

Phoenix Management Services “Lending Climate in America” Survey



**2nd Quarter 2018
Summary, Trends and Implications**

PHOENIX
"LENDING CLIMATE IN AMERICA"

2nd Quarter 2018

SUMMARY, TRENDS AND IMPLICATIONS

- 1. Historically, a flat or inverted Treasury yield curve has often preceded a recession. However, current Fed Chairman Jerome Powell does not believe the inverted curve is an accurate predictor of a recession in the current economic climate. In response to a recent question on the historical significance of a flattening curve, Mr. Powell was quoted recently saying: "A lot of that was just situations in which inflation was allowed to get out of control and the Fed had to tighten and that put the economy into recession. That's really not the situation we're in now." Do you agree with Fed Chairman Jerome Powell that market participants should worry less about the yield curve's current slope given recent economic growth?**

60% of lenders somewhat agree with Fed Chairman Jerome Powell that market participants should worry less about the yield's curve current slope given recent economic growth, and believe that while the flattening of the yield curve is concerning, a recession is highly unlikely given the current economic climate. Garnering the second highest amount of responses, 20%, were lenders that somewhat disagree and believe that while market conditions are different now than before previous recessions, market participants should take note of the flattening of the yield curve despite the current economic climate. Of the lenders surveyed, 16% of completely agree with Chairman Jerome Powell, while 4% completely disagree.

- 2. In early April 2018, the Federal Reserve unveiled its proposed changes to its annual stress test procedures. According to an article by Sam Fleming and Alistair Gray for the Financial Times, the proposed changes will increase capital requirements for the nation's largest and most complex groups by \$10bn to \$50bn in aggregate, but will offer relief to smaller lenders who are not considered "systematically important" by \$10bn to \$45bn in aggregate. What is your opinion on the changes to the Federal Reserve's stress procedures, both in relation to the previous procedures as well as the likelihood that they accurately quantify downside risk in the financial system and effectively protect against it?**

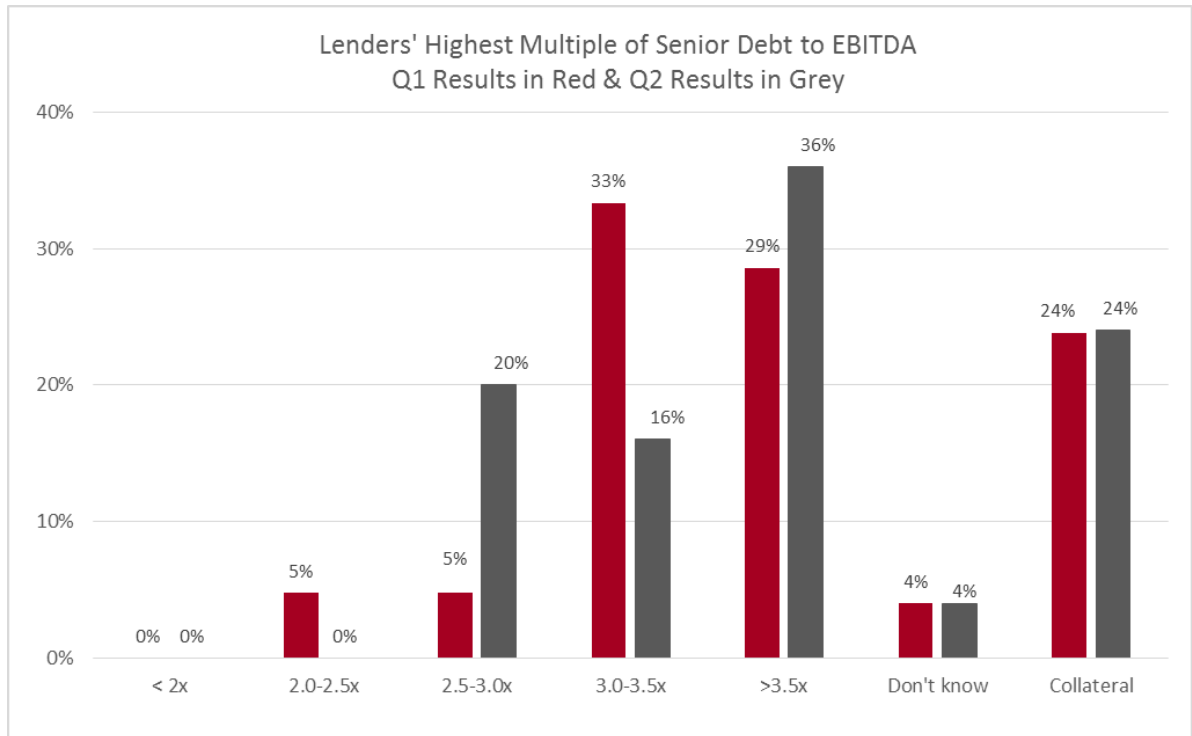
The answer that received the highest percentage response, 48%, were the lenders that are neutral and believe the prior procedures were an academic exercise that did not accurately quantify and effectively protect against downside risk in the financial system, and the revised procedures reflect more of the same. Lenders whose opinions were positive and believe that the revised procedures are more practical than the prior procedures, and are more likely to accurately quantify downside risk in the financial system and effectively protect against it, garnered 28% of the responses. Of the lenders surveyed, 24% believe the changes are less practical than the prior procedures and are less likely to accurately quantify downside risk and effectively protect against it.

