Middle Market Update

Q3 2021

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Third Quarter Economic Performance and Future Outlook

Federal Reserve Perspective

- The economy continues to strengthen due to progress in vaccine rollout and fiscal policy support. While economic activity and employment indicators are improving, the spread of the Delta variant has slowed the recovery, and major supply chain issues are hindering output and causing inflationary pressures throughout the economy[1]
  - The Consumer Price Index increased 0.4% in September on a seasonally adjusted basis, compared to a 0.3% increase in August; the Index has risen 5.4% over the last 12 months[2]
  - Some of the largest increases include the indices for energy, commodities and used cars, which rose 41.7% and 24.4%, respectively, over the last 12 months
  - While the Fed views inflation as largely transitory, it is unclear when upward pricing pressures will ease
  - The Federal Open Market Committee ("FOMC") has kept, and expects to maintain, the target range for the federal funds rate near zero until the labor market reaches maximum employment and inflation moderately exceeds 2%
- Supply chain bottlenecks and labor shortages continue to cause challenges to companies attempting to keep up with surging demand[1]
  - Industries particularly affected include motor vehicles and retail

Employment

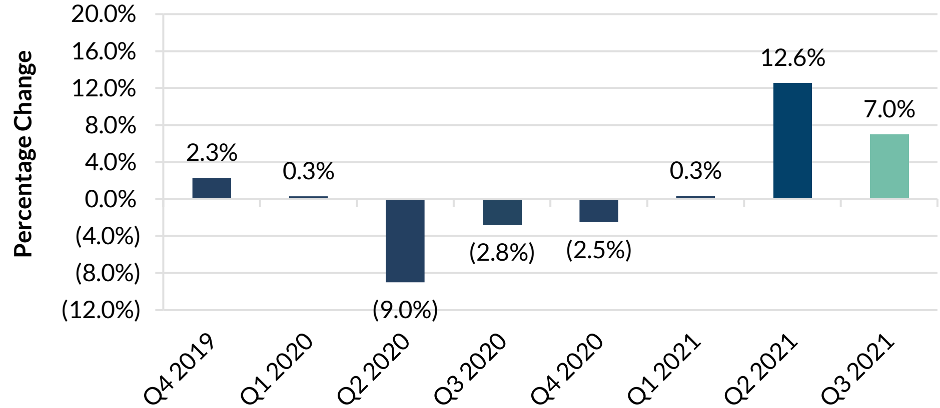
- The U.S. unemployment rate decreased to 4.8% in September 2021 from 5.9% in June 2021[2]
  - 7.7 million people were unemployed in September 2021, a decline from Q2 2021, but still significantly above the pre-pandemic level of 5.7 million in February 2020
- The number of unemployed people on temporary layoff decreased to 1.1 million in September 2021 from 1.8 million in June 2021[2]
- In September 2021, 13.2% of employed people worked from home due to the pandemic, a small decrease from 14.4% in June 2021[2]

U.S. Treasury Securities

- Long-term Treasury yields fell slightly in Q3 2021 despite rising inflation figures, indicating that markets are not pricing in significant long-term inflation[3]

	Q4 2020	Q1 2021	Q2 2021	Q3 2021
1-Year Treasury Bill	0.11%	0.08%	0.06%	0.07%
5-Year Treasury Note	0.37%	0.61%	0.83%	0.80%
10-Year Treasury Note	0.86%	1.32%	1.58%	1.32%
30-Year Treasury Bond	1.62%	2.08%	2.26%	1.93%

Real Gross Domestic Product ("GDP") Year-Over-Year Growth[4]



