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

In this issue of Transaction Trends, BMO Sponsor Finance analyzed 2023 revenue and EBITDA performance across ~300 portfolio companies and compared results to budget.

Additionally, we consolidated 2024 budgets across four industry verticals (Industrial, Business Services, Healthcare, and Food & Consumer) to get a sense of the 2024 outlook and how they differ across sectors.

Overall, 70% and 64% of our portfolio grew revenue and EBITDA in 2023, respectively; however, only 35% and 45% beat budget expectations.

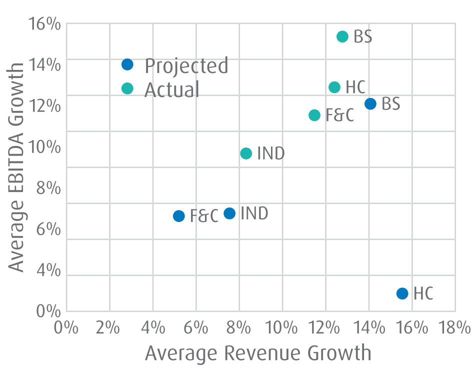
EBITDA margins overall contracted modestly from ~20.5% in 2022 to 19.7% in 2023 likely due in part to the widely covered inflationary pressures; however it's likely this was somewhat mitigated by companies' ability to continue passing on price increases.

Navigating the 2024 Outlook

We expect the portfolio to demonstrate continued resilience throughout 2024 despite headline risks including (i) higher interest rates for longer, (ii) supply chain disruptions, (iii) geopolitical tensions, and (iv) relatively muted M&A activity.

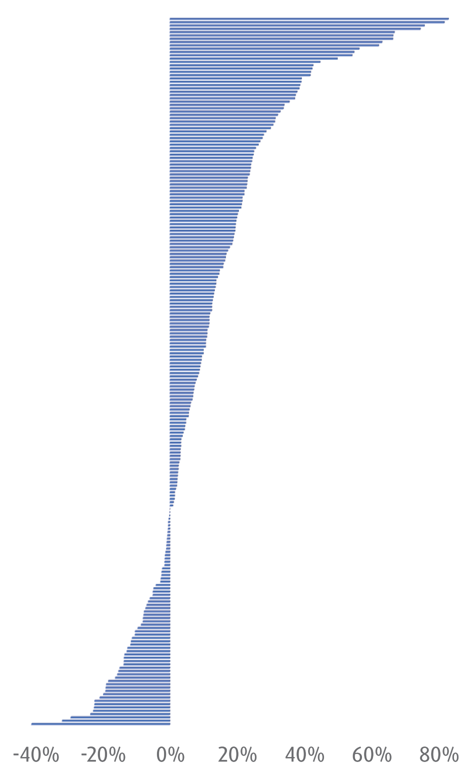
While as a whole, our portfolio is forecasting revenue and EBITDA growth of 11.3% and 16.6%, respectively in 2024 (compared to 12.5% and 16.4% in 2023)—each industry vertical has a different perspective.

FY24B vs. FY23A Average Growth Rates



Source: BMO Proprietary Data

Actual Revenue Growth for Portfolio



Source: BMO Proprietary Data

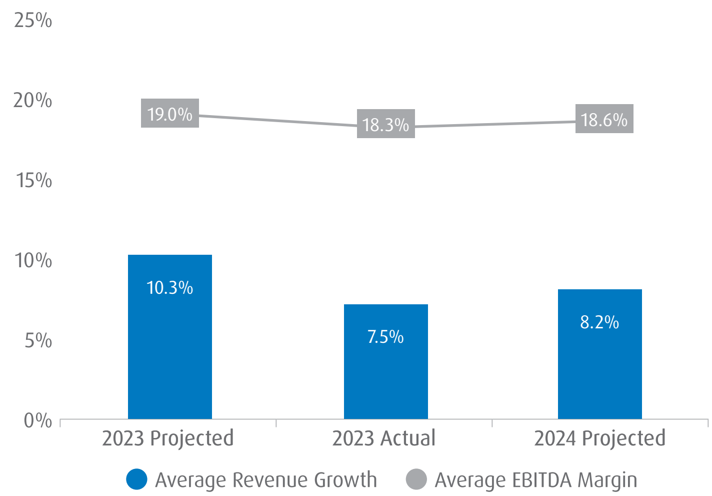
Industry sectors

Industrial

This sector was impacted largely by the (i) macroeconomic demand, (ii) destocking, and (iii) higher interest rates which were all factors driving lower than anticipated revenue growth and EBITDA margins in 2023.

