### SPP’s Middle Market Leverage Cash Flow Market At A Glance

<table>
<thead>
<tr>
<th>Deal Component</th>
<th>August ’15</th>
<th>June ’14</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash Flow Senior Debt</td>
<td>$&lt;7.5MM EBITDA 1.50x-2.50x</td>
<td>$&lt;7.5MM EBITDA 1.50x-2.00x</td>
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<tr>
<td>(x EBITDA)</td>
<td>$&gt;10.00MM EBITDA 2.50x-3.50x</td>
<td>$&gt;10.00MM EBITDA 2.00x-3.50x</td>
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<tr>
<td>Total Debt Limit</td>
<td>$&lt;7.5MM EBITDA 3.00x-4.00x</td>
<td>$&lt;7.5MM EBITDA 3.00x-4.25x</td>
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<tr>
<td>(x EBITDA)</td>
<td>$&gt;10.00MM EBITDA 3.75x-4.50x</td>
<td>$&gt;10.00MM EBITDA 3.75x-4.50x</td>
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<tr>
<td>Senior Cash Row Pricing</td>
<td>$L+1.75%-3.50% (bank)</td>
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<tr>
<td></td>
<td>$L+4.00%-6.00% (non-bank potential for a 1.00% floor)</td>
<td>$L+4.00%-6.00% (non-bank)</td>
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<tr>
<td>Second Lien Pricing (Avg)</td>
<td>$&lt;7.5MM EBITDA L+8.00%-11.00% floating (1.00% floor)</td>
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<td>$&gt;10.00MM EBITDA L+6.00%-9.00% floating (1.00% floor)</td>
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<td>Subordinated Debt Pricing</td>
<td>$&lt;7.5MM EBITDA 12.0%-14.0%</td>
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<tr>
<td></td>
<td>$&gt;10.00MM EBITDA 11.0%-13.0%</td>
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<tr>
<td>Unitranche Pricing</td>
<td>$&lt;7.5MM EBITDA L+8.00%-11.00% (1.00% floor)</td>
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<tr>
<td>Mezzanine Opt. Prepayment</td>
<td>$&lt;25.00MM EBITDA L+6.00%-7.50% (1.00% floor)</td>
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<td>Minimum Equity Contribution</td>
<td>25.0%-35.0% total equity (including rollover); minimum 10.0% new cash combined with rollover or seller notes. Focus continues to be more on aggregate credit metrics (Total Debt/EBITDA, etc.) than on the level of equity contribution. &quot;Promote to Independent Sponsors&quot; will differ but fall in the 5.0%-15.0% range with or without a minimum return to common.</td>
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<td>Recap Liquidity</td>
<td>While recap liquidity remains robust, lenders are becoming more focused (i.e.-less aggressive) if: (i) there is no sponsor, or (ii) there is a sponsor, but the investment is in an older fund that is not eligible for additional capital (or more than 100% of initial investment is being recapped). It is best to pair a recap with an accretive use of capital (i.e.-an acquisition) in order to maximize reception.</td>
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<td>Story Receptivity</td>
<td>The mid-summer slump has settled in and it is arguably the best time of the year to bring a stronger credit to market. Investors have the time, patience, and, importantly, portfolio capacity to undertake more challenging credits. It is also a perfect opportunity to “sanitize” potential issuers (getting appraisals, quality of earnings, etc.) to expedite Q4 financing.</td>
<td>The enduring supply/demand mismatch (more money than deals) has kept the market open to more stronger paper and challenged credits, but that may be slowing as (i) banks continue to take a more conservative approach, and (ii) BDC lenders become increasingly risk adverse due to depressed stock prices and an increased focus on credit quality.</td>
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<td>Tone of the Market</td>
<td>With year-end in sight, lenders are offering among the most aggressive pricing and terms we have witnessed in 2015. Commercial banks are still focused on the “3/4” leverage guidelines, but many are willing to go “outside-the-box” to secure higher quality credits. Structured equity products are growing in popularity to bridge the gap between higher multiples and equity contribution limitations.</td>
<td>From Labor Day until year-end, the private capital markets will be increasingly difficult to access for stronger paper, out-of-market metrics, and aggressively structured deals. The OCC-induced bank pullback has been constant for a quarter, and banks continue to take a progressively conservative stance.</td>
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*Changes from last month in red*
“It’s time to begin, isn’t it?
I get a little bit bigger but then I’ll admit
I’m just the same as I was
Now don’t you understand
That I’m never changing who I am
So this is where you fell
And I am left to sell
The path to heaven runs through miles of clouded hell
Right to the top
Don’t look back
Turning to rags and giving the commodities a rain-check”

“It’s Time,” Imagine Dragons

It’s Time

In her second meeting on Capitol Hill this year as part of the Fed’s Biennial Humphrey Hawkins Testimony, Janet Yellen stayed the course by acknowledging the continued slack in the labor market and reassuring monetary policy doves that even after lift-off, the Fed will remain in an accommodative mode for the foreseeable future.

