Volume 7 | April 2021

MID-STATES ADVISORS
A Private Placement and Business Brokerage Firm
Newsletter

Mid-States Advisors, Inc.
Monthly Article & Updates

Good Morning,

As the Covid-19 vaccine rollout continues we are seeing increasing activity in the business world. Clients, business associates and friends are all busy and many expect 2021 revenues to meet or exceed their pre-Covid levels. There was a short period where the market quieted due to spring break/Easter when families were able to vacation for the first time in many months but that activity has now returned.

Mid-States closed two transactions in the early part of 2021 and expect the remainder of the year to remain robust.

Since we are seeing a significant amount of transaction activity both on the financing and M&A sides we thought now would be a worthy time of revisiting a discussion on EBITDA and its role in transaction valuation and determining the financial stability of a company.

As always, if you are interested in learning more about this week's content or if we can help you or a client in any way please feel free to reach out to one of our team members.

Best Regards,
The Mid-States Team

Joseph P. Alam III, 313-670-5713, jp3@midstatescapital.com
Joe Alam, 313-215-1700, jpa@midstatescapital.com
Jim Mies, 248-766-7884, jm@midstatescapital.com

Visit our Website

Using a Multiple of EBITDA in Valuing a Business

The non-GAAP term EBITDA has come into common usage, often supplanting Net Income or Operating Cash Flow. It is defined as **E**arnings **B**efore **I**nterest **T**axes **D**epreciation and **A**mortization. Simply stated, it is Net Operating Income, a GAAP term, after adding back depreciation and amortization.

EBITDA has found favor because it offers an approximation of cash flow for a stable business. But it is only one of many financial measurement tools. It is simplified, easy to understand, and valuable when comparing prices of companies in similar situations. But, the widespread practice of using a multiple of it for valuing a business is unwarranted unless combined with other methodologies. The value of the balance sheet assets as well as the debt structure must be considered. The current value of discounted future cash flows as well as the quality of current or future management should be taken into account. The market value of under-performing or non-core assets which can be sold is another factor.

We will try to bring clarity to the use of EBITDA, in the Valuation process. A commonly used method of valuing a business involves some variation of a multiple of EBITDA. This is an oversimplification as it ignores the strengths or weaknesses of the Balance Sheet. The value of the Balance Sheet assets, including receivables, inventory, plant and equipment, intellectual property, as well as the role of both funded and non-funded debt weigh heavily in the valuation process. Additionally, there are other financial measurement tools that often point to a higher or lower valuation than that provided by a measurement based solely on an EBITDA multiple.

Have you ever wondered why some of the largest Private Equity Funds pay very high multiples of EBITDA? These firms are professionally managed and do not overpay for the companies they buy. We suspect that in the due diligence process, they have prepared a projection of earnings under their management and are using a multiple of discounted cash flow to value the business.

A former partner of mine successfully used a process of valuing the various segments of a business. Assets, usually plants or equipment, that were not earning acceptable returns, or operations (divisions or subsidiaries) that were not key to the core business, were slated for sale. He acquired these businesses based on a multiple of EBITDA which undervalued the worth of the various pieces. He proceeded to sell the under-performing or non-core assets and used the sale proceeds to repay debt or increase liquidity. He has become extraordinarily wealthy employing this process. Additionally, he was successful in recruiting management that could grow revenues 5 and 10 times in a fairly short time. He then sold the businesses, usually to Private Equity Funds.

Which brings us to the next and perhaps the most important ingredient: Management. We know of Private Equity Funds that actively recruit successful CEOs with the express purpose of finding a company for them to manage. Acquiring a business to match the talents and experience of an already successful CEO can also bring very dramatic operating results.

Successful entrepreneurs often build competent management teams. But in their heart of hearts, they believe that no one can run the business as well as they can! That is simply not true, and if you remove the founder, the managers can often move the company forward in dramatic fashion. This is particularly true if they have access to the capital a PE fund can bring to bear.

Volumes have been written regarding valuing a closely held company. The

Internal Revenue Service has its own formulas used for estate, gift, and income tax purposes.

If you are considering selling or buying a business and would like to discuss valuation, we would be delighted to discuss our ideas with you.

If you would like to discuss our services in more detail, please contact us to learn more about how we can assist your company or client. Below are the direct phone numbers and emails for a Mid-States team member who can answer your questions (yes, we answer our own phones):

Joseph P. Alam III at 313-670-5713,JP3@midstatescapital.com
Joe Alam at 313-215-1700, JPA@midstatescapital.com
Jim Mies at 248-766-7884, JM@midstatescapital.com.

See our team at Midstates Advisors' website