### SPP's Middle Market Cash Flow Market At A Glance

<table>
<thead>
<tr>
<th>Deal Component</th>
<th>November '17</th>
<th>October '17</th>
<th>November '16</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash Flow Senior</td>
<td>$&lt;5.00 MM EBITDA 1.75x-3.00x</td>
<td>$&lt;7.5MM EBITDA 1.75x-3.00x</td>
<td>$&lt;7.5MM EBITDA 1.50x-2.50x</td>
</tr>
<tr>
<td>Debt Multiple</td>
<td>$&lt;10.00MM EBITDA 2.75x-4.00x</td>
<td>$&lt;10.00MM EBITDA 2.75x-4.00x</td>
<td>$&lt;10.00MM EBITDA 2.50x-3.50x</td>
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<tr>
<td>(x EBITDA)</td>
<td>$&lt;20.00MM EBITDA 3.25x-4.75x</td>
<td>$&lt;20.00MM EBITDA 3.25x-4.75x</td>
<td>$&lt;20.00MM EBITDA 3.00x-4.00x</td>
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<tr>
<td>Total Debt Limit</td>
<td>$&lt;5.00 MM EBITDA 3.25x-4.50x</td>
<td>$&lt;7.5MM EBITDA 3.25x-4.50x</td>
<td>$&lt;7.5MM EBITDA 3.00x-4.50x</td>
</tr>
<tr>
<td>Multiple (x EBITDA)</td>
<td>$&lt;10.00MM EBITDA 3.50-5.00x</td>
<td>$&lt;10.00MM EBITDA 3.50-5.00x</td>
<td>$&lt;10.00MM EBITDA 3.00x-4.50x</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+1.50x-4.50x</td>
</tr>
<tr>
<td>Pricing</td>
<td>Non-Bank: $&lt;10.00MM EBITDA L+5.50x-8.00x</td>
<td>Non-Bank: $&lt;15.00MM EBITDA L+4.50x-6.00x</td>
<td>Non-Bank: $&lt;10.00MM EBITDA L+6.00x-8.00x</td>
</tr>
<tr>
<td></td>
<td>[potential for 1.00% floor]</td>
<td>[potential for 0.50% floor]</td>
<td>[potential for 0.50% floor]</td>
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<tr>
<td>Second Lien Pricing (Avg)</td>
<td>$&lt;5.00 MM EBITDA L+7.00x-11.00x floating (1.00% floor)</td>
<td>$&lt;7.5MM EBITDA L+7.00x-12.00x floating (0.50% floor)</td>
<td>$&lt;7.5MM EBITDA L+8.00x-11.00x floating (0.50% floor)</td>
</tr>
<tr>
<td></td>
<td>$&lt;10.00MM EBITDA L+6.50x-8.50x floating (1.00% floor)</td>
<td>$&lt;20.00MM EBITDA L+6.00x-7.50x floating (0.50% floor)</td>
<td>$&lt;20.00MM EBITDA L+6.00x-7.50x floating (0.50% floor)</td>
</tr>
<tr>
<td></td>
<td>Fixed rate options range from a low of 7.0% to 11.0%.</td>
<td>Fixed rate options range from a low of 7.0% to 11.0%.</td>
<td>Fixed rate options now available.</td>
</tr>
<tr>
<td>Subordinated Debt Pricing</td>
<td>$&lt;5.00 MM EBITDA 12.00x-14.00x</td>
<td>$&lt;7.5MM EBITDA 12.00x-14.00x</td>
<td>$&lt;7.5MM EBITDA 11.00%-14.00%</td>
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<tr>
<td></td>
<td>$&lt;10.00MM EBITDA 10.00x-13.00x</td>
<td>$&lt;10.00MM EBITDA 10.00x-13.00x</td>
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<td></td>
<td>Warrants limited to distressed and special situations; Second lien may buy down rate to ~9.00%.</td>
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<td></td>
</tr>
<tr>
<td>Unitranche Pricing</td>
<td>$&lt;5.00 MM EBITDA L+7.00x-11.00x floating (1.00% floor)</td>
<td>$&lt;7.5MM EBITDA L+7.00x-12.00x floating (0.50% floor)</td>
<td>$&lt;7.5MM EBITDA L+8.00x-11.00x floating (0.50% floor)</td>
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<td>$&lt;10.00MM EBITDA L+6.50x-8.50x floating (1.00% floor)</td>
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<td>$&lt;20.00MM EBITDA L+6.00x-7.50x floating (0.50% floor)</td>
</tr>
<tr>
<td></td>
<td>Fixed rate options range from a low of 7.0% to 11.0%. ABL revolver can be arranged outside the Unitranche to arbitrage all-in pricing.</td>
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**Liber Floors**

