



**MONROE
CAPITAL**

LEADER IN MIDDLE MARKET PRIVATE CREDIT

PRIVATE EQUITY'S SAAS REVOLUTION AND THE COMPELLING OPPORTUNITY IN PRIVATE DEBT

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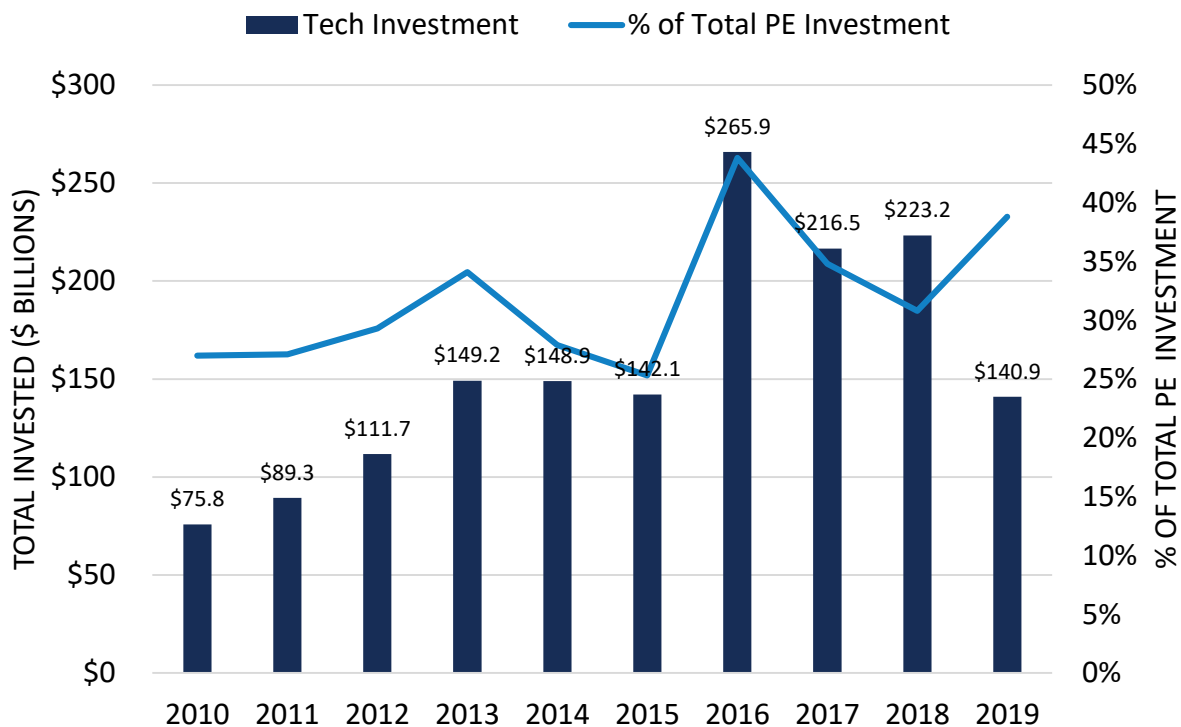
PRIVATE EQUITY’S SAAS REVOLUTION AND THE COMPELLING OPPORTUNITY IN PRIVATE DEBT

Historically, technology investing has been confined to a small subset of specialist sponsors and lenders. Software business models, however, have evolved over time. This transformation has not been readily understood by a majority of private credit lenders. Today, the sector is distinguished by unique characteristics that differ from those of traditional enterprise-value cash-flow loans. This has created a unique opportunity for a small segment of private credit lenders who understand the risks, are equipped to conduct the appropriate level of due diligence, and have the experience to monitor such investments.

INTRODUCTION

In 2008, investments in information technology and software represented a fraction, or about one fifteenth, of the total private equity-backed deal volume in the United States. Fast forward 10 years, and deal volume in the sector increased approximately 6x, according to data from PitchBook. While the pace of investment activity has decelerated across every other sector as of the midpoint of 2019, technology buyouts should eclipse last year’s total by a significant margin. In the first half of this year, activity in information technology represented almost 40% of all private equity deal volume.

