**Deal Component** | **January '17** | **December '16** | **January '16**
--- | --- | --- | ---
Cash Flow Senior | <$7.5M EBITDA 1.5x-2.5x | <$7.5M EBITDA 1.5x-2.5x | <$7.5M EBITDA 1.5x-2.5x
Debt (x EBITDA) | $>10.0M EBITDA 2.75x-3.75x | $>10.0M EBITDA 2.75x-3.75x | $>10.0M EBITDA 2.5x-3.5x
Total Debt Limit (x EBITDA) | $>20.0M EBITDA 3.25x-4.25x | $>20.0M EBITDA 3.25x-4.25x | $>20.0M EBITDA 3.4x-4.0x
Senior Cash Flow | $>7.5M EBITDA 3.0x-4.5x | $>7.5M EBITDA 3.0x-4.5x | $>7.5M EBITDA 3.0x-4.0x
Pricing Bank: L+3.00%-4.50% | $>20.0M EBITDA 4.25x-5.75x | $>20.0M EBITDA 4.25x-5.75x | $>20.0M EBITDA 4.0x-5.50x
Non-Bank: $<10.0M EBITDA L+6.00%-8.00% | $<10.0M EBITDA L+6.00%-8.00% | $<10.0M EBITDA L+6.00%-8.00%
Non-Bank: $<15.0M EBITDA L+4.50%-6.50% (potential for 5.00%-1.00% floor) | $<15.0M EBITDA L+4.50%-6.50% (potential for 5.00%-1.00% floor) | 
Second Lien Pricing (Avg) Bank: L+3.00%-4.50% | $>7.5M EBITDA L+8.00%-11.00% floating | $>7.5M EBITDA L+8.00%-11.00% floating | $>7.5M EBITDA L+9.00%-11.00% floating
$>10.0M EBITDA L+6.50%-8.50% floating | $>10.0M EBITDA L+6.50%-8.50% floating | $>10.0M EBITDA L+7.00%-9.00% floating
$>20.0M EBITDA L+6.00%-7.50% floating | $>20.0M EBITDA L+6.00%-7.50% floating | $>20.0M EBITDA L+5.50%-7.50% floating
Fixed rate options range from a low of 7.0% to 11.0% | Fixed rate options range from a low of 7.0% to 11.0% | Fixed rate options range from a low of 7.0% to 11.0%
Subordinated Debt Pricing | $>7.5M EBITDA 11.00%-14.00% | $>7.5M EBITDA 11.00%-14.00% | $>7.5M EBITDA 12.00%-14.00%
| $>10.0M EBITDA 10.00%-13.00% | $>10.0M EBITDA 10.00%-13.00% | $>10.0M EBITDA 11.00%-13.00%
| $>20.0M EBITDA 10.00%-12.00% | Warrants limited to sub $5 million EBITDA and special situations; | Warrants limited to sub $5 million EBITDA and special situations; | Warrants limited to special situations;
| Second lien may buy down rate to ~9.00%. | Second lien may buy down rate to ~9.00%. | Second lien may buy down rate to ~9.00%.
| Equity co-invests readily available. | Equity co-invests readily available. | Equity co-invests readily available.
Unitranche Pricing | $>7.5M EBITDA L+6.00%-7.50% (0.50%-1.00% floor) | $>7.5M EBITDA L+8.00%-11.00% (0.50%-1.00% floor) | $>7.5M EBITDA L+9.50%-11.00% (100% floor)
| $>10.0M EBITDA L+6.50%-8.50% (0.50%-1.00% floor) | $>10.0M EBITDA L+6.50%-8.50% (0.50%-1.00% floor) | $>10.0M EBITDA L+7.00%-9.00% (100% floor)
| $>20.0M EBITDA L+6.00%-7.50% (0.50%-1.00% floor) | $>20.0M EBITDA L+6.00%-7.50% (0.50%-1.00% floor) | $>20.0M EBITDA L+6.00%-7.50% (100% floor)
| Fixed rate options range from a low of 7.0% to 11.0% | Fixed rate options range from a low of 7.0% to 11.0% | Fixed rate options range from a low of 7.0% to 11.0%
Libor Floors ABL revolver can be arranged outside the Unitranche to arbitrage all-in pricing. | No Libor floor for club bank deals, though still common 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. | Most unitranche lenders allow a small ABL facility outside of the unitranche facility; larger ABL facilities are provided directly by unitranche lenders. | 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.
Minimum Equity Contribution Most lenders are looking for deals to have a 30%-40% base level of equity (inclusive of rollover) in a deal and would like leverage to not exceed 80.0% of the purchase price. Insurance Companies and Credit Opportunity Funds will provide both debt and equity tranches in deals. Family offices are also looking to invest directly and can provide generous returns to sponsor common equity. | Most lenders are looking for deals to have a 30%-40% base level of equity (inclusive of rollover) in a deal and would like leverage to not exceed 80.0% of the purchase price. Insurance Companies and Credit Opportunity Funds will provide both debt and equity tranches in deals. Family offices are also looking to invest directly and can provide generous returns to sponsor common equity. | Most lenders are looking for deals to have a 30%-40% base level of equity (inclusive of rollover) in a deal and would like leverage to not exceed 80.0% of the purchase price. Insurance Companies and Credit Opportunity Funds will provide both debt and equity tranches in deals. Family offices are also looking to invest directly and can provide generous returns to sponsor common equity. | Most lenders are looking for deals to have a 30%-40% base level of equity (inclusive of rollover) in a deal and would like leverage to not exceed 80.0% of the purchase price. Insurance Companies and Credit Opportunity Funds will provide both debt and equity tranches in deals. Family offices are also looking to invest directly and can provide generous returns to sponsor common equity. |
Equity Co-Investment We anticipate this to be one of the fastest growing sectors of the market in 2017, with an increasing constituency comprised of family offices, credit opportunity funds, and insurance companies willing to support management teams, independent sponsors, and traditional equity sponsors from complimentary co-investment to the entire equity stack. Types range from structured preferred to common equity with a promote range from 5.00%-15.00%.
Recap Liquidity Recap deals traditionally get a better audience in the quiet January and February timeframe, but given the increasing level of optimism in the market for greater GDP growth and continued economic strength, liquidity in recap deals should be close to all-time high. While sponsored deals are generally favored, non-sponsored recaps will also find a receptive audience.
Story Receptivity Q1 is almost always the best market to bring challenged or "storied" credits, and 2017 is no exception. The recent recovery in the energy sector (particularly in red) highlights "irrational" dysfunctions, the potential for contagion is high. Story receptivity has sharply declined due to the traditional Q4 market influences (investors are trying to close deals by 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.
Tone of the Market Whether the current level of exuberance in the market is "irrational" remains to be seen, but insurers’ conditions have never been stronger entering 2017; investors from commercial banks to credit opportunity funds are liquid and hungry. While it is difficult to imagine pricing metrics tightening from current levels, everything from greater leverage tolerance to more lenient covenant structure is in play. We kick off 2016 in a very different place than where we were a year ago. Base rates are higher, credit standards are stricter, and pricing for high-risk or leveraged profiles is at a premium. Yields for 144A and public high-risk bonds are approaching the 12.0% range (a new high since 2010). While middle market terms tend to be less volatile in light of high-yield dysfunction, the potential for contagion is high.

