(EBITDA) A Quest for Erudition

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There is a confusing myth among the professional on use and efficacy of EBITDA and it use a barometer to gauge the financial health of the companies. In the normal course of business scenarios investors, shareholders, bankers, mutual funds, and equity brokers focus on Cash Flow, Net Income and Revenues as the fundamental barometer to gauge corporate pulse and Value. However in recent years, another measure has sneaked the prominent place in the quarterly reports and accounts of Corporate: Earnings before Interest, Taxes, Depreciation and Amortization. EBITDA is used to analyze and compare profitability between companies and industries, investors should understand that there are serious limits to what the metric can tell them about a company. Here we look at why this measure has become so popular and why, in many cases, it should be treated with caution.

EBITDA Rationale

EBITDA first came to surface and in prominence some time in 1980s as testing tool for leveraged buyout proposal by the investors who examined distressed or cash anemic companies in need for financial restructuring. They used EBITDA to calculate quickly efficacy or capability whether these companies could pay back the interest on the financed deals.

In a Leveraged buyout deal bankers promoted EBITDA as a tool to determine whether a company could service its debt in the near term, say over a year or two. At least in theory, looking at the company's EBITDA-to-interest coverage ratio would give investors a sense of whether a company could meet the heavier interest payments it would face after restructuring. For instance, bankers might argue that a company with EBITDA of RS5 million and interest charges of RS 2.5 million had interest coverage of 2 - more than enough to pay off debt.

The use of EBITDA spread to a wide range of businesses for financial structuring or structuring of investment profile with a gearing. Its proponent advocates that EBITDA offers a clearer reflection of operations by stripping out expenses that can murky how the company is really performing.

A debt with interest bearing financing which, is largely a function of management's choice carrying an interest is ignored. Taxes are left out because they can vary widely depending on acquisitions and losses in prior years; this variation can distort net income. Finally, EBITDA removes the arbitrary and subjective judgments that can go into calculating depreciation and amortization, such as useful lives, residual values and various depreciation methods

By eliminating these items, EBITDA makes it easier to compare the financial health of various companies. It is also useful for evaluating firms with different capital structures, tax rates and depreciation policies. At the same time, EBITDA gives investors a sense of how much money a young or restructured company might generate before it has to hand over payments to creditors and the taxman.

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Currently working as Director Strategic Development with Getz Pharma, a country's leading pharmaceutical company ranking as number 5th in the country, with a wide range of product portfolio and having distribution and marketing set-up in more than 25 countries of the world.

He has over 35 years experience of working with world renowned chemical, pharmaceutical, logistics and cargo division of Lufthansa Airline within Pakistan and abroad. During the employment period he has an extensive experience of working in the different capacity to look after Finance, Treasury, ERP, Supply Chain, ERM, Strategic and Project development, business process management on operation and strategic sphere and cadre.

Professionally he is a fellow member of the Institute of Cost and Management Accountant of Pakistan. He is also Vice President of the national council and technical advisor on the board member of SAFA. He did his MPhill in Supply Chain Management,, Fellow member of Institute of Supply Management (USA) and also Chartered member of Charter Institute of logistics and transport. Have a recognized and approved 15 thesis in the field of Business Process Outsourcing, Business Process Engineering, SCOR, and Supply Chain Management dynamics, Leverage Financing, Employees Stock Options, SCM Risk and Enterprise Risk Management. His PhD thesis on Enterprise Management is being Evaluated Have attended many vocational and professional training programs around the world. He is also educationist and employed as honorary Chairman of Supply Chain Management stream by the country largest private university. Have presented many papers and have conducted various workshop and training program locally and also in Asian Pacific on ERP, BPR, SCM, EVA, Project financing, ProVision, TTM, Corporate Finance, Financial Management. Enterprise Management and ERM, On World Trade Organization, and TRIPS he has worked on South Asia Region within his previous job and has worked out various policies related to logistics and transport with the Indian and Chinese counter part. He also received the best presentation award on WTO in 2005 by the WTO organization.

All the same, one of the biggest reasons for EBITDA's popularity is that it shows more profit than just operating profits. It has become the metric of choice for highly leveraged companies in capital-intensive industries such as energy/cable and telecommunications, where bona fide profits are sometimes hard to come by. A company can make its financial picture more attractive by touting its EBITDA performance, shifting investors' attention away from high debt levels and unsightly expenses against earnings.

