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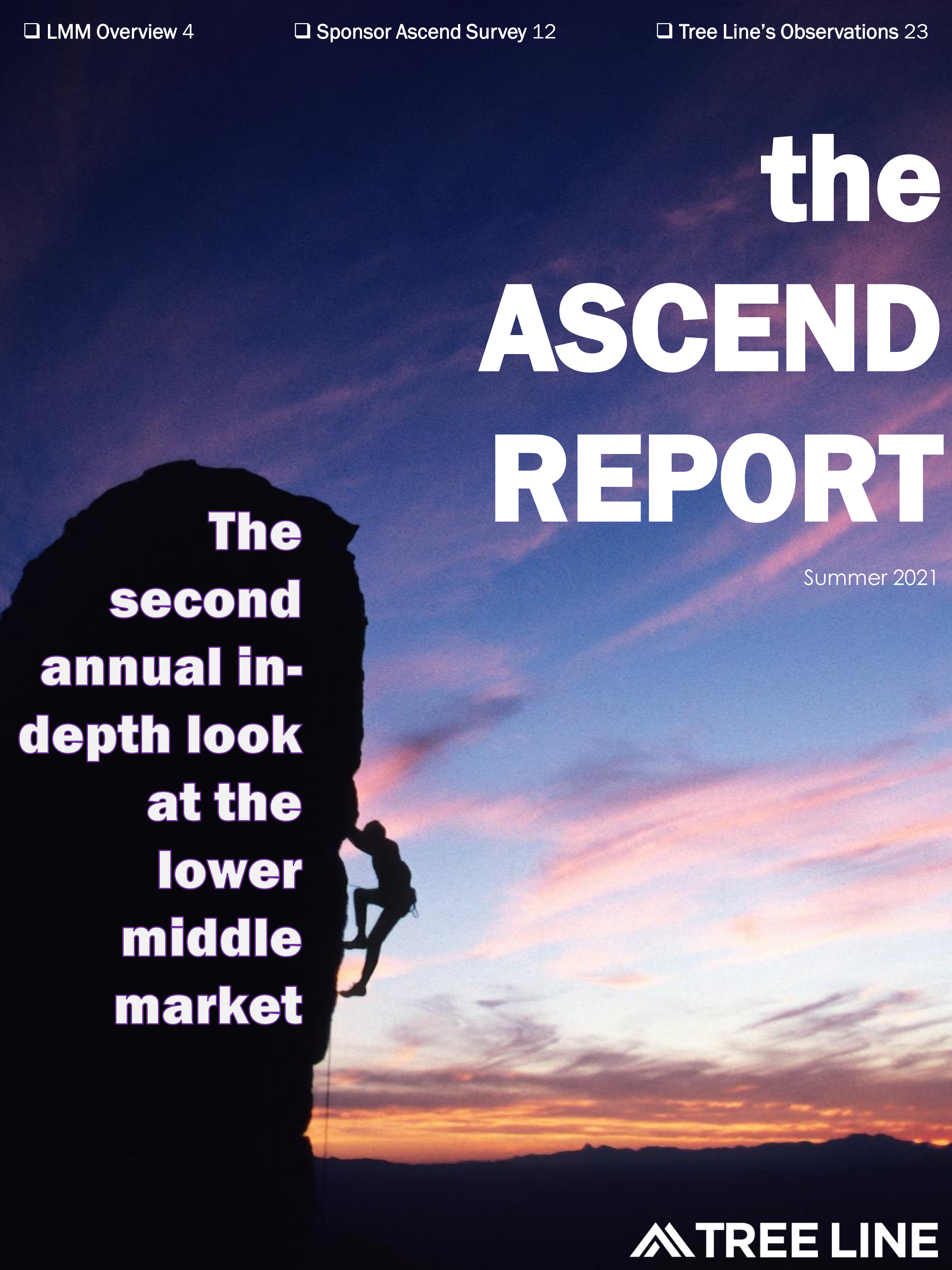
the ASCEND REPORT

Summer 2021



The second annual in-depth look at the lower middle market

TREE LINE

the ASCEND REPORT

Second Annual Report

In this Year's Report

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2021 ASCEND REPORT

Tree Line is pleased to present the Second Annual Ascend Report, which provides insight into the state of the lower middle market (“LMM”). We begin by providing an introduction to the LMM, including market sizing statistics, deal flow activity through the COVID-19 Pandemic (“COVID”), the surge of add-on acquisition activity and continued growth of LMM funds. Additionally, we present findings regarding troubled sectors, which utilizes our proprietary database that tracks business development companies (“BDCs”) public findings to highlight sectors that exhibit the highest probability of mark downs.

Following the market overview, we provide a summary of the survey of over 60 LMM private equity managers recently conducted by the Tree Line team. Private equity managers provided valuable feedback on deal activity through 2020, expectations for 2021 and changes to sector focus as a result of COVID. Participants noted that while COVID temporarily paused platform acquisitions and fundraising, the expectation is for deal activity and fundraising targets to largely stay on plan. The data from the Ascend Survey is extremely valuable and we are grateful to our sponsor relationships for participating.

The Ascend Report concludes with Tree Line’s summary of how the examined trends within the LMM have influenced Tree Line’s own investment outlook. We highlight our 2020 activity, a shift in sector focus to COVID resilient businesses and the resultant impact on the performance of our portfolio companies. Following an intense focus on portfolio management in the early days of COVID, the market has remained as active as ever and we believe 2021 will be one of the strongest, if not the strongest, deal flow years in history.

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Lower Middle Market Overview

Lower Middle Market Definition & Statistics

- LOWER MIDDLE MARKET OVERVIEW

Tree Line defines the LMM as being comprised of companies with between $3M - $30M of EBITDA, which translates to revenues of ~$10M - $100M. Private equity firms targeting LMM companies typically raise funds up to $500M with more established firms raising up to $1B.

The LMM has experienced rapid growth as there is a significant addressable set of acquisition targets and opportunities for sponsors to drive value through attractive valuations and buy-and-build strategies.

175,000

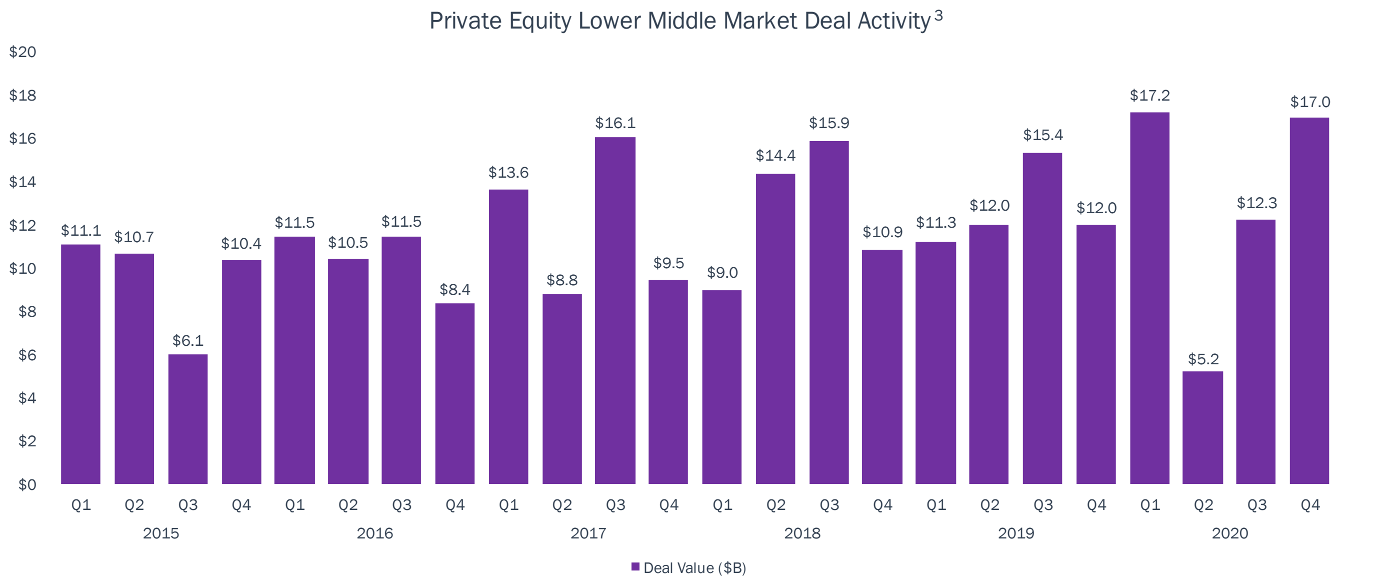
Companies with revenue between $10M - $100M[1]

