# Market At A Glance

**Cash Flow Senior Debt/EBITDA**

<table>
<thead>
<tr>
<th></th>
<th>&lt; $5.0MM EBITDA</th>
<th>&gt; $10MM EBITDA</th>
<th>&gt; $20MM EBITDA</th>
</tr>
</thead>
<tbody>
<tr>
<td>April 2019</td>
<td>1.75x - 2.50x</td>
<td>2.50x - 3.50x</td>
<td>3.00x - 4.50x</td>
</tr>
<tr>
<td>March 2019</td>
<td>1.75x - 2.50x</td>
<td>2.50x - 3.50x</td>
<td>3.00x - 4.50x</td>
</tr>
<tr>
<td>April 2018</td>
<td>1.75x - 3.00x</td>
<td>2.75x - 4.00x</td>
<td>3.25x - 4.75x</td>
</tr>
</tbody>
</table>

**Commentary:**

*Lenders indicating greater scrutiny to leverage metrics (“late in the credit cycle”), especially for more cyclical sectors.*

**Total Debt/EBITDA**

<table>
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<tr>
<td>April 2019</td>
<td>3.00x - 4.00x</td>
<td>4.00x - 5.00x</td>
<td>4.50x - 5.50x</td>
</tr>
<tr>
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<td>4.50x - 5.50x</td>
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<td>3.50x - 4.50x</td>
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**Senior Cash Flow Pricing**

<table>
<thead>
<tr>
<th></th>
<th>Bank</th>
<th>Non-Bank &lt; $7.5MM EBITDA</th>
<th>Non-Bank &gt; $15MM EBITDA</th>
</tr>
</thead>
<tbody>
<tr>
<td>April 2019</td>
<td>L+ 2.50% - 4.50%</td>
<td>L+ 5.00% - 6.50%</td>
<td>L+ 4.00% - 6.00%</td>
</tr>
<tr>
<td>March 2019</td>
<td>L+ 2.50% - 4.50%</td>
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<td>L+ 4.00% - 6.00%</td>
</tr>
<tr>
<td>April 2018</td>
<td>L+ 3.00% - 5.00%</td>
<td>L+ 5.50% - 8.00%</td>
<td>L+ 4.50% - 6.00%</td>
</tr>
</tbody>
</table>

**Commentary:**

*Abundance of available capital keeping pricing exceedingly competitive.*

**Second Lien Pricing**

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**Sub Debt Pricing**

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<tbody>
<tr>
<td>April 2019</td>
<td>11.00% - 14.00%</td>
<td>10.00% - 12.00%</td>
<td>8.50% - 11.00%</td>
</tr>
<tr>
<td>March 2019</td>
<td>11.00% - 14.00%</td>
<td>10.00% - 12.00%</td>
<td>8.50% - 11.00%</td>
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**Unitranche Pricing**

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**Tone of the Market**

Though most recent economic indicators continue to support the narrative of a weakening US economy, coupled with the chorus of lenders and economists declaring the recovery is on its last (or close to last) legs, the much anticipated “credit down-cycle” is not translating into any material changes in credit behavior. To the contrary, the sheer abundance of excess capital in the market, combined with a precipitous slowdown in new deal activity is driving even fiercer competition for new assets, resulting in more aggressive pricing, higher leverage tolerances, and weakening of covenant protections. In short, the market is behaving diametrically opposite to what conventional wisdom would dictate. Market conditions remain aggressive so far in April.
Minimum Equity Contribution

With an increased focus on downside protection, lenders are likely to avoid thinly capitalized deals, especially for sub-$10.0 million EBITDA borrowers. Aggregate minimum of 40.0% base level equity (inclusive of any rollover) is required for most deals. As leverage levels creep up in excess of 5.00x, 40.0%-50.0% cash equity (exclusive of rollover) is required. Most lenders discount rollover equity in excess of 20.0%.

Equity Investment and Co-Investment

Liquidity for direct equity investment (and co-investment) is still quite robust among insurance companies, family offices, credit opportunity funds, and select SBICs. Most traditional mezzanine funds will also provide up to 20% of their aggregate debt commitment as an additional strip of equity. Capital to support independent sponsors is at an all-time high, with new funds created exclusively to support independent sponsors. Promotes and carry will vary depending on the role the sponsor plays post-closing and how much, if any, of their own equity is deployed. Most carry provisions will contain performance contingencies to enhance the initial promote. While structures differ based on the circumstances of each deal, most investors are willing to sacrifice some yield for the liquidity preference.

Recapitalization Liquidity

Unsponsored dividend recapitalizations are running into greater headwinds given larger macroeconomic concerns. While circumstances will dictate each particular case, as a general rule, an unsponsored dividend recapitalization for more than 2.00x LTM EBITDA will be more difficult to execute. Recapitalizations combined with an accretive use of capital (i.e.-acquisitions, growth capital) or share recapitalizations to buy out non-operating shareholders will be better received. For time being, however, liquidity recapitalizations for sponsored deals continue almost unabated.

