

# Global Private Debt Report

H1 2020

# Prognostication Overload



**Disciplined execution at the peak creates opportunity at the trough, regardless of its shape.**

*Tree Line's investment strategy is designed to withstand unforeseen events and capitalize on market dislocation. Our investors and borrowers benefit from a cycle-durable approach that delivers value when it matters most.*

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**LOWER MIDDLE-MARKET DIRECT LENDING**

**\$1.4B**  
AUM

**\$1.6B**  
Commitments  
Issued

**\$3-\$30M**  
Target EBITDA

SAN FRANCISCO - NEW YORK - LOS ANGELES - AUSTIN



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# Introduction

Private debt managers have quickly adapted to the COVID-19 pandemic, focusing on opportunistic strategies amidst widespread economic tumult. Direct lending, on the other hand, has seen a slowdown in fundraising due to its reliance on leveraged buyouts (LBOs)—which have also slowed—for deal flow. Overall, private debt fundraising is on pace for its slowest year in at least half a decade, but those figures are expected to accelerate in the back half of the year as many of the opportunistic vehicles in the market hold a final close.

Short-term performance figures for private debt funds are expected to be their worst since the global financial crisis (GFC). As an early indicator, most public PE firms marked down their credit portfolios between 11% and 16% in Q1 2020. The worst could be yet to come, as higher levels of default and bankruptcy are expected if the pandemic lingers and government aid packages expire.

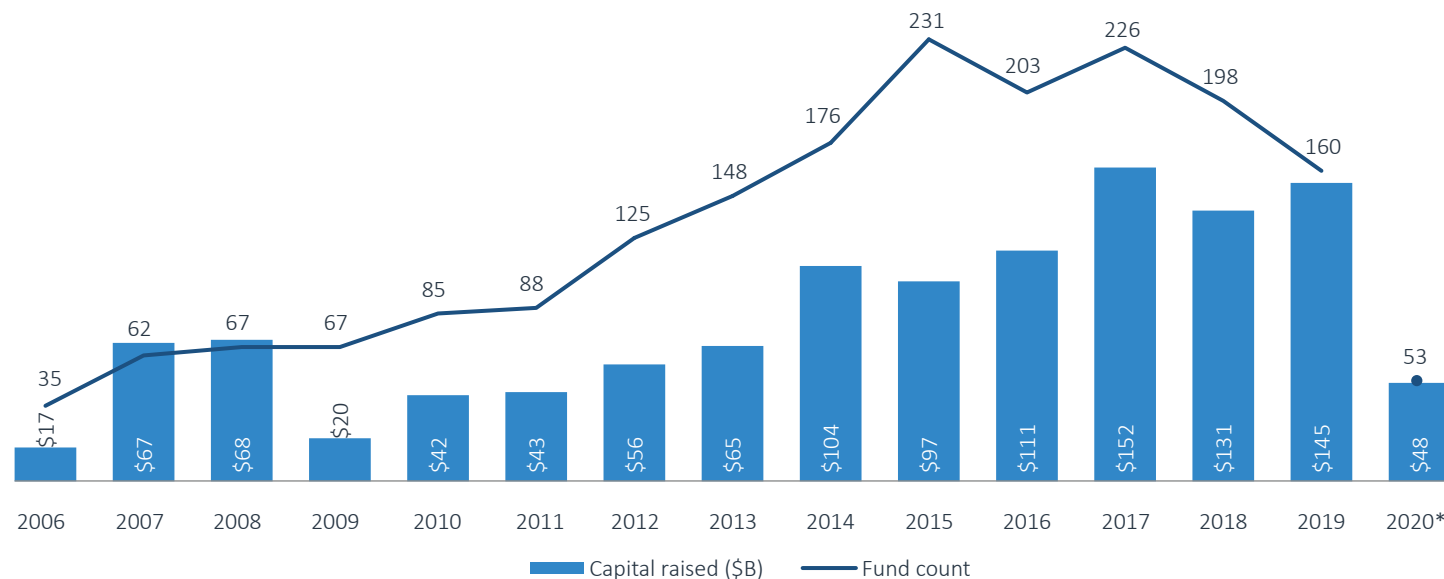


Dylan Cox  
 Lead Analyst, PE



# Overview

## Private debt fundraising



Source: PitchBook | Geography: Global  
\*As of June 30, 2020

The COVID-19 pandemic caused many portfolio companies to experience unforeseen demand shocks as new direct lending opportunities temporarily dried up and a wave of distressed and special situations funds came to market hoping to capitalize on market turmoil. In part because of these changing dynamics, private debt fundraising—in terms of both capital raised and number of funds—is on pace for the lowest levels of the last half decade, totaling \$47.8 billion across 53 vehicles in H1 2020.

