

# CONTRACTOR SUSTAINABILITY: UNDERSTANDING THE NUMBERS

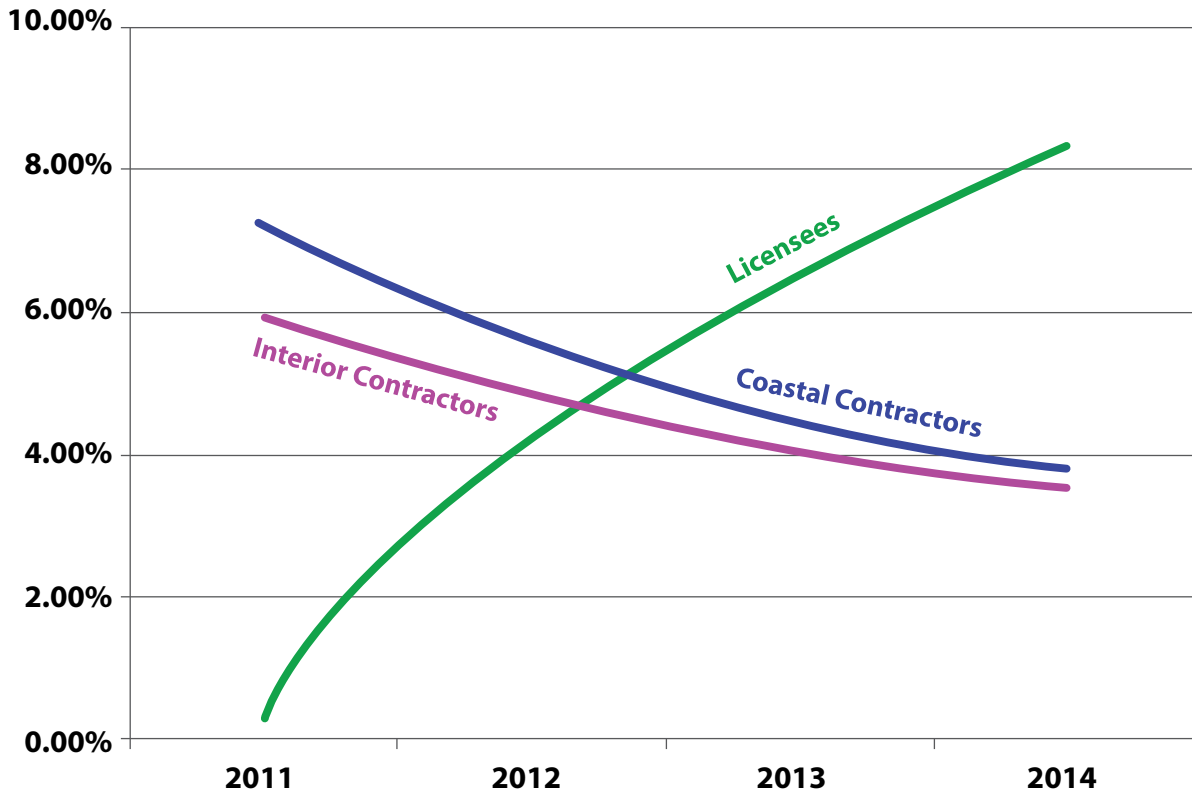
By Aaron Sinclair

At the 73rd Convention and Trade Show in January, I was honoured to be invited to speak on the sustainability of logging contractors. One part of the presentation featured the graph below showing the profitability trend of logging contractors and publicly traded licensees operating in British Columbia.

We analyzed the financial statements collected and adjusted them to remove non-operating income and expenses and normalized tax planning measures. We also adjusted management compensation to a consistent amount to recognize differences in compensation that

wards a reasonable profit margin. At the same time, contractors have experienced a less aggressive softening in their profit margins.

Four years is a short time period to establish a trend but four years for small private enterprises like logging contrac-



Source: PNL Consulting Inc.

Figure 1: Licensee and Contractor Profit Margin Trends (2011 - 2014)

## How Our Analysis Works

Our company has been fortunate to work with some great logging contractors over the last few years who have trusted us with their confidential information, including their financial statements. They know how much confidentiality means to us and that we take their trust seriously.

The contractors that shared their financial statements with us represent both Interior and coastal contractors. The Interior sample represents an annual harvest capacity of approximately 23 per cent of the Interior harvest. The coastal sample represents an annual harvest capacity of approximately 14 per cent of the coastal harvest.

could influence the performance. Then we calculated the median adjusted operating profit margin in each fiscal year and calculated the logarithmic trendline to smooth the variation from year-to-year. This is how we arrived at the Interior and coastal profitability trendlines in the graph above. The same process was followed using the available financial statements from publicly traded licensees to establish the profit margin trend of licensees.

## What Our Analysis Found

The results of this analysis shows that from 2011 through 2014 licensees have moved fairly aggressively from a near breakeven profit margin to-

wards a reasonable profit margin. During that time, a contractor is likely to have turned over at least half of their fixed assets while a licensee may have turned over less than 20 per cent. This disparity is reflective of the differences in capital intensiveness of contractors relative to licensees.

