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Recurring Revenue Loans: Key Considerations for Market Participants

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This Article discusses key considerations for market participants in annualized recurring revenue loan transactions (ARR Loans), also known as recurring revenue loans. It covers key definitions and terms in ARR Loans, including those relating to annualized value of revenues, revenue recognition, and financial maintenance covenants.

Annualized recurring revenue loan transactions (ARR Loans), also known as recurring revenue loans, have developed in the last two decades to allow lenders to facilitate the financing of growth-stage companies with low or negative EBITDA. The borrowers of ARR Loans are typically companies that generate significant revenue and positive cash flow, but they choose to reinvest their cash flow in sales, marketing and other customer acquisition activities in order to continue growing.

For businesses with **sticky** customer relationships, whether through ongoing contracts or low customer churn, revenue can provide a performance metric that acts as a viable alternative to EBITDA. ARR Loans rely on the premise that the borrower will be able to transition from a focus on growth to generating profits within a specified time horizon. ARR Loans are most prominent in the technology space, but as market participants become increasingly familiar with the product, it is likely to expand to other sectors with subscription businesses and similar growth and customer acquisition models.

In this Article, we focus on:

- The contours of the **recurring revenue** definition.
- How the definition is used in ARR Loan documentation.
- Some related considerations for market participants.
- The unique features of ARR Loan transactions and how they differ from more traditional EBITDA-based financing transactions.

For each of these topics, we highlight recent developments, areas of negotiation and key considerations for market participants. However, we do not purport to cover all permutations of the terms of ARR Loans. Highly negotiated agreements that are entered into by sophisticated counterparties inevitably feature a wide variety of negotiated terms, reflecting unique considerations for any specific transaction (for example, amount of recurring revenue, track record of sponsor or management team or both, market dynamics, size of lender group and concentration of loans and commitments among the group, and so on).

To provide reference materials to practitioners that may be encountering ARR Loans for the first time, certain publicly filed ARR Loan credit agreements are referenced below.

The Bifurcated ARR Loan Market

Lower Value Transactions

One end of the market is composed of transactions in the $10 million to $100 million range. These ARR Loans generally contain relatively conservative terms and covenant baskets, as well as financial maintenance covenants that vary widely from transaction to transaction. Often, these ARR Loans are made by a single lender and are not heavily negotiated. Some publicly filed examples include:

- Amended and Restated Loan and Security Agreement, dated as of October 6, 2017, by and between Health Catalyst, Inc. as borrower and Silicon Valley Bank as lender (the Health Catalyst Credit Agreement).
- Amended and Restated Loan and Security Agreement, dated as of February 14, 2020, by and between Procore Technologies, Inc. as borrower and Silicon Valley Bank as lender (the Procore Technologies Credit Agreement); and

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- Loan and Security Agreement, dated as of January 7, 2021, by and between Zerofox, Inc. as borrower, the guarantors party to the agreement and Stifel Bank as lender (the Zerofox Credit Agreement).

Higher Value Transactions

At the other end of the market are much larger ARR Loans, which are often sponsor-driven, with sizes ranging from $100 million to more than $1 billion (with a few closed or underwritten transactions in the $3 billion to $5 billion range). These ARR Loans are more heavily negotiated and contain more borrower-friendly terms. They increasingly resemble the more traditional EBITDA-based sponsor transactions and use loan documentation that is more typical of these EBITDA-based leveraged loan transactions. The movement towards more borrower-friendly terms is driven by several factors, including the significant equity cushion (frequently in excess of 65%) and conservative loan-to-value.

Because sponsor-backed borrowers are typically private companies, few (if any) publicly filed examples of these ARR Loans are available.

For an example of a non-sponsor-backed ARR Loan credit agreement that nonetheless contains some (but not all) of the same features as sponsor-driven transactions, see Credit Agreement, dated as of April 8, 2021, by and among Par Technology Corporation as borrower, the guarantors party to the agreement, the lenders party to the agreement, Owl Rock Capital Advisors LLC as lead arranger and bookrunner and Owl Rock First Lien Master Fund, L.P. as administrative agent (the Par Technology Credit Agreement).

Recurring Revenue

Measures and Uses

Rather than using EBITDA as a core financial metric, ARR Loans use the concept of **recurring revenue**, usually on an annualized basis. The recurring revenue definition generally includes revenues in respect of maintenance, support or licenses (for instance, of a borrower's proprietary software) that are expected to be ongoing, pursuant to a contract or a subscription. The amounts are typically measured by reference to revenues actually received or payable to the borrower pursuant to binding contracts over a prior test period and annualized (that is, multiplied by four if the test period is the prior quarter or multiplied by 12 if the test period is the prior month).

