Adjusted EBITDA

In particular for high-yield bonds

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At a glance

A successful debt listing depends, among other things, on a thorough understanding of how adjusted EBITDA can affect the way in which your company is viewed by potential investors.

Most offering memoranda include at least one non-GAAP measure.

Communication with investors is crucial in order to get the right outcome from the high-yield bond ("HYB") listing process.

Companies involved in this process use a variety of methodologies to attract investors' attention and increase their appetite. The most common strategy is by showing the management view of the company's performance, which is a key driver for investors in shaping their future expectations, showing at least one non-GAAP measure.

The most common non-GAAP measure used in the HYB space is adjusted EBITDA; this is a measure derived from EBITDA (earnings before interest, tax, depreciation and amortisation) amended to include or eliminate the impact of certain financial items or the financial impact of certain events (e.g. activities outside the normal course of business or non-cash transactions).

This measure is also used when formulating various financial ratios, and makes it easier to compare different periods or companies. Therefore, investors will be better able to understand and benchmark the company in the environment in which it competes.

However, the nature of certain adjustments are often criticized by regulators, analysts and other stakeholders; also, focus should be given when certain adjustments are defined as "other".

A non-GAAP measure should not be misleading and should be presented together with the most directly comparable GAAP measure, and ideally with reconciliation between the two.

EBITDA and adjusted EBITDA

A sneak peak

Earnings before interest, tax, depreciation and amortisation ("EBITDA") and adjusted EBITDA are often already used by companies as a way of understanding and monitoring the underlying performance of the business.

In addition, adjusted EBITDA ratios in particular are often used to understand and track the company's ability to generate cash and service debt obligations.

Such presentations are a key metric in pricing, allocating a yield to a HYB, establishing acceptable leverage levels and drafting related covenant packages. Therefore, investors and lending institutions place significant focus on these measures.

In the absence of accounting standards and regulations in a Rule 144a and Regulation S ("Reg S")[1] environment, presentations have evolved and market practice has developed regarding the types of adjustments that are considered acceptable.

It is important to note that, in a U.S. Securities Exchange Commission ("SEC")-regulated environment, non-GAAP measures are governed by three basic presentation and disclosure models depending on where the information is presented:

- Regulation G ("Reg G"): applicable to all public non-GAAP financial-measure disclosures (e.g. oral, telephone, press release, Internet, etc.);
- Instruction 2 to Form 8-K 2.02 ("8-K 2.02"): applicable when material non-public information regarding a complete fiscal year or quarter is disclosed externally and provided to the SEC on Form 8-K;
- Regulation S-K 10(e) ("Reg S-K 10(e)"): applicable to information filed with the SEC (e.g. registration statements, Form 10-K or Form 10-Q (Forms 6-K and 20-F for an FPI[2])).

Additionally, in the Compliance and Disclosure Interpretation ("C&DI") issued on 25 January 2010, the SEC clarified its guidance on the presentation and disclosure of non-GAAP performance measures that exclude the effects of recurring items.

In this respect, in Europe, following the introduction of the Transparency Directive[3] and the Market Abuse Regulation[4], the European Securities and Markets Authority ("ESMA") has issued guidelines on Alternative Performance Measures ("APMs") applicable to those issuers whose securities are admitted to trading on a regulated market, in order to harmonise the approach and the application of non-GAAP performance measures.

Analysts, investment banks, rating agencies and advisors generally scrutinise adjustments, especially if such items are claimed to be non-recurring yet appear each period, or where the assumptions stated are inconsistent with the company's strategy or historical performance. Therefore, each adjustment should be viewed in the context of the individual company and the specific business plans and proposals currently being considered.

1. Rule 144a and Reg S are safe harbor exemptions from the registration requirements of Section 5 of the Securities Act of 1933, as amended (the "Securities Act").
2. A Foreign Private Issuer ("FPI") is any issuer incorporated or organized under the laws of a foreign country (non-U.S.), except an issuer meeting both of the following conditions: (i) more than 50 percent of the outstanding voting securities of the issuer are directly or indirectly held of record by residents of the United States; and (ii) any one of the following: (a) the majority of the executive officers or directors of the issuer are United States citizens or residents; or (b) more than 50 percent of the assets of the issuer are located in the United States; or (c) the business of the issuer is administered principally in the United States.
3. Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are traded on a regulated market and amending Directive 2001/34/EC.
4. Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse.

What adjustments can be made?

The challenges facing companies, lenders and their advisors relate to diligence, comfort and association risk.

Whether certain information can be comforted or "verified" in a Rule 144a and Reg S offering (typical for most European HYBs) is governed by the American Institute of Certified Public Accountants in AU-C 920 ("Letters for Underwriters and Certain Other Requesting Parties") or its local equivalent. This is an auditing standard that governs what can and cannot be comforted by an auditor of a company in its offering memorandum prepared for the purpose of a securities offering.

To be able to comfort the individual adjustments and the total adjusted EBITDA financial data, the following should be taken into consideration:

- The presentation should be reconciled with the nearest historical GAAP measure (i.e. profit or operating profit for the period);
- The adjustments should be:

1. Factually accurate
2. Historical and verifiable
3. Supportable

(I.e. each adjustment should be consistent with the underlying historical accounting records, subject to the internal controls around financial reporting, which the auditor understands).

Additionally, the adjustments should be non-recurring items and not linked to the ongoing business. Typical adjustments may include gains or losses on disposal of investments or plant and equipment, restructuring costs associated with closing a production centre, contract termination fees, etc.

A summary of a few key and common items

Restructuring costs

Restructuring costs are frequently included in adjustments to EBITDA. These are sometimes one-off costs for redundancy payments, cancellation of a lease, or relocation costs.

In other circumstances, adjustments are also made to remove the underlying salary cost incurred for part of the year for employees who were subject to severance during the most recent year.

Where these amounts are factually supportable and can be evidenced by accounting records, they can be comforted.

Pre-acquisition results

Adjustments are also often made to EBITDA to include the pre-acquisition results of companies that were acquired during the year.

Where these acquisitions are greater than 20% of EBITDA, the separate audited accounts of the company would be expected to be included in the offering memorandum. Where the acquisitions are smaller, there is often still a desire to include the EBITDA adjustment.

Pre-acquisition results often cannot be comforted by the auditor of the issuing company, as they were not the auditor of the acquiree previously.

Other non-cash items

Certain non-cash items may also be adjusted, such as share-based compensation or impairment charges.

Cost savings

By their nature, adjustments for planned cost-saving initiatives often do not meet the definition of a historical and verifiable item.

How we can help

It is important to fully understand likely EBITDA adjustments early in a financing, refinancing or leverage buy-out (“LBO”).

Thanks to our active presence and vast experience in the high-yield market as it has evolved over the years, we can advise you on what could be achieved and what would be acceptable in a high-yield-bond offering memorandum.

The initial task of looking at adjusted EBITDA is not a costly or time-consuming process, but it is very important in making sure that financing and refinancing options are taken up and LBO decisions are made with the right basic information and facts.

We have assisted many financial buyers, in particular those looking at financing or refinancing their existing portfolio companies or considering LBO scenarios.

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