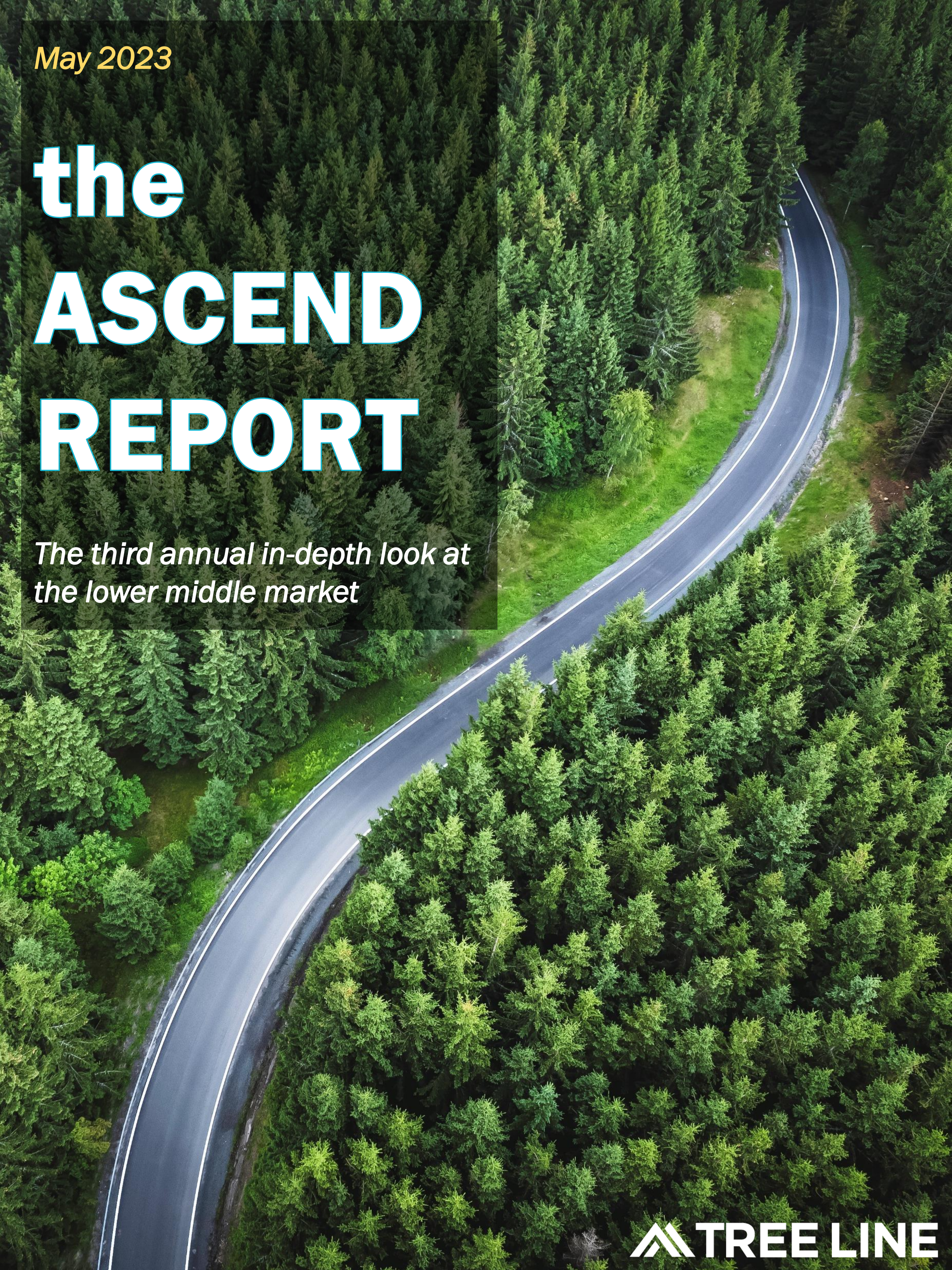


May 2023

the ASCEND REPORT

The third annual in-depth look at the lower middle market

TREE LINE

Table of Contents

ISSUE #3 | MAY 2023

Executive Summary

Tree Line is pleased to present the third annual *Ascend Report*, which provides insight into the state of the lower middle market ("LMM"). We begin by providing a refreshed introduction to the LMM, including market sizing statistics, recent private equity deployment, fundraising metrics and key macro trends that are impacting deal flow in 2023. In addition, we analyze troubled industries through the data of ~10,000 borrowers reported in business development companies ("BDCs") public findings to highlight sectors that exhibit the highest probability of investment mark downs.

Next, we highlight the findings from our annual *Ascend Survey* of over 80 LMM private equity managers recently conducted by the Tree Line team. Our sponsor relationships provided valuable insight into the 2022 deal environment and expectations for 2023. We are grateful for the participation and support of all participants as the feedback is incredibly valuable to take a pulse on the state of play in the LMM.

The 2023 *Ascend Report* concludes with Tree Line's market insights. Over the past nine years since Tree Line's inception, we have invested substantial time and resources to build a best-in-class team and system to track critical data points throughout the LMM. Tree Line's findings suggest that thoughtfully structured and levered capital structures provide the best path to success. The notion that bigger, over levered, cov-lite companies will enjoy more success in a recession compared to reasonably structured LMM businesses is dispelled.

Opinions expressed in this Ascend Report are those of Tree Line Capital Partners, LLC as of May 2023 and are subject to change. Furthermore, the data contained herein is for informational and discussion purposes only and is neither an offer to sell nor a solicitation of any offer to buy any securities, investment product, or investment advisory services.

Stephan Schneck
Managing Director
Ascend Project Lead

Frank Cupido
Partner

Jeff Fier
Managing Director

Jonah Glick
Managing Director

Ben Perlman
Vice President

Lower Middle Market Overview

Lower Middle Market Definition & Sizing

Deal Activity Update

Pitfalls and "Bad Deals"

The Lower Middle Market

Lower Middle Market Definitions and Statistics.

A growing niche.

Definition & Overview

Tree Line defines the LMM as being comprised of companies with between $3M - $30M of EBITDA, which translates to revenues of ~$10M - $100M.

There is a vast and expanding opportunity set of deals driven through a network of direct relationships with private equity sponsors.

Private equity firms targeting LMM companies typically raise funds up to $500M with more established firms raising up to $1B.

The LMM has experienced rapid growth as there is a significant addressable set of acquisition targets and opportunities for sponsors to drive value through attractive valuations and buy-and-build strategies.

By the Numbers

$312B

Raised in Funds < $500M Since 2019[1]

175,000

Companies with between $10 - $100M in Revenue[2]

$400B+

North American Middle Market PE Dry Powder[3]

48%

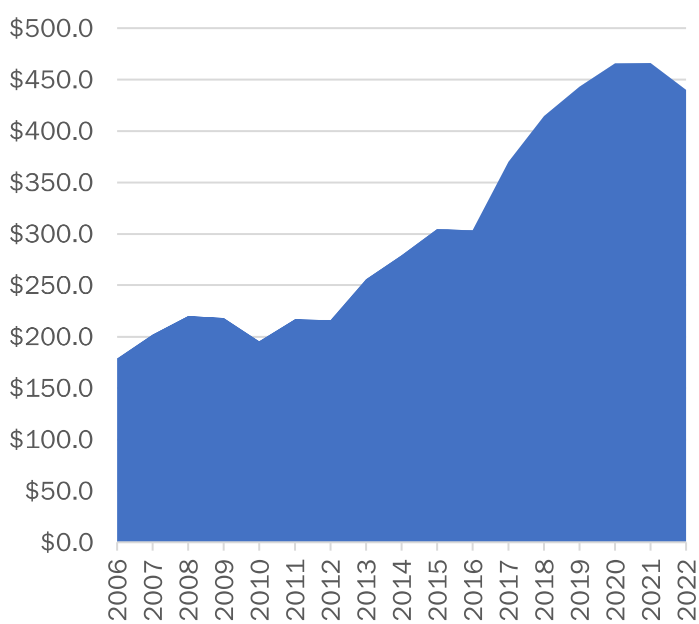
Of PE Deals Completed in 2022 Between $25 - $100M in Size[4]

Private Equity Growth & LMM Private Credit Demand

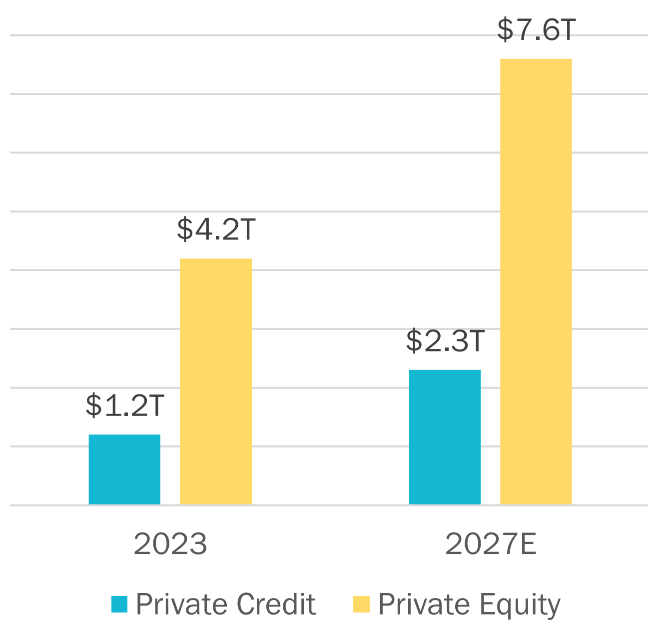
Near Peak Dry Powder. Sponsors maintain significant dry powder; however, the macro conditions examined on the following page have driven spotty deal flow.