However, the market is still developing and the scope of the applicable revenues included and the measurement methods vary. What constitutes recurring revenue is likely to continue to evolve and may be the subject of transaction-specific negotiations, as discussed further in Negotiated Points.

For an example of a definition that calculates the recurring revenue on an annualized basis by multiplying the prior quarter's figure by four, see the definition of Annual Recurring Revenue in the Procore Technologies Credit Agreement.

For examples of definitions that calculate recurring revenues on an annualized basis by multiplying the prior month's figure by 12, see the definition of Annual Recurring Revenue in the Par Technology Credit Agreement and the definition of Recurring Revenue Leverage Ratio in the Credit Agreement, dated as of October 16, 2020, by and among Alkami Technology, Inc. as borrower, the lenders party to the agreement and Silicon Valley Bank as administrative agent (the Alkami Technology Credit Agreement).

Recurring revenue is used as an input for a recurring revenue leverage metric, which is the ratio of the relevant type of debt to recurring revenue (similar to leverage metrics in EBITDA-based transactions). In certain larger sponsor-backed ARR Loans, recurring revenue leverage is used similarly to EBITDA-based leverage under traditional credit agreements (ratio-based debt incurrence baskets, financial maintenance covenants, and so on), although with lower multiples. For example, see Par Technology Credit Agreement (the Annual Recurring Revenue figure is used to determine the financial maintenance covenant, various ratio-based negative covenant incurrence baskets (that is, baskets equal to a maximum specified level of a borrower's debt as measured against its Annual Recurring Revenue) as well as negative covenant **grower** baskets (that is, baskets equal to the greater of a dollar amount and a percentage of Annual Recurring Revenue)).

For smaller ARR Loans, recurring revenue leverage may be used exclusively for the financial maintenance covenant, because negative covenant baskets and other thresholds at the smaller end of the spectrum are often set based on fixed-dollar amounts (without ratio or grower prongs). For example, see:

- Loan and Security Agreement, dated as of April 7, 2020, by and between AvePoint, Inc. as borrower, the guarantors party to the agreement and HSBC Ventures USA Inc. as lender (the AvePoint Credit Agreement) (the only recurring revenue-based financial maintenance covenant is a measurement of the amount of Annual Recurring Revenue).

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- The Zerofox Credit Agreement, (Annual Recurring Revenue is used solely to calculate two financial maintenance covenants: minimum Annual Recurring Revenue and maximum leverage).

Negotiated Points

The variation among recurring revenue definitions typically occurs along three different axes:

- The scope of the revenues included.
- Annualization.
- Limitations around accounting recognition.

Interestingly, variation is more likely during the negotiation and drafting of the calculation methods than from the actual breadth of the revenues considered.

In more lender-favorable ARR Loans, the recurring revenue definition is limited to contracted maintenance or subscription revenues related to the software licensed or sold by the borrower, with explicit exclusions for one or more of:

- One-time revenues (for example, set-up fees), see Health Catalyst Credit Agreement.
- Deductions for customer discounts, see Alkami Technology Credit Agreement.
- Revenues tied to contracts that have been cancelled, see Procore Technologies Credit Agreement.
- Revenues tied to contracts with customers that have failed to pay for a certain period of time (for example, last 90 days) or have become insolvent, see AvePoint Credit Agreement.

In some ARR Loans, borrowers have successfully eliminated the **contracted** requirement or included revenues related to intellectual property other than software or from ancillary services like hosting or transaction fees (or both) (see Par Technology Credit Agreement (no reference to contracted and includes revenues derived from merchant transaction fees)). In addition, some ARR Loans do not include explicit deductions for customer discounts (see, for example, Health Catalyst Credit Agreement and Procore Technologies Credit Agreement).

Considerations for Market Participants

Defining Revenue

From a lender's perspective, the types of revenue included as recurring revenue should align with the **sticky** revenue sources the lenders are using to underwrite and evaluate the credit. Similarly, characteristics, such as whether the revenue should be subject to a contract versus a subscription or the degree to which rebates are deducted, should be based on the borrower's business model. Lenders may want to avoid using a precedent document to determine the appropriate definition if the borrower under the proposed precedent document does not have a similar business model or revenue recognition practices as the current borrower.