Story Receptivity

While the market continues to be exceedingly liquid for most issuers, “storied credits,” and lower middle market (<$5 million EBITDA) issuers still face increased scrutiny due to a potential credit “down-cycle.” Most investors will underwrite to a base case that bakes in a 10%-20% reduction in EBITDA, especially for issuers in more cyclical sectors deemed most vulnerable to macroeconomic volatility. While the market is not closed to these issuers, they will be subject to higher pricing, less aggregate leverage (i.e. one turn less of EBITDA) and potentially, some equity upside incentive features. Most bank lenders will consider all committed capital (whether drawn or undrawn) in calculating total funded debt.

LIBOR Floors

LIBOR floors continue to be a mainstay of the senior debt market. A recent survey by the Lead Left reported that approximately 56% of respondents reported that 80%-100% if their loans have LIBOR floors, while only 15% noted that LIBOR floors appear on less than 20% of their deals. Though many commercial bank club deals have removed floors they are routinely found in non-bank and institutional senior loans, second lien, subordinated, and unitranche deals.

"Cause we got tired of your charms
And tired of your false alarms
You're just a book that never turns its page

You can stand on the edge shouting out that you're ready to change, ready to change
You can say what you want
You won't jump, you're not ready to change, ready to change

You can stand on the edge shouting out that you're ready to change, ready to change
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You won't jump, you're not ready to change
Ready to change"

“Ready to Change,” Kodaline
Ready to Change?

The Great Recession ended in June 2009, which means the current recovery has lasted 118 months through April 2019. That exceeds the expansion from 1961 to 1969, an era of big government spending under President John F. Kennedy and then President Lyndon Johnson’s Great Society. The current recovery will inevitably run out of steam, and in light of an ever-increasing tide of weaker economic indicators in 2019, it is hardly news that most credit professionals, economists, and institutional investors are steeling themselves for an inevitable credit downturn.

In the last month alone, we learned that ISM Non-Manufacturing (Services) Index dropped 3.6% month-over-month to 56.1%, that wage growth slowed from 3.4% year-over-year in February to 3.2% year-over-year in March, and that U.S. fourth quarter GDP growth was revised downward to 2.2% from an initially estimated 2.6% reading. The IMF has forecast that U.S. growth will slow to 2.3% in 2019 and global growth will slow to 3.3% in 2019. In light of a weakening macroeconomic environment, one would anticipate lenders underwriting to a stricter standard. Going into April however, apparently the market is simply not Ready to Change.

An economic slowdown is not an abstract concept; it correlates directly to revenue growth, EBITDA generation, leverage ratios, and ultimately, to an issuer’s capacity to service debt. The National Center for the Middle Market reported S&P 500 companies experienced revenue growth decline from 8.0% in the third quarter to 4.7% in the fourth quarter of 2018. With respect to middle market companies, revenue growth declined from 8.5% to 7.9% for the same period. Importantly, this decline in revenue growth occurred when leverage levels have increased precipitously. During the recovery period (2010-2019) Russell 2000 EBITDA generation has grown from approximately $90 billion to approximately $190 billion; however, debt levels during the same period ballooned from approximately $100 billion to $600 billion. According to Debtwire, in the first quarter of 2019 alone, adjusted leverage on new deals has edged up to 5.10x from 4.80x in the fourth quarter of 2018. Compounding the rise in Debt/EBITDA levels is the definition of “EBITDA” itself. As Debtwire notes, “EBITDA adjustments remain large, with the majority of M&A leveraged loans this year (2019) having addbacks of greater than 25% of unadjusted EBITDA.”

During the same period, lender credit protections have declined in dramatic fashion. Moody’s tracks lenders’ covenant quality with its “Quality Covenant Indicator” (“CQI”). The most recent CQI showed the three-month rolling average has declined 10% in 2019, hitting its weakest level ever in February. Moody’s notes “The last CQI report shows deterioration across all major categories of creditor protections.”

Surprisingly, slower earnings growth, higher leverage, and weaker covenant protections have not translated to an increased default rate. According to LCD, the US leveraged loan default rate declined to a seven year low in March 2019 of 0.93% from 1.62% in February. There is an important observation to made however; as covenant protections are diminished, it becomes much harder to default a deal.

There clearly is a big disconnect in the data presented. Conventional wisdom suggests that as macroeconomic conditions deteriorate, lenders should be seeking more protection, not less. Historically, during credit downturns, pricing is more expensive, leverage tolerances tighten, and covenants become stricter...just ask any issuer, banker, lender or portfolio manager doing deals between 2009-2012. That is clearly not the case today. The reason is quite simply that there is much more cash than deals right now. Most market participants bemoan the lack of new deal activity. To provide some empirical support, according to LCD, US Institutional leverage loans are down 40% from last year, dropping from $129 billion in 2018 YTD, to $77 billion YTD.

Accordingly, SPP is not making any changes to its pricing or leverage metrics for April. Though we selectively increased pricing for lower
middle market issuers in March (and concurrently tightened leverage levels modestly), our recent anecdotal experience suggests that conditions remain exceedingly liquid. Investors need assets, and while they are not oblivious to the larger macroeconomic issues, the competition among commercial banks, non-bank direct lenders, insurance companies, credit funds, SBICs, BDCs, and CLOs is just too strong. Make no mistake, this is very much an issuer’s market.