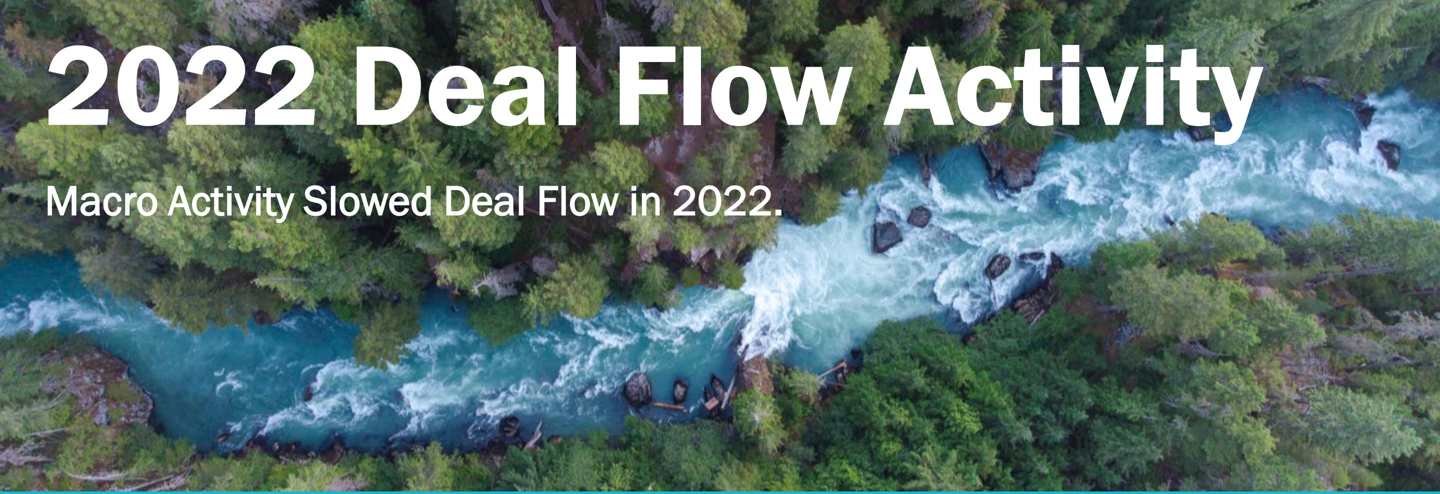
Mega-funds dominate the headlines, but LMM private equity growth remains robust. Since 2019, LMM private equity funds (sub-$500M fund sizes) have raised $312B[5]. There is significant capital targeting the attractive valuations (~7-9x) found in the highly fragmented LMM that consists of 175,000 companies with revenue of between $10M and $100M. Although fundraising slowed in 2022, private equity dry powder remains near all-time highs, which continues to drive deal flow and the need for private debt. Existing dry powder estimates of $400B[6] will require ~$400B of debt financing assuming a 50% equity contribution.

LMM Private Equity Dry Powder[6]



Private Market Forecasted Growth[7]





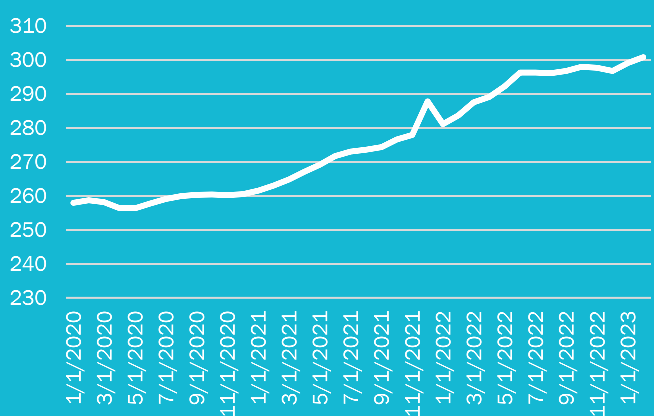
2022 Deal Flow Activity

Macro Activity Slowed Deal Flow in 2022.

The LMM experienced slower deal flow in 2022 driven by macro headwinds following record deployment in 2021. The US saw the highest level of inflation in 40 years, which weakened consumer sentiment. Additionally, the conflict in Ukraine, rising interest rates and general economic uncertainty resulted in a 26% decline in deal volume on a year-over-year basis.[8]

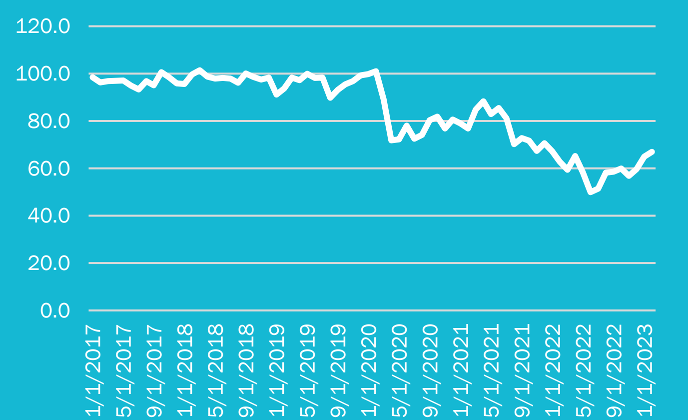
Rising Inflation[9]

Source: Consumer Price Index (CPI)

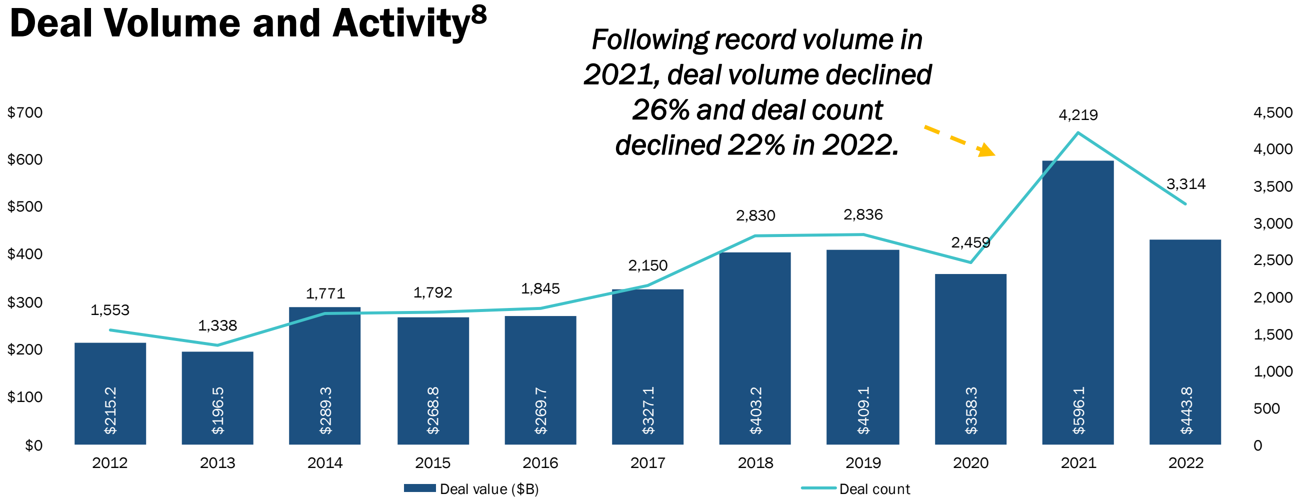


Weakening Consumer Demand[9]

Source: University of Michigan Consumer Sentiment Index



PE Deal Volume and Activity[8]



Bad Deal Database

Tree Line's Proprietary Process Tracks Troubled Deals.

Tree Line tracks data comprising ~10,000 borrowers from public BDC filings to monitor the probability of default by sector. A "bad deal" is defined as a deal marked at less than 80% of fair market value ("FMV"). For example, of the 32 Retail Food & Drug deals published in BDC quarterly public filings, 7 deals (22% of total Retail Food & Drug deals) are bad deals.