951

LMM private equity funds ($50M – $500M fund sizes) have been raised in the last five years[2]

2020 Deal Activity: Pause and Growth

- LOWER MIDDLE MARKET OVERVIEW



2018-2019

- Average annual deal flow of $50B
- Relatively consistent quarter-over-quarter deployment with the maximum and minimum deal volume quarters representing $15.9B and $10.9B, respectively, from 2018-2019

2020

- Annual deal flow of $51.7B
- Q2 2020 deal flow **declined 59%** from 2018-2019 average quarterly levels
- The market re-activated in a significant manner in Q4 2020 as sponsors and lenders had significant dry powder and focused on businesses that were resilient through COVID
- **2020 deal volume of $51.7B outpaced 2018-2019 average annual volumes**

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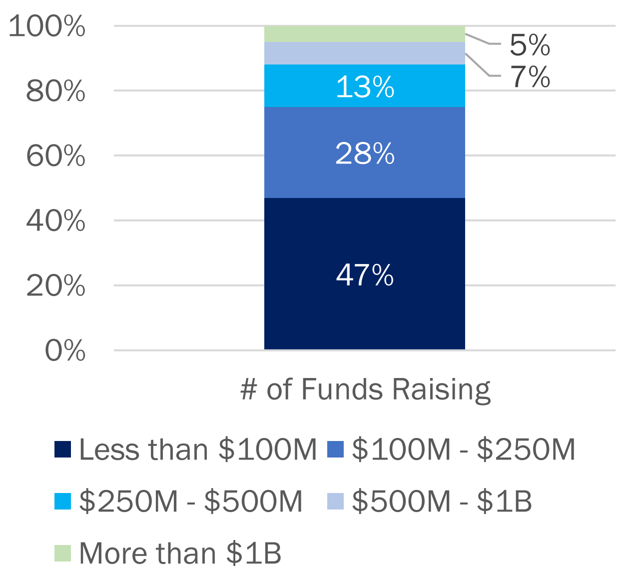
Significant LMM Sponsor Growth

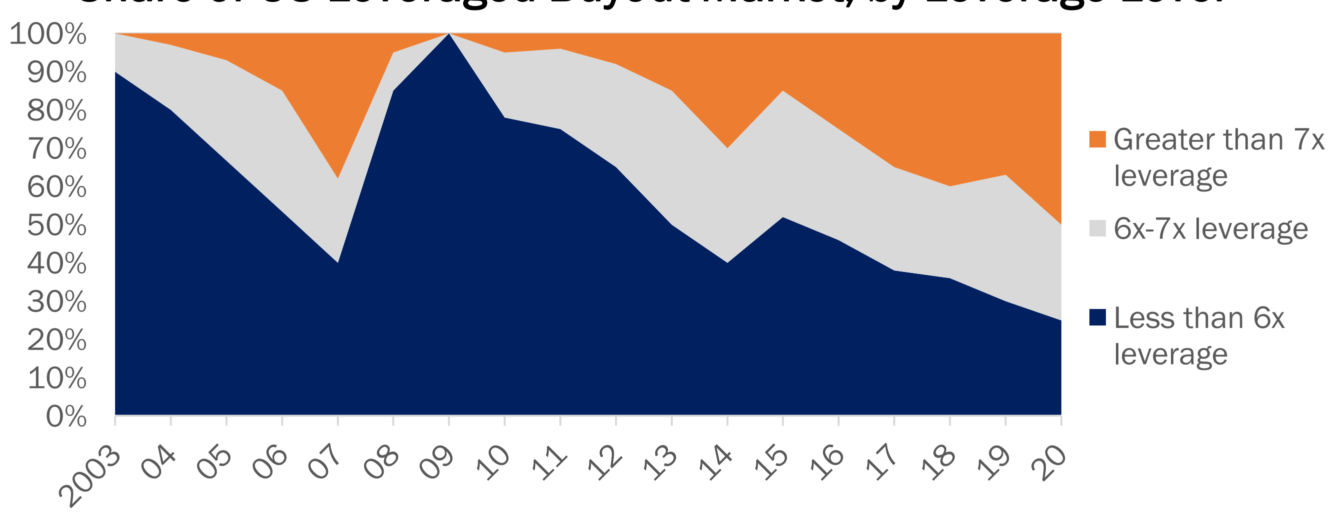
- LOWER MIDDLE MARKET OVERVIEW

Private Equity Funds in Market by Target Size[4]



- The fragmentation trend has continued in private equity as 88% of private equity funds currently in market are targeting fund sizes less than $500M (as shown to the left).
- There is a significant need for experienced LMM lenders to support the increased growth in LMM funds.
- The lender supply/demand dynamic is favorable in the LMM compared to the large market. Only eight lenders can invest up to $400M per deal and >50% of large market LBO deals utilize 7x+ leverage (as shown below).

Share of US Leveraged Buyout Market, by Leverage Level[5]

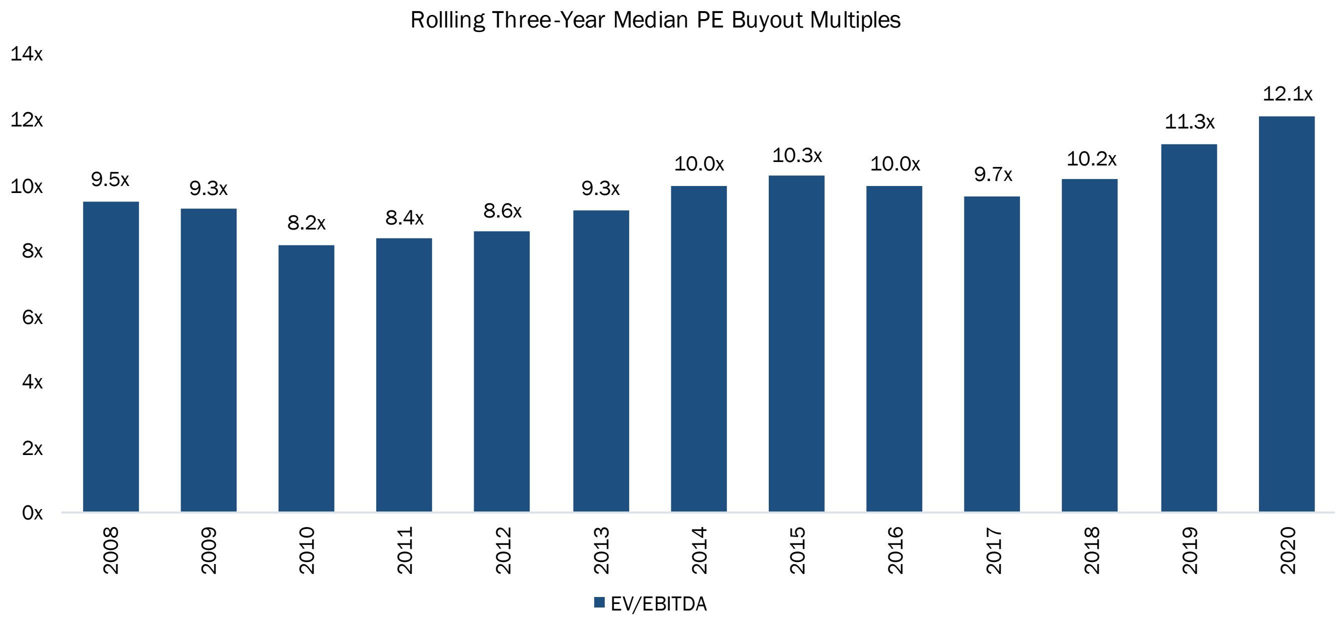


- The private credit asset class has reached $1 trillion in assets under management,[6] with most managers focused on high levered deals. Real demand from LMM sponsors exists in a niche segment.

