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

Deal Component | February '16 | January '16 | February '15
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Cash Flow Senior | <$7.5MM EBITDA 1.50x-2.50x | <$7.5MM EBITDA 1.50x-2.50x | <$7.5MM EBITDA 1.50x-2.00x
Debt | $10.0MM EBITDA 2.50x-3.50x | $10.0MM EBITDA 2.50x-3.50x | $10.0MM EBITDA 2.00x-3.50x
(x EBITDA) | $20.0MM EBITDA 3.00x-4.00x | $20.0MM EBITDA 3.00x-4.00x | $25.0MM EBITDA 3.00x-4.25x
Total Debt Limit (x EBITDA) | <$7.5MM EBITDA 3.00x-4.00x | <$7.5MM EBITDA 3.00x-4.00x | <$7.5MM EBITDA 3.00x-4.00x
Senior Cash Flow | - | - | -
Bank: L+3.00%-4.00%
Non-Bank: <$1.00MM EBITDA L+7.00%-8.00%
Non-Bank: $1.00MM EBITDA L+4.50%-6.50%
(5.00% for a 1.00% floor)
Second Lien Pricing (Avg) | <$7.5MM EBITDA L+9.00%-11.00% floating | <$7.5MM EBITDA L+9.00%-11.00% floating | <$7.5MM EBITDA L+8.00%-11.00% floating
(1.00% floor) | $10.0MM EBITDA L+7.00%-9.00% floating | $10.0MM EBITDA L+7.00%-9.00% floating | $10.0MM EBITDA L+6.50%-8.50% floating
(1.00% floor) | $20.0MM EBITDA L+5.50%-7.50% floating | $20.0MM EBITDA L+5.50%-7.50% floating | $25.0MM EBITDA L+6.00%-7.50% floating
(1.00% floor)
Subordinated Debt Pricing | <$7.5MM EBITDA 12.0%-13.0% | <$7.5MM EBITDA 12.0%-14.0% | <$7.5MM EBITDA 12.0%-14.0%
|x EBITDA 11.0%-13.0% | $10.0MM EBITDA 11.0%-13.0% | $10.0MM EBITDA 11.0%-13.0% | $20.0MM EBITDA 10.0%-12.0%
(1.00% floor) | $20.0MM EBITDA 10.0%-12.0% | $20.0MM EBITDA 10.0%-12.0%
(Warrants limited to special situations; Second lien may buy down rate to ~9.0%)
Equity co-invest readily available.
Unitarine Pricing | <$7.5MM EBITDA L+8.50%-11.00% | <$7.5MM EBITDA L+9.50%-11.00% | <$7.5MM EBITDA L+8.00%-11.00% floating
(1.00% floor) | $10.0MM EBITDA L+7.00%-8.50% | $10.0MM EBITDA L+7.00%-8.50% floating | $10.0MM EBITDA L+6.50%-8.50% floating
(1.00% floor) | $20.0MM EBITDA L+6.00%-7.50% | $20.0MM EBITDA L+6.00%-7.50% floating | $25.0MM EBITDA L+5.50%-7.50% floating
(1.00% floor)

