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Measuring Shareholder Value

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Today's business environment is characterized by an ever increasing threat of global competition and the shortening of technology life-cycles which in turn requires fast strategic responses on the part of most business owners. But, as most entrepreneurial teams focus on the dynamics of the marketplace to remain competitive, it is also important that they develop a proper understanding of financial metrics in an effort to maximize business value. Aside from their efforts in developing a sustainable competitive advantage, the discipline of focusing on the right financial metrics can have a significant impact on their ability to enhance the value of their businesses.

A large number of entrepreneurs, measure their operating performance by the growth in revenues compared to previous periods. They assume that as long as the top line is growing the value of their businesses is increasing as well. Others focus on the bottom line arguing that a business enterprise is all about creating a profit. Yet some others focus on the increase in shareholders' equity as a more appropriate measure of shareholder value. Although there is some merit to most of these financial metrics, the

fact still remains that any business, regardless of the industry it operates in or the markets it serves, is really in the business of generating cash. As a result, how much shareholder value a business creates is closely tied to its ability to generate cash.

Focusing on any financial metric other than cash can lead to strategic decisions that will prevent an entrepreneur from realizing the maximum potential value of the business. For instance, increasing revenues do not always reveal a healthy business. A company may be selling more in the marketplace, but if its margins (gross, operating and net) are eroding the company may be heading into a crisis. Operating profits can also be misleading as there are a number of non-cash charges, most notably depreciation, which can distort how profitable a business truly is. Likewise, capital expenditures can also distort profits as the business incurs in investments to remain competitive. Finally, shareholders' equity most often has no correlation to the true market value a business, as it represents the extent to which the cost of the assets exceed the liabilities.

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Most companies in the market are valued as a multiple of adjusted EBITDA (earnings before interest taxes depreciation and amortization). This widely used metric starts with the company's earnings before interest and taxes adjusted by non-cash expenses (depreciation and amortization) as well as by revenues and expenses which are considered to be one-time and/or extraordinary. This number, times a market-based multiple specific to the particular industry in which the business operates, is considered the best proxy for what a potential buyer would be willing to pay for a company. This is the reason why adjusted EBITDA receives so much attention on the part of both business owners and investment bankers alike.

It is important to note that EBITDA is a good metric to evaluate profitability and to establish comparisons between companies and industries, but it is not a good measurement for cash flow. Moreover, although multiples of EBITDA are frequently used in investment banking circles as a measure of enterprise value, it is simply a convenient way of comparing values across companies and across industries. As such, it merely represents a short-hand proxy for value comparisons but it should not be considered a driver of enterprise value.

As previously noted, cash is the only metric that shows "true" profitability and a company's ability to continue operations. Hence, operating cash flow is a better measure of how much cash a company is generating and as a result, whether or not a company is increasing shareholder value. The calculation of operating cash flow begins with the company's net income which is then adjusted by non-cash charges (depreciation and amortization). This number is then further adjusted by changes in working capital which use/provide cash to the business (such as changes in account receivables, payables and inventories). If changes in working capital are omitted in the analysis important clues will be missed that indicate whether or not the company is losing money because it cannot sell its products.

The experience of the W.T Grant Company is a good case study of the importance of cash generation over EBITDA. Grant, which was founded in 1906, evolved into one of the largest retail operation in the nation. But, due to various management mistakes the company went bankrupt in 1975. One of the main

reasons for the company fall can be traced to increased levels of inventory which forced the company to borrow heavily to maintain operations. Eventually, the company started experiencing difficulties to service its debt which culminated with the company bankruptcy. Most Wall Street analysts missed the company's problems because they were focusing on EBITDA. Had they focused on the company ability to generate cash rather than on its reported profitability they would have realized early on that the company was headed for trouble.

In short, any of the more common financial metrics such as sales, profits and book value are simply ineffective proxies for measuring cash flow and consequently shareholder value. If an owner wants to understand whether a business is creating shareholder value and to make strategic decisions that will enhance such value, it is important to measure the business ability to generate cash on a regular basis. Any potential buyer will also be doing the same analysis.

