Senior deals, second lien, and floating-rate markets have been constant for a number of years. Despite market volatility, lenders are preparing for the Q4 crush of new deals that need to close by year-end. While recap liquidity is abundant, but is the best (pricing and terms) associated with a combination recap and accretive event (acquisition, expansion, etc.). Commercial Banks are likely to be less aggressive across the board than their non-bank competitors on most recaps.

Recap Liquidity
Recap liquidity is still quite robust, but favors (i) sponsored deals where there is additional cash available for investment; (ii) when coupled with an acquisition or other accretive use of capital. "Busted" auctions that morph into a recap are still well-received and often generate aggregate proceeds not significantly less than a sale/rollover structure - but without the dilution.

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Stony Receptivity
While story receptivity is still good, it will decrease geometrically as Q4 continues. September through mid-October is the best time to launch a storyed or challenged credit (investor still sees a path to 2015 close), but the market for tough deals will largely shut down by November 1st for all practical purposes.

Tone of the Market
2015 has been characterized by excess liquidity conditions combined with increased deal flow - a "win win"; but, post Labor Day there is always a "Q4 Crush" of new deals that need to close by year-end, and this year it will likely be augmented by expectations of a 2016 interest rate lift-off. Best strategy - get in quick while investors have the time and resources to bid aggressively. Stronger credits will benefit as Q4 progresses; weaker credits - not so much.

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

<table>
<thead>
<tr>
<th>Deal Component</th>
<th>September 15</th>
<th>August 15</th>
<th>September 14</th>
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<tbody>
<tr>
<td>Cash Flow Senior Debt (x EBITDA) &lt;7.5MM EBITDA 1.50x-2.50x</td>
<td>&lt;7.5MM EBITDA 1.50x-2.50x</td>
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<td>Total Debt Limit (x EBITDA) &lt;7.5MM EBITDA 3.00x-4.00x</td>
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<td>&gt;10.0MM EBITDA 3.75x-4.50x</td>
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<td>&gt;20.0MM EBITDA 4.00x-5.50x</td>
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<td>&gt;25.0MM EBITDA 4.00x-5.75x</td>
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<tr>
<td>Senior Cash Flow Pricing L+2.50%-3.50% (bank)</td>
<td>L+1.75%-3.50% (bank)</td>
<td>L+1.50%-4.50% (bank)</td>
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<tr>
<td></td>
<td>L+4.00%-6.00% (non-bank; potential for a 1.00% floor)</td>
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<tr>
<td>Second Lien Pricing (Avg) &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>
<td>&lt;7.5MM EBITDA L+8.00%-11.00% floating (1.00% floor)</td>
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<td>&gt;20.0MM EBITDA L+5.50%-7.50% floating (1.00% floor)</td>
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<td>Subordinated Debt Pricing &lt;7.5MM EBITDA 12.0%-14.0%</td>
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<td>Warrants limited to special situations; Second lien may buy down rate to -9.0%</td>
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<td>Unitranche Pricing &lt;7.5MM EBITDA L+8.00%-11.00% (1.00% floor)</td>
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- Changes from last month in red
Things Have Changed

As highlighted in the August edition of the SPP Market Update, more than 80% of private economists anticipated “lift-off” from the Fed's near zero interest rate policy in September, but things seem to have changed. In the most recent Bloomberg News survey, conducted between Aug. 27-31, only 48% percent of 54 private economists polled now anticipate a September increase in the benchmark lending rate (the same survey conducted between Aug. 7-12 came in at 77%).

The first hint that the Fed was reconsidering a September lift-off came on August 19th, when the minutes from the July FOMC meeting were released. According to the release, most meeting participants “judged that the conditions for policy firming had not yet been achieved, but they noted that conditions were approaching that point.” And later in the release, “Almost all members” indicated that “they would need to see more evidence that economic growth was sufficiently strong and labor market conditions had firmed enough for them to feel reasonably confident that inflation would return to the Committee's longer-run objective over the medium term.”

