The Limitations of Using EBITDA for Mid Market Companies

Looking behind the numbers

"Does management think the tooth fairy pays for capital expenditures?" – Warren Buffett

EBITDA, follow-on to EBIT, was created by investment bankers to find out the true operating profitability of the company. EBITDA is a great tool to measure the profitability of companies with expensive assets that get depreciated over an extended period of time. Financiers look at EBITDA to measure the debt carrying capacity of the company. It is common to measure mid-market company profitability and cash flow using EBITDA and use EBITDA as the exclusive indicator of the business performance.

Each business has its own unique set of strengths, weaknesses, opportunities and threats, none of which can be captured by EBITDA or any other single metric. Intelligent business acquirers must consider the amount, the growth rate, and the variability of cash flow generated by the operations. EBITDA, when used properly, can be a helpful starting point in this regard. However, as you will see from the discussion below, EBITDA has several limitations when it is used for measuring cash flow.

To arrive at EBITDA for a business, acquirers add back Interest, Taxes, Depreciation, and Amortization to the Net Income of the company. Let's look at each of the items in EBITDA to understand the rationale and limitation of these add backs:

- **Earnings**

  The most common mistake seen in EBITDA calculations is the inclusion of non-operational earnings in the earnings number. To start off the process, it is imperative that all non operating profits have been factored out of the earnings. Are one time real estate or other asset sales factored into the earnings calculations? How about warranty cost reserves and bad debt allowances? The earnings data needs to be scrubbed to make sure that the earnings number used in EBITDA reflects operating earnings.

- **Interest**

  Interest payments of a business are primarily a function of the company's financing strategy and vary widely depending on the debt to equity ratio preferred by the ownership.

The resulting leverage factor can artificially inflate or deflate the net income. While adding back interest makes sense in terms of identifying operating profitability, it does not make sense to add interest back in terms of cash flow. Interest payments are certainly a burden on the cash flow! To get a more meaningful measure of cash flow, it would be necessary to subtract from EBITDA the anticipated cost of financing under the new regime.

❖ **Taxes**

Taxes are accounting and owner dependent and a pre tax view of the profits would be a better indicator of the operating profit stream. However, like interest payments, taxes are a real expense and estimated taxes under the new financing and operational structure should be factored into calculating the expected cash flow.

❖ **Depreciation**

Depreciation is an accounting construct that provides for an indirect and backward looking measure of capital expenses. Depreciation expense can be a highly misleading indicator. The accounting treatment of depreciation for many businesses is substantially different from real world depreciation. For equipment intensive businesses, adjustments to EBITDA are almost always necessary to get a true picture of the earnings.

Since depreciation is a non cash expense, it makes sense to add the line item back for cash flow calculations. However, keep in mind that some of the depreciated items need to be replaced over time and new equipment needs to be added in. Any cash flow calculation should factor in the cost of the replacement equipment.

❖ **Amortization**

Amortization is similar to depreciation except that what is being depreciated are intangible assets such as goodwill of the business – very likely from a past acquisition or startup costs. Barring a few rare exceptions, amortization can be fully added back for profitability and cash flow calculations.

In addition to the above, there are some other limitations to EBITDA. It is important to understand that EBITDA only accounts for two non-cash items - Depreciation and Amortization. There is no provision in EBITDA to adjust for some very important non-cash items such as stock grants, stock option grants, inventory value adjustments, bad debt allowances, and gift certificate redemption credits.

EBITDA also ignores the impact of changes in working capital. Increases in working capital consume cash and a business could have great EBITDA numbers but terrible cash flow numbers and could be on the verge of going out of business. To have a meaningful picture of the cash flow, acquirers need to review working capital changes to see if there are growth related issues or other working capital changes of significance and adjust cash flows accordingly.

In summary, acquirers should not rely exclusively on EBITDA or any other single metric to measure the performance of a business. To the extent EBITDA is used, acquirers should replace the removed interest, taxes, depreciation, and amortization from their earnings calculations with their own expected operating numbers to get a better picture of anticipated profitability and cash flow and the variability to the cash flow. This can be accomplished by:

- Substituting the Interest costs with expected capital costs under the anticipated capital structure

- Substituting the Tax items with their own tax-rate calculations under the new capital structure.

- Substituting Depreciation expense with an estimate of future capital expenditures.

- Amortization can be kept at zero unless there are extraordinary items that need to be factored in.

- Reviewing working capital changes and adjusting cash flows accordingly.

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