Select A Lender That Will Keep You On Course.

Consistently delivering the Lower Middle Market a relationship approach. With 70% of our deal flow coming through our Repeat & Referral channel, sponsors and borrowers choose to work with us again and again for a reason.

$1.1B
Issued Commitments

92%
Agent or Lead Lender

$3-30M
Target EBITDA

$5-150M
Investment Size

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Introduction

Through the first six months of 2019, US PE dealmaking has matched 2018’s pace. A recovery in leveraged lending market sparked confidence in dealmakers and lessened financing costs, causing many to leap into action. Additionally, public equity markets prolonged their upward climb and EV/EBITDA multiples rose in tandem. The technology and B2B sectors drove dealmaking, with each sector recording a $10 billion+ deal in the second quarter. Some of the buyouts were sourced from carveouts after a 10-year M&A spree has left many companies looking to carveouts to streamline operations. These deals ought to help sate PE’s desire for mega-deals in the coming quarters. Though markets are pricing in an optimistic future, several headwinds could derail this economic expansion and lead to a diminution in PE activity.

While dealmaking activity remained robust, exit activity fell below its historical pace. Several massive IPOs boosted exit value in the quarter, representing the highest proportion of value in over five years. A soaring public equity market, which posted the best first-half results since 1997, made IPOs an attractive exit route despite their high cost and protracted execution timeframe. Regardless, SBOs continue to account for the bulk of PE exits as other GPs most often offer the best mix of transaction speed and price.

Fundraising figures are on pace to top 2018 with over $100 billion raised in the first six months. 2Q registered particularly healthy results as a pair of Boston-based firms each closed on a mega-fund in the quarter. In fact, mega-funds have accounted for more than half of US PE capital raised to date—a record if current figures stand. Fund sizes are soaring higher, approaching half a billion dollars, as GPs seek to take advantage of today’s friendly fundraising environment. Some GPs are even raising funds now with the intention of waiting several months before investing.
1H 2019 experienced plentiful PE deal activity, seeing 2,142 deals close totaling $297.1 billion—approximately in line with the figures we reported through 1H last year. Dealmaking in 1Q of this year suffered from a slowdown in the leveraged loan and high-yield markets during prior quarters. As the US economic expansion became the oldest on record and financing markets returned to stability in 1Q and into 2Q, deal activity perked up in unison. Healthy financial markets, including public equities and leveraged lending, and a pick-up in fundraising activity bode well for dealmaking figures through the end of the year. While activity through the first half of 2019 kept pace with 1H 2018, it would require a quickened pace during the back half of the year—as we saw in 2018—to match the herculean figure achieved in 2018. However, the odds of a swell in activity are diminished by several headwinds that lie ahead, including an escalation in geopolitical tensions, slower global growth and a deterioration of corporate profits.

Technology has propelled PE dealmaking in recent years, and three of the nine deals completed above $1 billion in 2Q were buyouts of tech companies. The preeminent tech deal in the quarter was the $11.0 billion take-private of Ultimate Software Group. A Hellman & Friedman-led consortium of heavy-hitters including Blackstone, GIC and CPP Investment Board played a role in buying the human capital management company. Notably, the company was public for over 20 years before being purchased. Our research shows that take-privates have been occurring after companies had been public for an average of 8.5 years. The deal, heavily financed with equity rather than debt, is taking place as the company transitions from a growth company to a slower-growing mature one. As noted in an SEC filing, the company’s CTO, Adam Rogers, argued that going private will allow the company “increased responsibility and accountability” without the hindrance of quarterly earnings calls and constant filings. This argument is made by countless executives and one of the reasons investors and executives have adjusted their perception regarding public and private ownership. We expect more public executives to laud private ownership and perhaps even put themselves up for sale if public investors are less than cooperative.

