As we sit in the seventh year of the recovery following the Great Financial Crisis, the credit markets are anything but certain. Larger liquid debt securities continue to underperform with stagnant yields, the banking sector continues to consolidate and face regulation and a crowd has formed to commoditize direct lending in the middle market. With the middle market following pre-crisis trends, portfolio managers need to be acutely focused on portfolio volatility. For those willing to evaluate the opportunity, the lower middle market offers a real opportunity to capture alpha and invest in disciplined structures to prepare for the possibility of a cycle.
Moneyball for Portfolio Managers Seeking Yield

In 2003, Michael Lewis introduced the world to Moneyball. A book about the small market Oakland Athletics and its general manager Billy Beane who pioneered an analytical, evidence-based, sabermetric approach to assembling a competitive baseball team. The central thesis of Moneyball is that the collected wisdom of baseball insiders over the past century is subjective and flawed. A paradigm shift was occurring in how to construct a team and value talent. Beane realized he could spend a fraction of top payrolls and win by identifying overlooked and undervalued players.

In baseball, Moneyball subscribers have to step away from the pack and challenge the old-school traditions of the game. Beane shifted the mindset of his organization to buying wins versus buying players, and in order to buy wins you need to buy runs. As Beane assembled a small group of undervalued baseball players, many of whom were rejected as unfit for the big leagues, he proved the strategy works. The A’s created one of the most profitable and successful franchises in Major League Baseball. Beane put his faith in the numbers and statistics that delivered him hard evidence to where dollars should be invested on the field. Beane proved that the traditional yardsticks of players and teams are fatally flawed as he showcased his strategy with the second lowest payroll in baseball.

As we evaluate the state of the credit markets, with a focus on the compelling opportunities that exist in the lower middle market, we will highlight the lessons that can be learned from Moneyball. When applying the philosophy to credit, the shift in mindset is to invest in risk adjusted return (i.e. wins) versus simply to invest in large company debt (i.e. players).

The Moneyball & Lower Middle Market Comparison

There are many similarities between Moneyball and lower middle market investing. In baseball, general managers employing the Moneyball philosophy will seek players that consistently deliver a specific result necessary to produce a run or a win. However, many players have been rejected or overlooked as they possess some trait that conflicts with the norms. Turning the focus to statistics and metrics enables general managers to set aside preconceived subjective necessities such as size, height, weight or even throwing motion. The objective is to identify overlooked talent at a discount price that can produce a desired result. For example, a player that walks to reach first base is of equal value to a player that hits a single to reach first base. The same result is obtained. Beane discovered that on base percentage was an undervalued asset and power hitters were overvalued assets as baseball insiders valued hitting a single over a walk.

“A company providing a required service to contracted customers maintains a 25 year operating history with a demonstrated ability to generate consistent cash flow. No one is paying attention to this company because it has $4 million in EBITDA. If this company was larger it would borrow capital at 4%. We can lend at 3x EBITDA in a first lien amortizing loan and earn 12%.”

- Lower Middle Market

In the credit world, a perception can exist that a portfolio carries more risk or volatility if it is comprised of loans to smaller companies. Investors will often take comfort in a belief that larger companies will mitigate risk in a distressed market. The idea that risk, or even access to liquidity, is simply a function of a company’s size of revenue and EBITDA is misguided. This ignores critically important credit fundamentals, such as security type, structure, yield, leverage, covenants and market conditions. Beane found value in overlooked players and acquired them at a discount whereas lower middle market investors can invest in underserved smaller companies and earn a premium. Lower middle market direct lenders can capture alpha in the form of excess yield and return and do so in favorable securities and structures because few focus on the market opportunity. There is simply a gap in supply and demand between lower middle market companies and lower middle market investors. A willingness to look beyond simply the size of a company’s revenue and EBITDA will provide a more accurate understanding of risk and return associated with the lower middle market.

As in Moneyball, the message is about targeting market inefficiencies, stocking up on players and skills, or in this case companies and loans, that are overlooked. Those willing to step away from the herd mentality and truly evaluate risk across the credit spectrum will be rewarded.

