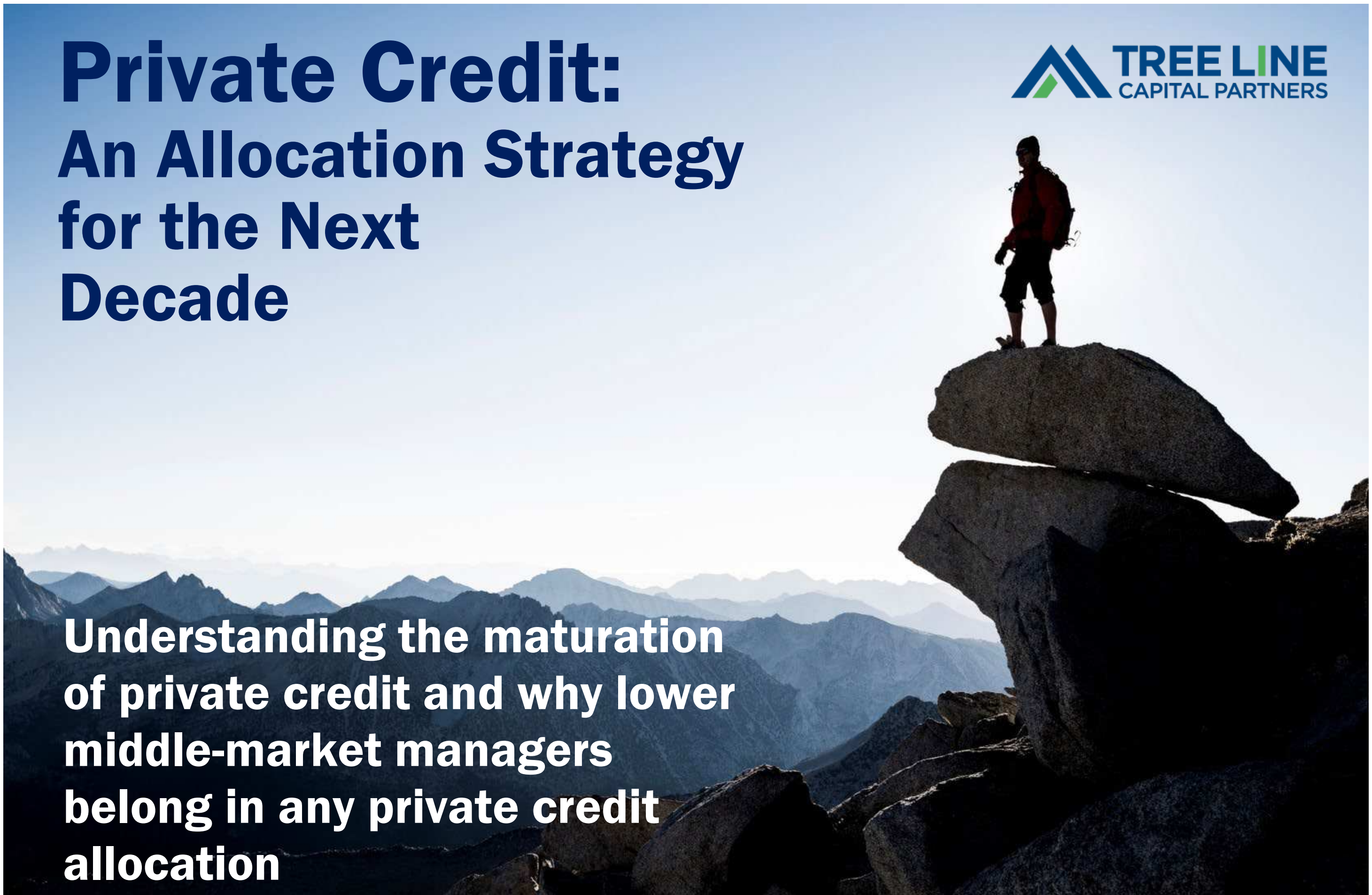


Private Credit:
An Allocation Strategy for the Next Decade

Understanding the maturation of private credit and why lower middle-market managers belong in any private credit allocation