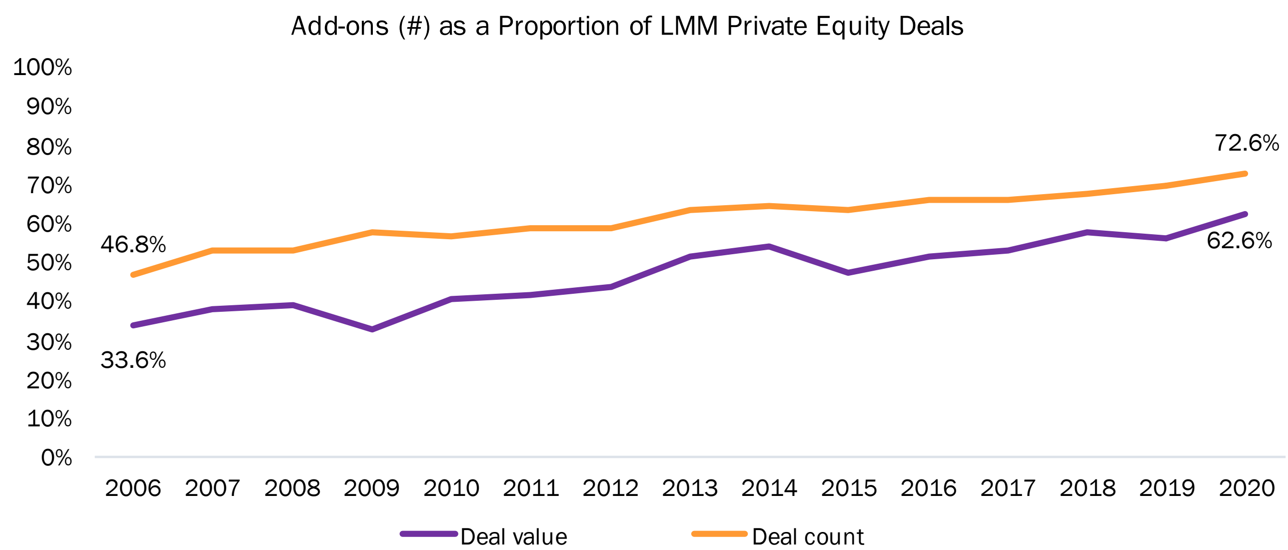
Buy and Builds Continue to Gain Steam

- LOWER MIDDLE MARKET OVERVIEW

New platform purchase multiples continuing to rise to all time highs in 2020[3]



As a result, add-on acquisitions have become a core strategy of many LMM sponsors as sponsors seek multiple arbitrage by bolting on small add-ons that drive equity value. In 2020, add-ons accounted for 72.6% of total deal count[3]



Lender Bad Deal Database: Troubled Sectors

- LOWER MIDDLE MARKET OVERVIEW

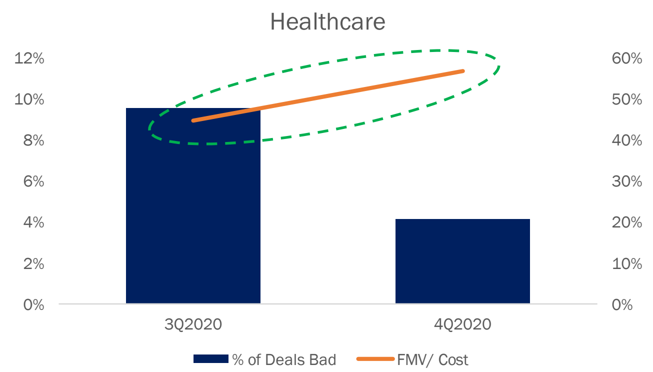
- Tree Line maintains a database of ~10,000 borrowers from public BDC filings to monitor the probability of default by sector.
- A “bad deal” is defined as a deal marked at less than 80% of fair market value (“FMV”).
- For example, of the 38 Retail Food & Drug deals published in BDC quarterly public filings, 12 deals (31.6% of total) are bad deals.[7]

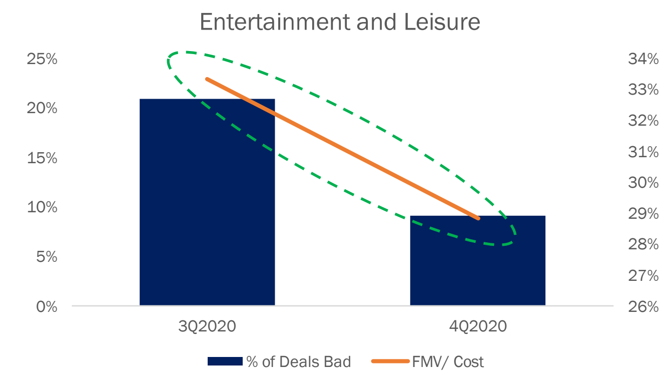
Q4'20 Filings

Probability of Markdown by Sector	Total Deals	Bad Deals	% of Total
Structured Finance - CLO	154	71	46.1%
Retail Food & Drug	38	12	31.6%
Utilities	61	12	19.7%
Steel	11	2	18.2%
Oil & Gas	240	37	15.4%
Forest Products	15	2	13.3%
Educational Services	92	12	13.0%
Metals & Mining	37	4	10.8%
Securities & Trusts	67	7	10.4%
Retailing	425	44	10.4%
Gaming and Hotels	40	4	10.0%
Entertainment and Leisure	251	23	9.2%
Manufacturing	170	14	8.2%
Home Furnishings	73	6	8.2%
Telecommunications	160	13	8.1%
Top 15 Sectors	**1,834**	**263**	**14.3%**
Other	8,111	295	3.6%
Total	**9,945**	**558**	**5.6%**

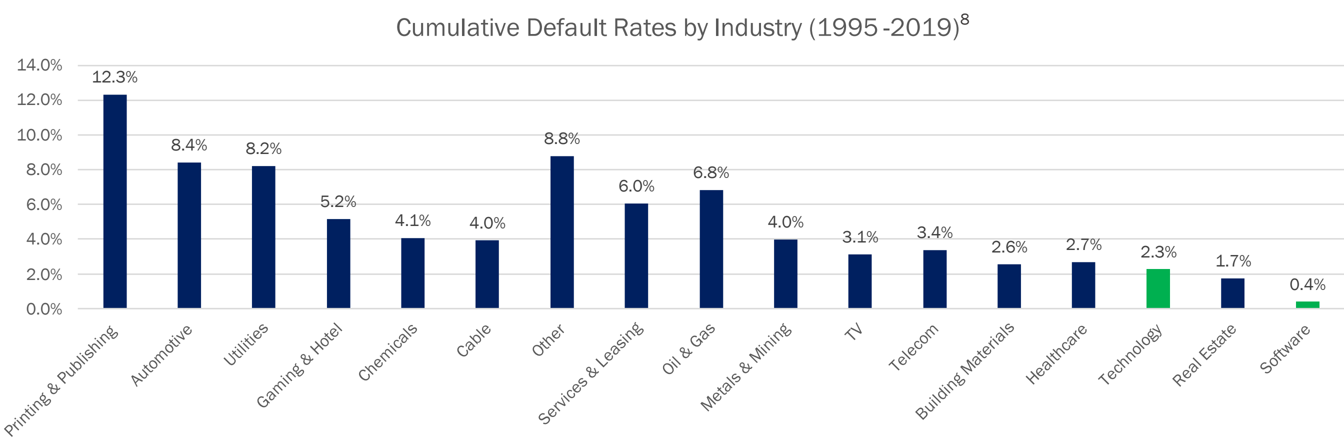
Lender Bad Deal Database: Troubled Sectors

- LOWER MIDDLE MARKET OVERVIEW





- Sector selection is critical as markdowns are widely disparate across industries. From Q3 2020 to Q4 2020, healthcare deals experienced both a decline in the % of bad deals as well as an increase in FMV/Cost from 45% to 57%. Conversely, entertainment & leisure experienced a decline in the % of bad deals, but a decline in FMV/Cost from 33% to 29%, suggesting the remaining bad deals are not trending towards recovery.[7]



- In addition to healthcare, tech-enabled services and software borrowers have shown far lower probabilities of default versus other industries. Software's key characteristics involving high customer loyalty driven by non-deferable spend, strong revenue visibility and high free cash flow conversion, have resulted in best-in-class default rates compared to other sectors.
- Software companies are unique in their ability to adapt to different economic cycles. Favorable working capital dynamics driven by upfront customer payments and asset-lite operating models result in a majority of opex being devoted to R&D and S&M, two variable features which can be adjusted according to the economic environment.
- As a result, software borrowers face fewer challenges in tough economic times such as cyclicality, customer loss, one-time revenues, and capital-intensive operating models.

