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Recurring Revenue Financings: A Primer

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RECURRING REVENUE FINANCINGS
A PRIMER

Origins of Recurring Revenue Financing

In recent years, the subscription model has seen stratospheric growth and has changed the goods and services economy. Subscription services have become ubiquitous in both the professional and personal realm, realizing growth in a multitude of technology sectors utilizing "software as a service" business strategies such as application software, healthcare information technology, data analytics, eCommerce, security, mobile platforms, digital media and gaming. Businesses using this monetization model rely on predictable income sourced from a contractually obligated stream of payments from customers (rather than one-off payments for goods or services) which is commonly referred to as recurring revenue.

The increase of high growth companies generating recurring revenue has led to the development of recurring revenue credit facilities as a financial product that allows private equity sponsors to accomplish leveraged buyouts of companies that would otherwise not be able to procure typical leveraged loan facilities. Traditional facilities typically utilize EBITDA-based financial metrics as a way to measure the ability of a borrower to take on leverage and many companies relying on recurring revenue may have very low or even negative EBITDA. These businesses usually have *de minimis* positive cash flow as a result of high operating and startup costs, but deploy strategies that exhibit fast future growth. While the financial picture of such companies at that stage may not be strong enough to permit for standard debt financing, recurring revenue loans have developed as a key source of capital for many in this position.

Recurring revenue based facilities have their roots in smaller deals from two decades ago. As the "software as a service" and technology sectors accelerated in growth, financial sponsors turned to recurring revenue loans as a means to facilitate their interest in early stage companies. In the early days, private equity sponsors had only a handful of lenders that would participate in the space, but as deals grew in number and subsequently in size, most direct lenders with a portfolio in the tech sector today are willing to underwrite recurring revenue facilities and tech-enabled investments. The further growth of technology companies during the COVID-19 pandemic has resulted in record breaking recurring revenue financings such as Thoma Bravo's take private acquisition of the cloud-based software company Anaplan for a total consideration of over $10 billion, which was financed in part by a $2.5 billion recurring revenue loan. While the recurring revenue space is primarily dominated by direct lenders, traditional institutional banks have increasingly shown interest in potential investments, especially amidst market instability. On the private equity side, many sponsors with increasingly larger portfolios have begun to utilize recurring revenue financings to take advantage of the higher yield technology investments in the post-COVID world as the size of recurring revenue deals continues to grow and there is an increasing number of transactions in excess of $1 billion.

Characteristics, Terms and Mechanics

Given the reliance on the recurring revenue of a company and the minimal or negative EBITDA, recurring revenue credit facilities have key features that distinguish them from standard leveraged loans that aim to achieve adequate lender protection while maintaining flexibility for the borrower to execute on its growth plan. Much focus is placed 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, as described in further detail below:

- **Financial Covenants.** In a recurring revenue loan, the financial leverage covenant measures the total debt to recurring revenue of the borrower (unlike a traditional term loan B, where debt is compared against EBITDA). The test is measured by either utilizing the trailing four quarter period or by annualizing the most recent quarter of recurring revenue, which is dependent on the nature of the business. Annualizing is more common for fast growing businesses while a trailing four quarter figure is often used for more cyclical business models in order to capture a full cycle. Transactions typically feature leverage in the range of 1.25x to 2.50x of either the trailing or annualized recurring revenue.

Most deals include a liquidity covenant as well. Usually tested quarterly, but sometimes monthly, it sets a minimum threshold of liquidity (defined as unrestricted cash and cash equivalents, such as undrawn working capital facilities) which the borrower must maintain on its balance sheet, as a way of guaranteeing that it will be able to meet its interest payments and operating expenses.

Given the expected rate of growth of most companies utilizing recurring revenue financings, there is typically an expectation that they will generate positive EBITDA within a certain agreed-upon period, as discussed below. For that reason, lenders typically do not expect to rely on a financial covenant based on recurring revenue for the full tenor of the loan, as set forth below.

- **The "Covenant Flip"**. One of the most prevalent mechanics seen in the majority of recurring revenue transactions is known as the "covenant flip", which, after certain conditions are met, transforms the recurring revenue financial covenant into a more typical debt to EBITDA leverage covenant.

