

EBITDA – VIRUS OR VACCINE?

Position Paper by Performance Enablers LLC

A Benchmarking Company

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EBITDA is one of the more popular measures of cash flow – because it levels the field between companies with different debt loads. It is for that reason and others we will address, that we ask the question, Is that really a good idea? We have some thoughts and suggestions by the end of this article to make the small to medium size privately held business holder think about their current use of metrics in the decision making process.

Having this short hand EBITDA has become universal among publicly held companies when holding their analyst calls. EBITDA was insider talk for this is how I want to you look at my cash flow.

Since we already had in place GAAP (Generally Accepted Accounting Principles) supported by the rule of law from FASB (Federal Accounting Standards Board). FASB derives its power because it is the accepted standard for the Securities and Exchange Commission. The final link in the chain – The SEC determines what is legal or not on the stock exchanges.

So we have in place a reasonable set of rules agreed upon and used for rule of law since 1973 when adopted by the SEC. What makes a CEO / CFO of a publicly traded company want to have some other way to define their performance?

Maybe under GAAP their performance does not look so appealing. In order to offer an alternative – perhaps more appealing picture to the investing public EBITDA was born.

EBITDA is Earnings Before Interest, Taxes, Depreciation & Amortization. It is calculated by starting with the Operating Income and adding back depreciation and Amortization. EBITDA became a profit indicator commonly used by public reporting companies when other measures were not presenting such a rosy picture.

‘Take Coke and Pepsi in fiscal 2001, for example. Both of these companies operate businesses that are easy to understand.

	Coke	Pepsi
Revenue	20,092	26,935
Cost of Goods	6,044	10,754
Gross Profit	14,048	16,181
Selling & Admin. Exp.	8,696	11,608
Operating Income	5,352	4,021
Depreciation & Amort.	803	1,082
EBITDA	6,155	5,103

For you purists out there who will actually look at the entire income statement, both Coke and Pepsi have items like interest income, equity income in affiliates and other non-operating gains and losses that I have excluded from the above to keep it simple.

Assuming you could place your own capital structure on either of the companies above and assuming only the information given, which company would you buy? How about Coke? Why? Several reasons. First, Coke generates over \$1 billion more than Pepsi in economic cash flow that you could use to pay interest, taxes, and other stuff. EBITDA as a percentage of sales was 30.58% for Coke and 18.95% for Pepsi. Second, operating income for Coke is greater by more than \$1.3 billion and as a percentage of sales is 26.64% for Coke versus 14.93% for Pepsi. Additionally, the ratio of Gross Profit to Selling expense is 1.62x for Coke and only 1.39x for Pepsi. Coke is much more efficient in operating its business than is Pepsi. It generates both higher operating income margins and uses fewer dollars of selling expense to generate a dollar of gross profit than does Pepsi.

Don't fall into the EBITDA trap however. GAAP operating cash flow for both companies is essentially equal in fiscal 2001. Take a look.

	Coke	Pepsi
Net Income	3,969	2,662
Dep. & Amort.	803	1,082
Other Gains/Losses	-200	373
Changes in Work. Cap.	-462	84
GAAP Oper. Cash Flow	4,110	4,201

Coke had \$200 million in other losses versus \$373 million in other gains for Pepsi, making for a \$573mm swing to Pepsi's advantage. Likewise, Coke invested \$462mm in working capital for such things as inventory and accounts receivable on an aggregated basis. Pepsi generated \$84 million in cash from similar items, providing a \$546 million advantage for Pepsi. So, as Coke was more operationally efficient as demonstrated above, Pepsi did a much better job at generating other gains and losses and at managing their investment in working capital (inventory and receivables, primarily) than did Coke.¹

So is EBITDA a Virus or Vaccine?

VIRUS – a harmful or corrupting agency – infectious agent that replicates itself – software program capable of reproducing itself and usually capable of causing great harm.

