

STATE OF THE MARKET

EVERCORE | Private
Funds Group



STATE OF THE MARKET 2024

EVERCORE

DESTITUTUS VENTIS, REMOS ADHIBE

EVERCORE

The contents of this document are not provided for any person other than those specified below including, without limitation, any retail persons.

This document must not be copied, reproduced, published, distributed, disclosed or passed to any other person, directly or indirectly, in whole or in part, by any person, through any medium or in any form, at any time without the formal written authorisation of Evercore Partners International LLP (“Evercore”). By accepting this document, the recipient agrees to be bound by the obligations and limitations in this disclaimer.

This document has been prepared using materials and information that were made available to Evercore and other organisations that have authored articles herein from publicly available sources. In writing the content of this document, Evercore and the other organisations that have authored articles herein may have assumed and relied upon the accuracy and completeness of any financial and other information and data they have used without independent verification of such information or data.

This document does not purport to be comprehensive or exhaustive or contain all the information that a recipient may need in order to evaluate or act on any of the matters disclosed within it. This document speaks as of the date hereof and has not been independently verified and no representation or warranty, express or implied, is made as to the accuracy or completeness or sufficiency of such information and nothing contained herein is, or may be relied upon as, a representation, whether as to the past, the present or the future. Each of Evercore, its affiliates and their respective directors, officers, employees, agents, representatives, affiliates and/or advisers expressly disclaims any obligations or undertaking to update or verify any such information.

This document is necessarily based upon economic, market and other conditions as Evercore believes to be in effect on, and the information made available to Evercore as of, the date hereof. There are a number of risks, uncertainties and factors that could cause actual results and developments to differ materially from those expressed or implied by these statements and forecasts. Past performance cannot and should not be relied on as a guide to future performance. To the maximum extent permitted by law, and except in the case of fraud, Evercore, its affiliates and their respective directors, officers, employees and agents expressly disclaim any liability which may arise from this document and any information contained within it, or any other written or oral information provided in connection therewith, and any errors, misrepresentation or misstatement contained therein and/or omissions there from.

This document has been prepared for information purposes only and is not to be construed as an offer or invitation or solicitation or recommendation or provision of advice to sell or purchase any securities or conduct any other investment activity or transaction and is not a commitment by Evercore (or any of its affiliates or their respective officers, employees, representatives or agents or advisers) to provide or arrange any financing or other service for any transaction or to purchase or sell any security or other investment in connection therewith.

This document may not reflect information known to other professionals in other business areas of Evercore and its affiliates.

By accepting this document, the recipient acknowledges and agrees that Evercore does not and will not act in a fiduciary capacity for the recipient. Evercore may only be regarded by any recipient as acting on its behalf as financial adviser or otherwise following the execution of an engagement letter between us on mutually satisfactory terms.

Evercore and its affiliates do not provide legal, accounting or tax advice. Accordingly, any statements contained herein as to tax, legal or accounting matters are neither written nor intended by Evercore or its affiliates to be used and cannot be used by any taxpayer for the purpose of avoiding tax that may be imposed on such taxpayer. Each person should seek legal, accounting and tax advice based on his, her or its particular circumstances from independent advisors regarding the impact of the information or matters described herein.

This document should not be viewed as advice or recommendations with respect to any particular investment or investment strategy. This document contains articles written by Evercore employees and by third parties. All third-party articles were written specifically for this issue, and any data or viewpoints contained in any third-party articles belong solely to their authors, may not reflect the viewpoints or authorship of Evercore or its affiliates, and in no way shall Evercore or its affiliates be held liable or responsible for them. Any views or opinions expressed herein reflect the judgment at this date of the respective authors and are subject to change without notice.

Where Evercore or an affiliate is licensed in a jurisdiction, the recipient of this document shall consider such distribution to have come from only from the relevant licensed Evercore entity (ies). Notwithstanding the foregoing, this document is not directed at, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any jurisdiction (including the United Kingdom) where such distribution, publication, availability or use would be contrary to applicable law or regulation or which would subject Evercore and/or its subsidiaries or affiliates to any registration or licensing requirements in such jurisdiction.

