**SPP's Middle Market Leverage Cash Flow Market At A Glance**

<table>
<thead>
<tr>
<th>Deal Component</th>
<th>January '18</th>
<th>December '17</th>
<th>January '17</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash Flow Senior</td>
<td>&lt;$5.00 MM EBITDA 1.75x-3.00x</td>
<td>&lt;$5.00 MM EBITDA 1.75x-3.00x</td>
<td>&lt;$7.5MM EBITDA 1.50x-2.50x</td>
</tr>
<tr>
<td>Debt Multiple</td>
<td>$10.0MM EBITDA 2.75x-4.00x</td>
<td>$10.0MM EBITDA 2.75x-4.00x</td>
<td>$10.0MM EBITDA 2.75x-4.00x</td>
</tr>
<tr>
<td>(x EBITDA)</td>
<td>$20.0MM EBITDA 3.25x-4.75x</td>
<td>$20.0MM EBITDA 3.25x-4.75x</td>
<td>$20.0MM EBITDA 3.25x-4.75x</td>
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<tr>
<td>Total Debt Limit</td>
<td>&lt;$5.00 MM EBITDA 3.50x-4.50x</td>
<td>&lt;$5.00 MM EBITDA 3.50x-4.50x</td>
<td>&lt;$7.5MM EBITDA 3.00x-4.50x</td>
</tr>
<tr>
<td>Multiple</td>
<td>$10.0MM EBITDA 4.00x-5.00x</td>
<td>$10.0MM EBITDA 4.00x-5.00x</td>
<td>$10.0MM EBITDA 4.00x-5.00x</td>
</tr>
<tr>
<td>(x EBITDA)</td>
<td>$20.0MM EBITDA 4.50x-6.00x</td>
<td>$20.0MM EBITDA 4.50x-6.00x</td>
<td>$20.0MM EBITDA 4.50x-6.00x</td>
</tr>
<tr>
<td>Senior Cash Flow</td>
<td>Bank: L=3.00%-5.00%</td>
<td>Bank: L=3.00%-5.00%</td>
<td>Bank: L=1.00%-4.50%</td>
</tr>
<tr>
<td>Pricing</td>
<td>Non-Bank: &lt;$7.50MM EBITDA 1.50%-5.50%-8.00%</td>
<td>Non-Bank: &lt;$10.0MM EBITDA 1.50%-5.50%-8.00%</td>
<td>Non-Bank: &lt;$10.0MM EBITDA 1.60%-6.00%-8.00%</td>
</tr>
<tr>
<td>Second Lien Pricing</td>
<td>(&lt;1.00% floor)</td>
<td>(&lt;1.00% floor)</td>
<td>(potential for 0.50% floor)</td>
</tr>
<tr>
<td>(Avg)</td>
<td>&lt;$5.00 MM EBITDA L+7.00%-11.00% floating (1.00% floor)</td>
<td>&lt;$5.00 MM EBITDA L+7.00%-11.00% floating (1.00% floor)</td>
<td>&lt;$5.00 MM EBITDA L+8.00%-11.00% floating (0.50%-1.00% floor)</td>
</tr>
<tr>
<td>Subordinated Debt Pricing</td>
<td>&lt;$10.0MM EBITDA L+6.50%-8.50% floating (1.00% floor)</td>
<td>&lt;$10.0MM EBITDA L+6.50%-8.50% floating (1.00% floor)</td>
<td>&lt;$10.0MM EBITDA L+6.50%-8.50% floating (0.50%-1.00% floor)</td>
</tr>
<tr>
<td>ABL revolver can be arranged outside the Unitranche to arbitrage all-in pricing</td>
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<tr>
<td>Unitranche Pricing</td>
<td>&lt;$5.00 MM EBITDA L+7.00%-11.00% floating (1.00% floor)</td>
<td>&lt;$5.00 MM EBITDA L+7.00%-11.00% floating (1.00% floor)</td>
<td>&lt;$5.00 MM EBITDA L+8.00%-11.00% floating (0.50%-1.00% floor)</td>
</tr>
<tr>
<td>Libor Floors L/24, Libor 1.24, Libor 1.39, and Libor 1.86%</td>
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**Libor floors** Libor 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, Libor floors are not a highly contested matter. To the contrary, may unitranche and mezzanine lenders are now considering Libor "Caps", not floors, to protect issuers from increasing Libor costs (currently ~5%).