- **Macroeconomic demand** exhibited some mild softness over last 12 months; however, sentiment has been more positive around expectations for 2024. The ISM manufacturing index was < 50 (signaling contraction) for 17 straight months up until a 50.3 reading for March 2024. We expect demand to remain stable near term although the outlook is modestly better than in late 2023, partly due to the dissipation of destocking and supply chain challenges. As one sector that has performed above most others, A&D demand has remained solid on the heels of stable defense spending and the rebound in travel.
- **Destocking** impacted our packaging and chemicals companies most acutely but these headwinds have largely dissipated as supply chains normalized towards the end of the year. We believe these subsectors are well poised to rebound in 2024.
- **Higher interest rates** caused certain subsectors selling into infrastructure investments (i.e., water, utilities, telecom, etc.) to see a larger pullback as the cost of capital remains elevated. While not the sole reason, the current expectation of sustained higher rates relative to earlier expectations is likely tampering expectations in 2024 within these industry verticals.

Industrial Average Revenue Growth and EBITDA Margins



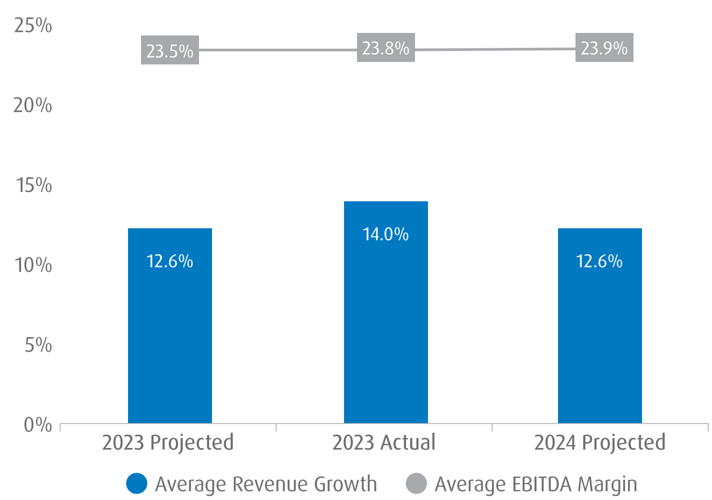
Source: BMO Proprietary Data

Business Services

Business Services was our sole industry vertical that experienced higher than budgeted revenue growth as well as EBITDA margin expansion in 2023. This vertical consists of a wide range of subsectors including Technology Services, Insurance & Financial Services, Professional Services, Residential & Commercial Services, and Marketing Services, among others. Because of this, there are a variety of performance drivers; however, common themes include (i) non-discretionary or non-deferrable solutions, (ii) highly recurring/reoccurring revenue streams, (iii) strong retention rates, and (iv) an ability to pass through price increases given the low cost/high value nature.

- **As mentioned, our Business Services vertical was one of the strongest performers in 2023** with 14% topline growth, 12% EBITDA growth, and expanding EBITDA margins. In 2024, our borrowers are anticipating slightly lower revenue growth (12.5%) but higher EBITDA growth as labor challenges ease and contractual/modest price increases are implemented. Heightened focus on IT and marketing budgets and questions around the stability of the end customer (be it enterprise-level, SMB or individual consumer) are often challenges cited by our management teams.

Business Services Average Revenue Growth and EBITDA Margins



Source: BMO Proprietary Data

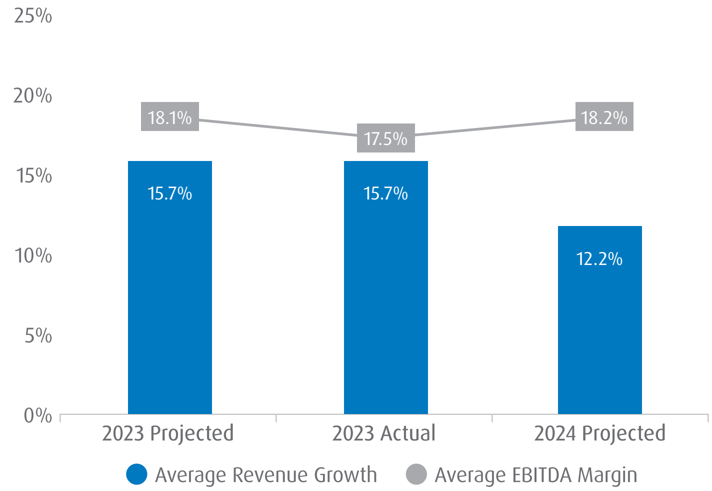
Industry sectors

Healthcare

As healthcare providers and services represent a meaningful percentage of the portfolio, there were continued industry-wide headwinds experienced due to (i) increased wage inflation/ pressure and (ii) lack of offsetting topline growth given lag/ delays in reimbursement rate increases. This led to a softer 2023 actual when compared to original 2023 forecast of borrowers. Our borrowers' view is that the margin deterioration attributed to wage increases experienced over the last 18-24 months has normalized, which should lead to margin stability/increases during 2024 as reimbursement rates are received, leading to increased operating leverage.

