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Lease Capitalization, Financial Agreements and EBITDA

EXECUTIVE SUMMARY

EBITDA, earnings before interest, taxes, depreciation and amortization, is used by many firms as a measure of performance in financial covenants and incentive compensation agreements. In 2009, when the FASB, in conjunction with the IASB, likely begins requiring firms to report virtually all leases as capital leases, we expect calculated measures of EBITDA to increase. As a result, firms may find unexpected slack in financial covenants and increases in incentive compensation that are unrelated to real improvements in performance. In anticipation of the change in accounting for leases, companies will want to revise contracts that employ EBITDA to ensure that unanticipated consequences are avoided.

This research report examines the effects of lease capitalization on EBITDA in cases where it is employed in financial agreements. Our focus is on companies noted to employ EBITDA in financial covenants or incentive compensation agreements with significant exposure to operating leases. For a sample of 25 companies we recalculated EBITDA, treating operating leases as though they were capital-lease commitments. For some firms, we found significant increases in EBITDA, with a sample-wide median increase of 7.7%

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The Georgia Tech Financial Analysis Lab conducts unbiased research on issues of financial reporting and analysis. Unbiased information is vital to effective investment decision-making. Accordingly, we think that independent research organizations, such as our own, have an important role to play in providing information to market participants.

Because our Lab is housed within a university, all of our research reports have an educational quality, as they are designed to impart knowledge and understanding to those who read them. Our focus is on issues that we believe will be of interest to a large segment of stock market participants. Depending on the issue, we may focus our attention on individual companies, groups of companies, or on large segments of the market at large.

A recurring theme in our work is the identification of reporting practices that give investors a misleading signal, whether positive or negative, of corporate earning power. We define earning power as the ability to generate a sustainable stream of earnings that is backed by cash flow. Accordingly, our research may look into reporting practices that affect either earnings or cash flow, or both. At times, our research may look at stock prices generally, though from a fundamental and not technical point of view.

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Lease Capitalization, Financial Agreements and EBITDA

Introduction

Off-balance-sheet financing in the form of operating leases has been a concern for financial analysts for some time. Recently, the FASB announced a project to reconsider lease accounting¹. The project will be an international effort composed of FASB and IASB members. A discussion paper is expected in 2008 with a final document expected in 2009. Early indications are that when these new guidelines become effective, virtually all leases will be reported as capital leases, that is, *on* the financial statements.

An earlier research report published by the Georgia Tech Financial Analysis Lab, *The Effects of Lease Capitalization on Various Financial Measures: An Analysis of the Retail Industry*, dated June, 2007, discussed the effects on key measures of performance and financial position of bringing onto the financial statements operating leases that are presently accounted for off-balance sheet. In the report we noted that EBITDA, or earnings before interest, taxes, depreciation and amortization, actually increased with lease capitalization. At times the increases were quite dramatic. We surmised that such increases in EBITDA could have important effects on contracts that employ EBITDA, such as financial covenants and compensation agreements. Increases in EBITDA may force lenders to revise financial covenants and compensation committees or to revisit incentive compensation agreements currently in place with management personnel.

This research report examines more closely the effects of lease capitalization on EBITDA in cases where it is employed in financial agreements. Our focus is on companies noted to employ EBITDA in financial covenants or incentive compensation agreements with significant exposure to operating leases.

Financial Covenants and EBITDA

Because it is useful in assessing debt service capacity, EBITDA is often used in financial covenants. Two companies that are evaluated using EBITDA are American Greetings Corp. and Martin Marietta Materials, Inc.

American Greetings Corp.

As reported by the company:

EBITDA is presented in the earnings release because management believes that it is of interest to its investors and lenders in relation to its debt covenants, as certain of the debt covenants include EBITDA as a component of a covenant calculation.²

¹ FASB Formally Adds Project to Reconsider Lease Accounting, July 19, 2006, www.fasb.org/news/nr071906.shtml.

² Source: American Greetings Corporation, Form 8-K Report to the Securities and Exchange Commission, April 3, 2003, p. 1.

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Martin Marietta Materials, Inc.