*Changes from last month highlighted in red*
“Makin’ my connection as I enter the room
Everybody’s chillin’ as I set up the groove
Pumpin’ up the volume with this brand new beat
Everybody’s dancin’ and they’re dancin’ for me
I’m your operator, you can call anytime
I’ll be your connection to the party line

I’m comin’ up so you better you better get this party started
I’m comin’ up so you better you better get this party started
I’m comin’ up so you better you better get this party started
I’m comin’ up so you better you better get this party started

Get this party started
Get this party started right now…”

“Get the Party Started” - Pink

Get the Party Started

Issuers contemplating an offering in Q1 of 2017 are likely in for a pleasant surprise and though dubbing the current market a “party” might be succumbing to some hyperbole, the metaphor is not far off.

Though the Fed upped the Fed Funds rate a quarter percent in December (the range is now 0.50%-0.75%) and economists expect at least two or maybe even three more in 2017, the most recent minutes from the December FOMC meeting show the Fed is firmly in a sit and watch mode for the time being. Fed members noted “considerable uncertainty” respecting the direction of the Trump administration, on the one hand noting that “the Committee might need to raise the federal funds rate more quickly than anticipated to limit the degree of undershooting and stem a potential buildup of inflationary pressures,” but on the other hand, expressing “the need for caution in evaluating the implications of recent financial market developments for the economic outlook in light of the uncertainty about how federal spending, tax, and regulatory policies might unfold.” In short, the Fed isn’t ready to pull the punch bowl yet and rates remain at historically low levels.

That is not to suggest there has not been any movement in rates; three month LIBOR just recently crested 1.0% for the first time since May of 2009; however, putting this in perspective, three month Libor was at 5.70% in early September of 2007—we are still very much in a low interest rate environment.

While talk of tax cuts, infrastructure investment, decreased regulation, and continued economic recovery have stoked euphoria in the equity markets (e.g. the Dow up and flirting with 20,000), the credit markets are also anticipating an “up-cycle” in credit performance. According to Barclays, corporate spreads anticipate it will be over five years until the next recession, making the current recovery the longest in recent history. In the world of the private capital markets, expectations for continued economic growth translate to increased competition for assets, and consequently, tighter pricing, greater leverage tolerances, and more latitude in covenant structures.

The most recent spate of economic releases certainty lend support to the wave of optimism permeating the credit markets, further stoking expectations for continued economic growth:

- Unemployment Rate in December if 2016 was 4.7% - With 156,000 jobs added in December (down from 229,000 in November), the unemployment rate climbed slightly from November’s 4.6%. On the year, 2016 was marked by slower job growth (2015 averaged 229,000 a month vs. 180,000 for 2016); however, on the positive side, hourly pay jumped 2.9% from a year earlier, while the Participation Rate was flat at 62.7%.
• Consumer Confidence is at its highest level in 13 years - The Conference Board Consumer Confidence Index for December came in at a staggering 113.7—since the election it has jumped 12.9 points. The University of Michigan’s Consumer Sentiment also climbed in December to 98.2 (November was 98.0). The recent gains are rooted in the expected favorable economic impact of a Trump presidency.

