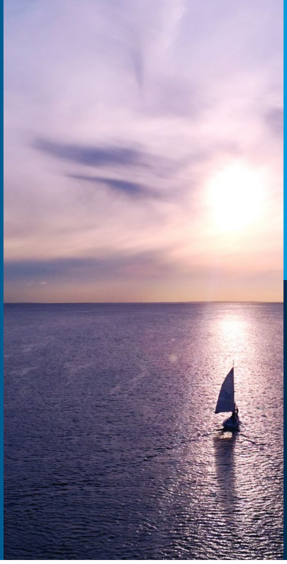
Morgan Stanley

INVESTMENT MANAGEMENT

A New Era for Middle Market Private Equity

Five Imperatives for an Evolving Market



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Key Takeaways

- The middle market private equity landscape is in the midst of real change, and the conditions that drove returns in the 2010s are no longer guaranteed
- Competition for quality assets has intensified, at the same time limited partners have become more selective about which managers they choose to invest with
- Deep subsector expertise and a differentiated sourcing strategy are critical to identifying and unlocking investment opportunities
- A proven and well-resourced value creation playbook can reduce volatility and strengthen underwriting; AI is becoming a source of measurable advantage
- A disciplined approach to liquidity generation is emerging as a point of differentiation across the middle market landscape

The Middle Market Landscape is Shifting

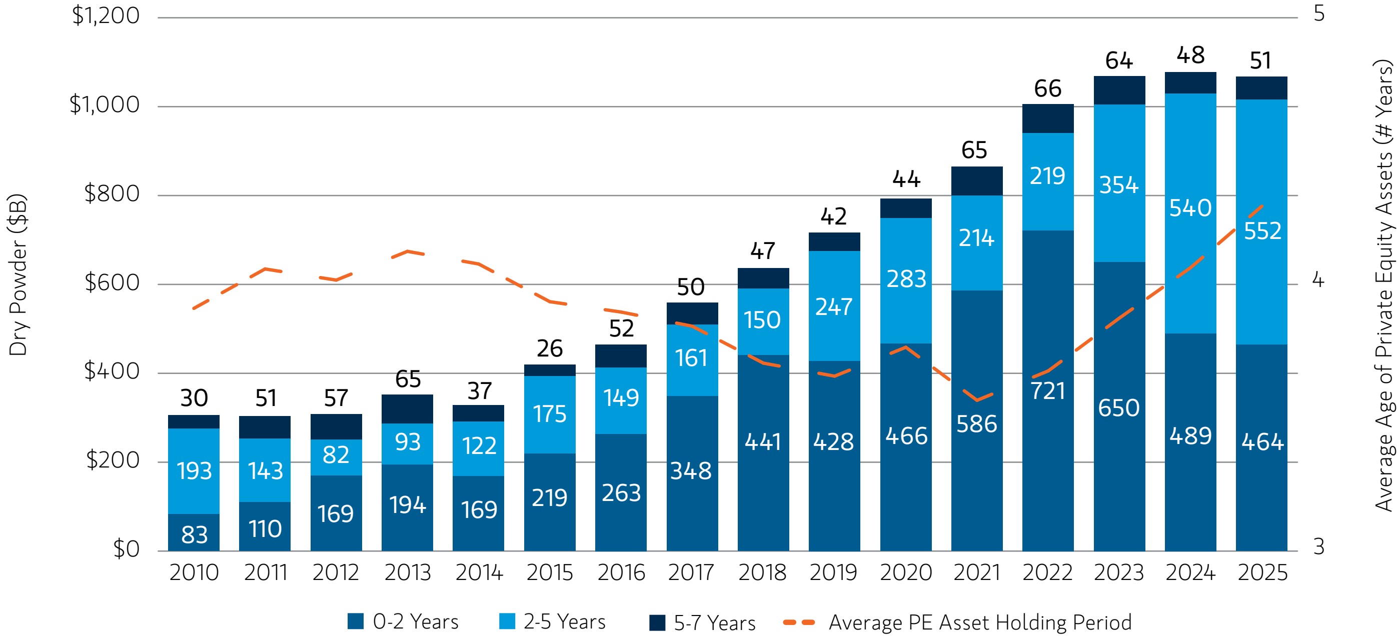
For roughly a decade before the pandemic, middle market private equity operated against a generally favorable backdrop. Debt was inexpensive and readily available, valuations generally rose over a five-year holding period, and exit markets were dependably open. These conditions rewarded investing discipline but also forgave missteps – a private equity fund manager ("sponsor") who bought a good business at a reasonable price could deliver an acceptable return with little more than a 'buy and hold' strategy. We believe that backdrop has changed. Macroeconomic growth has slowed and volatility has risen across consumer demand, input costs, labor markets, and trade policy, compressing the margin for error.

