Non-Recurring Charges in a Valuation

- Question that came in the other day…

- “When you’re forecasting the Income Statement, shouldn’t you remove the **non-cash items** such as stock-based compensation and provisions for losses? What about extraordinary items? It’s difficult to understand a company if you leave them in there.”

- “How do you **decide** when to add back or remove these items, and when to ignore them?”

Non-Recurring Charges in a Valuation

- There is a **TON** of confusion about this topic:
- **Non-cash** vs. **non-recurring** charges
- **How** do you find non-recurring charges?
- **Add** them back? **Remove** them? **Ignore** them?
- **Why** do they even matter in the first place?

Why I Hate Non-Recurring Charges

- **Admission:** I have a <u>personal vendetta</u> against non-recurring charges…

- Excellent way to **waste time** when valuing companies – cruel and unusual punishment from senior bankers

- **Why:** Non-recurring charges only impact the *historical* financials, and in a valuation you are mostly concerned with <u>future estimates</u> (in a DCF) and <u>forward multiples</u> (from the comparables)

Non-Recurring Charges 101:

- **Why** do non-recurring charges matter?
  - **Historical** financial statement analysis and metrics – might throw off the numbers

- **How** do you find non-recurring charges? (Two solutions depending on the level of detail you need…)
  - **Quick** IS and CFS analysis, and/or…
  - **Detailed** review of the notes to the statements

- **Do** you add them back or adjust in some way?

Why Do Non-Recurring Charges Matter?

- Could **throw off** financial statement analysis and multiples such as EV / EBITDA in the historical period

- **EX:** Company records a big write-down or a big Gain or Loss… is that item really representative of the company's *ongoing*, *recurring* business activities? NO!

- **Example for Alcoa:** The big Goodwill Impairment charge really throws things off in Year 2, so we should consider adjusting for it

Why Do Non-Recurring Charges Matter?

- **But…** does this *really* matter for valuation / financial modeling / analytical purposes?

- I would say, **"No"** because it's not in the most recent period – and normally you focus on the LTM or Last Fiscal Year figures when calculating valuation multiples

- So you care more about <u>very recent</u> or <u>anticipated</u> non-recurring charges

How Do You Find Non-Recurring Charges?

- **Easy Method:** Look at the Income Statement and Cash Flow Statement and search for anything that might be "non-recurring," i.e. it does not appear in every year

- Does **NOT** matter whether an item is cash or non-cash – all that matters is **whether or not it impacts the metric you are calculating, such as EBIT or EBITDA**

- Companies will often, though not always, list major non-recurring items on the IS and CFS

How Do You Find Non-Recurring Charges?

- **Alcoa:** We are **NOT** adding back Restructuring because it's effectively a recurring item

- **Alcoa:** Not adding back Stock-Based Compensation, Provisions for Doubtful Accounts, etc. – yes, they're non-cash, but they're <u>not</u> non-recurring

- **Alcoa:** What about Gains and Losses? And does anything else exist? Need to do some more <u>detective work</u> now… time permitting

How Do You Find Non-Recurring Charges?

- **Hardcore Method:** Sift through the Notes to the Financial Statements if you have hours of time to spend

- **COGS:** A few write-downs… but are they non-recurring?

- **Other Income:** Gains from CFS appear there – so we don't add these back – don't impact EBIT or EBITDA

- **Restructuring:** Could make the case that the Loss is non-recurring… but even that is debatable

Do You Add Back Non-Recurring Charges?

- **Historical Financial Statements:** No – you only “add them back” in metrics like EBIT, EBIDA, and *maybe* “Pro-Forma” Net Income (but not getting into that here)

- **Criterion #1:** Is it really non-recurring? *Really*? **HAS NOTHING TO DO WITH CASH VS. NON-CASH!**

- **Criterion #2:** Does it actually <u>impact</u> the metric you are adding it back to?

Non-Recurring Charges 101:

- **Why** do non-recurring charges matter?
  - **Historical** financial statement analysis and metrics – might throw off the numbers

- **How** do you find non-recurring charges?
  - **Quick** IS and CFS analysis, and/or…
  - **Detailed** review of the notes to the statements

- **Add Back?** Only if they're non-recurring and "above-the-line" (i.e., they affect the metric you are calculating)