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TREE LINE CAPITAL PARTNERS

Global Private Debt Report

2021 Annual

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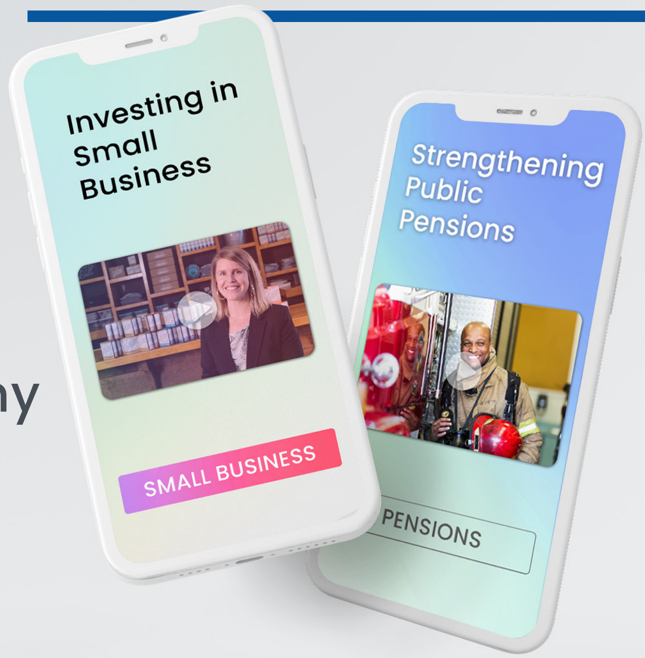

The American Investment Council (AIC) is an advocacy and resource organization established to develop and provide information about the private investment industry and its contributions to the long-term growth of the U.S. economy and retirement security of American workers. Member firms of the AIC consist of the country's leading private equity, growth capital, and private credit firms united by their successful partnerships with limited partners and American business.

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Contents

A note on methodology: Beginning in October 2021, PitchBook reports began classifying mezzanine funds under private debt instead of private equity. This will lead to some discrepancy between current and past data.

Introduction

Private debt managers raised $191.2 billion in 2021, a 12.1% YoY gain and the second-highest annual tally on record. Investors continued piling into these funds despite the puzzling macroeconomic environment due to a confluence of factors including negative real yields on government bonds, lower-than-expected default rates, accommodative monetary and fiscal policy, and positive recent performance by private debt as an asset class.

Private debt funds in Q2 2021 recorded their strongest performance since 2010. Debt strategies with more equity-like characteristics, such as mezzanine and distressed debt funds, buoyed the performance of private debt overall, while direct lending—which relies more on steady interest payments from portfolio companies—experienced more modest gains.

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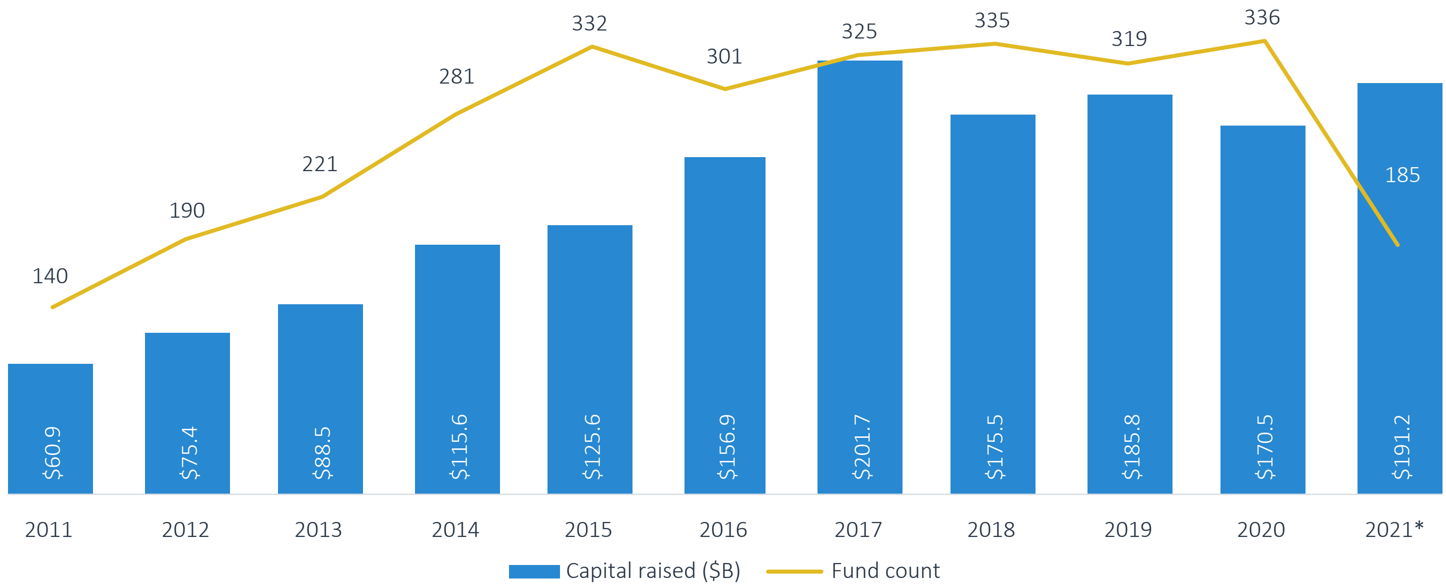
Click here for PitchBook's report methodologies.

