

## **EBITDA:** *How It Affects Your Borrower Cash*

*Earnings Before Interest Taxes and Depreciation. Sounds simple, right? This is not always the case. Lenders, investors, management, and other interested parties use EBITDA as one of the key measures of financial health. But how reliable is it?*

By John Calabrese and Brigid A. Rafferty

**E**BITDA is used as the foundation for times earnings-based business valuation methodologies, financial covenants, and determining debt service capability among other things. This can motivate businesses to attempt to represent EBITDA in the most positive light. The temptation to do so is greater still when a business is in trouble. Whether used as a yardstick of profitability and ongoing business value or a basis for calculating free cash flow, decision-makers must understand what is being measured and sometimes more importantly, what is not.

In our role as turnaround consultants, we frequently see situations where a cash crisis comes as an unpleasant surprise to management and a company's lenders due to misunderstandings surrounding the measurement of EBITDA. In times like these, turnaround management professionals can provide critical insight to and understanding of true profitability helping to develop a more meaningful understanding of a company's cash flow.

When EBITDA is used as a measure for evaluating a borrower, lenders should be wary of falling prey to aggressive accounting practices of which they are unaware. Some of these practices can prevent a clear understanding of the borrower's cash flow. More important, the expectation gaps that result can create tension and conflict between the company and the parties critical to its on-going survival — their lenders.

One issue lenders should be concerned with is the existence of add-backs to EBITDA year after year. This can be an early warning sign that a company is playing with its EBITDA calculation. These add-backs need not necessarily be identical in classification. TRG often sees professional fees, recruiting expenses, severance expenses, etc. added-back to EBITDA to create an "adjusted" or pro forma EBITDA. Often, a review of historical performance will show these types of expenses can be expected to recur. Another common add-back relates to inventory write-downs. Inventory obsolescence due to "made to order" products or minimum production quantities can be a normal, recurring event.

Because businesses and the environments within which they operate are dynamic, management should be very careful in evaluating what should be classified as "below the line" activity. Any misrepresentations, intentional or not, will only lead to conflict and complications for the company further on down the line.

TRG has been involved with several client companies that created an add-back for sub-par performance on a contract or group of contracts. As turnaround professionals we were able to carry out the analysis necessary to determine whether this performance is a unique event as claimed or is in reality a normal business risk in the industry and "above the line". Business involves risk and even the best businesses miss the mark from

time to time. The company should provide an EBITDA measure that allows investors, lenders and other parties to evaluate these business risks clearly.

Another client playing the add-back game was a supplier to major defense contractors. The company's business plan was based upon becoming the sole source for certain parts and assemblies on multi-year weapons and aerospace platforms. In attempting to establish an adjusted projected EBITDA, the financial team was adding back losses on certain contracts. The rationale was that the losses were due to estimating errors and that better estimating and controls going forward would allow these losses to be avoided. At the same time that the finance department made the argument for improved processes and controls, the sales and estimating groups were explaining to us the necessity of "loss leaders" to maintain the company's position with major customers. While TRG believed that some losses could be avoided or minimized through better management, we advised the company of the danger in restating EBITDA as if contract losses didn't exist. Their common practice was unrealistic and misleading.

### **Potential lenders should query a borrower as to what economies of scale have already been achieved versus those that are forecasted.**

Yet another TRG client seeking to maximize EBITDA convinced its banks that it was appropriate to add-back selected income statement activity from rolled-up business units arguing that certain expenses would not be recurring. However, the company was never able to achieve the economies of scale they had promised and the banks ended up with a borrower that was unable to meet its debt retirement commitments. Potential lenders should query a borrower as to what economies of scale have already been achieved versus those that are forecasted.

Sometimes EBITDA can be misrepresented without any knowledge on the part of the borrower. A former retail client believing itself to be highly profitable made expansion commitments and restructured its lending relationship only to discover two years later that its auditors had failed to uncover a serious inventory valuation discrepancy. The problem was discovered when the company hired a new controller. However, by that time any working capital available to fund a restructuring had been consumed in the build-out of a new super-store the company found itself unable to complete. Additionally, the company found itself with a lending agreement that no longer provided them the liquidity to weather the storm.

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A third issue of serious concern to lenders should be the handling of non-cash revenue. While management usually takes great pains to identify non-cash expenses, many times not enough focus is brought to bear on non-cash components of revenue. The issues here can be as simple as timing differences between revenue recognition and receipt of cash or they can be actual "in-kind" revenue that will never become cash.

Percentage of completion accounting is a perfect example of the effects of timing differences between receipts and revenue. Where percentage of completion accounting is used, revenues are recognized based upon the incurrence of costs. Consequently, the timing of revenue recognition may not have any direct correlation to the timing of invoicing to the customer or to the delivery of a product. More importantly, it may not have any direct relationship to cash receipts.

