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

### Deal Component

<table>
<thead>
<tr>
<th>Cash Flow Senior</th>
<th>October '16</th>
<th>September '16</th>
<th>October '15</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt;$7.5M EBITDA</td>
<td>1.50x-2.50x</td>
<td>&lt;$7.5M EBITDA</td>
<td>1.50x-2.50x</td>
</tr>
<tr>
<td>(x EBITDA)</td>
<td></td>
<td>&lt;$10.0M EBITDA</td>
<td>2.50x-3.50x</td>
</tr>
<tr>
<td>&lt;$20.0M EBITDA</td>
<td>3.00x-4.00x</td>
<td>&lt;$20.0M EBITDA</td>
<td>3.00x-4.00x</td>
</tr>
<tr>
<td>Total Debt Limit</td>
<td>&lt;$7.5M EBITDA</td>
<td>&lt;$7.5M EBITDA</td>
<td>&lt;$7.5M EBITDA</td>
</tr>
<tr>
<td>(x EBITDA)</td>
<td>3.00x-4.50x</td>
<td>3.00x-4.50x</td>
<td>3.00x-4.00x</td>
</tr>
<tr>
<td>&lt;$10.0M EBITDA</td>
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<td>3.00x-4.50x</td>
</tr>
<tr>
<td>&lt;$20.0M EBITDA</td>
<td>4.00x-5.50x</td>
<td>&lt;$20.0M EBITDA</td>
<td>4.00x-5.50x</td>
</tr>
</tbody>
</table>

### Senior Cash Flow Bank

- L+3.00% to 4.50%
- L+3.00% to 4.50%
- L+2.50% to 3.50%
- (non-bank; potential for a 1.00% floor)

### Second Lien Pricing

- (x EBITDA) (potential for 0.50%-1.00% floor)
- L+8.00% to 10.00% floating (0.50%-1.00% floor)
- L+8.00% to 10.00% floating (0.50%-1.00% floor)
- L+6.00%-7.50% floating (0.50%-1.00% floor)
- L+6.00%-7.50% floating (0.50%-1.00% floor)

### Subordinated Debt Pricing

- (x EBITDA) (potential for 0.50%-1.00% floor)
- L+8.00% to 10.00% floating (0.50%-1.00% floor)
- L+8.00% to 10.00% floating (0.50%-1.00% floor)
- L+6.00%-7.50% floating (0.50%-1.00% floor)

### Unitranche Pricing

- (x EBITDA) (potential for 0.50%-1.00% floor)
- L+8.00% to 10.00% floating (0.50%-1.00% floor)
- L+8.00% to 10.00% floating (0.50%-1.00% floor)
- L+6.00%-7.50% floating (0.50%-1.00% floor)
- L+6.00%-7.50% floating (0.50%-1.00% floor)

### Libor Floors

- No Libor floor for club bank deals, though still common on syndicated bank facilities, second lien deals, and unitranche facilities. Markets anticipate a Fed rate increase of 25bps in December to a target range of 0.50%-0.75%, which could reduce floors from many facilities.

### Minimum Equity Contribution

- Probably the most dynamic area in the market right now: while lenders still expect min. 30.00%-40.00% total equity (incl. rollover), insurance companies, endowments, large family offices, and specialized asset managers are all actively pursuing opportunities to support sponsors and management teams, in some cases requiring limited or no equity co-investment and providing attractive promotions.

### Equity Co-Investment

- “Market” term for equity products (structured and common) are increasingly more stratified. On “head up” common, larger promates (15.00%+ and catch-up) are limited to “value” acquisitions (low multiple), material co-investment positions (25.00%+ of equity contribution), willingness to fund deal expenses, and “value-add” sponsorhsip (expertise in sector).
- Structured redeemable preferred tranches are routinely invested alongside mezz or unitranche debt.

### Recap Liquidity

- Recap deals are back with a vengeance. After three quarters of tightening liquidity, lenders across the spectrum from (banks to credit op funds) have opened the doors again. Dividend and share recaps are both being actively bid. While a recap combined with an accretive use of capital is still preferred (and may garner better terms), pure non-accretive deals are still getting done on competitive terms.

