Market Update

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

<table>
<thead>
<tr>
<th>Deal Component</th>
<th>November '16</th>
<th>October '16</th>
<th>November '15</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash Flow Senior</td>
<td>$7.5M EBITDA 15.0x-25.0x</td>
<td>$10.0M EBITDA 22.0x-35.0x</td>
<td>$10.0M EBITDA 2.50x-3.50x</td>
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<tr>
<td>Debt</td>
<td>$10.0MM EBITDA 2.50x-3.50x</td>
<td>$2.00MM EBITDA 3.00x-4.00x</td>
<td>$2.00MM EBITDA 3.00x-4.00x</td>
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<tr>
<td>Total Debt Limit</td>
<td>$10.0MM EBITDA 3.00x-4.50x</td>
<td>$10.0MM EBITDA 3.00x-4.50x</td>
<td>$10.0MM EBITDA 3.75x-4.50x</td>
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<tr>
<td>(x EBITDA)</td>
<td>$10.0MM EBITDA 3.00x-4.50x</td>
<td>$2.00MM EBITDA 4.00x-5.50x</td>
<td>$2.00MM EBITDA 4.00x-5.50x</td>
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<td>Senior Cash Flow</td>
<td>$10.0MM EBITDA 3.00x-4.50x</td>
<td>$2.00MM EBITDA 4.00x-5.50x</td>
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<tr>
<td>Pricing</td>
<td>$10.0MM EBITDA 3.00x-4.50x</td>
<td>$2.00MM EBITDA 4.00x-5.50x</td>
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<tr>
<td>(non-bank)</td>
<td>$10.0MM EBITDA 3.00x-4.50x</td>
<td>$2.00MM EBITDA 4.00x-5.50x</td>
<td>$2.00MM EBITDA 4.00x-5.50x</td>
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<tr>
<td>Subordinated Debt</td>
<td>$10.0MM EBITDA 10.00%-13.00%</td>
<td>$10.0MM EBITDA 10.00%-12.00%</td>
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<td>Untranche Pricing</td>
<td>$10.0MM EBITDA 10.00%-13.00%</td>
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<td>Libor Floors</td>
<td>$10.0MM EBITDA 10.00%-13.00%</td>
<td>$10.0MM EBITDA 10.00%-12.00%</td>
<td>$10.0MM EBITDA 10.00%-12.00%</td>
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<tr>
<td>Minimum Equity</td>
<td>$10.0MM EBITDA 10.00%-13.00%</td>
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<td>$10.0MM EBITDA 10.00%-12.00%</td>
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<tr>
<td>Contribution</td>
<td>$10.0MM EBITDA 10.00%-13.00%</td>
<td>$10.0MM EBITDA 10.00%-12.00%</td>
<td>$10.0MM EBITDA 10.00%-12.00%</td>
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<td>Equity Co-investment</td>
<td>$10.0MM EBITDA 10.00%-13.00%</td>
<td>$10.0MM EBITDA 10.00%-12.00%</td>
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<tr>
<td>Recap Liquidity</td>
<td>$10.0MM EBITDA 10.00%-13.00%</td>
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<td>Story Receptivity</td>
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*Changes from last month highlighted in red*
“What comes next?
You’ve been freed
Do you know how hard it is to lead?
You’re on your own
Awesome...wow
Do you have a clue what happens now?
Oceans rise
Empires fall
It’s much harder when it’s all your call
All alone
Across the sea
When your people say they hate you
Don't come crawling back to me
Da da da da da
Da da da da daye da
Da da da da daye da
You're on your own…”

“What Comes Next? (from “Hamilton”) - Lin-Manuel Miranda

What Comes Next?

Not surprising to anyone, the November FOMC meeting adjourned without any change to the Fed Funds rate target rate of 0.25%-0.50%, the same range in effect since December of last year. It is pretty much a given that any major policy modifications will only take place at one of the four FOMC meetings (out of eight) with both a press conference and an update to their projections.

The official FOMC meeting announcement from the November meeting contained little new language to support either a hike or a continuance of the status-quo, but there were some nuanced changes from the September announcement that suggest the rate hike would more likely occur in December. Specifically, (i) the previous assertion that inflation will “remain low in the near term,” was dropped (i.e. rising energy costs), (ii) the case for increasing the fed funds target rate has “continued” to strengthen, and (iii) now the Fed only needs “some” further evidence of progress towards full employment and 2.0% inflation.

Given the strength of the most recent spate of macroeconomic releases—GDP (2.9% for Q3), Consumer Spending (up 0.5% in September), and Employment (161,000 in October; 4.9% Unemployment Rate)—it looked pretty much like a done deal for another 0.25% hike at the December FOMC meeting, bringing the target range between 0.50%-0.75%...but that was before the election.

