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

**Deal Component** | **June ’16** | **May ’16** | **June ’15**
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Cash Flow Senior | <$7.5M EBITDA 1.50x-2.50x | <$7.5M EBITDA 1.50x-2.50x | <$7.5M EBITDA 1.50x-2.00x
Debt | >$10.0M EBITDA 2.50x-3.50x | >$10.0M EBITDA 2.50x-3.50x | >$10.0M EBITDA 2.00x-3.50x
(x EBITDA) | >$20.0M EBITDA 3.00x-4.00x | >$20.0M EBITDA 3.00x-4.00x | >$20.0M EBITDA 3.00x-4.25x
Total Debt Limit | <$7.5M EBITDA 3.00x-4.00x | <$7.5M EBITDA 3.00x-4.00x | <$7.5M EBITDA 3.00x-4.00x
(x EBITDA) | >$10.0M EBITDA 3.75x-4.50x | >$10.0M EBITDA 3.75x-4.50x | >$10.0M EBITDA 3.50x-4.00x
Senior Cash Flow | >$20.0M EBITDA 4.00x-5.50x | >$20.0M EBITDA 4.00x-5.50x | >$20.0M EBITDA 4.00x-5.50x
Pricing |
Bank: L-3.50%-4.50% | Non-Bank: L-1.75%-3.50% | Non-Bank: L-4.00%-6.00%
Senior |
Bank: L-3.50%-5.00% | Non-Bank: L-1.50%-2.00% | Non-Bank: L-4.00%-6.00%
Subordinated Debt |
Bank: L-3.50%-5.00% | Non-Bank: L-1.50%-2.00% | Non-Bank: L-4.00%-6.00%
Pricing |
Bank: L-3.50%-5.00% | Non-Bank: L-1.50%-2.00% | Non-Bank: L-4.00%-6.00%
Subordination |
Bank: L-3.50%-5.00% | Non-Bank: L-1.50%-2.00% | Non-Bank: L-4.00%-6.00%
Fixed rate alternatives available. Most unitranche lenders allow a small ABL facility outside of the unitranche facility though pricing likely to be impacted by size of revolver if external to unitranche. Capex, acquisition lines, and equity co-investments readily available.
Recap Liquidity |
Recaps are still available, however minority share repurchases (share recaps) are more well received than pure cash distributions (dividend recaps). Cash distributions are still financially possible but will have closer scrutiny on aggregate leverage metrics, level of sponsor’s equity remaining invested, and the sponsor’s capacity to deploy capital back to the issuer if needed. Cyclical sectors are subject to more conservative leverage metrics (<3.50x total leverage).
Receivables |
Recaps are still available, however minority share repurchases (share recaps) are more well received than pure cash distributions (dividend recaps). Cash distributions are still financially possible but will have closer scrutiny on aggregate leverage metrics, level of sponsor’s equity remaining invested, and the sponsor’s capacity to deploy capital back to the issuer if needed. Cyclical sectors are subject to more conservative leverage metrics (<3.50x total leverage).
Story Receptivity |
Slow market activity in Q1 combined with an abundance of freshly minted credit on funds created unusually competitive market conditions and heightened pricing. That may be changing again as activity begins to pick up in Q2. Pricing remains ~10.00%-14.00%.
Tone of the Market |
After a brutally slow Q1, deal activity is picking up; investors report twice the level of new deal flow in May vs. April. For the immediate future, pricing for the better credits remains very competitive and spreads are compressing, but given concerns for a decline in general economic conditions, covenant structures will remain conservative with stricter underwriting standards.

*Changes from last month are in red*
“Stop pretending I don’t care
Comparisons won’t get me
They won’t get me anywhere
We’re all diamonds in the rough
It doesn’t matter what you think
I’m good enough
Climbing up this ladder
And it doesn’t really matter what you say
No matter what it takes
I’m gonna make it yeah I’m gonna find a way

Go on and take your sweet time
It’s just my heart you set aside
I’ve done everything I can
Done everything you’ve asked
D’you think I’ll stand here and wait?
D’you think I’ll fall, think I’ll break?
Think I’ll give up and forget?
Not me, not yet
Not me, not yet
No, not me, not yet
Not me, not yet”

“Not Yet” - Jenn Bostic

**Not Yet**

Though there was a fair amount of speculation in May for a June rate hike, it doesn’t look as though rates will be going anywhere this month.

