# Annual Recurring Revenue Financings

DEBT FINANCE: MARKET TERMS AND TREND ANALYSIS

DLA PIPER

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# Introduction

The technology sector has undoubtedly proven one of the most resilient sectors of the last few years (in terms of the underlying strength of tech businesses; we acknowledge upfront the correction in Big Tech public equity valuations in 2022). DLA Piper has worked on financings for businesses that facilitate everything from international payments to data analysis, from remote access software to workforce management, from extended reality environments to expense management, to name but a few. The innovation economy really is thriving globally.

Many believe that the tech sector may continue to be relatively resilient, notwithstanding the undoubted and substantial macro headwinds. Indeed, further capital may turn to the technology sector as potentially a relatively safe place to invest in uncertain times, as has been the case historically.

The combination of resilience of sector, and the desire to invest in it, as well as ever intense competition for quality assets in M&A activity, both in terms of equity and credit, has provided fertile conditions for the development of annual recurring revenue (or ARR) financing in Europe (as is often the way, the product was originally established in the US).

It is perhaps also worth noting that, at the time of writing, the public equity markets are essentially closed for tech IPOs, leaving private equity as one of the relatively few exit opportunities for founder owned business (and of course PE will often fund (or recap) acquisitions with debt finance).

Conversely, debt financing provides an attractive solution to businesses looking to retain control/not-dilute equity, and extend runway between more dilutive funding rounds. Debt financing not only saves dilution, but it also does not "price" equity.

As an aside, the use of ARR financing certainly does not need to be limited to businesses in the tech sector, but the nature of many tech businesses (which often have recurring revenue) lends itself (forgive the pun) to the product. This note will focus on the use of ARR financing for tech businesses, which is our direct experience, but the principles can be extrapolated to other sectors.

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# The basics – what is recurring revenue?

It is not particularly revolutionary to observe that many tech businesses have minimal or negative profit in the early-to-mid stage of growth (and often later). The focus at this stage of development, post-revenue but pre-profit, is typically rapid growth, which generally requires substantial investment in items such as research and development (R&D) and customer acquisition – the expense of which often exceeds revenue. Indeed, many tech businesses do not *want* to be making profit at this stage; all revenue (and funding) is reinvested back into growth. Later, as a business scales-up and becomes established, the focus shifts from revenue growth to profitability, costs are reduced (or flatten), and (assuming decent margins) revenue is better able to off-set the costs of maintaining and continuing to develop the platform.

Recurring revenue is a feature of many businesses in the technology sector, most notably software-as-a-service (SaaS) and enterprise software businesses. In simple terms, recurring revenue means contracted and predictable revenues that, well, recur, and in particular excludes any one-off payments. Revenue from service contracts, license subscriptions and/or maintenance fees, often paid annually in advance, provides steady and financeable income.

The best suppliers of enterprise software are relied on by their customers to provide business-critical software and services that are central to day-to-day operations. Aside from recurring revenue, such businesses often have many attractive features to lenders; for example, valuable intellectual property, good customer retention, and high margins. Integration and embedding of these business-critical services into a customer's business can often lead to sticky customer relationships.

The following includes some of the key points to consider on an ARR financing deal.

Note that ARR loan documentation takes the same form as that used in the traditional leveraged financing market (ie. LMA based… to a greater or lesser extent!), albeit with a different financing metric at its centre.

**Definition of Annual Recurring Revenue**

While the definition of recurring revenue will vary on a case-by-case basis, the fundamental principle is to include only revenue that is truly recurring, and exclude all one-off transactional income, revenue of a non-recurring nature and, usually, any revenue that is merely repeating/repeatable. ARR is determined on a trailing 12-month basis as either actual recurring revenue during that period or annualised by reference to the most recently ended/reported quarter or month. ARR structured on the basis of an annualised shorter period is likely to be more sensitive to deterioration, and so lenders may have an earlier warning of a decline in performance, but this formulation will likely not be appropriate for a business where revenue is 'lumpy'; for example, a SaaS business that receives all subscriptions around the same time each year.

**Principal amount**

The multiple of ARR that a lender might be willing to offer in principal amount of debt varies and will depend on a number of factors, including age, growth stage, and most importantly quality, of the business, as well as the strength of(/existing relationship with) any private equity sponsor. At the lower end of ARR financing, the available debt multiple may be less than 1x but as a business grows, develops a longer track record, and moves closer to becoming ultimately profitable, debt multiples (and number of potential lenders) will increase for good businesses, potentially up to around 2x or even 2.5x (for the largest ARR deals and typically with strong sponsors).

**Maintenance financial covenants**

ARR financings will often provide for a two-stage approach for maintenance financial covenants.

- During the first phase, typically running from the closing date until the end of the third year (although we do see variance), maintenance financial covenants will generally include an ARR-based leverage covenant (ie. total debt: ARR) and often a liquidity covenant. It's not hard to work out why a lender would look to include a liquidity covenant for a business that is intended to be loss making (or at least pretty close). Given the purpose of ARR financing is to finance growth, the ARR leverage profile (in the first phase) will tend to decrease over time (if ARR leverage is not improving, then the business aint growing, and probably burning a lot of cash in the meantime).
- Then, on the agreed conversion date, the loan will 'flip' into a second phase, during which financial covenants would be a more traditional EBITDA-based leverage covenant (ie. total debt: EBITDA).

