

A photograph of three doors in a hallway. The two doors on the left are white with silver handles, and the door on the right is bright red with a silver handle. The floor is made of light-colored wooden planks.

THE CEO'S GUIDE TO  
**UNDERSTANDING EBITDA**

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# EBITDA is one of the most closely examined metrics in the M&A process.

During negotiations in an M&A deal, buyers and sellers look closely at several factors in order to agree on a price that properly captures a company's value. EBITDA — which stands for earnings before interest, taxes, depreciation, and amortization — is used as a way to measure company performance. EBITDA indicates whether a business is profitable by revealing the amount of its normal operational earnings.

In this ebook, you'll learn:

- How investors use EBITDA
- Whether EBITDA is the same as cash flow
- How to use adjusted EBITDA to make your company more attractive to buyers

EBITDA has many uses in addition to the M&A sales process. For traders, analysts, portfolio managers, and others, it is an indicator of whether companies are properly valued. It is also a gauge for lenders to know if companies will be able to pay their future debt obligations. However, while EBITDA provides a valuable snapshot of a point in time in a firm's cycle, it does not necessarily provide a complete picture of a business' true value or performance.

If you're considering selling your company, understanding how EBITDA is calculated can help you present your company's financials in a way that makes your firm's post-sale cash flow attractive to buyers.

Investors use EBITDA to measure the enterprise value of the company.

"In a sale process, generally what a buyer pays for a company is a multiple of EBITDA," says James Cassel, chairman of Cassel Salpeter & Co.

*EBITDA does not necessarily provide a complete picture of a business' true value or performance.*

## Is EBITDA the Same as Cash Flow?

Many think of EBITDA as synonymous to a company's cash flow, but is this really the case?

Adams Price, a managing director at The Forbes M&A Group says that EBITDA serves as "a proxy for pre-tax operational cash flow. It gives a sense of what cash flows might be expected to come out of the business after an M&A transaction." Since a company's depreciation, amortization, debt, and tax profile can change as a result of a deal, EBITDA removes those components from the picture. EBITDA is also a more standardized way for buyers to compare companies within their respective sectors.

What EBITDA effectively does, according to Cassel, is take the earnings of a company while not accounting for capital expenditures (capex) and the interest on a company's debt.

EBITDA removes the factors that distort a company's profit from the equation. This is why even though EBITDA is not precisely cash flow, it can be considered the best proxy.

## How is EBITDA Calculated?

What goes into calculating EBITDA? Kenneth Eades, a professor of business administration at the Darden School of Business, explains how EBITDA is calculated to arrive at this standardized number. "The metric starts with EBIT," a company's profit before interest and taxes, "which is a nice number because it indicates how

much profit a company produces before it pays debt holders and the government,” Eades says. :5

After taking EBIT and adding back the depreciation and amortization expenses for the period, we get EBITDA. EBITDA has the benefit of being a number that is not affected by how much debt a company carries. However, “this comparison is ideally used within the same industry because the depreciation and amortization part of EBITDA will differ across industries,” Eades says.

Depreciation expense is created when the cost of a long-term asset is divided and reported as an expense over a period of time. For instance, companies that are in capital intensive industries often have a lot of equipment on the books that creates a significant depreciation expense. When this depreciation expense is added to EBIT, the resulting figure is significantly larger. By contrast, other industries will have little or no depreciation to add back, which means the two figures will be approximately the same value.

While depreciation relates to “real” assets such as equipment, amortization involves adding back expenses tied with intangible assets such as intellectual property or patents. An amortization expense is created when a cost of a patent, for instance, is divided over the length of the patent’s life.

There are differences in companies’ multiples and earnings. When buying the assets of a company, the transactions are mostly on a cash-free and debt-free basis, with the debt being paid off at closing. In terms of cash flow, buyers look at non-cash items such as depreciation. From these, many private equity firms come up with range of multiples of EBITDA depending on the industry and business characteristics.

# How Using Adjusted EBITDA Can Make Your Company More Attractive to Buyers

*Getting a better valuation is one of the most important considerations when selling a business.*

Getting a better valuation is one of the most important considerations when selling a business. Using an adjusted EBITDA calculation can help enhance your company's attractiveness by providing the buyer an accurate depiction of future cash flow.

The adjusted EBITDA calculation takes into account certain items that have no bearing on a firm's actual operational costs including non-recurring or one-time expenses.

Due to the way private companies account for these items, the use of adjusted EBITDA is more typical of private deals.

"A private company's expense structure may not reflect market compensation rates, and often are not reported in accordance with generally accepted accounting principles (GAAP) standards," says John Weld, a managing director of Strategic Value Advisors. "In publicly traded companies, which are subject to GAAP accounting, such anomalies aren't as prevalent."

Aside from distinctions in size, the items that are included in the adjusted EBITDA calculation vary for every company depending on its payment structure and expenses.

