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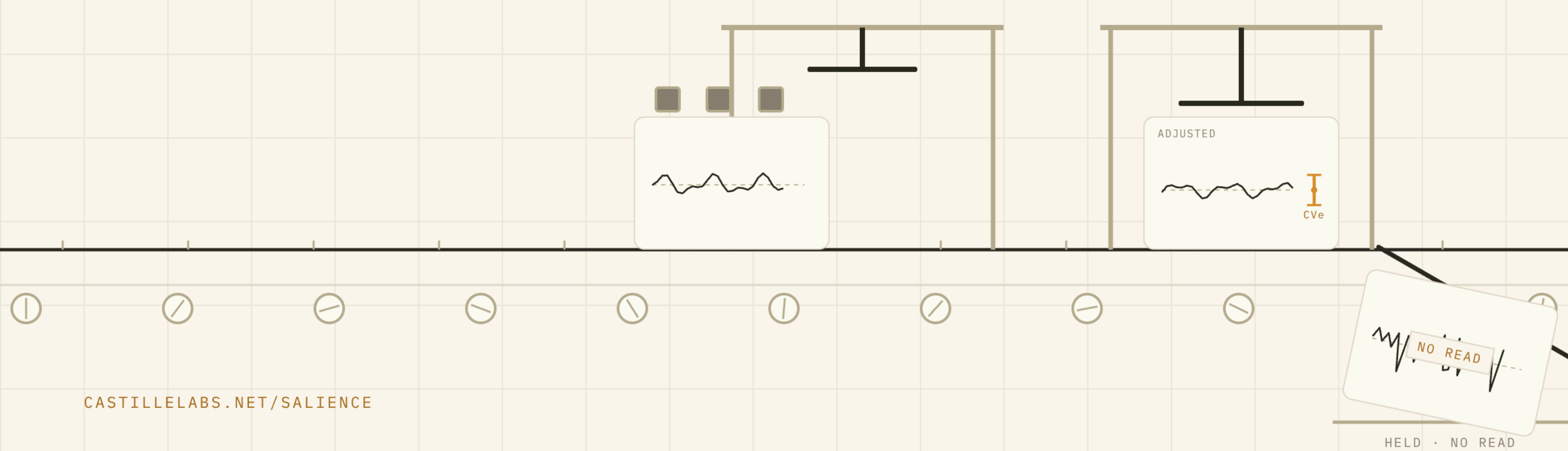
QUALITY OF EARNINGS: UPDATED

Extending & Refining What Quality Actually Means



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Almost every thoroughly considered private equity deal comes with a quality of earnings (QoE) report to closely examine the EBITDA under consideration. In a typical scenario, a diligence team spends weeks producing it and the fund pays handsomely for it. Despite the usefulness of these reports, they remain highly deal specific. The typical goal is to separate idiosyncratic or one-time charges from the earnings that are expected to be consistent going forward. This means there is no widely accepted measure of quality that can be carried to the next deal and compared. The term QoE is universal in private markets diligence, but there is no comparable definition beneath it. Our goal here is to correct that defect, and in doing so, increase the value of the concept and its application.

The primary issue is that traditional QoE analysis doesn't go far enough. Idiosyncratic issues certainly affect diligence results, but the trap laid in the definition above is the assumption that earnings that remain after adjustment for one-time events are consistent. By their very nature, earnings are not consistent. Uncertainty arrives in many forms, and revenue and expense uncertainties cascade on a regular basis into EBITDA. A full measure of QoE needs to go beyond one-off considerations to consider the underlying ongoing quality of “consistent” earnings.

The Underlying Quality of Earnings

We can get to these underlying measures of quality by looking at the variance of earnings. In Salience, the risk model for private equity, we measure this with the coefficient of variation, or CV. The CV of earnings divides the expected standard deviation of earnings by the expected level of earnings. The risk estimate comes from Salience. The forecast estimate comes from the partner and the due diligence process. It's a scale-free estimate that can be compared across companies and periods. A CV of 0.2 for an HVAC company can be compared with a CV of 0.25 for a SaaS firm. A CV computed for one target can be set beside the CV of the last target, the next one, and the rest of the portfolio. In Salience, each of these measures relies on a compact set of data most companies have readily at hand and will almost certainly be in the data room for any deal. The variance of earnings for a company, business line, or portfolio of either can be estimated in minutes.

What CV of Earnings Buys Us

When a general partner describes a company's earnings as high quality, the term refers to the behavior of earnings around their level rather than to the level itself. A volatile business producing $10M and a metronomic business producing $10M are different assets. An investor prices them differently based on this difference. The adjustment work of traditional QoE diligence settles how much a company earns once the one-time items are removed, and the CV addresses the long-term reliability of those adjusted earnings.

The earnings dispersion the CV summarizes has origins in the revenue activities of the business: the count and size of deals that close for a deal-driven business, renewal and expansion behavior for a contracted book, transaction volume for a usage model. Counts, sizes, retention and expansion rates are numbers most operating companies already hold, which keeps the data needs compact and ready.