- 3. The current Presidential Administration has proposed a number of trade tariffs that could directly impact the U.S.'s trade relationship with important trade partners including China. Do you think legislation will be passed in the next 12 months to materially change the U.S.'s trade policy, and if so, what do you expect the impact will be on the U.S. economy?**

Lenders garnering 28% of responses think legislation will be passed in the next 12 months to change the U.S.'s trade policy and the impact on the U.S. economy will be neutral. Lenders were evenly split on the three other responses, which garnered 24% each: a) material changes to U.S trade policy will be made in the next 12 months and the impact on the U.S. economy will be positive, b) material changes to U.S trade policy will be made in the next 12 months and the impact on the U.S. economy will be negative, and c) don't believe material changes to U.S. trade policy will be made through legislation in the next 12 months.

4. Leverage multiples shifted this quarter.

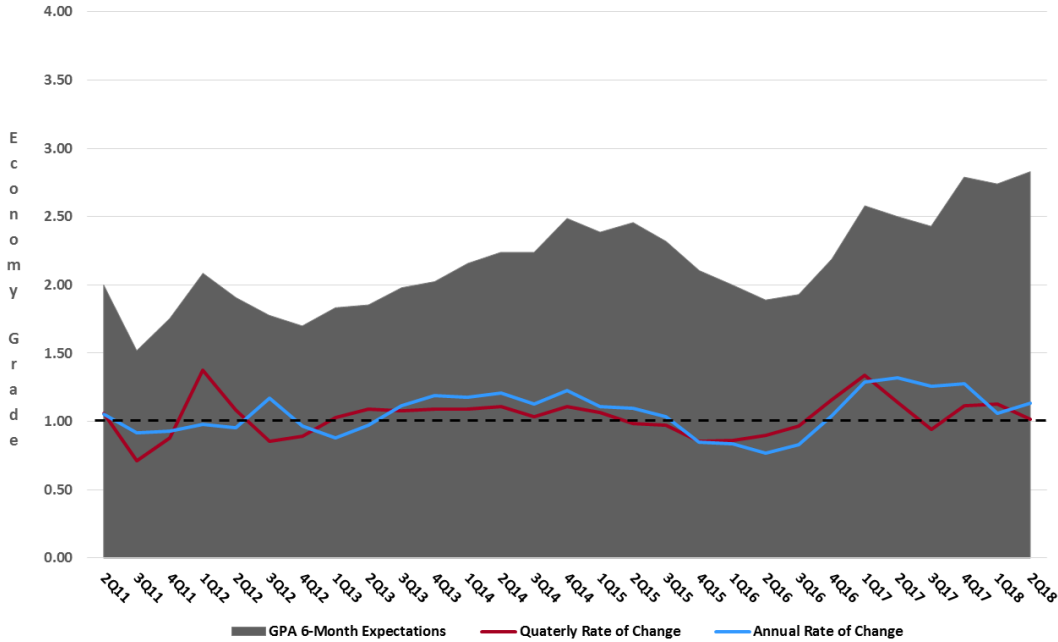
Multiples shifted in 2Q 2018 with 36% of lenders indicating that the >3.5x range would be the highest EBITDA ratio they would consider versus 29% in 1Q 2018. The percentage of respondents who would consider a debt to EBITDA ratio of 3.0-3.5x decreased to 16% from the previous quarter's results of 33%. The percentage of lenders who indicated the highest ratio they would consider is between 2.5-3.0x increased 15 percentage points to 20%, and 24% of lenders responded that they were collateral lenders and therefore do not make decisions based on cash flow/leverage multiples.



