> *"Stone Age. Bronze Age. Iron Age. We define entire epics of humanity by the technology they use."*
>
> **- Reed Hastings**

Software Lending Has Arrived in the Lower Middle Market

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Introduction

As the COVID crisis hit, portfolio managers spanning all asset classes were forced to answer a simple question: did we make the right decisions at the peak of the cycle? Sectors that were already fighting an uphill battle, like Retail and Oil & Gas, were hit hard, while other sectors on stable footing in a strong economy, like Travel, Tourism and Manufacturing, suddenly faced a new environment. Software and Tech-enabled Services were standout sectors displaying durability, instilling further confidence in investors. This should not come as a surprise to anyone who studied sector performance during the Great Financial Crisis. Software led the way at that time and is proving its value to both debt and equity investors once again. It was posed in the early days of COVID, when market anxiety was high, what is the better credit? A senior secured loan or a subscription-based software product? However, why choose when you can have both.

In today's deal environment, significant investment is chasing Software and Tech-enabled Services companies which is driving a meaningful growth opportunity for lenders. Combining recession-resistant characteristics with favorable credit structures delivers attractive opportunities. Growth in lower middle-market technology private equity coupled with the dearth of pure play lower middle-market lenders has created a compelling opportunity for managers and allocators alike to capture strong risk adjusted returns.

What is Creating the Opportunity?

Industry acceleration to SaaS and software business characteristics have driven material increases in tech-focused private equity, which will require lenders with similar sector expertise.

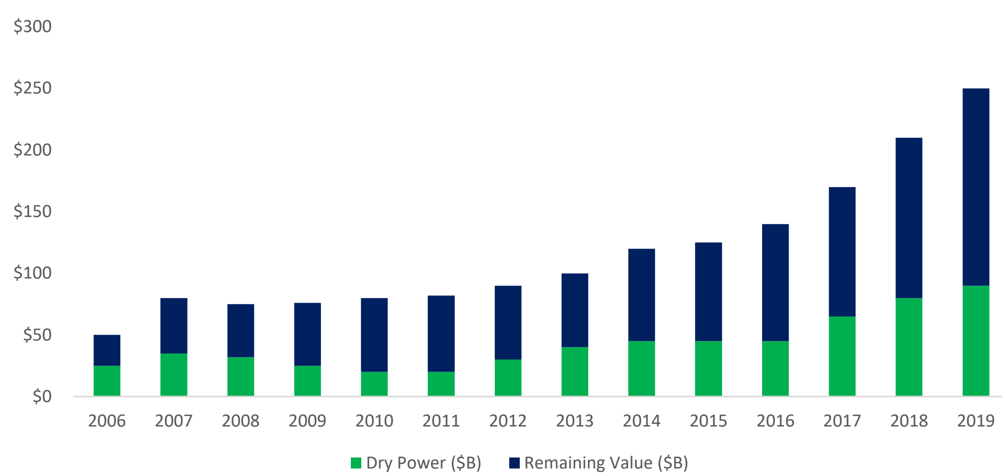
The opportunity set for private equity software investors, and, as a result lenders to software companies, has experienced significant growth in the past decade. Driving this are reductions in cost of computing power and storage coupled with the increasing level of expertise required to maintain on-premise equipment, leading companies not only to replace outdated systems through technology but do so with cloud or off-premise solutions.

These cloud solutions have given rise to software-as-a-service ("SaaS") sales models in which users pay recurring fees for subscriptions to software accessible from the cloud previously housed on-site. This particular development has created operating efficiencies for companies that no longer need to manage labor and technology assets. As a result, software as a service ("SaaS") spending is projected to grow from $158B in 2020 to $307B by 2026[1].

Private equity investors have taken notice, with aggregate technology-focused assets under management increasing nearly 2.5x in the past five years[2].

It should come as no surprise that private equity managers are shifting focus to technology and software assets. These businesses carry inherently attractive investment characteristics.

Technology Focused Private Equity AUM[2]



Software Investment Characteristics

- ***Non-deferable, critical and recession resistant spend***: enterprise software is typically highly ingrained into a company's operations, running critical functions such as payroll, marketing and IT automation.

- ***Revenue visibility through contracts with high customer retention:*** SaaS is generally delivered in a subscription pricing model, in which customers pay regular fees subject to multi-year contracts with customer retention typically > 90%.