In terms of the middle market, Liber floors are found within non-bank senior debt, second lien, and unitranche facilities. In anticipation of modest improvement throughout '17, December, we have seen the yield curve get a little flatter in recent weeks (one-month Liber 1.24%, three-month 1.39%, and six-month 1.86%).

**Minimum Equity Contribution**

Lenders still want sponsors to have substantive skin in the game, which translates to a 30%-40% basis level of equity (this level is inclusive of any rollover). As a general proposition, new sponsor equity of less than 20% will not attract the best terms (though may still get done). There is no dearth of additional capital available to cover for potential equity shortfalls from both equity and debt providers. Lenders still want sponsors to have substantive skin in the game, which translates to a 30%-40% basis level of equity (this level is inclusive of any rollover). As a general proposition, new sponsor equity of less than 20% will not attract the best terms (though may still get done). There is no dearth of additional capital available to cover for potential equity shortfalls from both equity and debt providers.

**Equity Co-Investment**

The market for equity co-investments remains robust among insurance companies, family offices, and credit opportunity funds. As a general proposition, promotes and carries insurance carry only depending on the role the sponsor plays, posts-close and how much, if any, of their own equity is deployed, though not carry/promotes will be performance contingent. Mezz lenders generally will not exceed 20% of their debt investment.

**Recap Liquidity**

Recap liquidity remains strong going into the fall, though a clear preference seems to be forming for sponsored deals over non-sponsored issuers. Most aggressive leverage terms have generally been found outside the commercial banking community, but banks are still bidding on a competitive basis. Very little pricing discrimination between “pure” recap and those combined with an accretive use of capital.

**Story Receptivity**

While the market continues to be exceedingly forgiving for many paper, in general, investors are weary of certain sectors (i.e. brick and mortar retail, casual dining, etc.) and will be looking for yield—possibly even some equity upside—for more challenged credits.

**Tone of the Market**

In a year characterized by highly liquid conditions, it is no surprise that Q4 issuance metrics remain firmly in the issuer’s favor. Spreads have compressed throughout 2017, while leverage metrics have expanded and lender protections have diminished. Declining defaults have only added fuel to the hottest market in years. With deal flow thinning, middle market lenders are being forced to compete on smaller deals for lower middle market opportunities.

*Changes from last month highlighted in red*
“Still don’t know what I was waitin’ for
And my time was runnin’ wild
A million dead end streets and
Every time I thought I’d got it made
It seemed the taste was not so sweet
So I turned myself to face me
But I’ve never caught a glimpse
How the others must see the faker
I’m much too fast to take that test

Ch-ch-ch-changes
Turn and face the strange
Ch-ch-ch-changes
Don’t want to be a richer man
Ch-ch-ch-changes
Turn and face the strange
Ch-ch-ch-changes
There’s gonna have to be a different man
Time may change me
But I can’t trace time”

“Changes,” David Bowie

Changes?
The White House has notified Federal Reserve governor Jerome Powell that President Donald Trump intends to nominate him as the next chairman of the central bank. In his five years at the Fed, Mr. Powell has been a reliable ally of Chairwoman Yellen and would likely continue the Fed’s current cautious approach to reversing the central bank’s crisis-era stimulus policies as the economy expands.

