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

Overview

Over the course of the last ~10 years the physician practice management ("PPM") roll-up strategy has been incredibly popular across private equity and private credit lending, which peaked at ~9% of total loan volume during 2018–2019 (source: pitchbook LCD Data). During that time, competition across PE and direct lending allowed for favorable terms across the PPM borrower universe.

The COVID-19 pandemic and post-pandemic environment then brought forward stress across this industry where (i) lack of integrated practices, (ii) poor M&A strategies, (iii) RCM issues, (iv) lack of top-line rate increases to offset recent inflationary issues (e.g., rising wages, increased turnover, etc.) and (v) rising interest rates, led to softness across the PPM industry and lack of overall transactions being completed, with HC service loan volumes decreasing below 1% of total loan volume through the 2022/2023 period(s).

During the YTD'24 period, while overall deal volume has been lacking, there is much more caution when investing in the sector with a higher focus/diligence bar on overall platform integration, historical wage inflation along with more conservative leverage structures with recent deals getting done being more of the "stronger" credit profile types. Several lenders have completely exited the PPM sector.

BMO PPM portfolio impacts

The BMO Sponsor Finance Healthcare team currently finances ~30 physician practice management businesses and has seen the aforementioned impacts to its overall portfolio, with the biggest impacts related to wage inflation, borrowers' inability to offset rising costs with rate and an increase of ~50% of borrowing costs.

Across the BMO SF portfolio, overall PPM margins trended down from an average of 16.3% to 14.9% from 2022 to 2023, with cash flow profiles becoming stressed given bottom-line softness and rising interest rates. For context, based on PPM borrower 2023 budgets there was a ~100bps "miss" when compared to actual 2023 performance given how severe the rising wage environment actually impacted borrowers, as opposed to original expectations and forecasts.

Within RCM, the most common portco missteps are making the decision to outsource to a third party, not centralizing the function and leaving too much of the collection responsibilities at the individual practices, and/or expecting an increase in rates for acquisitions where the portco has no density in that specific market.

Regarding M&A, notable issues have been acquiring practices with older physicians that are closer to retirement, highly structured deals with earnouts/deferred purchase price, and most importantly, weak integration that limited the ability of the management team to push down initiatives to practices. Companies that adhered to a "low-touch" integration operating philosophy led to selecting physicians who expected such, creating cultural issues when cost challenges required more management controls. These companies tried to pivot in 2022–2023, and push down controls without buy-in from doctors, which can create cultural issues.

Outlook

Based on actual performances through the YTD 2024 period for PPM borrowers, the situation does not appear to be worsening as most of the uptick in labor along with other inflationary costs have stabilized over the last 6–9 months.

Given that dynamic, borrowers are forecasting an increase to margins by ~25bps during the 2024 period. Further, while not baked into forecasted figures, there is overall industry optimism that there will be potential rate increases through both governmental and commercial payors, which have been realized across a subset of PPM-related industries already.

The BMO SF team continues to evaluate PPM opportunities and has closed two new PPM investments in 2024, with much higher credit bars. For new investments, BMO is highly focused around sub-industry, strong provider retention metrics, ensuring that physician rollover equity is "in the money" upon a covenant default, RCM functions, platform integration, EBITDA & Run-Rate adjustments, M&A and growth plans, along with potential PE buyer track records and experience within the PPM space due to the prior mentioned headwinds experienced within the space.

BMO spotlight

BMO provides LBO financing leadership to multiple private equity clients for United Air Temp.

United Air Temp (or the "Company"), a leading provider of residential HVAC, plumbing, and electrical services, was acquired from Summit Park by Littlejohn & Co ("Littlejohn") in March 2024. BMO Sponsor Finance was the existing Sole Lead Arranger, Sole Bookrunner, and Administrative Agent for United Air Temp under Summit Park's ownership and led the financing for Littlejohn's acquisition of the Company.

Summit Park originally acquired United Air Temp in 2021, and since its acquisition, the Company completed six transformative acquisitions that further strengthened the residential services platform and set the stage for continued organic growth.

The transaction exemplifies BMO Sponsor Finance's ability 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 throughout a company's maturation.

