MARKET INSIGHTS

TREE LINE CAPITAL PARTNERS

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ANSWERING LIMITED PARTNER MARKET CONCERNS IN DIRECT LENDING

On October 4th, 2019, Private Debt Investor released a letter where they summarized LP concerns regarding the direct lending market that were voiced at the Private Debt Investor New York Forum. With many of the issues raised being topical as they primarily relate to the state of the middle-market, the Tree Line team took the opportunity as part of our Market Insights series to share our thoughts and performance on the topics raised.

IN THIS ISSUE

ISSUE: COVENANTS

LP Concern: Many direct lenders say they have at least one covenant in their deals. How material are those covenants in the protection they offer? Do they really make any difference?

This may be the most brazen development in the market as middle-market and large cap lenders are creating a narrative that covenants simply don't matter. "They're overrated. Don't worry about cov-lite…everyone's doing it."

Now, it's human behavior to explain away what you can't have but this is truly astounding. At a recent conference there was a panel discussion billed as, *'The Great Debate: Do Covenants Matter?'*.

As a senior secured lender for 20 years, this alarms us at Tree Line. We would liken this to a national debate as to whether we should rethink the fire code and make smoke detectors optional.

In 2018, 80% of the loan issuances in the leveraged loan market were cov-lite. Cov-lite is typically defined as having a debt incurrence test, which limits maximum debt allowed at the company, without the presence of any other financial covenants such as leverage, EBITDA, fixed charge coverage or CAPEX. So, the large liquid lenders, or any one participating in the broadly syndicated loan market, certainly cannot say they have at least one covenant. Many middle-market lenders can likely claim they have one covenant but one must look closer and understand the % of cushion to plan and how EBITDA is defined or adjusted to determine the value of that covenant. We routinely see examples of middle market EBITDA definitions that render covenants useless due to exceedingly wide baskets for unrealistic synergies, "one time" expenses which in actuality appear annually and covenant cushions over 35% which allow for a significant deterioration in earnings prior to lenders having rights.

TREE LINE PERFORMANCE:

At Tree Line, we require two to four covenants in 100% of the loans in our portfolio and strive to maintain reasonable definitions that are not inflated by addbacks. We have never done a cov-lite deal and have never done a one covenant deal. Our covenants are typically set with 20-30% cushion to plan which is market convention. While we have had a healthy portfolio with very strong performance since inception with 0.0% in realized losses to date, we have had financial maintenance covenants tripped in select situations. This enabled us to take action which is the purpose a covenant serves. We've summarized a few examples below in how we have utilized a financial covenant to deliver value to our investors.

- **Covenant Example A:** Leverage covenant was tripped at 4.75x following approximately 12 months of soft revenue performance. Upon the covenant default, we utilized it to decrease our risk and exposure given the topline trends. We negotiated an agreement where the sponsor invested an additional $5M of new cash equity to reduce our term loan, instituted a semi-annual excess cash flow sweep and charged a 50 bps amendment fee. Taking this action delivered additional return and less risk to our investors.

- **Covenant Example B:** Leverage and fixed charge covenants were tripped following a significant increase in SG&A expenses to drive future growth. The company's revenue performance was strong while significant investment in growth was causing EBITDA to underperform resulting in higher leverage and lower fixed charge coverage. While we were comfortable with the value being created due to consistent revenue growth, we negotiated a 100 bps increase to the interest rate, and a 50 bps one time amendment fee to compensate Tree Line for higher leverage. Taking this action is delivered additional yield and fees to our investors.

- **Covenant Example C:** A myriad of issues, including a soft selling season due to weather and a dispute with a supplier, resulted in the company tripping its leverage and fixed charge coverage covenants. Our analysis pointed to a series of challenging trends in the future given the company would have to carry a much higher level of inventory for a long period of time with associated working capital constraints. We utilized the defaults to require the installation of a chief restructuring officer and an investment bank to explore strategic sale options. This was critical to our success as we were able to act early and use our rights as senior lender to drive the process which is the goal of any senior secured lender. This was our most challenging deal to date at Tree Line but we were able to successfully exit the company through a 363 sale of its assets in a bankruptcy process. This resulted in Tree Line recovering 111% of its principal to date with a gross unlevered IRR of approximately 6%.