Q3'22 Filings

Probability of Markdown by Sector	Total Deals	Bad Deals[1]	% of Total
Structured Finance - CLO	228	55	24.1%
Retail Food & Drug	32	7	21.9%
Securities & Trusts	41	6	14.6%
Printing & Publishing	70	8	11.4%
Wholesale Trade	71	8	11.3%
Gaming and Hotels	47	4	8.5%
Telecommunications	195	15	7.7%
Educational Services	95	6	6.3%
Oil & Gas	177	11	6.2%
Utilities	71	4	5.6%
Building Materials	196	11	5.6%
Construction	136	7	5.1%
Retailing	421	21	5.0%
Home Furnishings	102	5	4.9%
Forest Products	22	1	4.5%
Top 15 Sectors	**1,904**	**169**	**8.9%**
Other	**12,262**	**366**	
Total	**14,166**	**535**	

- Structured Finance:
  - CLO and Securities & Trusts remained the most challenged sector, driven by the embedded risk of structured finance investments compared to senior securing lending.
- Retail Food & Drug:
  - Despite a reversal of COVID-related shutdowns, retail continues to be the most challenged non-CLO sector given the reliance on foot traffic and ever-changing consumer preferences.
- Telecommunications:
  - Telecom and media-related sectors saw softness driven by industry-specific headwinds mirroring large-cap, publicly-traded names.
- Wholesale Trade:
  - Experienced the largest notional change in deals marked bad on a Q/Q basis.

2023 Ascend Survey

Feedback from Over 80 Private Equity Sponsors

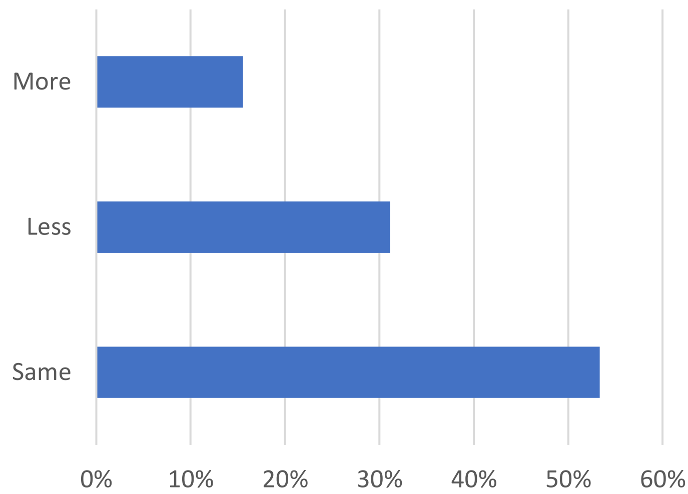
Assessment of 2022 Activity

Expectations for 2023

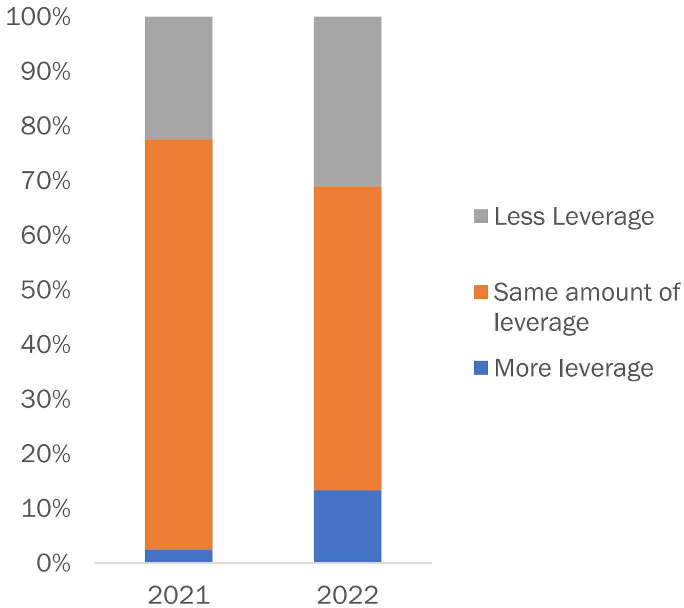
2022 Recap

In response to the broader macro challenges, the Ascend Report Survey corroborated that private equity sponsors delayed taking portfolio companies to market in an effort to maximize value. Additionally, the scarcity of high-quality platforms to acquire drove down capital deployment with 47% of respondents noting that their firm deployed less capital in 2022 vs. 2021.

Were sell side processes more, less or comparably competitive in 2022 vs. 2021?



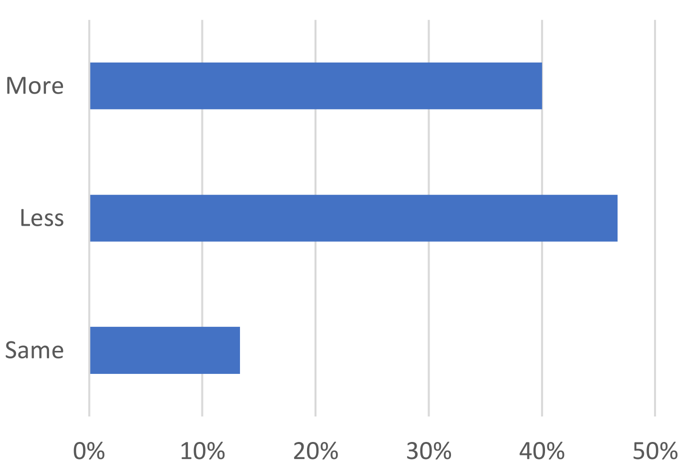
Did you use more, less or the same amount of leverage compared to prior year?



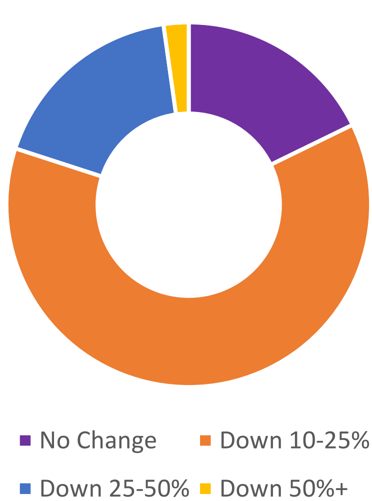
44%

of Sponsors delayed taking portfolio companies to market due to market conditions

How much capital did you deploy in 2022 compared to 2021?



How did Q4'22 deal flow compare to prior Q4s?



2023 Outlook

LMM sponsors are forecasting a continued slowdown in 2023, a decline in purchase multiples and a decline in leverage utilized. Pitchbook data highlighted the slowdown in deal activity in 2022 (see page 7) and the survey respondents state they expect these trends to continue in 2023. However, add-on acquisitions have remained a key component of LMM private equity investment strategies. In 2022, add-ons accounted for 58.7% of total deal value in LMM private equity and the data shown below indicates that over 75% of LMM sponsors expect to complete at least one add-on acquisition in 2023.

62%

of Sponsors expect to deploy <u>less or the</u> same amount of capital in 2023 compared to 2022.

45%

of Sponsors expect utilize <u>less</u> leverage in 2023 compared to 2022.

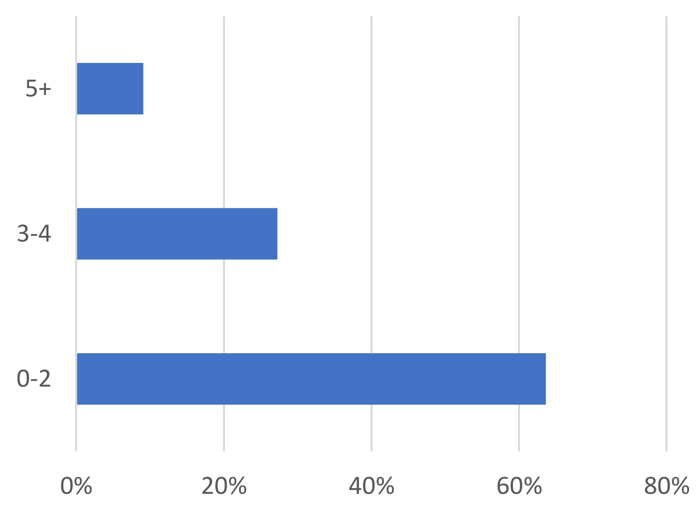
57%

of Sponsors expect lower middle market M&A activity to be <u>less</u> active in 2023 vs. 2022

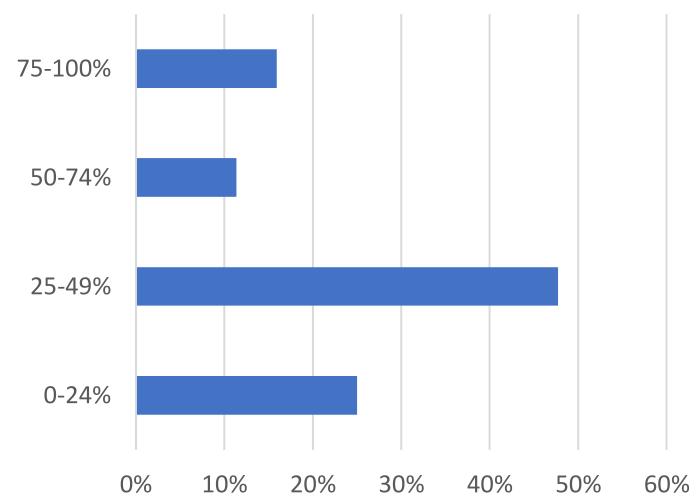
64%

of Sponsors expect purchase multiples to <u>decrease</u> in 2023 compared to 2022.

