

Private Markets

Private Debt in Focus

State of Technology

BlackRock

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Private Debt in Focus

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Key takeaways

- After reaching cycle lows, technology spending has rebounded. We maintain a favorable view of the sector as temporary macro and market challenges fade.
- Private credit opportunities should accelerate in technology, supported by earnings growth, continued investor interest and a recovery in M&A.
- Annual recurring revenue underwriting is a noteworthy, emerging financing tool to technology companies with high revenue, but low or negative earnings.

Introduction

As the technology sector is continuously evolving, investors need to maintain a key focus for investment opportunities. The rise of Artificial Intelligence (A.I.) has driven global optimism for the potential societal impact leading public and private investors to search for investment opportunities. And even though the 3Q2024 global market selloff was short-lived, it caused anxiety for some technology investors. However, it is important to distinguish between the structural outlook versus the tactical outlook.

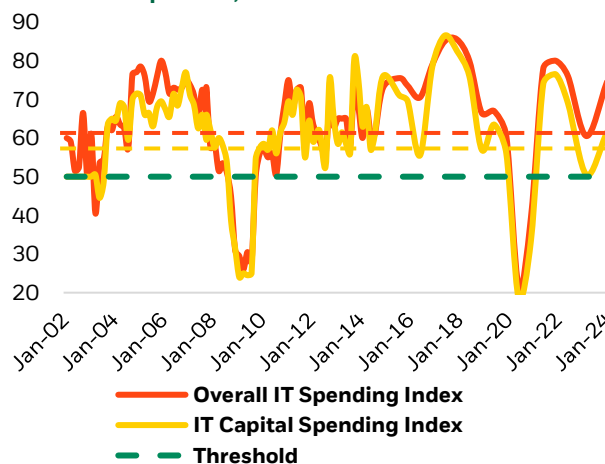
Since the pandemic, technology (along with other sectors) has passed through unique economic phases. Global government stimulus helped shorten the duration of the pandemic driven-recession. As businesses and consumers weighed the aftereffects of the pandemic, there was much expectation that remote work and an enhanced digital life would be brought forward as a result. Businesses made significant investments in technology to meet the expected demand.

However, this proved unrewarding as consumers cut back spending amid high inflation impacting the top and bottom line for businesses. Businesses reacted by consolidating technology vendors and/or declining to renew vendor subscriptions. Positively, we appear to have

passed this near-term trough. According to Goldman Sachs, Information Technology spending is rising above or back to long run averages which suggest businesses recognize the structural necessity to invest for future growth (see chart below).

