Middle Market Update

Q1 2022

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First Quarter Economic Performance and Future Outlook

Federal Reserve Perspective

- Economic and employment indicators have continually improved with unemployment falling lower, although inflation remains elevated. There is still uncertainty surrounding the impact of the Russian invasion of Ukraine on the U.S. economy. The Federal Reserve (the "Fed" or "FOMC") believes that the invasion will continue to drive inflation and impede general economic activity. The Fed decided to raise the Fed funds rate to 0.25% to 0.50% percent with continued increases in the near future. Additionally, balance sheet reduction will likely be announced at an upcoming meeting[1]
  - The Consumer Price Index increased 1.2% in March on a seasonally adjusted basis, compared to a 0.6% increase in December; the index has risen 8.5% over the last 12 months[2]
  - Some of the largest increases remain in indices for energy commodities and used cars, which rose 48.3% and 35.3%, respectively, over the last 12 months[2]
- Market participants have been increasingly expecting the Fed to remove their accommodative policies, specifically with increases in the target fed funds rate[1]
  - Futures prices currently are implying a 170bps increase in the Fed funds rate through the end of 2022 and projections then see the rate increasing to above the longer-run level in early 2024 before leveling back out by 2025
    - This is roughly 70bps more by year-end than was priced in during the January meeting

Employment

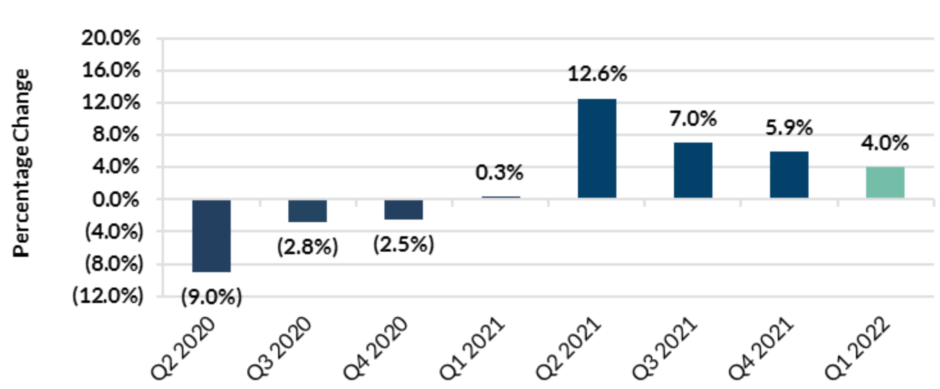
- The U.S. unemployment rate decreased to 3.6% in March 2022 from 3.9% in December 2021[2]
  - 6.0M people were unemployed in March 2022, a decline of 3.7M people over the last year
- The number of unemployed people on temporary layoff decreased to 787,000 in March 2022 from 812,000 in December 2021[2]
- In March 2022, 10.0% of employed people worked from home, a decrease from 11.1% in December 2021[2]

U.S. Treasury Securities

- Short-term Treasury yields rose significantly in Q1 2022; the average 1–year and 5-year yield increased by 74bps and 65bps, respectfully, from Q4 2021[3]

	Q2 2021	Q3 2021	Q4 2021	Q1 2022
1-Year Treasury Bill	0.06%	0.07%	0.18%	0.92%
5-Year Treasury Note	0.83%	0.80%	1.18%	1.83%
10-Year Treasury Note	1.58%	1.32%	1.53%	1.95%
30-Year Treasury Bond	2.26%	1.93%	1.95%	2.26%

