**Market At A Glance**

January 2019

- **Cash Flow Senior Debt/EBITDA**
  - **< $5.0MM EBITDA**
    - January 2019: 1.75x - 2.50x
    -November 2018: 1.75x - 2.50x
    -January 2018: 1.75x - 3.00x
  - **> $10MM EBITDA**
    - January 2019: 2.50x - 3.50x
    -November 2018: 2.75x - 3.75x
    -January 2018: 2.75x - 4.00x
  - **> $20MM EBITDA**
    - January 2019: 3.00x - 4.50x

**Commentary:** Lenders indicating greater scrutiny to leverage metrics ("late in the credit cycle"), especially for more cyclical sectors.

- **Total Debt/EBITDA**
  - **< $5.0MM EBITDA**
    - January 2019: 3.00x - 4.00x
    -November 2018: 3.25x - 4.00x
    -January 2018: 3.50x - 4.50x
  - **> $10MM EBITDA**
    - January 2019: 4.00x - 5.25x
    -November 2018: 4.00x - 5.00x
    -January 2018: 4.00x - 5.00x
  - **> $20MM EBITDA**
    - January 2019: 4.50x - 5.75x

**Commentary:** Lenders indicating greater scrutiny to leverage metrics ("late in the credit cycle"), especially for more cyclical sectors.

- **Senior Cash Flow Pricing**
  - **Bank**
    - January 2019: L+ 2.50% - 5.00%
    -November 2018: L+ 2.50% - 5.00%
    -January 2018: L+ 3.00% - 5.00%
  - **Non-Bank < $7.5MM EBITDA**
    - January 2019: L+ 4.00% - 6.50%
    -November 2018: L+ 4.00% - 6.50%
    -January 2018: L+ 5.50% - 8.00%
  - **Non-Bank > $15MM EBITDA**
    - January 2019: L+ 4.50% - 6.00%
    -November 2018: L+ 4.50% - 6.00%
    -January 2018: L+ 4.50% - 6.00%

**Commentary:** Abundance of available capital keeping pricing exceedingly competitive.

- **Second Lien Pricing**
  - **< $5.0MM EBITDA**
    - January 2019: L+ 7.00% - 10.00%
    -November 2018: L+ 7.00% - 10.00%
    -January 2018: L+ 7.00% - 11.00%
  - **> $10MM EBITDA**
    - January 2019: L+ 6.00% - 8.50%
    -November 2018: L+ 6.00% - 8.50%
    -January 2018: L+ 6.50% - 8.50%
  - **> $20MM EBITDA**
    - January 2019: L+ 5.00% - 7.00%
    -November 2018: L+ 5.00% - 7.00%
    -January 2018: L+ 6.00% - 7.50%

**Commentary:** Abundance of available capital keeping pricing exceedingly competitive.

- **Sub Debt Pricing**
  - **< $5.0MM EBITDA**
    - January 2019: 11.00% - 14.00%
    -November 2018: 11.00% - 14.00%
    -January 2018: 12.00% - 14.00%
  - **> $10MM EBITDA**
    - January 2019: 10.00% - 12.00%
    -November 2018: 10.00% - 12.00%
    -January 2018: 10.00% - 13.00%
  - **> $20MM EBITDA**
    - January 2019: 8.50% - 11.00%
    -November 2018: 8.50% - 11.00%
    -January 2018: 10.00% - 12.00%

**Commentary:** Abundance of available capital keeping pricing exceedingly competitive.

- **Unitranche Pricing**
  - **< $5MM EBITDA**
    - January 2019: L+ 7.00% - 10.00%
    -November 2018: L+ 7.00% - 10.00%
    -January 2018: L+ 7.00% - 11.00%
  - **> $10MM EBITDA**
    - January 2019: L+ 6.00% - 8.50%
    -November 2018: L+ 6.00% - 8.50%
    -January 2018: L+ 6.50% - 8.50%
  - **> $20MM EBITDA**
    - January 2019: L+ 5.00% - 7.00%
    -November 2018: L+ 5.00% - 7.00%
    -January 2018: L+ 6.00% - 7.50%

