**SPP's Middle Market Leverage Cash Flow Market At A Glance**

**Deal Component** | **April ’18** | **March ’18** | **April ’17**
---|---|---|---
Cash Flow Senior | <$5.0MM EBITDA 1.75x-3.00x | <$5.0MM EBITDA 1.75x-3.00x | <$7.5MM EBITDA 1.50x-2.50x
Debt Multiple | >$10.0MM EBITDA 2.75x-4.00x | >$10.0MM EBITDA 2.75x-4.00x | >$10.0MM EBITDA 2.50x-3.50x
(x EBITDA) | >$20.0MM EBITDA 3.25x-4.75x | >$20.0MM EBITDA 3.25x-4.75x | >$20.0MM EBITDA 3.00x-4.00x
Total Debt Limit | <$5.0MM EBITDA 3.50x-4.50x | <$5.0MM EBITDA 3.50x-4.50x | <$7.5MM EBITDA 3.00x-4.00x
Multiple | >$10.0MM EBITDA 4.00-5.00x | >$10.0MM EBITDA 4.00-5.00x | >$10.0MM EBITDA 3.75x-4.50x
(x EBITDA) | >$20.0MM EBITDA 4.50x-6.00x | >$20.0MM EBITDA 4.50x-6.00x | >$20.0MM EBITDA 4.00x-5.50x
Senior Cash Flow Bank: L+1.00%-5.00% | Bank: L+1.00%-5.00% | Bank: L+1.50%-5.00% | Non-Bank: <$10.0MM EBITDA L+7.00%-8.00%
Pricing Non-Bank: <$7.5MM EBITDA L+5.50%-8.00% | Non-Bank: <$15.0MM EBITDA L+4.50%-6.00% (potential for 1.00% floor) | Non-Bank: ><10.0MM EBITDA L+4.50%-6.50% (potential for a 1.00% floor)
Second Lien Pricing ($ Avg) | <$5.0MM EBITDA L+7.00%-11.00% floating (1.00% floor) | <$5.0MM EBITDA L+7.00%-11.00% floating (1.00% floor) | <$7.5MM EBITDA L+9.00%-12.00% floating (1.00% floor)
| >$10.0MM EBITDA L+6.50%-8.50% floating (1.00% floor) | >$10.0MM EBITDA L+6.50%-8.50% floating (1.00% floor) | >$10.0MM EBITDA L+7.50%-9.00% floating (1.00% floor)
| >$20.0MM EBITDA L+6.00%-7.50% floating (1.00% floor) | >$20.0MM EBITDA L+6.00%-7.50% floating (1.00% floor) | >$20.0MM EBITDA L+5.50%-7.50% floating (1.00% floor)
Subordinated Debt Pricing | <$5.0MM EBITDA 12.00%-14.00% | <$5.0MM EBITDA 12.00%-14.00% | <$7.5MM EBITDA 12.00%-14.00%
(x EBITDA) | >$10.0MM EBITDA 10.00%-12.00% | >$10.0MM EBITDA 10.00%-13.00% | >$10.0MM EBITDA 11.00%-13.00%
| >$20.0MM EBITDA 10.00%-12.00% Warrants limited to distressed and special situations; | >$20.0MM EBITDA 10.00%-12.00% Warrants limited to distressed and special situations; | >$20.0MM EBITDA 10.00%-12.00%
Unitranche Pricing | <$5.0MM EBITDA L+7.00%-11.00% floating (1.00% floor) | <$5.0MM EBITDA L+7.00%-11.00% floating (1.00% floor) | <$7.5MM EBITDA L+8.50%-11.00%
(x EBITDA) | >$10.0MM EBITDA L+6.50%-8.50% floating (1.00% floor) | >$10.0MM EBITDA L+6.50%-8.50% floating (1.00% floor) | >$10.0MM EBITDA L+7.50%-8.50% floating (1.00% floor)
| >$20.0MM EBITDA L+6.00%-7.50% floating (1.00% floor) | >$20.0MM EBITDA L+6.00%-7.50% floating (1.00% floor) | >$20.0MM EBITDA L+6.00%-7.50% floating (1.00% floor)
Libor Floors Libor floors remain only in syndicated or non-bank senior debt, second lien, subordinated, and unitranch | Libor floors only are found in syndicated or non-bank senior debt, second lien, and unitranch deals. Given the assumption of three to four additional rate hikes in 2018, Libor floors are not a highly contested matter. | No Libor floor for club bank deals. Generally, 1.00% floor for large, syndicated bank facilities, and non-bank senior deals. Recently seeing pressure by unitranch lenders to increase Libor floors to 1.50%