- ***Scalable, high-margin business models:*** software providers routinely have gross margins in excess of 80% with little fixed cost requirements.

Although significant capital has been raised for large-cap technology funds ($5-10B+), the lower middle market has not been left behind. Large managers typically raise dedicated lower middle market funds in conjunction with their large-cap vehicles as well to take advantage of smaller opportunities, such as the Marlin Heritage and Thoma Bravo Discover funds. In addition, experienced managers are increasingly spinning off from larger technology private equity platforms to form new vehicles exclusively focused on the lower middle market. Examples include Crest Rock Partners, Luminate Capital and Cove Hill Partners which were formed in recent years by ex-principals of Marlin Equity, Silver Lake and TA Associates, respectively, and are now managing funds ranging from $250M - $1.5B.

Why is the Credit Case in Software Investing Compelling?

Simply put, tech-enabled services and software borrowers have shown far lower probabilities of default versus other industries.

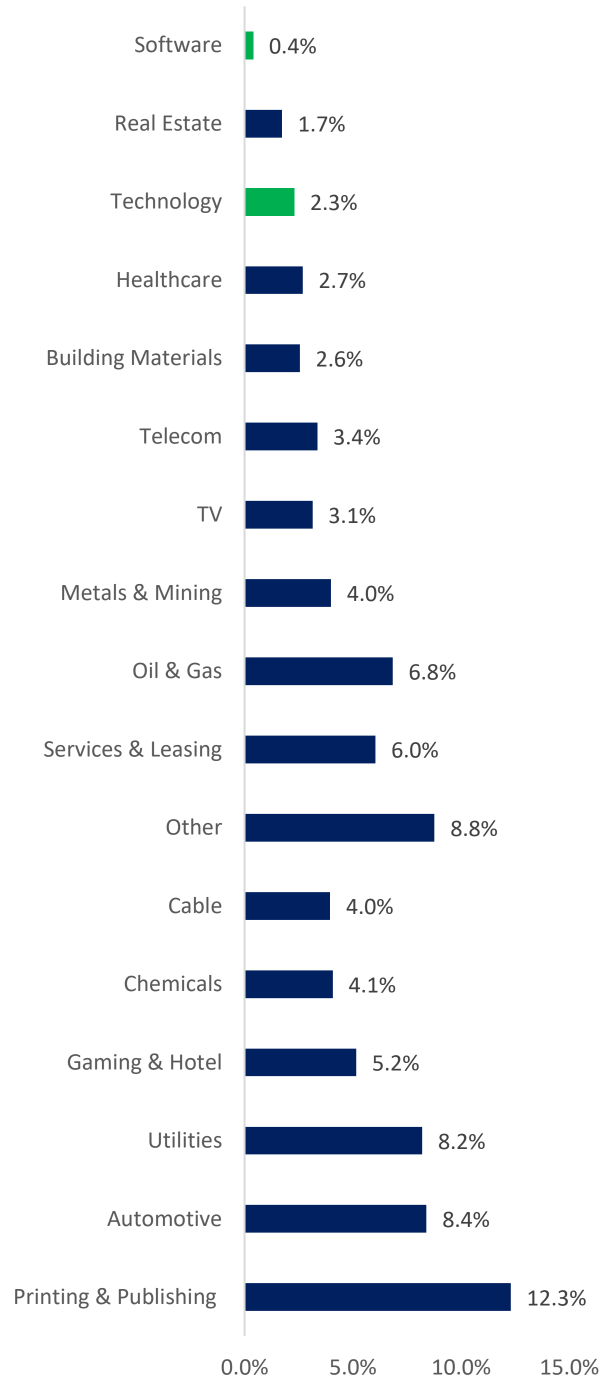
Software's key characteristics involving high customer loyalty driven by non-deferable spend, coupled with strong revenue visibility and high free cash flow conversion, have resulted in best in class default rates as compared to other industries.

Additionally, software companies are unique in their ability to adapt to different economic conditions. Favorable working capital dynamics driven by upfront customer payments and asset-lite operating models result in most of operating expenses being devoted to research & development and sales & marketing, two variable features which can be adjusted according to the economic environment.

