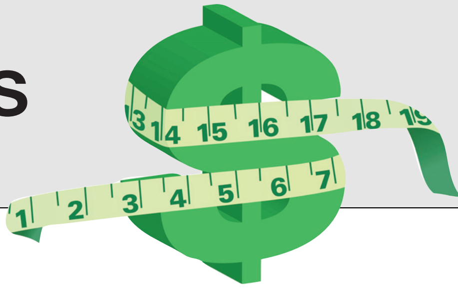

EBITDA is the Key to Financial Health

If you are in business there is one supreme, almighty financial goal: earnings. We can talk about things that enhance your reputation and long-term growth, but the goal always remains earnings. Therefore, the key question of any business owner or manager should be: "How do you measure earnings?" I have looked at all methods to measure earnings, but the one measure I use consistently is earnings before interest, taxes, depreciation and amortization, otherwise known as EBITDA.

By Daniel M. Isard, president of The Foresight Companies

EBITDA is a top-line look at earnings. There are other computations such as:

• Earnings before interest and taxes or EBIT.

• Earnings before tax or EBT.

• Earnings after tax or EAT.

Each of these is a progressive computation. EBITDA is simple math. Gross revenue, minus cost of goods sold equals gross profit. Gross profit minus operating overhead equals profit or earnings before tax. However, to measure earnings accurately we need to do away with some items that may have gotten into the operating overhead.

We need to factor out:

• Interest, because we are focused only on the operating profit before the effects of debt service. Some businesses have debt and some don't. Without factoring this item out of earnings I can't compare two businesses to each other. This is the same for interest earnings, because some funeral businesses have excessive cash or investments that are not going to be the same for all.

• Tax (on income at the state or federal level), because I often have to compare companies that are C Corporations to Pass-Through Corporations (Sub S) and often compare them to nonincorporated enterprises such as sole proprietorships, limited liability companies or partnerships). If I do not remove taxes from the analysis I can be looking at misleading data.

• Depreciation and amortization are eliminated because companies that have new assets in the business are going to have more depreciation. Companies that have the real estate inside the business will have more depreciation than those that own the real estate personally, and lease it to the company. Amortization and depreciation are the same concept. They are deductions within the tax code to benefit a business for investing in assets. The difference is "depreciation," which is the systematic write-off of tangible assets, whereas "amortization" is for intangible assets.

How can we compare some businesses that have the real estate within the corporation to others with the real estate owned outside the business? We do it by creating a new means of earnings measurement. We call it EBITDAR.

The R stands for "rents." We study earnings at EBITDA plus R, to compare companies with the real estate owned outside the business to those companies that have the real estate within their corporation.

EBITDAR is an important analysis for setting the pricing of a funeral home. We have found companies with the real estate inside their corporation have lower prices than those that pay rent, as they do not have rent as an overhead. However, their value is also lower than those that have the real estate outside the business. That is because the average rent is about 6 to 8 percent of revenue. So, businesses with the real estate inside the enterprise should take note of this.

I use EBITDA for management and valuation references because it allows me to compare dissimilar companies and make them similar. For management purposes, I can see if we are getting the operating profit we want for a client when looking at the ratio of EBITDA to gross revenue. This is expressed as a percentage. For valuation purposes I can use EBITDA to arrive at the fair market value of a business. In one style of valuation EBITDA is divided by a capitalization rate and that results in a method of determining value.

EBITDA varies due to the savvy of the business owner. I have seen some at 5 percent of revenue and a few in the 40 percent of revenue. It is not a reflection of the pricing of the firm, but it is a mark of how effective the business is. If you are at my funeral, make sure my kids have EBITDA on my grave marker. I hope to account for something where I am going! •