

# You Can't Manage What You Can't Measure: Know Your Key Metrics

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**H**ow would you answer someone who asks, "How is your business doing?" As an entrepreneur, being able to answer this question accurately requires you to know whether or not your business has created value for you and your partners and where it is headed. Unfortunately, most entrepreneurs usually answer in terms in the latest financial results, referring to either the business' latest revenues or profits.



Successful businesses—those that consistently increase in value—are managed by entrepreneurs who focus on certain key performance metrics as the cornerstones for their business strategy, operating decisions and improvement initiatives. Generally speaking, the right performance metrics are those measurements that assess progress in areas of the business that: (1) directly affect the creation of shareholder value, (2) are SMART (specific, measurable, actionable, relevant and timely), reinforce desired behaviors, (4) are supported by a proven process for data collection and (5) provide useful information to support decision-making.

The trouble is that most entrepreneurs focus on the wrong metrics. Some CEOs focus on revenues and assume that as long as the top line increases, so will business value. Others focus on the bottom line, arguing that profits are a more critical performance measure. Also, there are those who think that shareholders' equity or book value constitute the primary indicator of shareholder wealth creation. Focusing exclusively on these metrics can lead to the wrong conclusion and can contribute to the impairment of shareholder value rather than its creation.

Growing the top line without paying attention to the contribution margin that those sales provide can have serious consequences in terms of deteriorating profits. Similarly, focusing on profits without considering the impact and distortions created by such non-cash accounting charges as depreciation and amortization can lead to sub-optimal decisions. Depreciation reduces accounting profits, a.k.a. earnings, even though in many cases the true value of certain "depreciable" assets such as real estate may actually increase. But, the company may be operating with antiquated technology, which may require significant investments in capital expenditures to remain competitive, but only a fraction of the outlay hits the bottom line. Lastly, book value (or the equity account on the balance sheet) may have no correlation at all to true economic value. For the most part, net asset values do not drive company value.

So the critical question is, "What is the operating metric that most closely correlates with the creation of shareholder value?" The answer lies in understanding and measuring the company's ability to generate cash as this is the essential metric that gauges whether or not business value is being maximized.

In the final analysis, every company, regardless of its industry sector or the markets it serves, really is in the same business: generating cash. And, it is the company's ability to generate cash that is most closely tied to increases in its business value. Focusing on any other metric can lead to business decisions that reduce the value of the company while producing misleading signals about its financial health.

Net cash flow is defined as that portion of the profits that can be removed the business without affecting its future operations because all of the company's internal capital needs have been taken into consideration. It is the only return that accurately portrays the company's true wealth-creating capacity, and it is determined by sales volume, operating margins, tax rates, and

As seen in

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REPRINTED FROM THE WASHINGTON BUSINESS JOURNAL, APRIL 25, 2008

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investments requirements for working capital and capital expenditures that will support the future growth in the business.

There is a proxy, however, for the business' cash flows that is commonly used by buyers of businesses and as such is a commonly accepted measure of value. This metric is known as adjusted Earnings Before Interest and Taxes (EBIT).

To measure it, start with the company's pre-tax earnings. Add back any interest charges as well as any documentable expenses that would not be incurred by a third party seeking to maximize cash flows. These are expenses related to non-essential cars, boats, family vacations or salaries for family members who don't really do any work.

Generally, the largest adjustment is related to the owner compensation. Any excess or deficit in relation to current market compensation levels for someone with similar duties and responsibilities constitute reasons for adjusting the business' earnings for the period under consideration.

This "adjusted EBIT" is the primary metric sophisticated buyers will apply to a market-based multiple (primarily influenced by the size and the growth opportunities in your business) to arrive at what they will pay for the company. In capital-intensive industries, buyers add back depreciation and/or amortization expenses—non-cash charges to earnings—to arrive to an "adjusted EBITDA" number.

It is interesting to note that although "adjusted EBITDA" is the number that most accurately predicts the value of your company, it rarely appears in any financial statement (at least in normalized form). Financial metrics such as sales, profits and book value are simply proxies for measuring cash flow and are often ineffective and misleading.

If you want to understand whether your business is creating shareholder value and make business decisions that will enhance that value, you need to measure cash flow on a regular basis. Any buyer who knows what they are doing will run the same analysis someday.

**About the Author:** Enrique C. Brito is a partner and senior managing director of The Mclean Group, a national investment bank providing merger and acquisition, valuation and private equity financing services. He has over 17 years of corporate finance and investment banking experience and lectures nationally on the subjects of M&A and business valuation. He can be reached via e-mail at [ebrito@mcleanllc.com](mailto:ebrito@mcleanllc.com) or call 703-827-5093.