

Transaction Trends

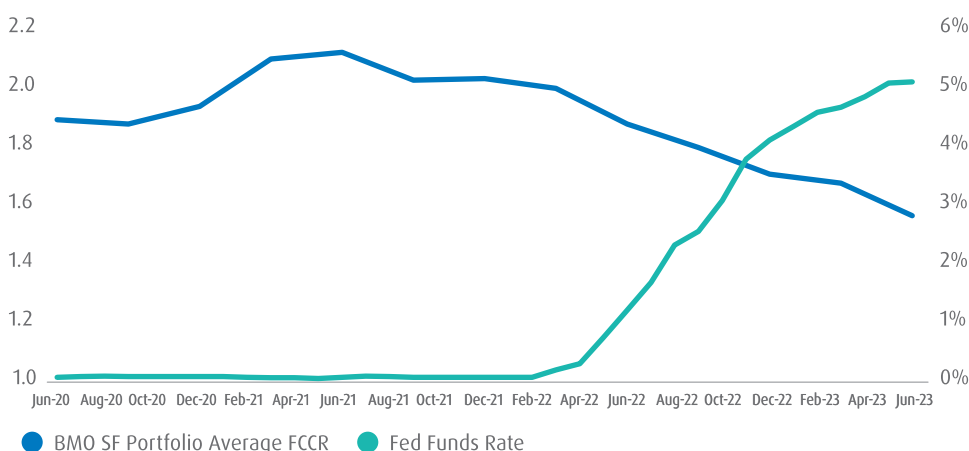
Transaction Trends provides private equity sponsors and investors with middle-market transaction information and insights compiled by the BMO Sponsor Finance group—information that helps sponsors and investors better understand the current financing climate in the middle market.

The rise in rates—the impact on revolver utilization and fixed charge coverage within BMO's portfolio

The Federal Open Market Committee ("FOMC") has raised the target federal funds rate at 11 out of the last 13 meetings resulting in a current target rate of 5.25-5.50 bps. The rapid rise in rates over the last ~18 months has driven a ~65% increase in debt service costs for our borrowers. While this represents a significant cashflow impact, the BMO SF portfolio has continued to show strong performance and resilience.

- The average fixed charge coverage ratio ("FCCR") across the BMO SF portfolio has historically been in the 1.7-1.8x range and peaked just over 2x during the low interest rate environment at the end of 2021 and early 2022.
- Predictably, as rates have increased, FCCR for the portfolio has contracted to 1.5-1.6x as of Q2-23.
- As illustrated below, for every 1.0% that the targeted fed funds rate has increased, our portfolio's average FCCR has decreased by roughly 0.10-0.11x (assuming a 1% SOFR floor).

FCCR and Fed Funds Rate



FOMC Meeting Date	Rate Change (bps)	Fed Funds Rate
Nov-23	0	5.25% to 5.50%
Sep-23	0	5.25% to 5.50%
Jul-23	25	5.25% to 5.50%
May-23	25	5.00% to 5.25%
Mar-23	25	4.75% to 5.00%
Feb-23	25	4.50% to 4.75%
Dec-22	50	4.25% to 4.50%
Nov-22	75	3.75% to 4.00%
Sep-22	75	3.00% to 3.25%
Jul-22	75	2.25% to 2.50%
Jun-22	75	1.50% to 1.75%
May-22	50	0.75% to 1.00%
Mar-22	25	0.25% to 0.50%

Source: BMO Proprietary Data

The rise in rates—the impact on revolver utilization and fixed charge coverage within BMO’s portfolio, continued

Likewise, in connection with increased debt service costs, BMO Sponsor Finance evaluated revolving line of credit (“revolver”) utilization over the last three years. While the portfolio has historically been at ~20% average revolver utilization, we have seen a slight uptick closer to ~30% over the course of 2023. However, even at 30%, utilization remains well below the early COVID-19 pandemic peak of 60%, which occurred during a time of historically low interest rates – demonstrating that there are additional factors impacting revolver utilization outside of interest rates.