As a result, software borrowers face less of the challenges other businesses must confront in tough economic times such as cyclicality, customer loss, one-time revenues, and capital-intensive operating models. An examination of the 16 publicly traded SaaS companies in 2006 shows that the combined index did not experience a quarter of revenue contraction during the 2008 – 2011 period. Revenue growth slowed but began to recover in 2009 as shown below.

SaaS Index Quarterly Revenue Growth (2006-2011)[4]

Cumulative Default Rates by Industry (1995-2019)[3]



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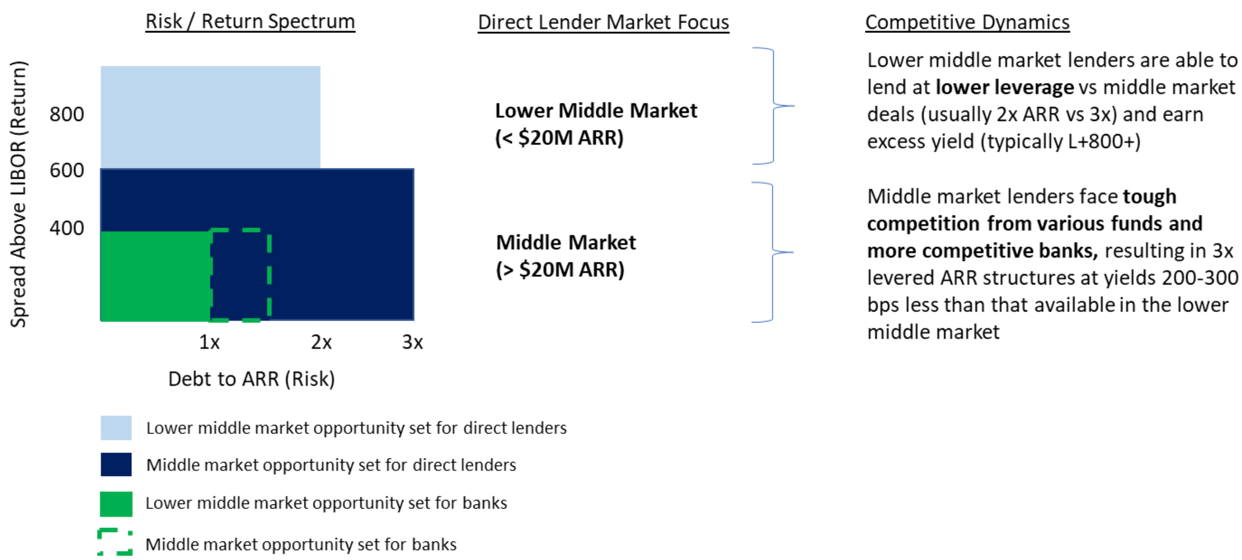
Software Lending Opportunity Set

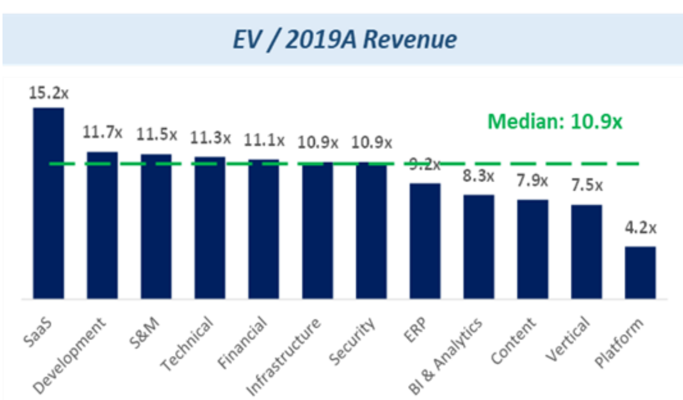
While there are various ways to access credit exposure within software, the lower middle market continues to offer attractive risk reward profiles for lenders.