Outlook for 2021 and 2022

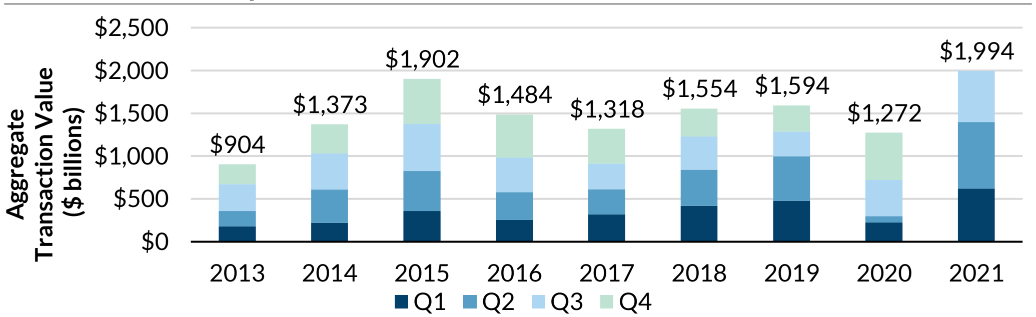
- Business Roundtable's CEO Economic Outlook Survey, a composite index of CEO plans for capital spending, hiring, and expectations for sales over the next six months, had an index reading of 114 in Q3 2021, decreasing by 2 points from Q2 2021[5]
  - The CEOs surveyed cite difficulties in finding and retaining qualified workers, adverse changes to U.S. corporate tax policy, and slow progress in global vaccinations as the most significant threats to business prospects
- The Federal Reserve projects U.S. real GDP expansion of 5.9% and 3.8% for 2021 and 2022, respectively[1]
  - The projection for 2021 decreased from 7.0% in June, while the 2022 projection increased, demonstrating the Federal Reserve's view that current economic headwinds are largely transitory
  - U.S. real GDP increased 4.7% in Q3 2021 from Q3 2020, decelerating from Q2 2021 due to a slowdown in consumer spending, reopening delays due to the Delta variant, and a decrease in government assistance to consumers, businesses, and states[4]
- As of September 2021, members of the Federal Reserve Board project 4.2% inflation in personal consumption expenditures in 2021, up 3.4% from the June 2021 expectation[1]
  - Inflation is expected to decline to 2.2% in 2022 and remain near 2.0% over the long run
- Economic outlook among consumers has deteriorated during Q3, reflecting the slower than expected economic recovery[6]
  - The Expectations Index, which is based on consumers' short-term outlook for income, business, and labor market conditions, fell to 86.7 from 107.0 in June 2021

1. *U.S. Federal Reserve*
2. *Bureau of Labor Statistics*
3. *The Wall Street Journal*
4. *U.S. Bureau of Economic Analysis*
5. *Business Roundtable*
6. *The Conference Board*

