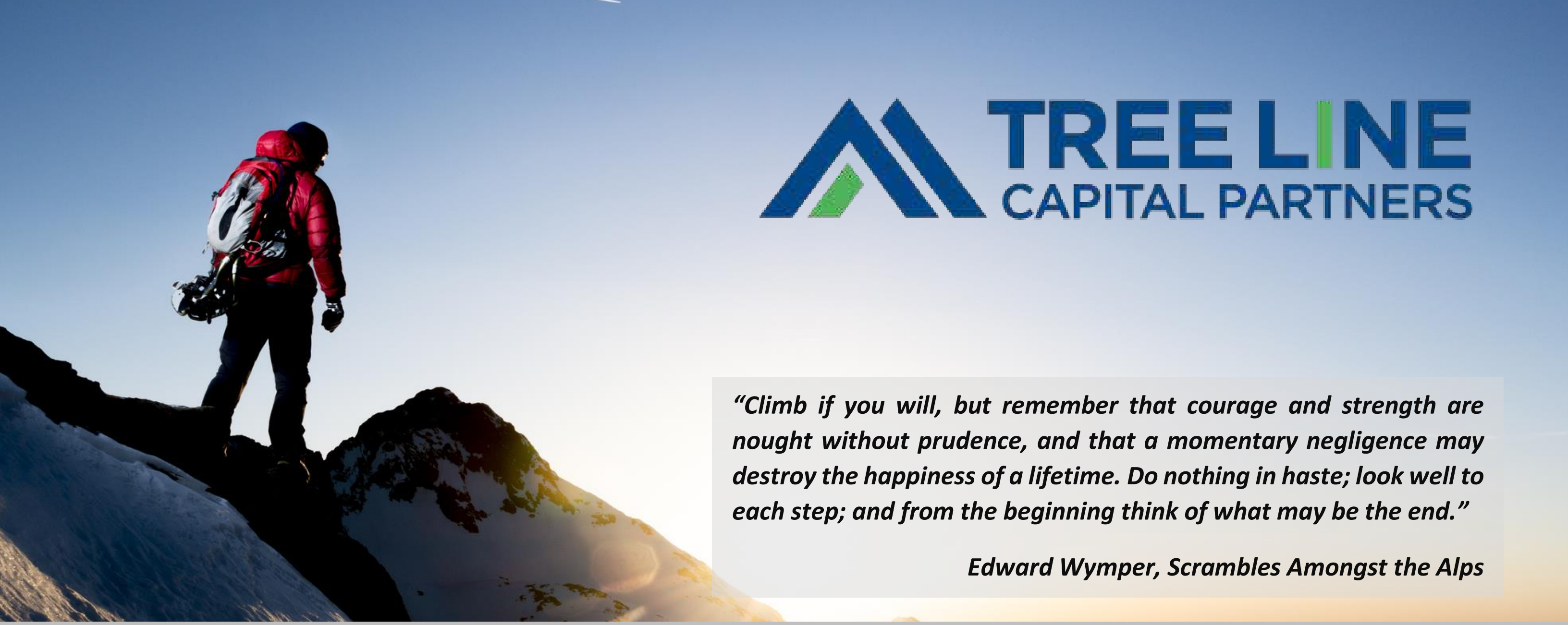


Navigating the Summit: Investing in Direct Lending Near (At) the Peak

Introduction

DOW 23,000, 24,000 and 25,000 have all been surpassed by a market that has a short memory and a desire to climb even higher. The Great Financial Crisis ("GFC") is now hardly visible from these heights with some investment professionals moving towards the tenth year of their career having only experienced one side of a cycle. The markets are at an all-time high and for those that did live through the GFC it has to leave even the most bullish of investors a bit uneasy.

