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

<table>
<thead>
<tr>
<th>Deal Component</th>
<th>May ‘16</th>
<th>April ‘16</th>
<th>May ‘15</th>
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</thead>
<tbody>
<tr>
<td>Cash Flow Senior</td>
<td>&lt;$7.5M EBITDA 1.50x-2.50x</td>
<td>&lt;$10.0M EBITDA 2.50x-3.50x</td>
<td>&lt;$7.5M EBITDA 1.50x-2.00x</td>
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<tr>
<td>Debt</td>
<td>&lt;$20.0M EBITDA 3.00x-4.00x</td>
<td>&lt;$20.0M EBITDA 3.00x-4.00x</td>
<td>&lt;$25.0M EBITDA 3.00x-4.25x</td>
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<tr>
<td>Total Debt Limit</td>
<td>&lt;$7.5M EBITDA 3.00x-4.00x</td>
<td>&lt;$10.0M EBITDA 3.75x-4.50x</td>
<td>&lt;$7.5M EBITDA 3.00x-4.00x</td>
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<tr>
<td>Senior Cash Flow</td>
<td>Bank: L+3.50x-5.00x</td>
<td>Bank: L+3.50x-5.00x</td>
<td>Bank: L+1.75x-3.50x</td>
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<tr>
<td>Pricing</td>
<td>Non-Bank: &lt;$1.0MM EBITDA L+6.50x-8.00x</td>
<td>Non-Bank: &lt;$15.0MM EBITDA L+4.50x-6.50x</td>
<td>Non-Bank: L+4.00x-6.00x</td>
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<tr>
<td>Second Lien Pricing</td>
<td>(Avg)</td>
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<td></td>
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<tr>
<td>Subordinated Debt</td>
<td>&lt;$7.5M EBITDA L+9.00x-12.00x floating</td>
<td>&lt;$10.0M EBITDA L+7.50x-9.00x floating</td>
<td>&lt;$7.5M EBITDA L+8.00x-11.00x floating</td>
</tr>
<tr>
<td>Minimum Equity</td>
<td>L+11.00x-13.00</td>
<td>L+10.00x-12.00x</td>
<td>L+12.00x-14.00</td>
</tr>
<tr>
<td>Co-investment</td>
<td>Fixed rate alternatives available. Most unitranche lenders allow a small ABL facility outside of the unitranche facility to be inticketed by size of revolver if external to unitranche. Capex, acquisition lines, and equity co-investments readily available.</td>
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<tr>
<td>Equity Co-Investment</td>
<td>“Market” terms for equity products (structured and common) are increasingly more stratified. On “heads-up” terms, larger promissors (15.00x and catch-up) are limited to “value” acquisitions (low multiple), material co-investment positions (25.00x of equity contribution), willingness to fund deal expenses, and “value-added” relationships (expertise in sector). Structured redeemable preferred tranches are routinely invested alongside mezz or unitranche debt.</td>
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<tr>
<td>Libor Floors</td>
<td>No Libor floor for club bank deals. Generally 100% floor for large syndicated bank facility and non-bank senior deals. Recently seeing pressure by unitranche lenders to increase Libor floors to 1.50%.</td>
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<tr>
<td>Minimum Equity Contribution</td>
<td>Acquisitions need 25.00%-40.00% total equity (inclusive of rollover); minimum 10.00% new cash combined with rollover or seller notes. The market continues to be sensitive to “thin capitalization” and will seek greater equity cushion in cyclical sectors and challenged credit stories. Fortunately, there is significant (and growing) interest in structured equity products to supplement equity contributions from independent sponsors, management teams, etc.</td>
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<td>Recap Liquidity</td>
<td>Recaps are still available, however minority share repurchases (share recaps) are more well received than pure cash distributions (dividend recaps). Cash distributions are still financed 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 (&lt;3.50x total leverage).</td>
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<tr>
<td>Story Receptivity</td>
<td>Slow market activity in Q1 combined with an abundance of freshly minted credit op funds created unusually competitive market conditions and heightened liquidity for structured/challenged tranches, notwithstanding a perceived “down cycle” in credit overall. That may be changing as activity begins to pick up in Q2. Pricing remains ~10.00%-14.00%.</td>
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<tr>
<td>Tone of the Market</td>
<td>2016 market conditions continue to surprise. In January, credit tightening was anticipated, and spreads crept up, but by the end of February, sluggish market activity prompted previously apprehensive lenders to get more competitive with pricing and terms loosen. That may be changing again as we enter May, with increased activity providing lenders the opportunity to be more selective and potentially tighten again. Banks are simply not stretching on recap deals where leverage is outside the three-four-bank (3.0x senior debt by 4.0x total debt leverage) acceptable circumstances. Banks are also increasingly strict on recaps with no sponsor. Non-bank and unitranche lenders are still bidding recaps aggressively, while 50-60% are split on interpretations of how to treat the terms of recaps that are subject to heightened scrutiny.</td>
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| *Changes from last month are in red*
The market keeps on crashin’
Tattered jeans are back in fashion
‘Stead of records, now it’s MP3s