Despite abundant capital, sustained higher costs have created a challenging borrowing environment. Record inflows have made private credit a deep and competitive financing market, yet interest rates remain well above 2010s levels.

DISPLAY 1

Dry Powder and Invested Assets Have Aged to Record Levels

US Private Equity Dry Powder by Age of Fund



Source: Pitchbook, US Only. Dry powder data as of December 31, 2025. Asset holding period data as of June 30, 2026.

Higher borrowing costs consume more portfolio company cashflow and reduce the equity return benefit from leverage. As a result, earnings growth must drive a greater portion of private equity returns: compared to the pre-pandemic interest rate environment, the average private equity investment now needs to deliver roughly double the earnings growth to generate the same MOIC.

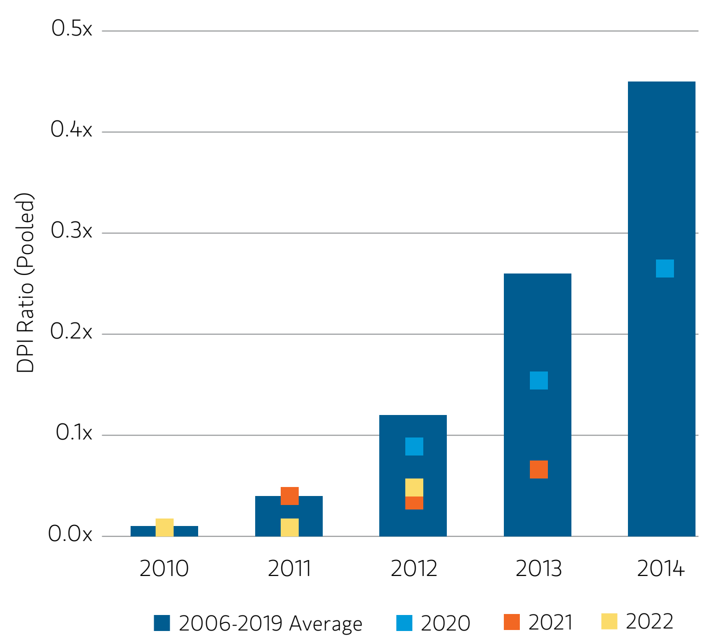
Dry powder remains elevated versus the 2010s, but its age matters more than the total quantum. Over $600 billion, roughly 55% of total dry powder, is now sitting in funds more than two years old, which is an all-time record *(Display 1)*. This capital was raised under different market conditions, has been deployed more slowly than historical norms, and is now nearing the end of its investment period. Sponsors racing the deployment clock may bid more aggressively, which can lead to increased competition, irrational entry pricing, and ultimately compressed returns.

Transaction volumes compound the problem. Holding periods have stretched from three-to-five years to five-to-seven or more, leaving a backlog of unsold private equity assets that PitchBook estimates at more than 30,000. Even if conditions improved tomorrow, this backlog would take years to clear.

DISPLAY 2

DPI Evolution for Recent Fund Vintages Trending Well Below Historical Averages

US Private Equity Fund DPI by Vintage



Source: Pitchbook, US Only. As of December 31, 2025.

