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Recurring Revenue Financings: Market Update

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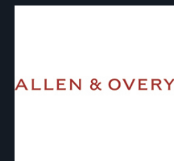

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Recurring Revenue Financings Market Update

Emergence of annual recurring revenue financings as a leveraged lending product

The ever-expanding number of companies successfully using a subscription model for the goods and services they offer has transformed the economy and has allowed such companies to access new customers and increase profitability. From application software, healthcare IT, data analysis, online commerce and cyber security to mobile platforms, digital media and gaming, subscriptions have emerged as an almost universal monetization solution for both new businesses and established players on the market looking to deploy innovative products without imposing high adoption costs for the consumer.

These businesses generate steady and predictable income from uniform (or tiered) subscription fees, known as recurring revenue. Annual recurring revenue (ARR) has consistently been used as a key metric of the value of these businesses by stakeholders – founders, private equity and venture capital backers, and in recent years has exceedingly been used by sponsors in leveraged buyouts. Most recently, lenders have begun to utilize ARR when developing recurring revenue leveraged finance products in order to open access to financing for such companies (and their takeovers), who are oftentimes yet to mature into positive-EBITDA generating businesses. Traditional leveraged finance facilities usually rely on EBITDA-based metrics to assess the borrowing capacity of a business, but many recurring revenue businesses have low or negative EBITDA because of high operating and startup expenses. However, they expect to grow rapidly in the future as founders and sponsors implement their development strategies and scale the businesses. This has led to the rise of recurring revenue loans as an essential source of funding for many companies in this situation.

In the past several years, recurring revenues experienced both growth and hesitancy. The pandemic years of 2020 and 2021 were characterized by the meteoric rise of IT company valuations and both the US and the European markets showed an increasing appetite for recurring revenue deals. The uncertainty that has characterized 2022 and 2023, which included the collapse of the Silicon Valley Bank – one of the primary startup financing sources and the *de facto* venture capital bank of the US, has had an impact on ARR loans too. Interest rate hikes continue to affect technology company valuations across the board and inflation has dampened the appetite of customers for subscription-based services and has led to consumer loss (measured as “churn” in ARR loan agreements), even for market leaders. Despite the broader sector remaining stable, lenders are naturally concerned about prospects, especially with companies where revenues are heavily dependent on consumers rather than other businesses. The changing landscape has not stopped deals from being done, but terms are different. In the last year, lenders have shifted focus to providing ARR loans mostly to software companies with steady recurring revenue and a more proven track record, as opposed to prior years where continuing growth of the IT sector made up-and-coming startups attractive borrowers as well.

How do financial covenants in ARR financings work

The terms of annual recurring revenue-based facilities are, at least initially, not based in the EBITDA of a company. Instead, they use ARR as a metric to evaluate the ability of a business to take on debt, typically combined with a “liquidity” covenant to ensure lenders that the borrower has enough cash on hand to

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meet interest payments. This loan structure in turn also suits the Software-as-a-Service (SAAS) business model that many sponsors favor. A tech company deploying a SaaS solution in growth stage typically has minimal or negative EBITDA and relies on its ARR. These features give recurring revenue facilities certain key distinguishing features when compared to standard leveraged loans. The focus is on how the financial covenant is structured, how it changes throughout the life of the loan and what additional protections should be included in the credit agreement.

The borrower's financial leverage in ARR loans is assessed by comparing its total debt to its recurring revenue from customers. This is different from a conventional leveraged loan facility, where the borrower's debt is measured against its EBITDA. A common feature of most recurring revenue loans is the "covenant flip", where the financial leverage covenant "flips" from recurring revenue-based to EBITDA-based after the borrower meets certain conditions (or often a specified period of time). These conditions usually include reaching a specified level of positive EBITDA by a certain deadline (typically two to three fiscal years) after the loan is made, which shows that the borrower has achieved the expected growth. Until then, the borrower must comply with stricter requirements and has limited access to some benefits of the loan. After the borrower attains the required EBITDA level, the financial leverage covenant switches to a standard debt to EBITDA ratio, and the negative covenants, which restrict the borrower's actions, also change to reflect EBITDA metrics. Moreover, some of the limitations that applied before the covenant flip are removed or relaxed. In many ARR deals, the borrower can trigger the covenant flip earlier than the deadline (if it can comply with the post-flip EBITDA-based leverage covenant), and thus enjoy the advantages of the post-flip terms.