Liber Floors No Liber floor for club bank deals. Generally 1.00% floating for large, syndicated bank facilities, and non-senior deals. Recently seeing pressure by unitarine lenders to increase Liber floors to 1.50%
Minimum Equity Contribution Acquisitions need 25%-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 “thick capitalization” and will seek greater equity cushion in cyclical sectors and challenged credit stories. For many credit products there is significant (and growing) interest in structured equity products to supplement equity contributions from independent sponsors, management teams, etc.
Equity Co-Investment Equity co-investment is actively sought for traditionally sponsored, independently sponsored, and unsponsored deals. Investors include BDCs, insurance companies, credit opportunity funds, SBICs, traditional mezz funds, and family offices. Variety of structures available from “debt-like” redeemable preferred to heads up common. Promotes of ~15.0% after return of 8.00% are becoming baseline.
Recap Liquidity Recapcs are under pressure in the current environment, especially where leverage exceeds 3.00x/4.00x TD (non-starter for most banks), or where the sponsor retains little or no “skin in the game.” Low leverage recapcs or recapcs with an acquisition or other accretive use of capital are still viable, but are subject to heightened scrutiny. Refinancing of sponsor-provided junior debt is readily available.
Story Receptivity Contrary to conventional wisdom, there appears to be an abundance of capital for storied credits in this tightening market. While some attribute the liquidity to investors’ hunger for yield or a general slowdown, the reality is that there are a number of new credit opportunities in the market with an eye toward storied or challenged credits. Rates tend to be in the ~10.0%-14.0% range.
Tone of the Market Credit conditions have tightened into 2016. Banks continue to adhere to tighter leverage in what many believe to be the start of a “down cycle,” and many BDCs are affected by diminished liquidity. Offsetting tighter leverage conditions is a dearth of new deal activity combined with an increase of some new high liquid market entrants, primarily freshly minted credit op funds and insurance companies.

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Most unitrainche lenders allow a small ABL facility outside of the unitrainche facility; larger ABL facilities are provided directly by unitrainche lenders (internally arranged with ABL bank lender). Capex, acquisition lines, and equity co-investments readily available.

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Recapcs are becoming less palatable to lenders with 4Q recap activity among the lowest in years. High leverage recapcs (above 3.00x/4.00x) are non-starter for most banks and BDCs. Low leverage recapcs with an acquisition or accretive use of capital are still viable, but are subject to heightened scrutiny. Refinancing of sponsor-provided junior debt are still getting done.

While recap liquidity remains quite robust, the cast of characters providing recap capital is becoming increasingly divided. Many commercial banks are beginning to back off recapcs that: (i) are unsponsored; (ii) exceed the 3.00x/4.0x TD-to-EBITDA metric; or (iii) are with issuers less than $10.0 million EBITDA.

Market conditions remain on the quiet side, and accordingly, favorable conditions are still in place for refinancing challenged, storied issuers. New High Risk Borrower (“HRB”) guidance from Fed, OCC, and FRB is putting banks into a less forgiving lending constituency. Luckily, unitrainche and non-bank commercial lenders are picking up the slack.

*Changes from last month are in red

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Market Update February 2016

Check out SPP online: http://sppcapital.com/
“My mother told me
'Fore she passed away
Said son when I’m gone
Don’t forget to pray

’Cause there’ll be hard times
Lord those hard times
Who knows better than I?

Well I soon found out
Just what she meant
When I had to pawn my clothes
Just to pay the rent

Talkin’ ‘bout hard times
Lord those hard times
Who knows better than I?”

**Hard Times?**

The Federal Reserve’s January 2016 Senior Loan Officer Opinion Survey on Bank Lending Practices confirmed what most of us who toil in the middle market financing markets already know too well: (i) excess liquidity conditions that have defined the private capital markets for the last three years have deteriorated, and (ii) current macroeconomic conditions present headwinds that will likely have a chilling effect on leverage capacity in coming months. The Fed report noted, “A majority of the domestic respondents that tightened either standards or terms on commercial and industrial (‘C&I’) loans over the past three months cited a less favorable or more uncertain economic outlook as well as a worsening of industry-specific problems affecting borrowers as important reasons, with some banks noting in their optional comments that energy-related industries, including oil and gas, were the concern. Significant net fractions of banks also attributed the tightening of loan terms to reduced tolerance for risk; decreased liquidity in the secondary market for these loans; and increased concerns about the effects of legislative changes, supervisory actions, or changes in accounting standards.”