I tell you one more time with feeling
Even though this world is reeling
You’re still you and I’m still me

I didn’t mean to cause a scene
But I guess it’s time to roll up our sleeves

The more things change
The more they stay the same
The same sunrise
It’s just another day”

“The More Things Change”- Bon Jovi

The More Things Change...

The more they stay the same.

For the third consecutive time this year, the Federal Reserve chose not to raise rates. Not surprisingly, the April FOMC meeting ended with keeping the target range for the Fed Funds rate at 0.25%-0.50%, with nine out of the 10 Fed policy committee members supporting the decision. Only Esther George of the Kansas City Fed dissented (as she did in March); she wanted to see a 0.25% uptick in rates immediately.

Though rates were not increased, the Fed Statement did contain some minor distinctions from prior statements that can be interpreted as both hawkish and dovish, but as a practical matter did not provide much guidance respecting a rate increase at the next FOMC meeting in June. Specifically (and with a nod to the doves):

- growth in economic activity “appears to have slowed,”
- growth in household spending was “moderating,” and
- exports and business investment was “soft.”

By the same token (and with a tip to hawks):

- “labor market conditions have improved,”
- household real income was rising “at a solid rate,” and
- consumer sentiment remains “high.”

If there is one decidedly hawkish aspect to the April statement it was the removal of “global economic and financial developments” as downside risks to the economy. Instead, the April Statement notes that the “Committee continues to closely monitor...global economic and financial developments.” The market take-away from the April FOMC Statement is that a June rate hike is off the table for now. According to the CME Group as of May 6th, the fed funds futures market showed only less than a 6.0% implied probability that the Fed will raise rates at the next FOMC meeting scheduled for June 14th.

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

- **Consumer Confidence/Retail Sales:** Though the April FOMC statement says that consumer sentiment remains high, the most recent University of Michigan Consumer Survey suggests otherwise. The Sentiment Index for April fell to 89.0 from 91.0 in March. This is the *lowest level* of consumer sentiment since September of 2015 and is a product of a downturn in the...
“expectations” component which fell four points to 77.6. The Conference Board’s measure of Consumer Confidence for April shows a similar pattern; in April the measure of consumer confidence fell to 94.2, down two points from the March reading of 96.2. Again, the downward trend can be attributed to the “expectations” component, which fell 4.3 points to 79.3 (the lowest reading in expectations since November of 2013). The most recent retail sales report also reflects a less confident consumer; March retail sales dropped 0.3%, primarily driven by weaker auto sales which dropped 2.1% in March.

- **Inflation**: There is little upward pressure on the inflation front. The PCE Index (the Fed’s preferred measure of inflation) rose 0.1% for the month of March, as did the monthly PCE Core Index (less energy and food). For year-over-year growth, the PCE Index was up only up 0.8%—well below the Fed’s 2.0% target and a 0.1% reduction from a month earlier. Even the year-over-year Core PCE Index, which came in at 1.6%, was down 1.7% year-over-year from February. The Consumer Price Index (CPI) which includes the more inflationary costs of both shelter and healthcare also grew by only 0.1% in March; Core CPI followed suit at 0.1%, down from 0.3% growth in February. For the year, CPI and Core CPI are up 0.9% and 2.2% respectively. The collective take-away from all the inflation indices is that they are moving in the wrong direction and provide more than enough cover for the Fed to take no action in the short term.