**Minimum Equity Contribution** Lenders still want sponsors to have substantive skin in the game, which translates to a 30.0%-40.0% base level of equity (this level is, however, inclusive of any rollover). As a general proposition, new sponsor equity of less than 20.0% will not attract the best terms (though may still get done). There is no dearth of additional capital available to cover for potential equity shortfalls from both equity and debt providers.

**Equity Co-Investment** The market for equity 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 in structuring 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.

**Recap Liquidity** Recap liquidity remains strong going into the fall, though there are some concerns as to the ability for sponsored deals over non-sponsored issuers. Very little pricing discrimination between "pure" recaps and those combined with an accretive use of capital.

**Story Receptivity** Historically, January is the best time of the year to bring a more "storied" credit to market, as there tends to be a dearth of new deal activity early in Q1, and investors have more allocation to roll up their sleeves and dig into a more challenging credit. Given the proliferation of new non-bank lenders in the private market, 2018 will only prove to be more liquid than usual.

**Tone of the Market** After what was likely the most competitive year in market liquidity since the Recession, 2018 is starting off with never having been so optimal issuance conditions. There is an increasing constituency of non-bank lenders and excess capital available for deployment. Fears of a credit "downcycle" in 2018 have in large part dissipated after the passage of the new tax law and expectations for infrastructure improvements. Nevertheless, there is good portion of the market still focused on re-balancing and reducing their risk profiles.

While the market continues to be exceedingly forgiving for storied paper, in general, investors are wary of certain sectors (i.e. brick and mortar retail, casual dining, etc.) and will be looking for yield—possibly even some equity upside—for more challenged credits.

*Changes from last month highlighted in red*
"If you start me up
If you start me up I’ll never stop
If you start me up
I’ve been running hot
You got me ticking gonna blow my top
If you start me up
If you start me up I’ll never stop
Never stop, never stop, never stop

You make a grown man cry
You make a grown man cry
You make a grown man cry
Spread out the oil, the gasoline
I walk smooth, ride in a mean, mean machine
Start it up"

"Start Me Up," The Rolling Stones

**Start Me Up**

It was a seven to two vote but the FOMC, as expected, has indeed lifted its federal funds target by 25 basis points to a 1.25% - 1.50% range, and the Fed is now paying banks 1.5% on their reserve balances. The real news came in the Fed’s outlook for future economic growth. Following the much-anticipated third rate hike of 2017, the Fed is now expecting 2.5% GDP growth in 2018 (up from an earlier 2.1% projection) and expects stronger growth in 2019 - 2020 as well. With the 4.1% unemployment rate already below the Fed’s 2017 forecast of 4.3%, the Fed lowered its projection for 2019 to 3.9%. There was no upward movement in the quarterly FOMC forecasts for next year with three more 25 basis point moves still penciled in to between 2.00% and 2.25%, though here the bias may be to the downside as six members see funds below this rate by the end of next year versus four who see it above the rate. The outlook for 2019 also calls for three similar hikes with two hikes now the call for 2020, up from one previously.

As if the Fed needed validation for the rate hike, inflation continues to edge higher as Consumer Prices (CPI) rose 0.4% in November, which puts it up 2.2% versus a year ago driven largely by energy costs with gasoline prices up 7.3%. Food prices were flat, while “core” prices (which exclude food and energy costs) rose 0.1% last month. Core prices are up 1.7% in the past year, though 1.9% lower than a month ago, dragged down by apparel sales and holiday discounting. Housing costs rose 0.2% in November and are up 2.8% in the past year, while prices for services also rose 0.2% in November and are up 2.5% over the past 12 months. Both are key drivers in the rise of core prices and should continue to push inflation in the months ahead. Both core and total CPI hover at or above the Fed’s 2.0% target and both have been trending higher.

