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THE EBITDA ENIGMA

Adjusted Ebitda calculations reflect the complicated nature of valuation debates at negotiating tables, yet some say the methodology has evolved into a flawed concept over time

by THOMAS ZADVYDAS

LEAVE IT TO an M&A banker to create an accounting concept that goes beyond typical financial reporting to calculate every inch of value in a company — and give it a barely pronounceable name.

Finance and valuation professionals regularly use Ebitda — earnings before interest, taxes, depreciation and amortization — to assess what companies are truly worth in a sale. The concept has been lurking within the corporate finance community for at least 30 years, and is used so prominently today that companies often boast of Ebitda multiples in a press release announcing a sale.

"It's not a number that appears on the financial statements, it's not on the balance sheet, income statement or statement of cash flows, so accountants don't audit that number," explains Timothy Hartnett, U.S. private equity leader at **PricewaterhouseCoopers LLP**'s PwC Transaction Services unit. "It's the cash flow the business can generate in its purest sense, it's a pure mathematical number."

Ebitda first came to prominence in the mid-1980s as leveraged buyout investors probed distressed companies that needed financial restructuring. Investors such as Carl Icahn and Nelson Peltz as well as private equity firms including **Kohlberg Kravis Roberts & Co.** used the figure to calculate quickly whether these companies could pay back the interest on these financed deals. Leveraged buyout bankers advocated Ebitda as a device to determine whether a company could service its debt in the near term — say, over a year or two.

At least theoretically, looking at the company's Ebitda-to-interest coverage ratio would give investors clarity on whether a company could meet the heavier interest payments it might be burdened with after a leveraged buyout. For instance, bankers might argue that a company with annual Ebitda of $5 million and interest charges of $2.5 million had interest coverage of 2 — more than adequate to pay off debt.

"The reason we use Ebitda as a way to sell a company [is] you have to normalize the balance sheet by stripping the cash out and stripping the debt off and you say, 'Here's the business, here's the operating assets and operating liabilities.' That's what you're buying," says Lloyd Greif, president and CEO of Los Angeles investment bank **Greif & Co.**

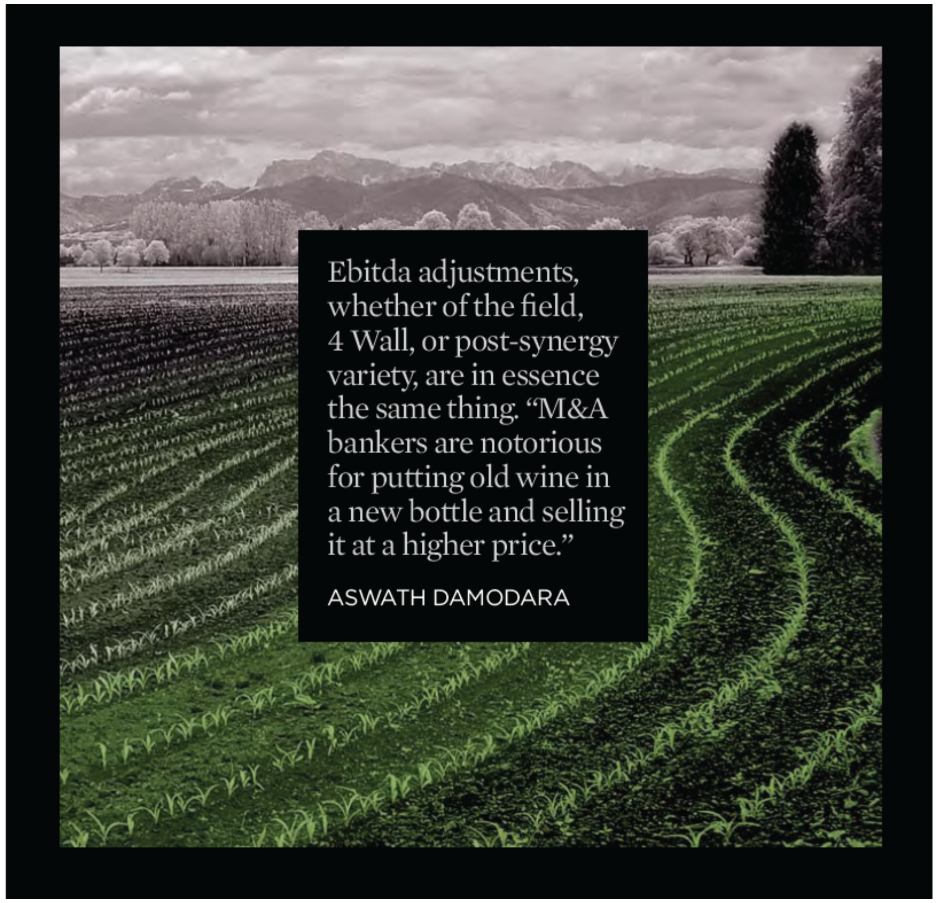
Of course, as the buyout game became more sophisticated over time, Ebitda calculations followed accordingly, becoming more complicated. Dealmakers tinkered with Ebitda in their dogged efforts to get the best price for their clients, using a plethora of different names for the numerous versions. "Ebitda is a proxy, and after your due diligence you find out other things [and make subsequent adjustments] that would make Ebitda a better indication of the cash a business can generate," says Hartnett.