• Consumer Confidence isn’t driving higher Consumer Spending however - The Personal Income and Outlays Report of November showed weakness, dropping to 0.2% from 0.4% a month earlier. Retail Sales in November also fell off, declining to 0.1% from a downwardly revised 0.6% in October.

• Q3 GDP was revised upward again, this time to 3.5% - Inflation adjusted Q3 GDP was revised upward from its last revision of 3.2%. Consumer spending was a significant factor, growing by 3.0% (up from 2.7% in the prior estimate)—this is the best growth in two years. The Atlanta Fed’s GDP Now is predicting Q4 GDP growth to be 2.9% (up from 2.5% in late December), suggesting continued strengthening of the economy.

• Inflation is Essentially Flat for December - The headline PCE Price Index and Core PCE Price Index were both unchanged in December, while the core PCE deflator actually declined to 1.6% from 1.8%. The lackluster inflation data provides the Fed greater running room on delaying additional rate increases while the new administration takes over.

• The Manufacturing ISM Index is at a two year high, and the ISM Non-Manufacturing (Services) Index shows continued strength - The ISM Manufacturing Index recorded a two year high of 54.7, suggesting the negative impact of the strengthening dollar continues to fade. Importantly, the strength in the New Orders component suggests continued strength into Q1 2017. The ISM Non-Manufacturing Index held steady at a very healthy 57.2; again, the New Orders component, which increased 4.6 points to 61.6 provides further support of sustained economic growth. Taken together, the reports are consistent with approximately 3.0% annualized GDP growth.

• Existing Home Sales offers hints at what to expect in 2017 - Existing home sales rose a surprising 0.7% to a 5.610 million annualized rate which is a yearly high and well above October’s 5.570 million. Year-over-year rates, which have barely been in the plus column this year, jumped sharply benefiting from easy comparison with November last year when new mortgage documentation rules slowed sales. Still thin, supply fell a very steep 8.0% in the month to 1.850 million which is down 9.3% year-over-year. The median price rose 0.3% in the month to $234,900. Aside from rising prices, rising mortgage rates are another factor that will limit the affordability of resales and with it the strength of next year’s market.

Private Market Update:

Issuers coming into the private capital markets in 2017 are facing a very different environment than those that entered the market in January of 2016. Not only are pricing and leverage metrics more aggressive, but investors also anticipate a credit “up-cycle” characterized by greater economic growth and stronger credit metrics. As noted in the SPP Market Update in January of 2016:

“Credit conditions in the middle market tightened through Q4 2015. The drivers for the reduced liquidity include: (i) continued credit scrutiny by commercial banks due to leverage guidance promulgated by the Fed, OCC, and FDIC; (ii) adverse trading conditions for BDCs (70%+ of publicly traded BDCs are priced at a discount to their net asset value); (iii) a fundamental repricing of risk in the 144A and high-yield markets (driven largely by energy sector dislocation); and (iv) a growing credit perspective that the market are at the beginning of a down cycle of profitability, a potential spike in corporate defaults, and a general deterioration of credit quality (higher leverage, slower EBITDA growth, and downgrades outpace upgrades by a factor of 5.0x).”

Today however, the leverage guidelines are well established in the commercial
banking community, and while most banks lending to the middle market still try to adhere to the “3/4 Box” (3.0x Senior Debt by 4.0x Total Debt) many institutions routinely exceed the guidelines for historical credit relationships, well regarded sponsors, and higher quality issuers. Additionally the BDC community continues to strengthen and is emerging in 2016 as a potent market force after a year of depressed share prices and reduced liquidity. As noted on the BDC Reporter on January 6th:

“A near record 40 of the 45 [publicly traded BDCs] are trading above their 50 Day Moving Average price level and 35 above the 200 Day Average….35 of 45 are trading within 10% of their 52 Week highs.”

Stronger share prices for the BDC community translate to greater access to capital for this lending constituency, and ultimately, more competition for assets, credit spread compression, and enhanced leverage tolerance. While SPP has not changed any of its leverage guidance for January, throughout Q4 2016 we have both reduced our indicative spread levels and increased leverage multiples. It our view at present that pricing has stratified at current levels though there continues to be upward pressure on leverage tolerances.

While it remains to be seen whether the new administration will live up to expectation (i.e. greater infrastructure investment, reduced regulation, lower taxes, and more protective trade policy), for the time being, lenders are anticipating greater earnings and EBITDA growth, and along with that expectation, issuers to the private capital market can expect:

- Continuity of the current spread levels,
- Upward pressure on leverage multiples,
- Greater access for challenged or “storied” credits,
- Increased receptivity for issuers in more cyclical sectors (energy, construction, and retail, etc.),
- More liberal covenant structures (“covenant-lite” for larger syndicated facilities),
- Reduced need for Libor floors, and
- Enhanced interest in structured equity products.

Get the Party Started...

**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
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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 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