TECHNOLOGY

The great enabler

Technology businesses are increasingly offering attractive opportunities to private debt investors with the right experience and specialist knowledge. We speak to **Jim Miller**, a partner with global alternative asset manager Ares Management

The past decade has seen technology become one of the most important drivers of economic growth in many markets worldwide. In the US, as an example, various parts of the technology landscape – from hardware, software and telecoms through to support services and e-commerce – are now key components of the national economy. And the significance of technology is only increasing. According to Forrester figures, the US technology market grew by over 6 percent in 2018, approximately three times the growth rate of US GDP. The technology industry now employs roughly six million Americans, representing nearly 4 percent of the US workforce and often at salaries that are meaningfully higher than those in other segments of the economy.

It is therefore unsurprising that 87 percent of lending institutions included in Proskauer's *Trends in Private Credit* survey for 2018 indicated they were considering investing in software and technology businesses over the next 12 months, just behind healthcare and business services. We sit down with Jim Miller, co-head of US direct lending at Ares Management, a leading global alternative asset manager with $131 billion in assets under management and $96 billion in various credit strategies, to discuss how technology has shaped the US economy and what sector expertise is needed to effectively lend to companies in this space.

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"At Ares, we view the technology sector as a core component within our US direct lending strategy," Miller notes. "Ares has been successfully lending to technology-related businesses for more than a decade and such transactions now account for about 15 percent of our total dealflow. A good example of a recent transaction is the funding we provided to support the acquisition of Avetta, a leading supply chain risk management SaaS platform that electronically connects global enterprise customers to contractors and suppliers, by Welsh, Carson, Anderson and Stowe."

Yet Ares Management's view is that

technology is not a discrete sector – it is unique in this regard. There is significant overlap with other sectors, with applications transforming industrial, healthcare, business services and transport and logistics companies, to name just a few.

"As a result, we tend to view technology as an enabler in a variety of sectors. For us, that means lending to technology-enabled businesses requires a dual evaluation. We have specialists with the knowledge and capability to evaluate the technology being employed in a business, complemented by another layer of detailed and expert analysis on the sector in which the company operates," Miller says.

While the due diligence can vary considerably when looking at technology-enabled businesses, there are some consistent factors that will determine whether to provide financing, according to Miller. "Clearly, as a lender, our overarching aim is to avoid loss. As a result, we look for high-growth businesses with strong free cashflow that can demonstrate long-term stability and sustainability."

He points out that these last two factors are particularly important. There are many high-growth businesses that are driven by technological developments, and they often attract a lot of capital. Yet high growth in and of itself does not necessarily make a good credit as there can often also be a high risk of disruption.

"Companies that look attractive early on can become far less so as competitors enter the market – and this is especially true in technology, where developments happen at a rapid pace. Businesses we lend to need to have clear differentiation, high switching costs and significant barriers to entry to ensure we have downside protection."

Miller emphasises that the market for lending into technology-enabled businesses has become more robust over the past few years as lenders have increasingly gained comfort from strong historical performance

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and credible growth projections. As with the broader credit markets, default rates remain low and the performance of technology-enabled business lending is, in Ares' experience, better than average.

"The strong performance and growth of technology companies has certainly deepened the pool of lending opportunity in the space," adds Miller. "Yet, there is another related factor that is making technology-enabled businesses an increasingly attractive area for direct lending strategies. A decade ago, private equity sponsors were largely circumspect about investing in companies that relied on technology for growth. Now, firms actively seek out such opportunities."

Highlighting this trend, Preqin figures indicate that IT accounted for the highest proportion of the value of private equity buyouts globally in 2018, at 15 percent, and the second highest by number, at 21 percent. And because these figures fail to capture the raft of technology-enabled businesses across other sectors, the real proportion of technology investment by sponsors is likely far higher.

Miller says: "This trend is accelerating as many companies are now choosing to remain private rather than list on the public markets."

IPO data support this assessment with a marked decrease in the number of private equity and venture capital-backed technology IPOs in recent years. By way of example, in 1997 there were 173 private equity and venture capital-backed technology IPOs, yet by 2017 that number had fallen to a mere 30. Also of note is that the median age of US venture capital and private equity-backed technology IPO companies rose to a record 13 years in 2017, more than double the median age of seven years seen in 1997, according to research carried out by Jay R Ritter of the University of Florida.

Miller concludes: "Companies are eschewing the costs associated with being public and are instead seeking private capital to invest in their growth. With continued healthy appetite from strategic buyers, the technology exit market remains robust.

"We are therefore highly optimistic about the growth in lending opportunity across the spectrum of technology-enabled businesses. The private credit market is well positioned to capture a sizeable share of the lending market for these companies as they become an ever larger and more mature component of the economy in the US and beyond." ■