## Understand EBITDA and Capital Intensiveness

Capital intensiveness is a reflection of the need for upfront investment in order to operate. The forestry industry is capital intensive and needs more cash flow to be sustainable than non-capital intensive industries. Contractors are capital intensive businesses with shorter asset lives and so they need more cash flow

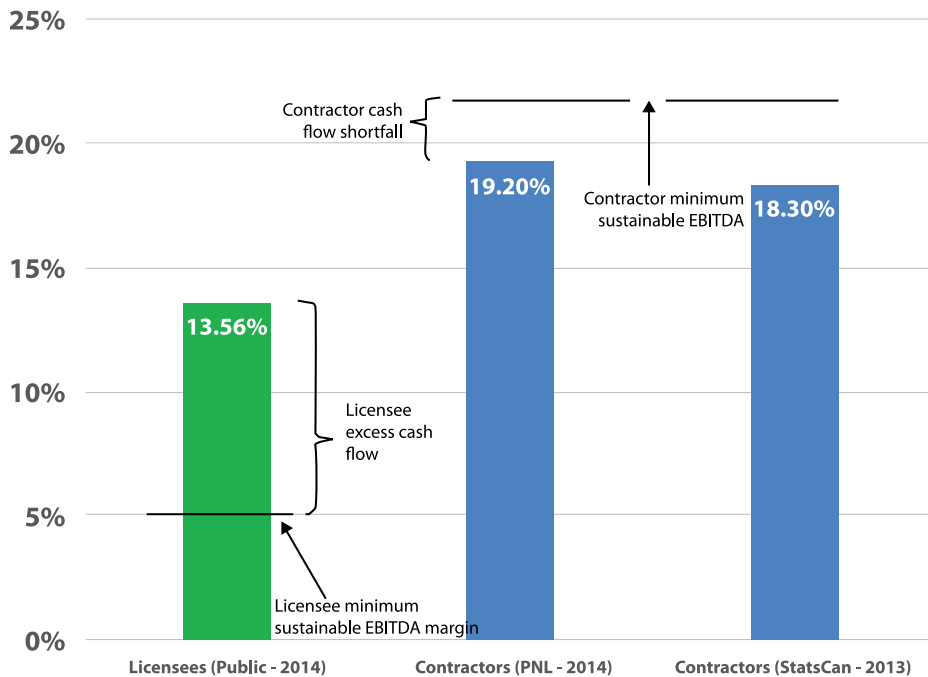


Figure 2: Licensee & Contractor Actual and Minimum Sustainable EBITDA Margins

than licensees that are capital intensive businesses with longer asset lives. The way to measure cash flow before capital is to use EBITDA—earnings before interest, income taxes, depreciation, and amortization. EBITDA is a measure of how much cash flow a business generates after paying its operating expenses but before paying for its capital assets, income taxes, or its ways of financing assets (i.e. debt and equity).

EBITDA margin is calculated like profit margin, as a percentage of revenue. The higher the EBITDA margin, the more cash flow the business generates. For a business to break even on capital intensiveness, it needs to generate enough EBITDA over the life of its capital assets to replace them when they require replacing. If it does not, then they must use equity to bridge the shortfall between the EBITDA generated and the replacement cost of a new capital asset.

### A Real Life EBITDA Example

Assume the full cost to purchase a new buncher is \$600,000 and it has an efficient useful life of five years. That buncher would need to generate at least \$120,000 ( $\$600,000 / 5 \text{ years} = \$120,000$ )

in cash flow after operating expenses such as fuel, wages, insurance, repairs, etc., every year just to replace itself. If an efficient buncher generates \$550,000 per year in revenue, it needs a 21.8% EBITDA margin ( $\$120,000 / \$550,000 = 21.8\%$ ) just to replace the machine. This margin does not consider any profit for the owner to justify investment in or risk associated with the business.

Comparing Statistics Canada data with our data (see graph below), logging contractors' average EBITDA margin is between 18.3 per cent and 19.2 per cent, respectively. In the buncher example, that means the average contractor is short 2.6 to 3.5 per cent in cash flow (\$14,000 to \$19,000) per year to replace that buncher in five years. It's not much in the context of a contracting business on an annual basis and not something a contractor may even notice until it is time to replace that buncher. The scenario gets worse if inflation and exchange rates mean a replacement buncher costs \$650,000 five years later. Now the contractor is short \$120,000 to \$145,000 to replace the machine (18 to 22 per cent of the purchase price).

As the contractors' shortfall increases, they may need to run the machine

longer and risk potential lost efficiency through downtime with increased repairs and maintenance expenses or use equity to purchase that replacement buncher. This is a pernicious scenario that is not easy to identify on an annual basis and may not even be obvious on the first or second replacement cycle of equipment.

### Impacts on the Forest Industry

Our data shows that BC's logging contractors are stuck in this pernicious scenario and it's getting worse. The industry knows it but is caught in an echo chamber that reinforces long gone stereotypes. Contractors dug deep after the financial crisis in 2008 to keep the industry afloat. However, unless major licensees are willing to invest some of their strengthening profits to improve contractor sustainability moving forward, the supply chain will reach a breaking point. Eventually, equipment must be replaced. Running older, worn out equipment or depleting equity to replace equipment is not sustainable. This path leads to more contractor exits and places major licensee operations and whole communities at unnecessary risk. 🌲

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