Although she reiterated the Fed’s policy of being data dependent, she also made it clear that the Fed remains on course to raise rates this year, “If the economy evolves as we expect, economic conditions likely would make it appropriate, at some point this year, to raise the federal funds target rate, thereby beginning to normalize the stance of monetary policy.” One of the best indications of the Fed’s intention to imminently raise rates was Yellen’s response to one lawmaker respecting the risk of waiting too long before lift-off: “If we wait longer, it certainly could mean that when we begin to raise rates we might have to do so more rapidly...An advantage to beginning a little bit earlier is that we might have a more gradual path of rate increases.”

Is the U.S. economy strong enough to withstand its first interest rate increase in more than eight years? Conventional wisdom would suggest that it is. According to a recent Wall Street Journal poll, four out of five private economists expect the Fed will raise rates in September. The headline numbers of the most recent economic reports certainly support the proposition. Labor conditions have continued to strengthen since Q1 (5.3% Unemployment Rate), inflation is fairly consistent with the Fed’s 2.0% target (year-on-year Core CPI is at 1.8%), and housing (a perpetual laggard throughout the recovery) is even showing continued signs of strength (housing starts are up nearly 10.0% in June). However, there is still significant noise below the headline numbers that also supports a more patient approach to lift-off.

- **Consumer Confidence/Retail Sales**: Consumer sentiment, as measured by the University of Michigan’s Consumer Survey Center, has softened almost 3 points from its prior reading in the last month to 93.3. Markedly, the “current conditions” component is down to 106.0 and portends weaker consumer activity for the month. Consumer sentiment has been pretty robust until this point and in stark contrast to retail sales, which have been lagging (i.e. - the strong sentiment has not translated into stronger sales). However, the latest sentiment numbers may suggest that this dichotomy is mitigating. Retail sales, on the other hand, have been more consistent, but unfortunately, in the wrong direction. Retail sales finished the second quarter weaker than expected with June down 0.3% and May revised downward to 1.0% (from 1.2%). The June fall-off was largely attributed to weaker auto sales. Excluding the more volatile auto sales component, the decline in the Retail Sales Index for June was only 0.1%. One other flashpoint of the June report was the decline in restaurant sales, which were down 0.2%, and provide one of the more palpable expressions of weakened consumer confidence.
**Inflation:** Inflation reports for June provide fairly strong evidence of increasing inflationary pressure in the economy and, taken in isolation, clearly support the proposition for a September lift-off. The Producer Price Index ("PPI") for May and June rose 0.5% and 0.4%, respectively, which represents the fastest two month growth in PPI since 2011. Q2 PPI rose at a 2.2% annual rate. Meanwhile, the Consumer Price Index ("CPI") for June reported a 0.3% gain, which translates to 0.1% increase in CPI on an annual basis (reduced energy costs heavily influenced the minimal per annum increase). This "all items" index increase of 0.1% is the first positive 12 month reading since December. Core CPI, which excludes volatile fuel and energy costs, rose 0.2% for June and is up 1.8% for the year (which is very close to the Fed’s 2.0% inflation target). June represents the fifth consecutive increase in consumer prices. In fact, consumer prices in Q2 have risen at the fastest pace since 2011 (a 3.5% rate - well in excess of the Fed’s target rate).

**GDP:** The next major GDP report won’t be released until July 30th; the last revision to Q1 GDP (released on June 24th) was -0.2%. While Q1 2015 was certainly weak, it wasn’t as bad at Q1 2014, which came in at -2.1%. Unlike 2014, however, in which Q2 GDP bounced back with a vengeance to 4.6%, Q2 2015 is not expected to be so robust. The latest forecast for real GDP growth prepared by the Atlanta Fed (the “GDPNow” model forecast) pegs Q2 GDP at 2.4% (unchanged since its last release on July 14th). The forecast is just below the low end of the Blue Chip Consensus range, which estimates Q2 GDP somewhere between 2.45% and 3.70%. With the current news cycle dominated by 2016 U.S. Presidential primary election coverage, the average rate of U.S. economic growth during the last few Presidential tenures (in descending order) provides some interesting “food for thought.”