How many new platforms do you expect to acquire in 2023?



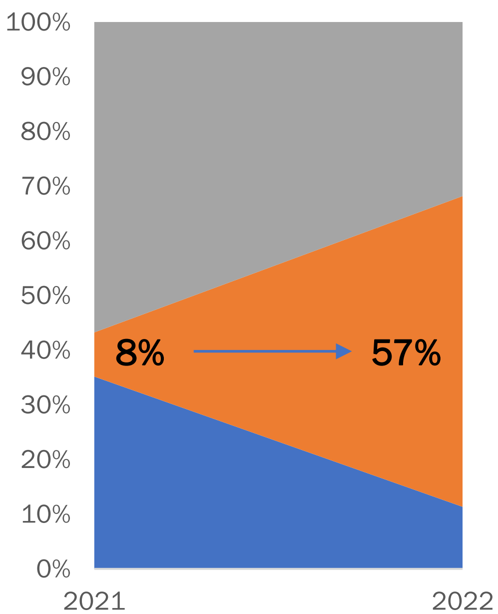
Approximately what percentage of your platforms do you expect will complete at least one add-on acquisition?



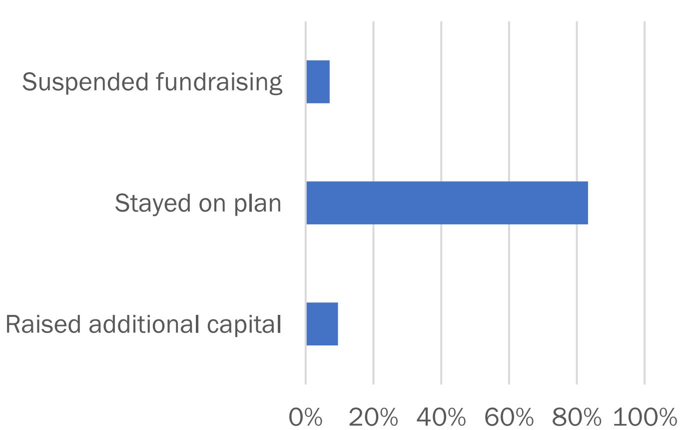
Fundraising

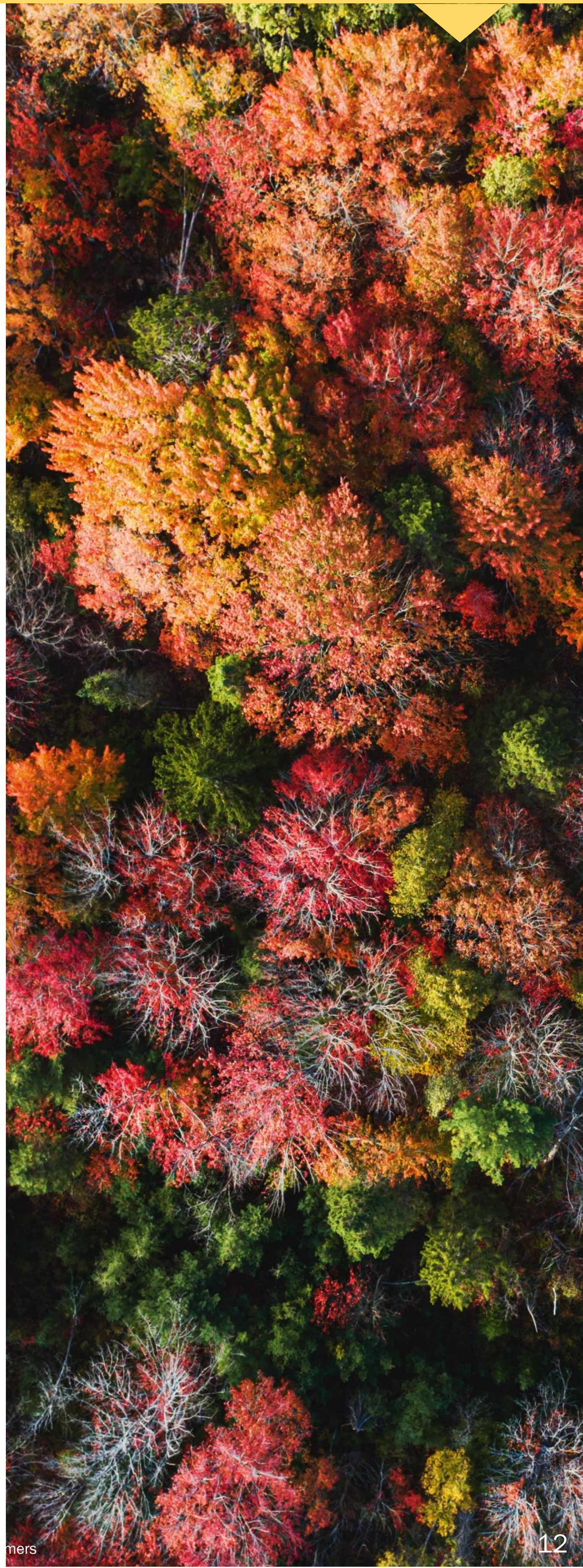
Fundraising is expected to slow from peak levels in 2021 (198 LMM funds raised) and 2022 (156 LM funds raised). Sponsor sentiment has worsened from 2021 (8% forecasted headwinds in 2022) to 2022 (57% of sponsors forecast headwinds in 2023). However, LMM private equity growth is increasing its share accounting for 42.6% of all funds closed in 2022 versus 33.1% in 2021.

As a lower middle market or middle market sponsor, do you feel tailwinds or headwinds in your fundraising?



Did your fundraising plans change as a result of the economic slowdown in 2022?

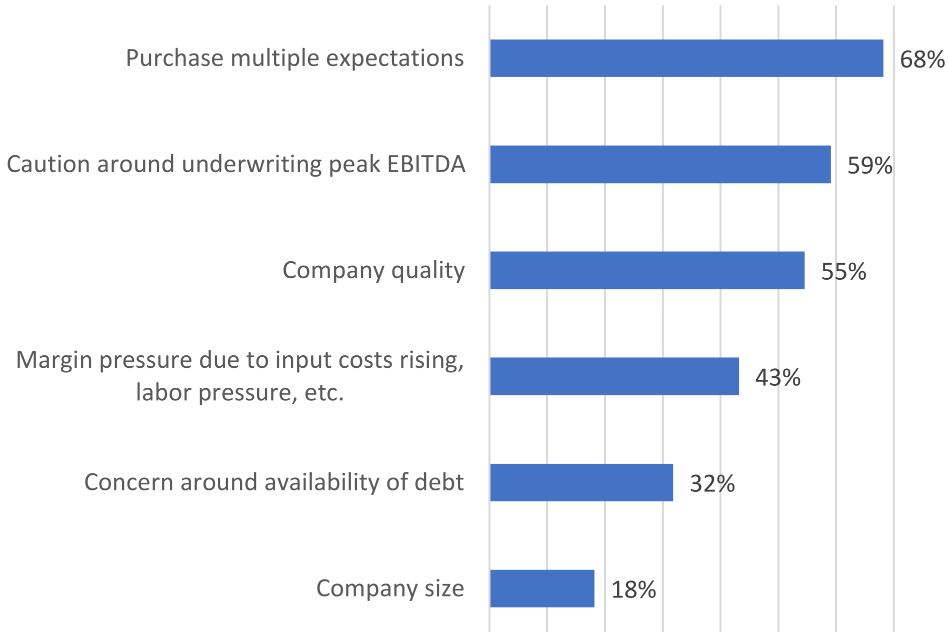




Current Environment

What are the most common reasons for electing to pass on a new platform acquisition in this environment?

