Credit conditions have tightened into 2016. Banks and most bank lenders and unitranche providers, as most non-bank deal sponsors recaps will become less sensitive to use of equity or debt in the current leverage, everything from greater leverage to arbitrage all floors altogether increases. The recent recovery in the energy sector "accretive" use of proceeds.

**Deal Component** | **February ‘17** | **January ‘17** | **February ‘16**
---|---|---|---
Cash Flow Senior | $<7.5MM EBITDA 1.5x-2.50x | $<7.5MM EBITDA 1.5x-2.50x | $<7.5MM EBITDA 1.5x-2.50x
Debt Multiple | $<10.0MM EBITDA 2.75x-3.75x | $>10.0MM EBITDA 2.75x-3.75x | $>10.0MM EBITDA 2.50x-3.50x
(x EBITDA) | $<20.0MM EBITDA 1.0x-2.45x | $>20.0MM EBITDA 1.0x-2.45x | $>20.0MM EBITDA 1.0x-2.45x
Total Debt Limit | $<7.5MM EBITDA 3.0x-4.50x | $<7.5MM EBITDA 3.0x-4.50x | $<7.5MM EBITDA 3.0x-4.00x
(x EBITDA) | $>10.0MM EBITDA 3.45x-4.75x | $>10.0MM EBITDA 3.45x-4.75x | $>10.0MM EBITDA 3.75x-4.50x
Senior Cash Flow Bank: L+3.00%-5.00% | Bank: L+3.00%-5.00% | Bank: L+1.00%-4.00%
Pricing Non-Bank: <$10.0MM EBITDA L+6.50%-8.00% | Non-Bank: <$10.0MM EBITDA L+4.50%-6.50% (potential for 0.00%-1.00% floor) | Non-Bank: <$10.0MM EBITDA L+7.00%-8.00%
 Libor Floors Fixed rate options range from a low of 7.0% to 11.0%.
 Libor Floors Most lenders are looking to have a 30%-40.0% base level of equity (inclusive of rollover) in a deal and would like leverage to not exceed 80.0% of the purchase price. Insurers, Credit opportunities 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 experience to sponsor common equity.
 Minimum Equity Contribution
 Equity Co-Investment
 Recap Liquidity
 Story Repeatability
 Tone of the Market

*Changes from last month highlighted in red*
The January statement was nearly identical to the December one except with respect to some language on inflation; specifically, a couple of references to the impact on overall inflation from energy and trade price inflation were dropped, and the Fed modified the phrase “inflation is expected to rise” with a stronger “inflation will rise” to 2.0% over the next few quarters. Finally, the statement noted some continued improvement in the economy, including the recent gains in consumer confidence.

While economists tend to parse the language of the monthly FOMC statements for any nuance of monetary policy modification, there was very little to suggest another interest rate increase at the March meeting—economic activity remains “moderate” notwithstanding a larger than expected gain in non-farm payrolls of 227,000 (expectation was 175,000). Currently, the implied probability of a rate hike at the March meeting sits at approximately 13.3%, while the implied probability of a June hike rises to just below 50.0% according to the CME Group.

Most of apprehension of surrounding a second rate hike (after the December 25bp increase) appears to be political and not merely economic. From a purely macroeconomic perspective, and as discussed more fully below, a case can certainly be made to support another rate increase. The most recent spate of releases for consumer confidence, employment, retail sales, inflation, manufacturing, and services almost all uniformly show continued gains. What appears to be giving the Fed pause however is the potential that the new administration may not be able to execute its fiscal policy and tax reform ambitions halting the subsequent inflationary influences associated with them. Remember, the Fed predicted four interest rate increases for 2016; we ended the year with only one.