In summary, covenants absolutely matter as they allow a lender to take action in advance of a payment default or liquidity challenge. A lender may deal with a covenant default in a variety of ways depending upon the severity of the issue but it is a pillar of senior secured lending. We have been able to either pass through additional return to our investors or reduce our risk through the existence of our covenants. We take great comfort that our lower middle-market strategy avoids the frothy, commoditized trends of the middle-market and results in our documentation including two to four financial covenants in 100% of our deals.

ISSUE: UNDERSTANDING SENIOR SECURED

LP Concern: Lenders state, "all we do is senior secured". There is no guaranty that you will write good loans, especially with the confusion over the definition of senior secured these days. Will the increase use of unitranche lower recoveries from what people are expecting?

TREE LINE INSIGHTS:

First, there shouldn't be any confusion around the definition of senior secured. The legal definition and application have not changed in the 20 years we've been direct lending. Senior secured lending means you have a secured lien and perfected interest in the assets of a company. This is typically evidenced by a Uniform Commercial Code ("UCC") filing which would eliminate any debate in the eyes of a court over who holds the lien. There can be a first, second, third lien filed but if one is claiming to be senior secured they should hold the first lien on the assets. Additionally, it is typical for a senior secured lender to receive a pledge of stock from the equity investors. What has changed and continues to evolve is how capital structures are put together and where lenders sit within that capital structure.

There are a few specifics to understand in terms of how deals get structured which we'll break down below. This is a high-level overview to simply illustrate the options available to senior secured lenders.

- **First Lien Term Loan (One-Stop)**
  The First Lien Term Loan is most easily understood of the senior secured options where there is one tranche of debt with a secured and perfected lien on all assets of the company. If there are multiple lenders in the loan, they would all share in the same rights on a pari passu basis and function as one class in a bankruptcy proceeding or liquidation.

- **Unitranche Term Loan - First Out/Last Out**
  The Unitranche Term Loan has seen the largest growth rate over the past ten years and has meaningfully impacted the usage of second lien or mezzanine in loan structures. The Unitranche Term Loan isn't a new product as GE Capital and Allied Capital pioneered it through a joint venture in the mid-2000s until Ares acquired Allied which further propelled the usage of the product. Today, there are a number of partnerships with lenders aiming to deliver the product where they can bifurcate a loan and each receive the yield they are targeting.

  The Unitranche Term Loan, at its core, is no different than the First Lien Term Loan. Two lenders agree to provide a First Lien Term Loan to a company but create a First-Out and Last-Out tranche within the loan. A borrower receives one credit agreement and, as far as it's concerned, has one lender group providing a single loan with one set of economic terms, covenants, etc. However, behind the scenes, the lenders enter into an Agreement Among Lenders which sets up a simple waterfall where the Last-Out lender agrees that the First-Out lender gets paid in full first in the event of a liquidation or sale failing to deliver ample proceeds to repay the full loan. In the eyes of a bankruptcy court, both lenders are treated as first-lien lenders which is critically important and valuable to the Last-Out lender. The First-Out and Last-Out lenders share in the same secured and perfected liens on the company's assets but have simply pre-agreed to a waterfall in terms of how proceeds will be paid to each of them. Importantly, Last-Out lenders do not face the same challenges that traditional mezzanine or second lien lenders face in that Last-Out lenders are still defined as first lien lenders without payment subordination or different covenants. These benefits that exist in a Unitranche First Lien Term Loan may read like semantics but become incredibly important and valuable when it matters most.

The key risk within unitranche lending is how large of a First-Out tranche is in place. If you're providing a 4x leverage loan and the First-Out lender is providing 1.5x of leverage and the Last-Out lender is providing 2.5x of leverage, one could deem that to be a fairly conservative structure given, in a downside scenario, it would be feasible for a Last-Out lender to utilize its buyout right of the First-Out lender since the First-Out is of manageable size. However, if you're providing a 5.5x leverage loan and the First-Out is providing 4.0x of leverage and the Last - Out is providing 1.5x leverage, then one might say, even with the benefits of the first lien, that you're deep in the waterfall in the event of a significant credit event. But, this is still a meaningful improvement to a second lien where the first lien lender has the ability to exercise standstill periods and shut off interest payments. Within a Unitranche Term Loan, the First-Out and the Last-Out are both senior secured sharing in the same collateral protection.

