Q+A

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Adapting & thriving in the current market for technology lending

A Q&A with Madison Capital Funding

Amid a decline in general M&A activity, the technology sector has remained more robust than others, seeing significant valuations and more pronounced volume. Not only has the industry matured to the point digitization is blurring the lines between traditional sectors, but also dynamics are relatively heated, with multiples in transactions rising against the backdrop of public market comparables trading at lofty heights. Especially as technology adoption expedites business operations across multiple lines and sector segments, PE sponsors have taken notice. About one-fifth of all private equity transactions are now in technology, with recent PitchBook figures revealing that nearly 32% of all IT M&A across North America and Europe is driven by PE sponsors. With such headiness in the market, there is plenty of opportunity but accompanying risk. In the following Q&A, Madison Capital Funding veterans David Kulakofsky—head of the firm's Software & Technology team—and vice president Brady Hahn discuss the current market environment, its challenges and risks, and how they maintain focus and discipline as they seek to grow the firm's practice.

How has Madison Capital's recent foray into technology lending been faring, and how has the range of approaches and areas of focus changed in 2017 to date?

David Kulakofsky: Madison is unique in that when we chose to officially launch our Software and Technology Services team Madison already had close to a $1 billion portfolio in the sector, resulting in significant institutional knowledge. This is one reason that Brady and I are excited – we had far more experience already in-house than a typical generalist lender entering the sector. Our formal entry into the technology-lending marketplace has been very well received and 2017 has been a very busy year for the team. We have closed a number of transactions, and expect a few more to close by the end of September. Since Madison only provides cash-flow based loans, the largest portion of our portfolio is what Madison classifies as technology-enabled services, followed closely by software. We're seeing a number of businesses that 10 years ago would have been considered traditional business services with average profit margins now producing very high profit margins through the use of new technologies. Payment processing and other financial technology is a new area of focus for Madison and a rapidly growing portion of our portfolio.

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Especially given how high market valuations can be in certain segments, such as technology or healthcare, how does Madison Capital prioritize transactions in the current environment?

David Kulakofsky: As valuations rise, lenders are being pushed to higher leverage multiples than have been offered historically. Specifically, companies that offer a combination of strong credit profiles and high-growth opportunities, including significant industry white space, will receive especially aggressive terms from Madison and its competitors. These factors provide a good runway for growth and de-leveraging over the coming years. Brady and I are also focused on building a relationship-based technology lending practice at Madison. Many of our sponsor relationships go back 10+ years, which can provide further comfort when stretching in today's environment.

Brady Hahn: From a sponsor's perspective, the factors David mentioned are at the top of their mind. Given the competitive market and resulting valuations, it is reasonable that there may be some level of EV multiple contractions in the future. Madison is still a cash-flow lender at its core. Given our 16-year track record, focus and patient capital base, we are not incentivized to be a flash in the pan, which may result from chasing opportunities beyond our comfort zone in this aggressive market. Rather, we are looking to deploy capital where it makes sense, with a strong focus on core credit metrics. To David's point, the strong credit profiles, particularly highly recurring revenue, strong customer retention metrics and strong cash flow conversion, found in these prospective borrowers allow a lender to remain true to its core credit principles despite high leverage multiples. For borrowers that exhibit strong metrics in each of the aforementioned credit attributes, it is difficult for us to imagine a scenario whereby we are taking outsized risk and accordingly, we are comfortable with stretching to win those opportunities.

What's your take on the tech sector currently, especially regarding the reasonability of the current level of valuations and types of lending packages you are seeing?

David Kulakofsky: The market for technology companies requiring debt has become highly efficient, and the lion's share of deals are likely appropriately structured and priced for the risk and credit profiles inherent in the underlying businesses. Madison believes there have been more tech companies with strong credit characteristics for sale over the past couple of years than at any time in history and we do not see any slow-down in the near future. It is particularly important for Madison in this environment to feel like we are working with experienced PE owners who have specific industry expertise. While the borrower profile is at the forefront when we consider our willingness to provide aggressive leverage, sponsor background and track record are also very important to Madison.

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Brady Hahn: Another idea you're alluding to is that auctions for high quality technology companies are very competitive processes for both potential buyers and potential lenders.
While ultimate enterprise value is not the most important metric for Madison, as we're not buying these businesses, we always evaluate debt-to-total capitalization ratios. At Madison we are always trying to put our best foot forward in the event one of our relationships prevails in an auction process. This approach is top of mind when we consider stretching our lending multiples. Madison also markets to our clients our strong track record and experience executing transactions with aggressive debt packages quickly and smoothly in today's competitive environment.

