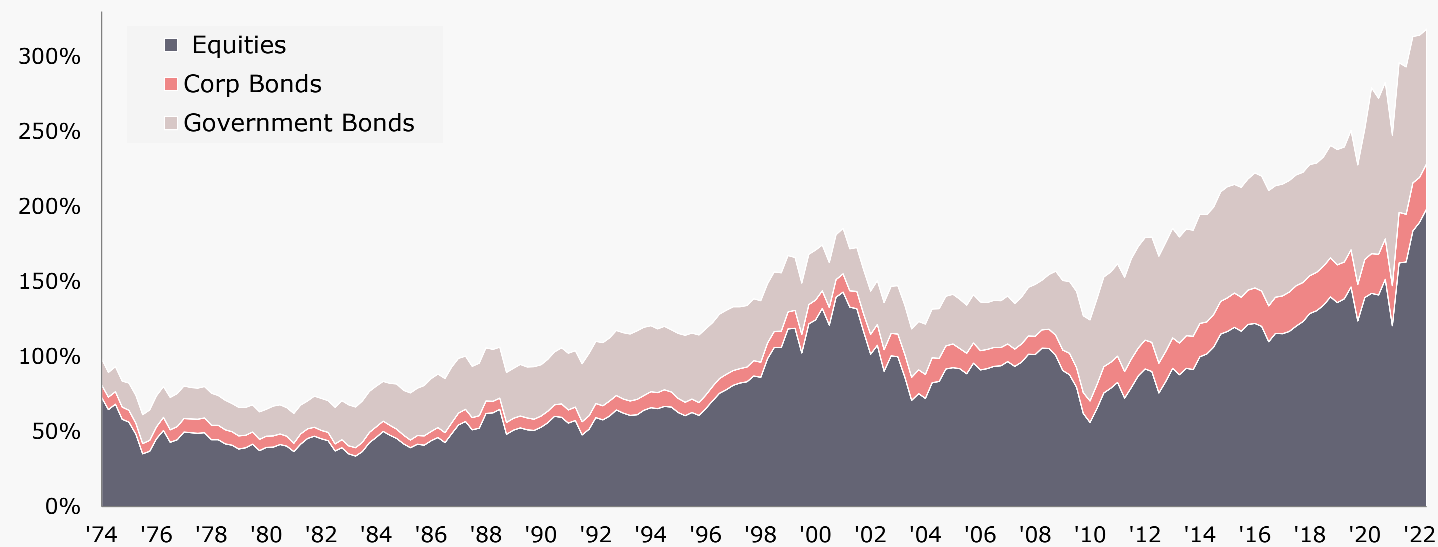


Further, these conditions, along with other macroeconomic tailwinds (e.g., globalization) have helped support elevated corporate profits across the US economy broadly for most of the past decade, as presented in the chart above.

Regardless of whether the US enters a recession in the near-term, mean reversion for US corporate profit margins seems likely. Since peaking in mid-2021 at ~15%, margins have come down slightly to 14%, still the highest level since 1951 and well above the long-term average of 9%.[1] In a more normalized environment, we would expect profits to fall to a level more in line with their long-term average, presenting challenges for public and private markets and making investment selection critical.

Various Asset Classes as a Share of US GDP

US Equities, US Government Treasuries, & Corporate Bonds[2]

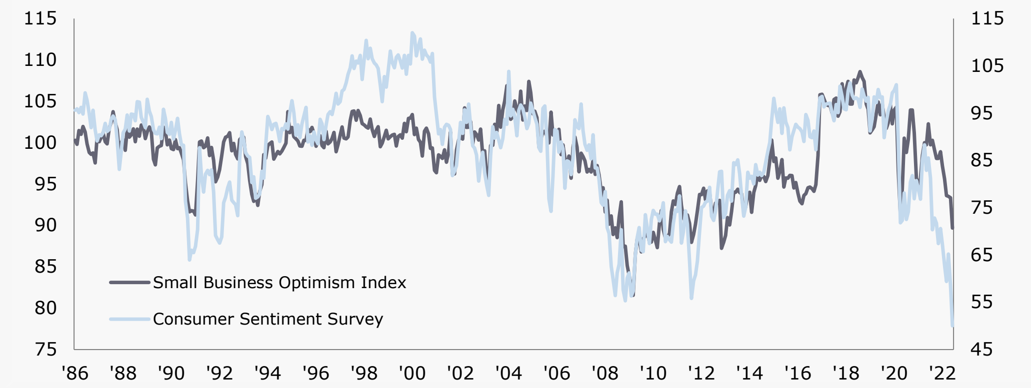


Introduction: Macroeconomic & Private Markets Update

The highest inflation in decades and the sharp drawdown in public markets have weighed heavily on consumer and business sentiment, which fell sharply in 2022 to among the lowest levels on record. While sentiment has withered, the labor market remains relatively strong, with the unemployment rate stable below 4% and robust job growth continuing in 2022 amid volatility in equity markets.

Sharp Drop in Small Business & Consumer Sentiment

Small business (left axis)[4] | Consumer sentiment (right axis)[5]



Private Markets Perspective

Private markets have also been impacted by the macroeconomic environment over the past decade, benefiting from the ample liquidity, stable growth, strong valuations, and low interest rates. Private equity was further boosted in 2021 by record high exit activity and a particularly hot IPO market.