“Chad Bradford is a relief pitcher. He is one of the most undervalued players in baseball. His defect is he throws funny. Nobody in the big leagues cares about him, because he looks funny. This guy should cost $3 million a year. We can get him for $237,000.”

- Moneyball
Defining the Market

Hunting for Yield

In the current market environment, investors have been forced to hunt for yield. Historically, investors have flocked to U.S. Treasuries, corporate investment grade bonds, municipal bonds or high yield (junk) bonds as a way to layer yield into a portfolio. There is no need to digress and overanalyze each of these established and known securities as what’s relevant is the resulting trend. The lack of yield being offered by liquid credit securities in the current environment with the U.S. 10 Year anchored below 2.00% has left investors to rethink, and ultimately shift, their allocation strategies. Simply put, historical liquid yield plays are weighing down overall returns and portfolio managers have been on the hunt to solve for yield. Enter the direct lending movement.

Since the recovery took shape following the Great Financial Crisis in 2009, direct lending strategies have become a mainstay in portfolio allocation discussions. Direct lending strategies typically take aim at the most underserved markets, being the middle market and the lower middle market. On a combined basis, these markets represent over $6 trillion in aggregate revenue or 40% of the U.S. GDP. This results in one of the largest market opportunities in the world. The market opportunity is enormously large in the wake of bank consolidation and regulation. Direct lenders have identified the bank consolidation trend as an opportunity and seek to fill the void banks have created. Figure 1.1 summarizes the market by product type and yield. The middle market is comprised predominantly of banks, business development corporations (BDC’s), collateralized loan obligations (CLO’s) and private funds. Middle market lenders traditionally target companies that have between $100 million and $500 million of revenue and hold a modest advantage over corporate high grade bonds generating a mid-single digit return.

The lower middle market is comprised of fewer BDCs, Small Business Investment Companies (SBICs) and private funds. Lower middle market lenders target companies that have between $10 and $100 million of revenue and can generate a low double digit yield. Collectively, direct lenders addressing the lower middle market and middle market can deliver a compelling yield opportunity to investors driven largely by the macro trend of bank consolidation against the backdrop of tremendous capital demand. Lower middle market and middle market direct lending strategies deliver a significant premium in yield to traditional fixed income bond yields, as seen in Figure 1.1.

The incremental return is captured through directly working with small to medium sized borrowers that are less intermediated and struggle to attract capital. While the premium in yield is present, it is paramount to understand the structure of the underlying securities within a direct lender’s portfolio. There is much to evaluate beyond simply yield and this will be analyzed in a later section of this paper.

Is Liquid really better?

Liquidity remains an active part of the dialogue when evaluating where to invest across the yield spectrum. Clearly, there are liquid yield options such as Treasuries and investment grade corporate bonds but we’ve already discussed the sacrifice that must be made in yield if one holds these securities. Simply following the herd into liquid securities would abandon the
Moneyball philosophy and eliminate an opportunity to capture value where few are looking. Some conclude where there’s liquidity there is less risk. When studying the historical recovery rates of defaulted loans from over the past 25 years (See Figure 1.2), the data is clear that a direct lending strategy, which is typically less correlated to the public market than that of a high yield bond, delivers a higher recovery rate (i.e. liquid securities do not always offer lower risk). Middle market loans showed the highest recovery rate of defaulted loans at 86% with senior secured bonds, senior unsecured bonds and senior subordinated bonds delivering recovery rates of 63.6%, 48.4% and 28.8%, respectively.

Direct Lending’s Edge

Direct lending has attracted investors in droves in recent years spanning institutional to retail investors. The asset class offers a long list of attractive traits but we’ll highlight and focus on three key themes: bank consolidation and regulation; the structural advantage in being senior secured; and reduced volatility.

Capital supply shortage due to bank consolidation and regulation

Bank consolidation and reduced participation in the loan markets, driven by increased regulation introduced through the Dodd Frank Act and Basel II, has generated a significant market opportunity for direct lenders. Over the last 20 years, over 5,000 commercial banks have exited the leveraged loan market and their market share has declined to less than 10%. The consolidation trend has removed commercial banks that were lending in their local markets throughout the U.S. Historically, these commercial banks were relied upon as a source of liquidity and worked with local businesses that sought working or growth capital. This results in approximately 40% of our economy, which consists of nearly 175,000 businesses, left to search for growth capital.