Nearly every corner of the globe saw a pandemic-related economic slowdown in the first half of 2020. The US unemployment rate peaked at more than 14% in April, despite about \$2 trillion in stimulus measures passed by Congress. In response, the Federal Reserve pursued an unprecedented asset purchase program, extending its purview even into corporate credit and high-yield bond exchange-traded funds (ETFs). The rest of the world felt negative effects, too. The EU's economy is now predicted to shrink by 7.5% in 2020, and while China managed a 3% GDP growth rate in Q2, it was measly by recent standards. The economic slowdown has already put pressure on portfolio companies and underlying loans within private debt funds, but much of the economic duress is likely still to come. Anticipating the damage a lingering slowdown

## Select fund closings from H1 2020

Fund name	Fund type	Size (\$M)	Location
GSO European Senior Debt Fund II	Direct lending	\$5,028	London, United Kingdom
Ares Special Opportunities Fund	Credit special situations	\$3,500	Los Angeles, CA
Ardian Private Debt IV	Direct lending	\$3,341	London, United Kingdom
Bain Capital Distressed and Special Situations Fund 2019	Distressed debt	\$3,200	Boston, MA
Churchill Middle Market Senior Loan Fund II	Direct lending	\$2,000	New York, NY

Source: PitchBook | Geography: Global  
\*As of June 30, 2020

might do to their portfolios, major banks have substantially increased their loan loss provisions. As JP Morgan CEO Jamie Dimon recently put it, "This is not a normal recession. The recessionary part of this you're going to see down the road."<sup>1</sup>

1: "This Is Not a Normal Recession": Banks Ready for Wave of Coronavirus Defaults," Morningstar, Ben Eisen and David Benoit, July 14, 2020.

# Q&A: Direct lending in a dislocated environment

**In the midst of a pandemic and ensuing recession, what will differentiate one direct lender from the next in this environment?**

**TQ:** Ultimately, it will come down to the decisions that were made at the peak of the cycle. Those decisions shaped current portfolios, which will dictate what firms have to work with through this crisis. At Tree Line, we saw real risk hiding in plain view over the past few years. In June 2019, the cover of our Annual Report included a key theme, “Preparing for a Recession.” In January 2020, we published a short paper titled, “Lending in an Uncertain Environment,” which highlighted the need for discipline as we entered the tenth year of an economic expansion. Having been direct lenders before, during, and after the global financial crisis, themes of caution and discipline remain at the forefront of our investment strategy. We simply believe it is what should comprise a lender’s DNA. Over the past five years, the credit market followed a familiar pattern where fundamentals were sacrificed, which, while attracting record inflows of capital, created a recipe for defaults and losses. We’re starting to see that play out where the pack is beginning to separate.

**JS:** For us, our value proposition to both investors and sponsors is about reliability and consistency in all phases of a cycle. Our focus has been to deliver investors consistent yield with low volatility and sponsor a source of financing they can rely on when it matters most. Too often we have seen growth come at the cost of discipline. It’s easy to originate during an economic expansion with a lowest-common-denominator approach, but it’s a short-sighted strategy when facing an economic downturn. When the dust settles, the performance of the pre-COVID-19 vintage will be tied to the quality of the GP and the level of underwriting discipline exercised at the peak versus the size of platform or company.

**You talk a lot about discipline and fundamentals as a key component to your strategy. How does discipline show up in portfolio construction, and what sectors are standing out as clear winners and losers?**

**JS:** It’s about both the fundamentals that we prioritize in building a senior secured-loan portfolio, which can



Tom Quimby



Jon Schroeder

Co-Founders & Managing Partners  
Tree Line Capital Partners

*Tom Quimby and Jon Schroeder are Co-Founding & Managing Partners at Tree Line Capital Partners, a private credit firm with \$1.4 billion AUM across six direct lending funds focused on senior secured lending to the lower middle market. Tom and Jon have worked together since 2000 when they were employees at GE Capital and have extensive direct lending experience spanning multiple economic cycles. Tree Line has strived to deliver investors yield in disciplined structures through a direct relationship approach targeting the growing lower middle market private equity community. Tree Line is headquartered in San Francisco with offices in New York, Los Angeles, and Austin.*

be seen in terms of metrics, as well as the discipline it takes to limit deployment amidst a frothy market, which becomes apparent once the market turns. It’s easy to go fast when times look good, but as lenders we’re making five-year decisions, so it’s imperative to maintain a long-term view. We are hold-to-maturity lenders, so trading out of a position is not a part of our playbook. Our downside case needs to deliver significant cushion to withstand economic volatility; otherwise, we’re doing our investors a disservice.

**TQ:** Our portfolio construction strategy, which emphasizes directly originated, senior-secured, low-leverage, high-free-cash, full-covenant, sponsor-backed loans, put us in as strong of a position as possible entering the crisis. Our portfolio carried a weighted average leverage of 3.6x, a fixed charge coverage of 2.1x, and a loan-to-value of 44%, while maintaining 100% covenants. We focused heavily on services businesses that maintained high levels of recurring revenue supported by contracts or subscription

## Q&A: Direct lending in a dislocated environment

agreements. For the COVID-19 period from March through the date of this article, 99% of our portfolio is making cash interest payments, and we have had zero payment defaults and have funded zero rescue dollars. Our approach is proving to be an enduring and winning formula through the initial challenges of COVID-19.

**JS:** We believe those results are a testament to our data-driven approach, and when we see these shifts in the market it provides invaluable information on performance trends. Following the onset of COVID-19, we studied 1,200 deals across 43 business development companies (BDCs) to build a “bad deal” database. We were hunting for every deal marked below 80% of cost to look for patterns of default. When we ran the numbers by sector, it was no surprise that oil & gas (37%), minerals & mining (33%) and consumer/retail (26%) led the way in highest percentage of deals being marked below 80%. Business service and tech-enabled services, two sectors Tree Line targets, fared among the best, which generally correlates with high free cash and low CAPEX.