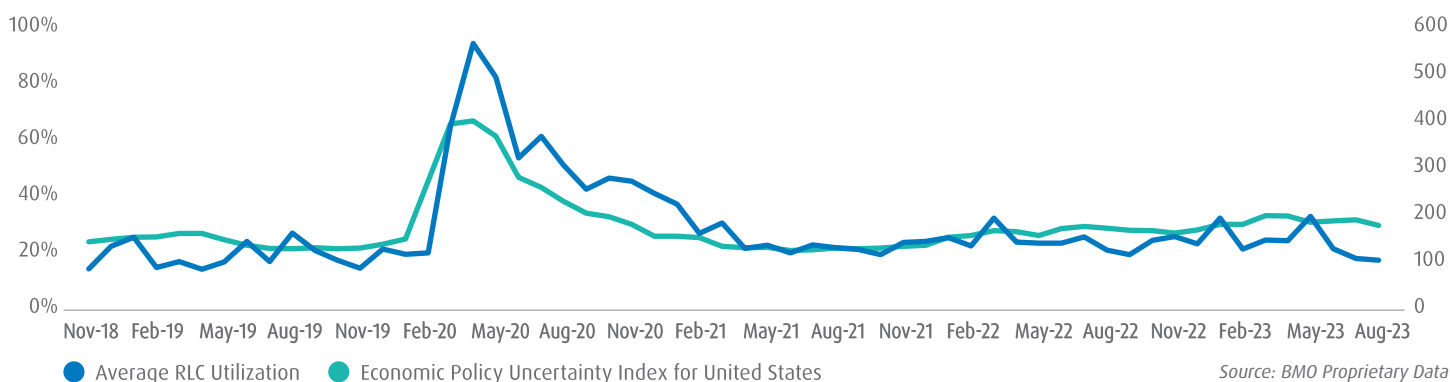
- While the rate hikes alone have not significantly increased revolver utilization, impacts have been exacerbated when paired with one or two additional cash flow hindering factors. This has proven the most evident in situations where borrowers were subject to some combination of (i) increased material costs due to global supply chain disruptions, (ii) destocking, (iii) rising labor costs, or other factors that may be unique to the business.

One common theme with increased revolver activity is the element of uncertainty. The chart below shows revolver utilization overlaid with the Federal Reserve Economic Data’s (“FRED”) Economic Policy Uncertainty Index. As shown to the right, this index closely follows revolver utilization for our borrowers. A couple highlights below:

- COVID (March 2020)—the onset of COVID led to increased revolver usage spiking for three months between March and May 2020 before declining to 40% in August and 30% by November. Uncertainty was somewhat soothed via the CARES act with stimulus checks issued in April 2020.
- Regional Bank Failures (March and May 2023)—Silicon Valley Bank was shut down by federal regulators in March 2023 and revolver usage ticks up, albeit modestly. Likewise, First Republic is auctioned off to JPMorgan Chase in early May and revolver usage remains elevated slightly above historical levels.

Rising interest rates, while increasing the interest costs for our borrowers, represents only one of many factors that impact the health of the portfolio. The most important takeaway, however, is that in a year that has been marked with uncertainty, BMO Sponsor Finance’s portfolio continues to exhibit stability as evidenced through adequate free cash flows via strong FCCRs, stable revolver utilization, and resilient year-over-year performance.

Average RLC Utilization vs. Economic Policy Uncertainty Index for United States



BMO spotlight

BMO executes sale of Datametica to Onix and leads the recapitalization financing.

Onix Networking Corporation (“Onix” or the “Company”) was acquired by Tailwind Capital Group, LLC (“Tailwind”) in July 2022. In October 2023, Onix refinanced & acquired Datametica with BMO Sponsor Finance leading the financing while acting as the Joint Lead Arranger, Joint Bookrunner and Administrative Agent. Additionally, BMO Capital Markets Corp. acted as financial advisor to Datametica. BMO provided differentiated advice and insights on this sell-side assignment and acquisition financing by leveraging its intimate knowledge of cross-border transactions as well as the software & cloud subsectors.

Onix is a global cloud consulting company that offers innovative and efficient cloud-powered solutions that are tailored to meet the distinctive needs of each customer. Onix provides cloud IT services to over 1,500 enterprises that enable customers to effectively leverage Google Cloud’s and AWS’ infrastructure and capabilities. Datametica is a global leader in the migration of legacy data platforms to the cloud, delivering automated tools with unmatched capabilities to take the business risk, cost, and time out of data platform migration and modernization. The Company’s acquisition of Datametica will position Onix as the leading Google-first cloud services partner.

BMO assisted Tailwind in maintaining a competitive bidding dynamic within an extended transaction timeline given the uncertainty in the markets at the time of Datametica add-on. BMO’s deep relationships and connectivity across the global software & technology industry, as well as our existing financing relationship, led to high impact advice and seamless execution on the transaction.



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.

