EXPERT COMMENTARY

Intact credit fundamentals allow for outsized returns while ensuring principal preservation, says Tree Line Capital Partners' founder and managing partner Jon Schroeder

Lower mid-market myths and misconceptions

Many institutions have paused from making new allocations to mid-market credit managers, given the frothiness in the market – as exemplified by historically low yields, peak leverage levels and deteriorating creditor protections. These factors, combined with the risk of late-cycle exposure, have driven investors to evaluate other niche credit strategies in the never-ending hunt for yield.

One subset of the broader private credit landscape that has generated significant interest from institutional investors is lower mid-market direct lending. By shifting their focus towards the lower end of the market, investors are benefiting from enhanced yields and stronger creditor protections.

These attributes are particularly important at this point in the economic cycle. Lower mid-market direct lending managers will be in a position to quickly take action and protect investor capital rather than being sidelined by weak or non-existent financial covenants.

SPONSOR

TREE LINE CAPITAL PARTNERS

Tree Line Capital Partners is an established credit platform with approximately $1.3 billion in assets under management and which focuses exclusively on sourcing, underwriting and managing investments in the lower mid-market. We have a footprint across the US and broad origination capabilities focused on sourcing senior secured loans with borrowers that generate $3 million to $25 million in EBITDA annually. We apply a data-driven approach to our senior secured lending strategy with a heavy emphasis on credit fundamentals including leverage, margin, coverage, stability and growth. We also have a sector bias that favours non-cyclical, asset-light, service-oriented businesses that are capable of withstanding the next economic downturn.

Direct lending as a whole is a relatively mature asset class, given the tremendous growth in assets under management over the past decade. However, there are many misconceptions among institutional investors when it comes to evaluating lower mid-market strategies. We will address several of these misconceptions as well as provide supporting data from the more than $1.3 billion in loan commitments we have issued to help debunk these lower mid-market myths.

Misconception 1: Lower mid-market companies are sub-scale and lack infrastructure, depth and durability

As the data in the table would suggest, these are companies that not only have significant revenues and customer bases, but which have been in operation for nearly two decades on average and which successfully navigated the last generational recession. On average, Tree Line originates 150-200 investment opportunities, but only closes between three and five new investments each quarter, all of which is a function of our extremely selective underwriting processes.

The result of our selective approach is a highly diversified portfolio of senior secured loans to companies that are regional leaders within their markets and that provide products or services that are critical to their customers. These attributes are critical to us as lenders given our acute focus on principal protection, which dovetails well into the next lower mid-market misconception.

Lower mid-market misconception	Tree Line's portfolio
Companies are sub-scale	$67m Average revenue
Companies lack infrastructure and depth	210 Average number of employees
Companies are less proven	19 Average age of company

Misconception 2: Lower mid-market companies will have a tougher time servicing debt in the face of a downturn

Lenders spend a significant amount of time focusing on downside scenario analysis. A critical part of this analysis focuses on a borrower's ability to service debt, which is often represented as ratio of free cashflow to debt service, otherwise known as fixed-charge coverage. Running a sensitivity analysis across Tree Line's portfolio, if all borrowers lost on average 25 percent and 40 percent of EBITDA, the resultant fixed-charge coverages would be 1.4x and 1.1x respectively. This highlights the importance of portfolio construction centred around high free-cash-flow businesses.

> *"Leverage levels in the mid-market and broadly syndicated loan market are approaching all-time highs"*

Additionally, this analysis reinforces the importance of constructing a portfolio with reasonable leverage and strong debt-service coverage statistics. Investor concerns across the broader mid-market are certainly warranted: according to Refinitiv, 73 percent of leveraged buyout issuances in 2018 were greater than 6.0x and 41 percent were in excess of 7.0x. Having said that, leverage is only as meaningful as the quality of the EBITDA used in its calculation, which leads us to our third misconception.

Misconception 3: Deteriorating credit fundamentals prevalent in the mid-market have found their way into the lower mid-market

The headlines aren't new, but the troubling leverage levels in the mid-market and the broadly syndicated loan market are approaching all-time highs. Compounding this risk is the virtual elimination of maintenance covenants, combined with a significant and often uncapped level of EBITDA adjustments.

To put EBITDA adjustments in perspective, according to data from Xtract Research covering the 12 months up 30 June 2019, 53 percent of sponsor-backed transactions in the broadly syndicated markets allowed uncapped addbacks for cost savings and synergies. That was up from 30 percent in the second half of 2018.

As trends in the large corporate issuance market permeate the mid-market it might be a natural conclusion that those trends will inevitably reach the lower mid-market, but that simply is not the case. Tree Line has originated more than $1.3 billion in commitments across 86 transactions over the past six years of operations with a consistent and disciplined approach to underwriting and deal selection.

Uncompromising credit fundamentals are at the core of our strategy with 100 percent of the transactions we have closed maintaining at least two financial covenants alongside weighted average leverage levels of less than 4.0x across Tree Line's total portfolio.

It's about knowing where to look

In a depressed interest rate environment the hunt for yield continues, but not all direct lending alternatives are created equal. Many larger credit funds are combatting yield compression by either subordinating at the asset level into second-lien or mezzanine securities or by employing more aggressive fund level leverage.

As we approach the 10th year of an economic recovery, it's more important than ever to peel back the onion on risk-adjusted return. The lower mid-market offers a compelling niche where credit fundamentals remain intact and allow experienced managers to generate outsized returns without losing focus on principal preservation.

The commonly shared view that bigger is better and lower mid-market companies are inherently riskier simply isn't true if one takes the time to drill into the data. Investors that are willing to dig into the data, however, will be pleasantly surprised by the opportunities that exist within the niche strategy that is lower mid-market investing. ■