The minutes of the April FOMC meeting suggested the Fed was on track to raise rates as early as June: “Most participants judged that if incoming data were consistent with economic growth picking up in the second quarter, labor market conditions continuing to strengthen, and inflation making progress toward the Committee’s two percent objective, then it would likely be appropriate for the Committee to increase the target range for the fed funds rate in June.” Those comments (according to CME Group) drove the probability of a June rate hike from approximately 8.0% to about 32.0%.

Against that backdrop, Q1 GDP was revised upward to 0.8% from 0.5%, and with the bump in energy prices, it looked as though inflation was finally gaining momentum; CPI for April jumped 0.4%, supplemented by a 3.4% increase in the energy sub-component. Then, at a Q&A hosted at Harvard on May 27th, Yellen herself noted that the Fed wanted to “gradually and cautiously” increase its benchmark rate which would “probably in the coming months... be appropriate.” Yellen wasn’t the only Fed official to suggest a June uptick was in the offing; William Dudley (NY Fed) stated, “The June-July time frame is a reasonable expectation,” while Fed Governor Jerome Powell also noted, “Depending on the incoming data and the evolving risks, another rate increase may be appropriate fairly soon.” Similar references to a June rate hike were echoed by a host of other Fed officials including Robert Kaplan (Dallas Fed), Dennis Lockhart (Atlanta Fed), John Williams (San Francisco Fed), Eric Rosengren (Boston Fed), Esther George (Kansas City Fed), James Bullard (St. Louis Fed), and Stanley Fischer (Fed Vice Chair).

All the chatter of a June rate uptick came to an abrupt halt on June 3rd however with the release of the May non-farms payroll report. Though expectation had been for approximately 170,000+ new jobs created, employers added only 38,000, and the April report was revised downward to 123,000 (from the 160,000 initially reported). To put this in perspective, the May report represents...
the lowest level of non-farm job creation in five years (since September of 2010). The trailing three month job creation average is now 116,000 (vs. the 212,000 12-month average). While the unemployment rate fell to 4.7% from 5.0%, it was primarily the result of almost a half-million Americans ceasing to look for work and thus technologically not being counted as part of the labor force (i.e. no longer considered “unemployed”). Though some of the downturn can be attributed to the Verizon strike, where 40,000 workers became technically unemployed in May, the slowdown in hiring, combined with the shrinkage of the labor force, represents a negative trend that cannot be ignored. Further evidence of an economic deceleration came, on the same day no less, with the release of the May ISM Non-Manufacturing Index, which shrank to 52.9 from the 55.7 level initially posted in April (it too was revised downward to 55.5).

Suffice it to say, the widely speculated June hike is off the table, with only a 1.9% implied probability as of June 14th, Yellen’s latest pronouncements (to the World Affairs Council of Philadelphia on June 6th) are markedly less hawkish; she conceded that the economic outlook is considerably more uncertain and stresses that monetary policy is “not on any preset course.” While acknowledging that great strides have been made toward the goal of maximum employment, she also noted that “somewhat less progress has been made toward our inflation objective.”

Below is a quick recap of the month’s headline economic reports:

• **Consumer Confidence/Retail Sales:** Notwithstanding the weak employment data, consumer confidence and spending remains robust. The University of Michigan’s Consumer Sentiment Survey released on June 10th registered a healthy 94.3 (down only slightly from the previous reading of 94.7 earlier in the month). In fact, the “current conditions” component jumped almost 2 points to 111.7, one of the biggest gains of the year. That upbeat sentiment is readily apparent in the most recent consumer spending data which leaped 1.0% in April and marked the biggest gain in almost seven years (expectation had been for a 0.7% gain). Auto sales drove the gain, which boosted the durable goods sales component by 2.3%. Spending on services also showed strength, increasing a healthy 0.6% for the month.

