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Thoughts on the software reset for private credit

Fidelity's direct lending team explores current conditions for software equities following a sharp decline, and where they are finding opportunities in more resilient segments of the market.

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Key takeaways

- Software equities have experienced a sharp drawdown, but the current reset may ultimately create a healthier lending environment than what has prevailed in periods where assets were overvalued and financed with aggressive leverage.
- Software has represented less than 10% of our direct lending investment activity over the past several years, reflecting our belief that there was indiscriminate excess focused more on loan-to-values (LTV) than business fundamentals.
- Such periods of pronounced volatility in public software markets tend to reshape capital availability, risk appetite, and, ultimately, transaction terms across the private markets. Several areas of mission-critical software should be resilient, such as cybersecurity and compliance infrastructure, enterprise controls, and secure data environments (including health care).

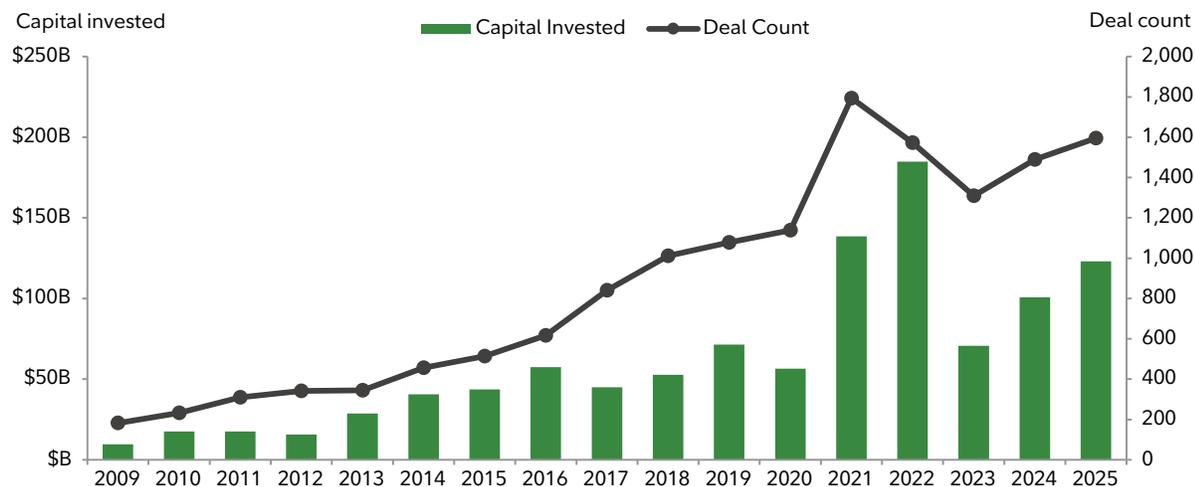
After underperforming the broader market in 2025, software equities began the year with a sharp drawdown, declining about 20% year to date through February 5, according to MSCI. Valuations abruptly reset amid growing concern that artificial intelligence (AI) is disrupting traditional software business models more rapidly than anticipated. The speed of the sell-off has been notable, even by the standards of historically volatile technology markets.

While public and private markets are often discussed as separate ecosystems, developments in public markets inevitably influence private valuations and underwriting assumptions, albeit with a lag and a more deliberate cadence. Periods of pronounced volatility in public software markets tend to reshape capital availability, risk appetite, and, ultimately, transaction terms across private credit, as was the case with the advent of cloud-based software approximately 10 years ago.

This dynamic has informed our direct lending investment activity over the past several years, with software representing less than 10% of our aggregate exposure. Based on publicly available business development company (BDC) data, this places us meaningfully below peers.¹ It was a deliberate choice in light of a market that exhibited incredible resilience and, as a result, grew very rapidly during and following the Covid-19 shutdown (Exhibit 1, page 2).

¹ Based on publicly available business development company (BDC) data, as of 2/12/26.

Exhibit 1: Global software deals (in size and deal count) have grown significantly over the past two decades.



Source: Pitchbook Data Inc., as of 12/31/25.

The tailwinds of this growth were strong, and as valuations expanded, a lender was required to provide increasingly higher leverage and more sponsor-favorable terms to “win.” We believed the risk-adjusted outcomes were less compelling, and broadly indiscriminate, especially for workflow and narrow point-solution software companies, as these businesses appeared disruptable and less mission-critical well before the proliferation of AI solutions. Rather than placing more weight on owner expertise and low LTVs, or stretching on structure and/or underwriting, we chose to remain selective and patient.