In the eighth year of a tepid economic recovery (fueled by unprecedented central bank policy and accompanied by record financial asset prices as well as seismic shifts in the global geopolitical and socioeconomic landscapes), we take time to evaluate the state of the direct lending markets and lend our observations on the unforeseen risks that may be lurking near (at) the peak. After all, summiting a peak is a temporary accomplishment, we all must descend eventually and we believe the decisions investors will make in the near term will greatly impact the success of their descent (and wherewithal to participate in future climbs).

Since 2008, global central bank balance sheets have grown ~188% with nearly $12 trillion of liquidity injected directly into the global financial systems through multiple rounds of quantitative easing driving yields on traditional income-generating securities to historic lows. Over the same period, the baby boomer generation entered retirement age fueling the need for current income and quality risk-adjusted returns as pension plans seek to close liability gaps, insurance companies attempt to offset narrowing spreads between their assets and liabilities, and retirees seek to bridge savings gaps and supplement income. These two conflicting forces have pushed investors out on the risk-spectrum, reallocating capital from traditional fixed income and large corporate leverage loan strategies to private debt strategies that have historically provided meaningful yield premiums. The result has been a steadily increasing demand in direct lending platforms and rapid capital accumulation across various private and public vehicles targeting current yield strategies. Recent market surveys show institutional investors demanding more of these products for the foreseeable future.

Consistent with all financial asset classes, private debt is not immune to the competitive issues that arise from popularity. Increasing pressure on managers emanating from supply/demand imbalances, competition for market share, deteriorating fee structures and capital deployment requirements, can all be expected to impact risk/return decisions across managers, strategies, vehicles, and vintages.

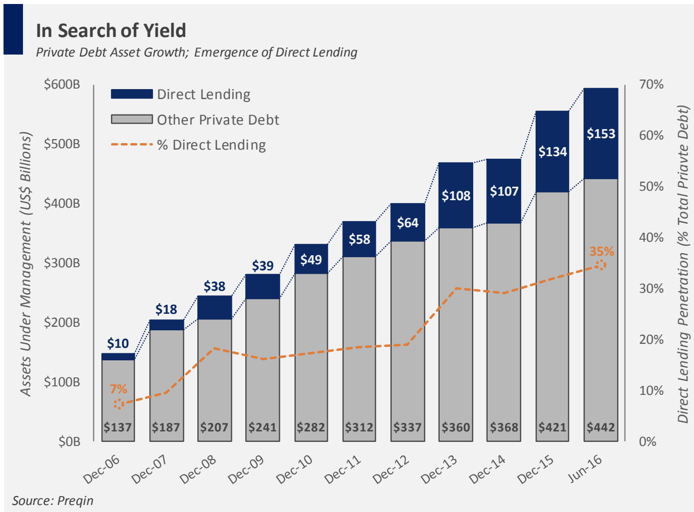
This paper will endeavor to highlight the state of the credit markets and share key metrics that should be monitored carefully to better understand one's true risk and how it could shift over time. We highlight key pitfalls that need to be avoided when navigating a peak environment and where value can be found to ensure direct lending delivers yield and reduces volatility as it is intended to do.

Finding the Path Less Traveled: Seeking Differentiation in Direct Lending

As allocations to middle market private credit strategies have continued to expand, investors appear to be taking note of the increasing competition among managers focused in the Middle Market and Upper Middle Market and are seeking to capture alpha through differentiated approaches. Notably, investors are showing increased interest in Lower Middle Market focused strategies where traditional banking retrenchment since 2007 has accelerated recently with the implementation of Dodd-Frank limitations on leveraged lending driving a widening supply/demand imbalance. Additionally, the Lower Middle Market offers investors an ability to invest in senior secured structures that deliver key credit fundamentals, such as, low leverage, amortization and covenants.

Direct Lending Fundraising Environment

Since December 2006, assets under management (AUM) among global direct lending managers has increased over 15x across both private and public funds, with investors seeking access to higher yielding assets relative to traditional fixed income investments without necessarily adding additional risk or volatility. Notably, some of the largest and most sophisticated institutional investors have been early to access the market, with insurance companies and pension funds accounting for six of the 10 largest allocators to the direct lending asset class. These early movers have been rewarded with a median net IRR of 8.9% for fund vintages 2004-2014 and modest volatility compared to other alternative asset classes.

