Capstone Headwaters

MIDDLE MARKET LEVERAGE FINANCE

CURRENT MARKET CONDITIONS | Q4 2019

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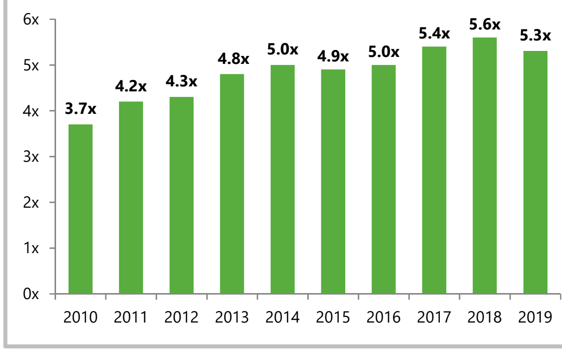
KEY MARKET STATS[1,2]

- **Broadly Syndicated Loan (BSL) volume** in the middle market (MM) declined throughout 2019, largely as a result of the continued growth of direct lending, a muted leveraged buyout (LBO) market, and a more conservative approach from lenders.
- **Interest rate spreads** for institutional MM loans increased 30 basis points in Q4 2019 compared to Q3 2019 and have increased more than 50 basis points throughout the year. Spreads closed the year up slightly from the previous two years.
- **Leverage multiples** in the fourth quarter ticked up modestly following a nearly year-long descent, but remain below 2018 levels. We expect leverage to remain flat to down in 2020 as lenders continue to seek out more conservative structures and stronger credits in the face of increasing macroeconomic volatility.
- **Equity contributions** from sponsors remain at a 10-year high of 50%; as valuations continue to rise, lenders are requiring more meaningful equity investments from sponsors.

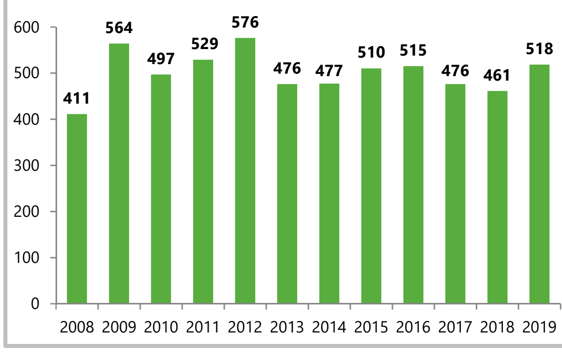
LEVERAGE MULTIPLES (MID-MARKET)[1]



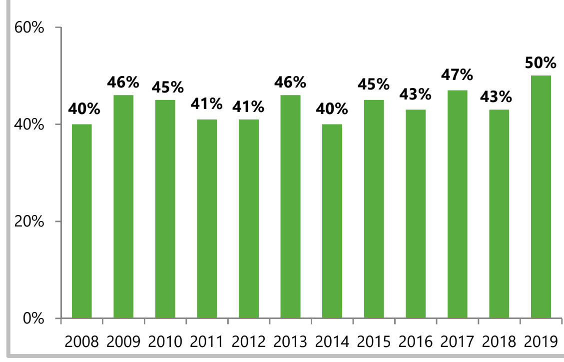
QUARTERLY MARKET OBSERVATIONS[1,2]