Borrowers are often expected to achieve certain levels of positive EBITDA by a specified deadline (typically two to three fiscal years) after the inception of the credit facility in order to demonstrate the expected growth, and until that happens, they are subject to more stringent requirements and are restricted from utilizing certain features of the credit facility. After the required level of EBITDA is reached, the financial covenants in such facilities convert from ones based on recurring revenue and liquidity (or, in some instances, other non-EBITDA metrics) to a single customary debt to EBITDA leveraged covenant. Upon conversion, negative covenants would also typically convert to being tested or growing based on EBITDA metrics and certain pre-conversion restrictions will either fall away or loosen. In most cases, the borrower can elect to convert prior to the required date if it can demonstrate it has achieved the necessary EBITDA to comply with the EBITDA-based leverage covenant level in order to take advantage of post-conversion baskets and the looser restrictions.

- **Equity Cushion.** While the borrower is subject to financial covenants based on recurring revenue and liquidity and there are less stringent debt service requirements, recurring revenue transactions have other characteristics to achieve the requisite risk balance between lenders' and borrowers' interests. In recurring revenue-based leveraged buyouts, private equity sponsors are typically (but not always) required to contribute a larger portion of equity, ranging from 50% to 80% of the total pro forma capitalization of the borrower versus an equity contribution of 30-40% usually seen in standard leveraged buyouts.

- **Amortization, Maturity and Call Protection.** Generally, recurring revenue transactions have no amortization required prior to the deal converting to an EBITDA-based loan, although some smaller sized deals may provide for principal payments. In terms of interest, the borrower may have the option to pay some interest in kind rather than in cash, with recent deals featuring as much as 100% of margin permitted to be paid in kind. The goal of having such payment relief for the borrower is to provide for liquidity that will allow reinvestment into the business. As previously noted, to facilitate this further and in order to preserve cash, excess cash flow payments are typically not required prior to conversion.

In a recurring revenue deal, both the term loan and the revolver usually have a matching tenor of 5 to 7 years. Furthermore, a robust call protection is typically present and can include a 103/102/101 soft call. A hard call may be used on smaller deals as well.

As a result of the foregoing structural and economic terms, recurring revenue loans are typically priced higher compared to traditional cash flow based leveraged loans and deals that contain a covenant flip generally provide for a step down in pricing levels post-flip.

- **Additional Covenants.** Recurring revenue credit facilities often include additional covenants in order to ensure the company is meeting financial goals important to lenders during the pre-covenant flip period. For example, a minimum recurring revenue covenant sets out the base recurring revenue a company is expected to maintain and may include step-ups as growth is achieved. Additionally, since the revenue stream is dependent on not just adding new customers but retaining existing ones, the measure of customer retention or cancellations as a percentage of total revenue, known as “churn”, is often reported to lenders as part of the financial reporting package. A number of deals will see a covenant to prevent churn from exceeding a certain amount.

These additional covenants help lenders get a clearer picture of borrower performance in the pre-covenant flip period, but what if a company fails to meet the required financial covenant metrics? As with standard cash flow type leveraged loans, recurring revenue credit facilities will often permit equity cures, with varying terms. Some facilities will only permit the deleveraging of the credit (i.e. through debt prepayment) while others will allow a more standard cure but where only a certain fraction of the contributed amount is permitted to be credited for the cure. Equity cure proceeds are typically required to be used to make mandatory prepayments until the financial covenant “flips”, after which this restriction is usually lifted, eliminating the need to use equity cure proceeds as a mandatory prepayment.

- **Baskets.** During the pre-covenant flip period, a recurring revenue credit facility will typically restrict a borrower’s ability to utilize certain negative covenant baskets. Smaller sized deals will offer additional flexibility post-conversion while larger ones may have smaller baskets but include EBITDA growers that kick in post-conversion. Some baskets such as certain restricted payments or the builder basket may be entirely blocked or be very limited pre-conversion on smaller deals. Post-conversion, fixed dollar baskets for debt, liens, restricted payments and junior debt

> prepayments typically increase in size (or begin to grow based upon a specific percentage of trailing twelve month EBITDA), and ratio carve-outs that permit uncapped amounts of additional debt, liens, restricted payments, investments and junior debt prepayments up to a specified EBTIDA-based leverage ratio become effective. When it comes to incremental debt, in larger deals prior to the covenant flip, an incremental facility is available subject to a closing date recurring revenue ratio and often includes a hard dollar cap plus a small freebie (but no grower). After a covenant flip, an incremental facility may look more similar to what is expected in a standard leveraged deal but set at or inside leverage levels that are predicted by the sponsor (usually in consultation with lenders) to be achieved at the time of the flip. Smaller deals may or may not include an incremental debt feature, but when they do, they are usually subject to a hard dollar cap. Any grower baskets that were permitted and that were set on a percentage based on last quarter's annualized or trailing twelve month recurring revenue also convert to an EBITDA-based percentage post-covenant flip.