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



Outlook for 2022

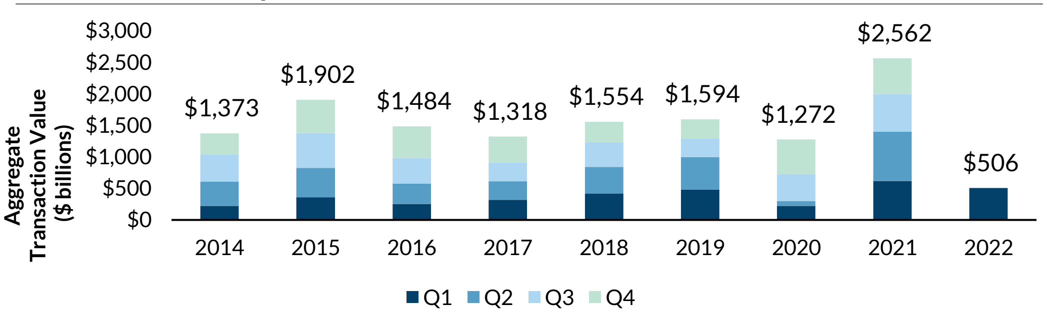
- Business Roundtable's CEO Economic Outlook Survey, a composite index of CEO plans for capital spending, hiring, and expectations for sales over the next six months, had an index reading of 115 in Q1 2022, a decrease of 9 points from Q4 2021[4]
  - The index dipped slightly off the record high Q4 2021 score of 124, due to global economic uncertainty and demand-driven inflation
  - The CEOs focused on hiring and developing investment plans, positioning their companies for a response to the historic demand across the market
- The Federal Reserve projects U.S. real GDP expansion of 2.8% and 2.2% for 2022 and 2023, respectively[1]
  - Although the projection for 2022 decreased from 4.0% in December, the 2023 projection remained consistent
  - Q1 2022 GDP increased to $4.8T, a 4.3% gain from $4.6T in Q1 2021[5]
- As of March 2022, members of the Federal Reserve Board projected 4.3% inflation in personal consumption expenditures in 2022, up 1.7% from the December 2021 expectation[1]
  - Inflation is expected to decline to 2.7% in 2023 and remain near 2.0% over the longer run
- Consumer confidence declined slightly in the first three months of 2022, however it remains supported by the continued employment growth[6]
  - The Expectations Index, which is based on consumers' short-term outlook for income, business, and labor market conditions, declined to 107.2 in March 2022 from 115.2 in December 2021

