Fresh Look at Add-Backs

Patrick Robey, Calder Capital

December 11, 2018

Bio / Background

Patrick Robey – Director of Corporate Development

The bulk of Patrick's experience is in Private Equity, Corporate Development, and Investment Banking, which he has been involved in since 2011 and where he has managed and executed multiple platform and add-on transactions. Patrick has experience in many areas of an acquisition, from sourcing potential targets to leading the due diligence and closing processes to managing and executing post-close operational activities and strategies.

Patrick has worked to close transactions ranging from over $100M in transaction value to deals as small as $1.5M in transaction value. Patrick has built his experience within the industry at firms such as J.P. Morgan Chase, Blackford Capital, Old National Bank, and Calder Capital.

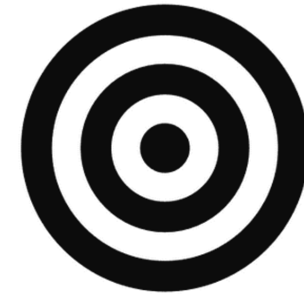
Patrick has bachelor's degrees in both management and economics from Hope College. He is actively involved in the Grand Rapids and Holland communities including active participation in Hope College through the Department of Economics, Management, and Accounting and the Hope Entrepreneurship Initiative as well as participation in the Association for Corporate Growth, West Michigan. Patrick resides in Holland with his wife, Olivia, and their two Australian Shephard puppies, Lincoln and Tilly.

Contact:
patrick@caldergr.com
Direct: 517.240.2895

Goals of Today’s Discussion

Goal #1

Provide new perspective in terms of how to view add-backs.



Goal #2

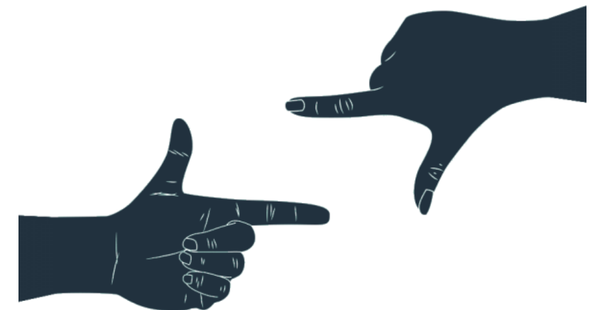
Provide tools and approaches for these type of questions when dealing with sellers, buyers and lenders:

- Sellers love add-backs, since they add to the business’ value.
- Conversely, lenders and buyers are generally quite conservative and may view add-backs skeptically.
- Let’s explore how to reconcile the differences among sellers and buyers.

Goal #3

Give a buyer’s perspective to add-backs

- This buyer will own the business post-close, and its legacy and continuity often depend on the price and structure of the transaction.
- Many deals are LBOs. Thus, the business needs to pay for itself.
- Failing to understand the appropriate add-backs can lead to difficulty for the new owner, and limit the ability for the business to grow.



Critical View of Add-Backs

What is EBITDA? (or, what does it represent?)

The net cash flow a new buyer can reasonably expect, based on history, to continue operating the business, continue investing and continue growing the business while also paying off associated capital used to purchase the business.

- **Depreciation:** Generally depreciation is thought of as a "no-brainer" add back. But what if it is a huge ongoing, year-after-year expense? What does that tell the analyst?
  - That you have a large amount of equipment and CapEx spend? So, really you need to add back (as a negative) the annual CapEx spend, which often eliminates or significantly reduces the depreciation add-back.
- **Overspend on Equipment/Repairs and Maintenance:** I know a lot of companies do this for tax purposes (to basically pay no taxes at the end of the year), but what is this doing?
  - It is inflating the equipment FMV and the depreciation figures.
  - Is the purchasing differentiation or making the company who it is today (a business with new, great equipment)?
- **Interest Expense:** This is always added back, but should it always be?
  - For instance, what if your company always needs a lot of capital outstanding on the LOC? Or what if you are doing a lot of capital expenditures each year and financing those expenditures?
- **New Systems / Equipment Needed:** Generally, analysts add all the depreciation back and even sometimes add back the annual CapEx over past few years. But what if the business has an outdated ERP or operating system? Or what about outdated equipment?

Critical View of Add-Backs (cont.)

