

E X P E R T Q & A

Private credit investing in the software and tech sector is well positioned to weather the current macroeconomic environment, say AB Private Credit Investors' Shishir Agrawal and Jay Ramakrishnan



Technology set to weather the storm

The drop in technology valuations since late 2021, following a period of steep rises in valuations across the sector, is reviving unhappy memories of the collapse of the dotcom bubble. High-profile companies such as Netflix and Robinhood have seen their valuations plummet amid growing evidence that their growth prospects were overhyped. A more volatile macroeconomic environment further adds to the trepidation.

But Shishir Agrawal and Jay Ramakrishnan, managing directors at AB Private Credit Investors, remain constructive on the tech sector. They tell *Private Debt Investor* that the fundamentals of the sector are far stronger

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than they were two decades ago. Furthermore, they point out that many business-to-business enterprise software companies have become 'mission-critical' for their customers – and are well positioned to maintain ground in spite of market volatility.

Q Tech stocks have declined in value since late last year, after rising rapidly during the pandemic. Is this a repeat of the early 2000s, when the dotcom bubble burst?

Shishir Agrawal: There has been a steady rise in the valuation of tech stocks over the last several years including a rapid run-up since the beginning of the pandemic. The NASDAQ, which can be a barometer for tech stocks, rose more than 60 percent from early 2020 until November 2021. Notwithstanding the recent declines, it remains above the pre-pandemic peak. The primary driver for the recent decline has been the shift in investor sentiment out of growth equities with the change in inflation, monetary policy outlook and the geopolitical environment. As a secondary consideration, some pullback and reversion to the mean after such a historical run-up makes sense.

But is this a repeat of the dotcom bubble burst? I don't think so. The big difference is that there were really no fundamentals back in 2000. Technology companies with unproven business models were then bid up to extremely high valuations based on all sorts of esoteric metrics.

Software and tech companies today are real. They have clear value propositions based on proven products and services, robust business models and real revenues supported by long-term secular tailwinds. People recently got ahead of themselves in terms of valuations – but I do think there are a lot of really good businesses out there in the market today.

Jay Ramakrishnan: I would highlight two differences. Unlike today, during the dotcom era there was very little focus on developing a sustainable path to profitability. Second, over the past 10 years, we have seen a shift in the revenue model of software businesses from a license-maintenance to a SaaS model. Today, a much higher percentage of technology businesses have a SaaS model with consistent recurring revenues and therefore garner higher multiples.

During the recent covid period, we saw the resiliency of this sector with revenue retention rates remaining healthy, especially in the B2B enterprise software areas where we play, and capital continued to flow into this sector. While growth may slow and valuations adjust accordingly in a tougher macro environment, the underlying business model supports greater resiliency.

Q What impact does inflation and rising interest rates have on software and tech businesses?

JR: The direct impact is an increase in the cost base of such businesses as well as a lower revenue growth trajectory against a potentially softening macro environment.

Q How is the Russia-Ukraine war affecting the tech sector?

SA: The availability of skilled labour has been a problem in the tech sector forever and the competition for the right labour continues to increase – if anything, it is getting worse. The war in Ukraine has hurt because Eastern Europe has always been a fantastic source of really good tech talent. Unfortunately, the war has brought into question the stability of several countries in that region and the ability for tech companies to potentially outsource tech work out there.

JR: When we assess whether to lend to a software business today, there is a higher bar if the company develops or hosts its IP, or its software support, primarily in a region with geopolitical conflict. We are not averse to lending to companies with operations in Eastern Europe, but we like to see companies have back-up plans, with the ability to have other regions meet such needs as the situation warrants to mitigate business disruption.



Software businesses, especially if mission critical solutions, often have reasonable pricing power, with price escalators built into contracts to pass on increasing costs. We would expect such companies to be able to retain existing customers, but experience slower new customer bookings growth. More consumer-oriented B2C players are more susceptible to performance volatility. Lastly, while the cost of capital will increase in a rising rate environment, impacting coverage ratios and possibly cashflows, we believe credit capital will continue to be available to the sector, and is likely more attractive for borrowers relative to the cost of equity today, providing opportunities for private credit providers.