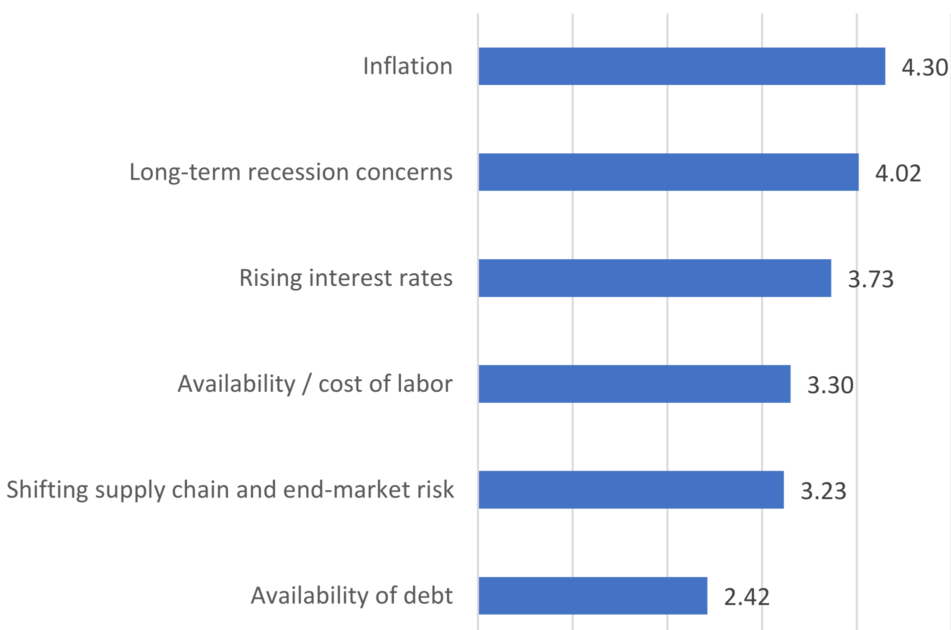
New to the 2023 Ascend Survey is a question regarding the key criteria that led a LMM sponsor to pass on a new platform in the current environment. Company size and availability of debt are not materially concerning factors to sponsors; however, underwriting peak EBITDA trends following COVID spikes and inflated purchase multiple expectations both garnered concerns from over 50% of respondents.



Rank the top concerns (1-5) in the current environment when evaluating a new platform?

Inflation took the top spot in the 2023 *Ascend Report* as the key concern for LMM private equity sponsors. On a year-over-year basis, inflation concerns grew 28% whereas concerns regarding availability / cost of labor declined by 30%.

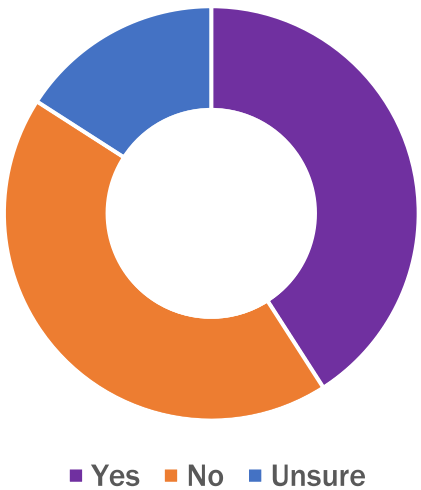
There remains significant private debt AUM ($1.2T) and dry powder ($395B), which translated to limited availability of debt concerns.



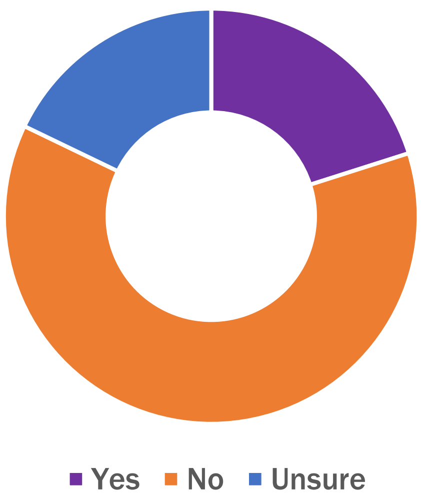
Current Environment

Recessionary fears are leading to tempered valuation expectations. Peak purchase multiples of 16.0x in 2019 in the middle market declined to 12.9x in 2022 per Pitchbook. This data point was validated through the 2023 Ascend Report with nearly 90% of respondents noting that recessionary concerns are impacting their view on valuation.

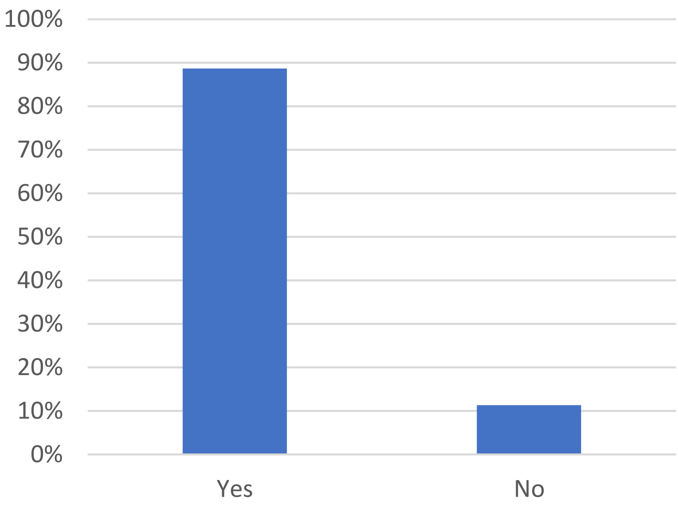
Do you expect to slow the pace of new platform acquisitions if the economic slowdown / recessionary environment persists throughout 2023?



Do you expect to slow the pace of add-on acquisitions if the economic slowdown / recessionary environment persists throughout 2023?



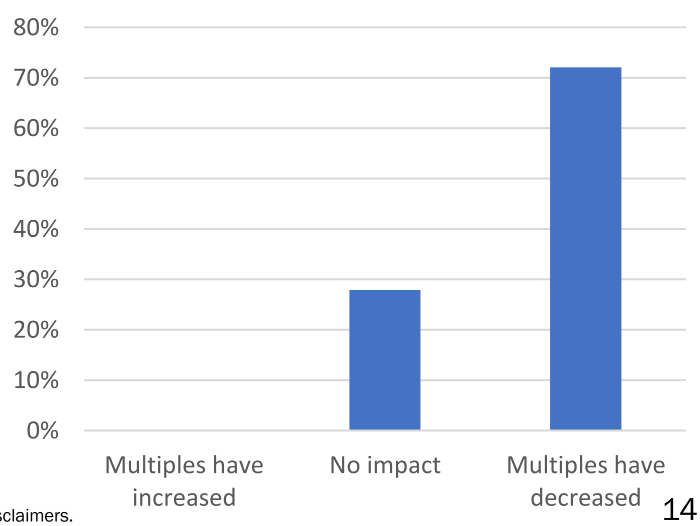
Are recessionary concerns impacting your view on valuation?



18%

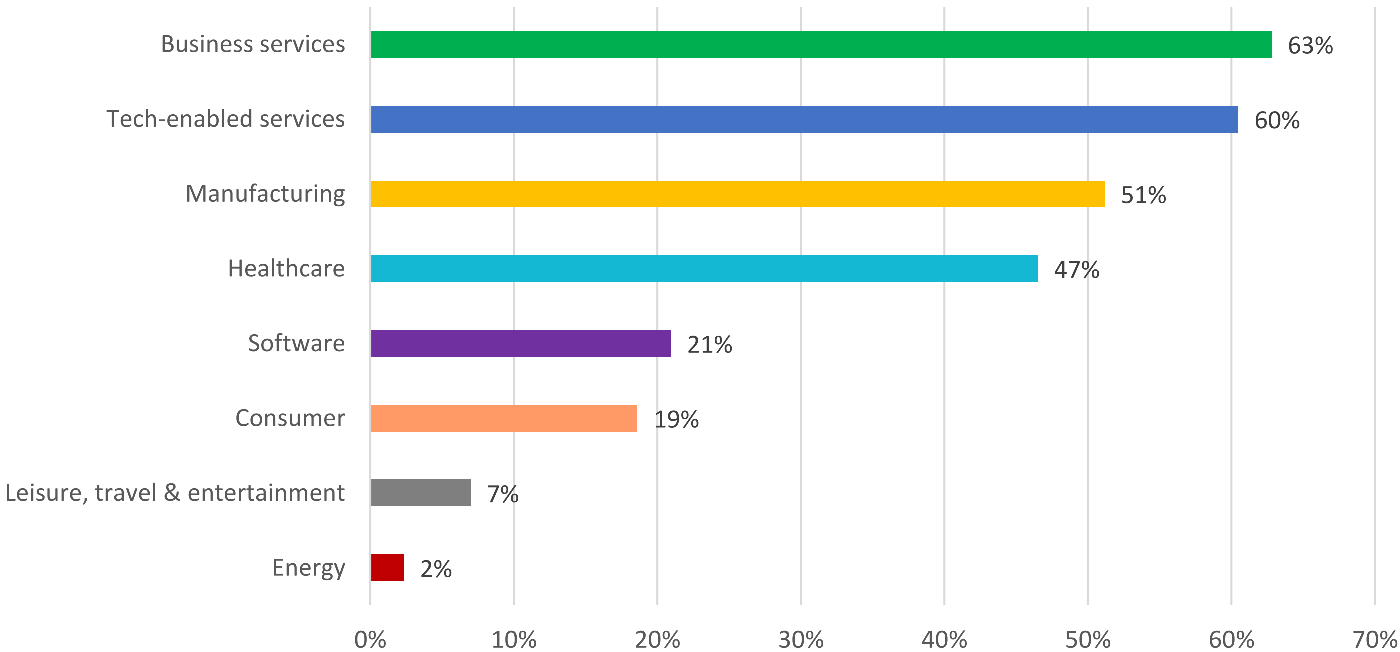
of Sponsors believe we will enter into a prolonged recession in 2023.

