



INSIGHT

The Appeal of EBITDA Multiples

EBITDA multiples are quick and convenient to calculate, but these attributes are precisely its downfall.

Shortcut methods to estimate business value have always been used. Benjamin Graham popularized net asset value as a measure of business value in the 1930's. Stock analysts have long quoted price to earnings ratios as a measure of equity value.

In the early 1980's, investment professionals began to focus on free cash flow as a measure of business value. Free cash flow was defined as cash generated from the operation of a business after reinvestment in working and fixed capital. However, because free cash flow is not readily ascertainable from income statements alone, the more simply calculated EBITDA (Earnings Before Interest, Taxes, Depreciation, and Amortization) became an accepted proxy.

Today, EBITDA multiples are pervasive. The popular press routinely quotes EBITDA multiples. Research analysts trumpet them. We constantly hear business owners quote EBITDA multiples of transactions that have occurred in their industry. We are often asked what EBITDA multiple an owner's business will command.

In our own work, we often find EBITDA multiples misleading and it is clear to us that only in a very few situations is the concept fully understood by those who use it.

The appeal of EBITDA multiples is under-

.....
We often find EBITDA multiples misleading and only in a very few situations is the concept fully understood.
.....

standable. It is a measure that is easily calculated, it is quick and convenient. It is common across all businesses. But, it is the simplicity and commonality of the measure that is precisely its downfall.

In fact, EBITDA multiples are a very crude

RESTORING CONFIDENCE?

If the new bill on corporate governance and accounting reform will restore confidence, hallelujah. A healthy dose of confidence is undoubtedly an important ingredient to restoring economic prosperity. However, it seems to us that too much is being expected.

As most businesspersons know, it is entirely possible to follow Generally Accepted Accounting Principals ("GAAP") and still present a deceptive picture of a company's finances. As much as we might desire, the accounting treatment is not always as clear as the answer to one of Abraham Lincoln's favorite riddles, "How many legs does a dog have if you call his tail a leg?" The answer: "Four, because calling a tail a leg does not make it a leg."

The fact is that accounting will always leave room for interpretation. And, while legislation may do some useful things, new rules can't legislate against dishonesty. Honesty is a matter of character. ♦

rule of thumb, perhaps useful in a broad context but usually misguided when applied to a particular situation. The only economically logical method to value a business is to evaluate its long term ability to generate future after-tax free cash flows.

WHAT'S WRONG WITH EBITDA?

No two businesses are the same. Even two businesses in the same industry can be very different from a valuation perspective. Applying EBITDA multiples to all businesses disregards those differences. Among the problems:

▪ EBITDA is Backward Looking

The value of a business is a function of its expected future performance. EBITDA is a

historic measure. Particularly in the current economic environment, future EBITDA may be meaningfully lower than historic EBITDA.

▪ EBITDA is not Free Cash Flow

All businesses require reinvestment, if only to maintain the existing productive capacity. EBITDA does not measure how much cash is left over after reinvestment and available to compensate the suppliers of capital.

▪ EBITDA Ignores Risk

A dollar of EBITDA is not the same in every business. One business may have considerable volatility in its business performance, others are steady and predictable. One business may have a significant concentration of revenues from a single customer, others diversified. Some businesses are growing rapidly, others not. EBITDA multiples do not catch these differences.

▪ EBITDA Ignores the Amount of Invested Capital

EBITDA measures the flow of earnings but offers no insight into the balance sheet. Business value however, must take into consideration a variety of other factors, such as whether the business has adequate working capital, whether there has been deferred maintenance on capital equipment, how much investment is necessary to add the next increment of capacity, or what contingent liabilities might result in future economic costs. A wise investor will not neglect these points.

▪ EBITDA is Subject to Manipulation

Calculated as it is from the profit and loss statement, EBITDA is subject to the same potential for manipulation as earnings whether the statements are audited or, as many private companies are, reviewed.