- **Healthcare borrowers** continue to be cautiously optimistic in relation to 2024 projected growth, with overall industry sentiment beginning to steer towards the positive.
- **In addition to healthcare providers, pharma services** also represent a significant percentage of the healthcare portfolio which has seen some slowdown in topline growth due to slowdowns in biotech funding. However, these portcos were able to offset any wage impacts with applicable pricing increases, given the non-reimbursed environment they operate in, which helped maintain margin consistency relative to projections.

Healthcare Average Revenue Growth and EBITDA Margins



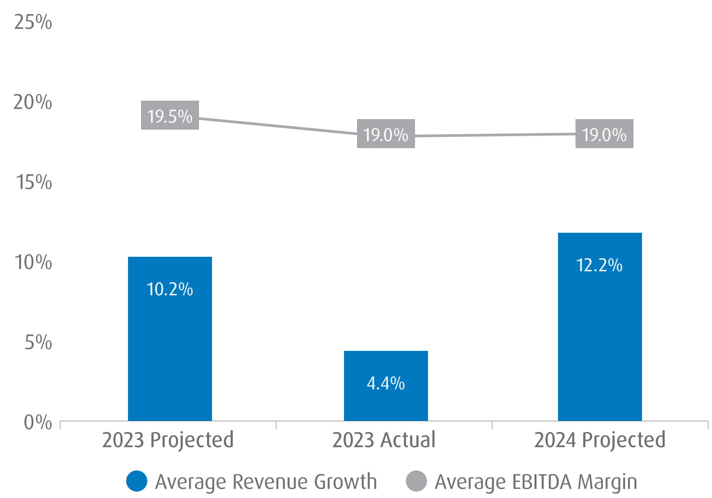
Source: BMO Proprietary Data

Food & Consumer

Despite the ~75% of the food and consumer portfolio underperforming relative to original company provided revenue budgets for 2023, the aggregate portfolio held up well in FY23 as only ~15% of the portfolio missed revenue budgets by >15%. Given sector diversity within the portfolio, misses to budget are largely company specific but in aggregate correlated to lower than forecasted sales volumes.

- **End markets and distribution channels that have shared a consistent theme of softness** in FY23 were particularly focused within the personal care and beauty and vitamin, minerals, and supplements sectors driven by de-stocking that began in FY22 and continued to impact 1H'23 performance. Many of these businesses experienced more normalized ordering patterns in 2H'23.
- **Our borrowers are projecting a strong year of top line growth** in FY24 (both price and volume) in what looks to be a much more normalized operating environment than recent years past. Consumer financial health and sentiment remains positive and inflationary pressures have eased.

Food & Consumer Average Revenue Growth and EBITDA Margins



Source: BMO Proprietary Data

BMO spotlight

BMO provides wholistic transaction support and advisory solutions for Patriot Pickle.

Patriot Pickle (or the "Company"), a leading manufacturer and distributor of pickles and other fermented food products to the foodservice and grocery retail markets, was acquired from Swander Pace Capital ("SPC") by H.I.G. Capital ("H.I.G.") in December 2023.

BMO Sponsor Finance was the existing Joint Lead Arranger, Joint Bookrunner, and Administrative Agent for Patriot Pickle under SPC's ownership and led the financing for H.I.G. on its acquisition of the Company. BMO Capital Markets also acted as a buy-side financial advisor to H.I.G. on the acquisition.

Swander Pace Capital originally acquired Patriot Pickle in 2021, and since its original acquisition, the Company has completed two transformative acquisitions that further strengthened the pickled and fermented foods platform and set the stage for even further organic growth.

The transaction exemplifies BMO's "one-bank" mentality and full service capabilities to start small on initial investments, scale capital commitments with the sponsor's M&A thesis, and deliver upon financing solutions across a range of transaction sizes as businesses continue to scale.

Given BMO's relationship with SPC and consistent support for Patriot Pickle, SPC provided BMO early access to vet a financing solution for potential buyers to provide as part of the process. BMO provided differentiated advice and insights on this buyside assignment by leveraging its unique knowledge of Patriot Pickle and the snacking subsector in addition to fully underwritten unitranche commitments with a large anchor ticket to support the transaction leading to a successful execution.

The Patriot Pickle transactions demonstrate BMO's depth of capabilities across our full-service platform, including extensive industry relationships and connectivity across the food manufacturing industry as well as seamless executions on financing solutions across our portfolio companies with the ability to continue to support as our businesses scale.

> This transaction highlights the strength of BMO's U.S. M&A and Sponsor Finance capabilities, and our ability to provide clients with a full suite of solutions across our platform.