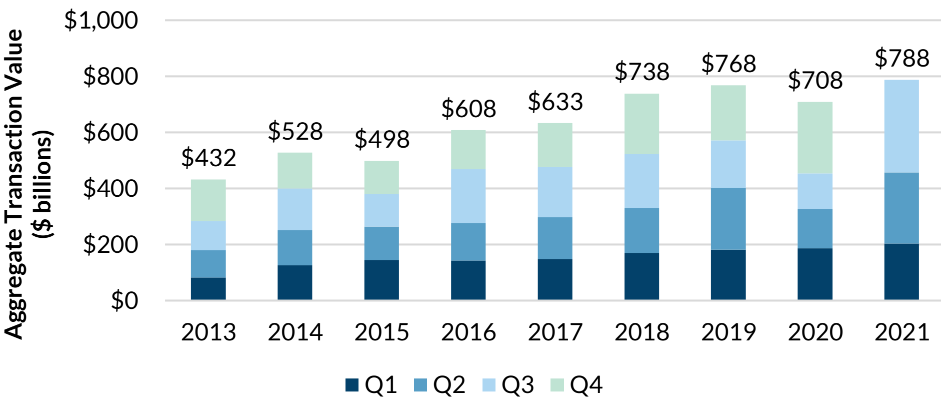
Mergers & Acquisitions

- Global merger and acquisition ("M&A") activity continued its momentum and increased to $1.3T in value in Q3 2021, a 11.6% increase compared to Q2 2021[1]
  - 9,245 deals were completed in Q3 2021, a 2.1% increase from Q2 2021
    - M&A activity was particularly strong in Europe, where robust vaccine deployment and a return of GDP to near pre-pandemic levels have prompted corporate consolidation efforts
    - Interest rate increases, a stronger U.S. dollar, and increased antitrust enforcement under the Biden Administration may become headwinds for future M&A activity
  - An abundance of capital is likely to drive further M&A activity, as private equity firms seek to deploy nearly $1.5T of dry powder
    - 40% of all M&A transactions were completed by financial sponsors in Q3 2021, when measured by both deal value and deal count
    - Strategic buyers are also looking to deploy capital, with nonfinancial companies now holding almost $7T in cash
  - Nearly half of all transactions were paid for, at least in part, with equity, up from 40% in 2020 as higher valuations resulted in larger transactions
- U.S. M&A deal value totaled $595.1B in Q3 2021, representing a 23.8% decline over Q2 2021; U.S. M&A volume also dropped to 1,575 transactions during the same period[2]
  - Companies sought to expand their capabilities and services as economic growth remained strong, even with President Biden's proposed tax reforms threatening heavier tax consequences for acquisitive corporations[1]
  - Canadian Pacific Railway's $29.7B acquisition of Kansas City Southern was the largest North American M&A deal of the third quarter, following a prolonged bidding war with Canadian National Railway Co. and forming the first direct rail connecting the U.S., Canada, and Mexico[3,4]
- The U.S. middle market median Enterprise Value / EBITDA multiple increased 17.6% from 9.1x in Q2 2021 to 10.7x in Q3 2021[3,5]

U.S. M&A Activity



U.S. Private Equity Deal Flow[6]



Private Equity

- U.S. private equity ("PE") fundraising cooled in Q3 2021, with $58.1B raised across 88 funds compared to $91.1B across 110 funds in Q2 2021[6]
  - The Q3 2021 YTD fundraising total of $237.7B remains 86.3% higher than the comparable period in 2020
  - Record-setting dealmaking is shortening the investment cycle, with GPs deploying capital at rates much faster than expected and pushing the average time between funds to 2.8 years in 2021, down from 3.5 years in 2020 and 4.8 years in 2011
- U.S. PE deal value in Q3 2021 rose to $331.0B across 2,296 deals, compared to $253.6B across 1,945 deals in Q2 2021[6]
  - Deal count and value totals already exceed the full-year record set in 2019
  - The unprecedented rise in PE activity is driven by robust economic growth, cheap debt, and a desire to close deals in advance of potential capital gains tax increases
  - Several large deals for family-owned businesses were consummated during the quarter, including Blackstone's (NYSE: BX) $5.0B acquisition of the Chamberlain Group, a maker of garage door openers[4]
- Q3 2021 saw U.S. PE exit value of $282.4B, exceeding the Q2 2021 figure of $193.9B, while Q3 2021 YTD exit value of $638.3B is already more than 50% higher than the full-year record of $412.6B set in 2018[6]
  - PE firms are increasingly employing public exits to take advantage of the higher valuation multiples offered by the equity markets
  - Strategic buyers are also eager to use their growing cash piles as they emerge from the pandemic
  - Private equity funds are sitting on record amounts of dry powder, driving increased sponsor-to-sponsor deal activity

1. *Pitchbook Global M&A report*
2. *White & Case using Mergermarket data*
3. *FactSet*
4. *Reuters*
5. *"Middle market" is defined as deals valued between $1 million and $500 million, plus undisclosed deals*
6. *Pitchbook U.S. PE report*

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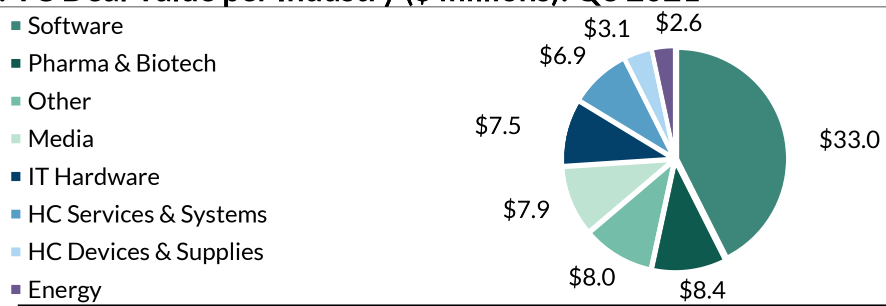
Venture Capital, PIPEs, Equity Markets, and Corporate Earnings