5. Economic performance expectations increase for the near term in this quarter's survey.

Lenders optimism in the U.S. economy for the short term increased this quarter but remains at an overall “B” grade; the index GPA increased to 2.83 from the 1Q 2018 results of 2.79. 67% of the lenders believe the economy will perform at a “B” level over the next six months, compared to 79% in the previous survey. Of the lenders surveyed, 8% expect the U.S. economy to perform at an “A” grade. Furthermore, 25% of lenders surveyed believe the economy will perform at a “C” grade, compared to 16% in the previous survey, and none of the lenders surveyed believe that the economy will perform at a “D” or “F” level.

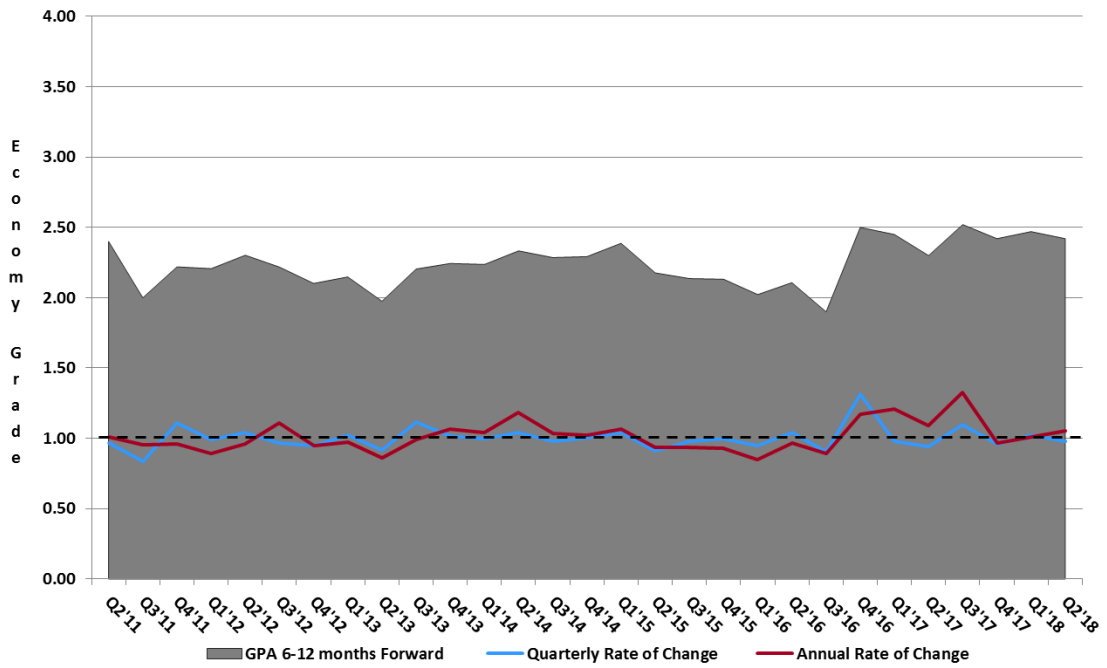
**Lender Expectations for Economy (Forward Six Months)
4.0=A, 2.0=C. 0.0=F**



* Rate of Change of 1.0 is at equilibrium and signifies “no change” from the corresponding prior period of comparison.