Have rising interest rates/cost of debt impacted purchase multiples?

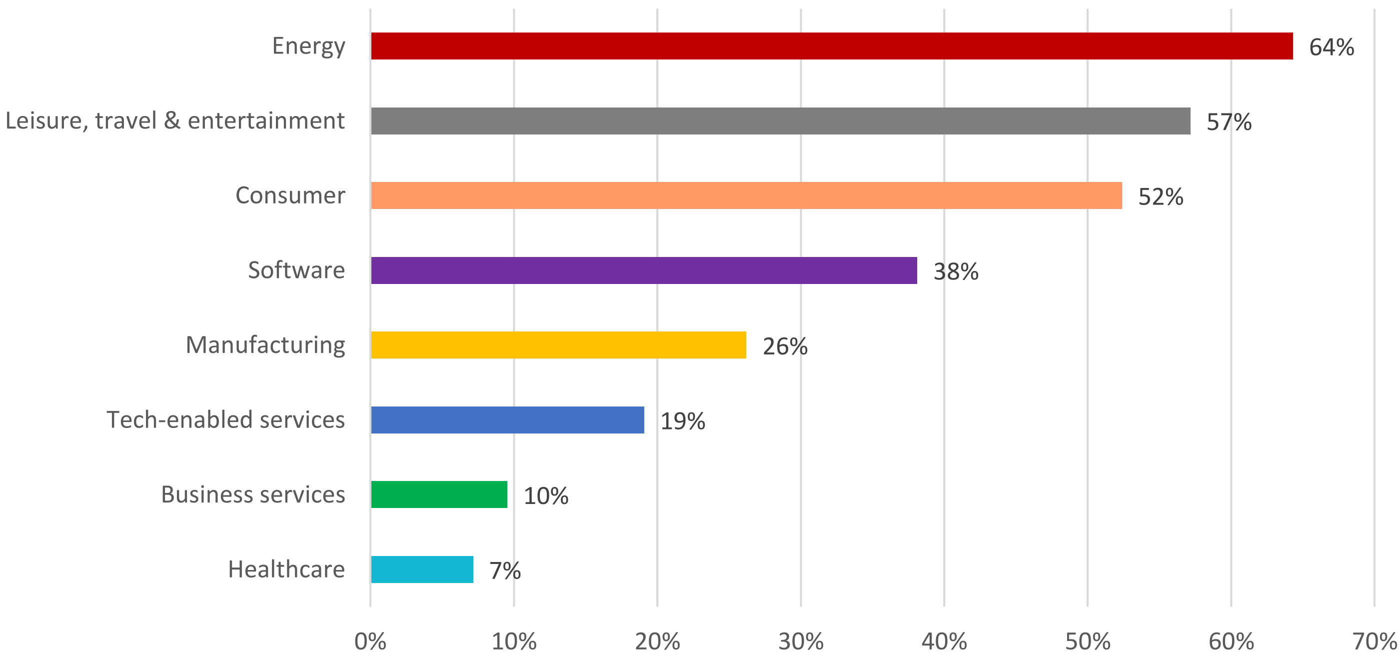


Current Environment

What sectors do you plan to target in the current environment?



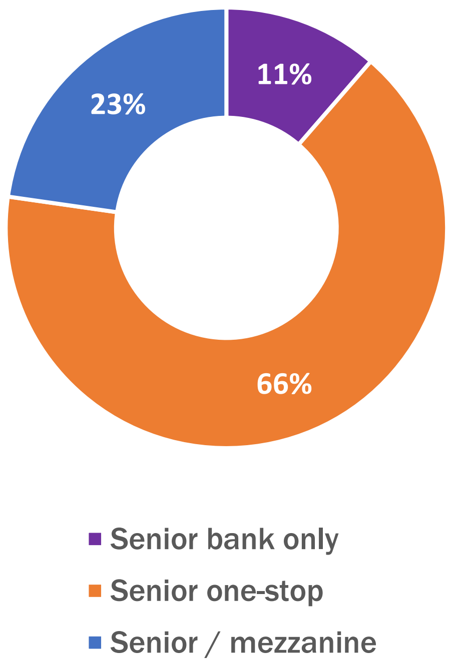
What sectors do you plan to avoid in the current environment?



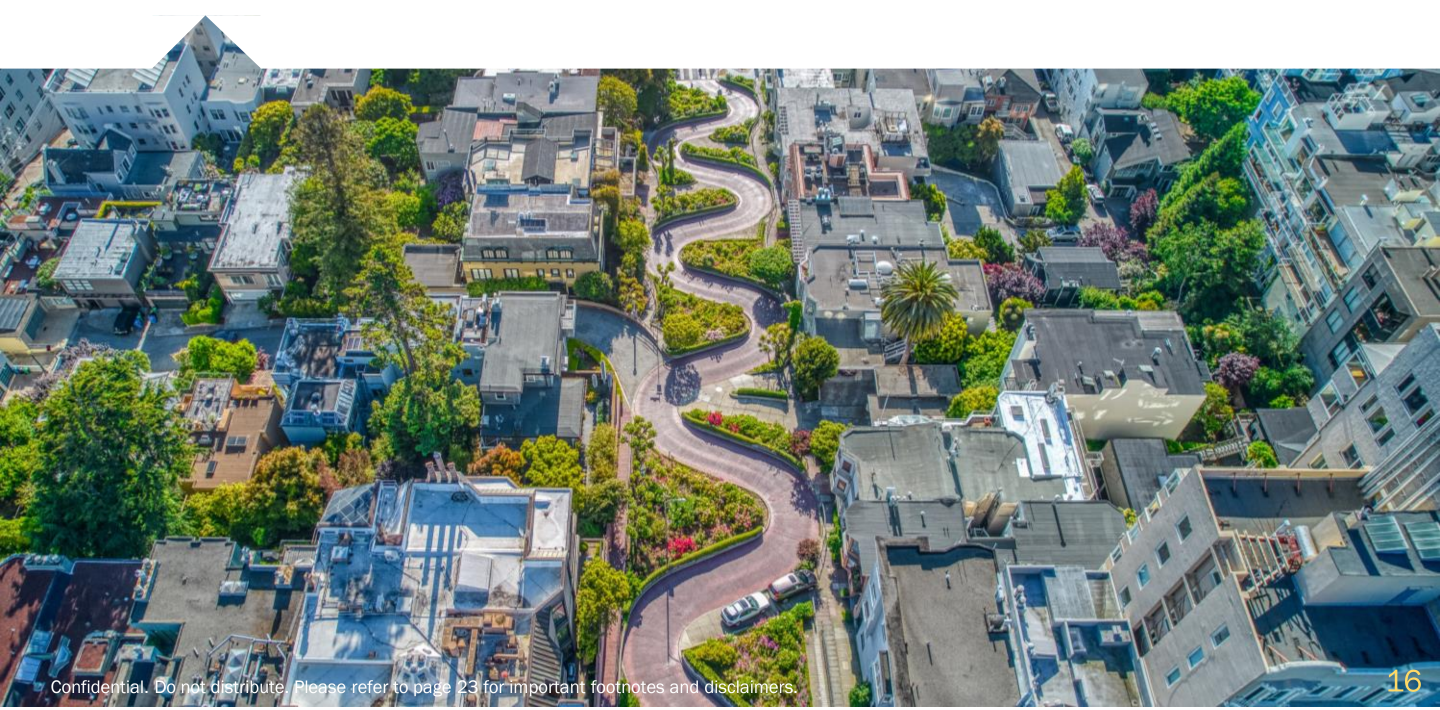
Lender Preferences

LMM sponsors indicated that relationship and flexibility remain the top two considerations when selecting a lender to partner with on a new platform acquisition. This dynamic translates to 65% of sponsors preferring a private credit firm as a key player in the capital structure (20% prefer first-out/last-out structures and 45% prefer flexible non-bank senior only).

