Spotlight on Recurring Revenue Financings

Key Characteristics

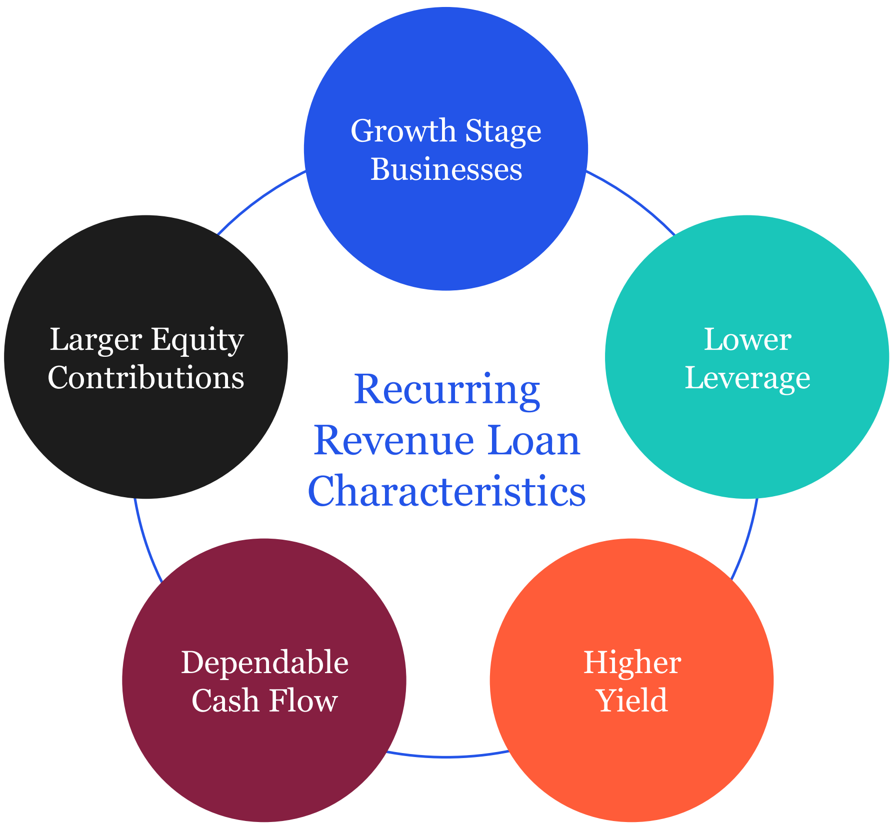
Recurring revenue loans are underwritten on the basis of a borrower's "recurring" or "subscription" revenue – lenders have historically relied on the fact that the cloud's subscription-based contract model creates revenue that is billed annually under contracts that are unlikely to be terminated / replaced by subscribers given transition costs (model is "sticky")

Typical Borrower Profile	▶ Commonly used in "growth" stage businesses where traditional EBITDA and ABL credit metrics will not provide sufficient leverage ▶ Companies obtaining Recurring Revenue loans have enterprise value as low as \$100M and as high as \$3B ▶ Even EBITDA negative companies can qualify
Advantages to Borrowers	▶ Allows a company to obtain debt financing often 2–3 years before traditional EBITDA metrics would permit ▶ Important source of capital for companies with high operating expense supporting fast growth strategies
Industry Sectors	▶ Most typically seen in software and technology deals, although theoretically applicable in other subscription model businesses
Loan Size	▶ Typically banks will lend principal equal to 1.25x–2.5x recurring revenue ▶ Tend to be smaller than unitranche and syndicated deals on average ▶ Average deal size is around \$100M, though some recurring revenue loans are as large as \$1B
Enterprise Value	▶ For their credit analysis, banks rely on dependable cash flow together with enterprise valuations that can range from 6x–10x recurring revenue in software deals
Lender Perspective	▶ While borrowers are often times not yet cash flow positive, lenders (and sponsors) often see a revenue stream strong enough to enable borrowers to increase profit to cover the debt service by cutting costs (in the event growth goals are not achieved) ▶ Lenders also likely take comfort in the significant equity cushions (50%–80%, rather than 30%–40% for a traditional leveraged loan) and track records of the sponsors doing recurring revenue loans – the value of the business will exceed the debt outstanding even in a down side case

Evolution of Recurring Revenue Facilities

Over past decade, recurring revenue loans have risen in popularity across the sponsor LBO space, as increasing numbers of sponsors look to expand their interest in earlier stage companies

- Started in smaller deals over past two decades
- Increased with growth of SaaS business model strategies
  - Increasingly common for businesses in the following sectors: software; application software; healthcare IT; data analytics ("big data"); eCommerce; security; mobile; digital media; gaming and other tech enabled sectors
- Over past decade it has grown in the sponsor LBO space, particularly as larger sponsors continued to expand their interest in earlier stage companies
  - Since March 2020, seeing new, larger sponsors utilize these facilities for technology and tech-enabled investments in a post-COVID environment
  - Almost every direct lender in the tech space now underwrites recurring revenue loans and increasing numbers of tech deals are based on recurring revenue
- In a trend seen throughout the direct lending market this summer, we are also seeing larger recurring revenue loans, with Thoma Bravo's $6.4 billion buyout of enterprise software provider Medallia financed with a $1.8 billion recurring revenue loan, the largest recurring revenue loan according to DLD since it began tracking this data