Minimum Equity Contribution Lenders are taking a harder line against thinly capitalized deals. As a general proposition, a minimum of 30.0%-40.0% base level of equity (inclusive of any rollover) is required. As leverage levels creep up (in excess of 4.5x), 40%-50% equity (inclusive of rollover) is becoming the "new normal." The market for equity co-investments remains robust among insurance companies, family offices, and credit opportunity funds. As a general proposition, promot | Lenders are taking a harder line against thinly capitalized deals. As a general proposition, a minimum of 30.0%-40.0% base level of equity (inclusive of any rollover) is required. As leverage levels creep up (in excess of 4.5x), 40%-50% equity (inclusive of rollover) is becoming the "new normal." The market for equity co-investments remains robust among insurance companies, family offices, and credit opportunity funds. As a general proposition, promot | Lenders are taking a harder line against thinly capitalized deals. As a general proposition, a minimum of 30.0%-40.0% base level of equity (inclusive of any rollover) is required. As leverage levels creep up (in excess of 4.5x), 40%-50% equity (inclusive of rollover) is becoming the "new normal." The market for equity co-investments remains robust among insurance companies, family offices, and credit opportunity funds. As a general proposition, promot |
Equity Co-Investment透过库 |透过库 |透过库
Recap Liquidity Though recap liquidity remains robust (best terms to sponsored deals and generally provided by the non-bank lending community), if the market begins to retranche, recap dollars will likely tighten in coming months. For the time being, little pricing discrimination between "pure" recaps and those combined with an accretive use of capital. Story Receptivity Recent reduction in deal floor is opening capacity for smaller or more challenged credits often overlooked in a more active market. Lower middle market issuers (<$7 million of EBITDA) are achieving spreads and terms historically reserved for significantly larger issuers. Cyclical sectors (homebuilding, brick and mortar retail) are still being well-received albeit at lower leverage tolerances. The one recurring theme as we enter April is "Where are the deals?" Activity seems to have slowed down in March and investors that were already competitive to capture deal flow have become more scarce. Given the new expanded leverage capacity afforded to BDCs (2.0x leverage) and the abundance of non-bank senior lenders offering unitranche financing, the pressure is most pronounced for commercial banks and mezz-only lenders. To capture deal flow, many banks are offering fixed rate alternatives, obviating the need for swaps. 
Tone of the Market
Notwithstanding higher levels of volatility in the equity and high-yield markets and increasing outflows in the high-yield markets, the market for middle market debt remain exceedingly robust. Lack of new deal flow in early March is only contributing to more aggressive leverage tolerances and tighter pricing. While lenders are tolerating higher leverage metrics, most are very sensitive to aggregate levels of equity below them, and with respect to recaps, how much of a sponsor’s original equity remains.