U.S. PRIVATE EQUITY INVESTMENT IN TECHNOLOGY COMPANIES¹



¹ Source: Pitchbook <https://pitchbook.com/news/articles/in-a-high-tech-world-private-equity-wont-be-left-behind>

It has not always been this way. Twenty years ago, several of private equity's early pioneers took material losses in the technology and telecommunication industries. In some cases, sponsors had to fend off lawsuits from their limited partners for straying too far from their stated mandates. In others, dalliances in technology were costly enough to prevent some from ever raising capital again. The struggles underscored the nuanced differences that have always distinguished technology from more traditional industries. Historically, investments in slow-growth industries did not generally excite the broader public, but these steady-performing assets tended to generate considerable cash flows to reliably pay down debt, attracting private equity's earlier pioneers. Technology companies, in contrast, were traditionally characterized by high growth at the expense of cash flow. Most investors concluded the value of these companies should remain constant regardless of whether the company was growing its top line or not. The early struggles in the tech sector reflected the growing pains of an industry that had not yet matured, as well as a lack of understanding by many of the early LBO investors in the industry.

Over time, private equity's narrative around technology evolved. Part of the driver for this evolution is that the technology industry's prevailing operating model has changed over time. The significant cost reductions in computing power, memory and storage, as well as the corresponding expertise necessary to maintain the infrastructure, has changed the method of deployment for software from an "on premise" solution to "Software-as-a-Service" (SaaS). The notion that every company is either "tech enabled" or must effect a digital transformation to survive does not hurt either. Gone is the view of software as a high-risk/high-reward proposition. Private equity, today, is drawn to the sector's high degree of revenue visibility, defensive economic characteristics, high-margin profile and prospects of continued future growth. Most importantly – given private equity's "leveraged buyout" lineage – the sector's evolution has also made the space more appealing to lenders.

The catch, even as the sector now draws specialists and generalists, is that expertise still matters, particularly, for lenders. Underwriting discipline and portfolio management are even more critical to overall returns when investing in technology and will become even more important as deal-flow increases. The payoff, however, is that these capabilities can provide a moat for lenders able to bring this skillset to bear, which provides compelling risk-adjusted returns for those with the requisite experience and capabilities.

THE EVOLUTION OF TECHNOLOGY IN PRIVATE CAPITAL

For years, technology commitments outside of the venture space were confined to specialists who largely gravitated to growth capital investments, or at least deals that inverted the traditional capital structure of debt to equity in a typical leveraged buyout. In 2000, for instance, shortly after David Stanton left TPG to launch technology specialist Francisco Partners, he distinguished in an article in *The Deal* that "the buyout model can work, [but] the leveraged buyout model may not."

The success of private equity's early technology trailblazers – from Silver Lake and General Atlantic to Vista Equity Partners, Thoma Bravo, Francisco Partners, and Insight Partners – led others to try their hand in the sector. To many, the \$17 billion buyout of Freescale Semiconductor in 2006 represented a landmark deal. Beyond just the players involved (Blackstone Group, Carlyle, TPG and Permira), the investment highlighted that technology had entered the mainstream. At the time, though, this was premised on the idea that a company like Freescale could reliably produce enough cash flow to pay down its debt. This allowed the sponsors to fund the deal with an equity stake that amounted to roughly 40% of the total purchase price, representing a more typical LBO debt-to-equity composition.

