Investors: Beware of This Measure!

Description

Warren Buffett's partner at Berkshire Hathaway, Charlie Munger, is well-known for his dislike of EBITDA. It stands for earnings before interest, tax, depreciation and amortisation. He apparently feels that it is not a useful measure for investors to use, since it does not paint an accurate reflection of a company's profitability. Here's why that seems to be the case, and why investors may be better off focusing on other measures of profitability.

Inaccurate picture

Perhaps the biggest problem with EBITDA is that it attempts to represent something for which it is not intended. In other words, it is used as a measure of profitability when in reality it does not measure profitability. For example, revenue is a useful tool in assessing how well a company's sales strategy is performing and in how much of a market share it currently has. However, revenue does not tell an investor how profitable a company is. A number of costs must be deducted from revenue in order to arrive at the bottom line of net profit.

It's the same story for EBITDA. It provides a figure before interest, tax, amortisation and depreciation costs must be deducted. In the case of interest and tax, they are perhaps understandable and operating profit (or EBIT – earnings before interest and tax) is used to provide a measure of the underlying profitability of a business. However, failing to deduct depreciation and amortisation is perhaps slightly illogical, since they are underlying costs of the vast majority of businesses which can reasonably be expected to occur each year.

Profitability downfalls

Of course, even using the bottom line of an income statement provides a limited picture of the performance of a business. The income statement uses the accrual basis of accounting and so it does not match the cash flow of a business. This can be problematic because a company can be highly profitable but still go under. If it does not receive cash from its debtors, for example, then it will be unable to pay taxes, salaries and its own creditors, and may cease trading.

Therefore, even net profit may be insufficient for investors to build a picture of the financial success of a company. As such, focusing on cash flow may be prudent, and specifically on free cash flow. It is calculated by subtracting capital expenditure from net operating cash flow and provides a figure for how much cash is available for distribution to shareholders. It can prove to be more useful than the net profit figure because it provides a more pragmatic measure of a company's performance in a given period.

Takeaway

EBITDA has experienced harsh criticism in recent years. Much of this is because fails to provide an accurate picture of a company's profitability. In the same way that costs must be deducted from revenue to arrive at a profit figure, EBITDA requires too many deductions in order to provide an accurate representation of a company's profitability which can then be compared to sector peers.

However, even the use of net profit can be somewhat misleading. Therefore, investors may wish to also consider free cash flow, since as the famous saying goes, revenue is vanity, profit is sanity and cash is reality.

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