Borrowers are waking up to a more conservative senior debt, second lien and unitranche structures. Rates tend to be in the ~10.0% funding environment.

Contrary to conventional wisdom, there appears to be an abundance of capital for senior credits in this tightening market. While some attribute the liquidity to investors verging on the more conservative, the reality is that there are a number of new credit funds in the market with an eye toward challenged or challenged credits. Rates tend to be in the ~10.0%-14.0% range.

Credit conditions have tightened into 2016. Banks continue to tighten leverage in commercial banks, BDCs, financial companies and other non-bank lenders report 50+ basis point increases across the board in pricing for senior debt, second lien and unitranche structures. Borrowers are waking up to a more conservative funding environment, especially for issuers with exposure to cyclical sectors.

While recap liquidity is still favorable, it is not as good as it was at the beginning of the year, especially for issuers with no sponsor. The banks are clearly backing off recaps outside the "3/4 box." Some, but certainly not all, SBICs now are interpreting SBA regs to prohibit recap deals as well.

SPP is generally the most competitive constituency.
"Darlin’ you got to let me know
Should I stay or should I go?
If you say that you are mine
I’ll be here ’til the end of time
So you got to let me know
Should I stay or should I go?

It’s always tease tease tease
You’re happy when I’m on my knees
One day is fine and next is black
So if you want me off your back
Well come on an’ let me know
Should I Stay or should I go?

Should I stay or should I go now?
Should I stay or should I go now?
If I go there will be trouble
An’ if I stay it will be double
So come on and let me know"

“Should I Stay or Should I Go” - The Clash

Should I Stay or Should I Go?

That’s the question on the mind of each member of the Fed Open Market Committee in anticipation of the March FOMC meeting.

2016 started with a rash of sub-par economic reports that almost precluded any discussion of additional rate increases; to the contrary, Fed Chairperson Yellen even referenced the topic of a “negative interest rate policy” currently being utilized by the European Central Bank (ECB), the Danish National Bank (DNB), the Swedish Riksbank, and the Swiss National Bank (SNB). However, in light of some recent surprisingly robust macroeconomic releases, additional rate increases in 2016 may be back on the table.

As the minutes of the January FOMC meeting denote, global economic uncertainty and unusually volatile equity market conditions weighed heavily in the decision to suspend additional rate increases after December’s initial rate hike (the first in a decade).

“Several participants noted that monetary policy was less well positioned to respond effectively to shocks that reduce inflation or real activity than to upside shocks, and that waiting for additional information regarding the underlying strength of economic activity and prospects for inflation before taking the next step to reduce policy accommodation would be prudent.”

In short, the Fed’s position was that continued economic deterioration outside the US could amplify the downside risk to the American recovery, and, absent some contrary evidence of continued economic strength in the US, most specifically inflation, future rate hikes would be premature. In her semi-annual report to the House Financial Services Committee Ms. Yellen echoed these sentiments, “Financial conditions in the United States have recently become less supportive of growth…These developments, if they prove persistent, could weigh on the outlook for economic activity.” But perhaps the most definitive statement of the Fed’s reluctance to continue with its initial plan to raise rates as much as 1.0% in 2016 was enunciated by St. Louis Fed President James Bullard (generally considered more hawkish on Fed monetary policy), “It would be unwise for the US Federal Reserve to continue hiking interest rates given the declining inflation expectations and recent equity market volatility…Inflation expectations have fallen too far for comfort making it more probable that inflation itself will fall and continue to miss the Fed’s 2.0% target.”

But all this was before the latest revision to Q4 2015 GDP (revised upward to 1.0% from 0.7%), the most recent spate of inflation reports (Core PCE Price Index at 1.7%, up from 1.4%, the biggest year over year gain since 2012, and Core
CPI at 2.2%, its largest rise since June 2012), and the February Employment Situation report (non-farm payrolls swelling by 242,000). Given the Fed’s stated goals of 2.0% inflation and 5.0% “full employment,” should the market “beware of the ides of March?”

Apparently not; most market participants believe the Fed will not raise rates at the March FOMC meeting, even in light of the marked increases in inflation and a surprisingly robust employment report. According to the latest data released by the CME Group (on March 5th), the implied probability of another 25 basis point adjustment at the March meeting is currently 0.0%, while there is only a 5.1% chance of a 2016 rate hike at all.