Private credit has experienced tremendous growth over the last 20 years and has become a main stay in institutional portfolios. The strategy gathered momentum in the mid-2000's before the Great Financial Crisis took the wind out of most sails, at least temporarily. What followed can only be described as explosive growth where private credit platforms filled in for what the banks left behind. For years, private credit managers would point to massive bank consolidations and exits leaving a prime opportunity to capture alpha. This pitch, compounded by the hunt for global yield, sent private credit and specifically direct lending on a significant growth run which resulted in $1 trillion in assets under management by 2020. However, along the way the asset class has matured, and within the market's largest segments even commoditized.

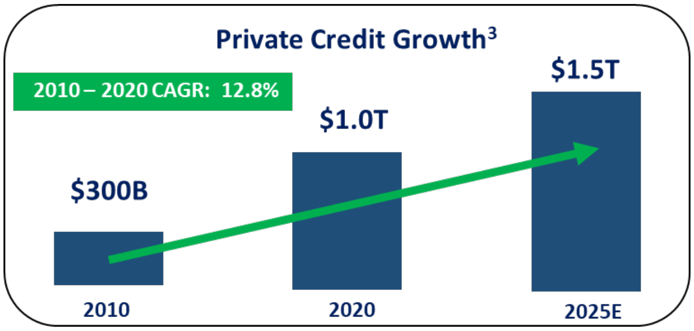
As we prepare for the next decade of private credit, the demand for yield remains, but the maturation of the asset class requires a closer examination of current trends. The analysis performed just a few years ago may be stale in a market that requires segmentation to keep pace with the evolving opportunity set. While the overall results of 2020 reinforce the resiliency of the asset class, stark differences have surfaced between the upper middle-market, the middle-market, and an emerging lower middle-market. With 53% of all private credit capital raised in 2019 going to 20 managers[1], commoditization has dominated the upper middle-market and replaced any notion of capturing alpha for investors. The lower middle-market, however, has emerged as a compelling alternative within the asset class having benefited from significant private equity growth and an underserved market. Niche and lower middle-market strategies remain overlooked with too many investors concentrated up market with an outdated playbook. With critical performance data in from 2020, there is a compelling case to be made to investors to reassess allocation strategies. The next decade will require a shift in strategy should investors want to maintain a balanced approach to private credit investing.

[1] PitchBook, as of Mar-2020

A Private Credit Growth Story

A look at how the market has evolved, commoditized, and given life to new segments.

Private credit has experienced tremendous growth since the Great Financial Crisis. The asset class has grown from $300 billion in 2010 to $1 trillion in 2020 and is projected to reach $1.5 trillion by 2025[2]. The growth is easily understood as global yields have been historically low and banks have exited in size following the Great Financial Crisis. However, it is the rapid evolvement of direct lending that interests us. Market segments, products and players have changed dramatically over the last two decades. The following summarizes six key periods in the growth and evolution of direct lending over the past 20 years.