The distribution of this document and its contents in jurisdictions other than the United Kingdom may be restricted by law and, accordingly, recipients of this document represent to Evercore that they are able to receive this document without contravention of any legal, registration or regulatory requirements in the jurisdiction in which they reside or conduct business, or any requirement for Evercore and/or its affiliates to undergo any registration or licensing requirements in such jurisdiction. Recipients of this document outside of the United Kingdom should inform themselves about and observe any applicable legal restrictions in their jurisdiction which may be relevant to the distribution, possession or use of this document and recognise that Evercore does not accept any responsibility for contravention of any legal restrictions in such jurisdiction or which are otherwise applicable to such recipient.

To the extent this document or any statement contained within it constitutes a financial promotion which is not exempt for the purposes of the Financial Services and Markets Act 2000 (Financial Promotions) Order 2005 (the “Order”), this document is only being distributed and delivered to certain persons in the United Kingdom on the basis that such person falls within one of the exemptions contained in the Order. The contents of this document have accordingly not been approved by an authorised person for the purposes of Section 21 of the Financial Services and Markets Act 2000 (“FSMA”). Such approval of this document would be required by Section 21 FSMA if the exemptions referred to below, or some other exemption, did not apply. This document and its contents are being distributed and delivered on a confidential basis only to persons in the United Kingdom who are (or who are reasonably believed to be):

- (i) a person having professional experience in matters relating to investments as defined in Article 19 of the Order; or
- (ii) a high net worth company or trust or other person of the kind to which Article 49(2) of the Order applies; or
- (iii) any other person to whom it may otherwise be law fully communicated in accordance with the Order.

Any investment or investment activity to which this document or information relates is available only to such persons as are referred to in the paragraph above and will be engaged in only with such persons. Persons not falling within these categories should not rely or act upon this document or any information contained within it. If you have received this document and you are not such a person you should immediately return it to Evercore. Otherwise you will be deemed to have warranted that you are such a person, or are otherwise a person to whom such information may be lawfully distributed and delivered by Evercore.

Evercore, its affiliates and their respective directors, officers, employees, agents, representatives and/or advisers shall not be responsible for any costs or expenses incurred by any recipient of this document in connection with the appraisal of it or its content and/or for any other costs and expenses incurred by such recipient.

Any matter, claim or dispute arising out of or in connection with this document or its contents, whether contractual or non-contractual, is to be governed by and determined in accordance with English law and the recipient, by accepting delivery of this document, agrees that the courts of England shall have exclusive jurisdiction to resolve any dispute, whether contractual or non-contractual, arising out of or in connection with it or its contents.

© Evercore. All rights reserved. This presentation is confidential and proprietary to Evercore. Evercore accepts no liability for the actions of third parties in relation to the redistribution of the material in this document.

Front cover photograph by Dmitrii Vaccinim

Beyond banks: Enterprise software's momentum in private credit direct lending

BY OLIVER THYM, PARTNER AT THOMA BRAVO

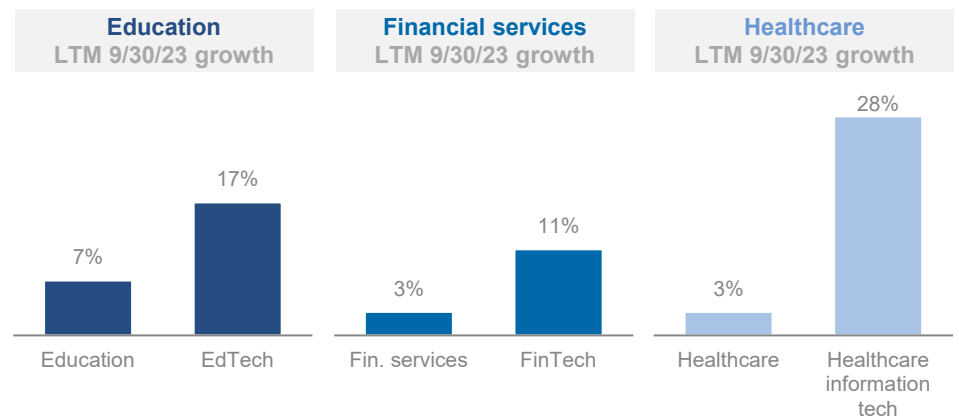
Thoma Bravo is one of the largest investors in the world focused on the enterprise software and technology industry with a portfolio that includes many of the leading companies in vertical applications, cybersecurity and infrastructure software.

