Software Investing and AI Disruption

MONROE CAPITAL

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While recent volatility in public SaaS equities may suggest a sudden shift in the long-term outlook for software, **AI risk has been a core underwriting consideration for us for several years**. In mid-2025, well before the launch of widely discussed tools such as Claude Code and Codex, we published the following white paper outlining our framework for evaluating AI risk and opportunity in software lending. The conclusions from that work remain highly relevant today.

Independent practitioners in the software ecosystem have noted that recent valuation compression in public SaaS markets is not primarily an indication that AI will render enterprise software obsolete, but rather that enterprise IT budgets are reallocating toward AI initiatives and outcome-oriented spend. This dynamic results in near-term growth moderation for traditional license and subscription models without undermining the long-term relevance of mission-critical software. Such reallocation reflects evolving buyer behavior rather than a collapse in the underlying utility of enterprise platforms that serve as systems of record.

We do not claim to predict the precise trajectory of AI innovation. No investor can. However, the increasingly popular narrative that AI will broadly displace enterprise software is, in our view, misguided. What we are seeing instead is the continued maturation of the software industry, where the most durable opportunities lie in specialization and the integration of new technologies, such as AI, into domain-specific, mission-critical solutions.

Enterprise software is not disappearing; it is evolving into more intelligent and more specialized forms. Incumbent providers that serve as trusted systems of record are often best positioned to lead this evolution, given their embedded workflows, regulatory standing, and access to proprietary data. As AI adoption becomes increasingly verticalized, these platforms are able to deploy AI in ways that deepen customer reliance rather than commoditize their offerings. We are already seeing this dynamic play out across our portfolio, particularly among vertical software businesses integrating AI to enhance functionality and strengthen customer lock-in.

As has always been the case, we believe disciplined underwriting, active portfolio management, and a focus on mission-critical enterprise software remain durable advantages for senior secured lenders as new technologies emerge.

While AI may pose an existential threat to certain software companies, vertical SaaS incumbents serving as systems of record that smartly deploy AI will deepen their competitive moats

Current Portfolio Observations

We actively monitor AI-related risks across the portfolio through monthly and quarterly reviews and at every investment committee. Across our strategies, software exposure represents approximately 15–20% of invested capital, and no individual software investment accounts for more than ~1% of total portfolio fair value. To date, we have not observed any material AI-driven financial impact within the portfolio.

In fact, the portfolio is navigating the AI transition well, with average ARR growth > 15% and strong profitability metrics (> 75% gross margins; > 10% EBITDA margins). Retention remains consistent with historical averages, with > 100% net revenue retention.

This performance is consistent with what we would expect from mission-critical enterprise software platforms, even amid heightened AI-related investment by customers. This observation aligns with broader market commentary that slowing growth in some public SaaS segments is driven more by budget reallocation to AI and productivity initiatives than by fundamental enterprise software obsolescence.

We do not view our portfolio companies as caught in an either-or, zero-sum competition. Our enterprise software companies are actively building and integrating AI functionality into their products, and we are seeing customers support those investments through continued high contract renewal rates.

Systems of record that combine proprietary data, embedded workflows, and enterprise-grade AI and agent capabilities have continued to demonstrate durable, profitable growth. ***While vigilance remains important, we believe the value of profitable growth will endure alongside continued technological innovation.***

Monroe's Software & Technology Track Record

Our perspective is informed by a long track record investing through multiple technology cycles. Since 2006, Monroe has completed approximately 180 software and technology investments, representing $12.6 billion of invested capital, generating attractive returns in excess of broader direct lending benchmarks. Of those investments, 96 have been fully realized, with only one software-related default over nearly two decades.

Monroe's deep software investing experience and disciplined underwriting is centered on downside protection, durability of cash flows, and mission-critical use cases. These principles remain essential in the AI era

How We Assess AI Risk in Software

01

Mission-Critical Enterprise Software (Core Focus)

The majority of our software exposure is in enterprise businesses that provide essential, embedded solutions with high switching costs and compliance-driven workflows. End markets that require accuracy, such as healthcare, financial services, and government work remain especially attractive and well-protected from AI-native players where hallucinations remain a major flaw. Accuracy, auditability, reliability, and data security are non-negotiable for these customers, creating meaningful barriers to rapid displacement by AI-native tools.

