
EXPERT COMMENTARY

Understanding just how private debt has matured as an asset class demonstrates why lower mid-market managers belong in any allocation, argues Tom Quimby, managing partner with Tree Line Capital Partners



Private credit: An allocation strategy for the next decade

Private credit has experienced tremendous growth over the last 20 years and has become a mainstay in institutional portfolios. The asset class gathered momentum in the mid-2000s 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 increased assets from \$300 billion in 2010 to

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\$1 trillion by 2020. However, along the way the asset class has matured, and within the market's largest segments even commoditised.

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 understand the evolving opportunity set. While the overall results of 2020 reinforce the resiliency of the asset class in the face of economic

distress, stark differences have surfaced between the upper middle-market, the middle-market, and a growing lower middle-market. With 53 percent of all private credit capital raised in 2019 going to 20 managers, according to PitchBook, commoditisation of the upper middle-market is a consequence. It is most observable through the continued rise of leverage and use of cov-lite structures, while additional risks lurk in credit agreements as terms continue to loosen.

The lower middle-market, however, has emerged as a compelling alternative within the asset class having benefitted from significant private equity growth and a stable credit environment. Niche and lower middle-market strategies

remain overlooked with too many investors concentrated up market with an outdated playbook. We are beginning to see that change.

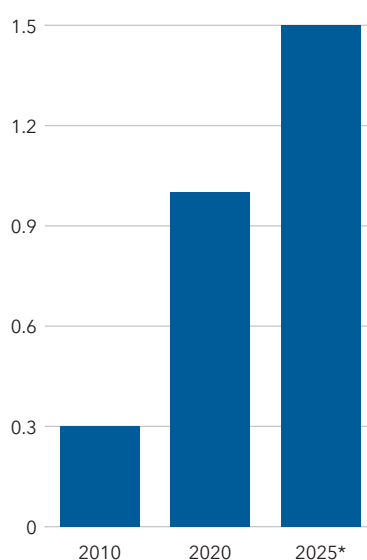
With critical performance data in from 2020, there is a compelling case to be made to investors to reassess allocation strategies and segment the asset class in a similar manner as private equity. The next decade will require a shift in mindset should investors want to maintain the disciplined approach to private credit that initially attracted them to the asset class. 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.

Lender discipline

First lien term loans have outperformed second lien and cov-lite term loans, looking at bank loan data for over 30 years. First lien recoveries are 75 percent versus that of second lien and cov-lite at 52 percent and 65 percent, respectively. The Cliffwater Direct Lending Indices also indicate superior performance in 2020 for BDCs with a senior-only focus. Senior focused BDCs delivered a total return in 2020 of 7.3 percent compared to general strategies of 5.5 percent. To take less risk and outperform by 1.8 percent is meaningful to any credit return.

Similarly, sector selection has unsurprisingly been a key performance driver. While most private credit platforms strive to achieve a diversified portfolio, participation in some sectors can come at a cost. We have seen the merits of tech-enabled services, software and healthcare services throughout two major economic events in the past 20 years. Meanwhile, oil and gas, retail, exposure to commodities and discretionary spending continue to cause pain in private credit portfolios where there is little room for error to maintain target

The explosive growth of private credit (\$trn)



*estimate
Note: 2010-20 CAGR 12.8%
Source: S&P/LCD

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 and 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.

Lenders able to focus on senior secured, full covenant lending in cycle-durable sectors throughout a cycle have a real edge. Lower middle-market lenders maintain this advantage with smaller fund sizes and a less crowded market. At Tree Line, our portfolio is 98 percent senior secured with a weighted average net leverage of 3.0x, cov-lite exposure of 0 percent and no exposure to highly volatile sectors, such as oil and gas and retail.

Upper middle-market platforms will stand by a fundraising narrative that 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. 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 a view formed in 2015 may not be relevant in 2021.

If we look at default rates over the past 20 years, S&P/LCD data concludes that companies with less than \$50 million of EBITDA outperform companies with greater than \$50 million of EBITDA. We build further upon this finding through our own experiences. Tree Line manages a \$1.1 billion portfolio of senior secured loans with an average EBITDA of \$16 million. Throughout covid, our portfolio experienced zero payment defaults, zero bankruptcies, zero rescue financings and 100 percent of our borrowers have maintained cash interest payments. Tree Line has 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 percent. The consistency of our credit metrics and strong performance throughout the pandemic, which is the most relevant stress test the market has had in over a decade, provides compelling data that at a minimum should pique the curiosity of investors. Those willing to examine the current trends and build an allocation strategy on a segmented approach will be positioned to outperform in the next decade. ■

Note: this article leverages data from Pitchbook, S&P/LCD, as of May-2021. For further details, see <https://treelinecp.com>