

EBITDA

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Profitability can be measured in a number of ways.

In this presentation we are talking about EBITDA – what it is and how it's used.



A good place to start is by defining what it means

So, its;

Earnings (that's the same as profit)

Before (the deduction of)

Interest,

Tax,

Depreciation and


Amortisation

The first part of that definition includes a profit measure called EBIT.

If we take a look at an income statement we can see what EBIT is.....

On an income statement, EBIT is earnings (profit) before interest and tax

Effectively, it's the same as operating profit but.....



Example Business Limited		
Income Statements for the year ended 28 February		
	2013	2012
Turnover	32,076,796	28,161,327
Cost of goods sold	(22,293,812)	(19,283,781)
Gross profit	9,782,984	8,877,546
Operating expenses	(6,896,393)	(4,143,044)
Depreciation & amortisation	(705,610)	(607,658)
Operating profit/(loss)	2,180,981	4,126,844
Interest expense	(340,863)	(522,759)
Net profit before tax	1,840,118	3,604,085
Tax	(460,400)	(867,448)
Profit for the year	1,379,718	2,736,637

.....it's only the same as operating profit if there are no exceptional items of income or expenditure shown in the income statement.

In our example on the previous slide there isn't, so it's safe to take the operating figure to be EBIT.

But if there were some exceptional items, you'd have to calculate EBIT.

If you look again at the income statement, you'll notice that the operating profit figure (what we take to be the same as EBIT in this case) is after the deduction of depreciation and amortisation.

So to get to the EBITDA figure, we simply have to add back that figure for depreciation and amortisation to the operating profit.



Now we know how to calculate the EBITDA figure, the question is



Having made the various adjustments to operating profit, what do we have?

We have the “cash” profits that the business made from its operating activity during the accounting period.

Some lenders use this figure as a proxy for cash flow since depreciation and amortisation have been removed.

The only thing to keep in mind if you use it that way is that the working capital changes have not been taken into account. For example.....

The profit that we have calculated as EBITDA will not necessarily turn immediately into cash.

If sales have been made on credit, it's only when the customers actually pay the business that the cash flow occurs.



A much better way to use EBITDA is as a comparison measure when you are looking at a business' performance compared to its industry peers.



What that enables you to do is to compare one business with another but without the effects of;

- Different capital and funding structures
- Different tax environments
- Different capex policies

Different capital and funding structures;

Businesses can fund themselves through a mixture of equity and debt. Obviously, the higher the use of debt, the more interest the business will pay.

Removing interest expense from the profit figures enables a better comparison of operating performance between different businesses.

Different tax structures;

Businesses that are geographically diversified may have various tax advantages and businesses that invest in certain types of fixed assets may be able to take advantages of tax shields, so removing the tax paid figure enables a better comparison of operating performance between different businesses.

Different capex policies;

Businesses may regularly replace fixed assets and so will have a higher depreciation charge in their income statements than those businesses that don't replace their assets so regularly.

Different capex policies;

Also, some businesses may invest in intangible assets so will have a higher amortisation charge in their income statement than those businesses that don't.

Removing the effects of depreciation and amortisation enables a better comparison of operating performance between different businesses.

In summary, EBITDA is a very useful tool for peer comparison of the real value of a business' profit from operations.

As a proxy for cash flow it has its uses also, but for that purpose, analysis of the cash flow statement is a better option.