Because transaction volume is down, distributions from sponsors to their limited partners (LPs) are down with it. The median 2006-2019 fund returned 0.45x of paid-in capital by year five and more than 1.0x by year eight.[1] Recent funds are returning capital more slowly: 2020 funds had returned 0.27x by year five, while 2021 funds had returned just 0.07x by year four *(Display 2)*, less than one-third of the historical pace at comparable points in fund life. This shortfall has reordered LP priorities, with many now ranking Distributions to Paid-In Capital (DPI) above Internal Rate of Return (IRR). It is already visible in capital formation: fund closings have declined by nearly 40% since 2022, concentrating capital with sponsors who can show a track record of returning it.

The result is a tougher market at both ends, making buying difficult and exiting even more challenging. Returns must now be earned through real EBITDA (earnings before interest, taxes, depreciation, and amortization) growth and portfolio company improvement rather than assumed from the market, which puts the burden on the sponsor to have a strong and differentiated process to source, manage, and exit their investments.

What Can Drive Outperformance

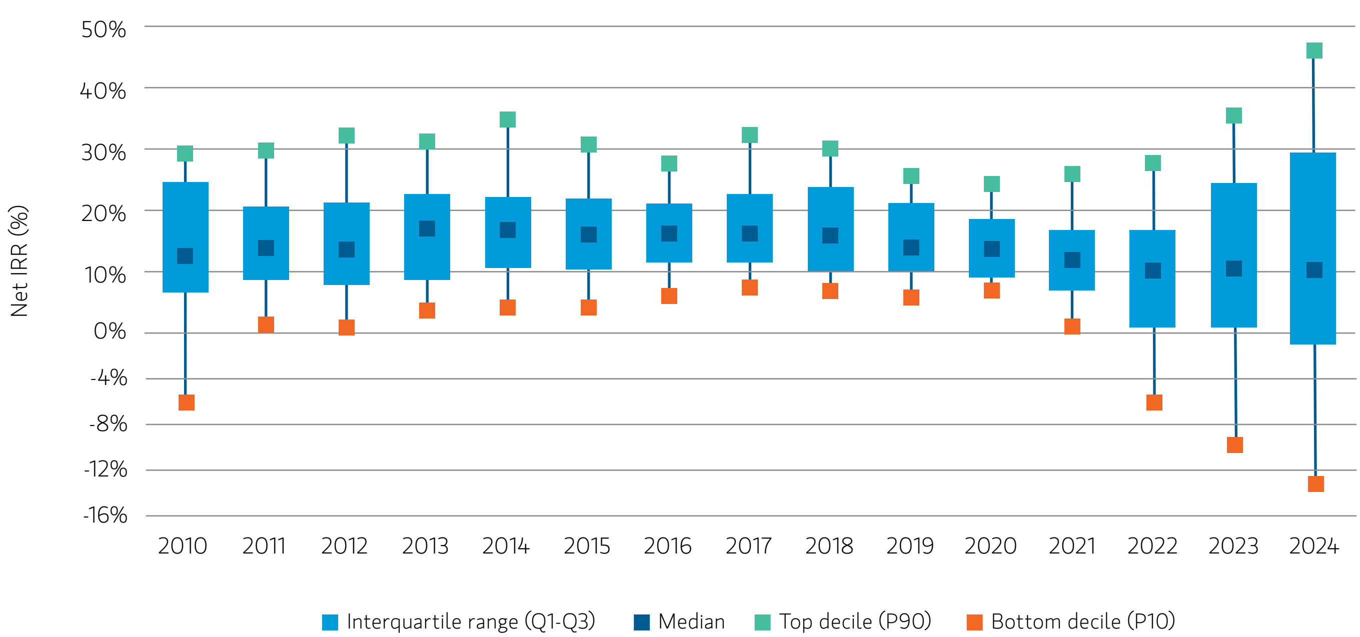
If the 2010s were characterized by a rising economic tide lifting all boats, we believe that the next decade will be the era of manager dispersion. Access to capital is no longer a differentiator given elevated levels of aged dry powder, and financial engineering is no longer a differentiator when debt financing is expensive. In our view, outperformance will increasingly be driven by the individual sponsor - strategy and focus, operating capability, and resources. We see five imperatives that, in our view, will separate top-performing managers from those who revert to mean performance.

