The Small Idea: EBITDos and Don'ts

Though neither perfect nor exhaustive, the basic financial statements required of US public companies can go a long way toward providing investors with a reliable picture of a business's financial standing.

These quarterly and annual filings mandated by the Securities and Exchange Commission contain a range of information about a company's assets and liabilities (balance sheet), its earnings and expenditures (income statement), money coming in and going out (cash flow statement), and more.

In preparing these statements, US companies are required to follow the Generally Accepted Accounting Principles (GAAP) established by the Financial Accounting Standards Board (FASB), which has been recognized by the SEC as the authority on such matters.[1] Financials also come with accompanying notes that can make them easier to understand and provide additional nuance, including disclosures related to accounting policies and practices, income taxes, retirement benefits programs and stock-based compensation.

While having a uniform accounting rulebook allows for apples-to-apples comparisons of companies, many companies have chafed at the prescriptive, rules-based nature of GAAP and have chosen to supplement the SEC-mandated principles with non-GAAP figures they believe more accurately represent their financial performance. In 2017, for example, 97% of the S&P 500 Index used at least one non-GAAP metric in their financial statements.[2] While these figures can offer valuable insight for investors, their subjectiveness suggests they should be taken with a grain of salt.

1. Note that since the early 2000s the FASB has been working with the International Accounting Standards Board, its non-US analog, to develop a single set of reporting standards that can be used globally. Convergence of GAAP with International Financial Reporting Standards (IFRS) remains ongoing.
2. Source: Audit Analytics; data as of October 10, 2018.

This edition was written by Bill Hench, head of the Small Cap team and portfolio manager.

Woke Up This Morning, Got Yourself an HP 12c

HBO prestige dramas aren't generally a reliable source of financial insight, but a recent rewatch of a season six episode of *The Sopranos* revealed surprising—but wholly contextual, as it turns out—depth in the character of Pauly Walnuts. "Do you even know what your EBITDA is?" the silver-winged underboss of the DiMeo crime family asked the son of a dead associate in an effort to dissuade him from selling his father's sanitation business. "Earnings before interest, taxes, depreciation and amortization. It gives a true picture of a company's profitability." While Pauly's fiduciary commitment may have been lacking given his boss's economic interest in said sanitation business, he wasn't wrong in questioning the comprehensiveness of the son's due diligence.

In fact, metrics related to earnings—such as EBIT and EBITDA—are among the most commonly used non-GAAP alternatives. EBIT, for example, takes GAAP earnings and adds back expenses related to interest payments and taxes; it is sometimes referred to as operating income as it reflects a company's gross earnings less expenses incurred in the generation of those earnings. EBITDA goes two steps further, adding back non-cash expenses related to depreciation and amortization; EBITDA is often used as a loose proxy for a company's cash flows. Meanwhile, more recent financial filings have seen the rise of "adjusted" metrics that strip out what are deemed to be one-time or nonrecurring items. This may include stock used for compensation, expenses related to disruptions from Covid-19 or some other catastrophic event, the write-off of failing operations and the cost of establishing replacements, and more. So in the case of adjusted EBITDA, we're left with an adjustment of an adjustment. I'm sure non-GAAP innovations will continue to evolve as long as there are CFOs looking to put their best foot forward.

Most professional investors understand that the data in financial reports—whether GAAP or non-GAAP—requires experience-based interpretation to be truly actionable. Further, qualitative factors unavailable on EDGAR play a huge role in the potential trajectory of a business. Both top-down—macroeconomic conditions, industry trends—and bottom-up—management quality, potential catalysts for improvement—factors are likely to have a significant impact on the movement of a stock. Instead of running screens to develop new ideas, we're reading—everything from general market and macro content to industry-specific publications like *Women's Wear Daily* or *Automotive News* or *Semiconductor Review*—for clues on the ground. We're also listening to company managements—we probably have 1,400 engagements a year through conferences, one-on-one meetings, earnings calls, etc.—to glean the details behind the numbers.

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Here's the Rule...No One Can Say No

Nearly 16 years after *The Sopranos* left the airwaves in 2007 with a sudden cut to black, another HBO program in the cultural zeitgeist is nearing the end of its run. Though *Succession* trades the pork stores and gentlemen's clubs of New Jersey for the board rooms and eight-figure penthouses of Manhattan, it too provides a glimpse into how a very small subset of Americans live and work. "You cannot win against the money," General Council Gerri Kellman shouts at the son of Waystar Royco's deceased founder upon learning that he and his brother are plotting to tank a mammoth acquisition of the company. "The money is gonna wash you away."

We couldn't agree more; in the end, cash is king. While non-GAAP metrics like EBITDA and adjusted EBITDA can be additive to the understanding of a company's performance, in our view they should never replace a good set of old-fashioned financials.

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