- Bill Clinton - 3.7%
- Ronald Reagan - 3.4%
- Barack Obama – 2.1%
- George H.W. Bush – 2.0%
- George W. Bush – 1.6%

**Manufacturing:** Industrial production rose 0.3% in June; manufacturing, excluding autos, also rose 0.3%. For the 12 month period, production and manufacturing were up 1.5% and 1.6%, respectively. The ISM Manufacturing Index for June came in at 53.5, up from 52.8 in May. For the second consecutive month, the highlight of the report was the new orders component, which rose to 56.0 and its best reading of the year (up from 55.8). The good news was somewhat tempered, however, by a weak recording in the new export orders component, which contracted to 49.5. The decline is hardly a surprise, given the continued strength of the dollar, but it may prelude a deceleration of manufacturing growth in the second half of the year. Importantly, declines in manufacturing could impair the recent gains in employment as firms start cutting back on hiring without continued demand.

**Employment:** The most recent news on the labor front is not particularly encouraging. Seasonally adjusted real average earnings for all employees declined 0.4% from May to June, as reported by the U.S. Bureau of Labor Statistics on June 17th. The decline is the product of stagnant hourly earnings combined with a 0.3% increase in CPI. Real average weekly earnings also decreased 0.3% over the month due to the real average hourly earnings (noted above) with no changes to the average workweek. Seasonally adjusted real average hourly earnings have risen 1.7% from June 2014 to June 2015. The earnings release follows a 223,000 gain in nonfarm payrolls for June, which is still a respectable gain (though expectations were for 230,000+). The report also included downward revisions totaling 60,000 in the prior two months (May revised down to 254,000 from the 280,000 previously reported, and April revised down to 187,000 from 221,000). While the Unemployment Rate clocked in at a seemingly impressive 5.3%, the U-6 Unemployment Rate (which captures “underemployed” workers) remains at a less than stellar 10.6%, and the
Participation Rate dropped to an alarmingly poor 62.6% (from 62.9%). Nonfarm monthly payroll growth averaged 221,000 for Q2, up from 195,000 for Q1. To provide a little perspective, average monthly nonfarm payrolls were 280,000 for the second half of last year.

- **Housing**: The housing market has remained one of the more volatile sectors, but has had a very explosive couple of months. Housing starts jumped 9.8% in June; the spike was largely due to multi-family starts and gave the second quarter its best showing since 2007. New home sales rose 2.2% in May to an annual rate of 546,000 (a total that was above the high-end of the Econoday forecast). Furthermore, existing home sales jumped 5.1% in May and are now at approximately 5.49 million on an annual rate. Meanwhile, housing permits surged 11.8% from the previous month. The first quarter’s poor housing performance can partially be attributed to severe weather conditions that gripped much of the country; however, make no mistake, the housing sector has shown great improvement in Q2.

**The SPP 2015 Mid-Year Metrics and Trends Summary**

1. **Asset-Based Loans**

- Asset-based lender market activity decreased in Q1 2015 compared to Q4 2014 in both volume and deal count. Fewer deals has translated to greater liquidity and better pricing.
  - Leverage lending guidance (from the Fed, OCC and FDIC) extends to the asset-based side of the institutions and, accordingly, there is continued scrutiny to fixed charge coverage:
    - In most cases, lenders require a fixed charge coverage ratio over 1.00x.
  - There is a continued bias against: (i) revolving credit facilities comprised primarily of inventory and (ii) large, undrawn facilities.
  - Lenders remain comfortable with a modest air ball (5.0%-15.0%) for most traditional asset-based structures.
  - Term facilities secured by fixed assets ("M&E") are readily accessible and most institutions are comfortable with the second liens behind them if asset coverage is strong:
    - Equipment loans can be structured as pure revolving credit facilities (though “draw-to-term” loans are more common);
    - Although it will vary by the nature of the asset, advance rates against M&E are generally up to approximately 85%; and
    - Complementary second lien capital advance rates can rise up to 100%+.
  - ABL middle market pricing is among the most competitive of the current rates available:
    - L+1.00%-1.75% for most clean deals (large, $150.0 million deals are toward the outer band);
    - L+2.25%-2.75% for storied credits;
    - No Libor floors; and
    - Term facilities that are secured by M&E are generally in the L+3.00%-3.50% range.
  - Capex, acquisition, and other “draw-to-term” credit lines are readily available:
    - Capex facilities typically can finance up to 85% of asset costs;
    - Amortization is likely to mirror term facilities; and
    - Capex facilities can provide a big boost to fixed charge coverage because only unfunded amounts are deducted from EBITDA (i.e. - fixed charge coverage = \[\text{EBITDA} - \text{unfunded capex}] / [\text{interest} + \text{fixed amortization} + \text{cash taxes}]).
  - Undrawn revolver pricing ranges from 0.250%-0.375%.
  - Maturities are typically four to five years.
  - Closing fees are exceedingly competitive:
    - 0.25%-0.50% of committed principal amount.
II. **Senior Cash Flow Middle Market Loans**

