

# Uncertainty drives a return to basics



The EBITDA model is being shunned in favour of the more straightforward 'profit after tax' model, writes Michael Andrew.

As turmoil in world financial markets tightens liquidity, business leaders and directors have shifted their focus back to the fundamentals in navigating their companies through challenging times. Experienced executives are focusing on the basics by shunning some of the popular programs of recent years, and reverting to measures such as cash flow performance and good, old-fashioned, long-term relationships.

A prime example is the shift away from the popular earnings before interest, tax, depreciation and amortisation (EBITDA) model, or normalised earnings, as the key performance indicator for business, to the straightforward profit after tax i.e. what cash is left over to pay dividends to shareholders. Measures such as return of equity that factor in the true finance cost of the business are now being used to assess strategic transactions and business plans in preference over the EBITDA model.

Also out of favour are capital management programs that return surplus capital to shareholders. These have been suspended while liquidity is difficult to access, being replaced by dividend reinvestment plans that induce the recapitalisation of shareholders. Some of our better performing companies were quick to anticipate and tap into the rights issue market, recapitalising their base and taking the pressure off the short-term funding rollovers they face. In addition, focus has returned to balance sheet quality

as opposed to growth. Gearing ratios are being adjusted to historical norms as markets grow sceptical of higher leverage models in such volatile debt markets and the comparative cost of equity reduces.

Certainly, the hugely popular margin loan schemes are now firmly out of vogue. Key executives and many employee share schemes funded by low-interest loans are being unwound as the ugly disincentive of bullet repayments or margin top-ups place huge pressure on share registers, key employees and company liquidity.

Enjoying a resurgence, however, is relationship banking. The days of shopping around for the best price and going overseas for short-term coupons' savings have cost many organisations when they have come to renegotiate more standard facilities with the banks operating in the Australian market. As capital and debt is rationed, priority has been given to those loyal customers who have stayed with the bank rather than chasing basis points cuts.

Asset quality should also be examined very closely. In recent times it was common for assets to be significantly revalued, increasing the leverage or gearing capability of the company and in many cases using such funds to return cash to shareholders in the form of distributions. With the significant decline in the value of assets, executives and directors should be going back and testing their assumptions. We can expect to see some pretty significant impairment in asset write-downs in the 2008 reporting seasons, which again will place pressure on gearing and insolvency ratios.

While the strong Australian dollar and escalating interest rates have been appropriately hedged by many competent treasury operations, such hedges tend to run out in the medium term. Budgets and capital expenditure programs should be reforecast or deferred to match these new costs. Alternatively, overseas assets are quite cheap for strong Australian balance sheets with good liquidity.

Directors should be seeking greater disclosure in terms of debt covenants and conditions that would trigger the reclassification of debt, from long-term to short-term. This is no easy task given the complex lending documents, cross-collateralisation arrangements, class orders and early repayment trigger clauses that exist. Already we have seen plaintiff lawyers pursue continuous disclosure actions. Directors must be fully versed with the conditions that could change their balance sheet profile.

Finally, counter party risk and credit risk should be at the top of the agenda in any supply chain. Customer suppliers are looking for additional assurance as to their financial capability so they are not left with knock-on consequences from corporate failure or failure to meet contractual terms.

This cycle will probably persist for the next 12 months or so and diligent directors must get back to the basics and count the cash in this year of uncertainty.

Authors:

**Michael Andrew**

Michael Andrew is Australian chairman of KPMG.

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