Annualized Value

While earlier ARR Loans consistently based the **annualized** concept on revenues actually realized in the prior fiscal quarter, some recent ARR Loans have featured some borrower-friendly modifications to this construct. Some ARR Loans have used a last-month annualized metric, allowing the borrower faster credit for revenue growth, or added an explicit pro forma effect for acquisitions, providing immediate credit for acquired revenue. For example, see:

- Par Technology Credit Agreement (giving pro forma effect for acquisitions in the definition of Pro Forma Basis and using a last-month annualized method to calculate portions of the Annual Recurring Revenue).
- Alkami Technology Credit Agreement (giving pro forma effect for acquisitions in the definition of Recurring Revenue).

When negotiating the method of annualization, market participants are deciding how quickly to give borrowers credit for revenue growth, factoring in seasonality and whether credit will be tied to **real** historical payments from customers or prospective expectations about future revenues.

Revenue Recognition

Early ARR Loans generally required revenue recognition to be consistent with pre-closing historical financial statements. That approach allowed lenders to rely on historical financials when evaluating the borrower with the understanding that going-forward, revenue growth would be recognized on a consistent basis with historical financials.

However, that limitation has mostly fallen away. Recent sponsor-driven ARR Loans typically address the issue by including either explicit rules (that is, term license revenue will be recognized ratably over the life of the license) or otherwise require consistency between revenue recognition and the sponsor model. Both approaches

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grant the sponsor some flexibility to modify the borrower's accounting treatment going forward and also provide some predictability for lenders.

Churn Rate, Retention Rate, and Effects on Borrowing Base

A segment of the ARR Loan market limits the amount a borrower may draw under its revolver by requiring sufficient borrowing base capacity as a condition to drawing (sometimes referred to as an availability amount). The availability amount expands (and contracts) relative to the growth (or contraction) of a borrower's revenues. Key to the borrowing base calculation are **churn rate** (which reflects the rate of recurring revenue loss) and **retention rate** (which reflects the rate of recurring revenue retention). The churn rate or retention rate percentage is used in the calculation of the borrower's borrowing base, thereby increasing or decreasing the available commitments under the revolver that may be drawn by the borrower. For example, see Procore Technologies Credit Agreement and Alkami Technology Credit Agreement.

ARR Loans with borrowing base concepts (as well as some middle-market transactions that do not include a borrowing base concept) require borrowers to report their churn rate and retention rate on at least a quarterly basis.

Unique Features of ARR Loans

Conversion Date

The **conversion date** concept is a mechanic under which the terms of an ARR Loan facility transition (or flip) from recurring revenue measurements to traditional EBITDA-based measurements. The feature is intended to require the borrower to eventually shift its focus from growth to profitability. However, conversion also gives the borrower access to certain more favorable terms, including lower pricing and the application of traditional leverage-based baskets and financial maintenance covenants.

A variety of structures are market-tailored to a borrower's path to profitability and the amount of **leash** lenders are willing to provide before requiring conversion. The most common approach in the larger sponsor-driven transactions is for conversion to occur on the earlier of:

- The borrower's election (often permitted only after a specified waiting period - usually one year after closing), subject to an EBITDA-based leverage test.
- A date certain (often two to four years after closing).

However, some ARR Loans permit, but do not require, the borrower to convert. Additionally, at the smaller end of the market, certain ARR Loans referred to as **ARR for life** transactions do not include any conversion date concept or EBITDA-based metrics (see, for example, Alkami Technology Credit Agreement, Procore Technologies Credit Agreement and Zerofox Credit Agreement). This is a key term that is determined based on a variety of factors, including tenor of the ARR Loan.

In terms of voluntary conversion features, lenders generally set the leverage test at a level where they would have financed the post-conversion transaction. This aligns voluntary conversion with the post-conversion pricing step-down. Thought should also be given to the interplay with the post-conversion maximum leverage financial covenant.

Negative Cash Flow: PIK Interest, Amortization, and ECF Sweep

Because borrowers may be generating negative cash flow (after customer acquisition/growth expenses), ARR Loans typically minimize the cash to lenders pre-conversion. Many ARR Loans allow for at least a portion of the interest to be paid-in-kind (PIK), often at a higher rate than cash-pay. In some cases, this PIK mechanic is facilitated through a limited use of proceeds delayed draw term loan (DDTL) feature, which allows borrowers to draw down a DDTL facility and apply its proceeds to interest payment only.