We're the experts—early childhood education

BMO maintains a deep level of expertise and dedicated resources focused on the education sector. A sub-sector that remains active for both strategic and private equity buyers is Private Early Childhood Education (e.g. providers serving infants through Kindergarten), which is a \$80Bn+ market. Only ~20% of private enrollment is served by the top 50 chains.

Several attributes make the sector attractive to private equity buyers. Most notably the sector benefits from (i) a highly fragmented and hyper-local landscape focus with ~75k education centers across the U.S. that provides for strong roll-up opportunities and valuation arbitrage through increased scale, (ii) positive tailwinds of increased dual income parents as well as those opting for professionalized early childhood education (versus home-based care) given proven efficacy of quality childcare and the socio-emotional development of children, (iii) strong business diversity across geography, sites, and customers, and (iv) strong revenue visibility with sticky, re-occurring streams and an ability to pass through annual tuition increases.

Tuition funding for early childhood is largely derived from private pay and subsidized programs, or a mix of both. Annual average tuition within the private early childhood education sector is ~\$14,500, and generally ranges from ~8K - \$30k depending on the geography, segment of the market being served (e.g. premium, standard, lower income/subsidized), and the perception of quality in the educational offering and brand.

For many parents at the higher price points, this purchase is viewed non-discretionary leading those providers to be historically recession resistant. Fully subsidized programs such as universal pre-k have long been a threat to the industry, however funding challenges and program administration is difficult. Where there is established universal pre-k (e.g., Georgia) operators have found ways to profitably serve the market by offering care before and after school. Needs based subsidies for childcare have long garnered bi-partisan support and have remained stable.

Given the sector is hyper-local, purchasing criteria is hyper-local and centered on quality of staff and curriculum, quality of facilities/cleanliness, safety and security protocols, communication with parents, and quality of meals. Tuition cost and location are typically initial filtering criteria for parents.

While the monetary switching costs are typically low, the average term of a given enrollment is ~2 years. Increases in pricing (typically ~3-5% annually) tends not to be a reason for switching as younger students have a higher tuition which provides some insulation to price increases as students matriculate to the next age group. Tuition increases have been elevated in recent years caused by inflationary wage pressure, which we've seen have little impact on enrollment trends when passed through.

In evaluating early childhood deals, BMO looks for platforms that (i) have strong business diversity (number of sites, operating brands, geographies, landlords, etc.), (ii) a differentiated curriculum/educational offering, (iii) strong unit level trends with the demonstrated operating history of scaling de novo and/or successful integration of acquisitions, (iv) ability to attract/retain labor, and (v) a track record of safe operations. Given the high operating leverage, utilization rates can be correlated to EBITDA margins which range from 10% to 15%+ for established operators. Off balance sheet lease liabilities and history of incidents are also another key consideration.

After over 15 years of investing in and advising early childhood companies, the sector remains an attractive area to invest with several underlying tailwinds. COVID demonstrated the resilience of the industry (enrollments are near or above pre-COVID levels in most platforms reviewed) and government programs provided support given the critical nature of the offering to the economy. The resiliency is further supported by market work suggesting the for private childcare industry only experienced a revenue decline < 5% during the Great Recession, when employment rates and household income was under the greatest pressure.



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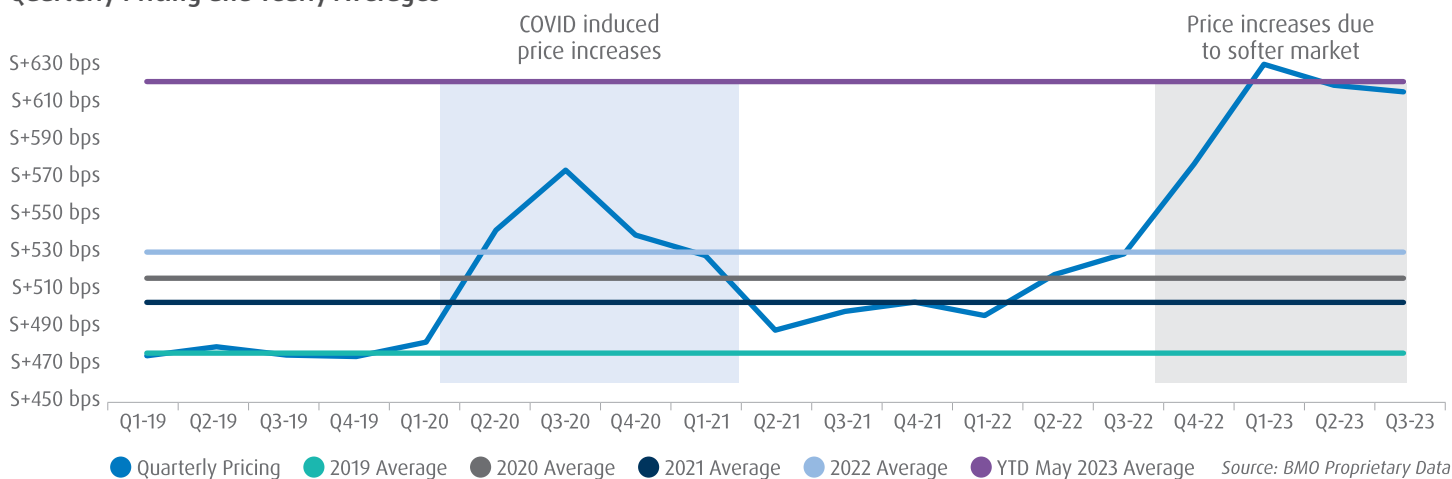
A peek behind the curtain

