## Market Update

### SPP's Middle Market Leveraged Cash Flow Market At A Glance

<table>
<thead>
<tr>
<th>Deal Component</th>
<th>February '18</th>
<th>January '18</th>
<th>February '17</th>
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<tr>
<td><strong>Cash Flow Senior</strong></td>
<td>&lt;5.00M EBITDA 1.75x-3.00x</td>
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<td>&lt;5.75M EBITDA 1.50x-2.90x</td>
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<td><strong>Debt Multiple</strong></td>
<td>&gt;$10.00M EBITDA 2.75x-4.00x</td>
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<td><strong>Total Debt Limit</strong></td>
<td>&lt;$5.00M EBITDA 3.50x-4.50x</td>
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<td>&lt;$7.5MM EBITDA 3.00x-4.50x</td>
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<td><strong>Multiple</strong></td>
<td>&gt;$10.00M EBITDA 4.00x-5.00x</td>
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<td>&gt;$10.00M EBITDA 3.25x-4.75x</td>
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<td>&lt;$20.00M EBITDA 4.25x-5.75x</td>
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<td><strong>Senior Cash Flow</strong></td>
<td>Bank: L+3.00%-5.00%</td>
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<tr>
<td><strong>Pricing</strong></td>
<td>Non-Bank: &lt;$7.50M EBITDA L+5.50%-8.00%</td>
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<td><strong>Second Lien Pricing</strong> (Avg)</td>
<td>&lt;$5.00 MM EBITDA L+7.00%-11.00% floating (1.00% floor)</td>
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<td><strong>Subordinated Debt</strong></td>
<td>&lt;$5.00 MM EBITDA 12.00%-14.00%</td>
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<td><strong>Unitranche Pricing</strong></td>
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<td><strong>Liber Floors</strong></td>
<td>Liber floors are only found in syndicated or non-bank senior debt, second lien, and unitranche deals. Given the assumption of three to four additional rate hikes in 2018, Liber floors are not a highly contested matter. To the contrary, many unitranche and mezz lenders are now considering Liber “Caps”, not floors, to protect issuers from increasing Liber costs (currently ~5%).</td>
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<td>Minimum Equity Contribution</td>
<td>Recent volatility in equity markets and concern over rising rates may drive potential increases in base equity contributions. For the time being, however, lenders want sponsors to have approximately 30.0%-40.0% base level of equity (inclusive of any rollover). As a general proposition, new sponsor equity of less than 20.0% will be the best terms.</td>
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<td>Equity Co-Investment</td>
<td>The market for co-investments remains robust among insurance companies, family offices, and credit opportunity funds. As a general proposition, 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, though not all carry/promotes will be performance contingent. Mezz lenders generally will not exceed 20% of their debt investment.</td>
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<td>Recap Liquidity</td>
<td>Though recap liquidity remains robust (best terms to sponsored deals and generally provided by the non-bank lending community) if the market begins to retrace, recap dollars will likely tighten in coming months. For the time being, little pricing discrimination between “pure” recaps and those combined with an attractive use of capital.</td>
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<td>Story Receptivity</td>
<td>Story receptivity is still strong resulting from excess liquidity in the system, competition by new funds, and lack of deal flow early in the year; but the most vulnerable constituency in a credit retrenchment will be smaller, marginal, or more “credit-challenged” issuers. If rate increases materialize, SBIC, BDC, and other lenders employing leverage will drive up issuance costs.</td>
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<td>Tone of the Market</td>
<td>With equity markets tumbbling (and notably here, BDC share prices), high-yield spreads climbing, and uncertainty concerning that interest rate increases may adversely impact both lenders (SBIC and BDCs) and issuers, much of the euphoria that enveloped the private market in January has transmogrified into a more measured, opinion; however, underlying macroeconomic conditions remain strong, and the market remains overwhelmingly liquid. Private market issuance conditions remain firmly in the issuers’ favor.</td>
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Check out SPP online: http://sppcap.com/
“Father, father
We don’t need to escalate
You see, war is not the answer
For only love can conquer hate
You know we’ve got to find a way
To bring some lovin’ here today

Picket lines and picket signs
Don’t punish me with brutality
Talk to me
So you can see
Oh, what’s going on
What’s going
What’s going on
What’s going on”

“What’s Going On,” Marvin Gaye

What’s Going On?

