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

<table>
<thead>
<tr>
<th>Deal Component</th>
<th>May ’15</th>
<th>May ’14</th>
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</thead>
<tbody>
<tr>
<td>Cash Flow Senior Debt (x EBITDA)</td>
<td>&lt;7.5MM EBITDA 1.50x-2.00x</td>
<td>&lt;7.5MM EBITDA 1.50x-2.00x</td>
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<tr>
<td>Total Debt Limit (x EBITDA)</td>
<td>&lt;7.5MM EBITDA 3.00x-4.00x</td>
<td>&lt;7.5MM EBITDA 3.00x-4.00x</td>
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<tr>
<td>Senior Cash Flow Pricing</td>
<td>L+1.75%-3.50% (bank)</td>
<td>L+2.00%-3.50% (bank)</td>
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<tr>
<td>Second Lien Pricing (Avg)</td>
<td>&lt;7.5MM EBITDA L+8.00%-11.00% floating (1.00% floor)</td>
<td>&lt;7.5MM EBITDA L+8.00%-11.00% floating (1.00% floor)</td>
</tr>
<tr>
<td>Subordinated Debt Pricing</td>
<td>&lt;7.5MM EBITDA 12.0%-14.0%</td>
<td>&lt;7.5MM EBITDA 12.0%-14.0%</td>
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<tr>
<td>Unitranche Pricing</td>
<td>&lt;7.5MM EBITDA L+8.00%-11.00% (1.00% floor)</td>
<td>&lt;7.5MM EBITDA L+8.00%-11.00% (1.00% floor)</td>
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<tr>
<td>Mezzanine Opt. Prepayment</td>
<td>Second lien and unitranche facilities are routinely 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: SIBCs tend to be stricter on prepayment than BDCs because capital cannot be recycled. Though it varies with the lender, there are increasingly no &quot;non-call periods&quot; with a market norm of 3.0% in year one, 2.0% in year two, 1.0% in year three, and par thereafter (SIBCs at 105 in year one and then decline); for second lien unitranche, there are more aggressive prepayment schedules (102, 101, par). Though still subject to negotiation, there are increasingly no &quot;non-call periods&quot; with a market norm of 3.0% in year one, 2.0% in year two, 1.0% in year three, and par thereafter; for second lien and unitranche, there are more aggressive prepayment schedules (102, 101, par).</td>
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<td>Minimum Equity Contribution</td>
<td>25.0%-35.0% total equity (including rollover): minimum 10.0% 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. &quot;Promote to Independent Sponsors&quot; will differ but fall in the 5.0%-15.0% range with or without a minimum return to common. 25.0%-35.0% total equity (including rollover): minimum 10.0% 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. &quot;Promote to Independent Sponsors&quot; 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>Recap Liquidity</td>
<td>Banks are simply not stretching on recap deals where leverage is outside the three-by-four box (3x0. senior debt by 4x total debt leverage) absent compelling circumstances. Banks are also exceedingly stricter on recap deals with no sponsor. Non-bank and unitranche lenders are still bidding recap aggressively, while SIBCs are split on interpretations of how to treat recap deals and the types of recaps that are subject to heightened scrutiny. The recent shake-up in the commercial banking world is having a materially adverse impact on bank funded recaps in excess of the 3x0. by 4x Fed leverage guidelines. There is no such limitation in the non-bank and unitranche communities. Sponsors looking to quickly recap are best served by structuring their initial investment as common shares, combined with a preferred or subordinated tranche, and positioning a subsequent recap as a refinancing. Increased deal flow into the market has made competition for assets a little less fierce; however, liquidity still far exceeds deal flow and &quot;storiied&quot; paper is still getting a good audience. Market activity tends to slow down in the summer, which translates to a greater audience for more challenging credits.</td>
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<td>Story Receptivity</td>
<td>Story receptivity is very high as a dearth of activity in the market is creating opportunities for more challenged credit stories. Greatest audience for “storiied paper” is going to be found among the unitranche community where lenders can get the benefit of a senior position on the assets (no risk of subordination) but gain higher rates of return commensurate with the higher risk profile. A surplus of liquidity combined with a dearth of new deal flow has created a window to execute more challenging credit stories. A number of &quot;distressed funds&quot; have been created to take advantage of the drop in valuations in the energy sector with a specific focus on oil and gas service businesses—but the anticipated inventory has not materialized to date.</td>
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<td>Tone of the Market</td>
<td>Market conditions continue to favor the issuer (big time) as a lack of deal flow combined with excess liquidity conspire to create a broad array of financing options across the middle market. Increased capital and a variety of new participants in the non-bank senior and unitranche lending constituencies are creating a much broader marketplace for smaller, more storied issuers. Pricing is holding for now, but stay tuned... The sponsor community is getting accustomed to a less aggressive banking community and the clear beneficiaries of the bank pullback are the non-bank commercial lenders and the unitranche providers. New non-bank lenders are emerging weekly; the most notable recent entrant is TIAA-CREF’s Churchill Alternative Management, which could signal a concerted push into the leveraged markets by the major insurance companies. Q2 market conditions remain in excess liquidity mode. Slight pullback by the commercial banks combined with increased inflows to BDCs and credit opportunity funds have made unitranche structures ubiquitous in the market. With the advent of significantly greater participation of unitranche financing comes new inter-creditor challenges among participants and ABL lenders funding the revolving credit component of a unitranche loan.</td>
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*Changes from last month in red*
So now don’t get me wrong
This is not a sad song
Just events that I have happened to witness
And time takes its toll as we head for the poll
And no one dies from physical fitness
So what the hell, we’ll take it right to the end
As the days grow more complicated the nightlife still wins

