

An acquisition target in the technology space may still be in the early stages of development and have significant growth expenditures that result in low or negative EBITDA. As M&A activity in the technology space continues to grow, an increasing number of private equity sponsors are utilizing recurring revenue financings to partly finance these types of acquisitions.

The terms of recurring revenue financings generally converge on the same central thesis—an acknowledgment from the lenders that a borrower in this type of financing is likely generating a de minimis amount of positive cash flow while in growth mode, in exchange for an acknowledgment by the borrower and its related private equity sponsor that these types of financings create more credit risk than a traditional cash flow financing. In furtherance of that central thesis, in a recurring revenue financing, for a period of time after the closing date, a borrower will be subject to financial covenants based on recurring revenue and liquidity, and less stringent debt service requirements, in exchange for higher pricing. After one to three years, a borrower will be expected to have achieved positive EBITDA. At that time, the terms of the financing will “flip” into more customary terms, including a total debt-to-EBITDA leverage covenant and a pricing stepdown.

Described below are certain key provisions of a recurring revenue financing, particularly in the acquisition financing context.

FINANCING SOURCES Direct lenders that provide unitranche facilities are the primary financing sources for recurring revenue deals. After a covenant “flip,” the terms of the financing will be similar to cash flow financing with a unitranche structure.

QUANTUM Recurring revenue financings require a larger equity contribution from a private equity sponsor than a traditional cash flow financing. The minimum equity contribution in a recurring revenue financing will likely range upwards of 60% of the total pro forma capitalization of the borrower.

The amount of funded debt at closing will be a multiple of trailing 12-month recurring revenue or annualized last quarter recurring revenue, generally ranging around 2.25x.

DEBT SERVICE Cash debt service during the initial term of a recurring revenue financing is limited. In particular, initially:

- **INTEREST** The borrower may have the ability to pay some or all of its interest obligations in PIK, rather than in cash. To the extent that the borrower elects to pay interest in PIK, the interest rate on the PIK portion will typically be higher than if the borrower elects to pay interest in cash.
- **AMORTIZATION** Required amortization will be less than in a traditional cash flow financing, and in some cases may not be required at all.
- **EXCESS CASH FLOW** Excess cash flow payments may not be required.

The flexibility described above typically falls away one to three years after the closing date.

FINANCIAL COVENANTS During the initial term of a recurring revenue financing, in lieu of a traditional total debt-to-EBITDA leverage covenant, recurring revenue financings will provide for the following financial covenants:

- **RECURRING REVENUE LEVERAGE RATIO** The total debt-to-EBITDA leverage covenant will be replaced with a covenant of total debt to recurring revenue. For the purposes of this covenant, recurring revenue may be calculated over a four-quarter period, or may be determined by annualizing the most recent quarter of recurring revenue.

The definition of recurring revenue will include subscription, maintenance and support revenues. In addition, there may be other adjustments, such as the ability to include a portion of term license revenue.

The recurring revenue leverage ratio will be tested as of the last day of the applicable fiscal quarter. When setting covenant levels, the prescribed cushion over a private equity sponsor’s financial model is generally in the range of 15% to 25%.

■ **LIQUIDITY** In addition to the recurring revenue leverage ratio, during the initial term of a recurring revenue financing, there will likely be a liquidity covenant. The liquidity covenant may be a maintenance test that is applicable at all times, or may be tested by averaging liquidity on certain dates, or tested as of the last day of a specific period.

The covenants described above typically fall away one to three years after the closing date, and are replaced with a total debt-to-EBITDA leverage covenant. The covenant “flip” will occur on a mandatory basis within one to three years after the closing date. However, a borrower may have the option to choose to convert the covenants on an earlier date, subject to compliance with a total debt-to-EBITDA leverage test that approximates opening leverage in a unitranche cash flow deal.

EQUITY CURE The recurring revenue leverage covenant may provide for an equity cure, subject to limitations that are similar to the limitations applicable to equity cures for a total debt-to-EBITDA leverage covenant. However, the proceeds of an equity cure will generally be required to be applied to pay down term loans, and rather than constituting a pro forma increase to recurring revenue, will be treated as a pro forma decrease to total debt.

The liquidity covenant will generally not be subject to any equity cure rights.

After a covenant “flip,” the total debt-to-EBITDA leverage covenant will provide for an equity cure on customary terms.

INCREMENTAL FACILITIES Incremental facilities remain available, subject to a pro forma compliance with a recurring revenue leverage ratio set at the closing date recurring revenue leverage ratio. After a covenant “flip,” the incurrence test applicable to incremental facilities will be based on a total debt-to-EBITDA leverage test that is generally set at the same level as required to trigger an early conversion of the financial covenants.

In addition, a “starter” basket for incremental facilities may be included, which may be smaller prior to the occurrence of the covenant “flip” and increase in size after the occurrence of the covenant “flip.”

NEGATIVE COVENANTS GENERALLY Prior to the covenant “flip,” lenders may negotiate for certain baskets to be unavailable or to be smaller in size. In addition, the use of certain baskets may be subject to additional conditions, such as pro forma liquidity tests or additional event of default “blockers,” that fall away after a covenant “flip.”

For more information regarding recurring revenue financings, please contact a member of Ropes & Gray's finance team.

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