What's Missing in EBITDA?

Brad Mewes | October 9, 2017

Takeaway: Is a multiple of EBITDA the right and accurate valuation for your company? Here are some common errors business owners make when considering EBITDA as a valuation method.

I've had a lot of conversations lately about EBITDA multiples. Generally, the question I receive is, "What do you think about this multiple? Is it fair/reasonable/realistic?" Invariably I respond with something along the lines of:

"Sure, it seems generally reasonable. But did you consider…" "Sure, but is that a forward multiple or a trailing multiple?" "Sure, but how did you compute the multiple?"

The challenge with EBITDA multiples is they are general in nature, and almost always contain a myriad of assumptions. Furthermore, they can be easily manipulated to suit the party using the multiple. I think Warren Buffett says it best, "People who use EBITDA are either trying to con you or they're conning themselves." Charlie Munger, Buffett's right hand man goes even further "I think that, every time you see the word EBITDA, you should substitute the word 'bullshit'." Strong words from one of the most successful businessmen on the planet. Yet EBITDA continues to be the gold standard in which a company is evaluated.

EBITDA — The Foundation

EBITDA (or Earnings before Interest, Taxes, Depreciation and Amortization) forms the foundation of most multiples. Generally speaking, when someone refers a multiple of 5x, they are referring the a multiple of EBITDA (unless you work in software and technology, then it's more likely you're referencing a multiple of sales).

The reason EBITDA is used when evaluating companies is that EBITDA normalizes earnings across companies with different levels of debt (interest), different tax structures and impacts (tax), and different investment decisions (depreciation and amortization). EBITDA is a quick and easy way to compare companies across an industry. EBITDA also approximates cash flow to the firm (rather than equity holders), which is a key component in valuation.

EBITDA — Real or Fake Expenses?

While EBITDA is an often-used metric when evaluating an acquisition because it approximates cash flow, it isn't exactly cash flow. Cash flow is critical in valuation because, ultimately, when buying an asset, the buyer is buying future cash flows. In other words, a buyer puts up money today in the expectation they will receive more money in the future than what they gave away today.

The "ITDA" of EBITDA is often referred to as non-cash expenses. But last I checked, interest, taxes and even depreciation represent very real cash outlays. Depreciation, while a non-cash expense, represents a very real cash outlay from a prior period that was not or could not be fully expensed in that period. And will likely need to be replenished at some point as well.

What Is and Is Not Included in EBITDA Multiples?

1. CAPEX

CAPEX, or capital expenditures, are the funds a company uses to buy or upgrade physical assets. Generally, I divide CAPEX into two buckets — maintenance and growth. Maintenance CAPEX are expenditures to keep a company competitive in the marketplace. Upgrading old computers or replacing that 15-year-old spot welder with the latest Car-O-Liner CTR12000 with dynamic pre-pulse and integrated quality assurance monitoring that recognizes and adjusts for substrates in real time (I think welders are cool). Growth CAPEX on the other hand are expenditures designed to increase existing capacity, such as expanding existing workspace or installing additional lifts, racks and booths.

CAPEX represents depreciable assets, and CAPEX expenses are removed from EBITDA. But CAPEX is a very real cost, and a critical consideration when evaluating a business. When working with clients on the buy-side, we include projected CAPEX expenditures post-close when evaluating the entire cost of the deal. If you are simply using a multiple to evaluate a business, you may overlook the very real cost of future capital expenditures.

2. Tenant Improvements (TIs)

Acquiring a business generally means assuming a location, whether that be through a lease or a purchase of property. It also means entering a location that a third party has maintained for a number of years. Tenant improvements, while technically a portion of CAPEX, are often missing from EBITDA multiples. Yet TI's represent a very real drain on cash, and are often a significant expense post-close as the acquiring party invests in paint, signage and other improvements to ensure the acquired location matches the brand image and standards of other existing locations. When evaluating the cost of an acquisition, we include projected TI expense as well as other CAPEX expenses.

3. Working Capital

Working capital is a measure of cash a business needs to support day-to-day operations. The formal definition of working capital is current assets minus current liabilities, a rather esoteric concept to many business owners. But when evaluating a company for an acquisition, not only is total working capital important, but even more important is the change in working capital. The change in working capital is important because it represents the additional cash that is used, or generated, as a result.

Relying solely upon a multiple does not take into consideration additional working capital a buyer will have to bring to a newly acquired business, post-close. When working with companies on acquisitions, we use numerous balance sheet metrics to estimate the working capital a buyer will need to bring post-close (a common way to project working capital needs post close is compute your cash conversion cycle). And we also include additional working capital required when evaluating the entire cost of the transaction.

Conclusion

Multiples are a quick and easy way to evaluate and compare multiple deals across an industry. EBITDA provides a tried and true method to approximate cash flow. But both can be misleading, and, when not fully understood, are prone to manipulation. When evaluating the merits of an acquisition, it often pays to devote the extra resources to develop a financial model that takes CAPEX, working capital and other relevant factors into consideration.

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Brad Mewes is the founder of Supplement!, a strategic, financial and M&A advisory firm specializing in the automotive aftermarket industry worldwide. He has been featured in publications globally including ABRN, Driving Sales News, Aftermarket Business World, Repairer Driven News, Ratchet + Wrench, Australasian Paint and Panel, and Motor China Magazine. Brad has an MBA from the University of California, Irvine with an emphasis in Finance. He graduated in the top 10% of his class. Brad received his undergraduate degree in International Economics with a concentration in Latin American Business from George Washington University in Washington, DC where he graduated with honors (cum laude). He has lived in both Mexico and Chile and has completed assignments in 14 countries on three different continents. Brad speaks Spanish fluently.