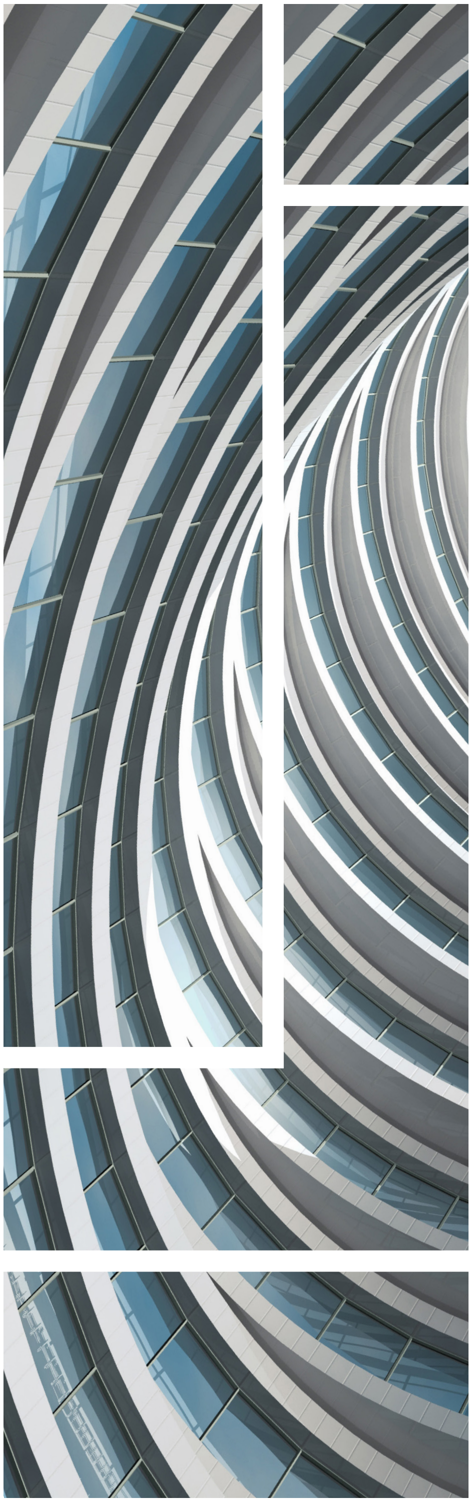
Are Normalized Earnings Acceptable? A Deep Dive into EBITDA Adjustments during the Pandemic



The challenges created by the pandemic have led CFOs to evaluate whether they should include incremental adjustments to Earnings Before Interest, Taxes, Depreciation, and Amortization, or EBITDA, as they attempt to accurately measure the earnings power of their company.

EBITDA adjustments have long been accepted by lenders and sponsors to more accurately estimate a company's earnings power and better reflect how a buyer would evaluate its performance. Commonly accepted adjustments across the industry—and particularly in compliance certificates agreed to between sponsors and lenders—include one-time expenses, like litigation or transaction related costs, and non-cash expenses, like impairment charges and stock-based compensation.

An unprecedented event like the pandemic would seem to be the existential moment for EBITDA adjustments to skyrocket as companies attempt to normalize earnings. Yet, surprisingly, the magnitude of EBITDA adjustments has waned, decreasing from 24.4% of EBITDA in Q4 2019 to 21.8% of EBITDA in Q4 2020; even more astounding only 1.6% were related to explicit pandemic derived adjustments, as indicated by analysis performed by Lincoln International across a database of over 1,700 predominately privately held portfolio companies. It seems unlikely that companies would not factor in adjustments to earnings given the circumstances, which may suggest that businesses are taking different approaches to estimating normalized earnings.

As CFOs evaluate the earnings power of their company, one question looms large: should I consider adding back pandemic related losses and costs? Or is the industry accepting different ways of measuring my company's performance?

THERE IS NO ONE SIZE FITS ALL

The answer to the above question depends on the company itself and in the context of the industry it operates at large. For businesses that experienced demand destruction during the pandemic, then it would be difficult to argue that you would return to historical levels and adjust EBITDA on this basis. However, for those that experienced demand disruption a very strong argument could be made that the business will eventually return to pre-COVID levels and therefore incorporating an adjustment would be deemed acceptable.

When assessing the appropriate value driver, buyers and sellers are striking a balance between prioritizing historical performance while being open to looking at additional metrics. However, in cases where companies were heavily disrupted, CFOs can convincingly argue that Last Twelve Month (LTM) EBITDA during the pandemic is not the right valuation driver as it would not capture the true earnings power of a company. Instead, other measures of earnings power should be considered.

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DETERMINING THE APPROPRIATE VALUE DRIVER

The events of 2020 could not have been predicted and were beyond expectation. The market recognizes that earnings need to be normalized, but to what degree remains of great debate. Sellers will not sell at trough earnings, but buyers need assurances that the lower earnings levels are not the new norm. As a result, three strategies have gained popularity in measuring earnings power during this time:

1. **Annualizing Earnings**
   For some, business during Q4 2020 returned to more normal conditions than in April to June when COVID-19 was at its height. As such, for businesses disrupted by COVID-19 in the spring, annualized earnings either in the form of Last Quarter Annualized (LQA) or annualizing post June performance may be a more accurate measure of business performance than metrics from 2020.

2. **2021 EBITDA**
   CFOs are more comfortable assessing 2021 EBITDA because they have better visibility into the full year's budget, including contracted revenues and full implementation of cost-cutting measures, and as a result would prefer to focus on 2021 performance and underweight 2020 results.

3. **The Swap Out**
   Another twist to LTM EBITDA is to replace the months most impacted by COVID-19 with the earnings results of those same months from 2019. Swapping out those months with 2019 performance is an easy way to reflect actual levels that were once earned.

No matter what path is chosen, it is critical that the metric selected is as defensible as possible. Evaluate KPIs to ensure the normalized metric selected is one that market participants would actually rely on. One strategy is to pressure-check your own approach, just as a valuations team would do during a due diligence discussion. Ask yourself: If you are accounting for cost savings made during 2020, are these temporary or truly permanent cost reductions? Are incremental costs required to generate growth? And have you achieved these earnings levels before? Ultimately, when considering any normalization or adjustment to earnings, be careful that you are not overstating EBITDA and that you can provide a clear rationale to solidify your position as buyers and sellers will certainly ask questions.

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