Industry observers, with the benefit of hindsight, might sooner point to an investment like Marlin Equity’s acquisition of Solarsoft as being more indicative of the trends that are playing out today. A provider of enterprise resource planning (ERP) software, Solarsoft was acquired by Marlin Equity for an undisclosed amount just a few months after Freescale was acquired. The investment was under the radar at the time, but over the next five years, Marlin used the company as a platform to acquire four other software providers in the ERP segment. When Marlin exited Solarsoft through a sale to Epicor in 2012, the company’s cloud-based offering and SaaS revenue model were key factors in drawing bidder interest. Epicor, acquired by Apax Partners a year earlier, was eventually sold to KKR for \$3.3 billion in 2016, a deal that today many view as private equity’s landmark SaaS investment.

Marlin’s investment in Solarsoft didn’t necessarily rewrite the record book in terms of its total proceeds, but the investment thesis – emphasizing recurring revenues, improving operating margins, the appeal of asset-lite businesses, and certain defensive characteristics – helped to establish an archetype for the asset class as both sponsors and lenders move more aggressively into technology.

SAAS COMES OF AGE

The evolution from software delivered in shrink-wrapped boxes to a web-based model – allowing data or applications to be accessed on demand and from any device – has certainly been significant to users. Consumers and businesses have been able to eliminate the headache of massive and disruptive “on premise” system implementations or the need to upgrade every few years to avoid obsolescence. A SaaS delivery model also allows users to spread the costs out over time and, in the case of enterprise software, enables companies to outsource related IT roles to their vendor.

From the perspective of investors, the SaaS transformation in technology has been just as impactful. In addition to enhancing the company’s value proposition, the biggest difference, particularly for long-term, “patient” capital, is that a recurring-revenue model offers investors and operators more visibility into future performance and more consistency in progressing along an established growth trajectory. High switching costs, coupled with the network effect that comes with critical mass, also offers protections that didn’t exist 10 years ago.

When it comes to value creation and driving enterprise value, one of the most compelling opportunities lies in helping a traditional software company transition to a recurring-revenue model. Beyond just the business advantages, as it relates to valuations, annual recurring revenues, or ARR, can be worth about twice as much as one-time revenues (depending on the pace of growth). Notably, this reintroduces multiple expansion as a return lever, even in an era in which asset prices continue to test new highs.

To cite one example, multi-media and digital marketing software maker Adobe initiated a similar transformation in 2013. In just five years its recurring revenues grew from \$200 million to \$5 billion, while its price-to-earnings ratio expanded from approximately 20x to around 50x. This is also the reason why consumers are inundated with subscription models for everything from vitamins, razors, cosmetics, television-, movie- and music-streaming services. Even Nike came out with a sneaker subscription service earlier this year.

CLOUD AS AN ENABLER

Modern cloud computing has been around since the 1990s. It wasn’t until 2006, however, when Amazon launched AWS and Google launched its Docs platform, that it really entered the corporate consciousness. Subsequently, Microsoft introduced its own cloud platform, Azure, in 2010. If the recurring-revenue model made technology palatable for private equity and debt investors, the cloud was the catalyst that made it possible.

To be sure, the cloud’s greatest impact relates to the costs involved to deliver technology and then service it. Consider that American Online (AOL) spent approximately \$1.19 to make each floppy disk and CD that were the centerpiece of the extended and ubiquitous mass-mailing campaigns conducted throughout the 1990s. The effort was wildly successful, but anecdotally cost in the hundreds of millions of dollars. Among enterprise software providers, meanwhile, the traditional deployment model might see software vendors bundle a suite of solutions and then deliver a large-scale release to clients to implement on premise. Standing-up a comprehensive accounting system in the back office, for instance, could take several months or even years in some cases. It is costly for both vendors and clients.

Through the cloud, clients can now benefit through the continuous deployment of new or enhanced software, while the subscription model – through its ease of use – facilitates customer retention and “stickiness.”

Software and technology providers, however, arguably realize even greater benefits. Beyond just a more efficient and lower-cost business model, cloud deployment offers business leaders more clarity around revenue growth and longer lead times to identify and deal with decelerating sales. With more data at their disposal, analytics around customer churn, the pace of new bookings, or growth in a particular vertical, to name a few of the obvious metrics, can alert executives to changing business conditions or client preferences well ahead of a meaningful degradation in financial performance.

