EBITDA vs. Cash Flow

EBITDA is Good, But Cash Flow is King

By Walt Lipski

At a recent M&A Source Conference, there was a recurring comment from Private Equity participants: "EBITDA is good BUT we need to understand the Cash Flow of any business we look at buying."

Many business owners, their advisors, and even intermediaries, often mistake EBITDA for Cash Flow. EBITDA is defined as **Earnings before Interest, Taxes, Depreciation and Amortization**. It is easily calculated by taking normalized operating income and adding back interest, depreciation and amortization expenses. It is better to think of EBITDA as an indication of profitability and only a "proxy" for Cash Flow.

EBITDA is:

- a starting point for business valuation discussions
- a good measure to evaluate profitability between companies and industries
- a good measurement for trending and industry benchmark analysis

Often a business is priced as a multiple of EBITDA, but behind the offer, Net Cash Flow is actually driving the terms and conditions of the transaction. Understanding the difference between the two is critical in educating the business Ownership and their advisors in the positioning and strategy leading up to any sale transaction endeavor. Generally, what EBITDA is not, Cash Flow is.

Net Cash Flow reflects:

- changes in working capital
- capital expenditures, i.e. CapEx
- includes taxes, cost of debt, the add back of non-cash expenses
- and changes in long term debt

Net Cash Flow is the cash that Ownership can put in their pocket in the form of dividends or distributions. Understanding the anatomy of the Net Cash Flow calculation adds clarity to this important financial metric:

Start with Net Income
Plus Depreciation and Amortization
Plus changes in Working Capital
= **Operating Cash Flow**
Minus CapEx
= **Free Cash Flow**
Plus or minus Borrowings or Pay-downs
= **Net Cash Flow**

Think of Net Cash Flow this way: it is the earnings of the business that could be removed without effecting the ongoing profitable operations of the business. Put another way, it is **the cash left over after salaries, ownership perks, etc., and after taking care of all the necessary business expense and commitments.**

Why is this distinction so important?

Consider a possible buyer's perspective, assuming an attractive acquisition opportunity. Now, let's ask the question, "What does every buyer need from a transaction?"

They need enough cash flow to cover:

- debt service
- adequate management capability
- a return on investment
- and eventually, a return of investment

This is why, from an intelligent buyer's perspective, Net Cash Flow is so important – because it **provides coverage for all of the above buyer needs**. EBITDA does not. Consider this example: a company in the transportation industry is growing at 10%+ per year, with $8MM in EBITDA, and is on the market for a 6X multiple or $48MM. On the surface, this sounds like an interesting opportunity based on the above metrics. So our super hero buyer investigates, only to learn that the company is a growing taxi cab business with $6MM in annual CapEx. This means real cash flow is closer to $2MM, not $8MM as originally thought. Would you as a buyer pay $48MM for a business earning approximately $2MM? Would you be in business very long if you did? Now let's look from the perspective of Ownership considering a sale of their business. What are their options?

Basically, they come down to:

- sell now and go
- close it down
- sell part of the company to a growth partner or management team
- or do nothing

Whenever the question of selling a company comes up, Ownership will consider the above options, and unless there are some unusual outside driving circumstances, (i.e. health, family, financial etc.) they will always have the option to do nothing. Usually this is the comfort option, the least risky from Ownership's perspective. As an intermediary, we have a wonderful opportunity to help both the Ownership and their advisors understand the true current economic benefit provided as a result of owning the business. This is a simple two part equation: first, Ownership receives the Net Cash Flow from the business, and second, if the ownership works in the business, then they are entitled to receive compensation in the form of salaries and "perks". The sum of these two deliverables is the economic benefit provided to Ownership. Is there any better starting point for Ownership and their advisors to begin shaping and forming expectations with regards to a possible exit transaction?

When we, as intermediaries, help a potential client and their advisor understand the difference between EBITDA and Net Cash Flow, we are starting them on the path to making an informed decision between "Sell Now and Go" or "Stay and Grow." - WL

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