▪ EBITDA is Misleading When Applied to Sale Transactions

The EBITDA multiple to the buyer is usually not the same as to the seller. EBITDA multiples of published transactions often report the multiple to the seller. The buyer, because of an ability to reduce costs or accelerate revenues in a business combination, may have rationalized a much lower multiple, one that is not relevant to the measure of another business, even in the same industry.

So, while the value of every business can be expressed as an EBITDA multiple, EBITDA multiples do not determine value.

.....
While the value of every business can be expressed as an EBITDA multiple, EBITDA multiples do not determine value.

WHAT'S THE ALTERNATIVE?

All businesses are not similar—each has its own unique set of strengths, weaknesses, opportunities and threats, none of which is captured in EBITDA multiples. Intelligent investment decisions in operating businesses must consider the amount, the rate of growth, and the expected variability of the free cash flow generated by the operations. It must consider the efficiency of the invested capital and recognize reinvestment obligations.

Relying on EBITDA multiples can result in paying too much or selling for too little. Consider two manufacturing companies operating in the same industry. Both generate the same EBITDA as shown below:

(\$ IN MILLIONS)	COMPANY A	COMPANY B
Sales	50,000	75,000
Gross Profit	17,500 35%	22,500 30%
Operating Profit	7,500 15%	6,750 9%
Depreciation	2,500	3,250
EBITDA	10,000	10,000
Net Working Capital	9,000	19,000
Annual Capex	2,000	3,000
Invested Capital	25,500	48,500
Return on Invested Capital	31%	15%

The smaller business, Company A, has invested in systems and equipment that has contributed to improved efficiency as can be seen in both the higher gross profit margins as well as the more efficient use of working capital.

One might naturally assume that the larger company is worth more or, considering equal EBITDA multiples, that the two businesses are worth a similar amount. However, a closer analysis would reveal that not only is the operating performance of Company A considerably better than for Company B, but Company A also manages its balance sheet more judiciously. Because of slower receivable collections and inventory turnover, Company B requires proportionately more investment to generate a dollar of sales. With lower net cash flow (EBITDA - capex) and a higher investment in assets, the return on invested capital for Company B is half that generated by Company A. Contrary to the conclusion reached using EBITDA multiples, a fundamental analysis would indicate that Company A is more valuable than Company B. ♦

Seller Math: The Missing Variables

Seller Math is a flawed economic argument often used by owners when considering a sale of their company.

In our years as bankers and financial advisors, we have learned that financial returns are but one of a number of reasons that people choose to own and run privately held businesses. Often it is not even the leading reason. There is a line of thinking that we repeatedly encounter and have come to refer to as “Seller Math.” It goes something like this—when an owner sells his business, pays the taxes, and invests the remaining proceeds,

.....
“Seller Math” goes something like this—when an owner sells his business, pays the taxes, and invests the remaining proceeds, the expected investment returns are invariably less than the “profits” earned from the business.

the expected investment returns are invariably less than the “profits” earned from the business. The conclusion often drawn is that if the investment income doesn't equal or exceed business earnings, then it doesn't make sense to sell (at least at that price).

Given our preoccupation with the economics of private business investment, we wince when a flawed economic argument is used as the basis for critical ownership decisions. In our view, Seller Math leaves certain key variables out of the equation including the difference between profits and distributable cash, management time, liquidity, and relative risk.

APPLES TO APPLES

When calculating Seller Math, business owners often compare profits earned by the business to the potential returns expected from the reinvestment of the sale proceeds. The fallacy is that profits can't be taken home, only cash can. Continued investment in working capital or fixed assets and repayment of debt consume cash. Therefore, the cash available to shareholders of a business is usually quite different from its reported earnings.

TIME IS MONEY

Most successful privately held businesses require close management of all aspects of their affairs. For many owners, running the business is an all-consuming activity—both vocation and avocation. Some of the “profit”

generated by the business may actually be payment for the time spent and, once the business is sold, the owner will be free to spend that time elsewhere. Owners are often surprised at how much it costs to replace their particular talents and experience. Somehow, the fact that the business owner would no longer have to spend countless hours at the business must enter the equation.