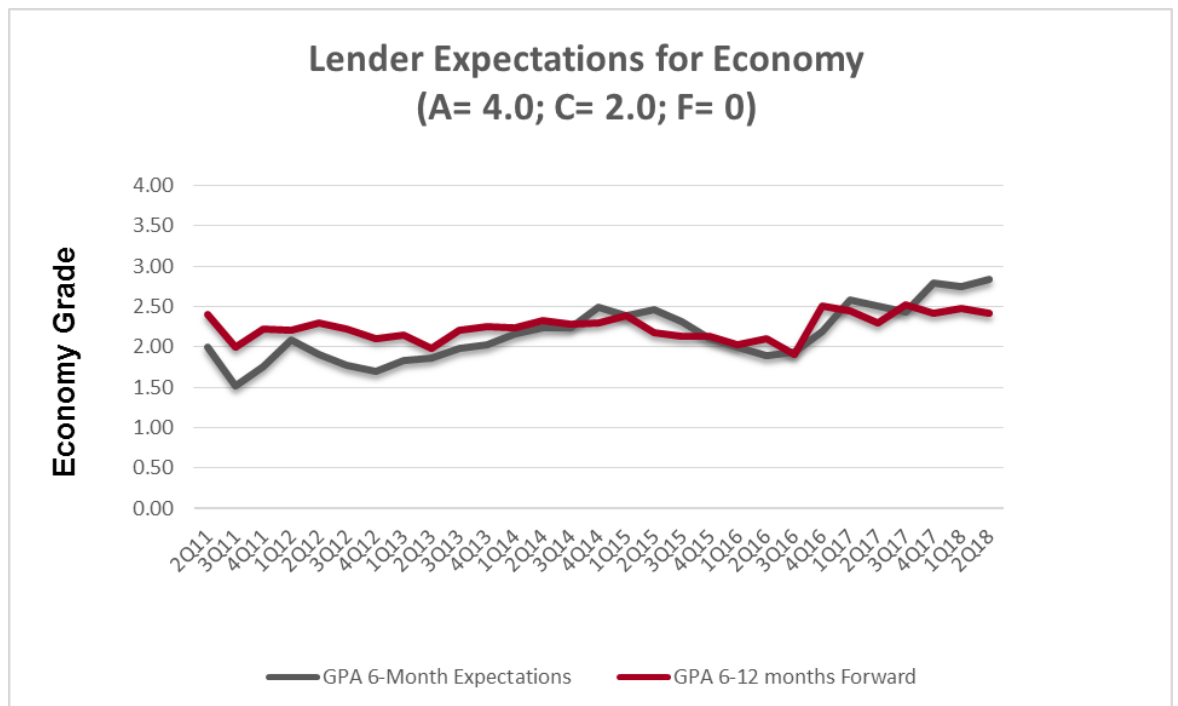
Lenders growth expectations for the U.S. economy beyond six months remained at an overall “B” grade this quarter. The weighted average decreased 5 points to a 2.42 GPA from 2.47 in the previous quarter. 46% of lenders believe the economy will perform at a “B” level in the next six to twelve months, which is a 7 percentage point decrease from the previous quarter. The percent of lenders (38%) that believe the economy will perform at a “C” level decreased 4 percentage points from the previous quarter. The percentage of respondents who believe the economy will perform at a “D” level beyond the next six months increased from 5% to 12%.

Lender Expectations for Economy (Forward Six-Twelve Months)
4.0=A, 2.0=C. 0.0=F



* Rate of Change of 1.0 is at equilibrium and signifies “no change” from the corresponding prior period of comparison.

The 2Q 2018 survey continues the recent trend of a higher near-term GPA than long term GPA. The grade of “B” reflects lender’s positive expectations for the economy in both the near and long term.



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Survey Results

- 1. The majority of Lenders somewhat agree with Fed Chairman Jerome Powell that market participants should worry less about the yield’s curve current slope given recent economic growth and believe that while the flattening of the yield curve is concerning, a recession is highly unlikely given the current economic climate.**

Lenders were asked: Historically, a flat or inverted Treasury yield curve has often preceded a recession. However, current Fed Chairman Jerome Powell does not believe the inverted curve is an accurate predictor of a recession in the current economic climate. In response to a recent question on the historical significance of a flattening curve, Mr. Powell was quoted recently saying: "A lot of that was just situations in which inflation was allowed to get out of control and the Fed had to tighten and that put the economy into recession. That's really not the situation we're in now." Do you agree with Fed Chairman Jerome Powell that market participants should worry less about the yield curve's current slope given recent economic growth?