The tumultuous economic issues in China and resulting global markets roller coaster has only exacerbated the risk associated with a premature lift-off for many market participants, but much more fundamental economic headwinds (inflation and unemployment) seem to suggest that the Fed decision to raise rates may be pushed out to year end or beyond. Inflation remains stubbornly sluggish; as the Fed’s “preferred” inflation index, the PCE Price Index’s most recent reading came in at an anemic 0.30% year on year; that is down from a revised 0.34% just a month earlier. The less volatile Core PCE price index (which excludes Food and Energy) was 1.24%, well below the 2.0% “target” articulated by the Fed. While recent employment numbers have been positive (unemployment currently stands at 5.1% and the workforce has expanded by an average of 208,000 workers per month for the first half of the year), the growth in jobs has not translated into wage growth. Average hourly earnings continue to grow only by 2.0% per year (nominal).

Finally, US manufacturing continues to struggle against a strengthening dollar; a rise in interest rates (even by the small increment articulated by Fed Chairperson Janet Yellen of 0.25%) would drive a stronger dollar, further impair manufacturing growth, and create more impetus to shift production abroad, which would only put increased downward pressure on wage growth. Below a deeper dive into the last month’s headline macroeconomic releases:

- **Consumer Confidence/Retail Sales**: Consumer spending, which represents more than two thirds of the economic activity that constitutes GDP, increased 0.3% in July, following a similar gain in June (as reported by the Commerce Department). In a strange twist however, consumer sentiment (as reported by the University of Michigan Consumer Survey) in August dipped to 91.9 from a 92.9 reading in July. Both reports contradict the trend earlier in the year where consumer sentiment was strong, but the positive sentiment was not translating into higher consumer expenditures. The consumer sentiment reading of 91.9 was actually something of a shocker — the expectation had been for a reading of 93.3. Taken together, the two reports are unlikely to have much of an impact on the Fed's decision to implement lift-off in September.

- **Inflation**: As noted above, recent inflation reports provide ample support for the Fed to delay lift-off. Core PCE at 0.30% year on year is at its lowest level in four years. Given seven years of zero interest rate policy and quantitative easing, this disinflationary trend in the PCE Price index is particularly problematic for the Fed. Since April of 2014 the Core PCE

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“Things Have Changed”, Bob Dylan
prices were heading up above the 1.5% level, only to recede to the 1.3% level in 2015. The Consumer Price Index (CPI) however, has been a little stronger; CPI rose 0.1% in July (its sixth monthly increase) and 0.2% year on year. Core CPI (which excludes food and energy) was up 0.2% for the month and 1.6% year on year (the 4th time in five months that Core CPI has been at 1.8%). Clearly, Core CPI is much closer to the Fed’s target inflation rate of 2.0%, justifying a September lift-off. The support for the stronger Core CPI can in large part be attributed to housing, rent in particular; “owner’s equivalent rent”, which comprises approximately 25% of the CPI, rose 0.3% for July and is up at 3.0% year on year growth when annualized.

- **GDP:** The second revision to Q2 GDP pushed growth to 3.7%, a significant boost to the 2.3% initially recorded. The expectation was closer to 3.0%. Though all the major components of GDP were revised upwards, “business investment” exhibited the most dramatic change, initially recorded at 0.6% growth and revised up to +3.2% (boosted by corporate investment and additions to inventory). The report also gave greater insight to corporate profits, which rose 2.4% in Q2 after falling 5.8% in Q1. Personal consumption expenditures rose at a 3.7% growth rate, driven in large part by an 8.2% consumption rate for durable goods (primarily new vehicle sales). The improvement in GDP is consistent with the pattern witnessed in 2014, where harsh weather contributed to an anemic Q1 followed by a robust improvement in Q2, and provides some credible support for a September lift-off. Expectations for Q3 provide a little less comfort however; the Atlanta Fed’s GDPNow estimate for Q3 2015 for real GDP growth (seasonally adjusted annual rate) is 1.5% as of September 3, up from 1.3% on September 1. The Blue Chip consensus for Q3 GDP remains a little more optimistic with the bottom 10 and top 10 forecast range spanning 2.0% to 3.4% respectively.