- **First Lien Split Collateral**
  A First Lien Split Collateral Loan is typically utilized when a First Lien Term Loan exists but carves out current assets for a Revolving Line of Credit. This is done to enable a company to receive working capital support where the revolving lender is traditionally advancing against accounts receivable and inventory. The First Lien Term Loan lender holds a secured and perfected interest in all assets other than current assets, the revolving lender holds a secured and perfected interest in the current assets, and the lenders swap second liens on their respective collateral. An Intercreditor Agreement is necessary to establish the relationship between the two lenders and their respective collateral. What's important here is that the First Lien Term Loan lender is not subordinating to the Revolving lender and would still be looked at as a first lien creditor in the eyes of a bankruptcy court. Each lender has a first lien on its pool of collateral, covenants and each can take action upon defaults occurring.

- **Second Lien Term Loan or Mezzanine**
  The Second Lien Term Loan or Mezzanine Term Loan requires an intercreditor with the First Lien Term Loan lender where the Second Lien or Mezzanine lender will subordinate. An Intercreditor Agreement will typically grant the First Lien lender standstill rights and payment subordination. Upon a default, the First Lien lender will have the right to turn off interest payments to the Second Lien lender and put them in a standstill period where they are precluded from taking any action. This is meaningfully more detrimental than being in a Unitranche Term Loan Last-Out tranche where the Last-Out still holds a first lien and would be seen by a bankruptcy court as a first lien creditor.

  In summary, the definition of senior secured has not changed. The key factor here is understanding where lenders sit in the waterfall within a first-out, last-out dynamic. Yes, there is risk to being deep in that waterfall but one can easily argue it's preferable to sitting in a second lien which is what was occurring prior to the unitranche product taking hold.

TREE LINE PERFORMANCE:

At Tree Line, we have consistently executed a senior secured lending strategy since our inception in 2014. Our current portfolio is 98% senior secured with 2% in equity co-investments. The table below illustrates Tree Line's portfolio allocation across our senior secured products. We have categorically avoided second lien and mezzanine as the structural and contractual protections are inferior. Tree Line puts great value on controlling our destiny which is why we push our capital to the top of the capital structure. We have utilized the unitranche product selectively but have done so with modest first-out tranches where the weighted average first-out detachment point today is 1.2x. We utilize revolving lenders in split collateral loans as we do not want the administrative burden of supporting daily or weekly borrowing requests, but do not enter into term loans behind large ABL providers in which a term loan is the minority of the debt structure.

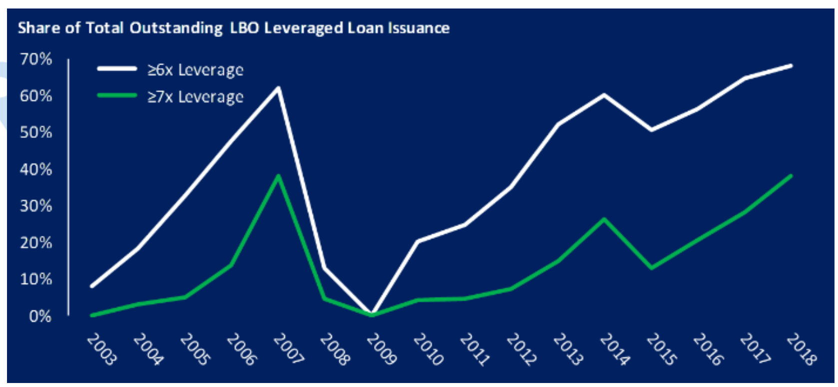
	Current Portfolio	2019 YTD
First Lien Term Loan (One-Stop)	64.7%	86.7%
First Lien Split Collateral	17.2%	3.9%
Unitranche Term Loan	16.0%	8.0%
Equity Co-Invest	2.1%	2.4%
Total	**100%**	**100%**

