EBITDA, A Financial Mirror or a Trip Through the Looking Glass?

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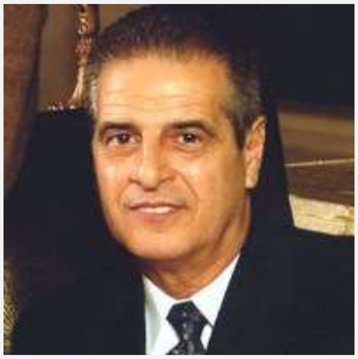

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EBITDA is one of those financial terms that prove the old adage that "a little knowledge is a dangerous thing." It seems as though every day, I hear business brokers, Merger and Acquisition specialists and owners of companies stating that the appropriate way to sell a business is to ask for some multiple of EBITDA.

After hearing a statement like this all I can think of is "wow, the purchaser of the business sold for the asking price based on this formula has just hit the lottery.

Sometimes, it gets even worst. I hear these same professionals using the term EBITDA when discussing recast financial statements and cash flows. At that point, I generally hand them the name of a good accountant and tax attorney and suggest that they invest some money and a few hours of their life speaking with the accountant and attorney so that they can at least speak in a semi-educated manner when discussing one of the basic elements in the value of a business.

EBITDA stands for Earnings before Interest, Taxes, Depreciation and Amortization. It is calculated by taking a business' operating income and "adding back" the interest, depreciation and amortization expenses.

By adding back, we mean taking these expenses on the profit and loss statement and adding it to the operating income to determine exactly what the EBITDA is. We generally use EBITDA to analyze a company's operating profitability before its non-operating expenses (such as interest) and non-cash charges (depreciation and amortization).

Now here is where things can get a little dicey for the uninitiated; the term EBITDA is a type of cash flow, but for privately held firms, it is not normally the best term or the most effective way of looking at a company's profitability. A better term is Discretionary Cash Flow. So you ask, what's the difference? The difference is in the allowable "add backs." As we discussed above, EBITDA really limits to us to just four add backs: Interest, Taxes, Depreciation and Amortization. Discretionary Cash Flow on the other hand allows us to add back all appropriate discretionary expenses, such as, the owners' personal automobile, personal insurance premiums, and the Country club dues. In other words, under Discretionary Cash Flow, we can add back any expense that is not necessary for the business to operate and that another business owner might spend in a different manner.

That being said, one might ask, is there ever a good time to use EBITDA? As my friends in the Midwest would say, "you betcha!"

EBITDA is a very effective analysis tool when we want to compare profitability between companies and industries. EBITDA eliminates the impact of a business' financing and accounting decisions, and thus offers a good "oranges-to-oranges" comparison. For example, EBITDA as a percent of gross revenues can be used to find companies that are the most effective with their operations within any given industry. Traditionally, it has been very difficult to compare two businesses as there are so many different variables in running a company even within the same industry. EBITDA levels the playing field to a certain degree, giving such comparisons a more reasonable basis in reality.

Once the EBITDA to Gross Revenues ratio is determined, we can also use it to look at industries over a period of time. This suddenly allows us to compare "heavy" or "traditional" industries, such as metal mold injection or printing industries with newer industries such as Applied Service Providers or Pay By Internet industries. This comparison is a great boom to angel investors or to a private business purchaser allowing them to make educated purchase decisions based not only on a single targeted business, but also on the direction such a targeted business' industry is heading.

While EBITDA is a great tool to aid in the comparing profitability between industries and companies and in determining a baseline for profitability, it is not the best hammer we have in the tool kit for aiding in the determining of the value of a smaller privately held business.

Again, we need to be careful with our terminology. We often use the term Cash flow when we discuss a business' profitability, operations and value. As appraisers, we are really concerned with Discretionary Cash flow, in other words, financial benefits, whether cash or non-cash, accrue to the business owner after all of his or her expenses. Accountants and financial executives however, often use the term "Cash Flow" to determine how much cash a company is generating. That is to say, they look at it more as a working capital rather then ultimate owner or shareholder benefits.

When EBITDA is used as a sole indicator of profitability or desirability of an investment in a private firm, we find ourselves walking on both thin and deceitful ice. Let's look at an example. Slice It, Inc. is a firm that manufactures golf clubs. It has $5,000,000 in gross sales. Its stated net income last year was $200,000. Upon looking at last year's profit and loss statement we find the following expenses:

- Depreciation – $100,000
- Interest – $35,000
- Amortization – $20,000
- Vehicles - $20,000
- Meals and Entertainment - $10,000
- Travel – $30,000
- Officer's Salary – $250,000

If we were to solely look to EBITDA, our profitability for last year would look like this:

Net Income:	$200,000
+	
Depreciation	$100,000
Interest	$ 35,000
Amortization	$ 20,000
Total Profit (EBITDA):	$355,000

However, if we approach it from a Discretionary Cash Flow approach, we would look at it a bit differently. Let's assume that the vehicle expense is a Mercedes Benz only used by the owner for his personal use. Further, both the meals/entertainment and travel expenses are primarily for the owner's personal enjoyment and are not in any manner related to a business necessity. Finally, let's presume that the average salary of a CEO of this type of company in this industry and trade area is $150,000. Then we see this profitability analysis:

Net Income:	$200,000
+	
Depreciation	$100,000
Interest	$ 35,000
Amortization	$ 20,000
Vehicles	$ 20,000
Meals/Entertainment	$ 10,000
Travel	$ 30,000
Adjusted Officer Salary	$100,000

Total Profit (EBITDA): $515,000

When we look at these two profitability analysis on a side by side basis, we can really get a feel for why we must be careful when determining the true profitability of a company. The valuation ultimately placed all of its weight on the capitalization method (which applies a capitalization rate against some measure of profitability). If the appraiser determined that the appropriate capitalization rate was 25% and applied it to EBITDA, the business would have been sold for $1,420,000. However, if the appraiser used the more appropriate Discretionary Cash Flow method to determine real profitability and applied it against the same rate, the owner would have received $2,060,000.

In today's litigious society, one can almost be assured that a savvy business owner would eventually catch the difference between these two approaches and probably would be filing a law suit against the entire team who under valued his business by $640,000 for not choosing the correct standard of profitability.

In the end, EBITDA has its place within profitability and economic analysis of companies. It is certainly a great way to evaluate the trends of industries and companies when we need to do so on a level playing field. Once we get to the level of business where discretionary expenses are rare, it is a good choice for determining profitability. However, when we are looking at businesses with under a certain level in gross sales, say ten million a year, it can become a financial "cracked mirror" distorting the real economic value of a company and just waiting to lead us into the "through the looking glass" of business litigation.