- **GDP**: Notwithstanding strong gains in employment (and to a lesser extent, in wages), productivity and economic expansion seem to have stalled in Q1. The first reading of GDP for Q1 came in at a lackluster 0.5%, down from 1.4%, 2.0% and 3.9% in the prior three quarters. This represents the slowest rate of growth in two years, due in large part to businesses slashing investment activities (non-residential investment was down 5.9%). In fact, if it was not for the strength of consumer spending (mainly on services) the number would have been even worse. Personal consumption expenditures rose at a 1.9% rate during Q1, a decline of only 0.5% from Q4 ‘15, buoyed by a 2.7% gain in spending on services (and largely offsetting a 1.6% reduction in durable goods). The other highlight of the report was a robust 14.8% gain in residential investment. While businesses may be increasing their payrolls, and those workers are spending their earnings more on services and home improvement, less capital is flowing into investments to actually generate productivity (i.e. growth in GDP)—which, if not reversed could have profoundly adverse effect on future growth. Low energy costs are providing the consumer with greater discretionary spending capacity, but it should not be lost on anyone that the dramatic reduction in business investment can also largely be attributed to the same downturn in the energy sector.

- **Manufacturing and Services**: The ISM Reports for both Manufacturing and Services could as easily be entitled “A Tale of Two Cities.” First the good news: in Services, ISM non-manufacturing posted another strong month in April, coming in at 55.7 (consensus expectation had been 53.5-55.5), and more than a full point above the March reading of 54.5. The highlight of the report was in the “new orders” subcomponent which jumped more than 3 points to 59.9. This represents the strongest rate of growth since October of 2015 and bodes very well for future releases. Not unexpectedly, the weaker dollar pushed the “new export orders” up to a very healthy reading of 56.5 (excluding March, this is the best reading since July of 2015). Now for the bad news: the ISM Manufacturing Index for April was below expectations at 50.8, though there were some highlights. The “new orders” subcomponent, while falling by 2.5 points since March, still achieved a comparatively respectable level of 55.8, indicating a healthy rate of growth (anything above 50 represents expansion, below 50, contraction). The weaker dollar also supported the “new export order” subcomponent, which was unchanged from March at 52.5 (the highest reading since December of 2014). The weakness in the April report was the “employment” subcomponent, which showed continued contraction at 49.2 (still 1.1 point higher than the March reading).
**Employment:** Employment news for April started off with some very positive developments: as reported by the Labor Department for the week of April 9th, Americans filing for unemployment benefits fell to its lowest level in 42 years (since 1973). Specifically, initial jobless claims fell 13,000 to 253,000. In a surprising twist however, the April non-farm payroll report came in significantly below expectation, at 160,000, and the unemployment rate was unchanged at 5.0% (7.9 million people unemployed). Expectation for the April payroll report ranged from a low of 175,000 to a high of 245,000, so the meager gain in jobs was a disappointment on a number of fronts. The Participation rate fell to 62.8% from 63.0% reversing a recent upward trend and, though average hourly earnings grew by a respectable 0.3% (2.5% year-over-year); March average hourly earnings were revised downward to 0.2%. The March non-farm payroll gains were also revised downward from 215,000 to 208,000. The weaker than anticipated jobs report combined with the anemic Q1 GDP casts a tall shadow over any contemplated rate hike at the June FOMC meeting.

**Housing:** While reaorts are generally upbeat, reports from March remain mixed and the housing market is not gaining much momentum heading into the Spring selling season. New home construction remains low relative to population growth despite firm house prices; housing starts for March dropped 8.8% from February, down to 1.089 million. Permits for new residential construction also fell in March, down 7.7%, to 1.086 million while single-family permits were down slightly, but the more significant large multifamily segment fell sharply, down 20.6%. On a positive note, existing home sales for March bounced back somewhat, gaining 5.1% and climbing to 5.33 million after falling by 7.3% in February. Hopefully the recent dip in mortgage interest rates, down near 3.5% for a 30 year fixed rate mortgage, will continue to help sales in April, but thus far in 2016 sales trends have been soft—a reflection of only moderate price appreciation which has not been strong enough to attract new supply into the market.