Portfolio Company of

Senior Credit Facilities

Administrative Agent
Joint Lead Arranger
Joint Book Runner

Acquisition of

Co-Advisor

Portfolio Company of

Administrative Agent
Joint Lead Arranger
Joint Book Runner

We're the experts—commercial aerospace: a tale of two recoveries

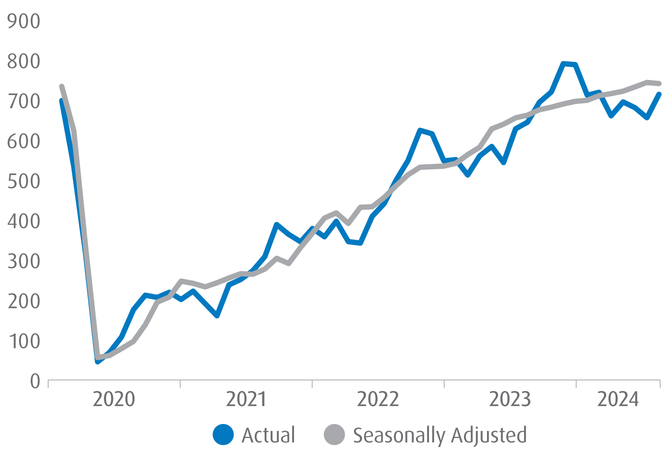
While the MRO market is soaring above pre-pandemic levels, the OE market is expected to remain turbulent.

MRO

The commercial Aircraft Maintenance, Repair, and Overhaul ("MRO") market is expected to continue its recovery in 2024 as increased air traffic drives higher fleet utilization and demand for new aircraft.

- **Increased air traffic.** Revenue Passenger Kilometers ("RPK"s) are expected to eclipse pre-pandemic levels in 2024 as sustained personal/vacation travel is supplemented by recovering business/corporate travel.

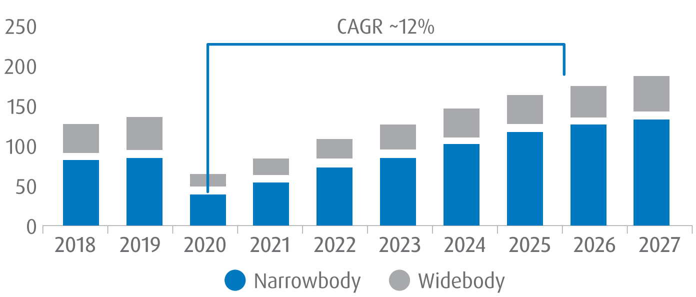
Global Air Passengers, RPK (billions per month)



Source: IATA Sustainability and Economics, IATA Monthly Statistics

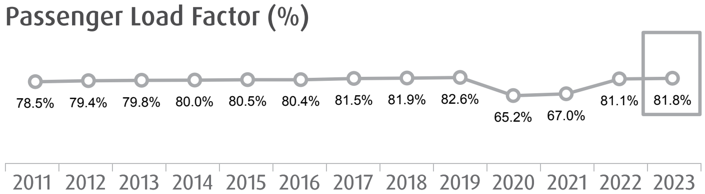
- **Higher fleet utilization.** Increasing RPKs have led to improved engine flight hours and passenger load factors continue to increase at/above pre-pandemic levels.

Engine Flight Hours (millions)



Source: Airfinance Journal

Passenger Load Factor (%)



Source: FRED

- **Demand for new aircraft.** In light of Boeing 737MAX delays, airlines have been forced to slow down retirement schedules of existing aircraft. Coupled with COVID-related maintenance delays, higher than average MRO spend is expected as airlines are forced to keep older aircraft in service at a higher maintenance cost than new aircraft.
- **Highly skilled labor.** Underpinning the broader recovery, highly skilled labor continues to be an issue for the MRO market as the 2020 volatility resulted in the early retirement or new job pursuits by thousands of well-tenured A&D workers who have not been fully replaced and in the cases where they have, have been replaced with new mechanics and engineers who are less efficient and lack the "tribal" knowledge leading to a significant cost premium on labor.

As a result of the above drivers, the commercial MRO market is estimated to grow at a 7% CAGR from $78.6Bn in 2023 to over $100Bn in 2027 with outsized growth expected in engine repair and overhaul ("ERO") and the Middle East, Africa, and Asia-Pacific regions. Over the same period, the in-service fleet is expected to grow from 21,606 to 27,440.

	Capability				Region			
	Line	Comp.	Engine	Air-frame	N.A./ S.A.	Euro	ME/ Africa	Asia-Pac
Size	11.6	14.4	34.1	18.5	25.3	19.6	9.6	24.1
Share	15%	18%	43%	24%	32%	25%	12%	31%
5y CAGR	6%	7%	10%	2%	4%	6%	10%	10%
10y CAGR	5%	4%	7%	1%	2%	4%	7%	7%

Source: Alton Aviation Consultancy—IATA MCC Conference

With the recovery in the commercial MRO market, BMO Sponsor Finance has seen an influx of founder-owned and sponsor-backed MRO platforms over the last 12-18 months. Similar to private equity buyers, lenders view commercial MRO companies favorably given the 1) re-occurring, critical nature of the services provided (break-fix and mandated repair schedules), 2) high barriers to entry of most services, and 3) industry-wide lack of highly skilled labor (leading to premium margins) with ultimate leverage dictated by 1) complexity/scarcity of the company's capabilities/services, 2) company's specific platform focus (737, 787, A320, etc.) and diversity, 3) financial profile (margins, capex, and free cash flow), and 4) enterprise value (which can range from 9.0-14.0x).

