Client Alert | Capital Markets

The Use of EBITDA in Capital Markets Transactions

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With multiple uses throughout an offering memorandum, EBITDA (and variations thereof) can be difficult to understand in terms of its characteristics and applications.

Current trends in European and international markets for EBITDA adjustments may provide investors with a more accurate picture of future operating performance but must be weighed against traditional concerns.

Introduction

EBITDA (earnings before interest, tax, depreciation and amortization) is a metric appearing in a number of contexts in capital markets transactions. By adding back interest, taxation, depreciation and amortization to net income, many view EBITDA as enabling more like-for-like comparisons of similar businesses by considering only those costs intrinsic to such businesses' operations and, particularly for debt offerings, better reflecting their ability to generate cash flow sufficient to service their debt while running their businesses. For example, net income may not fully represent the strength of a company if its operations are based in an unfavorable tax jurisdiction and at the same time may exaggerate the strength of a competitor based in a favorable tax jurisdiction. Similarly, two otherwise similar businesses with contrasting capital structures may look very different when factoring in interest costs. Such businesses may also spread depreciation and amortization costs differently. By adding back these items, the EBITDA of the two businesses may arguably be more comparable.

EBITDA is vulnerable to challenge, however, and the U.S. Securities Exchange Commission ("SEC") and auditors have pointed out its limitations. For example, many argue that taxes and interest expenses cannot be separated from a business's other costs. Of two businesses with otherwise identical income statements, exposure to different tax regimes or different applications of amortization or depreciation schedules may be of material interest to investors. Similarly, many businesses are highly leveraged by design and interest costs are therefore intrinsic to their operations and performance Periodically, the SEC, the European Central Bank ("ECB") and other regulatory agencies will publish guidance on the use of EBITDA and other non-GAAP/IFRS financial measures, including differentiating "one-time" vs. "recurring" factors that may influence a company's reported results.

With the above considerations in mind, the following discussion examines current trends in the use of EBITDA (and variations thereof) in European and other international capital markets transactions by examining their varied applications and the perspectives of auditing firms (which provide comfort letters in capital markets transactions), the SEC and the ECB.

Disclosure: "Basic EBITDA"

In connection with debt capital markets transactions, an important metric considered by investors when making an investment decision is often the debt to EBITDA coverage ratio. As investors are well aware, the detail of both the calculation of the debt numerator (*e.g.*, gross vs. net, first lien vs. total debt) and the EBITDA denominator (as described below) can vary from deal to deal based on factors such as structure, industry, sector or jurisdiction (all of which will be fully disclosed and described in the offering memorandum). Both the Office of the Comptroller of the Currency and the ECB have established non-binding leveraged lending guidelines for companies incurring debt. However, even under these rules there is room for broad interpretation of applicable definitions.

The SEC and the ECB permit the use of EBITDA and other metrics not prepared in accordance with the Generally Accepted Accounting Principles ("GAAP") or International Financial Reporting Standards ("IFRS") in an offering memorandum but, as mentioned above, they provide guidance and limitations on the presentation of such metrics to help ensure the accuracy and consistency of disclosure. For example, such metrics must include reconciliations against "the most directly comparable financial measure or measures calculated and presented in accordance with GAAP" – in the case of EBITDA, against net income. Additionally, the issuer's management must provide a statement explaining why they believe such measures provide useful information to investors regarding the issuer's financial condition and results of operations. The issuer must also avoid naming such non-GAAP/IFRS measures "the same as, or confusingly similar to, titles or descriptions used for GAAP financial measures".

As EBITDA is not a GAAP or IFRS metric, auditors provide only limited comfort for EBITDA-related disclosure in capital markets transactions. They will review and comfort EBITDA and certain other non-GAAP/IFRS figures but only to confirm they align with schedules of accounts prepared by management. Furthermore, auditors typically provide disclaimers in their comfort letters, highlighting the weaknesses of these figures as discussed in the introduction. Participants in debt capital markets transactions must carefully consider the basis for adjustments that are not derived from a company's accounting books and records.

Disclosure: Adjusted EBITDA, One-Off Costs/Extraordinary Items and Synergies

In many cases, issuers may provide "adjusted" EBITDA, a metric reflecting adjustments in addition to those included in the definition of "plain vanilla" EBITDA discussed above. In addition, to further differentiate certain types of adjustments, other terms are often used, for example "supplemental" EBITDA, "normalized" EBITDA or "run rate" EBITDA, to name a few. In addition, depending on the applicable industry, other metrics may be presented, including EBITDAR (where "R" is for rental payments which are added for businesses that lease rather than own most of the assets used in their operations). In fact, EBITDA as used in the unregistered Rule 144A and Regulation S offerings common in European transactions frequently includes other adjustments that are not strictly related to interest, taxes, depreciation and amortization (for example, losses or gains from foreign exchange).