Given BMO's relationship with Summit Park and the Company, we provided an early financing solution for potential buyers as part of the sale process. Our experience within the residential HVAC industry and investment banking sector coverage enabled an expedited diligence process and confidence to close.

Both transactions demonstrate BMO Sponsor Finance's depth of industry expertise, ability to finance clients M&A strategies, and facilitate seamless executions across our portfolio companies.

UNITED AIR TEMP

Portfolio Company of

SUMMIT PARK

Senior Credit Facilities

Administrative Agent
Sole Lead Arranger
Sole Book Runner

UNITED AIR TEMP

Portfolio Company of

LITTLEJOHN & CO.

Administrative Agent
Joint Lead Arranger
Joint Book Runner

We're the experts—accounting services: an industry in the midst of an evolution

Increasing sponsor activity looks to capitalize on an attractive sector with long-term growth tailwinds.

Accounting services trends

The growth in the $170+ billion accounting services industry has attracted significant interest from private equity buyers over the last few years. The industry grew at an ~11% CAGR over 2019-22, and is projected to grow at a ~9-10% CAGR through 2028, driven by growth across the core services lines (advisory, audit, tax) and expansion of small and midsized companies, as well as from IPOs, M&A activity, and bankruptcy filings.

While the Big Four (Deloitte, Ernst & Young, KMPG, PwC) comprise one-third market share, the remaining portion of the market is highly fragmented, providing opportunity for consolidation. Investors are attracted to accounting assets given growth avenues via service diversification (e.g. expanding to advisory and consulting), stable and recurring cash flows, M&A opportunities, and the ability to scale operations by adopting digital platforms. In addition, the sector is viewed as largely recession-resistant with revenue from more recurring service lines such as assurance and tax.

BMO expertise

BMO has extensive lending experience within the accounting and assurance services, committing over $900MM of financing across the sector. This includes relationships with 10 of the top 15 U.S. accounting firms, including Baker Tilly, Crowe, Deloitte, Grant Thornton, and RSM. Within Sponsor Finance, BMO's relevant portfolio companies include Schellman & Company, Source Advisors, and FMS Solutions.

BMO has outlined key considerations when evaluating potential investments within accounting services, which has experienced a high level of M&A activity from sponsors over the last several years.

Ownership and transaction structure

Given a focus on preventing conflicts of interest, the American Institute of Certified Public Accountants mandates that assurance firms cannot be owned by non-CPAs. This requirement insulates attest services (i.e. assurance) and related judgements from marketplace pressure and ensures firms maintain independent views.

As a result, private equity-backed accounting firms split into attest and non-attest entities. The sponsor will only invest and maintain ownership in the non-attest business, leaving the attest (assurance) business CPA-owned. The non-attest firm will then enter into an agreement to provide the CPA-owned attest firm with employees and related administrative services.

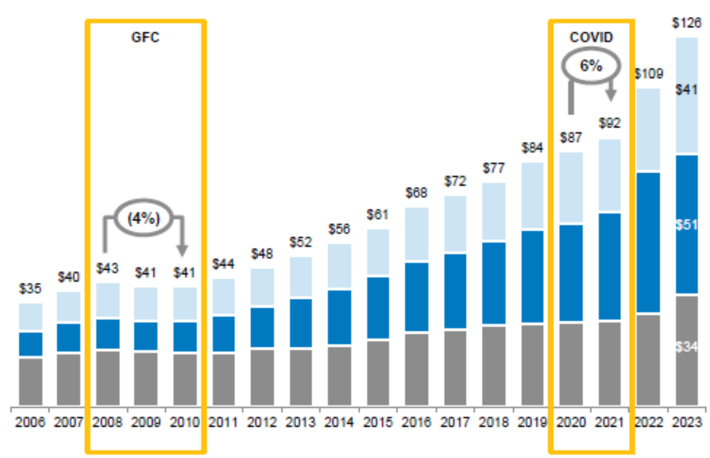
As part of a sponsor-backed investment, compensation for an accounting firm's partners is typically reduced 20-30%, which generates EBITDA and value. Private equity buyers and firms work to structure a mutually acceptable deal, with employees receiving a mix of cash and equity at close. On average, the highest earning senior partners receive larger cash payouts and reduced post-close compensation, with younger partners receiving a greater mix of equity and future potential returns at the sponsor's exit. Similar to a physician practice management transaction, ensuring partners are incentivized to drive go-forward business is a key component of an investor's thesis.

