### Market Update - December 2016

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

<table>
<thead>
<tr>
<th>Deal Component</th>
<th>December '16</th>
<th>November '16</th>
<th>December '15</th>
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<tbody>
<tr>
<td>Cash Flow Senior Debt</td>
<td>$&lt;7.5M EBITDA 1.5x-2.50x</td>
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<tr>
<td>(x EBITDA)</td>
<td>$&gt;10.0MM EBITDA 2.75x-3.75x</td>
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<tr>
<td>Total Debt Limit</td>
<td>$&lt;7.5M EBITDA 3.0x-4.50x</td>
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<td>(x EBITDA)</td>
<td>$&gt;20.0MM EBITDA 3.25x-4.75x</td>
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<td>Senior Cash Flow</td>
<td>Bank: L+3.00x-4.50x</td>
<td>Bank: L+3.00x-4.50x</td>
<td>Bank: L+2.50x-3.50x (bank)</td>
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<tr>
<td>Pricing</td>
<td>(non-bank; potential for a 1.00% floor)</td>
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<td>Second Lien Pricing</td>
<td>Fixed rate options range from a low of 7.0% to 11.0%.</td>
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<td>(Avg)</td>
<td>$&lt;7.5M EBITDA L+8.00x-11.00x floating</td>
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<td>($0.50%-1.00% floor)</td>
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<td>Subordinated Debt</td>
<td>Warrants limited to sub $5 million EBITDA and special situations; Second lien may buy down rate to ~9.00%.</td>
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<td>Libor Floors</td>
<td>No Libor floor for club bank deals, though still commonplace on syndicated bank facilities, second lien deals, and unitranche facilities. Markets anticipate a Fed rate increase of 25bps in December to a target range of 0.50%-0.75%, which could remove floors from many facilities.</td>
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<td>No Libor floor for club bank deals. Generally 1.00% floor for large, syndicated bank facilities, non-bank senior deals, second lien, and floating-rate unitranche facilities.</td>
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<td>Minimum Equity</td>
<td>Most lenders are looking for deals to have a 30.0%-40.0% base level of equity (inclusive of rollover) in a deal and would like leverage to not exceed 80.0% of the total price. Insurance companies and Credit Opportunity Funds will provide both debt and equity tranches in deals. Family offices are also looking to invest equity directly and can provide generous promissory notes to sponsor common equity.</td>
<td>Probably the most dynamic area in the market right now; while lenders still expect min. 30.0%-40.0% total equity (incl. rollover), insurance companies, banks, endowments, large family offices, and specialized asset managers are all actively pursuing opportunities to support sponsors and management teams, in some cases requiring limited or no equity co-investment and providing attractive promotes.</td>
<td>Acquisitions need 25.0%-40.0% total equity (inclusive of rollover); minimum 10.0% new cash combined with rollover or seller notes. The market continues to be increasingly sensitive to &quot;thin capitalization&quot; and will seek greater equity cushion in cyclical sectors and challenged credit stories. Fortunately, there is significant (and growing) interest in structured equity products to supplement equity contributions.</td>
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<td>Contribution</td>
<td>Equity co-investments and stand-alone equity tranches are readily available from an increasing pool of participants including Insurance Companies, Credit Opportunity Funds, Family Offices, BDCs, and SBICs. Structures run the gambit from &quot;below the line sub&quot; preferred instruments to heads up common with promissories. It presents a great opportunity for independent sponsors or committed funds wishing to preserve cash for future platform additions.</td>
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<td>Recap Liquidity</td>
<td>Recap rates are back with a vengeance. After three quarters of tightening liquidity, lenders across the spectrum from (banks to credit op funds) have opened the doors again. Dividend and share recap rates are both being actively bid. While a recap combined with an attractive use of capital is still preferred (and may garner better terms), pure non-accretive deals are still getting done on competitive terms.</td>
<td>Recap rates are back with a vengeance. After three quarters of tightening liquidity, lenders across the spectrum from (banks to credit op funds) have opened the doors again in Q3. Dividend and share recap rates are both being actively bid. While a recap combined with an attractive use of capital is still preferred (and may garner better terms), pure non-accretive deals are still getting done on competitive terms.</td>
<td>There is a profound drop in recap activity recorded for Q4 2015. The rationale for the significant drop can be attributed to a tighter and more risk adverse credit lending community and a significant jump in sponsors harvesting their portfolios (what was a recap in 2013 and 2014, is a sale in 2015).</td>
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<td>Story Receptivity</td>
<td>Interest in smaller, challenged, or marginal credits continues unabated through the year end. Credit op funds and mezz lenders are eager to lock in yield (rates 11.0%-14.0% both fixed and floating). Increasingly, lenders are providing grid based structures to reward issuers that de-lever or improve EBITDA generation over the life of the deal.</td>
<td>Contrary to conventional wisdom and historical practice, liquidity in Q4 for more &quot;stressed&quot; (challenged credit strength, distressed, or marginal issuers) remains robust for both debt and equity instruments. Pricing quickly trends to the low teens and leverage tolerances range from 3.00x-5.00x TD/EBITDA. Substantial latitude given to &quot;Adjusted&quot; EBITDA.</td>
<td>Story receptivity has sharply declined due to the traditional Q4 market influences (investors are trying to close deals before year-end and there is an increased focus on straightforward, non-storied issuers) and, in part, by a greater secular credit risk rationalization at play in the middle market.</td>
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<td>Tone of the Market</td>
<td>Q4 will end on a strong note with pricing and leverage metrics among the most aggressive for the year. Election results seem to be a non-event, and, if anything, suggest middle market issuers could be the beneficiaries of a more protectionist trading policy with lower tax rates and improved potential for growth. Rates seem to have stratified and will likely not become more aggressive in the new year.</td>
<td>Though Q4 market conditions remain exceedingly liquid, it looks like a floor and ceiling have been established for pricing and leverage tolerances respectively. Investors are particularly keen to book new assets for a year-end closing, so those issuers with the most comprehensive offering documents will likely get the most immediate responses.</td>
<td>There may be a sea change underway in middle market leveraged lending. Tighter leverage guidance for commercial banks, greater credit risk sensitivity by BDC lenders, and a growing perception that many credits are beginning to &quot;cycle down&quot; (more downgrades, increased leverage defaults, reduced EBITDA growth) have contributed to a more risk sensitive leveraged lending environment.</td>
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*Changes from last month highlighted in red*
"I miss the sound of your voice
And I miss the rush of your skin
And I miss the still of the silence
As you breathe out and I breathe in
If I could walk on water
If I could tell you what’s next
I’d make you believe
I’d make you forget."

