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

BY OLIVER THYM, PARTNER AT THOMA BRAVO

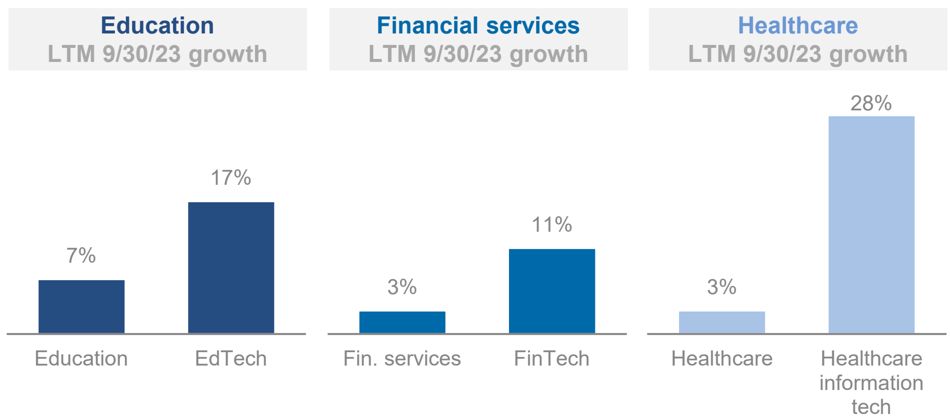
Thoma Bravo is one of the largest investors in the world focused on the enterprise software and technology industry with a portfolio that includes many of the leading companies in vertical applications, cybersecurity and infrastructure software.

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



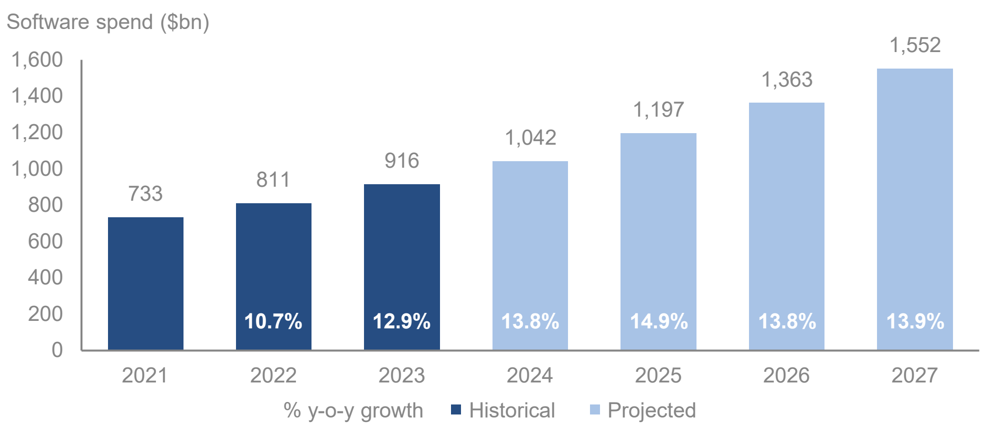
Source: PitchBook, CapIQ (accessed 1 December 2023). Data shown represents the average LTM revenue growth for the five largest publicly traded companies in each sector as measured by market capitalisation (for the LTM period as of 30 September 2023). Analysis excludes companies headquartered outside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