Propagation from revenue to earnings follows the expense structure. Expense uncertainty has its own sources, some tracking revenue as variable cost, some fixed by contract, and some, such as litigation or unplanned hiring, arriving on independent clocks. Variable costs pass revenue variance through at the contribution margin, while fixed costs reduce the level of earnings without absorbing any of the variance, so the dispersion that survives lands on a smaller base. More precisely, earnings CV is equal to revenue CV times contribution dollars divided by EBITDA. A company with $100M of expected revenue and a revenue standard deviation of $8M carries a revenue CV of 8%; with a 60% contribution margin and $40M of fixed costs, expected earnings are $20M, the standard deviation passing through is $4.8M, and the earnings CV is 24%. Operating leverage has tripled the relative dispersion between the top line and EBITDA. Earnings are noisier than the revenues that produce them, in proportion to the fixed costs standing between the two. Expense uncertainty then adds its own (typically smaller) contribution, dampening or compounding depending on how expenses move with revenue.

The CV also complements the partner's conviction in a way the traditional measures of QoE cannot. The forecast level is the partner's conviction, formed as an expected return. Two partners can hold identical $12M EBITDA forecasts for two targets while having different certainty around them. This difference currently lives in adjectives like *sticky* and *lumpy*. The CV gives those adjectives a number which is comparable in units to the forecast of return. If the goal of investing is to efficiently convert risk into return, the CV combines the partner's return forecast with inherent uncertainty in the firm's operations to indicate the likely efficiency of conversion. Where the traditional report delivers a one-time adjustment to the level, the CV is an ongoing measure of the dispersion around the partner's expectations, reconciled to economic events as they occur.

Putting It Together

Traditional QoE reports typically give one or more points from three types of measurement. Each can be enhanced by the CV of earnings.

The most common construction treats quality as the adjustment bridge. In this construction the bridge takes us from net income to Adjusted EBITDA. Examples of adjustments might be add-backs for charitable donations, the owner's personal accountant, above-market owner compensation, and personal travel, followed by diligence adjustments for recruiter fees, transaction costs, and a normalized lease. The output is a point estimate of trailing-twelve-month Adjusted EBITDA.

The CV of earnings begins where the bridge ends: it takes the adjusted level as its base and sets against it the dispersion those schedules already display, so the bridge's point estimate arrives with a stated band around it. The adjustments keep their value, but gain a second dimension to support the longer-term consistency of earnings in relation to your forecast.

A second type of construction supports a high-versus-low quality judgment with a cash conversion ratio, cash flow from operations over net income, offered with the acknowledgment that the ratio needs context to be read correctly and cash conversion is a single-period snapshot of accrual intensity, silent on how earnings behave across time. The CV of earnings supplies that missing dimension. Both measures are scale free, and where cash conversion characterizes the composition of a single period's earnings, the CV characterizes their dispersion across periods, so the two read together as complements: accrual quality in one, stability in the other.

A third construction treats the QoE as a waypoint between a proof of cash and a list of deal risks, with quality defined by whatever the specific deal's risks turn out to be. The framing is explicitly situation-specific. The CV of earnings gives that narrative a unit. Each named risk is a source of revenue or expense variance, and stated as contributions to the earnings CV, the deal-specific list becomes a decomposition that can be set beside the same decomposition for any other deal.

The table below compares the three measurements on the same questions.

	Adjustment bridge	Cash-conversion ratio	Risk narrative
Where does “quality” live?	The net-income-to-Adjusted-EBITDA bridge	High/low judgment plus cash conversion	A waypoint between proof of cash and deal risks
Is quality a number?	No — a schedule of adjustments	Partially — CFO ÷ NI	No — a narrative
What kind of number?	Level adjustments (dollars)	Single-period ratio	—
Terminal output	Point estimate (TTM Adjusted EBITDA)	Judgment plus context	Situation-specific risk summary
Comparable across deals?	No	Only with context	Explicitly not
What the CV of earnings adds	**A stated dispersion band around the adjusted level**	**The across-period behavior the single-period ratio lacks**	**A common unit that makes named risks comparable across deals**

Each approach in the table describes a different type of quality. The Salience approach expands the usefulness of all of them. The earnings CV captures something essential and intrinsic about how earnings are likely to behave on an ongoing basis after QoE adjustment.

How the Pieces Fit

None of this retires the QoE report. The bridge establishes the level, scrubbed and defensible; the partner's conviction sets the forecast against that level; the CV states the dispersion around the forecast in a unit comparable across the portfolio. The diligence industry has spent decades refining the first step under the name of quality. Salience expands that concept into ongoing measurement of quality, and as we'll see in a later article, Salience also provides the means by which quality can be most efficiently improved. Learn more on the method at castillelabs.net/salience.