The Macroeconomic Picture
March unemployment beat expectations, with the U.S. economy adding jobs for the 102nd consecutive month. Nonfarm payrolls increased to a seasonally adjusted 196,000, and unemployment remained unchanged at 3.8%. This release will improve optimism among investors and the Fed, after the lackluster addition of an adjusted 33,000 jobs in February. The February report is being deemed an anomaly driven by the partial government shutdown and weather-related distortion, rather than an indicator of dramatic deceleration of job growth. Wage growth in the private sector has slowed in March to 3.2% year-over-year from a hot February reading of 3.4% year-over-year.

The Federal Reserve has continued the “wait and see” approach to monetary policy and will hold the Federal Funds range at 2.25%-2.50%. In March 11 of 17 Fed officials did not forecast a rate increase in 2019, up from two in December.

The yield curve is a closely watched graph of the relationship between U.S. Government debt yields and maturity. Typically, the yield curve follows a positive arch that flattens as the x-axis (maturity) increases. The Fed has adopted a dovish tone with softer economic outlook resulting in the 10-year treasury note yield briefly falling below 3-month bill for the first time since 2007. Historically, an inverted yield curve is a harbinger for looming recession and precedes a recession by one to two years. While the front end (shorter maturity) of the yield curve is controlled by Fed monetary policy (increasing or decreasing interest rates, increasing or decreasing money supply), the back end (longer maturity) is dictated by investor fears about inflation and rate “expectations.” Long term Treasury yields are also impacted by a term premium (compensation for additional risk of lending over a longer period), but in recent years, this premium has been unusually low due to changing investor concerns around economic weakness and falling interest rates rather than inflation. Sustained inversion of the yield curve could lead to Fed officials cutting rates later this year; however, Dallas Fed President Robert Kaplan does not see “persistence” yet in the inversion.

While yield curve inversion has historically been an accurate predictor of recession, the timing from the initial inversion to an actual recession (generally measured as two consecutive quarters of GDP) is not as black and white. While we certainly see indicators generally predictive of a looming U.S. recession (slowing growth, trade uncertainty, slowing service sector outlook), combined with an exceptionally protracted duration of the current expansion, recessions have historically followed one to two years after a sustained inversion of the yield curve (over three months). The dynamics of the current economy, including a significant deficit where federal debt will be as large as 93% of GDP in the next decade (due to extensive tax cuts and spending), have changed the dynamics of the yield curve. Former Secretary of the Treasury Henry Paulson joked that the yield curve is “Trumped.” He described the current situation in a recent speech, “An unconventional president has put the U.S. economy in a unique spot – an inverted yield curve with significant fiscal juice.” Fiscal policy will likely have an impact on the yield curve during this cycle more than any other time in history, so conventional interpretations of its slope may not be accurate predictors of recession.
Below is a recap of this month’s key economic releases:

**Consumer Sentiment Falls in March, Missing Expectations and Conflicting with University of Michigan Measure:** The Conference Board’s Consumer Sentiment index fell in March for the fourth time in five months, mostly due to muted Q1 growth and slowing job growth (addition of only 33,000 nonfarm jobs in February). The index fell to 124.1 from 131.4, missing economic expectations of 132.5. The present situation and expectations components of the index both fell. The University of Michigan Index of Consumer Sentiment rose to 98.4, up 4.9% month-over-month.

**U.S. GDP Growth Revised Down to 2.2% Rate in Fourth Quarter:** GDP was revised downward to 2.2% in the fourth quarter (from an initially estimated 2.6%). The deceleration in GDP growth from 3.4% in the third quarter is attributed to declining consumer, government, and business spending as the residual effect of the 2017 tax cuts rolled off. The Atlanta Fed’s GDPNow predicts 2.3% GDP growth in Q1 2019 (up from 0.5% in March)

**U.S. Housing Starts Fall in February on Weak Single-Family Homebuilding:** U.S. housing starts fell 8.7% from a month earlier to 1,162 thousand units in February. This was the largest decline in housing starts since June 2018 and highlights new construction slowdown in the Northeast, West, and South. Single-family homebuilding, the largest component of the housing market, fell 17% to a rate of 805 thousand units in February, the lowest level since May 2017.

**Employment remains at 3.8% and Non-Farm Payrolls Beat Expectations:** U.S. Employers had added jobs for 102 straight months in March, with nonfarm payrolls increasing a seasonally adjusted 196,000 and unemployment remaining unchanged at 3.8%. This is welcome news to the Federal Reserve Bank, who was concerned about the meager 33,000 jobs added in February. The broader U-6 unemployment, which includes those too discouraged to look for work and Americans stuck in part-time jobs, remained steady at 7.3%.

Stefan Shaffer  
Managing Partner  
212.455.4502  

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Historical Senior Debt Cash Flow Limit (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 Unitranche 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"