ISSUE: LEVERAGE > 5X

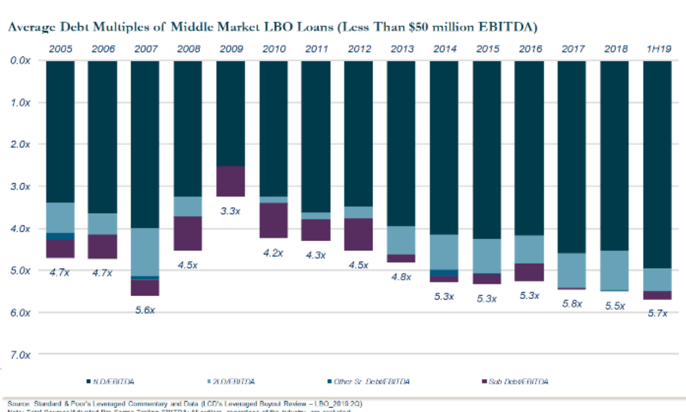
LP Concern: Lenders claim, "we never do deals at a multiple greater than 5x" with LPs replying, "yes, but everyone says that".

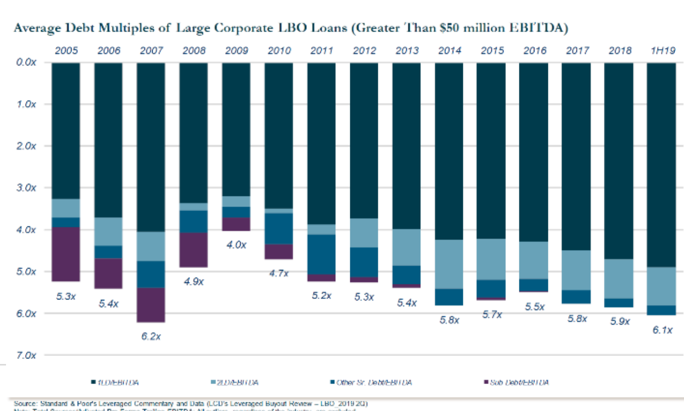
TREE LINE INSIGHTS:

"Never" might be a bit of a stretch based on the data we look at and we would be shocked if many can say that. They just can't. There very well may be a few lenders able to make this claim but simple due diligence can disprove this pretty quickly. In 2018, 73% of all new syndicated loan issuances were above 6x and 41% were above 7x. Any lender participating, even in part, in the broadly syndicated loan market is very likely to be investing in cov-lite deals at 6x, 7x and potentially greater.



If we want to take a closer look at the middle-market, Lincoln International produces a quarterly market report. In the report they summarize leverage multiples for activity above $50M of EBITDA and below $50M of EBITDA. The data is clear with the most recent period showing the average leverage for below $50M of EBITDA at 5.7x and above $50M of EBITDA at 6.1x. However, a really important element is the quality of the EBITDA. We've observed most middle-market lenders providing a standard 25% synergy addback to EBITDA. This would result in lenders understating leverage and overstating EBITDA.





TREE LINE PERFORMANCE:

At Tree Line, we currently maintain a weighted average leverage of 3.5x. A benefit of our niche strategy, managing a limited amount of capital (currently $1.3B), is we can control our deployment and remain highly selective. We simply don't have to take what the market offers but rather can execute our portfolio construction where we can hand pick our deals. Through Q3 2019, Tree Line's leverage for closed deals has ranged from 2.7x to 4.3x. We have consistently maintained a weighted average leverage of less than 3.8x since inception (October 2014). As the direct lending market has grown significantly and commoditized in the middle market, Tree Line has benefited greatly from its lower middle-market focus.

Tree Line Portfolio	2015	2016	2017	2018	2019
Wtd. Avg. Leverage	3.7x	3.4x	3.7x	3.7x	3.5x

In addition to our leverage levels being 2.0x below middle-market averages, we have a very high quality of EBITDA. We do not provide "synergy" related addbacks where you increase EBITDA today on the basis that some future cost savings or benefit will be achieved. Our addbacks are supported by a quality of earnings report where we need to confirm the benefit of the addback hitting the P&L day one. These addbacks are typically related to identifiable one-time items, such as owner compensation which would not continue upon a purchase by a new owner, transaction fees related to an acquisition or financing, or true one-time costs such as severance.