For many loans underwritten during the COVID-19 pandemic era, the time for the ARR covenant flip is fast approaching and lenders and sponsors are monitoring key financial performance indicators to measure company performance. Where liquidity appears insufficient, the expectation is for sponsors to add equity rather than lenders giving additional leeway on deadlines for covenants to convert. With private equity firms being thoughtful about opportunities to deploy cash in the past 12 months, there appears to be sufficient dry powder to prop up companies in their portfolios where necessary, even at the cost of immediate returns. This should not come as a surprise to anyone who has been following the genesis of recurring revenue financings. Even at their onset, in order to more fairly allocate risk between lenders and sponsors in recurring revenue-financed takeovers and account for the uncertainty that inevitably follows any developing business with negative EBITDA, equity cushions were generally bigger than comparable non-ARR leveraged financings. In recurring revenue-based leveraged buyouts, private equity sponsors were typically (although not always) providing equity cushions ranging from 50% to 80% of the total pro forma capitalization of the borrower as opposed to equity contributions of 30-40% that were usually seen in standard leveraged buyouts. In the same vein, recurring revenue credit facilities also usually permit equity cures with varying terms, but commonly require that cures are used for deleveraging of the credit through debt prepayment. Equity cure proceeds are typically required to be used to make mandatory prepayments until the financial covenant "flips", and after that more typical EBITDA cure mechanics apply, eliminating the need to use equity cure proceeds as a mandatory prepayment.

In a post-Fed interest hikes era where capital costs more, it can also be expected that the additional covenants that characterize recurring revenue credit facilities will play a larger role. The minimum recurring revenue covenant that sets out the base recurring revenue a borrower is expected to maintain, which typically includes step-ups as growth is achieved, is standard. The measure of customer retention

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or cancellations as a percentage of total revenue, (known as the “churn” we referred to above), is reported to lenders as part of the financial reporting package. Finally, the liquidity covenant is also expected to remain a feature of ARR financing in the coming years.

Current Market Conditions

In the past several years, the ARR segment saw both growth and hesitancy. In 2021, both the US and European markets showed an increasing appetite for recurring revenue deals. As previously mentioned, the uncertainty that has characterized 2022 and 2023 has had its impact on recurring revenue loans. Interest rate hikes have affected technology company valuations across the board and despite the broader sector remaining stable, lenders are naturally concerned about prospects, especially with companies where revenues are heavily dependent on consumers rather than other businesses.

Private-credit lenders have increasingly embraced ARR loans as a viable financing option for large software buyouts, as evidenced by several recent transactions in the sector. The latest example was the acquisition of New Relic by Francisco Partners and TPG for $6.5 billion, which closed in November, 2023 and was provided by Blue Owl, Golub Capital and Sixth Street as lenders of the ARR facility financing the acquisition. In September, 2023, Francisco Partners also acquired Accela, with ARR based funding provided by Silver Point. In the first half of 2023, Thoma Bravo and General Atlantic took Coupa Software private in a transaction using approximately $2 billion in ARR financing.

More recently, not just direct lenders, but traditional banks have also shown interest in ARR loans and as with traditional leveraged finance loans, they have diverged in the terms offered (though that gap has begun to narrow). Direct lenders are currently providing more favorable terms for borrowers, with pricing around SOFR plus 600 basis points and recurring revenue leverage between 2x and 2.5x (and reaching as far as 4x in some cases). Banks, on the other hand, will offer 1.5x-2x leverage of ARR, with loans priced in the SOFR plus 500s basis point range. Another positive development in 2023 is that the profile of borrowers is now generally more mature with a more established customer base and steady cash flows. Lenders are now typically expected to finance companies where there are less questions about the fundamental viability of the business and uncertainty is largely concentrated in whether the sponsors' assumptions and projections about the potential to expand the business will materialize. ARR loans continue to be designed to provide ample liquidity at the outset. The excess cash can then support the working capital needs that are necessary to drive growth at these companies. Lenders maintain a close oversight of the performance metrics of the borrowers to evaluate the progress and effectiveness of the growth investments.

The Future of Recurring Revenue

Shaky markets and fluctuating valuations in 2022 and 2023 seemed to threaten the viability of ARR financings, but with 2024 approaching, there does not seem to be any doubt that such financings will continue to be a feature of the leveraged finance market. Lenders are more cautious when evaluating borrowers at the onset and setting financial key performance indicators for them to reach before converting to EBITDA covenants and sponsors can no longer lever up their portfolio companies like they did in 2021, but deals keep being done and there is faith that ARR financing is still a solid financing option for growing companies.

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While the current ARR market is predominantly focused in the US, given the increased competition among various private lenders in Europe and other international markets, recurring revenue products have been expanding in presence and in size overseas as well. Europe lagged behind the US with respect to ARR for several years. This trend has started to change since 2019 as the two markets have grown closer and regulatory and structural hurdles are overcome. The European tech sector has also shown its ability to successfully implement the SaaS model and withstand the COVID crisis, which has boosted the frequency of financings based on recurring revenue. US lenders have expanded their offerings to the UK and the EU and new fintech startup ventures have started providing capital to companies on the basis of recurring revenue, and US financial sponsors who have crossed the Atlantic in search of investments have also driven significant interest in this type of financings. New entrants will still require sufficient know-how to compete in the ARR segment, but we would expect to see the product keep developing in Europe too.

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