EXPERT Q&A

As private debt investors target technology, direct lenders with experience and expertise will stand out in the crowd against a less-certain backdrop, say Zia Uddin, Stewart Hanlon and Mark Solovy of Monroe Capital

Specialisation hones edge in software

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Q There's obviously a lot to like about technology given the growth over the past decade. But from the perspective of a lender, what's drawing Monroe into the sector?

Zia Uddin: Our deep understanding around technology has been part of the firm's DNA for a long time. We've completed over 100 deals in the sector, so we can invest with speed and conviction, but more importantly, certainty for our clients. We have a broad breadth of subsector experience within technology and been an active player in this market for over 18 years. What continues to appeal to us is the steady growth of the addressable market. And we're still in the early innings.

You'll recall that 10 years ago, Marc Andreesen predicted that software was going to eat the world. Based on the activity we're seeing in the market, every company, in some part, is becoming a tech company. As cloud adoption grows and digital transformation trends work their way through traditional industries, the addressable market is only going to expand.

According to Pitchbook, there were over 600 tech deals completed in the mid-market alone last year, which is four times the number of deals just 10 years earlier. If you look at total M&A volume, including strategic activity, Refinitiv documented that the value of technology deals eclipsed $1.1 trillion last year and represented a fifth of all M&A globally. Given the enthusiasm for software across private equity and the ongoing digital transformation across more traditional industries, it wouldn't surprise us if at some point soon, tech deals represent as much as a third of all private equity activity.

Q What's driving borrowers' funding needs?

Stewart Hanlon: It can be hard to

generalise, but among private equity sponsors, the funding clearly supports deal activity, both to acquire platforms and then to pursue bolt-ons. But roughly 20 percent of our deals are for non-sponsored credits. In these cases, we're seeing more and more companies eager to tap the debt markets to fund growth without diluting their equity.

Our funding will often support sales and marketing efforts to drive revenue growth or R&D to introduce new products or enhance an existing product or service offering. Given the mission criticality of many software offerings, our borrowers are eager to capture as many new customers while there is still white space, as the recurring nature of the revenue stream will result in significant cashflows over the lifetime of that customer.

Q In the public markets, the tech space has been going through a bit of a rough patch, particularly some of the FAANG [Facebook, Amazon, Apple, Netflix, Google] names. How do you account for some of the macroeconomic risks beginning to surface?

Mark Solovy: Even after the correction, tech names are still trading at a healthy premium to most companies in other industries. But one of the appeals of the sector is that by and large, these are asset-lite businesses. They're more immune to the inflationary pressures affecting other areas of the market. They don't experience the same supply chain issues that many other businesses do. Also, because margins are so high, companies can absorb a level of economic turmoil without it affecting their ability to pay back their loans.

A lot these public companies were overvalued. And based on IPO activity so far this year – or lack thereof – there are quite a few unicorns out there burning through cash that have fallen out of favour with investors. As the public markets become inaccessible, this is actually creating more opportunities for direct lenders, particularly among some of the unicorns who are hesitant to raise equity at current prices and go through a down round. But the biggest risk in tech today revolves around valuations.

Through a "credit-first/zero-loss" lens, we know how important it is to be a steward of our investors' capital at the front end. Since we invest in senior secured debt, we take comfort in terms of where our commitments sit in the capital structure, but at the same time, we often receive better pricing than the more liquid larger-cap market, and our loan-to-value ratios are lower, typically in the low 20 percent range.

Q Are there other ways specialisation can inform your approach?

MS: It influences everything and every function from origination and underwriting to portfolio management and even appetites of our investment committee. The industry tailwinds supporting the sector are quite powerful, but you need people embedded in these markets to source deals and create choice; you need dedicated expertise to scrutinise intense competitive landscapes and understand the sector's unique valuation metrics; and you need to understand the dynamics of end markets to create a diversified portfolio.

SH: Even the KPIs to assess company health are different. For instance, generalist firms are programmed to focus on historic, "rear-view" metrics, such as TTM [trailing 12 months] sales or earnings. In software, you're only as good as your last quarter, so whatever happened over the last 90 days will get extrapolated out into the future. It's a different mindset. You're also looking at different metrics, such as retention and churn rates, upsell and downsell, and customer concentrations relative to annual and total contract values, among others.