Venture Capital Investing

- Global venture capital ("VC") investments hit a record high of $171.7B across 8,682 transactions in Q3 2021, an increase from $157.1B across 7,687 transactions in Q2 2021[1]
  - Mega-deals (deals with value over $1B) continued to play a leading role in the market with seven mega deals in the U.S. alone, led by a $2.5B raise by electric car manufacturer Rivian
  - Investors continue to show increased interest in ESG and cleantech, with alternative energy infrastructure company Generate raising $2.0B and energy storage company Svolt raising $1.5B during the quarter
- In Q3 2021, investments in U.S. VC-backed companies totaled $82.8B, an increase of 2.9% from Q2 2021[2]
  - There were 207 VC deals over $100M that closed this quarter, bringing Q3 2021's YTD total to $136.5B invested across 597 deals
  - Mega-deals are increasingly common, representing 57.2% of total capital investment in Q3 2021 YTD
  - U.S. VC fundraising reached $96.0B across 526 funds in Q3 2021 YTD, surpassing 2020's total of $85.8B
- Q3 2021 YTD exit value rose to $582.5B, more than doubling 2020's record high of $289.0B[2]
  - Public listings accounted for the largest exit strategy by value, making up 88.2% of the total exit value for 2021 thus far
  - The IPO market had the most active quarter of the year, with 93 IPOs during Q3 2021
  - Robinhood's $30.0B IPO was the largest of the quarter
- Nontraditional activity, defined as activity outside of traditional VC firms (such as corporations, LPs, PE firms, etc.) has surpassed 2020's full year figures by 45.4% in investment value, with $183.6B Q3 YTD 2021 compared to $126.3B in 2020[2]
  - An estimated 4,300 deals received investment from a nontraditional institution Q3 YTD 2021, as compared to an estimated 3,982 deals in 2020
  - 33.5% of all venture deals so far in 2021 have received participation from at least one nontraditional investor

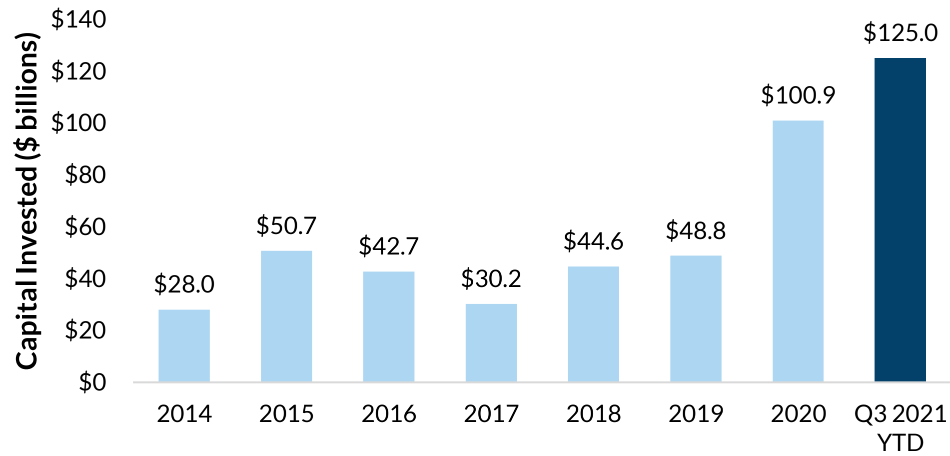
U.S. VC Deal Value per Industry ($ millions): Q3 2021[2]



PIPE Investing

- There were 1,502 U.S. Private Investment in Public Equity ("PIPE") deals valued at $125B Q3 YTD 2021, an increase in volume and value of 38.6% and 93.5%, respectively, compared to the first three quarters of 2020[3]
  - PE firms focused on big-ticket investments, causing average deal size to increase by approximately 27%[4]
  - PIPE transactions represented over 50% of global private equity deals completed in Q3 2021[4]

U.S. PIPE Activity[3]