I’m growing older but not up
My metabolic rate is pleasantly stuck
Let those winds of time blow over my head
I’d rather die while I’m living than live while I’m dead
Let those winds of change blow over my head
I’d rather die while I’m living than live while I’m dead.

“Growing Older But Not Up,” Jimmy Buffett

Growing Older But Not Up

Almost six years (since June 2009) into what has been the frailest recovery in modern history, and GDP is still struggling to stay in positive territory. The first estimates for Q1 2015 GDP came in at a meager 0.2%; with the release of the international trade deficit for March (a higher than expected -$51.4 billion, the largest deficit since October 2008), it is widely accepted that the next revision will put Q1 GDP in the negative territory (i.e. - the economy actually contracted in Q1).

Clearly, there is an abundance of data that suggests that the most recent contraction in economic growth is event-driven and transitory (harsh Q1 weather conditions, continued strength of the U.S. dollar, unwinding of the port strike on the West Coast), and that Q1 GDP is an outlier (after all, Q1 2014 GDP was -2.1%, only to be followed by an average GDP growth +4.8% for Q2 and Q3). However, the expectation that the Fed will forestall any lift-off from its current zero interest rate policy until later in the year has certainly been reinforced.

Not surprisingly, the FOMC’s latest release (released April 30th) focused on current “economic weakness” and acknowledged that economic conditions have “slowed” since its March meeting and “moderated” since January. In respect to the description of specific economic sectors in April:

- **Labor Conditions**: Changed from “Improving” in March to “Moderating” in April.
- **Household Spending**: Changed from “Rising Moderately” in March to “Declining” in April.
- **Business Investment**: Changed from “Advancing” in March to “Softening” in April.
- **Exports**: Changed from “Weakening” in March to “Declining” in April.
- **Housing**: “Slow” in both March and April.
- **Inflation**: “Running Below Target” in both March and April.

While there were no explicit statements respecting lift-off timing, consensus is that a June interest rate hike is very unlikely given the totality of the adverse economic data. As noted above, however, much of the bad news results from one-off events and ephemeral factors; the Fed is clearly of the opinion that as the year progresses, economic activity will expand at a stronger pace.

Fed lift-off discussion, however, is increasingly focusing on the current
interest rate policy's effect on the investment markets and not just on each month's macroeconomic reports. On March 6th, during a Q&A with Christine Lagarde (Managing Director of the IMF) at the Finance & Society Conference (sponsored by the Institute for New Economic Thinking), Federal Reserve Chairwoman Janet Yellen responded to whether current interest rate policies were creating a bubble:

“I would highlight that equity-market valuations at this point generally are quite high...Now, they’re not so high when you compare the returns on equities to the returns on safe assets like bonds, which are also very low, but there are potential dangers there.”