What is your preferred debt structure?



Rank the most important factor when selecting a lender:



Tree Line’s Market Insights

Tree Line’s History and Growth

Structure Over Size

Value Creation through Add-On Acquisitions

Bank Collapse Fallout

The Ascend Survey was completed prior to Silicon Valley Bank's ("SVB") collapse on March 10, 2023, and as a result, sponsor feedback regarding the fallout is not reflected in the *Ascend Report*. However, we wanted to provide real time feedback and insights from Tree Line.

Q1 2023 Earnings Summary – Regional Banks

- Six of eight key regional banks[10] met or exceeded analyst expectations in Q1 2023. Net interest income ("NII") fueled higher than expected earnings; however, the drop in deposits introduces significant headwinds for future quarters. While NII exceeded analyst expectations, analysts forecast challenges through 2023.
- The KBW Regional Banking Index has contracted 23% in 2023 with select regional banks experiencing declines over 90%.
- Analysts at Wells Fargo noted that Q1 2023 deposit outflows were worse than expected and at "a level that could prove very hard to come back from." Deposits declined by 10.5% across the eight regional banks in Q1 2023 and analysts believe deposits have continued to decline since earnings were reported.
- The failure of two regional banks in March 2023 sparked consumer fear and regional banks experienced a "run on" deposits as cash was swiftly moved to money market funds or "too-big-to-fail" institutions.
- Deposits at every publicly traded mid-sized bank dropped in Q1 2023 vs. Q4 2022 compared to JPMorgan Chase, which saw deposits increase by 2% to $2.4T over the same period.

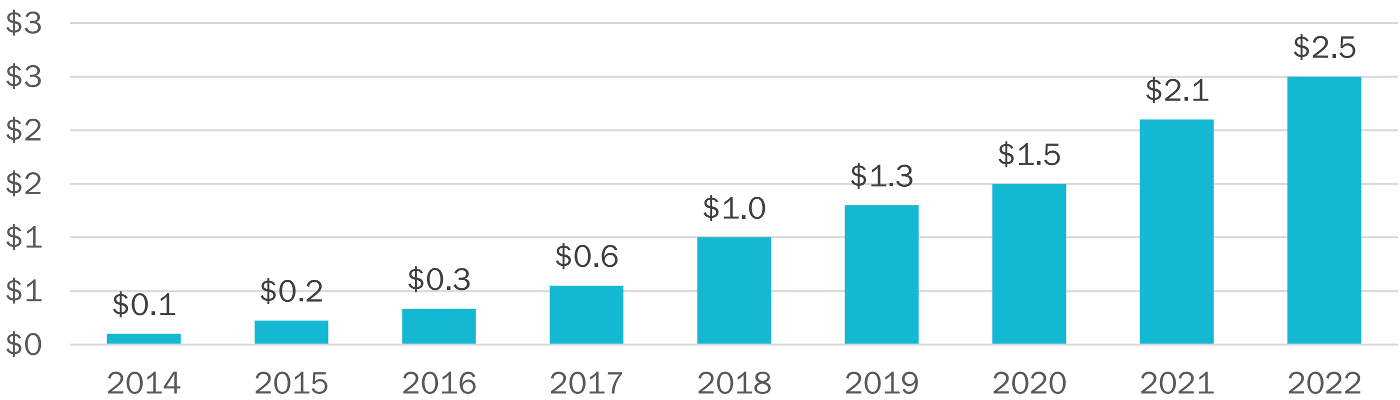
Tree Line's Conclusions

Tree Line continues to monitor the situation and has not seen any disruptions across our portfolio. Tree Line's expectation is that pressure on deposits and money moving to money market accounts will drive further constraints across the regional bank market. 66% of Sponsors noted in the Ascend Report that they prefer senior one-stop, non-bank credit facilities and we'd expect that percentage to increase as regional banks struggle to remain active.

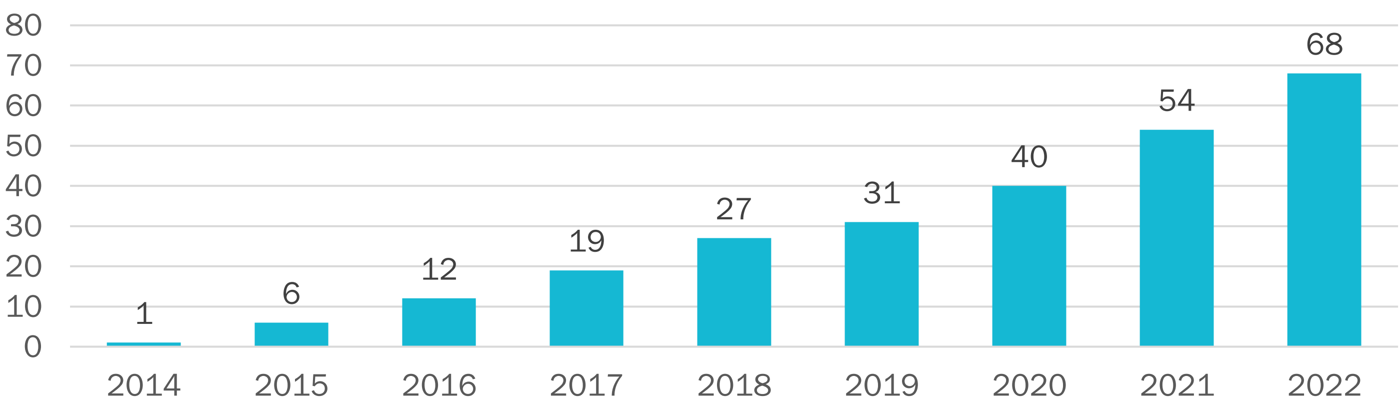
Tree Line's History & Insight into the LMM

Over the past nine years, Tree Line has made significant investments in our platform, systems and team. The data-focused approach provides Tree Line with a unique ability to analyze trends in the lower middle market. Since inception in 2014 through 2022, Tree Line has issued $4.0B in commitments, financed 279 companies and partnered with 68 unique private equity sponsors.[11]

AUM Growth Since 2014 *($ in Bs)*



Cumulative Sponsor Relationships (Closed Deals)

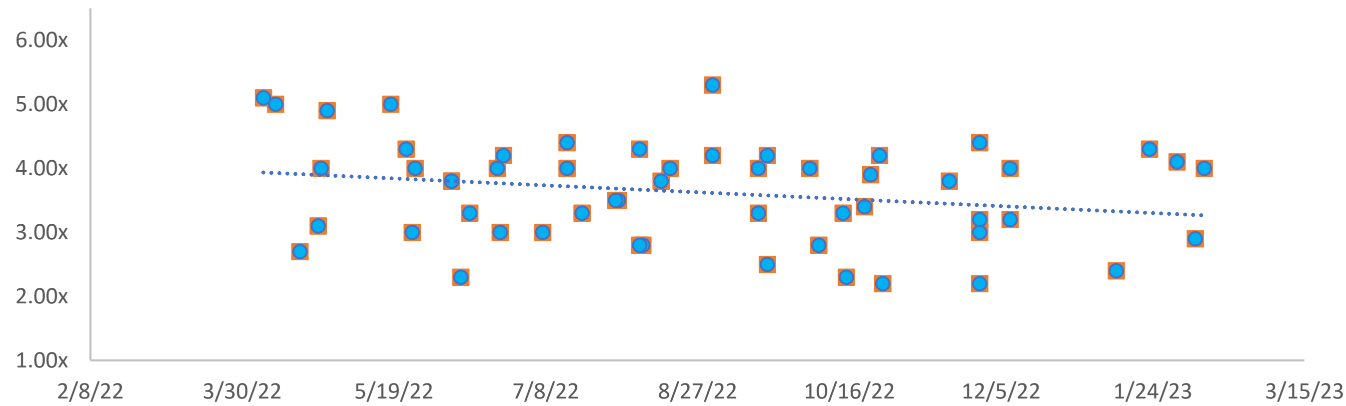


Structure over Size

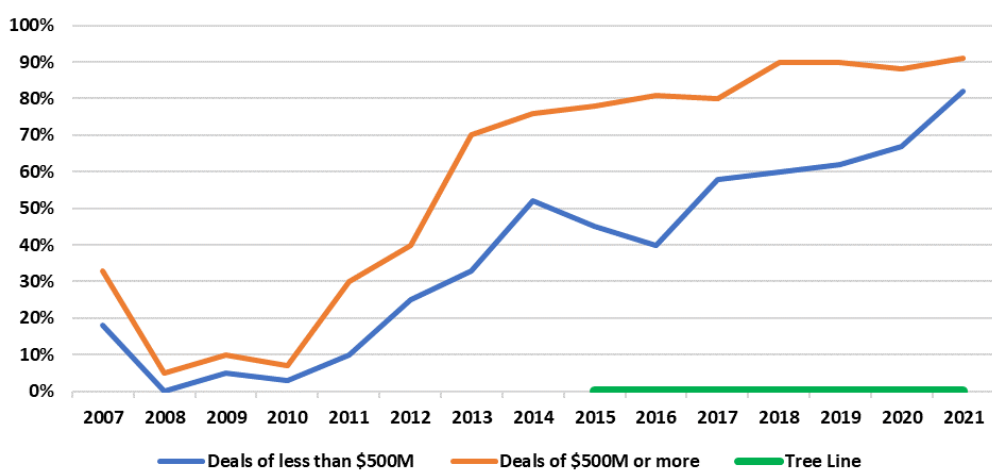
Dispelling the Narrative that Up-Market (over $50M EBITDA) Borrowers Outperform LMM in Times of Volatility.

