EXPERT Q&A

Software lending continues to provide an attractive opportunity for direct lenders, but today's market requires extra attention on deal selection, says Frank Cupido of Tree Line Capital Partners

Navigating ARR lending in today's environment

Software lending has exploded in recent years to support record private equity fundraising focused on technology deals. With activity and valuations at an all-time high, underwriting approach is important now more than ever for lending based on annual recurring revenues, Frank Cupido, partner at Tree Line Capital Partners, tells *Private Debt Investor*.

SPONSOR

TREE LINE CAPITAL PARTNERS

Q Annual recurring revenue lending has experienced significant growth over the past few years, but much of that has been occurring up market. Given Tree Line's focus on the lower middle-market, what is attracting you to the space and what are you seeing in your market segment?

We're excited to have formally established our ARR loan product following years of work. Our research of sector performance has continued to show that software transactions exhibit the lowest likelihood of default. Driving this are fundamental credit dynamics typically sought by lenders, including high revenue visibility driven by contracts with robust customer retention, high switching costs resulting from the mission-critical nature of services provided by software and strong sponsor support with low loan-to-value ratios.

Specifically, regarding the lower middle-market, we are finding the opportunity to invest at more moderate ARR leverage levels in the 1-2x range, as compared with 3x-plus in the middle market, in businesses which have the same drivers of credit quality in terms of growth, retention and sponsor support. As the upper and middle-market continue to face an erosion of terms, the lower middle-market offers lenders an opportunity to capture conservative structures with more favourable terms.

Q Given ARR lending does not involve traditional cashflow analysis, what

screening criteria are you employing to identify the best credits?

The common thread in our underwriting is that we take a data-driven approach to all that we do. At our initial screen, we measure key quantitative metrics including ARR growth, gross and net customer retention, liquidity and loan to value. We're generally looking for businesses that are growing ARR 20 percent-plus per year with gross and net customer retention of 90 percent/100 percent-plus, respectively.

If a business is not yet generating positive EBITDA, as is the case with many software businesses, we evaluate both starting liquidity and the timeline on which EBITDA materialises, which we'll test with covenants. This initial analysis provides us with critical data to determine if the opportunity is a fit for our system, and if so, we'll proceed to more complex analysis directed at understanding customers' true switching costs and the competitive environment.

Q How is the current environment different to a few years ago in terms of where deals are getting done?

There is certainly a lot to monitor in the current environment, but what ultimately gives us confidence is that Tree Line is taking a historically conservative approach. We're continuing to see purchase multiples for $10 million-$20 million ARR businesses with attractive growth and retention characteristics reach 8-12x multiples of ARR. This was likely 4-8x a couple of years ago and represents a meaningful increase in valuation supporting software credits.

Total available leverage for these deals ranges is based on deal size, and routinely reaches 3x ARR for larger deals, but we are finding that more attractive terms involving lower leverage (<2x) and higher yields are available in the less than $20 million ARR market. The terms we are lending at simply do not exist up market. We are fully cognisant that these valuations may not continue in the future, particularly as interest rates increase and the market resets, but the underlying fundamentals give us confidence.

Q Private capital has seemed to flow to technology opportunities over the past two years. What areas are you avoiding versus targeting in terms of business model, sector and demand drivers?

Yes, we've seen a significant increase in interest among private equity in software and technology deals. We are avoiding opportunistic or on the margin situations that don't exhibit the growth and retention characteristics that will garner premium value. Specifically, we will avoid businesses where growth has plateaued while still unprofitable, or that involve high growth with low ratios of customer lifetime value to acquisition cost. We need to balance growth, retention and a path to profitability to conclude we are supporting a business winning in its respective market.

From a sector perspective, we find that we're able to gain comfort with software businesses tied to required services, such as regulatory compliance, rather than product features which could eventually be taken in-house by a customer, such as e-commerce plug-ins. These latter cases can involve retention, which can be deceptively high as true switching costs are far lower than that of a software offering serving a required use by a customer such as OSHA reporting.

Q Without covenants based on traditional EBITDA, how are you structuring covenants that provide a true check on overall performance and loan quality?

In the lower middle-market, we are routinely seeing and achieving in credit documentation covenant packages including maximum leverage based on the ratio of ARR to debt and minimum liquidity.

Importantly, the leverage definition will convert to one based off of EBITDA in the later years of the deal, which provides a check on transition to a typical cashflow-based loan. Larger businesses in the middle-market are less likely to see an EBITDA conversion feature which may have been present a couple years ago for these loans, and commonly do not have a liquidity covenant either.

Q Although covid-driven challenges may wane, we are seeing new alarming trends in supply-chain dynamics, commodity prices and geopolitical instability. What is your outlook for 2022?

We are excited about the overall momentum at Tree Line. In 2021, we completed transactions with 14 new private equity relationships and committed over $1.1 billion in new capital. We have had a strong start to 2022 but there is certainly a lot to monitor and our strategy naturally puts us in a defensive position. We will monitor real-time trends developing in supply-chain complexity, labour-cost inflation and commodity costs, but believe our target underwriting set is relatively insulated given our sector and geographical focus.

Our borrowers are based in the US with little in the way of international operations, and we will continue to avoid sectors which are seeing significant inflation including commodities, oil and gas and heavy manufacturing. That said, there is significant dry powder within private equity, and we are well positioned to continue our growth while delivering investors attractive yields in disciplined structures. ■

Tree Line Capital Partners is a private credit firm focused on senior-secured lending to the lower middle-market with $2.2 billion AUM, and is headquartered in San Francisco, with offices in New York, Los Angeles and Austin. It strives to deliver to investors access to the growing lower middle-market targeting "where size of company and credit structure intersect to provide the highest risk-adjusted return".