EXPERT Q&A

Enterprise software is an attractive industry for private equity and offers real opportunity for direct lending, says Thoma Bravo's Oliver Thym

All systems still go for enterprise software

Enterprise software has been an attractive industry to investment managers for some time, and macroeconomic trends and the flow of capital into private credit offer a unique opportunity for direct lenders and borrowers. We spoke to Oliver Thym, a partner and head of credit at Thoma Bravo, about the enterprise software sector and how the firm's industry expertise has helped to create a differentiated private credit strategy.

SPONSOR
THOMA BRAVO

Q With expertise in software tech, how did you launch your private credit strategy?

We have seen and continue to see many indications of the continued expansion of the technology and software industries. Gartner Research forecasts global software spending will grow 13 percent annually for the next five years, and historically speaking, this is not an anomaly – and with that growth, there is an opportunity for equity and debt capital solutions.

Our private credit strategy grew from interest from our LPs, who liked what we were doing on the private equity side and wanted to invest in the debt components of these companies. Our investors asked to co-invest in those opportunities and partner with us, so after considerable thought and discussion, we raised our first pool of direct lending capital and started our dedicated direct lending strategy in 2017.

As a historical private equity investor, we observed the overall growth in the private credit market and saw direct lending as an alternative source to finance our buyout investments. We observed what rates were paid and what lenders received in return for their capital outlay, and we found the opportunity to be exciting from a risk-return perspective.

For us, enterprise software direct

lending is a natural extension of Thoma Bravo's industry focus and expertise. We believe private credit is uniquely well-positioned to capitalise on the software industry's momentum, and our credit strategy seeks to provide strong risk-adjusted returns with reliable downside protections.

Q How do you describe your direct lending strategy?

Our strategy focuses predominantly on first lien, private equity sponsor-backed debt through direct origination. As a credit business, we also have the flexibility to help finance Thoma Bravo equity transactions. In those deals, we have a high conviction of their value, with a differentiated, earlier and deeper access to due diligence compared with other debt investors.

As the business has grown, so have our relationships with other private equity firms. Our disciplined sponsor coverage efforts have really been paying off, and we are pleased to have so many sponsors that look to us repeatedly for debt financing. We look forward to continuing to strengthen our existing relationships and to further broaden our coverage universe.

We believe software lending has significant momentum, and we have played meaningful leadership roles in deals where other private sponsors own the equity. While we originate and lead transactions, we also have the flexibility to play in the primary and secondary markets if there is a market dislocation and we believe we have differentiated sector and company insights.

Q How do you look at the software lending space?

In general, software lending is popular, and the enterprise software sector is one of the larger industry allocations now that private capital has woken up to this business model. We love the visible and recurring revenue streams, strong free cashflow, high profitability and attractive loan-to-value ratio of the companies in which we invest – all with enterprise software's historic resilience through economic cycles.

We have focused on enterprise software investing for more than 20 years, and the industry is the full-time focal point of our credit investment team. We evaluate each opportunity by leveraging the expertise and due diligence resources of our equity and capital markets investment professionals, operating partners and advisers. We believe our unique set of capabilities and industry expertise is our competitive edge.

People tend to window-dress their business on paper, and enterprise software is no exception. There often are great metrics and grand visions, but more importantly, we pride ourselves on getting to the raw data buried beneath that and analysing it using the best practices we have honed over decades.

At the same time, we dig into the companies' business models, competitive positioning, specific technology, the end market they serve in and many other characteristics of the company. We designed our strategy to leverage our institutional knowledge to foster better decision-making and superior risk mitigation.

Q What blind spots might new managers have?

We should perhaps step back and discuss why enterprise software is so attractive. First, when we speak about customers, we are talking about the corporate customer, not the consumer. When the economy is humming, the consumer dollars are there; when the economy is not, consumer dollars often dry up. But once corporate customers buy the products of our portfolio companies and integrate those products into their workflow, those products are no longer a discretionary spend.

We believe investors can take advantage of the software industry's shift towards more predictable revenue streams driven by subscription and SaaS models. But this is why we dive deep into the quality of the revenue and believe our industry focus differentiates.

We dig into the underlying retention data and adjust our gross and net retention calculation based on our firm's best practices, which can paint a very different picture. We understand how to assess a company's revenue algorithm and its historical growth drivers to determine how sustainable those are going forward.

Resilience – consistent performance through economic cycles – is key to our strategy. If a manager has yet to observe multiple cycles in the industry closely, it can be hard for them to see why that resiliency is so important and why you cannot overemphasise the need to understand the numbers. We think enterprise software companies have a more downside-protected business model. Our industry expertise enables us to identify the best-positioned companies.

Q How do you gauge risk amid a volatile market?

We always try to separate what we can control from what we cannot. We cannot control interest rates or the overall economic environment and we cannot predict a soft or hard landing. What we can control is our fundamental underwriting discipline.

We continue to invest in what we think are best-in-class, mission-critical enterprise software companies across sectors with the right capital structures, giving us exposure to various end markets. During tougher times, when new logo bookings might slow, these companies could push through price increases, creating downside protection.

Not all software companies have the same profile and we understand the differences – what is best-in-class for a vertical application company is different from a cybersecurity company, which is different from an infrastructure software company. The companies we invest in include not only today's market leaders but also businesses with the foresight to develop the next generation of products to maintain market leadership across many end markets while focusing on profitable growth. ■