Senior secured structures dominate cash flow recapture

Most direct lending investments are structured as senior secured loans, typically in the form of a first lien, second lien or unitranche term loan, which affords the direct lender the first or second right of repayment in the event of a default, bankruptcy or liquidation. Additionally, the structure of a senior secured loan delivers its investors a contractual cash interest coupon which is senior to all other interest payments, distributions or dividends. Direct lending investors build a cash on cash return on a monthly or quarterly basis and avoid the J-curve affect that confronts private equity investors. In private equity, it can take years before cash on cash returns are available given the contractual relationship that exists between senior secured debt and equity. More importantly, direct lending portfolios, with their ability to recapture cash along the way, put less pressure on an investor to predict the economic environment years in advance. Contractual amortization and cash flow sweeps are typically present in loans which enables lenders to reduce exposure and risk as a company generates cash. There is often additional upside participation received in the form of prepayment penalties, portfolio management fees and warrants.

Figure 2.2, illustrates the strength of a senior secured loan and the multiple of its initial investment that is contractually earned simply by recapturing cash flow.
If a lender makes a $100 loan with a 12% cash interest coupon, which is not uncommon in the lower middle market, it has the ability to earn up to 1.6x its initial investment prior to private equity realizing its return. This assumes holding the loan for a five year term. At maturity, whatever amount of the loan hasn’t been amortized is due and approximately $60 of cash interest, or $12 per year, has already been paid to the lender. Additional upside can deliver up to earning 1.8x its initial investment when receiving various upside features or participating in the equity returns.

Direct lenders benefit from equity investors and the private equity industry putting multiples of capital at risk behind the firewall of its contractual principal and cash interest return. A senior secured loan may be capped in contractual return but investors benefit from far less volatility. If you’re an investor in private equity it is very difficult to argue that allocating to the direct lending space does not offer an attractive hedge and reduce speculation.

**Reduced Volatility**

Although private equity investors benefit from theoretical unlimited upside, the path to obtain lofty levels of return across a portfolio is a challenge as demonstrated by historical return data. Due a senior secured loan’s priority of payment, direct lending returns are historically less volatile than private equity and present a much narrower distribution of returns (i.e. more predictable). The spectrum of returns when studying +/- two standard deviations from the mean (which statistically accounts for 95% of all data) results in direct lenders maintaining positive returns while private equity extends into negative territory in poor economic environments.

As illustrated in Figure 2.3, the direct lending median return is 11.4% with a standard deviation of 5.8% achieving positive returns over multiple economic cycles. The median private equity return is 10.5% with a standard deviation of 16.6% introducing significantly more volatility to a portfolio and the risk of investors losing principal. The downside of a low performing private equity investment can push returns to (22.7%). Many portfolio managers will emphasize that they will only invest in top quartile private equity funds. However, when studying 324 private equity funds, data tells us that only 34% of top quartile private equity funds stay in the top quartile in the successor fund with 25% falling to the third quartile and 15% falling to the bottom quartile.

The conclusion is not necessarily to declare a winner between private equity and direct lending, rather, it is an evidence based argument that would suggest an allocation to direct lending helps minimize portfolio volatility. It delivers clear and present risk mitigation through exposure to senior secured positions at a time when equity markets are best overheated and at worst in decline.

The challenge for portfolio managers is to identify direct lenders and a market strategy that can deliver the consistency in performance while maintaining the key pillars of the strategy.
Why Lower Middle Market and Why Now?

Directly investing in senior secured structures that offer higher yield, lower leverage and full covenant packages is the lower middle market value proposition.