ILLIQUIDITY HAS A COST

Selling a privately held business takes considerable time. Depending on the business' market position, its recent financial performance, and the continuity of the business in the hands of the next owner, it can take a minimum of six months to close a sale. If the business is under performing and/or has other issues or unique challenges, it may take longer or not be achievable at all. The value discount attributable to the illiquid stock of a privately held business may be quite large to account for the time and uncertainty of converting ownership to cash. Studies have demonstrated that liquidity discounts for control positions in privately held businesses are in the range of 15-20%. If minority ownership positions are considered, the discount can exceed 40%.

IT'S ALL ABOUT RISK

Financial markets reward investors for taking risks. Greater risk is expected to result in greater returns. For example, a treasury bond has an expected return in the 4 - 5% range, whereas the return on a small-cap

.....
In our view, Seller Math leaves certain key variables out of the equation including the difference between profits and distributable cash, management time, liquidity, and relative risk.

stock is expected to provide a double-digit return. This concept of relative risks is sometimes difficult for a business owner to acknowledge when applied to his/her own business. For the owner that lives and breathes the business (and its risks) every day, the risks are familiar and seemingly manageable. Most business owners don't have the opportunity to see a wide range of businesses because they are engrossed in their own. The fact is that small privately held businesses are

Economic Update

Based on all the clanging alarm bells set off by the media and politicians, the past six months has been grim: accounting fiascos, executive malfeasance, employee layoffs, and bankruptcies. All of this has been capped by a stock market swoon unlike any other in the past 30 years. It sounds pretty bad and a lot of remedies are being bandied about including intensified government regulation to “make sure this doesn’t happen again.” It has been a tough period for many but, as painful as they are, recessions clear away the rubble of failed deals that accumulate during economic expansions. It seems that the longer and stronger the expansion, the more traumatic the cleansing. This necessary purging process lays a solid foundation for the next period of economic growth.

The downward tumble of the financial markets since March of 2001 directly followed the pricking of the internet/telecom

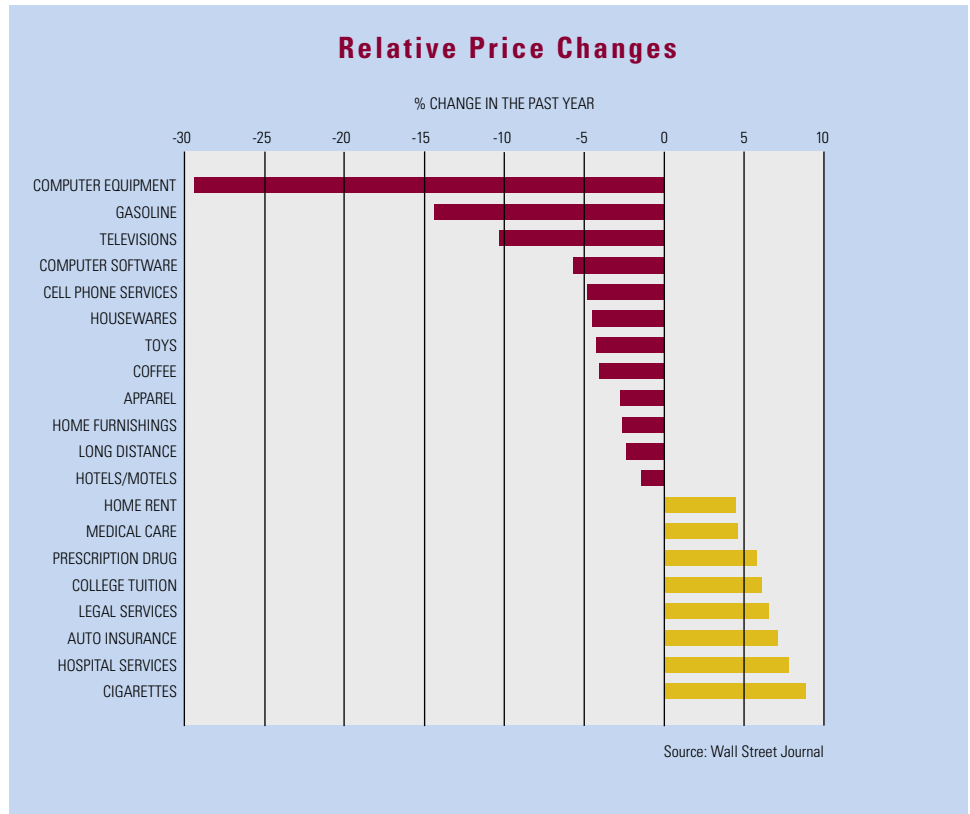
.....