Tech Spending on the Rebound

Index: >50 is Expansion; <50 is Contraction

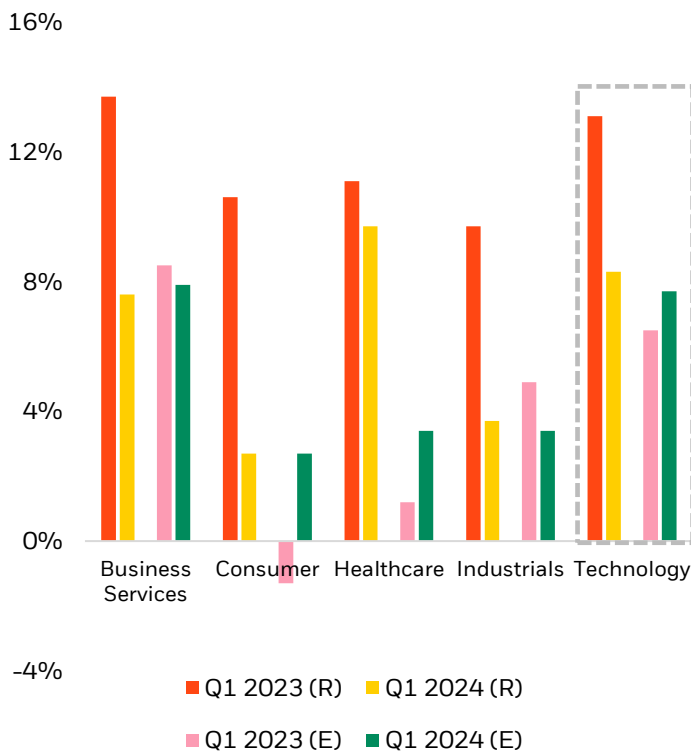


Source: Goldman Sachs, BlackRock. The chart shows the Goldman Sachs Overall IT Spending & IT Capital Spending Indices. The "threshold"/dashed green line indicates expansion when index score is greater than 50 and indicates contraction when index score is less than 50. Dashed orange and yellow lines are long run averages associated with the respective series. Data as of 30 June 2024. **Past performance is not a reliable indicator of current or future results.** For illustrative purposes only. There is no guarantee that any forecasts made will come to pass.

The gyrations in the public markets and the volatility in tech spending has muddied the structural outlook for the sector. However, we remain optimistic that the technology sector will remain a key focus for investors. We devote this **Private Debt in Focus** to highlighting why we maintain a favorable view on the sector, discuss how A.I. is influencing our underwriting, discuss an evolving approach to technology private credit investing, and present a recent investment case study.

There are fundamental and technical reasons that underpin our favorable structural view. From a fundamental perspective, we are encouraged by the sector's resilience. The technology sector like other sectors over the past year witnessed declines in year-over-year revenue growth. However, the sector has been able to implement fiscal discipline managing costs effectively such that the sector saw a higher earnings growth rate compared to this time last year and produced one of the better earnings growth rates when compared to all major sectors (see chart below).

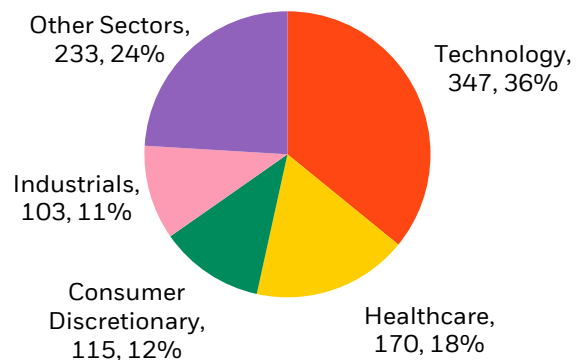
YoY LTM Revenue (R) & EBITDA (E) Growth



Source: Lincoln International, BlackRock. The chart shows the year-over-year (YoY) Last Twelve Months (LTM) Revenue & EBITDA Growth/Decline. Technology is Technology, Media & Telecom. Data as of 31 March 2024. **Past performance is not a reliable indicator of current or future results.** For illustrative purposes only. There is no guarantee that any forecasts made will come to pass.

With respect to technical factors, we evaluate investment activity through the prism of deal volume. According to Preqin, technology has seen the largest deal volume of all industries since 2019, more than double the next sector (see chart below). Additionally, technology led deal volume in 4 of the past 6 years. This demonstrates the structural investment activity around the sector.

Aggregate Deal Value (USD Bn, 2019-2024)