Vaccine – immunogen consisting of a suspension of weakened or dead pathogenic cells injected in order to stimulate the production of antibodies. Something containing some of the harmful stuff to stimulate the immune system to produce a protective agent.

Let's start with **VACCINE**. Does EBITDA contain any of the good stuff maybe weakened or dead? Well it certainly has some of the important issues an investor wants to know about the health of a company. Things like Earnings. Are the earnings results weakened? They don't tell us about the taxes, depreciation or amortization being accounted for by the company. So does EBITDA stimulate any positive reaction within the organization? Like so many Vaccines we may never be sure this was the sole agent for change.

It EBITDA a **VIRUS**? Does EBITDA act like an infectious agent and spread itself into a harmful agent within the company and investment community?

‘EBITDA like most financial metrics is only a tool and the without sufficient understanding of its limitations and in the wrong hands, is indeed a dangerous measure of performance, like most anything else when it is your sole focus.’¹ SO HERE IN LIES the core for a Virus.

‘In the proper context and with its limitations fully exposed, EBITDA is a valuable metric. There are at least two implicit assumptions that must be considered when using EBITDA.

1) Working capital needs are self funding over time.

GAAP operating cash flow is defined as net income, plus depreciation, plus or minus changes in working capital items such as inventory, AR. GAAP also considers other changes in current assets and liabilities. EBITDA does not include changes in working capital.

2) Current capital structure and tax structure are irrelevant.

The problem is that interest and taxes must usually be paid in cash and EBITDA is marked up for these legitimate expenses. GAAP operational cash flow already has interest, and taxes subtracted – it starts with net income.

Therefore EBITDA does not reflect changes in working capital needed to finance inventory and receivable growth (both vitally important to small – mid cap businesses) nor does it reflect legitimate expenses like interest and taxes.’¹

Well then what good is it? This EBITDA? ‘It is a great measure of what can be called economic cash flow. That cash flow available to the owner to actually pay for such things as interest expense, income taxes, and capital expenditures. It is also a good way to compare similar companies with vastly different capital structures.’¹ This is one reason why EBITDA is used by the Commercial lending community as one of several determining factors for loan preference.

Is EBITDA the only or best way to accomplish this objective? The objective being is this company being efficiently run and is it profitable enough to sustain its growth?

OTHER METRICS TO CONSIDER FOR SMALL BUSINESS

‘NOPAT is Net Operating Profit After Taxes. This looks at profit without considering Interest or Extraordinary items. It is calculated by starting with the Operating Income and subtracting the tax expense.

NOPACI is Net Operating Profit (after taxes and after interest) as a percent of net revenue, less Cost of Capital as a percent of net revenue. It is the Operating profit less Capital charges.

The Cash Flow Statement reconciles a company's Net Income to the change in Cash. The cash flow of a company is important, because --- *even though a company is profitable, it may have too little cash to meet its obligations*'²

NOW YOU CAN BE OFFICIAL CONFUSED!

'The basic formula that we all MUST internalize:

Net Income

+/- Net Cash from Operations

+/- Net Cash from Investing

+/- Net Cash from Financing

= Change in Cash'²

Cash is king for small to mid cap firms both private and public. The real difference is when we talk about privately held companies we are more directly into the stakeholders personal pocket book.

“Cash is KING” is a mantra for small business and its service providers. And yet, of the businesses that are growing 80% will run out of cash this year. Why? Measuring and watching the wrong metrics.

Is EBITDA a Virus contributing to this evil result? It could be. However, I have never heard anyone blame the demise of a company on EBITDA.

I am not sure that EBITDA or any financial metric is either virus or vaccine. I rather tend to believe that we have allowed it to become virus like in sole focus on it.

Lending reports are based on EBITDA as a percentage “For the month ended June 17, 2004, for all highly leveraged loans, the average EBITDA/Interest was 3.5x with EBITDA – CAPEX/Interest was 2.9x. As we have noted previously, leveraged has increased across the loan market.”