While IT accounted for the bulk of deal value, the largest deal was a manufacturing carveout. Brookfield and CDPQ bought Clarios, which makes about one-third of all car batteries globally, from Johnson Controls International (JCI). The deal allows JCI to rid itself of the slower-growing, high-margin, capital-intensive battery business while it focuses on its technologies and solutions business. After a decade-long M&A binge, a plethora of multinationals are shedding noncore assets via carveouts to focus on specific endeavors or business units and avoid the “conglomerate discount.”

The Clarios deal takes place amid a generational shift in the global automotive industry as ridesharing leads to decreased car ownership and as a future with autonomous cars rapidly
approaches, causing companies across the supply chain to act. Sensing this, KKR has been making moves in the industry as well. KKR-owned Calsonic Kansei purchased Magneti Marelli, a subsidiary of Fiat Chrysler, for €5.8 billion in 2Q 2019, creating a massive, worldwide auto parts manufacturer.² Fiat Chrysler also approached Renault in a merger attempt in 2Q. While this discussion fell apart, it reflects the heightened pace of mega-deals in the industry. More broadly, carveouts through concessions in mega-mergers or companies attempting to streamline operations are likely to supply a continual source of multibillion-dollar buyout opportunities for PE firms.

Increased consolidation and M&A activity are not unique to the automotive industry, though. Myriad sectors are seeing sweeping changes in the competitive landscape, forcing them to adapt, often through M&A. This flurry of activity has kept prices elevated for PE firms competing against strategics, and multiples have remained aloft. Additionally, actions taken by the Fed also augur well for expensive dealmaking. The controller of short-term interest rates has quickly changed its tune, now likely to refrain from raising them this year. In fact, the futures market is even pricing in a rate cut before 2020.³ Prolonged levels of lower rates will help GPs mitigate financing costs and allow for richly-priced bids. Indeed, as dry powder levels balloon and debt financing remains historically cheap, we expect the current trend of EV/EBITDA multiples comfortably topping 12x to endure through the year. Furthermore, US public equity markets recorded their strongest first half of the year since 1997, likely providing upward pressure on multiples through the end of the year.

As multiples have crept upward, the median PE deal size has soared in 2019. To date, the median US PE deal size leapt to $275.7 million from $190.0 million in 2018—an increase of 45.1%. With six months to go, it seems GPs are putting outsized sums of dry powder to work by targeting ever-larger enterprises. SBOs, which now make up 26.0% of US PE buyout count, surged to $740.0 million in median deal size since the 2009 nadir of $64.0 million, outpacing traditional LBOs and add-ons over the past decade. Add-ons, too, have swollen in size. Massive fund sizes have given GPs the firepower to tack on sizable add-ons to portfolio companies. For example, KKR-backed PHC Holdings, a Japanese manufacturer of healthcare devices, added on Epredia, another medical device manufacturer, for $1.1 billion in 2Q. In 2016, PHC was valued at $2.3 billion, making this add-on nearly half the size of the portfolio company. In certain cases, we’ve even seen add-ons worth even more than the portfolio company. As GPs seek huge add-ons to swiftly grow portfolio companies and spend down mounting dry powder, we believe add-ons—and all other deal types—will continue their current price ascension.

2: This will not show up in our numbers because the company is not based in the US.

3: “Traders Are Pricing in a 100% Chance of at Least One Fed Rate Cut in July,” CNBC, Yun Li, June 19, 2019

*As of June 30, 2019
Tree Line Capital Partners Q&A: Key trends in direct lending

How has direct lending contributed to or in any way helped shape current trends in the US PE dealmaking environment? Vice versa?

We’d have to start by looking at the tremendous growth in the private credit asset class over the last 10 years. Assets have increased by nearly $500 billion since 2009. Direct lending has significantly driven that growth as institutional investors hunt for yield and as direct lenders address the ever-growing demand of PE. The surplus of liquidity reaching private credit balance sheets has enabled PE to expand further into all segments of the market. At Tree Line, we focus on senior-secured lending to the lower middle market where this is certainly true. Direct lending chases PE, and the availability of debt fuels PE; therein lies the cycle.