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

- **Consumer Confidence/Retail Sales:** How well consumers are spending (and spending for that matter) is a little mixed between a variety of different reports. The Conference Board’s Consumer Confidence Index contracted considerably in February to 92.2 (down from 97.8 in January). At the same time, the University of Michigan’s latest consumer sentiment index rose to 91.7 in late February after falling to a reading of 90.7 earlier in the month (it was still below January’s measure of 92.0). Regardless of consumer sentiment however, consumer spending seems to be on course. Retail sales grew 0.2% in January after rising 0.1% a month earlier. Excluding vehicle sales, retail sales only increased 0.1% in January. The reading, excluding both auto and gasoline, is up 0.4% on the month for a year-over-year rate of plus 3.8%. Given that consumer spending accounts for approximately two thirds of American economic activity, the resilience of the US consumer is critical to continued macroeconomic growth.

- **Inflation:** As noted above, inflation is beginning to gain steam and is increasingly closer to the Fed’s target rate of 2.0%. The Fed’s preferred measure of inflation, the PCE deflator (aka the “PCE Price Index”), inched up 0.1% in January. The Core Price Index (excluding the more volatile food and energy components), jumped 0.3% for the month. The year-over-year gain in the Core PCE Index is even more encouraging, rising to 1.7% from 1.5% the previous month (and constituting the largest year-over-year gain since the beginning of 2013). In short, prices on just about everything are rising, from healthcare and services, to durable goods (up 1.2%), while at the same time energy price reductions are abating. The Inflation reports, while strong, will likely not be enough to drive a rate increase in March, but its continued growth certainly resumess the discussion.

- **GDP:** Real GDP for Q4 was revised upward to 1.0% from the 0.7% initially reported. Though this was a move in the right direction, it was not greeted with much fanfare. The revision was based primarily on higher inventory levels. In fact, the bigger inventory build is bad news for first-quarter GDP growth, as it means businesses will have little incentive to place new orders, which will continue to hold down production. The Atlanta Fed’s GDPNow model forecast for real GDP growth (seasonally adjusted annual rate) in the first quarter of 2016 is 2.2% as of March 4th, up from 1.95% on February 29th.

- **Manufacturing and Services:** The ISM Manufacturing Index for February improved slightly rising to 49.5 from January’s 48.2. Though moving in the right direction, the report still evidences economic contraction, not expansion, and constitutes the fifth consecutive monthly reading below the break-even 50.0 mark. The good news is that the February gain is the second monthly increase in the series since it bottomed out at 48.0 in December. There was also some good news buried under the headline numbers—the new orders component remained unchanged at a respectable level of 51.5; this index had been below 50.0 going into last year. Contraction in backlog orders slowed, which is another plus, though contraction in new orders for exports deepened slightly to 46.5 making for the weakest reading since September. While manufacturing continues to struggle, the greater bulk of the nation’s economy enjoyed a solid February. The February ISM’s Non-Manufacturing report stayed in expansion mode (over 50.0) and increased considerably from January at 57.8 (January was...
53.9). New orders came in at 55.5, down 1 point from January but still very respectable. Additionally, backlog orders continued to expand to 52.0 for a second month in a row. As a general proposition, strength in backlog orders often translates into future strength in employment.

- **Employment:** The Labor Department reported that US employers added a healthy 242,000 workers in February, a marked improvement from the 151,000 initially reported in January (consensus for February had been closer to 190,000). Additionally, the prior two months were revised upward by another 30,000. Retailers, restaurants, and health care providers all contributed to a third consecutive month of solid gains. The unemployment rate (the “U3” rate) held steady at 4.9%, in large part due to increasing numbers in the civilian workforce. It rose by a whopping 555,000 people in February driving the Participation Rate up to 62.9% (up from 62.7% in January). Even the larger U6 unemployment rate, which counts not only those seeking full-time employment (the U-3 rate cited above), but also “marginally attached workers and those working part-time for economic reasons,” fell a full 0.2% to 9.7%. The one glaring negative in the February report is a 0.1% decline in average hourly earnings that follows January’s healthy 0.5% gain. Year-over-year, average hourly earnings are down 0.3% to 2.2%. While likely not decisive, the non-farm payrolls report certainly supports additional speculation for a rate increase at the March FOMC meeting.

- **Housing:** Impressively, existing home sales rose 0.4% to an annual 5.47 million rate in January according to the National Association of Realtors (NAR), which was higher than a year ago by 11.0%. This rise comes even after a 12.1% jump in December, largely attributable to some catch-up from November, which saw the enactment of new closing regulations that delayed many sales. Inventory, however, remains tight—while supply increased slightly in January to four months’ worth of homes, this level is well below the six months supply that is generally considered healthy. Such a constraint is pushing prices higher for the fourth straight month; median price was up 8.2% from January 2015. On the other hand, new home sales dipped a steep 9.2% in January to an annualized rate 494,000 due to a large slump out West. The West, a key region for the new home market, fell 32.0% in January but this was somewhat offset by a sharp increase in the Northeast market and only minor year-on-year contractions in the South and Midwest. Housing starts were down 3.8% in January to an annualized rate of 1.09 million and permits down 0.2% to an annualized rate of 1.20 million, both proving a bit weaker than expected. Multi-family homes remain the core strength for the housing sector with 101,000 new units started in January, up 3.5% from December. This pace suggests housing permits will continue to rise through the year. Construction of single-family homes fell by a steep 9.2% in January to an annualized rate 683,000 due to a large pull back in the South. Such a drop marks a seven month decline in permits in the South and points to an industry struggling with the pace and cost of new construction.

