### Cash Flow Senior Debt/EBITDA

<table>
<thead>
<tr>
<th></th>
<th>&lt; $5.0MM EBITDA</th>
<th>&gt; $10MM EBITDA</th>
<th>&gt; $20MM EBITDA</th>
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<tbody>
<tr>
<td>July 2018</td>
<td>1.75x - 3.00x</td>
<td>2.75x - 4.00x</td>
<td>3.25x - 4.75x</td>
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<td>July 2018</td>
<td>L+ 2.50% - 5.00%</td>
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<td>L+ 4.50% - 6.00%</td>
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**Commentary:**

Libor floors remain only in syndicated bank or non-bank senior debt, second lien, subordinated, and unitranche deals. Most non-bank senior, second lien, and unitranche lenders are looking for a minimum 2.0% Libor floor but are willing to trade off other economics in exchange (e.g. lower prepayment premiums).
Minimum Equity Contribution

Lenders continue to insist on minimum cash equity contributions and steer away from thinly capitalized deals. As a general proposition, a minimum of 40.0%-50.0% base level of equity *(inclusive of any rollover)* is required. As leverage levels creep up, however (in excess of 5.0x), 40.0%-50.0% equity *(exclusive of rollover)* is becoming the “new normal.” Most lenders discount rollover equity in excess of 20.0%.

Equity Co-Investment

Liquidity for equity co-investments remains robust among insurance companies, family offices, and credit opportunity funds. 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, though not all, carry and promote provisions will be performance contingent. Mezz lenders generally will not exceed 20.0% of their debt investment. While many investors will look for a preferred position and sacrifice some yield for the liquidity preference, most investors are comfortable with a heads-up common position. The universe of committed funds backing independent sponsors continues to grow.

Recap Liquidity

Recap liquidity is as strong as it has been all year, with lenders making little distinction, if any, between accretive versus non-accretive use of proceeds; however, sponsored transactions will achieve higher leverage and better pricing for leveraged recapitalizations.

Story Receptivity

Recent reduction in deal flow is opening capacity for smaller or more challenged credits often overlooked in a more active market. Lower middle market issuers (<$7 million of EBITDA) are achieving spreads and terms historically reserved for significantly larger issuers. Cyclical sectors (e.g. homebuilding and brick and mortar retail) are still being well-received albeit at lower leverage tolerances.

Tone of Market

We end Q2 on a very solid note with leveraged lending at multi-year highs driven primarily by increased M&A activity. Competition for debt assets is fierce, forcing further compression in unitranche pricing. As the market’s true “low cost provider,” commercial bank lending activity continues to increase dramatically after dipping to historic lows in 2017. The traditional “summer lag” has not materialized and given the increased supply of capital that needs to be deployed, it is unlikely that the market will cool off anytime soon.

“I got my red dress on tonight
Dancin’ in the dark in the pale moonlight
Done my hair up real big, beauty queen style
High heels off, I’m feelin’ alive

Oh my God, I feel it in the air
Telephone wires above
Are sizzlin’ like a snare
Honey I’m on fire, I feel it everywhere
Nothin’ scares me anymore

Kiss me hard before you go
Summertime sadness
I just wanted you to know
That baby, you the best

“Summertime Sadness” - Lana Del Ray
Summertime Sadness?

From an issuer’s perspective, the summer of 2018 is turning out pretty great. M&A transaction activity is at its highest level in a decade, spreads remain at historic lows, covenants continue to loosen, and there is no dearth of capital available for acquisitions, leveraged recapitalizations, and refinancings. Even the most marginal and challenged of credits are greeted with surprisingly abundant liquidity.

For most lenders, however, July is ushering in a pronounced feeling of “summertime sadness.” 2018 has been especially cruel to unitranche lenders. For years, the unitranche community feasted at the expense of the commercial banks; they could offer low aggregate yields (due to the Fed’s zero interest rate policy), a “one-stop” solution that obviated the need for a separate junior capital instrument, and the benefit of competing with a foundering commercial bank market wrestling with government-mandated stress tests and ill-defined leverage “guidance” from the Fed, OCC, and FDIC.

