

In Practice

Authors Matthew Ayre and Jason Larkins

Recurring revenue-based deals

In this article the authors examine recurring revenue transactions in the UK and European markets – what are they, who are they for, how they work, what are the key features and market trends?

WHAT ARE RECURRING REVENUE-BASED DEALS?

In the absence of positive or substantial EBITDA as a metric for leveraged financing, growth stage businesses are increasingly turning to annual recurring revenue (ARR) as a reporting metric to access leveraged debt. An ARR loan is made available and sized on the resilience and reliability of the recurring revenue of the business, with leverage measured against the ability of the borrower to service that loan from such revenue streams. The debt available will be a multiple of trailing twelve-month recurring revenue or annualized last quarter recurring revenue, generally at around 2 to 2.5x.

WHO ARE THEY FOR?

As M&A activity in the technology sector continues to draw increased market attention, ARR financing has gained popularity amongst private equity sponsors looking to part-debt finance high growth software or similar businesses. Typically, these businesses have not yet reached the stage at which they have achieved positive EBITDA (or if they have, the EBITDA is insufficient to support a leveraged based facility) but can demonstrate (as supported by third party diligence) predictable and identifiable recurring revenue streams from customer contracts or subscription-based services they provide.

HOW DO THEY WORK?

The key difference between an ARR financing and a traditional EBITDA-based deal is principally found in the structuring of the financial covenants. Rather than there being a customary debt:EBITDA leverage test, the leverage covenant ratio is calculated as debt:ARR, with ARR being calculated on a run-rate basis. After a certain prescribed period (typically two to three years, or an earlier time as the Borrower may often have discretion to select), the covenant will automatically switch (flip) to a more normal debt:EBITDA leverage test. In most cases, the debt:EBITDA leverage test will be calculated on a gross basis, providing lenders with a more complete view of financial performance.

The debt:ARR covenant is also commonly accompanied by a minimum liquidity covenant (being the sum of cash and available working capital facilities), which is tested monthly rather than quarterly. The key focus for finance providers is that the cash included in any liquidity test is actually available to the business or is able to be converted to cash on short notice.

KEY FEATURES OF ARR FINANCINGS IN THE UK AND EUROPEAN MARKETS

- **Recurring revenue:** The definition of recurring revenue will vary on a deal-by-deal basis but will generally include subscription, maintenance and support-based revenues. Term based revenues are (consistent with GAAP) generally excluded from recurring revenue but are occasionally included as partial or capped adjustments to recurring revenue. Headroom on the recurring revenue covenant will usually be between 15% and 30% above the sponsor's financial model.
- **Pricing and equity cheques:** Private equity sponsors and lenders who participate in this space recognise the increased credit risk associated with businesses generating minimal positive cash flows and therefore generally agree higher and fixed margin pricing pre-flip. Post-flip, the borrower is likely to benefit from reduced pricing or be subject to a more traditional margin ratchet. Private equity sponsors also generally accept that a higher equity contribution (usually 60% or more) will be required to fund acquisitions on day one.
- **PIK interest:** During the initial pre-flip period when positive cashflows are lower, borrowers will usually have the option to PIK (ie capitalise) interest with an accompanied premium. Post-flip, the ability to PIK interest will either fall away, be subject to a cap or a higher percentage premium.
- **Equity cures:** Equity cures vary on a deal-by-deal basis but the general principle is that pre-flip, equity cure amounts may be required to be applied in prepayment of the loan (with the percentage of prepayment subject to negotiation). The liquidity covenant will generally not be subject to any equity cure rights. Following the flip, equity cure amounts are unlikely to be required to be applied in prepayment, in line with market practice in the wider UK and European markets.
- **Prepayment fees:** Prepayment fees are likely to apply during extended non-call periods pre-flip, with these either falling away or attracting lower repayment premiums post-flip.
- **Baskets and covenants:** Baskets and other permissions (particularly around distributions) will generally be more restrictive pre-flip, to support the overarching objective that financing is provided to support growth at a time when the business is not generating material cashflows or EBITDA. Post-flip, baskets and other permissions would generally resemble the terms of

In Practice

Biog box

Matthew Ayre is a partner and head of leveraged finance and Jason Larkins is a senior associate in the Finance department at Travers Smith LLP. Email: matthew.ayre@traverssmith.com and jason.larkins@traverssmith.com

a traditional leverage deal, based on fixed thresholds and/or percentages of EBITDA.

- **Incremental facilities:** As with baskets and covenants, incremental facilities are generally made available subject to incurrence tests measured as pro forma debt:ARR pre-flip and debt:EBITDA post-flip.

EVOLVING MARKET TRENDS

The increased focus on ARR transactions by both private equity sponsors and finance providers has meant that ARR structures and terms have and will continue to rapidly evolve. Although the above

gives an indicative guide on what to expect on “traditional” ARR deals, we are seeing an increasing number of loans provided on a life-time recurring revenue basis or parties invoking other creative measures to partly debt finance the acquisition of high growth businesses during their optimisation phases. ■

Further reading

- The rise of the liquidity covenant in leveraged and corporate loan documentation: is cash “King” once again? – 2020 9 JIBFL 638.

The essential guides and codes you need at your fingertips

Insolvency Practitioners’ Handbook Tenth edition

The Insolvency Practitioners’ Association, in unison with LexisNexis, brings you the Tenth Edition of the Insolvency Practitioners’ Handbook.

The essential, one-volume work will be fully updated for 2022 with all the codes and guides that insolvency practitioners and students alike need to have at their fingertips.

It is also useful for solicitors in practice, in particular the Statements of Insolvency Practice (SIPs).

Published: **June 2022**
ISBN/ISSN: **9781474323345**
Price: **£29.99**
Call: **+44 (0)330 161 1234**
Email: **orders@lexisnexis.co.uk**

