



“The growth in lower middle-market private equity has resulted in the most sophisticated the market segment has ever been..”

Jon Schroeder, Managing Partner

“The lower middle-market is moneyball for portfolio managers seeking yield.”

Tom Quimby, Managing Partner

“It’s experience you never really want but it’s hard to imagine where we’d be without it”

Frank Cupido, Partner



Talking All Things Direct Lending with the Partners of Tree Line Capital Partners

Introduction

Tree Line is a direct lender focused on senior secured lending to lower middle market borrowers in North America. The firm manages \$1.2 billion in investable capital across five funds and has committed nearly \$1B in capital across 65 transactions since its inception of October 2014. Tree Line focuses on borrowers with between \$3 and \$30 million in EBITDA with an emphasis on companies with less than \$15 million in EBITDA. The firm directly originates, underwrites and manages portfolios of senior secured loans that are highly diversified by geography, borrower and sector.

Managing Partners Tom Quimby and **Jon Schroeder** founded the firm in 2014 and **Partner, Frank Cupido** joined on the day Tree Line’s closed its inaugural fund. Tree Line received \$275 million in anchor investments from Stone Point Capital and the University of Texas Investment Management Company (“UTIMCO”). Since then, Tree Line has raised approximately \$1 billion in additional debt and equity commitments and built a lower middle market focused lending platform that is designed to deliver investors the benefit of scale with limited annual deployment to target premium return in favorable credit structures. The three partners have built a highly successful lower middle-market direct lending platform and are very excited about the present and future opportunity they have in their niche market.

➤ **Question: Let's start from the beginning and do a quick recap of how you all came together.**

Quimby: This could take a while so we'll go with the short version. Jon and I met in 2000 while working at GE Capital in Stamford, CT. I was in my first rotation in the Financial Management Program and Jon was a Summer intern. I was assigned to be Jon's "buddy" which as I recall entailed showing him where the bathroom was and it afforded us one lunch paid for by GE. Those were great years and we learned a ton from GE. I joined GE's Global Sponsor Finance business in 2002 and Jon joined in 2003. That's really where we cut our teeth on the direct lending strategy. GE was rigorous in their underwriting and asset management approach and it was a great training ground. Years later we were at Medley Capital and looking to expand our investment team and we came across Frank. He was wrapping up an investment banking program and he became our first hire.

Schroeder: The three of us have a lot of history, continuity and, perhaps most importantly, we all worked through the Financial Crisis together. Having that experience is invaluable as many people that are now ten years into their careers have only seen one side of a cycle. The 2007-2010 period has had significant influence on our investment strategy, underwriting philosophy, and the processes we have put in place at Tree Line.

Cupido: I joined Tom and Jon 12 years ago in 2007 at the beginning of what would become a generational global financial crisis. It's experience you never really want but it's hard to imagine where we'd be without it. We have worked very closely together since then and that is what ultimately allowed us to have great confidence in forming our partnership at Tree Line. Given our shared underwriting approach and long-term sourcing relationships, there weren't a lot of unknowns in deciding to join them in building Tree Line. It was ultimately about execution.

Quimby: The long-term personal and professional relationships we have all forged over 19 years is what has made it a truly fun and rewarding daily experience to build Tree Line.

➤ **Question: What was the genesis of Tree Line and what were you setting out to do?**

Quimby: In 2014, we saw a clear opening in the market. The majority of direct lending firms had been in business

Lower middle market supply / demand imbalance by the numbers

between three and 10 years and the vast majority were either focused on the middle-market or were extremely focused on getting to the middle-market. Our experience

More than 7x lower middle market business than middle market businesses

175,000 lower middle market potential borrowers with between \$10 and \$100 million in revenue

972 sponsors focused on lower middle-market with significant new capital finding spin-outs and new shops

Less than 10% of the private credit capital focuses on lower middle-market

was that the lower middle-market, typically borrowers with between \$3 and \$20 million of EBITDA, with an emphasis on borrowers with less than \$15 million of EBITDA, were getting much less attention. We had the data to support that we could lend to lower middle-market borrowers while capturing outsized yields in favorable credit structures.