A snapshot of BMO's proprietary portfolio and transaction data.

Pricing trends—all transactions

- As illustrated in the chart below, spreads on new transactions continued to widen from Q2'22 as a result of market disruptions that began in the Spring/Summer of 2022, followed by macroeconomic headwinds and Federal Reserve tightening.
- Spreads ultimately peaked in Q1'23 and began to tighten at the lower end of the S+[600 – 650] bps range in Q2'23 for normal course levered transactions. Spreads have continued to compress downward towards the end of Q3'23 as a result of an uptick in auction process launched around Labor Day and lenders increased appetite to put money to work.
- Existing platforms that are executing material amendments (i.e. incremental capital raise for an add-on) have continued to re-price existing tranches upwards to current market rates (most typically within the MFN).
- Based on early market feedback in Q4, spread and fee talk has continued to suggest a downward trajectory (particularly for high quality assets) from levels seen in recent prior quarters.

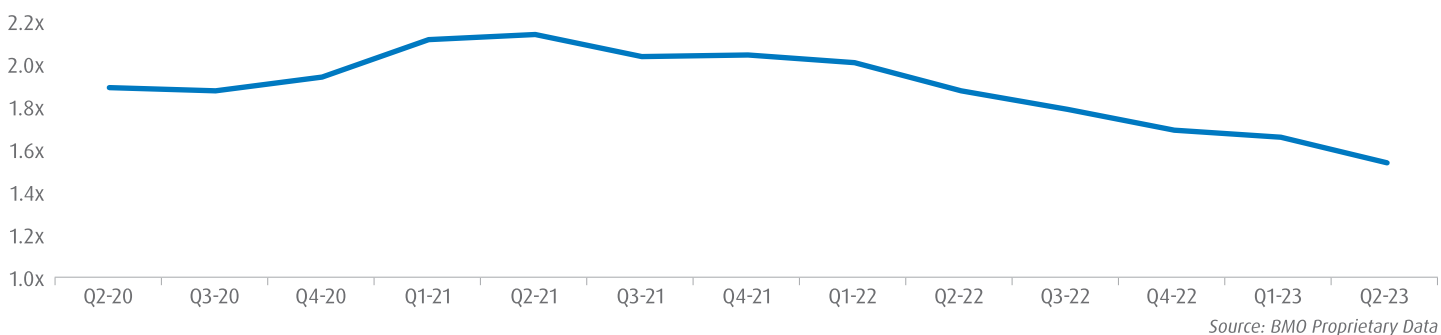
Quarterly Pricing and Yearly Averages



Fixed Charge Coverage Trends—BMO Portfolio

- Further on the fixed charge coverage topic, the below chart illustrates the impact rising rates has had across BMO's portfolio of ~300 borrowers now that we are ~18 months removed from the start of the rising interest rate environment.
- While difficult to point to rising rates alone, average revolver utilization within the portfolio has also increased from ~23% utilized in Dec-21 to >30% today.
- In some cases, deals that were executed at max leverage prior to current rate environment are experiencing liquidity tightness / issues before potentially tripping an actual financial covenant (i.e. Total Net Leverage covenant).

