Insighter

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KEY MANAGEMENT NEWSLETTER & UPDATES

Measuring Management - Avoiding the "EBITDA" Trap

Measuring and compensating senior management is a hot topic these days, particularly with the excesses that we have seen in recent business failures. Measurement and compensation has always been one of the primary concerns and responsibilities of senior management and a company's Board of Directors. At STORM, we often see financial owners focusing on EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization) as a management measurement. While this measurement provides a quick reference to enterprise value using an assumed multiple, over-reliance on this measurement can prove to be counter-productive when used as a primary measurement for senior management performance. We believe over-emphasis on any single dimension is inconsistent with building long-term growth and strategic value in an organization.

Our recommendation, based upon many years of successful operations management, is to use a balanced measurement and compensation program over extended periods of time. While EBITDA is one key measurement of senior management, it should not be the sole measurement, particularly when viewed on a short-term basis, such as annually. In addition, it is also important to distinguish between measurements that are appropriate for senior level managers and those that are applicable to other levels for management. Certain measurements of mid-level and line management are beyond their control or involve concepts that they do not understand. For example, we have observed instances where line managers refer to their positive EBITDA, but do not realize their company is operating at a significant net loss!

As we have recently seen, financial results can be manipulated in the short run to boost compensation for executives at the expense of the company's long-term financial welfare. During the 1990's, with the longest economic growth in the history of our country, many marginal managers and businesses appeared to be performing well. However, now that things have turned downward, many businesses assumed to be healthy are experiencing severe operational problems and events. Part of the problem here is the inexperience of senior management in anticipating and dealing with economic downturns. Management is focused on short-term goals and market valuations, rather than a balance of short-term and long-term operational performance. We believe that a balance of objective and subjective criteria, coupled with other longer-term incentives, such as stock options, is the best option to reward management for both short and long-term results.

We recommend a management team compensation package that includes the basics, such as management objectives for the company's business units and departments, and then the alignment of all management objectives to achieve the company's overall goals. These should be updated every six months and contain a balance of financial and operational goals. For example, financial objectives may include not only EBITDA, but also cash flow, revenue, growth, gross margin, cost control and other financial return on asset and equity measurements. Additional objectives, such as new product development,strategic positioning, market penetration, customer retention, diversification, management development and other

(See EBITDA on Page 2)

Operational Due Diligence...The Rest of the Story

One of the more subjective areas of the due diligence process is evaluating the day-to-day operating dynamics of a business. Often, due diligence gravitates toward the quantitative aspects of a business represented in financial statements or management reporting systems. While this information is foremost in traditional due diligence and valuation processes, it often fails to adequately portray existing operating issues and the potential impact on post-acquisition profitability. In today's environment, a company operating significantly below capacity can easily mask costly operational issues such as poor systems, production and quality issues. Too often the blame for poor performance is placed on external market issues. It is only when normalized activity levels return that the full extent of these problems becomes apparent.

To further illustrate this point, one must remember that the vast majority of information used to manage businesses today is historical. It is also periodic, meaning today's "good or bad" management decision will not show up in formal reporting systems for at least 45 or more days. Given the tendency to observe and then validate trends, it can easily be more than 90 days before the results of today's operating decisions begin to become apparent.

To mitigate downside operational risk in the due diligence process, one must go beyond traditional methods and seek that which is not readily apparent. What is typically overlooked in this process is what STORM refers to as "hidden" or "indirect" information. Unfortunately, this information is mostly subjective and therefore requires relevant experience and judgment to interpret and quantify. It is seldom found at the "corporate office" or divulged by those in senior positions. Instead, it resides on the shop floor, in warehouses and in conversations with front line supervisors and rank and file employees. It is most often obtained by indirect or leading questions, such as...

	Type Question	Lead in to:
1.	Do you rob spare parts from idle equipment for repairs?	Maintenance, idle equipment
2.	When was the last time you had a raise or review?	Employee morale
3.	What would you do to improve the company?	Employee involvement
4.	What was the best year you ever had here?	What's changed?
5.	What's going on with customers and competitors?	Sales and marketing focus

These are just a few types of questions that provide insight into recent developments or issues that are not readily apparent using standard due diligence methods. The executive team members at STORM, at some point in our careers, have held rank and file to senior level positions. We know where to look, how to ask the questions and how to listen to what is being said, or not being said. Our findings, when correlated with our clients' additional due diligence information, provides a more complete picture from which to determine valuation and mitigate risk. Issues uncovered by STORM are frequently material to the valuation or the entity. Let STORM be part of your due diligence team, and see how we can make a difference.

(EBITDA cont'd)

operational and strategic goals would be included, where appropriate.

Establishing measurement tools and goals is more than an annual event. It is extremely important to review and update critical measurements at least every six months to assure that the current economic and business environment is representative of the measurements being used in evaluating management's performance. All too often, benchmarks are established, and then not updated, when dramatic changes in the economic business climate or other major events occur outside of the scope of management. To ensure consideration of the long-term implications of decisions, we believe in establishing long-term objectives (3 to 5 years, or in some cases, 10 years) with annual benchmarks and semi-annual updates.

We have devised many compensation plans at all levels of management throughout our careers. By using a balanced approach, and incorporating reasonable objective and subjective criteria to evaluate management, it is possible to design a measurement and compensation plan that is more closely aligned to the economic environment and strategic positioning of the company. Careful blending of financial and non-financial objectives ensures management is not focusing on one aspect of the business to the exclusion of others. This ultimately leads to responsible actions that ensure the organization's long-term growth and survival.

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