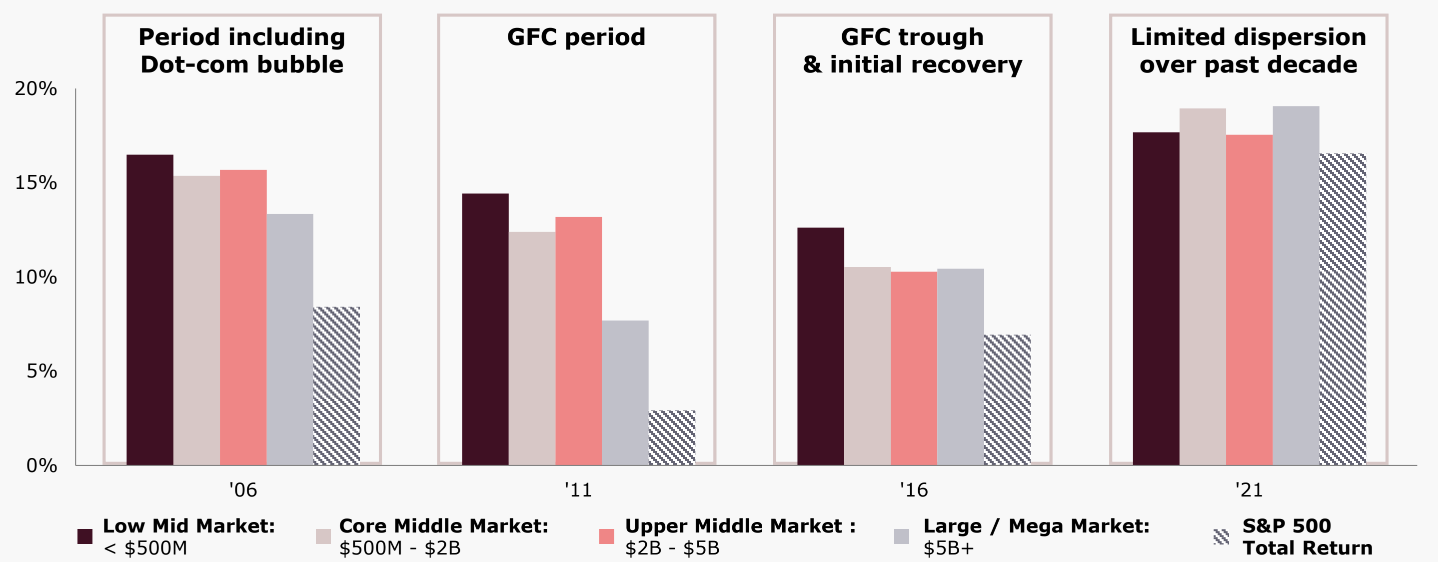
These tailwinds have helped support strong performance while driving down dispersion within the asset class.

Observing prior periods, however, dispersion tends to be higher, particularly during periods of economic downturns or market volatility. Over the past 20 years, lower middle and middle market funds have tended to outperform during most 10-year periods, generating a meaningful illiquidity premium relative to the S&P 500.[3]

As the economic tailwinds of the past decade recede in the current environment, we expect dispersion within the asset class to increase and investment and manager selection to become even more critical to generating alpha.

Pooled Buyout & Growth 10-Year IRR by Fund Size: Various Timeframes

North America | Each year as of December 31[3]

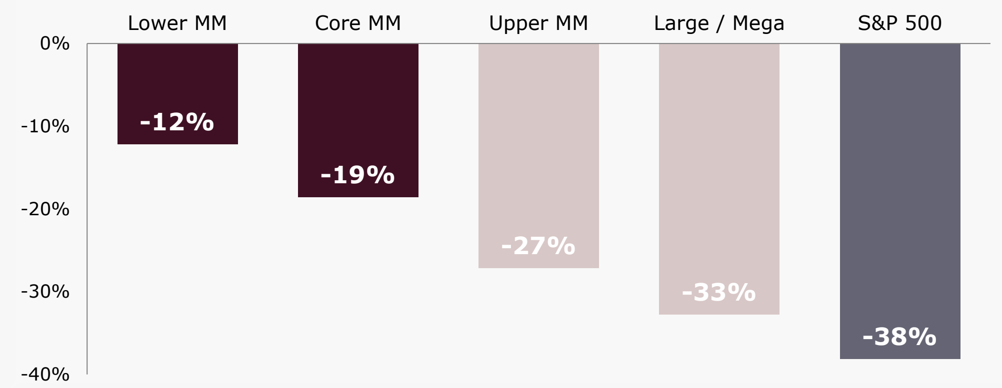


Historical Recession Resilience: Middle Market Private Equity

The potential for a recession naturally draws comparisons to the Global Financial Crisis ("GFC") and the performance of asset classes during that deep recession. As presented in the chart below, private equity generally outperformed public markets during the worst of the drawdown during this period, with lower and middle market funds proving more resilient than funds focused on the larger end of the market.[3] While the macroeconomic conditions in the current environment differ greatly from those during the GFC, the elevated valuations and fundraising dynamics in the private equity market leading into 2022 mirror the conditions prior to the GFC.