According to CME Group, the implied probability of a rate hike by year end peaked at **86.0%** on the morning of election day on November 8th. By 8:00am on November 9th however, the implied probability of a rate hike declined to **71.5%**. Amid the initial stock selloff in the equity markets (Dow futures dropped 650 points the night of the election before pivoting to a 257 point gain the next day), the sharp rise in the dollar, and soaring gold prices, it seemed to many that all bets were off respecting a rate increase in December. As the market quickly reset, investors began considering the prospect of proposed expansive fiscal spending that could bolster economic activity, push up inflation, and support higher bond yields in the coming years, all of which could also influence the Fed to move forward with its highly anticipated interest rate hike in December. By the same token, the Fed has repeatedly demonstrated a reluctance to modify monetary policy in times of increased volatility. Even in light of stronger macroeconomic reports and an ostensibly stable equity market, the likelihood of Fed action five weeks after such an electoral shock is seemingly still a stretch.
Below is a quick recap of the month’s headline economic reports:

- **Consumer Confidence/Retail Sales**: Notwithstanding a particularly ugly election cycle, consumer spending posted a solid 0.5% gain in September (impacted by higher than anticipated vehicle sales). Retail sales also came in with a healthy 0.5% increase in September (up from 0.3% in August). However, consumer confidence did not track the spending and retail sales data; according to the Conference Board’s measure, consumer confidence dropped to a level of 98.6 in October down from 104.1 a month earlier (September was also revised downward to 103.5). These constituted the lowest readings since July of this year. Consumer confidence levels are closely monitored by economists, as confidence in one month generally correlates to consumer spending in the future. Given that approximately 70.0% of economic demand in the U.S. economy is derived from household spending, the metric is a key determinant in macroeconomic well-being.

- **Inflation**: Inflation data for September came in positive yet still on the soft side; the PCE Price Index (aka the “PCE deflator”) increased from 0.1% to 0.2% month-over-month in September, bumping the year-over-year inflation rate up to 1.2% from 1.0%. The Fed’s preferred measure of inflation, the Core PCE Price Index (which excludes food and energy prices) edged down from 0.2% to 0.1% month-over-month, keeping the Core Price Index at 1.7% year-over-year. The results are on the low end of expectation but suggest inflation is at least going in the right direction. The other measure of inflation, the Consumer Price Index (“CPI”), also rose in September to 0.3% from 0.2% in August. In the 12 months through September, the CPI has increased 1.5% (versus 1.1% in August); Core CPI only rose 0.1% last month after gaining 0.3% in August. Not surprisingly, the big delta between CPI and Core CPI are energy costs, which surged 2.9% in September, and owner equivalent rent, which rose 0.4%. This is the highest CPI reading since October of 2014, and in a less politically charged environment would support a hike in December.

- **GDP**: Gross Domestic Product growth accelerated to a robust 2.9% in Q3, dwarfing Q2’s GDP of 1.4%. This represents the fastest growth rate in two years and exceeded the consensus growth rate of 2.5%. The third quarter acceleration largely reflected increased exports (which increased at a 10.0% rate in the third quarter, the best gain in nearly three years) and a buildup of inventories (which had been a drag on output the five previous quarters but contributed a gain of 0.61% in Q3). Digging further into the headline numbers however, the growth in exports was not really as strong as it might seem, buoyed in large part to a surge in soybean exports shipped to China, an event that will not be repeated in coming quarters. Consumer spending also increased, albeit at a slower rate (2.1%) than in Q2, where it grew at 4.3%. Non-residential business investment also grew at 1.2%, up from 1.0% in Q2.

- **Manufacturing and Services**: After slipping into contraction mode in August and returning to expansion territory in September, the ISM Manufacturing Index reading edged up slightly in October to a level of 51.9 (up from 51.4 a month earlier), which was consistent with consensus. Breaking it down, the New Orders component was somewhat disappointing, coming in at 52.1 after a strong September showing of 55.1 while Backlog Orders, at 45.5 for the month, were even softer, holding below 50.0 (i.e. contraction mode) for the fourth month in a row. The ISM Non-Manufacturing report (the “Services”) weakened modestly in September, dropping from 57.1 to 54.8. New Orders were solid, at 57.7, but were still down from September’s 60.6, and Business Activity, also at 57.7, was down from September.

- **Employment**: U.S. employers added 161,000 jobs in October; September’s non-farm payrolls were revised upward from 156,000 to 191,000, the unemployment rate inched down to 4.9% from 5.0%, and the Participation Rate dropped very slightly to 62.8% from September’s 62.9%. While the job gains were at the low end of the consensus range (155,000 to 211,000), all in all it was a solid report showing continued job and wage growth. Wages were in fact the highlight of the release—average hourly pay rose ten cents
an hour to $25.92, a 2.8% gain over last year, and the biggest 12 month increase in seven years. The October report certainly supports the Fed plans for a December rate hike absent the new level of volatility posed by the election results.