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Lender Default Rates in the Lower & Middle Market

- LOWER MIDDLE MARKET OVERVIEW

Leveraged Loan Annual Default Rates (2001 – 2020)[9]

	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%

Aggressive and loose structures lead large companies to higher levels of default.

- Data showing that large borrowers outperform default rates of smaller borrowers does not exist.

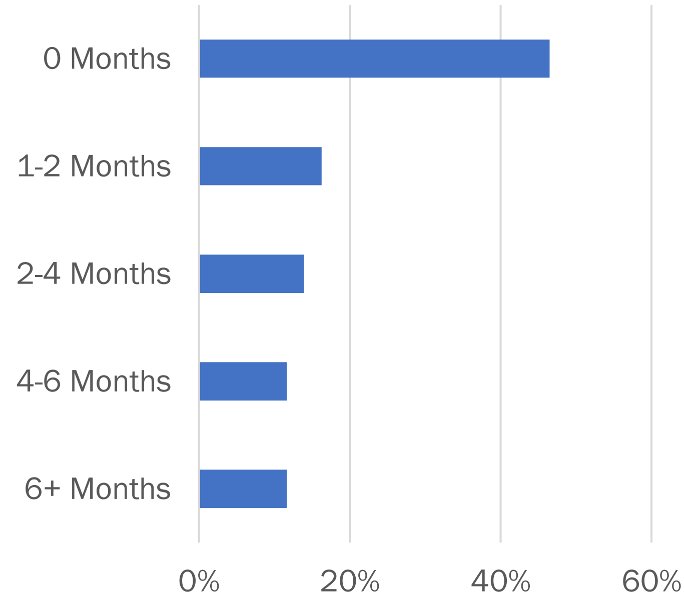
- In fact, smaller companies have shown consistently lower default rates, in part due to availability of covenants and more conservative leverage structures.

- Default rates for companies with <$50M of EBITDA have consistently underperformed companies with >$50M of EBITDA on a 5, 10 and 20-year basis.

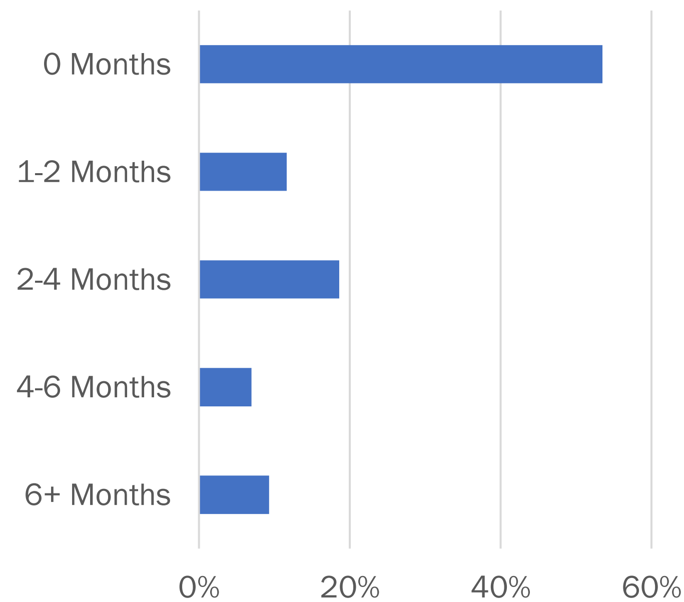
2021 Private Equity Sponsor Ascend Survey

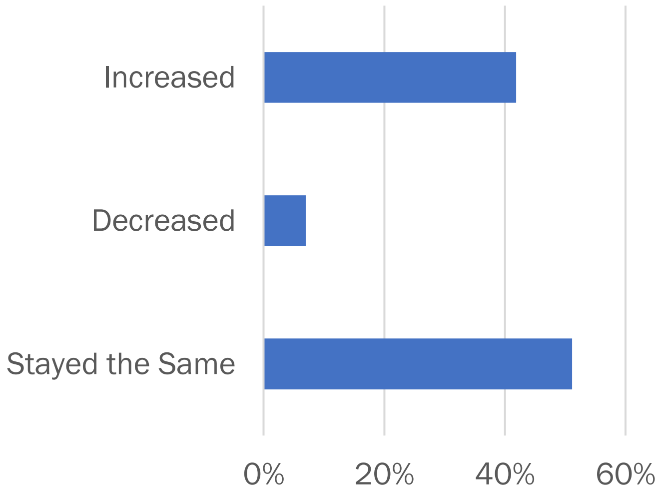
OVER 60 PRIVATE EQUITY SPONSORS CONTRIBUTED THE FINDINGS OF THE SECOND ANNUAL ASCEND SURVEY.

In 2020, how many months did you pause new platform acquisitions?

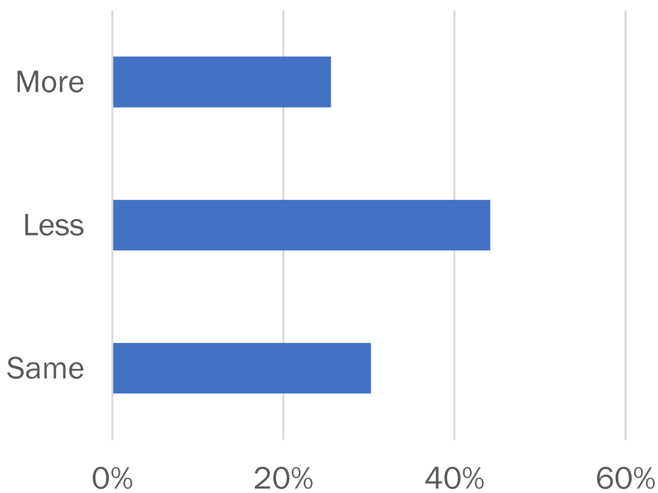


In 2020, how many months did you pause new add-acquisition fundings?

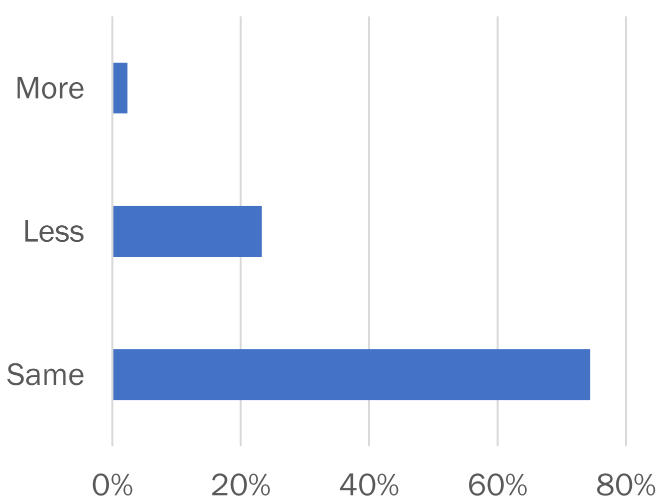




Did purchase multiples increase, decrease or stay the same post-COVID in 2020?