Equity Markets and Corporate Earnings

- U.S. equities posted 19 new highs during the quarter before ultimately receding to Q2 2021 levels to close out the quarter[5]
  - Markets pulled back from all-time highs due to concerns about the economic impact of the Delta variant, supply chain slowdowns leading to industry shortages, and regulatory crackdowns in China
  - The S&P 500 Index increased 0.58% during the quarter, while the Nasdaq Composite and the Dow Jones Industrial Average fell 0.23% and 1.46%, respectively
- Of the 56% of companies in the S&P 500 that reported Q3 2021 earnings, 82% reported positive EPS and revenue surprises[6]
  - 82% would mark the fourth highest percentage since tracking of the metric first began in 2008
  - Year-over-year earnings growth can be explained by the negative impact of COVID-19 across industries in 2020 and the energy, financials, and healthcare sectors leading overall revenue increases for Q3 2021

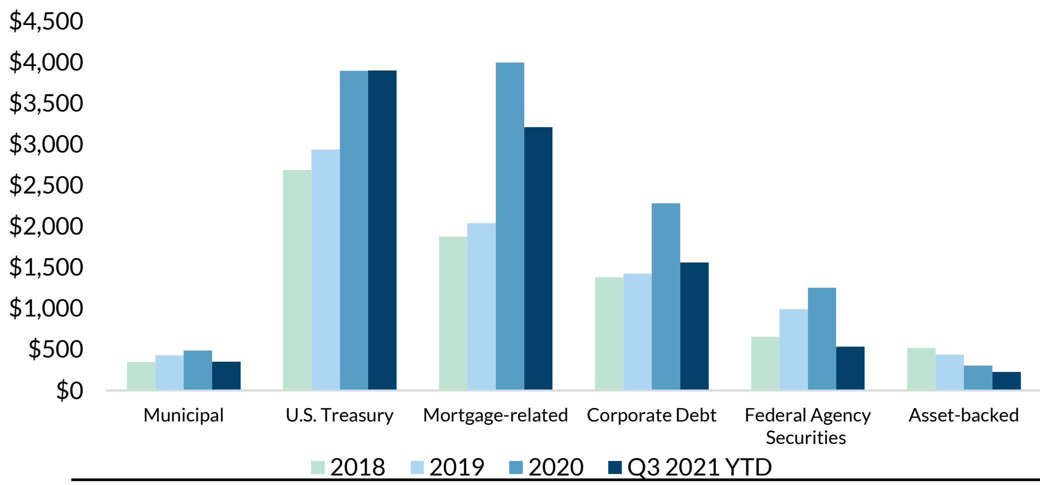
1. *KPMG*
2. *PitchBook*
3. *PlacementTracker*
4. *Aranca*
5. *Morningstar*
6. *FactSet (as of October 29, 2021)*

