EBITDA Adjustments From Crazytown

By Brent Beshore (http://www.axial.net/author/brentbeshore/), adventur.es | January 28, 2016

At least once a week, we find ourselves looking through adjustments made to earnings before interest, taxes, depreciation and amortization (EBITDA) on a business for sale, and saying, "What in the world...?"

Adjustments can be perfectly acceptable. Owners run excess personal expenses through their business that would not be assumed by a future owner (i.e., fun trips, memberships). Sometimes, family members are paid far-above-average salaries and will not be continuing with the company. On justifiable adjustments, you'll hear no contest from us. However, just because adjustments are justified, doesn't mean they'll leave a good impression on investors. We recently saw a business barely breaking even with a sizable adjustment for private air travel; such adjustments speak volumes about priorities.

Lately, we've started tracking some of the bogus adjustments people try to deduct out of companies. Here are some anecdotes illustrating how wishful thinking intersects with the bottom line.

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Owner Compensation

The most common add-back is completely subtracting owner compensation, boosting the supposed bottom line by between $200,000 and more than $1 million. Yet, they are usually the leader(s) of the company.

Some owners work full-time, while others are serving in more of an advisory capacity, but unless they permanently reside in another state without any oversight of or contact with the business (including financial), they are doing something worth a dollar amount. That figure may not be the same amount they've been paying themselves, but it's definitely not $0.

Leadership Compensation

A 150-person company had a leadership team of five people. All the leaders were paid quite well, based on below-market salaries and generous performance-based incentive compensation. The CIM argued that they were paid too well for the industry. So, each person's salary was adjusted down to an industry average, reducing the overall leadership compensation pool by more than $600,000. When we inquired as to whether the current team would be staying post-transaction and under what conditions, the intermediary explained that the adjusted salaries were meant as a starting point and that each leader expected to renegotiate his/her total compensation with the new owner, including base salary, incentives, and equity.

Imagine walking into a company and saying to one of the key leaders, "Hi, we're your new owners. We've heard you're an essential leader within this company we need to work hard to keep, but we're going to reduce your salary down to the industry average." Would you stay? Why should a buyer account for less than anticipated compensation?

Sub-Contracted Labor Costs

A manufacturing company kept a lean full-time team, and used sub-contracted labor during seasonal periods, which is perfectly reasonable. What was not reasonable was the more than $200,000 adjustment for "excess costs of sub-contracting."

A company can't have it both ways. A bigger team means bigger year-round operational costs. A lean team means you take a hit when extra labor is required. Pick the operating style and own it.

Marketing Expenses

A particularly courageous CIM presented a list of adjustments that included more than $200,000 in marketing expenses. We immediately requested further explanation and were told that it was an ineffective online marketing campaign the company had run the previous year for a new product line introduction.

Ineffective spending is still real spending. Enough said.

“One-Time” Expenses

Adjustments related to one-time expenses are quite common. Two examples of creative implementation include the cost to develop a company’s website and inventory write-offs conducted every year.

There are occasional one-time expenses that should be adjusted out, but they are rare. We often find lots of recurring non-recurring expenses. More often, these expenses represent necessary costs of doing business above and beyond the line items that normally appear on a company’s annual income statement. The bottom line is that, regardless of whether it’s normal, if it’s a necessary cost of doing business, it shouldn’t be adjusted out.

Research & Development Expenses

Companies seeking to grow must engage in ongoing investment, including R&D. In one recent case, the revenue from a new product line was included, but the associated costs of developing that line were adjusted out.

New revenue streams aren’t delivered by stork. Sustainable businesses require ongoing investment, which a buyer will have to invest in as well.

Retroactive Change Benefit

Two recent CIMs added back projected savings from recent, or even yet-to-be-fully-implemented, changes in process or software retroactively to previous years.

You can’t change the past. The best way to present effective change improvement is to provide evidence of its actual impact and how it might look in the future.

Legal Fees

A company had an unfortunate two-year legal battle. The CIM adjusted out over $700,000 in legal fees related to the “one-time litigation event."

If a company must enforce its position by legal action, or if its customers, suppliers, or competitors initiate suits against it, the company must spend real money. That won't change with ownership, and evidence of a substantial legal history will tell a prospective buyer that such events must be accounted for in projections and valuation.

A productive question to ask in making EBITDA adjustments is whether a public company could deduct such expenses to boost earnings presented to shareholders. Can a CEO be adjusted out? Can a leadership team's salaries be calculated as industry averages rather than what a company actually pays them? Can a website exist, be regularly updated, but not actually cost anything? No, unless you're Enron.

Including EBITDA adjustments from Crazytown may help you feel like you're presenting a better illustration of the company's earnings potential for a prospective buyer, but it's counterproductive. These types of adjustments create distrust with prospective buyers. And buyers are generous in estimates they must make independently. If you leave a gap, such as assuming there will be no acquisition costs in hiring competent leadership, the buyers will inevitably insert a big round figure into their formula to cover all unknowns.

The best advice on creating a list of adjustments? Be honest and conservative. The relationship with buyers will start out on a much warmer and productive path.

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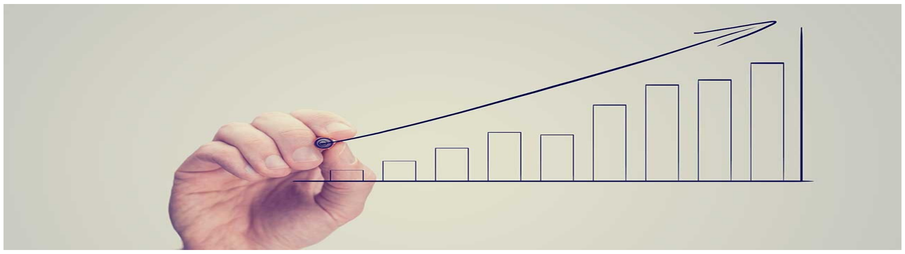
By Karen Sibayan | ***January 13, 2016*** ()

(http://www.axial.net/forum/what-is-ebitda-and-why-do-investors-care-about-it/)

During negotiations in an M&A deal, buyers and sellers look closely at several factors in order to agree on a price that properly captures a company's value. One of the closely examined metrics in this process is EBITDA, which stands for earnings



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