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

<table>
<thead>
<tr>
<th>Deal Component</th>
<th>March ’15</th>
<th>February ’15</th>
<th>March ’14</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash Flow Senior Debt</td>
<td>$&lt;7.5 MM EBITDA 1.5x-2.0x</td>
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<tr>
<td>(x EBITDA)</td>
<td>$&gt;10.0 MM EBITDA 2.0x-3.5x</td>
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<td>Total Debt Limit</td>
<td>$&lt;7.5 MM EBITDA 3.0x-4.0x</td>
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<td>$&lt;7.5 MM EBITDA 3.0x-4.25x</td>
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<tr>
<td>(x EBITDA)</td>
<td>$&gt;10.0 MM EBITDA 3.75x-4.50x</td>
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<td>Senior Cash Flow Pricing</td>
<td>L+2.00x-3.50% (bank)</td>
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<tr>
<td></td>
<td>L+4.00x-6.00% (non-bank)</td>
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<td>Second Lien Pricing</td>
<td>$&lt;7.5 MM EBITDA L+8.00x-11.00x floating</td>
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<td>(Avg)</td>
<td>(1.00% floor)</td>
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<td>Subordinated Debt Pricing</td>
<td>$&lt;7.5 MM EBITDA 12.0%-14.0%</td>
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*Changes from last month in red*
“One, two, one, two, three, four
Shed a tear ‘cause I’m missin’ you
I’m still alright to smile
Girl, I think about you every day now
Was a time when I wasn’t sure
But you set my mind at ease
There is no doubt you’re in my heart now

Said woman take it slow, and it’ll work itself out fine
All we need is just a little patience
Said sugar make it slow and we’ll come together fine
All we need is just a little patience (Patience)
Mm, yeah”

“Patience,” Guns N’ Roses

Patience

Higher interest rates, a more conservative banking community, and continued tightening in leverage metrics...is the party over?

Hardly.

The big question that is dominating the “Fed-speak” in March is whether the Fed will remove the word “patient” from their FOMC statement on future rate movement. Fed Chairwoman Yellen has already signaled that deletion of the word would herald any increase in forward guidance on rates (i.e.- if the word does not appear in the FOMC statement for the March 17-18 meeting, a June liftoff can be expected).

There is certainly ample support for the proposed imminent lift-off from the current near zero interest rate policy. With the official unemployment rate at 5.5% and inflation hovering just below 2.0%, ostensibly, the conditions precedent for lift-off have been satisfied. In fact, job growth has been so strong (3.3 million jobs created over the last 12 months – the largest 12 month gain since 2000), an argument can be made that the Fed has already waited too long.

The goal of monetary policy is to set rates low enough to nurture job growth, but not low enough to trigger an unacceptable rate of inflation (the Fed’s “dual mandate”). Balance is critical to the Fed’s current thinking and is the basis of the classical economic theory “NAIRU” (Non-Accelerating Inflation Rate of Unemployment). Current thought is that that balance is about 5.2% – 5.4% unemployment coupled with 2.0% inflation. Presumably, if the jobless rate declines too much, it triggers upward pressure on wages. Ultimately, that may lead to increased demand for goods and services, which, in turn, fans the flames of an inflationary cycle.

Although we have seen the drop in the jobless rate and the commendable increase in nonfarm payrolls...where is the upward pressure on wages and where is the inflation? The Fed’s preferred gauge of inflation, the personal consumption expenditures price index (the “PCE Index”) has been below the central bank’s 2.0% target for 52 of the last 68 months of the current expansion, and for the last 34 consecutive months. Although the economy is adding jobs, most of that growth has been in low-wage positions. Leisure and hospitality saw the greatest increase in jobs, which jumped by a healthy 66,000. The downside is that wages in the leisure sector average $14.23 per hour ($29,500 per year). The most recent employment data also shows continued weakness in wage growth. Average hourly earnings rose 0.1% in February, down from 0.5% in January (expectation was for a minimum 0.2%).
Since the beginning of 2013, wages have grown about 0.9% per year. While that level is consistent with the period preceding the recession, and still in excess of inflation, it is clearly not “inflationary.” Notably, a reduction in the Civilian Participation Rate impacted the low 5.5% unemployment rate (i.e. people dropped out of the labor pool; the labor pool population size decreased from 62.9% to 62.8%, which is among the lowest rates seen since the late 70s).

The most recent release on the inflation front was the February producer price index (“PPI”), which fell for the fourth straight month (a decline of 0.5% in February, following a 0.8% reduction in January). Falling gasoline prices are also certainly depressing inflation. In fact, in 2014, the US All Items Consumer Price Index posted its smallest increase since 2008. It is pretty hard to find any inflationary pressure in the current environment, much less enough to justify an increase in the current forward guidance on rates.

As of the date of this writing, the Euro to Dollar exchange rate is €1.00:$1.06, the strongest it has been in years. Any incipient interest rate increases will only fuel a stronger dollar, making American-made goods less competitive and potentially signaling greater weakness in manufacturing and more downward pressure on GDP. Manufacturing is already showing some concerning trends; the Fed’s monthly index of industrial production for February dipped 0.2% in February after falling 0.3% the month before. The drop marked the third consecutive monthly decline (initial forecasts indicated 0.1%). Notably, manufacturing was revised down for January from +0.2% to -0.3%.