From the perspective of investors, this business intelligence can then guide and improve capital-allocation decisions. The cloud can also create tremendous efficiencies for sponsors when growing portfolio companies. It not only eases M&A integration, but it can also create a powerful value-creation lever for cloud-native, SaaS-capable acquirers.



Monroe Capital recently provided a \$260 million credit facility to North Carolina-based Dude Solutions, backed by Clearlake Capital. The company has transformed its business over the last several years to become the leading cloud-based facilities and operations-management solution for the government, education, manufacturing and healthcare verticals. Over the last four years, Dude Solutions acquired smaller niche players in both competing and adjacent markets; and through their core platform, which is multi-tenant cloud-hosted SaaS, they were able to quickly deliver additional functionality to their core product as well as cross-sell the core SaaS platform into new bases of customers. Without a multi-tenant cloud hosted solution, this process would be more complicated and time consuming and the synergies less powerful.

GROWTH WITH A MOAT

Recurring revenue business models certainly aren’t immune to downturns or even flashes of volatility. The short-lived SaaS crash in 2016 – while a misnomer since the entire technology sector suffered – signaled to public shareholders that a ceiling does exist for even high-growth names with heady valuations. The quick rebound, however, speaks to the resiliency that is appealing to sponsors and lenders today.

This reflects several factors, not the least of which is the role of technology, both in people’s lives and in fueling the day-to-day operations of most companies. Gartner, last October, forecast that IT spending worldwide would reach \$3.8 trillion in 2019, representing a 3.2% increase over last year, with enterprise software setting the pace, showing growth of over 8%. Brookings, similarly, cited data from the U.S. Bureau of Economic Analysis in underscoring the “value-add” of technology supporting other areas of the economy, again emphasizing the mission-critical role of IT to deliver efficiencies and stimulate growth across the economy, even amid market unrest. The report, again citing BEA data, noted that the IT industry’s contribution to real economic output now exceeds professional- and business-services sectors, finance and insurance, and the manufacturing industry (all of which have traditionally represented some of private equity’s favorite targets).

WORLDWIDE IT SPENDING FORECAST (BILLIONS OF U.S. DOLLARS)¹

	2017 SPENDING	2017 GROWTH (%)	2018 SPENDING	2018 GROWTH (%)	2019 SPENDING	2019 GROWTH (%)
DATA CENTER SYSTEMS	181	6.4	192	6.0	195	1.6
ENTERPRISE SOFTWARE	369	10.4	405	9.9	439	8.3
DEVICES	665	5.7	689	3.6	706	2.4
IT SERVICES	931	4.1	987	5.9	1,034	4.7
COMMUNICATIONS SERVICES	1,392	1.0	1,425	2.4	1,442	1.2
OVERALL IT	3,539	3.9	3,699	4.5	3,816	3.2

Still-developing innovations, from artificial intelligence to big data and analytics, will become even more embedded in our daily lives. It’s hard to see a scenario in which the mission-critical nature of technology doesn’t become more acute. And 5G infrastructure, when it does arrive, will create new use cases for these and other technologies.

These secular trends, to be sure, have been in place for some time and still have a long runway ahead. What really appeals to private equity’s “risk averse” sensibilities, though, is the variable-cost, asset-lite model that offers defensive characteristics in the event of short- or medium-term turbulence. It’s not just the favorable working capital dynamics, in which contracts are generally paid upfront versus in arrears. The limited capex requirements in which the bulk of free cash flow is often directed toward either R&D or sales – both of which can augment the upside – provide companies and investors flexibility to quickly adjust as circumstances change.

