AI's Impact on Software & Private Credit

Understanding the risk to software and the value found in lower middle-market structures

TREE LINE
CAPITAL PARTNERS

Private Credit in Focus

Private Credit has been in focus of late as the market evaluates the potential impact of AI. This has renewed a discussion to evaluate the state of Private Credit in today's environment. Private Credit's growth has been significant over the past 15 years now estimated to total $1.7[1] trillion in assets under management. AI is the latest risk identified to Private Credit to stoke the debate, but the ultimate risk will likely be found in portfolios' fundamental credit metrics. Investors with an allocation policy that favors diversification by market segment and sector will likely outperform those that remain concentrated upmarket or in a specific sector.

The lower middle-market has emerged as not only a worthy allocation but a necessary one to blend in credit metrics that offset the commoditizing trends that have occurred upmarket. Private Credit platforms upmarket have been trying to convince the market that the fundamentals don't matter (i.e., leverage, covenants, documents) so long as there is a favorable loan-to-value ("LTV"). This may prove to be a costly miscalculation when it comes to certain software exposure.

Since Tree Line's inception over a decade ago, we have been consistently stating that structure is more important than size. Our focus is to deliver investors highly diversified portfolios with attractive current return in historically conservative credit structures. The recent focus on AI disruption is just the latest example that underscores the importance and strength of a manager that builds a portfolio focused on the fundamentals.

Recent Private Credit headlines have been focused on concerns over the market's software exposure and the potential for disruption from AI.

Private Credit has been making headlines because of growing software exposure over the past 10 years. Many Private Credit firms have built significant exposure to the software sector, with a large subset of this exposure tied to Annual Recurring Revenue ("ARR") versus EBITDA or cash flow that can service debt. It is not hard to understand why lenders were drawn to software given it wasn't more than five years ago that the market was singing the praises of software during the pandemic. Software was seen as an investment that delivered strong revenue growth, high valuations, high switching costs, and high customer retention to the point that some believed it was a safer investment than a senior secured loan. Many believed that a company would default on its debt before it would stop paying for a software subscription critical to running its business.

AI has now changed the conversation. AI poses the potential for significant disruption risk to software companies, which has created a material impact on underlying valuations as well as the Private Credit firms themselves who carry large exposure to the sector. However, it is important to note that in most cases, the risk of AI disruption is a projection as most software companies are not feeling the effect in their performance today. We believe it is important to understand both the risks of AI as well as the mitigating factors that exist for many software companies.

Tree Line Exposure to Software

A key tenet to Tree Line's strategy is to build highly diversified portfolios of senior secured loans by borrower, geography, and sector. Software is no exception, and prior to 2022, we felt software, and even ARR loans, had a place in our portfolio. The credit case was compelling with company attributes including strong recurring revenue, a subscription-based sales model, high switching costs, and strong sponsor support. Things changed for us post-pandemic, as inflation drove over 550bps of interest rate increases, we felt a premium should be placed on free cash flow. At that time, we had completed five loans on an ARR basis, and while the exposure was limited in our portfolio, we discontinued our focus on ARR lending. Of the five ARR loans we completed, four have repaid in full and the remaining single ARR loan in our portfolio represents 0.4% of our total portfolio and carries conservative ARR leverage of 0.57x.

Tree Line Portfolio		Tree Line Software Portfolio	
$3.3B	**96**	**5.6%**	**6**
Tree Line Total Portfolio (FMV)	# of Portfolio Companies	Software as % of Total Portfolio	# of Software Portfolio Companies

When including software loans made on a cash flow basis, Tree Line still has very limited exposure across its platform. Tree Line has direct exposure to software businesses across six borrowers out of 96, which represents 5.6% (or $188 million) of combined FMV across all Tree Line funds. The credit metrics are highly appealing, and representative of the value found in the lower middle-market relative to structures observed upmarket. The five software loans made on a cash flow basis carry a weighted average Adj. EBITDA, leverage, and fixed charge coverage of $13.9 million, 4.1x[2] and 1.9x, respectively. All loans pay cash interest and have 0% PIK in their structure.

Tree Line Software Credit Metrics

$13.9M	**4.1x**	**1.9x**	**0.4%**
Weighted Average Adj. EBITDA – Software Portfolio	Weighted Average Leverage – Software Portfolio[2]	Weighted Average Fixed Charge Coverage – Software Portfolio	ARR Exposure as % of Total Portfolio (1 loan at 0.57x ARR)

Given the present challenges introduced by AI to the software sector, Tree Line is not actively pursuing an increase to its exposure. However, we remain comfortable with the exposure we have, based on the underlying business models and visibility into 2026 performance. We also gain comfort from our position in the capital structure, as first lien lenders, and feel that, if there are pain points, the brunt will be borne by the equity investors.

All six software borrowers in our portfolio are sponsored by software-focused private equity firms and are performing at or above plan. Three of the six borrowers are likely to exit within the next 12 months, given conversations with the sponsors on sale timelines and loan maturities.