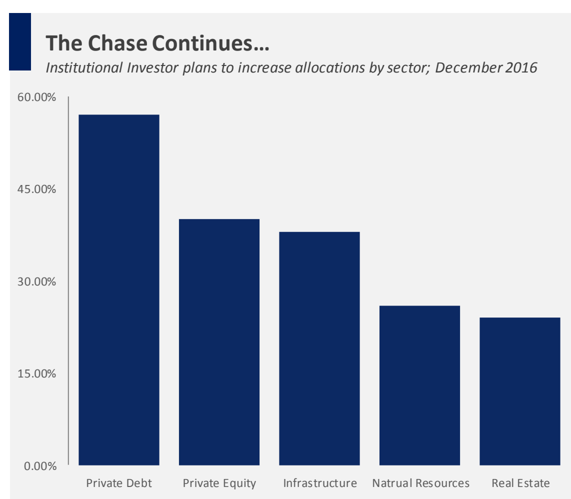


Source: Preqin

Based on a survey of 100 investors by Preqin, the flow of capital into direct lending strategies is expected to continue, with 91% of respondents currently allocating to private debt strategies and 77% of respondents planning to add to their allocations over the next 12-24 months. However, it is also becoming evident that investors are taking note of some of the competitive challenges facing managers investing in the Upper Middle Market and Middle Market, with continued pressure on yield and terms driven by a growing number of mangers and record dry powder competing for a limited supply of issuance volume. What has been so impressive is that as direct lending in the Middle Market and Upper Middle Market continues to mature and expected returns continue to be negatively impacted by competitive pressures, many investors continue to climb higher, increase exposure and take more risk within the direct lending asset class. This may be a product of where investors are in the cycle and the limited attractive alternative options that exist. Public and private equity valuations are very rich, liquid credit yields remain depressed so all considered direct lending strategies do continue to offer a sensible solution.

Investors are beginning to fall into two camps. First, there are investors that simply want to go with the pack and invest with the largest and most established brands with billions of dollars under management. This is simply a comfort in numbers strategy. The logic being it's hard to lose your job as a portfolio manager or consultant if you make a recommendation to invest in something that goes wrong when you have so much company. Second, there are investors beginning to dedicate resources and dollars to new managers, smaller funds and more focused strategies. Many investors have shown a real interest in the Lower Middle Market due to the ability to invest in senior secured structures with a yield premium offering compelling risk adjusted returns. (See 2016 Tree Line White Paper: *Moneyball: Investing for Portfolio Managers Seeking Yield*).

What is clear is that there is no sign of liquidity slowing into Private Debt Strategies. Where and how one invests will be critical in how they do navigating the peak of this market. Perhaps there is room to climb higher but even the most aggressive investor should think about the path they intend to take on the way down.



Source: Preqin

Scouting the Terrain: Middle Market Direct Lending

The US Middle Market consists of nearly 200,000 businesses generating over $10 trillion in annual revenue, employing approximately 45.6 million individuals, and comprising approximately 33% of all private sector US GDP. Given the scale and diversity of the middle market, we typically find it helpful to segment the market in terms of size, which determines the relevant capital sources for borrowers.