¹ Source: Gartner (October 2018)

Vista Equity Partners has been among the most active private equity investors in the SaaS space. While it has proven itself as a shrewd investor, Vista's performance offers some evidence of the software industry's newfound resilience against market dislocations. The firm's 2007 vintage, \$1.3 billion Vista Equity Partners Fund III, for instance, produced an IRR of over 33%, which compares quite favorably to the asset class' pooled average IRR of 11.84% that same year, according to Cambridge Associates' Q4 2018 Benchmark Index. Keep in mind that the fund's investment life preceded and extended into the teeth of the global financial crisis. Proof of investors' faith in the sector and the GP is evident in Vista Equity Partners' \$16 billion fundraise for its seventh fund in the third quarter of 2019.

THE CASE FOR SPECIALIZATION

Even as Vista and others have made a name for themselves in technology, and clearly bring a specialized skillset, the secular trends supporting the sector are drawing generalist investors into the space as well. In some cases, it may be firms who have specialties in other areas, such as healthcare, whose entry into technology navigates through software companies serving their preferred verticals. In other cases, it may be more risk-averse investors who simply had to gain more comfort in the sector or generalists who had a harder time accessing deal flow prior to the influx of opportunities.

Among lenders, however, the very idea of specialization – in any sector – is a fairly new concept for most, and many historically avoided software given the challenges and perceived risks around assessing valuations, underwriting, and understanding anomalous business models. These fears were only compounded by the cyclical nature of the industry witnessed in earlier eras. The improved backdrop certainly eliminates some of the unknowns, although other subtle differences highlight why specialization still matters among lenders.

DIFFERENT DEAL CALCULUS

As a result of specific changes to US GAAP accounting, as well as, the deviating business models utilized by software companies, expertise in underwriting by lenders is critical. For example, FASB's introduction of ASC 606 to US GAAP standards, which in January 2019 changed how software companies can recognize licensing and subscription-driven revenue, created incongruities in comparing current results with historical performance. The new accounting standards posed additional challenges in determining working capital needs and surfaced new issues with covenant compliance due to lost revenues or adjustments to retained earnings. Investors also encountered material purchase-price adjustments when acquiring companies with longer-term contracted revenues that were paid upfront.

Other regulatory risks also require scrutiny in due diligence. Last year, for example, the South Dakota vs. Wayfair, Inc. Supreme Court decision forced online companies to comply with state- and local-tax laws regardless of nexus in a local area. Additionally, in Europe, there has been a growing movement to charge a digital tax on revenues instead of profits.

TOP-LINES VS. BOTTOM-LINES

The other challenge that can confound newer entrants is more philosophical in nature. For example, Uber's warning in its S-1 filing ahead of its IPO that it may never be profitable was anathema to the sensibilities of most private equity investors, and certainly for lenders. Of course, Uber is a transactional revenue business versus one that produces recurring revenues, so it will generally attract a different kind of investor.

But even the commonly quoted “Rule of 40” – a metric that often guides how SaaS investors contextualize company performance – represents a marked departure for more traditional value investors. Put simply, the “Rule of 40” suggests that revenue growth and EBITDA margin, when added together, should equal or exceed 40 percent. It speaks to the emphasis on growth while also focusing on its relationship to profits for SaaS businesses. This criterion also underscores why discipline is so critical for investors and lenders, demanding a consistent and repeatable process amid an influx of opportunities in which the characteristics or fundamentals defining success can be so variable. Moreover, while the Rule of 40 is often cited by VCs as something of an aspirational metric, it’s rarely achieved by most software companies and is more of a guiding principal for companies rather than a black-and-white benchmark.