The findings of the Survey seem consistent with the “dovish” tone of the most recent Federal Open Market Committee’s (“FOMC”) statement after its January meeting. The January statement represented a pronounced retreat from the December statement, when the Fed increased the fed funds target range to between 0.25% and 0.50% (its first increase in nine years) and signaled a plan to raise rates by 1.0% in 2016. Among the highlights of the FOMC statement are:

- The removal of the phrase “the risks to the outlook for both economic activity and the labor market as balanced” and the addition that the Fed “is closely monitoring global economic and financial developments and is assessing their implications for the labor market and inflation, and for the balance of risks to the outlook” suggest that the Chinese meltdown and other global economic events will likely influence Fed policy;
- That inflation is expected to remain “low in the near term” and the economy has “slowed”;
- That growth “slowed late last year” and downgraded its view on household spending and business investment growth to “moderate” from “strong” in December; and
- In what is likely the most significant modification, the January FOMC Statement omitted language that the Fed “expects rates to increase at a gradual pace.”

The statement, taken in its entirety, suggests that absent some dramatic changes in current economic conditions, the Fed has revised the expectation of four 0.25% rate increases in 2016. According to the CME Group’s most recent private economist data sets, the implied probability of no rate hikes in 2016 (71.4%) is now greater than the probability of the Fed increasing rates even once in 2016.
(24.9%). The implied probability of four or more rate increases in 2016 (as enunciated by the Fed in December) is now 0.0%.

Below is a quick recap of the month's headline economic reports:

- **Consumer Confidence/Retail Sales:** With all the recent turbulence in the equity markets, consumer confidence appears to finally have been shaken. In mid-January, the University of Michigan's report on consumer sentiment hit a high of 92.6 (attributed to the combination of low energy costs and improving labor markets); by the end of the month, however, the same report dropped to 92.0 (that's also a drop of 6.2% from a year ago). The current conditions component dropped to 106.4 from 108.1. Adding some confusion to the mix, the Conference Board's measure on Consumer Confidence demonstrated a contrary trend, registering a 98.1 for January, up from 96.5 a month earlier. Given the continued declines in manufacturing, and a slowdown in growth in the services sector, the potential for GDP growth is clearly focused on consumer and retail spending trends, and, as of late, the trends have not been particularly noteworthy. Retail sales for December fell by 0.1% M/M, and retail sales less auto and gas registered a 0.0% M/M in December (after a 0.4% gain in November 2015).

- **Inflation:** The Fed’s preferred measure of inflation, the PCE deflator (aka the “PCE Price Index”), dropped 0.1% in December after a flat reading in November. The PCE Core Price Index (excluding the more volatile food and energy components), rose 0.1% for the month. The year-on-year gains in the Core PCE Index is a little more encouraging, rising to 1.4% from 1.3% in the previous month, a far cry from the Fed's stated goal of 2.0%. Inflation, though muted, is still moving in the right direction, the year-on-year PCE Price Index is up 0.6% (up from 0.4% a month earlier, and three times the reading for September, which was only 0.2% year-on-year). Inflation is likely not robust enough to justify continued rate increases in 2016.

- **GDP:** The first estimate of Q4 2015 GDP came in at an anemic 0.7%, suggesting the economy lost some momentum by year-end. The comparatively weak quarter (Q3 GDP was 3.9% and Q2 GDP was 2.0%) was attributed to softer consumer spending, falling exports, and a smaller build-up in business inventories. All totaled, this results in an annual rate of GDP growth of 2.4% for 2015. To put this in perspective, since the end of WWII to 2005, annual GDP growth averaged 3.5%; since 2005, GDP growth has yet to hit 3.0%. 2015 GDP growth of 2.4% was identical to 2014, and may represent “the new normal” for post-recession growth. It should be noted that this was only the first estimate of Q4 GDP, it will be revised twice more as new data comes in. Initial indications for GDP growth in 2016 are skewing in a decidedly more positive direction; the Atlanta Fed’s GDPNow model forecast for real GDP growth (seasonally adjusted annual rate) in the first quarter is currently at 2.5% (up from 1.2% earlier in the month). The forecast for the real consumer spending growth subcomponent increased from 2.5% to 3.0% and the forecast for real gross private domestic investment growth increased from -0.4% to 2.1%.