Debt Capital, IPO Market, and Middle-Market Lending

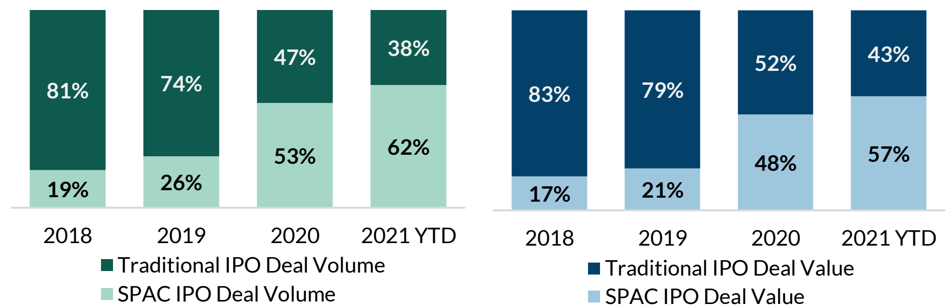
Debt Capital

- The Barclays U.S. Aggregate Bond Index returned 0.05% in Q3 2021, a decrease from the Q2 2021 return of 1.83%[1]
- The fixed income market will continue to experience headwinds due to persistent inflation and increased corporate regulation in response to several high profile defaults[1]
- The Barclays Investment Grade U.S. Corporate Bond Index remained flat in Q3 2021, a significant decrease from the 3.6% return posted in Q2 2021[1]
  - In Q3 2021, corporate bond issuance totaled $427.6B, a decrease of 19.2% from Q2 2021 due to uncertainty stemming from coronavirus variants
  - Investment-grade corporate bond issuance decreased by 17.2% compared to Q2 2021, with total issuance of $318.9B in Q3 2021
  - High-yield corporate bond issuance fell by 24.5% compared to Q2 2021, with total issuance of $108.8B in Q3 2021
- U.S. Bond issuances for Q3 2021 totaled $3.0T, a 7.8% year-over-year decrease from $3.3T in Q3 2020[2]
  - U.S. Treasuries accounted for $1.3T in total issuances in Q3 2021, a year-over-year increase of 19.4%
  - Municipal bonds performed the worst, with a -0.3% return in Q3 2021
- Sustainable-bond issuance slowed from Q2 2021, with a total of $217B of sustainable bonds issued in Q3 2021, a 25% year-over-year increase[3]
  - Sustainable bond issuance, which includes green, social, sustainable, and sustainability-linked instruments, is forecasted to reach $1T in 2021, higher than previous estimates

Issuances in the U.S. Bond Market ($ billions)[2]



SPAC IPOs by % of all U.S. IPO Activity[4]



IPO Market

- Q3 2021 saw 547 IPOs worth $106.3B globally, representing an 87% increase in volume and a 99% increase in value year-over-year[5]
  - This makes Q3 2021 the most active third quarter by deal count and value over the last 20 years
  - Six mega IPOs (IPOs of companies over $1B) were completed in Q3 2021 with gross proceeds of $9.6B, down from the 10 mega IPOs completed in Q2 2021[6]
  - Pharmaceutical and life science IPOs dominated Q3 2021, with 32 offerings raising $5B; 27 technology IPOs raised a total of $12.0B during the quarter
- SPAC IPO activity increased in Q3 2021, with 88 offerings raising $16.0B, an increase in deal volume of 38% from Q2 2021[4]
  - 71 companies completed SPAC merger processes in Q3 2021
- Announced SPAC acquisition activity slowed from the previous quarter, with 59 announced deals in Q3 2021, representing a decrease of 20%[4]
  - SPACs announced in Q3 2021 underperformed the broader market indices, largely due to increased investor scrutiny
  - An estimated $120B in cash sits on the sideline for SPACs mergers yet to be announced

Lending Market

- Investor demand for leveraged loans remained strong in Q3 2021, as issuance of total leveraged loans continued at record pace, while term loan and refinancing demand plateaued[7]
  - Q3 2021 YTD U.S. leveraged loan issuance of $472B has already surpassed the previous annual record of $397B in 2017
  - LBO loan issuance slowed in Q3 2021, decreasing 2.7% to $40.4B from $41.5B in the previous quarter, but remained at levels not seen since Q3 2018 as borrowers move away from syndicated loans to finance buyouts
  - Dividend recapitalizations reached a record total $66.4B in 2021

1. *Prudential*
2. *SIFMA*
3. *Moody's*
4. *PwC*
5. *E&Y*
6. *FactSet*
7. *S&P Global Market Intelligence*

By Tiffany Wilding, North American Economist, PIMCO

Since the previous Federal Open Market Committee (FOMC) meeting in June, new data suggest that U.S. economic activity has slowed more than many observers initially expected due to renewed anxieties around COVID-19 and continued supply chain disruptions. Despite this, FOMC members signaled at September's meeting their intent to announce the first reduction in the monthly pace of bond purchases as soon as the November FOMC meeting. The Federal Reserve also published a new summary of economic projections (SEP), which included a substantial upward revision to the Fed's core inflation forecast for 2021 and a similarly substantial increase in the median expected policy rate through 2023.

The Fed's new forecasts still imply an expectation that the currently elevated pace of inflation will fall back toward the central bank's longer-term 2% target in 2022. Nevertheless, with above-target inflation appearing to be more persistent than many observers initially believed, members on the committee appeared to view a faster pace of tightening as warranted. Although longer-term inflation expectations currently appear to be consistent with the Fed's 2% target, more persistent inflation likely raises the risk that inflation expectations accelerate higher, which in turn would warrant more aggressive tightening from the Fed. We believe the revisions in the September projections reflect Fed officials' efforts to manage these risks.

