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EBITDA Adjustments in Loan Negotiations

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A Practice Note providing an overview of EBITDA and explaining commonly negotiated adjustments to EBITDA in corporate loan transactions. Among the adjustments discussed in this Note are EBITDA add-backs for non-cash charges, restructuring and business optimization expenses, and cost savings and synergies.

Adjusted EBITDA is a financial metric commonly used in corporate loan agreements to assess a company's financial health and its ability to repay debt. Adjusted EBITDA goes beyond the traditional EBITDA measure by accounting for certain expenses or income items that are not considered representative of the company's ongoing operational performance.

In corporate loan agreements, lenders often focus on adjusted EBITDA because it provides a clearer picture of a company's ability to generate cash flows from its core business activities. By adjusting for non-recurring expenses, one-time charges, or other items that may distort the company's financial performance, lenders can better evaluate the borrower's capacity to meet its debt obligations. Equally, non-operating income, such as gains from asset sales or investment returns, is generally excluded from EBITDA to reflect the company's sustainable operating profitability.

Although adjusted EBITDA can provide valuable insights into a company's financial performance, it is not a standardized metric and can vary significantly from one transaction to another. In loan agreement negotiations, lenders carefully review the specific adjustments requested by the borrower and discussions often center on the rationale behind them, so that the lender can make an informed decision about whether to allow them.

Common EBITDA Adjustments

The adjustments made to EBITDA in a given loan agreement can vary depending on the specific terms of the deal and the industry in which the borrower operates. Common adjustments include:

- Non-Cash Items (see Non-Cash Charges, Expenses, and Losses).
- Extraordinary and Non-Recurring Items (see Extraordinary, Unusual, Non-Recurring, and One-Time Costs and Expenses).
- Restructuring Expenses (see Restructuring and Business Optimization Expenses).
- Cost Savings (see Cost Savings and Synergies).
- Business Interruption Insurance (see Business Interruption Insurance Proceeds; Indemnities).
- Quality of Earnings (QE) Reports (see QE Report).

Non-Cash Charges, Expenses, and Losses

In corporate accounting, non-cash charges, expenses and losses encompass various accounting entries that do not involve an immediate outflow of cash. They are important for portraying a comprehensive picture of a company's operations and profitability, as they capture expenses or losses incurred over a period, even though cash was not disbursed.

Although non-cash expenses and losses share similarities with non-cash charges, and the terms are often used interchangeably, they are not entirely synonymous, in that:

- Non-cash charges are items that are not accompanied by an immediate outflow of cash

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but are incurred to reflect the consumption of an asset's value over time, or other non-cash transactions. For example, if a business writes down the book value of its equipment so that its property reflects present commercial realty, the accounting reconciliation results in a non-cash charge equal to the extent of the write-off. Non-cash charges impact the borrower's income statement by reducing its reported income, thereby lowering profitability metrics such as net income or EBITDA. They may also affect the borrower's balance sheet by reducing the carrying value of its assets.

- Non-cash expenses and losses are specific expenses or losses incurred by a company during the reporting period that reduce the company's reported income on its income statement without involving an immediate cash outflow. However, unlike non-cash charges, they typically do not involve adjustments to the carrying value of assets on the company's balance sheet. Non-cash expenses and losses encompass a broader range of items, including such items as accounting for unrealized losses on investments and providing for doubtful debts.

In loan agreement drafting, general add-backs for non-cash charges, expenses and losses are commonly included in the definition of adjusted EBITDA, allowing the borrower to add back to EBITDA non-cash items that were deducted from the borrower's calculation of its net income. Specific adjustments are also commonly negotiated, depending on the nature of the borrower's business. Common examples of specific add-backs for non-cash items include:

- **Impairment Charges**. These reflect decreases in the value of the borrower's assets over time, such as where a retail chain determines that the carrying value of one of its stores exceeds its recoverable amount. In this case, the company may record an impairment charge to write down the store's value to its recoverable amount.
- **Stock-Based Compensation.** Companies commonly grant stock options to their executives and employees as part of their compensation package. As the employees exercise these options or as restricted stock units vest, the company recognizes an expense equal to the fair value of the shares granted. This expense is non-cash in nature but reflects the cost of compensating employees with equity.
- **Mark-to-Market Movements in Swaps**. Some businesses have significant swap exposure, especially companies that have dealings in foreign currencies. Non-cash charges usually include mark-to-market movement in swaps. Both parties should carefully review the impact such movements may have, which may be included as specific add-backs to EBITDA.
- **Accrued Management Fees**. Businesses that are owned by private equity sponsors often pay management fees to their sponsor owners, or affiliated management companies and advisers. Accrued, unpaid management fees may be included in specific EBITDA add-backs to the extent they are accrued in accordance with a management fee subordination agreement.

Extraordinary, Unusual, Non-Recurring, and One-Time Costs and Expenses

Loan agreements commonly include adjustments to the borrower's EBITDA based on extraordinary, unusual, non-recurring, or one-time costs and expenses. The idea behind making these adjustments is to obtain a clearer picture of the borrower's underlying operational performance by excluding expenses that are not expected to occur regularly or are unrelated to the borrower's core business activities. Although borrowers tend to focus on accounting for losses and expenses, the rationale for making these add-backs also supports reducing EBITDA to reflect any gains the borrower makes from one-time asset dispositions or other extraordinary gains. As a drafting matter, some deals simply exclude extraordinary items from the calculation of the borrower's net income entirely. This approach makes any adjustments to EBITDA unnecessary because no add-back is required for one-time expenses that were never accounted for as deductions from the borrower's net income calculation in the first place.

There are many examples of non-recurring or extraordinary expenses that may distort a company's EBITDA if they are included without adjustment. However, lenders are mindful of allowing too many adjustments because this could obscure an assessment of the borrower's true financial performance and undermine the lender's ability to accurately assess its credit risk. Lenders and borrowers may disagree on whether certain expenses should be classified as extraordinary, unusual, or non-recurring, and this often factors into the

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negotiations. It is not the nature of an expense alone that determines whether it should be treated as extraordinary or non-recurring, but how that expense is considered in the context of the borrower's business. For example, the cost to a borrower of sponsoring an industry trade fair may be considered extraordinary or unusual if the borrower is not ordinarily represented at these types of events, but if it participates in trade fairs regularly, the associated expenses could not be regarded as unusual or non-recurring.

For greater clarity around the types of adjustments that are permitted, and the extent to which they are permitted, a loan agreement may identify specific types of expenses that are eligible for adjustment and set out the criteria for determining the relevant amounts. Although not an exhaustive list, the following are common types of extraordinary, unusual, non-recurring and one-time expenses that are often addressed specifically in EBITDA add-backs in loan agreements:

- **Restructuring Charges** (see Restructuring and Business Optimization Expenses).
- **Transaction Fees.** Adjustments for transaction fees are common and not generally considered controversial by lenders, although caps and other limitations on the amounts that can be added back may apply. Issues that often arise in the negotiations of this adjustment include:
  - the types of transactions involved, which may include the loan transaction itself, corporate acquisitions, and equity issuances by the borrower;
  - whether the borrower so regularly engages in acquisitions or other specified transactions that the related expenses are not extraordinary;
  - in the case of an adjustment for the costs of the loan transaction, whether the add-back only applies to fees and expenses for the closing or whether it extends to fees and expenses of any future amendments;
  - whether due diligence costs should be included in specified transaction costs; and
  - whether the costs and expenses of unconsummated acquisitions or transactions should be included. Lenders sometimes limit addbacks for unconsummated transaction fees to those transactions that would have been permitted under the loan agreement if they had been consummated as intended.
- **Management Fees.** Sponsored borrowers often seek adjustments for management and advisory fees paid by the borrower. Where an adjustment is included, it is almost always capped at the rate specified in the management agreement or the advisory services agreement at closing. The add-back should align with the borrower's ability to amend the management agreement, so that if the borrower amends the management agreement, the EBITDA add-back applies to any increased fees paid by the borrower. Many deals prohibit payment of management fees if a default exists or if the borrower's financial covenant performance is nearing default levels, though the unpaid fees can accrue while the default or other threshold trigger exists and be paid at a later date. A later, larger payment may have a bigger impact on EBITDA if it is all added back at one time.
- **Litigation Expenses.** Litigation costs and settlement payments are sometimes added back to EBITDA, though add-backs may be subject to caps or other limits. Lenders consider the borrower's litigation risk more broadly in their lending due diligence. There may be industry norms that inform the lenders' approach to the litigation representations, covenants, and defaults in the loan agreement. Litigation-based EBITDA adjustments should be consistent with the other litigation-related provisions in the loan agreement. For instance, a permitted EBITDA add-back should not exceed the materiality thresholds in the loan agreement's litigation provisions that trigger other consequences.
- **Debt Refinancing Penalties.** Premiums, penalties, or similar payments in connection with the refinancing of debt by the borrower are included in EBITDA adjustments in some deals. These payments are by definition non-recurring, since they only apply on the occasion that the borrower pays off existing debt.
- **Receivables Discounting.** Some borrowers, especially those in industries such as healthcare where receivables are commonly sold or collected at a discount, negotiate for an add-back reflecting the loss or discount on receivables sold. This loss may be incurred in receivables collection or in connection with a receivables facility in which the borrower obtains credit based on the value of its receivables.
- **IT Upgrade Costs.** Some loan agreements include adjustments for the costs the borrower incurs to upgrade its IT systems. This adjustment may also

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include one-time consulting charges and other non-recurring expenses in connection with an IT upgrade. There is a distinction between the one-time costs of a system upgrade and the ongoing costs of regular maintenance to the borrower's IT systems, with the latter not being within the scope of an add-back to EBITDA.

- **Recruitment Expenses.** Some borrowers negotiate to include an adjustment for costs of recruiting for leadership positions and board roles, such as payments to headhunters and search services. These types of recruitment costs are distinguished from those associated with the regular recruitment efforts for non-executive employees which do not form the basis of an add-back. Although costs of hiring for senior leadership roles may be significant, adding these costs back to EBITDA is justified on the basis that they are not incurred by the borrower on an ongoing basis.
- **Corporate Rebranding, Marketing.** Some borrowers request an add-back for expenses associated with corporate rebranding. A rebranding initiative may involve significant costs and is sometimes part of a larger realignment of a business to focus on core activities and position itself for growth. The fact that businesses seldom undertake major rebranding exercises provides the rationale for adding back the associated expenses to EBITDA. Some borrowers also negotiate to include an EBITDA add-back for the costs of carrying out market surveys and other significant marketing efforts, but lenders may be reluctant to agree to add-backs for marketing costs. Most businesses engage in some level of marketing and an add-back would not extend to ordinary course marketing expenses.
- **Contingent Obligations in Acquisitions**. Some loan agreements include EBITDA add-backs based on earnout payments or other contingent obligations in connection with acquisitions. Contingent consideration plays an important role in some M&A transactions. It is negotiated and is typically based on some measure of the target's performance post-closing. The structure of an earn-out often includes milestones, and earn-outs may be paid in cash, stock, promissory notes, or a combination, as the parties agree. A seller may favor an earn-out to bridge a valuation gap in the purchase consideration, while a buyer might use one to reduce the amount of cash it must pay at closing and to incentivize the seller to provide services or support to the business after closing. Contingent obligations are measured at fair value at closing and included in the purchase price for purposes of financial reporting. A borrower's rationale for adding back to EBITDA amounts of contingent obligations in these circumstances is that they are contingent in nature and non-recurring.
- **Board Travel.** Some deals specifically include an adjustment for travel expenses of board members and sponsors. The amount of any add-back is often capped, and in some cases may also be subject to other limiting factors.