**Private Market Update**

2016 is proving to be one of the most confounding years yet in private market debt metrics and trends. Entering the year, expectation had been for a tightening credit environment. As a result of the leverage guidance issued by the Fed, OCC, and FDIC, commercial banks were increasingly pulling back from more aggressive leverage lending practices (>3.0x Sr. Debt/4.0x Total Debt, aka the “3/4 Box”). A good chunk of the BDC community was sidelined by share prices that were discounted heavily from their net asset value, and accordingly much more selective. The ratio of credit downgrades to credit upgrades was upwards of 5:1, and credit defaults were on the rise—the U.S. speculative-grade default rate rose to 4.1% in the first quarter of 2016 from 3.2% the prior quarter and is projected to climb to 6.0% by the end of 2016. Energy sector “contagion” had devalued high yield bond prices, driving up yields to levels unseen for years.

However, just as the market participants readied themselves for a more bearish credit market, deal flow shut down. Middle market M&A activity, exits, and overall deal flow contracted. While Q1 proceeded and deal flow failed to materialize, lenders became increasingly hungry and subsequently competitive. Rather than a tightening of credit metrics, we entered a period of stasis, with spreads and leverage tolerances becoming more stratified (consistent with Q4 ’15). In fact, for our May guidance, SPP has lowered our spread indications for sub $10 million EBITDA issuers in non-bank cash flow deals (from a range of 7.00%-8.00% to 6.50%-8.00%). This newfound “seller’s market” for credit was the focus of report in “The Lead Left:"

“Psychological factors are at work as well. As we head deeper into the year, managers are under increasing pressure to put money to work. This is particularly true given the weak first quarter many market participants experienced in deal volume. Structures and yields you passed over in January look better in June if you’re behind budget.”

Depending on your perspective, the good news is that deal flow in Q2 seems to be rebounding—market participants are reporting (anecdotally at this juncture) a
return to a more normalized deal flow and ostensibly away from lenders’ “cutting book” to entice deal flow. In fact, the most recent Senior Loan Officer Opinion Survey on Bank Lending Practices (April 2016) published by the Federal Reserve suggests that the long anticipated “tightening” may in fact be under way. Specifically,

“On balance, a moderate net fraction of banks reported a tightening of lending standards for C&I loans to large and middle-market firms over the past three months. Meanwhile, only a modest net fraction of banks reported tightening lending standards for C&I loans to small firms. Banks reported that they tightened some C&I loan terms for large and middle-market firms: a moderate net fraction of banks reported that they had increased premiums charged on riskier loans, a modest net fraction of banks reported that loan covenants had tightened, and most other terms to such firms remained basically unchanged on net. Banks reported mixed responses regarding changes in loan terms for small firms. A majority of the domestic respondents that tightened either standards or terms on C&I loans over the past three months cited a less favorable or more uncertain economic outlook as well as a worsening of industry-specific problems affecting borrowers as important reasons. Meanwhile, a significant net fraction of foreign respondents reported a tightening of lending standards for C&I loans.”

It remains to be seen where the market is headed. Conventional wisdom suggests that if deal flow continues to build while the overall credit environment remains static or deteriorates (i.e. GDP Q1 ’15 of 1.50%), the long anticipated credit crunch may finally take hold and borrowers will face higher costs of capital, reduced leverage tolerances, and a more selective lending community. If deal flow stagnates however, and institutional investors remain under-invested, market pressures will once again dictate.

The more things change, the more they stay the same.

SPP-Tracked Market Activity

While March saw deal volume recover slightly from the rock bottom numbers earlier in the winter, April’s subsequent dip (~18.0%) suggests there no clear-cut trend building. Both deals less than $500M and $250M declined from March numbers in April, and April LTM deal count was down over 20.0% as compared to April LTM 2015. Of note however, was exit count, which in April was the greatest it has been since the Fall of 2015, and was one of the higher counts in the past four years. April LTM exit count was also significantly higher than either 2015 or 2014, suggesting that many sponsors are seeking to harvest long overdue portfolio holdings.

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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