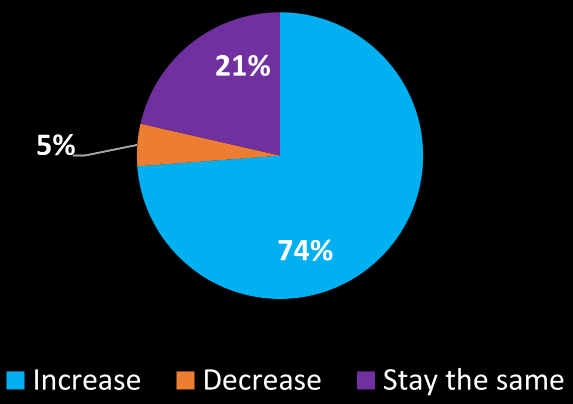
Did you deploy more, less or the expected amount of capital post-COVID in 2020?



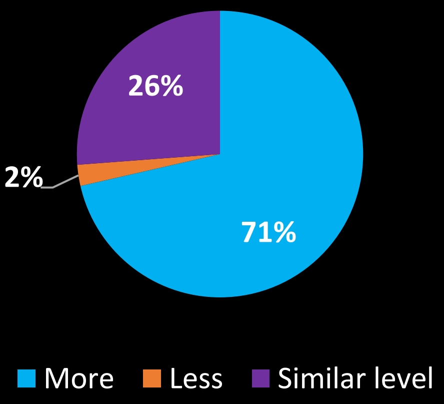
Did you use more, less or the same amount of leverage post-COVID in 2020?

▪ INVESTMENT ACTIVITY (CONT'D)

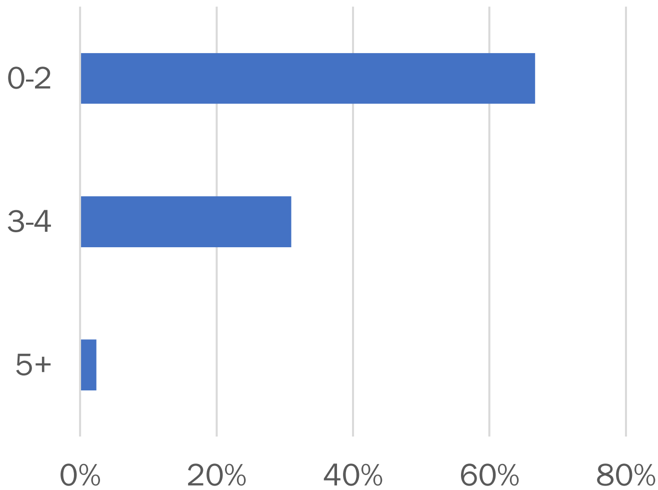
Other than industries materially impacted by COVID, do you expect purchase multiples to increase, decrease or stay the same in 2021 relative to 2020?



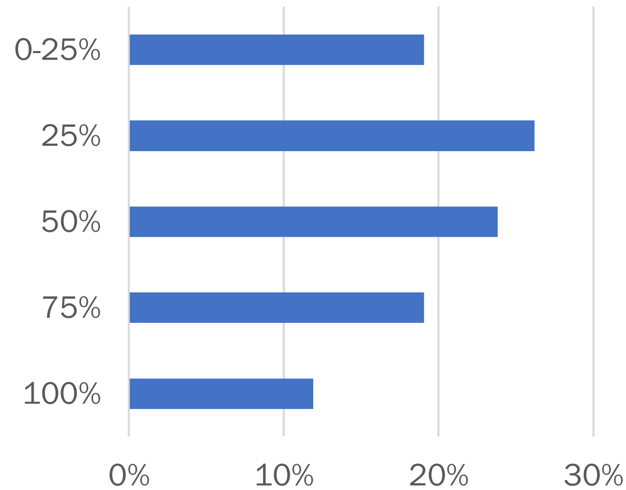
In 2021, do you expect lower middle market M&A activity (companies with less than $15M of EBITDA) to be more or less active compared to pre-COVID (FYE 2019) levels?



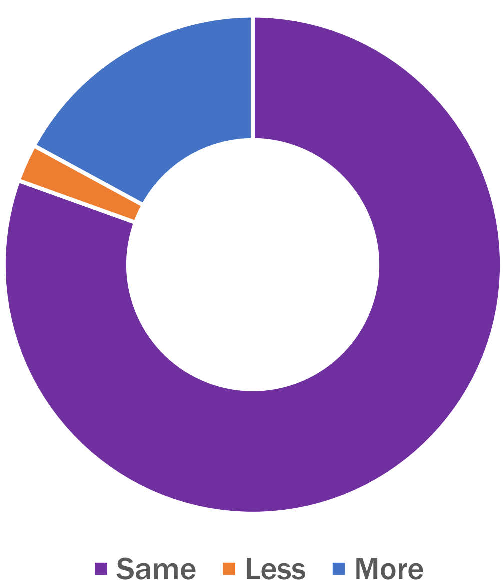
How many new platforms do you expect to acquire in the forward 12 months?



Approximately what percentage of your platforms do you expect will complete at least one add-on acquisition?



Do you expect to use more, less or the same amount of leverage in 2021 relative to 2020?



Did your fundraising plans change as a result of COVID?

81% of respondents reported their fundraising plans did not change

12% suspended fundraising in 2020

7% raised additional capital to capture the market opportunity

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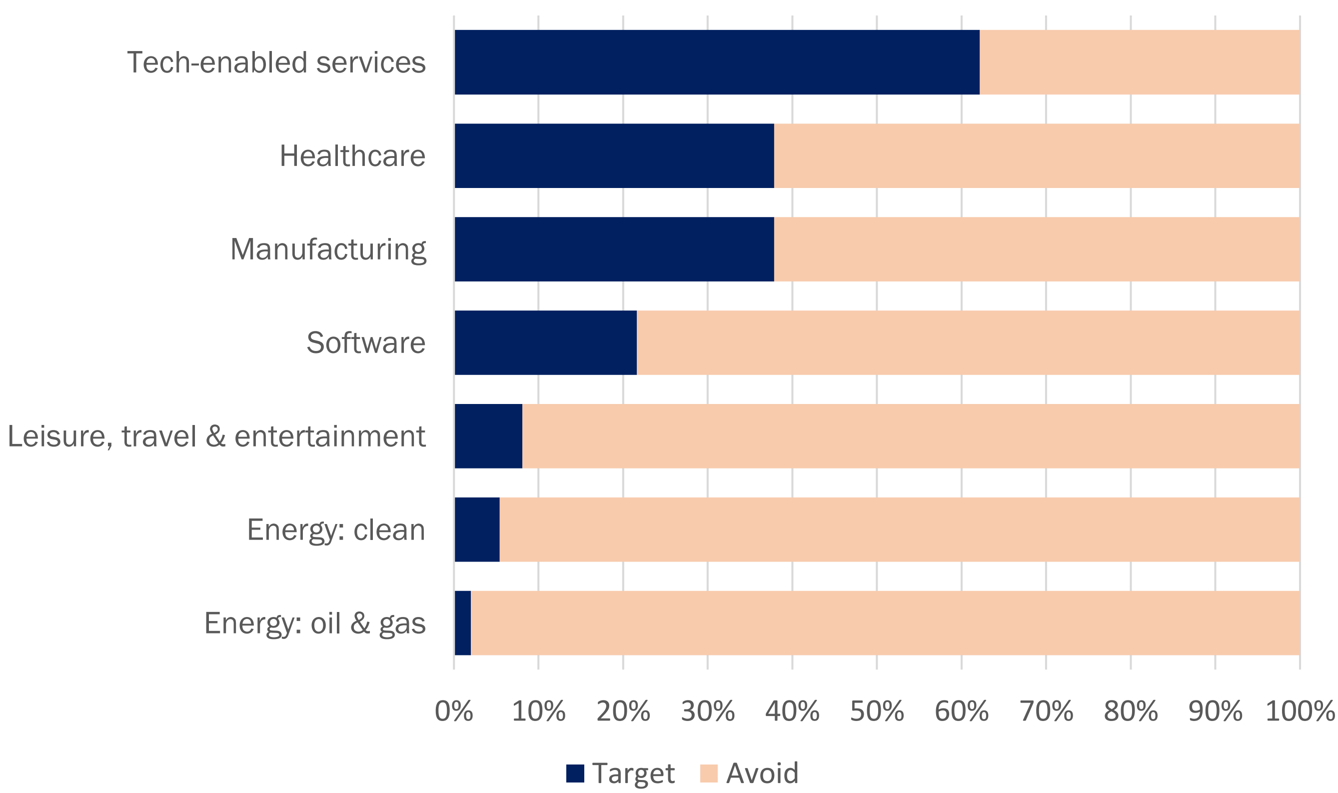
What sectors do you expect to target in the current environment?