Roll that forward to the present day. Already in 2018, the Fed has raised the federal funds rate to its current range of 1.75%-2.0%. Assuming a typical 4.0x leveraged financing: a unitranche cost of L+8.0% today translates to 10.32% (three-month Libor stands at 2.32%). A comparable 4.0x “bifurcated” senior/sub structure with a 3.0x senior bank facility priced at L+3.5% (5.82%) combined with a turn of subordinated debt at 11.0% fixed rate comes to a blended rate of 6.54% (savings of 3.78%). Stated succinctly, the unitranche pricing benefit is over and most issuers are comfortable having a dual lender structure if the savings are significant. Moreover, commercial banks are, for the most part, beyond the risk of “failing” stress tests, and the Fed’s leverage guidance has been successfully inculcated to the standard operating procedures of almost every bank engaged in leveraged lending.

The empirical data more than supports the narrative. Post-recession commercial bank loan growth declined from 12.5% per annum in 2015 to a low of less than 1.0% in Q4 of 2017, and in Q2 of 2018, it has swelled to more than 5.0%. Meanwhile, the average blended spread on unitranche facilities has fallen to a new low of 605 bps in Q2 of 2018, down from 633 bps in Q1 of 2018, and down from 690 bps in 2015 as unitranche lenders struggle to maintain deal flow in light of increased pressure from alternative capital sources.

In light of our own recent anecdotal experience, SPP has tweaked its pricing in July for both unitranche and second lien deals (1.0% less for the outside parameter for smaller deals and 0.5% less for the outside parameter for larger deals). Given the fact that we have continued to reduce spreads (and increase leverage tolerances) through the first half of 2018, we feel no further modifications are necessary at this time.

Notwithstanding the agate in the unitranche lending community, the headline story this month is the good news; specifically, the increased levels of M&A deal activity. According to Dealogic, 2018 is on pace to have the highest dollar volume of LBOs since 2007 and currently stands approximately 44.0% above last year at the mid-year point. Increased M&A activity in turn is driving record activity in U.S. leveraged loan issuance, pushing it to its highest level in the last five years. The horizon is even brighter for middle market players in PE; the percentage of PE funds raised by middle market investors jumped some 56.0% in Q1 of 2018. In short, there is no “summertime sadness” for the middle market sponsor community. They are enjoying enhanced access to capital among the LP community, increasing M&A opportunities, and excess liquidity conditions on a transactional basis.

The Macroeconomic Picture

On July 10th, the White House announced plans to assess 10.0% tariffs on more than $200 billion in Chinese goods, in what is almost sure to become an intractable war of attrition between Washington and Beijing. The proposed tariffs will be assessed on a variety of consumer products, including tuna, salmon and other fish, luggage, tires, dog leashes, handbags, baseball gloves, furniture, apparel, mattresses, electric lamps, and television cameras, among others. The new tariffs will not take effect for at least two months according to administration officials, which gives the U.S. industry time to comment on the products selected for levies.
and the two countries time to begin a new round of negotiations. Hearings on the products are scheduled for August 20-23. The new proposed tariffs would result in aggregate tariffs on Chinese goods of nearly $450 billion, which represents approximately 89.0% of the $505 billion in exports China sends to the U.S. (compared to the $130 billion of goods the U.S. sends to China).

While China has already retaliated with its own tariffs on $34 billion of U.S. farm goods, aircraft, and other items, China does not import enough from the U.S. to match Washington dollar for dollar. As such, Beijing is actively contemplating different forms of retaliation, which include holding up licenses for U.S. firms, delaying approval of mergers and acquisitions involving U.S. companies, and ramping up inspections of American products at borders. China could also devalue its currency, the Yuan, which, unlike the dollar that trades freely on the open market, is managed by China’s central bank. This allows Beijing to intentionally devalue its currency to make Chinese goods cheaper and thus more attractive to international buyers, which in theory could counteract the negative impact of tariffs. If, however, China devalues its currency too much, it could lead to a significant outflow of money from the Chinese economy, which would only exacerbate the country’s existing struggles.

