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The Business and Management Advisors

NEW DIRECTION PARTNERS

Stu's View

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Quality of Earnings: Beauty or Beast?

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Quality of earnings is an important indicator of the value of your company – but that is just one facet of its significance. A high quality of earnings improves your credit standing with your bank, providing greater borrowing ability and faster loan access at critical times. If you are considering buying or selling, it enhances your business's appeal. Alternately, if your company is an ongoing concern, it enables you to pay dividends to shareholders even during economic downturns.

EBITDA (*) is tightly connected to quality of earnings. This predictor of the cash flow generated by a business has become the language of buying and selling businesses. When we talk about quality of earnings and EBITDA, it's not just the earnings; it's the quality of those earnings that are as important as anything else we measure.

(*) EBITDA = Earnings Before Interest, Taxes, Depreciation, and Amortization

There are both positive (Beauty) and negative (Beast) attributes to consider in determining your quality of earnings:

1) **Sustainability.** A documented history of growth and stability is the most critical attribute. Growth spikes alone are not enough – they must be proven sustainable over a reasonable period of time and be perceived as continuing into future years.
2) **Equipment and Technology.** Machinery that is technologically current for a company's market niche and has a good maintenance program can enhance your quality of earnings. A reasonable amount of excess capacity must also be present to accommodate future growth. In buy/sell situations, outdated equipment is perceived as cause for significant investment in future years, so buyers are likely to discount the value of earnings.
3) **A good management team.** Companies with strong management capability and depth can continue successful operations even if unexpected circumstances impede management operations. A business run by a single critical manager is perceived as much more vulnerable, so quality of earnings is negatively impacted.
4) **Real estate.** Rent that is below market value may seem like a positive attribute -- but realistically, that rent will increase at some point to full market value. The savvy buyer recognizes this and therefore discounts quality of earnings accordingly.

5) **Business cycles.** Selling a business at the beginning of a projected economic downturn or when future sales are questionable can negatively impact quality of earnings. If positive business trends are expected to continue for 3-4 years, quality of earnings gets a positive boost.
6) **Fluctuation in Earnings.** If a company's earnings have spiked to the 100's after years of being in the 50 range, there is actually a negative impact on quality of earnings – at least until the higher numbers are proven to be sustainable over a reasonable time frame. Sellers experiencing fluctuation in earnings may get more than their historic 50, but not the full 100, until sustainability can be proven.
7) **Customer and sales executive concentration**. We have often seen highly successful printers with a single customer comprising more than 15-20% of total sales, or with their top 3 customers comprising more than 40-50% of total sales. These companies are more profitable because they have optimized their efficiencies in successfully servicing a particular market segment. Paradoxically, the increased productivity benefit of customer concentration can negatively impact quality of earnings. Buyers perceive customer concentration in terms of potential customer and revenue loss, so quality of earnings is negatively impacted. That same risk of concentration applies when a single sales executive covers 50% or more of the seller's customer base.
8) **The balance sheet.** There are multiple line items here that can impact quality of earnings, and each should be carefully examined during the due diligence period of any acquisition:
    a. Accounts receivable, especially those over 90 days old
    b. Excessive Credits
    c. Age of work in process
    d. Accurate inventory
    e. Liabilities, especially operating leases
9) **Union vs. Non-union.** With the stock market downturn, the impact of unions – and multi-employer defined benefit plans in particular -- must be considered in any sale transaction. Companies remaining in a multi-employer union plan have to cover the losses of companies that go bankrupt or make bad investment decisions. For buyers who plan to close a seller's union facility post-sale, the payment that has to be made to the pension plan by the people closing the plant is often greater than the value of the company – in many cases millions of dollars. Buyers considering a target company that is in a multi-union employer benefit plan therefore need to carefully do their homework before proceeding.

Quality of earnings is impacted by multiple factors – factors that must be considered in assessing a company's value. It's not the amount, but the true quality of earnings, that counts.

Stu's View is contributed by Stuart Margolis, CPA and Partner of MargolisBecker LLC to provide information that helps firms operate profitably. More information can be found at www.margolisbecker.com.

About MargolisBecker

MargolisBecker has long been recognized as the financial expert for the printing, packaging and allied graphic communications industries, assisting thousands of companies with strategic and financial management, valuation, mergers/acquisitions, accounting, audit and tax services. The firm is noted for its expertise in enabling companies to optimize profits. Proudly, it is the purveyor of the industry's *Cash is King*, and *Value-Added Principles of Management*, and compiles the annual Printing Industries of America Ratios, the printing industry's premier financial benchmarking tool.

About New Direction Partners

The team at New Direction Partners LLC has guided over 200 printing company owners through the sales and merger process. The advisory services reflect a full set of skills to help you sell or expand your business: valuation, management consulting, financial advisory and investment banking. The deep experience and industry expertise at New Direction makes it uniquely suited to serve printing, packaging and allied graphic arts businesses.