Q&A: Direct lending in a dislocated environment

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Tom Quimby and Jon Schroeder are Co-Founding & Managing Partners at Tree Line Capital Partners, a private credit firm with $1.4 billion AUM across six direct lending funds focused on senior secured lending to the lower middle market. Tom and Jon have worked together since 2000 when they were employees at GE Capital and have extensive direct lending experience spanning multiple economic cycles. Tree Line has strived to deliver investors yield in disciplined structures through a direct relationship approach targeting the growing lower middle market private equity community. Tree Line is headquartered in San Francisco with offices in New York, Los Angeles, and Austin.

In the midst of a pandemic and ensuing recession, what will differentiate one direct lender from the next in this environment?

TQ: Ultimately, it will come down to the decisions that were made at the peak of the cycle. Those decisions shaped current portfolios, which will dictate what firms have to work with through this crisis. At Tree Line, we saw real risk hiding in plain view over the past few years. In June 2019, the cover of our Annual Report included a key theme, "Preparing for a Recession." In January 2020, we published a short paper titled, "Lending in an Uncertain Environment," which highlighted the need for discipline as we entered the tenth year of an economic expansion. Having been direct lenders before, during, and after the global financial crisis, themes of caution and discipline remain at the forefront of our investment strategy. We simply believe it is what should comprise a lender's DNA. Over the past five years, the credit market followed a familiar pattern where fundamentals were sacrificed, which, while attracting record inflows of capital, created a recipe for defaults and losses. We're starting to see that play out where the pack is beginning to separate.

JS: For us, our value proposition to both investors and sponsors is about reliability and consistency in all phases of a cycle. Our focus has been to deliver investors consistent yield with low volatility and sponsor a source of financing they can rely on when it matters most. Too often we have seen growth come at the cost of discipline. It's easy to originate during an economic expansion with a lowest-common-denominator approach, but it's a short-sighted strategy when facing an economic downturn. When the dust settles, the performance of the pre-COVID-19 vintage will be tied to the quality of the GP and the level of underwriting discipline exercised at the peak versus the size of platform or company.

You talk a lot about discipline and fundamentals as a key component to your strategy. How does discipline show up in portfolio construction, and what sectors are standing out as clear winners and losers?

JS: It's about both the fundamentals that we prioritize in building a senior secured-loan portfolio, which can be seen in terms of metrics, as well as the discipline it takes to limit deployment amidst a frothy market, which becomes apparent once the market turns. It's easy to go fast when times look good, but as lenders we're making five-year decisions, so it's imperative to maintain a long-term view. We are hold-to-maturity lenders, so trading out of a position is not a part of our playbook. Our downside case needs to deliver significant cushion to withstand economic volatility; otherwise, we're doing our investors a disservice.

TQ: Our portfolio construction strategy, which emphasizes directly originated, senior-secured, low-leverage, high-free-cash, full-covenant, sponsor-backed loans, put us in as strong of a position as possible entering the crisis. Our portfolio carried a weighted average leverage of 3.6x, a fixed charge coverage of 2.1x, and a loan-to-value of 44%, while maintaining 100% covenants. We focused heavily on services businesses that maintained high levels of recurring revenue supported by contracts or subscription agreements. For the COVID-19 period from March through the date of this article, 99% of our portfolio is making cash interest payments, and we have had zero payment defaults and have funded zero rescue dollars. Our approach is proving to be an enduring and winning formula through the initial challenges of COVID-19.

JS: We believe those results are a testament to our data-driven approach, and when we see these shifts in the market it provides invaluable information on performance trends. Following the onset of COVID-19, we studied 1,200 deals across 43 business development companies (BDCs) to build a "bad deal" database. We were hunting for every deal marked below 80% of cost to look for patterns of default. When we ran the numbers by sector, it was no surprise that oil & gas (37%), minerals & mining (33%) and consumer/retail (26%) led the way in highest percentage of deals being marked below 80%. Business service and tech-enabled services, two sectors Tree Line targets, fared among the best, which generally correlates with high free cash and low CAPEX.

Distressed platforms appear to be busy at work raising funds and readying for deployment. How do you anticipate this impacting direct lending?

TQ: We don't believe distressed investors are going to gain any meaningful access to the direct lending channel. The narrative has been that when the market turns, distressed investors will be able to pounce on direct lenders following record levels of deployment in high-leverage, covenant-lite deals. It's not an unreasonable hypothesis, but direct lenders are predominantly private, unregulated, non-bank entities who generally hold loans through volatile periods of time and work out their own paper. Yes, there will be a few exceptions where single assets or portfolios get sold, but it won't be the rule. Direct lenders will be more inclined to restructure, subordinate, take control of, or force a sale of a company before trading a loan at a discount. The bid-ask gap is typically too wide for this to gain traction. This is not a commentary on the level of distress that may exist in portfolios but more a view on distressed players being on the outside looking in when it comes to direct lending.

JS: The flip side is that we believe direct lenders will benefit from the further market dislocation. For those that are healthy and liquid, there will be a great opportunity to take share from "zombie" lenders recovering from mistakes made at the peak. Specifically, many BDCs are being sidelined as a result of material valuation impact. Looking at a small subset of nine BDCs that have less than $500 million in market cap and maintain total loan portfolios of approximately $5.6 billion as of March 31, 2020, per public SEC filings, we see they were responsible for more than $2.1 billion in 2019 origination. This is just a small sample of significant lending capacity leaving the market.

Given you cover the PE market, what has the activity level been in recent months, and what deals are attracting your attention?