We’re the experts—commercial aerospace, continued

OE

Entering 2024, the stars were aligned for the commercial OE market as the tailwinds (incl new orders) remained strong despite geo-political tensions.

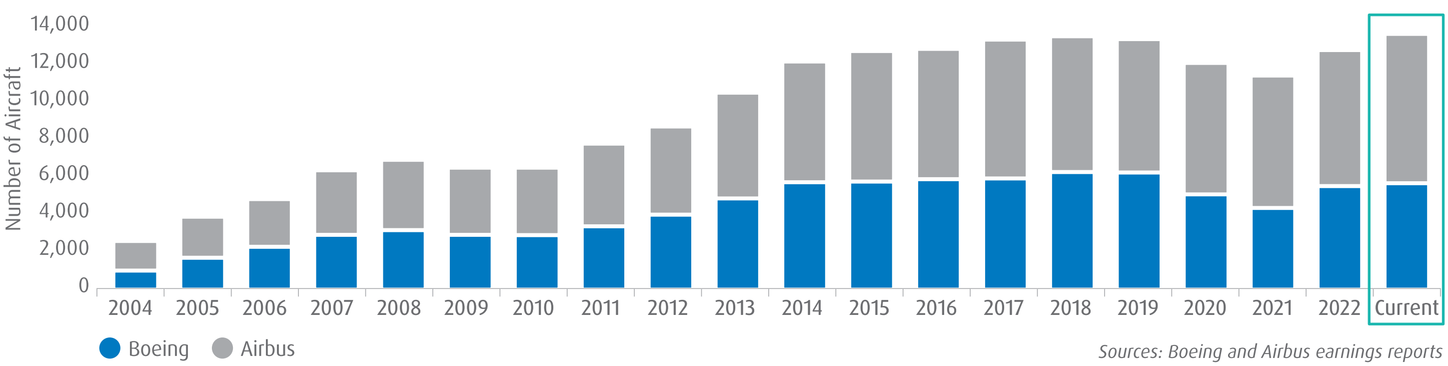
The sentiment changed in early 2024 as the Boeing operational and supply chains issues proved to be more drastic than previously thought wherein 737MAX production slowed considerably compared to the forecast of 35 per month (and the eventual 50 per month forecasted in 2025/2026). While there are talks of Boeing acquiring Spirit AeroSystems, it’s largest supplier, in order to stabilize its supply chain, market sentiment thinks this will likely be a net neutral transaction at best. That said, Boeing has come out recently with rhetoric about being a better partner to Tier 2 and Tier 3 suppliers which is hopefully a net positive around future margins; though these changes will take time to implement.

On the Airbus side supply chain delays for titanium and investment casting, which are critical for aero-engines, is delaying a strong ramp for the A320Neo which was running at 45 per month in 2023 but forecasting to increase to 65 per month in 2024 and 75 per month by 2026. Furthermore, the OE market is experiencing similar highly skilled labor shortages as the MRO market which only compounds the challenges and delays.

All that said, the near-term disruption should not take away from the fact that commercial OE backlogs remain incredibly strong so its not a matter of “if” but “when” production ramps to forecasted levels.

The reality is Boeing has been experiencing issues with the 737MAX since late 2018 so there was never really a recovery for many of the private-equity backed portfolio companies that potentially remain over-levered even though the long-term (5-10 years) trends remain strong. As a result, BMO Sponsor Finance has seen some M&A activity in the OE market but those companies that are highly indexed to commercial OE (e.g. 40-50%+) will continue to struggle to transact at healthy multiples given lack of lender interest.