Below is a summary of the last month's economic highlights:

- **Consumer Confidence/Retail Sales:** The University of Michigan's Consumer Sentiment Index for April came in at 95.0 (unchanged from mid-month April, and a nice improvement over a March index of 93.0). The two headline components, “current conditions” and “expectations,” both recorded nice gains at 107.0 (up 2.0 points from March) and 88.8 (up 3.5 points from March), respectively. Some of that confidence was reflected in the March Personal Income and Outlays report, which showed consumer spending up 0.4% for the month (up 3.0% from a year ago); however, the report also demonstrated that consumers still remain cautious in their purchasing habits notwithstanding lower prices at the pumps. This is a key metric for the Fed, as consumer spending accounts for roughly two-thirds of GDP. This is good news for Detroit because the gain in spending was positively impacted by purchases of big ticket items, like automobiles. Consumer confidence is positively impacted by lower gas prices, even if that extra cash hasn’t translated into increased retail sales. Correspondingly, consumer confidence will presumably suffer as gas prices rise. That correlation already appears to be in the process of evidencing itself.

- **Inflation:** The Consumer Price Index (CPI) rose 0.2% in March, with every sub-component showing rising prices. Over the last 12 months, however, this “all-items” index actually declined 0.1% before a seasonal adjustment (which was attributed to the reduction in energy costs over the last year – a decline of 18.3% for the period). Core CPI (which excludes the more volatile food and energy prices) also rose 0.2% in March, but showed a gain of 1.8% for the last year (not too far from the Fed's publicly stated goal of 2.0%). The airline industry is especially concerned, as the index for airline fares declined for the fourth time in the last five months.

- **GDP:** As discussed above, Q1 GDP came in at a very paltry 0.2% and was attributed, in large part, to the hostile weather conditions and strong dollar. In fact, exports were the heaviest drag on Q1 performance and dropped at a 7.2% annual rate, which reflected the reduced foreign demand for more costly U.S. products. That light gain of 0.2% will likely fall below zero when factoring in the higher-than-anticipated trade deficit that hit $51.4 billion. However, that deficit was heavily influenced by the unwinding of the port strike on the West Coast; almost $17.1 billion was reported as port backlogs were cleared. Giving full effect to the latest the trade deficit release, it is likely that GDP contracted 0.3% for Q1 2015. Now all eyes turn toward Q2 2015. Estimates vary dramatically and most commentators anticipate a bounce-back with more normalized GDP growth in Q2. However, given the continued strength of the dollar and continued sluggishness in manufacturing, current predictions fall short of the robust GDP growth recorded in Q2 2014 when GDP jumped to 5.0%. The Atlanta Fed’s GDPNow model (which accurately predicted the 0.1% Q1 GDP growth) pegs Q2 GDP growth at 0.8% (as of May 5th), which is significantly below the Blue Chip consensus range of 2.6%-4.3%.
• **Manufacturing**: The ISM Manufacturing Index for April came in at 51.5, unchanged from the March ISM index. On the bright side, the new orders component rose, up 1.7 points to 53.5, and export orders came in above 50.0 (i.e. - expansion, not contraction) for the first time in 2015. On the down side, the employment sub-index dropped 2.0 points to 48.3 (a month-on-month contraction). While a drop in the employment sub-component by itself is not shocking, the magnitude of the contraction, in light of the revised weak March unemployment report (85,000) is very surprising. This was the lowest reading since September 2009. Factory orders for March grew 2.1% and were positively influenced by aircraft and motor vehicle sales. The gain in March ended seven consecutive declines in the manufacturing reports (but provided a stark reminder of the magnitude of negative impact on exports from a strong dollar).

• **Employment**: U.S. employers added 223,000 jobs in April, a solid gain over the anemic 85,000 jobs recorded in March (which was revised downward from the 126,000 jobs initially reported), and a clearly positive development for this key driver in determining Fed policy. The nonfarm payroll increase was consistent with expectation and likely not a particularly momentous release. Among the good news, the Labor Department also reported that the Unemployment Rate fell to 5.4% from 5.5% in March, *which is the lowest level since May 2008*. In other positive developments, the Participation Rate crept up from 62.7% to 62.8%. There was a downtick in manufacturing hours; manufacturing employment remained dormant for the third month in a row, up only by 1,000. The new numbers, combined with the March downward revision, resulted in a three month average monthly increase of only 191,000 positions, which is a dramatic reduction from last year's monthly average of 260,000. While the nonfarm payrolls report is solid, it will not likely alter the expectation that lift-off is, at best, a Q3 or Q4 event.