In many ways, issuers to the private debt markets have the best of both worlds—continued low interest rates due to Fed inaction yet a lending community that still anticipates continued growth and improving credit conditions (as supported by an abundance of economic data):

- **January Non-Farm Payrolls Surprised with 277,000** – Its strongest reading in four months; expectation for the January Employment report was ~175,000. Though the unemployment rate ticked up to 4.8%, it was for a good reason: the labor force increased by 544,000 pushing the participation rate up to 62.9%. Wages were up 2.5% from a year ago and...
hours were up 1.1% resulting in a total wage gain of 3.6% from January.

- **Consumer Confidence Remains High Though It Moderated in January** – The Conference Board Consumer Confidence Index came in slightly lower than expectation at 111.8 (down from December’s staggering 113.7). The decline was almost entirely due to the “expectations” index while the “present situation” index jumped to 129.7 which was up from 123.5 the previous month and suggests strong consumption growth in Q1 2017. The Personal Income and Outlays Report also pointed to continued strength in real personal spending, which rose 0.3% month-over-month. The University of Michigan’s Consumer Sentiment was essentially unchanged in January which ticked down to 89.1 from December’s 98.2 (but still stronger than November’s 98.0).

- **The First Estimate of Q4 2016 GDP was 1.9%** – Most economists did not read too much into the drop in 2016’s Q4 GDP to 1.9% from 3.5% in Q3 because a temporary spike in soybean exports had the effect of boosting the Q3 number and depressing Q4. Examining 2016 on the whole, GDP for the first half of the year was an anemic 1.1% while the second half of the year was a much stronger 2.7%. Again, personal consumption expenditures were the big positive, rising at a 2.5% rate. The GDPNow model forecast for real GDP growth (seasonally adjusted annual rate) in the first quarter of 2017 is now 2.7%.

- **Inflation Continues to Climb at a Moderate Pace** – The headline PCE Price Index and Core PCE Price Index both showed improvement in January, rising 0.2% and 0.1% respectively. Over the course of the last year the PCE Deflator was up to a 1.6% annual rate while the Core PCE Deflator (which excludes food and energy) was up to 1.7% from a year ago. To give you a sense of the impact of recent gains in energy costs, for the last three months PCE prices are up to a 1.9% annual rate. The Consumer Price Index has also demonstrated modest gains and has already crossed the oft-mentioned 2.0% threshold; CPI year-over-year change for December came in at 2.1% and Core CPI year-over-year was 2.2% in December.

- **The January Manufacturing ISM Index Hits Its Best Level Since November of 2014** – In January to the ISM Manufacturing Index recorded a second consecutive two year high of 56.9 (up from December’s 54.7). The gains were broad based with every manufacturing sector expanding at a faster pace than last December. The New Orders component recorded a robust 60.4, which in combination with December’s 60.3, is the first back-to-back 60.0 plus reading since December of 2013. The ISM Non-Manufacturing Index remains strong at 56.5, but is a notch down from December’s revised reading of 56.6. January marked the 85th month in a row that the ISM Non-Manufacturing Index continued to expand (i.e. had a reading in excess of 50.0).

- **The Housing Market’s Best Year Ended on a Healthy but Somewhat Softer Note** – Solid job creation throughout 2016 and exceptionally low mortgage rates resulted in a good year for the housing market; however, rising mortgage rates and home prices combined with record low inventory levels stunted sales in much of the country in December. The pace of housing construction weakened at the start of 2016, as total housing starts fell 3.8% in January. The decline was consistent with the drop in home builder confidence, which fell three points to a level of 58 due to consumer worries about the state of the economy.

**Private Market Update:**

2017 is well underway and market participants report that liquidity conditions continue to be exceedingly robust and broad across the credit spectrum. Notwithstanding the ubiquitous excess liquidity however, SPP is actually raising its spread indications this month for those more challenged credits or issuers with LTM EBITDA of less than $7.5 million.

