Links Capital's Perspectives

EBITDA and Business Valuation

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What is EBITDA?

EBITDA stands for Earnings Before Interest, Taxes, Depreciation and Amortization, it is a widely used proxy for a business's cash flow and when multiplied by EBITDA market multiple, can determine the market valuation of a business.

Using EBITDA for valuation purposes, non-cash income statement items such as depreciation/amortization, along with interest expenses and corporate taxes, are added back to the net income to calculate EBITDA. EBITDA allows for the comparison of companies without the concern of different types of capital structures (lower versus higher levels of debt), differing tax rates or varying depreciation schedules on capital assets.

Other normalizing adjustments to EBITDA could include interest income and any other non-operational revenue and/or one-time expenses that are not included in the core operations of the business. These adjustments are often referred to as normalizations resulting in a normalized EBITDA which will be further examined in a future newsletter.

EBITDA, Debt and Valuation

	Leveraged	Non-Leveraged
Net Income Before Taxes	6,250,000	6,650,000
Add: Interest ($10 million @ 4%)	400,000	0
Add: Depreciation	850,000	850,000
EBITDA	**7,500,000**	**7,500,000**
EBITDA Multiple	8.0	8.0
Total Enterprise Value	**60,000,000**	**60,000,000**
Less Long Term Debt	10,000,000	0
Equity Value	**50,000,000**	**60,000,000**

Comparing two example companies: the leveraged company, has $10 million in long-term debt and an interest expense of $400,000, whereas the non-leveraged company is without debt. The non-leveraged company has a higher Net Income Before Tax, due to the lack of interest expense. However, both still generate the same EBITDA (cash flow) for valuation purposes when interest and depreciation is added back. This results in both companies having the same Total Enterprise Value, despite one having debt. The Equity Value (Total Enterprise Value less long-term debt) will be lower in the leveraged company when the debt is deducted.

If the interest expense was not added back to the leveraged company to calculate EBITDA, the valuation would be negatively impacted by a lower cash flow which is applied to the market multiple. The use of EBITDA with interest added back ensures that the valuation of the business is not impacted by the capital structure.

Net proceeds a seller realizes upon a monetization event is affected by the amount of debt deducted from the Total Enterprise Value, along with working capital requirements and other adjustments, but all other things being equal, differing capital structures should have no impact on the Total Enterprise Value of a company.

Links Capital specializes in the divesting and financing of businesses in the Canadian middle market.

Links Capital's philosophy is to preserve value throughout the entire transaction process. Senior partners handle all aspects of the transaction from inception to close and beyond, maximizing proceeds.

Being experts in private equity markets and corporate finance enhances value to our clients through extensive buy and sell-side experience.

NASCOR

Nascor Ltd. a leader in the manufacturing and supply of engineered wood products with three manufacturing plants in Alberta

has been acquired by

ARCTICOR STRUCTURES

$50,500,000

Links Capital acted as financial advisor to Nascor Ltd. in the structuring and negotiation of the divestiture

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

Ensuring EBITDA is Comparable

Beginning in 2019, both US GAAP and IFRS in the US adopted a new treatment for dealing with operating leases. Private US GAAP companies adopted this standard in 2020. In Canada, Accounting Standards for Private Enterprises (ASPE) has not required the same changes to operating lease reporting. The new US standard adjusts operating leases such that they are treated the same as capital leases, including them as a debt as well as an asset on the balance sheet. Using capital leases instead of operating leases may result in material changes to EBITDA, gross margins and certain financial ratios.

CAPITAL LEASE VERSUS OPERATING LEASE		
	Capital Lease	**Operating Lease**
Capital Lease	1,000,000	NA
Operating Lease	NA	1,000,000
Interest Rate	6%	6%
Term	5 Years	5 Years
Lease Payment	200,000	260,000
Useful Life of Assets	10 years	10 years
Revenue	55,000,000	55,000,000
Operating Expenses	47,000,000	47,000,000
Operating Lease	0	260,000
Depreciation/Amortization	100,000	0
Interest Expense	60,000	0
Net Income	7,840,000	7,740,000
Add Back:		
Depreciation/Amortization	100,000	0
Interest Expense	60,000	0
EBITDA	**8,000,000**	**7,740,000**
Market EBITDA Multiple	8.0	8.0
Total Enterprise Value	64,000,000	61,920,000
Deduct:Capital Lease	1,000,000	0
Equity Value	**63,000,000**	**61,920,000**

Adjusting operating leases to capital leases results in a higher EBITDA and Total Enterprise Value. Depending on market multiples and the value of the leases, one should also see an increase Equity Value realized, $1.08 million in the above case.

Comparing the EBITDA of an identical Canadian and US company, the US company with capital leases will generate a higher EBITDA than a Canadian company using operating leases. Adjustments will be required for direct comparison purposes.

EBITDA Margin

EBITDA is also calculated as a percentage of revenue to compare companies. The following table looks at two companies with the same EBITDA.

	Company A	**Company B**
Revenue	60,000,000	40,000,000
Net Income	3,800,000	3,800,000
Add: Income Taxes	1,200,000	1,200,000
Add: Interest	800,000	800,000
Add: Depreciation	700,000	700,000
EBITDA	6,500,000	6,500,000
EBITDA Margin	**10.8%**	**16.3%**

In the example above, both companies generate $6.5 million in EBITDA. However, Company B with a 16.3% EBITDA margin, yields more profit on revenue than Company A at 10.8%. Generally speaking, Company B is more sought after due to its ability to generate a higher percentage of earnings on each dollar of revenue earned. Companies with higher EBITDA margins may also produce a higher multiple of EBITDA, resulting in more net proceeds for the owner at close.

As a business grows, management should continuously track trends with their EBITDA and the respective margin, comparing current results to historical performance. If revenues and EBITDA are growing but margins are declining, this may be a cause for concern. Product mix and weather conditions are just two items that may have an impact on margins as a whole. It is important to understand what underlying drivers or changes one could make to improve EBITDA margins to increase Total Enterprise Value and ultimately the cash proceeds received when the business is sold.

Links Capital Partners Ltd. is a professional firm 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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