**Commentary:** Abundance of available capital keeping pricing exceedingly competitive.

**Tone of the Market**

Two themes dominated the narrative in the private market in 2018:

1. The sheer magnitude of capital in the private market competing for assets (which had profound effects on pricing, leverage metrics, covenant protections, and the definition of "Adjusted EBITDA"); and

2. The mounting fear that the US economy is in the last chapter of the longest recovery in its history and that a recession of some proportion is inevitable within the next 6-18 months.

While the first theme drove deal economics through Q4 2018, the second topic has moved to center stage and is increasingly impacting the way institutional investors scrutinize credit, allocate capital to certain sectors, and structure...
deals. Recent volatility in the equity markets and the reallocation of capital to safer harbors will most certainly impact private market activity and transaction metrics in early 2019. The recent downturn in BDC share prices and growth in commercial bank loans are only the latest evidence of a market going increasingly "risk-off".

Minimum Equity Contribution

| With an increased focus on downside protection, lenders are likely to avoid thinly capitalized deals, especially for sub $10.0 million EBITDA borrowers. Aggregate minimum of 40.0% base level equity (inclusive of any rollover) is required for most deals. As leverage levels creep up in excess of 5.00x, 40.0%-50.0% cash equity (exclusive of rollover) is required. Most lenders discount rollover equity in excess of 20.0%. |

Equity Investment and Co-Investment

| Liquidity for direct equity investment (and co-investment) is still quite robust among insurance companies, family offices, credit opportunity funds, and select SBICs. Most traditional mezzanine funds will also provide up to 20% of their aggregate debt commitment as an additional strip of equity. Capital to support independent sponsors is at an all-time high, with new funds created exclusively to support independent sponsors. 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. Most carry provisions will contain performance contingencies to enhance the initial promote. While structures differ based on the circumstances of each deal, most investors are willing to sacrifice some yield for the liquidity preference. |

Recap Liquidity

| Recap liquidity is strong, with lenders making little distinction between accretive (acquisition) and non-accretive (recapitalization) uses of proceeds; however, sponsored transactions will achieve higher leverage and better pricing for recapitalizations. After declining between 2014-2016, dividend recapitalization activity increased in 2017 and continued to track upwards in 2018 to a four-year high (approximately $30 billion for the year). |

Story Receptivity

| While story receptivity remains high, it is increasingly becoming more “sector selective.” Challenged issuers in more cyclical sectors deemed most vulnerable to macroeconomic volatility are more likely to receive higher pricing, less leverage (i.e. one turn less of EBITDA) and potentially, some equity upside incentive features. The general feeling in the market is that we are near the end of the current credit cycle, and lenders will stress test more marginal credits against less generous macroeconomic conditions. |

LIBOR Floors

| Libor floors are customarily found in non-bank senior loans, second lien, subordinated, and unitranche deals; however, it is becoming less of an issue for senior bank loans in a rising rate environment. When a floor is required, lenders are looking for a minimum 1.00%. |

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“All of the greatest
Greatest of all
Were chasing their fading star
Wanna know who
Who’ll be the latest
The latest to fall?
We’re marching into the dark
I wanna go marching into the dark
All of the greatest
Greatest of all
Were chasing their fading star
Who’ll be the latest
Latest to fall?
Marching into the dark”

*Marching Into The Dark*, John Legend
Marching into the Dark?

As the U.S. Economy continues its 121st month of expansion, the middle market private debt landscape is finally exhibiting signs of an inflection point. Heading into 2019, lenders are becoming increasingly concerned with perceived “red flags” (i.e. inverted yield curve, elevated stock market volatility, continued fed tightening, doubts respecting the sustainability of current unemployment levels), which indicate the twilight of the expansionary economic cycle and the increased probability of a downcycle.

