Wholesaler Seminar

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Understanding EBITDA and its Use in Distributor Transactions

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As acronyms go, “EBITDA” is a mouthful. For the uninitiated, EBITDA is short for Earnings Before Interest, Taxes, Depreciation, and Amortization. While this measurement rarely resembles what a business owner actually takes to the bank, for various reasons it has become a standard benchmark for use in valuing businesses of all types – and for assessing relative financial performance. Distributor owners and top managers should be well-versed in EBITDA performance – both for their own and contemporary businesses.

The Advantages of EBITDA

By definition, the EBITDA measurement “neutralizes” the impacts on an income statement of many “non-operating” items such as financing, the tax-effects of the corporate form of organization (i.e. C-corp, S-corp, LLC, etc.), and the somewhat fickle manner in which capital items and prior acquisitions are expensed. The result is a much more “apples-to-apples” comparison of true operating performance than Net Income ever thought of being. By further adjusting EBITDA to account for various related-party, non-recurring, and extraordinary charges, an “adjusted” or “normalized” EBITDA is useful as a guideline for tracking performance over time – or versus other distributor operations.

As a valuation yardstick, a multiple of EBITDA is often calculated. The most traditional valuation metric compares the total value of operating assets and divides this figure by a “normalized” EBITDA figure. This metric is increasingly used in the stock markets.

In reality, the markets for publicly-traded stocks are not always the best place to look for guidance as to valuation and profitability issues impacting privately-held businesses. But lessons can be learned.

For years, the public marketplace has been driven by discussions of price-to-earnings or “P/E” ratios. These rough measurements compare values of publicly traded securities to the underlying net profit (after taxes) of the business on a per-share basis. I have frequently witnessed distributor owners in potential transactions attempting to use (improperly, I might add) publicly-traded P/E ratios as a basis for valuing their own businesses. As of this writing, Anheuser-Busch was trading at an approximate P/E of 17. The application of this multiple to a before-tax, operating earnings base of a distributor results in an excessively high value.

More often now you hear references to EBITDA multiples in value discussions of public stocks. In particular, EBITDA is divided into something called the "Enterprise Value" to develop the multiple. Enterprise Value (EV) is most often defined in the public marketplace as the market value of equity plus debt. Often, cash is then subtracted. The result is compared to EBITDA.

