

EBITDA

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In accounting and finance, **EBITDA** «*ee-bit-dah*» or «*ee-bit-dee-eh*» stands for "**Earnings before Interest, Taxes, Depreciation, and Amortization**" (sometimes named OIBDA for operating income before depreciation and amortization). As the name suggests, this is earnings excluding expenses from depreciation, amortization, interest, and taxes (earnings + ITDA), in the order they usually appear on the income statement, up to down. It's the operating income with expenses for depreciation and amortization backed out. In layman's terms, EBITDA is called "Earnings, before all the bad stuff." An amusing variation of the term is "Earning before I tricked the dumb auditor."

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Depreciation and non cash earnings

A company's stated "income" number is always distorted by decisions that the company made in previous years. Depreciation of capital expenditures is a particularly strong factor. This is because of the differences between accrual accounting and cash basis accounting.

For example, if a company spends \$99 million in new desktop computers for all its employees, the company will often decide to depreciate the purchase over their expected lifetime of three years. This way, in the first year, when the company calculates its "income" number, it pretends that it has only spent \$33 million that year on desktop computers. The company's income number paints a more rosy and optimistic picture than actually occurred that year. In each of the second and third years, the company also pretends that it has spent \$33 million per year on desktop computers. Hence, the company's financial picture was probably healthier than indicated by the income number, since the \$33 million had actually already been paid out.

The EBITDA number, it is claimed, does not suffer from this distortion in the second and third years, so investors can get a better idea of how profitable the company really is. Some purchases are depreciated or amortized over 20 years or more, with a negative impact on the business' "income" number long after the actual financial effects of the purchases have ceased.

Critics include Warren Buffett, who famously asked, "Does management think the tooth fairy pays for capital expenditures?" Hypothetically, a company could spend a trillion dollars on capital expenditures, and this would never show up in the next million years of the company's EBITDA reports. The "income" number is therefore a more true picture, say critics of EBITDA reporting, and if an investor wishes to examine short-term financial performance, he should examine the "operating cash flow" and free cash flow numbers.

Important considerations with regards to EBITDA

One consideration is that a company's capital expenditures typically vary from year to year. Income measures try to account for this by artificially spreading the expense of capital investments over the years in which they will be generating value for the company. EBITDA removes this effect from the income measure. A professional investor can use EBITDA to approximate the fundamental earning power of the company's operations while separately factoring in the projected capital expenditures needed to maintain those operations. This is valuable because of the time value of money principle. A sophisticated investor knows that a large capital expenditure is less costly if it is to be made several years into the future (because during the interim period the firm can use the cash for that expenditure to generate income in other ways). Therefore the sophisticated investor looks at a "pure" measure of ongoing earnings-generating potential and then makes an educated assessment of the timing of significant capital expenditures. It is critical, however, to consider capital expenditures in conjunction with EBITDA; failing to do so ignores a very important company characteristic (consider two companies with identical EBITDA, but one requires twice the annual capital expenditures to maintain the EBITDA - this company would be worth less.)

A second consideration is that the value of a company's equity differs depending on its capital structure (whether and to what extent the company is financed with debt). Because EBITDA is also an earnings measure before interest and taxes (which vary with the amount of debt financing), it approximates the company's earnings potential if financed with no debt. If capital structure is the only concern (rather than timing of capital expenditures), then EBIT can be used. A professional investor that can contemplate changing the capital structure of a firm (e.g., through a leveraged buyout) first evaluates a firm's fundamental earnings potential (reflected by EBITDA or EBIT), and then determines the optimal use of debt vs. equity.

The third consideration is that the owner of a firm's equity receives all of the cash flows generated by the firm after meeting all of the firm's commitments. This is the company's free cash flow. Before factoring in capital expenses, this is the company's operating cash flow. Cash flow measures include the impact of changes in the company's balance sheet, and in that way differ from income measures. For example, if a company must purchase an increasingly large amount of inventory as its sales grow, then the company will typically use cash to buy that inventory before receiving cash in return from customers. The company faces costs as a result of this use of cash: it either gives up the profits it could have earned by using that cash elsewhere (e.g., by investing it in an income-producing security) or decreases returns to equity holders by issuing additional debt or equity. This use of cash reduces the company's cash flow, and reduces the value of the firm, but has no effect on income. EBITDA is not useful in assessing the impact of such changes in the company's balance sheet.

Finally, taxes are ignored when considering EBITDA. This may be relevant if a firm has tax-loss carryforwards to avoid paying tax currently (a valuable asset).

It is important to note that EBITDA is not helpful for valuing pre-earnings growth companies (e.g. technology companies). A negative EBITDA figure is not meaningful when consideration valuation multiples (namely Enterprise Value/EBITDA).

EBITDA and Bankruptcy

EBITDA is often used as a proxy for cash flow from operations, for the purpose of calculating debt coverage ratios. The key ratios used by lenders and investors are Debt/EBITDA and EBITDA/Interest expense. These ratios describe a company's ability to service its debt and make its interest payments. Occasionally the number EBITDA-Capital expenditures is used, and this number better approximates free cash flow. Generally lenders look for Debt/EBITDA ratios less than 5, and EBITDA/Interest expense ratios greater than 2.

EBITDA and Leverage

The Debt-to-EBITDA ratio, or even more common, the Net-Debt-to-EBITDA ratio (Net Debt being a company's interest-bearing liabilities minus cash or cash equivalents), is very widely used by banks and investors as a dynamic measure of leverage because the classic definition does not account for the ability of a company to decrease its debt burden. A company considered to have low or high leverage in this context depends on the industry. While for Oil & Gas companies it is very common to even have negative leverage, the water- and wastewater business considers leverage in

excess of 10 still acceptable. In leveraged buy-outs, Debt over EBITDA is also used as an indicator of willingness to provide certain debt instruments such as a senior loan, second lien loan, mezzanine loan and a PIK loan. While a bank might only consider to finance a buy-out up to a leverage of, eg. 5 times EBITDA, a high yield fund might even be willing to top up to 7 times EBITDA with mezzanine debt, and, in addition, up to 9 times EBITDA with PIK debt.

Historical Context

Most dot-com companies attempted to promote their stock by means of emphasizing either EBITDA or pro forma earnings in their financial reports, and explaining away the (often poor) "income" number. This would involve ignoring one-time write-offs, asset impairments and other costs deemed to be non-recurring. Because EBITDA (and its variations) are not measures generally accepted under U.S. GAAP, the U.S. Securities and Exchange Commission requires that companies registering securities with it (and when filing its periodic reports) reconcile EBITDA to net income in order to avoid misleading investors.

EBITDA has also historically ignored stockbased compensation expense. Even though companies are now required under FASB 123(R) to record stock-based compensation expense on their income statements (previously companies could just disclose these amounts in footnotes), management will often ignore stock-based compensation expense when reconciling net income to EBITDA on the basis that it is a non-cash expense. This methodology can be controversial, as many would argue that stock-based compensation should be treated for accounting purposes like cash compensation, due to its recurring nature.

References

See also

- Operating income

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