Fundraising and overview

Private debt fundraising activity



Source: PitchBook | **Geography**: Global
*As of December 31, 2021

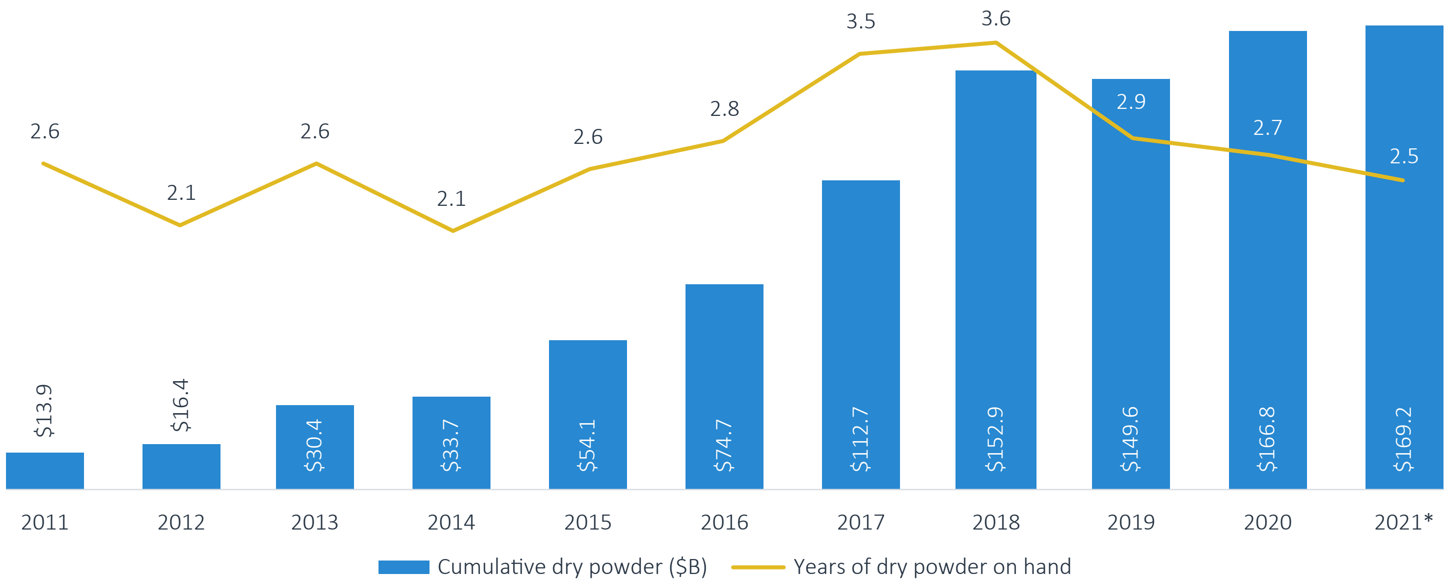
Private debt fundraising finished 2021 in near-record fashion. Globally, managers raised $191.2 billion, a 12.1% YoY gain and the second-highest annual tally on record. Investors continued piling into these funds despite the puzzling macroeconomic environment due to a confluence of factors including negative real yields on government bonds, lower-than-expected default rates, accommodative monetary and fiscal policy, and positive recent performance by private debt as an asset class.

In terms of AUM, private debt is now the third-largest private market strategy, trailing only private equity (PE) and venture capital (VC). The growth relative to other private market strategies reflects the expanding opportunity set for managers, including opportunities created by the growth in private equity. Leveraged buyouts—particularly in the middle market—increasingly rely on privately arranged financing rather than the traditional high-yield bonds or bank-syndicated loans. This trend has been underway since the global financial crisis but has accelerated recently. Fund sizes have grown to meet this need, and debt funds are able to write much larger checks. The median direct lending fund size reached $900.0 million globally in 2021, and there have been multiple $1 billion+ unitranche financings provided by these funds, sums that would have been unfathomable just a few years ago. Non-sponsored M&A is also a growing opportunity for credit managers; global M&A reached a record of nearly $5 trillion in 2021.

The growth in dry powder has made “too much capital chasing too few deals” a recurring talking point across private markets over the last few years. For direct lending funds, however, the data doesn’t bear this out. In fact, there is less dry powder on hand today (2.5 years) than there was in 2018 (3.6 years). Although it doesn’t account for changes in valuation and leverage, that this figure has decreased every year for the last four years indicates direct lenders are finding relative ease in deploying capital. Things could take a turn for the worse if PE dealmaking cools off, but so far there are no signs of that occurring. In fact, PE dealmaking has only accelerated in the last few quarters, reaching a record $1.2 trillion in the US in 2021, more than 50% above the previous annual record.

In many private debt portfolios, companies (and their corresponding credit risk) have been unevenly affected by the pandemic. There are those whose businesses depend on an open economy: people traveling, eating at restaurants, and generally conducting business as it was prior to COVID-19. Conversely, many portfolio companies are experiencing record sales and earnings: software, logistics, and business services businesses to name a few. What’s most interesting is that even

Direct lending capital overhang and years of dry powder on hand

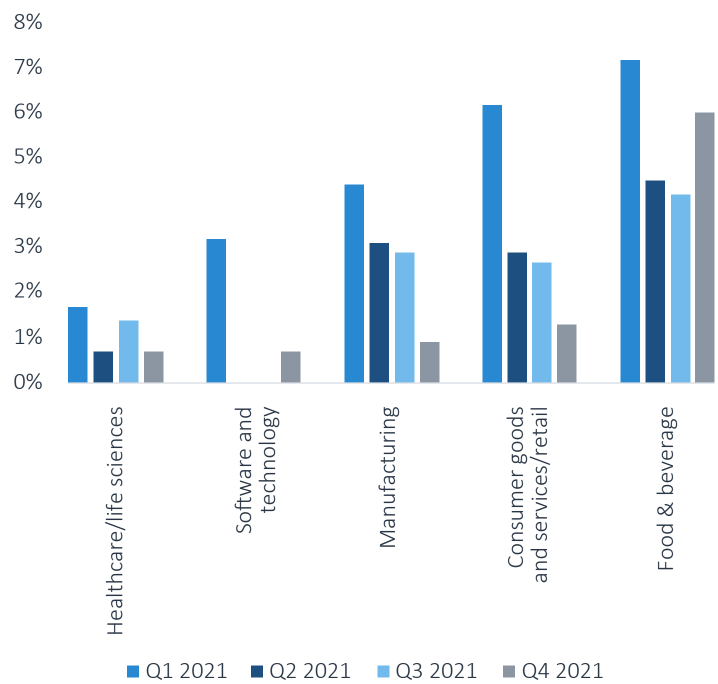


Source: PitchBook | **Geography:** Global
*As of June 30, 2021

businesses in the former category have been able to finance themselves relatively easily in the last two years. High-yield bond and leveraged loan issuance both reached record levels in 2021.[1] Default rates have also remained surprisingly low during this time, in part due to support governments provided to the industries most obviously suffering from lockdowns. According to the Proskauer Private Credit Default Index, the default rate for middle market businesses fell to just 1.04% in Q4 2021, down from 2.4% in Q1 2021. Default rates were lowest in the healthcare/life sciences and software and technology sectors, but higher in manufacturing, consumer, and food and beverage.[2]

Of course, this record issuance has been made possible in part by the backstop (either perceived or real) provided by central banks' ultra-accommodative policy in the last few years. For example, not only did most major central banks drop their benchmark rates to encourage borrowing in the first half of 2020, but the Fed began buying treasuries and even corporate debt as a way to bolster the market. The Fed's balance sheet ballooned from about $4 trillion to about $7 trillion between March and June of 2020. Around the same time, the US and certain European governments passed spending packages that further accelerated the economy during lockdowns. In the US, more than $2 trillion was earmarked for COVID-19-related spending.