Somewhat Agree: While the flattening of the yield curve is concerning, a recession is highly unlikely given the current economic climate.	60%
Somewhat Disagree: While market conditions are different now than before previous recessions, market participants should take note of the flattening of the yield curve despite the current economic climate.	20%
Completely Agree: the flattening of the yield curve is not an accurate predictor of a recession in the current economic climate.	16%
Completely Disagree: the flattening of the yield curve has been an accurate predictor of recession in the past and should continue to be viewed as such regardless of the current economic climate.	4%

- 2. Lenders are neutral with the regard to the proposed Federal Reserve changes to its stress procedures, both in relation to the previous procedures as well as the likelihood that they will accurately quantify downside risk in the financial system and effectively protect against it.**

Lenders were asked: In early April 2018, the Federal Reserve unveiled its proposed changes to its annual stress test procedures. According to an article by Sam Fleming and Alistair Gray for the Financial Times, the proposed changes will increase capital requirements for the nation's largest and most complex groups by \$10bn to \$50bn in aggregate, but will offer relief to smaller lenders who are not considered "systematically important" by \$10bn to \$45bn in aggregate. What is your opinion on the changes to the Federal Reserve's stress procedures, both in relation to the previous procedures as well as the likelihood that they accurately quantify downside risk in the financial system and effectively protect against it?

Neutral; The prior procedures were an academic exercise that did not accurately quantify and effectively protect against downside risk in the financial system and the revised procedures reflect more of the same.	48%
Positive; The revised procedures are more practical than the prior procedures. They also are more likely to accurately quantify downside risk in the financial system and effectively protect against it.	28%
Negative; The changes are less practical than the prior procedures and are less likely to accurately quantify downside risk and effectively protect against it.	24%

3. Lenders believe material changes to the U.S. trade policy will be made in the next 12 months and the impact on the U.S. economy will be neutral.

Lenders were asked: The current Presidential Administration has proposed a number of trade tariffs that could directly impact the U.S.'s trade relationship with important trade partners including China. Do you think legislation will be passed in the next 12 months to materially change the U.S.'s trade policy, and if so, what do you expect the impact will be on the U.S. economy?

Yes, I believe material changes to U.S trade policy will be made in the next 12 months and the impact on the U.S. economy will be neutral.	28%
Yes, I believe material changes to U.S trade policy will be made in the next 12 months and the impact on the U.S. economy will be positive.	24%
Yes, I believe material changes to U.S trade policy will be made in the next 12 months and the impact on the U.S. economy will be negative.	24%
No, I don't believe material changes to U.S. trade policy will be made through legislation in the next 12 months.	24%

4. Highest Senior Debt to EBITDA Leverage Institutions Would Consider

Respondents were asked the highest multiple of Senior Debt to EBITDA their financial institution would consider with regard to a loan request.

<u>EBITDA Level</u>	<u>1Q 2018</u>	<u>2Q 2018</u>
Greater than 3.5x	29%	36%
Between 3.01x and 3.50x	33%	16%
Between 2.51x and 3.00x	5%	20%
Between 2.01x and 2.50x	5%	0%
Less than 2.0x	0%	0%
Collateral lenders	24%	24%
N/A	4%	4%

5. Anticipated Change in Senior Debt to EBITDA Multiple

Respondents were asked, over the next six months, how the Senior Debt to EBITDA multiple would change at their financial institution.

<u>Change in Senior Debt to EBITDA Level</u>	<u>1Q 2018</u>	<u>2Q 2018</u>
Increase greater than 0.5x	0%	0%
Increase less than 0.5x	5%	12%
Decrease less than 0.5x	10%	4%
Decrease greater than 0.5x	0%	0%
No change	57%	56%
Collateral lenders	24%	24%
N/A	4%	4%

6. Factors with Strongest Potential to Affect Near-Term Economy

Respondents were asked, over the next six months, which two factors had the strongest potential to affect the economy.