### **Distressed platforms appear to be busy at work raising funds and readying for deployment. How do you anticipate this impacting direct lending?**

**TQ:** We don’t believe distressed investors are going to gain any meaningful access to the direct lending channel. The narrative has been that when the market turns, distressed investors will be able to pounce on direct lenders following record levels of deployment in high-leverage, covenant-lite deals. It’s not an unreasonable hypothesis, but direct lenders are predominantly private, unregulated, non-bank entities who generally hold loans through volatile periods of time and work out their own paper. Yes, there will be a few exceptions where single assets or portfolios get sold, but it won’t be the rule. Direct lenders will be more inclined to restructure, subordinate, take control of, or force a sale of a company before trading a loan at a discount. The bid-ask gap is typically too wide for this to gain traction. This is not a commentary on the level of distress that may exist in portfolios but more a view on distressed players being on the outside looking in when it comes to direct lending.

**JS:** The flip side is that we believe direct lenders will benefit from the further market dislocation. For those that are healthy and liquid, there will be a great opportunity to take share from “zombie”

lenders recovering from mistakes made at the peak. Specifically, many BDCs are being sidelined as a result of material valuation impact. Looking at a small subset of nine BDCs that have less than \$500 million in market cap and maintain total loan portfolios of approximately \$5.6 billion as of March 31, 2020, per public SEC filings, we see they were responsible for more than \$2.1 billion in 2019 origination. This is just a small sample of significant lending capacity leaving the market.

### **Given you cover the PE market, what has the activity level been in recent months, and what deals are attracting your attention?**

**JS:** Deal flow halted in March as the realities of COVID-19 set in. We worked closely with our sponsors and borrowers to ensure they were well-positioned to deal with the challenges ahead. We are proud that we met all of our revolving and delayed-draw commitments, providing companies with the liquidity support they needed in such a critical time.

**TQ:** As of today, our pipeline activity has picked up to pre-COVID-19 levels. The bar remains high, but we’re seeing some combination of higher yields, lower leverage, and higher EBITDA. The risk-adjusted return has moved materially in our favor. It’s counterintuitive, but we’re more excited about the opportunities we’re seeing today than we were a year ago. We tell our investors that if they liked this strategy in 2018, they should love it in 2020.

### **There’s a growing sense of responsibility for firms today in terms of environmental, social, and governance (ESG) and community impact. How has Tree Line taken up this challenge, and what role do you believe your ESG policy can play?**

**TQ:** Our ESG policy and the impact that we can make in our community is a living initiative. In January, we joined 1% for the Planet, and will contribute 1% of our management company revenue to support environmental causes. In May, our team made personal contributions, matched by Tree Line, for over \$58,000 to those impacted by COVID-19. Finally, in June, we renewed our focus to build a diverse culture and will explore how we can partner with our investors to leverage our ESG policy to effect positive change. We are a dynamic, young, diverse team that welcomes the responsibilities that come with managing capital on behalf of our investors in today’s world.

# Fundraising

## Select open and upcoming distressed debt and special situations funds

Fund name	Target fund size (\$M)	Fund type	Fund location
Oaktree Opportunities Fund XI	15,000	Distressed debt	Los Angeles, CA
Centerbridge Special Credit Partners IV	5,000	Distressed debt	New York, NY
Centrum Credit Opportunities Fund	5,000	Credit special situations	Mumbai, India
Fortress Credit Opportunities Fund V	5,000	Distressed debt	New York, NY
PIMCO Distressed Senior Credit Opportunities Fund III	3,000	Distressed debt	Newport Beach, CA
Arrow Credit Opportunities Fund	2,214	Credit special situations	Manchester, United Kingdom
Crestline Opportunity Fund IV	1,750	Credit special situations	Fort Worth, TX
Stellax Capital Partners II	1,750	Distressed debt	New York, NY
Cross Ocean Partner European Special Situations Fund III	1,500	Distressed debt	London, United Kingdom
H.I.G. Bayside Loan Opportunity Fund VI	1,250	Credit special situations	Miami, FL

Source: PitchBook | Geography: Global  
\*As of July 30, 2020

As one might expect, fund managers have responded to the crisis by launching a variety of opportunistic strategies, including distressed debt and special situations vehicles, which together accounted for 29.9% of capital raised in H1 2020, compared to just 19.7% for the entirety of last year. These funds include ones already in the market prior to the pandemic, which were rebranded as COVID-19 opportunity funds, as well as vehicles launched entirely in response to the newfound volatility. Distressed debt funds tend to invest in existing debt facilities: either in “distressed-for-control,” hoping to buy the debt of a company and convert it into equity, or in more liquid securities trading at steep discounts to par, such as high-yield bonds and leveraged loans. Special situations funds, on the other hand, tend to originate loans to companies that are considered too bespoke and/or risky for other lenders. In the current crisis, special situations funds are targeting investments where a company requires bridge or rescue financing to stay afloat through the pandemic.

