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# Add-backs: ‘some are real, some are fictitious’

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By: **Justin Slaughter**

*Borrowers and sponsors are getting more creative in reporting earnings on mezzanine deals, panellists at Pension Bridge conference said.*

With deal terms loosening, fund managers should take a closer look at the earnings private equity sponsors and borrowers report, advisors and investment managers said on a mezzanine debt panel at the Pension Bridge conference in Chicago on Tuesday.

The panel agreed some companies are projecting questionable future earnings in order to boost leverage levels on mezzanine debt deals, taking advantage of the crowded private debt space, which makes it harder for lenders to turn down a deal.

Chris Wright, a managing director in Crescent Capital Group’s mezzanine group, said there is now a common disconnect in private credit between the reported earnings on a quality of earnings report and the realistic picture of the company’s financial position.

For example, his firm saw a deal with a company that had reported $300 million in EBITDA, but $50 million of that total was add-backs and another $50 million was “synergies”, or expected revenue increases or cost savings through combining aspects of the company’s team or platforms.

“You’re seeing a lot of window-dressing, if you will,” Wright said, and when it comes to add-backs, “some are real, some are fictitious”.

Despite the creative add-backs in the space, gross returns in the mid-teens have “largely held at [the] lower part of market”, or where companies with sub-$50 million EBITDA operate, said Tom Cawkwell, head of private markets research at financial advisory firm Albourne America.

All the panelists agreed that leverage levels on mezzanine deals are typically in the 5x to 7x range. The most important risk in the mezzanine debt this space is that amount of leverage going up and equity

cushions shrinking, Cawkwell noted.

FT Chong, head of structured capital at PineBridge Investments, said its “very dangerous” for a lender to rely only on the reported earnings from accounting firms alone.

Chong said lenders need to dig deeper and do the real “forensic work” by looking into the borrower’s run rate, equity cushions and the cash flow, as opposed to projected earnings that are impossible to prove or disprove.

“There’s a zero percent accuracy rate in financial projections,” Chong said. “I look at what a company generates currently… which is not necessarily the price paid by the sponsor.”

Limited partners are still committing a fair amount of capital to mezzanine strategies. Private debt funds targeting mezzanine debt globally raised a total of roughly $16.01 billion the first half of this year, representing 26 percent of the $61.6 billion aggregate that such funds raised in H1, according to *Private Debt Investor*’s H1 Fundraising Report 2017.

According to a Coller Capital survey of 110 institutional investors around the globe – which the firm presented at the conference on Monday – at least 37 percent of the LPs polled believe that mezzanine debt will provide attractive credit investments in the next two years.

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