Restructuring and Business Optimization Expenses

Some loan agreements include an add-back specifically covering restructuring charges and business optimization expenses incurred by the borrower. A company may incur one-time restructuring costs in a reorganization of its business to eliminate inefficiencies and improve profitability, including by:

- Selling a subsidiary.
- Expanding into a new market.
- Relocating its headquarters.
- Implementing new technology.
- Acquiring or merging with another company.

Including a specific add-back for these types of expenses eliminates the need to analyze whether they might be within the scope of a general add-back for extraordinary, unusual, or non-recurring costs (see Extraordinary, Unusual, Non-Recurring, and One-Time Costs and Expenses). It also means that the loan agreement can include separate baskets for each category, with separate caps, which gives the parties flexibility in the loan agreement to address the detailed requirements of the borrower. Caps for this add-back are common in loan agreements and are typically either fixed dollar amounts or caps consisting of a stated percentage of EBITDA. A common point of negotiation in loan agreements that cap an add-back for restructuring and business optimization expenses is whether the percentage cap should be based on EBITDA before or after giving effect to the cost savings. If the cap is based on the larger figure for EBITDA, including added cost savings, the result is more favorable to the borrower, and vice versa.

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Cost Savings and Synergies

One of the more controversial and heavily negotiated EBITDA add-backs is a pro forma add-back for cost savings and synergies. Cost savings and synergies are the result of operational efficiency gains that will reduce the borrower's expenses in the future and are expected to have a positive effect on its net income. Although the add-back for cost savings and synergies was historically limited to identifiable transactions, such as an acquisition, many agreements have expanded the scope of the cost savings add-back to allow synergies for other initiatives, such as:

- Restructurings.
- Operational improvements.
- Revenue synergies.

To come within the scope of an add-back, cost savings must be measurable and based on identified actions taken by the borrower.

Run-Rate Savings

Loan agreements may further specify that cost savings can be added back on a run-rate basis. This means estimating the borrower's future performance by annualizing its current figures for projected savings. A risk with run-rate figures is that the amount of the add-back is determined using only the most current performance data and may not properly account for changes in circumstances, which could give the lender an inaccurate overall picture of the borrower's financial strength.

Forward-Looking Periods

Credit agreements sometimes permit EBITDA adjustments for cost savings and synergies. A key point of negotiation centers on the extent to which the relevant action that will generate the cost savings needs to be completed before the add-back applies. The parties should decide whether the relevant action must be taken, or initiated, before the add-back applies, or if the action need not be completed, whether certain substantial steps must have been carried out before the add-back applies. Typically, a forward-looking period limits how long the adjustment can be taken once the adjustment applies.

Caps on Cost Savings and Synergies Add-Backs

A common approach is to cap adjustments for pro forma cost savings and synergies. Although uncapped adjustments can be seen in some of the largest deals and deals involving strong sponsors, credit agreements commonly cap the amount the borrower can add to EBITDA so that it does not exceed either a fixed dollar cap or a stated percentage of EBITDA. A common point of negotiation is whether a cap based on a percentage of EBITDA should be determined before or after giving effect to the cost savings. If the cap is based on EBITDA as augmented by the cost savings, the percentage cap is based on a larger EBITDA figure and is therefore more favorable to the borrower, and vice versa.

Certification

Loan agreements may require that a responsible officer of the borrower provide a certification of claimed cost savings in accordance with the applicable cost savings plan, or a confirmation that a cost savings plan has been implemented. In the case of projected savings based on actions that are yet to be implemented, the loan agreement may require a responsible officer's confirmation that the cost savings are reasonably expected to be realized during the specified time-period. Some loan agreements expressly require the responsible officer to act in good faith when certifying projected cost savings.