Looking at broader dealmaking trends, there has been much talk of larger PE funds and brand-new fund managers pushing into the lower middle market. Putting aside data for the time being, what has your anecdotal experience told you regarding that trend?

We have seen a significant increase in PE firms entering the lower middle market. The new entrants typically spin out from larger, well-known firms and target a check size that maps well to the lower middle market. The sophistication, experience and pedigree of the PE firms in the lower middle market has never been stronger. Larger PE funds will also periodically enter the lower middle market when seeking a buy-and-build strategy. A platform company will be targeted, and the fund may concurrently have a pipeline of tuck-in acquisitions fueling future growth. For instance, a platform company with $10 million of EBITDA or less may look attractive at an 8x purchase multiple compared to what can be found in an auction-led process in the broader middle market. While the platform company alone may not meet the typical size criteria of a larger fund, completing tuck-in acquisitions at attractive valuations can achieve additional value. This acquisition-focused strategy can deliver a $15 million-$25 million EBITDA company that can be sold through the once-avoided auction-led process whereby meaningful multiple expansion can be realized. Tree Line has played an essential role in financing follow-on acquisitions for PE firms. It’s been an important part of our business.

Given the significant expansion of private credit over the past decade, what are the key hurdles to newer entrants, as well as potential differentiating opportunities?

The growth that has occurred has likely made it more difficult than ever to launch a private credit firm. Critical to getting launched are an established track record, ideally dating back to at least 2007; a sourcing strategy demonstrating how market share will be achieved; and an ability to convey what gap your firm will fill in today’s crowded market. Funds will likely differentiate through sector-specific or counter-cyclical strategies at this point in the cycle. With that said, there is still incredible demand for private credit. We expect this to continue for the foreseeable future as pensions face $1.6 trillion of unfunded liabilities in the US, with 10,000 baby boomers retiring each day for the next decade. However, we have seen investors re-up and expand with their existing private credit relationships, demonstrating a continued reluctance to invest with first-time funds.
As talk grows of wariness within the private debt space, what are the key priorities you are emphasizing?

In a word, discipline. We have remained highly disciplined over the past five years in our portfolio construction where we’ve achieved a high level of consistency in terms of seniority, leverage, debt service coverage and covenants. Our working assumption is that a recession is a quarter away and, since day one, we’ve constructed our portfolio with that in mind. This has served us well as we have deployed $1.1 billion across 80 transactions and have yet to lose a dollar. Our job is to remove volatility from an investor’s portfolio and deliver consistent returns in all phases of a cycle. Our portfolio construction values senior-secured loans with low leverage, high free cash, contractual amortization, full covenants and a direct relationship. Our weighted average leverage and fixed charge coverage today stand at 3.8x and 2.0x, respectively. We are well positioned to withstand potential meaningful shocks in the economy, and we want to align ourselves with best-in-class PE firms that put money to work versus take money off the table.

Within the lower middle market, what are the key considerations on an industry basis from your perspective, based on what PE sponsors are exploring?

As a direct lender, we strive to deliver our investors a diversified portfolio by geography, borrower and sector. We pay close attention to secular trends as well as the attributes of a borrower within various sectors. At its core, we look for companies with recurring revenue or selling on contract with high free cash flow and low capex/working capital needs. We focus on five sectors: business services, manufacturing, tech-enabled services, healthcare and financial services. We’ve seen a significant increase in PE activity within tech-enabled services, including software companies. We are highly interested in these companies as they deliver the attributes important to us. Manufacturing businesses may have an element of capex or working capital, so in those instances, it’s important to see contractual sole supplier and/or long-term customer relationships. Given the free cash may be lower than tech-enabled services, businesses we’d like take a more conservative view on leverage and expect to see high amortization. We are also cautious on the consumer sector right now, as retail has posed significant challenges with the rise of Amazon and the “retail apocalypse.” While we can easily avoid brick & mortar retail, we have to pay close attention to consumer products and the end-market exposure they have to retailers that may be under pressure. It takes the right product matched with a healthy and diversified distribution strategy for a consumer products company to be a fit. Lastly, we are active in the healthcare industry, but the business typically has a services bend to them. We avoid companies reliant on Medicaid or Medicare reimbursement rate risk as that has caused problems in the past. Overall, we’ll look across a wide variety of industries, but we remain focused on cycle-durable companies with contractual or recurring revenue and high free cash flow. We want our portfolio companies to withstand an economic shock when it occurs.