Backlog Remains Close to Historical Levels



Sources: Boeing and Airbus earnings reports

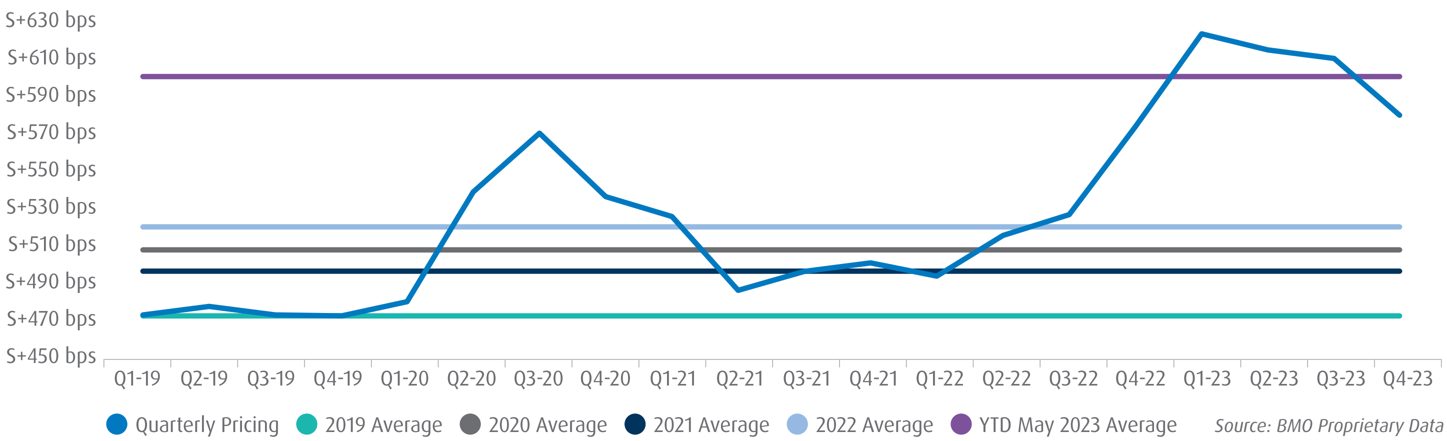
A peek behind the curtain

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) peaked in Q1'23 and have seen downward movement since, as Fed tightening has eased and the general macroeconomic outlook has improved, leading to increased appetite and competitiveness within the lending markets.
- Downward pressure on spreads and closing fees were particularly experienced in Q4'23 and have continued in Q1'24. While a year prior most deals were getting priced in the S+[600-650] bps range, most deals today are getting priced with opening spreads in the S+[500-550] bps range with lower closing fees.

Quarterly Pricing and Yearly Averages

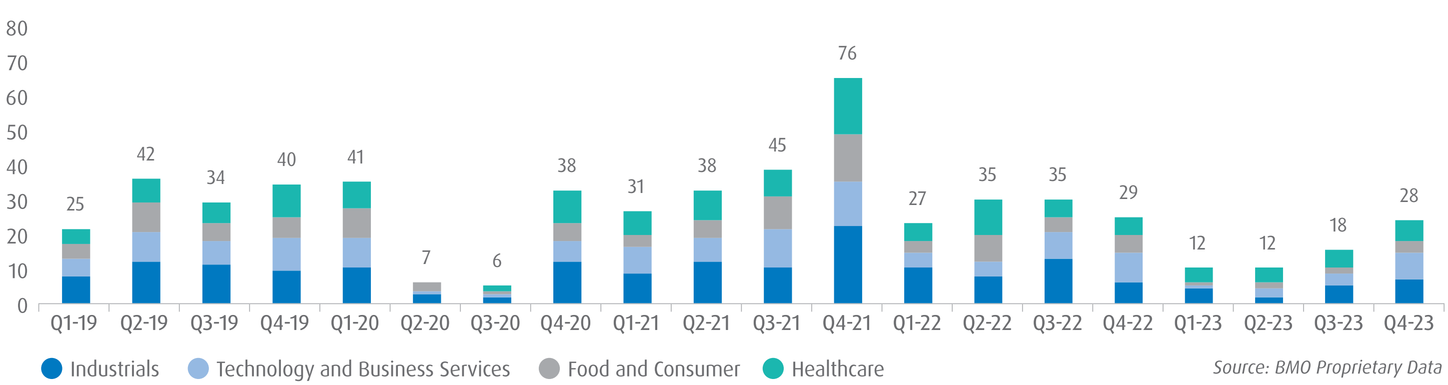


Source: BMO Proprietary Data

Quarterly transaction activity—all transactions

- Relative to 1H'23 when new deal activity was slow given dislocations in bid / ask valuations between buyers and sellers and disruptions in the financing markets (e.g. increasing rates, lower lending appetite given uncertainty, and increased lender focus on funded to unfunded mix in raising debt facilities), new deal activity has rebounded closer towards historical averages post-Labor Day, with momentum (partially sector specific) continuing into Q1'24.
- Sponsors have continued to remain highly active on their existing portfolio companies through ongoing tuck-in activity and there has been an uptick in refinancing opportunities and extension requests given the improved appetite and lower spreads in the lending markets.
- In conjunction with improved deal activity, BMO has also experienced an uptick in overall deal quality, which such transactions have continued to command strong valuation expectations and private equity interest.
- While history suggests deal activity could be tempered in a presidential election year, based on conversations with bankers and sponsors to date, many expect there to be limited impact.