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

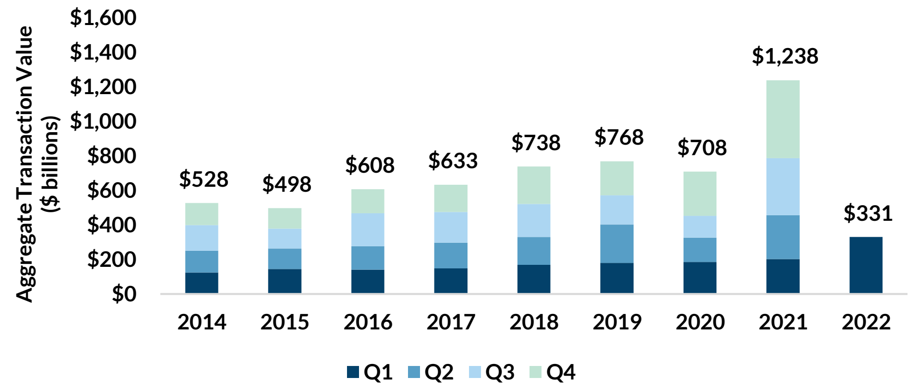
Mergers & Acquisitions

- Global merger and acquisition ("M&A") activity began this year with $1.3T worth of deal value for Q1 2022, a decline from the $1.6T in Q4 2021[1]
  - 10,006 deals were completed in Q1 2022, a decrease of 10.5% from Q4 2021
    - Although activity slowed in comparison to the latter half of 2021, M&A remains strong when compared to the past five years
    - Fallout from the Ukraine invasion will continue to impact activity entering the coming weeks; as shown in the data a decrease in announced deals has already begun
  - Global M&A activity in the financial services sector was reported at $102.8B for Q1 2022, a 24% jump from the activity logged in Q1 2021
    - Private equity deals remain a large portion of deal activity, with eight of the largest 20 deals in the quarter being purchased by financial sponsors
  - The energy sector has been attracting activity as inflation continues to raise the prices of natural resources. Traditional energy has received new capital, as high prices are anticipated to stay
    - The green energy sector has experienced similar capital injection, while simultaneously being driven by the call to reduce reliance on Russia's and China's natural resources
- U.S. M&A deal value totaled $506.2B in Q1 2022, representing an 11.0% decline from Q4 2021; U.S. M&A volume increased by 95 transactions to 1,542 transactions during the same period[2]
  - The announced acquisition of Arm Holdings for $40.0B was abandoned by Nvidia following increasing antitrust pressure. The news came only days after the Federal Trade Commission ("FTC") sued to block Lockheed Martin's $4.4B acquisition of Aerojet Rocketdyne[1]
    - The uncertainty surrounding impending regulations by the FTC has the potential to dissuade large M&A activity in the future
- The U.S. middle market median Enterprise Value / EBITDA multiple decreased 23.6% in the last year from 8.9x in Q1 2021 to 6.8x in Q1 2022[3,4]

U.S. M&A Activity



U.S. Private Equity Deal Flow[6]



Private Equity

- U.S. private equity ("PE") fundraising grew slightly in Q1 2022 with $64.8B raised across 98 funds, a 1.9% increase over Q4 2021 fundraising[1]
  - Current fundraising demand is beyond the supply available from traditional LPs. A few firms, including Blackstone, KKR, and Apollo, have made deals with insurance companies to provide additional capital
  - In the search for unique capital, some of the largest firms are targeting the retail market and currently only 1% to 2% of the retails market's $80T in capital is allocated to alternative investments
- U.S. PE deal value in Q1 2022 totaled $330.8B, declining 26.5% from $449.9B in the previous quarter, Q4 2021[1]
  - 2,166 deals were completed in the first quarter of 2022, up 403 from Q1 2021
  - Sponsors are preparing for longer hold periods on their portfolio companies as they attempt to demonstrate to the market strong performance prior to bringing a company for sale
    - Current market conditions including supply chain disruptions, inflation, and remaining Covid-19 irregularities will cause sponsors to take time and growth capital to produce attractive valuations
- Q1 2022 saw U.S. PE exit value of $90.1B, a significant slow down from the $162.0B in Q1 2021[1]
  - 276 companies were sold by PE firms in Q1 2022. The median exit size fell to $330.0M, a metric more consistent with historic values when compared to the $472.3M median of 2021
  - Public listings vanished in both size and number as market volatility continued. The median size of a public listing in 2021 was $1.8B compared to the Q1 2022 median of $191.3M

1. *Pitchbook*
2. *White & Case using Mergermarket data*
3. *"Middle market" is defined as deals valued between $1 million and $500 million, plus undisclosed deals*
4. *FactSet*

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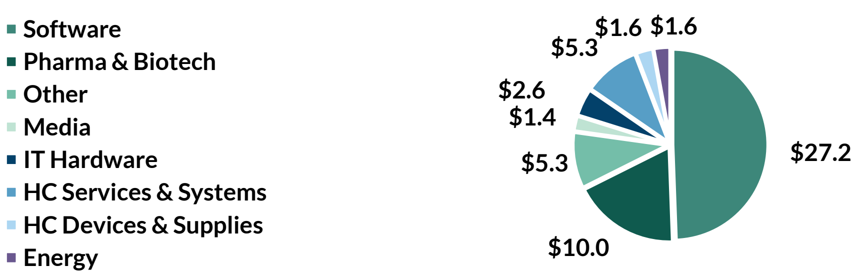
Venture Capital, PIPEs, Equity Markets, and Corporate Earnings