About Tree Line Capital Partners

Tree Line Capital Partners directly originates, underwrites and manages diversified portfolios of senior secured debt facilities. Our principals have been focused on direct lending for over 17 years with a tremendous breadth of experience through multiple investment cycles. We focus on the underserved lower middle market and through deep, long term relationships, we generate consistent repeat and referral investment opportunities. Through our comprehensive sourcing and investment process, we seek to partner with companies who have demonstrated proven performance and are led by best in class management teams.

Tree Line has a demonstrated ability to generate strong risk adjusted returns while protecting investor capital through senior secured investment structures. Our credit expertise and robust origination capabilities provide investors with unique access to alpha within the lower middle market.
Deals by size and sector

PE deals (#) by size

PE deals ($) by size

PE deals (#) by sector

PE deals ($) by sector

Source: PitchBook | Geography: US
*As of June 30, 2019
Spotlight: GP stakes

GP stakes fundraising ($B) including open funds

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This section appeared originally in an analyst note, written by Senior PE Analyst, Wylie Fernyhough, on June 12, 2019.

Introduction

GP stakes investing and fundraising continue to proliferate as the strategy develops a track record of high cash-on-cash yields, helping to tap into the swelling demand from LPs for PE investments beyond the vanilla buyout fund. A flood of capital is entering the space. Notably, all three of the largest players are raising follow-on funds. Blackstone’s Strategic Capital Holdings, Dyal and Goldman Sachs’ Alternative Investments and Manager Selection (AIMS) Group alone are seeking to raise a combined $17.0 billion, more than has been raised in the past decade. As an unprecedented tidal wave of cash pours into the strategy, these investors are looking for a place to deploy capital, targeting smaller GPs and expanding to other private market strategies.

Strategy evolution

The GP stakes strategy originally developed around open-ended strategies (i.e. hedge funds) but has evolved to be primarily focused on PE and other closed-end strategies. As investment in the top tier of North American PE managers has become saturated, Europe appears to offer fertile ground. In addition to expanding to Europe, GP stakes investors have sought smaller and younger firms that are more likely to be seeking growth capital than providing founder liquidity.

In addition to seeking out smaller GPs that may need development capital, GP stakes investors are expanding beyond traditional buyout managers and are increasingly targeting other closed-end private market managers, including debt, secondaries and VC. The risk/return profile and fee structures for these fund strategies may differ slightly, though the GPs often have similar economics, growth rates, and requirements for capital as their PE peers. There have been half a dozen investments in debt managers but few deals involving secondaries GPs. While the balance of carry and management fees for secondaries GPs closely resembles those of PE GPs, the stability of the yield component for debt and real estate means the carry tends to be less volatile, and funds often earn more from management fees. Going forward, we believe these closed-end fund structures bode well for future GP stakes investments. As these private capital managers pursue outsized step-ups and expand strategy offerings, the capital needs are outstripping the ability of partners to fund GP commitments and keep ample cash on the balance sheet.

Whereas debt and real estate funds earn proportionally more of their revenue through management fees, carry tends to be disproportionately important to the VC strategy due to its reliance on outlier investments. VC funds also tend to be smaller than other private market strategy funds, which means less in management fees and has traditionally resulted in muted appetite from GP stakes investors. Late-stage firms, though, tend to gather a larger and steadier sum of AUM on
which they can charge management fees. To that end, AIMS recently inked a VC investment in General Catalyst. With a greater emphasis placed on carry, these firms may require an adjustment to the valuation calculation, but we believe there will be more VC deals going forward, particularly as late-stage venture and growth equity strategies continue to proliferate.