These opportunistic vehicles will likely be much larger than their predecessors, reflecting both the growth in private market assets as well as the magnitude of opportunity created by recent market shocks. For example, Oaktree is currently in the market with a \$15.0 billion distressed debt fund. If successful, it would be the

largest distressed fund of all time. Bain Capital, PIMCO, and KKR are also among the notable names raising multi-billion-dollar opportunistic vehicles. Aside from these closed-end vehicles, credit-focused hedge funds have piled in as well, adding even more competition to an already crowded space.

Despite a surfeit of dry powder and swift recovery in asset prices, the magnitude of the pandemic’s economic shocks will continue to create distressed investment opportunities well into next year. Through the first half of 2020, about 25% more businesses filed for chapter 11 bankruptcy protection in the US than in the same period last year.<sup>2</sup> Similarly, leveraged-loan defaults reached their highest levels since the GFC.<sup>3</sup> While these figures may already seem grim, they are likely to get much worse if the pandemic lingers—as increasingly seems to be the case—or if government relief programs run out of steam before businesses are back on sound footing. To be sure, some of the most obvious (and most liquid) investment theses in the credit space have already been rendered null due to rapid recoveries in the price of those assets. To illustrate the rapid rebound, the Bloomberg Barclays High Yield Index (HYG) saw a maximum drawdown of 20.8% in March but had made up nearly all of that loss by the end of Q2. This was due in part to the Fed’s asset

2: “Chapter 11 Business Bankruptcies Rose 26% in First Half of 2020,” The Wall Street Journal, Aisha Al-Muslim, July 2, 2020.

3: “US Leveraged Loan Defaults Total \$23B in Q2, the Most Since 2009,” S&P Global, July 6, 2020.

4: Fed Discloses More Corporate Bond and ETF Purchases,” The Wall Street Journal, Matt Wirz and Tom McGinty, July 10, 2020.

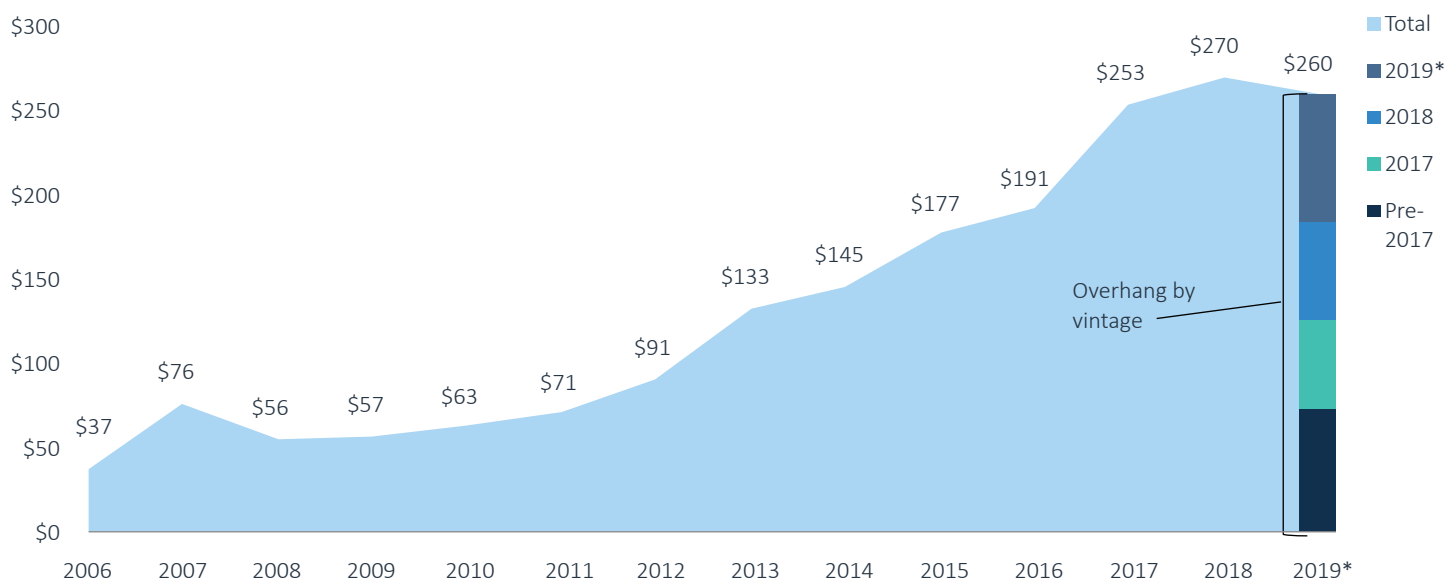
## Fundraising

purchase program, which drove up prices across fixed-income markets when it expanded into corporate credit.<sup>4</sup> But other opportunities, especially in the non-syndicated middle market loan space, will remain.

Following the GFC, some fund managers saw the advantage of investing in both sides of the capital stack and gave themselves the flexibility to invest in debt as well as equity. For example, when the pandemic hit in March, Apollo pivoted its \$24.7 billion buyout fund to focus almost entirely on distressed-for-control investments, rather than equity in an LBO model. The fund manager also announced on its Q1 earnings call that it expects to raise another \$20 billion in credit-focused strategies this year in response to the pandemic. It has already held a final close on a \$1.75 billion special situations fund, which was raised in just eight weeks. Apollo's recent investments include previously strong companies in hard-hit sectors such as travel and leisure. In a private placement structured as preferred equity, Apollo and Silver Lake sank \$1.2 billion into Expedia (NASDAQ: EXPE), which has seen massive revenue shortfalls due to the shutdown. We expect to see more deals like this in sectors such as entertainment, hospitality, and restaurants.

