A Tactical Software Playbook: How to Give a Good Company Breathing Room to Become a Great Investment?

Amid a shifting economic landscape, software companies face a new set of challenges as they try to find ways to de-lever, return capital to shareholders and/or finance new initiatives in a situation where growth rates and/or profitability have not met expectations.

In recent conversations with private equity (PE) firms in the software sector, several clients have identified portfolio companies with strong retention metrics, but only ~10% ARR growth and EBITDA margins that fall short of the highly sought after "Rule of 40". While these metrics are not out of sync with the "new normal," it is not where their current lenders underwrote deals or where a premium exit is likely. Growth has slowed and/or the time to hit in-model EBITDA has been delayed. In addition, in cases where lenders have worked with borrowers to amend their facility, these amendments are often temporary and fail to provide the company with the runway to execute on their strategic plan and potentially secure a better exit multiple.

For PE firms, the challenge is clear: how can they modify these balance sheets to create breathing room for portfolio companies and/or improve the expected MOIC on the exit?

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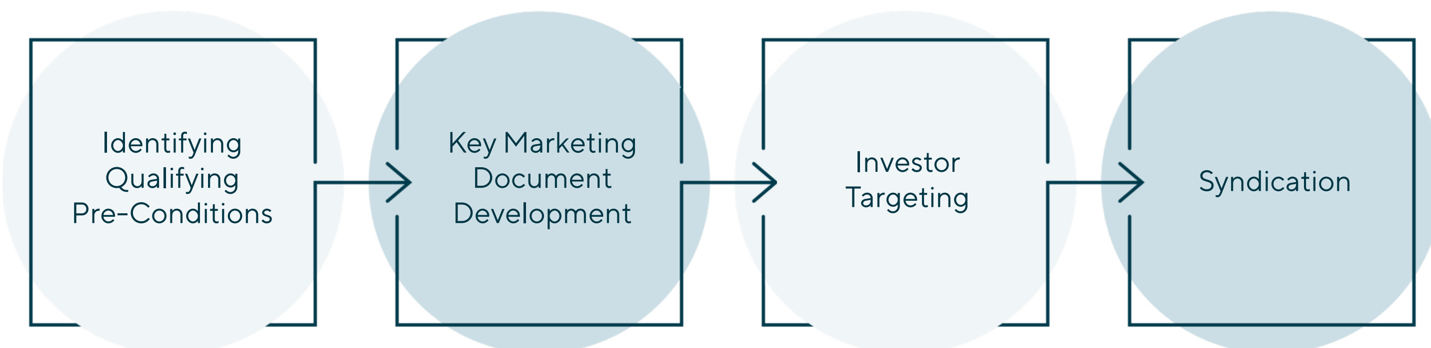
Structured Capital: A Creative Solution

Structured capital offers a creative solution for software companies grappling with over-leveraged balance sheets or seeking to return capital to shareholders. Unlike traditional debt, structured capital instruments—such as preferred equity or Holdco PIK notes—provide flexibility to de-lever (or assist with a recapitalization) without requiring cash pay interest or traditional financial covenants, and have the additional benefit of limited dilution to common equity holders. However, the process of executing such a transaction requires significant planning and knowledge of the investors operating in this niche area of the market. In addition, software companies must meet a certain group of key criteria prior to embarking on such a transaction. Lincoln International's dedicated team of bankers hold deep sector experience in the software industry, as well as extensive knowledge of the capital markets.

Our **Tactical Software Playbook** provides a roadmap on how to execute these deleveraging and recapitalization transactions alongside our expert advisory services.

A Tactical Software Playbook



Step 1: Identifying Qualifying Pre-Conditions

Before embarking on a structured capital transaction, it's critical to ensure the company meets specific financial and operational benchmarks. Investors in structured capital instruments look for clear indicators of growth and stability, even if the company is currently under financial pressure.

Qualifying Pre-Conditions

Projected ARR growth greater than **10%** one year from the expected closing date	Net dollar retention greater than **100%**	Gross dollar retention greater than **85%**	EBITDA breakeven when adjusted for pro forma cost saves that are expected to happen in the next 12 months

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Step 2: Key Marketing Document Development

