When EBITDA Is Just BS

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Between add-backs, adjustments, and general shenanigans, the EBITDA multiples offered up by private companies frequently mask the truth.

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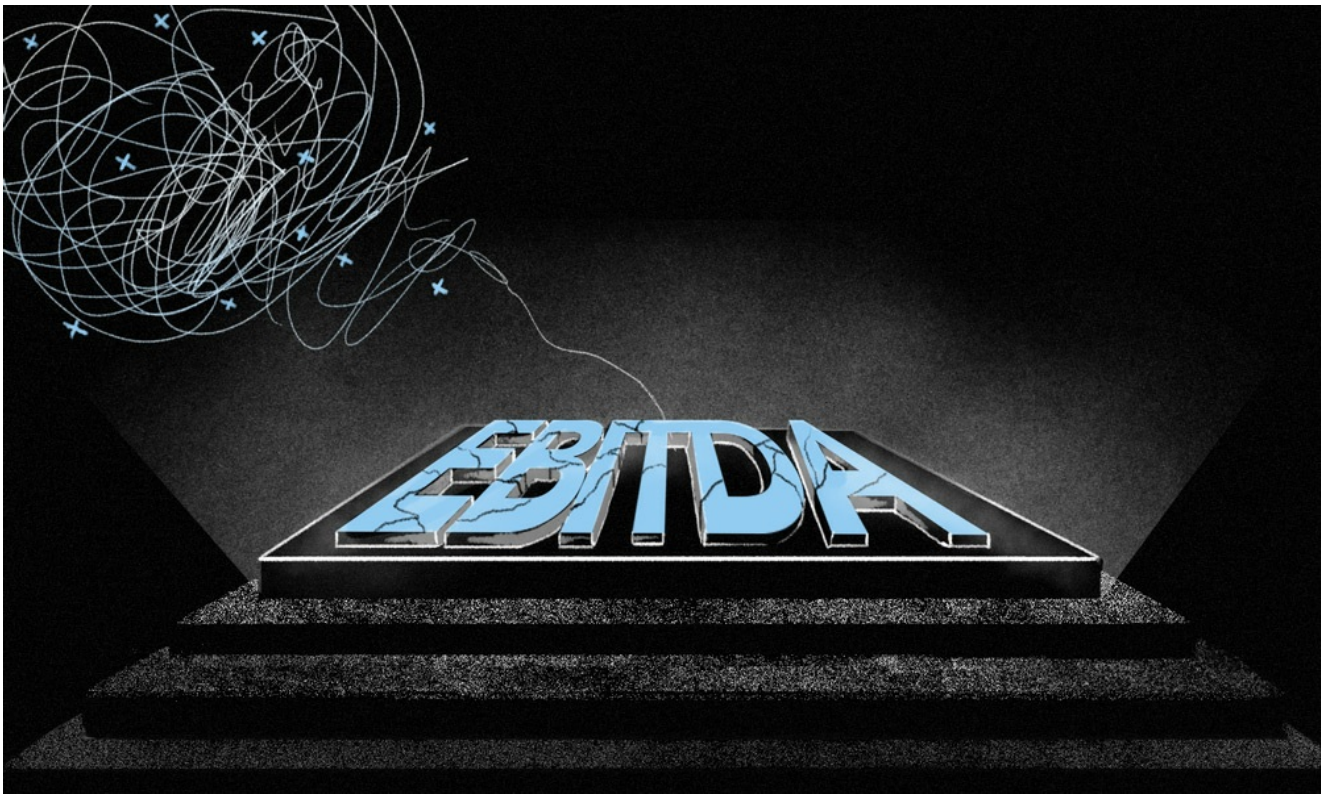
October 11, 2019



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One of the trends that you'd have been hard pressed to miss over the past decade has been rising valuations across virtually all markets. Developed and emerging, equity and credit, public and private —prices for everything have marched inexorably upward.

In private markets, the most commonly cited measure of average valuation is called the EBITDA multiple. Similar to the price-to-earnings ratio for public stocks, this number measures the capitalization, or price, of a business relative to its underlying earnings, in this case a specific metric called EBITDA, or earnings before interest, taxes, depreciation, and amortization. As we can see in the chart below, EBITDA multiples have continued to hit new highs, with the average buy-out deal transacting at approximately 11 times EBITDA through the first half of 2019.

But what exactly is EBITDA?

EBITDA is a normalized earnings measure, and it helps compare businesses with different capital structures, taxes, and non-cash expenses. Controlling for such non-operating differences is supposed to make comparisons of the actual profit potential of different underlying business easier and more meaningful. It's also a helpful number for lenders, since it's a rough approximation of a company's debt service capacity.

That is, if the number is any good.

Private companies are by definition not listed on an exchange, which means their earnings aren't subject to the same type of regulations and standardization as are public companies. Often, EBITDA is heavily inflated by a number of questionable adjustments.

Many private companies are still owned by the founders, who pay themselves above market salaries and run personal expenses such as rental cars, club memberships, and excessive travel and entertainment expenses through the corporate accounts. However, when they go to sell the business, they want the firm to be valued on earnings above those expenses, so they will present adjusted numbers to potential suitors. The justification is that when the business is run more commercially, those expenses will not be there going forward, so they get added back into the earnings.

More debatable is trying to get credit for future synergies, or adding back other costs that are likely to come out through M&A. Sometimes, management also tries to boost revenue assumptions because of capacity increases from recent investments into new equipment or plant expansions. If you build it, just pretend the money has already come.

In short, EBITDA is pretty much just a made up number at this point, whatever management wants it to be. And part of negotiating a private transaction today isn't just figuring out whether or not the appropriate multiple should be ten or eleven times, but what EBITDA actually is. PE funds are having to work harder and harder on the buy, arguing, for instance, that earnings aren't actually $5 million, but instead should be more like $3.5 million, while at the same time still trying to win the deal. If they push too hard, they are liable to lose out to a less discerning purchaser.

After years of hearing very little about this peculiar piece of financial arcana, so far this year we've had four different funds complain to us — unprovoked — about how bad the shenanigans have gotten in recent deals. According to data from the S&P's Leverage

Commentary and Data unit, over the last six months, a record percentage, a full 43 percent, of syndicated loan issues — loans that are often used to finance LBO transactions — contained such EBITDA adjustments.

And the S&P report also showed that for lower-quality credits, the amount of number fudging is even worse. Nearly half of the total earnings reported by companies rated single B were attributable to these so-called add-backs. For higher-rated BB credits, the above-mentioned adjustments only overstated income by 21%. Still, that's a meaningful bump.

However, a great deal of private companies can't access the broadly syndicated loan market for financing. Most of the middle market and all of the small market generally use more bespoke forms of lending from banks or private credit funds, often with higher interest rates attached. For these companies, it's a bit harder to estimate the impact of these embellishments, but it seems likely that the majority of transactions have add-backs embedded in earnings to some degree. A 20 percent to 30 percent impact is probably a reasonable assumption for the scale of the effect.

If these adjustments were properly accounted for, then leverage levels for most private equity deals would be closer to 7.5x EBITDA instead of 6.0x, and the average total valuation across the industry would be more like 12.5x versus the current headline numbers of 11.0x. Even in a world inured to rising valuations, that back-of-the-envelope calculation should be sobering.

And it's why Charlie Munger of Berkshire Hathaway reportedly once said, "I think that every time you see the word EBITDA, you should substitute the word 'bullshit' earnings." Perhaps it's time for a new acronym for this particular dubious metric. I'll propose the following: Entirely Bogus Income, Totally Devoid of Accuracy.