As reported by the company:

Consolidated Debt-to-Consolidated EBITDA is calculated as total long-term debt divided by Consolidated EBITDA, as defined, for the trailing twelve months. Consolidated EBITDA is generally defined as earnings before interest expense, income tax expense, and depreciation, depletion and amortization expense for continuing operations. Additionally, stock-based compensation expense is added back and interest income is deducted in the calculation of Consolidated EBITDA. Certain other nonrecurring items and noncash items, if they occur, can affect the calculation of Consolidated EBITDA. The Corporation presents this ratio, as it is a covenant within the Corporation's \$250,000,000 five-year revolving credit agreement. Under the agreement, the Corporation's ratio of Consolidated Debt-to-Consolidated EBITDA, as defined, for the trailing twelve months cannot exceed 2.75 to 1.00 as of the end of any fiscal quarter.¹

As seen in the American Greetings Corp. and Martin Marietta Materials, Inc. examples above, EBITDA is used as an important financial measure in financial covenants. Because it is measured before interest expense and income taxes, EBITDA is a measure of earnings that is available to service debt, especially interest expense on debt. An increase in EBITDA due to a change in accounting for operating leases could give a subject company more financial flexibility within its financial covenants in the absence of an actual improvement in financial performance. With improvements in measured performance relative to financial covenants, a company may be better able to avoid debt default or even find itself in an improved bargaining position with respect to terms on its debt agreements or for purposes of raising debt levels. Certainly, lenders will want to revisit and revise financial covenants to neutralize these accounting effects.

Incentive Compensation Agreements and EBITDA

Because it is a performance measure, EBITDA is also used in incentive compensation agreements. Two examples of companies that use EBITDA in their incentive compensation agreements are 24/7 Real Media, Inc. and Gilman and Ciocia, Inc.

24/7 Real Media, Inc.

As reported by the company:

The Compensation Committee set the performance targets in three categories, revenue, gross profit and EBITDA (earnings before income, taxes, depreciation and amortization). The target bonus and target short-term restricted stock and stock options grants are based on the Company's achieving the performance target in each of the three categories. For each of the revenue, gross profit and EBITDA

¹ Source: Martin Marietta Materials, Inc., Form 8-K Report to the Securities and Exchange Commission, May 8, 2007, Ex-99.2.

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components of incentive compensation, the named executive officers will be entitled to one-third of 100% of such target incentive compensation if the Company achieves 100% of the target component. Named executive officers may receive pro rata reductions in the levels of incentive compensation. For example, if the Company achieves 90% of the targeted revenue, 80% of the targeted gross profit and 100% of targeted EBITDA, executives would receive one-third of 90% of target incentive compensation for the revenue component, one-third of 80% of target incentive compensation for the gross profit component and one-third of 100% of incentive compensation for the EBITDA component. With respect to the EBITDA component, however, the Company's actual EBITDA must be at least 80% of the target EBITDA, or the named executive officers will not earn any incentive compensation under the EBITDA component. If the Company exceeds 100% of a target component, any increases in named executive officer incentive compensation shall be at the discretion of the Compensation Committee.¹

Gilman & Ciocia, Inc.

As reported by the company:

Incentive compensation for each Named Executive Officer will be determined one-third (1/3) based upon the Company's EBITDA budget for the fiscal year, and two-thirds (2/3) based upon criteria to be established by the Chief Executive Officer. The Named Executive Officer must be employed by the Company on the date that the incentive compensation is paid in order to receive the incentive compensation. Incentive compensation will not be paid to a Named Executive Officer who quits or who is terminated with cause prior to the date of payment. Incentive compensation will be paid to a Named Executive Officer who is terminated on other grounds, including a Named Executive Officer who quits with good reason.²

The EBITDA component of the incentive compensation will be computed ranging from 10% of base salary to 40% of base salary if actual EBITDA results for a fiscal year exceed at least 85% of the EBITDA budgeted for such fiscal year.

In the 24/7 Real Media, Inc. and Gilman & Ciocia, Inc. examples above, one can easily visualize how a change in the measurement of EBITDA can very directly impact incentive compensation. EBITDA is used in compensation agreements as a measure of corporate financial performance. The idea is that incentive compensation should be raised when management efforts lead to improved financial performance. When measures of performance are increased not because of real improvements but due to accounting changes, increases in incentive compensation are not warranted. Compensation committees will want to reconsider and revise incentive compensation schemes to address these accounting effects.

¹ Source: 24/7 Real Media Inc., Form 8-K Filing Report to the Securities and Exchange Commission, November 21, 2005, p. 2.

² Source: Gilman & Ciocia, Inc., Form 8-K Filing Report to the Securities and Exchange Commission, September 8, 2007, p. 2.

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The Effects of Lease Capitalization on EBITDA

We looked at the effects on EBITDA of capitalizing our sample firms' operating leases. More specifically, we measured reported EBITDA as follows:

Reported EBITDA = Income from Continuing Operations + Income Tax Expense + Interest Expense + Depreciation and Amortization Expense.