Our view is that while the current disruption in software is real—and will be painful for certain companies and subsectors—the broader narrative around the demise of software is overstated. In the spirit of Mark Twain, reports of software’s death appear greatly exaggerated. In fact, we believe the current reset may ultimately create a healthier lending environment than the one that prevailed during the past five years when software assets were broadly overvalued and frequently financed with aggressive leverage—often justified by headline LTV metrics rather than durable downside protection.

To explain why we hold this view, it is helpful to understand our priorities when assessing software risk.

We place significant emphasis on building an informed mosaic before committing capital, and software is one of the areas where that mosaic is particularly deep. Our investment philosophy emphasizes low use of leverage and a focus on downside risk management through first-lien structure and strong covenant protections. Our perspective is informed by several overlapping and proprietary sources:

- A scaled global asset management and research franchise, with nearly 500 research professionals who cover 30+ unique industry sectors including the software and technology, media, and telecom (TMT) ecosystem.² Our colleagues maintain active relationships with nearly all leading public innovators in technology, software, and AI, and consistently engage every management team we meet with on how they are deploying technology to drive efficiency and competitive advantage.
- A dedicated late-stage venture investment platform, with meaningful private company investments across the TMT ecosystem, including positions in several of the largest and most influential

² Research insights informed by 5,000+ in-house visits and 25,000+ in-house visits per year. Source: Fidelity Investments, as of 12/31/25.

innovators in AI.³ Through ongoing dialogue with founders and management teams, we gain early visibility into emerging technologies, adoption trends, and competitive dynamics—insights that inform our broader public and private investment activity.

- Direct operating insight as a vendor to (or customer of) 1,000+ software providers. A disciplined procurement process evaluates multiple competing platforms before selection. It provides broad, real-world visibility into product differentiation, pricing, implementation risk, and switching costs across a far wider universe than our final vendor count alone would suggest.

Taken together, this mosaic reinforces our conviction that software, as a category, is not disappearing. While valuations and margins may come under pressure (meaningfully) in certain segments, many infrastructure-level and system-of-record platforms remain deeply embedded in customer workflows and mission-critical operations. Importantly, AI itself relies on underlying software, data, and systems to function—disruption does not eliminate the need for these foundations.

Moreover, several areas of software appear particularly resilient. Durable demand is evident in mission-critical businesses where the cost of failure is high—such as cybersecurity and compliance infrastructure, enterprise controls, and secure data environments (including health care). Similarly, vertical software providers with deeply specialized offerings tailored to specific industries often benefit from high switching costs, regulatory complexity, and long-tenured customer relationships that insulate them from rapid displacement. Given their embedded role in customer operations, greater visibility into cash flows, and more defensible downside characteristics, these are the segments where we historically focus our lending efforts, even during more aggressive market environments.

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Lastly, and most importantly, entrusting core corporate functions to software is a deliberate, risk-weighted decision. These systems underpin the business, and failure or flawed implementation can materially disrupt operations. We have seen even “routine” migrations cause meaningful disruption. Management teams therefore distinguish sharply between software that is convenient and software that is essential infrastructure. When core systems fail—much like a prolonged network outage—business continuity is at risk. This divide drives switching costs and durability and informs our emphasis on true systems of record over more easily displaced coordination layers.

From a private credit perspective, periods like the current one for software have rewarded discipline. While selectivity remains essential, we believe the current environment may offer an opportunity to lend into higher-quality software businesses with more appropriate leverage and stronger downside protection than was available in prior years. For us, mission-criticality is not just a growth attribute, it is central to recoverability and how we think about outcomes across the cycle.

As always, we strive to have the humility and knowledge that we will not be “perfect” investors, even when we may have an information advantage. This is why we focus more on underwriting durable companies and structuring conservatively, while seeking to generate attractive current income in all our investments, and less on the owner or the perceived LTV. We believe that this is the only formula for success and resilience across market environments over the long term.

³ Source: Fidelity Investments, as of 12/31/24.

For more on Fidelity's direct lending solutions, please contact your Fidelity representative.

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