**Housing:** Existing home sales surged 3.2% in September to a 5.470 million annualized rate which exceeded even high end expectations, led by the single-family component (up 4.1% to a 4.860 million rate). Condos, where choices are limited and permits for new building are on the rise, fell 3.2% to a 610,000 rate on the other hand. As has been the case all year, home owners are still being somewhat reluctant to put their homes on the market, though supply did rise in the month to 2.040 million from 2.010 million; however, supply on a monthly basis, given the rise in sales, fell to 4.5 months from 4.6 months. Prices have not been firm—the median home price dipped 2.4% in the month to $234,200—which helps explain both the lack of supply and also the rise in sales. Existing home sales have not been showing the strength of new home sales, the latter of which has been accelerating strongly and may now even be lifting the resale market. Though prices are still not appreciating to really incentivize sellers (no better than in the 5% range), the housing sector is and continues to be a leading strength for the economy, as it has been most of 2016.

**Private Market Update**

As noted here repeatedly over the course of the last several months, private market liquidity has continued to strengthen through Q4 with tighter pricing and expanded leverage tolerances across the bank and institutional lending constituencies. These “excess” liquidity conditions have also resulted in greater access to capital for more marginal issuers (“storied” paper, lower middle market issuers, distressed credits) as well as purely non-accretive uses of capital (dividend and share recaps). Most of the heightened liquidity conditions in the middle market can be explained by simple supply and demand economics, i.e. a scarcity of deals creating a true buyer’s market. As the U.S. Bank Third Quarter Debt Market Snapshot reports:

“Through 3Q16 YTD Middle Market loan volume was $88.1billion, down 14% from already-depressed year-earlier levels. This is the lowest level since 2009, when the economy and the loan market were still distressed and illiquid during the Great Recession. Volatility earlier this year coupled with continuing weak economic conditions and macro uncertainties (including an especially raucous election campaign season) dissuaded most middle market companies from borrowing in the loan market. Issuance in the Large segment (deals >$100 million) of the Middle Market was down 6% for 2Q16, but for the traditional segment (Deals <$100 million) volume was down 25%...Even though banks remained very hungry for assets, there was little incentive for companies to refinance given generally flat pricing and as a result refinancing volume was down 22% in 3Q16. Likewise, there was little willingness by companies to pursue M&A, and non-sponsored M&A issuance declined 43% relative to 2Q16 and 46% on a year-over-year basis. The effects of HLT caps and Leveraged Lending were more apparent earlier in the year, as new credit constraints and return requirements seem to have kicked in at numerous regional banks. However, banks appear willing to do more levered deals as the year progresses and lenders fall further short of budgets. Unsurprisingly 77% of banks surveyed by LPC missed their third-quarter lending goals, citing limited deal flow, too aggressive terms on many of the deals they did review, and a lack of M&A.”

In short, earlier in 2016, increased bank regulation (i.e. the HLT leverage guidance) resulted in a general pullback by the banking community, leaving them underinvested going into the second half of the year. At the same time, the business development community, traditionally a competitor to the commercial banking constituency, also pulled back from the market as a result of significant market headwinds—BDC stock prices were trading at significant discounts to their net asset values (“NAV”) and hampered their own access to capital. Fast forward to the second half of the year, where, as banks had to compensate for the dearth of deal flow in the first half of 2016 by lowering pricing and loosening leverage tolerances, thus allowing them to re-enter the market in force, BDC
share price levels corrected, providing the BDC community greater liquidity and stiffer competition to the commercial banking establishment. Hence the excess liquidity conditions in Q3 and Q4.

As we head into the final stretch of 2016, it appears that pricing has stratified at current levels; SPP has made no changes to its pricing or leverage metrics for November. Our anecdotal experience suggests we have already hit the low point in pricing for the time being, and while it is premature to gauge what impact the election will have on the private capital market metrics, the sheer magnitude of the shock value alone gives rise to a new level of volatility (as a general proposition, volatility translates to conservatism in lending). Additionally, BDC prices, while stronger than earlier in the year, have fallen back in recent weeks. As of October 30th, approximately 50.0% of the publicly traded BDC community was trading a discount of 10.0% or more to their NAV. If there is a change coming to pricing and leverage metrics in the weeks to come, it is likely going to be in the form of tightening in credit and a pullback from the current excess liquidity environment.

**SPP-Track Market Activity**

At long last there appears to be a trend in deal flow and a positive one at that—deal count has risen steadily albeit slightly for the past three months, climbing out of the trough that the Summer and Spring months (with the exception of May) experienced. In fact, deal count is higher now than levels in Q4 of 2015, which makes sense given that this year’s Q4 crush has been exacerbated by lender under-investment and has yet to be tempered by a sharp slowdown as time runs out on the year. Of course, it should be mentioned that LTM deal counts are still well off 2015 and 2014 numbers, as has been the case all year. Exits, conversely, have decreased substantially, and seemingly fell off a cliff in the lower middle market, especially in October. One can speculate that economic uncertainty and election cycle turmoil may be to blame, and while this is likely true on some level, it is difficult to point to a clear reason, especially given October is usually a high point for investors to exit existing assets.

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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