• **Inflation:** The PCE Core Index, the Fed’s preferred measure of inflation, rose a humble 0.2% in April, keeping the year-over-year rate flat at 1.6% (well below the Fed’s stated goal of 2.0%). Even with the recent run up in energy prices, the overall PCI Price Index rose only 0.3%, which translated to an anemic 1.1% year-over-year. The Consumer Price Index (CPI) rose 0.4% for the month of April (1.1% year-over-year) and Core CPI rose 0.2% for the month and 2.1% year-over-year. Apparel prices have continued to decline despite a lower dollar, and higher costs of imports had an outsized depressing effect on the index, while service prices (think housing and medical costs) have contributed the most upward pressure.

• **GDP:** Q1 GDP was revised upward to 0.8% (up from 0.5%). The upward revision, while mild, was attributed to growth in residential investment as well as a small uptick in exports (i.e. a weaker dollar). Non-residential investment remains depressed and government services, while up a bit, remained essentially flat. The third and final revision will be issued on June 28th. Q2 GDP is increasingly now the focus and expectations remain for a significant uptick from Q1. The Atlanta Fed’s GDPNow predicts Q2 GDP to be 2.8%, which was recently upgraded from 2.5% as a result of higher than expected retail sales. The GDPNow indication is straight down the middle between the top 10 and bottom 10 economic forecasts.

• **Manufacturing and Services:** As noted above, the ISM non-manufacturing index was an eye opener when it was released on June 3rd—the index dropped from the 55.7 initially reported in April to 52.9. The report’s employment index was its weakest component, falling 3.3 points to 49.7 (anything below 50 demonstrates contraction vs. expansion) and is entirely consistent with the disappointing May non-farm payrolls report. New orders were down as well, dropping 5.7 points to 54.2, the lowest level since February of 2014. On the other hand, the ISM Manufacturing Index, which showed some positive movement in May and climbed higher into expansion...
trend to 51.3 (up from 50.8 in April). The delivery index was the driver, jumping 5.0 points to 54.1 (the rationale is that strong demand leads to greater delays and congestion in the supply chain). Other key metrics for the manufacturing report were essentially flat with new orders down 0.1 to 55.7 (still a solid number) and exports unchanged at 52.5. One glaring negative of the report was the backlog sub-index, which dropped 3.5 points to 47.0.

**Employment**: The headline May non-farm payroll report dominated the economic news of the month as hiring dropped to its lowest level in five years, suggesting that employers are cautious about hiring given the current state of the recovery. While the official unemployment rate (the U-3) dropped to 4.7%, it was almost entirely attributable to the loss of about a half-million workers in the nation’s workforce. The Participation Rate accordingly dropped to 62.6% (down from 62.8% in April). Another less followed gauge of employment conditions, the Labor Market Conditions Index was also weak, coming in at -4.8 points in May (it has been negative for five months now). The current trend is quite worrisome and could project more dire consequences to come; the last 40 years worth of data show it turning negative usually a year or more before the onset of a recession.

**Housing**: Growth in the housing sector has been slow but steady of late. Existing home sales grew 1.7% in April to a 5.45 million annualized number and are up a solid 6.0% from April 2015. Prices have also risen, with the median price 5.0% higher in April, up to $232,500 for a year-over-year gain of 6.3%. These numbers are outpacing growth rates in many other sectors, and the strength in home prices is finally starting to drive more homes into the market (2.14 million in April for a 9.2% gain); however, compared to last year, inventory is still down 3.6%, which is a significant factor slowing sales. Overall, April shows solid improvement with supply relative to sales at 4.7 months vs 4.4 months in the prior two months. The new homes component, volatile as ever, recorded the highest annualized rate since January of 2008, at 619,000, and almost 75,000 higher than February 2015, the next highest rate in the recent cycle; year-over-year, total sales are up 23.8% just like that. Even though low supply will limit future gains, the outlook for housing just got a shot in the arm and will likely lead to conversations around greater contribution from housing to overall economic growth.

