EBITDA Multiple: A Smart Valuation Method

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EBITDA (Earnings before Interest, Taxes, Depreciation and Amortisation) multiple is often called as **Enterprise Multiple** since it takes into account entire enterprise irrespective of capital structure. It takes into account a company's debt and cash levels in addition to its stock price and relates that value to the firm's cash profitability. It is calculated by using the formula given in the box.

Enterprise Value

Earnings Before Interest, Taxes, Depreciation & Amortisation

Enterprise Value	EBITDA
Market Capitalisation	Net Profit After Tax
Add: Long Term Loans Taken	Add: Depreciation / Amortisation
Less:Market Value of Non-Operating Asset	Add: Interest
Less: Loans Given to Group Companies	Add: Tax
Less: Financial Investments	Add: Non-operating Expenses
Less: Surplus Properties	Less: Non-operating Income

Typically, EBITDA multiple is used while doing valuation of cash-based businesses. Enterprise multiple is capital structure-neutral and hence, can be used for direct cross-companies application. It is often used in parallel with, or as an alternative to, the Price/Earnings (P/E) ratio. The reciprocate multiple i.e. EBITDA / Enterprise Value is used to determine cash return on investment.

Higher EBITDA multiple indicates that the company might be overvalued and vice-versa. However, it need to be understood that this multiple can vary depending upon the characteristics of industry and therefore, it is desirable to compare the multiple to other companies in same industry or industry multiple as a whole. Generally, EBITDA multiple is higher for high growth sectors (e.g. real estate) and lower for low growth sectors (e.g. metals). Even within the same sector, high growth companies usually have higher EBITDA multiple over others.

As per a research report (dated 12th March 2010) on 'Engineering / Infrastructure Sector' by ENAM Securities, following are expected EBITDA multiples of large engineering companies for FY2010 (Expected):

Company	EV / EBITDA (X)	Expected Growth In EPC Order Flow (FY10E)
Larsen & Toubro	17.3	26%
IVRCL	9.8	4%
Nagarjuna	10.3	-2%
Hindustan Construction Company	10.1	9%
(Source: Report on 'Engineering / Infrastructure Sector' by ENAM Securities)		

On analysis of the given table, L&T has the highest EBITDA multiple, however, it is also expected to grow fastest over its competitors despites its leadership position in the industry. Hence, it can still be a good investment opportunity despite higher valuations. On the contrary, IVRCL has lowest EBITDA multiple and hence, there is a possibility that it may outperform the industry.

Enterprise multiple is the most encompassing and generally considered the most useful in analyzing the current valuation of a target company because of variety of reasons:

1. It is purely driven by operations of the Company and do not have any impact of non-business factors of discretionary / non-recurring nature which are less predictable.

2. Since the comparison is done at operational level, there is no impact of differential tax rates across companies from difference countries which facilitates qualitative comparison.

3. Enterprise value takes into account debt component of target company which the acquirer will be taking over and hence, it is preferred over market capitalisation while doing M&A. As a normal practice, companies with lower enterprise multiple are better takeover targets as compared to their peers.

Enterprise multiple is somewhat difficult to calculate as compared to P/E multiple. However, its regular usage can certainly help investors to appraise corporate managements more efficiently and make smarter investment decisions for themselves in the days to come.