Venture Capital Investing

- Global venture capital ("VC") investments remained somewhat strong, with $144.8B invested across 9,349 transactions in Q1 2022, down from $171.4B across 8,710 transactions in Q4 2021[1]
  - Geopolitical tensions, supply chain issues, and capital markets volatility likely placed downward pressures on both valuations and VC investment
  - Nonetheless, Q1 2022 saw companies from 11 different countries raise $500M+ funding rounds across Europe, the Americas, and Asia
  - Increased cyberattack frequency and the Russia-Ukraine conflict have driven interest in cybersecurity and defense-related investments, with technology security platform 1Password raising $650M and countries in Europe announcing increased defense funds
- In Q1 2022, companies backed by U.S. VCs raised $70.7B, representing a 25.9% decrease from the $95.4B raised in Q4 2021[2]
  - Only 28 VC-backed companies publicly listed in Q1 2022, the lowest in a quarter since Q1 2020
  - 185 mega-deals (deals sized $100M or more) representing $36.6B in investments closed in Q1 2022, down 23.9% from Q4 2021 in number and 37.0% in value, but still setting 2022 to be on pace as the second most active year for mega-deals
  - Total U.S. VC fundraising reached $73.8B across 199 funds in Q1 2022, with the total value more than doubling the $32.7B figure during the same quarter last year
- Exit value created by U.S. VC-backed companies reached $33.6B in the quarter, an 82.5% decrease from $192.5B in Q4 2021[2]
  - Public listings remained the most popular exit strategy, accounting for 71% of the total value of VC exits during 2021
- Nontraditional investors in VC (such as corporations, LPs, PE firms, etc.) invested $52.5B in Q1 2022, down 28.6% from Q4 2021's figure of $73.5B[2]
  - An estimated 1,183 deals received investment from a nontraditional investor, compared to an estimated 1,399 deals in the previous quarter
  - Nontraditional investments accounted for 74.3% of total value raised by U.S. VC-backed companies

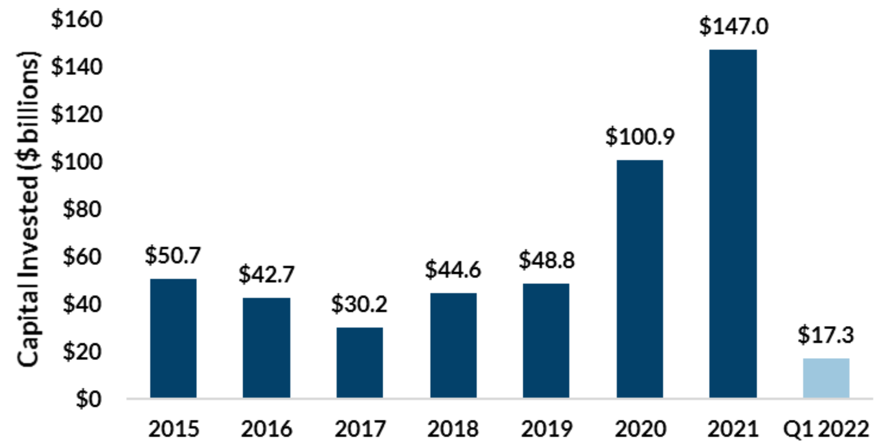
U.S. VC Deal Value per Industry ($ billions): Q1 2022[2]



PIPE Investing

- Through Q1 2022, there were 326 U.S. Private Investment in Public Equity ("PIPE") transactions with a total value of $17.3B, a decrease in volume and value of 53.4% and 73.8%, respectively, compared to Q1 2021[3]
  - Although deal volume decreased by 32.3% from Q4, global PE investments increased 9.7% in value, driven by investments in leveraged buyouts[4]
  - PIPE transactions represented 5% of global private equity deals completed in Q1 2022, down from 17% in Q4 2021; LBOs accounted for 49% of PE deals [4]

U.S. PIPE Activity[3]