Most sponsor-driven ARR Loans do not require quarterly amortization or sweep excess cash flow (ECF) pre-conversion. The ECF sweeps typically commence post-conversion (and often include leverage-based step-downs), with retained ECF building an **Available Amount** basket that can be used to make investments, restricted payments and restricted debt payments subject to negotiated terms and conditions.

Prepayment Premium and Most Favored Nation Pricing

Like unitranche products generally, ARR Loans feature meaningful prepayment premiums and most favored nation (MFN) pricing with a tight spread and limited or no exceptions. The MFN often applies to any pari passu debt (see Par Technology Credit Agreement (providing prepayment premiums in the first three years of the loan facility and a 0.50% MFN protection for incremental facilities with limited exceptions)).

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Covenant Basket Sizing

Covenant basket sizing and structure is one of the more prominent points of difference between the smaller ARR Loans and the larger sponsor-driven ARR Loans. The smaller, more conservative ARR Loans often include basket structures featuring only limited dollar prongs (as mentioned above, the recurring revenue concept is often applied only to the financial maintenance covenant and not as a grower for covenant baskets).

The larger sponsor-style ARR Loans often feature covenant basket structures that are similar to those in traditional EBITDA-based transactions. More recent ARR Loans have demonstrated a general trend toward terms that are common in EBITDA-based transactions of comparable size. Covenant baskets (other than ratio baskets) may be structured as fixed-dollar only pre-conversion, with a traditional EBITDA grower prong unlocked post-conversion (and sometimes a higher-dollar prong as well). Pre-conversion debt incurrence baskets are typically based on a recurring revenue leverage metric that flips to EBITDA-based leverage post-conversion. Other ratio-based baskets may be unlocked only post-conversion. In some recent ARR Loans, however, certain EBITDA growers and EBITDA-based leverage baskets are available pre-conversion. However, this change may not result in a practical difference because a low or no-EBITDA borrower would not be able to access these baskets even if they were theoretically available, while a borrower generating significant EBITDA would generally be incentivized to convert as early as possible to take advantage of the lower post-conversion pricing.

Financial Maintenance Covenants

For larger sponsor-style ARR Loans, pre-conversion financial maintenance covenants typically include a recurring revenue-based leverage covenant and a minimum cash liquidity covenant. Often one or both covenants include equity cure features, which can take a variety of forms. While there is no clear market convention on equity cures, market participants should consider what is appropriate for a specific transaction, how an equity cure should function as between the two covenants and whether pre-conversion equity cures of recurring revenue should be permitted or required to pay down debt or both.

For example, the Par Technology Credit Agreement (which is not a sponsor-driven transaction) only allows equity cures with respect to the recurring revenue-based leverage covenant and not the liquidity covenant. In addition, the proceeds of any equity cure under that credit agreement must be applied as a prepayment to outstanding loans.

Post-conversion, sponsor-style ARR Loans usually flip to traditional EBITDA-based maximum leverage maintenance covenants. A few transactions in early 2022 did feature covenant lite structures (that is, either the financial maintenance covenant is not tested at all or it is not tested unless a certain portion of proceeds have been drawn) post-conversion, consistent with typical (that is, EBITDA-based) sponsor transactions. To the extent an ARR Loan contains a covenant lite structure, lenders should be particularly aware that a borrower's post-conversion EBITDA-based leverage may be higher than anticipated, and if the borrower does not draw the revolver past the trigger level, the covenant will not be tested, leaving lenders with no ability to respond.

For ARR Loans on the smaller end of the spectrum, financial maintenance covenants are often more bespoke, including specific recurring revenue targets (rather than leverage), as well as other metrics including the **quick ratio** (a ratio of the borrower's unrestricted cash and cash equivalents to its current liabilities, which is meant to measure the borrower's ability to pay its current liabilities without needing to sell its illiquid assets or raise additional financing) and **liquidity ratio** (see, for example, Alkami Technology Credit Agreement, Procore Technologies Credit Agreement and Zerofox Credit Agreement). To the extent an ARR Loan is **ARR for life**, it would not transition to an EBITDA-based covenant.

Continued Development

The market has accepted recurring revenue structures as a means to finance growth-stage businesses as evidenced by the increasing frequency and size of ARR Loans, particularly in the sponsor-driven space. However, many of the key terms remain in flux as the market refines the scope and calculation method for the recurring revenue definition, conversion date mechanics and basket structures. As market participants look for new opportunities, including outside the software space, the provisions discussed in this Article will likely continue to develop.

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