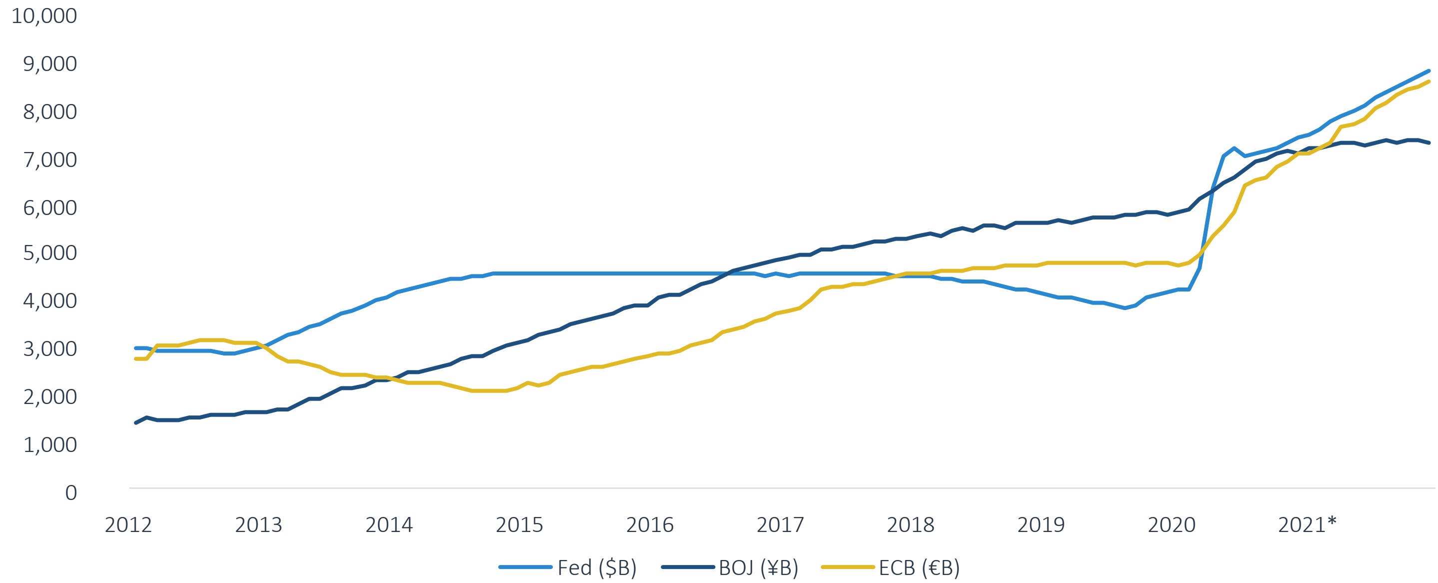
Private credit default rates by quarter



Source: Proskauer Private Credit Default Index | **Geography:** Global
*As of December 31, 2021

1: "2021 Wrap: Issuance Records Fall in Leveraged Finance as Q4 Caps Stunning Year," S&P Global, December 16, 2021.
2: "Proskauer Releases Q4 Private Credit Default Index, Reports an Overall Default Rate of 1.04%," Proskauer, January 27, 2022.

US Fed, BOJ, ECB balance sheets since 2012

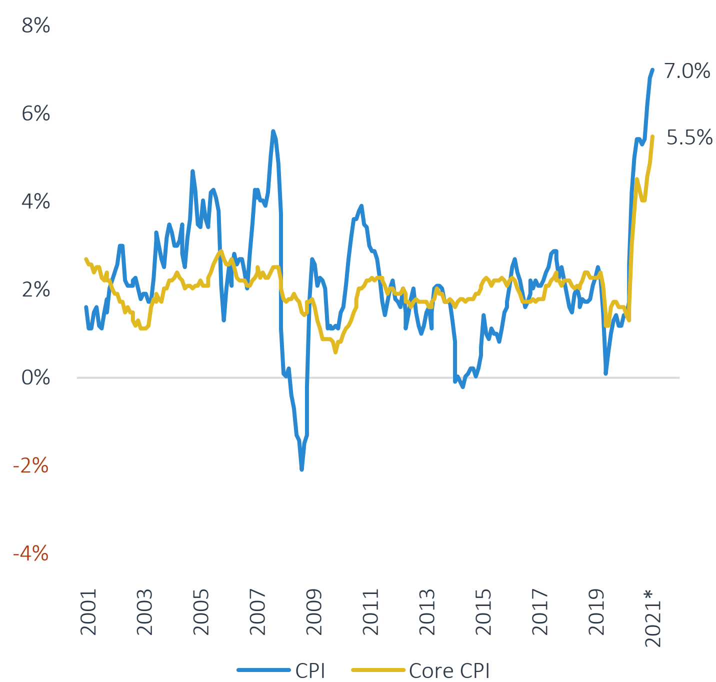


Source: FRED | **Geography:** Global
*As of December 31, 2021

By Q3 2021, inflation began to weigh on the minds of many investors. Annualized Core CPI reached 5.5% in December 2021—the highest since 1991 —and by January Fed Chairman Jerome Powell had not ruled out the possibility of four or five rate hikes in 2022, a serious departure from the year prior when most of the talk was of tapering (that is, slowing asset purchases) prior to raising rates. The prospect of rising rates will have varied knock-on effects across asset classes and has already taken its toll on growth stocks in 2022. While the S&P 500 has shed 7.6% and high-yield bonds 2.8% year-to-date, leveraged loans are more or less flat, at +0.21% (although negative in real terms).[3] This reflects the much lower interest rate sensitivity of floating rate loans, which applies to most private debt portfolios as well.

While we still expect private debt fundraising and AUM to continue growing, we believe the rate of increase will be dampened by interest rate increases over the medium term. One of the main selling points of private debt vehicles over the last decade has been income generation relative to bonds in an extremely low-yield environment. As benchmark rates rise, the yield on everything from government borrowing, to mortgage-linked-securities, to corporate bonds should rise too. This, in turn, may make allocators more likely to shift back to tried-and-true liquid credit strategies such as treasuries and corporate bonds.

CPI over time



Source: Bureau of Labor Statistics | **Geography:** US
*As of December 31, 2021

3: As of January 30, 2022. High-yield bonds measured as the Bloomberg US Corporate High Yield Total Return Index Value Unhedged USD. Leveraged loans reflect the S&P/LSTA U.S. Leveraged Loan 100 Index.