As painful as they are, recessions clear away the rubble of failed deals that accumulate during economic expansions. It seems that the longer and stronger the expansion, the more traumatic the cleansing. This necessary purging process lays a solid foundation for the next period of economic growth.

.....

bubble, which ended a period of massive over investment in technology driven by the exuberance of investors. Too much money chased too few good deals. The availability of easy capital allowed many to lose their grip on economic reality. With business scandals erupting weekly, it is easy to surmise that the breakdown in financial disclosure and corporate governance and, more than anything, a fundamental lack of investor due diligence and skepticism swelled this investment bubble well beyond the norm.

Coming at the end of a decade of expansion, the adjustment process was inevitable. The good news is that the excesses are now being wrung out of the economy. After a wretchedly difficult business recession, marked by weak earnings and sluggish investment, businesses have been forced to make some difficult decisions. Most companies have sharply slashed inventories, trimmed payrolls, improved productivity, and paid



down debt. It is not all negative news. Many of the technological advances that were the sizzle of “new economy” firms during the boom are now finding real application among more traditional businesses. As a result, companies are ever closer to their vendors and customers, which has in turn, tightened supply chains and enhanced productivity.

DEFLATION WATCH

One factor that is getting little attention, but evidently is shaping this economic recovery is deflation. The impact of deflationary pressure is difficult to quantify but it arises from the fact that in the aftermath of the

.....

The impact of deflationary pressure is difficult to quantify, but it arises from the fact that in the aftermath of the investment bubble, many industries are saddled with an unusually high degree of excess capacity on a global basis.

.....

investment bubble, many industries are saddled with an unusually high degree of excess capacity on a global basis. This, in turn, has created keen price competition, particularly

in consumer products and capital goods.

Auto sales, for example, have been an often-cited pillar of economic strength over the past year. New car demand, however,

.....

The downside of deflation is that demand stimulated by price cutting sacrifices profitability. In the absence of pricing power and profits, corporations are reluctant to hire new employees and are unwilling to undertake new capital spending.

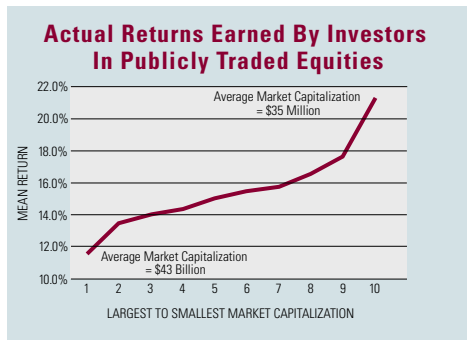
.....

appears to be stimulated by declining sticker prices and an abundance of discounts, rebates and zero-percent financing offers that collectively lower the cost of acquiring a new set of wheels. Because of a huge overhang in auto assembly capacity (as much as 40%) and high fixed cost structures, car manufacturers have little choice but to discount heavily to maintain sales volume. This phenomenon is also clearly at work in retail consumer spending where demand has been spurred by promotional pricing schemes and lower financing costs. In the last year, retail sales are up about 6% in real terms and only 3% in

Seller Math *continued*

risky, and the numbers prove it.

The following chart shows the actual returns earned by investors in publicly traded equities, segmented by size of business. The difference in returns is substantial and results from the higher perceived risk by investors in smaller, more fragile businesses. The smallest



segment of the population in this study is businesses having an equity capitalization of \$35 million. For that size of business, investors have earned (on average) annual returns of 21%. Equating this return to privately held businesses (using liquidity discounts), the return required by a control investor would be in the range of 25-27%. Smaller companies would require even higher returns.