Middle Market Outperformance During the GFC

Middle market vs. large and mega funds and the S&P 500 Index
North America buyout funds[3] | One-year return as of Q1 2009



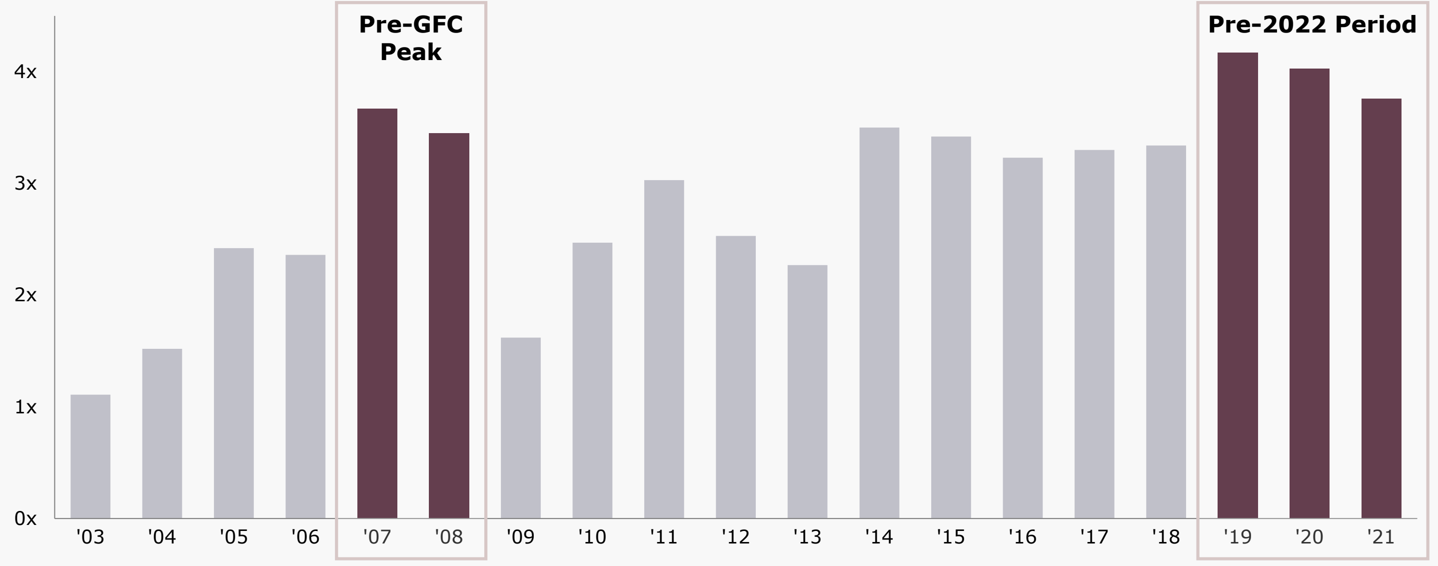
Elevated Valuations

Leading into the GFC, the differential between the valuations of large and small companies reached record highs. This dynamic was replicated in recent years, with a similar valuation premium for large companies.[6] The more conservative valuations and lower leverage multiples of smaller companies leading into 2022 may enable them to better navigate the current environment and allow their PE sponsors to exit these companies profitably, even if valuations compress.

Current Environment: In the first half of the year, valuations have remained elevated, avoiding the valuation compression experienced in public markets over the same period. Amid the economic uncertainty this year, some companies are likely delaying sales processes until the environment improves, while companies that can command premium valuations continue to enter the market, temporarily inflating valuations. As this dynamic fades, we expect valuations to compress and deal activity to slow.

Purchase Multiple Differential by Enterprise Value

Deals with EV > $500M vs. EV < $250M | Each year as of December 31[6]

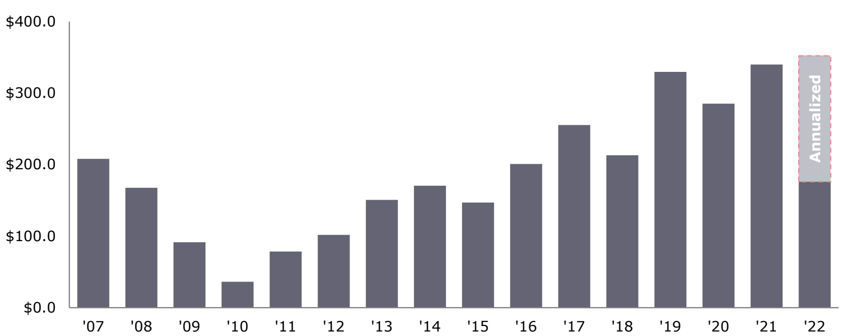


Record Fundraising Concentrated in Large & Mega Funds

Both the GFC and current environment were preceded by record levels of fundraising, particularly concentrated in large and mega funds, as investors committed significant capital to well-known fund managers to take advantage of the frothy environment. While the influx of capital can have the downside effect of increasing competition for target companies, particularly at the larger end of the market, it can also create a deep pool of capital to continue funding deal activity and present an exit opportunity for lower and middle market funds.