Equity Markets and Corporate Earnings

- U.S. equities fell off from 2021 near-record highs, generating a -5.3% return over Q1 2022[5]
  - Price volatility was driven by the changing expectations surrounding the Federal Reserve's response to high inflation rates as well as Russia's war with Ukraine
  - The Nasdaq Composite performed the worst, falling 9.0%, while the S&P 500 and Dow Jones Industrial Average were down 4.6% and 4.1%, respectively
- Of the 55% of companies in the S&P 500 that reported Q1 2022 earnings, 80% reported positive EPS and revenue surprises[6]
  - Earnings growth over Q1 2022 was 4.7% (with estimates up to 7.1%); in either case, it would mark the lowest earnings growth rate since Q4 2020
  - Energy, materials, and industrials companies led earnings growth, while consumer discretionary and financials sectors experienced declines in year-over-year earnings

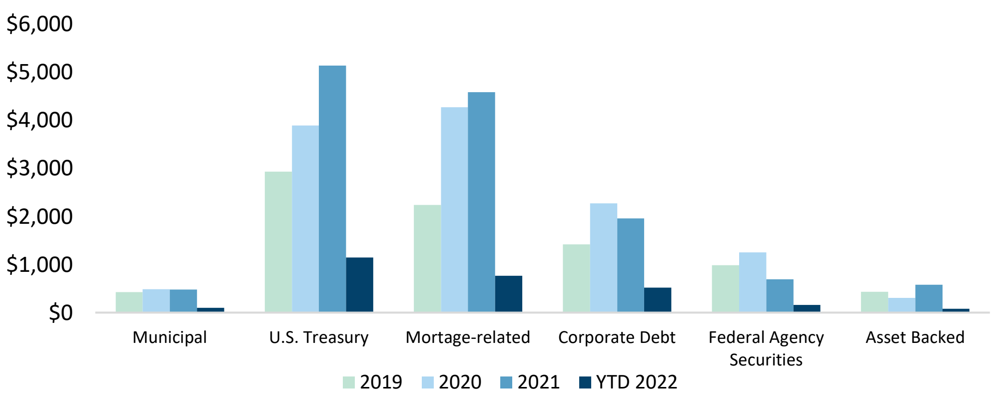
1. *KPMG*
2. *PitchBook*
3. *PlacementTracker*
4. *Aranca*
5. *Morningstar*
6. *FactSet (as of February 4th, 2022)*

Debt Capital, IPO Market, and Middle-Market Lending

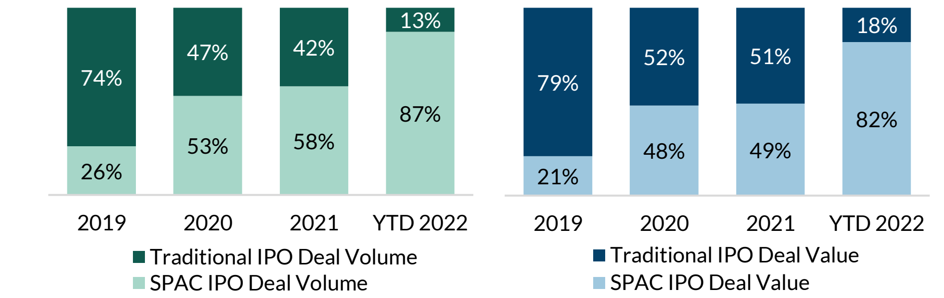
Debt Capital

- The yield on the Barclays U.S. Aggregate Bond Index was -5.9% at the end of Q1 2022, down significantly from its yield of 0.04% at the end of Q4 2021[1]
- Persistent inflation, anticipation of Federal Reserve rate hikes, and supply chain pressures surrounding the Russian invasion of Ukraine may continue to cause volatility in the fixed income market[1]
- The Barclays Investment Grade U.S. Corporate Bond Index had a return of -7.69% in Q1 2022, after posting a 0.23% return in Q4 2021[1]
  - In Q1 2022, corporate bond issuance totaled $521.8B, an increase of 37.5% from Q4 2021
  - Investment-grade corporate bond issuance increased by 54.7% compared to Q4 2021, with total issuance of $471.5B in Q1 2022
  - Despite high issuance volume, U.S. investment-grade corporate bonds performed the worst, with a -7.7% return in Q1 2022
  - Mortgage-backed bonds performed the best over the quarter but still only had a total return of -5.0%
- Total U.S. bond issuances for Q1 2022 were roughly $2.8T, a 10.0% decrease from Q4 2021 and a 24.6% decrease year-over-year from $3.7T in Q1 2021[2]
  - U.S. Treasuries, mortgage-backed, municipal, and asset-backed issuances were all down 7.3%, 25.7%, 17.7% and 51.2%, respectively
- Global sustainable-bond issuances, which include green, social, and sustainability-linked bonds, totaled $231.7B in Q1 2022, down 19% from Q1 2021 but up 8% from the previous quarter[3]
  - Green bond issuances reached $110.4B in the quarter, marking a two-year low