Being aware of a borrower's billing practices is critical to understanding the timing of cash flow and the conversion of revenue to cash. Since in this example revenue is recognized as a contract progresses, a company will show EBITDA (assuming the contract is profitable) throughout the contract but its cash position will be determined by the billing schedule it negotiates. The company could be flush with cash if it is successful in negotiating an upfront deposit and a billing schedule that precedes the incurrence of costs. Conversely, cash shortfalls might exist if payment is not made until completion or some date after expenses are funded. EBITDA should not be used to measure debt service capability if there are significant timing differences between revenues and cash receipts.

On a recent assignment, TRG was engaged at the request of the bank group to assist a telecommunications contracting company. In our first meeting, management confessed confusion as to why we were needed. They recognized that business was slow, but assured us that the company was generating positive EBITDA and was doing fine. About two hours into the meeting, the controller interrupted to tell the CFO that the bank had called to say it would be returning checks that day. There was obviously a disconnect between the CFO's expectation of cash flow based on his understanding of EBITDA and the actual liquidity of the business.

It didn't take long for TRG to discover the error in the way the CFO viewed cash. Investigation revealed that the company performed under large, long-term government contracts where percentage of completion accounting was used and where cost overruns were generally passed-on to the government and accepted after a review process. Unfortunately, when the company made a strategic decision to move into the commercial market it did not change the way it accounted for contracts in spite of having no indication that commercial customers would accept any cost overruns as pass-throughs. Additionally, the government was moving to a more market-based approach. By assuming that they could continue to alter contracts, the company ended up with \$12-15 million of revenue on the balance sheet in the form of receivables that represented amounts in excess of the contract amount for the work performed. These receivables were in various stages of negotiation and/or litigation with only a fraction potentially collectible. For as much as two years, management had been able to explain the delays in collection to the satisfaction of the owners and auditors while accounting practices masked the reality that they were losing significant amounts of money.

A fourth area worth mentioning concerns capitalized future earnings. While acting as receiver for a collection services company, TRG discovered an interesting example of how accounting practices cause differences between EBITDA and liquidity. During the assignment, we learned that the company was recognizing the value of future revenues on certain contracts as current revenue. The company was awarded contracts by the Department of Education and various states to collect payments due on student loans. Under these contracts, certain loans were placed with our client for collection with the company earning commissions based upon cash collected. The company maintained that a significant portion of the work

necessary to collect payments was performed in receiving the accounts, loading them into their collection system, and making initial contacts by mail and telephone. Based on this belief, they used statistical analysis to calculate projected collections and related commissions that could be due to the company. They then recognized a portion of that income as a receivable called work-in-progress. They were able to convince their auditors and the lender's collateral auditors that recognizing these billings as revenue was appropriate. However, these amounts were not actually owed to the company nor had the company actually performed the service that would entitle them to payment.

For several years, up to 50% of recognized revenue resulted from this practice. The balance of revenue was actual commissions invoiced based upon actual collections. On a cash revenue versus cash expense basis, the company was unprofitable. It was only able to continue funding its operations through additional borrowing. Once the lender refused to provide additional funding, the company quickly ran out of cash. Needless to say, in liquidation the work-in-progress had no value.

## **While EBITDA ignores these items, understanding the actual impact of the depletion of these assets on the business is necessary to assess the cash generation and debt service ability of the company.**

A fifth issue worth a second look concerns off-income statement cash uses. Depreciation and amortization are based upon the book value and useful life of certain assets on the balance sheet. Identical assets on two different companies' financial statements may have very different book values depending upon the date and method of acquisition. While EBITDA ignores these items, understanding the actual impact of the depletion of these assets on the business is necessary to assess the cash generation and debt service ability of the company. For example, a large trucking company has a tremendous amount of depreciation that is added back when calculating EBITDA. However, it also has a significant need for cash to replace trucks and trailers on a regular basis. If that need is not anticipated and accommodated, the company could find itself unable to maintain existing revenues let alone support growth.

Another example of this issue involves amortization as opposed to depreciation. A TRG client that purchased loans at a discount and then collected them for its own account had amortization as one of its largest expenses. The amortization of the purchased loans merely represented the replacement of the initial invested capital. This capital had to be reinvested in new purchases if the company was to continue to operate. While the company appeared quite profitable from an EBITDA standpoint, it wasn't true from a profitability or cash generation perspective. In this instance, TRG advised the stakeholders that EBITDA was a much better assessment of the profitability and cash generation of the business.

There are definite recognized advantages to having widespread acceptance of a single measure with which to benchmark the performance of a business. Recently, EBITDA has received a lot of attention and focus for this purpose. Unfortunately, it can often be misleading. There is no substitution for a thorough analysis and understanding of a company's financial statements and projections. We have noted here some of the areas that deserve a second look. In these situations, a turnaround professional can be highly effective in quickly identifying the salient issues and providing an assessment of the actual earnings capability and cash flow of a company. **abfj**

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