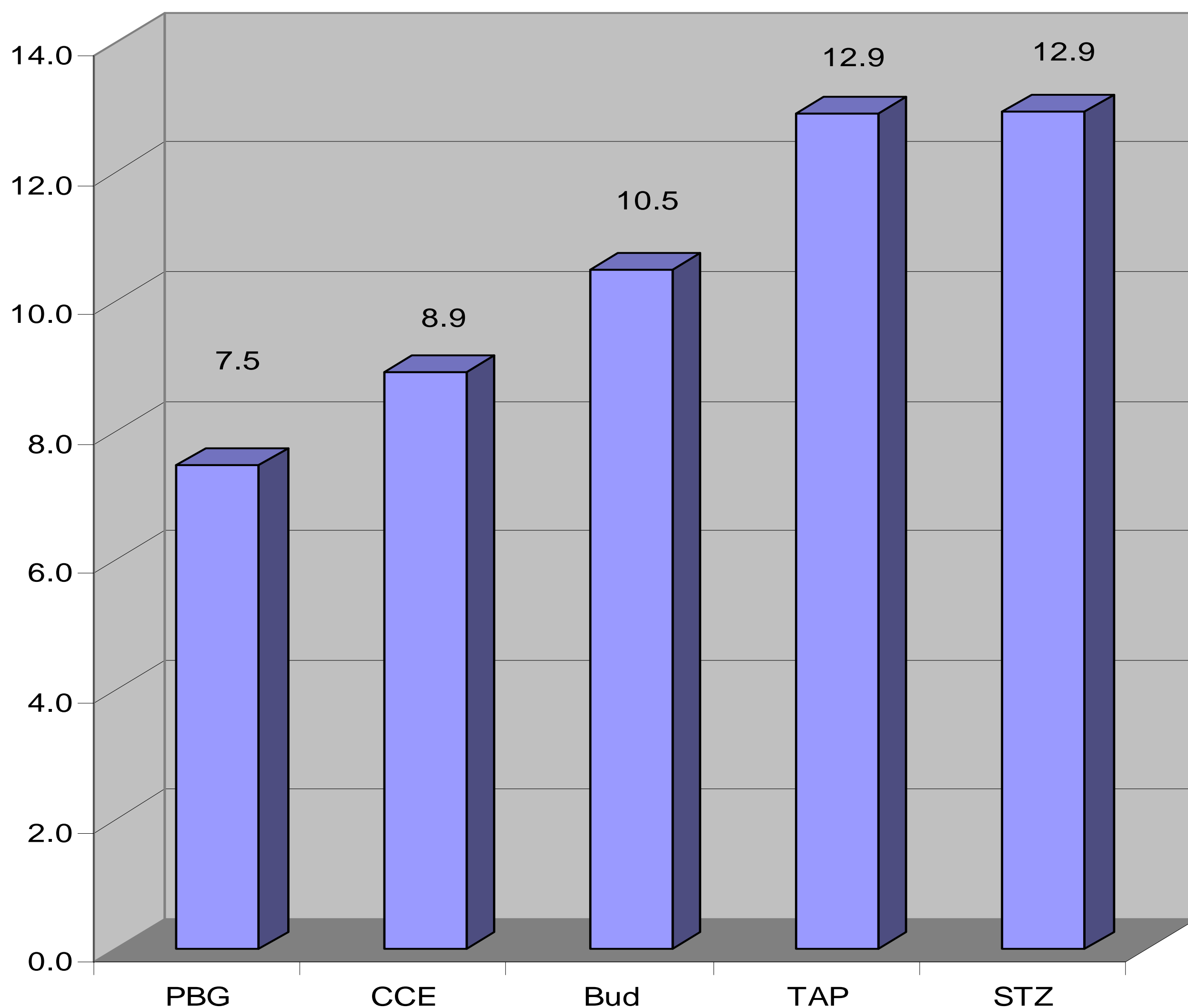

Figure 1

Figure 1 plots recent EBITDA multiples for some key breweries and soft drink bottling operations. Note the range for just these five samples is from about 7.5 to nearly 13. Two of the recent distributor transactions I have been involved with had a similar range of over 7 on the low-end to over 12 on the high-end.

It is important to understand why EBITDA multiples have such a wide range – and how lessons from the public marketplace can be applied to the private market for beer distributor operations.

There are other factors, but two key determinants of relevant EBITDA multiples are growth, and risk.

Growth

High-growth businesses command higher EBITDA multiples. Generally speaking, for a business to command a double-digit EBITDA multiple in a sale, a reasonable person should expect growth in excess of industry averages. Industry analysts with far more name recognition than my own are projecting long-term, annual industry volume growth to be in the range of 0.5 – 1.0%. Add some price-per-unit and/or mix change assumptions on top of that and average revenue growth expectations become clearer. Is your business – or the business you are looking to buy – expecting revenue growth in excess or below this level? This should impact your thinking on relevant EBITDA multiples. Figure 2 plots analyst growth expectations for the same companies previously discussed. As you can see, the stocks with the highest EBITDA multiples have the highest expected growth in revenues.