- There is intense competition for assets coming from commercial banks, non-bank commercial lenders, unitranche lenders, and BDCs.
- Lenders are reporting significant competition for new assets, especially for large middle market (> $10.0 million LTM EBITDA) issuers:
  - There is continued bias towards sponsored transactions; and
  - It is becoming increasingly difficult for small (< $7.5 million LTM EBITDA) issuers without professional equity, to access competitive cash flow commercial bank lenders and they may be relegated to the non-bank and unitranche communities.
- “Covenant-light” structures are still available for large, sponsored transactions, but are highly unlikely for lower middle market deals.
- The most common maturities are four to five years.
- Amortization structures are typically getting greater scrutiny:
  - Commercial banks:
    - The most common amortization structure is a seven to ten year straight-line with a balloon payment due in year five (i.e. - between 10.0%-14.3% per annum);
    - Lenders may allow for some “wiggle room” in the first couple of years (i.e. - 5.0% in year one, 7.5% in year two, etc.);
    - Lenders generally want to see a minimum of 30.0%-35.0% of principal amortized in the first three years, but will consider slightly back-loaded structures; and
    - Excess cash flow sweeps are evident wherever fixed amortization is below 10.0% per annum.
  - Non-bank commercial lenders:
    - Non-bank commercial lenders are providing significantly greater latitude in fixed amortization (i.e. - ranging between 0.0%-5.0% amortization per annum with a 50% excess cash flow sweep).
- Commercial banks do not require a Libor floor, but most non-bank senior lenders are still pushing for a 1.0% Libor floor. Some commercial banks are offering “Libor discounts” as a hedge against rising Libor in future years.
- Lower middle market leverage metrics (bank and non-bank):
  - Unsponsored sub-$7.5 million EBITDA issuers are rarely above 1.50x-2.00x SD/LTM EBITDA, but sponsored deals often achieve 2.50x-3.00x SD/LTM EBITDA; and
  - Large (> $20.0 million LTM EBITDA) issuers can get as much as 4.25x SD/LTM EBITDA.
- Pricing grids:
  - Commercial banks:
    - L+3.00%-4.00% for most leveraged middle market deals;
    - Higher quality, less leveraged deals can be priced as low as L+1.75%;
    - 0.250%-0.375% unused facility fees, but those can be higher in situations where there are significant unused funds;
    - Par call at any time;
    - Term facilities are being priced consistent with or at a small premium to (generally 0.25%-0.50%) revolving credit facilities;
    - As a result of Fed, OCC, and FDIC leverage lending guidance for commercial banks, anything out of the “3.00x senior/4.00x total box” is generally deemed an “HRB” (“High Risk Borrower”) and subject to greater scrutiny, and less appetite among most banks; and
    - Closing fees generally fall between 0.625%-1.00%.
  - Non-bank commercial lenders:
    - L+4.00%-5.00% for <2.50x SD/EBITDA;
    - L+4.50%-6.00% for >3.00x SD/EBITDA;
    - L+5.00%-6.50% for >3.5x SD/EBITDA (or <$7.5 million EBITDA);
    - Prepayment penalties are generally non-call or 2.0% in year.
III. Unitranche