02

Vertical SaaS with Embedded Domain Expertise (Structural Advantage)

We strongly favor vertical SaaS platforms over horizontal software tools. Vertical software is typically built around highly specific industry workflows, regulatory requirements, and domain knowledge that cannot be easily replicated by generic or horizontal AI solutions. These platforms often benefit from proprietary, industry-specific data sets and deeply embedded customer relationships, making them natural systems of record. As AI capabilities advance, vertical SaaS providers are uniquely positioned to apply AI within narrowly defined, high-value use cases where accuracy, explainability, and compliance are critical, deepening the competitive moat rather than eroding it. Market behavior and valuation trends continue to demonstrate a premium for vertical specialization relative to horizontal software, reinforcing the competitive advantages of domain-specific solutions in both growth and resilience amid changing technology cycles.

03

Diversified Customer Bases and Staggered Contract Renewal Cycles (Early Warning and Visibility)

We favor software businesses with diversified customer bases and staggered contract renewal schedules, rather than concentrated customers or highly synchronized renewal cycles. This structure provides meaningful visibility into customer behavior over time, allowing us to observe changes in renewal rates, usage patterns, pricing tolerance, and AI-related substitution risk well before issues become portfolio-wide. Importantly, the absence of “all-at-once” renewal cliffs gives management teams and lenders time to adapt strategy if market conditions change or if growth trajectories require a reassessment of the original investment thesis.

Enterprise Platforms Layering AI (Opportunity Set)

04

Many of our portfolio companies are actively embedding generative AI into existing systems to enhance workflows, improve productivity, and deliver better decision support. We view this as a structural opportunity for margin expansion, increased customer dependence, and higher switching costs over time.

SMB and Easily Replicable Software (Areas We Largely Avoid)

05

We intentionally limit exposure to SMB-focused software, marketing technology, content generation tools, call center software, and generic application development platforms. These categories tend to be less customized and more susceptible to AI-driven substitution and represent a small portion of our exposure by design.

Downside Protection Still Matters

Our software loans are structured with conservative leverage (typically around 2.2x ARR) and low loan-to-value ratios (generally below 30%). As a result, enterprise values would need to decline materially before impairments would occur, providing a meaningful buffer against valuation compression and technological disruption.

AI Risk Beyond Software

While current market attention is focused on SaaS, we believe it is equally important to understand how AI may impact non-technology sectors, including healthcare, manufacturing, and business services. In many cases, AI poses greater risk to labor-intensive service models than to embedded enterprise software platforms.

Our underwriting and portfolio management in these sectors is informed by the same technology and AI expertise we apply to software investing. ***Avoiding software exposure does not equate to avoiding AI risk.*** We believe investors without deep AI and technology expertise may underestimate obsolescence risk in industries traditionally viewed as "non-tech."

As an example, we were recently lenders to a strongly performing company owned by one of the best PE sponsors in the world in the medical language translation industry. The company sells its services to hospitals and physicians to meet regulatory requirements requiring translation into the native language for patients who do not speak English. When we were approached by the sponsor to help finance a dividend recap in 2025, based on our

views that AI could eventually supplant this company's labor-intensive translation services business model, we respectfully declined. This sponsor had no shortage of generalist healthcare and business-services focused private credit firms that were happy to step into our place. While we wish all parties well, this illustrates the type of risk we believe generalist investors may underestimate in a rapidly evolving technological landscape.

In Summary

- AI represents more opportunity than risk for the types of companies to which we lend. Across both software and non-software sectors, the most immediate impact we are seeing is improved automation and productivity, with potential cost and margin benefits.
- At the same time, we remain in close dialogue with management teams and sponsors to assess AI strategy, competitive positioning, and evolving risks on a company-by-company basis. Our conservative structures, active portfolio management, and long track record investing through multiple technology cycles continue to position us well.
- As always, we are happy to discuss our views further or walk through our framework in more detail

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