Using the adjusted EBITDA calculation, companies can take out an extraordinary item including one-time litigation expenses or not factor that into a company's ongoing expenses.

They can also take into account certain add-backs. "The adjusted EBITDA number is different due to certain add-backs, indicating what companies have to pay above the line to get to profitability," says James Cassel, chairman of Cassel Salpeter & Co.

He explains that to get to net profits from EBITDA, companies have to add back the taxes, depreciation, amortization, and interest. For example, in the case of a family-owned business, the salary of a family member who is not active in the business might be added back in an adjusted EBITDA figure.

Another potential add-back is cost savings based on expenses that can be eliminated after a merger happens and upon integration. These add-backs can be viewed as synergies in an M&A deal. For instance, a buyer might already have an accounting

department. Or Cassel cites selling a widget software business that has its own CFO or has : 7 excess capacity. “As investment bankers, we try to show that, due to synergies, there are X dollars of savings,” Cassel says.

But, the problem lies in who gets the benefit of the saving. For CEOs, this might mean convincing buyers to pay for those synergies with the help of their advisors. Having to use powers of persuasion can happen in cases where the buyer might not want to pay for those synergies. Cassel cites an instance where a buyer’s analysis shows that the synergies reduce the purchase price from paying 7X EBITDA to a lower multiple.

There are no set rules as to which of these items need to be removed or added back into the adjusted EBITDA calculation. Thus it is important for sellers to work closely with their advisors to determine what goes into the computation to get the best price and valuation for their companies in an M&A deal.

“When it comes to adjusted EBITDA, this is often a matter of negotiation as to which items can be added back to the operating expenses of the company and which items are discretionary, extraordinary or non-recurring” says Craig Dickens, CEO and founder of Merit Harbor Group.

“A good investment banker will construct a defensible rationale for add-backs and negotiate vigorously around these items; however, the best defense is to it’s best to run as clean an operation as possible leading up to a sale.”

Keeping a clean operation is a good rule of thumb for CEOs to remember — this means the less discretionary add-backs to EBITDA, the better it is for acquirer confidence.

# When EBITDA Is Just a Number

*Experts agree that EBITDA has limitations.*

Experts agree that EBITDA has limitations and should be taken in the context of other factors in the transaction. Buyers seriously interested in your company will also conduct in-depth due diligence processes to examine your company's financials over a longer period of time. This is essential for buyers to get a proper assessment of a business's worth.

"EBITDA is only the starting point and due diligence should result in the discovery of whatever operational issues there are in the financial reporting and EBITDA," says John Weld, managing director at Strategic Value Advisors.

The due diligence can either happen before or after the letter of intent (LOI). There is no set practice for when due diligence is conducted — many buyers already conduct rigorous due diligence before they submit an LOI or have a more intensive process after the LOI. An M&A advisor can provide you with more information about the due diligence process and timeline.

The norm is for buyers to examine a minimum of three years of financial statements and tax returns — with many of them looking at five years — to determine a target's profitability trends. "They look at a firm's tax returns and compare them to its financial accounting reports because these returns may tell something about the business' expense structure as well as the quality of a company's profitability that might not be apparent from the financial statements," Weld says.

Beyond this, buyers will look at a target company's balance sheet history as a means of discovering existing or potential cash flow issues. "Thus, reported EBITDA is important, but is not, by any means, all that a buyer looks at to determine value of a target," he says.

Conducting a quality of earnings review by looking at three- to five- years of EBITDA will allow buyers to see whether the metric has gone up or down or if it has shown consistency over that period. This gives a sense of a business' predictability.

Through due diligence, investors are looking for "growth and an indication of whether a company will continue to grow in the future," says Adams Price, a managing director at the Forbes M&A Group. "The more important things are consistency and quality of earnings."

Among other factors, what buyers seek "is EBITDA consistently growing over time," Price says. "Looking at a longer period of time is always better — certainly a period near an economic cycle, which would give a good indication of performance." Companies that still had predictable earnings or that had not gone down during the downturn in 2009-2010 are particularly attractive.



## The Limitations of EBITDA

EBITDA is a reliable number that the industry cannot ignore. However, investors have to use a variety of measurements when buying a company — including, as demonstrated above, testing for the quality of earnings as part of their due diligence.

“While EBITDA is a good measure especially when comparing investments, it is not a catch-all metric that can completely capture a company’s worth,” says Craig Dickens, founder and CEO of the Merit Harbor Group. “Many owners have become fixated on multiples of earnings or multiples of EBITDA. That can leave significant value on the table.” This is especially true, he says, as intangibles are increasingly becoming a larger part of a company’s overall value.

Intangibles — non-physical assets like intellectual property (i.e. patents and trademarks) and brand recognition — “are receiving more and greater importance in deals and, ultimately, multiples,” Dickens says. Building a company’s value through intangibles can significantly increase its value over time.