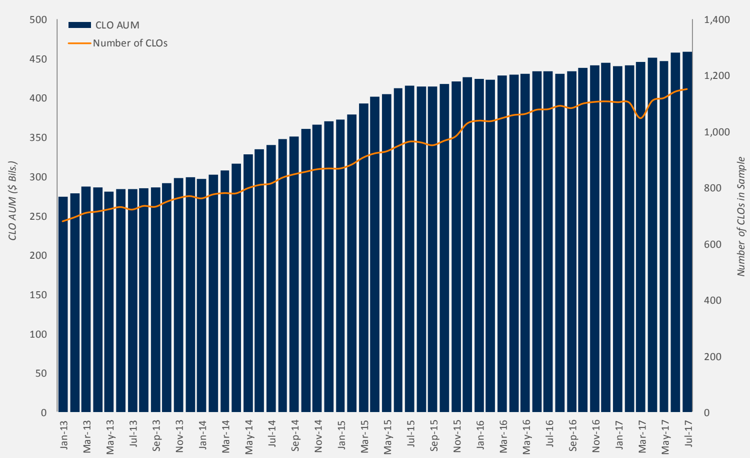
Market Segment	Upper Middle Market (UMM)	Middle Market (MM)	Lower Middle Market (LMM)
# of Active Businesses	~5,200	~17,000	~175,000
Size (Revenue US$)	$500M to $1B	$100M to $500M	$10M to $100M
Debt Capital Sources	Broadly Syndicated Loan Market Public High Yield Bond Market Large-Cap BDCs Insurance Companies Money Center Banks	Broadly Syndicated Loan Market Mid-Cap BDCs Direct Lending Funds Regional Banks Mezzanine Funds	Direct Lending Funds SBIC Funds Local Banks Mezzanine Funds

Upper Middle Market

Issuance in the Upper Middle Market is predominantly broadly syndicated loans, where purchasers primarily consist of collateralized loan obligations (CLOs), closed-end loan funds, and other institutional investors such as insurance companies and pension funds. In addition, there are a number of large, publicly-traded business development companies (BDCs) that have been successful in privately arranging these facilities.

Insatiable Appetite; The Return of Structured Vehicles

US CLO Assets Under Management ($Bils) versus Number of Active CLO Vehicles



Source: Thompson Reuters LPC Collateral (July 2017)

As shown above, CLO issuance and AUM growth has remained robust since late 2013, and CLOs currently hold ~48% of all institutional leveraged loans outstanding. Additionally, public vehicles such as BDCs, interval funds and loan mutual funds have continued to grow in scale, despite a brief pause in those markets during 2015 driven by concerns over exposure to commodity markets. Many BDCs are trading at or above a 1.0x net asset value which means they are issuing equity once again adding fuel to the fire throughout the Middle Market.

Given the strong demand for loans, issuance has also remained robust as issuers seek to take advantage of tight spreads and favorable terms, however record issuance has still not been able to keep up with demand. The result has been persistent yield compression and the increasing prevalence of "cov-lite" loan structures (zero maintenance covenants). Note, per S&P LCD analysis, 73% of all outstanding leveraged loans in the US were cov-lite as of July 2017 (up from ~55% in 2014). Inflows into leveraged loan vehicles such as CLOs and other public loan funds driven by the demographic and macroeconomic forces discussed previously has continued to outpace issuance resulting in narrowing spreads and deteriorated creditor protections. In addition, non-traded BDCs have been on the rise in recent years which utilize a BDC vehicle to attract thousands of retail investors through a network of broker dealers. Broker dealers funnel millions of retail dollars to asset managers in small check sizes for the promise of a steady and consistent yield. The capital flows in on a monthly basis and puts pressure on an asset manager to deploy it to ensure there is yield to make a required dividend payment to its investors. These structures tend to have substantial upfront fees ranging from 8-11% which has been a focal point for the SEC and FINRA.

