Links Capital's Perspectives

EBITDA Versus Years of Cash Flow When Selling

Visit us at www.linkscap.com

ACQUISITIONS
DIVESTITURES
FINANCINGS

RON CHICOYNE, CFA, CF, ICD.D
MANAGING DIRECTOR, LINKS CAPITAL PARTNERS LTD.

EBITDA Versus Years of Cash Flow

When businesses are sold the owners receive a multiple of EBITDA. Some business owners like to refer to the multiple as being how many years of cash flow they are giving up to divest of the business and receive the consideration now. This is not a correct assumption.

If a company is sold for 6.5x EBITDA it doesn't relate to 6.5 years of cash to the shareholders. It is 6.5 years of EBITDA, but then one must consider other annual deductions that are needed to run the business and the respective tax on the distribution of cash to the shareholders (whether it is management fees or dividends).

The annual after tax cash flow that is distributable to the shareholders must consider certain cash flow items when comparing with EBITDA such as:

- Long-term debt and line of credit and their respective interest costs;
- Annual capital expenditures;
- Other capitalized items, e.g. R&D costs, leasehold improvements;
- Corporate taxes;
- Personal tax rates; and
- Eligible dividend tax rates.

EBITDA	16,000,000
LOC Interest ($7.5 million @ 5%)	375,000
LTD Interest ($10.0 million @ 6%)	600,000
Annual Capital Expenditures	750,000
Cash Flow for Distribution	14,275,000
Management Fees (47% tax rate)	6,709,250
Annual After Tax Cash Flow	**7,565,750**
Multiple 6.5x	6.5
6.5 Years of After Tax Cash Flow	**49,177,375**

When one closes a transaction, the long-term debt is deducted from the tangible enterprise value (EBITDA times the market multiple) to arrive at the tangible equity value. The tangible equity value is the amount of pre-tax proceeds or cash flow that the shareholder would receive after paying off all long-term liabilities such as long-term debt or capital leases. The operating line of credit balance is a current liability that is typically caught in the working capital calculation (a required amount of working capital left at close to operate the business). The higher the line of credit is, the more cash, accounts receivable or inventory that must be left in the business reducing the ultimate net proceeds to the shareholders.

EBITDA Versus Years of Cash Flow When Selling

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

EBITDA	16,000,000
EBITDA Multiple	6.5
Tangible Enterprise Value	104,000,000
Long Term Debt	10,000,000
Tangible Equity Value	94,000,000
2020 Capital Gains Tax (24%)	22,560,000
Transaction Cash Flow Proceeds	**71,440,000**

It is assumed that the shareholder will be paying capital gains tax on the divestiture.

Transaction Cash Flow Proceeds	71,440,000
Annual After Tax Cash Flow	7,565,750
Years of After Tax Cash Flow	**9.4**

In this example, a 6.5x EBITDA multiple results in 9.4 years of annual after tax cash flow. This is due to the actual cash flows to the shareholders being lower than the EBITDA used to value the business.

Given changing economic conditions, there may be value disconnect between the buyer and the seller and an earnout may be used to help bridge valuation expectations. Earnouts involve additional payments post-sale, that are contingent upon the company attaining certain financial metrics which are often based on EBITDA. It is important to understand when earnouts may be included, how they are structured and calculated, and what are key points to consider when negotiating them. Earnouts can further increase after tax cash flow received by the shareholders and will be fully discussed in a future newsletter.

Tax rates and structuring are also critically important to maximize proceeds to the shareholders. The following table illustrates how changes in personal rates impacted Alberta business owners back in 2014. In 2020, BC increased the top personal income tax bracket from 16.8% to 20.5%. Good decision making will incorporate changing tax rates into your analysis to understand the true cash flows the shareholders receive.

Change in Corporate Taxes Alberta	**2014**	**2015**	**2016**
Alberta Highest Personal Rate	10.00%	11.25%	15.00%
Eligible Dividend Tax Rate	19.29%	21.02%	26.19%
Personal Tax Highest Marginal Rate	39.00%	40.25%	44.00%

The EBITDA multiple at close is based on today's trailing 12 months EBITDA and the future years of EBITDA and cash flow will most certainly be different depending on economic conditions.

Closing a transaction versus waiting to sell in the future eliminates some of the economic risks and can provide certainty. Multiple compression, changing interest rates, inflation, labour concerns, and the constant pressure of running the business all become a thing of the past.

An experienced advisor can work with a seller to help them understand their expected purchase price and how it relates to EBITDA and actual cash flows and proceeds. This type of information can be used to help a seller decide on what timing may be best based on the seller's current and future needs, along with their desire to continue running the business in the current and future economic environment.

Links Capital Partners 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.

Links Capital

Ron Chicoyne, CFA, CF, ICD.D, Managing Director
Phone 403-809-7985, Email rchicoyne@linkscap.com
www.linkscap.com