These adjustments are calculated by examining specific units of a company or its expense components, such as salaries, office space, accounting, payroll and other back-office functions that are absorbed in a merger by the acquiring business. "It could be called 'adjusted Ebitda,' 'Ebitda after synergies' — you sort of come up with whatever names you want," Hartnett says. "Field Ebitda" is another version, as is "business line contribution." (Ebitda in the traditional sense is called "consolidated Ebitda.")

As Ebitda calculations have become more complicated and diverse over time, some, particularly in the accounting profession, say they have evolved into inherently flawed concepts. Several accounting experts point out Ebitda's — or any conceived variant's — weaknesses as a valuation tool.

"In essence, valuation using field Ebitda is a simplified approach to incorporating potential cost-saving synergies from a business combination," explains accounting and finance professor Doron Nissim of Columbia University's Graduate School of Business, who adds that the approach has "several perils." Generally speaking, Nissim says many of the expected cost-saving synergies that field Ebitda accounts for often never materialize.

To formulate a field Ebitda calculation in the first place, a company must be "clearly headed" to a strategic buyer and "usually requires multiple strategic buyers," says **Fairmount Partners LP** managing director Andrew Greenberg. "Because if you only have one buyer, it's much harder to get them to share with the seller the economic benefits created by scale and efficiencies."



Joseph Maas of Seattle mergers and acquisitions advisory firm **Synergetic Finance** adds that these Ebitda adjustments mostly come into play in transactions involving strategics because financial buyers such as private equity firms, usually have less infrastructure in place to reap synergistic gains.

Few finance professionals outside of the M&A world use field Ebitda calculations, and companies rarely report it. One exception is Houston funeral services business **Carriage Services Inc.** The company records field Ebitda as part of a transparency initiative to achieve five-year annual revenue growth in the 6% to 7% range, according to its most recent earnings release on Nov. 4.

For Carriage, field Ebitda is calculated as Ebitda generated from all of its cemeteries and funeral operations acquired since Jan. 1, 2006, in addition to its core units, minus overhead expense. For the nine months ended Sept. 30, Carriage reported $47.4 million of field Ebitda, minus $15.6 million in corporate overhead, giving it consolidated Ebitda of $31.8 million. The overhead expenses decreased Ebitda by 32.9%, compared with a 30% decrease for the same period in 2009, based on lower overhead. The higher amount in 2010 is related to corporate development costs for future acquisitions and fees for those already closed.

One illustration of how field Ebitda works in M&A transactions is lighting fixture maker **Acuity Brands Inc.**'s January 2009 acquisition of Glendale, Calif., lighting switch manufacturer **Lighting Control & Design Inc.** Greif, whose bank represented LC&D, called the deal "a perfect example of a premium-priced transaction where we were successful in getting the buyer to pay for the company based on a field Ebitda analysis, looking at both cost-saving and revenue-enhancing synergies. He continues: "Acuity Brands is a major lighting-fixture company, and what they bought in LC&D was the brand name, and they bought their lighting-control technology but effectively eliminated all their corporate staff."