*Changes from last month highlighted in red*
"Well, they're still racing out at the Trestles
But that blood it never burned in her veins
Now I hear she's got a house up in Fairview
And a style she's trying to maintain

Well, if she wants to see me
You can tell her that I'm easily found
Tell her there's a spot out 'neath Abram's Bridge
And tell her there's a darkness on the edge of town
There's a darkness on the edge of town"

 Darkness on the Edge of Town, Bruce Springsteen

Darkness on the Edge of Town?

SPP is lowering spreads for subordinated debt in April; we are bringing in spreads by 100 basis points for issuers with greater than $10 million of EBITDA (from a range of 10.0% - 13.0% to 10.0% - 12.0%) and for issuers with greater than $20 million of EBITDA (from a range of 10.0% - 12.0% to 10.0% - 11.0%). On its face, it would seem that the market continues to get even hotter as we enter Q2, but in fact, the reduction in spreads is more a reflection of the recent dearth of deal flow, rather than the continued excess liquidity conditions in the private capital markets. Commercial banks and traditional subordinated debt providers (think SBICs and “pure” mezz players) are being hit the hardest; first by the pervasive lack of activity in the private market overall, but even more so by the disintermediation of unitranche players.

Commercial bank loan growth has dropped off a cliff since 2015 (falling from 12.7% annual loan growth in Q1 of 2015 to less than 1.0% in Q4 of 2017). Banks cannot offer the lower fixed amortization or less restrictive covenants that a non-bank unitranche lender can provide, though banks at least still have the capacity to offer the lowest cost of capital. While that might have had less significance in a zero-interest rate environment, with 3-month Libor now over 2.3%, bank pricing offers a palpable economic benefit over non-bank and unitranche pricing schemes. This might be one of the primary factors in commercial banks recently reversing the trends in declining loan growth. In fact, in Q1 of 2018, commercial bank loan growth has jumped back over 2.5%.

While commercial banks have felt the pinch of competition from unitranche lenders, the subordinated debt community is being particularly hard hit by the growth and spread of unitranche financing. Unlike commercial banks, traditional subordinated debt lenders do not provide any cost benefit over unitranche debt facilities. Because unitranche facilities are essentially “all senior” securities, they get better covenant protection than straight subordinated debt obligations and are not subject to any blockage or standstill provisions; accordingly, given their greater downside protections, unitranche lenders will generally also provide higher aggregated leverage than a traditional senior/sub structure. Additionally, unitranche facilities present a faster and more efficient transaction timeline than a traditional senior/sub bifurcated structure (i.e. no inter-creditor agreements, less documentation, lower counsel costs, one, not two, diligence processes, etc.). Finally, since the recession, the number of “cash flow” commercial bank lenders has also ebbed, making it more difficult for a subordinated debt lender to “attach” to a senior/sub structure, and in large part relegating the sub debt tranche to compliment only asset-based (“ABLs”) senior bank facilities.

While most of the information on the current slowdown in market activity is anecdotal (primarily an increasing chorus of lenders bemoaning the lack of deal flow), the most recent market data is also beginning to support the narrative. Leverage loan issuance in Q1 of 2018 has dropped off (see graphic) precipitously from last year for both sponsored and unsponsored transactions, falling to $32.2 billion (from $44.1 billion in Q4 of 2017). Syndicated middle market issuance fell 27.0% and 16.0% from Q4 of 2017 and Q1 of 2017 levels, respectively. In the
sponsored market, only $3.6 billion in LBO deals were syndicated, (down 53.0% quarter-over-quarter). If current trends continue, the market may be in the initial stages of a more pronounced down cycle in deal activity.

There also seems to be something of a gathering storm on the credit cycle front. After nine consecutive years of economic growth in the U.S., there is an increasing narrative that we are nearing the end of the current credit cycle and that a “down cycle,” if not full out recession of some sort, is becoming increasingly probable. The length of the current recovery – 105 months as of April 2018 – is the third longest of the 11 expansion periods since the end of World War II. Should the recovery last past May of this year, it would surpass the 106-month expansion of 1961-1969. It would match the longest period, 120 months, in July 2019. When the unemployment rate falls below 5.0%, as it has in all but two months since January 2016, a recession usually follows within the next two or three years. For example, the unemployment rate started sinking below 5.0% in December 2005, and the Great Recession started in January 2008 – 25 months later.