2018 was a year characterized by immense liquidity as the direct lending fund count grew to 5,273 with a total aggregate capital targeted at $1,547 billion. Due to expansion of the available capital pool and competition for transactions, lenders competed on a variety of fronts including compressed spreads, higher leverage metrics, aggressively structured covenant packages, and significant adjustments to EBITDA.

S&P Global Market Intelligence reports that middle-market corporate leverage came in at a decade long high of ~5.50x total debt/EBITDA in 2018. In the fourth quarter of 2018, 25.9% of underwritten EBITDA in M&A transactions was comprised of one-time adjustments. Increasingly, the adjustments to EBITDA were not only "one-time" (at closing), but also were prospective (with future addbacks for one-time costs and acquisitions). Additionally, in an effort to get assets in a competitive market, many lenders went down market with the more aggressive leverage metrics providing lower middle market issuers (sub $7.5 million EBITDA) with the same pricing and terms usually reserved for issuers with greater than $15.0 million of EBITDA.

The risks associated with these market dynamics are pretty simple; assuming conservatively that a 20.0% reduction in EBITDA in a down cycle, a deal executed at 4.00x leverage degenerates to 5.00x leverage, and if the EBITDA adjustments are consistent with the data above (~25.0% of EBITDA is “adjusted”), that same 4.00x deal executed in 2018 will likely become a 6.00x leveraged deal (of actual cash available for debt service) leading to lower fixed charge coverage ratios, tripping of covenants, and inevitably higher default rates. Moody’s Investor Services projects loan recoveries for 1st lien and 2nd lien term loans to decline 16.0% and 29.0%, respectively, in the next recession as higher leverage, weaker covenant protections, and more expansive adjustments to EBITDA not only enhance default risk but reduce potential recovery rates after such defaults.

The lender landscape for middle market issuers is also beginning to change as we head into the later stages of the current credit cycle. Commercial Banks, which have had to operate under the Fed/OCC/FDIC leverage guidelines for the last four years (and don’t have the “toxic” real estate portfolios they held during the last recession) are becoming increasingly competitive. Bank balance sheets continue to grow as loan volumes increase (commercial and industrial loan growth into the fourth quarter of 2018 is up over 10.0% from less than 1% loan growth in the first quarter of 2018). On the other hand, Business Development Companies (BDCs), which had largely marginalized commercial banks by providing competitive unitranche products, have suffered a reversal of fortune as their share prices come under pressure (because of the perceived risk of exposure to middle market issuers). Only 8 out of 44 (18%) of BDCs are trading at or above their Net Asset Value (NAV), while 36 (82%) are trading below NAV, 13 of which are trading at less than 70% of their NAV. On the larger syndicated banking market, non-bank institutional investors are also under increased pressure; leveraged loan outflows between November 21st and December 26th have totaled more than $13.0 billion.

Considering these declining credit dynamics, for January, SPP is lowering its leverage tolerance metrics. Please note we are not predicting a collapse of credit conditions by any measure, only a small contraction among the most aggressive leverage metrics as witnessed in 2018. From
a historical perspective, liquidity conditions remain robust and exceedingly competitive across the private debt capital markets. Not necessarily “marching into the dark” yet, but to paraphrase Bruce Springsteen, there may at least be a “darkness on the edge of town”.

The Macroeconomic Picture

The U.S. Government shut down has entered its second week as a split House of Representatives and Senate continue discussions over budgeting focused on the South Texas border wall. 9 of the 15 federal agencies are affected with 420,000 essential employees of these agencies working without pay and 380,000 furloughed through this week. The implications of a continued government shut down include a delay of tax returns for early filers, decreased household spending, and closing of non-essential Federal funded programs such as National Museums and Parks.