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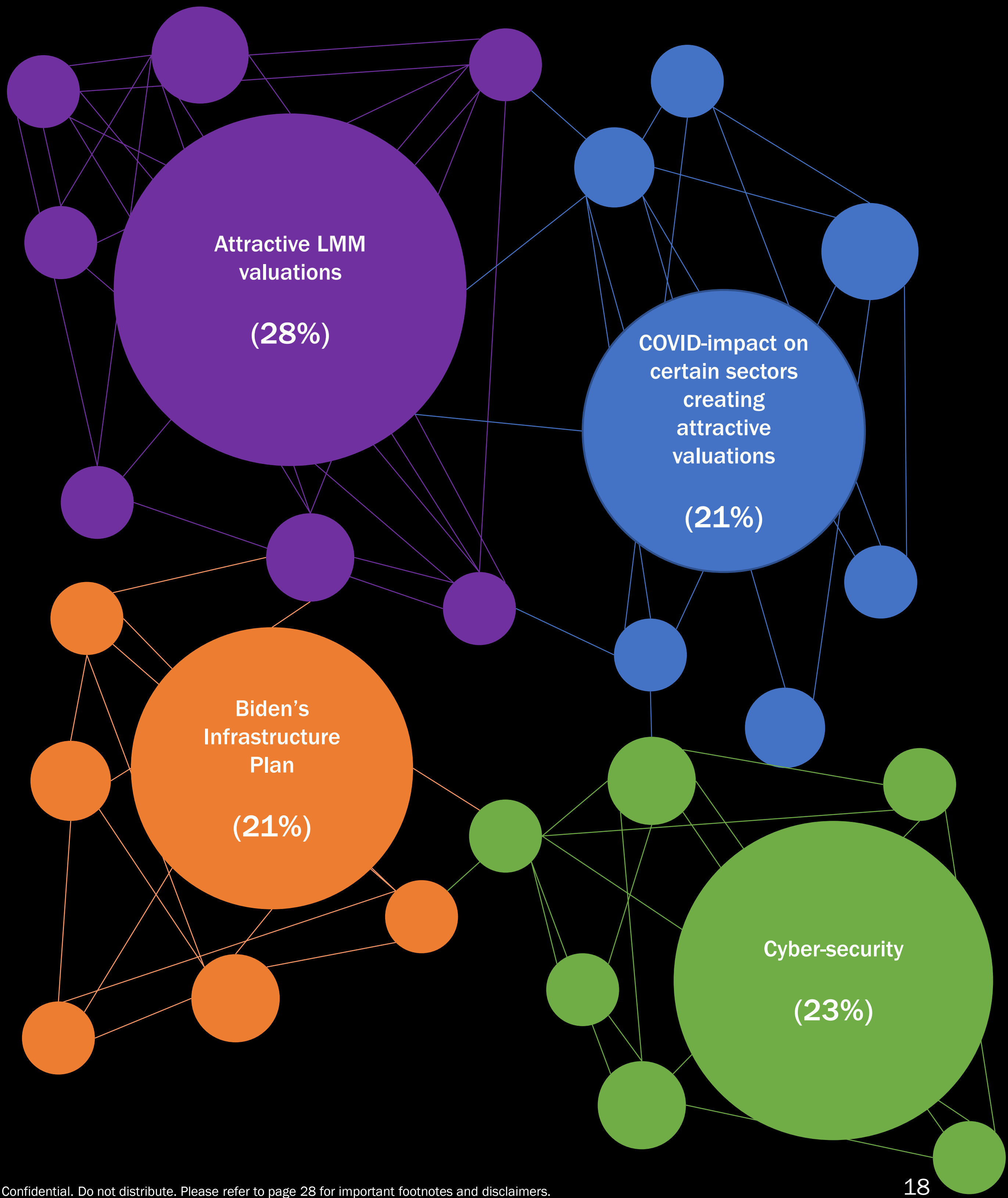
Rank the top concerns in the current environment when evaluating a new platform.



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Following the impact of COIVD and current challenges to global supply chains, will this impact the sectors or businesses you target going forward?

50%
said there will be an impact to their targeted industries

Will your investment strategy shift to focus on companies that can work remotely?

83%
responded that their investment won't change to focus on companies that can work remotely

Will your geographic focus change due to potential travel challenges?

100%
said their geographic focus will not change

Will you invest in businesses that were shut down for an extended period during COVID (e.g., restaurants, DSOs, auto collision repair shops, schools, etc.)?

65%
of respondents will not or are currently unsure if they will invest in businesses that were shut down during COVID

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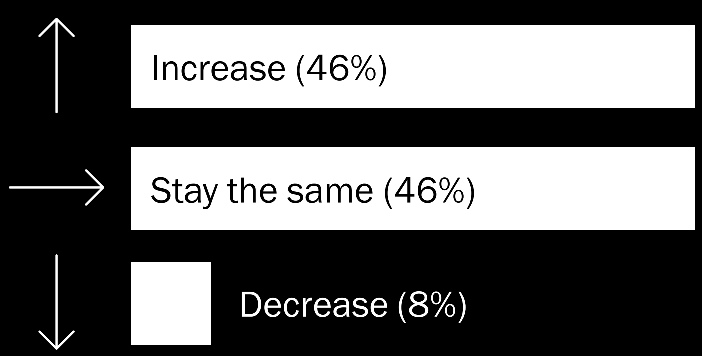
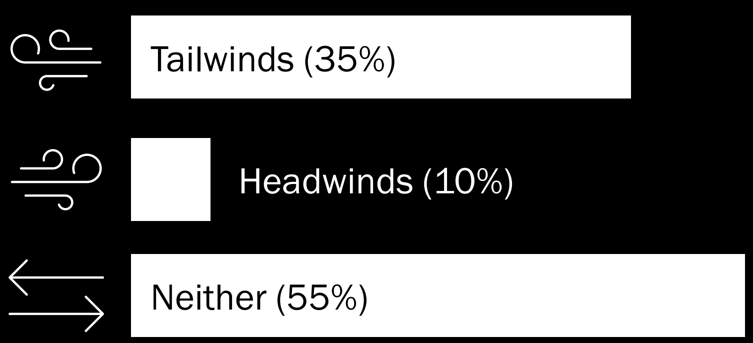
Do you expect to move up market, down market or remain focused on the same market?

Do you expect your target market of opportunities to increase, decrease or stay the same post-COVID?



As a LMM or MM sponsor, do you feel tailwinds or headwinds in your fundraising?



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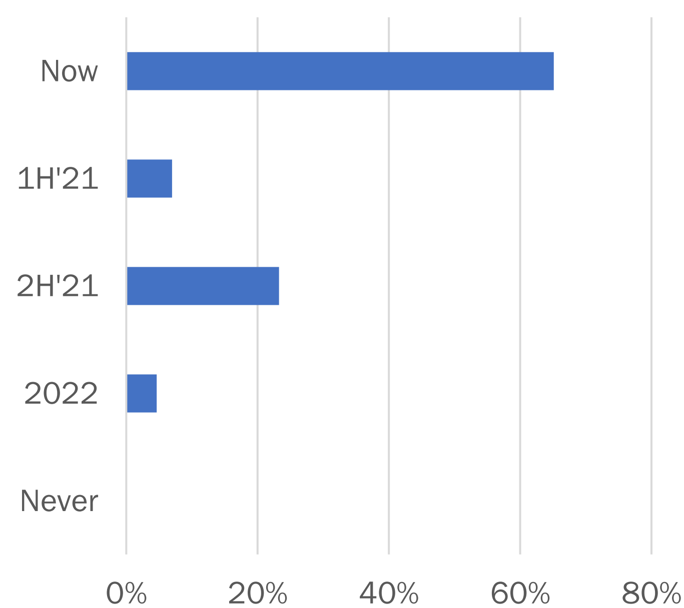
▪ TRAVEL & VISITOR RESTRICTIONS

When do you anticipate guests will be permitted in your offices?