- Conditions in the MM have become **more conservative** as lenders continue to shift their credit focus towards protecting portfolio credit quality as the end of the credit cycle approaches.
- **Leverage multiples generally declined** during 2019 by 0.25x to 0.5x depending on the sector, structure, use of proceeds, and sponsorship involved.
- BSL **volume** during 2019 in MM leveraged finance **decreased 26% year-over-year (YoY)** as lenders continue to shy away from cyclical credits, LBO-related volume remains slack, and increasing spreads limit refinancing activity. Direct lenders have substantially increased their market share largely offsetting the decline in BSL volume.
- Institutional loan **volume is expected to decline** further in 2020 due to weak merger and acquisition (M&A) volumes, lack of economic growth, rising recession risk, and the impact of the approaching election.
- Appetite among lenders for strong borrowers in **favorable sectors remains quite high** in our recent auctions, as lenders have become more discerning for less creditworthy issuers.
- Structure du Jour: Interest runs high among lenders for exposure from "first-dollar" with a bias for **unitranche facilities** where they provide the entire debt portion of the cap stack and retain control over structure, term, and documentation negotiations.
- **Expanding Buyer Universe:** Traditional private equity firms are facing more competition on smaller deals as independent sponsors and family investment offices become more assertive in auctions — further fueling the increase in purchase price multiples.
- Simple Math: Higher valuations now being paid have, in turn, increased the pressure on sponsors to drive portfolio company **earnings growth** in order to generate acceptable equity returns — which in turn has spurred the search for synergistic **add-on acquisitions** at prices that can be arbitraged over time.
- The expectation of continued add-on acquisitions is leading to greater use of **delayed draw term loan** (DDTL) commitments (f/k/a acquisition lines) included in LBO facilities to provide seamless and quick capital availability for private equity sponsors.
- Higher valuations are also driving **greater levels of equity** being contributed in LBOs, now about 50% of total sources (up from the 40%-45% range over the last decade), especially in non- (or lightly-) sponsored deals involving smaller credits and tougher sectors.
- Emerging Trend: Deals are **increasingly being circled amongst direct lenders** at the expense of the more traditional BSL market, driven by the massive amount of private credit that has recently been raised and the key advantages of direct lenders (size, speed, no ratings, etc.).

AVERAGE INTEREST SPREAD[1]



EQUITY CONTRIBUTION[1]



REQUIRED READING

- *Middle Market Lending's Race to the Bottom Set to Continue in 2020* – Forbes contributor, Bill Weisbrod, examines the increase in direct lenders entering the MM and the impact it is having on competition. — *Forbes*

NEW ISSUE VOLUME (EBITDA<$50m)[1]

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CURRENT MARKET TERMS

- **General Market Terms:** Provided in the adjacent table are the general loan pricing terms and leverage multiples that we are seeing in today's leverage finance market for various sized borrowers.
- In practice, the actual negotiated terms are more bespoke and will typically vary based on several important factors such as industry, sponsorship, financial performance (both historical and projected), cyclicality, use of proceeds, capital intensity, and equity contribution. In general, larger businesses in favorable sectors that are majority-owned by private equity firms pursuing growth oriented transactions secure the most favorable terms.
- Feel free to contact us for our perspective on likely terms and provisions on prospective debt transactions you may be considering.

		Lower Middle Market *(Below $15m EBITDA)*	Middle Market *($15m-$35m EBITDA)*	Upper Middle Market *(Above $35m EBITDA)*
Senior Debt *(Asset Based)*	Pricing[1]	L+ 200-275	L+ 175-250	L+ 150-225
	Leverage[2]	NA	NA	NA
Senior Debt *(Cashflow Based)*	Pricing[1]	L+ 450-575	L+ 425-525	L+ 400-500
	Leverage[2]	2.75x-3.75x	3.00x-4.00x	3.50x-4.50x
Unitranche	Pricing[1]	L+ 625-775	L+ 525-650	L+ 500-625
	Leverage[2]	3.75x-5.25x	4.25x-5.75x	4.50x-6.00x
2nd Lien	Pricing[1]	L+ 850-975	L+ 825-900	L+ 800-875
	Leverage[2]	4.50x-5.25x	4.75x-5.75x	5.25x-6.00x
Mezzanine	Pricing[1,3]	11%-13.5% (all-in)	10.5%-12.5% (all-in)	9.5%-12% (all-in)
	Leverage[2]	4.50x-5.50x	4.75x-5.75x	5.50x-6.00x

1). Libor floors of 1% or higher are common for non-asset oriented loan facilities.
2). Subject to a minimum equity contribution of 35%-40% of total capitalization at closing.
3). Mezzanine pricing often times 1%-2% in PIK with balance cash-pay.

REPRESENTATIVE MARKET TRANSACTIONS

Provided below are several transactions that have recently been marketed in the Leverage Finance market. The data set includes both smaller, unrated, private/club-type financings as well as larger, typically rated, BSL financings.