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



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



IPO Market

- Globally, Q1 2022 saw 321 IPOs, representing a 48% decrease in volume from Q4 2021 and a 37% decrease year-over-year[4]
  - IPO deal proceeds reached $54.4B in the quarter, a 52% decrease from Q4 2021 and a 51% decrease from Q1 2021
  - The three most common sectors for IPOs were technology, materials, and industrials, each with 58, 58, and 57, respectively, in Q1 2022
- The U.S. saw just 8 IPOs raise $2B in Q1 2022, down 88% in volume and 94% in proceeds from Q4 2021, marking the lowest number of IPOs since Q1 2016[5]
  - There were a total of 54 SPAC IPOs in the U.S. during Q1 2022
    - In volume, SPAC IPOs decreased by 67% from the previous quarter, raising only $9B this quarter
- A total of 32 SPAC merger announcements were made in Q1 2022, down 43% from 56 in Q4 2021[5]
  - As of March 2022, SPACs that are in search of acquisition targets have over $140B in estimated total equity
  - Market volatility and merger risk resulted in 44 SPAC withdrawals in the quarter, the highest number since 2016

Lending Market

- Issuances for institutional leveraged loans totaled $108.5B in Q1 2022, marking a 14.4% decrease from Q4 2021, as new issuances faltered following the Russian invasion of Ukraine and ongoing market volatility[6]
  - LBO issuance made up the bulk of issuances with a total of $39.3B issued in Q1 2022, up 92.6% from $20.4B in the previous quarter
  - However, non-LBO M&A, refinancing, and dividend recapitalization loans fell by 92.6%, 24.0%, and 42.9%, respectively, from Q4 2021

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

By Austin Kimson, Co-founder and Chief Economist, Macro Trends Group, Bain

Russia's invasion of Ukraine has claimed countless lives and set off a refugee crisis, prompting Ukrainians to flee to neighboring Poland, Hungary, and Slovakia (among others). In addition to its humanitarian toll, the war is expected to have a range of consequences for businesses and the global economy. In this article, we explore how the conflict could affect the global financial system in the medium to longer term.

The trade disputes between the US and China have clearly demonstrated the disruptions that can occur when the links of global trade are shaken by geopolitics. Now, the war in Ukraine is demonstrating the potential disruptions that can occur when the links of global finance are shaken. In a widely circulated note, Zoltan Pozsar, an analyst at Credit Suisse and arguably the world's preeminent expert on repo markets and financial plumbing, noted:

Banks' inability to make payments due to their exclusion from SWIFT is the same as Lehman's inability to make payments due to its clearing bank's unwillingness to send payments on its behalf. History does not repeat itself, but it rhymes …

Credit Suisse estimates that between the Bank of Russia and the private sector, Russia contributes roughly $1 trillion to liquid global wealth, of which about $300 billion is deployed in money markets. The many nuances and implications of severing Russia's relationship with the global financial system are beyond the scope of this piece, but such an action would be somewhat comparable to the failure of a $1 trillion balance sheet.