Business Interruption Insurance Proceeds; Indemnities

Business interruption insurance is a type of insurance coverage that provides financial protection to a business in the event of an unforeseen temporary halt or reduction in its revenue-generating activities. This could be due to damage to business premises, equipment breakdowns, or other events, such as natural disasters, fires, or other incidents that render the business unable to operate at full capacity. It is designed to compensate the business for lost income and allow it to continue to pay ongoing expenses, such as payroll, rent, utilities, and ongoing operating costs, while revenue-generating activities are interrupted.

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When a business receives insurance proceeds from a business interruption claim, it must account for these proceeds in its financial statements appropriately. Under GAAP, businesses must treat insurance proceeds as income when the loss event occurs, if it is probable that the insurance claim will be realized. Lenders typically view the receipt of business interruption insurance proceeds by borrowers positively, as it provides additional liquidity and financial stability to the borrower, reducing the risk of a default. In some loan agreements, the parties negotiate for an adjustment to EBITDA based on the receipt by the borrower of business interruption insurance proceeds. The accounting treatment of the adjustment is complicated because the insurance proceeds do not reduce EBITDA and so cannot be said to be added back to it. Sometimes the adjustment takes effect as an increase to the borrower's reported net income. When considering whether the adjustment is appropriate and not duplicative, the parties must consider the accounting treatment by the borrower of losses caused by the interruption to the business, as well as the receipt of the business interruption insurance proceeds.

A similar adjustment to EBITDA that has equivalent mechanics to the business interruption insurance proceeds adjustment involves amounts indemnified by a third party. Some deals will allow the borrower to add back to its EBITDA charges, costs, and losses to the extent another party indemnifies the borrower for these amounts. For example, in an acquisition financing, a borrower might be able to add back to its EBITDA an amount equal to a charge for a particular loss, if the borrower is entitled to be reimbursed for that loss by a recently acquired subsidiary as part of the purchase agreement.

QE Report

A QE report is a comprehensive analysis of a company's financial statements to assess the accuracy and sustainability of its reported earnings. It delves into the underlying factors that contribute to the company's earnings performance, including:

- Revenue recognition policies.
- Expense management practices.
- Accounting adjustments.
- Cash flow dynamics.

QE reports are used in many types of corporate transactions, such as mergers and acquisitions, initial public offerings, and private equity investments. They sometimes also play a role in loan transactions by forming the basis of an adjustment to the borrower's EBITDA. Not all acquisition financing deals include a QE report, but in those deals that do, the QE report is usually prepared for the buyer by a specialized financial advisory firm or an accounting firm that has expertise in forensic accounting and financial due diligence. Lenders typically require the QE report to be prepared by independent public accountants, sometimes specifying that the firm must be of a certain standing, such as nationally recognized. In some loan agreements the choice of firm must be approved by the lender.

Some loan agreements require the QE report to be based on the borrower's or the sponsor's financial model. Using various analytical techniques and industry benchmarks, the QE report gives an assessment of the quality and sustainability of the target's earnings, ensuring that all parties can have confidence in the accuracy and reliability of the target company's financial information. Adjustments based on a QE report most often relate to a particular acquisition, but sometimes the concept is extended to future acquisitions. The adjustments derived from a QE report must be specifically identified and quantified based on non-recurring or discretionary items that are seen as distorting the borrower's true operating performance and not expected to impact the borrower's future earnings. Restructuring costs, litigation settlements, and asset write-offs are all examples of EBITDA add-backs that may be based on adjustments identified in a QE report.

EBITDA Negotiations

EBITDA negotiations are heavily dependent on the specific transaction and can vary significantly from deal to deal.

In some transactions, the borrower may make specific requests for detailed adjustments to EBITDA, while in other deals EBITDA-driven financial tests may be agreed more broadly. Lenders may approach EBITDA

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add-backs differently and may resist some requests from borrowers or place caps on add-backs to better manage their risk. For more detailed discussion of approaches taken to EBITDA negotiations in corporate loans, see Practice Note, EBITDA: Loan Agreement Negotiating Considerations.

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