Mr. Powell has backed Chairwoman Yellen’s policy of gradually raising interest rates if the economy improves as projected. He expects inflation to move up to the Fed’s 2.0% target, economic growth to remain steady, and unemployment to fall farther, all signs of a robust U.S. economy capable of withstanding gradual rate increases to pre-crisis levels.

In September, Mr. Powell voted in favor of beginning the much-anticipated process of winding down the central bank’s $4.5 trillion portfolio of treasury bonds and mortgage-backed securities. He has noted that the Fed could resort to new rounds of asset purchases in the event of another financial crisis; however, the addition of new assets to the Fed’s balance sheet as a means of economic stimul

Much like many of his Fed colleagues, Mr. Powell has warned against over reliance on mathematical approximations of responsiveness to changes in the nominal interest rates, such as the Taylor Rule, which utilizes inflation and GDP, among other economic indicators, to predict the effects of central bank policy. While this view puts him at odds with congressional Republicans who have pushed the Fed to adopt such a formula, Mr. Powell has remained steadfast in his view that the complexity of human activity cannot be reduced a simple summary equation.

Mr. Powell has expressed willingness to ease some of the burdens imposed on financial institutions by the 2010 Dodd Frank Act, including, but not limited to, fewer trading restrictions, more transparency in stress tests, and less onerous capital requirements. He has also expressed interest in revising the supervisory requirements imposed on bank boards of directors after the crisis, indicating that the board’s role should be one of oversight, not management.

Echoing calls by some lawmakers to pull the country’s two mortgage-finance firms, Fannie Mae and Freddie Mac, out from under government conservatorship, Mr. Powell has called on Congress to overhaul the housing finance system. Powell argues that Congress must implement a system that promotes an inflow of private capital to stand between the housing sector credit risk and the American taxpayers to avoid another taxpayer-funded bailout in the event of a downturn.
Below is a recap of this month’s key economic releases:

- **Payroll Growth Responds After Weak September Report** – Wage inflation backed off, but payroll growth bounced higher and the unemployment rate shrank some more in what points to further tightening for the labor market. Non-farm payrolls rose 261,000 in October which is lower than the expected rebound but is offset by 90,000 in upward revisions to the two prior months. The unemployment rate edged one tenth lower to a new 17-year low at 4.1%. Hurricane effects are likely the cause of the monthly gyrations in this report and are most evident at restaurants where payrolls jumped 89,000 after plunging 98,000 in September. Manufacturing payrolls are a big plus in the report, up 24,000, with construction also positive at 11,000. Professional business services underscore the demand for labor, rising 50,000 with the temporary help component up a very sizable 18,000.

- **Soaring Confidence Suggests Spending Growth Will Rebound** – The unexpected surge in the University of Michigan measure of consumer confidence to its highest level since 2004 provides further reason to think that, although real consumption growth may have slowed in the third quarter, it will pick up again before long. The rise to 101.1 in October, from 95.1, was driven by strong gains in both the current conditions and expectations indices. The spike in gasoline prices following the recent storms does not appear to have had any impact on sentiment at the national level. Instead, confidence continues to be supported by the soaring stock market and conditions in the labor market which, looking through the disruption caused by the hurricanes in September, still appear very strong. Overall, although real consumption slowed to around 2.0% annualized in the third quarter, the Michigan index is now at a level consistent with spending growth of about 5.0%. Accordingly, this supports the view that the prospects for consumption growth over the next year remain fairly bright.

- **Economy Sees Q3 GDP Boost** – A rise in inventories, likely the result of the hurricanes, gave a boost to third quarter GDP, at a higher-than-expected, inflation-adjusted 3.0% annualized rate. Transportation snags and backup in the supply chain may have given a boost to inventories which rose $35.8 billion in the quarter and contributed 0.73 percentage points to the quarter’s GDP. But the core of the report is solid, led by personal consumption expenditures which came in at a roughly as expected 2.4% pace and contributed 1.62 points to the quarter. Durable spending was very strong, at 8.3% and reflecting, at least in part, hurricane replacement demand for vehicles. Residential investment was one of the few weaknesses, falling at a 6.0% pace, with non-residential investment rising at a respectable 3.9% rate. Net exports are a plus, narrowing nearly $20 billion to a $595.5 billion deficit and adding 0.41 points to the quarter. Durable spending was very strong, at 8.3% and reflecting, at least in part, hurricane replacement demand for vehicles. Residential investment was one of the few weaknesses, falling at a 6.0% pace, with non-residential investment rising at a respectable 3.9% rate. Net exports are a plus, narrowing nearly $20 billion to a $595.5 billion deficit and adding 0.41 points to the quarter.

