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Credit Financing: Adjusted EBITDA Cheat Sheet

In its simplest form, Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA), in a majority of credit financings, forms the basis for some type of leverage ratio financial covenant in such financings, and those covenant levels are derived from the operating entity's historical financial information as well as the projections provided by the private equity sponsor, borrower, financial advisor or similar representative. EBITDA serves many other functions as well in these types of facilities—for example, in loan pricing and incurrence-based restrictive covenant exceptions.

The negotiation by borrowers and lenders concerning the definition of EBITDA in cash flow-based credit facilities is fundamental to the size of the default risk of the applicable loan. Sponsors and borrowers, certainly, and even lenders, in many cases, have some interest in mitigating loan default risk by creating a leverage calculation that is a market-accepted approximation of the borrower's consistent operating cash flows. In addition, especially for highly leveraged deals, regulated lenders have an interest in creating a thoughtful definition of EBITDA that, within such lender's underwriting and risk policies, avoids unnecessarily painting an overly leveraged picture of the lender's loan portfolio and other consequences of regulatory "red flag" loans.

This article is a brief reminder (for all market participants to consider when negotiating the EBITDA definition in credit facilities) of the general types of EBITDA add-backs that are often included in middle-market, cashflow-based credit facilities, particularly those with private equity sponsor influence. The general objective of credit facility EBITDA is to add back to net income the interest, taxes, depreciation and amortization, as well as to addback certain other non-cash, extraordinary and transaction-related items deducted from earnings when determining net income.

Negotiation of EBITDA add-backs often include discussions around the following add-back types:

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- Losses from interest rate hedging agreements.
- Financing fees and other amounts arising in connection with incurring indebtedness.
- Restructuring charges and projected savings/synergies in connection with a restructuring.
- Management and advisory fees and indemnities and expenses under sponsor management agreements.
- Other extraordinary, nonrecurring or unusual losses or expenses (e.g., arising from transactions, integrations, transitions, facility opening, consolidation, relocation and expansion costs).
- Costs of employee benefit plans or management and board stock option plans, to the extent such plans are funded with contributed capital or equity proceeds.
- Cash receipts in respect of previously excluded non-cash gains.
- Losses on sales of securitization assets.
- The excess of GAAP rent expense over cash rent expense.
- Fees, costs and expenses arising in connection with a transaction permitted by the financing documentation.
- Proceeds of business interruption insurance for the applicable period.
- Litigation expenses.
- All other non-cash charges.
- Add-backs included in the borrower's projections.

Each of these add-back types (and many others not listed) have their own nuances and level of market acceptance to consider. EBITDA is only one definition in agreements that are often in excess of 150 pages of highly complex terms and provisions, and both lender and borrower/sponsor sides rely on strong representation from outside counsel to navigate credit documentation.

For a more in-depth discussion regarding the merits of different EBITDA-related contract provisions, contact Aaron Turner of Frost Brown Todd's Private Equity Industry team.

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