## SPP’s Middle Market Leverage Cash Flow Market At A Glance

<table>
<thead>
<tr>
<th>Deal Component</th>
<th>June ’15</th>
<th>May ’14</th>
<th>June ’15</th>
<th>May ’14</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash Flow Senior Debt (x EBITDA)</td>
<td></td>
<td></td>
<td>&lt;7.5 MM EBITDA 1.50x-2.00x</td>
<td>&lt;7.5 MM EBITDA 1.50x-2.00x</td>
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<td>&gt;10.00MM EBITDA 2.00x-3.50x</td>
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<td>&gt;20.00MM EBITDA 3.00x-4.25x</td>
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<tr>
<td>Total Debt Limit (x EBITDA)</td>
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<td>&lt;7.5 MM EBITDA 3.00x-4.00x</td>
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<td></td>
<td>&gt;10.00MM EBITDA 3.75x-4.50x</td>
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<td>&gt;20.00MM EBITDA 4.00x-5.00x</td>
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<td>Senior Cash Flow Pricing</td>
<td></td>
<td></td>
<td>L+1.75%-3.50% (bank)</td>
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<td></td>
<td></td>
<td></td>
<td>L+4.00%-6.00% (non-bank)</td>
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<tr>
<td>Second Lien Pricing (Avg)</td>
<td></td>
<td></td>
<td>&lt;7.5 MM EBITDA L+8.00%-11.00% floating (1.00% floor)</td>
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<tr>
<td>Subordinated Debt Pricing</td>
<td></td>
<td></td>
<td>&lt;7.5 MM EBITDA 12.0%-14.0%</td>
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<td>Unitarne Pricing</td>
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<td>Libor Floors</td>
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<td>No Libor floor for most bank deals (some banks offering &quot;Libor Discounts&quot;). Generaly 1.00% for non-bank senior deals, second lien, and floating-rate unitranche (but that could go away when Fed finally &quot;lifts-off&quot;).</td>
<td>No Libor floor for most bank deals. In fact, some deals now contain &quot;Libor Discounts&quot; 1.00% for non-bank deals, second lien, and floating-rate unitranche.</td>
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<td>Mezzanine Opt. Prepayment</td>
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<td>Second lien and unitranche facilities are typically set at 102 in year 1, 101 in year 2, and par thereafter. Subordinated notes generally start at 103; however, provisions will vary depending on the lender. SBICs tend to be stricter on prepayment than BDGs because capital cannot be recycled.</td>
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<td>Minimum Equity Contribution</td>
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<td>25.0%-35.0% total equity (including rollover); minimum 100% new cash combined with rollover or seller notes. Focus continues to be more on aggregate credit metrics (Total Debt/EBITDA, etc.) than on the level of equity contribution. “Promote to Independent Sponsors” will differ but fall in the 5.0%-15.0% range with or without a minimum return to common.</td>
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<td>Banks are generally not stretching on recap deals where leverage is outside the three-four box (3.0x senior debt by 4.0x total debt leverage). Banks are also exceedingly stricter on unsponsored recap. Non-bank and unitranche lenders are still bidding recaps aggressively, while SBICs are split on interpretations of how to treat recaps and the types of recaps that are subject to heightened scrutiny.</td>
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<td>&quot;Too few deals for too much cash&quot; continues to be the lenders’ mantra, and the excess liquidity conditions that have typified the market throughout 2015 may be beginning to show some signs of stress. While the “talk” is that lenders continue to bid very aggressively and drive pricing down and leverage metrics up, the “walk” is not matching up. The biggest change can be found in the BDC community where many funds are trading at a discount to their NAV and quality control is taking an increased significance.</td>
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*Changes from last month in red*
“Do you remember the 21st night of September?
Love was changing the minds of pretenders
While chasing the clouds away

Our hearts were ringing
In the key that our souls were singing
As we danced in the night
Remember how the stars stole the night away

Ba de ya - say do you remember
Ba de ya - dancing in September
Ba de ya - never was a cloudy day”

“September,” Earth Wind and Fire

September

We are now approximately 72 months into the current recovery. To put that in perspective, post-war economic expansions have lasted an average of 58 months. An argument can be made that the Fed’s focus at this juncture should be on what it can do to forestall the next contraction instead of normalizing monetary policy (i.e.-timing of the lift-off).

