Below we will demystify EBITDA by shedding light on:

1. The Meaning of EBITDA
2. Understanding Adjustments to EBITDA
3. EBITDA in Purchase Price Multiples

The Meaning of EBITDA

EBITDA is used to analyze a company's operating profitability before non-operating expenses (such as interest and "other" non-core expenses) and non-cash charges (depreciation and amortization). EBITDA stands for:

- Earnings from audited financials
- Before
- Interest expense for outstanding loans,
- Taxes, and
- Depreciation &
- Amortization of loans

EBITDA came into prominence in the 1980s as leveraged buyout investors used it to calculate whether companies could pay back the interest and retire debt on financed deals after a restructuring. Investors promoted EBITDA as a tool to determine whether a company could service its debt in the near term.

Why is EBITDA used so broadly today? The basic reason is to improve the comparability among companies by stripping out irregular operating and economic costs. Proponents of EBITDA argue that it offers a clearer reflection of operations by stripping out non-core line items that can obscure a company's operating performance. In the calculation of EBITDA, interest, which is largely a function of management's choice of financing, is ignored. Taxes are left out because they can vary widely depending on acquisitions and losses in prior years; this variation can distort net income. In sum, EBITDA removes the non-operating and often arbitrary factors that can go into calculating depreciation and amortization. Finally, non-recurring type expenses are added back.

By eliminating these items, EBITDA makes it easier to evaluate the financial health of various companies and to compare against industry averages. It also is useful for evaluating firms with different capital structures, tax rates and depreciation policies. EBITDA is a good measure of the fundamental earning power of a company's operations because it eliminates some of the extraneous factors and allows for a more "apples-to-apples" comparison with its peers. At the same time, EBITDA gives investors a sense of how much money a company might generate before it pays interest and taxes.
Understanding Adjustments to EBITDA

When selling a privately held company, an owner should consider several possible adjustments to EBITDA. The adjustments are “one-time” charges, arguably are out of ordinary course of business. Thus, they should be added back to estimate the company's cash-flow generation ability. The following is a list of some of the adjustments:

- **Excess Owner Compensation.**
  The most common EBITDA adjustment is “excess owner compensation.” The difference between the owner’s total compensation package and what a CEO in a similar type company would earn is often added back to EBITDA as “excess owners' compensation.”

- **Owner Perks.**
  This usually includes executive life and health insurance, medical benefits, and special travel and auto expenses. Would the company still generate its performance without these extra perks? However, please note that, if these expenses are necessary for a new CEO, they should not be added back.

- **Recapitalizing vs. Expensing Items.**
  Often, a seller makes balance sheet decisions that are aimed at minimizing taxes, rather than maximizing reported profits. Hence, sellers occasionally make judgments to expense certain items that would otherwise be capitalized. Examples are equipment purchases. These items can sometimes be included as adjustments, and would improve earnings.

- **Depreciation.**
  This is a non-cash expense. A portion of this expense may require an offset as a capital expenditure to maintain current equipment.

- **Non-Recurring Expenses.**
  Examples are litigation expenses, leasehold improvements, start-ups of a new facility, or other special expenses that would not occur in the future.

In addition, other potential add-backs can sometimes include the following:

- **Professional Fees.**
  This refers to the cost to hire consulting, legal and financial advisors, for services that would not be required post-deal.

- **Recruiting Expenses.**
  If there was an unusual recruiting surge, you may be able to add back the expense of hiring or transferring employees.

- **Severance Expenses.**
  If there was a reorganization, you may be able to add back the severance cost of laid-off workers.

- **Inventory Write-downs.**
  This refers to special charge-offs for unsaleable, obsolete or damaged inventory.

- **Restructuring Charges.**
  Did you undergo a one-time reorganization, and spend money on cost reduction initiative, a facility move, or another special event?

- **Non-cash Stock Compensation Expense.**
  For instance, incentive compensation may qualify.

Lastly, other categories that are sometimes relevant include charitable contributions, entertainment expenses, bad debt, and uncollectible accounts receivable.

It is worth noting that this type of analysis is a mix of art and science. Adjustments to EBITDA will not necessarily raise valuation multiples. We typically advise our clients to avoid adding back all savings and to be careful not to over-reach, as overly aggressive claims can undermine the credibility of add-backs as a whole.
EBITDA in Purchase Price Multiples

EBITDA multiples are commonly used to compare purchase prices in mergers and acquisitions. Bankers use EBITDA multiple comparisons within an industry to estimate the market values of companies and to predict and evaluate bids. For example, the sale of Wilpak to Jacobson in 2006 was a noteworthy double-digit EBITDA multiple. At the time, a typical value expectation for a contract packaging company of similar size to Wilpak might have been around 5-7 times EBITDA. Jacobson saw the opportunity to achieve high synergies, economies of scale, and cross-selling capabilities, and put together a strong bid. Of course, the business then doubled, and the forward-looking EBITDA ended up closer to the historical EBITDA multiple ranges of the sector.

There are many drivers that influence the purchase price multiple of an industry or company.

First, multiples tend to increase when the market factors are attractive. For instance: M&A activity is high, interest rates are low, the economic outlook is bright, there is widespread debt available, and market dynamics (supply and demand) are favorable for an industry.

Second, company factors are also crucial. Particularly important are variables such as growth, niche leadership, technology capabilities, differentiation, and prospects for predictable future profit expansion.

Third, buyer selection is crucial. When you pinpoint the right strategic buyer, you can often generate a higher valuation while accomplishing a win-win. Unlike financial buyers, strategic buyers are able to justify a higher price by accounting for extra value creation through economies of scale and cross-selling opportunities.

In summary, smart sellers – and buyers – should familiarize themselves with the EBITDA methodology, because it is an important tool in the deal process. In the right hands, and in conjunction with the right overall deal strategy, you can use an intelligent EBITDA analysis to maximize your value.