**Margin**

As a rule of thumb, ARR deals are typically priced a little higher during the ARR phase of the loan (ie. pre-flip) than regular post-profit senior financing. However, as noted, ARR financings clearly provide an attractive solution to sponsors looking to finance the acquisition of a reasonably early-stage tech business or to businesses looking to extend runway (cheaper than equity). We should note that deals will be priced over a reference rate so, as with all such financing structures, aggregate interest cost will be higher in the coming months.

**PIK toggle**

Borrowers may have an ability to convert cash margin into PIK and capitalise rather than pay in cash. If a borrower elects to PIK, the aggregate margin will typically be subject to a premium. Terms are very similar to post-profit leveraged financing.

## What else?

**Excess cash sweeps and amortisation**

mandatory prepayment from excess cashflow is not typically required during the ARR phase of a loan. We also see very little (if any) amortisation. The focus being on using cash to develop and scale-up the business.

**Incremental facilities**

The incurrence of additional pari passu ranking secured debt by way of incremental facilities is common in ARR deals, and is subject to many of the same conditions and parameters as on EBITDA-based financing.

**Security in respect of IP**

The intellectual property of many tech companies is very often highly valuable to its business and so lenders usually look to take security over such intangible assets to support financing. That said, the extent of the guarantees and security provided will vary from deal to deal – there is by no means a one-size-fits-all security package for any loan. The value, complexity and location of IP should be carefully considered when tailoring a package as IP can be a sensitive area of security.

As mentioned, ARR deals will typically 'flip' at a pre-agreed date from ARR-based maintenance and incurrence covenants into EBITDA-based covenants. Post-flip, a business may have access to greater flexibility not available during the ARR phase; for example, a margin ratchet or additional step downs in pricing, increased baskets and thresholds, the availability of basket adjustments (grower baskets and the like), enhanced equity cure rights or the removal of conditionality or block to certain transactions (eg. dividends). On some deals a borrower may have an option for an early flip into the EBITDA-based phase (subject in particular to an EBITDA-leverage condition), if it is looking for the post-flip flexibility.

Certain businesses and structures may be better suited to an ARR-for-life structure if a business/sponsor has a compelling commercial case to heavily invest in growth for the full term of the financing. Other structures we have seen include an extendable term based on achieving performance or investment milestones.

Post flip, we essentially enter the regular EBITDA-based leveraged finance world.

EBITDA adjustments continue to be keenly negotiated, along similar lines to non-ARR deals. However, a particular area of focus for lending to the tech sector (ARR or otherwise) is in respect of R&D costs. Tech businesses often capitalise R&D, which can result in a significant amount of cost not being expensed (and therefore not hitting operating profit/EBITDA). To avoid what would otherwise be an artificial inflation of EBITDA, and the impact this could have on any leverage-based covenant, capitalised R&D costs are typically deducted from operating profit when determining EBITDA, or at least a certain percentage is deducted.

On some ARR deals we have seen covenant reset provisions included, albeit only post-flip, in particular where there is a buy and build strategy (again, considerations are essentially the same as on a regular levfin deal).

Equity cure provisions are generally available, although pre-flip there tends to be no ARR cure (rather the cure amount is applied in deemed reduction of debt). Post-flip, EBITDA cures can be available, subject to otherwise customary conditions (one time only, no overcure etc.).

# The opportunities

The acceleration of ARR financing in Europe over the last year or two demonstrates the responsiveness of the lending market to provide a powerful solution to fast-growing albeit sometimes immature businesses, whilst they focus on rapid expansion, top line growth and customer acquisition. As competitive tensions continue between lenders, we expect this offering to gain further traction and for terms to evolve quickly as more lenders become cognisant of the opportunity to deploy capital in this space.

To date, whilst it has been much spoken about, there have been relatively few lenders actually, and regularly, active in ARR financing. Silicon Valley Bank being one of the most prolific. Although we're starting to see a lot more (genuine) interest from a more diverse group of lending institutions. Whilst the market conditions over the past couple of years have offered plenty of post-profit opportunities, many mainstream private credit lenders have, understandably, chosen to focus on those (and have deployed huge amounts of capital doing so). As more lenders get a better understanding of ARR financing, perhaps some non-tech-focussed lenders will look to deploy capital into this market (although potentially from special opportunity funds).

There is also a clear opportunity here for sponsors and borrowers. Revenue-based financings have been well received by the UK and European technology sector, and if appetite continues its upwards trajectory, tech businesses of all sizes may find they have access to a much greater pool of capital. Although, given the choice, lenders would prefer to lend to specialist tech investors, and private equity-backed businesses more generally, which have the experience and expertise to guide these businesses through a loss-making growth phase, and have the nous to be able to reduce costs effectively at an appropriate time.