One-Off Costs/Extraordinary Items - Businesses often consider further adjustments to EBITDA where, from managements' perspective, such adjustments better highlight such businesses' strengths or overall profitability by adding-back one-off costs or extraordinary items. For example, a growing retail business may calculate Adjusted EBITDA as EBITDA less expenses related to the opening of new stores. While auditors may support these figures, they will provide only limited comfort and will include disclaimers emphasizing that they make no comment on the business's definition, calculation or presentation of such figures or their usefulness. Further, issuers may highlight large, one-off costs in explaining their performance. Such costs often appear in the context of acquisitions. Examples include transaction costs and costs related to the implementation of synergies such as training of personnel and the integration of production facilities. Typically, auditors will not comfort these amounts unless they are actually incurred during a particular accounting period, are not estimations and can be derived from the company's books and records.

Synergies - In the context of an acquisition, issuers may emphasize synergies achieved by combining operations with the acquired company. Examples of synergies include economies of scale resulting from the shared use of production facilities, personnel or supplier networks. While auditors do not comfort these figures (as they are typically forward-looking or require aspects of estimation), issuers may hire third-party firms to evaluate synergies and issue synergy reports, providing some degree of confidence in their accuracy.

Like auditors, the SEC and the ECB are concerned with the use of non-GAAP/IFRS measures, for example when companies are differentiating recurring costs from one-off charges or synergies. Under Regulation S-K, the SEC specifically prohibits issuers from adjusting "a non-GAAP performance measure to eliminate or smooth items identified as recurring, infrequent or unusual when the nature of the charge or gain is such that it is reasonably likely to recur within two years or there was a similar charge or gain within the prior two years."

Thus, in a registered offering, many of the adjustments mentioned above cannot be presented. For Regulation S and Rule 144A offerings typical in the European market, there is more flexibility in the presentation of financial information, including EBITDA-based metrics. This can lead to the inclusion of some rather bespoke financial information. Recently, the presentation by WeWork of a “community-adjusted EBITDA”, which included add-backs to EBITDA for sales and marketing costs, growth and new market developments and pre-opening community expenses, gained considerable attention in the press given the various categories of costs being added back, transforming EBITDA from a negative to a substantial positive value.

The flexibility afforded to unregistered offerings is subject, however, to Rule 10b-5 of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), applicable exchange rules and other disclosure-based rules and regulations applicable to international capital markets offerings. These rules and regulations and the related case law subject transaction participants to liability for inaccurate disclosure. For example, Rule 10b-5 prohibits, as a general matter, the making of untrue statements of material facts, or omissions of material facts necessary to make other statements not misleading, in connection with the purchase or sale of securities in both registered and unregistered offerings. As a result, transaction participants will conduct considerable due diligence and other verification procedures to ascertain the basis for any non-GAAP/IFRS figures. This due diligence includes reviewing any company or third party reports given in support of such figures. Above all, the participants will work to ensure that all disclosure in the offering memorandum is clearly and transparently drafted.

Covenant EBITDA

The covenants governing company operations under a typical high yield covenant package will also use the term “EBITDA” in a number of instances, most typically for (i) debt incurrence under a leverage or fixed charge coverage ratio, (ii) restricted payment capacity under an “evergreen” leverage based basket or (iii) as part of “EBITDA grower” baskets for a number of covenant exceptions. In each case, EBITDA is used as a component of the equation, with a larger EBITDA affording the company greater flexibility. However, the use of EBITDA in such covenants often differs from its use elsewhere in the offering memorandum. The definition of EBITDA for covenant purposes typically starts with “Consolidated Net Income”, itself often including certain add-backs and exclusions from net income. EBITDA is then derived through add-backs and other adjustments to “Consolidated Net Income”, including for one-off items, run-rate adjustments and synergies, to arrive at the definition of EBITDA used in the covenants. Increasingly, issuer’s counsel will also insert a provision ensuring that all adjustments permitted under the definition of EBITDA in the offering memorandum also apply to the definition of EBITDA in the covenants, protecting the issuer in the event the definition in the covenants would otherwise be less generous than that in the offering memorandum.

Investors may expect EBITDA as used in the covenants to match EBITDA as presented to them elsewhere in the offering memorandum. However, this is not necessarily the case. While the drafters may exclude a particular adjustment to EBITDA in the offering memorandum for any number of reasons, including securing auditor comfort, such adjustments are typically not be prohibited in the context of covenant EBITDA, given such term is typically determined “in the good faith of management”. The desire for management to make such adjustments to EBITDA is understandable given that management likely has the greatest insight (and faith) in their business and in the delivery of items such as synergies, as well as the strongest conviction that covenant flexibility should support company growth. On the other hand, investors are arguably unable to judge the actual covenant leverage the company is operating under and thus may struggle to determine next steps.

Conclusion

EBITDA, adjusted EBITDA and the other non-GAAP/IFRS figures play an integral role in management’s presentation of the strengths of their business and their position relative to competitors and can often provide investors with a more accurate picture of future operating performance than historical results alone, particularly in the acquisition finance context. The challenge that arises as these types of adjustments become more prevalent in European and international debt capital markets transactions is to properly balance a realistic vs. opportunistic view of future performance to provide the most accurate picture to investors. As such, capital markets transactions are characterized by numerous discussions between issuers, underwriters, auditors and lawyers as to the appropriateness of such figures and care should be taken to establish a clear and transparent presentation of financial information, while understanding its limitations.

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