Our analysis shows that software is almost always a better business than the underlying “physical” industry or end markets that it serves, as demonstrated in Figure 1. Software typically grows faster and has better margins, and, if the business is well-managed, has the potential to be more profitable and produce higher returns for investors than most industries.

We believe digital transformation is the present and future of the economy. Digital solutions have evolved from utilities to essential pillars upon which companies build their strategic advantage in a rapidly changing market landscape. Enterprise software is a mission-critical tool for businesses across sectors. Companies use software to drive essential business processes and increase the efficiency of internal operations – which will continue to drive innovation. Most industries are still in the early stages of adopting modern, cloud-based software products, Software-as-a-Service (“SaaS”) and beyond. Generative artificial intelligence (“AI”) has opened entirely new possibilities for productivity and profit.

Traditional banking institutions, once the stalwarts of corporate finance, have in recent years become more circumspect due to the more volatile macro and geopolitical environment and changing bank and capital regulation. Enter private credit – a capital solution that can provide more customised financing solutions with speed and certainty where banks have retreated. The combination of enterprise software growth and the surge of private credit creates an exciting juxtaposition where innovation meets reliability.

Figure 1 – Application software vertical consistently outperformed end markets



Source: PitchBook, CapIQ (accessed 1 December 2023). Data shown represents the average LTM revenue growth for the five largest publicly traded companies in each sector as measured by market capitalisation (for the LTM period as of 30 September 2023). Analysis excludes companies headquartered outside of the US

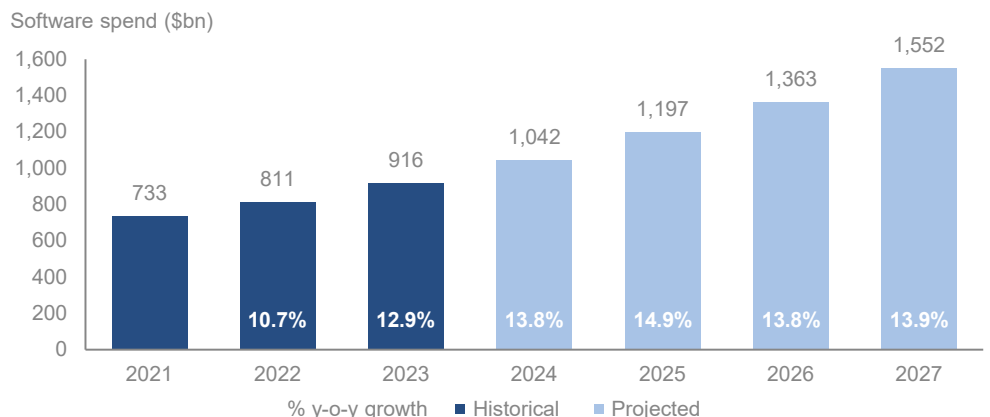
The evolution of enterprise software

Over the last 20 years, software industry trends have transformed the type of software created and consumed. Gartner Research forecasts that global software spending will grow approximately 14% annually for the next four years, as shown in Figure 2. With that expected growth, the addressable market for new investment opportunities will continue to expand.

The genesis of business software dates

back to when the primary focus was optimising productivity. Early iterations of software business models required significant capital expenditures (“capex”) from businesses. Companies would spend large sums to procure and maintain software licenses, server infrastructure and other associated hardware. This initial exploration into the digital realm was more of a commitment, both in terms of financial outlay and time. Though the benefits of streamlining operations and enhancing

Figure 2 – Growth in worldwide software spend



Source: Gartner Research (September 2023)

efficiencies were evident, these systems' initial cost barriers and complexities made software a luxury, primarily reserved for larger corporations with more resources.

