Links Capital's Perspectives

EBITDA and Business Validation

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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.