Deal Volume by Team—All Transactions

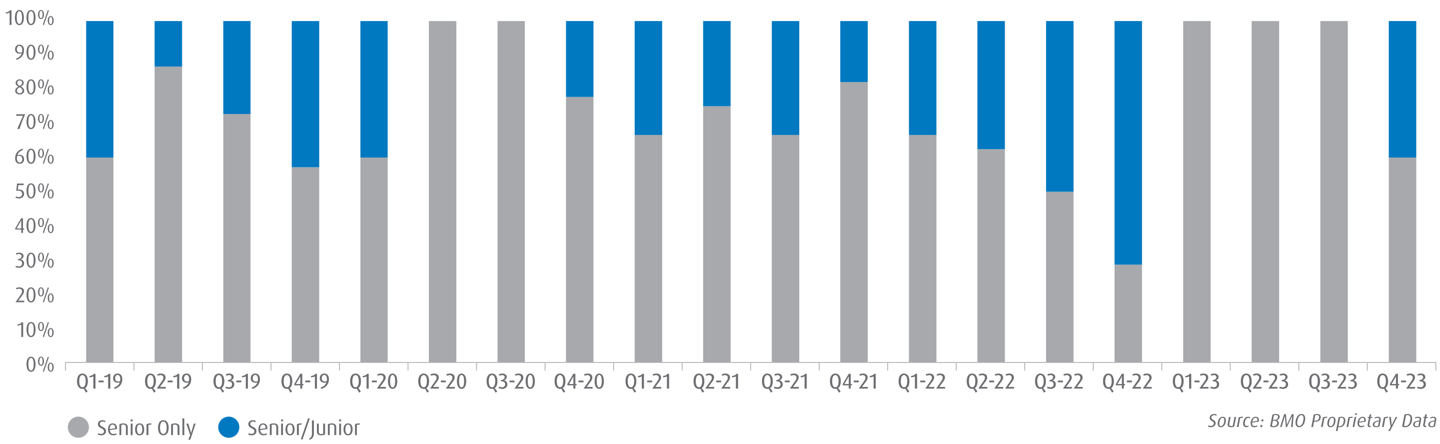


Source: BMO Proprietary Data

Capital structure type—new LBOs

- While single tranche structures have been favored in recent years given large lender holds and efficiency of execution, BMO saw increased usage of senior/junior structures in 2H’22.
- This was driven by a number of factors, including (i) pull-back in unitranche lender appetite and hold capabilities (or lack thereof), (ii) spiking SOFR and spreads on senior floating rate debt had made fixed mezzanine paper more attractive, and (iii) increasing willingness by mezzanine lenders to PIK a higher proportion of their yield, which improved cash flow dynamics.
- As financing markets and appetite improved in 2H’23, BMO saw a reversion back to Sponsor preferences for single tranche solutions.
- Furthermore, while funded to unfunded mix remains a key focus area for lenders, delayed draw term loan appetite improved has improved materially in recent quarters, particularly for businesses that have demonstrated quick usage of these facilities.