Specifically, SPP is raising its senior debt cash flow pricing by 0.50% as well as second lien and unitranche pricing by 1.00% on the outer range. The feeling in
the market is that everyone needs yield, and though it is almost impossible to get any premium or wider spreads on the more traditional, vanilla, or higher quality issuers, lenders are drawing a line in the sand and demanding yield (or simply passing) for small (~$7.5 million LTM EBITDA), distressed, storied or more marginal issuers. In short, there is an abundance of capital available, but it comes at a premium for the more marginal issuers, or those perceived as more vulnerable to a reversal. As a general proposition, the best lending constituency for these issuers will be unithanche whereby the lenders can get senior protection but build in sufficient yield through stretching beyond what commercial banks can tolerate.

With respect to the rest of the market however, conditions are only more competitive than they were in Q4 of 2016, with more funds competing, banks willing to stretch a little further to garner quality assets, and the BDC community experiencing its strongest share prices in a year. Specifically:

- In 2016, approximately $49.5 billion in direct lending/middle market funds were raised which is more than the combined amount of direct lending/middle market funds raised in both 2014 (~$16.3 billion) and 2015 (~$22.4 trillion). This is capital that needs to be deployed in 2017.
- The Commercial and Industrial ("C&I") loan portfolio of commercial banks has grown almost uninterrupted since February of 2012 and now totals approximating $2.1 trillion.
- For the week ending February 3, 2017, 32 of the 45 publically traded BDCs were trading above their 50 Day Moving Average, and 35 of them were trading above their 200 Day Moving Average. 36 of the 45 publicly traded BDCs are trading within 10% of their 52 week high—these are share price levels we have not seen since April of 2015.

In last month’s SPP Market Update, we reported that most lenders go into 2017 with an expectation of continued and robust GDP growth in addition to increased earnings for middle market companies (a credit “up-cycle”), suggesting they will be more competitive and ostensibly more forgiving with respect to leverage tolerances and covenant structures. The empirical support for that assertion is now available; the Federal Reserve issued its January 2017 Senior Loan Officer Opinion Survey on Bank Lending Practices (the “Survey”), and the Survey’s results in large part affirm a more aggressive lending posture by domestic commercial banks as well as improving credit conditions and an acknowledgement of increased competition from non-bank lenders. Among the Survey’s specific conclusions were the following:

- “Regarding loans to businesses, the January survey results indicated that over the fourth quarter of 2016, on balance, banks left their standards on commercial and industrial (C&I) loans basically unchanged;
- On balance, banks reported that they expect to ease standards on C&I loans and for the asset quality of such loans to improve somewhat this year;
- Specifically, a moderate net percentage of banks reportedly increased the maximum size of credit lines, while a modest net percentage of banks reportedly eased loan covenants, reduced the cost of credit lines, and narrowed spreads of loan rates over their cost of funds;
- Most domestic banks that reported having eased either their standards or terms on C&I loans over the past three months cited as an important reason more aggressive competition from other banks or nonbank lender;
- Significant fractions of such banks also cited as important reasons increased tolerance for risk and a more favorable or less uncertain economic outlook; and
- Regarding asset quality of loans to businesses, moderate net fractions of banks reported that they expect asset quality of all C&I loan categories to large and middle-market firms to improve somewhat in 2017, while a modest net fraction of banks reported expecting asset quality of C&I loans to small firms to similarly improve over this period.”
The clear takeaway from Survey is that banks are optimistic about improving credit quality and need to be more aggressive because of the increased presence and threat of the non-bank lending community. They are therefore willing to engage on a more competitive basis.

**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.

For your smaller capital needs, SPP’s direct lending 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)

![Graph showing historical senior debt cash flow](image)

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

### Historical Total Debt Limit (x EBITDA)

![Graph showing historical total debt limit](image)

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](image)

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](image)

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

### Historical Second Lien Pricing

![Graph showing historical second lien pricing](image)

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

### Historical Subordinated Debt Pricing

![Graph showing historical subordinated debt pricing](image)

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

### Historical Minimum Equity Contribution

![Graph showing historical minimum equity contribution](image)

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

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

![Bar chart showing deal flow by quarter](image)

Source: Pitchbook