Top private debt funds closing in H2 2021

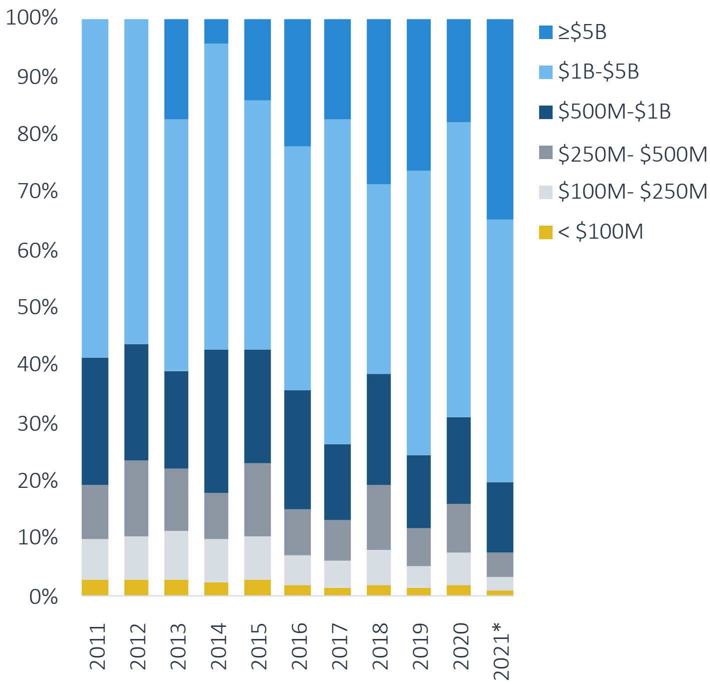
Fund name	Size ($M)	Fund type	Location
Oaktree Opportunities Fund XI	$15,900.0	Distressed debt	Los Angeles, US
HPS Specialty Loan Fund V	$11,700.0	Direct lending	New York, US
Ares Senior Direct Lending Fund II	$8,000.0	Direct Lending	Los Angeles, US
Arcmont Senior Loan Fund II	$5,797.4	Direct lending	London, UK
Ares Private Credit Solutions II	$5,100.0	Direct lending	Los Angeles, US
Strategic Value Special Situations Fund V	$5,000.0	Distressed debt	Greenwich, US
Brookfield Real Estate Finance Fund VI	$4,000.0	Real Estate debt	Toronto, CA
Golub Capital Partners 12	$3,485.5	Mezzanine	New York, US
Hayfin Special Opportunities Fund III	$2,595.6	Direct lending	London, UK
Vista Credit Partners Fund III	$2,300.0	General Debt	Austin, US
Torchlight Debt Opportunity Fund VII	$2,040.0	Real estate debt	New York, US

Source: PitchBook | **Geography**: Global
*As of December 31, 2021

Regardless of the effect of rising rates, evidence appears to point to continued support for private debt strategies. First, survey data indicates that two-thirds of institutional investors plan to increase their allocations to private debt.[4] Second, private equity and non-sponsored M&A deal flow—two key drivers of private debt deal flow—have continued to accelerate in recent quarters and show no signs of slowing. Third, one of the most salient refrains about private debt in the last decade has been that nobody knows how it will perform in a downturn. That it has weathered the last two years relatively unscathed will further propel future commitments to the strategy.

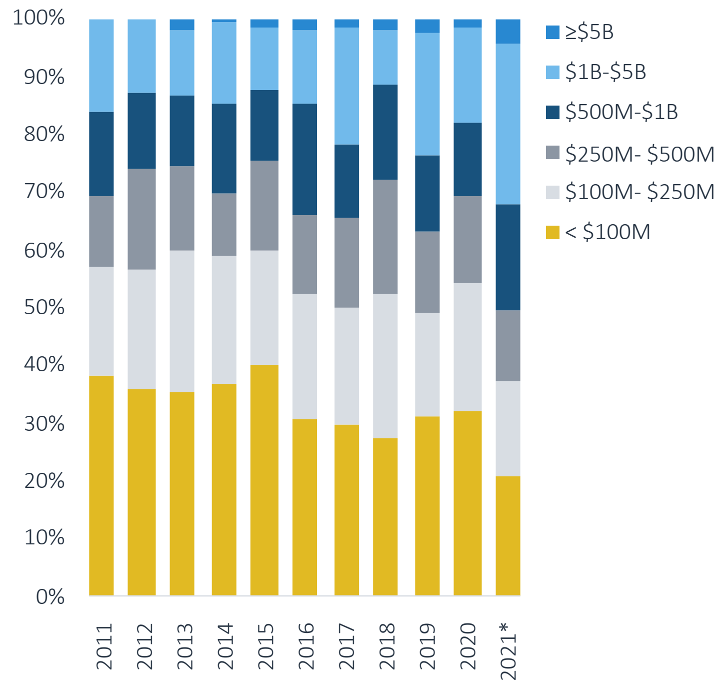
4: “2022 DCM Investor Report: Key Findings,” Intralinks, January 2022.

Share of private debt fundraising value by size



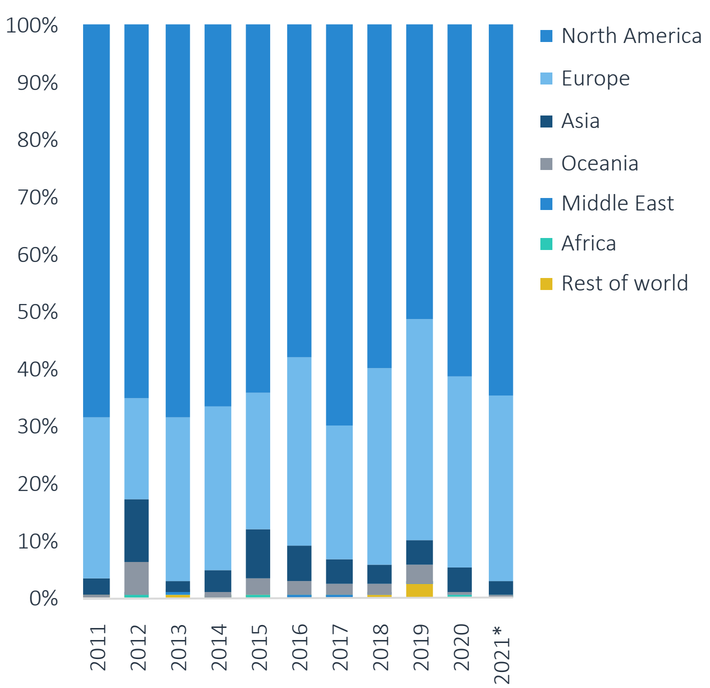
Source: PitchBook | **Geography**: Global
*As of June 30, 2021

