EBITDA and
Normalized EBITDA

EBITDA is a measure of a company's financial performance that adds back interest, taxes, depreciation, and amortization expenses to net income. It is one of the most commonly used measures of a company's overall financial performance. It is often a key measure in the valuation of a company. EBITDA is calculated as illustrated in the table below.

Illustrative Profit & Loss Statement		
In 000$	**FY17**	**FY18**
Sales	**10,000**	**11,000**
Gross Profit	5,000	5,500
Salaries, rent and other expenses	2,200	30%
Interests	100	75
Amortization	200	250
SG&A	**2,500**	**2,825**
Earnings before taxes	2,500	2,675
Income Taxes	500	535
Net Income	**2,000**	**2,140**
Interests	100	75
Income Taxes	500	535
Amortization	200	250
EBITDA	2,800	3,000

EBITDA

EBITDA is used to measure a company's profitability before accounting for financing and tax decisions. EBITDA is a tool for comparing the core operating performance of companies with different capital/debt structures (e.g. a highly leveraged business would have a larger interest expense and therefore lower net income but could still have a higher EBITDA than a comparable business with a higher net income). Furthermore, comparisons of companies with different effective tax rates can be facilitated with the EBITDA calculation. As an example, one company could be eligible for the small business income tax rate and another company might not be eligible for the small business income tax rate due to it being part of a larger group of companies yet utilizing EBITDA makes meaningful analytic comparisons feasible.

Valuation and Enterprise Value ("EV")

Even though there are numerous valuation approaches utilized in a transactional context, the EBITDA multiple approach is often the most commonly utilized as it is simple and straight forward. By applying a multiple to EBITDA based on different factors such as comparable public companies, previous industry transactions, growth opportunities, risk profile, capital expenditures requirements, and other factors we can refine valuations of companies. Refer to the table for an example of an EBITDA multiple valuation matrix.

EBITDA multiples					
EBITDA/Multiples	**2.0x**	**3.0x**	**4.0x**	**5.0x**	**6.0x**
$3,200	6,400	9,600	12,800	16,000	19,200
$3,100	6,200	9,300	12,400	15,500	18,600
$3,000	6,000	9,000	12,000	15,000	18,000
$2,900	5,800	8,700	11,600	14,500	17,400
$2,800	5,600	8,400	11,200	14,000	16,800

Normalized EBITDA

Normalized EBITDA adjusts for non-operating revenue or expenses that are not related to the normal course of business, so that a company's core operating performance can be more accurately compared. Normalization adjustments to EBITDA will increase the EBITDA if we reverse out ("add-back") an expense and it will decrease the EBITDA if we reverse out ("deduct") revenue. As a result, the aforementioned adjustments will have a direct positive/negative impact on the Enterprise Value. Furthermore, a smaller normalization adjustment could still have a material effect on the Enterprise Value as the adjustment amount will be multiplied to obtain the Enterprise Value. As an example, a company valued with a 4x EBITDA with a positive $100k adjustment will result in a $400k increase in valuation.

Highlighted below is what we view as the most common EBITDA adjustments that are generally identified by a company's management team or adjustments that are made during the due diligence process.

Fair market value adjustments "FMV"

FMV adjustments aim to reflect the true value of expenses incurred by a company. Common examples include adjusting salaries to market levels, adjusting lease expenses to fair market value, and reversing out personal expenses not related to the business. We present below common examples of FMV adjustments.

Management/Shareholder compensation – A shareholder who is acting CEO and eligible to receive dividends from the company might receive a lower salary than what the market would pay for a similar position. An active shareholder's compensation in terms of salary or bonus should reflect what a non-shareholder would be paid if the non-shareholder held the same position in the company. Given the aforementioned circumstances, the salary would be adjusted upward to reflect true FMV. Furthermore, if the shareholder's family members are involved in the business, their salaries would also be potentially adjusted to FMV levels and/or be reversed out if they are not active in the company.

Inter-company transactions – In a situation where the building used by the company is owned by the shareholder in a separate legal entity, other adjustments may be required. If the lease cost charged is below/above market price (e.g. for tax planning purposes) then the lease expense should be adjusted upward/downward to FMV.

Personal expenses – Personal expenses included in financial statements of private companies for tax deduction objectives that are not related to actual business purposes, such as a personal fishing trip or the personal use of a ski cottage rental, should be reversed out.

Non-recurring adjustments

Loss/Gain from an exceptional event – A loss or gain that does not stem from the normal business activities of the company, that does not occur regularly, and is abnormal in nature should be reversed out. Examples of these events may include: a fire; a strike; and a singularly unique opportunistic inventory purchase at a low cost.

Start-up costs, legal claims, restructuring costs – As the expenses noted are non-recurring in nature, they should be reversed out from the reported operating EBITDA.

Pro-forma adjustment

The objective of this endeavor is to present the business on a going forward basis given specific current or expected events or market conditions.

Loss/Gain from of a significant customer – This would be a situation where the company would have lost a significant customer which represented a large portion of its previous year's revenue. The revenue and associated gross margin from this client should be excluded for all the fiscal years in the analysis period.

Foreign Exchange – The foreign exchange ("FX") example could be illustrated by a company selling to US customers where the USD/CAD FX rate changed significantly over the analysis period. The current USD/CAD FX could be applied to the net exposure instead of the historical rate to provide a view of what the earnings would be given the current rate.

Note that there are several other potential adjustments that could exist such as: balance sheet movement/reserve adjustments; GAAP differences; aggressive/inconsistent forecasting; and period adjustments among others.

Conclusion

In conclusion, EBITDA is a practical and useful earnings analytic tool commonly used in valuation for potential transaction evaluation purposes. For the EBITDA calculation to be relevant, it should be normalized to exclude the "noise" that is not related to the normal course of business. As reflected in our text, there are multiple potential adjustments and these adjustments could have a material impact on the bottom line and the overall enterprise value.

Whether you are contemplating the sale of your company in the short term or in the longer term, consider the potential advantages a discussion on adjusted EBITDA could provide with respect to insight into business valuation and potential operational accretive decisions. A meeting for a discussion of adjusted EBITDA and potential impacts on the valuation of your business can be scheduled with our team.

For more information, please speak with your BMO financial professional.

BMO Private Wealth provides this publication for informational purposes only and it is not and should not be construed as professional advice to any individual. The information contained in this publication is based on material believed to be reliable at the time of publication, but BMO Private Wealth cannot guarantee the information is accurate or complete. Individuals should contact their BMO representative for professional advice regarding their personal circumstances and/or financial position. The comments included in this publication are not intended to be a definitive analysis of tax applicability or trust and estates law. The comments are general in nature and professional advice regarding an individual's particular tax position should be obtained in respect of any person's specific circumstances.

BMO Private Wealth is a brand name for a business group consisting of Bank of Montreal and certain of its affiliates in providing private wealth management products and services. Not all products and services are offered by all legal entities within BMO Private Wealth. Banking services are offered through Bank of Montreal. Investment management, wealth planning, tax planning, and philanthropy planning services are offered through BMO Nesbitt Burns Inc. and BMO Private Investment Counsel Inc. If you are already a client of BMO Nesbitt Burns Inc., please contact your Investment Advisor for more information. Estate, trust, and custodial services are offered through BMO Trust Company. BMO Private Wealth legal entities do not offer tax advice. BMO Trust Company and BMO Bank of Montreal are Members of CDIC.

® Registered trademark of Bank of Montreal, used under license.

All rights are reserved. No part of this publication may be reproduced in any form, or referred to in any other publication, without the express written permission of BMO Private Wealth.

09/22-1012_ACC ID6936