

Deal Destination

April 28, 2020

M&A IMPACT: SHOULD CORONA LOSSES BE ADDED-BACK IN EBITDA COMPUTATION IN PE / M&A TRANSACTIONS?

The global economy and world at large, is reeling under the impact of COVID-19, with several countries under full or partial lockdown, affecting businesses, and resultantly, the revenue of several companies globally, in an economy which is increasingly dependent on cross-border trade. The impact that COVID-19 will have on the private equity and M&A market will be seen in the coming months. However, it appears that a pandemic of this nature has managed to get the investors and promoters into a huddle, to discuss the manner in which businesses are valued for the purposes of private equity and M&A deals.

EBITDA and its multiples is a common benchmark in private equity and M&A deals to determine the fair valuation of a company and therefore, to determine earn-outs and other post-closing adjustments. Given this background, in this article, we examine the basic tenets of EBITDA, the common adjustments made to EBITDA, including the manner in which COVID-19 losses are likely to be treated and the manner in which adjustments to EBITDA will be negotiated, going forward.

1. What is EBITDA? Does the concept of EBITDA have statutory sanction?

'EBITDA' stands for 'Earnings Before Interest, Tax, Depreciation and Amortization'. EBITDA is one of the more popular and commonly used benchmarks for determining the value of a portfolio. EBITDA is essentially an indicator of the operating profit performance of an enterprise. The calculation does not take into account, the impact of non-operating factors like taxes, interest expenses, intangible assets and non-cash expenses like depreciation and amortization. It is one of the primary methods adopted by investors to focus on the cash reserves of a company, by minimizing the non-operating components that may be unique to each company, depending on the capital and debt structure of the company. EBITDA, thus, provides an insight into the profitability of a company, eliminating entries that may be specific to such company, enabling a comparison with other companies operating in the same sector in the same jurisdiction; thus, assisting in the valuation exercise.

While the Indian Income Tax Act, 1961 does not recognize the concept of EBITDA as a methodology for determining the profitability of an enterprise, Section 94B does refer to the concept of EBITDA to limit the amount of interest deductions that may be claimed by a company. Besides this section, neither the tax laws in India nor the generally accepted accounting principles in India provide a statutory sanction to the concept of EBITDA from the perspective of valuation.

2. Given the lack of statutory backing to EBITDA, how is it relevant in private equity and M&A transactions?

Typically, private equity is creation of value in companies whose shares are not traded in public markets. Similarly, acquisition of private companies or control deals involving private companies take place off-market through a commercial understanding between the promoters and shareholders of the company being acquired and the acquirer. Unlike investments in public markets and acquisition of listed companies, where the investors have the benefit of the trading price to determine the valuation, private equity investors and acquirers have to rely on other methodologies, like an EBITDA multiple, to determine the valuation.

A multiplier of EBITDA is one of the most commonly used benchmarks to value a private company – this multiplier is usually determined on the basis of the trading price of companies in the same sector in public markets in the relevant jurisdiction. Besides, EBITDA also provides an insight to the investor into the debt repayment capacity of the company.

In a private equity or M&A deal, EBITDA's relevance is not limited to determining the deal value, but also with respect to determining the value of other components like promoter payouts and working capital adjustments. Often, control deals are effected in a staggered manner, whereby the price for acquisition of shares in the second and subsequent tranches is determined on the basis of certain metrics related to the valuation (*in most cases, an EBITDA multiple*).

3. Is EBITDA a genuine indicator of the financial health of a company? Are there any loop holes in the manner of calculation of EBITDA?

While EBITDA is a specifically helpful metric to determine the cash generation potential of an enterprise, its use as a genuine indicator of the overall financial health of an enterprise is questionable due to several factors. For instance, EBITDA does not consider tax and interest payouts, which are actual expenses that will have an impact on the financial health of the company and adding-back of depreciation, amortization and stock-based compensation to EBITDA may create an inflated illusion of the company's earnings.

Research Papers

Compendium of Research Papers

April 11, 2024

Third-Party Funding for Dispute Resolution in India

April 02, 2024

Opportunities in GIFT City

March 18, 2024

Research Articles

Private Client Insights - Sustainable Success: How Family Constitutions can Shape Corporate Governance, Business Succession and Familial Legacy

January 25, 2024

Private Equity and M&A in India: What to Expect in 2024?