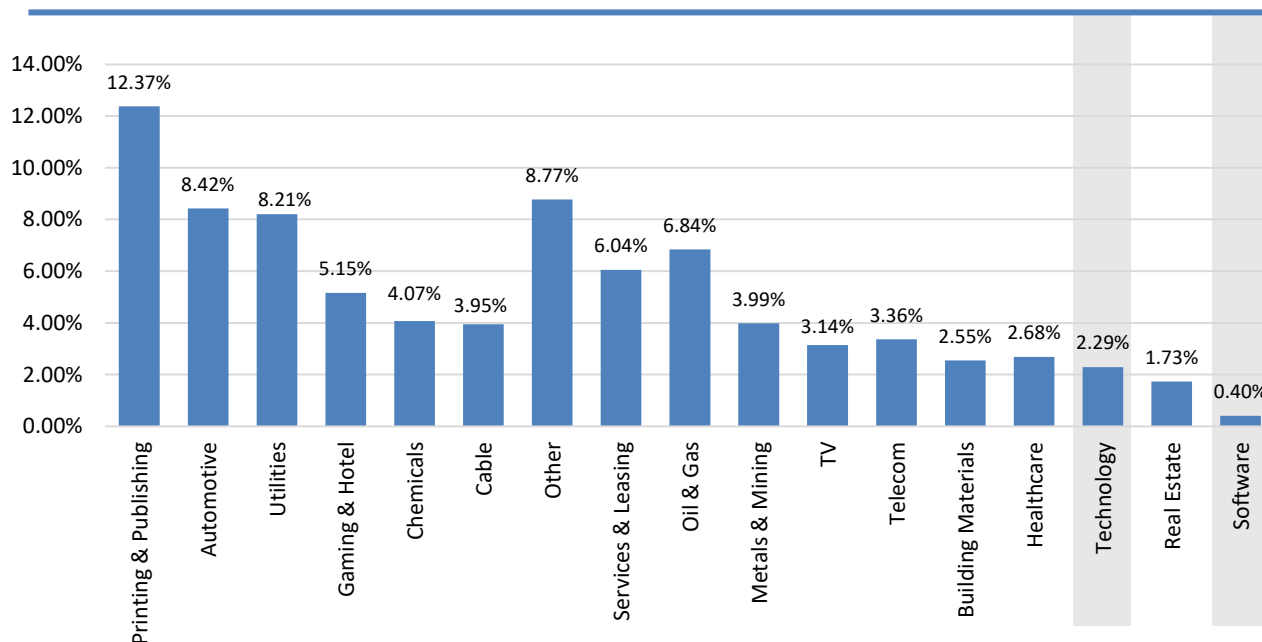
Of note, too, even amid the hype accompanying the rise of SaaS, it bears repeating that the technology lending segment is not without risk. The bankruptcy of adtech firm Sizmek in April also provided a timely reminder that the technology sector can be just as exposed to trends influencing certain end markets or consequential business decisions that don’t play out as planned. Sizmek was ultimately done in by its acquisition of former unicorn Rocket Fuel, whose programmatic marketing platform saw its top-line growth decimated by competition from Google and Facebook.

ATTRACTIVE RISK-ADJUSTED RETURNS

Even in an era of high asset prices, however, the defensive characteristics of information technology endure. Indeed, the high valuations in the sector, particularly for SaaS companies, can at times seem absurd to those less familiar with the evolving dynamics of the business model. When Vista acquired Marketo, a provider of marketing-automation software, for \$1.8 billion in 2016 (representing a 64% premium to its stock price), the valuation may have seemed high to observers outside of technology. Vista turned around and sold Marketo to Adobe two years later for \$4.75 billion, or 14.8x TTM revenues, reflecting both the company’s strong top-line growth and an ecosystem that appreciates ARR momentum as much or more than the bottom line.

Not to be overlooked, though, when Vista acquired Marketo in 2016, it reportedly funded the deal with \$1.3 billion of equity. While investors are paying higher multiples, they’re also generally providing a larger equity cushion to backstop the debt. This dynamic helps explain why since 1995, technology debt has a cumulative default rate of 2.3%, while software debt has a miniscule 0.4% cumulative default rate. To put that into context, healthcare – the prevailing safe-haven for credit investors – has a cumulative default rate of 2.7% over the same time period.

