CORPORATE FINANCIAL SOLUTIONS

Discover the Roots of Growth

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Normal...is in the Eyes of the Beholder

When it's Critical to Recognize when that Positive Number Is Really Negative!

Anyone who has family knows that people are not always the way they appear. After all, when you introduce Great Aunt Betty to your friends they always comment on how sweet and wonderful she is; however, you've grown up with Great Aunt Betty and know her differently. It's funny how business imitates family relationships. Let's consider normalized earnings, and I'll show you what I mean.

As we all know, EBITDA, an acronym for earnings before interest, taxes, depreciation and amortization, is a common measure of a company's operating financial performance. It is a non-GAAP metric of profitability, not cash flow. This measure doesn't address changes in working capital and fixed asset additions but is essential to determine business value and therefore important to understand its components. Lenders may use EBITDA to evaluate a borrower's ability to repay debt. Investors use it to assist in determining enterprise value. Management uses it for evaluating performance within the industry. Like any metric, EBITDA could lead the user to the wrong conclusions if not examined judiciously.

In practice, EBITDA typically is adjusted to eliminate nonrecurring charges and gains with the purpose of illustrating what might be "normal and recurring" results. This is known as "normalized earnings." These adjustments reflect the preparer's view of what "is" nonrecurring. Because the metric is subjective, users of "normalized earnings" must exercise professional skepticism in evaluating the calculation. Therefore, the first step in using a normalized earnings calculation must be to drill into the number to ensure understanding and agreement with its components.

Certainly, when possible, management wants to present a favorable view of the company's normalized earnings. Buyers use normalized earnings to determine a company's viability and trends. While it may seem counterintuitive, management may not always find it in their best interest to present the highest possible EBITDA. Users (generally, buyers), on the other hand, are looking for increasing positive trends that indicate a growing, well-run business. With that in mind, management and other stakeholders may want to exercise some discretion in applying adjustments for normalized earnings. So, what are those un-included adjustments that should be considered for an accurate view of "normal"?

Recently, in reviewing financials of an acquisition target, I noticed some adjustments which would have increased historical normalized earnings. I was surprised that those who prepared the computation had overlooked these increases to earnings. Drilling deeper I saw that the potential adjustments coincided with a change in management, and I realized, that what had appeared to be a "growth company" was actually in decline - an extremely significant change in status. In a sale situation, that conclusion could reduce the multiple paid due to the necessary "turnaround." In an evaluation of management performance, the new team may not stack up against the prior management group. Reasons like these can motivate the company to omit positive adjustments to historical normalized earnings.

Deep-drilling into the numbers can reveal both negative and positive adjustments that may lead to negative conclusions and significantly impact value. When it comes to normalized earnings, approach them as you would your Great Aunt Betty, be respectful but aware that just like people, numbers can appear lovely at first, but aren't always as they appear to be.

When you need to sort out the normal from the simply unusual to the truly abnormal in order to discover the roots of growth^sm, consider the senior level experience provided by Corporate Financial Solutions, LLC. We're experts in evaluating the issues crucial to minimizing risk for businesses in transition.

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