Stock market volatility, a declining manufacturing sector (ISM Manufacturing index at a two year low of 54.1), a decelerating service sector (ISM Non-Manufacturing index down 5.1% month-over-month), and inflation readings coming in soft (PCE at 1.8% in November) have increased investor fear of slowing growth. However, the December jobs report (non-farm payroll at a robust 312,000), and consumer sentiment (98.3 University of Michigan Consumer Sentiment Index in December) indicate there is still runway to grow. These conflicting indicators have made 2019 outlook uncertain for monetary policy, with the Fed signaling two rate hikes in 2019 and the Fed Funds futures market indicating there is a 0% probability the Fed hikes rates in 2019.

The labor force grew by 419,000 last month with wages rising 3.2% year-over-year, the highest gain since 2009. Non-farm payroll came in at 312,000, above expectations of 177,000. Corporate tax cuts have motivated businesses to invest in new employees and expand benefits. U-3 unemployment increased to 3.9% due to the growth in labor force participation and for the first time in history, total U.S. employment eclipsed 150,000,000.

Overall, many indicators point to a cautious outlook headed into a correction soon. A combination of Fed's interest rate hikes in 2018 slowing expansion, rising corporate debt, trade war on the horizon, and conflicting economic indicators point to an uncertain new year. Every economic cycle has peaks and valleys, and conventional wisdom suggests we may be now heading into an inflection point over a peak.

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

**Non-farm payrolls beat expectations and U-3 unemployment rate rises to 3.9%** - Nonfarm payroll came in at 312,000 in December, soaring above expectations of 177,000. U-3 unemployment increased 0.2% to 3.9% in December, impacted by a 419,000 increase to the labor force as wages increase. U-6 unemployment remained constant at 7.6%. Job gains occurred in health care, food services and drinking places, construction, manufacturing, and retail trade.

**Consumer Sentiment edges up heading into the new year** – The University of Michigan consumer sentiment index increased to 98.3 (up 2.5% year-over-year), ending a record year for the index. The average index for 2018 was 98.4, the highest average since the 2000 internet bubble. Headline stock price decline did not seem to have a significant impact on sentiment as it was only mentioned by 12.0% of participants as a primary concern about the economy. Consumers did report lower optimism for job prospects and concern over income with the index of consumers component declining 1.2% month-over-month, and the current economic conditions component increasing 3.4% month-over-
month. Unemployment remains low and consumers are still leaving jobs at a record pace.

*Personal consumption expenditure (PCE) slowed as the Fed raised benchmark interest rates* – PCE declined in November to 1.8% and core PCE excluding food and energy increased to 1.9%. Consistent with prior guidance, the Fed has raised the Fed Funds Target rate range to 2.00%-2.25% to slow growth head off any potential “over-heating” of inflationary influences on the economy. The most recent pronouncements (to the elation of the equity markets) from Fed Chair Powell suggests a more measured monetary policy in months to come, noting, “With muted inflation readings that we’ve seen coming in, we will be patient as we watch to see how the economy evolves. We will be prepared to adjust policy quickly and flexibly and use all or our tools to support the economy should that be appropriate.”

*ISM Manufacturing and Non-Manufacturing Indices suffer major decline in December* – The Institute for Supply Management Manufacturing Index fell to a two-year low of 54.1 (down 5.2% month-over-month), missing expectations and logging the largest month-over-month fall since October 2008. Manufacturers reported increased concern over tariffs, softening customer demand, and cautious outlook headed into a correction. The ISM Non-Manufacturing Index fell to a five-month low of 57.6 in December (down 5.1% month-over-month).

*Building Permits, Housing Starts, and Housing Completions rise due to increased construction investment and moderate weather in November* – Privately-owned housing starts in November beat expectations and jumped 3.2% month-over-month to a seasonally adjusted annual rate of 1,256,000. Starts increased in the Northeast and South but declined in the Midwest and West. Multi-family starts were the main contributor to the increase with a hot 24.9% rise month-over-month to 417,000. Single-family starts had a down month with a 4.6% reduction month-over-month in starts to 824,000. Building permits and housing completions also increased 5.0% and 0.4%, respectively.

Stefan Shaffer
Managing Partner
212.455.4502

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Supporting Data

### Historical Senior Debt Cash Flow Limit (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 Unitranche 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"