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What is EBITDA and why do lenders care so much about it?

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What is EBITDA?

EBITDA is short for 'Earnings Before Interest Taxes Depreciation and Amortization'. In other words, it is the income that a business generates before interest, taxes, depreciation, and amortization to net income. It is a metric that excludes some non-core and non-cash expenses that a business incurs to better understand its primary financial performance.

EBITDA is a key measure of profitability, but does not consider the timing of cash flow on how the profitability is achieved. While the EBITDA speaks to various audiences, this article focuses on what it means from a borrowing perspective.

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Why do lenders rely on it?

EBITDA is used for the following:

1. Financial performance – EBITDA is a metric that provides lenders a view on the financial performance of the business, before taking cost of capital, depreciation, and taxes into consideration.

2. Apples to apples comparison – It is a useful measure to facilitate an "apples to apples" comparison between companies and the industry. This helps lenders know if the forecasted financials provided by the borrower are reasonable.

3. Debt service – EBITDA is used as part of a formula to quickly calculate the debt repayment ability of the business without building a cashflow statement (known as the Debt Service Calculation or DSCR; see my previous article on this).

4. Valuation – Lenders can use EBITDA multiple as one of the ways to value a business, especially when warrants or stock options are involved as part of the loan.

Lenders may also adjust the EBITDA to analyse the historical financial performance and trends of a business. These adjustments are done to negate effects of one-time or non-recurring expenses, such as professional fee costs pertaining to an acquisition or costs associated to a plant move. This way, the historical EBITDA trends can be compared meaningfully. This process is called 'normalizing the EBITDA'.

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Depending on the type of loan, some lender due diligence focuses on EBITDA more so than other types of loans. For example, lenders focus on EBITDA more when it is a cash flow loan versus an asset-based loan. This is because, for a cashflow loan, lenders primarily rely on the future financial performance of the business to get repaid.

Cash flows and profitability are important to ABL lenders, as well, and they generally only lend to businesses that are viable. However, they rely on the future stream of cash flows less to repay their loan, as they are shorter term in nature and typically have hard collateral to support getting repaid if cash flows ultimately do not materialize.

Conclusion

EBITDA is a powerful and versatile metric that tells a lot about a company's performance. It is important to note that it is not the only metric that is considered by lenders in the financing evaluation process. EBITDA does not consider working capital or debt levels of a business and, as such, business owners should not use it as a measure to evaluate the cash flow of the business, or as a measure of value creation in a single year. Lastly, business owners can use it as a metric that tells them how their core business is performing and can use it to build a case when approaching lenders and investors.

At Isaacs Advisory, we have extensive experience in advising, structuring, and sourcing a wide range of traditional and non-traditional financing solutions of $100K to $1 million for our clients.

For more information on raising financing solutions for a start-up, early stage, growth, or in-transition business, or a business in distress, please contact Dheeraj Nair at 647-673-4969 or dnair@isaacsadvisory.ca.