1. **Detailed and Thematic Subsector Focus**
2. **Differentiated Sourcing Strategy**
3. **Resourced and Repeatable Value Creation**
4. **Tangible Value Creation Through AI**
5. **Intentional Liquidity Planning**

DISPLAY 3

Dispersion in Private Equity Fund Returns Has Increased in Recent Years

US Private Equity Fund Net IRR Distribution by Vintage Year



Source: Pitchbook, US Only. As of December 31, 2025.

[1] PitchBook. As of December 31, 2025. US buyout funds only.

1 **DETAILED AND THEMATIC SUBSECTOR FOCUS**

With the margin for error in entry pricing narrowed, we believe deep subsector focus has become a requirement. Sponsors with real expertise in a defined set of industries can identify opportunities before they are broadly marketed, credentialize themselves with sellers and target company management teams, and bring pattern recognition to both diligence and value creation. These capabilities compound over time and, in our view, allow sponsors to move more quickly and with more conviction than the field.

However, this is not an argument for narrow focus or single-sector specialization. Sectors move in and out of favor over time *(Display 4)*, and a portfolio concentrated in one industry inherently displays that cyclicality regardless of individual asset selection. We believe the optimal strategy is depth across several defined subsectors rather than generalist coverage of everything or a myopic focus on one sector alone.

2 **DIFFERENTIATED SOURCING STRATEGY**

Relationships with middle market intermediaries remain a critical part of successful private equity investing, and no sponsor can operate without them. We believe, however, that a proprietary sourcing engine capable of identifying and unlocking opportunities outside broadly-marketed auctions has become a meaningful differentiator. Proprietary sourcing allows for early target identification, the ability to move before the rest of the market has organized around an asset, and often an advantage on entry valuation.

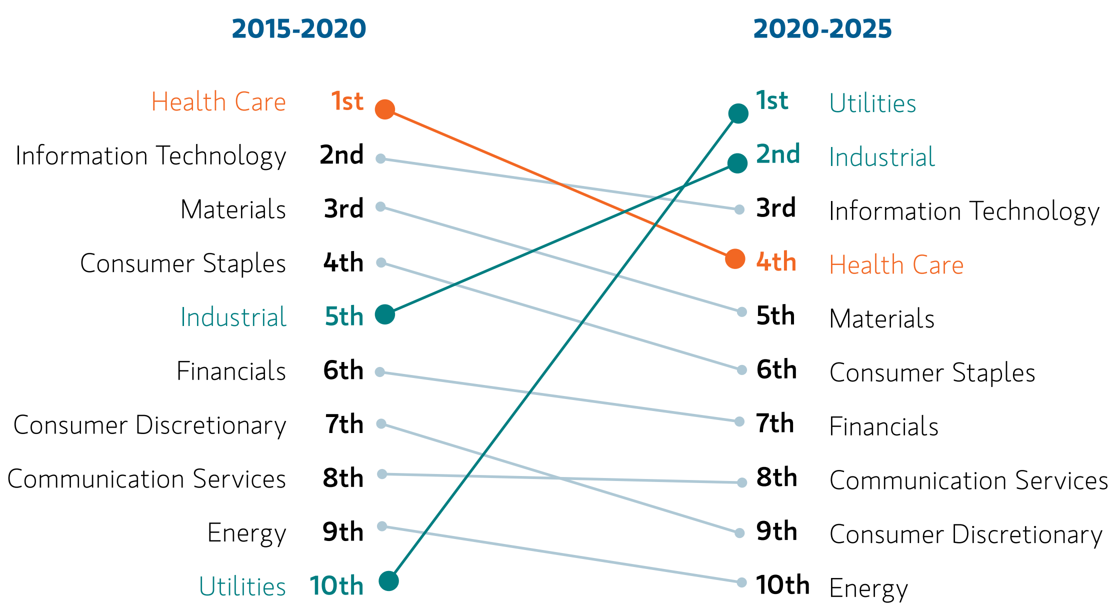
The potential for an advantaged entry valuation is particularly important given the competitive dynamics discussed previously. In a private equity market where a large number of sponsors are under pressure to deploy aging capital, broadly marketed auctions create an environment that drives entry valuations up. Estimates of the valuation gap between proprietary and competitive transactions vary, but market participants generally recognize a discount on proprietary acquisitions.