Cautious Approach

While EBITDA may be a widely accepted indicator of performance, using it as a single measure of earnings or cash flow can be very misleading. In the absence of other considerations, EBITDA provides an incomplete and dangerous picture of financial health. Here are four good reasons to be wary of EBITDA:

1. No replacement for Cash Flow

some financial or business analysts or journalists urge investors to use EBITDA as a measure of cash flow. This advice is illogical and hazardous for investors: for starters, taxation and interest are real cash items and, therefore, they're not at all optional. A company that does not pay its government taxes or service its loans will not stay in business for long.

Unlike proper measures of cash flow, EBITDA ignores changes in working capital, the cash needed to cover day-to-day operations. This is most problematic in cases of fast-growing companies, which require increased investment in receivables and inventory to convert their growth into sales. Those working capital investments consume cash, but they are neglected by EBITDA.

For example, one of the quoted companies in the textile sector in Karachi Stock Exchange depicted RS28.4 million EBITDA for the fiscal year 2008. But if you turn to the company's cash flow statement, you'll see that it consumed RS48.8 million in additional working capital, which largely accounts for company's negative cash flow from operations. Clearly, EBITDA paints a rosier financial picture than other measures.

Furthermore, while capital expenditures are a critical, ongoing cash outlay for almost every company, EBITDA ignore or neglects capital expenditures. Consider a small company as service provider. In its Q4 2005 earnings release, the company reported RS14.3 million EBITDA. That represents a 30% improvement from Q4 2004, when it reported EBITDA of RS11 million. But this measure disregards the company's sky-high capital expenditures. Looking at the notes to the accounts, we see that the company spent RS46.9 million on network capital equipment in Q4 2005; in order to grow, it will need to continue spending annually to upgrade and expand its networks. This number is significant, but it is not part of the EBITDA mix.

Clearly, EBITDA does not take all of the aspects of business into account, and by ignoring important cash items, EBITDA actually overstates cash flow. Even if a company just breaks even on an EBITDA basis, it will not generate enough cash to replace the basic capital assets used in the business. Treating EBITDA as a substitute for cash flow can be dangerous because it gives investors incomplete information about cash expenses.

2. Skews Interest Coverage

EBITDA can easily make a company look like it has more money to make interest payments. Consider a company with RS10 million in operating profits and RS15 million in interest charges. By adding back depreciation and amortization expenses of RS8 million, the company suddenly has EBITDA of RS18 million and appears to have enough money to cover its interest payments.

Depreciation and amortization are added back based on the flawed assumption that these expenses are avoidable. Even though depreciation and amortization are non-cash items, they can't be postponed indefinitely. Equipment inevitably wears out, and funds will be needed to replace or upgrade it.

3. Ignores Quality of Earnings

While subtracting interest payments, tax charges, depreciation and amortization from earnings may seem simple enough, different companies use different earnings figures as the starting point for EBITDA. In other words, EBITDA is susceptible to the earnings accounting games found on the income statement. Even if we account for the distortions that result from interest, taxation, depreciation and amortization, the earnings figure in EBITDA is still unreliable.

Let's say, for example, that a company has over- or under-reserved for warranty cost, bad debt or restructuring expenses. If this is the case, its earnings will be skewed and, as a result, EBITDA will be misleading. Furthermore, if the company has recognized revenues prematurely or disguised ordinary costs as capital investments, EBITDA will provide little information to investors. Remember, EBITDA is only as reliable as the earnings that go into it.

4. Makes Companies Look Cheaper Than They Really Are

Worst of all, EBITDA can make a company look less expensive than it really is. When analysts look at stock price multiples of EBITDA rather than bottom-line earnings, they produce lower multiples.

For Example consider A company the stock of which trading at 7.3 times its forecast EBITDA. That might sound like a low multiple, but it doesn't mean the company is a bargain. As a multiple of forecast operating profits, the same company traded at a much higher 20 times. The company traded at 48 times its estimated net income. Investors need to consider other price multiples besides EBITDA when assessing a company's value.

Conclusion

Despite its widespread use, EBITDA isn't defined in GAAP - as a result, companies can report EBITDA as they wish. The problem with doing this is that EBITDA doesn't give a complete picture of a company's performance. In many cases, investors may be better off avoiding EBITDA or using it in conjunction with other, more meaningful metrics. EBITDA doesn't exist in a vacuum. The measure's bad reputation is more a result of overexposure and improper use than anything else. Just as a shovel is effective for digging holes, but wouldn't be the best tool for tightening screws or inflating tires, so EBITDA shouldn't be used as a one-size-fits-all, stand-alone tool for evaluating corporate profitability. Like any other measure, EBITDA is only a single indicator. To develop a full picture of the health of any given firm, a multitude of measures must be taken into consideration. If identifying great companies was as simple a checking a single number, everybody would be checking that number and professional analysts would cease to exist.