Select Terms Comparison: Traditional Leverage vs. Recurring Revenue Loans (1/2)

Recurring revenue loans are different than traditional term B loan financings in that they require larger equity contributions, higher pricing, stronger call protection and a financial covenant tied to recurring revenue (sometimes with a future “flip” to a traditional leverage covenant)

	LEVERAGED FACILITY	RECURRING REVENUE FACILITY
Maturity	▶ Term Loan: 6–7 Years ▶ Revolver: 5 Years	▶ Term Loan: 5–6 Years (typically matches Revolver) ▶ Revolver: 5–6 Years (typically matches Term Loan)
Amortization	▶ Term Loan: 1.00% per annum	▶ Term Loan: Generally none (occasionally in smaller transactions)
Equity / Contribution	▶ 30%–50%	▶ 50%–80%
Pricing	▶ Customary and varies by market conditions and borrower rating	▶ Often significantly above customary term loan B margins (though in deals with a covenant flip you can see pricing step downs ranging from 50–200 bps)
Pik Option	▶ Not typically	▶ Historically, sometimes small portion of interest (e.g. 1.00%) payable in kind during first year or two (to conserve cash for growth and operations) ▶ More recently, 100% of margin can be PIKed, or 100% / 50% can be PIKed depending on margin step-up ▶ In some deals, PIK permitted for as long as 3–4 years (particularly where the covenant flip doesn’t happen for that long or longer)
Underwriting Fee	▶ ~2.25% on TL and RCF ▶ 50–100bps OID on TL (depending on syndication)	▶ Generally around 2.00% (with some sponsors getting 1.75%)
Call Protection	▶ 101 soft call for 6–12 months	▶ 102 / 101 (with some sponsors getting 101), 102 / 101.5 / 0.75 or sometimes 103 / 102 / 101 (in each case, with greater use of hard call)

Select Terms Comparison: Traditional Leverage vs. Recurring Revenue Loans (2/2)

	LEVERAGED FACILITY	RECURRING REVENUE FACILITY
Excess Cash Flow Sweep	▶ Included	▶ None in small deals ▶ Typically included in larger deals, commencing with the first full FY ending after the covenant flip
Financial Covenant	▶ Springing* Leverage Ratio ▶ Fixed Charge Coverage Ratio*	▶ Debt to Recurring Revenue, with cushion over a sponsors model generally raging 15–25% ▶ Minimum recurring revenue (more typical in smaller deals) ▶ Minimum Liquidity (in larger deals, often set at < 25–33% of Revolving Commitments)
Covenant Flip	▶ N/A	▶ Flip to leverage covenant after 2–3 years, depending on Sponsor model ▶ Generally required, though sometimes at Borrower's option and sometimes no covenant flip
Cash Netting	▶ Leverage typically net of cash, sometimes control agreements or cap	▶ Cash netting possible for larger deals
Equity Cure	▶ Permitted	▶ Recent development to include for recurring revenue covenant, including for application to debt-paydowns
Baskets	▶ Customary	▶ In smaller deals, similar to direct lending leverage deals and often more flexible following covenant flip ▶ In larger deals, baskets are typically a bit smaller across the board than a traditional leverage loan but may include EBITDA growers throughout ▶ But growers based on a % of LQA or LTM Recurring Revenue are more common in deals that never flip to EBITDA, or in which the flip is at the borrower's option

* Covenant packages vary based on deal type and market size

Post-COVID Recurring Revenue Financings

In the post-COVID period, we have seen both an increasing number of sponsors use recurring revenue financing structures as well as a broader base of lenders now playing in this space. Still, despite increased volume, the non-syndicated nature of most recurring revenue loans, and the material variation between different lenders' recurring revenue products, make market data on recurring revenue loans scarce

RECENT RECURRING REVENUE DEALS — PUBLIC REPORTING

Sponsor	Date	Borrower	Arrangers	Size ($M)
Advent International Global Private Equity	Feb 2020	Forescout	Owl Rock Capital Partners	$440
Vista Equity Partners	Mar 2020	LogicMonitor	Antares Capital	Add-on
Blackstone	Apr 2020	HealthEdge	Ares	Not Publicly Avail.
Vista Equity Partners	Aug 2020	LogicMonitor	Antares Capital	Add-on
Permira	Oct 2020	Seismic	Antares Capital	$225
Thoma Bravo	Dec 2020	Instructure	Golub Capital	$2,000
Vista Equity Partners	Apr 2021	Pluralsight	Owl Rock Capital Partners	$1,175
Clearlake	May 2021	Appriss Knowledge for good.	Carlyle	$1,500
Vista Equity Partners	Jun 2021	AlertMedia	Antares Capital	Not Publicly Avail.
Thoma Bravo	Jul 2021	Medallia	Blackstone	$1,800
JMI Equity	Aug 2021	Passageways	Antares Capital	Not Publicly Avail.

Source: LCD, Direct Lending Deals, as of August 4, 2021
* Incremental