David Kulakofsky: The industry in which Madison competes has changed significantly over the past few years. The proliferation of dedicated capital markets professionals employed by our clients has really accelerated the leverage structure conversation. For example, we're talking much earlier in an auction process about the sponsor's desired leverage level, as opposed to being asked to put our best foot forward; we are seeing far fewer reverse auctions for the debt. We typically know our target much earlier in the conversation, which enables us to decide whether or not to move forward. I think this process evolution for the lenders is partially driven by the trend over the past two or three years of investment banks not awarding exclusivity to a potential buyer without the completion of due diligence. This dynamic also requires potential buyers to have a debt package fully negotiated and committed when they are submitting final, fully diligenced bids.

> ***"At Madison we are always trying to put our best foot forward in the event one of our relationships prevails.***

What structures and/or terms is Madison Capital adapting in response to the current market, if at all?

Brady Hahn: Madison is comfortable with leveraging a business that, from a cash flow perspective, is not necessarily a comfortable prospect for other lenders, particularly businesses with less than $10 million of EBITDA. Our team has closed credit facilities for many borrowers that have less than $5 million of EBITDA.
We're seeing niche technology businesses in the sub-$10 million EBITDA range that exhibit credit profiles similar to larger businesses that are fetching fulsome leverage. Are we able to identify inefficiencies in that space? It's less competitive than other areas of the credit market and Madison has a strong track record of lending to smaller businesses.

> ***"We've seen consistently strong deal flow there all year, and our clients expect the current level of deal flow at this size range to continue.***

David Kulakofsky: To add to what Brady's saying, there are tech businesses that have EBITDA below $10 million, which makes them, for the most part, too small for many of the finance companies we compete against. But these prospective borrowers also have high operating margins, which make them difficult to fit into a commercial bank's credit policies, as the implied revenue multiples are outside of a traditional bank's comfort zone.

Where do you find the best-valued opportunities in the tech sector nowadays?

Brady Hahn: Primarily in the sub $10 million of EBITDA end of the market we discussed earlier. We've seen consistently strong deal flow there all year, and our clients expect the current level of deal flow at this size range to continue.

David Kulakofsky: I do not foresee structures getting much more aggressive, particularly because there's really nowhere else to go, especially relative to historical averages and standards.

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From the perspective of a general partner, what would be the primary concerns in the current market? What about Madison Capital's perspective?

David Kulakofsky: In today's environment, everyone is looking for an angle to help generate good returns despite high purchase price multiples. The large majority of PE firms are utilizing management and industry resources far more than in the past, through a combination of operating partners on staff, a strong rolodex of executives they can bring in on a deal-by-deal basis, or industry experts partnering with firms to source new opportunities.

Brady Hahn: Each private equity firm has a certain approach but all appear to be feeling pressure on modeled returns. Technology investing, in particular, has become more competitive as more private equity firms have entered the space. In response, some firms are relying more heavily on operating partners or their executive networks to drive growth and/or cost optimization in order to meet their return thresholds.

Mr. Kulakofsky heads Madison Capital's Software & Technology Services team, focusing on new business origination and strategy. He is also involved in structuring and closing transactions with his team's clients. Mr. Kulakofsky joined Madison Capital at its inception in 2001 as an Associate and was a Vice President and Underwriting Team Leader before transitioning to an originations role. Prior to Madison Capital, Mr. Kulakofsky was an Analyst in the Investment Banking group at Robert W. Baird & Co., focusing primarily on industrial M&A transactions. Mr. Kulakofsky earned a B.A. in Economics with a minor in Sociology from Northwestern University and an MBA in Analytical Finance from the J.L. Kellogg School of Management at Northwestern University.

Mr. Hahn leads deal execution for Madison Capital's Software & Technology Services team and is also focused on new business origination with West Coast technology-focused private equity sponsors. Prior to rejoining the firm in 2014, Mr. Hahn spent five years executing control equity, structured equity and leveraged finance transactions in the lower middle market as a Senior Associate with Corridor Capital. Prior to Corridor Capital, Mr. Hahn spent three years as a Senior Associate with Madison focused on executing Madison-led leveraged finance transactions. Mr. Hahn has also worked as a management consultant with Deloitte Consulting LLP, focusing on repositioning a Fortune 200 technology company. Prior to Deloitte, Mr. Hahn was a financial analyst with Ford Motor Company focusing on financial planning and analysis for the manufacturing of the Ford Focus. Mr. Hahn earned a B.S. in Finance and a B.S. in International Business from Indiana University's Kelley School of Business.