Schroeder: It was clear to us that most other credit firms were focused on maximizing AUM which leads to inevitable pressure on deployment and ultimately results in these platforms moving up market. Many of these firms started out lending to lower middle-market borrowers but due to their own success in fundraising they were forced up market to join the pack of lenders commoditizing their terms. That never appealed to us and the lower middle-market just offered a premium opportunity where we were confident we could deliver a compelling value proposition to investors.

Quimby: The goal was simple. Build an institutional quality platform that was dedicated to the lower middle-market. We want our borrowers and sponsors to know that we understand this market and are committed to it. We are focused on

companies of this size with the goal to balance scale with an ability to selectively construct a portfolio with favorable risk adjusted return. Jon, Frank and I knew we had the requisite relationships and a clear vision on how to build our firm that spans cultural values, underwriting philosophy, systems, team alignment and total transparency with our investors. We had a full vision that we were confident we could bring to life if given the opportunity. In 2014, we presented our vision to Stone Point Capital, and later the University of Texas Investment Management Company (“UTIMCO”), and put together an initial deal that allowed us to launch with \$225 million of committed capital. This allowed us to build our team, launch our brand and begin to construct a portfolio.

➤ **Question: And where does Tree Line stand today?**

Schroeder: Today, we’re proud to have built a firm comprised of 20 people in offices in San Francisco, New York and New Orleans.

We have grown assets under management to over \$1.2 billion and have raised approximately \$1 billion in

debt and equity commitments since our initial close with Stone Point and UTIMCO. We have provided just over \$1 billion in loan commitments across 65 transactions to nearly 50 borrowers and 30 unique sponsors. We have also significantly invested in our firm infrastructure to provide our investors with best-in-class portfolio management, reporting and transparency.

➤ **Question: Direct Lending has been rapidly growing asset class over the past 10 years. What’s the state of the market and where does Tree Line fit in?**

Schroeder: In the mid-2000s, direct lending or private credit was really emerging as an asset class yet still remained nascent. You were trying to figure out whether to call the fixed income or the private equity contact of a prospective investor and those

investors were trying to determine where this new direct lending bucket should sit within their portfolio. There was still very much an education process going on highlighting that private credit firms could fill the void as a result of the massive bank consolidation. This led to significant growth of private credit firms forming and focusing on the middle-market. Many of which formed as business development companies (“BDCs”) which are 1940 Act governed public vehicles.

Quimby: So, today we see a more mature private credit asset class within the middle-market. Firms focusing on companies with greater than \$50M of EBITDA have really seen and felt a commoditization of their strategy. Yields have compressed meaningfully, leverage has returned to 2007 levels and structures have been gutted. Covenant lite structures prevail, EBITDA is highly adjusted and based on forecasted synergies from an acquisition and there is very little amortization. Tree Line has

had a very different experience lending to the lower middle-market. We have consistently been able to lend with discipline, with a focus on maintaining full suites of financial covenants at

reasonable levels, strict EBITDA definitions and contractual amortization. When we look at the \$1 billion in loan commitments that we have made we are very pleased to see the consistency by vintage. This has been an aggressive credit environment and yet we have consistently been able to identify lower middle-market opportunities with favorable yield, leverage and credit structures.

➤ **Question: If the opportunity, yield, structure, etc. is that much better in the lower middle-market, why isn’t there more of a focus on it?**

Cupido: Jon touched on it earlier where many of our larger, middle-market competitors simply need to deploy in larger amounts. We have been primarily focused on loan opportunities between \$5 and \$50



million but we have a genuine interest in making a \$10, \$15 or \$20 million loan. That just doesn't interest many firms who are managing \$3 to \$100 billion and thus creates some dislocation in our end of the market. Additionally, the lower middle-market is labor intensive. We work hard and have built our firm to have a national footprint where we focus on 16 U.S. markets to effectively review hundreds of opportunities. In 2018, we evaluated over 600 loan opportunities. Approximately 250 loans will be formally screened and we'll ultimately spend significant time on 50-100 to likely close 12-15. So, it's a significant commitment to sourcing, screening and underwriting to construct our portfolio. The lower middle-market just isn't efficient where we can rely on a handful of relationships with the big capital markets desks and mega private equity firms. We have to go direct and we cast a very wide net. We are the lead arranger or agent in over 90% of our deals so the direct relationship with a sponsor or borrower truly matters in all that we do.