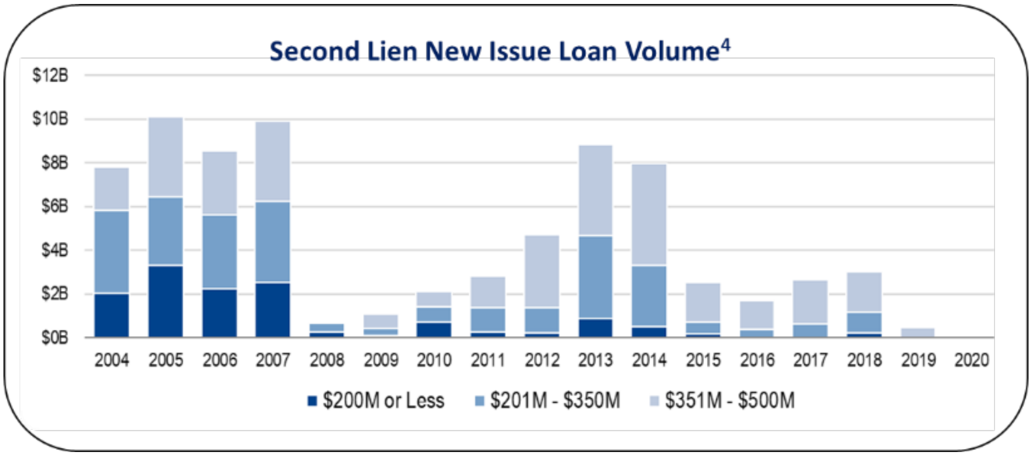


Formative Years (2000 – 2003)

Direct lending primarily consisted of middle-market players executing a direct coverage model and large banks leading syndicated high yield structures. A handful of direct lenders dominated middle-market lending and reciprocated deal flow through club syndications. The two-tranche senior & mezzanine structure was at its peak utilization with very attractive levels of leverage at ~3x senior and 4-4.5x total.

Second Lien Surge (2004 – 2007)[3]

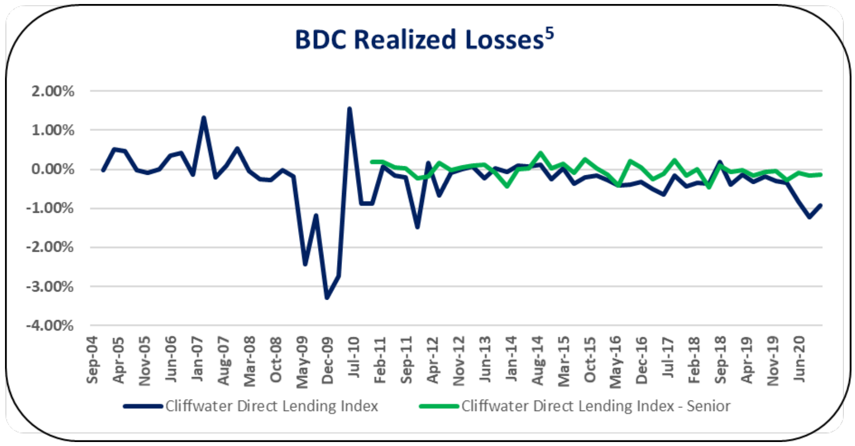
In 2004 and 2005, the proliferation of second lien changed capital structures and accelerated growth with significant demand from institutional investors and collateralized loan obligations. The surge in demand began to drive leverage higher and overall cost of capital lower with second lien lenders displacing traditional mezzanine investors. In response to expanding institutional demand for higher-yielding corporate credit assets, corporate balance sheets became more complex (via multi-tranche secured debt structures) laying the groundwork for the expansion of private lending vehicles (such as BDCs) and the emergence of structured products (such as CLOs), further accelerating capital formation and expanding demand from the traditional large corporate market into the middle market. The lower middle-market had yet to meaningfully develop across private credit or equity leaving most small companies under or unbanked.



[2] PitchBook
[3] S&P/LCD

Great Financial Crisis (2008-2009)

The Great Financial Crisis caused volatility across virtually all market segments and all but eliminated the use of second lien. A study of business development company ("BDC") losses during this two-year period shows realized losses of 7.7%[5], higher than the next six-year period combined, in part driven by BDCs broad participation in second lien loans. Three themes would begin to set the tone for capital preservation and outperformance as the data came in following the Great Financial Crisis. Senior structures, covenants and sector selection would prove to be the differentiating factors when contrasting one private credit portfolio to the next. While a largely benign credit cycle followed this period, BDCs that focused on primarily senior lending outperform the broader index of all BDCs since the data was first tracked by Cliffwater in December 2010. The advantage for senior lenders shows up again in the face of the pandemic only recording (0.7)% in realized losses versus all BDCs generating (3.3)%[4]. The biggest development for private credit during this period would ultimately be the retrenchment of banks through closure and consolidation, setting the stage for significant post-crisis growth in public and private credit vehicles.



