E X P E R T Q & A

*Software continues to be an attractive lending space despite changing market conditions, says Erik Bissonnette, managing director at Owl Rock, a division of Blue Owl, and co-portfolio manager of Owl Rock's technology investing vehicles*

# The appeal of lending to software

**Q What does Blue Owl find attractive about lending to technology companies? Where do you see the greatest opportunities for returns?**

Technology can broadly be broken into four major subsectors – software, IT services, technology hardware and equipment, and semiconductors and semiconductor equipment. While there are investable themes across all of these categories, our focus at Blue Owl is on application and systems software. These businesses tend to be more stable, exhibit highly recurring and diversified revenue, have stronger customer retention rates and deliver substantial organic growth.

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**Q Why do software businesses have these attractive attributes?**

From a first principles perspective, we believe that great software businesses provide mission critical solutions for their customers – enhancing productivity, driving efficiency, optimising supply chains, and replacing manual and error-prone ways of conducting business. Once these solutions are adopted in an organisation, they become deeply embedded in the workflows of their end users. We believe that digital transformation is one of the most important secular trends in the world today.

Further, the embedded nature of these products drive near 100 percent renewal rates and their revenues are largely from recurring subscription sales. So, the hard and soft switching costs are substantial. When you combine this with the capital-efficient nature of software as a product, we also see durable and visible cashflow streams.

Lastly, software is not an industry, but rather an enabling technology that services almost every sector and company in the world. That means that when we think about building a portfolio of software assets, we have the benefit of being naturally diversified by end market and by industry. Further, these are stable, durable businesses akin to a utility with relatively inelastic demand that should provide some recession resistance.

### Q Can you describe the type of specialist resource required of direct lenders in this space?

Owl Rock has a dedicated team of over 30 investment professionals focused on technology, with backgrounds in private equity, venture capital, growth equity, investment banking and operations. It's a substantial investment. We organise ourselves around key subsectors that we think are the most salient today – we have sector coverage focused on cybersecurity, healthcare information technology, fintech and many others.

Complementing our direct lending group, we have a large and experienced team on the ground in Menlo Park, California, that is focused on cultivating relationships with companies, intermediaries and venture capital firms. The team focuses on direct-to-corporate structured debt and equity investments, mostly for later stage pre-IPO opportunities. These businesses are often looking for a single capital provider to design a financing solution and we pride ourselves on the flexibility of our solutions. It's important that we are adept in our ability to structure the deal, but also that we commit to and hold very large positions with no reliance on sell-down or prolonged exposure to market risk.

### Q Can you talk about what you're seeing in the market today? Will direct lending continue to take market share from the public markets?

Direct lenders have been taking market share from the public markets for the past few years, for reasons that I think are well known. It's important to note that these gains occurred in a very strong market environment. Now, banks are re-evaluating underwriting risk given macro uncertainty and CLO liabilities are starting to widen, so our capital – predictable, private, and partnership-oriented – is more valuable than ever before.

For our software practice specifically, we have seen a massive dislocation in the public SaaS market. Many of these companies have traded off substantially, more than 40-50 percent. The real debate, in our view, isn't whether these are viable businesses or have a need to exist, it's around how much do I want to pay for world-class software businesses. The same forces that aided the exceptional performance from a capital flow perspective have begun to reverse. The market is dealing with inflation and interest rate dynamics. So as these public companies evaluate their historical valuations and growth expectations, we have seen a sharp rise in private equity taking these businesses private. There can be a big opportunity for PE firms to own great companies that they never would have thought they could engage with less than a year ago.

> *"We believe that great software businesses provide mission critical solutions for their customers"*

But they need debt for that. There are dedicated pools of capital like ours which, given the amount of capital we have raised, can likely now handle multi-billion dollar loans with a fairly small group of lenders. That, combined with bank de-risking and other technical factors, may create a pretty remarkable opportunity.

### Q How do you differentiate yourselves as a software lender?

Our key differentiating attributes are our knowledge base and sector specialisation, our relationships both with private equity sponsors and with companies, and the amount of investment we've made in our team. As I noted earlier, we cover software by subsector so that when a sponsor calls or we source something direct, it is highly likely that we will be familiar with the asset and in a position to make educated decisions on opportunities quickly.

Another differentiating factor is our downside-protected approach. We assemble portfolios in a defensive-minded manner, by focusing on large, stable, recession-resistant software assets. We are not focused on early or mid-stage opportunities, nor are we providing venture debt solutions.

The loans we make can provide us with a combination of above-market returns, low loan-to-value ratios and better covenant packages.

We've always believed loans to these businesses would perform well in a variety of economic conditions, and that these investments would be more resilient in a downturn. We are seeing this thesis play out and are encouraged by what we are seeing across our investments.

## Q What types of solutions do you provide? And what types of companies do you look to lend to?

In the buyout universe, which is 75 percent of our business, it's primarily unitranche and recurring revenue loans. On the structured side, we are providing an alternative form of capital to a last round of venture capital equity.

We negotiate contractual rights that limit our downside, so we have negative covenants and restrictions on how much additional capital can be incurred. This is not venture lending because these are mature, late-stage companies that are otherwise – in a different market environment – likely to be going public. We seek to reduce dilution and the cost of capital for the company and generate excess return to our traditional loan products, but with similar contractual downside protections.

## Q What is the impact on the broader investable universe of current macro uncertainty and public market valuations?

If you see a 50 percent dislocation across the board in an industry category, you need to re-underwrite what is happening holistically, to analyse if there has been some fundamental shift that dramatically changes your perspective. We don't see that. Digital disruption and transformation is not going away – this secular theme is not abating as no one is going to unwind their software investments and start going back to doing things manually.

Software is effectively deflationary, because the one way you can do more with less in a labour-restricted inflationary environment is to use software for the benefit of productivity.

When we look at what is happening in the public markets, we see no change in long-term secular trends and see these software companies continuing to perform strongly, which suggests to us that business demand for their products remains robust. Business outcomes are driven by these software investments, and that's where the customers are focused.

Valuations reached very high levels in a low interest rate, low inflationary environment, causing investors to bid up prices. Now, those assets are trading off 50 percent, but they are still not cheap on an absolute basis. The market views these as strong assets but is recognising that valuations ran a bit too far.

*"We are looking for stable, durable businesses within sectors of the economy that should provide some recession resistance"*

As a lender, if someone is buying those assets at these new lower levels and you are providing 30 percent of the capital, you have a 70 percent cushion, which is attractive.

Finally, there is currently no IPO market. But a tremendous number of world class companies have raised capital in the last two years at very lofty valuations and now need to raise more capital and adjust their operating expenses to get through some challenging times ahead.

Those businesses have limited options for raising capital, and if they want to avoid a down valuation then the capital solutions that we can offer them are quite compelling. ■

## Q What are your predictions for private credit opportunities in software over the next few years?

We expect to see many of the same trends continue to drive the opportunity set. We have seen a very large amount of private equity fundraising for software in the past year, and we believe we are perfectly positioned – given the relationships we have – to support those sponsors. The dislocation only helps us, given our position at the top of the capital structure for resilient businesses, so this is a part of the market that we clearly want to remain focused on.

There has always been competition in software lending, but the reality is you can't just show up and start doing this when you see other parts of the economy dropping off. You certainly can't build an industry-leading team overnight. Direct lending is about sourcing, structuring, and managing your deals, and all of that relies on experience.