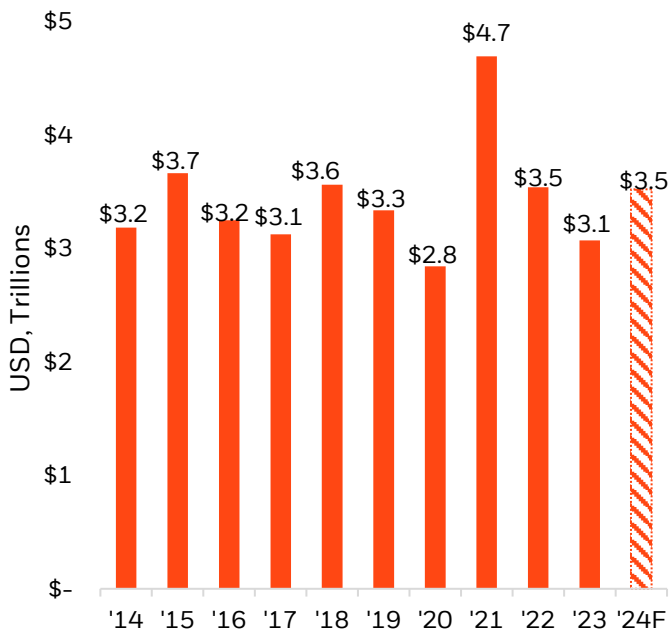
Source: Preqin BlackRock. The chart shows the aggregate deal value from 2019 to 2024 (USD, billions). Other Sectors includes Financials, Materials & Natural Resources, Business Services, Energy & Utilities and Real Estate. Data as of 30 June 2024. **Past performance is not a reliable indicator of current or future results.** For illustrative purposes only. There is no guarantee that any forecasts made will come to pass.

A second technical factor that we are following is the M&A environment. Private Equity has been on hold for longer than normal in this part of the cycle. After strong M&A activity in 2021, M&A has stalled. Unable to exit out of their portfolio companies as capital markets closed, the hold period for portfolio companies has extended to decade highs. According to Preqin, the median hold period for a portfolio company in a Private Equity fund has extended to 6.4 years, up from a current cycle low of 5.1 years in 2007.

As one measure of this dynamic in the technology sector, Bain & Company estimates that in 2023, 45% of technology buyout-backed companies owned by private equity have been held longer than four years, up from a cycle low of 29% in 2018. This has and is likely to continue to impact future fundraising efforts as limited partners receive smaller and/or delayed distributions. Challenged fundraising for private equity sponsors should motivate them to complete transactions as the M&A environment improves.

Some of the factors that caused a global M&A decline such as higher interest rates, a valuation gap between buyers and sellers and heightened regulatory risk may be moderating. In fact, the M&A environment is showing early signs of recovery. We expect this will lead to more transactions requiring funding which would bode well for private debt. According to Pitchbook, global M&A activity is tracking 10% to 15% ahead of 2023 deal count and deal value (see next chart). Pitchbook data also shows that historically, M&A rebounds following consecutive annual declines. The prior two episodes of 2007-2008 and 2001-2002 registered total peak-to-trough declines of approximately 60% to 70%, whereas the present decline has measured 34.5% from the peak in 2021. This suggests a less aggressive rate outlook can be beneficial taking us out of this trough.

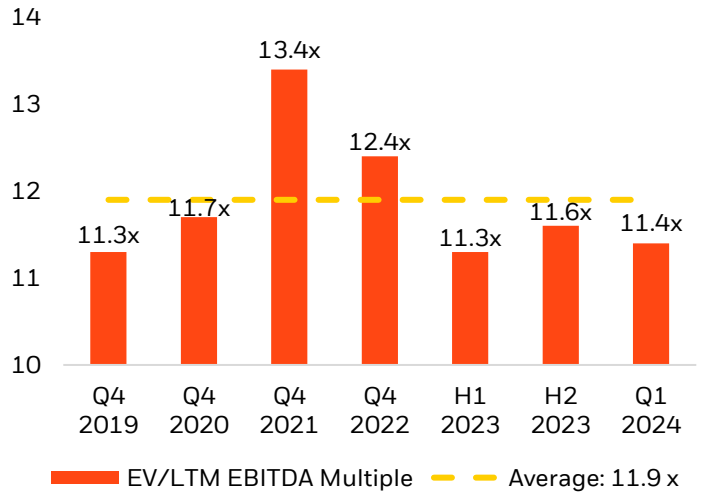
Global M&A Activity



Source: Pitchbook, BlackRock. The chart shows the annual deal value (USD, trillions). Data as of 30 June 2024. 2024 is a forecast. **Past performance is not a reliable indicator of current or future results.** For illustrative purposes only. There is no guarantee that any forecasts made will come to pass.