Transactions by Type—New LBOs

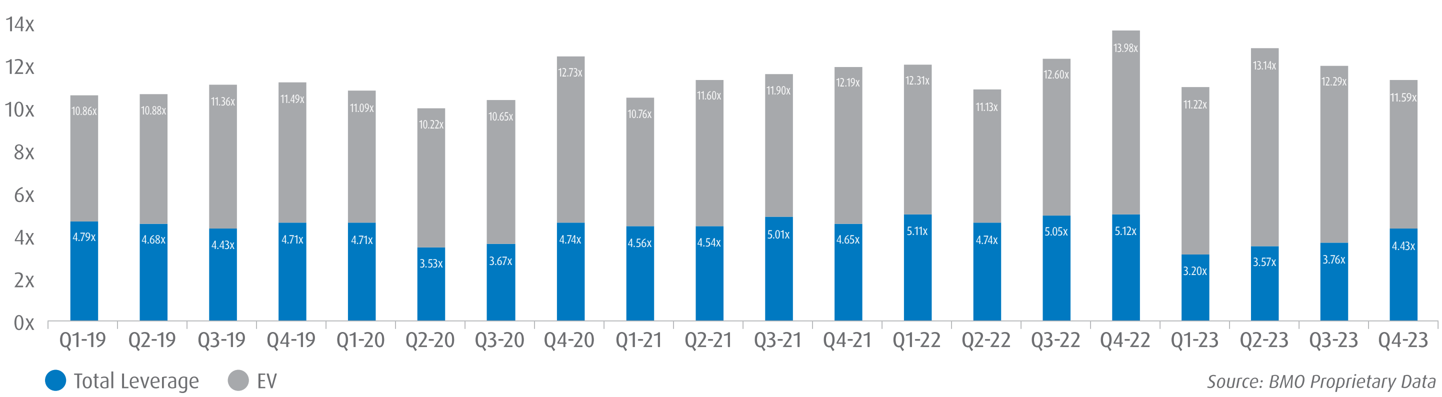


Source: BMO Proprietary Data

Average total leverage trends—new LBOs

- Over the past 12 months there has been a flight to quality by Sponsors and lenders where highly attractive and non-cyclical assets continue to command strong lender interest with similar leverage profiles as in past quarters.
- Some of the challenges in evaluating businesses (e.g. COVID normalizations, supply chain disruptions, de-stocking, inflationary pressure impacts, quantum of adjustments to EBITDA) in 2022 and early 2023 have eased as the broader macroenvironment and perceived outlook for a potential soft landing has improved.
- The limited new deal activity and types of transactions that closed in 1H’23 skewed leverage levels relative to historical norms. Given the continued increase in SOFR and spreads that have impacted cash flows, leverage indications have been governed by ensuring satisfactory fixed charge coverage ratios exist.
- From a lender perspective, despite higher interest rates BMO has not seen a material deviation in EV multiples for businesses that are ultimately trading compared to prior years.
- Given increased appetite in financing markets in Q4’23 and into Q1’24, BMO has seen lenders put forth more aggressive leverage proposals and have modestly relaxed previous fixed charge coverage targets.

Average Total Leverage and EV—New LBOs



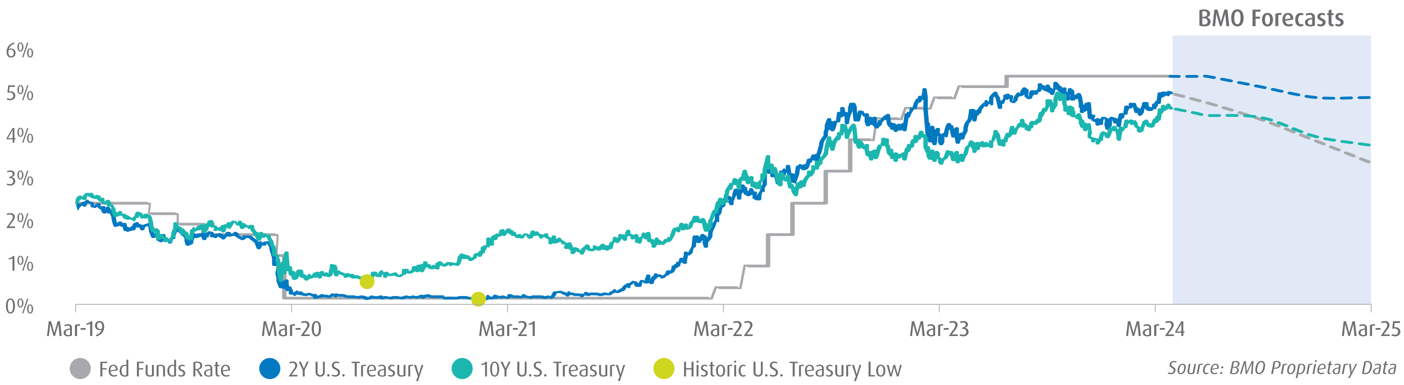
Source: BMO Proprietary Data

A word from our Global Markets colleagues

2024 Interest rate outlook

BMO's Rates Strategy team expects benchmark term rates to remain elevated in Q2, with the yield curve steepening during the balance of 2024. Short-term yields are expected to see the most dramatic move given the expected shift of Fed policy from tightening to 'normalizing'. BMO anticipates 2 quarter point rate cuts in 2024 with the first cut to be delivered at either the July or September FOMC meeting (inflation data dependent). Fed funds futures are currently pricing in between 1-2 cuts by year-end with the first full rate cut at the September meeting.

BMO's forecast for lower rates in 2024 assumes that the global policy tightening executed during 2022-2023 continues to catch up with the real economy, causing inflation to trend lower and the labor market to eventually loosen with the unemployment rate increasing to a range of 4.5-5.0%. This assumes the neutral policy rate hasn't changed materially from the 2.5% pre-pandemic level and that there are no external shocks (e.g., equity market crash, contagion event in the credit market, escalation of geopolitical tensions, or other unforeseen financial market crisis).



Source: BMO Proprietary Data

	Forecast Source	Q2 2024	Q3 2024	Q4 2024	Q1 2025
Fed Funds Rate (Midpoint)	BMO Capital Markets	5.38%	5.13%	4.88%	4.88%
	Bloomberg Survey Median	5.38%	5.13%	4.88%	4.38%
2-Year U.S. Treasury Yield	BMO Capital Markets	4.75%	4.35%	3.85%	3.35%
	Bloomberg Survey Median	4.73%	4.42%	4.05%	4.00%
10-Year U.S. Treasury Yield	BMO Capital Markets	4.45%	4.40%	3.95%	3.75%
	Bloomberg Survey Median	4.40%	4.25%	4.10%	4.00%

Source: Bloomberg/BMO Capital Markets as of 19-Apr-24

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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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