CUMULATIVE DEFAULT RATES BY INDUSTRY (1995-2019)¹



¹ Source: S&P LCD Default Review – Q3 2019; Technology is classified as “Computer and Electronics” and Software is classified as a sub-category, “Software and Data Integration”, by S&P

To be sure, as more traditional private equity sponsors test the waters in technology and software, deal-flow will likely continue to grow. As valuations increase more sellers will enter the market as well. Boston Consulting Group, in its research “Cracking the Code in Private Equity Software Deals,” estimates that approximately 900 late-stage VC-backed software companies could enter the market by 2021.

From a lenders’ perspective too, the opportunity set can also incorporate non-sponsored deal-flow. In a 2019 BDO Technology Outlook Survey, 45% of IT-company executives said they would focus on private debt to fund future growth, versus 25% who identified private equity or 14% who said they would look to the public markets. Moreover, with sponsors having raced headlong into the sector over the past few years, this activity will only drive future financing events, whether through executing dividend recaps or pursuing exits via sponsor-to-sponsor sales.

According to PitchBook, the total volume of technology deals since 2016 has exceeded \$200 billion. Without assuming any growth in the market, based on a loan-to-value ratio of between 25% to 50%, the market for sponsor-backed private credit opportunities, alone, is conservatively between \$50 billion to \$100 billion in size.

For lenders new to the sector, this speaks to the importance of discipline, particularly as an influx of opportunities can create bandwidth challenges in performing timely due diligence and underwriting. Portfolio management will also become more important for funds to spread their risk across different end markets. For lenders with experience and a track record – with dedicated capabilities to both source and underwrite technology and software credits – the supply/demand dynamic should augment risk-adjusted returns.

In order to generate the appropriate risk-adjusted returns for private credit lenders, differentiated sourcing, underwriting and monitoring capabilities need to be developed since these transactions are fundamentally different than traditional cash-flow lending. In addition, industry expertise is critical in understanding various technological risks in the products and solutions that these companies deliver. And as the Sismek bankruptcy demonstrated, investors should also recognize where the competitive threats reside.

For the above reasons, there has been, and continues to be, a limited number of lenders, such as Monroe Capital, with a strong track record, industry expertise, and dedicated capabilities to source, underwrite and monitor technology and software investments and generate superior risk-adjusted returns for their limited partners. As a result of activity in the market and the secular trends in the industry described earlier, a number of new direct lenders will enter the market to invest in software transactions in the future. Those who do not have experience and expertise in the sector will invest limited partner capital at their peril.

MONROE EXPERIENCE IN SOFTWARE, TECHNOLOGY & RECURRING REVENUE¹

- **75**
TECHNOLOGY TRANSACTIONS CLOSED
- **\$3.2**
BILLION INVESTED CAPITAL IN TECHNOLOGY
COMPANIES

MONROE FIRMWIDE EXPERIENCE¹

- **1,300+**
TRANSACTIONS CLOSED SINCE FIRM INCEPTION
- **\$17.0**
BILLION IN TOTAL FINANCING VOLUME
- **16**
YEARS IN BUSINESS

ABOUT MONROE CAPITAL

Monroe Capital LLC is a private credit asset management firm specializing in direct lending and opportunistic private credit investing. Since 2004, the firm has provided private credit solutions to borrowers in the U.S. and Canada. Monroe's middle market lending platform provides debt financing to businesses, special situation borrowers, and private equity sponsors. Investment types include cash flow, enterprise value and asset-based loans; unitranche financings; and equity co-investments. Monroe is committed to being a value-added and user-friendly partner to business owners, senior management, and private equity and independent sponsors. Our team has experience across many industry verticals, including specialization in software and technology, business services, healthcare, media, distribution, manufacturing, consumer goods, and specialty finance. The firm is headquartered in Chicago and maintains offices in Atlanta, Boston, Los Angeles, New York, and San Francisco. For more information, please visit www.monroecap.com.