As is evident by the many negative covenant options, once a borrower achieves the necessary goals and is able to convert to an EBITDA-based model, flexibility typically increases substantially.

Current Market Conditions

In 2021, both US and European markets showed an increasing appetite for recurring revenue deals. However, the uncertainty that has characterized 2022 so far has had an 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.

Nevertheless, recurring revenue loans are still a reliable source of financing for the technology sector and remain an attractive proposition for lenders. The US market in particular keeps evolving and maturing, with competition increasing as more and more prospective investors enter the scene. Recurring revenue loans have traditionally been provided by private credit lenders, but institutional banks are now considering the space more closely. Even though syndication for these types of deals still appears to be off-limits and it is hard to imagine that this will change anytime soon, the good news is that recurring revenue loans are beginning to infiltrate CLO portfolios, which will continue drive interest in institutional investment banks to get involved.

While the nature of recurring revenue deals is by definition riskier than comparable traditional leveraged finance loans given the borrowers' low or negative initial EBITDA, lenders continue to enjoy a larger equity cushion and increased returns, with pricing higher than EBITDA-based facilities. From an investor's perspective, as an asset class, recurring revenue can also offset some of the risks associated with making equity investments in startups or growth-stage tech companies, such as the risks associated with the ongoing volatility of capital markets and the unclear investment horizon. Borrowers benefit from the flexibility that recurring revenue deals come with and given the state of play on the tech IPO market that is all but closed at the moment, recurring revenue loans may be a funding lifeline until they reopen.

Despite the overall slowdown in lending activity in 2022, the year was not without its success stories when it comes to recurring revenue deals. Vista Equity Partners took Avalara Inc. private through a

$2.75 billion transaction in August 2022, with Blue Owl leading more than 20 direct lenders, including Apollo, Blackstone and Partners Group and others. Earlier in the year, the Silicon Valley Bank backed Marlin Equity Partners in a recurring revenue financing to recapitalize portfolio company Heimdal Security, with Marlin also using a recurring revenue loan to purchase cyber security provider Silobreaker earlier in the year for an undisclosed amount.

This outlay shows that, despite cooling markets, private equity sponsors can still get deals done and lenders are willing to provide funds through recurring revenue financings if a transaction otherwise makes sense from their perspective. While so far direct lenders are still driving the majority of deals in the recurring revenue loan segment, it can be expected that institutional investors will express interest in setting a larger foothold in this space in the coming years.

The Future of Recurring Revenue

Recurring revenue loans have seen quite the evolution from the early 2000s. These deals will remain an important source of financing in the leveraged finance markets and shall continue to see likely growth throughout the coming years, even through potential market instabilities. Optimistic forecasts from the end of 2021 estimate that the total volume of recurring revenue loans can reach $40 billion in the next five years and that recurring revenue financing will become available to companies outside the tech sector. Companies that are often not yet cash flow positive will look for ways to accelerate growth. Lenders will provide credit to such companies to enable them to increase profits and risks will continue to be off-set with increased sponsor equity contributions, higher margins and loan mechanics that will provide protection while companies are in growth mode.

Continued growth of the technology sector and opportunities in potential new sectors will fuel the pipeline of available companies to execute recurring revenue transactions. However, the current market is predominantly in the US and given the increased competition among various private lenders in Europe and other international markets, recurring revenue products will likely expand both in presence and in size outside US borders. Additionally, new players will likely continue to enter the space. Now that there is a proven track record in the recurring revenue space, banks that typically participate in the syndicated markets are expected to also enter the recurring revenue space. It will be exciting to see the development of terms in the US and other significant financial markets, and the role institutional investors will play as this product grows in popularity.

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