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Private Credit EBITDA Addbacks

What Do They Mean and Why Should Investors Care?

A common question among investors, credit managers and consultants is: "Where are we in the credit cycle?" While credit markets will ebb and flow, most believe we are presently at the more competitive end of the spectrum. And in a competitive market, pressure on financing structures and documentation can be expected. In our view, a key challenge is the current shift in magnitude and type of EBITDA addbacks that are being used to justify higher debt levels and valuations.

EBITDA (earnings before interest, tax, depreciation and amortization) is a proxy for cash flow to service debt and used to value a company by applying a multiple, such as 8x EBITDA. Since this metric is a key driver for company valuation and financing capacity, it is not surprising that investment bankers and company owners seek to maximize EBITDA.

From a credit perspective, EBITDA addbacks are not a new concept. It gets tricky when borrowers propose more subjective addbacks that are intended to justify debt issuance that is not prudent.

The types of EBITDA adjustments may include:

1 Transaction Related

Seen in most financings, these common adjustments are for one-time deal related costs, sponsor management fees, non-cash or non-recurring compensation and severance costs

2 Potential Cost Savings

Addbacks for anticipated savings such as modified compensation, reduced rents and headcount reductions are more complex. To evaluate these, a quality of earnings report can be obtained to analyze the proposed adjustments. These can be allowed as an EBITDA addback with proper review and documentation

3 Run-Rate EBITDA

Later in a credit cycle, borrowers may propose addbacks that are extrapolations of recent performance. For example, a borrower may propose annualized credit based on a short period of recent performance (three-month EBITDA multiplied by four to calculate an annual rate). In these cases, it's best to look to the borrower's history of achieving projected outcomes as well as considering seasonal impacts

4 Maturity Credits

In certain industries, a borrower may request adjustments for future expected performance. For example, if new offices have been opened in a medical practice, the borrower may seek credit for a mature patient load. Quantifying and approving these adjustments requires significant work

5 Incremental Expenses

Corporate carveouts and family-owned businesses may need to build in costs for additions to staff, systems, and facilities

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For any lender, getting to an accurate EBITDA amount is important for making appropriate credit decisions as well as setting financial covenants, specifically the maximum permitted leverage ratio (funded debt / EBITDA). For lower middle-market companies, a miss of the leverage covenant is often the triggering event bringing borrowers and lenders to the table for discussion. In most cases, getting to the table earlier helps to preserve value.

Unjustified addbacks can hide the true level of leverage so astute lenders should know how to analyze and challenge EBITDA adjustments line by line to ensure they understand the borrower's ability to service debt. To gauge portfolio risk, it is important for investors to understand a private credit manager's philosophy around and process for evaluating EBITDA addbacks.

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About NXT Capital

NXT Capital, based in Chicago with more than 115 professionals, is a leading provider of senior structured financing solutions to the U.S. middle market. Since inception to 6/30/2018, the company has originated approximately $20 billion in total financing volume spread over 600+ transactions. NXT Capital also manages capital for third parties through its asset management platform. Investment programs are managed by NXT Capital Investment Advisers, LLC, which is registered with the SEC as an investment adviser.

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Linda oversees NXT Capital's investor relations activities and fundraising efforts. She is actively involved in raising third party funds and developing and maintaining investor relationships across the institutional LP community, including insurance companies, public and corporate pension plans, foundations, endowments and consultants. Linda brings over 20 years of investor relations, fundraising, private equity, corporate finance and M&A investment banking experience to NXT.