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EBIT“DUH”

As a business valuation specialist I occasionally get this phone call, “John, I’m looking at a small manufacturing that does about \$5 million of EBITDA. Can you give me a ballpark for what it’s worth?” I reply, “OK. How much of that is DA?” Needless to say he wasn’t looking for that follow-up. For some reason nobody seems to care about that.

I have a love/hate relationship with EBITDA (Earnings Before Interest, Taxes, Depreciation, and Amortization). I love it because it is far and away the most commonly utilized financial metric for the valuation of companies. When I look for similar transaction data to support my analyses, there’s always lots of information about the Purchase Price to EBITDA relationship. Used properly it is a great tool. It’s to the point where business people in conversation might say, “Hey did you hear that so and so bought ABC Company for 8 times?” It’s understood that the missing term is “EBITDA” – 8 times EBITDA. There’s the sun, the moon, and EBITDA.

This is also why I hate it. It’s too easy. Even a poorly performing company can show large EBITDA. It’s amazing the story you can tell when you add back your interest expense, taxes, depreciation and amortization. The story gets even better when you multiply EBITDA against the latest deal multiple you heard over lunch to come up with a great big value for what is really a lackluster performer.

A great example is Sirius Radio (NSDQ: SIRI). As of January 25, 2011 its enterprise value was \$8.9 billion. Yahoo! Finance tells me this equates to an EBITDA multiple of 11.6 times (call it \$770 million of EBITDA). Not bad right? Well, about \$250 million of this EBITDA is annual depreciation coming from satellites that wear out faster than the brakes and calipers on my car. The capital spending necessary to replace this obsolescence combined with the capitalized satellite launch costs is much more than an offset. Another \$300 million pays interest expense used to fund satellite purchases and ongoing losses. The aggregate change in cash over the past twelve months was negative \$120 million. As far as I can tell the only investors making any return out of this company are debt investors. The face value of debt is currently about \$3.0 billion which means approximately \$6.0 billion of value is supported by almost nothing but optimism. That’s the magic of EBITDA. If you don’t dig into the deals you can be easily fooled.

A handwritten signature in black ink, appearing to read 'John S. Ellis'.

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