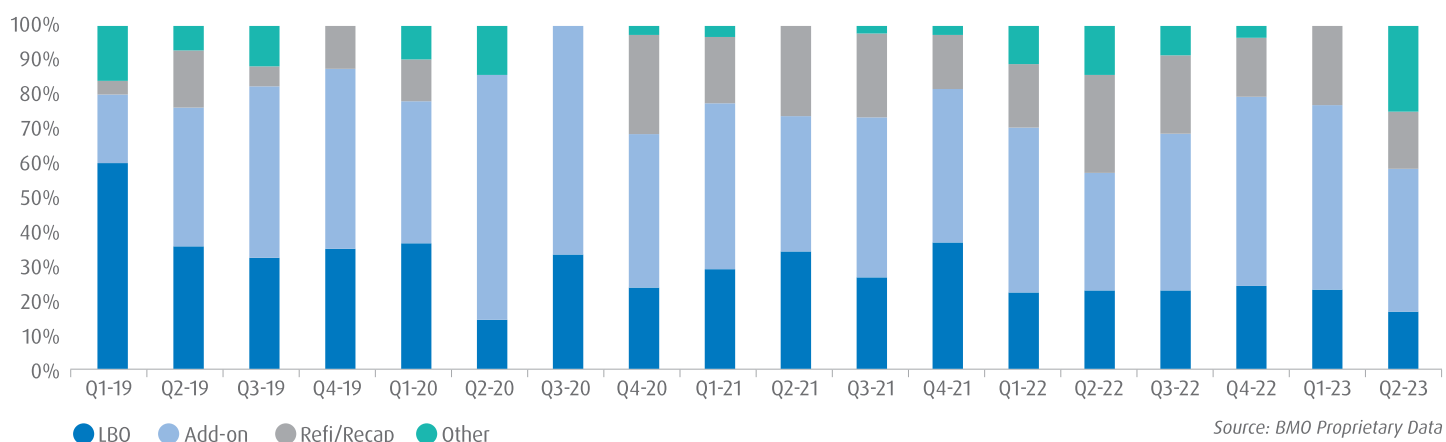
Fixed Charge Coverage—BMO Portfolio



Quarterly transaction activity by deal type—all transactions

- While existing portfolios have remained active with add-ons, new deal activity remained suppressed in Q2'23 relative to prior year.
- Suppressed new deal activity has largely been attributed to tightening of appetite within the financing markets (primarily driven by increasing rates which has impacted leverage) and dislocations in bid/ask valuations between buyers and sellers with mixed signals on the economic outlook (though outlook sentiment seems to have improved relative to earlier in the year).
- As such, there has been a flight to quality (and to extent more scale) where “A-list” assets continue to command strong buyer interest and lender support, whereas “B and C-list” assets have been best executed via strategic buyer angles, if they’ve traded at all.
- There has been an uptick in auction processes (and deal quality) leading up to and post-Labor Day across most sectors, with an expectation for a much busier Q4'23/Q1'24 relative to 1H'23.
- BMO has also seen an increased willingness of lenders to entertain higher levels of funded/unfunded mix (particularly associated with delayed draw term loan raises) than in past quarters.
- M&A bankers continue to indicate healthy pipelines and pitch activity, with the key decision point being the right time to launch the process to the broader market and ensuring company is well positioned to demonstrate stable results through the sales process.

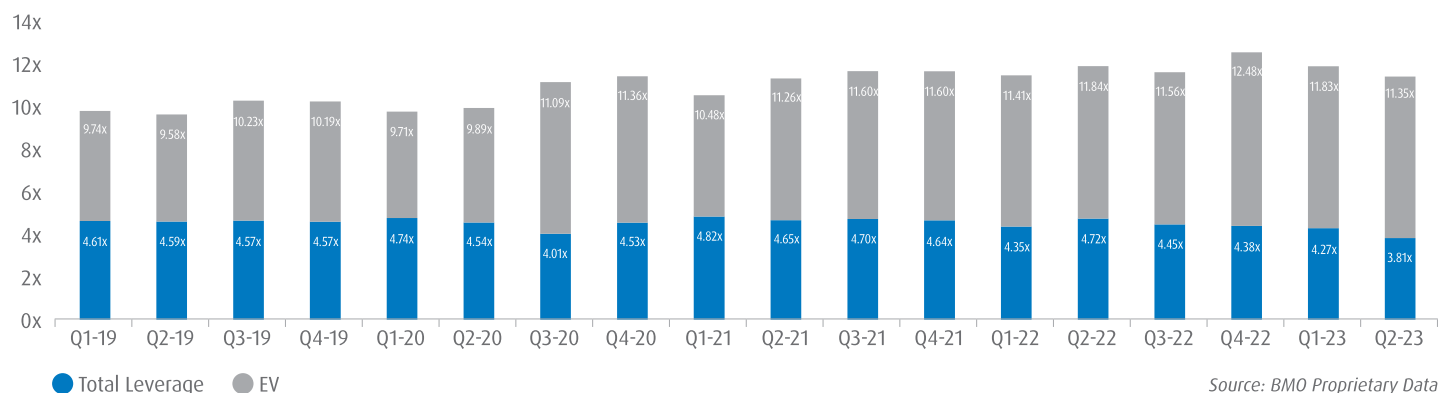
Deal Volume by Transaction Type—All Transactions