- **Manufacturing and Services:** The manufacturing data remains among the most disappointing of recent macroeconomic reports. The January ISM Manufacturing Index came in at 48.2 for January (unchanged from December’s initial reading, though it was revised downward to 48.0), representing the fourth consecutive “sub-50” (i.e. - contraction) reading in a row. According to Econoday, this represents “by far the worst run for this closely watched indicator since the Great Recession days of 2009.” Digging deeper, the employment subcomponent fell a steep 2.1 points to 45.9 (the third sub-50 reading) and the “backlog” subcomponent was 43.0. There is one bright spot in the report: the new orders subcomponent registered a 51.5, constituting the second “plus 50” reading in the last five months. While manufacturing is a closely watched indicator of economic strength, it is not the determinative gauge of prosperity that it used to be. In 1955, manufacturing constituted more that 30% of the economy; today, it is less than 16%. The ISM Non-Manufacturing Index also caused some alarm in January, dropping to 53.5 from a revised 55.8 in December. Though still in
expansion mode (i.e.-above 50), there was as a widespread slowing of activity. The employment subcomponent dropped 4.2 points to 52.1, and new orders dropped to 56.5 from December’s solid 58.9.

- Employment: January non-farm payrolls recorded a gain of 151,000 for January, well below the consensus estimate of 200,000 and a stark reduction from the 292,000 initially reported in December (it was subsequently revised downward to 262,000). Though the headline number was weaker than anticipated, the January report did contain some positive trends as well. Specifically, the unemployment rate (the U3 Rate) dropped to 4.9% and average hourly wages were up 2.5% over the last year (which constituted the second best monthly gain since 2010). Additionally, the Civilian Participation Rate ticked up to 62.7% (from 62.6%). On the negative side, however, the broader U6 Unemployment Rate (which includes a larger group of jobless workers plus those part-time workers seeking full-time employment: the “Underemployment Rate”) remained unchanged at 9.9%. Taken in its entirety, the payroll report left as many questions unanswered as it answered and provides little insight concerning its impact on Fed monetary policy with respect to future rate hikes.

- Housing: Consistent with consensus expectations, existing home sales bounced back sharply in December, jumping 14.7% to a 5.46 million annual rate and more than reversing the 10.5% dip in November, which was slowed due to a change in closing document regulations (dubbed “Know Before You Owe”) that pushed many closings into December. Lack of supply remains a major concern across the housing market, creating higher prices as the number of homes for sale fell to 1.79 million units from 2.04 million the previous month. Housing starts and new construction permits still managed to slip 2.5% and 3.9% respectively, but this is after 10.1% and 10.4% gains the previous month. Total sales for 2015 were 5.26 million, well up from 4.94 million on 2014. Overall, housing is showing signs of life but despite price appreciation, gains are being limited by lack of supply.

**Market Update**

Most middle market capital participants are bracing for what is anticipated to be a tightening of credit metrics later in the year. The January 2016 Senior Loan Officer Opinion Survey on Bank Lending Practices asked participants two sets of questions: the first set asked banks about their outlook for lending practices and conditions over 2016, and the second set asked banks about their outlook for credit quality in 2016. The report summarized the responses from 73 domestic banks and 24 U.S. branches and agencies of foreign banks. Highlights from the survey included:

- “On balance, banks tightened their standards on commercial and industrial ("C&I") loans.
- Demand for C&I loans had weakened somewhat.
- Banks expected standards on C&I to continue to tighten over 2016.
- A majority of the domestic respondents that tightened either standards or terms on C&I loans over the past three months cited a less favorable or more uncertain economic outlook as well as a worsening of industry-specific problems affecting borrowers as important reasons, with some banks noting in their optional comments that energy-related industries, including oil and gas, were the concern.
- Significant net fractions of banks also attributed the tightening of loan terms to reduced tolerance for risk, decreased liquidity in the secondary market for these loans, and increased concerns about the effects of legislative changes, supervisory actions, or changes in accounting standards.
- On balance, a significant fraction of domestic banks reported that they expect an increase in delinquency and charge-off rates for all categories of C&I loans included in the survey over this year.
- A majority of foreign respondents expect an increase in delinquency and charge-off rates for syndicated leveraged C&I loans to large and middle-market firms this year, and a significant net fraction expects such an increase for C&I loans to small firms.”