Remember the Coke and Pepsi Example lets look at two other reporting methods this time using our household budget as the sample:

Analytical Ratios

In your personal lives, if you followed the accounting methods businesses use, you might analyze you monthly finances as follows:

Salary & Bonuses	\$6,000	← Revenues
Less Non-Financial Expenses (ie: Utilities, gas, food, entertainment, Dinner out, clothes, etc.)	\$1,200	← Operating Expenses (Utilities, Transportation, Raw materials, Salaries & Wages, etc.)
Taxes (Federal, State, FICA, etc.)	\$1,500	← Taxes for Uncle Sam
Net Operating Income before Interest	\$3,300	← NOPAT—(Net Operating Profit After Taxes)

Wow, you are doing great with a 55% Operating Profit !!

But wait. Where's the \$2,600 Mortgage and \$400 Car Payments ????

Let's take another look.....

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Taxes (Federal, State, FICA, etc.)	\$1,500	← Taxes for Uncle Sam
Income before Interest	\$3,300	← NOPAT—(Net Operating Profit After Taxes)
Less Interest on Loans (ie: Mortgage, Car loans, etc.)	\$3,000	← Capital Charges / Interest (Fair return to Lenders & Shareholders)
Change in Net Worth	+\$ 300	← Economic Profit

NOW I get why we don't just use NOPAT, but more importantly NOPACI !

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SO WHAT IS OUR RECOMMENDATION - SGR – SUSTAINABLE GROWTH RATE

Sustainable Growth Rate Analysis: How Fast Should Your Company Grow?

For companies with a growth rate of 15% annually or greater they have an 80% chance of running out of cash before the years end. Almost every business owner intuitively knows that their business can grow too fast even if the company is well managed during the growth period. What is needed is the ability to calculate the rate of sales growth that a particular business can afford so that realistic growth objectives can be established. Professor Robert Higgins of the University of Washington has developed a simple technique for calculating the sustainable growth rate for a company that can be easily used by business owners and managers. Once the sustainable growth rate has been computed, management can see whether growth objectives are realistic, and incorporate techniques to find solutions when desired growth is higher than the affordable rate for the company.

The Model

To calculate your firm's sustainable growth rate using the Higgins approach, you will need the following financial information for your company:

P = Profit Margin on Sales After Taxes

R = Percent of Profit Returned to Owners

L = Debt to Equity Ratio

A = Asset to Sales Ratio

The model for computing sustainable growth rate is:

$$\text{Sustainable Growth Rate} = \frac{(P)(1-R)(1+L)}{A-(P)(1-R)(1+L)}$$

Financial data for a typical manufacturing business will be used to illustrate the Sustainable Growth Rate Model.

P = .055

R = .333

L = .88

A = .73

$$\text{Sustainable Growth Rate} = \frac{(.055)(1-.33)(1+.88)}{.73-(.055)(1-.33)(1+.88)} = 10.5\%$$

The growth rate for this company **should not exceed 10.5%** of sales given its existing capitalization structure.³

So is EBITDA a virus or vaccine? If it is the sole or primary focus of your financial metrics we strongly suggest you have a virus.

If on the other hand you use EBITDA along with other financial metrics and especially looking for and driving your business by LEADING PERFORMANCE INDICATORS - LPI – like Sustainable Growth Rate (SGR) your chances of being one of the companies that fails or runs out of cash are much smaller.

Using LPI metrics makes your company a through the windshield rather than through the rear view mirror company. We all knowing driving forward is so much easier than driving backward.

Avoid Virus metrics look for Vaccine metrics and when you have trouble knowing the difference –

Call Performance Enablers LLC a benchmarking company offering solutions for the CEO Tool Belt –

Where we assist you to **Maintain** your relationship with your stakeholders and customers with **Accurate** reporting and improved **Profitability**.

When you need a clear MAP call Performance Enablers.

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