The current economic cycle, however, is particularly combustible; corporate debt has been pretty cheap for the last six plus years, and as a result, corporations have continued to pile on debt. The percentage of deals with more than 6.0x leverage is higher in Q1 of 2018 than in any quarter in all of 2017. Following another rate hike in March, what will be the impact of all this debt being refinanced in a higher interest rate environment? This is anything but a hypothetical proposition, as U.S. financial conditions continue to tighten. Both the most recent Chicago Fed Adjusted National Financial Conditions Index and the Bloomberg United States Financial Conditions Index point to tighter financial conditions, increasing pressure on issuers seeking financing in the coming months. Already, the number of U.S. Chapter 11 filings has peaked in Q1 of 2018, approaching levels not seen since April 2011.

While it may be premature to predict the imminence of the next recession, there can be little doubt that given the potential for a less forgiving credit environment in coming months (and more likely, years), today’s market still presents an exceedingly beneficial opportunity for issuers to take advantage of both relatively low rates and historically low spreads.

**The Macroeconomic Picture**

A majority of Federal Reserve officials voiced concerns over the trade tensions between the U.S. and China and the risks posed to the U.S. economy at the FOMC policy meeting held in late March. Participants did not see the steel and aluminum tariffs initially proposed by President Trump, by themselves, as likely to have a significant effect on the national economic outlook. A strong majority of participants, however, viewed the prospect of retaliatory trade actions by other countries, as well as other issues and uncertainties associated with trade policies, as downside risks for the U.S. economy.

The fallout from such a conflict between the world’s two largest economies will likely create other losers, as well as winners. Any escalation in trade tensions that leads to a significant fall in U.S. imports from China would have a sizable negative impact, not just on China, but on other countries such as Taiwan and Malaysia which export a high number of intermediate goods to China which are then used in the manufacturing of products that are ultimately exported to the United States. Japan, which relies on the United States for 19.0% of its exports and on China for another 19.0%, would face a relatively low direct impact from the tariffs, but the country’s economy could be significantly impacted by stock market volatility and fluctuations in its currency, the yen, if trade tensions escalate. Additionally, big financial centers such as Hong Kong and Singapore, which rely greatly on the Chinese manufacturing sector, would also suffer if trade tensions escalate. Companies with global operations, such as German carmaker BMW, have also warned that a U.S.-China trade war would ripple around the globe.
Not everyone will lose, however. Some regions could benefit from a drop in exports of U.S. goods, such as soybeans. China was the largest buyer of soybeans from the United States last year, and given that China's agricultural import needs are generally inelastic, there would likely be a redistribution in trade flow, which could see China substitute U.S. soybeans for those from Latin America. Additionally, China's proposed tariffs on fossil fuel imports from the United States could also see the Middle East gaining a greater share of Chinese trade. While China already gets most of its polyethylene imports from that region, the decision to increase taxes on American supplies would only increase its reliance on Middle Eastern countries.

Despite the looming effects of a potential trade war, at the March 20th - 21st meeting, the FOMC voted to raise its benchmark interest rate by 25 basis points to a range of 1.50% to 1.75%, as had been widely expected. It was the sixth hike since December 2015 and another step further away from policies that were designed to recover the economy after the Great Recession. The Fed maintained its forecast for two more rate hikes this year, following speculation on whether budding inflation would push it toward raising its outlook to three more increases. Fed officials were confident that inflation would return to their 2.0% target as tax cuts and increased government spending provide a boost to the economy.

Below is a recap of this month’s key economic releases:

- **Modest Non-Farm Payroll Growth** – In mixed results, March payroll growth of 103,000 is well below expectations, but wage indications from average hourly earnings do show a little pressure as was expected, up 0.3% on the month with the year-on-year rate up one tenth to 2.7%. The unemployment rate did not move down which was the consensus, instead holding steady at what is still a very low 4.1%.