Share of private debt fundraising count by size



Source: PitchBook | **Geography**: Global
*As of June 30, 2021

Share of private debt fundraising value by region



Source: PitchBook | **Geography**: Global
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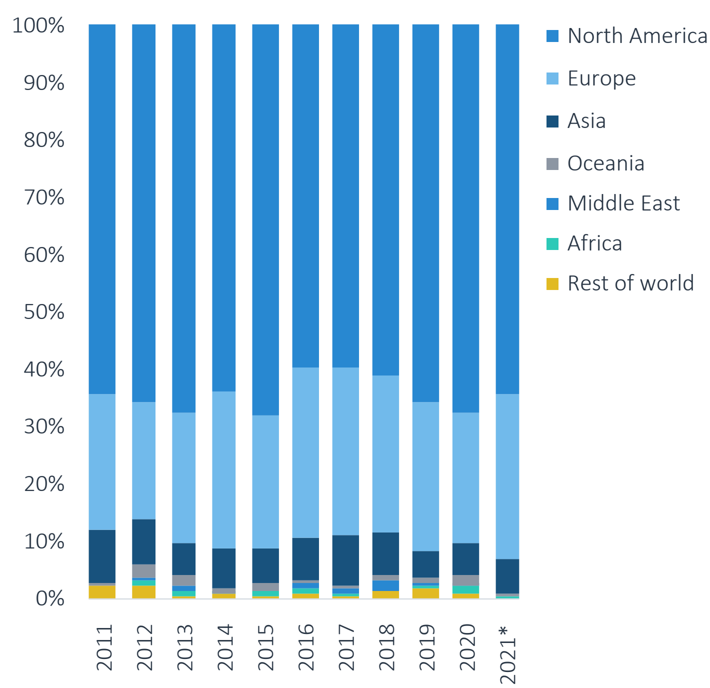
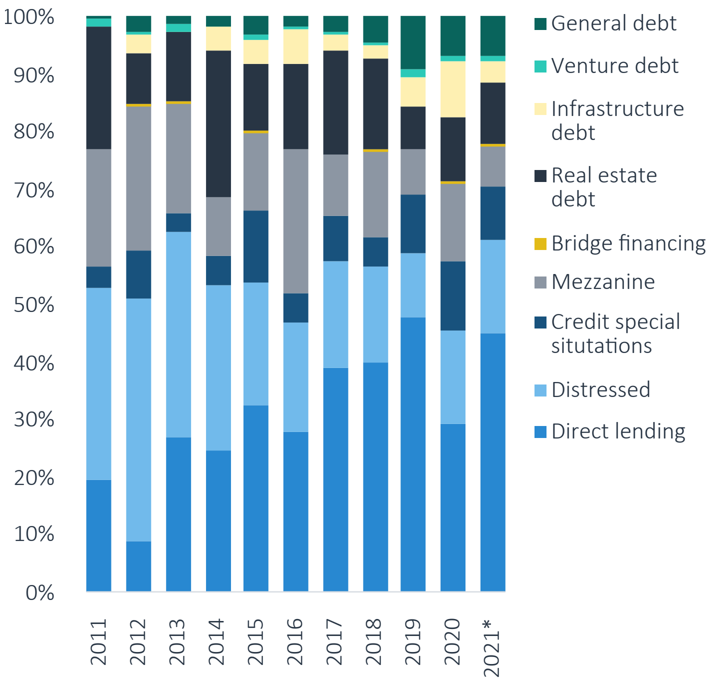
Share of private debt fundraising count by region



Source: PitchBook | **Geography**: Global
*As of December 31, 2021

Share of private debt fundraising value by type



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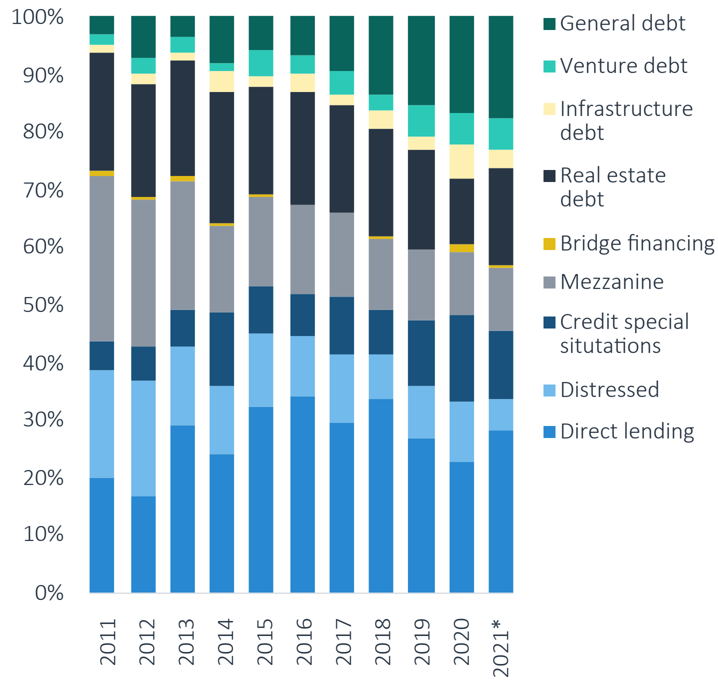
Share of private debt fundraising count by type



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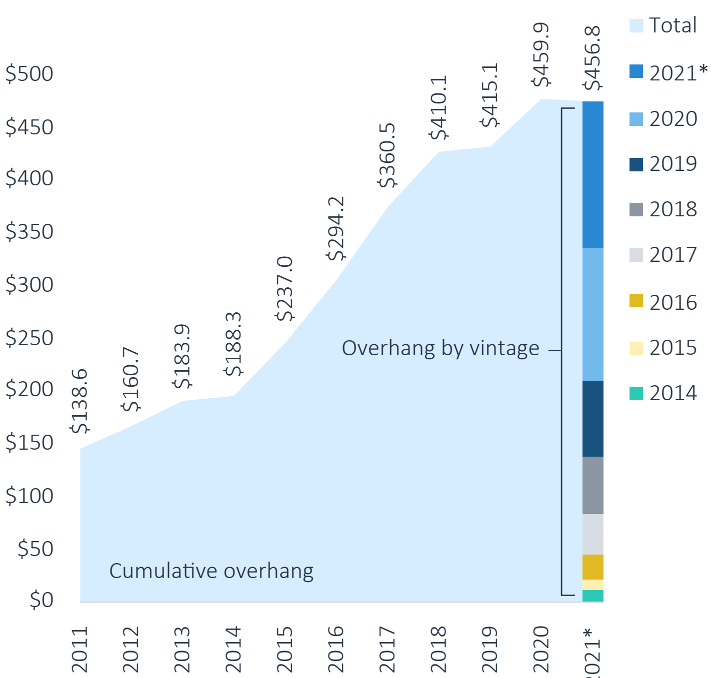
Private debt capital overhang



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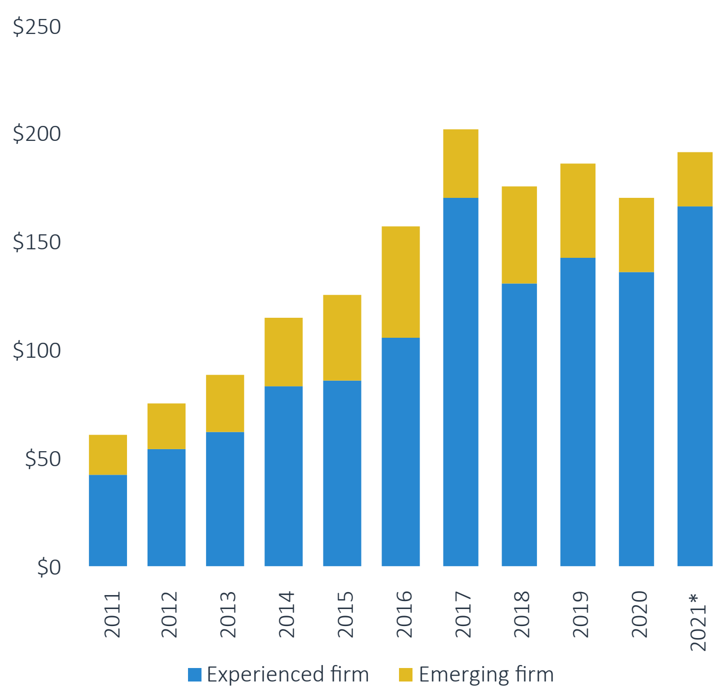
Private debt fundraising ($B) by manager experience