### Story Receptivity

- Though Q4 is historically a less forgiving market for storied paper or challenged issuers, 2016 is bucking the trend. Enhanced liquidity conditions stretch from even the most marginal of issuers (though pricing will reflect the situation). There exists a great opportunity to change out “fatigued” incumbent lenders.

### Tone of the Market

- Q4 market conditions are as aggressive as they have been in all of 2016. Pricing is tighter, leverage metrics are lower, and investors are especially eager to book assets that they can close by year end. Accretive deals will garner the best pricing terms, but liquidity is robust across the credit spectrum.

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*Changes from last month highlighted in red*
“Woke up this morning my house was cold
Checked out the furnace she wasn’t burnin’
Hit the engine but she ain’t turnin’
We’ve given each other some hard lessons lately
But we ain’t learnin’
We’re the same sad story that’s a fact
One step up and two steps back

Bird on a wire outside my motel room
But he ain’t singin’
Girl in white outside a church in Ju
But the church bells they ain’t ringing
I’m sittin’ here in this bar tonight
But all I’m thinkin’ is
I’m the same old story same old act
One step up and two steps back”

“One Step Up” - Bruce Springsteen

One Step Up

There seems to be little doubt that that the Fed will raise interest rates ‘one step up’ at their December meeting, setting the central banks benchmark federal funds interest rate (i.e. the overnight interbank lending rate) to a range between 0.50% - 0.75%. As Fed Chair Yellen noted after the September Federal Open Market Committee (FOMC) meeting, “Most participants do expect that one increase in the federal funds rate will be appropriate this year…I would expect to see that if we continue on the current course of labor-market improvement and there are no major new risks that develop, we simply stay on the current course.” Ms. Yellen’s comments might suggest a broad consensus among the Fed Officials respecting current monetary policy, however the last FOMC meeting was actually one of the more divisive meetings on record during the Yellen tenure. Three of the current ten voting members of the Committee dissented, going on record that they preferred an immediate 0.25% bump in rates. While Esther George (Fed Reserve Bank of Kansas City) has been consistent in her preference for such an immediate rate hike; at the September meeting however, she was joined in this opinion by Eric Rosengren (Fed Reserve Bank of Boston) and Loretta Mester (Fed Reserve Bank of Cleveland). Overall, there now exists a much broader agreement for at least one increase in 2016; 14 of the 17 officials at the meeting expect at least one rate this year.

At the center of the debate to raise rates is the Fed’s fundamental mandate of balancing full employment and inflation. At the current 5.0% unemployment rate, inflation continues to run below the Fed’s stated target of 2.0%. The Fed’s preferred measure of inflation, the change in Core Personal Consumption Expenditures (Core PCE Price Index) moved up 0.1% in August, to 1.7%. The fear in not raising rates now is that the unemployment rate will continue to fall, raising costs in the future at a pace that could quickly overheat the economy. This in turn would force sharp rate hikes in the future, which ultimately could push the economy into a recession. In any event, the market now seems to be anticipating a rate hike in December—according to the CME Group’s 30 Day Fed Fund futures prices, the implied probability of an interest rate at the December FOMC meeting currently stands at 59.5% (vs. only 14.5% in November).
Below is a quick recap of the month’s headline economic reports:

**Consumer Confidence/Retail Sales:** The Conference Board’s Consumer confidence index hit a nine year high in September, registering at 104.1 (up from 101.1 in August). Notwithstanding the angst of a particularly volatile Presidential election, the driver for the gain in the headline index is attributable to the “present situation” index, which rose in September to 128.5 up from 125.3. The University of Michigan’s Consumer Sentiment Survey also improved in September to 91.2, up from an 89.8 August reading. Interestingly, unlike the Conference Board’s report, the “current conditions” index fell nearly three points to 104.2, which would suggest weaker consumer spending. In fact, Consumer Spending was flat in August (after four months of gains) showing 0.0% change for the month and falling from a 0.3% increase in July. Part of the slowdown in consumer spending can be attributed to increased savings, which are currently at 5.7%, up 0.10% for the month.

