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What's Wrong with Using EBITDA as a Valuation Tool

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Earnings before interest, taxes, depreciation and amortization, also known as EBITDA, is an accounting technique that's widely used to indicate the value of a company. It is calculated by adding back interest, taxes, depreciation, and amortization expenses to net income, providing an operating picture of the company as people believe that it excludes the impact of non-operating expenses (interests and taxes) and non-cash charges (depreciation and amortization). EBITDA helps investors have a better understanding of a company's performance and make more informative decisions about the value of a company.

However, while many believe EBITDA can indicate a company's performance, others find it may be misleading.

One of the arguments against using EBITDA to value a company is that it wrongly classifies the expenses. Interest and taxes are direct factors that can affect a company's real cash flow as they must be paid, which would reduce current assets. At the same time, depreciation and amortization expenses are actually cash expenses as they are recorded to match how much the company has spent, in the past, on capital expenditures. By adding back all the expenses, the company may show a healthier performance than in actual fact. What's more, for start-up companies, capital expenditures may be significant while sales level may be relatively low. Investors should value a company's performance in a more comprehensive and objective way. It is important to consider the amount of assets it holds, both current and long-term investments, which EBITDA fails to reflect. It should be noted that interest on the purchase of capital expenditures should be considered as part of the company's real cash flow, however interest on operating lines of credit can be normalized.

Another reason that EBITDA cannot be relied on is because it ignores the changes in working capital. A company's liquidity level is affected not only by interest, taxes, and capital expenditures, but also by working capital. Investors may not be able to, based on EBITDA, get a complete understanding of a company's profitability. Although a negative EBITDA shows clearly that the business is unprofitable, a positive EBITDA does not necessarily indicate a valuable company, as interest and taxes are going to eventually be paid out each year. Meanwhile, considering changes in working capital, a business associated with a low liquidity level can still have a high profitability level, if the majority of a company's assets are capital assets they cannot easily be converted into cash. For a company with a large amount of capital assets, using EBITDA would improve the value, as depreciation and amortization expenses are added back to net income. Therefore, it is necessary to examine a company's performance from both income statement and balance sheet perspectives. Excluding working capital, as EBITDA does, may lead to a significant misevaluation.

EBITDA can be misused due to duplicity. Depreciation and amortization are expenses that require a lot of judgement. The useful life of capital assets, residual value of assets, and change in depreciation methods need to be determined and adjusted based on the accountants' experience. It is possible for management to manipulate depreciation expenses in order to modify profitability levels that are often targeted for debt covenants. In addition, General Accepted Accounting Principles (GAAP) does not regulate the reporting of EBITDA, and financial statements may be misrepresented by excluding information that should been included, or vice versa. As a result, EBITDA, as a pro-forma figure, cannot truly provide the company's value and accurately reflect a company's ability to generate profits under unregulated accounting practices.

EBITDA is also commonly misused to evaluate a company's ability to generate cash as a substitute for cash flow. Although EBITDA puts focus on income generated from operating activities, it still differs from the cash received from operations. In essence, EBITDA reflects the profit or loss before interest, taxes, depreciation, and amortization a company can generate. Under cash flow statements, transactions are recorded on a cash basis, in other words, at the time when cash is paid out or received, instead of at the time sales are made. Financial reporting users should distinguish between net income and cash actually earned, because EBITDA may not contain all cash transactions collected or paid out from a company. For a company to successfully survive and be profitable, cash is always king. The ability of generating cash, which EBITDA cannot show, needs to be considered as it shows whether a business can continue operating or not.

As Warren Buffett mentioned in 2002 and 2003 BRK Annual Meeting, "*It [depreciation] is not a non-cash expense — it's a cash expense but you spend it first. It's a delayed recording of a cash expense. People who use EBITDA are either trying to con you or they're conning themselves. Telecoms, for example, spend every dime that's coming in. Interest and taxes are real costs.*" EBITDA provides an opening for businesses to look healthier than they actually are by adding interest, taxes, depreciation, and amortization expense back to net earnings. It also gives opportunities for management to create deceptiveness by altering accounting records. In order for investors to get an overview of a company's value other aspects, such as free cash flow and liquidity level, need to be considered.

If EBITDA is going to be used as a valuation tool, then a normalization of the figure is required. The purpose of this normalization is to remove expenses that would not be incurred by a buyer after the acquisition. These normalizations are made for expenses that are either not expected to recur or considered discretionary in nature.

"The true value of a business lies in its ability to make a profit in the future, and is not based on a "Rule of Thumb" of so many times EBITDA."

D.M. (Doug) Robbins – 2001

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