January 23, 2024

Emerging Legal Issues with use of Generative AI

October 27, 2023

Audio

IBC allows automatic release of ED attachments: Bombay HC reaffirms

April 15, 2024

The Midnight Clause

February 29, 2024

Enforceability of unstamped or inadequately stamped Arbitration Agreements

January 10, 2024

NDA Connect

Connect with us at events, conferences and seminars.

NDA Hotline

Click here to view Hotline archives.

Video

Cyber Incident Response Management

February 28, 2024

Webinar : Navigating Advertising

4. What is 'Normalized EBITDA'?

As discussed above, in private equity and M&A deals, parties usually agree on certain adjustments that may be made to EBITDA either at the time of closing or post-closing, as part of payment of earn-outs or amount payable in the subsequent tranches. These adjustments are referred to as 'add-backs' in common parlance and the resultant number is often referred to as '*Normalized EBITDA*'. The rationale for such adjustments is that, since certain one-time, irregular, and non-recurring items do not have a predictive value, *that is*, since they are not repetitive in nature, these items should be adjusted so that the person analyzing these numbers is able to develop a better estimate of the true economic benefits of the operations of the company in normal market conditions and enhance comparability with similar companies. The nature of items that may be adjusted differ from sector to sector and deal to deal.

The American Institute of Certified Public Accountants defines 'normalized earnings' as economic benefits adjusted for non-recurring, non-economic or other unusual items to eliminate anomalies and/or facilitate comparisons. Items such as damage from natural catastrophes like hurricane, tsunami or human events such as labour strikes, litigation claim settlements are usually adjusted in the earnings.

The Indian Accounting Standards 5 ("**AS 5**") defines 'extraordinary items' as income or expenses that arise from events or transactions that are clearly distinct from the ordinary activities of the enterprise and therefore, are not expected to occur frequently or regularly. The AS 5 defines the term 'extraordinary items' in the context of inclusion of such items in the profit and loss statements. The AS 5 provides earthquake and attachment of property of the enterprise as examples of events that may give rise to extraordinary items.

From the above explanations, it may be inferred that, for an item to be adjusted from the earnings, it is essential that such item (a) be extraordinary or unusual; (b) be non-recurring in nature; and (c) have a direct nexus to the event that causes such expenses/losses. In this regard, one point that comes up for discussion is whether expenses towards repairs, maintenance or increased manufacturing costs should be added-back to the earnings or whether adjustments should be limited to expenses outside of the ordinary course of business. While there is no settled position on this, largely, the market view is that if an expense or loss can be justified as being extraordinary and non-recurring and a direct nexus with an extraordinary situation may be established, such expenses/losses should be permitted to be added-back.

Advocates of such add-backs justify it on the rationale that these items are truly extraordinary and non-recurring in that, non-inclusion of such items in EBITDA, is likely to result in a distorted return profile from the operations of the company, which will not reflect the actual profitability of the company in normal market conditions. However, critics of such add-backs are of the view that some of these add-backs may merely be a tool to inflate the financial results of the company and may ignore some factors that are likely to have a real economic impact on the company. While there is merit in adding-back such items in order to not allow such items to distort the valuation when such items will not have an impact on the financial health of the company, there is a potential for misuse when such add-backs become more frequent in use and the scope of such add-backs becomes wider.

Stock-based compensation in the form of sweat equity and employee stock options granted to promoters and employees that is added-back to the earnings, is subject to frequent debate. While such compensation is added to EBITDA (*that is, unlike remuneration expenses which would not be part of EBITDA, stock based compensation would be part of the earnings of the company*) since there is no cash outflow from the company, such compensation will ultimately result in the dilution of the remaining shareholders and will have an economic impact on their investments.

5. Would the losses or interruption in business caused due to COVID-19 qualify as an event that is 'extraordinary, unusual or non-recurring' and thereby, permitting an add-back to EBITDA?

To analyse this, let us consider whether a pandemic will constitute an 'extraordinary, unusual or non-recurring' event. This determination will have to be made on a case to case basis, subject to the language in the contract (*specifically, whether business losses or additional expenses incurred due to a pandemic are permitted to be added-back*).

If a pandemic of this nature is identified as one of the trigger events permitting an adjustment to EBITDA, the nature of amounts that may be adjusted will need to be determined – for instance, whether the language covers only add-back of any additional expenses incurred by the company during COVID-19 or whether it also covers losses due to interruption or cessation of business.

Further, the language must be carefully examined to determine whether the promoters/shareholders and/or the investor/ acquirer has the right to determine the permissibility, scope and extent of such adjustments.