However, as technology evolved, so did the software industry's business models. The emergence of the subscription model marked a pivotal shift. Software solutions were no longer just tools to facilitate business operations; they became integral components that could drive a company's strategy and bottom line. The subscription or SaaS model allowed businesses to access sophisticated software platforms without substantial upfront costs. Instead, firms could pay predictable, recurring fees, often monthly or annually. This shift democratised access to top-tier business tools for companies of all sizes and provided software companies with a stable and consistent revenue stream. The customers and software companies could both benefit: businesses could rapidly adapt to market changes with agile software solutions, and software providers could enjoy the predictability and scalability of recurring revenues.

The enterprise software landscape expects another transformative wave with generative AI. As artificial intelligence technologies mature, they are poised to permeate the enterprise software ecosystem. AI's integration goes beyond just automating routine tasks. Generative AI models can produce new content, make decisions and predict future trends based on vast amounts of data. Businesses can harness the power to revolutionise core operations, from sales forecasting to product design, leading to improvements in operational efficiencies and EBITDA margins. AI-driven tools in the enterprise software suite signal a shift from passive, tool-based software to proactive, intelligence-driven business partners. This new era, which is still evolving, showcases the resilience and adaptability of enterprise software, affirming its role as a cornerstone of modern business strategy.

Resilience of the enterprise software model

In the volatile landscape of global business, few sectors demonstrate the resilience of enterprise software. Even in economic downturns, the steadfast performance of enterprise software is a testament to its intrinsic value and its foundational role in the modern corporate world.

One primary reason enterprise software thrives during challenging economic times is its deeply embedded nature in daily business operations. As highlighted earlier, today's software solutions aren't merely ancillary tools; they are central to the functioning and strategy of organisations across sectors. While discretionary expenditures often get

cut during downturns, essential business operational tools commonly remain, and enterprise software often falls into this latter category. For instance, a company might cut back on marketing or business travel, but it's unlikely to stop paying for its core customer relationship management or enterprise resource planning systems that underpin daily operations. The subscription models further bolster this by offering scalable solutions.

Moreover, the adaptability of the enterprise software business model is another critical factor in its sustained profitability. Unlike many traditional sectors, the software industry is not bound by the rigidities of physical inventory or extensive overhead costs. It can pivot with agility in response to changing market demands. Features can be added, scaled or pivoted with relatively lower marginal costs compared to traditional industries. This malleability means that during economic downturns, software companies can quickly innovate and adapt to new market conditions, finding novel revenue streams or tapping into emergent needs arising from the very challenges of the downturn itself. Additionally, many software companies' operating expenses are variable (versus fixed), allowing management teams to adjust the cost structure more quickly, if necessary, to maintain profit margins.

Furthermore, the global reach of software solutions means these companies can tap into diverse markets, mitigating risks. If one region faces an economic slump, the interconnected digital ecosystem allows for mitigation by tapping into growth in another area. This geographical diversification is another strength of the software industry, aiding its resilience.

Direct lending in the software industry

The private credit market has evolved in recent years, driven by increased bank regulation, changing macroeconomic conditions, increasing investor appetite and shifting borrower needs. The infusion of capital into private credit and the transformative landscape of borrower-lender relationships have opened new avenues and investment opportunities.

Private credit has grown substantially over the past decade into a mature, \$1.6 trillion asset class and continues its expansion at more than 20% per year, according to Prequin.¹ Traditional lenders face a changing regulatory landscape and the fallout from the collapses of Silicon Valley Bank, Signature Bank and First Republic Bank further drive the need for private capital. Underwriting banks have transitioned into a "risk-off" mode.

Many investors seek to gain or expand their private credit allocations. Given the breadth of strategies, illiquidity – and in some cases, limited historical data – disciplined portfolio construction is paramount. Direct lending is an income-based solution, with potential return drivers including yield, commitment fees, original issue discount and prepayment penalties. Direct lending is directly originated debt of corporate borrowers across a wide range of industries and sizes. Direct loans are generally structured as first lien, second lien or unitranche – a hybrid loan combining senior and subordinated debt elements at a single blended interest rate – but can also include other junior debt. The strategy is typically categorised by borrower size (revenue- or EBITDA-based), sponsor involvement, geography and generalist or sector-focus. Financing solutions are generally used for LBO transactions, subsequent acquisitions (M&A) or refinancing purposes. Borrowers like direct lending for its greater flexibility, speed and execution certainty relative to the more volatile syndicated loan market.