The sheer size of the lower middle market, with approximately 175,000 companies, creates an immediate advantage as it enables disciplined direct lenders to construct a highly selective portfolio. There is a clear lower middle market supply / demand imbalance that exists in today’s environment. There is approximately $24B of lending capacity in the lower middle market that addresses a market that consists of 175,000 borrowers that maintain revenue between $10 and $100 million. The supply / demand imbalance has been exacerbated by the recent phenomenal growth of BDC’s that have abandoned the lower middle market as they moved their larger balance sheets up market.

Conversely, there is $457B of lending capacity addressing the middle market which consists of 16,000 borrowers. The middle market, which is 10% of the size of the lower middle market, has seen the most new entrants attack its space. While the opportunity set still substantiates a need for direct lenders as banks have become less active, today’s middle market lenders have become commoditized which leads to lower yields, subordinated securities and “cov-lite” structures (i.e. less rights more risk).

The Lower Middle Market Approach

Lower middle market lenders in particular are working with companies that are typically smaller in size but have established track records and a demonstrated ability to generate consistent cash flow. In this case, smaller is not synonymous with venture or unproven. Lower middle market companies will typically have revenues of between $10 and $100 million and are meaningful participants in all sectors of the U.S. economy. They manufacture and sell parts to OEMs such as Boeing or GM, stock the shelves of Home Depot or Wal-Mart or provide a required and necessary service for businesses to operate. Lower middle market companies are embedded within the greater U.S. supply chain and show up in our daily lives far more than one would realize. The U.S. economy relies upon the robust business activity that occurs in the lower middle market to function and grow. This is where the Moneyball approach comes into play. An investor will be rewarded if willing to thoughtfully participate in the underserved portion of the economy.
The Middle Market Craze – Commoditized, Crowded and Volatile

Investing in a commoditized and crowded market that follows a playbook that has historically only led to volatility is a tough place to be. Moreover, it completely contradicts and sacrifices the merits of a direct lending strategy. The middle market, which will be defined as those lending to companies with greater than $25 million in EBITDA, has attracted significant capital from institutional and retail investors over the past several years, is beginning to show characteristics of a selective memory turning a blind eye to mistakes made leading up to the Great Financial Crisis. The middle market has seen a number of new entrants since 2008 with many coming to market in the form of a BDC. Today’s 13 largest BDCs who have a minimum of $1B under management have increased assets by $21B since 2010. This growth has forced many in the BDC community to abandon its support to low er middle market companies and focus on larger deals that deliver volumes that enable a quarterly dividend to be met. On the one hand, the size of the market can justify some new entrants. On the other hand, most new middle market entrants rely on auctioned private equity deal flow. These lenders quickly create a crowd in a narrow segment of the market and commoditize themselves and their products. It doesn’t take our friends in private equity long to chip away at terms and effectively gut the rights and remedies of a lender. When lending gets competitive, two things generally get sacrificed in order, price and structure. Yield compression is stage one. In an increasingly competitive environment, middle market funds run down price to keep the origination volumes moving. Structure is stage two. Securities begin to take deeper and deeper subordination risk and turn covenant packages into “cov-lite” packages. Rights and remedies, which are critical in a downturn to equip lenders to act in advance of defaults, are watered down if not eliminated.

Liquidity is widely discussed and often the rationale for why an investor will select to allocate to the middle market as opposed to the lower middle market. A public structure will offer investors an opportunity to access liquidity in a performing market. However, the underlying securities of most middle market funds remain illiquid and most importantly the share prices of those vehicles (BDCs, ETFs) tend to trade at substantial discounts during times of market dislocation. The illusion of liquidity in middle market funds will be exposed as subordinated securities at high leverage multiples trade down offering little value to investors who want to exit near par.