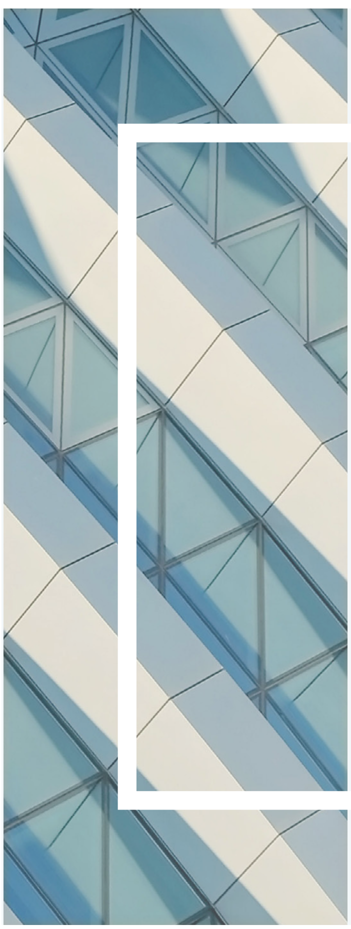
Meticulous preparation is the cornerstone of a successful structured capital transaction, which typically requires at least one month of work prior to launching a transaction. For software companies, this phase is critical to translating complex financial metrics—such as ARR growth and retention rates—into a compelling narrative for potential investors.

By addressing sector-specific nuances upfront, software companies can significantly improve their odds of securing favorable terms and attracting the right investors. Key deliverables include:

1 | A short-form Quality of Earnings (QoE) analysis to validate recurring revenue metrics

2 | A capital raise financial model that aligns with investor expectations

3 | A Confidential Information Memorandum that positions the company as an attractive investment



De-leveraging and recapitalization processes for software companies can be a heavy lift for the internal capital markets team at a private equity firm, and these transactions require a great deal of preparation to deliver an outlier execution.

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Step 3: Investor Targeting

Finding the right investor is a critical step in any structured capital transaction. The software sector's reliance on ARR-based business models means investors must have a deep understanding of recurring revenue metrics and the nuances of high-growth companies.

> **Preferred Equity** – These investors typically structure their investments as 100% PIK instruments with no financial maintenance covenants, making them ideal for growth-oriented software companies. If structured appropriately, it can also receive equity treatment under U.S. generally accepted accounting principles, which is often viewed favorably by incumbent senior lenders. For software companies seeking to de-lever while maintaining control and avoiding financial covenants, preferred equity can be an effective tool, provided the company has a clear plan to deliver the growth needed to meet return expectations. In addition, during a recapitalization transaction these instruments can often return capital to shareholders with significantly less dilution than a minority common equity investor.

> **Holdco-Co PIK Note Investors** – This investor class offers a flexible financing solution by structuring their investments as a PIK toggle, shifting from PIK interest to cash pay interest after two to three years when the company is expected to generate stronger cash flows. In addition, Hold-Co PIK Notes generally have a lower cost of capital than preferred equity. However, these investors tend to impose financial covenants (often 20% to 25% above senior debt levels—and may require warrant coverage to meet their return expectations). For companies seeking this type of capital, it's critical to balance these requirements against the flexibility PIK toggles provide.

> **Uni-tranche Investors** – These investors act as a blend between senior debt and structured capital providers, offering higher senior leverage while enabling the investor to assert greater control in cases of financial underperformance. For software companies, this type of capital can provide a streamlined solution, but it often comes with higher cash interest and financial maintenance covenants. Uni-tranche investors provide a unique alternative for companies facing resistance from other structured capital providers.

Step 4: Syndication

After distributing marketing deliverables to a targeted investor group, the next step is to carefully review all submitted Indications of Interest (IOIs) and narrow the pool to those most closely aligned with the financing objectives of the transaction. IOIs typically outline preliminary terms, indicative pricing, covenant expectations and a proposed deal timeline, which provide key decision points for management teams to evaluate.

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Selected investors will then participate in a series of organized management presentations (MPs), designed to provide deeper insights into the company's strategy, operations and financials.

Following these presentations, investors will conduct further due diligence with access to a secure data room and other materials to support their final investment committee process. It is important to note that due diligence for structured capital transactions is typically longer than a traditional senior debt placement.

At the end of this process, final investors are invited to submit Letters of Intent (LOIs). The management team and advisors will then select a single investor (or group of investors, if applicable) to move forward with documentation and finalize the transaction.

Partnering with Lincoln for Long-Term Success

De-leveraging and recapitalization processes for software companies can be a heavy lift for the internal capital markets team at a private equity firm, and these transactions require a great deal of preparation to deliver an outlier execution. Often, financings such as these require an experienced advisor with both software industry expertise and a broad array of investor relationships.

Lincoln International has the expertise, relationships and sector-specific knowledge to execute these complex transactions with precision. Whether recapitalizing a software company's balance sheet or securing new investors to drive long-term growth, our team delivers tailored solutions to meet your goals. Contact us today to learn how Lincoln International can help your portfolio companies thrive in 2025 and beyond.

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Ready to discuss the opportunities ahead for you?
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