Average total leverage trends—all transactions

- Similar to themes earlier in the year, there has been a continued flight to quality for both sponsor and lenders on deals being executed, where highly attractive and non-cyclical assets continue to command strong interest (and valuation multiples) as in past quarters. Many lower quality assets have either had processes drag on or pulled.
- As a result of rising rates, leverage for new transactions moderated modestly over the past ~12, but EV multiples (on deals being financed) have not experienced material movements.
- Many deals in today's market are likely getting lower leverage reads than they would have received 18 months ago. This is not due to conservatism by lenders factoring in cushion for potential future headwinds, or change in views of sectors. Rather, where we've seen leverage levels come in has solely been driven by rising rates (SOFR and spreads) which has impacted some company's ability to adequately service debt where past leverage reads were indicated.

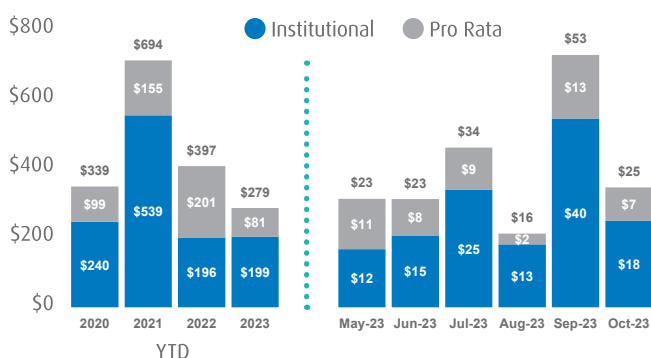
Average Senior Leverage, Total Leverage and EV—All Transactions



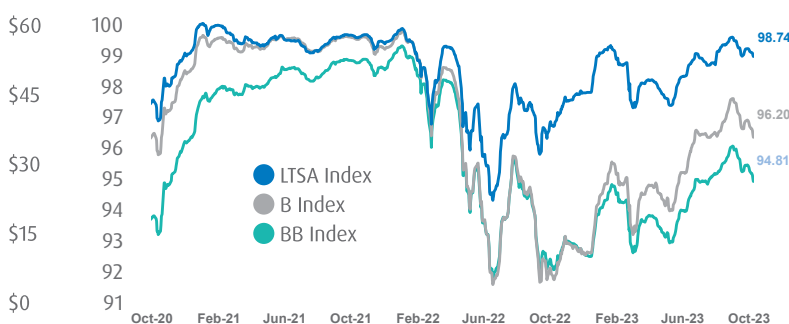
A word from our Leveraged Finance colleagues

- Despite softer market conditions, the U.S. leveraged loan market has remained active through year-to-date 2023 albeit below 2022 levels driven by weak Pro Rata issuance from elevated capital demand across banks, potential regulatory changes, and concerns around negative credit migration. Institutional U.S. leveraged loan new issue volume in the year-to-date has surpassed last year's \$196B in the year-to-date from opportunistic refinancings during the summer when market conditions were optimal and sizeable LBO trades for names like Worldpay, Syneos, Univar, and Arconic.
- U.S. CLO issuance year-to-date is \$94.1B, down over 18% from last year's \$115.7B due to the rate/spread environment. The decline is more pronounced within the BSL CLO market, where issuance is 24% behind last year's pace. In contrast, middle-market/private credit CLO volume has more than doubled this year and now accounts for 22% of total issuance.
- The loan secondary has been gradually widening with the broad index hovering ~95 during Oct-23.
- BMO Leveraged Finance continues to be active most recently acting as joint lead arranger on Cetera Financial's (B2/B) \$1,689mm TLB supporting its acquisition of Avantax, with the add-on term loan allocating at S+CSA+450/97.

Leveraged Loan New Issue Volume*



LSTA Leveraged Loan Index



Source: Bloomberg, LCD, LFI. Note: Data as of October 26, 2023.

*Excludes existing tranches of add-ons, amendments, and restatements with no new money. Volumes comprise loans denominated in all currencies

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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