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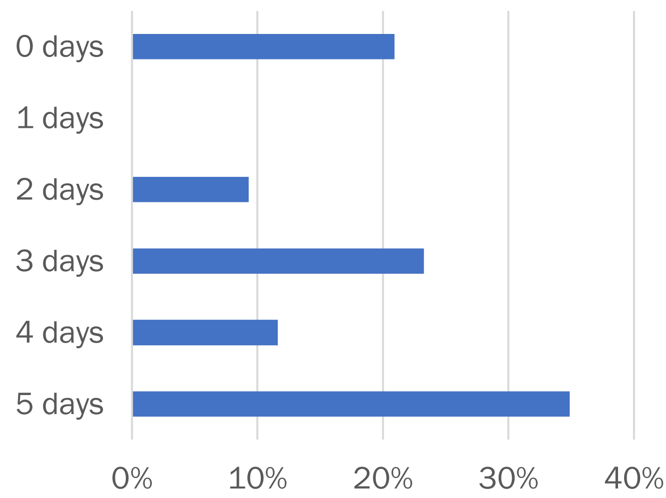
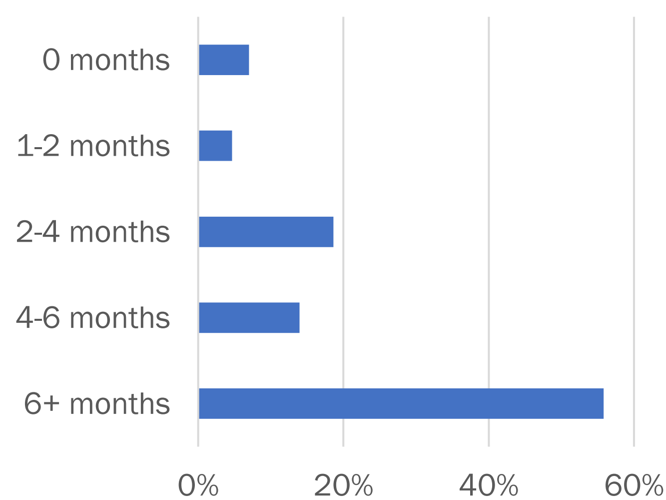
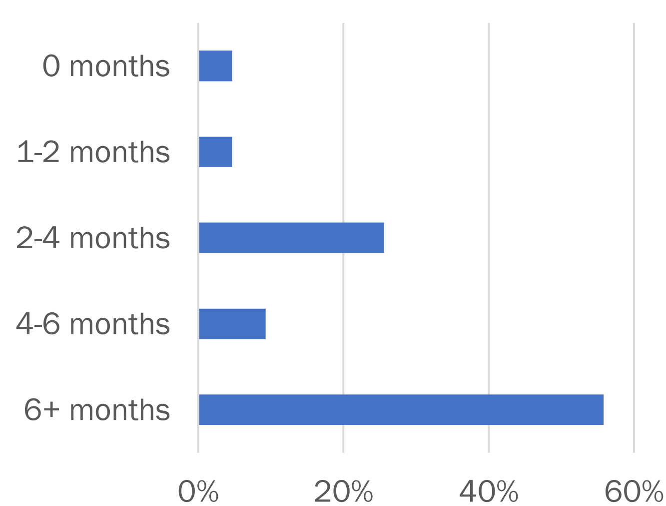


How many days per week do you expect employees to be in the office on a weekly basis?



In 2020, how many months did you pause travel for new platform acquisitions?



In 2020, how many months did you pause travel for portfolio management?

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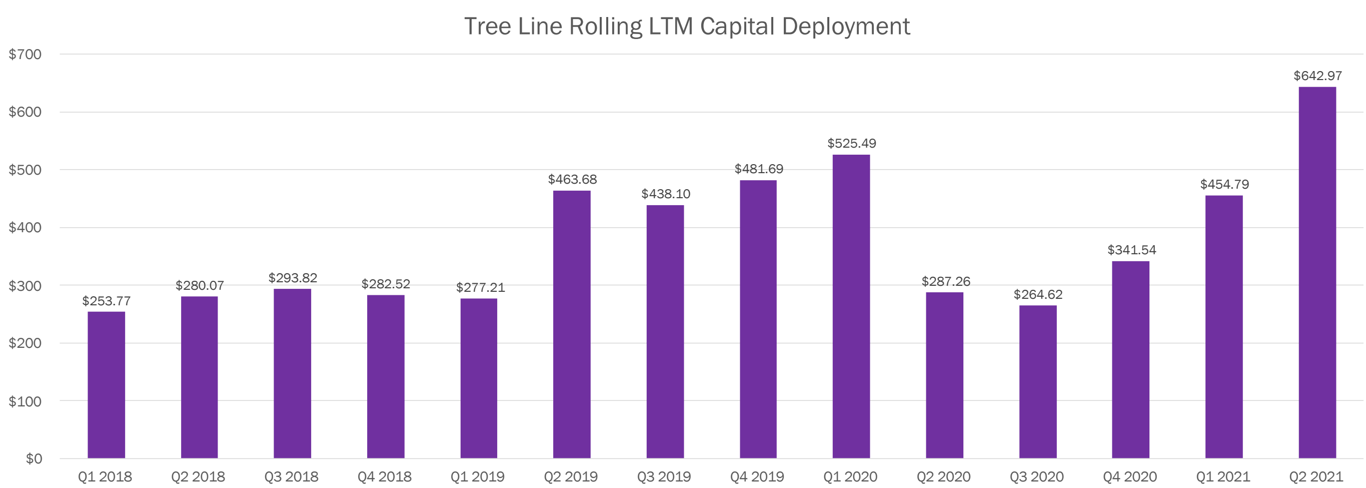
Tree Line's Market Insights

Tree Line's Data Focus & Investing History

- TREE LINE'S INSIGHTS

Over the past seven years, Tree Line has built processes and systems to track deal flow data and market trends, which are included on the following pages. Our proprietary data provides an inside look into trends impacting the equity and credit markets.

3,789	$2.3B	50
Deals reviewed since inception in 2014[10]	Capital invested by Tree Line across 156 companies (81 platforms, 75 add-ons)[10]	Unique sponsor relationships[10]



Similar to the broader market, deal flow materially declined in Q2 2020 as sponsors and lenders intensely focused on their portfolios. Since re-starting origination activities in Q3 2020, Tree Line has generated its most active three-quarter origination stretch due to a performing portfolio of borrowers and significant lower middle market sponsor dry powder and deal activity.

Focused Approach to Sector Selection

- TREE LINE'S INSIGHTS

Tree Line's deal teams and Investment Committee intensely focus on the bad deal database detailed on pages 9 – 10 to avoid troubled sectors and target high performing, low default risk industries.[7]

	Q4'20 Filings			Tree Line Analysis
Probability of Markdown by Sector	**Total Deals**	**Bad Deals**	**% of Total**	**"Bad Deal" Industry Exposure based on 2020 Tree Line Deal Flow**
Structured Finance - CLO	154	71	46.1%	0.0%
Retail Food & Drug	38	12	31.6%	0.3%
Utilities	61	12	19.7%	0.0%
Steel	11	2	18.2%	0.0%
Oil & Gas	240	37	15.4%	0.0%
Forest Products	15	2	13.3%	0.0%
Educational Services	92	12	13.0%	0.0%
Metals & Mining	37	4	10.8%	0.0%
Securities & Trusts	67	7	10.4%	0.0%
Retailing	425	44	10.4%	0.0%
Gaming and Hotels	40	4	10.0%	0.0%
Entertainment and Leisure	251	23	9.2%	0.0%
Manufacturing	170	14	8.2%	2.9%
Home Furnishings	73	6	8.2%	0.0%
Telecommunications	160	13	8.1%	0.0%
Top 15 Sectors	**1,834**	**263**	**14.3%**	