Quimby: That sums it up well. The combination of firms seeking to raise tens of billions and the labor intensive nature of the lower middle-market is a mismatch. We've designed our entire platform to focus on this market opportunity.

➤ **Question: You highlight your focus on lower middle market. I presume that means you're dealing with smaller companies and thus taking more risk? Why would an investor be willing to take this risk versus investing in a strategy targeting companies with EBITDA greater than \$50M?**

Quimby: This is "the" question we get from investors and it's been a really important issue for us to address and unpack correctly. It's truly a question of how to analyze risk adjusted return across the direct lending asset class. We start with market

segmentation. Just as in any other asset class, the market can change greatly from one end to the other. Given private credit has matured as an asset class, we encourage investors to segment the market. There is the large-cap, liquid market where companies have greater than \$75M of EBITDA with most exposure found in high yield bonds or broadly syndicated loans. There is the broader middle market which we would define as companies having between \$25 and \$75M of EBITDA. This is where the pack of middle-market direct lenders live. Finally, there is the lower middle-market where companies have between \$3 and \$25M of EBITDA. We wrote a white paper, "Lower Middle-Market Direct Lending: Moneyball for Portfolio Managers Seeking Yield", that is available on our website by the way. In that paper, we tried to highlight how smaller companies are consistently overlooked with too much emphasis simply placed on the size of the company. There is more to consider than revenue and EBITDA. We encourage investors to truly analyze risk adjusted return across these segments of the market. We have found that there is premium value in the lower middle-market when you compare yield, leverage, structure, rights, covenants, amortization and other loan features. When you truly peel the onion back and evaluate risk adjusted return across these market segments side by side, we feel the risk is not where most believe it to be but it takes real analysis and large amounts of data to reach this conclusion.

We hope our white paper helps.

Schroeder: All good points yet we wouldn't advocate simply taking a blind pool of the lower

middle-market as it's just not that easy. As we mentioned earlier, we look at over 600 deals per year to finance 12-15 so there is an expertise factor in evaluating these deals. We see significant volume by sector and have worked hard to build a database to be able to properly benchmark performance. We have done this for nearly 20 years and with the appropriate underwriting practices and philosophy

Tree Line's approach and focus on the lower middle market has led to consistent performance and terms in a competitive credit market.

Tree Line Portfolio	2015	2016	2017	2018
Senior Secured	100%	100%	98%	98%
Unlevered YTM ⁶	12.3%	12.0%	11.7%	11.8%
Wtd. Avg. Leverage ⁷	3.7x	3.4x	3.7x	3.7x
Avg. EBITDA	\$9.2M	\$10.2M	\$10.8M	\$12.5M
Covenants (Min. 2)	100%	100%	100%	100%
Cum. Realized Losses	0.0%	0.0%	0.0%	0.0%

you can construct a portfolio of loans with very attractive risk adjusted return. That's the moneyball argument. Most direct lenders are all chasing the same assets in a crowded sandbox. We find overlooked value and target favorable price and terms for our investors.

➤ **Question: Ok, so how do the loss and recovery rates stack up?**

Schroeder: Well, we'd certainly be quick to point out that Tree Line has enjoyed a 0.0% realized loss rate since inception.

