EBITDA – What You Need to Know

by Chris Burand

I was recently reviewing an article from 2005 by Hales & Company regarding how many sellers leave a lot of money on the table because the seller does not understand EBITDA. That point was true then and it is even more true now. Some points sellers need to know:

1. EBITDA stands for Earnings Before Interest, Taxes, Depreciation, and Amortization.

2. The EBITDA valuation methodology is simple, overly so as applied by many. It works like this: Agency's EBITDA x EBITDA Multiple = Value. For example, if the EBITDA is $100,000 and the EBITDA multiple is 6, the value equals $600,000.

3. The EBITDA multiple ONLY applies to the book of business not the stock or other assets.

4. Hales' first point was perfect. Too many sellers do not understand that EBITDA is a pro forma number. It is not the agency's actual EBITDA. Pro forma EBITDA is not always materially higher than actual EBITDA but it usually is. If the seller does not know this, they likely will sell their agency for too little. For example, the actual EBITDA might be $80,000 but the pro forma EBITDA may be $100,000. This $20,000 difference is a $120,000 difference in price.

   If you do not think buyers will not take advantage of your lack of knowledge, you should really think again.

5. EBITDA is based on the BUYER's version of the seller's pro forma, not the seller's version of their pro forma! This is more of a problem with small agencies. The owner thinks that because they take their compensation below the bottom line, and their compensation may be as much as 50% of revenue, that their EBITDA is 50%. Of course this thought process is totally wrong. First, a pro forma adjusts for compensation taken below the bottom line. Second, just because it appears on the seller's income statement as though the principal works for free, the buyer has to pay someone to work at least some of the accounts. This is one of those situations in which the buyer's pro forma EBITDA will be less than the incorrectly calculated seller's EBITDA. A lot of seller's create considerable frustration, damage their reputations, and even damage the value of their agencies because they do not understand this key point.

   On the other hand, because the buyer's pro forma EBITDA is the one that counts, a seller will benefit themselves by calculating the economies of scale the buyer will achieve on their income statement. For example, they may not have to pay for a receptionist or a bookkeeper and they may be willing to fire the nonperforming relative.

6. EBITDA is directly related to the multiple of sales. For example, an agency with a pro-forma EBITDA of 15% and a value of 6 times EBITDA would have a book of business value of approximately of .9 times revenue. Alternatively, an agency with a multiple of revenue value of 1.25 times and an EBITDA of 25% would have a book of business value of 5 times EBITDA. EBITDA just sounds more sophisticated. I hear many unsophisticated agency owners talking about EBITDA multiples and because a buyer has approached them using this methodology, they are feeling good about this more "sophisticated" way to value agencies. At its heart, it is just as simplistic as the multiple of revenue methodology is.

7. EBITDA lends itself to the gambling game of Monte. What often occurs is the buyer says they will pay, for example, 6 times EBITDA but the earnout brings the final price to 10 times EBITDA. However, the final price is highly unlikely to ever be near 10 times EBITDA.

   Even the biggest buyers of agencies suggest they do not plan on making the full payment based on my analysis of the publicly traded brokers' annual reports. Under new accounting rules, they have to estimate how much of the earnout they expect to pay and many are telling the S.E.C. they are not expecting to pay anywhere close to the full earnout.

   Additionally, the multiple likely stays the same throughout. It doesn't go from 6 to 10. This is important. The most common goal for each year is the original multiple times that year's EBITDA. At the end of say three years of achieving all the goals and earning all the bonuses at 6 times each respective year's EBITDA, the buyer will often add all the bonuses together and then divide by the original EBITDA. Of course that EBITDA is a much smaller denominator which thereby greatly increases the EBITDA multiple. But this is apples and oranges. The denominator should be the same as that year's bonus.

For example, using a multiple of 6 over three years:

	EBITDA	Times Annual Earnout Multiple (6/3 years)	Earnout Amount	Actual EBITDA Multiple
Year 1	$100,000	2	$200,000	6
Year 2	$110,000	2	$220,000	6
Year 3	$120,000	2	$240,000	6
TOTAL			$660,000	

The buyer will tell the seller they are getting a higher multiple of 6.6 ($660,000/$100,000) by using the first year's EBITDA as the denominator. The real denominator should be each year's EBITDA which still results in a multiple of 6. More than one seller has fallen hard for this shell game of moving denominators.

The EBITDA methodology is not that sophisticated but it has many more moving parts. In the hands of a skilled buyer, these moving parts can be used to convince an inadequately advised seller they are getting a good deal when in reality, they are getting a lousy deal.

On the other hand, I see too many sellers demanding far too much for their agencies because they think they understand EBITDA methodology when they do not understand it at all. Going back to #1, they don't know what EBITDA really means. Some confuse earnings and revenue. Knowledge is power and money. If you're selling, understand EBITDA really well or hire and adviser that does.

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