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FOR PROFESSIONAL INVESTORS ONLY

# Global Value and Income Dispatch

## The “smoke and mirrors” of financial analysis: adjusted EBITDA



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***In summary, analysis based solely on adjusted EBITDA runs the risk of forgiving poor operational and strategic execution, and on top of that, rewarding the company with an ability to add debt, which in the end could be detrimental to the bond and equity holders.***

*“Not everything that counts can be counted and not everything that can be counted counts!” - (William Bruce)*

Companies are required to file their financial results in accordance with GAAP (Generally Accepted Accounting Principles) which compel the filer to adhere to a uniform set of rules. Given differences across industries, analysts have come up with EBITDA (earnings before interest, taxes, depreciation & amortization) to account for differences in depreciation and amortization schedules, leverage and taxpayer status. Over time, however, EBITDA has morphed into adjusted EBITDA as issuers and analysts continued to broaden the definition.

### **Why should you care?**

EBITDA is a non-GAAP figure that is subject to many “subjective” adjustments and forms the key metric in many bond covenant calculations. The majority of the covenants in bond and loan agreements use an adjusted EBITDA metric to determine how much debt a company can incur. To read more on covenants, please refer to our earlier note in May, titled “Swiss cheese and covenants.”

*In our opinion, relying on adjusted EBITDA alone can lead one to misjudge the true health of a company. This can result in permanent loss of capital, particularly late in the economic cycle.*

### **The widespread use of add-backs can badly distort the reliability of adjusted EBITDA as a measure**

Some of the most common add-backs we see in adjusted EBITDA are listed below:

**Restructuring, integration and severance costs** – I strongly believe that these costs should be treated as a normal operating expense. Business environments change and restructuring to right size the company or incurring transition costs after an M&A deal should be considered general business costs. It’s important to note how frequent these “one-time” costs are. There are many in the high yield universe that have some form of restructuring/one-time costs added back every year and therefore can’t credibly be labelled one-time costs.

**Share-based compensation** – This one is tricky, as it generally tends to be non-cash in nature. However, awarding shares to management increases the share count and is therefore dilutive to earnings from an equity perspective. We have now seen high yield companies where the share-based compensation can be as large as 20% of EBITDA. At its core, it is a compensation expense, not a gift, and worth paying attention to.

**Sector-specific expenses** – This is the category where I find some of the most outrageous add-backs. Let me give some examples:

- Take store opening, closing, and remodeling expenses in retail companies. Retail companies generally operate stores. If you are opening a store or remodeling it to grow your business, why is that expense added back? Conversely, if you made a mistake and opened too many stores such that profitability suffers, why should the closing expenses be allowed to be added back?
- Another personal favorite is the capitalization of expenses such as research & development or sales & marketing. For instance, some tech companies capitalize a large portion of their R&D costs. In a rapidly changing and highly competitive industry, one can argue that some of these investments are vital for the company’s ability to remain relevant, competitive and to be able to grow its earnings. However, when capitalized, it is not captured in EBITDA and therefore may need to be adjusted lower.
- Finally, the generic “other” line”. I think of this as a catch-all basket for anything including run-rate cost synergies. Recall that many high yield covenants now allow for up to 30% of EBITDA add-backs for one-time costs and run rate cost synergies. You may be surprised to know that 30% is well used!

### **Common pitfalls of an analysis solely focused on adjusted EBITDA**

- It may lead to overstatement of company’s true liquidity position as it ignores working capital and adds back some costs that may be cash (e.g. store opening/closing, restructuring costs).

- It may result in higher implied enterprise valuation as a multiple of EBITDA as it ignores capital replacement costs that gets depreciated but may need to be replaced longer term. Investors should always ask themselves what percentage of capex and R&D that is capitalized can be postponed for a very long time without damaging the long-term value of a business. As Warren Buffett suggests, "there are very few businesses that can spend a lot less than depreciation and maintain the health of the business."
- Since leverage and interest coverage metrics are expressed as a multiple of EBITDA, credit metrics can be overstated very easily.
- It tells the investor nothing about the quality of earnings. EBITDA is not EBIT!

*In summary, analysis based solely on adjusted EBITDA runs the risk of forgiving poor operational and strategic execution, and on top of that, rewarding the company with an ability to add debt, which in the end could be detrimental to both the bond and equity holders.*

### **We don't ignore the cash flow statement in our credit analysis.**

Unlike equities, bondholders have limited upside but share similar downside risk should a company's performance worsen. As the credit cycle nears its end, it is critical to assess each issuer's creditworthiness on cash flow metrics along with covenant strength. **We believe that focusing on business quality, stability and cash flow are a critical part of the analysis.**

I think the below comment from Warren Buffett's 2018 annual letter to Berkshire Hathaway shareholders summarizes the issue very well.

*"Abraham Lincoln once posed the question: 'If you call a dog's tail a leg, how many legs does it have?' and then answered his own query: 'Four, because calling a tail a leg doesn't make it one.' Abe would have felt lonely on Wall Street."*

***We always adjust company reported results to assess the true earnings potential and credit quality.***

## **JOHCM Global Income Builder Fund**

5 year discrete performance (%)

Discrete 12 month performance (%):

	31.08.19	31.08.18	31.08.17	31.08.16	31.08.15
A GBP Class	13.13	-	-	-	-
MSCI World NR	7.00	-	-	-	-
Bloomberg Barclays US Agg	17.58	-	-	-	-
BofAML Glb HY Constr (BB-B)	15.70	-	-	-	-
IA Mixed Investment 20-60% Shares	3.02	-	-	-	-

### **Past performance is no guarantee of future performance.**

Source: JOHCM/MSCI Barra/Bloomberg Index Services Limited, NAV of Share Class A in GBP, net income reinvested, net of fees. The A GBP Class was launched on 30 April 2018. Performance of other share classes may vary and is available on request. BLOOMBERG® is a trademark and service mark of Bloomberg Finance L.P. and its affiliates (collectively "Bloomberg"). BARCLAYS® is a trademark and service mark of Barclays Bank Plc (collectively with its affiliates, "Barclays"), used under license. Bloomberg or Bloomberg's licensors, including Barclays, own all proprietary rights in the Bloomberg Barclays Indices. Neither Bloomberg nor Barclays approves or endorses this material, or guarantees the accuracy or completeness of any information herein, or makes any warranty, express or implied, as to the results to be obtained therefrom and, to the maximum extent allowed by law, neither shall have any liability or responsibility for injury or damages arising in connection therewith.

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