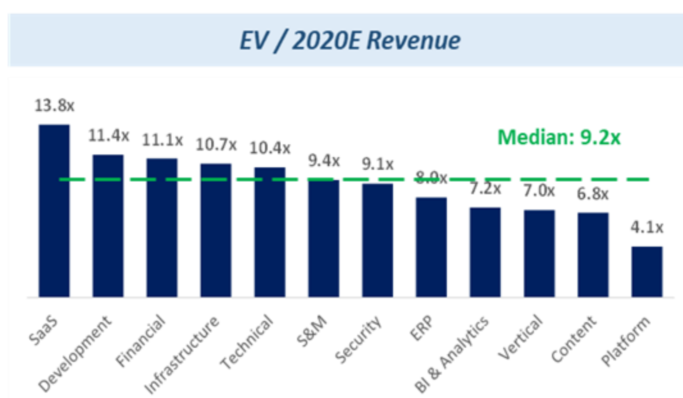
Software Lending Ecosystem[5]



Managers active in technology and software lending include banks and private credit funds. Banks typically provide up to 1.0x annual recurring revenue ("ARR") for lower middle market deals and up to 1.5x for middle market deals. Direct lenders typically structure transactions in one of two ways: (i) a "one-stop" transaction in which the direct lender is the sole lender in the capital structure, and (ii) a "first-out / last-out" transaction in which the direct lender partners with a bank partner. In either case, direct lenders are typically providing 2-3x ARR depending on the size of company, which results in typical loan to value ratios of 20-30% based on current SaaS acquisition multiples of over 10x ARR as shown below from GCA global.

Recent Market SaaS Acquisition Multiples[6]





Growth in interest in financing software companies among middle market versus lower middle market lenders has been imbalanced. Various middle market lenders have formed and are efficiently serving large-cap private equity firms purchasing businesses with over $20M of ARR. Conversely, few direct lenders are focused on the lower middle market in which companies' ARR is less than $20M. As a result, lenders in this market face less competition and are able to lend at more attractive terms including less leverage and higher yields. Although smaller, these borrowers exhibit the same margin, revenue retention, customer diversification and high switching costs as compared to middle market borrowers, resulting in a similar risk profile with higher returns.

Controlling for Risk in Software Lending

Underwriting processes will remain focused on granular analysis of customer retention and competitive positioning. Lenders are able to structure debt and covenant packages tailored to software transactions that provide significant downside protection.

Lenders to software companies place heavy focus not only on the growth of revenues but on the quality and sustainability of those revenues. Driving this are detailed analyses of gross and net customer retention to quantify customer stickiness and complex understanding of a borrower's competitive environment. Lenders spend considerable time understanding the degree to which the software can be either removed or replaced by a competing product, and as a result are targeting companies that lead their market and have clear scale advantages over competitors. Lenders seek to gain conviction in a debt thesis built around a diversified customer set with high revenue retention, lack of competing products, extremely high switching costs and healthy capitalization with a supportive equity partner.

Key Underwriting Themes in Software Loans

- > 90% gross / > 100% net customer retention
- Market leader with few competitors
- Operationally challenging to switch or remove vendors
- Support of experienced and liquid equity partner

Major considerations in documenting technology loans are financial covenants. Traditional cash flow loans will generally have fixed charge coverage and EBITDA-based leverage covenants. Given software companies are typically valued based on their ARR, lenders have shifted to structuring covenants in software financings to those based on minimum levels of ARR coupled with minimum liquidity. Often times, the ARR covenant will convert to EBITDA-based leverage in year two or three of the loan.

Key Structural Considerations in Software Loans[7]

	Traditional Cash Flow Loans	Software Loans
Structure	First Lien One-Stop or First-out / Last-out	First Lien One-Stop or First-out / Last-out
Profitability	EBITDA positive	EBITDA slightly negative to positive, with line of sight to profitability based on ARR retention and growth
Covenants	(i) Fixed Charge Coverage tested quarterly (ii) Debt to EBITDA test quarterly	(i) Recurring Revenue (includes contracted subscription, maintenance and support revenues) which transitions EBITDA-based leverage after year 2 or 3, tested quarterly (ii) Minimum Liquidity maintenance test at all times

Conclusion

Businesses are shifting their capital spending to technology given the demonstrable efficiency gains. As a result, there is a significant buildup of software-focused private equity capital set to be deployed in the inherently attractive tech-enabled services and software industries. These business models generate highly predictable revenue through long-term contracts and growth prospects supported by industries in transition. Although various managers have stepped into fill this need for large companies, lower middle market borrowers with ARR less than $20M remain underserved despite exhibiting very similar credit profiles. Lenders active in this space with granular knowledge of how to assess credit risk for these companies should be expected to earn premiums versus what is available in larger borrowers while taking less risk on a debt to ARR multiple basis.