Upper Middle Market Snapshot

Market Statistics and Key Considerations

Key Market Metrics	
Issuance Volume (TTM Q2'17)	**$120.3 Billion**
Change Y/Y	*15.2% / $15.8 Billion*
Average Leverage (Q1'17)	**5.7x**
Change Y/Y	*0.2x*
Unlevered Yields (June 2017)	**4.72%**
Change Y/Y	*-0.28%*
Key Structural Considerations	
Seniority	Senior & Junior
Security	1L; 2L; Unsecured
Covenants	Primarily Cov-Lite
Issuance Type	Broadly Syndicated
Holders	CLOs, Loan Funds, Insurance Co's
Liquidity	Moderate
Volatility/Risk Profile	Beta

Source: S&P LCD; Lincoln International; Reuters LPC

Middle Market

The Middle Market was once the underserved and overlooked segment of the market benefiting from the consolidation and regulation of banks. However, over the past ten years the market segment has become a mainstay in most investors' allocation strategy. Direct lenders in the Middle Market are managing between $2 and $30B in assets creating a highly competitive and increasingly commoditized market.

Middle Market Snapshot

Leveraged Lending Statistics and Key Considerations

Key Market Metrics	
Issuance Volume (TTM Q2'17)	**$33.3 Billion**
Change Y/Y	*5.1% / $1.6 Billion*
Average Leverage (Q1'17)	**5.6x**
Change Y/Y	*0.8x*
Unlevered Yields (June 2017)	**6.52%**
Change Y/Y	*-0.32%*
Key Structural Considerations	
Seniority	Senior & Junior
Security	1L; 2L; Unsecured
Covenants	Full & Cov-Lite
Issuance Type	Syndicated & Direct
Holders	BDCs; Private Funds; Banks; Mezzanine
Liquidity	Limited
Volatility/Risk Profile	Beta; Limited Alpha

Source: S&P LCD; Lincoln International; Reuters LPC

However, the Middle Market has continued to attract investor attention and new entrants continue to form bringing billions of fresh capital to the market segment. A significant portion of this growth came primarily through the BDC market, which has increased in total assets under management from ~$25B in 2010 to ~$72B as of Q2 2017. In addition, private vehicles have attracted significant amounts of capital in recent years with direct lending fund AUM growing at a 10-Year CAGR of 31.4% since 2006 reaching $153B as of December 2016 (see "In Search of Yield" on Page 2). The result has been very similar to what has been observed in the Upper Middle Market, with Middle Market issuances more closely resembling the pricing and terms found up market. Typical loan spreads are in the 500-600 bps range, leverage can reach upwards of 6.5x, and issuer-friendly term packages (i.e cov-lite, no amortization, limited call protection) are being routinely provided, with cov-lite loans increasing from ~11% in 2012 to 27% in 2017 per Standard & Poors.

Additionally, given the structures of many vehicles, increased competition in the Middle Market has driven BDCs and other yield-focused lenders into subordinated positions to achieve adequate yields to meet dividend and carried-interest hurdle rates.