Business development companies (“BDCs”), the second major lender constituency to the middle market, are also experiencing something of a major
With commercial banks and BDCs taking a more restrained role in providing liquidity, conventional wisdom would suggest that pricing and terms overall will be adversely impacted, but, surprisingly, SPP has yet to expressly increase pricing or tighten leverage metrics in this month’s “Market-At-A-Glance.” In fact, we have even lowered our pricing indications on unitranche financing (<$7.5MM EBITDA: 8.50%-11.00%). The truth of the matter is that while most market participants expect liquidity conditions to tighten, the current lack of deal flow and abundance of capital providers has offset any short term liquidity concerns. Over the course of the last year, we have witnessed greater participation in the middle market by insurance companies, credit opportunity funds, and commercial finance companies, which has more than compensated for the pullback by commercial banks and BDCs. For those issuers ready and able to issue in the near future, market conditions remain exceedingly liquid.

SPP has decided to tighten pricing for senior cash flow deals for non-bank lenders in February:

- Bank: L+3.00%-4.00%
- Non Bank: <$10MM, L+7.00%-8.00%
- Non Bank: >$15MM, L+4.50%-6.50%

If an issuer qualifies for bank financing, lenders are relatively agnostic to the size of the borrower; whether its EBITDA is $6MM or $36MM, bank pricing will still average between L+3.00%-4.00%; but when you leave the commercial banking market, the level of EBITDA is a primary source of pricing discrimination—there are just not lenders willing to provide typical non-bank pricing to smaller (<$10MM EBITDA) issuers, and accordingly, pricing falls off a cliff, averaging rates, at best, around L+7.00% (and in most cases, L+8.00%).

**SPP-Trackerd Market Activity**

January LTM 2016 deal count is down approximately 22.0% from January LTM 2015 and January 2016 deals and exits were the lowest they have been since June 2015. Still, total deal volume in the middle market has remained relatively stable over the past year, especially in the lower middle market, as deal flow remains robust, but the decline in capital invested over 2015 will likely continue in 2016. Multiples are accordingly normalizing.

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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**SUPPORTING DATA**

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

![Graph showing historical senior debt cash flow vs EBITDA multiples from 2014 to 2016.]

Source: SPP’s "MIDDLE MARKET LEVERAGE CASH FLOW MARKET AT A GLANCE"

### Historical Total Debt Limit (x EBITDA)

![Graph showing historical total debt limit vs EBITDA multiples from 2014 to 2016.]

Source: SPP’s "MIDDLE MARKET LEVERAGE CASH FLOW MARKET AT A GLANCE"

### Historical Senior Cash Flow Pricing (Bank)

![Graph showing historical senior cash flow pricing for bank deals from 2014 to 2016.]

Source: SPP’s "MIDDLE MARKET LEVERAGE CASH FLOW MARKET AT A GLANCE"

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

![Graph showing historical senior cash flow pricing for non-bank deals from 2014 to 2016.]

Source: SPP’s "MIDDLE MARKET LEVERAGE CASH FLOW MARKET AT A GLANCE"

### Historical Second Lien Pricing

![Graph showing historical second lien pricing from 2014 to 2016.]

Source: SPP’s "MIDDLE MARKET LEVERAGE CASH FLOW MARKET AT A GLANCE"

### Historical Subordinated Debt Pricing

![Graph showing historical subordinated debt pricing from 2014 to 2016.]

Source: SPP’s "MIDDLE MARKET LEVERAGE CASH FLOW MARKET AT A GLANCE"

### Historical Minimum Equity Contribution

![Graph showing historical minimum equity contribution from 2014 to 2016.]

Source: SPP’s "MIDDLE MARKET LEVERAGE CASH FLOW MARKET AT A GLANCE"

### U.S. PE LMM Deal Flow by Quarter

![Graph showing deal flow by quarter from 2012 to 2016.]

Source: Pitchbook