Notwithstanding the seemingly unprecedented volatility for the last 10 days in the publicly traded markets (especially for those of you under 50), SPP is not making any changes to its pricing schemes, leverage tolerances, or EBITDA thresholds for the month of February. That is not to suggest that the private capital markets are immune to the same influences battering the public equity and high-yield debt markets, but given the lack of active trading, the relatively “permanent” nature of private capital (not subject to volatility of inflows and outflows that characterize the high-yield bond and broadly syndicated loan funds), and the more parochial nature of middle-market loan activity, the dislocation evident in the Dow, S&P 500, and high-yield marketplace has yet to have any discernable impact on the private debt and equity markets. The private market is subject to its own unique set of pressures, however, and a change in middle-market liquidity conditions could materialize very quickly. Interesting side note, however—it may be good news for commercial banks that have been losing market share to non-bank funds and unitranche lenders for the last three years.

Make no mistake, with respect to middle-market debt and equity investments, this is still very much an issuer’s market. Growth in unitranche loans continues unabated; in Q4 of 2017, unitranche loans hit a new high, growing to over eight billion for the quarter. Mezzanine lenders, BDCs, and non-bank direct lenders offer a unitranche alternative to the more traditional bifurcated senior/sub structure. Much of the growth in the unitranche product can be attributed to the accelerated growth in middle-market fundraising that has added an unprecedented amount of dry powder to the private market.

As noted last month in the SPP Market Update, private debt fundraising hit a record high in 2017; as of year-end, it was reported that 126 existing and new credit vehicles raised approximately $107 billion (vs. $99 billion in 2016 and $100 billion in 2015). Of that total, middle-market targeted fundraising was approximately $43 billion in 2017. These fundraising efforts have resulted in record amounts of “dry powder” (i.e. dollars available for investment); specifically, as of December 2017, private debt dry powder sits at approximately $235 billion (eclipsing the prior record of $218 set in December 2015). Of that total, the direct lending component of dry powder sits at approximately $81 billion.
The public high-yield market is being adversely impacted by both the disruption in the equity markets and the fear of higher interest rates in 2018. High-yield fund outflows have accelerated, and high-yield rates, though still historically low, have increased approximately 60 basis points since the beginning of the year. Traditionally, when high-yield rates increase, there is some contagion in the middle-market as well, resulting in higher pricing and more conservative leverage metrics as both markets are considered more risk-oriented and generally more vulnerable in an economic downturn. The empirical data, however, really does not support that conclusion; to the contrary, middle-market loans actually show better loss rates than broadly syndicated loans (of all credit quality); the implied annual loss rate for middle-market loans for the period 2007 - 2017 sits below 0.8%, whereas the implied loss rate for broadly syndicated loans is above 1.0%.

The middle-market has its own unique pressures however; should rates rise as anticipated in 2018, many of the funds in the private market that employ leverage in their investment activities (SBICs - 2:1 leverage; BDCs - 1:1 leverage) will also be adversely impacted by rising costs, often without the capacity to pass along the increased cost of capital (fixed-rate instruments). In 2013, 3-month Libor was ~0.34%. 3-month Libor today is ~1.78% (a change of 1.44%). During the same period, all-in rates for higher-risk debt have only increased from 5.99% to 6.18% (.19)—that delta is coming right off the hide of spread to the lender.

BDCs are experiencing even more pressure; in addition to facing increasing costs of capital for leverage on their portfolios, recent BDC share prices have been on a relatively precipitous decline. According to loanpricing.com, as of the first week in February, “the average share price to book value for the public universe plummeted to 0.87 times, the lowest level since mid-2016. In fact, only 13.0% of the public BDCs are still trading above book value, down from 30.0% in December 2017.”