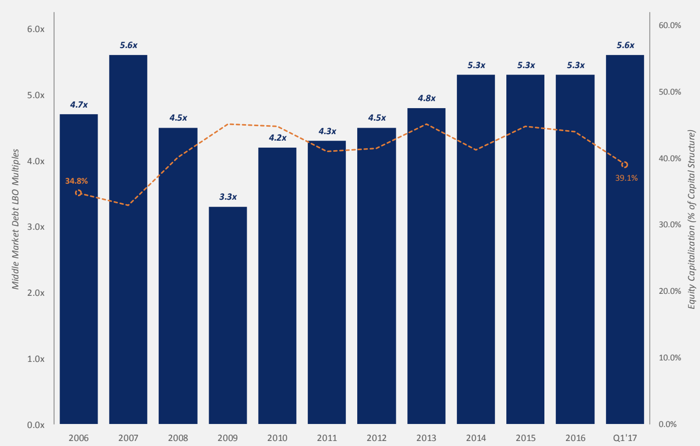
Lower Middle Market

Lower Middle Market is the path less traveled. This market segment has historically been underserved and highly fragmented. Direct lenders initially focus on this market segment to simply manage diversification as they target smaller loans, but as asset growth occurs they flee and join the crowd in the Middle Market. The Lower Middle Market has seen an increase in direct lending competitors in recent years but the segment remains highly fragmented with virtually all dedicated participants managing less than $1B in assets. This fact coupled with the significant increase in Lower Middle Market focused private equity firms has created a large addressable market. The Lower Middle Market offers investors a unique opportunity to capture alpha by taking advantage of persistent supply/demand imbalance created by the initial and accelerating retrenchment of bank lenders from the Lower Middle Market driven by regulation and the concentration of institutional capital in Upper Middle Market and Middle Market strategies. Additionally, given the broader set of opportunities in the Lower Middle Market versus the Upper Middle Market and Middle Market, with approximately 8x the number of businesses, we believe there is significant white space providing extended runway before the Lower Middle Market segment reaches the stage of maturity seen up market.

In the current environment, Lower Middle Market lenders have also experienced pressure on yields and terms emanating from the activity up-market. However, the Lower Middle Market has continued to provide 300 to 500 bps of excess yield and leverage has remained 1.0 - 2.5x lower on average compared to the Middle Market. Additionally, opportunities in the Lower Middle Market continue to offer a disciplined approach to investing. Loans are typically senior secured with contractual amortization and full covenant packages. This delivers more compelling risk adjusted returns when taking a comprehensive look at a loan's yield, security, structure, leverage and rights, particularly in the context of a downside scenario where a middle or upper middle market subordinated lender has far less influence on the outcome of a workout compared to a lower middle market lender with access to true first lien opportunities.

Ascending to New Peaks

Middle Market LBO Debt Multiples versus Equity Capitalization



Source: Thompson Reuters LPS; Lincoln International

Market Conclusion

The Upper Middle Market and Middle Market have become increasingly commoditized due to continued investor demand for yield and supply/demand imbalances have further deteriorated terms and pricing. The combination of lowered yields, higher leverage and cov-lite structures are leaving Upper Middle Market and Middle Market direct lending portfolios highly vulnerable to rising interest rates or an underperforming economy.

The Lower Middle Market continues to offer excess yield at more modest leverage to fund managers willing to focus its direct lending strategy below the radar. While the Lower Middle Market requires an investor to carefully select an asset manager with the requisite track record and strategy, it can deliver a compelling risk adjusted return superior to what's available in the Upper Middle Market and Middle Market. An investor should not underestimate the power of lending in reasonably levered senior secured structures with full covenants if capital preservation is a key criterion to make a direct lending allocation. As Upper Middle Market and Middle Market leverage levels climb higher into more subordinated structures it begins to create a highly volatile credit product that begins to look and feel like equity.

➢ Identifying and Avoiding Pitfalls in the Trek for Yield

Role of Senior Management: Understanding Who is Executing the Strategy

Understanding the involvement of the most experienced investment professionals in sourcing, underwriting and asset management activities at a firm is key. Typically, investors meet with the most senior investment professionals at a firm and hear an intimate story of how the strategy is executed. In the case of a first or second fund the managing partners and directors are integral to the deal sourcing and underwriting process. As firms grow, however, managing partners and directors can be seen shifting a disproportionate amount of their time to marketing, firm strategy and general fund management. The critical sourcing and underwriting activities of meeting with management teams, conducting on-site diligence visits are delegated to younger team members. Many deals are being led by investment professionals that have only worked on one side of the cycle. These may be highly talented individuals but the experience gained in a downturn is hard to replicate. The investment committee will naturally be comprised of the most senior investment professionals but understanding the role the senior most investment professionals actually play is critical.

It can be misguided to simply take comfort in the size of a platform and the fundraising team you meet. The lifeblood of any direct lender is the relationships they hold with their borrowers and portfolio companies. It is critical to understand who is representing your interests at the heart of the strategy.