Looking ahead: Assessing AI risks and opportunities

While projecting the full impact of AI is an unreasonable task at this time, there are both clearly identified risks and mitigating factors to software exposure. To the extent strong mitigating factors exist within a company's operating model, it will provide further value and stronger protection to the risks of AI.

We view the limited software exposure we have as being well-insulated from AI risks given the common features across the group such as status as a system of record, imbedded AI offerings within the software, housing of proprietary and sensitive data, and vertical focus germane to specific industries requiring significant sector expertise.

Highest Risk Software Attributes	Lowest Risk Software Attributes
Rule-based software (e.g., IF>THEN services, automatic invoice processing, HR onboarding, customer support)	System of Record
Platforms that lack proprietary data set, reliance on customers' internal documentation (language translation, document review)	Imbedded AI offerings within the software
Software priced on per-seat basis (user bases may decline electing to use AI substitutes)	Housing of proprietary and sensitive data
Creative design software	Vertical focus germane to specific industries

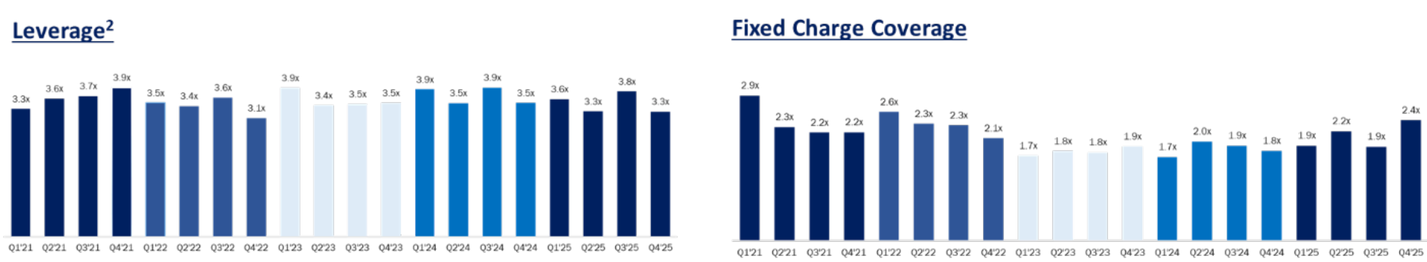
Equity valuations for software companies will likely be impacted but lending to companies on a cash flow basis versus ARR basis will offer a significant advantage to lenders. The combination of low leverage and high free cash flow will provide meaningful cushion and enable companies to continue to service debt. ARR loans pose a higher risk of lender involvement given the lack of free cash flow and a higher requirement to reinvest cash in growth versus servicing debt. ARR structures typically require stronger sponsor involvement which may see challenges if valuations decline.

Summary: Lower Middle-Market Value in Private Credit

Overall, Tree Line will work to continue to deliver the value sought in Private Credit. We will continue to deliver investors highly diversified portfolios of senior secured loans with attractive current return. Based on our limited exposure to software and avoidance of PIK in structures at close, we are well positioned to perform in the current environment. We continue to emphasis the value found in the lower middle-market which is built on a thesis that structure is more important than size of company.

Recent quarters highlight the benefits found in our market segment. The charts below summarize favorable leverage and fixed charge coverages we continue to receive in the lower middle-market.

Tree Line Quarterly Credit Metrics



The combination of historically low leverage of less than 4.0x at close and high fixed charge coverages imbeds meaningful cushion to withstand economic challenges. We structure loans without PIK in the structure and PIK-toggle is not a concept found in the lower middle-market, in our experience. These credit metrics are unmatched and cannot be found upmarket. Tree Line has always focused on credit fundamentals as opposed to simplistically relying on LTV as a credit case. The view that lenders can rely heavily on LTV as a credit thesis is too dependent on an equity case. Tree Line builds value from the bottom up as our strategy is intended to perform in all phases of a cycle.

We have consistently advised investors to evaluate the Private Credit market by market segment. It is a necessity today as the risk profile of the upper middle-market has increased significantly relative to the lower middle-market. We continue to describe the credit metrics in the lower middle-market as both compelling and differentiating. We believe the differentiation will be highlighted even further in future periods.

About Tree Line

Tree Line Capital Partners is a private credit asset management firm focused on direct lending to the lower middle-market with $5.3 billion in AUM. The firm provides first lien term loans and equity co-investments to lower middle-market borrowers with between $5M-$30M of EBITDA in North America in transaction sizes up to $150M. Tree Line has completed over 488 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 and Austin.

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Important Notes:

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Footnotes:

1. *Prequin – Private Credit AUM as of October 2025*
2. *"Wtd Average Leverage" is defined as the sum of (a) the product of (i) the leverage multiple for each investment [X] (calculated by dividing the most recently reported outstanding loan balance [Y] for each investment by the most recently reported LTM EBITDA for each company) and (ii) [Y], divided by (b) the total outstanding loan balance for the entire portfolio of investments held by Tree Line Funds.*