**Inflation:** Inflation headed (moderately) in the right direction in August; the PCE Price Index (aka the “PCE deflator”) increased by a modest 0.1% month-over-month in August, which moved the annual inflation rate up to 1.0% (from 0.8%). Meanwhile, the Fed’s preferred measure of inflation, the Core PCE Price Index (excludes food and energy prices) bounced up 0.2% month-over-month, pushing the Core Price Index to 1.7% year-over-year. The results are consistent with expectation. The other measure of inflation, the Consumer Price Index (“CPI”), rose 0.2% in August after being unchanged in July. In the 12 months through August, the CPI increased 1.1% after advancing 0.8% in July. Core CPI rose 0.3% last month, the biggest increase since February, after gaining 0.1% in July. The delta between the PCE Price Index and the CPI Price index has become largely due to one category—medical costs. The PCE measure of core inflation is still being depressed by declines in the administered prices set by Congress for Medicare and Medicaid, while in contrast, the CPI measure, which covers only households’ out-of-pocket health spending, shows medical care inflation accelerating at a significantly faster pace.

**GDP:** Q2 GDP was revised upward in September, from an earlier revised 1.1% to a surprisingly positive 1.4%. The largest contributor to the increase was non-residential investment which was reported earlier at a negative 0.9% but jumped up to positive 1.4% in the third revision. Increased consumer spending and exports also contributed to the upward revision. Q3 GDP is now the focus and the latest Atlanta Fed’s GDPNow report, which is forecasting at approximately 2.2%. While this would be a substantial increase over Q2, it has still dropped from earlier Q3 forecasts which came in around 3.4%. It is also below the range of the “Blue Chip” consensus of economists (i.e. the top 10 and bottom 10 forecasts) as well as the 2.9% forecast by the Wall Street Journal’s survey of more than 60 economists.

**Manufacturing and Services:** After slipping into contraction mode in August, Manufacturing returned to expansion territory in September with the ISM Manufacturing Index reading of 51.4 (from 49.4). The report was above consensus. The “new orders” component was the standout item in the report, rising 6 points to a solid 55.1 and suggesting continued strength into the fourth quarter. The ISM Non-Manufacturing report also strengthened in September, shooting up to a very respectable 57.1 from August’s anemic 51.4. Again, the “new orders” component was the greatest contributor to the headline number, jumping 9 points from August to 57.2 (the strongest rate of growth since September of 2015). Business activity was reported at a very healthy 60.3, and total backlog orders rose up to 52.0. The report clearly supports a Fed rate increase at the September meeting but also represents something of a disconnect with recent downgrades to Q3 GDP.

**Employment:** Given the focus on a December rate hike, unemployment data is being closely scrutinized, especially in light of the fact that the inflation data still lags the Fed’s 2.0% target. The first hint that the unemployment data would be strong enough to support a hike was the release of the “jobless claims” data for the first week of October; the four week average of
U.S. unemployment claims fell to 249,000 (down from 254,000), representing the lowest reading of this measure since 1973. The headline non-farm payroll came in at a timid 156,000 for September (at the low end of the consensus range of 155,000-200,000), and the August report was revised upward to 168,000 from 151,000. Job growth has averaged 178,000 per month so far this year, down from last year’s pace of 229,000. The unemployment rate was little changed, inching up to 5.0% from 4.9%, but for a good reason, the Participation Rate rose to 62.9% (from 62.8% in August). The totals are not necessarily noteworthy in either a positive or negative way, but do provide the Fed with continued support for a December rate hike (or conversely enough cover for not raising rates).

