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EBITDA and credit stretching

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Earnings season will get underway next week. Banks should live up to their reputation as being boring albeit with pretty good results. Loan growth looks as though it will be modest, but net interest margins should increase following the March and June rate hikes and the accompanying move higher in the London Interbank Offered Rate. And credit does not seem to be on investors' radar beyond concerns about retail commercial real estate generally and auto and credit card losses specifically following several years of rapid credit growth. Healthcare might go on the list, too, if a handful of unrelated situations at several banks that required provisioning last quarter occur again.

That said, I wonder about the serenity-until-further-notice environment after recently attending Creditflux's Private Credit conference on lending to private middle-market firms by credit funds. The presenters and panelists by and large were lenders of their and their clients' capital with some amount of leverage added to enhance returns. Like many Street commentaries found elsewhere, there was musing about it getting late in the cycle eight years after a very deep recession ended and a modest recovery began. What got my attention, however, was a discussion about EBITDA, or earnings before interest, taxes, depreciation and amortization.

EBITDA as a universal measure of unlevered earnings may get more play than is warranted because CapEx requirements can vary widely among firms even within the same industry. Nevertheless, EBITDA is the baseline profitability measure for lenders and equity investors across many if not most industries other than financials. Creditflux held a panel discussion titled "Getting EBITDA right." My more descriptive title after listening to the panel's comments would be along the lines of: "Is adjusted EBITDA a hoax?"

If this seems like an offbeat observation about a sector that has attracted vast sums of capital since the financial crisis, I think it is worthy of bank investors' consideration. Another take is that leverage is understated, at least as it relates to leverage lending generally, though perhaps more broadly, too.

One business development company executive on the panel called adjusted EBITDA something akin to broad-based stupidity in the market. When asked by the moderator what was an acceptable amount of adjustment, the panel indicated that something on the order of 5% to 10% would not raise too many eyebrows. The discussion then turned to how aggressive adjustments had become in recent years. Why? Because there has been a flood of capital into the once-obscure private credit market given a dearth of fixed-income investments that provide much yield and the pullback by commercial banks as a result of post-crisis regulations. It seemingly has the makings of a scenario of outsized losses whenever the next downturn emerges, or even if there is a modest pullback in credit availability as has occurred with subprime auto and credit cards.

Covenant Review reports that over the past two years, leverage multiples for leverage buyouts, or LBOs, based upon adjusted EBITDA has been running in the vicinity of 5.5x, while leverage based upon reported EBITDA has ranged from about 6.0x to 7.5x, with each of the last four quarters as of March 31 exceeding 7.0x. There is nothing new per se about add-backs, but the gap is wide and points to stretching, referenced by the Creditflux panel to indicate leverage that is higher than it appears.

Xtract Research offers a case in point with the term lenders to J. Crew Group, which operates struggling retailer J Crew. Its total leverage was 8.4x latest-twelve-months adjusted EBITDA as of March 31; however, leverage calculated under the looser covenant definition was below the 6.0x requirement after add-backs for costs to close and open stores, for strategic initiatives and for business optimization costs. The research firm does not describe what the difference is between the reported "adjusted" EBITDA and reported EBITDA; nevertheless, the effect of the add-backs is to disguise leverage and therefore credit risk. In J. Crew's case the "who cares" about adjusted and covenant EBITDA multiple matters because the term loan creditors are litigating the rights to the trademark that were moved from one subsidiary to another to affect a restructuring of other debt. One of the covenant tests is, of course, debt that does not exceed 6.0x EBITDA to take certain actions.

Public-market equity investors should sympathize with the credit investors who are pointing fingers at each other about who is responsible for moving the goal posts. Maybe it was equity investors who set the stage. The panel did not offer any dating of out-of-control adjustments to EBITDA, but my comparative public equity analogy began a couple of decades ago when investors began to focus less on what a company made in the form of latest-12-month earnings in favor of quarterly operating earnings that are necessary to create a bridge to the next year's higher earnings. When that next year arrives, the process is repeated via add-backs to create the bridge to the subsequent year with its higher earnings. Wall Street is a sales organization, and the focus on next year's higher earnings offers a lower valuation than the here-and-now as reported.

One other observation made by the credit investors centered on liquidity risk with finger-pointing that some elements of the private credit market were overly reliant on short-term borrowings to fund longer-term assets. If Fed hikes, as some now argue, are really designed to somewhat deflate asset bubbles, then the comment is an interesting one. Funding mismatches can lead to more pressure on asset values, even unrelated ones as long as they are liquid, as levered investors are forced to sell assets that cannot be refinanced.

All this is not to argue a turn in the credit cycle is at hand, but many of the traditional signs that it is late in the cycle are popping up, including Fed rate hikes and what appears to be stretching in the credit markets to find incremental yield.

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