The capitalization of operating leases replaces rent expense on the operating leases with interest expense on the underlying capital lease obligations and amortization expense on the capitalized lease assets. Accordingly, under lease capitalization, rent expense is reduced (actually eliminated) and interest expense and amortization expense are increased. However, EBITDA is measured before interest expense and amortization expense. Thus, any increase in these expense captions, interest expense and amortization expense, do not serve to reduce EBITDA. As a result, EBITDA with lease capitalization is greater than EBITDA measured under operating lease treatment by the amount of rent expense. Stated more directly, Revised EBITDA can be calculated as follows:

Revised EBITDA = Reported EBITDA + Rent Expense.

In summary, we expect Revised EBITDA to exceed Reported EBITDA by the amount of rent expense.

It should be emphasized that EBITDA is not a GAAP measure. As such, there are no specific guidelines on how EBITDA is to be calculated. Nonetheless, our so-called *Reported* EBITDA is calculated using an approach that we find to be used most often in practice.¹

For a closer look at our calculations of Revised EBITDA, consider the calculations for Sears Holdings Corp. presented below. For the year ended February 3, 2007 the company reported income from continuing operations of \$1,490,000,000. To this amount we added back income tax expense of \$930,000,000, interest expense of \$337,000,000 and depreciation and amortization of \$1,142,000,000 to get the Reported EBITDA of \$3,899,000,000. We then added back rent expense of \$887,000,000 to Reported EBITDA to get Revised EBITDA of \$4,786,000,000. The addition of Rent Expense to Reported EBITDA increased it by 22%.

¹ Some analysts would adjust EBITDA for nonrecurring items. Given the subjective nature of what items of income or expense are nonrecurring, we did not adjust for them.
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Calculation of Reported and Revised EBITDA Sears Holdings Corp., Year ended Feb. 3, 2007 (Dollars in thousands)	
Net Income from continuing operations	\$1,490,000
Income tax Expense	+ 930,000
Interest expense	+ 337,000
Depreciation and amortization	+ 1,142,000
Reported EBITDA	3,899,000
Rent Expense	+ 845,000
Revised EBITDA	\$4,744,000
% Change in EBITDA	21.67%

Results

We searched public filings to identify examples of firms where EBITDA was used as a metric in financial covenants or incentive compensation agreements. Our focus was on firms with a market capitalization of \$1 billion or greater. However, we did include in our sample a limited number of smaller firms. While the sample was not scientifically selected, we do think that it offers a representative set of cases where EBITDA was employed in financial decision making.

Our results are provided in Table 1. For each company, we present our Reported EBITDA, rent expense, Revised EBITDA and the percent change in Revised vs. Reported EBITDA. As noted in the Table, the median increase in EBITDA for the entire sample was 7.7%. However, individual company results varied greatly, ranging from less than 1% for Eagle Materials, Inc. and Mylan Laboratories, Inc. to as much as 87% for 24/7 Real Media, Inc. and 76% for Gilman & Ciocia, Inc.

To Apply the Revised EBITDA figures to two of the previously-mentioned focus companies, consider Martin Marietta Materials, Inc. and 24/7 Real Media, Inc. In the case of Martin Marietta Materials, the company's financial covenants indicate that the firm's consolidated debt-to-consolidated EBITDA for the trailing twelve months cannot exceed 2.75. On the 2006 balance sheet, short- and long-term borrowings total \$705,264,000. For the year ended 2006, Reported EBITDA totals \$540,670,000. Using these figures, the ratio of consolidated debt to consolidated EBITDA is 1.30, well within the covenant requirements. Employing Revised EBITDA of \$612,918,000, the ratio improves (i.e., declines) to 1.15. While the company indicates that there may be adjustments to the measure of consolidated debt-to-EBITDA for which we have no details, for example, for the effects of certain acquisitions, it is clear that the measure does improve when Revised EBITDA is employed in its calculation.

For 24/7 Real Media, Inc., a named executive is entitled to one-third of 100% of a target incentive compensation amount if the Company achieves 100% of its target measure of EBITDA. While the company did not disclose target EBITDA, an 87.06% increase in EBITDA caused by a change in the accounting for operating leases would improve the probability that the company would reach its target.