- **Manufacturing:** The recent reports on the manufacturing sector will likely be weighing on the minds of the Fed when it meets on September 17th. The ISM Manufacturing Index for August came in at a disappointing 51.1 (down from 52.7 a month earlier and a fairly big miss from the consensus expectation of 52.8). This represents the slowest rate of growth for the factory sector since May 2013. Foreboding what yet may come, the new orders component posted a 51.7 — one of the slowest rates of monthly growth of the recovery. Backlog orders came in at 46.5 — signaling the third month of contraction (anything below 50 signifies contraction and anything above 50 signifies expansion). The weak results of the August ISM report, however, follows a relatively upbeat Durable Goods release for July; Orders for Durable Goods (products that last for three years or more) rose 2.0% in July and June Durable Goods orders were revised up from 3.4% to 4.1%. While most of the gains can be attributed to the transportation sector, which is particularly volatile due to the impact of large aircraft orders, auto purchases were up a healthy 4.0%, confirming the trend for increased consumer consumption for the month. It should be noted that manufacturing only accounts for approximately 13.0% of the economy; so while it is still a visible and important metric in gauging economic growth, manufacturing may not be as significant a metric in setting monetary policy as the employment or consumer spending metrics.

- **Employment:** Non-farm payrolls increased by a less than anticipated 173,000 in August (expectation was closer to 220,000), but the prior two months were revised upward by 44,000. That brought the unemployment rate down to 5.1% unemployment rate (from 5.3% in August and 6.3% a year ago). While this was the weakest jobs report in five months, (the economy that had averaged approximately 208,000 jobs added per month for the six months preceding the August report), conventional wisdom suggests that the Fed currently has achieved the critical mass needed to justify a lift-off in September. The big disconnect is that the seemingly robust growth in job creation has not resulted in higher wages for the average American worker. Average hourly earnings for all private sector workers were up 2.1% in July from a year earlier. In the last three months, hourly pay rose at a 1.6% annualized rate (below its average a year ago). The rationale for this anomaly between seemingly “full employment” at
5.1% and stagnant wage growth can be found in the concept of NAIRU as enunciated by the Congressional Budget Office’s (“CBO”). The non-accelerating inflation rate of unemployment, or NAIRU, is the lowest level of unemployment the economy can support without causing inflation to rise. The CBO had earlier estimated NAIRU to be at 5.3%, but it has since revised its expectation to peg the number at 5.0%. In short, there is still “slack” in the labor market even at these lower unemployment levels; ostensibly, according to the CBO, wages will begin to rise at an unemployment rate of 5.0%.

- **Housing:** The housing market continues to show signs of a revival and the summer has been a particularly good time for both housing starts and existing home sales. Housing starts rose to 1.2 million on an annualized basis, which was attributable largely to a 12.8% rise in single-family starts - the highest rate of starts since 2007. On a related note, the total number of homes under construction, started but not finished, increased by 2.0% in July and is almost 15% above the level it was at a year ago. Another major housing metric, existing home sales, also gave credence to the strength of the housing market by notching up 2.0% in July despite rising existing home prices.

**Private Market Notes: Q4 Issuance and High Yield “Contagion”**

The last quarter of the year is always the busiest, and there is no reason to suspect that is year is going to be any different. The fundamental caveats about Q4 issuance to consider include:

- **The Sooner the Better:** It has been our singular and consistent experience that those deals first in after the Labor Day holiday tend to get the best reception, which often translates into better pricing and terms. More importantly, investors are confident that early post Labor Day deals will result in a 2015 closing and this makes them more incentivized to compete. Given the elevated amount of deal flow throughout 2015 and the potential for higher rates in 2016, deal activity is expected to get only more frenetic this year. Accordingly, if it is your intention to go forward with a financing this year, it is pretty safe to say that there is no more opportune time than now. Importantly, given the current level of volatility in the high yield markets and the potential for contagion in the less liquid private debt markets, timing considerations take on even greater significance.