Cupido: What often surprises people is that direct lending strategies to the lower and middle-market, which means having a first hand relationship with a borrower and sponsor with direct communication as needed, perform better than other larger, broadly syndicated loans. First, we have a full suite of covenants. 100% of our loans have at least two financial covenants and the vast majority have at least three financial covenants (i.e. Maximum Leverage, Minimum EBITDA, Fixed Charge Coverage, CAPEX, Minimum Cash Balance, etc.). This gives us a voice well in advance of a payment default or liquidity issue. Second, the direct and often sole lender relationship allows us to physically sit in a room with our borrower and sponsor to discuss the issues at hand. Tree Line is designed to deal with unforeseen events and bumps in the road. We lend to companies that have high free cash flow resulting in fixed charge coverage levels of 1.8x+, and as a result can absorb significant volatility in the event it occurs. We understand companies may have issues and some borrowers will most certainly face challenges in an economic downturn. However, we are able to establish new operating plans and milestones using our rights and remedies and partner in a recovery effort. Most importantly our voice at this juncture matters and is heard through the structure of our loans. Larger and broadly syndicated loans get complex with various levels of participants and little direct access to management or the ownership group. You'll often have multiple sets of attorneys involved, restructuring officers and consultants and that's where value gets destroyed. On the other hand, the role we usually play as the

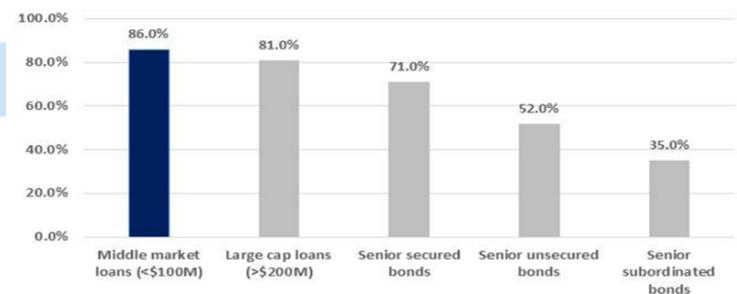
sole lender at the top of the capital structure affords us maximum influence.

Quimby: If you study the BDC index since 2004 it suggests an annualized loss rate of 1.04%. This is favorable to the loss and recovery rates you see in more liquid strategies.

➤ **Question: How does Tree Line compete against direct lending platforms that have been in place for 10, 15 years? Said another way, why Tree Line?**

Quimby: Well, I think there are two parts to that question. First, how does Tree Line differentiate within direct lending and deliver value to investors? Second, how does Tree Line compete against our competitors to win deal flow? We'll tackle the differentiation within direct lending first. Tree Line has immediate differentiation by our sheer willingness to dedicate our platform to lower middle-

Loan Recovery Rates



market lending. As we discussed, most firms just aren't willing to spend time here as you have to limit your AUM.

Schroeder: It's just not an efficient strategy to put but \$5-10 billion to work in lower middle-market check sizes. That would be incredibly-labor intensive. Tree Line is targeting three to five deals per quarter in \$5 - \$50 million bite sizes with most deals falling below \$30 million. This allows us to offer expertise in a segment of the market that remains dislocated. We are one of the very few firms that is dedicated to this strategy AND has built a platform to scale.

Quimby: This is an important point. We have built an institutional quality lower middle-market direct lending platform backed by best-in-class investors,

such as Stone Point Capital and UTIMCO, with a real focus on a scalable infrastructure, process and team. The investment we've made in our systems, process and team has been significant and that's how we've achieved the growth we have had in such a short period of time. From day one, we have been focused on building a firm versus simply managing a fund. When we highlight this with the benefits of a lower middle-market focused strategy it's a very compelling message.

Cupido: The second piece of the question around, "how Tree Line, a five-year old firm, can compete with a 10 or 15-year old firm", the answer is pretty simple. Relationships. We've held ourselves out to be relationship lenders since day one. Jon, Tom and I have worked together since 2007. Jon and Tom have worked together since 2000. We have all focused the vast majorities of our careers on direct lending and much of that has been together. We have a highly cohesive management team which allows us to act quickly and deliver clear feedback to our borrowers and sponsors. It is rare for direct lenders to be able to have multiple partners and investment committee members on the front lines of a deal. Again, we can do this because we have limited our AUM and have designed our platform to take a hands-on approach up to the partner level. Our borrowers and sponsors know who is making decisions and they value that they have a direct line of communication with our investment committee. Most other firms can't say that, and it matters. At the end of the day, this is and always will be a relationship business to us.