However, that opinion is clearly a minority position. Conventional wisdom is that the Fed is on schedule for a September rate increase. The weak Q1 GDP report (revised downward to -0.7%) is being discounted as merely the sum of a series of one-time events (i.e.-harsh winter conditions, strong dollar, West Coast port strike, etc.), and recent gains in employment (280,000 new jobs in May) and strong “core” inflation growth (+1.8% CPI year-on-year) are better indications of the current state of macroeconomic strength.

The April FOMC report also provides support for a September lift-off. The minutes reiterate the Fed’s commitment to be “data-dependent.” Much of the weak Q1 data, however, is dismissed as an anomaly and “transitory.” Ostensibly, in an effort to prepare volatile markets for the inevitable rate increases, the minutes noted that Fed officials were confident in their ability to raise interest rates without disrupting financial markets. However, one doesn’t have to go back too far to remember the “Taper Tantrum” in May of 2013 when then Fed Chairman Bernanke set both the equity and bond markets into a tailspin when he first mentioned the idea of gradually reducing or “tapering” the Federal Reserve Board’s monetary expansion.

Those arguing for a delayed lift-off approach found an unusual ally in IMF Managing Director Christine Lagarde:

“We completely agree with Chairman Yellen that the rate hike should be based on data, both inflation-related data and job market-related data. What we are seeing in the data, particularly on inflation, is that the pick-up is very slow and we believe that there is a good argument to actually defer, until early 2016, any rate hike in order to err on the side of having potentially a little bit more inflation than 2.0%, but certainly not having the risk of disinflation and having to then lower the rates when they had just been hiked. So, that’s a policy area where our recommendation is to err on the side of a little bit too much inflation, but certainly support growth pick-up and inflation pick-up a little bit longer than what is currently expected by markets. That’s one policy area where we have a clear sense that we would be better off in early 2016 than in the course of 2015 with a rate hike.”

Like the April FOMC report, Lagarde’s comments acknowledge the headwinds facing the economy in Q1. Rather than marginalizing their impact as “transitory,” however, she cites these same influences as having a profound effect on GDP growth for the full year:

"Remember how the stars stole the night away
As we danced in the night
Our hearts were ringing
While chasing the clouds away

Love was changing the minds of pretenders
21st night of September?"

Do you remember the 21st night of September?

"Including a strong dollar, bad weather...the West Coast labor dispute and the collapse in oil sector investment amid plummeting energy prices...long term unemployment and high levels of part-time workers point to continued slack in the labor market, with wage data showing only tepid growth."

The debate surrounding the timing of a normalization of monetary policy will continue to intensify each new economic release, whether it is positive or negative. Below is a summary of last month’s economic highlights:

- **Consumer Confidence/Retail Sales:** The Conference Board’s Consumer Confidence Index came in at 95.4 for May, which was slightly above consensus and up from April’s reading of 94.3. Consumer Confidence has been robust through 2015 and seems to be stabilizing at its current high level. While Consumer Confidence is strong, that strength has not translated into better Retail Sales. Retail Sales were unchanged in April (below expectation for approximately 0.2% improvement). Excluding the more volatile automobile and gas components, Retail Sales were up 0.2% month-on-month, but still below the expectation of a 0.4% gain. Retail Sales are only up 0.9% year-on-year (versus a 1.7% year-on-year reading in March). Given that consumer spending accounts for roughly two-thirds of GDP, Retail Sales reports are routinely scrutinized as barometers for GDP and macroeconomic strength. It should be noted, however, that the monthly report on Retail Sales actually only covers less than half of all consumer spending (money spent in retail establishments). Other consumer expenditures (services, for instance) are actually much improved. Healthcare spending is up 6.6%, car leasing is up 11.0%, air travel is up 5.5%, and hotel spending is up 7.4%.