In addition, the Fed will keep reducing its massive balance sheet of Treasury bonds and mortgage securities by $10 billion per month, further reducing its balance sheet by $20 billion in the first quarter of 2018, then by $30 billion in Q2, $40 billion in Q3, and $50 billion in Q4. The Fed will then continue with $50 billion monthly reductions until it is satisfied with the size of the balance sheet; Jerome Powell, who will serve as Fed Chairman beginning in February of 2018, expects it will likely take about three to four years for the Fed to roll off its balance sheet from $4.5 trillion to the $2.5 to $3.5 trillion range. This is the first hard guidance on the length of the unwinding and its degree.

During the press conference following the rate announcement, resigning Fed Chair Janet Yellen said most Fed policymakers had included the probability of tax cuts into their growth and rate forecasts. While most members expect that the Republican tax cuts will drive consumer spending and capital investment (which could spur output over the next few years), other officials believe that companies may be more cautious about making new business investments in response to the

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**Probability of a Rate Hike at March Fed Meeting**

<table>
<thead>
<tr>
<th>Probability</th>
<th>125-150 bps</th>
<th>150-175 bps</th>
<th>175-200 bps</th>
</tr>
</thead>
<tbody>
<tr>
<td>35.0%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>64.7%</td>
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<td></td>
<td></td>
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<tr>
<td>30.0%</td>
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</tbody>
</table>

**Non-Farm Payroll Employment (Seasonally Adjusted)**

**Unemployment Rates (U-3 and U-6)**

**University of Michigan Consumer Sentiment**

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"Start Me Up"

I walk smooth, ride in a mean, mean machine
Spread out the oil, the gasoline
You make a grown man cry
You make a grown man cry
You make a grown man cry
Spread out the oil, the gasoline
I walk smooth, ride in a mean, mean machine
Start it up"

"Start Me Up," The Rolling Stones
tax cuts, instead using the cash windfall for corporate takeovers, debt reduction, and stock buybacks.

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

- **Unemployment Rate Reaches 17-Year Low** – Hiring cooled though employment levels remain very high, and, importantly, there is also a hint of wage inflation in December’s employment report. Non-farm payrolls rose 148,000 which is lower than expected (consensus was ~190,000) but still favorable and enough to absorb new entrants into the jobs market. Revisions are slightly negative with November now sharply higher at 252,000, but October sharply lower at 211,000 for a net 9,000 decline. The number of unemployed actively looking for work rose slightly to 5.308 million with the unemployment rate remaining at a 17-year low of 4.1%. The pool of available workers, which includes those not actively working but nevertheless wanting a job, held little changed at 11.884 million. The labor participation rate is also unchanged, at 62.7%. Wage data shows a little pressure, as average hourly earnings rose a noticeable 0.3% on the month though November gets a one tenth downgrade to only a 0.1% gain. Year-on-year, this reading is moving in the right direction though very slowly, up one tenth to 2.5%.

- **Consumer Confidence Remains Strong, Despite Soft Report** – Consumer sentiment slowed in December, down to a final 95.9 which, compared to the mid-month preliminary reading of 96.8, implies roughly a 95 score for the last two weeks for the softest showing since September. But a positive for the final holiday results is that the current conditions component is firm, at 113.8 versus November’s 113.5. Weakness in December is in expectations which are down 4.6 points to 84.3. Comments on tax reform were split with Republicans calling it a positive and Democrats a negative. Year-ahead inflation expectations, at 2.7%, improved two tenths versus November with five-year expectations unchanged at 2.4%. While levels in this report have been edging lower, they still constitute among the best in 17 years in what points to a strong holiday season for consumer spending.

