The Shortcomings of Using EBITDA and other Financial Metrics in Evaluating Corporate or Project Finance Transactions

Financial metrics provide the basis for historical corporate financial analysis. EBITDA (earnings before interest, taxes, depreciation and amortization) is a commonly-used metric to evaluate a company's:

- Cash flow
- Debt service capacity
- Equity valuation

EBITDA can be a better indicator of cash flow than Net Profit After Taxes, because of the following accounting adjustments:

- Interest expense may be "capitalized", or it may be considered non-recurring.
- Companies can often defer paying taxes, sometimes indefinitely, due to different (legal, accepted) accounting practices for investor purposes and for tax purposes.
- Depreciation and amortization are literally "non-cash charges".

Although these adjustments may have merit, simple historical EBITDA and other financial metric trend analysis can have major shortcomings in evaluating a company's or a project's future health.

The following are examples of unforeseen events that could cripple a company or a project within months, but they would not be taken into consideration by historical EBITDA or by other financial metric analysis:

- The bankruptcy of a major corporate client.
- A dispute with or non-payment by a major government client..
- A force majeure event.
- A violation of the Foreign Corrupt Practices Act.
- The default of a loan agreement.
- A major environmental incident or violation.
- A major accident or health and safety violation.
- Significant regulatory changes or restrictions.
- Financial fraud or malfeasance.
- Over-exposure to a poorly-conceived or poorly-executed acquisition
- A major (credible) lawsuit.
- The imposition of significant import or export tariffs or controls.
- Over-exposure in weak currencies or the imposition of exchange controls.
- Rapid growth and insufficient working capital funding.
- Insufficient CAPEX to maintain efficient operations.
- Technology failures or cyber-crimes/events.

Conclusion:

Decisions concerning proposed future corporate acquisitions, corporate financing transactions or projects require a forward-looking, "beyond the numbers" approach. A diligent evaluation of the circumstances, opportunities and risks a company faces, and of management's ability to manage those opportunities or to mitigate those risks is essential.

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