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The Benefits of Private Debt

Investors of all types recognize the benefits of private debt, particularly pension funds and insurance companies, as they seek investment returns to meet their liabilities. But the benefits are not exclusive to investors. Borrowers benefit from the speed and flexibility that private debt financings can provide. Thousands of companies have benefited from credit made available by private debt vehicles. These vehicles have helped businesses finance acquisitions, build new facilities, and provide capital for day-to-day operations, among other things. Private debt has helped businesses—many of which have limited access to capital—make investments to grow and create jobs.

Jamal Hagler

Vice President of Research
American Investment Council

Jamal Hagler serves as the Vice President of Research at the American Investment Council. In this role, he leads the AIC's research department. Previously, Jamal served as Director of Research at the AIC. Prior to joining the AIC, Jamal worked at the Center for American Progress, where he researched a range of policy issues.

Private debt a maturing asset class

In the aftermath of the 2008 financial crisis, and by design, increased regulation led to banks reducing their lending activities, particularly to middle-market businesses. This development created an opportunity for nonbank lenders, particularly private debt vehicles, to provide financing primarily for middle-market businesses. While still a relatively new asset class, private debt is maturing. Funds are raising more capital as investors search for yield, and the capability of private debt is increasing. In the past, for large transactions, borrowers would turn to the broadly syndicated loan market where a bank originates a loan with the purpose of distributing it to investors. Recently, private debt funds have been able to increase the size of their financings, and in some cases a single lender can provide all the capital needed to finance a transaction. Private debt can customize the borrowing terms to fit the specific needs of the borrower and can offer the flexibility that other lenders, particularly banks, are unable to provide.

The COVID-19 pandemic put private debt to the test. Many detractors believed the asset class would be unraveled by an economic downturn, but the results have proven this prediction false. Private debt has continued its strong performance. And private debt vehicles were some of the most active lenders when other sources of capital were unavailable.

A low-yield environment

Institutional Investors, particularly pension funds and insurance companies, have relied on fixed-income investments to provide diversification, preserve capital, generate income, and to protect against inflation. Unfortunately, the past decades of ultra-low interest rates have reduced the benefits of fixed-income allocations. Yields are so low that significant allocations to the asset class provide a drag on returns, causing investors to search for outsized returns in other portions of the portfolio. As the US faces the highest levels of inflation seen in decades, the likelihood of multiple interest rate hikes is high. Rising rates cause fixed-income portfolios to decrease in value.

Private debt provides an opportunity to achieve meaningful yield without taking on the higher risk associated with equity allocations. One of the great benefits of many private debt strategies is the interest charged on debt tends to be floating rate, insulating investors from interest rate hikes that can reduce the value of traditional fixed income. Additionally, private debt tends to be less volatile than public market debt. Private loans are not traded, and as a result, managers are not made to mark the investments to market. Despite the lower volatility of these debt instruments, the yield offered is strong on both a risk-adjusted and absolute return basis, particularly compared to public debt and including high-yield debt, which pays a meager yield for the associated risk. Private debt encompasses a wide variety of strategies with different risk-return profiles, and investors can tailor their portfolio to meet their specific needs.

Private debt and insurance

One recent trend is private capital firms partnering with life insurance companies or managing insurance assets, such as annuities. As previously mentioned, sustained low interest rates have made it increasingly difficult for insurance companies to achieve the necessarily yield from their debt portfolios to meet their liabilities. This leaves these investors with two choices: take on increased risk or seek alternative credit products that offer better returns without increased credit risk. Private debt provides investors with the latter solution. Increasingly, insurers are looking to have a portion of their portfolio managed by alternative asset managers. Private debt vehicles provide the necessary yield and are structured in a way that is well suited for the long-dated liabilities of these insurers.

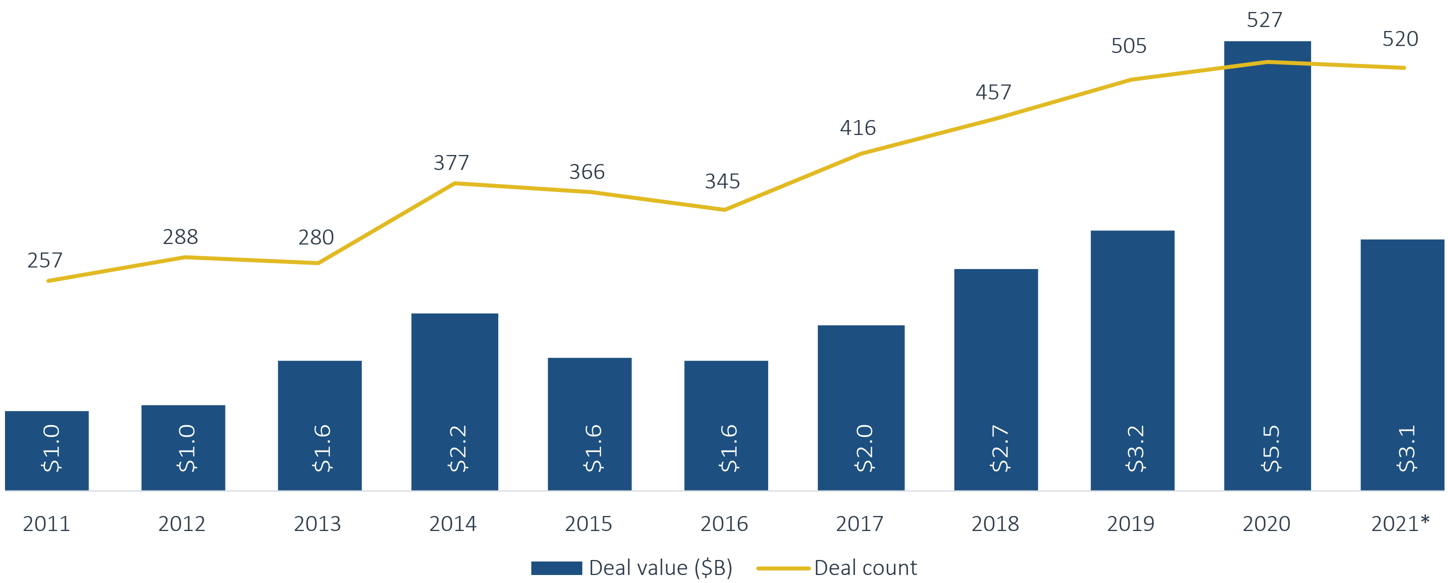
Looking ahead

The private debt market has grown substantially in a short amount of time. According to PitchBook, across the asset class, total AUM is approaching $1.3 trillion, more than double what it was in 2015. While rate increases are likely, it is also likely that low yields on fixed-income portfolios will persist. Institutional investors will continue to need returns that they are unlikely to earn investing exclusively in public debt markets. In addition, PE funds have continued to raise significant capital, not to mention the considerable dry powder that these firms are waiting to deploy. Private debt has been an important source of debt for PE firms as they pursue buyouts. Continued activity by PE will present ample opportunities for private debt firms to deploy capital.