The Seller Math dilemma is that it is impossible to trade an investment with an expected return in the range of 25% or higher into a less risky, more liquid investment and obtain a comparable earnings stream.

Ostensibly, this high rate of return reflects the fact that the risk inherent in small privately held businesses is substantially higher than the risks associated with the investments that business owners are likely to undertake with proceeds from a sale. The Seller Math dilemma is that it is impossible to trade an investment with an expected return in the range of 25% or higher into less risky, more liquid investment and obtain a comparable earnings stream.

As business owners contemplate the economic trade-offs of selling their businesses, it is important to consider all of the variables that impact the relative risk and return of the investment in their business. ♦

Economic Update *continued*

nominal terms. The difference is price deflation— more goods for fewer dollars.

The downside of deflation is that demand, stimulated by price cutting, sacrifices profitability. In the absence of pricing power and profits, corporations are reluctant to hire new employees and are unwilling to undertake new capital spending. With prices falling faster than costs in many industries, there is little incentive to replenish dwindled inventories. It is better to postpone inventory investment, hiring and capital spending than to be caught with excess. Until consumption and capacity are back in sync, the pace of business investment will remain sluggish. If consumer confidence is undermined and spending is seriously curtailed, there is a danger that the advances made so far will be undone. In the extreme, left unchecked, deflation could put the economy on the slippery slope to the kind of economic stagnation that has plagued Japan since the early 1990s.

INVESTOR CONFIDENCE

The current stock market turbulence, at least in part, reflects investors' concerns about the strength of the economic rebound. Corporate corruption and business failures have a role in the bear market but are not the sole culprits. Contrary to the political and media chatter, concerns regarding accounting veracity and corporate integrity are overblown. Only a small minority of companies is guilty of falsifying their financial reports and willfully deceiving investors. Rather, prices seem to be falling into line with less bullish economic expectations based upon concerns about business investment and the resilience of consumer spending.

In order for robust economic growth to be re-established, businesses must earn their way forward. Profits are required to trigger

the investment in labor, inventory, and capital goods needed to drive the economy forward. And, capital must be available to fund these investments.

CREDIT MARKETS

The health of the commercial banking system is one factor that gives us reason to believe that progress can be made. Banks were relatively minor players in the excesses of the late 90's. The public equity and debt markets provided much of the fuel for the bubble. This is not to say that major banks have escaped completely unscathed. They have been burned by on and off-

Workout groups here in the Northwest are beginning to see some respite in the troubled deal pipeline.

balance sheet financing for high-flyers such as Enron, Worldcom, and Global Crossing, and leveraged lending activities for private equity funds. Nevertheless, many banks have spent the past two years scouring their balance sheets of problem loans (to many companies' pain and torture).

It seems that the folks in bank special assets or workout groups here in the Northwest are beginning to see some respite in the troubled deal pipeline. We're also seeing signs that attitudes toward booking new business are shifting. For the first time in several years, if a company presents a good opportunity bankers may do more than yawn and look at their watch.

Until demand appears sustainable and business margins improve, overall economic conditions will remain sluggish. The Pacific Northwest, with its high rate of unemployment and decimation of the high tech sector, has a ways to go before emerging from these economic doldrums. ♦

ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott go to www.zacharyscott.com.

Mark Working
206.224.7382
mworking@zacharyscott.com

Frank S. Buhler
206.224.7383
fbuhler@zacharyscott.com

Ray D. Rezab
206.224.7386
rrezab@zacharyscott.com

William S. Hanneman
206.224.7381
bhanneman@zacharyscott.com

Michael T. Newsome
206.224.7387
mnewsome@zacharyscott.com

Doug Cooper
206.224.7388
dcooper@zacharyscott.com

500 Union Street, Suite 1000
Seattle, Washington 98101



Zachary Scott
INVESTMENT BANKERS