While the debate respecting the timing of the lift-off will undoubtedly continue, and every nuanced Fed official comment will be scrutinized and analyzed ad nauseam, it may yet be difficult to reach the critical mass necessary for a June (or September, for that matter) increase in rates. To paraphrase two of Chicago’s most famous public access TV icons, Wayne Campbell and Garth Algar, “Party On.”

**Private Market Update Notes**

As highlighted above in the “Market At A Glance,” the private debt capital markets are taking on an increasingly barbell-like appearance. Conditions remain exceedingly liquid. While there is no need to sound any alarms, pricing seems to be stratifying in a distinctly polarized fashion. As a result of the policy guidelines set by the FED, OCC, and FDIC, banks simply can’t have as strong of a presence in the higher-leveraged profile deals as they did in 2014. However, for those deals that are within the proverbial “3/4 Box” (3.0x senior leverage by 4.0x total leverage), pricing is becoming fiercely competitive. SPP has lowered its pricing guidance for senior cash flow pricing from L+3.00% – 4.00% in February to L+2.00% – 3.50% in March, reflecting the heightened competition for low-leverage bank assets.

For those deals that fall outside the 3/4 Box, there is still intense competition, just not as much from the commercial banking constituency. Non-bank commercial lenders and unitranche providers are more than picking up the slack, and although there will likely be a corresponding premium in pricing, there is no dearth of liquidity. Importantly, these non-bank providers can provide other benefits, making them a preferred lender. These benefits include:

- **Lower Amortization:** Non-bank commercial lenders and unitranche lenders routinely require 0.0% – 5.0% fixed amortization per annum (combined with an excess cash flow sweep), which provides a higher fixed charge coverage and lower aggregate cash cost of debt service than a corresponding commercial bank term facility (which often ranges between 10.0% – 15.0% fixed amortization per year); and
- **Covenant Latitude:** As a general proposition, non-bank commercial lenders often provide issuers with a less restrictive covenant package
than their commercial banking counterparts. This is especially salient in the unitranche context where covenant packages are specifically tailored to strike a middle ground between traditional senior and subordinated debt bifurcated structures.

By the same token, non-bank commercial and unitranche lenders pose some distinctly negative attributes compared to the commercial banks (besides pricing), including:

- **Fees:** Whereas a traditional bank facility will have closing fees that range from as low as 0.25% to a maximum of about 1.0%, non-bank commercial and unitranche lenders routinely seek closing fees ranging from 1.0% – 2.0%;
- **Prepayment Premiums:** Whereas most commercial banking facilities are prepayable at par, the non-bank community generally seeks a declining premium structure that can start as high as a 103.0% premium in year one (declining to par in subsequent years); and
- **Libor Floors:** As a general proposition, Libor floors simply do not exist in most commercial banking deals (at least, in the non-syndicated context). In fact, in some recent transactions, commercial banks have offered “Libor Discounts” to capture competitive transactions (essentially providing a hedge against future rate increases). Almost every non-bank commercial and unitranche lender seeks a 1.0% Libor floor on their floating-rate offerings.

The current market offers an abundant array of financing alternatives that can benefit issuers. It is critical that potential borrowers cast a wide enough net to capture all the distinctive benefits that different lending constituencies can provide. If there is a single, overriding advantage to an SPP-managed process, it is that every viable lender within each potential lending constituency will have an opportunity to compete for a given asset. That broad offering strategy has resulted in an average 6.0x oversubscription rate on SPP-managed deals since 2010.

**SPP Tracked Market Activity**

In a month characterized by a quickly changing environment, the phrase “March Madness” is not simply an apt description of the NCAA College Basketball Tournament. Large deal and exit activity has declined, yet smaller deals and exits have not (which provides a fitting metaphor for the tournament bracket predictions of many college basketball enthusiasts). Total deals declined from 242 in January to 210 in February and total exits declined from 98 to 88. However, there was no change in the total deal and exit count in transactions under $250 million. February LTM deal and exit totals remain considerably higher than previous years.

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)

- Less than $7.5MM EBITDA
- $10MM EBITDA
- Greater than $25MM EBITDA

- Source: SPP’s “Middle Market Leverage Cash Flow Market at a Glance”

### Historical Total Debt Limit (x EBITDA)

- Less than $7.5MM EBITDA
- $10MM EBITDA
- Greater than $25MM EBITDA

- Source: SPP’s “Middle Market Leverage Cash Flow Market at a Glance”

### Historical Senior Cash Flow Pricing (Bank)

- Bank Lower Bound
- Bank Upper Bound

- Source: SPP’s “Middle Market Leverage Cash Flow Market at a Glance”

### Historical Senior Cash Flow Pricing (Non-Bank)

- Non-Bank Lower Bound
- Non-Bank Upper Bound

- Source: SPP’s “Middle Market Leverage Cash Flow Market at a Glance”

### Historical Second Lien Pricing

- Lower Bound
- Upper Bound

- Source: SPP’s “Middle Market Leverage Cash Flow Market at a Glance”

### Historical Subordinated Debt Pricing

- Less than $7.5MM EBITDA
- $10MM EBITDA
- Greater than $25MM EBITDA

- Source: SPP’s “Middle Market Leverage Cash Flow Market at a Glance”

### Historical Minimum Equity Contribution

- Lower Bound
- Upper Bound

- Source: SPP’s “Middle Market Leverage Cash Flow Market at a Glance”

### Secondary High Yield Pricing

- Secondary High Yield Pricing
- SPP Value Inflection Point

- Source: SPP’s “Middle Market Leverage Cash Flow Market at a Glance”

- Source: Piper Jaffray Debt Capital Markets Update