The case of intangibles is clearly a situation where EBITDA plays a smaller part in valuing a company. “Especially at early stages of operations of such companies, EBITDA might not provide a sound basis for determining the real value of the enterprise,” says Strategic Value’s Weld.

The warning here is — “don’t just stop at looking at EBITDA as a proxy for value. Great bankers can help owners monetize the intangibles as well,” Dickens says. “As with many things, the total value of a company cannot be reduced to just one number.”

He encourages acquirers to factor in the following as part of their analysis:

- Growth rates
- Size
- Intangibles
- Quality of earnings
- Intellectual property
- Barriers to entry
- Recurring revenue
- Customer concentration issues

These are “on par or even more important than EBITDA,” Dickens says. For a business owner considering sale, it’s important to focus on and account for each of these factors of interest.

*Placing the stock in the FLP wrapper creates opportunities for valuation discounts.*

# Alternatives to EBITDA for Measuring Financial Performance

Most industries use a combination of adjusted EBITDA and free cash flow to measure how companies are faring. However, although EBITDA has become a standard metric for financial performance, certain types of companies or industries have relied on other metrics for various reasons.

Other metrics that measure financial performance:

- Variance of a company's capex cycles (e.g. manufacturing firms)
- Multiple of revenue (e.g., technology companies)
- Multiple based on the return on a company's assets/book value (e.g., banks and financial institutions)
- Network effect (e.g., services and technology businesses)
- EBITDAR (e.g., restaurants and casinos)

There are some types of businesses, for instance, where EBITDA is not an indicator of a firm's profitability. Profits that cannot be measured through EBITDA can be explained by a number of factors including a variance in company cycles.

Consider manufacturing firms that require ongoing and significant capex. Since EBITDA does not take into account a company's capex, the calculation might not reflect how the frequency and severity of these expenses have hurt a company's profit.

Buyers have taken these discrepancies in company cycles into account when calculating the price they want to pay for targets in these industries. So even if "there may be EBITDA issues that surface during due diligence, an offered and accepted purchase price might still be expressed in some multiple of EBITDA," says John Weld, a managing director at Strategic Value Advisors. "In such cases, the EBITDA might just be a catch-all after buyers determine that they want to pay X price for a deal."

Aside from capex cycles, in some privately held situations, buyers do not use EBITDA, but develop a price as a multiple of a firm's revenue.

For technology and services companies, for instance, a multiple of revenue is used

because of limitations in their cash flow and EBITDA. “While many technology companies have high revenue and other metric growth rates, they are generally reinvesting to fund their growth and, therefore, are not yet cash flow positive or have limited EBITDA,” says James Cassel, chairman at Cassel Salpeter & Co.

Buyers are concerned about revenue streams. Technology and services companies in particular measure performance through their growing customer lists. For these firms, the number of subscribers is a draw for investors — even if they cannot show strong EBITDA.

“This is what is known as the network effect,” Kenneth Eades, a professor of business administration at the Darden School of Business, says. “Once a firm gets to a critical number, it does not have to wait to profit before investments can start to come in. In this instance, investors do not need to wait for EBITDA, but invest in these companies a little bit earlier.”

For banks and other financial institutions, they typically use a multiple based on the return on a company’s assets or book value. In this case, the financial industry is generally looking at the return on equity.

A different measurement known as EBITDAR is used for organizations with high rent costs such as restaurants and casinos. EBITDAR expands on EBITDA by including “R” for rents to provide a more accurate picture of a firm’s financial performance.

## Buyer Characteristics

The use of EBITDA, to some degree, also depends on whether the buyer is a strategic or a private equity firm.

“Financial buyers are just purchasing a cash stream,” says Strategic Value’s Weld. “They are going to drill down on financials and try to understand what the real cash flow is.”

As a result, these buyers will usually not pay more than 3X EBITDA. This is typical of many service businesses with a cash flow that is not growing but is consistent.

Meanwhile, strategic buyers will traditionally pay a higher EBITDA multiple as “they might be a little bit more focused on a target’s growth profile and customer base than a financial buyer,” Weld says.

What these buyers are most interested in are the drivers of value that may or may not have to do with a company’s current cash flow. An offer or an agreed price will often be expressed as a multiplier of EBITDA, but the buyer will have considered many factors other than EBITDA in determining its view of the value of the target.

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“While EBITDA can be defined and agreed to by a buyer and seller, for a strategic buyer, the most important issues will be the market strength of the seller, its growth profile, and what the buyer believes it can accomplish with the business if it buys it,” Weld says.

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This is why in M&A deals that involve strategic buyers, for as long as the positive factors mentioned above are present, investors would not mind paying a higher multiple of EBITDA. In this case, EBITDA plays a smaller part in the buyers’ determination of value. For example, a dynamic, privately held company with growing and repeatable revenue can be expressed through an elevated multiple of EBITDA of up to 6X or 8x EBITDA, or even higher.