Interestingly, the one lending constituency that may actually benefit from the dislocation in the non-bank community is commercial banks. Since banks are primarily floating rate lenders, they have the capacity to pass along interest rate increases. Commercial bank business loan growth has declined steadily since February 2015 (from ~14.0% to ~1.0% in December 2017), but now seems to have stabilized and is heading north to ~2.0% in January 2018.

The Macroeconomic Picture

President Donald Trump released a $4.4 trillion budget plan for 2019 that proposes increased spending for the military, infrastructure, border security, and programs to combat the opioid epidemic. The blueprint underscores what has become clear in recent months: that any lingering Republican budget austerity has largely dissipated and that a more steadfast willingness to tolerate larger budget deficits deep into an economic expansion has prevailed. GOP lawmakers and President Trump are now pursuing fiscal policies that tolerate wider deficits in a bid to ramp up economic growth. The GOP president’s proposed budget, an annual document that outlines the priorities of the administration, does not balance for over a decade, even with slightly stronger economic growth, as it projects the government will collect less federal revenue than it forecasted last year. The decrease in government revenue projections is due to one of the biggest legislative deals in Donald Trump’s presidency—the $1.5 trillion tax cut enacted in late December 2017. The administration’s latest budget assumes the economy can grow at a much stronger pace than independent forecasters expect. It projects
the economy will grow about 3.0% annually over the coming decade, with output rising 3.2% next year before declining to 3.0% in 2021 and 2.8% by 2026. Congressional scorekeepers estimate the new tax law will increase the deficit by $1 trillion over a decade when accounting for its estimated effects on growth and revenue collections.

Historically, deficits have grown largest during economic downturns, when tax receipts fall, and spending rises on unemployment insurance and other safety net programs, and they shrink during periods of economic expansion. Despite the continued growth of the U.S. economy in recent years, however, deficits have edged higher. During the recession, there was a large gap between the economy’s actual output and its potential output given the number of available workers and overall productivity. The Congressional Budget Office estimates that gap has now closed and the economy is expanding at a pace that exceeds its potential, a combination that could cause overheating throughout the economy. Additionally, larger deficits give the federal government limited flexibility in the future to leverage tax cuts, boost spending, or enact other forms of economic stimulus should the economy suffer in the next downturn. Even though the economy does not need fiscal stimulus right now, there is a strong case for both cutting corporate taxes to make the U.S. more competitive and boosting military spending.

In theory, tax cuts and government spending could boost the economy in two ways. The concept of demand-side stimulus says that tax cuts and government spending give businesses and consumers money to spend on equipment, homes, and other goods, though it tends to be fleeting in nature. Certain policies also encourage people to work more and businesses to invest more, raising productivity. That is called supply-side stimulus, which in theory, has long-lasting benefits that produce growth without inflation.

The Trump administration is betting it is delivering the latter. In addition to tax cuts, a deregulatory agenda and infrastructure spending are designed to make the economy more efficient. “The big growth effect...is supply-side stimulus,” said Kevin Hassett, chairman of the White House Council of Economic Advisers. If he is right, the Fed will not have to push against fiscal policy and the bond market will not rebel, leaving the economy and markets on a higher path. If he is wrong, however, “Trumponomics” could lead to trouble after a brief economic burst.

Below is a recap of this month’s key economic releases:

- **Hourly Wages Rise in Lieu of Cold January Weather** – Total non-farm payroll employment increased by 200,000 in January, and the unemployment rate was unchanged at 4.1%, according to the U.S. Bureau of Labor Statistics. Employment continued to trend up in construction, food services and drinking places, health care, and manufacturing. The reported acceleration in wage growth last month, which triggered the recent market sell-off, was actually nothing more than a weather-related distortion. Bad weather has a disproportionate impact on low-paid workers and their absence artificially raises the average for hourly earnings. In the payroll survey, workers are only counted as employed if they are paid during the survey period. Bad weather also lowers the number of hours worked. The unseasonably cold January explains both the surge in average hourly earnings and the drop in average weekly hours worked. If history is any guide, those distortions will be unwound in February.
• **Consumer Confidence Rebounds Late in January** – Consumer sentiment shot higher the last two weeks as January’s final reading came in at 95.7, which is at the high end of Econoday’s forecast range and up a very sizable 1.3 points from the mid-month preliminary reading. The gain implies a two-week run at roughly 97 which would match recent levels for this index in November and October. But the strength is in future expectations which nevertheless leaves this component at a year-on-year decline of 4.4%. The component for current conditions fell in the month which is a reminder of recent weakness in unit auto sales and which is also not positive for the January retail sales report. Year-on-year, current conditions are down 0.7%. Inflation expectations are steady, unchanged at 2.7% for the year-ahead outlook and up one tenth to 2.5% for the five-year outlook.