In summary, we challenge the idea that "everyone" is claiming they don't lend above 5x leverage but would love to put the market to a challenge to see if they can match our weighted average of 3.5x.

ISSUE: FEE ARRANGEMENTS

LP Concern: Lenders skimming origination fees when they can't hold the entire position that they originate.

TREE LINE INSIGHTS:

There could be a longer academic discussion here regarding whether the lender should be able to compensate its team for capital markets activity. However, the point LPs are making is very fair.

TREE LINE PERFORMANCE:

This is pretty easy for Tree Line. Tree Line has delivered 100% of all fees to investors. We pass through 100% of closing fees, origination or syndication fees (including anything we skim if we sell down a deal we are leading), portfolio management fees and prepayment fees. We want to ensure we are highly aligned with our investors and feel we have accomplished that.

OTHER ISSUES

LP Concern: Lenders claiming they perform "private equity style" diligence.

TREE LINE PERFORMANCE:

At Tree Line, we are the Agent or Lead Lender in 94% of our deals since inception and 98% in our current portfolio. We do not participate in broadly syndicated loans and rarely participate in club deals that we aren't leading. It's critically important to us to have a first-hand relationship with the company's management team and to be able to do our own work. This is why we have very little deal flow (only one deal in 2019) where we buy into deals led by other lenders. We want to do our own work and be in a position to have great influence over a workout should that occur. A workout's complexity can increase in line with the number of participants so we like the benefit of being the sole lender in the vast majority of our deals.

LP Concern: Track records being shorter for many lenders.

TREE LINE PERFORMANCE:

Our partners been working together since 2000 and have been focused exclusively on direct lending since 2002. We have built an exceptionally strong track record over that time where we've completed nearly 200 transactions. Most importantly, we have been direct lending before, during and after the Great Financial Crisis. Those lessons learned are at the core of Tree Line's underwriting ecosystem which has contributed to our strong performance. This has enabled us to avoid troubled sectors such as Oil & Gas and Retail where others have taken losses in recent years.

Our senior secured, low leverage, high free cash focus will serve us well when the economy shifts. Our working assumption is that the economy is always one quarter away from a recession. That assumption keeps us focused on fundamentals which is what we believe a lender should do. While Tree Line just celebrated its fifth anniversary in 2019, we have a great wealth of knowledge across our team that dates back to the early 2000s that is present in our daily portfolio construction discussions.

LP Concern: Return compression between risky and less risky strategies. LPs do not feel they are being paid to take the risk.

TREE LINE PERFORMANCE:

We understand this concern as most LP capital has landed in the middle-market where yields have compressed and credit metrics have worsened. Leverage has climbed higher, covenants have become lite or loose and the quality of EBITDA needs to be questioned. At Tree Line, we benefit from two things. First, we benefit from focusing on the lower middle-market which has enjoyed significant private equity growth delivering an uncrowded and large opportunity set. Second, we have limited the amount of capital on our platform so

Tree Line Portfolio	2015	2016	2017	2018	2019
Senior Secured	100%	100%	98%	98%	98%
Wtd. Avg. Leverage	3.7x	3.4x	3.7x	3.7x	3.5x
Avg. EBITDA	$9.2M	$10.2M	$10.8M	$12.5M	$12.0M
Wt. Avg. Fixed Charge Coverage	1.7x	1.7x	1.8x	1.8x	2.0x
Wtd. Avg. LTV %	57%	44%	48%	43%	46%
Covenants (Min. 2)	100%	100%	100%	100%	100%
Cum. Realized Losses	0.0%	0.0%	0.0%	0.0%	0.0%

we have the ability to be patient. Our metrics have been highly consistent year in and year out. We believe that we are outperforming the broader market when evaluating unlevered yield, leverage, covenants and quality of EBITDA.

Contact

San Francisco
101 California Street
Suite 1700
San Francisco, CA 94111
415.795.7580

New York
600 Lexington Avenue
Suite 1401
New York, NY 10022
212.207.3385

New Orleans
201 St. Charles Street
Suite 3400
New Orleans, LA 70170
504.569.7900

INVESTOR INQUIRIES:

Tom Quimby
tquimby@treelinecp.com
415.795.7576

Jon Schroeder
jschroeder@treelinecp.com
415.795.7577

TREE LINE

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