A proprietary sourcing engine is not something that can be built overnight. We believe truly differentiated origination requires dedicated focus at the sponsor level, a concerted and consistent effort to build broad relationships with business owners and operators, and a long-term mindset around building and maintaining a strong reputation in the market.

DISPLAY 4

Private Equity Industry Performance Has Rotated Over the Last Decade

Composition of Private Equity Exit Returns by Factor



Source: MSCI Private Assets, as of March 31, 2026. 75th percentile (top-quartile) TVPI of realized exits; Real Estate and unclassified funds excluded.

3 RESOURCED AND REPEATABLE VALUE CREATION

Without the benefit of financial engineering, we believe the majority of future returns must be driven by earnings growth. Recent exit data supports this: from 2022 to 2025, revenue and margin growth drove roughly 80% of exit MOIC, up from 55% in the 2015 to 2019 period, while the contribution from multiple expansion fell from 0.95x to 0.49x *(Display 5)*. Building sustainable platforms that can drive real earnings growth is no simple undertaking in the middle market, and in our view sponsors with a dedicated team and repeatable playbook will outperform those who have neither.

The clearest dividing line, in our view, is whether sponsors rely on operating expertise deal-by-deal or have built a dedicated in-house capability. A dedicated team engaged from pre-investment diligence through exit can apply consistent expertise across core value creation levers such as commercial effectiveness, pricing discipline, procurement, and working capital management.

Developing a truly repeatable value creation approach also reinforces a virtuous cycle with a sponsor's underwriting process by reducing outcome dispersion. A sponsor that has executed a given operational program across multiple companies can underwrite the next similar investment with more confidence than a sponsor attempting it for the first time. In an elevated pricing environment where entry pricing carries more uncertainty, we believe the ability to underwrite earnings growth with confidence and speed can be a real differentiator.