In an economic downturn, lower middle market direct lenders, with little exposure or correlation to public markets, will be best positioned to minimize default rates and offer a higher return of capital due to a direct process that invests in senior securities at lower leverage levels, higher amortization rates and maintains full covenants.

| Figure 3.3 Lower Middle Market to Middle Market Comparison |
|-----------------|-----------------|-----------------|
|                | Lower Middle Market | Middle Market | Large Cap |
| Securities     | Senior Secured    | Senior Secured, Subordinated | Unsecured |
| Unlevered Yield| 11 - 16%          | 5-8%           | 2 - 8%    |
| Correlated to Public Markets | No | Yes | Yes |
| Borrower Size (Revenue) | $10M-$100M | $100M-$500M | $500M+ |
| Borrower Size (EBITDA) | $2M-$25M | $25M-$100M | $100M+ |
| Loan Size      | $5M-$50M         | $50M-$500M    | $500M+   |
| Direct Origination | All | Some | None |
| Leverage       | 2.5 - 4.5x       | 4.5x - 6.0x   | 5.0x+    |
| Covenants      | Full Package      | Covenants/Cov-Lite | None / Cov-Lite |
| Competitors    | Regional Banks / SBICs / Private Funds | BDCs / CLOs | Institutional / Retail |

Source: Tree Line market estimates
Key Takeaways

State of the Market, Prepare for a Cycle & Lower Middle Market Value

To wrap up where we started, as highlighted in Michael Lewis’ *Moneyball*, value is often found where few are looking. Subjective decision making in any facet usually falls short and sacrifices performance. In the case of investing and portfolio construction, we find it imperative for portfolio managers to look beyond the size of a company or the size of a fund. The details that lie within an investment strategy or philosophy are critically important to understand when measuring risk adjusted return.

In the current environment, portfolio managers will need to continue to hunt for yield as liquid alternatives fail to deliver satisfactory returns. The credit markets have evolved beyond the historical fixed income strategies, such as treasuries and corporate bonds. A portfolio manager in today’s environment needs to evaluate smaller and direct strategies to capture the opportunity set that exists within the credit markets.

Direct lending has proven to be an attractive asset class with tens of billions of dollars being allocated to the strategy over the past several years. Direct lenders are filling the void that has been created by bank consolidation and regulation. However, portfolio managers cannot be misguided that middle market or large market strategies will provide the necessary risk mitigation in a downturn. The risk adjusted returns that were once available in the middle market have simply been eroded as lenders have reduced yields, increased leverage, increased subordination and gutted rights and remedies.

The lower middle market direct lending opportunity continues to be an overlooked segment of the credit market that is still capturing value. If working with an experienced and capable asset manager, the lower middle market offers unique value in what is a clearly underserved, yet vital, segment of our economy. The sheer size of the lower middle market supply/demand capital imbalance delivers lenders a distinct advantage in deal volume and selection. This advantage is capitalized upon in the pricing and structuring of a loan. Lower middle market direct lenders are making loans at higher yields, lower leverage levels and maintaining key rights and remedies, such as covenants, that help navigate a lender through a downturn. *Moneyball* has taught us to set aside subjective thinking and look more closely at the ingredients of what it takes to win. The philosophy requires one to step away from the herd mentality and execute a plan based on data. We observed Billy Beane deliver the Oakland A’s success as a small market, low payroll Major League Baseball team employing the strategy. Portfolio managers seeking alpha in today’s credit markets would be well served to set an allocation strategy that is supported by data and be willing to invest where few are spending time.

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**State of the Market**

- Large, liquid debt securities continue to underperform – investors must hunt for yield
- Banks continue to consolidate and feel regulatory pressure (aka “the Bern”)  
- Direct Lending fills the void with a middle market crowd taking pre-crisis risk and lower middle market maintaining discipline

**Prepare for the Cycle**

- Consider more than size of revenue and EBITDA – historical recovery rates don’t support the notion that size wins
- Evaluate leverage, covenants, relationship (i.e. risk adjusted return)

**Lower Middle Market Value**

- Blue ocean opportunity with 175,000 lower middle market companies in the U.S.
- Direct lending relationships with borrowers
- Niche strategy with few committed direct lenders delivered favorable securities, spreads and covenant packages
About Tree Line

Tree Line Capital Partners, LLC is a direct lender that provides customized credit solutions to small and medium sized companies in North America. We address the underserved needs of the lower middle market through offering one-stop financing solutions, which include first lien, second lien and unitranche term loans. Having worked with lower middle market companies through multiple economic cycles, we understand the needs of our borrowers. We deliver a flexible, patient and cycle supportive approach.

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