Service lines and client retention

While core service lines such as audit & assurance and tax continue to be in demand, accounting firms are increasingly looking to diversify revenue streams by expanding to advisory and consulting services, which represent the fastest growing segment of the market. While advisory and consulting solutions can be less recurring relative to traditional assurance and tax work, they can be value-added differentiators as customers increasingly seek out full-service providers.

Regarding customer mix, investors take into account both client end market and size (e.g. enterprise, mid-market, small business, individual / personal tax filers). While accounting services is more recession resistant relative to other sectors, certain end markets and smaller customers can impact performance in a softer macroeconomic environment. A firm's degree of exposure to public company clients is another consideration, as potential headline issues at the customer level can result in reputational risk for the accounting firm.

Stable Industry Performance Across Cycles ($ billions)



Audit Advisory Tax

Sources: IBISWorld, Accounting Today

We're the experts—accounting services, continued

Partner and talent retention

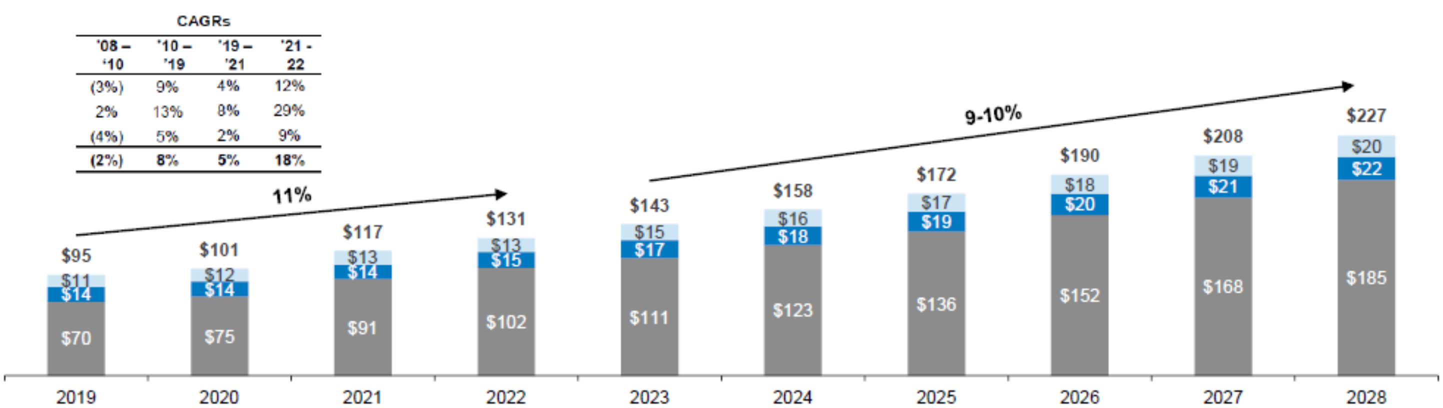
As accounting services is a people-driven business and demand for services has significantly outpaced licensed CPA capacity over the last five years, investors are highly focused on recruiting talent and retaining top performers. As noted earlier, private equity-backed transactions typically involve providing post-close ownership to junior partners, helping with potential succession planning. Investors also consider partner concentration with regards to client relationships and niche industry expertise, given these can significantly impact a firm's competitive positioning.

Technology and offshoring investment

While accounting services is a relatively mature industry, investors have been focused on making technology and offshoring investments to set the stage for firms' next level of growth. Accounting firms have increasingly begun utilizing automation and Artificial Intelligence to increase productivity and efficiency. These technology enhancements are typically focused on streamlining more manual or lower-level work, freeing up employees to handle the more complex and advisory related work.

Given the labor shortages within North America, accounting firms have also increasingly shifted certain work offshore to countries such as India. This has helped partly mitigate increased employee churn and inflationary wage pressure experienced over the last few years, though the offshoring dynamic has created increased labor competition within these geographies as well.