<u>Factors Affecting Near-Term Economy</u>	<u>1Q 2018</u>	<u>2Q 2018</u>
Stability of Stock Market	52%	46%
Unstable Energy Prices	5%	46%
Other	38%	33%
U.S. Budget Deficit	38%	25%
Sluggish Housing Market	29%	17%
Constrained Liquidity in Capital Markets	14%	8%

7. Industries Expected to Experience Greatest Volatility

Respondents were asked, over the next six months, which industries will experience the most volatility (i.e. Chapter 11 filings, mergers and acquisitions, declining profits, etc.). Respondents were asked to select the top three industries.

<u>Industries Experiencing Most Volatility</u>	<u>1Q 2018</u>	<u>2Q 2018</u>
Retail Trade	71%	70%
Healthcare and Social Assistance	29%	42%
Real Estate and Rental/Leasing	29%	25%
Mining	5%	25%
Educational Services	5%	21%

8. Customers' Plans in the Next Six to Twelve Months

Respondents were asked which of the following actions their customers planned in the next six to twelve months. Lenders were asked to designate all potential customer actions that applied.

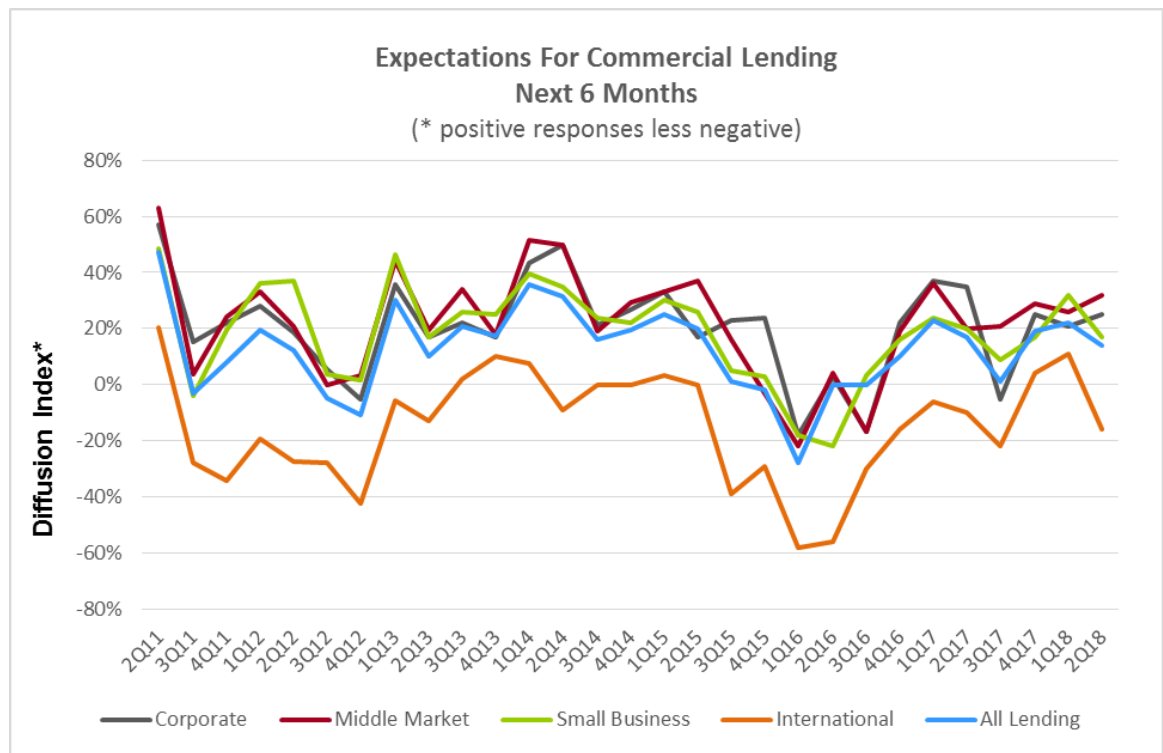
<u>Customers' Plans</u>	<u>1Q 2018</u>	<u>2Q 2018</u>
Capital Improvements	81%	79%
Making an Acquisition	62%	67%

Hiring New Employees	57%	63%
Introducing New Products or Services	43%	46%
Entering New Markets	43%	42%
Raising Additional Capital	33%	38%
“Other” Initiatives	0%	4%

9. Economic Indicators

Respondents were asked whether they expected the following economic indicators to be up, down, or remain the same over the next six months.

