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Dear Executive:

It seems that more and more of the companies that drive our economy and employ our citizens are being purchased by private-equity firms and investment banks. Here in the Midwest, it seems like a private-equity firm is taking over a key player in the automotive industry every time one picks up the business news. The ultimate financial gain for these firms comes when they eventually divest of the acquired company – hopefully at a substantial profit.

EBITDA – Earnings Before Interest, Taxes, Depreciation, and Amortization – appears to have become the most popular corporate performance measurement for investors such as these. It appeals to them because it gives them a measure of how much a steeply leveraged buyer can afford to pay for a company. At least theoretically, if capital expenditures and repayment of loan principal can be postponed, if expenses can be held to a minimum, and if working capital need not be expanded, the entire amount of EBITDA can be handed over to investors as interest until the inevitable divestment takes place. No wonder investors are so fond of this measurement.

Although it does have its detractors in the investment community, I don't propose to address my problem with EBITDA from that perspective. My concern is the impact EBITDA has on the day-to-day management of businesses that are critical to both our personal and collective economic success. Because "what gets measured gets done" and so many of our businesses are now owned by private-equity firms who use EBITDA as the key global performance measurement, I have found more and more managers of businesses who are also using EBITDA as guide in making both strategic and tactical business decisions. I have even encountered several who have gone so far as to use EBITDA as a measure of profit margin when quoting individual products. Having executives who base their day-to-day decisions on such a one-dimensional measure can prove to be a long-term disaster for any business and, possibly, our overall economic well-being.

The objective of a private-equity firm can be summed up as follows; buy a pig (or some pigs) with other peoples' money, spend a few years covering it with lipstick and starving it so it has a more elegant figure, and then sell the pig at a profit to someone who thinks it looks like Miss Universe. The key to the process is to be able to generate enough cash to pay for renting the "other peoples' money" while at the same time being able to afford all the lipstick. EBITDA turns out to be an effective measure for charting this process' success. There is nothing inherently evil in this process. The point is that the owners of a business managed in such a way appear to have no concern whatsoever for its long-term success or even its continued existence after it is sold. Their goal is to pay for the interest and lipstick until they can sell the pig at a profit.

With EBITDA as the measure emphasized by a company's owners, how can you blame the business' management (who serve at the owners' pleasure) from looking at each of their individual decisions in light of its impact on that measure? Just like teachers who "teach to the test" instead of teaching the fullness of their subject, top executives "manage to the measure" instead of managing for the long-term success of their organization. As a matter of fact, their position is not unlike that of the owners. Like soldiers in an ancient army, they have usually been brought in by the owners with the promise that they will share in the plunder at the end of the process so who can blame them for buying into the EBITDA measure. It is to their personal advantage when the process works.

Those who believe that the long-term growth of innovative and efficient businesses is critical to the economic success of our society should find this focus on the concept of EBITDA disturbing. It rewards short-sightedness and underachievement. It overlooks many of the factors that are critical to insuring the kinds of economically successful businesses that are fundamental to a well-functioning economy and society.

Let's explore just three of these factors; accrued liabilities, preserving the business' capital base, and employment of the company's assets.

Accrued Liabilities

One of the "tricks of the trade" is to accrue a big liability today to make it appear that profits have improved in the future when, in reality, the company would have been better off leaving things as they were.

For example, a company has a group of managers three years from retirement who collectively earn \$5 million per year. Management makes these managers "an offer they can't refuse" to retire three years early at 60% of their normal pay and then replaces them with managers who will collectively earn \$4 million annually. Upon the older managers' retirement, the company books a \$9 million liability (60% of \$5 million for three years) that will be paid off at \$3 million per year.¹ The total cost is expensed in the year the liability is booked.

In each of the next three years, \$4 million is paid to the new managers and \$3 million to the retirees. Although the cash paid for the work performed by these managers is now \$7 million per year, the "expense" recorded on the books (and that is used to determine EBITDA) is only \$4 million – a \$1 million per year "savings." At the end of three years, the company will have paid \$21 million for the work performed by these positions instead of the \$15 million it would have paid had the incumbents stayed in their jobs. Although EBITDA will have been \$3 million higher, the company will be \$6 million worse off – hardly a way to improve the organization's long-term performance.

Preserving the Business' Capital Base

In a note to Berkshire Hathaway's shareholders in 2000, Warren Buffett said, "References to EBITDA make us shudder." He indicated that the measure only makes sense, "if you think capital expenditures are funded by the tooth fairy."