Large and Growing Serviceable Addressable Market ($ billions)



Audit Advisory Tax

Sources: IBISWorld, Accounting Today

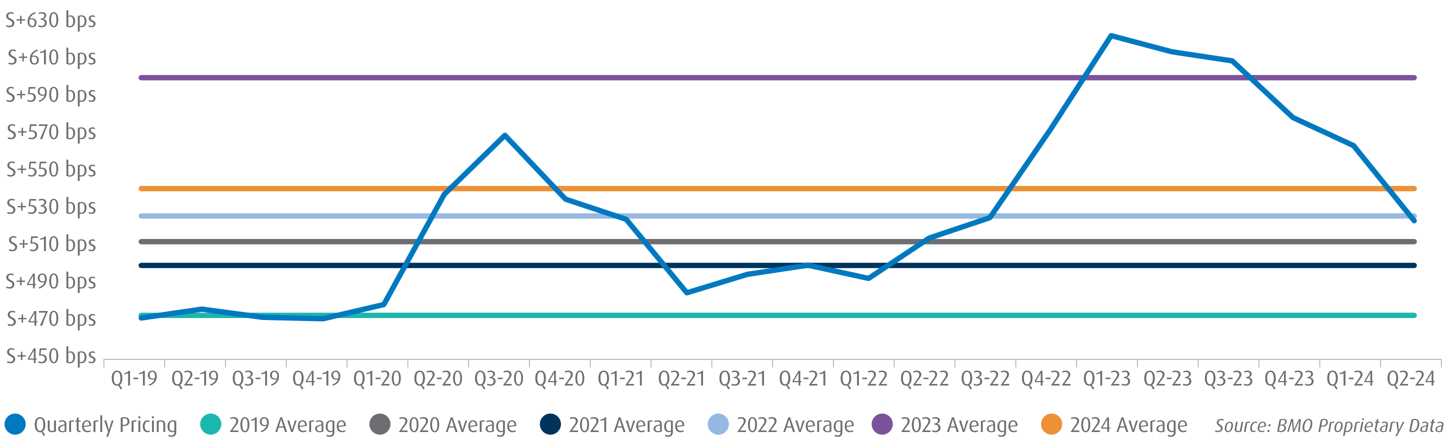
A peek behind the curtain

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 have continued through Q2'24 with most deals getting priced in the S+[500+/-] bps range, with lower closing fees than ~6 months prior.

Quarterly Pricing and Yearly Averages

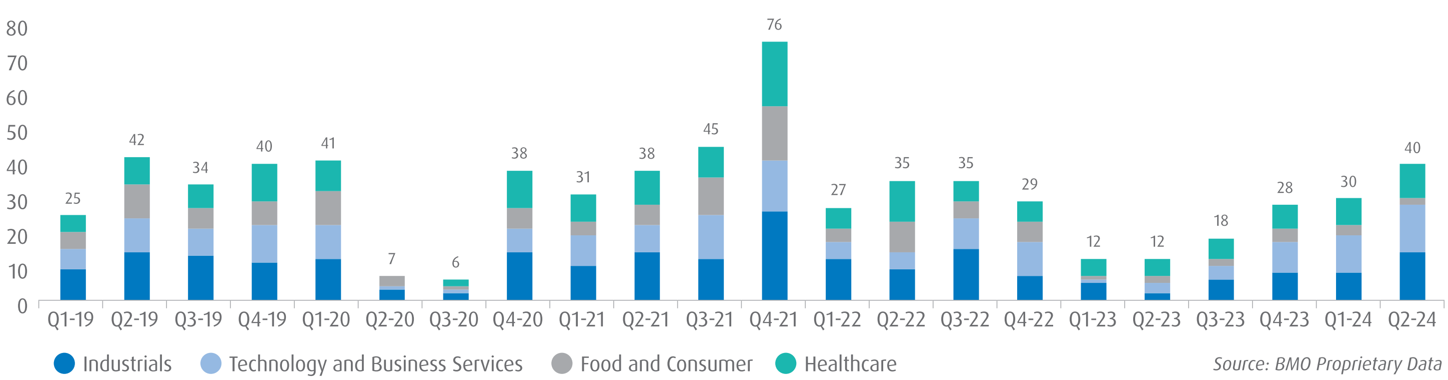


Source: BMO Proprietary Data

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.
- 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 in recent months, many expect there to be limited impact. However, it remains to be seen what impact President Biden's election to exit race will ultimately have on markets.