Shifting Landscape: Understanding Change in Risk in a Competitive Environment

The rapid influx of capital inflows into institutional middle market lending since the GFC has been supported by a steady, albeit tepid, recovery in the underlying US economy, as well as benign credit markets supported by zero (or near-zero) interest rate policy allowing borrowers to support greater debt levels relative to cash flow, so long as these conditions continue to exist. As we continue to struggle with anemic economic growth in the late-stage of the economic recovery and enter a phase of monetary policy tightening in the US, we expect interest coverage ratios to tighten and default rates to increase across the economy. Given the leveraged nature of most investment vehicles holding middle market loans, increasing defaults and loan losses can have meaningful effects on investor returns, making capital preservation tantamount.

Let's look at a typical middle market loan in today's credit environment.

Performing Loan…

Exemplary Middle Market Loan Metrics at Close

Loan Parameters	
Total Leverage (@ Close)	5.5x
All-In Interest Rate (L+5.50%)	7.0%
Annual Principal Amortization	5.0%
Operating Metrics (@ Close)	
Revenue	$100.0
EBITDA	$25.0
Annual Maint. CapEx	$2.5
Credit Profile	
Interest Coverage	2.33x
Fixed Charge Coverage	1.19x

Source: Tree Line Capital Partners, LLC

Now let's look at the impact to the same loan with LIBOR simply increasing 3% and the company underperforming by 10%.

… to Non-Performing Loan

Rising Rates Magnify Modest Underperformance

Assumptions	
Percent Change in Earnings	-10.0%
Increase in Base Rate	3.0%
Credit Profile	
Leverage	6.11x
Interest Coverage	1.45x
Fixed Charge Coverage	0.91x

Source: Tree Line Capital Partners, LLC

The combination of maximum leverage, subordinated structures, thin debt service and cov-lite structures is at great risk in the current environment. Direct lenders participating in similar structures are introducing significant volatility to their investors and sacrificing a key pillar of the strategy, capital preservation.

Making the Dividend: Capital Deployment Pressures on BDCs

BDCs are required under the Investment Act of 1940 to distribute 90% of net investment income (NII) to investors in the form of a quarterly dividend. As with most income-related investments, the market tends to expect a regularly increasing flow of distributions on a quarter-by-quarter basis. Thus, when dividends are reduced or suspended, stock prices are battered often causing further issues for BDCs, which typically cannot issue stock at a share price below the net asset value per share. As such, BDC managers are highly focused on maintaining and growing dividends, which can often lead to the selection of sub-optimal investments to generate NII though closing fees and driving higher current income immediately prior to the end of a quarter. These investments often take the form of purchases of broadly syndicated loans more typically held by CLO and loan fund investors, whereby the BDC investor has little ability to negotiate terms given their size relative to other BSL participants.

While many investors find comfort in the fact they are not investing in a BDC structure, what should be top of mind is whether or not the private fund you are investing in is attached to a BDC through an asset allocation policy. Typically, BDC managers will seek Exemptive Relief from the SEC which allows all funds under the manager to invest side by side to avoid cherry picking assets for select strategies. If a BDC exists then that may be the loudest voice within the platform (BDC vehicles often carry lucrative fee structures compared to private fund peers) thereby pulling the private fund into deals it may not otherwise find attractive. It's often interesting to look at the quantum of deals that close in the last month, or even week, of a financial quarter of the BDC. If a private fund is active alongside a BDC at the end of a quarter on a routine basis there may be cause for concern.

The Value of Scale (for Who?): The Rise of Public Alternative Asset Mangers

Beginning a decade ago with the IPO of Fortress Investment Group in February 2007, there has been a flood of alternative asset management firms that have sought liquidity in the public markets. These IPOs have been predicated on the stable and growing stream of management and incentive fees generated by these managers, driven primarily by increasing AUM, as pressure from fund-investors on fees continues to challenge the viability of these cash flow streams. Similar to public fund pressures discussed with BDCs below, the public ownership of the investment manager creates an additional set of conflicting incentives for managers that can be misaligned with those of the fund-level investors.

