King & Spalding

Private Credit & Special Situations

WHAT IS IT?

ARR Loan Facilities – Recent Developments

Summary

Recurring revenue financings (or “ARR loan facilities”), a type of loan facility based on a multiple of the borrower’s annual recurring revenue (“ARR”) rather than a multiple of EBITDA, have grown in popularity in recent years. They provide borrowers with the ability to preserve cash in the near term by significantly reducing debt servicing requirements (e.g., little to no required amortization, ability to PIK some or all interest payments) in exchange for higher pricing, often meaningfully limited negative covenant flexibility, minimum liquidity covenants, financial maintenance covenants and larger equity contributions from sponsors (which have historically ranged upwards of 50% of total capitalization). These terms typically remain in place until the “flip date”, at which point they switch to more closely resemble a traditional cash flow financing.

In light of broader market conditions, sponsors have successfully pushed for more favorable terms in the last few years. Among other things, these developments have included (i) enhancing the ability of borrowers to incur new debt under the ARR construct (i.e. through the use of ratio baskets), (ii) including grower baskets based on a percentage of ARR, (iii) drastically increasing opening ARR ratios (which have historically been in 2.0x – 3.5x range), (iv) reducing or eliminating liquidity and ARR maintenance covenants, (v) reducing sponsor equity cushions and, in some cases, even (vi) either eliminating the concept of a “flip” entirely, such that ARR terms are employed for the life of the facility, or building in a “toggle” option that allows the borrower or sponsor to choose whether to continue utilizing ARR terms or switch to cash flow financing terms. Note that this piece supplements the **ARR Loan Facilities** piece that we published in March 2022.

ARR Loan Facilities – Recent Developments (cont'd)

Current Trends

However, these trends have begun to shift over the last year in the wake of rising interest rates and increasing economic volatility. ARR loan facilities inherently involve risker borrowers that have low or negative EBITDA. There is concern that such borrowers' operating cash flow, in many cases, may not be able to support significantly higher interest expense, resulting in a higher rate of defaults and workouts. Some borrowers are more exposed to this risk than others; those with lower leverage and stronger fundamental business models, for example, are more likely to receive additional support from their sponsors. Nevertheless, lenders are negotiating stricter terms for ARR loan facilities. ARR ratios, which at their peak reached 2.5-3.0x and, in some cases, even above 3.0x, are being pushed back down.

Facilities that utilize ARR terms for the life of the loan are becoming less common, a trend that is likely to continue in the near future. Moreover, lenders' willingness to provide ARR loan facilities in the first instance is decreasing, as well, given the risk profile of the borrowers involved. While demand has not disappeared entirely and private credit funds are still engaging in this space, they are doing so more selectively and less frequently. Notably, Silicon Valley Bank ("SVB") was a significant provider of ARR loan facilities prior to its collapse in March. While the treatment of the ARR loans held by SVB remains unclear in the short term, its collapse means that there is one less important provider of such facilities in the market. This event reinforces the broader trend of decreasing demand for these products by private credit funds. We will likely continue to see ARR terms tighten and demand for these facilities continue to cool so long as current economic conditions persist.

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