Post-Crisis Growth (2010-2014)

Private credit managers capitalized on banks pulling back, or out, of the lending business. A chart used in virtually every private credit presentation 10 years ago highlighted the consolidation trend. The ~10,000 commercial banks in existence in 2002 had fallen by 40% to ~6,000 in 2014[5]. Establishing a BDC under the 1940 Act was a vehicle of choice. Assets under management by BDCs tripled from 2011 to 2015 rising from $25 billion to $75 billion with growth marching on to reach $130 billion[6] in 2020. This growth only represents a portion of the lending capacity that was built by private credit platforms as private funds and separately managed accounts were formed with similar success as the asset class was on the rise.

Commoditization & the Lower Middle-Market's Rise (2015-2019)[7,8]

Over five years into an economic recovery and private credit continues to attract record amounts of capital, but most of the capital is flowing to the largest managers. In 2019, 53% of the capital raised went to the top 20 managers. While institutional investors have generally formed a pack mentality through private credit's maturation, there have been significant shifts in key credit terms and market segments which are worthy of both consideration and allocation. Upper middle-market private credit managers capitulated to a commodity product and slashed management fees. Managers began to feel real pressure to deploy to keep up with fundraising, leading to a consistent erosion of terms year-after-year. To counter a decline in fees, managers went all in on AUM growth. CLO issuance became a tool of choice to embed more leverage in fund structures to off-set

[4] Cliffwater Direct Lending Index website, as of May-2021
[5] Bankingstrategist.com
[6] Houlihan Lokey Quarterly BDC Report
[7] Prequin
[8] PitchBook, as of May 2021

declining asset yields. These trends began to shift the value proposition to the manager over the investor in certain segments of the market.

Meanwhile, the lower middle-market was embracing significant growth and benefiting from highly stable credit structures and metrics. To understand the emergence of the lower middle-market is to understand the focus private equity placed on this market segment. Since 2016, $176B has been raised across over 800 private equity funds with less than $500M[9]. Strategies were aimed at attractive valuations and buy & build opportunities within the lower middle-market. This has delivered an ever-growing opportunity set that simply did not exist prior to 2010. This is a unique dynamic where private credit dollars are flooding the top of the market, while private equity is showing significant signs of growth in the lower middle-market creating a true supply-demand imbalance.

53%[8]

% of Capital Raised in 2019 Going to Top 20 Private Credit Managers

$176B[9]

Raised in Private Equity Funds < $500M between 2016 - 2021

COVID-19 Pause & Growth (2020-2021)

2020 delivered the world an unforeseen event in the COVID-19 pandemic. This was the big test investors were waiting for to assess private credit's durability. Substantial distressed capital was raised in 2020 preparing for the demise of direct lending, but the durability of the strategy and the shift into senior secured one-stop and unitranche positions gave distressed buyers little to work on. Most private credit managers focused on direct lending will describe a halt in origination beginning in March through June of 2020. Lenders who were in a liquid and healthy position began reengaging in Q3 2020 with borrowers in sectors proving to be "COVID-durable". By Q4 2020, direct lenders were issuing at record levels and this has carried into 2021. 2020 now looks like an anomaly as the current environment looks more like the peak environment of 2019. The resilience seen throughout COVID is reassuring but key credit metrics deserve a close look across various segments of the market to best position a portfolio for the next phase of growth.