- Unitranche lenders have secured a leading role in the middle market leveraged lending community:
  - Unitranche lenders have historically focused on the lower middle market (\$5.0 million to \$15.0 million in LTM EBITDA), but are now becoming a more prominent player for larger middle market issuers (<\$30.0 million LTM EBITDA); and
  - They remain largely industry agnostic.
- Unitranche lenders are primarily cash flow-based because asset-based pricing is much more competitive with commercial banks.
- Revolvers with unitranche facilities:
  - Unitranche lenders can often be paired with a third party ABL revolver from a commercial bank to create a significant arbitrage opportunity (L+2.0% ABL vs. L+7.0%-8.0% unitranche), but typically only when the ABL revolver is less than 25% of the total debt need;
  - If the ABL revolver component is greater than 25% of the total debt need, then the unitranche lender will likely keep the revolver (or arrange it internally); and
  - Generally, ABL revolver lenders will get a first lien on current assets (AR and inventory) and the unitranche lender will get a first lien on all other assets (and a second lien on current assets).
- Unitranche pricing has stabilized after compressing in the second half of 2014 and first half 2015:
  - <\$7.5 million EBITDA (or "storied"), L+8.00%-11.00% (1.00% floor);
  - >\$10.0 million EBITDA, L+6.50%-8.50% (1.00% floor);
  - >\$25.0 million EBITDA, L+6.00%-7.50% (1.00% floor); and
  - Fixed rate alternatives are available with BDC and mezzanine-oriented unitranche lenders (10.0%-12.0%).
- Flexible amortization alternatives are available:
  - Amortization ranges from 0.0%-10.0% per annum with an excess cash flow sweep; and
  - Most lenders focus on 5.0% amortization with a 50% excess cash flow sweep.
- Closing fees generally range from 1.0%-2.0%.
- Prepayment provisions range among investors, but the standard is a 2.0%, 1.0% declining premium in years one and two, and par calls thereafter.
- There is significant investor diversity: unitranche lenders include non-bank commercial lenders, commercial finance companies, BDCs, traditional mezzanine funds, credit opportunity funds, and some mezzanine LPs.
- Maturities are commonly five years.
- Typical middle market unitranche total debt tolerance metrics range from 3.00x-5.00x LTM EBITDA:
  - Average leverage of approximately 3.75x-4.00x;
  - Most aggressive levels are at 5.50x; and
  - High leverage levels are restricted to large EBITDA issuers (>\$15.0 million).
- Equity co-investments readily available (either "heads-up" or "structured equity" instruments).
- Fixed charge coverage and other material covenants are routinely set at a 20.0% discount to projections.

IV. Mezzanine Market

- The mezzanine market remains among the most competitive spaces in the private debt capital markets (fierce competition for assets).
- Mezzanine alternatives are abundant (i.e. last-out notes, senior unsecured notes, second lien notes, split lien notes, subordinated notes
[with or without second lien] and preferred shares). There are second lien structures with advance rates of 100%+, in some cases.

- Current total leverage metrics:
  - <$7.5 million EBITDA: 3.00x-4.00x;
  - >$10.0 million EBITDA: 3.75x-4.50x;
  - >$20.0 million EBITDA: 4.00x-5.50x; and
  - Storied or challenged credits: 3.50x-4.00x.

- All-in (cash & PIK) pricing schemes:
  - <$7.5 million EBITDA: 12.0%-14.0%;
  - >$10.0 million EBITDA: 11.0%-13.0%; and
  - >$20.0 million EBITDA: 10.0%-12.0%.

- Warrants are rarely ever required (limited to small leveraged recaps with no sponsor, storied credits, or “nose-bleed” leverage).

- Investors are routinely seeking “silent second lien” positions (but not necessarily getting them).

- Subordinated notes with a “real” second lien (a second lien “with teeth”) can garner 9.0%-10.0%.

- Traditional, unsecured subordinated notes usually require an 11.0% cash-pay coupon.

- Maturities are equal to the greater of five years or six months after maturity of the senior debt facility.

- There is full participation by all investor constituencies:
  - Traditional LP funds, credit opportunity funds, captive bank funds, hedge funds, commercial finance companies, BDCs, credit opportunity funds, and insurance companies create pricing pressure; and
  - Regional bank captive mezzanine funds often provide below-market pricing dynamics.

- Minority equity and co-invest equity strips are readily available (“heads up” or structurally preferred).
  - Equity co-invest generally does not exceed 10.0%-20.0% of associated debt instrument).

- Prepayment provisions are highly negotiable and very investor-specific (general acceptance of traditional 3.0%, 2.0%, 1.0% prepayment premium schemes).

- Upfront fees average 1.0%-2.0%.

**SPP Tracked Market Activity**

Although private equity tracked deal activity and total capital invested have trended downward, there are certainly exceptions within the middle and lower middle markets for buyers seeking to capitalize on relatively lower deal valuations. The number of smaller deals in June has actually increased despite a decline in total deal count. Total exit activity has noticeably dropped within the past month and further evidences generally lower multiples.

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.

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