- **Recurring Add-Backs:** Another general "no brainer" add back is bad debt or gains/losses on sales. But what if it happens every year or happens more than once, then is it really an add back?
- **Owners Compensation/SDE:** SDE is computed for a reason, but a couple of thoughts on this:
  - First off, if your SDE is less than $200k or $300k, there is one big reason valuation multiples are not 4 or 5x – you need to pay a new owner.
  - When compensation is very high for the current owner, and then only a "manager" for $60 or 70k is added back, is this appropriate? You are removing someone who built this company, who has years of experience, someone who cares deeply about the company and telling the buyer that all this value is expected to be replaced with a general manager?
  - Also, what about when the owner is the sales person, the operations person, and the administrative person?
  - Spouse Salary: Often the spouse's salary is added back no matter the circumstances. Consider what value that spouse is contributing before simply adding back the total of their compensation.
- **Perks and Other:** We can all get carried away with these, but this is somewhat of a tough sell for the new owner and for the lender. Owner perks will ultimately need to be substantiated, particularly for a lender.
- **"Non-recurring" Expenses:** For instance, adding back a previous general manager that "didn't work out" or "one-time" consulting expenses, or adding back recruiter expenses that "are no longer used."
- **Bonuses or Employees Perks:** Oftentimes we see owners wanting to add back annual bonuses, claiming they're "discretionary". But if employees come to expect these perks and bonuses, buyers and lenders will argue that they are not a legitimate add-back, but built into the business model.

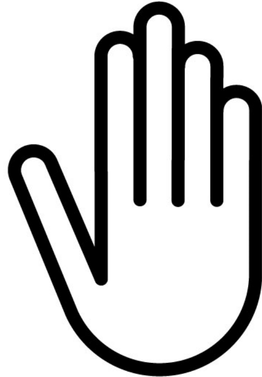
Critical View of Add-Backs (cont.)

- **Non-Arms-Length Transactions:** If you are buying supplies at a lower or higher price than what is fair market from a somewhat related business, these purchases need to be adjusted to fair market value.
- **Rent:** If rent is reduced to below fair market value, this makes the business more valuable, but the real estate not as valuable. And vice versa when you set the rent too high. At the end of the day, this is baked into the same cash flow pie and it is best to present adjustments that reflect a fair market rent paid by the business.
- **Add-Backs Based on Improving the Business / Synergies:**
  - Examples of this are:
    - "Overpaying" an outsourced accounting person to do the books. The argument is: "you should be able to do that in-house at a 1/5 of the cost."
    - "We have a huge IT expense, but it can be streamlined by going to the cloud and not having a server and IT person. "
    - "We have been purchasing from one supplier for all of our materials, but you can save a ton by going out to the market and being competitive instead of continuing to buy from our friend."
    - "This is a redundant person and you could easily do without them."
  - My critiques:
    - So, the buyer needs to make these changes/improvements, but the seller should get the credit?
    - What benefits are being overlooked with these add backs (relationships or work from the good friend supplier? Years of built in knowledge from the accountant?)
    - If these add backs are to be included, then they really should be part of an earnout as they are positive improvements being implemented by the buyer to be proven out over time.

How Do Banks Approach Add-Backs?

Banks are very conservative on add backs generally

I almost never see the bank take all the EBITDA adjustments in their underwriting. Sometimes, to a frustrating degree, they take few at all.



Banks Do Not Typically Accept the Following:

Perks and Other owner expenses (or at least they will be modest here).

They are very conservative on owner compensation and the negative add back for the new buyer. In required 3rd party valuations, the valuation firm will simply impute an executive salary based on market data & NAICs code.

They will not include add-backs where buyer needs to change or improve the business.

They will not include cost savings from potential synergies.

What does this result in?

Elimination of add-backs reduces financing availability/capability and makes the deal either a lower price or higher note/earnout. In either scenario, it likely will stall or derail the deal by everyone being thrown off by what the bank *isn't* able to finance.

If SBA financing is used, this also may kill their valuation. If they are taking a multiple of a much lower EBITDA number (you calculated $700k EBITDA and they have $550k), then they will not even get there on the valuation for the SBA loan ($700k times 4 and $550k times 4 results in a $600k shortfall, or 21.4% shortfall).

Structure Implication of Add-Backs?

What Does All of This Lead To?

Reduced purchase price or multiple when financing comes back with lower add-backs than what seller and buyer thought.

Reduced cash at close for the business.

Higher degrees of seller financing – notes or earnout structures as add-backs are proven out.

Getting these wrong can derail deals by not setting expectations appropriately.

Can set unknowing buyers up for failure.

Moral of the Story: There are many sellers who, once they learn the impact of add-backs, are more than ready to throw everything and the kitchen sink to boost cash flow. As advisors, it is responsible for us to have candid discussions with our sell-side clients up front about how buyers and lenders view addbacks.