JS: Deal flow halted in March as the realities of COVID-19 set in. We worked closely with our sponsors and borrowers to ensure they were well-positioned to deal with the challenges ahead. We are proud that we met all of our revolving and delayed-draw commitments, providing companies with the liquidity support they needed in such a critical time.

TQ: As of today, our pipeline activity has picked up to pre-COVID-19 levels. The bar remains high, but we're seeing some combination of higher yields, lower leverage, and higher EBITDA. The risk-adjusted return has moved materially in our favor. It's counterintuitive, but we're more excited about the opportunities we're seeing today than we were a year ago. We tell our investors that if they liked this strategy in 2018, they should love it in 2020.

There's a growing sense of responsibility for firms today in terms of environmental, social, and governance (ESG) and community impact. How has Tree Line taken up this challenge, and what role do you believe your ESG policy can play?

TQ: Our ESG policy and the impact that we can make in our community is a living initiative. In January, we joined 1% for the Planet, and will contribute 1% of our management company revenue to support environmental causes. In May, our team made personal contributions, matched by Tree Line, for over $58,000 to those impacted by COVID-19. Finally, in June, we renewed our focus to build a diverse culture and will explore how we can partner with our investors to leverage our ESG policy to effect positive change. We are a dynamic, young, diverse team that welcomes the responsibilities that come with managing capital on behalf of our investors in today's world.

Prognostication Overload

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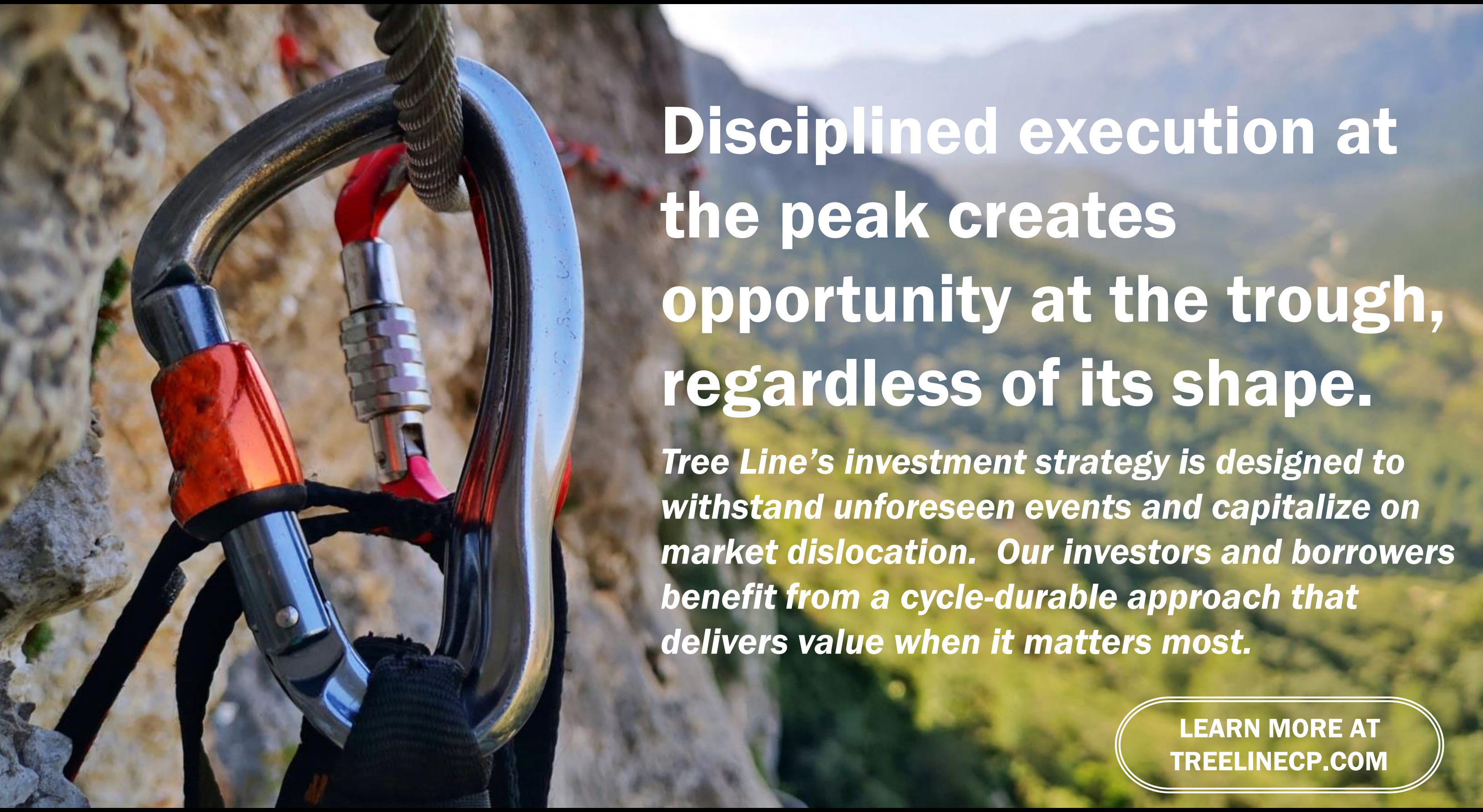

TREE LINE

LOWER MIDDLE-MARKET DIRECT LENDING

$1.4B	$1.6B	$3-$30M
AUM	Commitments Issued	Target EBITDA

SAN FRANCISCO - NEW YORK - LOS ANGELES - AUSTIN

1% FOR THE PLANET MEMBER