One immediate tactical policy response would be to enlist the Federal Reserve to plug the gap (Pozsar suggests some specific likely measures in his note). But this would have the concerning implication of requiring the Fed to expand its balance sheet again before it has even slowed the pace of expansion from the "last crisis"—all against the backdrop of an already inflationary economy facing the threat of an additional energy supply shock. We have written recently about how the Federal Reserve is trapped between its two official mandates (low unemployment, stable inflation) and its unofficial third mandate: stable financial asset prices. The unfolding Ukraine conflict is the type of problem that could nudge the Fed into an effectively unwinnable situation: It could potentially pose both a liquidity shock due to the effects of sanctions and an inflation shock due to interrupted energy/commodity supplies.

In the longer term, the weaponization of financial systems is likely to hasten the balkanization of the US dollar–based global financial system. The breach of a long-standing precedent—that of not using the plumbing of the financial system in service of geopolitical aims—ushers in a new era of potential risks to the global financial system. As we have written in the past, we believe that one of China's key geopolitical goals is to be able to buy what it needs in a currency that it controls (e.g., the renminbi). (We wish to note here that Louis Gave and our friends at Gavekal have been asserting this point consistently for a number of years.) Recent events are likely to serve as a big flashing signpost to China to redouble its efforts in this area. We expect to see tangible consequences of that redoubling in the months and years to come, likely to the detriment of the global dollar system and the capital superabundance it helped facilitate.

That said, we are frequently asked if we believe that the Chinese renminbi could displace the US dollar at the apex of the global financial system. Putting aside the vast gap in the US dollar's current preeminence with respect to its use in international trade and as a reserve currency (it accounts for 59% of global foreign exchange reserves), our working hypothesis is that the position of universal apex currency is likely to ultimately become vacant ("sede vacante" or "the vacant seat"). The existence of globally preeminent reserve currencies—like the British pound sterling and French livre before that—has a long historical precedent, but the emergence of one national currency at the apex of a globalized fiat currency system is a fairly recent anomaly. This state is likely more than coincident with the rise of global capital superabundance, and the conclusion of this anomaly could hasten the ending of this era. The world doesn't need a universal apex currency to facilitate normal and relatively balanced trade, but it is difficult to generate large, persistent capital surpluses (and corresponding large debts) without a dominant and frictionless reserve currency.

For businesses and investors, the pace of events in the Russia-Ukraine war will only permit tactical reactions as information becomes known. As we have said since the middle of last year, the global economy has been riding the consensus "middle path" of recovery along a knife's edge, buffeted by strong winds, so we neither recommended conviction around the middle path nor offered an alternate scenario as the single most probable one. The invasion of Ukraine prompts us to further expand our range of possible scenarios; an inflation-induced recession continues to be our favored alternate scenario for planning purposes.

In the longer term, there is more room for strategic realignment. If there was any doubt about the reality of post-globalization, recent events should confirm three things:

- the globalized order is in slow but terminal decline;
- post-globalization is not just about trade and China; and
- geopolitical fracture lines build slowly over time, making it tempting to delay tough strategic realignments, but once those lines fracture, it is often too late to do anything but react.

On this last point, BP's recent decision to divest of its Rosneft stake should serve as a warning of how suddenly geopolitical motion can accelerate. Businesses should consider their risk exposures carefully, and not just in Russia. The fault line between China and the West remains unstable, and the risk of any type of "financial disconnect" across any border has increased now that the precedent discussed above has been broached. These recent events should raise the premium for home market strength and increase the discount for far-afield holdings.

About the Author

Austin Kimson is the co-founder and Chief Economist of Bain & Company's Macro Trends Group, out of the Dallas office.

Austin's expertise is in global macroeconomics, market pricing dynamics and corporate failure and distress. He is principal author and developer of all of the Macro Trends Group's major studies including the recent megatrends series on capital markets, spatial economics, and the intersection of demographics and automation.

He joined Bain in 2004 and has also worked in Bain's San Francisco/Silicon Valley offices. Austin has served clients in all major sectors with emphasis on financial services, industrials, technology and privately held companies.

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Selected Transactions

$300,000,000 HONOR CAPITAL has raised debt and equity growth capital, and recapitalized its balance sheet EXCLUSIVE FINANCIAL ADVISOR	Amount Not Disclosed ACUMEN has been acquired 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
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