While interest in more opportunistic strategies has grown due to the economic duress caused by the pandemic, demand for direct lending funds—which usually make up the bulk of private debt fundraising—has waned considerably. Fundraising for direct lending funds totaled just \$18.2 billion across 17 vehicles through the first half of the year. By either measure, this is more than any other sub-strategy, but it still puts direct lending on pace for its slowest year since 2015 in terms of capital raised. Direct lending funds generally provide financing for LBOs, which have fallen off the pace of recent years due to the pandemic. With fewer LBOs being completed, there will be less demand for the funds that finance those deals. The three largest funds to-date all held a final close before the end of March, indicative of the headwinds faced by managers once the pandemic took hold in the US and much of Europe. A list of familiar names accounts for most of the dollars dedicated to direct lending funds this year: Blackstone's GSO unit raised just over \$5 billion, while Ardian and Churchill raised \$3.3 billion (€3.0 billion) and \$2.0 billion, respectively. The Ardian and GSO funds (both based in London) speak to Europe's relative rise in the private debt space over the last decade, a trend that we expect to continue.

## Private debt dry powder

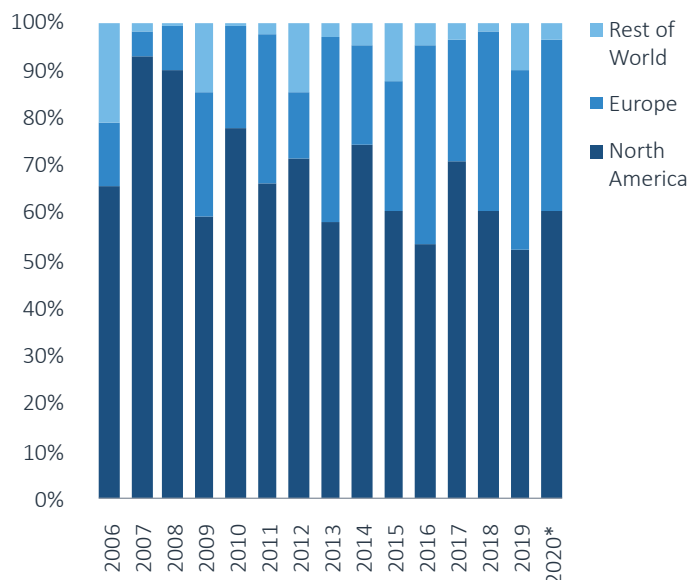


Source: PitchBook | Geography: Global  
\*As of September 30, 2019



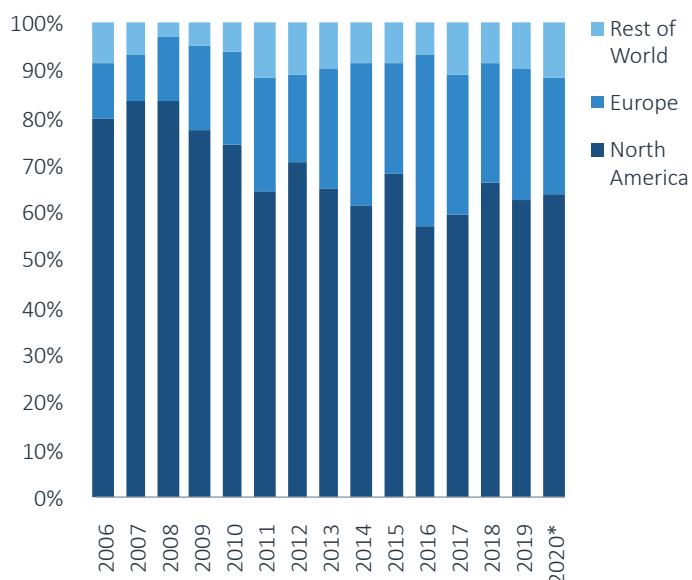
Fundraising

### Private debt fundraising by region (\$)



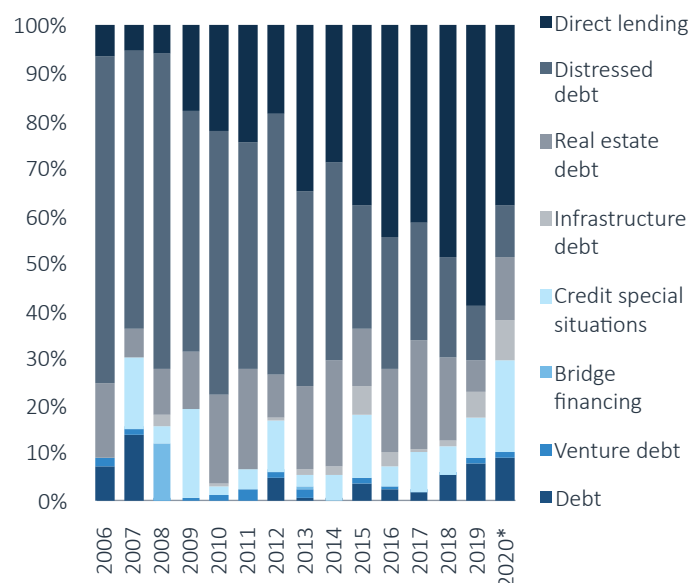
Source: PitchBook | Geography: Global  
\*As of June 30, 2020