- **Be Comprehensive:** The depth and breadth of offering documents are the single greatest determinant of what deals are chosen to be processed when the market is busy. Summary or “high level” presentations that are not supported by substantive financial models and detailed support translate into more work for an investor preparing for committee approval and a slower track to closing by year end; by definition these deals are less appealing to increasingly selective investors as Q4 progresses. To the extent there are significant add-backs to construct an “Adjusted” EBITDA, or in the absence of an audit, it is almost certain that a quality of earnings (“QoE”) will be required—it is worth the time to get the process started (preferably with an established player in the sector); the same applies to appraisals.

- **Go Broad:** In an effort to expedite an offering, issuers commonly look to a narrower audience of investors; while this strategy may be intuitive, it is also likely to make the bids less competitive and actually slow down the process (additional investors need to be approached if and when initial contacts fall away). Finally, it shifts the power from the issuer to the investor, as the winning bid is often contingent on the last lender standing as opposed to a more competitive bid process.

- **The Story Credit Expiration Date:** Deals that are more challenging, storied, or have other “hair” on them, by definition, need more time to process. A storied deal launched in mid-August or early in Q1 of 2016 is going to get a much better audience than a deal launched in Q4 of 2015. If investors assume a deal won’t be able to close by the end of Q4, they
are likely to defer — thus requiring an issuer to pull a deal at year end only to remarket after the turn of the new year. This on-again off-again syndrome only increases the risk of non-closure (you are dealing with both a storied credit and the perception of a "failed" deal).

**High Yield Contagion**

As noted above, one of the primary motivations to move sooner rather than later if contemplating a 2015 financing is the risk of high yield "contagion"; i.e. that the dislocation currently being experienced by the high yield markets will bleed into the private debt markets. High yield spreads are currently at levels that the market hasn’t seen since 2012, and outflows from loan funds and high yield bond funds are at alarming levels. To provide an order of magnitude, as of August 24<sup>49</sup>, loan funds have seen $6.0 billion in outflows, while high-yield funds have seen $1.5 billion in outflows.

The good news is that to date, there has been little, if any, contagion in the private debt markets. If the current level of dysfunction continues in the high yield arena, however, it is only a matter of time before the lower middle market will be adversely impacted as well. In fact, there are a number of head winds that could severely impact liquidity in the middle market debt arena at play already: commercial banks still wrestle with the leveraged guidelines articulated by the Fed, OCC and FDIC, and most banks are simply unwilling to bid deals outside the “3/4 Box” (3X Senior Debt/EBITDA by 4x Total Debt/EBITDA), absent a strong allegiance to the issuer or owner equity sponsor. In addition, one of the most prolific sources of capital to the lower middle market, business development companies (“BDCs”), continue to struggle against lower share valuations. Approximately 70% of BDCs are trading at a discount to net asset value (NAV). Credit quality is the paramount concern in the BDC community, limiting the potential liquidity of more marginal credits.

With higher interest rates in late 2015 or early 2016 all but guaranteed, greater focus on leverage metrics and credit quality in the commercial bank and BDC community and a profound deterioration of liquidity in the high yield market, could a significant correction in middle market loan liquidity be far behind? Suffice it to say that if an issuer is serious about a Q4 financing, the preeminent consideration has to be speed to market.

**SPP Tracked Market Activity**

Although overall private equity deal activity as gauged by dollars invested has trended downwards in 2015, the middle market space has been very active in the months of July and August when compared to the rest of the year. Total deal count in July and August were 314 and 251 respectively, compared to a deal count of 151 in June. Bank and non bank pricing have held steady throughout the course of the summer. As the post Labor Day flurry of deals approaches, this phenomenon is likely to be amplified by the expectation of a rate increase in the near future. Nevertheless, lenders and credit funds will likely be more receptive to stronger, less storied credits as more and more deals hit the table.

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)

Historical Total Debt Limit (x EBITDA)

Historical Senior Cash Flow Pricing (Bank)

Historical Senior Cash Flow Pricing (Non-Bank)

Historical Second Lien Pricing

Historical Subordinated Debt Pricing

Historical Minimum Equity Contribution

U.S. PE Capital Invested by Quarter

Source: SPP's "MIDDLE MARKET LEVERAGE CASH FLOW MARKET AT A GLANCE"

Source: Pitchbook