Finally, on the bond purchases, even though the FOMC forcefully signaled its expectations for tapering starting in November, we see a risk that this is delayed until December. The U.S. Treasury debt ceiling is likely to become binding around the time of the November FOMC meeting, and the Fed may not want to further contribute to what is likely to be a period of elevated volatility. Nevertheless, the Fed can easily adjust the pace of tapering to still end purchases "around the middle of next year," as Fed Chair Jerome Powell indicated during the press conference.

Economic impact of the delta variant and hurricane

Since the June FOMC meeting, a renewed rise in coronavirus cases from the more contagious delta variant has slowed activity in the services industry, while similar outbreaks in emerging markets have created more problems for suppliers and slowed production in the auto industry in particular. Production disruptions from Hurricane Ida also likely further exacerbated logistical issues, while damages, especially of vehicles, will likely augment demand and prices in the quarters to come, especially given persistent low vehicle inventories.

These issues also led PIMCO to revise down our outlook for 2021 U.S. growth and revise up our forecast for inflation. And although we continue to view the current bout of inflation as being driven by factors that should dissipate over the course of the next year, we've also become somewhat more concerned about longer-term inflation expectations accelerating further. According to the Fed's Common Inflation Expectations (CIE) index, inflation expectations appear to be hovering right around the Fed's 2% longer-term target. However, if a series of transitory factors (like the recent hurricane) produce more persistently elevated inflation, inflation expectations risk accelerating further, necessitating a more aggressive reaction from the central bank. While longer-term inflation expectations have not, as of yet, exhibited this type of behavior, it's a risk that the Fed likely wants to mitigate.

September FOMC forecasts for growth and inflation

Substantial revisions to the Fed's 2021 growth and inflation forecasts were met with a similarly large increase in the projected median rate path through 2023. Although the currently elevated level of inflation is still forecast to moderate in 2022, FOMC members projected a faster pace of hikes throughout the forecast horizon. The SEP median estimate for 2021 real GDP growth was adjusted down to 5.9% (versus 7.0% in June), while 2022 real GDP was adjusted up to 3.8% (versus 3.3% previously). The median 2021 core PCE inflation forecast was revised higher to 3.7%, and the 2022 and 2023 medians also rose 0.2 to 0.1 percentage points to 2.3% and 2.2%, respectively. (PCE, or personal consumption expenditures, is the Fed's preferred inflation measure; it is typically a few tenths of a percentage point lower than CPI.)

These forecast changes prompted Fed participants to lift their projections for the path of interest rates as well, and this includes the most dovish members, who shifted their expectations for the first rate hike to 2023, and the more hawkish, who added further hikes in 2022. Overall this resulted in a median policy rate forecast of 0.25% for 2022, and 1.0% for 2023. The September SEP also introduced 2024 rate forecasts at a median of 1.8%, indicating a projected pace of three 25-basis-point rate hikes per year between 2022 and 2024.

The Fed's balance sheet

Against this backdrop for growth and inflation, Chair Powell confirmed that the FOMC still plans to announce the first reduction in their monthly pace of bond purchases at the November meeting. However, we believe the Fed will ultimately be constrained in how quickly it can announce tapering by the late October or early November timing for when the U.S. Treasury debt ceiling will become binding. In the past, market volatility has risen ahead of these deadlines, and the Fed will likely be planning for the scenario in which Treasury coupon payments are delayed, or in the worst case, Treasury auctions fail. As a result, we see the risk that the announcement is delayed until the December meeting. Having said that, we also see the possibility that the Fed announces a faster pace of tapering than the $15 billion monthly reduction that we've previously discussed. Regardless of whether the Fed starts tapering in November or December, we believe it can easily adjust the pace of tapering to end its bond-buying program by the middle of 2022. This will also give the Fed more flexibility to hike rates sooner in the event that inflation expectations accelerate and inflation turns out to be more persistent.

Bottom line

Elevated risks to inflation expectations appear to have prompted Fed officials to revise their rate hike projections higher. Previously more dovish members revised their expectations for the start of rate hikes into 2023, while more hawkish members built in additional hikes, resulting in a hawkish surprise.