Greif says Acuity was able to outbid other strategics and several private equity firms at the auction because it had a much more established distribution base. Gaining LC&D's lighting control systems "gave them another tool in their toolbox," he says, adding that Acuity's pre-existing sales and marketing team could promote and distribute the product, effectively guaranteeing synergies in the deal. "They obviously didn't need [LC&D's] accounting staff, HR [department], or [most of] the corporate staff," he says. Though Greif declined to discuss the deal's exact terms, he said the cost savings made through these synergies justified a higher Ebitda valuation.

To highlight the plethora of Ebitda adjustments, Greif cites another example. His bank advised management on its private equity-assisted buyout of **BF Acquisition Co. LLC,** the holding company for Carson, Calif., grocery chain **Bristol Farms**. Management reacquired the chain from **SuperValu Inc.** with help from Portland, Ore., buyout shop **Endeavour Capital** in October. The bankers in the deal did not use field Ebitda but, rather, its close cousin, "4 Wall Ebitda." Using this Ebitda adjustment, bankers look at the profitability of a company within the four walls of its stores themselves. "It means forget the corporate overhead, forget the corporate office, any of that stuff, because if you're selling one retailer to another retailer, all that is eliminated," Greif says.

No matter the variance between Ebitda calculations, or their clever names, these adjustments are an integral driver of, as well as a reflection of, the active valuation debates at negotiating tables. Sellers, in particular, can use their heightened Ebitda figures from synergy projections as leverage.

"A knowledgeable seller looks at it from the standpoint of saying, 'Hey, I'm bringing all this to you. I'm giving you this advantage, I'm giving these benefits, [so] I expect you to convey part of that value to me,' " says Greif. "It can increase the seller's expectations."

Of course, creating valuations based on several varying calculations can prove perilous. Columbia University's Nissim explains that many of the expected cost-saving synergies that the field Ebitda accounts for might not materialize. Also, "field Ebitda is difficult to measure because companies generally do not provide information about overhead costs. This limitation is relevant even when the acquirer obtains access to the target's record, because calculating the multiple requires having similar information [from peers] for the comparables," Nissim says.

The transparency inherent in a competitive bidding situation often offsets this problem. However, according to Nissim, Ebitda valuation "suffers from the same limitation as traditional Ebitda valuation." These include the exclusion of a company's fixed costs in Ebitda calculations, miscalculations in estimations of capitalized depreciation and the inclusion of complicated financing items, such as the expected return on pension plan assets or the interest costs on postretirement benefits.

"Even if the field Ebitda is right, the amount might not be available to do what you want to do because the company might have infrastructure investments they have to make, they may have working capital needs," says finance professor Aswath Damodaran who teaches at New York University's Stern School of Business. "The 'field' component of it is not always under your control. You think you can slice $150 million in costs, but once you get into a company after you've acquired it, you discover many of these costs are written in, contracted, and you might not be able to cut them."

Bankers that use different Ebitda adjustments counter that the calculations are not meant to inflate a deal's valuation or fabricate cost savings. Truly successful deals are not those where the parties use mathematical or accounting sleight of hand to outwit each other. Rather, the best deals are often when these techniques are used to find middle ground.

"It's not about the benefits all accruing to the buyer in terms of cost savings; it's not about the benefits accruing to the seller in terms of purchase price; it's about a sharing of benefits," Greif says.

Despite the chameleonlike nomenclature, Ebitda adjustments, whether of the field, 4 Wall, or post-synergy variety, are in essence the same thing. "M&A bankers are notorious for putting old wine in a new bottle and selling it at a higher price," Damodaran says. "The word 'field' is perhaps the only innovation in this process."

Or, as Maas says: "They're all right and they all give you basically the same conclusion if you do your work properly. Finance is part science and part art."

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