- **Consumer Sentiment Hints at Soft April Labor Market** – Consumer sentiment came in below low estimates, at 97.8 for the preliminary April index. Expectations fell 1.2 points to 86.8, but the easing so far this month is centered in current conditions which are now at 115.0 and well off the extremely strong 121.2 of March. The decline in current conditions hints at trouble for April consumer spending and may be, like weekly jobless claims, an early negative signal on the month’s labor market.

- **Q4 GDP Revised Upward in Third Estimate** – Fourth-quarter GDP is revised four tenths higher in the third estimate to a 2.9% annualized rate. Consumer spending gets a two-tenth upgrade to a 4.0% rate as spending on services is revised two tenths higher to 2.3% with non-durable spending getting a five-tenths upgrade to 4.8%. Spending on durables is revised one tenth lower to a still very strong 13.7% that reflected hurricane-replacement for autos and which pulled vehicle sales out of the ongoing quarter.

- **Core Inflation Consistent with Fed’s Expectations** – The core PCE price index managed only an as-expected 0.2% gain in February though the year-on-year rate moved a notch higher to 1.6%. Overall prices also rose 0.2% with this yearly rate also up one tenth, at 1.8%. Movement is slow but is consistent with the Fed’s expectations for a gradual rise this year to their 2.0% inflation target.

- **ISM Manufacturing Slows Following 14-Year High** – ISM manufacturing eased back from February's 14-year high, slipping 1.5 points and back below 60 to what is nevertheless an outstandingly strong 59.3 in March. Unusual strength eased a bit in March for ISM's non-manufacturing sample as the index came in near expectations at 58.8 versus 59.5 and 59.9 in the two prior months.

- **Robust Housing Trends Continue in Q1 of 2018** – The residential construction business had a very strong March: housing starts easily topped estimates at a 1.319 million annualized rate while permits came in
just shy of the top estimates at a very strong 1.354 million. Multi-family units are the standout in the March report. Starts for this group rose 14.4% in the month to a 452,000 rate with permits 19.0% higher at 514,000.

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Please feel free to call any of the professionals at SPP Capital to discuss a particular financing need, amendment, or restructuring situation, or just to get a little more color on the market. You don't need an imminent or market-ready deal to call us. Our hope is that you use SPP as your go-to resource for any information, analysis, and review of potential transactions.

For your smaller capital needs, SPP’s direct lending platform, SPP Mezzanine Partners, is currently investing in senior, second lien, mezzanine, and unitranche instruments ranging from $5 to $15 million. We focus on established lower middle market companies with proven business models, stable cash flows, and strong management teams.

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**SUPPORTING DATA**

### Historical Senior Debt Cash Flow (x EBITDA)

- **Source:** SPP’s “MIDDLE MARKET LEVERAGE CASH FLOW MARKET AT A GLANCE”

### Historical Total Debt Limit (x EBITDA)

- **Source:** SPP’s “MIDDLE MARKET LEVERAGE CASH FLOW MARKET AT A GLANCE”

### Historical Senior Cash Flow Pricing (Bank)

- **Source:** SPP’s “MIDDLE MARKET LEVERAGE CASH FLOW MARKET AT A GLANCE”

### Historical Senior Cash Flow Pricing (Non-Bank)

- **Source:** SPP’s “MIDDLE MARKET LEVERAGE CASH FLOW MARKET AT A GLANCE”

### Historical Second Lien Pricing

- **Source:** SPP’s “MIDDLE MARKET LEVERAGE CASH FLOW MARKET AT A GLANCE”

### Historical Subordinated Debt Pricing

- **Source:** SPP’s “MIDDLE MARKET LEVERAGE CASH FLOW MARKET AT A GLANCE”

### Historical Minimum Equity Contribution

- **Source:** SPP’s “MIDDLE MARKET LEVERAGE CASH FLOW MARKET AT A GLANCE”

### U.S. PE Middle Market Deal Flow by Quarter

- **Source:** PitchBook

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**Note:** Prior to November 2017, “< $5.0MM EBITDA” represents “< $7.5MM EBITDA” for senior debt cash flow and total debt limit.