First, as public scrutiny of quarterly earnings at the asset manager level become increasingly important to the personal financial well-being of key management members, additional resources are likely to be allocated to AUM growth (key driver of earnings expectations) rather than investment performance. Furthermore, to the extent asset gathering by the manager is successful, strategies that formerly delivered excess return tend to move up-market into more commoditized products to maintain scale.

Second, the liquidation of ownership interests through the IPO and subsequent issuances remove financial incentives for key senior management members who formally had a larger portion of their personal compensation tied to carried interest income driven by investment performance.

Dashboard Metrics

In addition to the pitfalls we have identified, there are four key dashboard metrics we believe are worthy of tracking to monitor your risk; yield, leverage, seniority and covenants. These can be tracked over time and each investor can set their tolerance for limits. However, over time if you see your yield and concentration of first lien dropping with leverage climbing and the cov-lite indicator flashing then you may need to reevaluate your allocation plan to this particular vehicle.

What's Important?

Exemplary Credit Portfolio Dashboard Metrics

Security	*Example Target*
First Lien (% Total)	> 80%
Second Lien (% Total)	< 15%
Unsecured (% Total)	< 10%
Seniority	
Average Loan Attachment Point	< 1.0x
Average Loan Detachment Point	< 4.0x
Risk-Adjusted Return	
Average Loan Duration	< 4.5 years
Average Spread	> 700 bps
Average Yield	> 10.0%
Duration Wtd. Average Call Protection	> 1.5%
Creditor Protections	
Average Number of Maint. Covenants	> 2.5
Average Covenant Cushion to Base Case	< 25.0%

Source: Exemplary. Tree Line Management.

Parting Thoughts

Racing to the Summit

With the confluence of exogenous factors acting to push investors farther out on the risk-spectrum in search of adequate yields – including central bank policy, shifting global demographic landscapes, and growing funding gaps for holders of long-term liabilities (pensions and insurance companies) – in combination with perceived unsustainable outsized valuations for publicly traded asset classes, the explosion of investor interest in high-yielding middle market private credit securities should not come as a surprise to many investors. However, the mechanisms by which comprehensive risk exposure is expressed in private credit markets can often be opaque, even to experienced and astute investors, with critical matters of security, priority, covenants, and other creditor rights (often negotiated on an individual basis, creating a wide spectrum of risk profiles) being leveraged as competitive differentiators within an increasingly crowded landscape.

We believe the combination of continued growth in allocations to private credit strategies and manager incentives to reach scale (and deploy rapidly in the case of public fund managers) has fostered a highly issuer-friendly environment in the Upper Middle Market and Middle Market where capital can be deployed in larger increments. Furthermore, given the fund-level limitations on managers to continue to reduce yields (hurdle rates), we believe competitive forces are being increasingly expressed in the form of weak structures and foregone creditor protections as asset yields reach their economic floors for these managers. Given these dynamics, we view the Upper Middle Market and Middle Market as over-extended and near (at) its peak.

A Patient Approach on the Path Less-Traveled

The Lower Middle Market, by contrast, is characterized by a significantly larger pool of issuers and limited competitive landscape driven by the challenges (for managers) associated with reaching economic scale. As such, the Lower Middle Market has yet to see broad-scale proliferation of cov-lite structures while continuing to offer a meaningful yield premium at lower leverage levels. While perceived risks associated with investing in smaller businesses along with limited transparency into historical credit performance statistics can act as a deterrent to investors considering Lower Middle Market strategies, we believe a fundamental analysis of key risk metrics (leverage, priority, security, covenants) provides compelling evidence that the Lower Middle Market clearly provides alpha opportunities to prudent managers.

It can be easy to grow complacent in a market characterized by historically low default rates and a benign macroeconomic landscape, but it in our experience it is the prudent investor that relies on fundamental analysis and capital preservation that avoids being trampled as the market stampedes down from the summit toward safety below the tree line. Or, to take more simply from Warren Buffet, "In order to succeed, you must *first* survive."

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