



EBITDAR as a Financial Health Indicator for Franchises and Retailers

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One trick marketers use to generate awareness or gain credibility is to define a market so narrowly that they can make a plausible claim that they are number one. Consider how many car dealerships claim superiority in a big suburban area. On a personal level, my wife and I often tell our three children that we are by far the best parents they will ever have.

The financial measure of EBITDA (Earnings Before Interest Taxes Depreciation and Amortization) follows this concept. Slice and dice the data conveniently enough, and any company can appear successful. Simply put, EBITDA means that a company is profitable before:

- Interest or principal paid to investors or lenders, meaning not having to pay for the capital required to start and operate the business;
- Taxes;
- Depreciation; and
- Amortization of debt or other value associated with the start up of the business or acquisitions used to grow the business.

Therefore, from a slightly cynical standpoint, EBITDA means: the company is not earning enough to show a positive net income, but if properly defined, it can proclaim it is making money. EBITDA plays a critical role in evaluating businesses that are undergoing change, and is often used in mergers and acquisitions as an alternative for earnings before capital costs and income taxes. But is it always the best alternative measure of financial health?

In the franchise industry, businesses are often evaluated using EBITDAR or EBITDA plus Rent as the “R.” EBITDAR serves a distinct purpose in the retail world and actually helps make analyses involving the profitability of retail locations much more clear and concise.

Understanding Costs Associated with Store-Level Operations

In retail finance, store-level operations are the critical measure of success or failure. Inadequate merchandising and ineffective strategy at the corporate level can be overcome by a decent location and capable store management. Conversely, the best products can gather dust on shelves of poorly run storefronts in low-traffic locations. Therefore, store-level profitability is probably the single most meaningful measure of the near-term financial viability of a retail company.

Store-level profitability takes into account the ability of store management to drive local sales, control the cost of goods sold (including costs of products purchased and/or costs of direct production or service supplies), utilize labor effectively and monitor the direct costs of running the location, including day-to-day supplies, repairs and utilities. These costs are typically grouped as “controllable costs.”

There are also location-specific costs, such as real estate taxes, common-area maintenance charges and lease and rent costs, which retailers typically call “uncontrollable costs.” Given the dramatic increases in property costs during the last decade, most people would agree that occupancy costs are part of the “uncontrollable” economy. However, the definition actually refers to costs that are “uncontrollable by store-level management.”

Complicating matters is that rent paid on a retail location can be tricky to calculate, due to the different types of rent and the various accounting rules associated with reporting rent costs, which are generally divided into two categories:

1. Third-party lease payments, which may or may not include costs related to:
 - Amortization of build-out or tenant-incentive monies.
 - Property taxes.
2. Owned property rents, which may or may not include costs related to:
 - Amortization of principal on real property debt.
 - Payments to closely held entities owned by them operating company owners which include interest plus amortization of principal, taxes and other payments.
 - Profit on the lease or owner dividends disguised through lease payments.

Given the many potential components of rent, EBITDA analysis may require portions of that expense to be reinserted into the total operating costs, thereby changing EBITDA projections. Those adjustments complicate what should be a fairly simple calculation and often lead to internal confusion.

Finally, this already complicated situation is further confused by the accounting treatment of both leased and owned properties. Under FAS 13, the GAAP accounting rules that retailers use to account for capitalized leases force a reconciliation of cash payments to accrued expenses to ensure that all of the cost components are accounted for. If these adjustments are not taken into account, profitability

may be understated in the short term and overstated in the long term.

Much of this confusion can be lessened if retail companies utilize EBITDAR as a measure of financial health, rather than the standard measure, EBITDA.

Why EBITDAR?

EBITDAR can be used to analyze store-level profitability and to more efficiently determine if a property can be made profitable or is a candidate for closure. For example, using EBITDAR MorrisAnderson has developed a store cash-flow analysis to evaluate numerous franchise and retail clients (see table below). It evaluates retail locations by sorting them from highest to lowest profitability, as follows:

Stores with Positive Earnings

These locations represent a foundation for future growth, whether that is through franchise portion of a potential sale.

Stores with Positive EBITDAR

These locations should be reviewed to determine how profitable they could be if rent concessions were acquired.