• **Housing**: News on the housing front continues to get better. The adjusted Case-Shiller 20-City Index rose a very robust +0.9% in February, which was higher than the expectation, and the best metric recorded since late 2013. All 20 cities in the index showed gains with no declines since September 2014. Higher prices translate to greater equity value and, ostensibly, better inventory as owners become more sanguine about putting their homes on the market. Existing home sales also saw a nice rebound in March, growing 6.1% from February (a 5.19 million annual pace, the best since September 2013). This puts sales up 10.4% from a year ago, and portends a robust spring sales season.

**Private Market Update Notes**

Private market liquidity conditions are becoming increasingly favorable to issuers as lenders continue to compete for a decidedly smaller pool of assets. Though banks have taken a pronounced step back from the leveraged lending marketplace due to the heightened regulatory guidance promulgated by the Fed, OCC, and FDIC, there has been a veritable explosion of non-bank lenders stepping into the void. If you think nature abhors a vacuum, take a look at the amount of new capital flowing into non-bank funds. Insurance companies and pension funds are becoming a greater part of the leveraged finance private capital landscape and the continued flow of capital into existing and new BDCs continues unabated.

SPP’s own anecdotal experience is particularly compelling. Road show attendance for the most recent set of financings is up approximately 40% in 2015 as lenders across the private capital spectrum vie for assets. A typical 4.0x-4.5x total leverage ask will result in bids from four distinct combinations of lender constituencies:
Senior Commercial Bank combined with a Subordinated Debt Fund (SBC, BDC, Traditional Mezz LP, or Credit Opportunity Fund);

Non-Bank Senior Lender (BDC, Commercial Finance Company, or Credit Opportunity Fund) combined with a Subordinated Debt Fund;

Unitranche Lender (BDC, Traditional Mezz LP, or Credit Opportunity Fund); and

Unitranche Lender combined with an Asset-Based Revolving Credit Facility that is provided by a Commercial Bank.

In short, in this market, for any widely distributed financing, there is a multitude of competing debt providers both within a specific lending constituency, and among different lending constituencies. An increasing number of lenders are willing to participate in different levels of the capitalization in a given deal.

Thus far, we have not witnessed a marked compression in pricing for leveraged transactions, but that might emerge as lenders with lower cost of capital (i.e. - insurance companies and pension funds) continue to join the private middle market leveraged lending community. However, we have seen a greater tolerance for risk as lenders seeking yield drop deeper in the lower middle market (sub $7.5 million EBITDA), source assets in out-of-favorable sectors (FIG, Energy Services, etc), or raise leverage metrics (3.5x senior leverage/5.0x total leverage).

SPP Tracked Market Activity

A frigid winter has left many awaiting the annual promise of warmer and hotter months to come. Similarly, despite a slow beginning to 2015 and decline in recent market activity, many are anticipating a thaw to relieve the bitterness that nipped the private capital market. SPP tracked activity presents several positive trends: (i) Private equity firms report greater emphasis on building their current portfolios through add-on acquisitions; (ii) increased activity is emerging in carve-out transactions; and (iii) rising valuations are spurring some sellers in the middle and lower middle market to consider a sale, perhaps earlier than initially planned.

Total deal and exit counts this month remained fairly low at 113 and 20, respectively. However, small deal sizes did not drop considerably from previous months.

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)**

![Graph of Historical Senior Debt Cash Flow (x EBITDA)](image1.png)

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

**Historical Total Debt Limit (x EBITDA)**

![Graph of Historical Total Debt Limit (x EBITDA)](image2.png)

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

**Historical Senior Cash Flow Pricing (Bank)**

![Graph of Historical Senior Cash Flow Pricing (Bank)](image3.png)

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

**Historical Senior Cash Flow Pricing (Non-Bank)**

![Graph of Historical Senior Cash Flow Pricing (Non-Bank)](image4.png)

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

**Historical Second Lien Pricing**

![Graph of Historical Second Lien Pricing](image5.png)

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

**Historical Subordinated Debt Pricing**

![Graph of Historical Subordinated Debt Pricing](image6.png)

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

**Historical Minimum Equity Contribution**

![Graph of Historical Minimum Equity Contribution](image7.png)

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

**U.S. PE Capital Invested**

![Bar Chart of U.S. PE Capital Invested](image8.png)

Source: Pitchbook