Let us take a sample definition of EBITDA for analysis:

"EBITDA" means earnings for the year ended March 31, 2020 (normalized on the basis of averages of year ended March 31, 2018 and March 31, 2019) but before interest, taxes, depreciation, amortization and non-cash items calculated in accordance with applicable accounting standards, and after adding back all non-recurring expenses and removing all one-off gains.

After analyzing the above definition and the explanation of 'Normalized EBITDA', one may argue that any additional expenses incurred by a company in its operations by reason of COVID-19 (for example, increased expenses for procurement of additional or different raw material or investing in new technology, etc. which is required solely due to the effects of COVID-19), should be permitted to be added-back to EBITDA, provided such expenses can be shown to be extraordinary and non-recurring (*that is, such expenses will cease once the pandemic is resolved*). However, since the definition uses the term 'non-recurring expenses' and not 'non-recurring losses', while it may be argued that the company should be able to add-back the increased expenses, the losses due to COVID-19 may not be permitted to be added-back. For instance, if there is cessation in the business of a company, due to the manufacturing unit being closed or unavailability of workmen, the notional losses incurred as such, may not be added-back by virtue of this definition.

6. What is the foreseeable impact of valuation in private equity and M&A deals under negotiation?

For the deals still under negotiation, especially in sectors that have been affected by COVID-19, it is likely that the valuation will be re-negotiated, the extent of which will depend on whether the investor/ acquirer foresees the impact

of COVID-19 to be short-term or long-term. In this regard, one practical approach that may be taken to arrive at 'Normalized EBITDA' is to annualize the earnings of the company for a few months pre-COVID-19 and a few months post-COVID-19. This number is likely to provide a more accurate picture of the earnings of the company, legalese aside, since it factors in the earnings in normal market conditions, ignores the effect of a pandemic and factors in the earnings post the pandemic, in a market which would have likely changed post a pandemic of this nature.

With respect to deals that have closed fully or in part, if the documentation provides for post-closing adjustments or valuation adjustments in the subsequent tranches, it will not be surprising if such adjustments are negotiated. However, it is also important to note that under Indian foreign exchange laws, a window of 18 months is available to the buyer from the date of the transfer agreement, to pay the deferred consideration. This may also give rise to potential disputes if the parties are unable to reach an agreement with respect to adjustments.

7. Will business interruption insurance help in adjustment of EBITDA?

If a company has availed of an insurance policy, covering business losses and related risks, it may be able to add-back the losses/ expenses covered by the insurance policy, provided the documentation contemplates such adjustment. The justification for making such adjustments is that since these losses/ expenses are capable of being recovered from the insurer, it will not have an impact on the cash situation of the company.

8. How does one achieve a balance between the interests of the investor/acquirer and the promoters?

While a higher EBITDA is more beneficial to the promoters, if EBITDA is inflated in an unrealistic manner, the resultant impact may be unfair to the investor/ acquirer. Conversely, leaving out certain irregular and one-time losses from EBITDA may be unfair to the promoters, as this may reduce the valuation substantially, though such events are extraordinary and may never occur again. It is, therefore, essential that the nature, scope and extent of adjustments be narrowly identified and such clauses be interpreted strictly.

CONCLUSION

COVID-19 and its impact is yet to be tested on private equity and M&A deals in the offing. While, from a short-term perspective, the impact on valuation may be temporary, it is certain to change the manner in which adjustments to EBITDA are commercially negotiated between parties and documented. Adjustments to EBITDA are likely to become one of the most negotiated points in a deal – with the promoters negotiating for more add-backs and the investors/ acquirers restricting such add-backs.

– **Saumya Ramakrishnan & Ruchir Sinha**

You can direct your queries or comments to the authors

DISCLAIMER

The contents of this hotline should not be construed as legal opinion. View detailed disclaimer.

This Hotline provides general information existing at the time of preparation. The Hotline is intended as a news update and Nishith Desai Associates neither assumes nor accepts any responsibility for any loss arising to any person acting or refraining from acting as a result of any material contained in this Hotline. It is recommended that professional advice be taken based on the specific facts and circumstances. This Hotline does not substitute the need to refer to the original pronouncements.

This is not a Spam mail. You have received this mail because you have either requested for it or someone must have suggested your name. Since India has no anti-spamming law, we refer to the US directive, which states that a mail cannot be considered Spam if it contains the sender's contact information, which this mail does. In case this mail doesn't concern you, please unsubscribe from mailing list.