- **Non-Residential Fixed Investment Leads Q3 GDP Boost** – The third estimate puts third-quarter GDP at a very solid 3.2% annualized rate though the gain is not based on consumer spending which rose at only a 2.2% pace. What held up the quarter was a very solid 4.7% showing for non-residential fixed investment in what was the third straight strong reading for this key measurement of business spending. Other positives included a constructive build in inventories and a nearly as constructive improvement in net exports, as exports rose, and imports fell. Government spending was very soft, at a 0.7% rate, while residential investment contracted sharply, at 4.7% for a second straight sizable decline. But residential investment looks to rise sharply in the fourth quarter given the enormous gains underway in the new home market while fourth-quarter GDP, perhaps also boosted by acceleration in consumer spending, looks to roughly match the third quarter in what would be the third straight 3.0% quarter for GDP.

- **Core PCE Remains Well Below Fed’s Target** – Consumer spending, up 0.6% in November, is strong, but there are still soft spots in the personal income and outlays report. Income rose only 0.3% as transfer receipts from the government fell sharply to offset a respectable 0.4% gain in wages and salaries. And behind the rise in consumer spending is a 1.2% spike in nondurable spending that reflects higher gasoline prices in the month. Durable spending, held down by a slowing in vehicle sales, was unchanged in November though service spending accelerated four tenths to a strong 0.6% monthly gain. Behind all the spending was a sharp three tenths drawdown in the savings rate to only 2.9% which is the weakest showing in 10 years, since November 2007. The central trouble is once again in the report’s inflation data as the core PCE price index, the most closely followed by the Fed of any inflation indicator and which excludes energy and food, inched only 0.1% higher with the year-on-year rate also one tenth higher at 1.5%
and still far below the Federal Reserve's 2.0% target. The overall PCE price index rose 0.2% with this year-on-year rate up two tenths to 1.8%.

- **ISM Manufacturing Rises, Non-Manufacturing Cools** – Headlined by a 14-year high for new orders, ISM’s manufacturing index rose 1.5 points to 59.7 in December. New orders posted their seventh straight plus-60 reading and nearly broke 70 at 69.4 with backlog orders up one point to 56.0 which is very strong for this reading. Backing up the order strength are new export orders which are up 2.5 points to 58.5 which is very strong for this reading as well. Production is up, and inventories are being drawn down. Adding to the headline strength are once again lengthening delivery times which is consistent with demand-related congestion in the supply chain. Input prices remain very elevated. ISM’s non-manufacturing index dropped to 55.9, down 1.5 points from November’s reading. The level is still very favorable with details led by a one-point rise in employment to 56.3. New orders did slow a sharp 4.4 points but also remain well in plus-50 positive ground at 54.2 with new export orders strong at 56.5.

- **Significant Lift to Homebuilder Sentiment, Housing Starts Remain Strong** – New home sales began to surge back in September and are now giving a significant lift to home builder sentiment as the housing market index rose a very sharp five points to a new expansion high of 74. The traffic component is a standout in the December report, surging eight points to an expansion high of 58 to indicate a flood of new buyers in the market. Current sales are up four points at 81 with six-month sales up three points to 79, also expansion highs. Housing starts rose 3.3% in November to a 1.297 million annualized rate and though permits fell 1.4% to 1.298 million, they show a 1.4% gain for the key single-family category to an 862,000 rate. Starts for single-family homes, up 5.3% to 930,000, are the highest of the expansion since 2007.

**Private Market Update:**

Issuers entering the market in 2018 have good reason to be optimistic. Coming off the most aggressive credit market since the recession, 2018 promises to be among the most liquid (i.e. competitive) of environments in the history of the private capital markets. In fact, most of the factors that contributed to the record liquidity conditions of 2017 have only intensified in strength, most prominently, the sheer amount of new capital in the market competing for assets.

Private debt fundraising hit a new record in 2017; as of year-end, it was reported that 126 existing and new credit vehicles raised approximately $98 billion (when the final numbers are calculated, Prequin expects those totals to rise by another 10%). To provide perspective, 2016 and 2015 saw 164 vehicles raising $99 billion and 169 vehicles raising $100 billion respectively. The most prolific amount of fundraising came in the “direct lending” sector, followed by mezzanine, special situations, distressed debt, VC, and fund of funds. The ever-increasing constituency of non-bank senior lenders is putting increasing pressure on the commercial banking community, already in large part marginalized in the leverage lending community by competition from one-stop providers and the influence of Fed/FDIC leverage lending limitations. In fact, business loan growth on banks’ balance sheets now remains below 1.0% (that is down from approximately 13.0% at this time in 2015).

