EBITDA Can Be Misleading

George Abraham, Business Evaluation Services

George Abraham, Business Evaluation Services

EBITDA, otherwise known as earnings before interest, taxes, depreciation, and amortization, has become the buzz word of the century, touted by many as the measure of company performance and indicator of value. Not so fast, it is only one of the methods used to measure performance. It is exactly what it is and should be used as one indicator of earnings for comparison purposes. By itself, EBITDA does not measure how healthy a Company is.

Understanding the amount of asset depreciation is of limited value in determining the present viability of a company; instead, it is a measure of what the company has spent, in the past, on capital expenditures. If you are trying to evaluate the health of the company, depreciation and amortization are "non-cash" items and are irrelevant. Calculating the company's future capital expenditures is much more meaningful. The assets purchased in the past, can be a measure of calculating needed purchases in the future, and the future is what is important.

EBITDA is only one indicator of how much debt the company can service after it is acquired, but is not a measure of the company's health. EBITDA does not address working capital requirements, which are critical to a company's health. Again, EBITDA is only one method for evaluating a company's performance.

EBITDA is very appealing when it comes to valuing a company, as the multiples represent a fast and convenient way to determine value, but again, it is only one method. There does not exist, a quick convenient method to value a business. No two businesses are alike, not even in the franchising world. EBIT, EBITDA, Adjusted EBITDA, Sellers Discretionary Cash are all backward looking.

The value of a business is a function of its expected future performance. EBITDA is a historic measure. Particularly in the current economic environment, future EBITDA may be significantly lower than historic EBITDA.

While the value of every business can be expressed as an EBITDA multiple, EBITDA multiples do not determine value.

EBITDA measures the flow of earnings but offers no insight into the balance sheet. Business value, however, must take into consideration a variety of other factors, such as whether the business has adequate working capital, whether there has been deferred maintenance on capital equipment, how much investment is necessary to add the next increment of capacity, or what contingent liabilities might result in future economic costs. A wise investor will not neglect these points.

EBITDA may not represent the actual profitability of the company. Large companies with stockholders and investors strive to show as much profit as they can. Smaller, privately owned companies with no investors and just family shareholders strive to show the least amount of profit. Between these two psychologies, are a myriad of other companies doing a little of both. The key to determine value is to determine which earnings are the most representative of the subject company for comparison purposes.

All businesses are not similar—each has its own unique set of strengths, weaknesses, opportunities and threats, none of which is captured in EBITDA multiples. The multiples used to value a company must be based an assessment of future risk from research on what challenges the company will face in the future, its cash needs, capital expenditures and working capital needed for growth.

This article is not meant to discredit EBITDA, it is meant to convey that it is only one of many measures of earnings and is not, by itself, a sole method of measuring a company's performance or a quick way to value a business. If you replaced EBITDA in this article with EBIT, Adjusted EBITDA, Sellers Discretionary Cash, it would still be the same.