“Come On Get Higher” - Matt Nathanson

**Come On Get Higher**

The cost of capital is going to get higher...and very soon. The Fed is poised to raise rates for the first time in a year (since December 2015). According to CME Group, the implied probability of a rate hike by year end currently stands at 94.9% while The Wall Street Journal, which surveys a group of more than 60 economists on more than 10 major economic indicators on a monthly basis, put the potential for a rate hike at the December FOMC meeting even higher at 96.43%. It is roundly anticipated that the hike will be 0.25%, bringing the Fed Funds rate from its current range of 0.25%–0.50% to 0.50%–0.75%. Most of the markets have in fact already priced in the upcoming rate hike; three month LIBOR currently sits just below 1.0%, or about 35 basis points higher than it ranged between January through June of 2016.

Support for the rate hike can certainly be attributed to the continued strength in the economy:

- **The Unemployment Rate is at a Nine Year Low of 4.6%** - The U.S. economy has averaged gains of ~180,000 jobs a month in 2016;

- **Payroll Growth is Solid** - Though average hourly earnings declined 0.1% in November, October saw a surge of 0.4% suggesting the emergence of underlying wage inflation and diminution of wage slack;

- **Consumer Confidence is at a Nine Year High** - The Conference Board Consumer Confidence Index for November registered at 107.1. Similarly, the Economic Optimism Index, released by The Investor’s Business Daily (IBD) TechnoMetrica Institute of Policy and Politics (TIPP), which measures the sentiment of consumers related to economic conditions, came in at 54.8 in December, its highest measure since September of 2012;

- **Q3 GDP was Revised Upward to 3.2%** - The most recent revision was up from 2.9% with upgrades in consumer spending (personal consumption expenditures rose at a 2.8% pace) and downgrades in inventory growth (inventories added $7.6 billion, down from an initial estimate of $12.6 billion). Q4 GDP predictions are currently at 2.6%;

- **Inflation is Finally Beginning to Gain Steam** - After a prolonged period of dormancy, Core CPI and Core PCE Price Index were at 2.1% and 1.7% respectively for November. Energy prices also seem to have stabilized and are now on the rise;