Additionally, valuations for M&A appear to be moderating to levels where buyers and sellers can engage. With interest rates high, buyers sought some concessions, mainly in the form of lower purchase multiples. As the next chart shows, since multiples peaked in 2021, transaction multiples have declined 1.5x-2x, bringing multiples below the current cycle average.

Multiples Moderating



Source: Lincoln International, BlackRock. The chart shows the Enterprise Value (EV) / Last Twelve Months (LTM) EBITDA transaction multiples for new third-party M&A buyouts. Data as of 31 March 2024. **Past performance is not a reliable indicator of current or future results.** For illustrative purposes only. There is no guarantee that any forecasts made will come to pass.

While this technical analysis of the M&A environment should support all sectors, we believe technology should be a leading beneficiary. Most recent deal activity has been focused on business services. In a recent private credit survey by Lincoln International, 33% of respondents are seeing the most activity in Business Services with only 15% seeing an activity pick-up in Technology. This suggests to us, there is pent up demand for the sector which should reopen opportunities as the M&A environment improves.

An Evolving Approach

We segment technology opportunities into three categories: Business-to-Business; Business-to-Consumer; and Business-to-Business-to-Consumer.

In the technology ecosystem of infrastructure, hardware and software, our focus is to lean more into software due its lower capital intensity and less reliance on supply chains. Specifically, within software, we are focused on Business-to-Business enterprise software with specific sub-sectors. This is where we are seeing more activity and what looks attractive from a credit perspective. These subsectors include Governance, Risk Management and Compliance; Enterprise Resource Planning/Business Productivity; and Supply Chain with a vertical focus (i.e., targeted industry or niche). The vertical focus of software vendors is a continuation of a theme we've been seeing, whereby software is really addressing inefficiencies across most industries.

With respect to technology investing there are two major evolving themes that we are focusing on in private credit. The first is the focus on A.I. which is clearly a positive area of growth and investment for the sector but can present a risk to select incumbent software and IT services businesses. For example, we project customer engagement/contact center software vendors will see declines in number of agents as A.I. replaces or reduces demand for labor. This will ultimately drive lower revenue for these incumbents. Also, the increase of coding automation will affect revenue/profit pool for IT service/software integrated players.

We believe that A.I. will largely enter most businesses via existing enterprise software vendors highlighting the need for these vendors to invest to stay ahead of the curve on building out A.I. features and functionality to retain competitive edge. This is a key area of diligence for us on a deal-by-deal basis as we pursue software deals because we want to ensure our portfolio companies do not become obsolete with new entrants coming into the market.

A second major theme is the implementation of Annual Recurring Revenue (ARR) loans to finance deals in the private credit industry, but particularly in the Software-as-a-Service (SaaS) industry.

We apply two underwriting approaches: 1) EBITDA based and 2) Annual Recurring Revenue (ARR) based. In an EBITDA or traditional “cash-flow” underwriting approach, the debt quantum provided to borrowers is based on EBITDA. However, many middle market companies have yet to reach a mature phase in their business lifecycle. In this phase, operating costs are high as companies focus on driving growth. They are not producing significant and/or positive cash-flow or EBITDA.

Therefore, we cannot anchor to an EBITDA based underwriting approach to measure a business’ progress that is in the growth stage. As such, over the past few years, industry practitioners have employed an alternative approach – ARR based underwriting.

Many technology companies, specifically software companies, have recurring revenue through a subscription model with clients. As one measure, we look at the stickiness of client subscriptions year-over-year (i.e., how binding are these subscriptions). This ensures steady, predictable and consistent revenue over various reporting periods depending on the length of the contract with the end customer.