This strategy evolution has led some LPs to fear that premier opportunities have dried up and that a supply and demand imbalance may cause GP stakes investors to pay up for deals or resort to lower-quality firms, having a negative impact on performance. However, these investments in more nascent GPs are likely closer to the beginning of a firm’s growth curve, increasing the risk profile, but potentially offering a greater return. Moving forward, both Goldman and Blackstone are pursuing middle-market GPs, though only Goldman appears to be expanding to VC. Dyal has no plans to change tactics, however. Dyal’s managing director Michael Rees reportedly told investors he has only 10 to 15 more firms he wants to add to his stable. In a PitchBook webinar, Rees said the firm intends to slow the pace of new partnerships and begin focusing on deploying capital in new ways with existing partners.

To visualize the GP stakes strategy evolution, we looked at the target GP’s fundraising total before each investment. We see VC, debt, and secondaries as wide-open opportunities, but they will likely follow the same trajectory as PE as top targets are picked off over time.

**What makes you different?**

GP stakes investors want to invest in firms that will steadily grow AUM and the associated fee revenue. Performance is one of the key indicators of firms likely to grow assets consistently. Our research shows that private market performance tends to be sticky, meaning the top performers tend to stay on top over longer periods of time. LPs often choose to allocate more to top performers, top performers are also allowed to falter every so often and are given the benefit of the doubt when they have a poorly performing fund, raising the chance of LPs recommitting to subsequent funds. This has the benefit of stabilizing a firm’s asset base and lowering investment risk. Additionally, elevated performance levels afford managers the freedom to pursue more offerings in terms of strategy and geography. These established managers can act as a platform used to attract and retain talent, keeping strategy expansion in-house while pitching to an established LP base. Of the firms that have received a GP stakes investment, over 60% of their previous funds were in the top two quartiles, on average.

While performance is paramount in understanding which firms are in the best position to target healthy step-ups and expand offerings, not all firms with top-quartile performance are seeking to expand. Although IRRs and TVPIs are important, GP stakes investors want to see AUM growth and, concurrently, fee growth. In conjunction with performance, we looked at step-ups for managers most recent funds prior to receiving GP stakes investments. We noticed these firms tend to achieve larger step-ups than their peers, likely one of the triggering events for investors trying to find targets. Firms that have received a GP stakes investment in the past three years have seen step-ups of nearly twice the industry average. Though we were only comparing PE funds for this analysis, the same is likely to hold true for other strategies because large step-ups can create a cash crunch for the firms’ partners.

*As of May 24, 2019*

5: “Buying Stakes in Private-Equity Firms, Not Just Their Funds, Pays Big,” The Wall Street Journal, Miriam Gottfried, November 18, 2018
In the second quarter of 2019, exit value and count came in above 1Q’s figures at $62.0 billion across 168 exits, but both figures are below historical rolling averages. Deals over $2.5 billion comprised 58.4% of 2Q exit value, the second-highest proportional figure recorded for this size bucket, while deals from the second-largest bucket ($1 billion-$2.5 billion) accounted for 21.6%. This stands in contrast to 1Q figures, as the largest bucket held only 11.7% of exit value and the second-largest bucket held 40.9%. The trend of bigger exits is largely due to prominent IPOs, as the value of IPOs in 2Q ($21.8 billion) is the highest in five years (since 2Q 2014). Furthermore, the percentage of IPO value as a proportion of total exit value (35.1%) is the highest in six years (since 2Q 2013). One notable IPO in 2Q was the public offering of Grocery Outlet (NAS: GO), a discount grocery retailer based in Emeryville, CA. The company’s stock has been doing well since initially going public despite a volatile IPO market, which offers a bright spot amid PE’s well-publicized struggles in the retail space.
Outsized exits also led to outperformance on a sector level as two other massive liquidity events in the quarter buoyed materials & resources. The $3.1 billion sale of Momentive Performance Materials to South Korean manufacturing company Wonik QnC and the $3.8 billion IPO of Avantor Performance Materials (NYS: AVTR) led to materials & resources posting its highest percentage of quarterly exit value on record (12.8%). Through 1H, IT accounted for 18.6% of exit count, the highest proportion on record. This highlights PE’s recent shift toward increased interest and activity within the IT sector, which we anticipate will continue going forward.

