EXPERT Q&A

Software and technology is one of the most promising growth sectors in the US direct lending market, with a shift to cloud computing helping support an attractive opportunity set, says Brent Humphries, president of AB Private Credit Investors

The risks and rewards of targeting tech

AB Private Credit Investors is the mid-market direct lending platform of AllianceBernstein, managing approximately $8.7 billion in investable capital and lending across first lien, unitranche, second lien, mezzanine debt, structured preferred stock and minority equity co-investments. With a focus on mid-size companies with an EBITDA of $5 million to $50 million and enterprise values of $75 million to $500 million or more, it recently launched a growth stage capital initiative to capitalise on opportunities outside of traditional sponsored direct lending.

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Q How do you see the overall dynamics in US direct lending today?

The cycle has clearly extended longer than people expected, with the consensus now that growth is slowing in the US, although it remains in a strong position relative to most other developed economies. We have seen a significant inflow of capital into direct lending, leading to deterioration of underlying documentation terms and spreads.

That said, while it is easy to quantify the supply of new capital coming into the market, it is harder to measure the supply that has left the market, particularly from banks de-emphasising mid-market lending. One factor that is often overlooked is the significant scale and fragmentation within the US middle market. Estimates peg the US middle market at $6 trillion in revenues, which would be the third largest global economy on a standalone basis, and upwards of 200,000 companies. While there are certainly a large number of lenders in the space, many focus on different channels such as sponsor versus non-sponsor, industry verticals and deal sizes. This has enabled platforms such as AB-PCI to still deploy capital prudently.

From a relative value perspective, I believe this remains one of the best places for investors to deploy capital. The private debt industry still generally targets net returns of 8-12 percent, which compares favourably to the public debt and equity markets on an absolute basis and is even more attractive on a risk-adjusted basis.

Q Where do you see opportunities outside the traditional sponsored direct lending space?

The market is more competitive and you need to be cautious and selective, but there are still areas to expand the opportunity set. One competitive edge we have observed is within our industry sector expertise, where we see software and technology as one of the most promising industry verticals. The software sector, including Software-as-a-Service (SaaS), stands out given both the significant amount of growth being witnessed in that sector and the demand for private capital.

There are a number of factors driving this, including the fact that technology is prevalent in all aspects of our daily lives. Venture-backed companies are also remaining private for much longer periods of time

and regularly reach the size and scale to attract the interest of core PE buyout funds and direct lenders.

The shift to cloud computing is driving significant sector growth, and the SaaS business model is conducive to private debt because it can support meaningful levels of leverage given its predictable, recurring subscription-based revenue streams. This is an area where we are going to continue to see growth, both in core private equity-backed direct lending but also increasingly by expanding into the growth stage segment of the market by partnering with VC firms.

Q What is it about the growth stage segment that is particularly attractive at this point for private debt?

Growth stage for us typically means companies with annual recurring revenues in excess of $20 million and up to $100 million-plus, and enterprise values ranging from $100 million to $1 billion or more. So, growth stage does not mean early stage – these are not small companies. When we invest in growth stage companies, we look for companies with well-established products and strong competitive positioning. We are comfortable underwriting execution risk in the growth stage segment, but we do not take on significant technology risk.

From an underwriting perspective, this is a natural progression of what we do today in our core software private equity lending practice, where we have strong expertise evaluating SaaS business models.

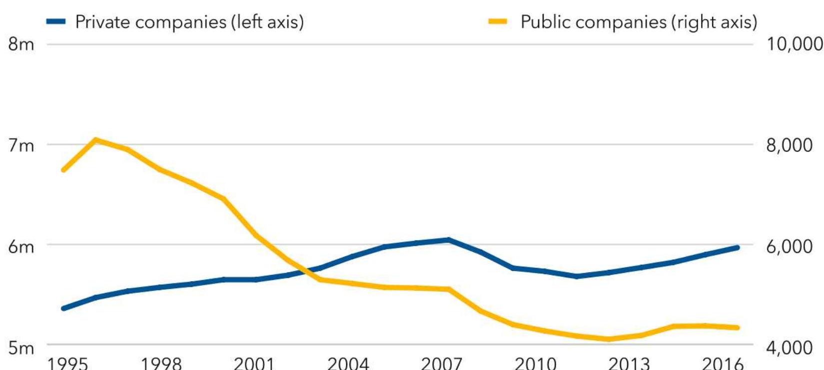
Away from debt capital, we also see a significant opportunity to co-invest alongside venture capital firms as they often need additional sources of later stage, pre-IPO equity for larger companies. Many times the VC firms want to broaden their investor base to support future capital raising rounds. Our ability to provide flexible growth capital across debt, hybrids and equity, as well as our scale, are viewed as value-added in this context. In addition, AllianceBernstein carries a strong reputation as a public investor in the technology sector at the IPO stage and beyond.

Q How do you mitigate risk in the high-growth segment of the technology sector?

We have been investing in software for a long time and believe we have significant expertise in the sector. Our focus is to drive attractive risk-adjusted returns for our investors by being selective on the opportunities we pursue. We can take a discerning approach to asset selection as we intend to deploy capital within the growth stage segment methodically, rather than simply trying to grow market share. Our focus on scaled businesses with established products and solutions, along with enterprise values typically of $100 million to $1 billion or more is another way that we mitigate risk. We view our approach in the growth stage segment as less risky compared to venture lending, for example.

We also focus on businesses with strong IP and differentiated technology, and we look at the lifetime value of a contract and a customer relative to the customer acquisition cost. We avoid businesses that are not generating good returns on investment from their sales and marketing spend. We also avoid businesses that exhibit concentration within their customer base or value chains.

The number of US private companies is growing as the number of public companies shrinks



Source: US Census Bureau, World Federation of Exchanges, Bank of America Merrill Lynch

Q A rush of capital is moving into this space. What mistakes are new entrants making and how can platforms differentiate themselves?

We are seeing increased interest in the sector, including from new entrants. Many of the newer competitors are deploying aggressive tactics to gain market share that may ultimately backfire. One major area of concern is lenders that do not place enough emphasis on ensuring a secured interest in IP. We believe that IP is very important, particularly when lending to software companies, but also in other markets. For example, we often see weak terms and structural protections that enable material IP to be held or transferred outside of the guarantor group, including instances where IP is located outside the US.

Another concern is around firms adopting a one-size-fits-all mentality when making recurring revenue loans. There is a need to size the debt quantum for SaaS businesses using multiple factors, including capital efficiency, the growth rate, profitability and stickiness of recurring revenue streams, in addition to loan-to-value and debt-to-recurring revenue multiples. Some new entrants consider all recurring revenue to be created equal, which it is not. Simply placing a multiple on recurring revenue without considering these other factors is not sound underwriting in our opinion.

Q Companies are staying private for longer. How do you see this impacting the future of capital markets and the evolution of LPs' overall investment behaviours?

It is true that venture-backed companies are staying private for longer periods and becoming larger in size. These companies are also motivated to raise additional cash on the balance sheet to fund growth initiatives or simply to provide a liquidity cushion. This creates additional demand from growth stage businesses for private capital, including private credit. Investor behaviour is also shifting as direct lending has become an established alternative investment segment and investors have become more comfortable with the tech sector in general. With the number of US public companies nearly cut in half over the last 25 years, it has become essential for investors to allocate an increasing amount to the private markets to gain exposure to the largest and fastest growing segments of the corporate economy. ■