# **Investment Focus:** The Demise of EV/EBITDA - How Accounting Standards are Messing with Valuation Metrics

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INVESTMENT MANAGEMENT

We have seen in the past how Price-to-earnings (PE) and Price-to-book (PB) valuation ratios, which are reliant on accounting data, have become less useful given the many changes in accounting standards. Most notably the idea to push capital movements through the income statement results in reported earnings not reflecting the operational earnings of the company. In addition, getting management to "guess" the value of certain future assets (biological assets for example) and liabilities and push their movements through the income statement has created a lot of non-operational line items.

The sugar companies, Tongaat and Illovo, are required to revalue the still growing sugarcane by estimating the remaining time until harvest, yield and sugar price. Changes in value from year-to-year in the unharvested sugarcane are reflected in the company's earnings, often forming the largest part of earnings, and are unrelated to cash flows or actual operations during the year. Of course, we now know that there were big accounting issues at Tongaat. (Mondi was also affected by biological assets accounting standards but gave very good disclosure to separate balance sheet movements in the income statement from operational items).

EV/EBITDA became a popular valuation metric because EBITDA stripped out a lot of the balance sheet items moving through the income statement. EBITDA is used to analyze and compare profitability across companies and industries because it eliminates the effects of financing and capital expenditures. For this reason, it is favoured by private equity who use it as a proxy for cash flow without any capex change associated. But of course, EBITDA is not cashflow as capex remains a cost along with working capital. Buffett likened EBITDA to "playing golf but not counting the putting". Now, with the new lease accounting standard, IFRS 16 the demise of EV/EBITDA is complete. It might have been a good shortcut 20 years ago but today its increasingly just plain wrong.

For a tenant, the new lease accounting standard reflects the transaction as if they had borrowed to buy the property. In the income statement there is an additional interest and depreciation cost and no rental expense. So, EBITDA is completely missing any rental occupancy cost, which we believe to be an operating expense of the company. Enterprise value, or EV, was previously the combined value of equity and debt stakeholder values, being market cap plus outstanding borrowings. Now the lessee has an additional interest-bearing liability on its balance sheet which adds materially to its EV. In the case of Pick n Pay debt (in the eyes of auditors) went from R2.3 billion 2018 to R 18.4 billion in 2019.

Retailers are some of the most affected by the change. Let's look further at how it impacts Pick n Pay.

Pick n Pay leases most of its store footprint and the table below shows the impact on its EV/EBITDA before and after the implementation of IFRS 16.

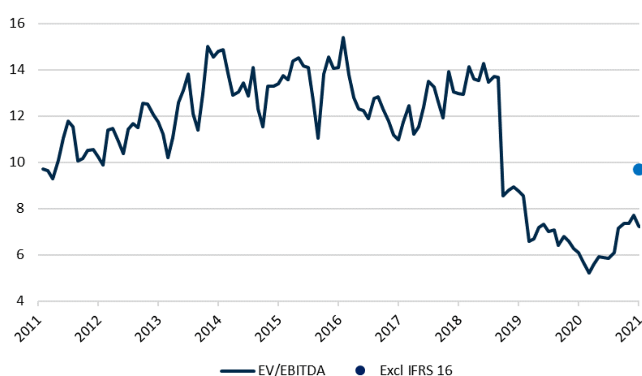
**Figure 1: EV / EBITDA for Pick n Pay before and after IFRS 16**

| Fiscal 2021 | Before | After |
|---|---|---|
| Market cap | 24 707 | 24 707 |
| Interest-bearing borrowings | 5 283 | 5 283 |
| Lease liabilities | - | 16 359 |
| less: Cash | (5 415) | (5 415) |
| **EV** | **24 575** | **40 934** |
| | | |
| **EBITDA (Before is estimated)** | **2 624** | **5 820** |
| | | |
| **EV/EBITDA** | **9.4** | **7.0** |

*Source: Bloomberg, Company results, BlueAlpha estimates*

As a result of the significant change, evaluating Pick n Pay's EV/EBITDA trend over time is now meaningless. The dramatic fall in EV/EBITDA in late 2019 aligns with when the company adopted a new lease accounting policy in its results

**Figure 2: EV / EBITDA for Pick n Pay**




*Source: Bloomberg, BlueAlpha estimates*

It is not purely a change in classification, the bottom-line earnings of the company are also impacted. We estimate Pick n Pay's fiscal 2021 EPS to have been 4% lower as a result of the new lease accounting standard.

In the cash flow statement, most of the true cash rental paid is no longer reflected in operating cash flows, but rather in financing cash flows, thereby boosting the reported cash generated by operations (by 42% in 2021). Of course, the tenant is physically paying cash to operate its stores and so we reassign the "leasing cost" from the financing cash flows back into operating cash flows to make it more useful. The table below shows how this plays out in Pick n Pay's 2021 results.

**Figure 3: Pick n Pay Cash Flow Statement**

| Fiscal 2021 | As reported | Adjusted | Difference |
|---|---|---|---|
| Cash flow from operating activities | 3 991 | 3 991 | |
| less: Principal lease liability payments | | - 1 677 | |
| **Adjusted operating cash flow** | | **2 314** | **-42%** |
| Cash flow from financing | 719 | 719 | |
| Exclude: Principal lease liability payments | | 1 677 | |
| Adjusted financing cash flow | | **2 396** | |

*Source: Bloomberg, Company reports, BlueAlpha estimates*

Management makes a choice whether to rent or borrow and buy an asset and we think this should reflect differently in the financial statements as the risks are different. Moreover, IFRS 16 removes occupancy costs from operating expenditure which does not make sense or would have been better for the accounting bodies to demand better disclosure on leases. Then analysts could do all the accounting gymnastics they wanted without it distorting the income, balance and cash flow statements.

Our best suggestion for accountants and auditors would be to improve on the cash flow statement. Providing segmental cash flows would be a big improvement to usability and integrity. If Steinhoff had been forced to disclose segmental cash flows, the fraud would have been evident a long time before it actually came to light.

Ultimately, we as shareholders need to ask: What is the cash flow available to me after capex, taxes, minority payments, debtor costs etc.? Equity investors are last in the queue after all other stakeholders.