- **Manufacturing and Services are Demonstrating Continued Momentum** - The ISM Manufacturing Index was at a five-month high of 53.2 in November notwithstanding a stronger dollar. The ISM Non-Manufacturing Index jumped to 57.2 in November from 54.8 in October, a 13-month high; and

- **Robust Housing Gains** - U.S. Housing Starts jumped 25.5% in October. Both housing starts and permits for new construction rose in October, a sign that new construction is gearing up to accommodate demand.
Though improving and seemingly in numerous scenarios such sustained strength in the macroeconomic data would be enough to prompt Fed activity, a more substantive and potentially political motive seems to be at play in the Fed’s imminent move to a less accommodative monetary policy. As detailed in the Fed Minutes from the November FOMC Meeting, the Fed is just as concerned about losing its own credibility and its role in perpetuating excessive risk-taking in the market (“reaching for yield”) if it were to leave rates stagnant:

“Some participants noted that recent Committee communications were consistent with an increase in the target range for the federal funds rate in the near term or argued that to preserve credibility, such an increase should occur at the next meeting...In addition...many expressed concern that an extended period of low interest rates risked intensifying incentives for investors to reach for yield, potentially leading to a mispricing of risk and misallocation of capital.”

Reaching for yield, mispricing of risk and the misallocation of capital? To many, that could be a very appropriate summation of private market conditions as we close out 2016. More on this in the Private Market Update below—

### Private Market Update: What to expect in 2017

The private market is ending the year in much the same the way it started Q4—an excess liquidity environment propelled by an underinvested, more aggressively oriented commercial bank lending community and a more robust BDC constituency reinvigorated by increasing share prices and greater access to liquidity.

By December of 2016, almost all commercial banks have a pretty good sense of what constitutes highly leveraged risk exposure, and while HLT credit policy is by no means uniform in the middle market, most institutions are comfortable with 3.00x senior by 4.00x total debt limitations (the “3/4 Box”) and in many cases are willing to go beyond this metric for long term relationships and special circumstances. Dividend and share repurchase recapitalizations, which were almost nonexistent in the first half of the year, have emerged as an increasingly common and accepted use of proceeds.

In response to continued excess liquidity conditions, we are expanding our senior debt and total debt leverage tolerances by a quarter turn (0.25x) for issuers with LTM EBITDA in excess of $10 million. For issuers between $10 million and $20 million, senior leverage now caps out at 3.75x and total leverage at 4.75x; for issuers with greater than $20 million of LTM EBITDA the metrics go up to 4.25x and 5.75x respectively. By the same token, we do not see any additional pricing pressure in the current environment as lenders seem to have really hit historic lows in recent months and, as the market is still in need of yield, pricing is unlikely to compress any further.

In fact, current pricing in the market seems to confirm the statements respecting the “mispricing of risk” expressed in the minutes of the November FOMC meeting—it is not unusual to get bids as low as 11.0% for unsecured, non-amortizing subordinated debt of smaller middle market issuers (~$7.5 million of LTM EBITDA) with 4.00x aggregate leverage. Historically, this risk profile would have generated pricing closer to 14.0%-15.0% (and might even have warrants attached).

We anticipate that market conditions in 2017 will remain on the competitive side:

- Recent surveys of leading economists suggest increased GDP growth in the new year ranging from 2.2%-2.9%, along with heightened wage inflation and increased consumption of goods and services. All are drivers of increased EBITDA for middle market companies.
- Middle market issuers will be the natural economic beneficiaries of increased infrastructure investment, a more protectionist trade policy, and tax cuts if the new administration follows through on its campaign rhetoric.
- Similarly, policy initiatives supporting greater deregulation, especially in
the banking system (and the potential gutting of Dodd-Frank) could inject even more liquidity into the private capital market.

On the negative side of course, are the impending increases to the cost of capital and the eventual return to a more traditional interest rate environment. Capital Economics not only predicts a 0.25% bump to the Fed Funds rate this December, but also at least two more rate increases in 2017 for a cumulative 125 basis points, taking the fed funds target range to between 1.75% and 2.00%. The assumption that a sizeable fiscal stimulus is coming early next year has already pushed the 10-year Treasury yield up from roughly 1.70% pre-election to 2.24% today. Issuers contemplating a financing in the new year would be well served to lock in capital at today’s low rates where conditions still heavily favor the borrower.

Contact SPP Today

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.

Stefan Shaffer
Managing Partner
212.455.4502

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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