Private Equity

Private Credit to Discover If ARR Loans Work Only in Bull Market

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- Annual recurring revenue deals financed software takeovers
- Recession worry likely stops multi-billion dollar ARR loans

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(Bloomberg) -- A particular kind of loan used to finance loss-making companies helped swell the $1.4 trillion private credit industry. Now comes a test of whether such financings were built solely for a bull market.

Annual recurring revenue (ARR) loans became popular last year as part of a flurry of private-equity takeovers in the software industry, where companies can be unprofitable for years as they spend cash to fuel growth. Among a surge in ARR transactions in 2022 was a $2.6 billion loan for Thoma Bravo LLC's acquisition of Coupa Software Inc. and a $2.75 billion financing for the purchase of Avalara Inc. by Vista Equity Partners.

Software producers — and deals to take them private — face several hurdles in 2023, including Wall Street forecasts for a US recession and depressed valuations after last year's 27% drop in equity prices, as measured by the S&P 500 Software & Services Industry Index. At a minimum, there's likely to be fewer huge loans like the $5 billion ARR financing led by Blackstone Inc. for the buyout of Zendesk Inc. by a trio of private equity firms.

ARR transactions differ from regular corporate loans in that key credit metrics are based on a measure of recurring revenue as opposed to Ebitda, or earnings before interest, taxes, depreciation, and amortization.

Lenders typically take comfort from the fact that most of the revenue comes from long-term contracts and that the company could quickly rein in costs by cutting customer-acquisition expenses if times get tough. In addition, ARR loans typically represent only 20% to 30% of a company's total value, much less than traditional corporate loans.

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For these reasons, market participants say payment on the loans — even multibillion dollar ones — is likely to remain current barring a collapse in a company's equity value. "There is always a larger equity check involved compared with normal LBO financings," said Jake Mincemoyer, partner at law firm Allen & Overy LLP. "So, there is a much larger cushion to blow through before the lenders have any risk." Still, many private-credit firms have cut back on the size of the loans they offer, meaning sponsors can't get financing for some takeovers. Debt, too, is more expensive as the Federal Reserve continues to raise rates and investors are demanding more protection, making it more attractive to do deals where large borrowings aren't necessary.

“We will continue to be active in the recurring revenue market in 2023 but anticipate a slowdown in the large-cap ARR financings that were mostly addressing public to private activity,” said Erik Bissonnette, co-head of tech investing at Blue Owl Capital Inc. “There are very attractive opportunities to finance meaningfully sized private businesses with strong unit economics even though they may be less well-known to the broader public.”

But even smaller deals get hurt in an economic downturn. If the US economy slips into recession, acquirers may indeed have to cut costs, including workforce reductions. “Sponsors focused on the software sector have experience operating high growth companies; if recurring revenue growth slows during a recession, they will cut costs to generate liquidity and Ebitda,” said Daniel Landis, a managing director at Antares Capital. “Maintaining an appropriate balance between growth and profitability is a key objective.”