Expertise is also required to bridge the difference between traditional GAAP accounting and the extent to which bookings are converted into revenue and which dollar, ultimately, can drop to the bottom line under ASC 606. This stuff isn't necessarily intuitive without experience and expertise.

Q Were there any takeaways from the pandemic that might speak to how the sector will perform amid a disruption?

SH: The onset of the pandemic represented something of a "pull forward" in terms of where companies and even consumers were in their adoption curve. That likely contributed to some of the inflated valuations we saw last year. It's also difficult to find parallels when the government drops $6 trillion from the sky in the form of stimulus.

That being said, the pandemic did provide an interesting data point as it relates to technology spending during a downturn. It confirmed the prevailing thesis that businesses would prioritise their mission-critical software spending above all other expenses. Software, generally, takes labour costs out of operations and makes companies more efficient. It's not exactly counter-cyclical, but these dynamics can help to mute recessionary impacts that might be more acute in other sectors.

Q Over the past few years specialisation in tech may not have seemed so critical; as the market begins to experience some turbulence, I imagine it's becoming increasingly important.

ZU: There has been a lot of wind at the backs of direct lenders the last several years. That's quickly changing. If you don't understand technology or the specific software products and how they're positioned in their respective markets, you're going to take on risks that you don't get compensated for.

Private credit, as it relates to its maturation, tends to be five to 10 years behind private equity. And just as buyout investors embraced certain specialisations, the private debt market is now undergoing the same evolution. Tech, in particular, has some of the nuances that have heretofore provided a moat for Monroe as competitors struggled to get their arms around how to lend against recurring revenues versus cashflows or even assets. Truly understanding what some of the products are is a challenge for many traditional lenders as well. This has fuelled higher risk-adjusted returns in the sector to date.

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>
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Q So what does specialisation look like?

MS: I think from the borrower's perspective, specialisation is reflected in our deep understanding of the business and the opportunities and risks in front of it. We can come in and make an assessment very quickly. Even a quick "no" demonstrates our experience. I spend the bulk of my waking hours looking at tech deals. It's what we live and breathe. We understand the value proposition of companies in the space, the latent risks, and have an intimate understanding of the market. This drives conviction, which translates into speed and certainty, and it allows us to be better partners than our peers.

SH: From an LP's perspective, what they may not realise is that without a deep understanding around where the threats may reside, most generalists will be absorbing undue risks. All recurring revenue is not created and valued equally. Many of these companies are not generating a significant amount of EBITDA, so if lenders are wrong about the extent to which recurring revenues are "truly" recurring or the actual margin derived from those recurring revenue streams is lower than originally estimated, they will see value degrade very quickly.

Q So given the shifting landscape, any predictions in terms of how the market will continue to develop?

ZU: An estimated 97 percent of all software companies are still private. The bulk of these companies reside in the mid and lower mid-market. You now have a growing population of founder-owned, sometimes minority venture-backed, companies looking for funding that won't further dilute their equity stakes. The opportunity set will only become more compelling for private credit firms such as Monroe as time goes on. We obviously are bullish about the opportunity set and have been investing for years in our infrastructure to take advantage of it.

It's unavoidable that the supply of capital serving this market will grow. But when you look at the amount of dry powder in private equity, the growing proportion of tech dealflow, and the digital transformation trends in other legacy sectors, there's still a material structural supply/demand mismatch. If you look at the size of some of the recent tech PE funds being raised, you would assume one should see a similar corresponding size for a tech private credit fund – it hasn't happened yet but I think it will.

Success, however – and the ability to deliver consistent risk-adjusted returns – will ultimately trace back to how well lenders understand this market and their willingness to roll up their sleeves and drill into the underwriting to discern the appropriate risks. Specialisation, in this regard, really does define our investment edge and underscores how we distinguish ourselves among borrowers and other investment firms. At the end of the day, our goal is to provide a differentiated risk-adjusted return that investors will not be able to get elsewhere. ■

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