- In the restaurant industry, if rent at a specific store location represents 7 percent or less of sales, which corresponds to full occupancy costs of about 10 percent of sales, then in the long term, the location should be profitable.
- If the rent at store locations with a positive EBITDAR can be reduced to 7 percent of the location's sales through negotiations with the landlord, the location will likely be profitable in the long term and should be retained as a core unit.

Stores with Negative EBITDAR

The stores that would not be profitable even after achieving rent concessions represent a group that is operationally unsound and necessitates an operational revamp or closure. Unless these stores are in startup mode, they are deeply distressed and are prime candidates for immediate closure.

- As a standard rule of thumb, assuming a normalized rent of 7 percent of sales if a standard real estate capitalization rate valuation of 9-10 percent is applied, then the value of the real property cannot be more than about 85-90 percent of annual sales or an acute location issue results.

Sample Financial Health Analysis Utilizing EBITDAR									
Store	Total Net Sales	EBITDAR	Capex	Rent	Lease Payments	Level Cash Flow	Adjusted % Rent	Store Level Cash Flow	
Group 1 - Positive Net Cash flow									
1	506	\$ 2,728	\$ 524	\$ 7	\$ 183	\$ 89	\$ 246		\$ 246
2	507	2,384	512	7	89	-	416		416
3	511	3,092	752	7	203	90	452		452
4	513	2,703	692	7	259	96	331		331
5	803	2,868	581	7	268	96	211		211
		13,775	3,061	35	1,001	370	1,655		1,655
Group 2 - Profitable with rent concessions									
6	201	1,551	220	7	179	63	(29)	109	41
7	802	2,724	606	7	550	90	(41)	191	318
8	801	2,043	316	7	350	85	(126)	143	81
		6,318	1,142	21	1,079	239	(197)	442	440
Group 3 - Unprofitable even with rent concessions									
9	312	2,167	231	7	162	90	(28)	152	(18)
10	503	1,366	98	7	161	-	(70)	96	(5)
11	401	1,723	215	7	216	90	(99)	121	(3)
12	708	1,550	153	7	230	90	(174)	108	(53)
13	711	2,036	320	7	276	210	(173)	143	(40)
		8,843	1,016	35	1,044	481	(544)	619	(119)
Total		\$ 28,936	\$ 5,219	\$ 91	\$ 3,125	\$ 1,089	\$ 914		\$ 1,977

EBITDAR Is an Important Step, Not the "Be All End All"

Usually, this cash flow analysis provides a very clear picture of where the company stands as to what is required for a successful turnaround. However, as with all financial analyses, this is only one step in the complex turnaround process.

After undergoing this cash-flow analysis utilizing EBITDAR as an evaluation criterion, internal steps such as identifying and implementing appropriate operational changes (including sales and marketing efforts), strategic and tactical initiatives, operational efficiencies and system modifications should be undertaken at the store location before considering refinancing or restructuring options.

If, after the above internal steps are taken, refinancing or restructuring are deemed the only options, EBITDAR can be used to help guide these decisions.

- First, third-party rents are taken out of the EBITDAR number as an expense that cannot be changed without external assistance.
- From this adjusted EBITDAR, a store location's true cash flow can be evaluated. This is achieved after determining how to accommodate debt obligation payments related to the owned locations.
- Finally, when combined with operational improvements that are fundamental to a successful turnaround effort, final decisions can be made about suitable refinancing or restructuring strategies.

Conclusion

Utilizing EBITDAR as an appropriate evaluation criterion for store-level profitability in multi-unit retail companies makes assessing client situations easier and therefore leads to quicker development of turnaround strategies and options. However, as with all strictly financial analyses, the conclusions need to be validated with store management and corroborated by key location-specific information, such as area demographics, employment trends, strength of local management, competitiveness in the local market and other mitigating or extenuating criteria which may impact the conclusions of strictly financial analyses.

Although utilizing EBITDAR to evaluate store-level operations is not the "be all end all" of profitability analyses, it does offer a common basis for more efficient operational evaluations. Using this as a reference point allows more time and energy to be focused on determining the next steps, developing strategies and implementing successful changes that will provide the heart of a solid turnaround plan.

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