**Table 1. Effects of Capitalizing Operating Leases on EBITDA, Fiscal Year 2006
(Dollars in thousands)**

Company Name	Fiscal Year ¹	EBITDA Ref. ²	Reported EBITDA ³	Rent Exp. ⁴	Revised EBITDA ⁵	% Change ⁶
24/7 REAL MEDIA INC.	12/31/06	2	-\$3,331	\$2,900	-\$431	87.06%
AMERICAN GREETINGS CORP.	02/28/07	1	\$153,727	\$55,302	\$209,029	35.97%
ARCADIA RESOURCES, INC.	03/31/07	2	-\$32,896	\$2,463	-\$30,433	7.49%
BAUSCH & LOMB, INC.	12/30/06	1	\$271,400	\$33,200	\$304,600	12.23%
BIOGEN IDEC, INC.	12/31/06	1	\$868,904	\$26,200	\$895,104	3.02%
BLACKBAUD, INC.	12/31/06	1	\$52,185	\$2,586	\$54,771	4.96%
BOWATER, INC.	12/31/06	1	\$402,900	\$8,500	\$411,400	2.11%
CKE RESTAURANTS, INC.	01/29/07	1	\$164,240	\$65,002	\$229,242	39.58%
CONSOL ENERGY, INC.	12/31/06	1	\$872,223	\$43,611	\$915,834	5.00%
DRS TECHNOLOGIES, INC.	03/31/07	1	\$383,739	\$31,500	\$415,239	8.21%
EAGLE MATERIALS, INC.	03/31/07	1	\$349,757	\$2,200	\$351,957	0.63%
GILMAN & CIOCIA INC.	06/30/07	2	\$2,617	\$2,000	\$4,617	76.44%
HANDLEMAN CO /MI	04/28/07	1	-\$19,285	\$9,206	-\$10,079	47.74%
INPHONIC, INC.	12/31/06	1	-\$43,829	\$1,923	-\$41,906	4.39%
LIONS GATE ENTERTAINMENT	03/31/07	2	\$55,777	\$4,400	\$60,177	7.89%
MARTIN MARIETTA MATERIALS, INC. ⁷	12/31/06	1	\$540,670	\$72,248	\$612,918	13.36%
MENTOR CORP /MN	03/31/07	1	\$98,043	\$4,000	\$102,043	4.08%
METALICO, INC.	12/31/06	1	\$24,454	\$1,181	\$25,635	4.83%
MYLAN LABORATORIES, INC.	03/31/07	1	\$539,089	\$3,944	\$543,033	0.73%
NCI BUILDING SYSTEMS INC.	10/29/06	1	\$175,036	\$11,900	\$186,936	6.80%
REYNOLDS AMERICAN, INC.	12/31/06	1	\$2,241,000	\$24,000	\$2,265,000	1.07%
SEARS HOLDINGS CORP	02/03/07	2	\$3,899,000	\$845,000	\$4,744,000	21.67%
SPX CORP	12/31/06	1	\$414,800	\$42,500	\$457,300	10.25%
STEINER LEISURE LTD	12/31/06	1	\$58,594	\$11,788	\$70,382	20.12%
VERIFONE HOLDINGS, INC.	10/31/06	1	\$121,692	\$8,885	\$130,577	7.30%
Mean Change (%)						17.2%
Median Change (%)						7.7%

¹ Fiscal Year refers to date of Form 10-K annual filing to the Securities and Exchange Commission.

² EBITDA Ref. 1 refers to EBITDA used in calculating financial covenants. EBITDA Ref. 2: refers to EBITDA used in calculating both financial covenants and incentive compensation.

³ Reported EBITDA = Income from continuing operations + Income tax expense + Interest expense + Depreciation and amortization expense.

⁴ Rent Expense is net of Sublease Rentals.

⁵ Revised EBITDA = Reported EBITDA + Rent expense.

⁶ %Change = (Revised EBITDA - Reported EBITDA)/Reported EBITDA.

⁷ The company noted that in computing EBITDA, stock-based compensation is added back as an additional non-cash expense.

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Conclusions

EBITDA is used by many firms as a measure of performance in financial covenants and incentive compensation agreements. In 2009, when the FASB likely begins requiring firms to report virtually all leases as capital leases, we expect calculated measures of EBITDA to increase. As a result, firms may find unexpected slack in financial covenants and increases in incentive compensation that are unrelated to real improvements in performance. In anticipation of the change in accounting for leases, companies will want to revise contracts that employ EBITDA to ensure that unanticipated consequences are avoided.

Interestingly, many firms, especially commercial banks, employ EBITDAR or earnings before interest, taxes, depreciation, amortization and rent expense as a performance measure in financial covenants. As EBITDAR is already measured before rent expense, it will not be impacted by the change in accounting for leases. In the interim, as financial covenants and incentive compensation agreements are written and revised, firms may want to consider replacing EBITDA with EBITDAR in financial agreements.