Tree Line's Edge in Software Lending

Tree Line operates a lower middle market direct lending platform with a national footprint and a first-class reputation. With four offices throughout the country, a direct team of originators who cover 18 sponsor markets and a cycle-tested track record, we have been a go-to lender for sponsors resulting in 60% of our deal flow coming from our repeat & direct referral channel. Our relationship lending approach puts us in a strong position to expand our product offering and support sponsors targeting software opportunities.

Tree Line has traditionally gravitated towards businesses with recession-resistant demand drivers, high predictability of revenues, robust margin profiles and which are supported by substantial equity investment resulting in low loan to value ratios. As we observe a meaningful increase in software and technology opportunities, we are planning to add an ARR product in 2021 that will support the growing demand in our core market.

600+
Private Equity Relationships

- Extensive market coverage with significant focus on tech-enabled services/ software
- Historical dedication to LMM

$10M - $100M
Deal Sizes

- Ability to upsize significantly to handle buy & build strategies

>$400M
Historical Tech Commitments

- Flexibility to grow facilities to $100m+ with buy and builds
- 14 platform companies with 14 add-ons

8
Origination Professionals

- National coverage with strong presence on west coast
- Active referral network of tech-focused sponsors, banks and intermediaries

Select Tree Line Technology Transactions

Facility	Company	Sector	Portfolio company of	Date
First Lien Term Loan	peoplenet (It's About Time)	Software	The Gores Group	July 2016
Unitranche Term Loan	taskstream	Software	Quad Partners	September 2017
First Lien Term Loan	vcreative	Software	Banyan	April 2019
First Lien Term Loan	Symphony Azima AI	Software	SymphonyAI	April 2019
First Lien Term Loan & Revolver	Med Tech Solutions	Healthcare IT	Sunstone Partners	April 2019
Unitranche Term Loan	New Charter Technologies	IT Managed Services Provider	Oval Partners	March 2020
First Lien Term Loan	ingenio	E-Commerce Consumer Advice Platform	Alpine	August 2020
Unitranche Last Out	Pair Software	Software	Turn/River	December 2020

About Tree Line

Tree Line Capital Partners is a private credit asset management firm focused on direct lending to the lower middle market. The firm provides first lien term loans, unitranche term loans and equity co-investments to lower middle market borrowers with between $3M-$30M of EBITDA in North America in transaction sizes up to $150M. Tree Line currently manages $1.5B in investable capital, and has completed over 125 transactions for acquisitions, recapitalizations, refinancings, expansion projects and other growth capital needs. Tree Line's team has extensive direct lending experience spanning multiple economic cycles and has generated significant repeat investment opportunities from the private equity community through reliable execution coupled with a direct relationship approach. Tree Line is headquartered in San Francisco with offices in New York, Los Angeles and Austin.

Visit www.treelinecp.com to learn more.

The Authors

Frank Cupido, CFA, Partner

Grant Saunders Vice President

Tree Line Team & Contact Information

SAN FRANCISCO
101 California Street | Suite 1700 | San Francisco, CA 94111
415.795.7580

NEW YORK
600 Lexington Avenue | Suite 1401 | New York, NY 10022
212.207.3385

LOS ANGELES
22809 Pacific Coast Hwy | Malibu, CA 90265
415.795.7580

AUSTIN
415.795.7580

INVESTOR INQUIRIES

Tom Quimby
tquimby@treelinecp.com
415.795.7576

Jon Schroeder
jschroeder@treelinecp.com
415.795.7577

NEW TRANSACTION INQUIRIES

Frank Cupido, CFA
fcupido@treelinecp.com
415.795.7578

Drew McCauley
dmccauley@treelinecp.com
415.795.7579

Grant Saunders
gsaunders@treelinecp.com
415.795.7584

Jonah Glick
jglick@treelinecp.com
646.829.3603

Stephan Schneck
sschneck@treelinecp.com
415.795.7581

Ben Perlman
bperlman@treelinecp.com
415.795.7585

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Footnotes

1. *Source: Valuates Reports press release, June 2020.*
2. *Source: Pitchbook.*
3. *Source: S&P LCD.*
4. *Source: SEC public filings.*
5. *Based on Tree Line market observations.*
6. *Source: GCA Capital.*
7. *Based on Tree Line market observations*