### Private debt fundraising by region (#)



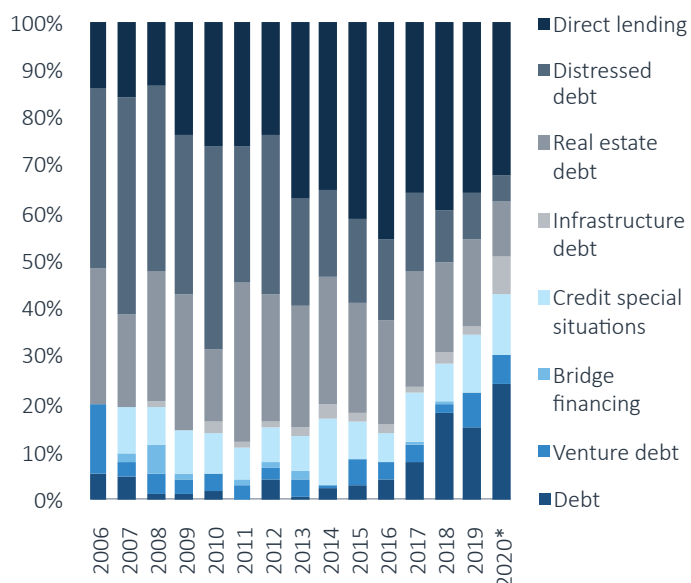
Source: PitchBook | Geography: Global  
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### Private debt fundraising by type (\$)



Source: PitchBook | Geography: Global  
\*As of June 30, 2020

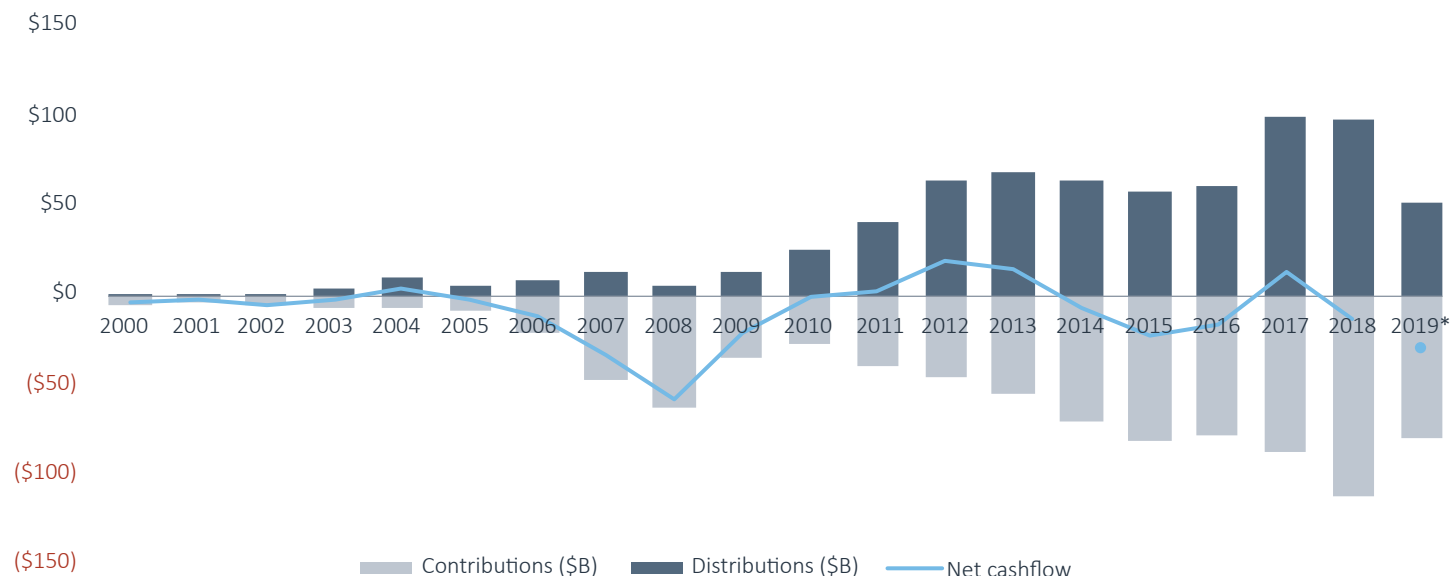
### Private debt fundraising by type (#)



Source: PitchBook | Geography: Global  
\*As of June 30, 2020

# Performance and cash flows

## Private debt cash flows



Source: PitchBook | Geography: Global  
\*As of September 30, 2019

*This section was amended from PitchBook's 2020 Global Fund Performance Report (with data as of Q3 2019), which contains similar data and analysis on PE, VC, funds of funds, secondaries, and real assets funds.*

The volatility seen in early 2020 was in marked contrast to the placid market environment in Q3 2019, when performance figures for private debt funds hardly budged. The rolling one-year horizon IRR for the strategy inched up to 5.1% from 4.1% in the prior quarter. Similarly, few vintages saw any meaningful changes in TVPI figures, with the majority clocking trailing 12-month changes of .02x or less. To be sure, these figures include unrealized mark-to-market changes in portfolio holdings and are sure to dip with the market turmoil stemming from COVID-19. For reference, the S&P/LSTA US Leveraged Loan 100 Index fell by 9.9% in Q1 2020, with drawdowns as much as 22.3% from where it began the year. Early indications from public PE firms also paint a dire picture. This group marked down its credit portfolios anywhere from 8.1% to 21.0% in Q1 2020, with most portfolios experiencing markdowns in the 11.0% to 16.0% range.