# Our experience

DLA Piper has now worked on many ARR financing deals and so we have unrivalled expertise in this relatively new (to Europe) product. We are true specialists in financing technology businesses. We expertly guide our clients through the unique aspects of these deals.

As well as our specialist team in the UK,
we have 600 lawyers globally who act for lenders, entrepreneurs, tech businesses, venture and growth funds and financial institutions funding this dynamic space.

We are able to work seamlessly across jurisdictions, including the USA, United Kingdom, Ireland and all across Europe. DLA Piper is the only law firm with an office in each of the countries in the Nordics, which has a really vibrant and developing tech market. Complex cross border financing is just what we do.

In addition, in every year over the last decade, DLA Piper has advised on more M&A deals than any law firm globally, across Europe and in the UK.

**#1 Most active: Europe Private Equity**
(PITCHBOOK, 2018-2021)

**#1 Global M&A deal volume for the last twelve years**
(MERGERMARKET, 2010-2021)

**Law Firm of the Year: Transactions**
(UNQUOTE PRIVATE EQUITY AWARDS 2018 AND 2021)

# Key contacts

If you would like to discuss the insights in this report, or explore how DLA Piper can help you to navigate the debt finance space, please reach out to any of our team.

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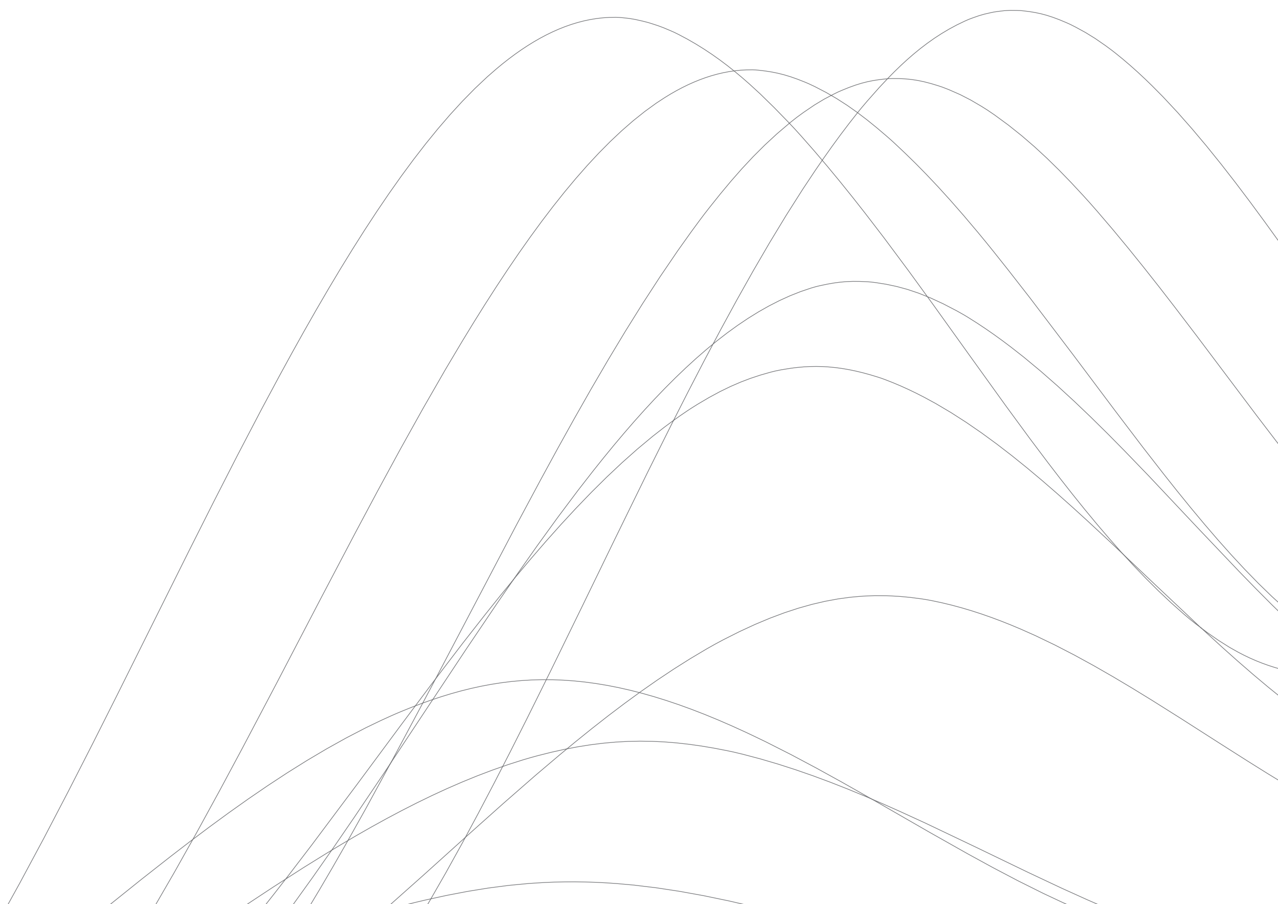

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