Key Metrics – Then and Now

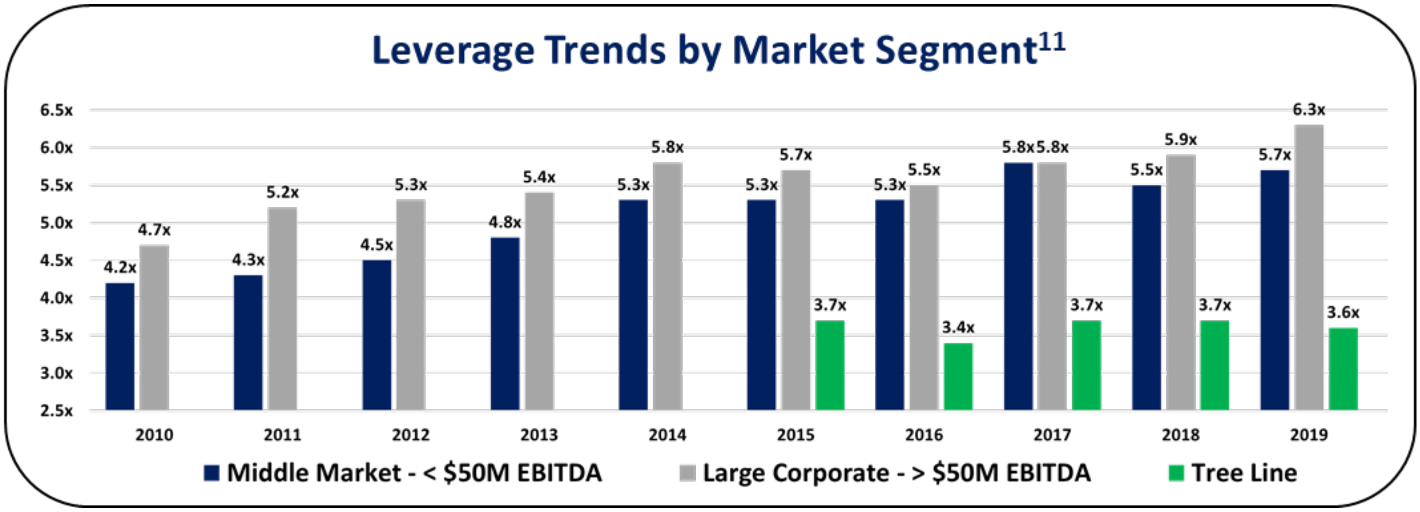
Understanding the maturation of private credit growth is best viewed through its change in terms.

The fundamentals of any maturing asset class are likely to change over time and private credit is no exception. Underlying portfolio construction has shifted dramatically over the past 10 years with respect to key credit fundamentals. An examination of leverage and covenant trends shows upper & middle-market managers assuming an increasing level of risk while borrowers benefit further from loose documents that often understate risk through highly structured credit terms and baskets.

