Capstone Headwaters

MIDDLE MARKET LEVERAGE FINANCE

CURRENT MARKET CONDITIONS | Q1 2019

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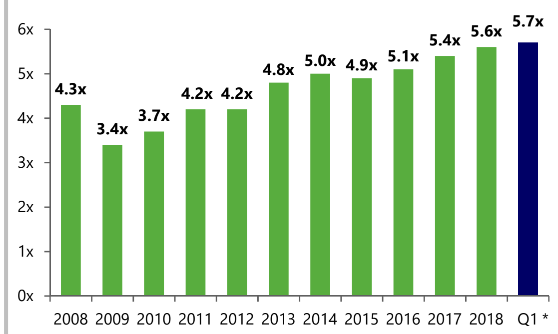
KEY MARKET STATS[1,2]

- **Loan volume** in the middle market (MM) started off slowly this year with Q1 volume down almost 50% compared to Q1 2018, driven primarily by lower merger and acquisition (M&A) activity in the quarter.
- **Interest rate spreads** for institutional MM loans widened by ~100 bps in Q1 2019 compared to 2018, driven by increased cautiousness in the market. MM loans exhibited a spread gap of ~160 bps over larger corporate loans in Q1 2019, the widest gap in 15 years, due to increased appetite for larger corporate credits versus MM credits which are perceived to be riskier.
- **Leverage multiples** continued to creep up in Q1 2019 to 5.7x (an all time high), although we generally expect leverage to remain flat or down throughout 2019 as lenders migrate to more conservative structures. Lower MM multiples are likely to top out at 5.0x (all in) in the near-term.
- **Equity contributions** from sponsors were flat in Q1 2019 as compared to 2018 and have remained in a relatively tight band in the low to mid 40% range.

LEVERAGE MULTIPLES (MID-MARKET)[1]

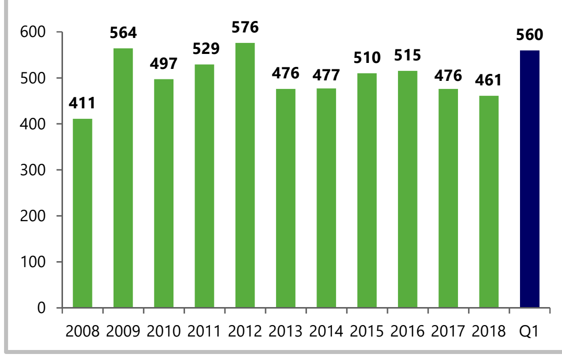


Trailing twelve month period ended Q1 2019

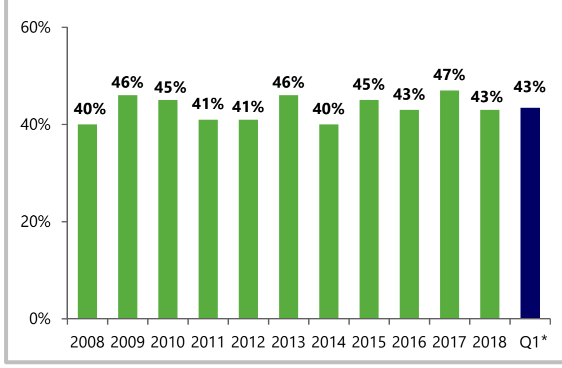
QUARTERLY MARKET OBSERVATIONS[1,2]

- On the heals of a turbulent December, 2019 got off to a rocky start as investors took a wait-and-see approach. Sluggish volume of $2.1 billion through February was buttressed by an additional $2.1 billion of new issuance in March as **investor concerns eased** and M&A activity picked up. The latest data indicates that April is poised for a strong showing with $1.9 billion of volume through mid-April.
- Despite the slow start, market conditions remain issuer-friendly, which we expect to continue in the near-term. In the twelve months ending March 31st, two-thirds of upper MM transactions **were covenant-lite—**the highest percentage on record.
- As the current credit cycle reaches the late innings, lenders are increasingly looking to deploy capital in **recession-resilient sectors** including healthcare, business services, and technology. Alternatively, energy, retail, and industrials continue to face increased scrutiny from lenders reluctant to add cyclical holdings to their portfolios. We expect this market bifurcation to continue, which highlights the importance of broadly marketing cyclical credits in a thoughtful manner to ensure execution.
- The MM lending landscape continues to shift driven by the proliferation of direct lending. Armed with a reported $115 billion of dry powder (including $21.8 billion raised in Q1 2019), **private debt funds have largely supplanted syndication desks** for sub-$200 million loans. The reason for this is twofold. First, the sheer number of funds capable of writing $75+ million checks has grown substantially, thereby making a $200 million club execution feasible. Second, and perhaps more importantly, is the need for speed among sponsors to close quickly given the hyper-competitive environment for attractive assets.
- Not to be outdone, US commercial **banks have become more aggressive** and accounted for 9.2% of volume for the six months ended in mid-March. This is the highest level since 2009 and our recent transaction experience indicates the trend is likely to continue.
- We expect M&A activity to remain steady, underpinned by a stable economic outlook and supportive lending conditions for the remainder of 2019.

