Links Capital's Perspectives

EBITDA Normalizations

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As discussed in a previous newsletter, EBITDA is a widely used proxy for the cash flow of a business and as a valuation metric for comparing businesses. Non-cash items such as depreciation/amortization, along with income statement expenses of interest and corporate taxes, are added back to net income to arrive at EBITDA. These adjustments to net income derive EBITDA allowing for the comparison of companies with different kinds of capital structure (more debt versus less), differing tax rates, or different depreciation schedules on capital assets. When a business value is determined there may be expenses that are one-time in nature or in other cases differ from what a normal business would expect to incur operating in the same industry, which may be a reason to normalize EBITDA. These normalizations to EBITDA should be considered to determine the true operating cash flows of the business for valuation purposes as the normalized EBITDA is multiplied by the EBITDA multiple to arrive at the enterprise/entity value of the company. Failure to properly normalize EBITDA may result in an under or over valuation of the business.

Shareholder Compensation

Shareholder's compensation should be considered when looking at EBITDA normalizations and be analyzed in the context of market comparables for the respective management positions.

Consider the situation where business owners are actively involved in the business and are not receiving management fees or salaries but instead choose to pay a dividend to themselves during the year. Dividends are paid to shareholders with after-tax income resulting in zero salary expense on the income statement for the operational and management positions held by the shareholders, thus overstating the EBITDA of the company. In these cases, there should be a negative adjustment to EBITDA, equivalent to what the market salaries would be.

In another situation, shareholders pay management fees to themselves that are expensed on the income statement, but these management fees may be higher than what industry participants would pay for the same position. If the shareholder holds the position of president and the market compensation for a president of a similar business would be $500,000 per year including bonus, yet the shareholder pays themselves $1.25 million in management fees during the year, $750,000 in management fees should be normalized. Without the normalization of EBITDA, the EBITDA would be understated with the overpayment of management fees. It is important to understand what the market compensation of the equivalent shareholders' positions should be and compare it to actual expenses which may result in normalizations to the EBITDA.

Owned Real Estate Leased to Operating Company

Many business owners decide to own the property in a holding company and lease this property to their operating company at an agreed upon lease rate. The questions from

Links Capital are specialists working with private equity firms, institutional investors and strategic purchasers in raising capital and divesting of businesses

an EBITDA normalization standpoint are: what is the market value of a commercially reasonable structured lease considering the term of the lease, conditions and payments? If the lease is entered into an amount other than what the current market value is for a similar lease (all other things being equal), a normalization to the EBITDA should be considered. Assuming the market rate of the lease is $680,000 per year and there is an agreement with the property holding company for $500,000 per year, the EBITDA would be overstated by $180,000 and a negative normalization to the EBITDA would occur. The same process would be applied for above market lease rates. However, in this example if a divestiture occurred and the purchaser entered into a long-term lease at the discounted lease rate of $500,000, an argument would be made that the lease should not be an adjustment to EBITDA.

One Time Costs

When completing an analysis on a company, it is critical to understand all aspects of both the income statement and the balance sheet. Keeping track of historical income statements using common sized statements (expenses compared on a percentage basis of revenue) helps to identify areas which may require further investigations for normalizations of expenses.

Companies can have expenses from one-time events that are beyond the control of management and others outside the scope of normal operations. These normalizations may include and are not limited to natural disasters that may require operations to shut down, costs related to research and development that should be capitalized, owners receiving perks such as life or critical life insurance, or even expense items of a related company that are not part of the core operations.

In many of these cases, it is important to understand if the expense is a true normal operating cost and if not, how should those expenses be adjusted to arrive at the normalized EBITDA used to value the company.

Multiplier Effect

Every dollar of EBITDA is multiplied by the EBITDA multiple to arrive at the enterprise/entity value. In the example below, the EBITDA multiple is 8.00x which means for each dollar that is not normalized correctly, the enterprise/entity value is impacted by $8.00.

	ABC Corp.
EBITDA	$7,500,000
EBITDA Multiple	8.00x
Enterprise Value	$60,000,000
Normalizations	
Below Market Lease	($180,000)
Management Fees	$750,000
Legal Costs (non-reoccuring)	$125,000
Forest Fire Closure	$200,000
Total Normalizations	**$895,000**
EBITDA	$7,500,000
Normalized EBITDA	**$8,395,000**
EBITDA Multiple	8.00x
Normalized Enterprise Value	$67,160,000
Incremental Value	**$7,160,000**

In our example, normalizations of $895,000 results in $7.16 million of incremental value using an 8.00x multiple.

What Does This All Mean?

Incorrectly normalizing EBITDA is a compounding problem as the entity value received is driven by the EBITDA multiple. It is critically important to work with professionals that are immersed in these types of normalizations in the context of completing market transactions. Our past transaction experience has shown that many professionals that work on the peripheral of transactions sometimes lack the full understanding of what should or should not be normalized resulting in incorrect normalizations of the business and potentially lower transaction values for the seller.

Links Capital Partners is focused exclusively on selling businesses, raising capital and assisting our clients acquire businesses. Links Capital are specialists in working with private equity firms, institutional investors and strategic purchasers in raising capital and divesting of businesses.

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