**Private Market Update**

Though the pace of deal flow has picked up in Q2, lenders are still exceedingly liquid and hungry for new assets and such is reflected in this month’s pricing indications:

- Senior Cash Flow Bank Pricing reduced 0.50% to L+3.50%-4.50%;
- Senior Cash Flow Non-Bank EBITDA <$10.0MM reduced 0.50% to L+6.00%-8.00%;
- Unitranche Pricing <$7.5MM EBITDA reduced 0.50% to L+8.00%-11.00%; and
- Unitranche Pricing >$10.0MM EBITDA reduced 0.50% to L+7.00%-8.50%.

The reduction in the cost of capital would suggest that the market is not only becoming more competitive on pricing, but more liquid in general—this is decidedly not the case. To the contrary, notwithstanding the tighter pricing environment, investors report their credit committees are becoming more conservative respecting credit review and underwriting. The recent reduction in pricing is really more reflective of a small “flight to quality” as lenders compete aggressively for the more attractive assets. Stated another way, as credit underwriting standards are tightening, lenders would rather take a lower return on a higher quality asset than yield on a lower quality asset.

Not surprisingly, this translates into a less competitive pricing environment for cyclical, storied, smaller, and marginal issuers. Though pricing may be more competitive for higher quality issuers, covenant structure and leverage
tolerances are still subject to greater scrutiny and conservatism. While not a sea change in credit perspective per se, there seems to be an ever increasing constituency underwriting against what they believe to be a more volatile macroeconomic environment and cyclical downturn. Whereas most middle market commercial banks are still comfortable with underwriting to a 3.0x Senior Debt / 4.0x Total Debt leverage profile, factor in a smaller credit (less than $7.5 million of LTM EBITDA), a cyclical sector (automotive, aerospace, construction, etc.), or credit exposure (30.0%+ client concentration) and leverage quickly migrates to a 2.5x Senior Debt / 3.5x Total Debt profile.

Are lenders underwriting against a potential recession? The current data suggests that a recession is still unlikely (Q2 GDP is projected to be 2.5%), but a cyclical downturn is certainly supported by the most recent ISM Manufacturing and Non-Manufacturing reports as well as the headline employment data—this is not lost on any credit committee. As noted above, the Labor Market Conditions Index has been negative for five consecutive months, and it historically has gone negative about a year before a recession. The U.S. has experienced a recession every 6.1 years on average; it has been 8 years since the last one. Historically, if unemployment drops below 5.0% (we’re now at 4.7%) we go into a recession 73.0% of the time (see the “Unemployment Rate and Recession” graph—gray vertical bars represent each recession from 1945 to 2016).

If there is a single take away from this month’s data it is this: if you are planning an issuance in 2016, it is critical to move sooner rather than later. Pricing remains exceedingly competitive for higher quality credits. Even though yields are higher for smaller, cyclical, or marginal credits, deals are still getting done on comparatively competitive terms (this is still a historically low yield environment). If U.S. macroeconomic activity continues to decline, or dips into recession territory, the credit markets will react accordingly—leverage tolerances will compress dramatically, spreads will widen, and the credit markets will be largely closed to those same smaller, cyclical, or marginal issuers.

To repeat, if a 2016 issuance is contemplated for an issuer, it is highly advantageous to get to market sooner rather than later. The risk to not moving forward could prove to be draconian and actually preclude issuance later in the year.

**SPP-Tracked Market Activity**

While April saw exit volume pop versus deal volume, suggesting that sponsors were seeking liquidity in overdue portfolio holdings, May saw the exact opposite. As noted in the “Tone of the Market” section, Q2 2016 is finally starting to experience a recovery in deal volume, and this is supported by May’s 248 deals, up across both the <$500M and <$250M segments. May LTM deal count is still down from 2014 and 2015, but it is headed in the right direction, recording the highest LTM thus far in 2016. Exit volume dipped again in May, but last month’s lofty number meant this was real possibility.

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.

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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 Second Lien Pricing

Historical Subordinated Debt Pricing

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

Historical Minimum Equity Contribution

U.S. PE LMM Deal Flow by Quarter

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

Source: Pitchbook