- **PCE Sees Modest Increase, Core PCE Remains Stagnant** – Core inflation remains lifeless in an unwanted highlight of an otherwise solid income and spending report. Personal income rose 0.4% in September and was underpinned by wages and salaries which also rose 0.4%. Consumer spending jumped 1.0% driven by a 2.1% surge in durable goods that was tied to vehicle replacement following Hurricanes Harvey and Irma. But the rise in income and spending did not heat up ex-food ex-gas core inflation which posted a marginal 0.1% gain. This is the fifth straight 0.1% gain for this key reading. The Core PCE’s year-on-year rate has been stuck at a rock bottom 1.3% for the last two months. Total inflation, reflecting a hurricane-related gain for energy prices, rose 0.4% with the year-on-year rate rising two tenths to 1.6%.

- **ISM Non-Manufacturing Reaches 12-Year High** – The rise in the ISM non-manufacturing index to a 12-year high of 60.1 in October, from 59.8, suggests that economic growth has continued to accelerate going into the fourth quarter. The index is consistent with annualized GDP growth of more than 5.0%, although the actual out-turn is expected to be between 2.5% and 3.0% annualized. ISM manufacturing’s sample reports only a slight cooling, at a still unusually strong composite of 58.7 in October vs September’s 13-year high of 60.8. New orders remain the stand-out positive in the report, at 63.4 for only a 1.2% dip from September’s four-year high of 64.6. Export
orders, are a strong positive. Employment is also unusually strong at 59.8 and only five tenths lower from the six and a half year high in the last report.

- **Soft Housing Starts in Lieu of Hurricanes** – Housing starts fell 4.7% in September as the storms wreaked havoc in the South. Starts of single-family homes in the South fell 54,000, which meant that the rest of the country suffered only a 2,000 drop. Without the storm-related dip, starts were virtually unchanged from August as single-family starts were up in all other regions of the country. Multi-family starts (which are more volatile month-to-month) fell 5.1% last month. Overall, starts are up 6.1% from a year ago and should make up for lost time in the quarters ahead. Total permits for new construction fell 4.5% in September (and are down 4.3% from a year ago) due to a decline in multi-family permits. Single-family permits rose 2.4% in September and are up 9.3% in the past year, as starts evolve from multi-family construction (which led the way from 2011 to 2015) to more single-family starts.

### Private Market Update:

Issuance conditions going into November are consistent with the trends established in the August through October period; specifically, excess liquidity conditions continue to persist. The pressure is on lenders to accept tighter spreads and increased leverage tolerances, often with less covenant protection. In sum, we continue to experience a singularly favorable issuer’s market where lenders are forced to accept lower returns for higher risk opportunities. Adding insult to injury, market participants also report a recent but pronounced reduction in deal flow, only serving to increase demand and competition for assets. An example of the recent drop in deal flow can be found in the most recent “U.S. Loan Activity” report, which notes that U.S. loan issuance totaled $242 billion in Q3 of 2017, down 31.0% from Q2 of 2017.

While this may seem like a classic “bubble” (i.e. higher risk, lower return) forming among the middle market debt constituency, surprisingly enough, default rates are moving down, at the very least suggesting a lower-risk credit environment. Fitch has reported that its large middle market default rate is currently at 1.9%, compared to 3.9% as of June 30th, 2017. Commodity (oil and gas, energy) default rates continue to decline as well; however, and not surprisingly, there is a marked increase in U.S. retail and apparel default rates.