• **Q4 GDP Bolstered by Durable Spending** – The 2.6% headline rate does not do justice to fourth-quarter GDP where consumer spending rose a very strong 3.8% that reflects a 14.2% burst in durable spending. Residential investment, which is another consumer-related component, rose at a very impressive 11.6% annualized rate. Turning to business spending, non-residential fixed investment rose at a 6.8% rate which is the fourth straight mid-single digit result. Government purchases, at a 3.0% rate, also added to GDP in the quarter. What pulled down fourth-quarter GDP were net exports, at an annualized deficit of $652.6 billion, and inventories which rose at a slower rate than the third quarter. The Atlanta Fed’s GDPNow real GDP estimate comes in at a robust 4.0% as of February 9, 2018.

• **Boost in Spending Dampered by 13-Year Low in Savings** – Personal income rose 0.4% in December with wages and salaries up a solid 0.5%. Spending also rose 0.4% in December with November revised two tenths higher to a very strong 0.8% gain. Giving a boost to spending but hinting at trouble for the consumer is a one-tenth dip in the savings rate to a 13-year low of 2.4% which follows a sharply downward revised 2.5% rate in November (2.9% initially reported). Price data remain very subdued, up 0.1% for the overall index and up 0.2% for the core which excludes food and energy. Year-on-year, the overall PCE price index is up 1.7% which is one tenth below November while the PCE core price index (the Fed’s preferred guide to inflation is stable at 1.5%.

• **ISM’s Non-Manufacturing Beats Estimates, Manufacturing Slows** – ISM’s non-manufacturing sample is reporting some of the very best conditions in the 20-year history of the series. The composite index rose nearly four points in January to 59.9 which is well beyond Econoday’s high estimate. New orders are arguably more important than any composite result, and the reading, at 62.7, is back at last year’s peak. Employment is a special standout, up more than five points to a very rare plus 60 score of 61.6 which is by far the best of the post-2008 expansion. Overheating must be the concern of ISM’s manufacturing sample where the January index came in at 59.1, a level held down by a slowing in employment which may signal that the sample cannot find enough people to keep up production. Production has been in the mid-60s the past three months leading to slower delivery times which are at 59.1.

• **Strong Housing Reports Despite Dip in Single-Family Starts** – A surprising but perhaps one-time drop in single-family starts masks what is otherwise a very solid housing starts and permits report for December. First the negatives, as starts fell 8.2% to a 1.192 million
annualized rate and reflect an 11.8% plunge in single-family starts to an 836,000 rate that far offsets a 1.4% gain in multi-family starts to 356,000. Starts can be affected by weather which along with related adjustments are always factors for this reading in the winter months. But the backlog behind future starts continues to build as permits came in very strong, virtually steady at a 1.302 million rate and showing a noticeable 1.8% gain for single-family permits to 881,000. Lack of homes has been holding down new home sales though new supply did move into December’s market, as completions for single-family homes jumped 4.3% to an 818,000 rate.

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 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.

Stefan Shaffer
Managing Partner
212.455.4502

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**SUPPORTING DATA**

- **Historical Senior Debt Cash Flow (x EBITDA)**
- **Historical Total Debt Limit (x EBITDA)**

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

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

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

- **Historical Second Lien Pricing**
- **Historical Subordinated Debt Pricing**

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

- **Historical Minimum Equity Contribution**
- **U.S. PE Middle Market Deal Flow by Quarter**

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

**Note:** Prior to November 2017, "< $5.0MM EBITDA" represents "< $7.5MM EBITDA" for senior debt cash flow and total debt limit.