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The Appeal of EBITDA Multiples

EBITDA multiples are quick and convenient to calculate, but these attributes are precisely its downfall.

by William S. Hanneman

Shortcut methods to estimate business value have always been used. Benjamin Graham popularized net asset value as a measure of business value in the 1930's. Stock analysts have long quoted price-to-earnings ratios as a measure of equity value.

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We often find EBITDA multiples misleading, and only in a very few situations is the concept fully understood.

Today, EBITDA multiples are pervasive. The popular press routinely quotes EBITDA multiples. Research analysts trumpet them. We constantly hear business owners quote EBITDA multiples of transactions that have occurred in their industry. We often are asked what EBITDA multiple an owner's business will command.

In our own work, we often find EBITDA multiples misleading, and it is clear to us that only in a very few situations is the concept fully understood by those who use it.

The appeal of EBITDA multiples is understandable. It is a measure that is easily calculated, and it is quick and convenient. It is common across all businesses. But, it is the simplicity and commonality of the measure that are precisely its downfall.

In fact, EBITDA multiples are a very crude rule of thumb, perhaps useful in a broad context, but usually misguided when applied to a particular situation. The only economically logical method to value a business is to evaluate its long term ability to generate future after-tax free cash flows.

WHAT'S WRONG WITH EBITDA?

No two businesses are the same. Even two businesses in the same industry can be very different from a valuation perspective. Applying EBITDA multiples to all businesses disregards those differences. Among the problems:

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- ***EBITDA is Backward Looking***

The value of a business is a function of its expected future performance. EBITDA is a historic measure. Particularly in the current economic environment, future EBITDA may be meaningfully lower than historic EBITDA.

- ***EBITDA is not Free Cash Flow***

All businesses require reinvestment, if only to maintain the existing productive capacity. EBITDA does not measure how much cash is left over after reinvestment and available to compensate the suppliers of capital.

- ***EBITDA Ignores Risk***

A dollar of EBITDA is not the same in every business. One business may have considerable volatility in its business performance, others are steady and predictable. One business may have a significant concentration of revenues from a single customer, others are diversified. Some businesses are growing rapidly, others are not. EBITDA multiples do not catch these differences.

While the value of every business can be expressed as an EBITDA multiple, EBITDA multiples do not determine value.

- ***EBITDA Ignores the Amount of Invested Capital***

EBITDA measures the flow of earnings but offers no insight into the balance sheet. Business value, however, must take into consideration a variety of other factors, such as whether the business has adequate working capital, whether there has been deferred maintenance on capital equipment, how much investment is necessary to add the next increment of capacity, or what contingent liabilities might result in future economic costs. A wise investor will not neglect these points.

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- ***EBITDA is Misleading When Applied to Sale Transactions***

The EBITDA multiple to the buyer is usually not the same as to the seller. EBITDA multiples of published transactions often report the multiple to the seller. The buyer, because of an ability to reduce costs or accelerate revenues in a business combination, may have rationalized a much lower multiple, one that is not relevant to the measure of another business, even in the same industry.

So, while the value of every business can be expressed as an EBITDA multiple, EBITDA multiples do not determine value.

WHAT'S THE ALTERNATIVE?

All businesses are not similar—each has its own unique set of strengths, weaknesses, opportunities and threats, none of which is captured in EBITDA multiples. Intelligent investment decisions in operating businesses must consider the amount, the rate of growth, and the expected variability of the free cash flow generated by the operations. It must consider the efficiency of the invested capital and recognize reinvestment obligations.

Relying on EBITDA multiples can result in paying too much or selling for too little. Consider two manufacturing companies operating in the same industry. Both generate the same EBITDA as shown below:

($ IN MILLIONS)	COMPANY A		COMPANY B	
Sales	50,000		75,000	
Gross Profit	17,500	35%	22,500	30%
Operating Profit	7,500	15%	6,750	9%
Depreciation	2,500		3,250	
EBITDA	**10,000**		**10,000**	
Net Working Capital	9,000		19,000	
Annual Capex	2,000		3,000	
Invested Capital	25,500		48,500	
Return on Invested Capital		31%		15%

The smaller business, Company A, has invested in systems and equipment that have contributed to improved efficiency, as can be seen in both the higher gross profit margins, as well as the more efficient use of working capital.

One might naturally assume that the larger company is worth more or, considering equal EBITDA multiples, that the two businesses are worth a similar amount. However, a closer analysis would reveal that not only is the operating performance of Company A considerably better than that of Company B, but Company A also manages its balance sheet more judiciously. Because of slower receivable collections and inventory turnover, Company B requires proportionately more investment to generate a dollar of sales. With lower net cash flow (EBITDA - capex) and a higher investment in assets, the return on invested capital for Company B is half that generated by Company A. Contrary to the conclusion reached using EBITDA multiples, a fundamental analysis would indicate that Company A is more valuable than Company B. ❖

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ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, please go to ZacharyScott.com.

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