Visit PIMCO's inflation page for further insights into the inflation outlook and investment implications.

About the Author

Ms. Wilding is an executive vice president and North American economist based in the Newport Beach office. She leads PIMCO's Cyclical Forum, crafts the firm's outlook for the U.S. and Canadian economies and monetary policy, and analyzes key macro risks for the firm's Investment Committee. She also co-heads the firm's Americas portfolio committee. Prior to joining PIMCO in 2016, she was the head of global interest rate research at Tudor Investment, responsible for recommending trade ideas based on global macro trends. Previously, she was a vice president for U.S. interest rate research with Morgan Stanley and a Treasury market policy analyst for the Federal Reserve Bank of New York, where she helped structure and implement the central bank's response to the 2008 financial crisis. She has 14 years of investment and economics/financial markets experience and holds an MBA in quantitative finance from New York University's Stern School of Business. She received an undergraduate degree from Rhodes College.

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Selected Transactions

Amount	Transaction	Role
Amount Not Disclosed	ACUMEN has been acquired	FINANCIAL ADVISOR
Amount Not Disclosed	PRO•MED CAPITAL has been acquired by experity ventures	EXCLUSIVE FINANCIAL ADVISOR
Amount Not Disclosed	REVENUE GUARD has been acquired by CORONIS	EXCLUSIVE FINANCIAL ADVISOR
$50,000,000	HIGH RISE FINANCIAL — Senior Secured Debt Facility	EXCLUSIVE FINANCIAL ADVISOR
$250,000,000	DIVIDENDSOLAR has merged with Figtree Financing and secured equity and debt financing affiliates of LL Funds, LLC	EXCLUSIVE FINANCIAL ADVISOR
$75,000,000	PAWNEE LEASING CORPORATION — Term-Out Facility	EXCLUSIVE FINANCIAL ADVISOR
$104,500,000	lēgis — Capital Raise	EXCLUSIVE FINANCIAL ADVISOR
Amount Not Disclosed	NORTH MILL EQUIPMENT FINANCE LLC has been acquired by WAFRA CAPITAL PARTNERS	EXCLUSIVE FINANCIAL ADVISOR
$31,000,000	ReMeD has been acquired by US Community Behavioral, a portfolio company of BregalPartners	EXCLUSIVE FINANCIAL ADVISOR
$35,000,000	HEALTHCARE FUNDING + PARTNERS — Senior Secured Debt Facility	EXCLUSIVE FINANCIAL ADVISOR
Amount Not Disclosed	Lighthouse Life — Growth Capital Investment	EXCLUSIVE FINANCIAL ADVISOR
$150,000,000	MoneyLion — Senior Secured Credit Facility	EXCLUSIVE FINANCIAL ADVISOR
Amount Not Disclosed	nuehealth — Senior Credit Facility — ARES	EXCLUSIVE FINANCIAL ADVISOR
$95,600,000	US HOME SYSTEMS (NASDAQ:USHS) has been acquired by THE HOME DEPOT (NYSE: HD)	EXCLUSIVE FINANCIAL ADVISOR
$150,000,000	GOLDEN PEAR FUNDING — $100,000,000 Senior Secured Credit Facility, $50,000,000 Additional Commitment	EXCLUSIVE FINANCIAL ADVISOR
$200,000,000	ENTERRA ENERGY TRUST, Oil & Gas Income Trust (NYSE: ENT and TSX: ENT.UN) — Senior and Junior Secured Credit Facilities	EXCLUSIVE FINANCIAL ADVISOR
$185,000,000	glori ENERGY has merged with INFINITY CROSS BORDER ACQUISITION CO. (NASDAQ: INXBU)	EXCLUSIVE FINANCIAL ADVISOR
$20,000,000	ADF APPLIED DATA FINANCE — Mezzanine Debt	CO-ADVISOR
$140,000,000	EnergySouth MIDSTREAM (NASDAQ NMS: ENS) & FORTRESS have acquired MISSISSIPPI HUB LLC	EXCLUSIVE FINANCIAL ADVISOR
$278,000,000	i-trax (AMEX: DMX) has been acquired by Walgreens	EXCLUSIVE FINANCIAL ADVISOR