AVERAGE INTEREST SPREAD[1]



EQUITY CONTRIBUTION[1]



QUARTERLY FOCUS: BUSINESS DEVELOPMENT COMPANIES (BDCs)[1,2]

- BDCs are a special type of tax-advantaged lender that were created nearly 30 years ago to give small and medium-sized companies more access to debt capital.
- Today, BDCs are a major lender to the middle market with the **67 BDCs** (43 public, 23 private) collectively providing **over $85 billion** of capital to US companies.
- They typically raise equity capital in the public (and increasingly private) markets, lever up with bank loans (often in a 1:1 ratio), and reinvest the funds in 1st and 2nd lien term loans, unitranche term loans, mezzanine debt, and even preferred equity.
- While access to permanent public equity is a key advantage, the **share prices of public BDCs have proven volatile** which has served at times to limit their new-loan origination activities.
- Given the late stage of the credit cycle, investors have become increasingly selective based on BDC manager's performance, scrutinizing default rates, portfolio diversification, origination pace, and yield/expense ratios—which has pressured stock prices.
- Nearly two-thirds of all public BDCs now have **share prices below their net asset value (NAV)** which severely limits their ability to issue new equity and, in turn, grow their portfolio—new investments must largely be made from recycled capital (repayments), limiting their appetite.
- The resulting pressure has also led to a **wave of consolidation** among BDC managers, including Triangle Capital, BDCA Advisors, Fifth Street Finance, TCP, Full Circle, Benefit Street Partners, and MCG.

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

Kent Brown, Managing Director
303.951.7127
kbrown@capstoneheadwaters.com

Brian Schofield, Managing Director
818.936.2240
bschofield@capstoneheadwaters.com

Adam Morris, Vice President
720.407.6270
amorris@capstoneheadwaters.com

Brad Harrop, Vice President
303.531.5007
bharrop@capstoneheadwaters.com

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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+ 425-575	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+ 575-675	L+ 550-650
	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+ 800-925
	Leverage[2]	4.50x-5.25x	4.75x-5.50x	5.25x-5.75x
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, broadly syndicated loan (BSL) financings.

Private/Club Transactions[2]

Borrower	Month	Lender(s)	Sponsor	Facility	Pricing	Business/Service
Cerus	04/19	MidCap Financial	NA	$90.0	NA	Biomedical products company
Caregiver	04/19	White Oak Healthcare Finance	DW Healthcare	$82.0	NA	Intellectual and developmental disability services
Mustang Bio	04/19	Horizon Technology Finance	NA	$20.0	NA	Clinical-stage biopharmaceutical company
Rhythmlink	04/19	Madison Capital Funding	New Heritage	NA	NA	Disposable neurodiagnostic consumables manufacturer
Allied Dental	04/19	Twin Brook	Riverside Partners	NA	NA	Management services provider to dental practices
Global Claims Services	04/19	Twin Brook	PNC Riverarch	NA	NA	Replacement value assessments for insurance claims
Five Star Food Service	04/19	Ares	Freeman Spogli	NA	NA	Office coffee and water services, vending solutions
SirsiDynix	03/19	AB Private Credit	ICV Partners	$175.0	NA	Library automation solutions
Bitfarms	03/19	Dominion Capital	NA	$20.0	10.0%	Operator of blockchain farms powered by clean energy
ProPharma Group	03/19	Monroe Capital	Linden Capital	NA	NA	Compliance, regulatory and medical info services
SCA Performance	03/19	Regions Bank	Kinderhook	NA	NA	Specialty vehicle manufacturer for light-duty trucks
Yalber	03/19	Park Cities Asset Management	NA	$20.0	NA	Royalty investment company

Larger Middle Market Transactions[2]

Borrower	Month	Lead Agent	Sponsor	Facility	Pricing	Business/Service
Transact	05/19	Deutsche Bank	Reverence Capital	$260.0	L + 425	Payment and software solutions platform
Enstor Mercury Holdings	04/19	Morgan Stanley	ArcLight Capital	$255.0	L+ 450	Non-utility US natural gas storage facilities
Cook & Boardman	04/19	Goldman Sachs	Littlejohn & Co.	$247.0*	L + 575	Specialty distributor of commercial doors
Aptean	04/19	Golub	TA Associates	$350.0	L + 425	ERP, supply-chain mgmt. and compliance software
Quick Base	04/19	Golub	Vista Equity	$275.0	L + 400	Platform-as-a-service application development tools
Lonestar II Generation	04/19	Morgan Stanley	Blackstone Group	$250.0	L + 500	Portfolio of electricity generating assets
Addison Group	04/19	KKR	Odyssey Partners	$310.0	L + 475	Contract staffing and placement services
PetVet Care	04/19	Jefferies Finance	KKR	$125.0	L + 325	Network of veterinary hospitals
PS Logistics	04/19	UBS	One Equity Partners	$270.0*	L + 475	Flatbed transportation and logistics services
Lyons Magnus	04/19	RBC Capital Markets	Paine Schwartz	$75.0	L + 400	Producer of food toppings and beverages
CONSOL Energy	03/19	Citi	NA	$300.0	L + 400	Producer of metallurgical coal
PSS Industrial Group	03/19	Key Bank	Goldman Sachs	$300.0	L + 550	Value added distributor to the energy industry

**Represents the total amount of the facility including the most recent add-on transaction in April 2019*

Kent Brown, Managing Director
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kbrown@capstoneheadwaters.com

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bschofield@capstoneheadwaters.com

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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.

CITATIONS

1. S&P Global Market Intelligence, "High End Middle Market Lending Review 1Q 2019," www.lcdcomps.com, accessed April 9, 2019.
2. S&P Global Market Intelligence, "LCD Middle Market Weekly: April 4, 2019," www.lcdcomps.com, accessed April 9, 2019.