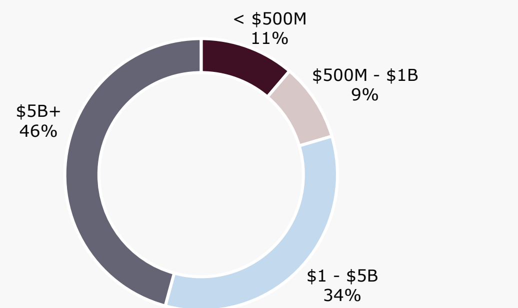
Back to Back Years of Record US Private Equity Fundraising

$ in billions | 2022 value annualized as of June 30[8]



Recent Fundraising Concentrated in Large & Mega Funds

$ raised by fund size (2019 - 2022)[8]



Evolution of Private Markets Over the Past Decade

While fundraising and valuation dynamics mirror the GFC era, the private equity market has evolved significantly over the past decade, which may enable it to better weather a prolonged downturn, avoiding the sharp drop off in new deal and exit activity experienced during the GFC.

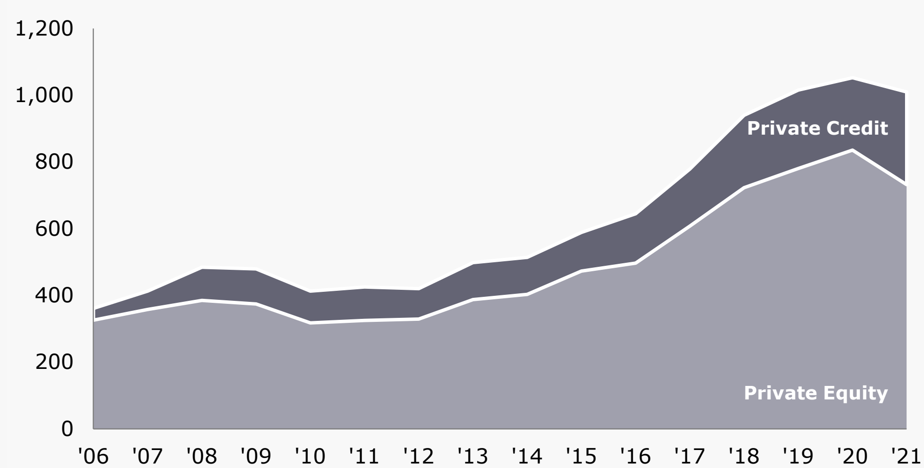
The robust fundraising activity leading into 2022, described previously, has resulted in a near record level of dry powder. The deep pool of dry powder available to private equity funds is well in excess of the amount held by PE funds during the GFC and is particularly concentrated in larger PE funds.[7] With this mountain of dry powder, PE managers may be encouraged to continue putting capital to work even in a challenging environment. This dynamic could also create more opportunities for smaller companies to be sold up market to these larger funds.

Further, the US private credit industry has developed rapidly since the GFC, and now manages over $600 billion of assets.[7] In the GFC period, private equity was more reliant on traditional banks for credit. Since then, private credit dry powder has increased nearly 3x, potentially supporting continued deal activity during a downturn.

While these structural changes may support deal activity, if economic conditions continue to deteriorate, PE managers may pivot to using dry powder defensively to shore up their existing portfolios.

Rapid Growth in US PE & PC Dry Powder

As of December 31, 2021 | $ in billions[7]



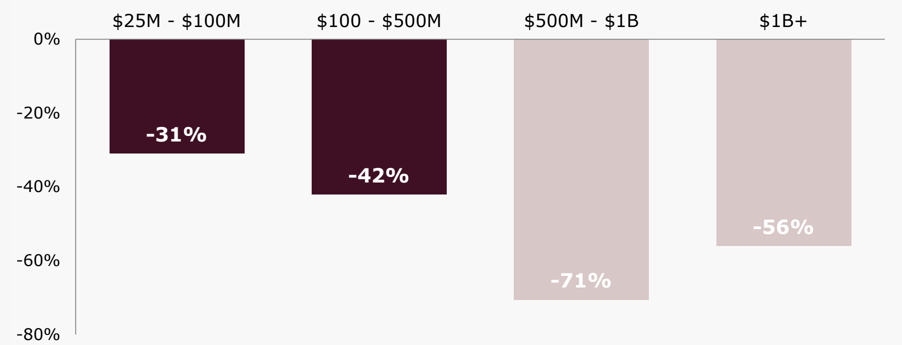
Current Private Equity Environment: Deal Activity

Deal activity in 2022 has slowed considerably from the accelerated pace of 2021, however, it continues to outpace its long-term average, with ~50% more deals closing in Q2 2022 than the prior quarterly average (inclusive of estimated deals). Middle market deal activity has proved more resilient than the larger end of the market, which experienced the greatest run-up leading into 2022.[8]

Deal activity in the first half of 2022 partially benefits from the momentum leading into the year. Many of the deals that have closed in 2022 were negotiated towards the end of 2021 or in early Q1 2022, before the market volatility fully set in. As these deals clear from the market, deal activity in the second half of the year may slow.

Q2 2022 YoY Change in Deal Count

Percent change from Q2 2021 to Q2 2022[8]



If the current economic uncertainty and market volatility persists, we could see deal flow fall more considerably as lower valuations may deter sellers and buyers.