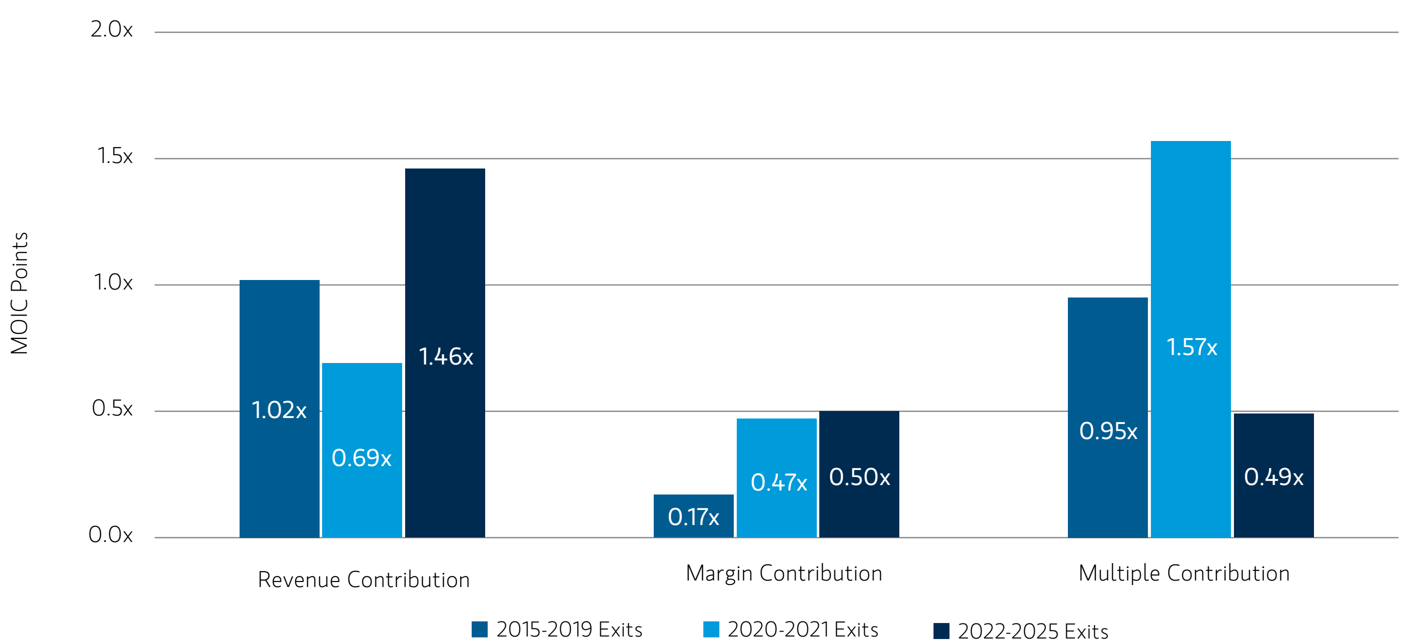
4 TANGIBLE VALUE CREATION THROUGH AI

Over the last two years, we have seen Artificial Intelligence move from an interesting edge case to a genuine driver of value. The question is no longer whether AI will be impactful, but where it can be best deployed. We see two applications driving real value today. The first is during diligence, where commercially-available tools can now review an entire data room and answer specific, detailed questions almost instantly. In competitive diligence processes where speed and conviction can create real advantage, we believe that acceleration can be a genuine edge.

The second, and ultimately larger, application of AI is within the individual portfolio companies of a middle market sponsor. We see AI enabling growth, cost control, and operating efficiency in a meaningful way. Middle market businesses are frequently under-resourced and under-invested in the Technology function, which in our view makes them particularly good candidates for AI-driven improvements in pricing analytics, sales productivity, customer service, and back-office automation. The upside

DISPLAY 5

Revenue Growth Has Been a Significantly More Impactful Driver of Return in Recent Vintage Exits



Source: MSCI Private Assets. As of June 30, 2025.

may be particularly significant because many middle market companies are starting from a low level of technology adoption, while the core system barriers that may have existed in the pre-AI era are no longer insurmountable.

We believe that private equity-backed companies not actively adopting AI will be left behind, though we also acknowledge that tangible results across the market remain uneven. In our view, the obstacles to AI value creation are often organizational rather than technical, with fragmented data, unclear ownership, and weak governance driving more project failure than issues with the underlying technology. The sponsors that drive repeatable value, we believe, are those who treat AI as a core part of their operating discipline with defined ownership and key performance indicators (KPIs), rather than a one-off project deployed on an ad-hoc basis.