Q Has the fall in valuations affected your approach to

lending to software and tech?

SA: The answer is actually no. We remain very active in lending to software and tech companies, notwithstanding the change in the macroeconomic environment. We adhere to our asset selection framework that we have developed over the last couple of decades and consistently apply it as a standard part of our underwriting process.

We play primarily in the B2B enterprise software space – and we look for companies that are providing mission-critical, entrenched, and sticky solutions. We have a simple rule of thumb that if a company's software becomes unavailable, it should result in a business disruption for the company's end customers.

Furthermore, we look for well-diversified businesses with defensible competitive positioning, retention

characteristics, strong unit economics, and IP and strategic value. We develop our own internal views on valuation based on various methodologies with a strong focus on the fundamental assessment of the company's business outlook, cashflow profile and performance through the cycles. Then we determine how much credit we want to advance against the company.

So, our approach is far more based on fundamental asset characteristics and valuation, and the volatility in public market valuations has a somewhat limited impact on how we go about selecting assets and underwriting and structuring private credit deals.

Q Within the B2B software space, which sectors and subsectors are most attractive?

SA: We look for sectors and subsectors that are supported by strong secular trends. One of those trends is the shift to cloud computing. Companies that are providing SaaS-based solutions and software and infrastructure for cloud computing are winning in the market. They are a huge area of focus for us.

We also look at companies that are providing data management, data analytics, AI and machine learning solutions. Companies are producing mountains and mountains of data – and customers are keen to make sense of the data and improve their business decision-making. We find companies providing cybersecurity solutions another attractive subsector as their products and services have become mission-critical components of any IT infrastructure.

Then there are classic vertically focused application software companies – companies that provide software products to a variety of different industry verticals, whether it is education, government, healthcare, financial services and so on. They offer business process automation solutions that become a mission-critical, entrenched, sticky part of the day-to-day workflows of

“Potentially, credit capital is more attractive in this environment than equity capital, which is clearly very expensive”

JAY RAMAKRISHNAN

their end customers and often fit well with our investment frameworks.

JR: While we focus on B2B, some areas of B2B2C sector can also be attractive. For example, software that enables or runs a diverse set of e-commerce participants can be more insulated from direct end market dynamics. Another area would be supply chain and warehouse management/fulfillment software for similar reasons. Lastly, healthcare IT is a sub-segment we invest in. This is one vertical which still lags in the adoption of modern, scalable SaaS solutions, and we see continued growing needs to this more defensive end market segment.

Q Can software and tech remain resilient - and will valuations rebound?

JR: We have been investing in software and technology since the early to mid-2000s, and this sector represents a meaningful part of our portfolio. Throughout this period, we have realised attractive returns in our software book with zero realised losses. So, our own experience has been one of good performance and resilience.

Irrespective of cycles, the software business model lends itself to better

retention of customers and revenues. Given this, if companies can manage cash burn and liquidity, even with slower growth in a cycle, they will be more resilient. Lastly, we believe access to credit capital will remain available to these businesses in this environment.

In a bull market environment, the emphasis and focus on growth takes centre stage. However, in a softer cycle, operating and capital efficiency and unit economics comes to the forefront. One important attribute of software businesses is their discretionary cost structure. Sales and marketing are mostly focused on new customer acquisition, which can be dialled down, and the incremental cost of servicing existing customers is minimal. Similarly, R&D on new products can be postponed, and headcount can be cut if needed. All these expenses can be managed to conserve cash and extend the runway. Finally, notwithstanding recent valuation declines, there remain healthy equity cushions beneath the debt layer.

That being said, not all software companies are created equal, and there will be dispersion between high performers and laggards. To reiterate the earlier point, underlying asset selection, the value proposition and a fundamental evaluation of unit economics when making an investment are paramount. As it relates to valuations, public market valuations will ebb and flow. While tech sector valuations have declined since the peak of November 2021, the consumer-oriented technology plays have realised outsized declines relative to the B2B software sector. As business conditions and market sentiment improves over time, the underlying strong attributes of B2B software, coupled with secular demand drivers set the stage for a rebound in valuations. ■

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