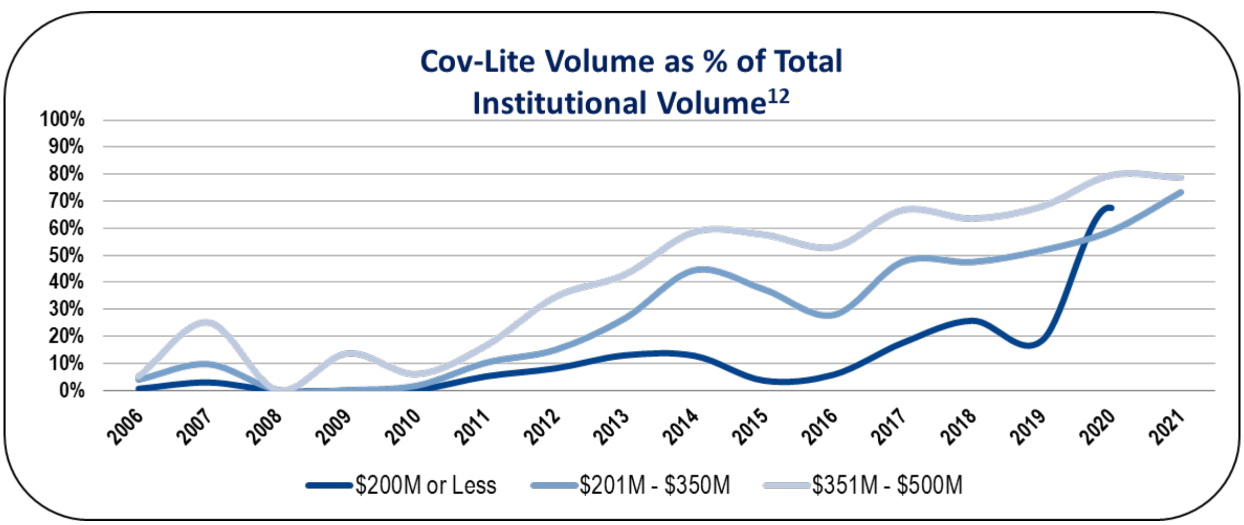
[9] PitchBook

Leverage & Covenants

A crowded market makes for a frothy market and leverage and covenants have been two of the most observable sacrifices upper & middle-market lenders have made to keep pace with deployment. As the private credit market has enjoyed significant growth since 2010, leverage has consistently increased to large corporate borrowers with greater than $50 million in EBITDA and middle-market borrowers with less than $50 million in EBITDA[10]. Both segments have added an additional half turn of leverage since 2015 and run one-to-one and a half turns higher than 2012.



While similarly high leverage levels existed in 2007, cov-lite structures did not. Cov-lite loans essentially eliminate financial covenant requirements of a borrower with only a debt incurrence test in place which limits the maximum amount of debt permitted. This is a highly permissive structure as it sidelines lenders from acting until a capital "D" default occurs which is often triggered by a payment default. Cov-lite structures have shown inferior recovery rates versus first lien loans with covenants likely due to the delayed ability of a lender to act.[11]



[10] Lincoln Quarterly Market Report
[11] S&P/LCD as of May 2021

Credit Document Quality

Leverage and cov-lite trends are easily observable but additional risks lurk deep within the credit agreement negotiated between a lender and borrower which can exacerbate the trends outlined above. For instance, a credit agreement is filled with defined terms and baskets that get heavily negotiated between sponsor or borrower and lender. The definition of Adjusted EBITDA historically meant simply accounting for one-time adjustments such as transactions fees or an owner's compensation who is exiting the business. Adjustments were limited to true one-time events where the costs immediately were excluded from the business or there was a clear end date in site to an expense. This definition has become a target for private equity firms to request a long list of adjustments including forward looking synergies that are anticipated to generate a savings in the future. The synergy adjustment is often targeted at 25% of EBITDA in the middle-market. The result is that actual EBITDA is overstated by this amount which understates leverage. If there is any disruption to the execution of these synergy related initiatives, whether it be idiosyncratic or macro-driven, the lender will be holding a loan to a company with materially less EBITDA and materially more leverage. This occurring on top of historically record high levels of leverage is where there is cause for concern.

Tree Line's LMM Summary[13]

$2.1B

Issued Commitments by Tree Line to Lower Middle-Market Companies (Since Oct '14)

3.0x	**0%**
Weighted Average Net Leverage	Cov-lite Loans

The lower middle-market, as seen through Tree Line's experience where we have issued over $2.1 billion[12] in commitments to finance over 150 companies since October 2014, is a vastly different market. Since inception, leverage has remained historically low, where our weighted average leverage has been below 3.7x , and the portfolio has maintained zero percent exposure to cov-lite loans or synergy-related adjustments. It's simply a market that resembles the discipline of the early 2000's, yet its compelling attributes have been lost in the upper & middle-market due to rapid growth and commoditization.

Performance & What the Data Tells Us

2020 provides investors with critical data examine portfolio performance across managers.

The current environment provides a unique opportunity to assess performance by manager and market segment. While the markets may have enjoyed a swift recovery, it would be wise to look closely at performance, and more importantly, what drove performance and differentiation across private credit managers.