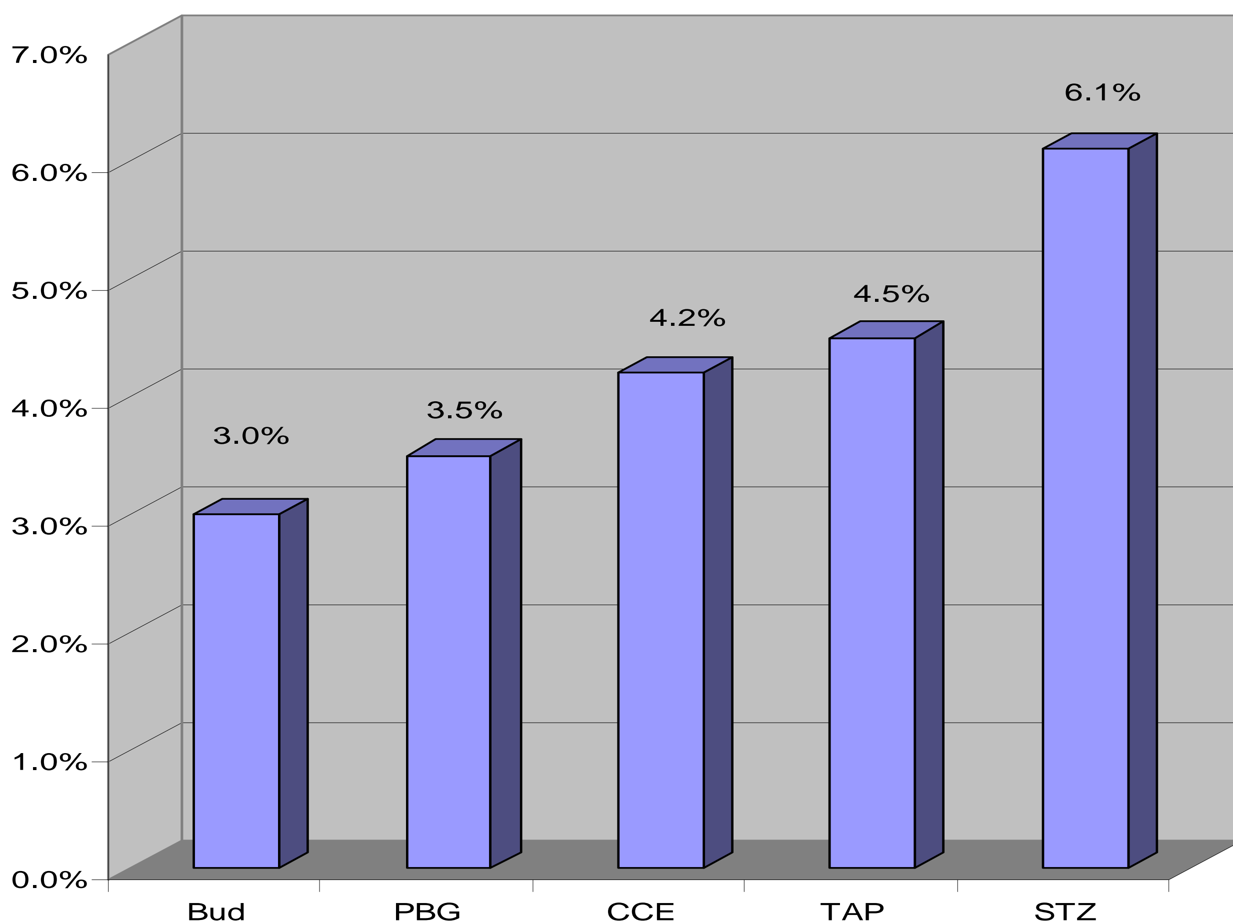

Figure 2

Of course, revenue dollars are not what owners put in the bank. Changes in EBITDA are driven by top-line (i.e. revenue growth) but also gross margins, the operating expense structure, and re-investment requirements. And operating expenses are on the rise for many wholesalers. The most recent public data available on beer distributor performance – from the NBWA Distributor Productivity Report – indicates the "typical" wholesaler experienced revenue increases of 4.3% per year from 2000-2002. However, during that same period, operating costs increased by 5.2% per year. More than

anything else, improving gross margins have been the driving force behind wholesaler profitability, and values, as measured by EBITDA multiples in the new millennium. Consumers appear to be willing to continue to "trade-up" but there is certainly a risk that the favorable gross margin trends experienced by the industry in recent years will not continue. Such a change should have direct impacts on EBITDA multiples.

Risk

There are always risks in owning any private business. Economic theory tells you that owning a private company is riskier than owning a well-diversified portfolio of publicly-traded stocks. Compared to many private businesses, the typical beer distributor is less risky – primarily due to the security afforded by supplier contracts and by regulatory protections. Significant developments in the industry continue to alter this landscape, generally.

Specifically, in any given transaction, owners should be cognizant of the impacts on risk – and value – made by various supplier arrangements and legal options. All other things being equal, strong suppliers offering distributor-friendly agreements in states with well-crafted beer franchise laws drive higher "blue-sky" values.

Consolidation Impacting EBITDA Multiples

In prior articles, I have described how lenders approach the financing of distributor acquisitions. They generally look at financing an EBITDA multiple of greater than 6.0 as being relatively highly-leveraged (i.e. more risky). This implies a total value of around 7.5 times EBITDA as a ceiling - assuming typical equity contributions up front. But of course consolidation synergies greatly impact such calculations. Depending on the horizontal and/or vertical nature of the transaction, a synergistic acquirer should be able to shave 20% or more out of the operating cost structure. This pushes up resulting profits (from the acquirer's perspective) and can sometimes drive double-digit EBITDA multiples – even for relatively low-growth businesses. Indeed, some distributors – especially smaller ones – have seen EBITDA multiples fall to pretty low levels but still have potential to generate high EBITDA multiples in strategic sales (assuming the "seller-perspective" EBITDA is the base for developing the calculation).

Summary

The public marketplace for stocks is increasingly moving away from "P/E" approaches to EBITDA multiples – or even better, multiples of operating cash flow. In markets for privately-held businesses (especially consolidating industries like the beer business), professionals are moving away from long-held beliefs on per-case value techniques toward discounted cash flow analyses and EBITDA multiples.

In the end, from a strictly financial standpoint, prices paid for beer brands and/or distributor operations need to be justified through an adequate return-on-investment (ROI). A thorough discounted cash flow (DCF) analysis is a first step – and this will lead to calculations and comparisons of EBITDA multiples. A recent study indicates an average EBITDA multiple paid for all privately-held businesses is around 5-6. In my experience, the trading range for many (not all) beer wholesalers is higher. While a mature and relatively low-growth industry, the beer business has less risk and volatility due to the strength of supplier agreements and legal protections. The consolidation dynamic – and the relatively cheap debt acquirers can use now to finance transactions – continues to sustain values. The key issue at this point is how long any of these factors are going to last.