

# Is EBITDA a Useful Metric?

- **EBITDA:** Earnings Before Interest, Taxes, Depreciation & Amortization
- **VERY** common in valuations, LBOs, credit analysis...
- But... is it really accurate? Or are there problems with it? **Are there ways to see how accurate it is?**
- **Yes!** It's called "Free Cash Flow Conversion Analysis"

# Problems with EBITDA

- **EBITDA:** *Supposed* to be a proxy for a company's Cash Flow from Operations – just like CFO, D&A gets added back and CapEx is excluded
- **PROBLEMS:**
  - What about taxes and interest? Could be huge!
  - Or Working Capital requirements?
  - And can you really just *ignore* CapEx? It impacts a company's ability to repay debt...

# FCF Conversion Analysis

- **Solution:** Compare a company's Free Cash Flow (CFO – CapEx) to its EBITDA

Key Metrics and Ratios:	Units	Historical			Projected					
		FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17	
<b>Free Cash Flow Conversion Analysis:</b>										
EBITDA:	¥ M	¥ 334.8	¥ 396.5	¥ 563.8	¥ 748.2	¥ 836.4	¥ 921.6	¥ 979.2	¥ 1,045.0	
Less: CapEx:	¥ M	(425.6)	(566.8)	(546.2)	(553.6)	(466.0)	(435.6)	(395.0)	(353.3)	
Less: Net Interest Expense:	¥ M	1.0	(1.0)	(13.6)	(38.4)	(28.5)	(15.7)	(8.0)	1.3	
Less: Taxes:	¥ M	(35.8)	(36.3)	(67.5)	(87.5)	(102.7)	(117.5)	(126.7)	(138.4)	
Plus/Less: Other Non-Cash Items:	¥ M	(1.8)	(3.7)	(7.1)	(9.1)	(13.5)	(14.9)	(20.2)	(21.9)	
Plus/Less: Change in WC:	¥ M	21.6	58.2	69.8	56.9	40.5	47.5	38.6	47.5	
<b>Free Cash Flow:</b>	¥ M	¥ -105.9	¥ -153.0	¥ -0.9	¥ 116.4	¥ 266.3	¥ 385.4	¥ 467.9	¥ 580.2	
<b>FCF Conversion %:</b>	%	(31.6%)	(38.6%)	(0.2%)	15.6%	31.8%	41.8%	47.8%	55.5%	
FCF Yield %:	%				3.1%	7.0%	10.1%	12.3%	15.2%	

- **Goal:** How close is a company's EBITDA to its discretionary cash flow?

# Interpreting FCF Conversion

- **Question:** Is 100%, or over 100% FCF conversion “good”? It must be, right?
- **Truth:** Depends on *why* it is that high... if it's sustainable and based on high cash payments from customers upfront, sure...
- **But...** if it's based on one-time tax benefits, non-recurring items, weird Working Capital treatment, etc., not so positive

# FCF Conversion Analysis

- **How** can you use this analysis?
- **Method #1:** Compare peer companies, and see which one has the highest conversion % (HomeAway) → higher conversion = higher valuation multiple?
- **Method #2:** Use it to develop your investment thesis in a company (7 Days Inn) – do the numbers work because of improved FCF generation?

# FCF Conversion Analysis

- **Method #3:** Use it along with other credit stats/ratios to determine how much debt a company can take on
- **Median from Comps:** 4x Debt / EBITDA, 50% FCF Conversion
- **This Company:** 75% FCF Conversion
- **Implication:** Maybe more than 4x Debt / EBITDA?

# Recap and Summary

- **FCF Conversion:** How much of a company's EBITDA gets “converted” into its Free Cash Flow?
- Higher percentages are generally more positive, *if* they are sustainable
- **Uses:** Compare peer companies and valuation multiples, support investment/LBO theses, and use it in conjunction with credit stats and ratios