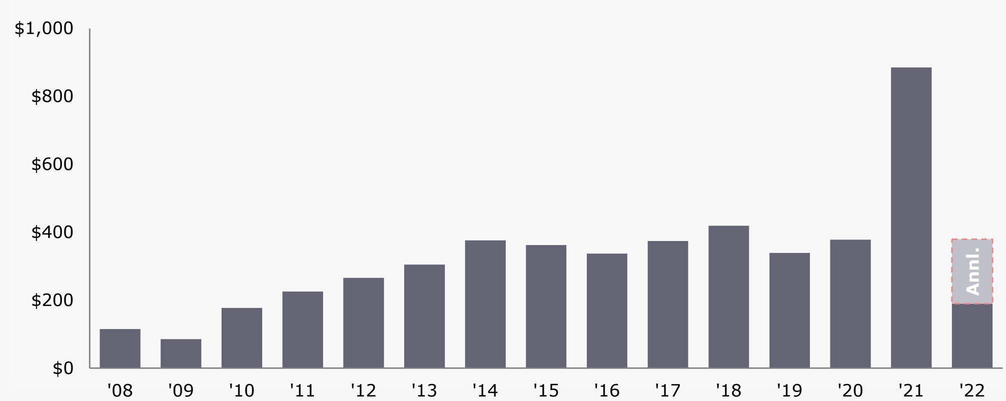
While market volatility and lower valuations may discourage some business owners from selling, these impacts may be somewhat offset by the desire for owners to partner with experienced private equity sponsors to manage their business through an uncertain environment, particularly in the middle market where PE sponsors focus on founder / family-owned businesses. The opportunity for take privates and buying assets spun out of larger companies may also increase if equity valuations continue to fall or companies divest non-core assets to generate cash.

Current Private Equity Environment: Exit Activity

2021 was a record year for PE exit activity, with exit value nearly double the previous record,[8] driven by pent up demand from delayed 2020 exits and a hot IPO market. The current macroeconomic environment has weighed heavily on exit activity, with activity in the first half of 2022 falling sharply from 2021 levels.

Exit Activity Reverting to Normal After Record 2021

$ in billions | 2022 value annualized as of June 30[8]



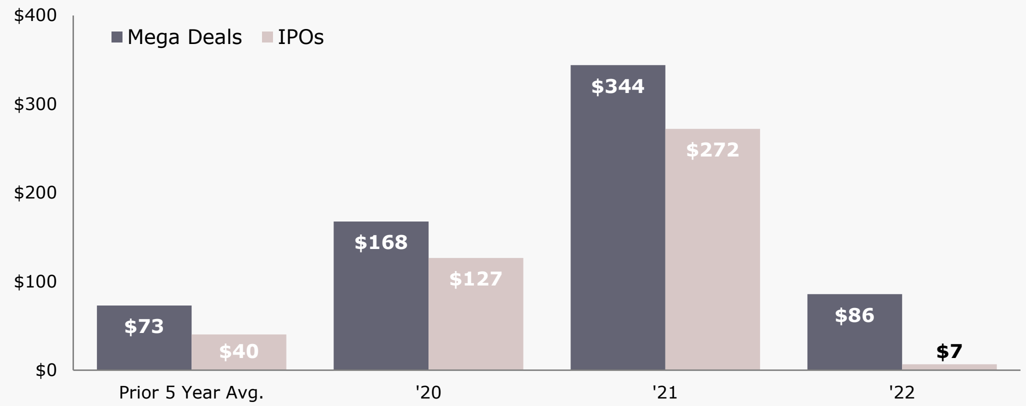
While market volatility impacted exit activity, the pullback brings the 2022 exit activity more in line with the long-term trend in the market. As presented on the following page, mega deals and exits via IPOs have fallen most sharply since 2021.

While unlikely to return to 2021 levels, the significant dry powder available to PE firms and secondary funds, as well as the evolution in the secondaries market described on the following page, may enable PE exit activity to remain more resilient relative to the GFC era amid market volatility or a prolonged economic downturn.

Exit activity for mega deals (valued above $2.5 billion) have surged the most of any segment over the past two years, doubling between 2019 and 2020 and again between 2020 and 2021. Mega deals have grown to account for over 40% of exit activity, relative to 20% average prior to COVID.[8]

Mega Deal & IPO Exit Activity

Change from prior 5-year average | 2022 value annualized as of June 30[8]



This segment of the market also pulled back the most sharply in 2022, contracting by ~75% from the heights achieved in 2021. Relative to the broader market, the middle market held up better, down less than 15% from its longer-term average.[8]

The robust exit environment for private equity companies in 2020 and 2021 was in part driven by the IPO market, which accounted for over 30% of exit activity, relative to an average of ~10% prior to COVID. The IPO market has reversed in 2022, with PE exits through IPOs accounting for a minimal amount of total exit activity. This is partially a driver of the contraction in mega deal exits, as PE IPO exits generally skew larger.[8]