Tree Line continues to prioritize credit structure over the size of a company in our approach to portfolio construction. Reasonably levered LMM deals have outperformed the upper market given the ability to withstand economic volatility. Opening at over 6.0x leverage in cov-lite structures provides limited ability to withstand headwinds as evidenced by the elevated default rates in the upper market and lack of ability to cover debt service in the current market. Additionally, sponsors in the LMM typically share Tree Line's approach to reasonably structured deals as highlighted in the chart below. In response to the market volatility, leverage request from LMM sponsors to Tree Line have decreased from ~4.00x in Q1'22 to ~3.25x in Q1'23.

Leverage Trends (Deals Reviewed by Tree Line)[12]



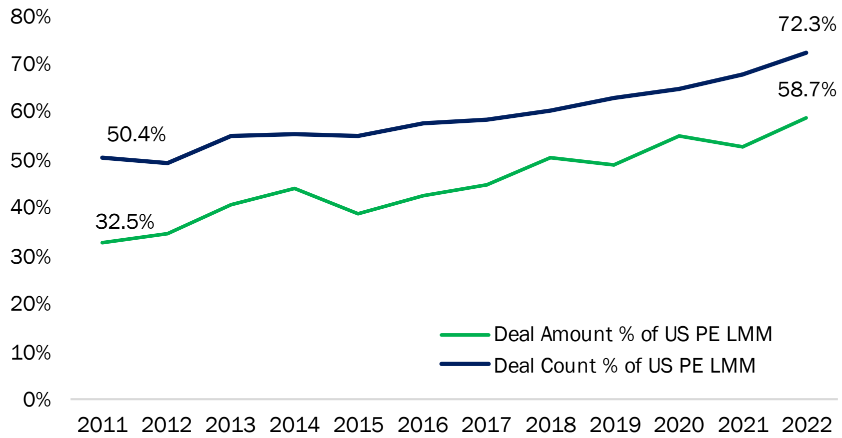
Cov-Lite Trends by Market Segment[13]



Building Value Through Add-on Acquisitions

Add-ons as a Share of US LMM Deal Flow[14]

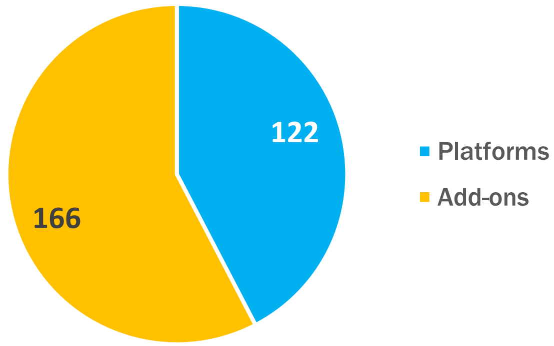
LMM sponsors have achieved significant success through buy-and-build strategies where add-on acquisitions are able to be tucked in at attractive valuations. In 2022, add-on deals reached the highest-ever share of LMM deal activity, according to Pitchbook.



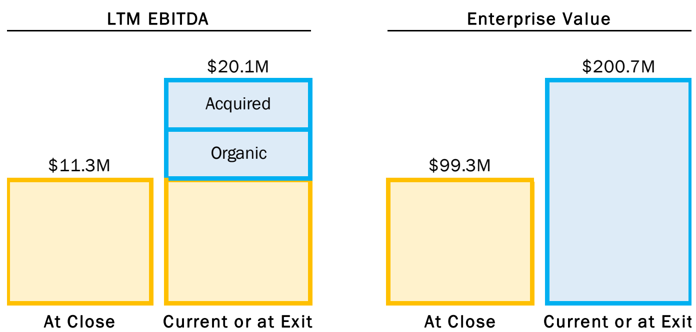
Tree Line's Insights

Tree Line has supported the growing trend of LMM sponsors acquiring a LMM platform at a reasonable valuation and driving significant value creation through accretive add-on acquisitions.

Tree Line Transactions Closed Since 2014



Financing Buy-And-Builds to Drive Value Creation[15]



Tree Line's portfolio companies have on average grown from $11.3M of EBITDA at close to $20.1M of EBITDA on an LTM basis today or at exit. Growth has been facilitated through organic initiatives as well as a strong focus on add-on acquisitions. Since inception in 2014 through Mar'23, Tree Line has financed 122 platforms and 166 add-on acquisitions (58% of deal activity).

Conclusions

To the readers:

Since our founding in 2014, Tree Line has been singularly focused on financing and supporting the growth of businesses within the lower middle market. Nine years since inception, we are pleased to remain committed to the lower middle market, which is a growing and important segment of the economy. Tailwinds remain strong with over $312B of capital raised in private equity funds with funds sizes of less than $500M since 2019. Capital continues to be raised at an accelerating pace as the opportunity set of over 175,000 companies with $10-100M of revenue presents a highly fragmented and large addressable market of acquisition targets in the lower middle market.

At Tree Line, our objective is to use our unique access to data within the growing lower middle market segment to share our insights with investors and sponsor partners. We believe the next decade of private market investing will be defined by properly understanding and bifurcating market segments. The maturation and growth of the private credit asset class will require investors to segment allocations to outperform in the current environment. Lower middle-market exposure will enable investors to blend to more favorable metrics and returns.

2022 proved to be a turbulent year across the private capital markets and Tree Line has a unique ability to analyze trends and risks through our proprietary data systems. Capital has continued to flow to the LMM; however, a disciplined approach to sector selection and thoughtful structuring of the capital structure remains paramount to success.

Default rates of large market borrowers spiked to 4-5% in 2020 due to over levered balance sheets and acquisitions of risky, cyclical businesses. As highlighted in the Ascend Survey, an uncertain year lies ahead in 2023. 57% of sponsors forecast fundraising headwinds and inflation concerns grew 28% on a year-over-year basis.

At Tree Line, our investment strategy focuses on first lien structures, modest leverage, and business models with high free cash flow with strong sponsor support. Our portfolio managed through COVID, 2021 and 2022 with no payment defaults with minimal interruption among portfolio companies. We believe this performance is a testament to our underwriting ecosystem, which filters out weak business models and minimizes exposure to sectors that present a higher likelihood of default. Our strategy will continue to be designed to deliver consistent returns in all phases of a cycle.

Thank you again to our sponsor partners that provided valuable insight through responses to the Ascend Survey. We look forward to a productive 2023.

Best Regards,

The Tree Line Team

Disclaimer & Footnotes

Disclaimer

Opinions expressed in this *Ascend Report* are those of Tree Line Capital Partners, LLC as of May 2023 and are subject to change. Furthermore, the data contained herein is for informational and discussion purposes only and is neither an offer to sell nor a solicitation of any offer to buy any securities, investment product, or investment advisory services.

Footnotes & Sources

1. *PitchBook (data as of May 1, 2023)*
2. *2012 US Census: 2012 SUSB Annual Data Tables by Establishment Industry*
3. *PitchBook's 2022 Annual US PE Middle Market Report*
4. *PitchBook (data as of May 1, 2023)*
5. *PitchBook (data as of May 1, 2023)*
6. *PitchBook's 2022 Annual US PE Middle Market Report*
7. *Preqin; Future of Private Credit & Private Equity Report (2023)*
8. *PitchBook's 2022 Annual US PE Middle Market Report*
9. *Data as of January 31, 2023.*
10. *Eight key bank set includes: FRC, ZION, EWBC, PACW, CMA, WAL, FITB and KEY.*
11. *Tree Line internal data*
12. *Tree Line internal data*
13. *https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/covenant-lite-deals-exceed-90-of-leveraged-loan-issuance-setting-new-high-66935148*
14. *PitchBook's 2022 Annual US PE Middle Market Report*
15. *Tree Line internal data*