- **Inflation:** The Personal Income and Outlays report for April was released on June 1st and showed that the PCE (i.e.-Personal Consumption Expenditures) Price Index was unchanged from the prior month. The Fed’s preferred inflation measure, the Core PCE Price Index (which excludes volatile food and energy costs), rose a meager 0.1% in April. The year-on-year Core PCE Price Index rose 1.2%, well below the 2.0% inflation target set by the Fed. In stark contrast to the April PCE Price Index, the April Consumer Price Index (“CPI”), the other prime measure of inflation, showed core year-on-year inflation at a robust 1.8%. The month-on-month Core CPI Index rose 0.3%, its largest gain since January 2013. The difference between the CPI and PCE readings can be attributed to rising prices in medical costs and housing, two sectors hardly picked up in the PCE Price index. Notably, Core CPI inflation now outpaces the PCE index by the most significant level since the recovery began. On its own, the April Core CPI Index lends hawkish support for a September lift-off.

- **GDP:** Q1 GDP was revised downward to -0.7% in May, which represents a 0.9% reduction to the +0.2% Q1 GDP growth initially reported. The main cause of the downward revision was attributed to a wider-than-expected trade gap resulting from the West Coast port slowdown. Harsh winter weather conditions, the strong dollar, and the trade gap certainly conspired to depress Q1 GDP, but -0.7% is a far cry from the annual GDP growth of nearly 5.0% recorded for the spring and summer of 2014. Expectations were originally that 2015 GDP would stabilize at approximately 3.0%, but those expectations now seem unrealistic and question the advisability of raising interest rates anytime soon. The Atlanta Fed’s “GDPNow” pegs Q2 GDP growth at 1.1%, which is up from 0.8% growth reported on June 1st. That measure is still a healthy discount to the 2.0%-4.0% range of the top 10 and bottom 10 GDP forecasts, and supports a more patient approach to lift-off timing.

- **Manufacturing:** The ISM Manufacturing Index for May came in at 52.8, up from the 51.5 recorded in April. The highlight of the report
was the New Orders component which rose 2.3 points to 55.8, its best reading of the year. In addition to the healthy New Orders component, the Backlog Orders component clocked in at 53.5 (its first reading over 50.0 since February of this year). While a strong dollar continues to plague U.S. manufacturing output, a healthy New Orders component, combined with an improving Backlog Orders component, suggests that the worst may be over. U.S. manufacturing growth may finally be emerging from its slowest pace in almost two years, and that output should improve from here on in.

- **Employment:** Some of the best news for the economy, and further support for a September lift-off, came on the employment front. Employers added 280,000 jobs in May, a healthy bump from the 223,000 recorded in April (which was revised up from an initial reading of 221,000). May showed the strongest gain in nonfarm jobs since December and represents the 63rd consecutive month of growth in private payrolls. The report was solid on just about all fronts, the labor force grew by almost 400,000 (which brought up the Unemployment Rate from 5.4% to 5.5%) and the Participation Rate edged up to 62.9% from 62.8%. Average hourly earnings rose by a respectable 0.3% and year-on-year earnings are up 2.3% (a rate matched only twice during the recovery, and last in August 2013). The employment news only got better when the Labor Department’s Job Openings and Labor Turnover Survey (“JOLTS”), released on June 9th, showed that Job Openings surged to 5.376 million, the highest reading in the history of these reports going back to 2000. Year-on-year job openings are up a dramatic 22.0%. The report is particularly important as it demonstrates that “slack” in the labor market is dissipating and, ostensibly, that employers will have to start to raise wages to fill positions. Rising employment, rising participation, and rising wages should precipitate rising inflation and, ultimately, form a strong argument for normalization of monetary policy.