- **Housing:** After a huge increase in July (up 13.8% to the fastest pace since 2007), new home sales contracted 7.6% in August, but despite the dip, the pace of sales remains robust. August saw the fastest sales rate since 2008 (excluding July numbers) and sales were nearly 21.0% higher year-over-year. The inventory of unsold homes rose 4,000 in August, but supply remains stubbornly low by historical measures. The gain in inventories August was due to homes where construction has not yet begun, and in fact, the majority of sales in August came from these same properties that have yet to break ground, marking a shift from a year ago when completed homes represented the majority of sales. It also suggests that builders are falling behind the demand for new homes, and any concerns about a bubble forming in housing may be overblown. Overall, August is a very positive report which underscores the accelerating strength of the new home market, strength that is making up for less far momentum on the resale side.

**Private Market Update**

Private market liquidity conditions going into Q4 remain as aggressive as they have been for all of 2016. In fact, for the sixth consecutive month, SPP has lowered at least one of its pricing metrics; this month lowering our pricing indications for both Unitranche and Second Lien issuers with more than $10 million in EBITDA to a range of 1.0x - 6.5% - 8.00%

Historically, our issuing guidance is that Q4 issuance is best left for accretive deals (i.e. acquisition vs. recaps), stronger or repeat issuers, and transactions with more conservative leverage tolerances, relegating more “storied paper,” marginal or challenged credit profiles, highly levered financings, or dividend recaps to Q1 of the next year when market conditions tend to be quieter and more receptive. This is especially so later in the quarter when the market is preoccupied with the traditional crush of deals that need to close by year end. 2016, however, has been the exception to the rule.

Our anecdotal deal evidence suggests that investors are relatively indifferent to timing this year—lenders are bidding aggressively across the credit spectrum regardless of size, use of proceeds, or general credit quality. Not only are deals being actively pursued, but the delta between the most competitive bids is often measured in hundreds of basis points. In a small subordinated note offering recently marketed by SPP for an issuer with approximately $10 million of EBITDA (aggregate leverage of ~4.0x), the final bids ranged from an all coupon deal of 10.0% to 14.0% (with warrants). Interestingly enough, the competing proposals included bids from insurance companies, traditional mezzanine funds, BDCs, and SBICs. The takeaway from the example above is that given the sheer magnitude of liquidity from competing lending constituencies, it makes eminent sense to go as broad as possible in the offering process for a financing. Lenders will of course compete on price, but also in other areas such as timing to close, conditions precedent to closing (i.e. quality of earnings, etc.), pre-payment provisions, covenants, and even inter-creditor provisions. The increased liquidity in the market may even in fact be influencing M&A multiples; PitchBook’s most recent “Deal Multiples Survey” reported a median enterprise value to EBITDA multiple of 6.13x at the sub $25 million enterprise value range in Q2 2016. That figure is nearly a turn higher than what was recorded in the first quarter of the year.

In addition to being a particularly aggressive market for debt products (senior,
subordinated, second lien, and unitranche), there is an unprecedented amount of liquidity for alternative equity products as well. Most unitranche and mezzanine lenders will provide supplemental equity capital ranging in size from 10.0% - 100.0% of their parallel debt commitments. Straight equity investments are also readily available and range from minority structured preferred instruments to "heads up" equity with promotes spanning from 10.0% - 20.0%+ for co-investing sponsors, independent sponsors, and management teams.

What is even more extraordinary is that this abundance of liquidity for private debt and equity products is blossoming in the face of arguably one of the most volatile and controversial presidential elections in U.S. history, which, combined with an almost certain increase in interest rates promises to make for an interesting Q4.

SPP-Tracked Market Activity

September deal and exit count saw a slight uptick from August, though both volumes were essentially flat across the middle market (<$500M). While perhaps this minor rise can be read as a product of the headwinds of the Q4 crush and increasingly liquid market conditions, as has been the case for some time now, we will have to wait to see. September LTM deal numbers are still around 37% below where they were this time 2015 (though exit LTM numbers have now surpassed 2015), so it seems that 2016 can be officially marked as a major downturn in new deal activity, which is unsurprising given the first rate hike and uncertainty that has shadowed the market all year. Perhaps Q4 will bring its customary increase in activity, but with another rate hike looming, the long term outlook for deal numbers will likely mean a new normal is upon us.

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.

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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 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”

**Historical 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