Evolution of PE Secondary Market

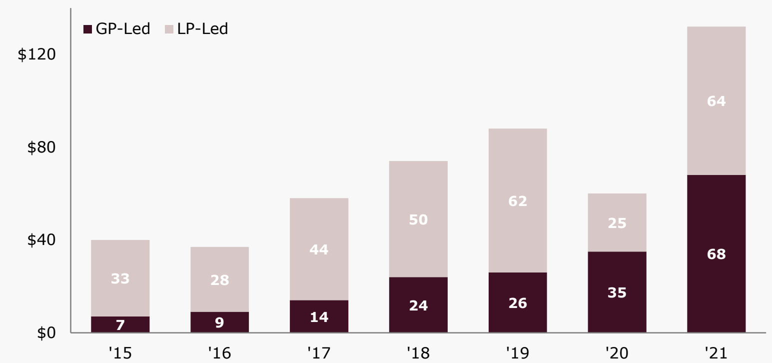
Secondary funds experienced back-to-back record fundraising in 2020 and 2021, with particularly sharp growth for large and mega secondaries funds, which accounted for over 80% of capital raised in this period.[9] As a result of the strong fundraising environment, secondary dry powder has increased over 2x over the past decade, with dry powder being somewhat offset by robust deployment.[9]

In addition to growing in terms of capital raised, the secondary market has also expanded from focusing on acquiring LP interests in private equity funds to a much broader array of creative liquidity solutions, including a variety of GP-led transactions (e.g., continuation vehicles, restructurings, strip sales).

In 2021, GP-led secondary transactions accounted for over half of secondary transaction volume, a tenfold increase from 2015. GP-led secondaries can enable PE managers to manage position sizes or extend their ownership of assets while offering liquidity to investors, among other potential uses.

Rapid Growth in GP-Led Secondaries

$ in billions | As of December 31, 2021[10]



As this market has evolved, liquidity options exist for both PE sponsors and investors that were less widely available during the GFC. Investors in this environment may tap the secondary market to pivot their private markets holdings (e.g., sell more mature vintages to redeploy or manage exposure) or generate cash by selling positions on the secondary market. PE sponsors can also utilize the deep pool of secondary capital to engage in continuation vehicles or other structured secondaries and hold onto assets longer to avoid near-term volatility.

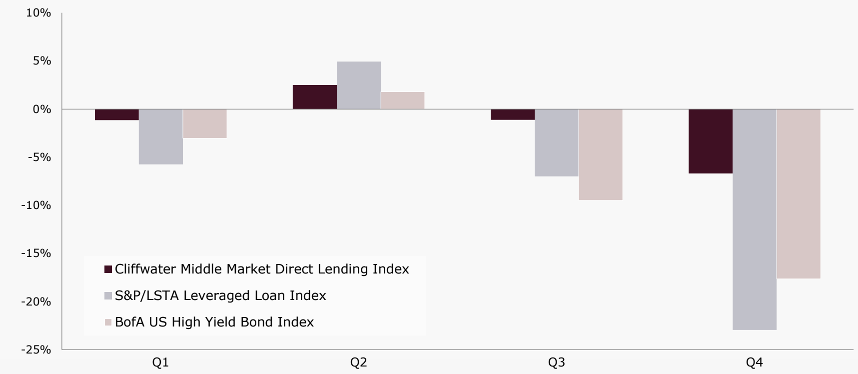
Leveraged Loan Market & Private Credit Update

The availability of credit plays an important role in private equity investing. As mentioned previously, private credit direct lending has developed substantially over the past decade, offering an alternative to the leveraged loan market and traditional financial institutions to PE sponsors.

The development of this asset class also creates new opportunities for investors, offering more access to the credit side of private market transactions. Middle market direct lending has historically offered more downside protection than other segments of corporate credit, proving more resilient than leveraged loans and high yield bonds during the worst of the GFC, as shown on the right.[14] Middle market direct lending has also generated stronger annualized results with lower volatility over the past ~20 years than these assets.[14]

Credit Assets Performance in 2008

Quarterly total return | Middle market direct lending, leveraged loans, & high yield corporate bonds[14]



As presented in the charts below, middle market loans typically possess attractive characteristics relative to large corporate loans, including historically attractive yields, downside mitigation potential through lower default rates, and less leverage, enabling companies to better navigate economic downturns. These loans are also typically at the top of the capital structure, limiting downside relative to equity investments and junior debt, and generally have better loan documentation terms, including at least one financial covenant.

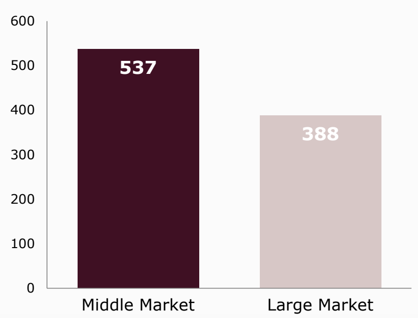
Particularly relevant in the current environment, middle market PE loans also have limited duration risk, benefiting from the floating rate loan terms where the rate adjusts as the base rate (typically LIBOR or SOFR) changes. With the uncertainty around future rates in the US, the floating rate structure can offer investors a potential hedge against inflation and rising rates.

The downside of floating rate loans (i.e., rising debt service costs for the borrower) can potentially be mitigated through a diversified portfolio focused on non-cyclical sectors and high quality companies alongside experienced PE managers. Further, the loan sponsor is typically an active partner, working with PE sponsors to address liquidity concerns and negotiate workouts, potentially resulting in lower losses and higher recovery rates in downside scenarios. Middle market lenders are typically "buy and hold" investors with strong sponsor relationships that can deter sponsors from taking adverse actions against the lender, contrasting with the more transactional nature of large broadly syndicated loans.