Notwithstanding the talk of tariffs and a potential trade war, it is becoming increasingly difficult to ignore the continued flattening of the yield curve as the Fed continues to raise short-term rates. Traditional economic theory holds that the yield curve is upward sloping (i.e. short-term interest rates are less than long-term rates to compensate investors for expected economic growth and the inflation that comes with it). Lately, though, long-term bond yields have been slow to rise. The gap between two-year and 10-year United States Treasury notes is approximately 0.34 percentage points, which roughly equates to the difference in 2007 ahead of the 2008 recession. As the gap between short- and long-term rates continues to narrow, there is a risk that short-term rates exceed long-term rates, and the yield curve becomes inverted (i.e. downward sloping), which historically has been a strong predictor of recessions. Every recession for the past 60 years has been preceded by an inverted yield curve, according to research from the San Francisco Fed. Curve inversions have “correctly signaled all nine recessions since 1955 and had only one false positive, in the mid-1960s, when an inversion was followed by an economic slowdown but not an official recession,” the bank’s researchers wrote in March. In addition to 2007, another notable yield curve inversion occurred in February 2000, just before the stock market’s dot-com bubble burst.

Though talk of a looming recession may seem pre-mature given that unemployment is at an 18-year low, corporate investment is picking up steam, and consumer spending continues to improve, all these economic indicators are in large part attributable to short-term stimulus from the Trump administration’s tax cut. While the Fed continues to unwind its balance sheet, the sheer amount of government bonds that remain outstanding could continue to force long-term rates down in conjunction with the Fed’s commitment to raising short-term rates. The combination of the two strategies points to a flattening yield curve, which, as previously mentioned, has historically been all but a positive economic indicator.

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

- **Employment Report Remains Strong** – A very healthy employment report that shows brisk growth and also a movement into the workforce is headlined by a stronger-than-expected 213,000 rise in non-farm payrolls for June. A sharp rise in the number of unemployed actively looking for a job, to 6.564 million from 6.065 million in May, lifted the unemployment rate two tenths to 4.0% and also lifted the participation rate two tenths to 62.9%.

- **Healthy Consumer Sentiment Despite Talk of Tariffs** – Tariffs and talk of trade wars may be pulling down expectations, but they are not affecting the consumer’s immediate view. The consumer sentiment index for preliminary June is 99.3, which represents the best showing in two months. In a positive indication for June consumer spending, the current

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### Non-Farm Payroll (Seasonally Adjusted)

![Non-Farm Payroll Graph](source: FRED)

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

![Unemployment Rates Graph](source: Bureau of Labor Statistics)

### University of Michigan Consumer Sentiment

![Michigan Consumer Sentiment Graph](source: FRED)

### Quarterly Change in Real GDP

![Quarterly Change in Real GDP Graph](source: FRED)
Higher-Than-Expected Inflation Causes Q2 GDP Estimates to Dip – Inflation was a little bit warmer than thought in the first quarter, a factor that deflates the third estimate of first-quarter GDP more than expected, which came in at a 2.0% annualized rate. The GDP price index is now at 2.2%. The GDP core, however, remains unchanged in the third estimate at 2.6%. The Atlanta Fed’s GDPNow forecast for Q2 dipped below 4.0%.

Core PCE Hits Fed Target – The most notable surprise is the core PCE price index rose 0.2% on the month, which hits expectations, but jumped two tenths on the year to 2.0%. This hits the Federal Reserve price target, which means inflation is now where the Fed wants it and that there is less of a need to stimulate the economy.

ISM Indices Rally in Face of Tariffs – Business continues to boom for ISM’s non-manufacturing sample where the headline composite came in at 59.1 for June. Forecasts for July may be bumped up given an outstanding showing for new orders, at 63.2 for a 1.7-point gain that was fed by strong acceleration in export orders, up three points to 60.5 and showing no drag from tariff talk (which has so far been centered in goods, not services). Capacity stress, due to robust demand and also tariff disruptions, is a major concern for ISM’s manufacturing sample. ISM’s index, up 1.5 points in June to 60.2, got a boost from long delays in supplier deliveries, up more than six points to 68.2 to signal some of the worst disruptions since the oil crises of the mid-70s.

Housing Starts Likely to Spur Residential Investment – The good news in May’s housing starts report is centered in the present, less so in the outlook. Starts jumped 5.0% in the month to a 1.350 million annualized rate that should give a boost to residential investment in the second-quarter GDP report. Good news also comes from completions, which rose 1.9% to a 1.291 million rate and will help feed a housing market starving for immediate supply.

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"