Sponsored by
TREE LINE CAPITAL PARTNERS

Q&A: Tree Line Capital Partners

Direct lending is poised for a quick return to growth in 2021.

Tom Quimby
Co-Founding and Managing Partner
(left)

Frank Cupido
Partner
(right)

Tree Line Capital Partners is a private credit firm focused on senior-secured lending to the lower middle market with $1.5 billion AUM. Tom and Frank have worked together since 2007 through multiple cycles. Tree Line strives to deliver to 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.

After an extraordinary 2020 with unprecedented challenges to all asset classes, how would you summarize the year?

TQ: First, we must acknowledge the incredible hardships that so many people have dealt with as a result of COVID-19. As we discuss market performance and growth, it is not lost on us how difficult of a year 2020 has been for so many. 2020 was ultimately a tale of two halves. During the first half, we saw origination grind to a halt in March, when all focus shifted to the portfolio. We performed intensive portfolio work and witnessed firsthand the value of our direct relationships and data-driven approach. Tree Line serves as an agent and/or a lead lender across 94% of our portfolio, and the direct access we were afforded during H1 enabled us to engage in critical, real-time analysis. The second half of the year stood in stark contrast to the first half, with market activity building toward a crescendo in Q4. Due to the strength of our portfolio, Tree Line emerged from the first half of 2020 healthy, liquid, and in a position to grow.

FC: 2020 provided us with an opportunity to prove our thesis that senior secured lending in disciplined structures can withstand significant economic challenges. We have emphasized that originating senior secured, low-leverage, high-free-cash, full-covenant, sponsor-backed loans is a winning and enduring formula. As a result of COVID-19, Tree Line experienced zero payment defaults or bankruptcies, funded zero rescue dollars, and currently receives cash interest payments from 100% of our portfolio. The work we did at the peak of the cycle yielded a portfolio that proved resilient and put Tree Line in a position to unlock material origination growth in the second half of the year. In 2020 we completed 26 transactions, which included loans to 10 new sponsor relationships.

It seems private credit enjoyed a strong recovery in 2020. Where do credit markets stand today?

TQ: Looking at the macro data across the leverage lending industry through Q4 2020, a steady decline emerges in defaults by both amount and issuer count. Quarterly EBITDA losses are abating in most industries other than oil & gas. In our view, the combination of robust liquidity, a steadily improving credit market, and managers seeking to make up for lost deployment in H1 2020 set up an extremely active close to the year.

FC: Yes. In Q3, there was some evidence of wider spreads and closing fees, but as we approached Q4, the highest quality credits returned to pre-COVID-19 pricing levels. However, in the lower middle market, we experienced a net improvement to risk-adjusted return as we lend into lower-leverage, higher-free-cash, and lower loan-to-value (LTV) structures. The 2020/2021 vintage that is taking shape is quite attractive. Our H2 2020 vintage delivered weighted average leverage, fixed charge coverage, and LTVs of 3.2x, 2.6x, and 43%, respectively. Our market's consistency proved to be meaningfully valuable and partly explains the outperformance we are experiencing versus the middle market and broadly syndicated loan (BSL) market.

TQ: We are not seeing private credit take a protracted, 2009-esque recovery. We believe the middle and BSL markets will snap back to peak leverage and covenant-light levels faster than anyone would have projected back in the spring of 2020.

You mention 2009, which was when markets were last tested during the GFC. How would you compare the impact of COVID-19 in 2020 to the last major correction in 2009?

TQ: Looking back to the spring of 2020, the prognosticators predicted a catastrophic impact to the markets with projections of 20% unemployment or higher. At that time, many were turning to the 2009 distressed playbook. Ultimately, it was only a matter of weeks before it became clear that, with both the assistance of the Fed and significant liquidity entering the market, the economy was going to recover more quickly than anticipated—at least on Wall Street. As it pertains to direct lending, stark differences exist between the current economic environment and what occurred in 2009. In 2009, regulated banks were predominately in the distressed position to liquidate assets. With banks exiting the leveraged loan market through consolidation, it took years to rebuild this lending infrastructure. Today, we are in a markedly different place, as direct lenders have built significant infrastructure over the past 10 years and are no longer forced sellers.

FC: We would certainly expect to see a wide range in terms of performance on this vintage, but the notion that direct lending would somehow collapse was way off the mark. Private credit platforms are built to work out their own paper, which gives these platforms—even those that materially underperform—a long runway before they would have to admit defeat. Many in the distressed world expected direct lending to deliver a large opportunity set but misunderstood that the catalyst from 2009—primarily regulatory pressure—was absent across much of the private credit industry this time around.

What do you believe investors will take away from the year as they look at private credit investing today and in the future?

FC: We are encouraging investors to use 2020 to confirm the thesis that private credit is durable and senior-secured lending is highly durable. It has performed across multiple cycles and has delivered consistent current return to investors. Many investors who were cautiously on the sidelines in 2018 and 2019 have expressed interest in direct lending after witnessing its resilient performance in 2020. Overall, the asset class did very well, and in the current yield environment, this performance is hard to overlook.

TQ: Taking it one step further: Beyond gaining comfort with the asset class as a whole, a real opportunity exists for investors to utilize recent performance data to better understand performance by market segment and to differentiate across GPs.

Some have suggested that the lower middle market would suffer disproportionately in the face of an economic downturn. How do you think a year like 2020 could shift investor allocation, and what do you see on the horizon in 2021?

TQ: We certainly hope investors look carefully at both the data and the performance trends. A great way to do that is by studying total return across different direct lenders. Total return measures gross investment income +/- realized gains/(losses) +/- unrealized gains/(losses), all divided by the amortized cost of a portfolio. This provides an excellent apples-to-apples view on how successful a GP is at lending dollars and generating yield for investors. Tree Line is proud of the results we have generated—meaningfully outperforming market indexes and some of the biggest business development companies in the industry. We have been adamant for years that investors need to look beyond the size of a borrower or platform.

FC: We feel we have a real advantage with our lower-middle-market focus. Significant PE growth drives our rapidly growing market, yet we can still structure historically conservative senior-secured loan structures. Our lower-leverage and higher-fixed-charge coverage levels deliver a lower likelihood of default and concurrent higher recoveries. Further, we are nimble and highly selective in our portfolio construction. Larger platforms have immense pressure to deploy, which often leads to participation in aggressive structures across all industries.

TQ: Looking ahead, Tree Line is healthy, liquid, and growing. We continue to build market share with new sponsors while also delivering a stable lending relationship to existing sponsors to help drive further portfolio company growth. We will capitalize on our approach taken at the peak of the cycle, which delivered a highly durable senior-secured portfolio to our investors. While we remain in a fluid macroeconomic environment, we are encouraged by the opportunities that we are sourcing today. We expect to continue delivering to our investors consistent, current return where we combine yield with discipline.

Disclosure: The information 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.