Potential Advantages of Middle Market Private Credit

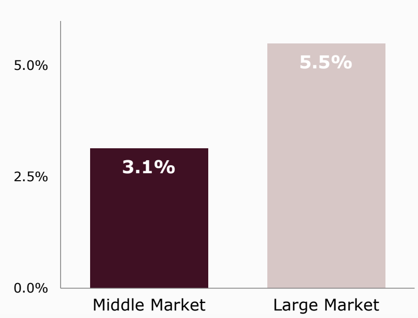
Higher Yields

Average spread for middle market loans ~150 bps above large market[11]



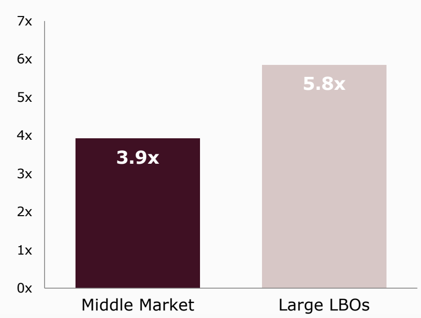
Lower Default Rates

Default rates ~235 bps lower for middle vs. large market loans[12]



Less Leverage

Average leverage / EBITDA ratios ~2x below large market loans[13]



Conclusion & Final Thoughts

We do not believe private markets will be immune to the larger headwinds and disruptions facing markets and the economy. However, as discussed throughout this outlook, private markets have evolved significantly over the past decade, with more tools and capital available to potentially weather an economic downturn or prolonged market volatility.

Within private markets, we believe the middle market is best positioned to navigate an economic downturn. This segment has historically outperformed during challenging periods, and we believe it continues to benefit from lower entry valuations, more conservative use of leverage, and significant pools of capital available to potential acquirers of middle market PE portfolio companies.

Further, we believe the middle market offers an opportunity for PE sponsors to potentially generate value independent of the macroeconomic environment. Middle market sponsors typically acquire family or founder-owned companies, grow and professionalize the underlying businesses, and sell these professionalized companies up market to strategic acquirers and larger PE funds. We believe this "business building" approach to PE investing can potentially generate more consistent results across cycles.

As we are evaluating investment opportunities in the current environment, we keep some key themes and guidelines top of mind:

- **Diversification:** we believe broad industry diversification will be essential to navigating the current environment. In just a few years, we have seen sectors rapidly fall in and out of favor. While the long-term nature of private equity investments can enable managers to potentially wait out short-term fluctuations in valuations, a well-diversified portfolio can enable in favor sectors to offset out of favor investments and potentially mitigate volatility
- **Consistent vintage year deployment:** we believe diversifying investments consistently across vintage years, and thereby investing through various market, credit, and valuation cycles, can result in more attractive risk-adjusted returns
- **Patience and discipline:** in terms of portfolio construction, investment pacing, and maintaining adequate capital reserves to support our existing portfolio companies
- **Underwriting resilience:** building in a near-term recession and slower top line growth, margin compression, and exit multiple pressure into our underwriting cases
- **Remaining highly selective:** emphasis on companies with manageable debt levels that preserve operational leverage in a downturn and investing alongside quality partners with experience building businesses and investing across cycles

About Apogem Capital

Apogem Capital
A NEW YORK LIFE INVESTMENTS COMPANY

Apogem Capital was formed in April 2022 through the combination of PA Capital, Madison Capital Funding and GoldPoint Partners to create a singular and unified, world class private markets alternative investment firm.

With approximately $39 billion in assets under management[15] as of March 31, 2022, Apogem has the deep relationships, data, and history in the middle market to deliver innovative solutions to both clients and sponsors. Apogem Capital offers investors access to the middle market's growth engine through investments in leading private companies and funds. The Firm manages a streamlined suite of capital solutions, including direct lending, junior debt, primary fund investments, secondary investments, equity-co-investments, GP stakes, private real assets and long/short equity.

Apogem Capital is a wholly owned subsidiary of New York Life Insurance Company ("NYLIC"), through New York Life Investment Management Holdings, LLC ("NYLIM").

Endnotes & Disclosures

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Endnotes

1. *Source for Corporate Profits:* U.S. Bureau of Economic Analysis, Nonfinancial Corporate Business: Profits After Tax (without IVA and CCAdj), retrieved from FRED, Federal Reserve Bank of St. Louis. *Source for Gross Value Added:* U.S. Bureau of Economic Analysis, Gross value added of nonfinancial corporate business, retrieved from FRED, Federal Reserve Bank of St. Louis. As of June 30, 2022.

2. *Source for Equities:* Wilshire Associates, Wilshire 5000 Full Cap Price Index, retrieved from FRED, Federal Reserve Bank of St. Louis. *Source for Government Bonds:* Federal Reserve Bank of Dallas, Market Value of Marketable Treasury Debt, retrieved from FRED, Federal Reserve Bank of St. Louis. *Source for Corporate Bonds:* Bloomberg. Represents the market value of the Bloomberg US Corporate Bond Index, which measures the investment grade, fixed-rate, taxable corporate bond market. As of June 30, 2022.

