



EBITDA

By Brian Madigan

Peculiar initials, but what do they mean? The definition of EBITDA is earnings before interest, taxes, depreciation and amortization.

It is said to be a measure of the profitability of a business. Frequently, a business will be prepared for sale. The business will be removed from the real estate it occupies. Separate financial statements will be prepared for each. The vendor's objective is to make both aspects look good on paper. In many cases, there will be two different buyers, one for the business and another for the real estate.

There is a real opportunity here for some creative accounting. The real estate can probably stand on its own. Ultimately, the real estate should fetch a market price coincident with that otherwise found in the marketplace.

The business is a little different. Most businesses are sold on the basis of a multiplier calculated on net profits. Small businesses will trade from one-half of one year's earnings plus inventory up to three times in some cases. Medium sized companies will often trade in the range of three to seven times earnings (with or without inventory) and large companies will trade for seven to fourteen times earnings (inventory included). This is the usual range for profitable companies listed on a major stock exchange. Obviously, the technology companies are an exception.

This is where EBITDA comes in. Stockbrokers and particularly stock promoters wished to have their companies appear in a very good light. In fact, it can make capital intensive marginally profitable companies look quite good on paper. Market analysts over the past few years have criticized this approach pointing out that it does not truly represent real operating cash flow. EBITDA omits to consider variations in accounting methods, cash required for working capital, debt payments and other fixed expenses, as well as capital expenditures. These issues are critical to every operating business, and it can be foolhardy to base an evaluation of a business on the earnings calculated in this manner. EBITDA has its place in a proper

analysis, but don't let the vendor establish a sale price using this method alone.

The Real Estate and Business Brokers Act governs the real estate profession in both matters: the property and the business. But it doesn't say anything about how to undertake the math or which formulas to use. So, be careful and fully understand the accounting methods used to justify the sale price when you are considering purchasing an operating business.

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