The risk drivers for investors include credit, portfolio concentration and origination volume. Seniority, security, floating rate interest, affirmative and negative covenants and broader documentation protections highlight the downside protection of the asset class.

Direct lending, often the "gateway" allocation to private credit, is a large and mature asset class. Institutional, insurance and retail investors adopted this strategy as a defensive source of income with an attractive illiquidity premium. Given its defensive characteristics (e.g., senior, secured, floating rate), the strategy can be levered (typically 1x to 2x) to enhance potential returns for investors.

As an efficient and competitive market, asset-level returns tend to be range-bound. That said, the strategy is evolving to reflect increased specialisation and differentiation, including sector focus (e.g., technology, healthcare), ESG (e.g., SFDR Articles 8 and 9), non-sponsored and geography (e.g., Europe, Asia). This evolution allows investors to construct a portfolio with more nuanced exposures to the asset class.

Understanding software borrowers from a lender's perspective

In the evolving market for software debt financing, understanding what makes an attractive borrower is crucial for lenders and software companies seeking capital. As private credit firms step into the shoes of traditional lenders, they seek specific attributes in software companies that not only help to ensure loan repayment, but

also align with the growth trajectory of the enterprise software sector. There are five characteristics and KPIs to consider:

1. Recurring revenue: This is arguably the lifeblood of software companies, especially those operating under the SaaS model. High recurring revenue indicates a stable customer base willing to continually invest in the software product. From a credit perspective, it offers predictability, ensuring lenders have a consistent cash inflow that can service debt. When viewed from a financial lens, one of the defining attributes of the enterprise software industry is its lower default rate, especially when benchmarked against the broader loan market average;

2. Customer retention: Beyond revenue, customer retention rates provide a deeper dive into the company's value proposition. Strong gross retention rates suggest that the software is indispensable to its users, further emphasising the recurring nature of its revenue. It also often means reduced marketing and acquisition costs, enhancing potential profitability. Furthermore, software solutions are viewed as "must-haves" rather than "nice-to-haves", especially in B2B, where these tools are integral to business operations;

3. EBITDA margins: This metric offers a lens into the operational profitability of a company, excluding non-operational costs and potential financial leverage. For software companies, a high EBITDA margin indicates efficient operations and a strong market position. For lenders, it's an assurance that the company has healthy operating profits to service its debt;

4. Cash flow conversion: Beyond mere profits, converting these earnings into actual cash is crucial. Robust free cash flow conversion ratios demonstrate low capital expenditure requirements and the company's ability to effectively manage its working capital and translate its revenues into tangible cash. This metric assures lenders that the borrowing company can manage its financial obligations seamlessly; and

5. Capital structure: Given the above characteristics, well-managed, market-leading software companies typically have strong equity cushions beneath the debt investments, resulting in lower loan-to-value than other industries.

At Thoma Bravo, we seek to invest in best-in-class, market-leading enterprise software companies focusing on mission-critical solutions, high recurring revenue, strong retention rates, high profitability and strong free cash flow. We believe our focus on high-quality businesses with prudent

capital structures will provide us with significant downside protection in uncertain macroeconomic environments like these.

Yet, it's essential to recognise that not all enterprise software companies are created equal. Being adept at distinguishing what qualifies as "best-in-class" involves a rigorous diligence process and extensive experience through many different economic cycles and varies from sector to sector. Whether assessing a vertical application, cybersecurity or infrastructure software company, we believe understanding these nuanced differences is paramount.

1. Prequin (December 2023)



Oliver Thym is a Partner on the Credit team at Thoma Bravo. Based in New York, Oliver joined the firm in 2020 to lead the Thoma Bravo Credit platform and oversee the firm's credit funds and strategic debt investments. Previously, Oliver spent his entire career at Goldman Sachs, where he was a Partner and Head of Private Credit in the Americas for the Merchant Banking Division. Oliver served on various divisional and firmwide committees, including the Merchant Banking Credit and Corporate Investment Committees and Firmwide New Activity and Credit Policy Committees.

Oliver earned an M.B.A. from the Stanford Graduate School of Business after receiving a B.S. in Operations Research and Industrial Engineering and a B.A. in Economics from Cornell University, where he graduated Phi Beta Kappa.