5 INTENTIONAL LIQUIDITY PLANNING

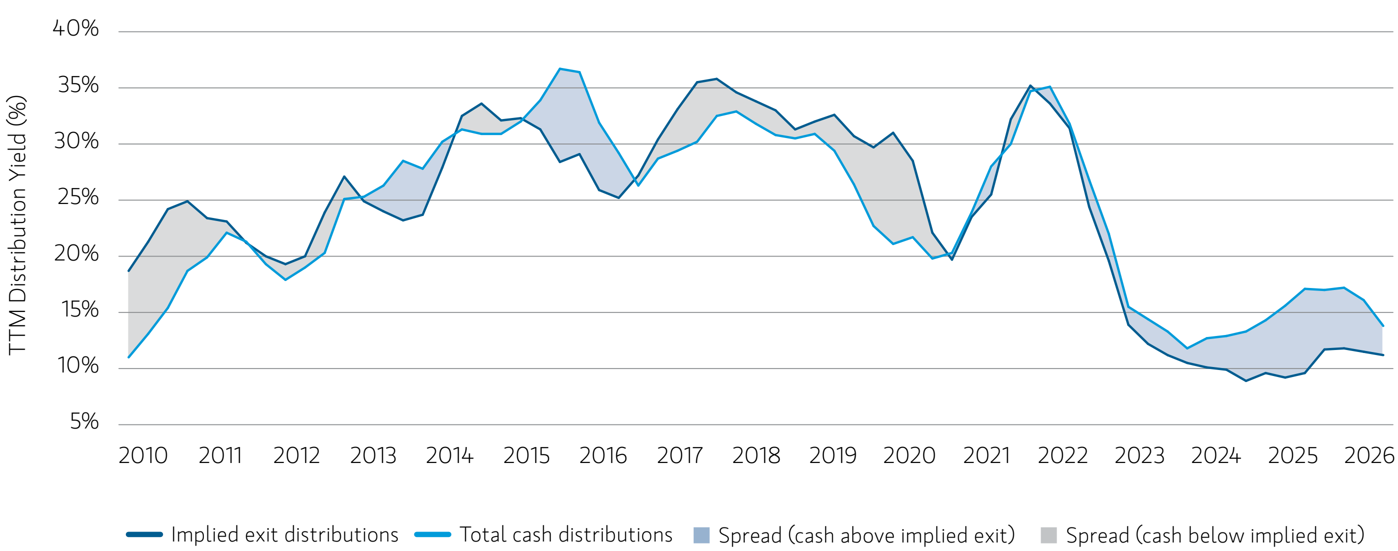
Given the muted transaction and distribution environment previously discussed, sponsors have two options. They can wait for the market to improve and for "regular-way" exits to resume, or they can take an active approach to consistently delivering liquidity. The sponsors delivering top-quartile DPI are generally taking the latter approach, constantly finding ways to return cash to their investors using a full set of tools.

The most important and impactful tool for driving DPI remains the traditional full exit at a strong MOIC. Regardless of the broader economic backdrop, sponsors who can invest at fair entry valuations, generate underlying earnings growth, and build an attractive platform should continue to exit in a timely manner and at a premium valuation. Upper middle market and large cap sponsors continue to raise ever-larger funds, and we believe the buyer universe for high-quality middle market assets remains strong.

Beyond traditional exits, a broad suite of options has emerged over the last decade. Continuation Vehicles (CVs) have moved from a one-off solution to a deep and liquid segment of the market, with GP-led secondary volume reaching record levels. Minority sales and other forms of structured liquidity allow sponsors to deliver partial monetization without giving up control of an asset that has further embedded upside, and dividends provide another interim liquidity tool for companies that are sub-optimally capitalized.
Used judiciously, we believe these different tools allow sponsors to return capital to their limited partners on a reasonable timeline while avoiding the value erosion that could occur from selling into an unconstructive market.
In a market where limited partners have made DPI the key metric governing future fund commitments, sponsors who can generate consistent distributions should have an advantage in sustaining and growing their business.

DISPLAY 6

Spread Between Total Private Equity Cash Distributions and Implied Exit Distributions is Expanding, Suggesting Additional Liquidity Tools Are Being Utilized



Source: PitchBook, Morgan Stanley Investment Management. US only. As of March 31, 2026.

Positioning for the Decade Ahead

In our view, none of these five imperatives will drive strong returns in isolation; executing across all of them is what separates top-quartile managers from the pack.

A middle market sponsor without subsector expertise risks being outbid by those who have it. A sponsor without proprietary sourcing capabilities will more often pay market-clearing prices, and one without a defined and proven value creation playbook may face greater difficulty generating the earnings growth required to deliver acceptable returns at those prices. Finally, and perhaps most importantly for managers, a sponsor that cannot consistently return capital to investors is likely to face increasing difficulty raising the next fund.

Looking ahead, we expect continued dispersion in middle market private equity fund performance. Our view is that sponsors who cannot execute across these five imperatives will face real challenges in maintaining their returns, while those who can are likely to outperform For managers that have invested in building these capabilities, we believe that a more demanding economic environment may actually create a favorable backdrop, as it may create greater differentiation between managers who can drive true alpha and those who have been primarily riding a favorable market tailwind.

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