Private debt is an important asset class for a variety of stakeholders. Businesses unable to obtain financing from banks or through public debt issuance can access capital to help them grow. Investors searching for yield can achieve it without taking on added risk. And the economy overall benefits as the lock up, draw down structure of these funds allows fund managers to deploy capital when other lenders pull back, which has a stabilizing effect during credit market dislocations.

Spotlight: Venture debt market in life sciences

US life sciences venture debt deal activity



Source: PitchBook | **Geography**: US
*As of December 31, 2021

Kyle Stanford, CAIA Senior Analyst, VC
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This spotlight is an abridged version of previously published research. The full version is available here.

Life sciences companies borrowed $5.5 billion in venture debt in 2020, the fourth consecutive year that venture loans to the industry have increased in amount. Although this adds up to roughly 16.6% of the total venture debt issued during the year, it was funded through more than 17.1% of the completed loans. At first glance, this proportion of deal count to deal value seems low, but as with the equity market, a large portion of venture debt is driven by relatively few loans. In 2020, $12.6 billion (38.1%) of the total US venture debt market value was loaned through just 10 (0.3%) financings.

The life sciences venture debt market has grown rapidly. By loan count, the market has nearly doubled since 2012. By loan value, the market has grown nearly 5.5x during that time, with the pandemic-driven borrowing taking 2020's loan value to $5.5 billion. Although the market data is similar to tech's, life sciences is the engine behind much of the venture debt market; it introduces a different set of risks for lenders and borrowing companies, as well as a different set of methods to secure loans.

An increasing number of lenders are operating in the life sciences market. Examples include several of the large business development companies and smaller fund lenders, which are providing new borrowing opportunities for VC-backed companies. This shift, along with the continued growth of the broader venture market, portends a further boost to venture lending. Although interest rates are likely to increase from the basement rates that have marked the past decade, the use cases of borrowing and the return profile of venture lending will likely prove to be insulators against low to moderate rate increases.

TREE LINE

LOWER MIDDLE-MARKET DIRECT LENDING

$2.0B AUM	**$2.4B** Commitments Issued	**$3-$30M** Target EBITDA

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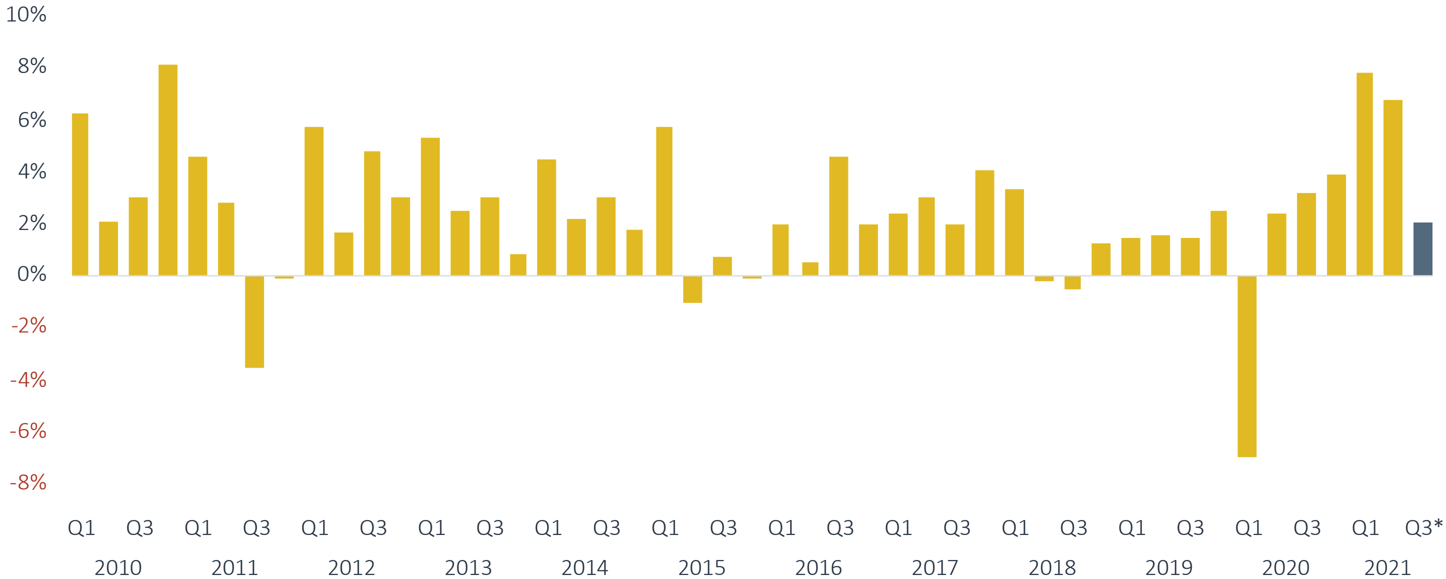
Performance

Private debt quarterly pooled IRR



Source: PitchBook | **Geography**: Global
*As of September 30, 2021
Note: Q3 2021 data is preliminary