However, revenue doesn’t always predict long run profitability. As such, a key characteristic in ARR loans is a “covenant flip”. As lenders, we want to ensure that a business is ultimately driving towards profitability given profitability influences the valuation multiple that a business commands when it becomes an acquisition target. A “covenant flip” dictates that the debt will transform from being measured against recurring revenue (Debt/ARR) to being measured against EBITDA (Debt/EBITDA) after certain conditions have been met or by an established timeline (usually 2 to 3 years after loan closing).

	EBITDA-based	ARR-based
Business Performance Metric	Earnings	Recurring Revenue
Leverage	Debt/EBITDA: 4.5x-7.5x	Debt/ARR: 1x-3x
Equity Cushion	Typically, lower than ARR based loans	Typically, higher than EBITDA based loans
Covenant Flip	No	Yes

Source: BlackRock. The leverage bands are representative of deals sourced, originated, and funded across the BlackRock Private Debt Platform.

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Putting it into practice

The Investment:

In 2Q2022, we were a lender into a late-stage venture enterprise SaaS company that offers an A.I. /Machine Learning (ML) search engine for market intelligence. The company's platform leverages A.I. technology to help its customers monitor information about their markets, competitors, and customers. The platform aggregates information from over 10,000 sources including brokerage research, regulatory content, company filings, transcripts, presentations, industry journals, news media, and expert transcripts.

We viewed the investment as an attractive opportunity to invest in an enterprise SaaS asset with an entrenched blue-chip customer base supported by highly visible and recurring revenue streams, strong retention metrics and a healthy financial profile. The company's platform is industry agnostic and caters to customers in both financial services and corporates fields that includes many of the top financial services, corporate, and global consulting firms in the U.S. Contracts are sold either on an annual or multi-year per seat basis, with upsell coming from increasing the penetration (i.e., number of seats) within an organization.

The Deal Structuring:

We provided a US\$100 million 1st Lien Term Loan facility at close that represented a Gross Debt to ARR ratio of 1x. Additionally, our loan was protected via a covenant package that included a Debt to ARR covenant ceiling (i.e., max leverage) of 1.50x that would be tested in each quarter and stepping down 0.05x every two-quarter increments. The inclusion of this step-down mechanism functioned as a built-in deleveraging tool for the company. We also structured a minimum liquidity covenant of US\$7.5 million.

The Performance:

From our initial underwrite through 4Q2023, the company produced strong results.

- ARR increased 133% from US\$94 million to US\$217 million.
- Leverage (Debt/ARR) decreased from 1x to 0.5x.
- Customer retention remained healthy with 2023 gross /net retention of 90%/127%, respectively.
- A 3Q2023 equity fundraise round drew US\$150 million bringing the company's valuation to US\$2.5 billion, a +40% increase from the prior round.

The Refinancing:

With the strong performance, the company sought to refinance their existing debt. While the company was well-capitalized with significant cash savings on the balance sheet, they desired to optimize their capital structure to raise additional funds for an acquisition.

Since the company was one of the largest credits in our growth lending portfolio and we had a strong relationship with the management team, we desired to stay in the credit and supported their desire to refinance. The company elected to pay off our US\$100 million term loan and combined with our built-in call protection, the investment generated a double-digit gross IRR over a 2.3-year hold period.¹

Given our strong partnership with the company, BlackRock won the ability to lead the new US\$300 million 1st Lien Term Loan facility. The facility was 3x oversubscribed. However, we were able to negotiate a 1% Original Issue Discount (O.I.D.), pricing the loan at US\$99, the same price as our original loan. The new loan's spread decreased from SOFR+750bps to SOFR+625bps, which we viewed as still attractive given projections for forward rates. We secured the largest allocation amongst the final three lenders and negotiated several structural improvements on behalf of the lender group such as an enhanced covenant package. Lastly, we structured a maintenance covenant to continue receiving monthly financial reporting. In addition, the company raised a new US\$650 million equity round bringing the company's valuation to US\$4 billion valuation in 2Q2024.