Deal Volume by Team—All Transactions

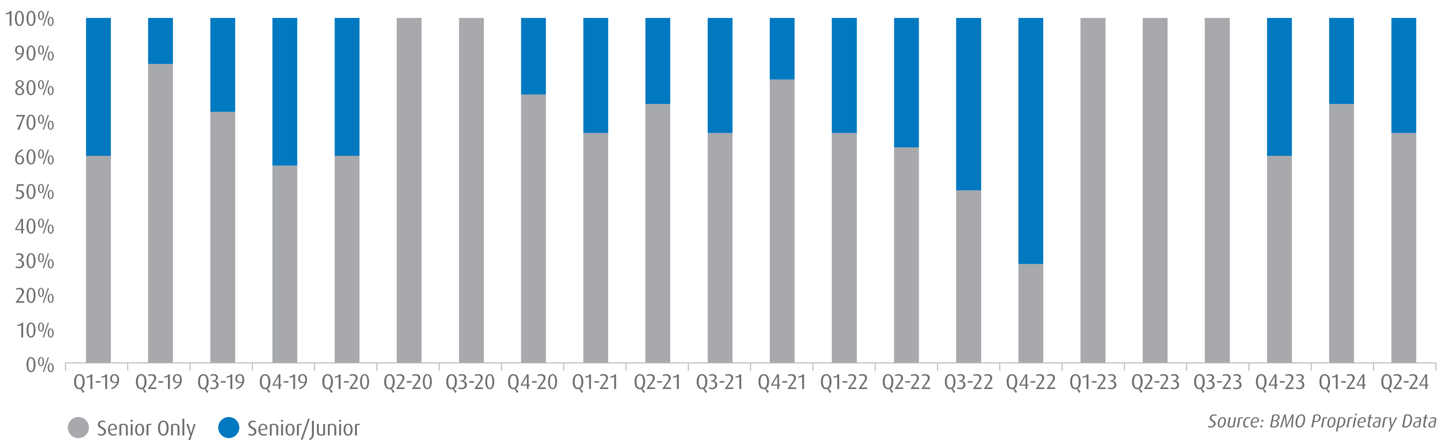


Source: BMO Proprietary Data

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 through YTD'24, BMO saw a reversion back to Sponsor preferences for single tranche solutions.
- Furthermore, while the funded to unfunded mix remains a focus for lenders, delayed draw term loan appetite has increased materially in recent quarters, particularly for businesses that have demonstrated quick usage of these facilities