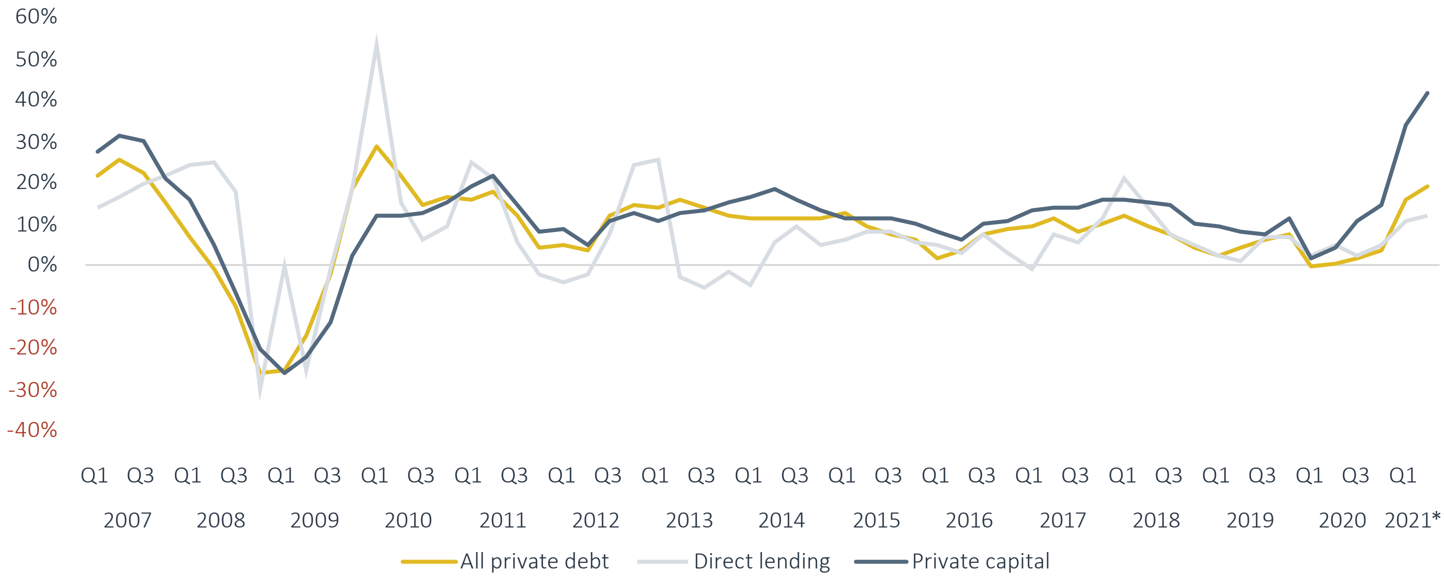
This section was originally published in the 2021 Annual Global Fund Performance Report, which also includes analysis on private equity, venture capital, real assets, secondaries, and other private market strategies.

Riding the wave of strong corporate earnings and continued recovery from the first year of the pandemic, private debt funds in Q2 2021 recorded their strongest performance since 2010. The rolling one-year horizon IRR for private debt reached 19.0%, while direct lending funds lagged at a still impressive 12.3%. Debt strategies with more equity-like characteristics, such as mezzanine and distressed debt funds, buoyed the performance of private debt overall, while direct lending—which relies more on steady interest payments from portfolio companies—experienced more modest gains. Preliminary figures for Q3 2021 point to more subdued—albeit still positive—performance for private debt. The preliminary quarterly IRR slipped to 2.1% in Q3, the lowest figure since Q1 2020, when the pandemic began to roil markets.

The prospect of multiple interest rate hikes in 2022 will have varied effects on private debt funds. Direct lending funds tend to hold floating rate instruments, which will be relatively immune to rate increases. Higher inflation, however, will diminish the real returns provided by interest payments. High-yield credit spreads, often seen as a proxy for direct loans, will be just as important to future performance and markups of these funds. Other substrategies, such as real estate debt and infrastructure debt, may be more adversely affected by rate rises and any potential slowdown in the real economy, but will likely prove more resilient in an inflationary environment.

Performance

Rolling one-year horizon IRR for private debt funds



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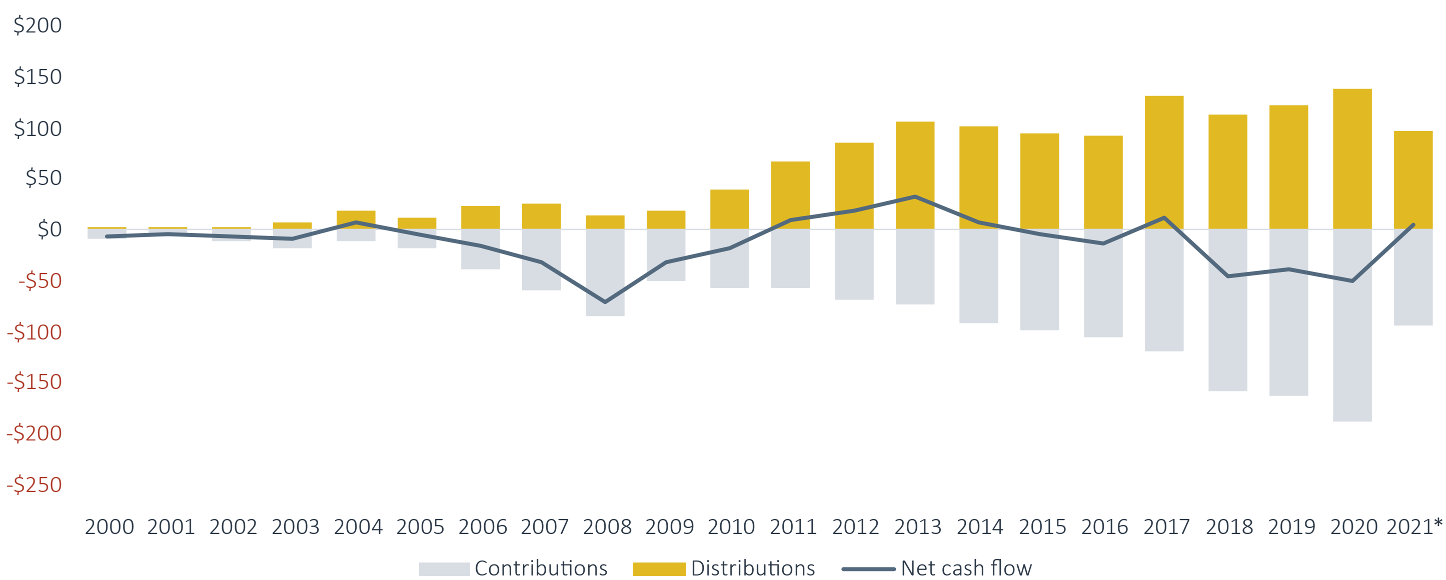
Private debt cash flows ($B)



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*As of June 30, 2021

Q&A: Tree Line Capital Partners

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


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.

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 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 tech-enabled services, business services, and asset light businesses, we have not seen much pressure from a supply chain perspective. Rising labor costs are being 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 middle-market 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.

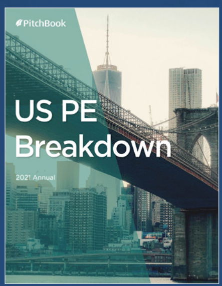
What advice would you give to investors in the current environment?

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.

Additional research

Private Debt Performance



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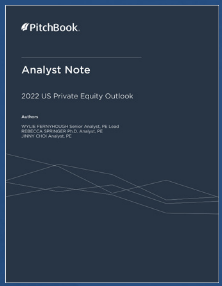

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