Market metrics remain on the same trajectory established in Q4 of 2017, and given the passage of the new tax law (aka the “Tax Cuts and Jobs Act”) and the Administration’s purported new focus on infrastructure spending, most market participants report only added pressure on lenders and investors competing to deploy capital in 2018; specifically:

- **Pricing Remains at its Lowest Point in a Decade** – SPP continued to lower its pricing indications throughout 2017 and is maintaining its current spread indications in January of 2018. SPP has, however, lowered its “minimum EBITDA” threshold for non-bank pricing from $10 million of EBITDA to $7.5 million of EBITDA in January to reflect the increased...
competition for senior debt among non-bank lenders and their willingness to go down-market to compete for assets. While it is too early in the year to glean much empirical data supporting lower pricing across the credit spectrum, already there has been a minor compression in investment grade spreads (often a bellwether of lower spreads for less credit-worthy issuers) because of increased inflows into the sector.

- **Continued Upward Pressure on Leverage Tolerances** – SPP is increasing its “Total Debt / EBITDA” range in January for issuers with less than $5 million of EBITDA to 3.50x - 4.50x (from 3.25x - 4.50x) and for issuers with greater than $10 million of EBITDA to 4.00x - 5.00x (from 3.50x – 5.00x). In the larger traded credit markets, the trend is the same; Moody’s reports that average leverage on sub-investment grade corporate loans continued to climb into Q4 2017 to 6.50x (up from 6.40x in Q2), the highest since 2014.

- **Deal Flow Remains Robust** – The “excess liquidity” conditions omnipresent throughout 2017 spurred a precipitous uptick in activity. In the middle market, LBO issuance hit a high of approximately $24 billion in 2017 (versus approximately $19 billion in 2016), the highest level of activity since 2007. Again, increased transaction activity was not unique to the middle market; aggregate U.S. syndicated loan volume also jumped in 2017, establishing a new record of approximately $2.5 trillion (yes, trillion).

- **Fears of the “Credit Bubble” Bursting and Anticipated “Downcycle” Have in Large Part Dissipated** – Given the sustained multi-year climb in leverage tolerances and continued reductions in both pricing and credit protections (i.e. “covenant-lite” deals), many market participants predicted a downturn in credit quality going into 2018. While the probability of a recession has in fact slightly increased in the most recent “Probability of U.S. Recession Predicted by Treasury Spread” published by the New York Fed, the absolute level of probability remains at approximately 11.46% for the year ending 2018 (it was over 41.0% in the 2008 - 2009 reporting period). Another indication of the renewed confidence in the current economic cycle can be found in the National Federation of Independent Business (“NFIB”) Business Optimism Index. The December NFIB Index (for November) came in at 107.5 up 3.7 points from the previous month and near the all-time high reached in July 1983. The index is in the 99th percentile of this series. The passage of the new tax law, a renewed effort for infrastructure spending, and record setting stock prices have conspired to affect an almost incendiary level of optimism in the credit markets, quashing much of the talk respecting any downturn in economic activity in the near future.

Notwithstanding the seemingly unbridled euphoria referenced above, there is still a small constituency of lenders/investors taking a diametric track and aggressively “de-risking” their portfolios into Q1 of 2018. SPP’s recent anecdotal experience suggests this re-balancing of risk is taking two distinct directions; first, with respect to existing portfolio assets with higher credit risk profiles, some lenders are actively shedding assets through secondary sales or encouraging issuers into refinancing them out (SPP has been contacted by a number of lenders expressly seeking such refinancing strategies); second, with respect to new portfolio assets, many lenders are declining to participate in purely mezzanine securities, opting instead for a unitranche position, and accordingly, providing themselves superior senior debt rights in the event of a credit downturn. While it is too early to deem this de-risking activity a “trend,” it is definitely a deliberate strategy being employed by an increasing number of market participants and a clear change in tactics from Q4 of 2017.

**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)**

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

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