Key Performance Indicators

Seniority, Covenants & Sector Selection[13],[14]

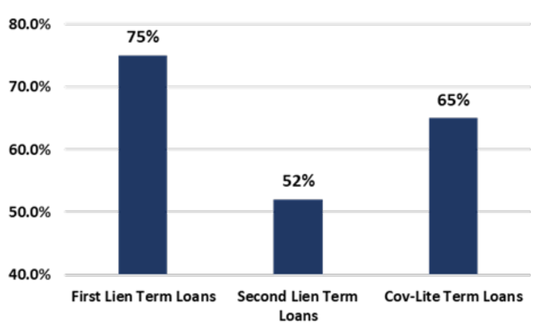
First lien terms loans have outperformed second lien and cov-lite term loans for over 30 years. First lien term loan recoveries are 75% versus that of second lien and cov-lite at 52% and 65%, respectively. On page 3, the BDC

[12] Tree Line portfolio performance as of May 2021
[13] S&P/LCD
[14] S&P/LCD – Tree Line database

realized loss history also illustrates the consistent outperformance among senior focused BDCs versus all BDCs over the past 10 years with a noticeable gap in 2020 as a result of COVID.

Similarly, sector selection has unsurprisingly been a key indicator of performance. While most private credit platforms strive to achieve a diversified portfolio, participation in all sectors can come at a cost. We continue to see the merits of tech-enabled services, software and healthcare services throughout two major economic events in the past 20 years. While oil & gas, retail and exposure to commodities and discretionary spending continues to cause pain in private credit portfolios where there is little room for error to maintain target returns. Tree Line's team runs quarterly research tracking all BDC deals marked below 80 percent of cost to create a "bad deal database". We study this data to understand current trends across the market even if they do not exist within our own portfolio. Oil & gas has consistently wreaked havoc on private credit portfolios over the past 20 years along with retail exposure over the past five years. Simply avoiding these two sectors has proven to be a differentiator. Larger lenders with mega-funds or lenders tempted to take the additional return to participate in these storied sectors often trail the pack in terms of performance. Sector discipline is a key ingredient to a private credit firm's success and being selective and nimble, as can often be the case in the lower middle-market, creates an edge.

Bank Loan Recoveries (1987-2019)[14]



BDC Bad Deal Database (Q3 2020)[15]

Top 5 Underperforming Sectors	% of BDC Deals Marked Below 80	# of Total Deals
Retail Food & Drug	35.9%	64
Oil & Gas	28.7%	341
Educational Services	26.3%	171
Entertainment & Leisure	25.6%	305
Steel	25.0%	20

Total Return Analysis[15]

Total Return performance is an important tool that investors can use to strip down performance across managers and simply look at how good a manager is at generating and protecting yield (see Total Return formula on table below). The historical data shows senior focused strategies meaningfully outperform strategies willing to lend in second lien or subordinated structures. The Cliffwater Direct Lending Index and the Cliffwater Direct Lending - Senior Index support the same conclusion. The CDL-SI, which is comprised of senior focused BDCs, outperforms the broader index comprised of all BDCs in the most recent distressed period.

Total Return Index Comparison[16]

As of 12/31/2020	1 Year	3 Year	5 Year
Cliffwater Direct Lending Index	5.5%	7.5%	8.5%
Cliffwater Direct Lending - Senior Index[20]	7.3%	7.6%	7.8%

*TOTAL RETURN measures the unlevered, gross of fees performance.

Gross Investment Income +/- realized gains/(losses) +/- unrealized gains/(losses)/Average Amortized Cost of Portfolio

[15] Cliffwater Direct Lending Index website, as of May-2021

Dispelling the Myth

Upper & middle-market platforms will stand by a fundraising narrative that claims when the cycle turns you want to be lending to the largest companies, arguing they are the most durable. The flaw here is that the argument places a singular focus on size and lacks an appreciation for key performance indicators that influence performance and returns. As we've shown, studying credit data over a 20-year period suggests that seniority in structure (i.e. first lien versus second lien), covenant structure and sector selection remain critical indicators of success. There is no data that we have seen that would suggest the size of a borrower alone is a meaningful indicator. Further, this argument fails to account for the significant private equity growth that has occurred in the lower middle-market producing a sophisticated and diverse market for lenders to target. The private credit asset class has evolved and what you diligenced in 2015 is not necessarily what is in your portfolio in 2021.