This investment is a strong example of how we aided a technology company in the early stage of its development and opted to remain a partner as they entered their next stage.

Source: BlackRock. As of 30 September 2024. **Past performance is not indicative of current or future results.** Case study is shown for illustrative purposes only and was selected to demonstrate BlackRock's capabilities with respect to investment process. There is no guarantee an actual strategy will be executed or executed as shown above, or that if executed, will be profitable. This investment was selected as it represents one of the largest credits in our growth lending portfolio. This case study does not predict future results, even if a similar strategy is used. ¹This investment's returns do not include an accrual for the investment management or fund-level administrative costs and, if applicable, certain third-party acquired fund fees and expenses. If the returns did include accruals for these fees, the returns would be lower.

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Conclusion

In this edition of **Private Debt in Focus**, we've demonstrated that the technology sector is not immune to macro and market challenges. However, the sector is rebounding as evidenced by its strong absolute and relative earnings growth and continued investor interest.

The employment of ARR loans is increasing as a mechanism to fund companies in the early stage of their development. We expect continued use in the SaaS industry. Our platform has the expertise to capitalize on technology opportunities across Direct Lending, Growth Lending and Opportunistic Credit. Additionally, our teams will focus on technology oriented real estate and infrastructure investments as A.I. drives demand for data centers and related infrastructure.

History has proven markets and sectors, especially technology, can emerge stronger from downturns. We are cognizant that not all opportunities will prove rewarding. To be clear, there will be winners and losers, in our view. Therefore, we will continue to adhere to our investment philosophy of selectivity. Over the past few years, we have routinely sourced over 2000 deals annually, but only funded 3-4% of those deals. Our focus will remain on identifying credit opportunities that are differentiated, have well structured business plans and offer the ability to perform through a cycle.

BlackRock Private Debt

USD \$65B

Assets under management in direct lending, opportunistic, special sits, multi-debt solutions, and real estate debt

23+

Years of investing track record seeking to deliver attractive results through market cycles

170+

Investment professionals executing on cycle tested capabilities

18

Offices across the globe providing unparalleled local and global market access & perspective

2000+

Investment opportunities reviewed annually

Strategy AUM

USD \$46B

Direct Lending

USD \$3B

Venture & Growth

USD \$6B

Opportunistic Credit

USD \$6B

Multi-Strategy Debt

USD \$4B

Real Estate Debt

All figures shown above are as of 30 June 2024 unless otherwise stated. Figures may not add up due to rounding.

Source: BlackRock. As of 30 September 2024. **Past performance is not indicative of current or future results.**

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Risk Warnings

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Risk Warnings:

Capital at risk. The value of investments and the income from them can fall as well as rise and are not guaranteed. You may not get back the amount originally invested. All investing subject to risk, including possible loss of money invested.

Private Credit Risks:

Risks associated with an investment in a private credit strategy (the Strategy) include, but are not limited to, the following: (i) the Strategy is speculative and its investments are subject to a risk of total loss, (ii) the performance of the Strategy may be volatile, (iii) the general partner of the Strategy will retain ultimate authority over the Strategy's assets and investment decisions, (iv) there are restrictions on the ability of investors to withdraw capital and on the transferability of investor ownership interests in the Strategy, (v) the fees and expenses of the Strategy may offset any profits of the Strategy, (vi) investing the Strategy may involve complex tax structures and delays in distributing important tax information, (vii) the Strategy is not subject to the same regulatory requirements as mutual funds. Investors should also be aware that as a global provider of investment management, risk management and advisory services to institutional and retail clients, BlackRock engages in a broad spectrum of activities. Although the relationships and activities of BlackRock may help offer attractive opportunities and service to the Strategy, such relationships and activities create certain inherent conflicts of interest between BlackRock and the Strategy and/or the Strategy's investors.

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