**Private Market Update**

Not surprisingly, private capital market debt participants are beginning to inch up the spreads. SPP’s anecdotal data (deals currently being marketed) suggest that most commercial banks are targeting rates for leveraged deals (i.e. ~3.00x Senior/4.00x Total) in the 4.00%-4.50% range, and that second lien and unitranche lenders are uniformly seeking an additional 0.50% in their base rates. While the Fed’s January 2016 Senior Loan Officer Opinion Survey on Bank Lending Practices provided the empirical support for a tightening lending market, higher pricing, and more conservative leverage metrics had not really taken hold until February. In short, lenders were “talking” about increasing spreads, but not actually bidding higher spreads when pressed (i.e. talking the talk but not walking the walk). This was largely attributable to a particularly slow start to the year in deal flow—but that is changing—palpably, for those of us in the market every day.

Accordingly, SPP is making the following changes to the March Market At A Glance:

- **Senior Cash Flow Pricing:** Bank: L+3.50%-5.00% (= +0.50%-1.00%)
- **Second Lien Pricing:** <$7.5MM EBITDA L+9.00%-12.00% (= +0.00%-1.00%)
- **Second Lien Pricing:** >$10.0MM EBITDA L+7.50%-9.00% (= +0.50%-0.00%)
- **Unitranche Pricing:** >$10.0MM EBITDA L+7.50%-8.50% (= +0.50%-0.00%)

Source: BLS

<table>
<thead>
<tr>
<th>Total Housing Starts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Source: BLS</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Labor Force Participation Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Source: BLS</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Domestic Loan Growth: Large and Small Banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Source: FRED, Ambrose EP</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Market Loan Activity January &amp; February 2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Source: TRLPC, reprinted in Daily Shot</td>
</tr>
</tbody>
</table>
Why now? What’s changed? There are a variety of explanations for the increased pricing/tightening metric phenomena—some attribute it to increased spreads in the loan syndication and high yield markets and to a more general “revaluation of risk;” others attribute it to the perception that the US economy is “cycling down” (slowing EBITDA growth, larger default rates, and increases in downgrade activity). Finally, it could simply be the result of the Fed’s tightening taking hold (the December increase in the fed funds rate, along with the perception of more to come in 2016). While all of these factors are contributing to higher costs of capital, some of the latest pricing increases and contraction in aggregate leverage can also be attributed to middle market banks simply normalizing their rate of loan growth. From July 2014 to January 2016, middle market bank domestic loan growth skyrocketed, jumping from 14.0% to about 30.0% (during this same period loan growth for large banks only increased about 1.0%). Given all the negative credit influence noted above, it was only natural that credit tolerances would tighten and risk capital would be re-priced. That is readily apparent in the reduction of middle market loans in February of 2016. It also can be contributing to the attrition of new loan activity in February.

**SPP-Tracked Market Activity**

February LTM 2016 total deal count is down approximately 32.0% from February LTM 2015 and February 2016 deals and exits continued to drop from January, which saw the lowest deal total in almost two years. However, middle market deal count (<$500M) actually rose slightly from last month, suggesting middle market deal flow continues into 2016 as stable, though still constricted from the numbers seen across 2014 and the first half of 2015.

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

**DISCLAIMER:** The “SPP Leveraged Cash Flow Market At-A-Glance” and supporting commentary is derived by the anecdotal experience of SPP Capital Partners, LLC, its specific transactions, discussion with issuers, lenders and investors consistent with its standard operating practices. Any empirical data specifically derived by third parties, or intellectual property or opinions of third parties are expressly attributed when utilized. The factual information provided has been obtained from sources believed to be reliable, but is not guaranteed as to accuracy or completeness. All data, facts, tables or analyses provided by Governmental or other regulatory bodies are deemed to be in the public domain and not otherwise expressly attributed herein. SPP Capital Partners, LLC is a member of FINRA and SIPC. This information represents the opinion of SPP Capital and is not intended to be a forecast of future events, a guarantee of future results or investment advice. It is not intended to provide specific advice or to be construed as an offering of securities or recommendation to invest.

To unsubscribe to this email, please [click here](#). To request to be added to our distribution list, please [click here](#).
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 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"

**U.S. PE LMM Deal Flow by Quarter**

Source: Pitchbook