If we look at default rates over the past 20 years, the data concludes that companies with less than $50M of EBITDA outperform companies with greater than $50M of EBITDA[16]. We build further upon this finding through our own experiences. Tree Line manages a $1.1B portfolio of senior secured loans with an average EBITDA of $16M. Throughout COVID, the portfolio experienced zero payment defaults, zero bankruptcies, had no rescue financings and 100% of borrowers have maintained cash interest payments.

Leveraged Loan Annualized Default Rates (2001-2020)[17]

	Defaults/Total Outstanding	
	Large Corporate >$50M EBITDA	Middle-Market <$50M EBITDA
5 Year Average	2.1%	1.9%
10 Year Average	1.9%	1.4%
20 Year Average	2.7%	1.9%

Tree Line has built its platform on the basis that the fixation on size is flawed and casually overlooks critical credit metrics that historically have proven credit quality is more valuable than size (Read our white paper: *Moneyball for Investors Seeking Yield* for an in-depth review of this argument. www.treelinecp.com).

We have taken a data driven approach that targets a specific segment of the market where we can combine yield with discipline. The lower middle-market, often larger than many believe, has allowed us to build a portfolio with a weighted average enterprise value of $130 million and a weighted average loan to value of 39%. The consistency of our credit metrics and strong performance throughout the pandemic provides compelling data that should at a minimum pique the curiosity of investors in the current environment.

Summary: Portfolio Allocation Strategy for the Next Decade

Building a portfolio allocation strategy based on the facts, present trends and the next decade of private credit.

Institutional investors have evolved right alongside the growth in private credit. Private credit once stuck between fixed income and private equity teams, now receives dedicated resources with strong acumen for the asset class. However, we believe the strategies of the last decade will need to be reevaluated to protect what is most appealing about this asset class, being yield and capital preservation. The next decade will require taking a market segmentation approach. Each segment will certainly serve a purpose in a portfolio, after all the asset

[16] S&P/LCD, as of May-2021

class has proven its durability, but simply consolidating allocations to the largest end of the market as we have seen in recent years will likely underperform investors willing to allocate to niche segments.

Private credit's growth shows no sign of relenting. The largest credit managers will continue to attract record levels of capital so there is no reason to conclude the erosion of terms will subside in the crowded segments of the market. Over time, however, the convenience to investors of concentrating allocations in one segment will be outweighed by the credit discipline of the underlying loan portfolio one is investing in. The lower middle-market, which has not only shown its stability in credit metrics over the past five years but also its ability to outperform the broader market is difficult to overlook. Private equity growth is a driving force that has brought credibility to this market segment that did not exist a decade ago. We believe the lower middle-market will gain much attention in the next decade as investors seek to rebalance their portfolios prioritizing the credit fundamentals and the merits of capital preservation that initially attracted them to the asset class.

The compelling data available following two major economic events allows us to set aside narratives and focus on the facts. Investors willing to acknowledge the maturation of the asset class, study the historical data and look carefully at current portfolio trends across both managers and market segments will be well positioned to reshape their portfolio and win in the next decade.

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About Tree Line

Tree Line Capital Partners is a private credit asset management firm focused on direct lending to the lower middle market. The firm provides first lien term loans, unitranche term loans and equity co-investments to lower middle market borrowers with between $3M-$30M of EBITDA in North America in transaction sizes up to $150M. Tree Line currently manages $1.5B in investable capital, and has completed over 150 transactions for acquisitions, recapitalizations, refinancings, expansion projects and other growth capital needs. Tree Line's team has extensive direct lending experience spanning multiple economic cycles and has generated significant repeat investment opportunities from the private equity community through reliable execution coupled with a direct relationship approach. Tree Line is headquartered in San Francisco with offices in New York, Los Angeles and Austin.

Visit www.treelinecp.com to learn more.

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