



Q&A: Tree Line Capital Partners

Lower middle-market direct lending will provide investors with an edge.

Private credit markets were highly active in 2021. How did 2021 compare to Tree Line's expectations, and what did you observe in the lower middle market?

TQ: 2021 certainly had significant momentum coming out of 2020, which was disjointed with the onset of the pandemic. Tree Line took advantage of its strong performance and market position and delivered record results in 2021. We grew our AUM by 40% to \$2.2 billion, made over \$1.1 billion in new loan commitments, realized \$461 million in repayments, introduced an annual recurring revenue (ARR) loan product, and grew our team by five. Perhaps most importantly, our data-driven investment strategy, which combines attractive yields in disciplined senior-secured structures, continued to outperform the broader market. We've maintained zero defaults since the pandemic began, which speaks to the strategy's durability. It was a winning year for Tree Line and our investors.

JS: Lower middle-market private equity experienced continued growth. Since 2017, over \$700 billion has been raised in PE funds of \$500 million or smaller, creating a highly fragmented addressable market for lower middle-market-focused direct lenders to cover. Given the magnitude of capital raised, lower middle-market PE firms are as active as ever, with a focus on buy & build strategies. We're also seeing a growing universe of PE firms focused on software and tech-enabled services, which is driving demand for ARR loans. While our bar remains high for ARR lending opportunities, we believe this space will offer significant growth over the next five to 10 years, and we expect it to be a meaningful component to our platform.

As we enter 2022, rising interest rates and supply chain and labor challenges are in the spotlight. How well prepared is Tree Line to absorb these challenges, and where will the squeeze be felt across direct lending?

JS: In the current environment, several macro factors are certainly at play that warrant our focus. We have





Tom Quimby (Left) & Jon Schroeder (Right) Co-Founding and Managing Partners Tree Line Capital

Partners

Tree Line Capital Partners is a private credit firm focused on senior-secured lending to the lower middle market with \$2.2 billion AUM. Tom and Jon have worked together since 2000 through multiple cycles, products, and fund innovations. Tree Line strives to deliver to investors access to the growing lower middle market, targeting the nexus of company size and credit structure to provide the highest risk-adjusted return. Tree Line is headquartered in San Francisco, with offices in New York, Los Angeles, and Austin.

confidence in our portfolio construction strategy regardless of where we are in an economic cycle. In a year like 2021, with its fast-moving market, it's tempting to drift away from credit fundamentals. We have not done that, and our zero-default performance throughout the pandemic reinforces our portfolio construction principles. We consistently say that it's what you do during the fast-moving times that will differentiate you from the pack. Our strategy relies on senior-secured, low-leverage, high-free-cash, full-covenant structures backed by highly sophisticated equity investors. This formula lays the foundation to successfully deal with economic challenges and is both historically conservative and proven. Overall, we have little sensitivity to interest rate risk, given 100% of Tree Line's loans are floating rate and we'll be in position to capture a benefit from rising rates.

TQ: Given these challenges will put pressure on a company's operating margins, if you were to zero in on one metric, it would be fixed charge coverage (FCC). We benchmark to a 2.0x FCC, and our current portfolio's weighted average FCC is 2.5x. This gives our borrowers significant cushion either to absorb rising labor and shipping costs and interest rates or to deal with general supply chain complexities. Given our focus on techenabled services, business services, and asset light businesses, we have not seen much pressure from a supply chain perspective. Rising labor costs are being





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observed more consistently but still have not had a material impact on margins or bottom-line performance across our portfolio. Direct lenders willing to trade credit fundamentals for 50 to 200 basis points of spread always seem to take a disproportionate hit to performance when economic challenges set in. Fundamentals remain the key.

Enterprise valuations continue to sit at record highs as of year-end 2021. How have high asset valuations affected your debt structures?

TQ: Enterprise valuation is a great starting point to discuss market segmentation. Many investors still casually look at direct lending as one general asset class or strategy. We believe it varies greatly based on market segment. It's clear that enterprise valuations remain at or near record levels in the upper and middle markets, but we see far more stability in the lower middle market where sponsors are focused on acquiring companies valued between \$50 million and \$150 million. Middle-market multiples are 12x to 15x trailing EBITDA, and we typically see lower middlemarket multiples in the 8x to 10x range, with exceptions for various sectors such as tech-enabled services or those businesses demonstrating strong recuring revenue. Tree Line's weighted average enterprise value upon close has been \$94 million, and upon current valuation or exit, has grown to is \$174 million. We are lending against good value, with a historically low-weighted average leverage of 3.4x, which contrasts to the up-market leverage multiples of 6x to 8x-and that's if you buy into the EBITDA adjustments. Circling back to our thesis, we can give investors access to the market where EV and capital structure intersect at the highest risk-adjusted return.

As of the date of this interview, January 25, 2021, public markets are showing real volatility. Are you seeing any volatility or pullback in private markets?

JS: Not yet. It takes time to show up in private markets—if it shows up at all. We can point to many volatile periods in public markets that never manifested in private market valuation shifts. Clearly, as we sit here today, we're seeing a pullback in public markets as the Fed shrinks its balance sheet and takes liquidity out of the market. As this volatility plays out, we take comfort in our senior-secured strategy's data-driven approach. One of the critical benefits to exposure in our asset class is that it reduces volatility particularly relative to the more liquid public markets. Our weighted average loan-to-value is 42%, which provides ample cushion to downward valuation adjustments. While

valuations have continued to reach new highs, we have not seen this adversely push on our credit structures within the lower middle market. Leverage and loan-to-value remain historically low, while we've continued to maintain full covenants in 100% of our deals.

What advice would you give to investors in the current environment?

TQ: We may sound a bit like a broken record, but it's for good reason: The data supports it. While we do not expect to convince the market to abandon their investments in upper middle market in the face of commoditizing and eroding terms, we encourage investors to look across the market segments that have taken shape over the last decade. Our strategy focused on the lower middle market offers structural discipline that cannot be found up-market and complements portfolios that were designed within the last decade. We can offer a solution that will blend yields higher and leverage lower on real EBITDA and deliver a durable credit document. Upper-market players will continue to fearmonger about the lower middle market, but the data tells a different story. Tree Line has invested \$2.9 billion to lower middle-market companies, with only one realized loss since inception and zero losses or defaults as a result of the pandemic.

JS: Investors would benefit from a portfolio construction strategy within private credit that focuses on a market segment approach. For most, this means evaluating the lower middle market, which will deliver attractive yield and structure discipline that has been lost up-market. It will complement exposure up-market and deliver access to a rapidly growing segment of the economy fueled by increasing PE focus. It's unclear what 2022 will bring, but with pressure on equity valuations, our senior-secured strategy should look attractive to investors looking to minimize portfolio volatility. A detailed review of direct lending performance throughout the pandemic will provide valuable insights, but the insights won't be found in net returns. Investors who look deeper will see the warning signs that might have been bigger issues had the markets not received significant liquidity or bounced back so quickly in 2020. These warning signs will be important tools to differentiate for the next economic event, which may not provide such a swift market recovery. Direct lending is designed to deliver yield and consistency, so investors should not overlook the fundamentals.