Transactions by Type—New LBOs

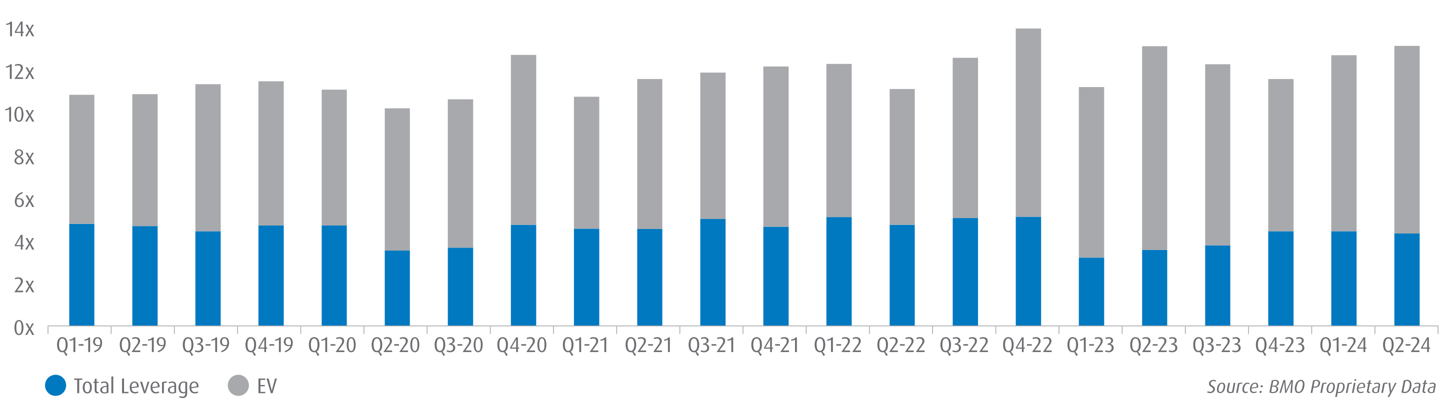


Source: BMO Proprietary Data

Average total leverage trends—new LBOs

- Average total leverage metrics have not changed materially over the last ~6–9 months despite lending markets being more aggressive in putting dollars to work.
- While minimum fixed charge coverage/debt service requirements have relaxed a bit from ~12–18 months ago, higher interest rates have continued to place a governor on the quantum of leverage businesses can support and comfortably cash flow.
- Despite higher interest rates and lower leverage than 2021/2022 levels, BMO has not experienced a material change in EV multiples on the transactions executed.
- As spreads have come down over the last ~6 months, which has improved cash flow metrics, we'd assume the average total leverage to support transactions may increase in future periods, especially if competitive tensions remain.

Average Total Leverage and EV—New LBOs



Source: BMO Proprietary Data

A word from our Sponsor Fund Lending colleagues

Sponsor Fund Loan Program Overview

BMO has been providing loans to Financial Sponsor Funds since 1992 and formed a dedicated team in 2004 around the flagship Sponsor Fund Loan Program (SFLP). BMO's SFLP provides private equity and venture funds the ability to bridge capital calls as well as interim financing solutions for buyout fund portfolio companies. Sponsor Fund Lending has clients ranging from middle market buyout funds, debt funds, venture funds, and funds of other asset managers with an institutional investor base.

BMO Sponsor Fund Loan mechanics

Portfolio company loans (buyouts)

- Usually approved and documented within 5 business days
- Credit is based upon guaranty from the Fund
- Loan allocated to portfolio companies reduces availability for Fund Loans under the global credit facility
- Loans can be made in the form of committed term loans, subordinated loans, Hold Co PIK notes, etc.

Fund loans (buyouts and venture)

- Usually funded within 60 minutes of loan request
- Same day funding assuming loan request is received by 2 p.m. CT

Credit products available under SFLP

- Loans
- Letters of Credit
- Cash management
- Foreign exchange hedging and trading
- Interest rate hedging products
- Commodity hedging products

SFLP fund benefits

- Finance capital call requirements and only issue capital call when the exact funding requirement is known.
- Ease administrative burden on finance staff for small and/or frequent capital needs by consolidating capital calls on the line of credit.
- Warehouse capital calls to be repaid in 90, 180, 270 days or other periodic schedules.
- Bridge capital requirements until the Fund's final close and eliminate true-up capital calls associated with the admission of new investors.

Why BMO Sponsor Fund Lending?

- Experienced and flexible lender with over 31 years in the fund finance industry.
- BMO is sole lender and holds 100% of exposure, in most cases, which promotes streamlined approvals and limits sharing of confidential information.
- Evergreen structure eliminates annual renewals and associated costs.
- Dedicated and responsive service team.
- No non-use fees, syndication, or agency fees.

Key Contact

Kristy Burden
Managing Director, Head of Sponsor Fund Lending
BMO Bank N.A.
Direct: 312-461-2804
kristy.burden@bmo.com

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.

Timothy Dana, Managing Director
312-461-2529 | timothy.dana@bmo.com

Brian Boczkowski, Managing Director
312-461-3503 | brian.boczkowski@bmo.com

Patty Weitzman, Head of Sponsor Finance
312-461-5444, | patricia.weitzman@bmo.com

Kristy Burden, Managing Director
312-461-2804 | kristy.burden@bmo.com

Jennifer Kloud, Managing Director
312-461-5336 | jennifer.kloud@bmo.com

Adam Lively, Managing Director
312-461-7256 | adam.lively@bmo.com

Todd Meggos, Managing Director
312-350-1956 | todd.meggos@bmo.com

Jason Swanson, Managing Director
312-286-3953 | jason.swanson@bmo.com

Dan Weeks, Managing Director
312-953-4213 | dan.weeks@bmo.com

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