The Art of Addbacks

Learn as much as you can about this part of an M&A negotiation. It can ruin a deal.

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We were asked recently why deal facilitators like us provide not only EBITDA (earnings before interest, taxes, depreciation, and amortization) on our information sheets but also "adjusted EBITDA." This term lumps together a bunch of one-time and special factors—known as "addbacks"—that can substantially raise or lower the original EBITDA figure. Nearly all M&A transactions have addbacks, and their size, number, and style can matter a lot.

Addbacks can boost EBITDA when an item that's part of current operating costs won't continue under the new ownership. For example, the payroll may include a seller's relative who doesn't do any work.

Addbacks can also be negative. If the selling company pays rent to an affiliated entity at below-market rates, the rent increase for the buyer constitutes a negative addback. Another mistake is to add back the entire rent expense on the assumption that the buyer will own the real estate. First, most don't buy real estate. Beyond that, though, buyers typically will bake in a market rent regardless of whether they choose to actually be their own landlord.

Owner compensation can produce both positive and negative addbacks. Consider the case of an owner who stopped taking a salary or now pays himself $50,000 a year for work that on the open market would be worth $200,000. In this example, the buyer knows they would have to quadruple the CEO's payroll line to get the right executive in place. That addback would reduce the company's EBITDA by $150,000.

Going the other direction, some owners trying to sell the company think they can add back their entire salary and benefits to the EBITDA line. That would be the case, but only if no replacement for the owner would be hired post-transaction. And owners whose salary exceeds market norms can add back the excess.

How much should get added back also varies based on whether owner compensation comes through salary (in which case it's part of operating expenses) or a distribution (in which case the dollars show up on the balance sheet).

Acknowledging negative addbacks rather than making the buyer find them shows honesty and good faith. That matters, because it may take time for the buyer to accept the addbacks.

Even if a seller has focused on well-documented and valid addbacks, there still may come a point where the sheer number or dollar amount of them make buyers nervous. A private equity investor told us recently that they had seen a company with so many addbacks that actual EBITDA went from a negative to a positive $2 million adjusted EBITDA. Some buyers will begin to discount addbacks once they reach too high a percentage of total adjusted EBITDA. This is because the buyer assumes that, if the addbacks were real, the company would have captured more of them.

Most buyers do approach EBITDA addbacks with a healthy level of skepticism, but they accept most that are properly presented.

Adjustments should be presented in a truthful, thorough, and well-documented manner. Prospects then will analyze them and calculate the risk of the company not delivering the adjusted EBITDA when the company comes under new ownership. The successful buyer will be the one that is the most accepting of the adjustments and, thus, sees their way to placing the highest valuation on the company.

ILLUSTRATION: PATRICK WELSH