Business Valuations using EBITDA

The terms EBITDA (Earnings Before Interest, Tax, Depreciation & Amortisation) and EBITA were introduced in the USA 30 years ago as a practical measure of the financial performance of a business, which can then be compared with other similar businesses, whilst excluding the effects of corporate taxation, capital spending and financing working capital, which can be different from one business to another. So charges including depreciation, interest paid and received, taxation and amortisation (e.g. of goodwill) are excluded. Over the years these terms were refined to allow for normalisation add backs, such as directors' excess remuneration and other remunerated benefits of directors and other expenses above market rates, plus add-backs the other way, such as substantial capital spending and additional salaries and benefits or additional expenses. It is, in effect, a measure of cash flow generation, rather than movement in net earnings. So its use must be treated with careful consideration, with regard to the end result.

This performance measuring tool was subsequently extended to cover business valuations, which has become common place among some of the larger UK companies, which can also include unincorporated businesses, such as partnerships and sole traders etc. The EBITDA multiple can be used to directly compare those businesses that may have differing levels of investment in the business (capital expenditure) as well as differing levels of debt. But the EBITDA multiple needs careful use, particularly where businesses are displaying low profit margins, otherwise an estimated valuation using EBITDA figures may not be accurate.

Although widely used in many areas of finance when assessing a company's performance (e.g. securities analysis) EBITDA and EBITA are financial measurements that are not recognized by the GAAP (Generally Accepted Accounting Standards) in the UK nor the US Securities & Exchange Commission and its application has always been controversial amongst members of the UK accounting profession. The EBITDA based valuation technique is not widely used in the UK for smaller business valuations because it excludes the effects of capital expenditure when evaluating the profitability of a business. It is important to remember that capital expenditure is required to maintain the asset base which in turn allows for profit generation. Depreciation charges are a good approximation of the capital expenditure required to maintain an asset base.

When EBITDA is employed in valuing a business, it is used to determine the business's ability to generate sustainable operating cash flows (rather than earnings) and to this figure is applied a multiple. The EBITDA figure will be normalised, where normalising adjustments ("add-backs") should take into account items such as:-

- Below fair market rates for sales, purchases or expenses
- Owners salary or bonuses that are not at a fair market rate
- Repairs and maintenance charges that should have been capitalised (eg improvements)
- Non-recurring expenditure, including but not limited to professional and legal fees, patent & trade mark fees, donations, employee bonuses etc
- Stock levels that are too high for one reason or another

The normalised EBITDA multiple is not arrived at in the same way that Price to Earning ratios are arrived at in the UK, which is directly related to the performance of quoted companies on the Listed Securities Market as commonly measured by the FTSE Actuaries Share Indices Price to Earnings Ratios and where a discount (up to and over 50%) is applied for private Companies. The EBITDA multiple in the valuation process is often based on an industry based average, calculated on a sample of similar businesses sold used for comparison purposes with the Company under evaluation. It can also be an arbitrary decision and for small company valuations where it is usual for the multiplier to be between 3 and 5 but then adjusted to take account of:-

- The rate of sales growth
- The gross profit margins
- Annual EBITDA
- The EBITDA margin (EBITDA as a ratio of sales turnover)
- Annual capital expenditure
- Working capital needs of the business
- Concentration of business with a few customers
- Any perceived risk element
- The transaction values and multiples of similar sized businesses sold.

It is possible that in some cases the EBITDA valuation technique can be manipulated and therefore, misused and this could apply in the normalising adjustments. Particular care must be taken to check through any normalising adjustments, to ensure that they are seen to be reasonable. A negative EBITDA result generally indicates that a business has fundamental problems with profitability and cash flow. A positive EBITDA does not necessarily mean that the business generates cash because as mentioned, EBITDA does not take into account changes in the working capital of the business (often required in a growing business) or in capital expenditure needs (often required to replace ageing assets or for the introduction of new manufacturing methods for new products etc) or in interest received & paid, plus taxation.

It is often recommended to use an alternative valuation technique in order to obtain another comparable figure (eg a valuation using **multiples of net earnings or P/E ratios**).

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Stirling Business Solutions Ltd provides an independent valuation service, where business valuations are undertaken by an independent FCCA, FCA or ACA fully qualified Accountant. To request a business valuation report, contact details are:-

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