3. Source: US & Canada Buyout data as per Cambridge Associates. "Low Mid Market" includes fund sizes less than $500 million, "Core Middle Market" includes fund sizes $500 - $2B, "Upper Middle Market" includes fund sizes $2B - $5B, and "Large / Mega" includes fund sizes $5B+. As of December 31, 2021. S&P 500 TR Index as per Altsoft.

4. Source: National Federation of Independent Businesses, "Small Business Optimism Index." As of June 30, 2022.

5. Source: University of Michigan Survey of Consumer Sentiment. As of June 30, 2022.

6. Source for Large LBOs: PitchBook LCD Global Research, "LCD's Leveraged Buyout Review." As of June 30, 2022. Large LBOs defined companies with > $500 million in EV. Source for Middle Market: GF Data's "GF Data M&A Report May 2022." Includes companies with less than $250 million in enterprise value.

7. Source: PitchBook, "Quantitative Perspectives: US PE Enters New Regime." As of June 30, 2022.

8. Source: PitchBook, "US Annual Private Equity Breakdown, Q2 2022."

9. Source: PitchBook, "Global Private Equity Fund Strategies Report, Q1 2022."

10. Source: Jefferies, "Global Secondary Market Review, January 2022."

11. Source: PitchBook LCD Global Research, "LCD's High-End Middle Market Lending Review." As of June 30, 2022. Middle Market defined as issuers with EBITDA < $50M. Large Market defined as issuers with EBITDA > $50M. Represents average since 2010.

12. Source: PitchBook LCD Global Research, "LCD Institutional Loan Default Review." Produced June 2022. Comprises loans closed between 1995 and Q1 2021. Middle market defined as issuers with less than $250 million in enterprise value. Large Market defined as issuers with more than $500 million in enterprise value.

13. Source for Large LBOs: PitchBook LCD Global Research, "LCD's Leveraged Buyout Review." As of June 30, 2022. Large LBOs defined as issuers with EBITDA > $50M. Source for Middle Market: GF Data's "GF Data Leverage Report May 2022." Includes companies less than $250 million in enterprise value. Represents average since 2010.

14. Source for Middle Market Direct Lending: Cliffwater Direct Lending Index. https://www.cliffwaterdirectlendingindex.com/. As of March 31, 2022. Source for Leveraged Loans: Leveraged Commentary & Data, S&P/LSTA Leveraged Loan Index. As of June 30, 2022. Source for High Yield Bonds: Ice Data Indices, LLC, ICE BofA US High Yield Index Total Return Index Value, retrieved from FRED, Federal Reserve Bank of St. Louis, as of August 3, 2022.

15. AUM is estimated and unaudited as of March 31, 2022. AUM includes non-discretionary and co-advised assets, as well as assets managed for New York Life and certain of its subsidiaries.

Index Definitions

S&P 500 Total Return Index (or "S&P 500 TR") – The index is an unmanaged index of 500 common stocks that is generally considered representative of the U.S. stock market. The index is heavily weighted towards stocks with large market capitalizations. The index assumes reinvestment of dividends and capital gains at net asset values. You cannot invest directly in the Index.

Cambridge Associates Buyout & Growth Benchmark – Cambridge Associates U.S. Buyout & Growth Benchmark Statistics represents a robust collection of institutional quality private fund performance and are based on data compiled from institutional-quality global buyout and growth equity funds formed since 1986. The benchmark aggregates portfolio-level performance information. Fund and investment-level performance information is drawn from the quarterly and audited annual financial statements of the fund managers and each manager's reported performance numbers are independently recreated from the financial statements and verified by Cambridge Associates.

ICE BofA US High Yield Index - tracks the performance of US dollar denominated below investment grade rated corporate debt publicly issued in the US domestic market.

S&P/LSTA Leveraged Loan Index - market value-weighted index designed to measure the performance of the US leveraged loan market and dates back to 1997.

Cliffwater Direct Lending Index - seeks to measure the unlevered, gross of fees performance of US middle market corporate loans, as represented by the underlying assets of Business Development Companies ("BDCs"), including both exchange-traded and unlisted BDCs, subject to certain eligibility requirements. The CDLI is an asset-weighted index that is calculated on a quarterly basis using financial statements and other information contained in the U.S. Securities and Exchange Commission ("SEC") filings of all eligible BDCs.

Note: Performance of broad public market indices, such as the S&P 500, are for informational purposes only and do not provide a basis of comparison for private equity fund investments as the market volatility, liquidity and other characteristics of private equity fund investments are materially different from those of broad public market indices. Comparisons to alternative investment indices/benchmarks are subject to material inherent limitations. Data included in alternative investment indices or benchmarks generally do not represent the returns of all funds but rather only those to which the index/benchmark provider has access. The number of funds included in the index/benchmark data for a specific vintage year will likely vary. Moreover, performance information for all funds within a specific category may differ from those reported by the index/benchmark provider. Additionally, the universe from which the components of an alternative investment index/benchmark are selected include a significant element of "survivor bias" into the reported levels of an index/benchmark, as generally only successful funds will continue to report for the required period. Accordingly, indexation of alternative investment strategies tends to overstate the beneficial aspects of these strategies while obscuring certain risks, including the "risk of ruin."