SPP has not lowered its pricing guidance or increased its leverage tolerances for November (though we have tightened spreads between 50 - 100 basis points and expanded leverage metrics by at least a half turn of EBITDA already in 2017); however, this month we have lowered the lower end of our issuer profile threshold. Prior to this point, the lowest end of our metric analysis was “issuers < $7.5 million of EBITDA.” This month the lowest end of our metric analysis is “issuers < $5.0 million of EBITDA.” Our modification is simply a reflection of the broader market phenomena of lenders continuing to go down market (and presumably increasing their risk profile) to attract assets consistent with their return requirements.

With only two months left in the year, the empirical data is unequivocal; to wit, 2017 will likely be the most aggressive lending environment in a decade, since the halcyon days preceding the great recession.

- **Commercial banks continue to loosen credit in an effort to regain market share from non-bank competitors** – The latest Senior Loan Officer Survey (SLOS) shows the net proportion of banks relaxing lending standards on C&I loans increased again in the third quarter. In the face of lower credit standards, demand for business loans also continued to fall. As reported by the SLOS: “Specifically, for C&I loans to large and middle market firms, a significant net percentage of banks reported decreased spreads of loan rates over their bank’s cost of funds; moderate net shares of banks reportedly increased the maximum size of their credit lines, lessened their use of interest rate floors, and eased loan covenants; and a modest net share decreased the cost of credit lines. Banks also eased some terms for C&I loans to small firms: A moderate net fraction reported decreased spreads of loan rates over their bank’s cost of funds and lessened their use of interest rate floors; a modest net fraction increased the maximum size of their credit lines and eased loan...
covenants; and banks reportedly left the cost of credit lines to these firms unchanged.

- Leverage levels continue to diverge among commercial bank and non-bank commercial lenders – Through Q3 of 2017, non-bank lenders have provided approximately 14.3% higher leverage than their commercial bank counterparts. In addition, unlike commercial banks, which will require greater amortization on term facilities (ranging from 10.0% - 20.0% per annum), non-bank commercial lenders generally require between 2.5% - 7.5% per annum (usually accompanied by an excess cash flow sweep).

- Spreads across the credit spectrum have continued to compress through 2017 – Investment grade spreads have declined from an average of approximately 220 basis points in January of 2016, to less than 90 basis points in October of 2017, while high-yield spreads in the U.S. have declined on average by more than 500 basis points during the same period. Even in the less liquid lower middle market unitranche world, spreads have declined from approximately 690 basis points in 2014 to approximately 660 basis points in Q1 of 2017.

While competition for assets may be unprecedented among most middle market lenders, one major lending constituency that might be less competitive approaching year-end are the publicly traded business development companies (BDCs). Most BDC share prices continue to experience downward pressure, with BDCs struggling to trade at their net asset values (“NAV”). In Q3 of 2016, rising non-accruals, dividend cuts, and declining yields conspired to drive down the average ratio of share price to NAV to a low of 0.92x. As of this writing, only 16 of the 46 publicly traded BDCs (~34%) are trading at a premium to their NAV, while 28 of the 46 (~61%) are trading at a discount to NAV. While discounted BDC share prices detract a little liquidity from the current market, given the macro trends discussed above, it will likely have a negligible effect on overall market liquidity between now and year-end.

**Contact SPP Today**

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.

For your smaller capital needs, SPP’s direct lending platform, SPP Mezzanine Partners, is currently investing in senior, second lien, mezzanine, and unitranche instruments ranging from $5 to $15 million. We focus on established lower middle market companies with proven business models, stable cash flows and strong management teams.

Stefan Shaffer
Managing Partner
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**HISTORICAL DATA**

**Senior Debt Cash Flow (x EBITDA)**

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

**Total Debt Limit (x EBITDA)**

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

**Senior Cash Flow Pricing (Bank)**

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

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

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

**Second Lien Pricing**

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

**Subordinated Debt Pricing**

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

**Minimum Equity Contribution**

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

**U.S. PE Middle Market Deal Flow by Quarter**

Source: PitchBook

**Note:** For November 2017, “< $7.5MM EBITDA” represents “< $5.0MM EBITDA”