While performance figures have been steadfast, capital calls and distributions for the strategy have changed dramatically. Ample capital raised led to record capital deployment in 2018 (\$111.9 billion), with 2019 nearly

## Horizon IRRs for debt funds compared to public indices

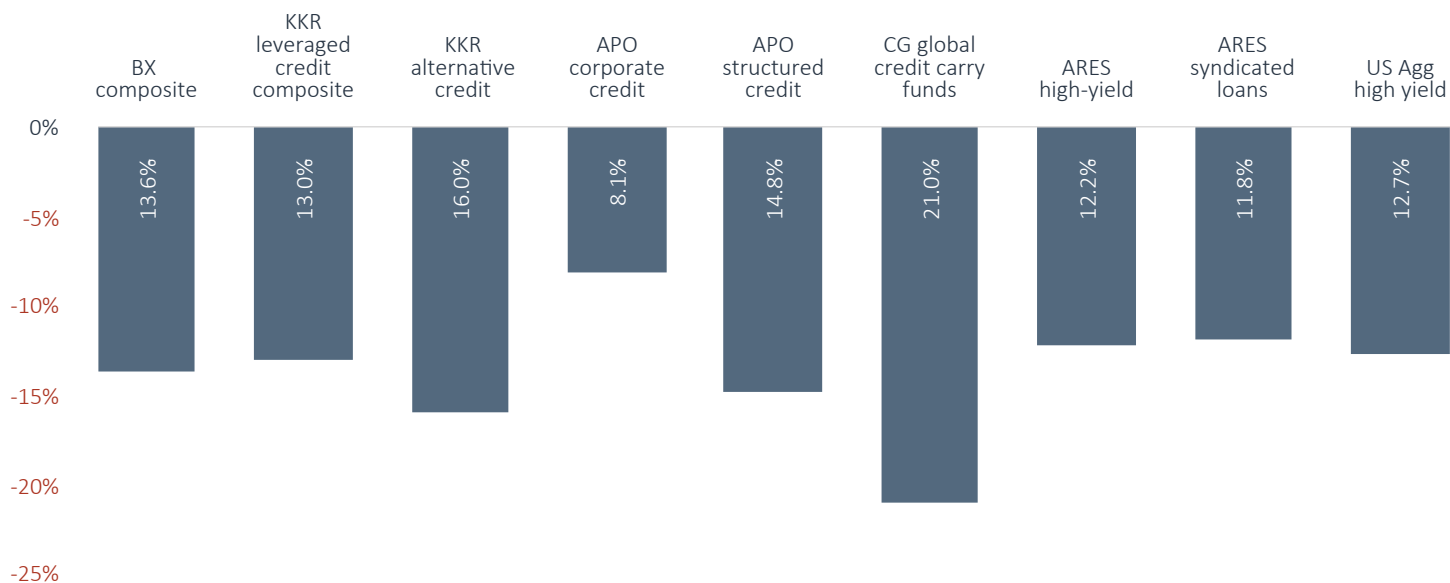
Strategy	1-Year	3-Year	5-Year	10-Year
Debt	5%	7%	6%	9%
S&P 500	4%	13%	11%	14%
Russell 3000	3%	13%	11%	13%
Russell 2000 Growth	-10%	10%	9%	13%
Morningstar US Real Assets	1%	2%	2%	4%
Bloomberg Barclays US Corporate High Yield	6%	6%	5%	8%

Source: PitchBook | Geography: Global  
\*As of September 30, 2019

on pace to match. Distributions, meanwhile, have not quite kept pace through the first three quarters of 2019, meaning that net cash flow to LPs (distributions minus contributions) is on track to be negative for the second consecutive year. We attribute this to the growing LP interest in the space; heightened fundraising has caused capital calls to outpace distributions, which are also strong from a historical perspective. That said, based on Q3 2019 data, distributions are likely to dampen in 2020 as companies of all stripes could struggle to make debt repayments during the COVID-19 pandemic.