A company needs to preserve its existing capital base if it is to stay in business. The cost of funding this capital preservation process is a legitimate, ongoing business expense. Failure to

incorporate this expense into the measurement of the company's performance overlooks a critical factor in determining its ability to simply survive over the long-term. Although depreciation expense as measured by GAAP-based accounting rules is an extremely poor way of measuring this cost, some measure must be included to determine whether or not the business is in the process of liquidating itself. By excluding depreciation and amortization (or some more relevant measure) from their key performance measure, owners and managers are showing their long-term disregard for the business and its other stakeholders.²

Employment of the Company's Assets

EBITDA totally ignores the effective use of assets by management. It is not alone in doing so – the popular “profit as a percentage of sales” measure shares the same shortcoming. To succeed in the long-term, a business must make good use of the funds it has tied up in its assets. Ignoring asset utilization encourages the use of outdated “batch and queue” concepts, the buildup of in-process and finished goods inventories, and sales to customers who take forever to pay their bills.

It is not only working capital that gets ignored. If a business has one productive asset worth \$2 million it needs to earn twice the annual profit using that asset than it does when using another productive asset worth \$1 million if both assets are to generate the same return on investment. Failure to incorporate some measure of the effectiveness of asset utilization excludes another critical factor in leading an organization toward a long-term successful future.

Is EBITDA Even an Effective Measure for the Private-Equity Firm?

In one of his recent *DM Review* columns³, Gary Cokins pointed out that a recent research study reported that less than half of the acquisitions studied reached their ROI goals.⁴ Is it possible that potential buyers can actually distinguish between an emaciated pig covered with lipstick and the real Miss Universe? Is the short-term vision of the private-equity firm compounded by the short-term measure it uses to track its performance?

Perhaps it would even be better for the private-equity firm if they managed their investment with the objective of turning its underperforming investment into a powerful economic engine that will increase in real value for years and decades to come.

Conclusion

The business world is populated with two types of executives: game players and stewards. Game players know how to play the game in a way that maximizes their personal gain with little or no regard for the damage they may inflict on the organizations they manage. Stewards don't look at their jobs as a game, but as a position in which they are entrusted with the task of insuring the long-term success of the organization they oversee and leaving it stronger when they depart than it was when they arrived. In our capitalist system, both are legitimate approaches to management. But the effect of playing games with our long-term ability to complete in the world economy cannot be positive.

Although EBITDA is one of many legitimate measures of a business' performance, emphasis on this one measurement – such as that made at many of today's highly-leveraged,

short-term focused business – leads to long-term underachievement. As more and more organizations fall victim to this underachievement, its impact on the overall economy is inevitable.

As we move forward into an ever more competitive world marketplace, it is no wonder that we continue to lose ground. Using major companies in our key industries as a basis for playing games cannot bode well for the future and the growing focus on EBITDA as a measure of success only adds to the negative momentum we can already see all around us.

UPDATE

During May, I had an opportunity to prepare and deliver a webinar titled “Improving the Bottom Line with Activity-Based Costing” for the Finance Leadership Exchange – an organization I had never heard of until this spring. FLEx is an organization that addresses financial issues as they relate to mid-sized businesses and enables the collective experience and resources of a network to become powerful management tools for each member of that network. As I’ve been preaching for nearly a quarter century, small and mid-sized businesses are not just “little big businesses” – you can’t simply downsize big business solutions and apply them at smaller organizations. The same concept applied successfully at organizations that are vastly different in size can take on very different forms. FLEx attempts to approach issues in finance, accounting, taxes, and cost management from the perspective of the mid-sized organization and, as a result, can present new concepts and ideas in ways that make them actionable for businesses of any size and type. You can learn more about Finance Leadership Exchange by visiting their website at www.financeleadershipexchange.com.

Don’t forget to check our website – www.dthicksco.com – for upcoming events, white papers, case studies and other resources that can help you bring your organization’s cost and performance measurement information into the 21st Century.

Have a great summer! If you have any questions or would like further information, please do not hesitate to contact me. I’d be glad to discuss this or any other related subject with you. As always, please feel free to forward a copy of this letter (or mention our website) to anyone you believe would be interested.

Very truly yours,

Doug

Douglas T. Hicks, CPA, CMC
President

¹ To keep the example simple while still making the point, the impact of discounting, taxes, etc. has been ignored.

² A more comprehensive discussion of this subject can be found in two of our recent executive letters at <http://dthicksco.com/execletter/2007Spring.pdf> and <http://dthicksco.com/execletter/2005Summer.pdf>

³ <http://www.dmreview.com/news/10001231-1.html>

⁴ Deloitte Research – Economist Unit M&A Survey (2007)