Quimby: In 2014, we hit the ground running and were very pleased with the immediate support the sponsor community showed us and much of that was due to having worked directly with these firms and professionals in past deals. In many cases, the associates and vice presidents Jon and I were interacting with in the early 2000s, in our GE days, are now principals and partners at private equity firms we're covering today.

Schroeder: So, to round out the question, relationships in this business are incredibly important. That said, of course we are able to

compete and offer market terms with creative credit solutions. Our platform has grown considerably since we launched in 2014 with \$1.2 billion assets under management. This growth has allowed us to expand our team, product offering, hold size and deliver that value to our sponsors and borrowers. Nearly 70% of our deals have come from a repeat sponsor or borrower. These are borrowers and sponsors that have choices in a healthy credit environment and they are choosing to award their repeat business to Tree Line. We don't take that for granted and seek to earn that trust with every relationship, every day.

➤ **Question: Where do you see the direct lending asset class in five years?**

Schroeder: The growth of lower middle-market private equity has been incredible over the past few years. We continue to see highly talented teams spin out of well known, blue-chip middle-market firms to plant their flag and establish their first fund. The vast majority of these groups are establishing \$150 to \$500 million fund sizes which overlaps perfectly with Tree Line. We believe the opportunity in lower middle-market direct lending is as compelling as it has ever been. We are seeing more and more sophisticated private equity firms enter the space and that creates an ever-growing addressable market.

➤ **Question: Will that invite new competitors?**

Quimby: It may, but candidly, there is still significant white space and it will still take the right group to build a platform that is designed for the lower middle-market. We note often how rare it is to consistently see the same competitors in our pipeline. We rarely are going head to head with the same list of competitors and that just shows how big the opportunity set is. The luxury we have is that we don't have that much capital, relatively speaking, to put to work each year and this is by design. We have the luxury of being selective in an enormous market.

Schroeder: Now, if we look more broadly at direct lending it's likely we'll continue to see some consolidation. It's the most efficient way for firms in

the middle market to grow and this is nothing new. In the early 2000s, GE buys Heller, then Merrill, then Antares and you are beginning to see some consolidation occur today.

Cupido: Specifically, we've seen consolidation begin in the BDC channel, in which sub \$1b BDCs (such as Triangle) have been absorbed by larger asset managers (such as Barings). These asset managers typically re-orient the investment strategy of the BDC to align with a larger AUM platform and inevitably exit the lower middle market, creating more opportunity for Tree Line.

Quimby: That's been interesting to watch. The BDC vehicle is attractive for many reasons not least of which is the permanent capital aspect. However, you can't pull a couple of people off of a trading desk and ask them to go originate lower middle-market deals. It's a completely different network. We've spent our entire career building our network and refining our underwriting approach so it was no surprise to us when a few groups had to call it quits. Since Tree Line's inception, we have continued to deliver record origination year after year with highly consistent underwriting metrics. We are really pleased with the market share we have established and the prospects ahead of us but it hasn't happened by chance.

➤ **Question: What's next for Tree Line?**

Quimby: We are laser focused on our current strategy. We will continue to invest in our infrastructure, process, products and team and deliver that value to our sponsors, borrowers and investors. There are complementary strategies that we'll likely evaluate in the future but we'll address that when the time is right. We're incredibly proud of the platform we have built and the relationship we have forged to date. We're in the heart of our careers and each one of us is all-in on Tree Line. This

has truly been a rewarding experience and most importantly we're having fun doing it.

Schroeder: I couldn't agree more. We're right where we want to be and our focus is really on what's in front of us. We know if we continue to execute our strategy at a high level today, tomorrow will be bright.

Cupido: I am on my way to Two Meats right now because it's split pea soup Wednesday.

TREE LINE

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