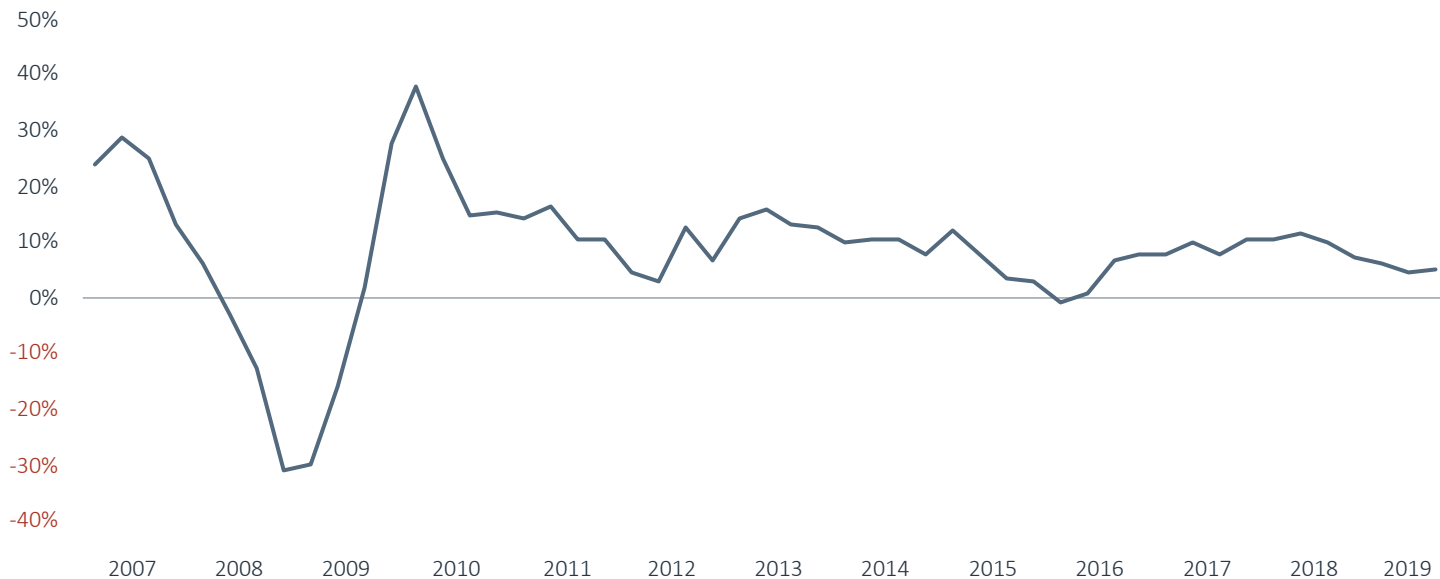
Performance and cash flows

### Q1 2020 credit markdowns by select manager



Source: PitchBook | Geography: Global

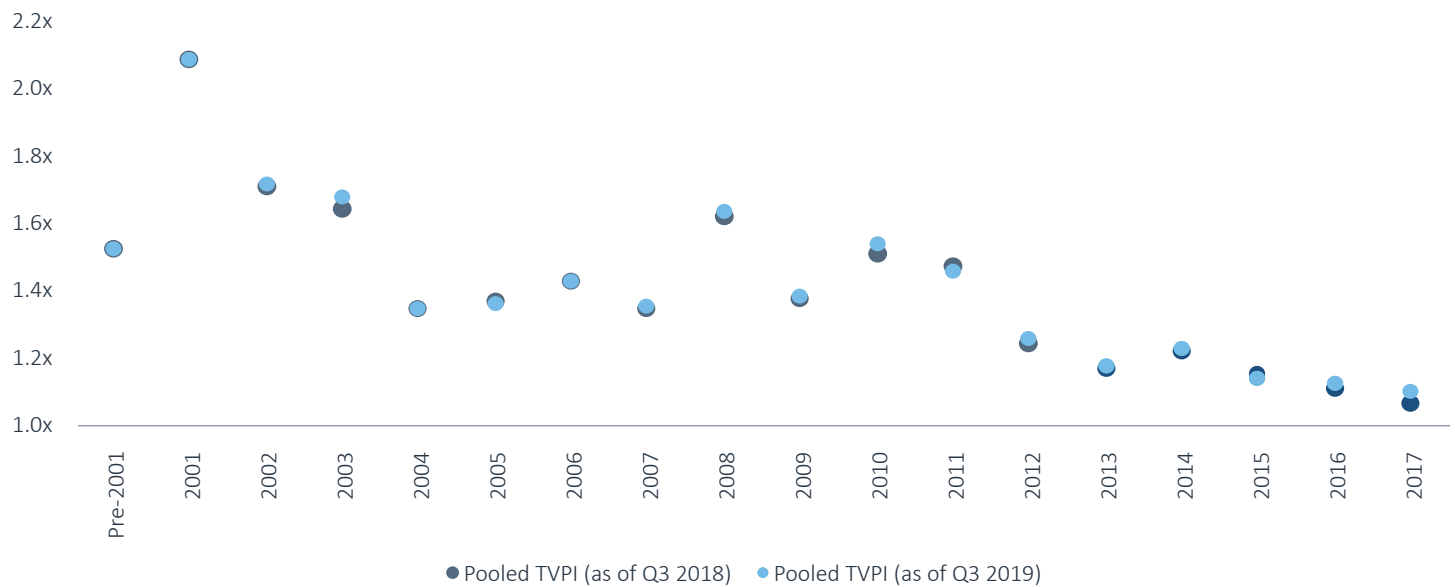
### Global private debt rolling one-year horizon IRR



Source: PitchBook | Geography: Global  
\*As of September 30, 2019

Performance and cash flows

### Private debt one-year change in pooled TVPI by vintage



Source: PitchBook | Geography: Global  
 \*As of September 30, 2019