- **Housing:** Recent data from leading housing market indicators suggests that the U.S. housing industry is poised to rebound from a weak Q1 over the next few quarters. Housing starts increased 20.2% in April, which is the fastest pace since February 1991. Furthermore, new construction permits grew 10.1% to its highest level since 2008. One month will not necessarily translate into any trends, but the 12-month moving average for new construction permits is also at its highest level since September 2008. April new one family home sales increased 6.8% from the previous month (which was higher than expectation) to 517,000. The housing market is often volatile month-to-month but positive recent trends are encouraging and the industry has shown signs of continued and upward progression.

### Private Market Update Notes

A review of current metrics and trends in the private leverage debt capital markets shows little change from last month. There are no quantitative modifications or amendments to the June “Market Update At a Glance.”

Market participants continue to rue the continued dearth of deal flow and, more importantly, the intense competition for those opportunities available for investment. This will likely intensify as we enter the traditionally quiet summer months. Accordingly, the market is still a particularly forgiving one for storied or challenged credits, as well as complex debt and equity products.

One area of particular interest to potential issuers is the increased availability of structured equity assets such as redeemable, participating, exchangeable, and convertible preferred equity structures that sit below unitranche or subordinated debt in the capital stack, but are senior to owner’s common equity. These products are highly customized and case-specific. Structured equity products can contain cash or PIK dividends and detachable warrants.
that provide upside. This hybrid instrument will have yields that are generally at a healthy premium to traditional subordinated debt, but will be significantly less dilutive than a traditional “heads-up” equity investment.

Historically, the use of structured equity instruments was limited to those situations where debt metrics have been maxed out (i.e.-an issuer pro-forma Debt/EBITDA is in excess of 4.5x and there is simply no more available debt capacity). Increasingly, however, structured equity products are being employed by independent sponsors with limited equity capital capacity or to supplement the equity account for management in MBOs. Alternatively, sponsors can avail themselves of structured equity products in lieu of sponsor common, which leaves additional cash to make add-on investments, fund capital expenditures, or simply to enhance the IRR on their initial equity investment. The investor base for these products includes credit opportunity funds, insurance companies, and some business development companies (“BDCs”); and the products can arranged as a stand-alone security or in combination with another level of the capital stack (unitranche or subordinated debt). This is a still a small, but growing, market that can significantly enhance common equity returns.

Although the refrain in the market throughout 2015 has been that “excess liquidity” conditions exist (which many blame for the increase in recent purchase multiples), there are some ominous clouds forming on the horizon. It’s not news that the leverage guidelines imposed by the Fed, FDIC, and OCC have contributed to commercial banks taking a more conservative approach to leverage lending. Recently, however, another major private market lending constituency, publicly traded BDCs, is also taking a markedly less aggressive role in leveraged transactions. A quick review of the top 25 BDCs (as measured by AUM) shows a surprising reduction to their share price in 2015, and many are trading at a pronounced discount to their net asset value (“NAV”). A significant discount to NAV translates into an incapacity to raise additional capital, and greater scrutiny to asset quality. That usually results in a markedly less aggressive posture in the debt markets and, given the magnitude of the capital in the BDC community, could have a materially adverse impact on current liquidity. While there is not much evidence of a massive pullback yet, it is an area that we are closely monitoring.

**SPP Tracked Market Activity**

To paraphrase an old saying, showering April unitranche and non-bank commercial liquidity brings budding May market activity. Despite a series of negative macroeconomic events in Q1, SPP tracked market activity shows that deal activity has rebounded moderately from previous months. In particular, total May exit activity was 106, which channels totals last seen in 2014. Additionally, May total deal count increased 15.9% from April.

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
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 Minimum Equity Contribution

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 Second Lien Pricing

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

U.S. PE Capital Invested by Quarter

Source: Pitchbook