Private/Club Transactions[2]

Borrower	Month	Lender(s)	Sponsor	Facility	Pricing	Business/Service
Digi International	12/19	BMO and Silicon Valley Bank	-	$150	L+225	Provider of internet-of-things products and services
Produce Pay	12/19	CoVenture and TCM Capital	-	$205	-	Offers farmers advances throughout growing season
Franchise Group	12/19	Great American Capital	-	$70	L+900	Operator and acquirer of franchised businesses
Prospect Capital	12/19	Regions Capital Markets	-	$70	-	Business development company
IntelePeer	12/19	TPG Sixth Street Partners	-	$55	-	Provider of omni-channel communication platforms
Orchestra BioMed	12/19	Silicon Valley Bank	-	$20	-	Provider of solutions for procedure-based medicine
AccessOne	12/19	PNC	-	$225	-	Offers payment options for medical patients
AmerCareRoyal	12/19	M&T Bank	HCI Equity Partners	$236	-	Supplier of disposables to the foodservice market
Lazer Spot	12/19	Owl Rock and Antares	Harvest Partners	$325	-	Provider of truck yard management services
TiVo	11/19	HPS Investment Partners	-	$715	L+575	Provider of media and entertainment products
Ritter Communications	11/19	Fifth Third Bank	Grain Management	$190	-	Local independent communications provider
ALM Media	11/19	Twin Brook Capital	-	$100	-	Provider of specialized business news
True Religion Apparel	11/19	Crystal Financial	TowerBrook	$60	-	Retailer and wholesaler of high-quality apparel

Larger Middle Market Transactions[2]

Borrower	Month	Lender(s)	Sponsor	Facility	Pricing	Business/Service
Unison Software	12/19	SunTrust Bank	ABRY Partners	$50	L+450	File-synchronization tool for Windows
CoreCivic	12/19	Nomura Bank	-	$250	L+450	Owner and manager of private prisons
EMG Utica	12/19	Credit Suisse	-	$173	L+425	Private energy holding company
Century Casinos	12/19	Macquarie Capital	-	$170	L+525	International casino operator
DRW Holdings	12/19	Jefferies Finance	-	$300	L+425	Principal trading company of financial instruments
STV Group	12/19	Macquarie Capital	Pritzker Organization	$225	L+525	Provider of construction management services
Houghton Mifflin	12/19	Citigroup	-	$330	L+600	Publisher of educational content for primary schools
Mediaocean	12/19	Macquarie Capital	Vista Equity Partners	$275	L+400	Provider of advertising services software
Flexitallic	11/19	Natixis	Bridgepoint Capital	$200	L+600	Manufacturer and supplier of static sealing solutions
84 Lumber	11/19	Wells Fargo	-	$310	L+425	Building materials supply company
Vision Integrated	11/19	BNP Paribas Group	HIG Capital	$90	L+625	Provider of tech-enabled marketing solutions
High Liner Foods	10/19	Royal Bank of Canada	-	$300	L+425	Processor and marketer of value-added seafood
Cooper's Hawk	10/19	Bank of America	Ares Management	$200	L+650	Restaurant and winery chain

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BUILT FOR THE MIDDLE MARKET

Capstone Headwaters' **Debt Advisory Group** specializes in providing debt placement services to middle-market companies in connection with senior credit facilities, second-lien loans, unitranche facilities, and mezzanine debt across a range of industry sectors. The firm is one of the few national investment banks that maintains a debt-only placement (non-lending) practice staffed by leveraged finance veterans focused solely on the debt funding needs of mid-sized companies and the sponsors that invest in them. The majority of our engagements involve raising debt for acquisitions, recapitalizations, refinancings, and growth/expansion financings with a particular focus on special situations where non-traditional debt capital is required.

NOTES & CITATIONS

1. S&P Global Market Intelligence, "High End Middle Market Lending Review 3Q 2019," www.lcdcomps.com, accessed January 9, 2020.
2. S&P Global Market Intelligence, "LCD Middle Market Weekly" www.lcdcomps.com, accessed January 9, 2020.