EBITDA Part 2 - Using EBITDA and Its Limits

In Part One, we met EBITDA, which is earnings before interest, taxes, depreciation and amortization, and we learned to calculate it in two ways. For Cedar Print Works, both routes gave five hundred thousand dollars and a margin of twenty percent. Now the bank and a possible buyer want to know what that number means, and Nadine must answer honestly. This part follows two steps: how EBITDA is used, and where it falls short. Throughout, we keep one question in mind: what does this number leave out?

1. Use it

EBITDA is used in three main ways. First, to compare companies. Because it ignores funding, tax rates and depreciation methods, it puts a debt-heavy company and a debt-free one on a similar footing. Second, in valuation. Enterprise value divided by EBITDA gives a multiple. A lower multiple than similar companies may suggest a bargain, and a higher one may suggest an expensive price, although growth and risk also matter. Third, lenders often look at EBITDA to judge whether a business earns enough to carry its debt. Lenders also divide a company's debt by its EBITDA, and a lower result means the debt is easier to repay. Compare companies in the same industry, because typical multiples differ widely between industries.

Example: Two similar flats in the same street are for sale. The first costs ten times the rent it earns in a year, the second twenty times. A sensible buyer does not decide yet, and first asks why the second is so much dearer. Perhaps it has a new roof, or the area is growing. That is exactly what a valuation multiple such as enterprise value divided by EBITDA means: compare price with earnings among similar things, then ask why.

At work: A buyer offers an enterprise value of three million dollars for Cedar Print Works. Nadine divides it by EBITDA of five hundred thousand dollars and finds a multiple of six. She compares six with similar printers and asks how fast they grow and how risky they are. If the bank divided the company's debt of one million dollars by the same EBITDA, it would get two. That is exactly how EBITDA is used: to value a company and to judge its debt.

2. Know the limits

EBITDA is not cash flow. It ignores capital expenditure, so a company that must keep replacing expensive machines can look healthier than it is. It ignores working capital, so profit can rise while cash is stuck in unpaid invoices and unsold stock. It ignores interest, which a lender still

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expects to be paid, and taxes, which are real costs. Depreciation reflects real wear, so ignoring it can flatter asset-heavy businesses. Finally, many companies publish adjusted EBITDA, with extra items removed by management. The United States Securities and Exchange Commission expects such measures to be reconciled to net income and clearly labelled, and does not allow EBITDA to be shown per share. Always ask what was adjusted and why.

Example: A family's salary looks healthy every payday. But this year the old car broke down and a new one had to be bought, the roof needed repair, and a friend still has not repaid a loan. The salary on paper is the same, yet the bank balance keeps falling. That is exactly what the limits of EBITDA mean: strong earnings can hide spending on equipment and cash stuck elsewhere, so EBITDA is not cash flow.

At work: Cedar Print Works plans to buy a new press next year, and some customers pay their invoices late. Nadine knows that EBITDA of five hundred thousand dollars shows none of this. So she places the planned press spending, the unpaid invoices and the cash balance beside it in her note to the bank. Now the bank sees profit and cash together. That is exactly the limit of EBITDA: it is not cash flow, so read it beside capital spending, working capital and cash.

Conclusion

In summary, EBITDA helps us compare companies, value them with a multiple, and judge whether debt is manageable. In our example the multiple was six and the debt ratio was two. But it is not cash flow, so we always read it beside net income, capital expenditure and cash. We also ask: what did the company adjust, and why? Next time a report shows this number, we calculate it ourselves from the income statement, and then we ask: what does this number leave out?

Sources

- Corporate Finance Institute: EBITDA (definition, both formulas, uses, EV/EBITDA, limitations) – https://corporatefinanceinstitute.com/resources/valuation/what-is-ebitda/
- Wall Street Prep: EBITDA (non-GAAP definition, EBITDA margin, uses, limits on capital expenditure and working capital) – https://www.wallstreetprep.com/knowledge/ebitda/
- U.S. Securities and Exchange Commission: Non-GAAP Financial Measures, Compliance and Disclosure Interpretations, Questions 103.01 and 103.02 (naming, reconciliation to net income, no per-share EBIT or EBITDA) – https://www.sec.gov/rules-regulations/staff-guidance/corporation-finance-interpretations/non-gaap-financial-measures
- Corporate Finance Institute: Net Debt to EBITDA (a lower ratio means debt is easier to repay; used by creditors) – https://corporatefinanceinstitute.com/resources/commercial-lending/net-debt-to-ebitda/
- Cedar Print Works is an invented example company and all its figures are illustrations, not real data.

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