Another trend within IT—and especially software—is the growing prominence of SBOs, which are steadily accounting for a higher share of exit count. SBOs captured 54.8% of overall exit count in 2Q, which is the second-highest proportional figure ever recorded. Previously, many investors perceived SBOs as an inferior exit path compared to both corporate acquisitions and IPOs under the belief that selling to cost-conscious financial sponsors would result in a lower valuation. However, the strategy has recently gained favor as GPs are better able to keep up with corporates in terms of competitive bidding and subsequent purchase prices, in part due to a sustained cheap debt environment and a surplus of dry powder. One notable software SBO was that of GlobalTranz. The Jordan Company sold the Phoenix-based freight management and software logistics company to Providence Equity Partners for $930 million one year after acquiring it for $400 million. This also spotlights the emerging trend of VC-to-PE buyouts, in which PE firms buy out VC-backed companies. GlobalTranz was formerly VC-backed, as were 26.7% of all PE-backed IT buyouts in the quarter. Given rampant PE activity in the IT and software space, we expect both SBOs and VC-to-PE buyouts will remain attractive strategies within this sector.
2Q 2019 fundraising activity remained elevated with $48.8 billion raised across 39 funds. Although fundraising value declined in 2Q compared to 1Q, the number of funds closed was higher. The figures for value and count, however, are still in line with both four- and eight-quarter rolling averages. Mega-funds ($5+ billion) were the driving force propelling PE fundraising in the quarter, raising $26.0 billion across just five vehicles, which represents 53.3% of total capital raised but only 5.1% of fund count.

At this rate, we anticipate 2019 fundraising to surpass 2018 full-year figures, especially given multiple mega-funds expected to close in the year from GPs such as Blackstone and Warburg Pincus. The mega-fund Blackstone is currently raising, for example, has a target of $25 billion and raised over $22 billion in three months. To put this in perspective, that fund’s activity alone is equivalent to almost half the total amount of capital raised in 2Q. LPs are rushing to invest in these outsized vehicles, seeking to deploy capital in large amounts. This is a simpler task, administratively speaking, when dealing with larger GP funds, and GPs are happy to accept these commitments, even if they already have open funds with surpluses of dry powder.
The largest fund raised in the quarter was Advent Global Private Equity IX, totaling $17.5 billion—a significant step-up from Advent’s previous fund worth $13.0 billion. The firm’s latest fund has also seen step-ups in LP commitments from its 2016 counterpart, despite the 2016 vintage still holding $4.0 billion in dry powder. Notably, the Minnesota State Board of Investment and the Washington State Investment Board increased their allocations by 50% and 25%, respectively. In fact, more than 90% of the fund’s commitments are coming from LPs in prior Advent vehicles.

Another indication that we’re in a GP-friendly fundraising environment is that managers are able to raise funds and then shelve them for a few months before they begin investing. TA Associates is one such firm taking this approach with its latest growth equity fund TA XIII. This was the second-largest fund raised in the quarter at $8.5 billion, a significant step-up from the firm’s previous fund worth $5.3 billion.

Of the seven first-time funds raised thus far in 2019, four are growth equity funds. Diversis Capital I, one of these four, highlights a prominent trend appearing in US private equity: the proliferation of software investment funds. The growth equity fund based in Santa Monica, CA is pursuing software investments, as are many comparable growth equity funds across the West Coast. This follows, given the funds’ proximity to the Bay Area and Silicon Valley, a hub for potential targets. Most of the first-time funds raised in 2Q, including all the first-time growth equity funds, are chasing software and tech investments. Though growth equity tends to disproportionately focus on software, we are also seeing a proliferation of VC-backed software LBOs. Looking forward, we expect continued and intensified PE interest in the sector.