What is EBITDA?

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When folks ask me what is the catalyst that determines business value I respond, "cash flow." Then I explain that cash flow is synonymous with EBITDA. That's when I usually receive one of two responses 1) the recipients' response and countenance tells me they are familiar with EBITDA or 2) there is a long pause and the proverbial "deer in the head lights look." All joking aside unless you work in the finance industry, EBITDA is often a completely foreign concept. So for folks reading this article who are unfamiliar with EBITDA it is the acronym for earnings before interest, taxes, depreciation, and amortization. One of the most effective means to learn a new concept is to see it. So the EBITDA for Wonder Woman, Inc. is depicted in the table below.

To calculate EBITDA you begin with Net Income of $147,000 then you add interest expense of $3,000 and depreciation/amortization of $50,000 which equals $200,000 (note: net income is before income taxes). EBITDA depicts the cash flow of the business without the cost of capital (which is stripped out by removing the cost of debt). EBITDA is useful in considering the value of a company because it normalizes capital structure, tax structure, non-cash accounting, and net working capital. But there is a limitation to consider EBITDA does not include capital expenditures necessary to maintain the property, plant & equipment.

Wonder Woman, Inc.	
Profit and Loss	
January - December 2024	
Revenue	$550,000
Cost of Goods Sold	$300,000
GROSS PROFIT	$250,000
Depreciation/Amortization	$50,000
Other SG&A expenses	$52,000
Total Expenses	$102,000
NET ORDINARY INCOME	$148,000
Other Income/expense	
Interest Income	$2,000
Total Other Income	$2,000
Other Expense	
Interest Expense	$3,000
Total Other Expense	$3,000
Net Other Income (Expense)	($1,000)
Net Income	**$147,000**
Plus:	
Interest Expense	**$3,000**
Depreciation/Amortization Expense	**$50,000**
EBITDA	**$200,000**

Normalizing EBITDA

To get this metric for purposes of a valuation, often owners will need to "add back" into EBITDA certain expenses from the Profit and Loss that are non-recurring or non-operational. The term addbacks describes the adjustments necessary to EBITDA to give buyers a more normalized and realistic picture of what level of EBITDA they could actually receive if the business was acquired. Normalized EBITDA provides the owner with the cash flow stream adjusted to economic reality which is the benefit stream that can be sold or enjoyed.

Personal or non-business expenses are common addbacks. These can include personal travel expenses, personal meals and entertainment, and all other expenses included in the P&L that were for the benefit of the owners as opposed to necessary operating expenses incurred by the business.

Other common addbacks are excess owners' compensation and non recurring expenses. For example if an owner receives a $1 million salary when the market salary for a replacement CEO is $250 thousand then an addback of $750 thousand is warranted. However, if the owner's compensation is deficient then it can result in the need to increase expense which will decrease normalized EBITDA.   An example of a non-recurring expense is one-time legal fees related to merger & acquistion activity.

Fun Fact

EBITDA was originally coined by American Media Billionaire John Malone, during the 70's as a way of analyzing cash flow generating capabilities of companies. At the time earnings per share "EPS" was the most popular way of examining high growth capital intensive companies but Malone argued that EBITDA was a better metric. At that time in history Cable television companies' primary source of growth was through acquiring systems and investing in expanding infrastructure; EPS did not reflect this growth.