Instead, Tree Line placed a heavy emphasis on business with strong recurring revenue trends, stable customer demand and both cycle- and pandemic-resistant businesses. Tree Line's 2020 deal flow by sector is highlighted below:

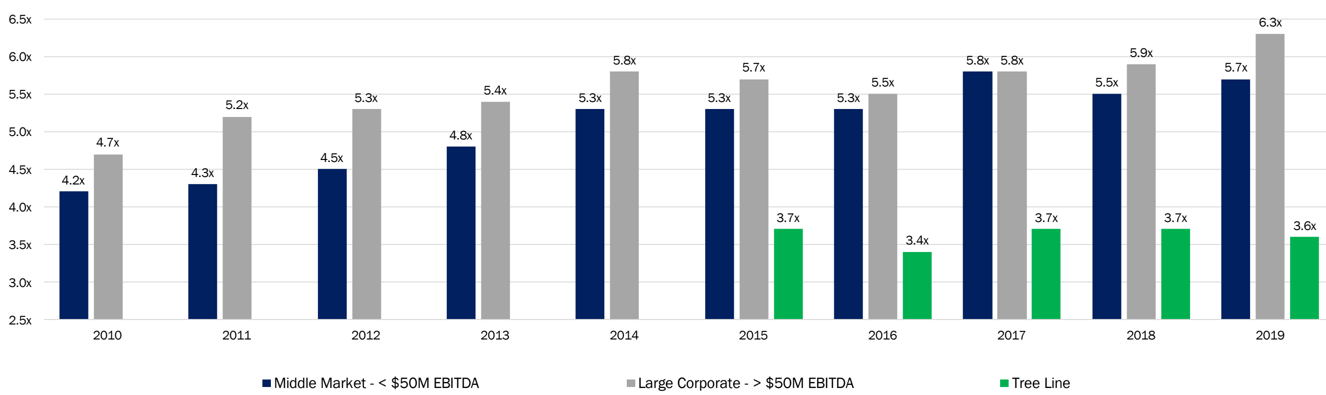
Sector	2020 Tree Line Capital Deployment		% of Total
Tech-Enabled Services	$	117,569,264	34.4%
Business Services	$	75,529,115	22.1%
Consumer Related	$	72,688,004	21.2%
Food & Beverage	$	30,934,000	9.0%
Healthcare	$	30,472,500	8.9%
Manufacturing	$	10,000,000	2.9%
Transportation	$	5,000,000	1.5%
Total	**$**	**342,192,883**	**100.0%**

Disciplined Approach Drives Low Default Rate

- TREE LINE'S INSIGHTS

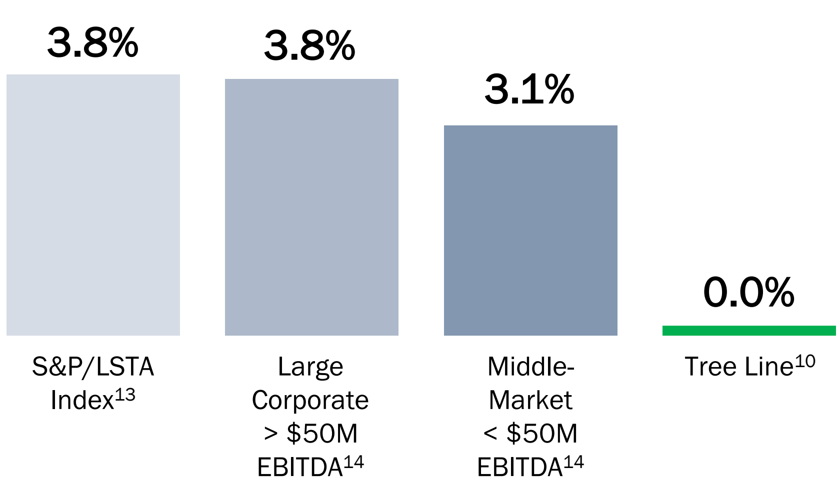
Tree Line is highly selective in its deal criteria, closing 152 of 3,773 total opportunities since inception (4.0%). Additionally, Tree Line has avoided industry trends in the upper market to continue pushing total leverage. While leverage to companies with greater than $50M of EBITDA has increased from 4.7x in 2010 to 6.3x in 2019, Tree Line has delivered consistent performance < 3.7x.[11, 12]

Tree Line Leverage vs. the Middle Market and Large Corporate



A disciplined investment approach, including highly selective deal screening, avoidance of "bad deal" sectors and reasonably levered capital structures drive best-in-class default rates as well as performance through COVID.

2020 Annualized Default Rate



COVID Performance[10]

0 Payment Defaults

$0 Rescue Dollars Funded

100% Portfolio Companies Operational

CONCLUSIONS□□□

To the readers:

At Tree Line we publish frequent market assessments, which are posted to our website and shared with sponsors, investors, borrowers and others seeking to gain insight into the lower middle market. In January 2020 we published “Tree Line Market Insight: Direct Lending In An Uncertain Environment.” In hindsight, there was unknown foreshadowing in the report with the following quote from Tree Line’s Managing Partners:

“We will be the last to predict when a market will shift but we will acknowledge that it can happen quickly. To that end, we will remain relentlessly focused on the fundamentals to ensure our portfolios are well positioned to perform through any uncertainty that lies ahead.”

We could never have scripted the events that would take place in 2020 as the COVID-19 Pandemic unfolded. The pandemic took a toll on nearly every person globally and from an investment standpoint, required intense focus by sponsors and lenders to ensure our companies would survive and come out the other side of COVID healthy and ready to capitalize on opportunities in the market.

Our investment strategy which prioritizes first lien structures, modest leverage, and business models with high free cash flow with strong sponsor support, was validated throughout 2020. Tree Line experienced no payment defaults with minimal interruption among portfolio companies. We thank our underwriting ecosystem for this which filters out weak business models and minimizes exposure to sectors that present a higher likelihood of default.

We are excited to enter the second half of 2021 with our strongest team ever, consisting of 24 highly talented professionals who have gained invaluable perspective through a challenging 2020. In addition to our investing focus, we have continued a responsibility to positively impact our communities. Tree Line has integrated a robust ESG policy into underwriting standards, is a member of 1% for the Planet in which 1% of its management company revenue is donated to environmental causes, and partners with Upward Bound to provide academic opportunities to high school students in the San Francisco and New York areas.

As our Ascend survey indicates, sponsors have maintained a high degree of investment activity and expect to do so for the balance of 2021. Our areas of focus including tech-enabled services, healthcare services and buy & build activity align well with respondent feedback. We will continue to leverage the conclusions our research and data provide on lower middle market lending trends to serve as a go-to lender in this market and construct winning portfolios for our investors.

Best Regards,

The Tree Line Team

Disclaimer & Footnotes

Disclaimer

Opinions expressed in this Ascend Report are those of Tree Line Capital Partners, LLC as of June 2021 and are subject to change. Furthermore, the data contained herein is for informational and discussion purposes only and is neither an offer to sell nor a solicitation of any offer to buy any securities, investment product, or investment advisory services.

Footnotes

1. *Source: 2012 US Census: 2012 SUSB Annual Data Tables by Establishment Industry*
2. *PitchBook*
3. *PitchBook's 2020 Annual US PE Middle Market Report*
4. *Preqin Quarterly Update: Private Equity & Venture Capital, Q3 2020*
5. *Bain & Company – Global Private Equity Report 2021*
6. *PitchBook as of May 2021*
7. *BDC public filings*
8. *S&P LCD*
9. *S&P LSTA 100; S&P LCD: LLI Default Rates as of January 31, 2021*
10. *Tree Line internal data*
11. *"Wtd Average Leverage" is defined as the sum of (a) the product of (i) the leverage multiple for each investment [X] (calculated by dividing the most recently reported outstanding loan balance [Y] for each investment by the most recently reported LTM EBITDA for each company) and (ii) [Y], divided by (b) the total outstanding loan balance for the entire portfolio of investments held by Tree Line Funds.*
12. *Q1 2020 Lincoln Quarterly Market Update*
13. *S&P LSTA 100; S&P LCD: LLI Default Rates as of January 31, 2021*
14. *S&P Global LCD Research Default Table as of April 2021*