- In 2Q 2018, lenders optimism increased slightly in large corporate (25%) and middle market (32%). However, expectations decreased for small business in 2Q 2018 with a diffusion index of 17%, a 15-percentage point difference from the previous quarter of 32%. The diffusion index for international lending decreased from 11% in 1Q 2018 to -16% in 2Q 2018. The diffusion index for the average for all domestic lending slightly decreased from 27% in 1Q 2018 to 25% in 2Q 2018, and the diffusion index for all lending decreased to 14% from 22% in Q1 2018.



	<u>1Q/2018</u>					<u>2Q/2018</u>			
	<u>Up</u>	<u>Down</u>	<u>Same</u>	<u>Diffusion Index</u>		<u>Up</u>	<u>Down</u>	<u>Same</u>	<u>Diffusion Index</u>
Corporate Lending	37%	16%	47%	21%	Corporate Lending	33%	8%	59%	25%
Middle Market Lending	42%	16%	42%	26%	Middle Market Lending	45%	13%	42%	32%
Small Business Lending	37%	5%	58%	32%	Small Business Lending	38%	21%	41%	17%
International Lending	22%	11%	67%	11%	International Lending	13%	29%	58%	-16%

- The interest rate diffusion index increased 10 percentage points to 100% compared to 90% the previous quarter. Loan losses diffusion index decreased 10 percentage points to 29% in Q2 2018 compared to 39% in Q1 2018, and the bankruptcies diffusion index also decreased from a 38% in Q1 2018 to 29%.

	<u>1Q/2017</u>					<u>2Q/2018</u>			
	<u>Up</u>	<u>Down</u>	<u>Same</u>	<u>Diffusion Index</u>		<u>Up</u>	<u>Down</u>	<u>Same</u>	<u>Diffusion Index</u>
Loan Losses	39%	0%	61%	39%	Loan Losses	33%	4%	63%	29%
Bankruptcies	44%	6%	50%	38%	Bankruptcies	42%	13%	45%	29%
Interest Rates	95%	5%	0%	90%	Interest Rates	100%	0%	0%	100%
Unemployment	5%	32%	63%	-27%	Unemployment	8%	21%	71%	-13%
Bank Failures	0%	26%	74%	-26%	Bank Failures	4%	17%	79%	-13%

10. U.S. Economy Grade – Next Six Months

Respondents were asked how they expected the U.S. economy to perform during the next six months on a grading scale of A through F.

- Lenders optimism on the U.S. economy increased this quarter from 2.74 in 1Q 2018 to 2.83 in 2Q 2018, which continues to remain at an overall “B” grade. In the current quarter, 67% of respondents believe the economy will perform at a “B” level, which represents a decrease of 12 points from the previous quarter. However, there was an increase of lenders (8%) that believe the economy will perform at an “A” level, and none of the lenders believe that the economy will perform at a “D” level in the near term.

<u>Grade</u>	<u>1Q/2018</u>	<u>2Q/2018</u>
A	0%	8%
B	79%	67%
C	16%	25%
D	5%	0%
F	0%	0%
Weighted Average Grade	2.74	2.83

11. U.S. Economy Grade – Beyond the Next Six Months

Respondents were asked how they expected the U.S. economy to perform beyond the next six months on a grading scale of A through F.

- Lenders expectations for the U.S. economy’s performance in the longer term decreased from the prior quarter. The weighted average GPA decreased 5 points from a 2.47 in the previous quarter to 2.42, which is a “B” grade. 46% of lenders feel as though the economy will perform at a “B” level beyond the next six months (compared to 53% last quarter). Lenders who believe the economy will perform at a “C” over the next twelve months decreased 4 percentage points to a 38%. However, there was an increase of lenders (12%) that believe the economy will perform at a “D” grade over the next six to twelve months, and 4% believe the economy will perform at an “A” grade.

<u>Grade</u>	<u>1Q/2018</u>	<u>2Q/2018</u>
A	0%	4%
B	53%	46%
C	42%	38%
D	5%	12%
F	0%	0%
Weighted Average	2.47	2.42

12. Customers' Future Growth Expectations

Lenders assessed their customers' growth expectations for the next six months to a year.

- The percentage of respondents indicating their customers have “moderate” growth expectations for the next six months to one year decreased 10 percentage points from 68% in Q1 2018 to 58% in Q2 2018. 34% of lenders ascribe “strong” growth for their borrower’s in the next six months, a 2-percentage point increase from Q1 2018. Furthermore, 8% of lenders believe their customers have “very strong” growth prospects. This view of “moderate” and “strong” growth is a positive signal from lenders on the U.S. economy.

<u>Indication</u>	<u>1Q/2018</u>	<u>2Q/2018</u>
Very Strong	0%	8%
Strong	32%	34%
Moderate	68%	58%
No Growth	0%	0%

13. Loan Structure

Respondents were asked whether their financial institutions planned to tighten, relax, or maintain their loan structures (collateral requirements, guarantees, advance rates, loan covenants, etc.) in each of four different-sized loan categories.

Many lenders are content right now and plan to maintain their current loan structure. However, in 2Q 2018 we did see a slight decrease, 6 percentage points, of lenders that plan to tighten their loan structure. This trend towards tightening was most pronounced at the lower end of the market.

	<u>1Q/2018</u>			<u>2Q/2018</u>		
	<u>Tighten</u>	<u>Maintain</u>	<u>Relax</u>	<u>Tighten</u>	<u>Maintain</u>	<u>Relax</u>
Loans > \$25 million	25%	69%	6%	5%	77%	18%
\$15 – 25 million	19%	75%	6%	5%	86%	9%
\$5-15 million	12%	76%	12%	17%	70%	13%
Under \$5 million	11%	72%	17%	16%	71%	13%
Overall Average	17%	73%	10%	11%	76%	13%

14. Interest Rate Spread

Lenders were asked whether their financial institutions planned to reduce, maintain or increase their interest rate spreads and fee structures on similar credit quality loans.

A majority of lenders continue to maintain their interest rate spreads and fee structures. In Q2 2018, the percentage of lenders that plan to reduce their interest rate spreads remained unchanged at 20%, and there was a 1 percentage point increase (16%) that plan to tighten their interest rate spreads.

	<u>1Q/2018</u>			<u>2Q/2018</u>		
	<u>Reduce</u>	<u>Maintain</u>	<u>Increase</u>	<u>Reduce</u>	<u>Maintain</u>	<u>Increase</u>
Loans > \$25 million	31%	63%	6%	23%	73%	4%
\$15 – 25 million	19%	69%	13%	23%	73%	4%
\$5-15 million	13%	67%	20%	22%	52%	26%
Under \$5 million	17%	61%	22%	13%	57%	30%
Overall Average	20%	65%	15%	20%	64%	16%

15. The Fed and Interest Rates

Respondents were asked in what direction they thought the Fed would move interest rates and by how much in the coming six months.

100% of respondents in 2Q 2018 believe the Fed will raise interest rates in the next six months, with 96% of respondents favoring an increase of +1/2 point or more and 4% of respondents favoring +1/4 point increase.

<u>Bps Change</u>	<u>1Q/2018</u>	<u>2Q/2018</u>
+ 1/2 point or more	89%	96%
+ 1/4 point	0%	4%
Unchanged	5%	0%
- 1/4 point	0%	0%
- 1/2 point or more	6%	0%
Weighted Average	0.46 bps	0.58 bps

16. Current Competition

Respondents were asked to identify the segment of the industry from which they were experiencing the most competition.

- Regional Banks continue to place at the top of the survey, garnering 50% of responses. Commercial Finance Co., at 17% of respondents, saw an increase of 11 percentage points. Local Community/Commercial Bank saw a significant increase with 13% of respondents, and Money Center Banks also saw a slight decrease in respondents (8%).

	<u>1Q/2018</u>	<u>2Q/2018</u>
Regional Bank	39%	50%
Commercial Finance Co.	6%	17%
Local Community/Commercial Bank	33%	13%
Money Center Banks	11%	8%
Factors	0%	4%
Other	11%	8%