Perpetual Equity Investment Company Limited

Perpetual knowledge bank series: EBITDA

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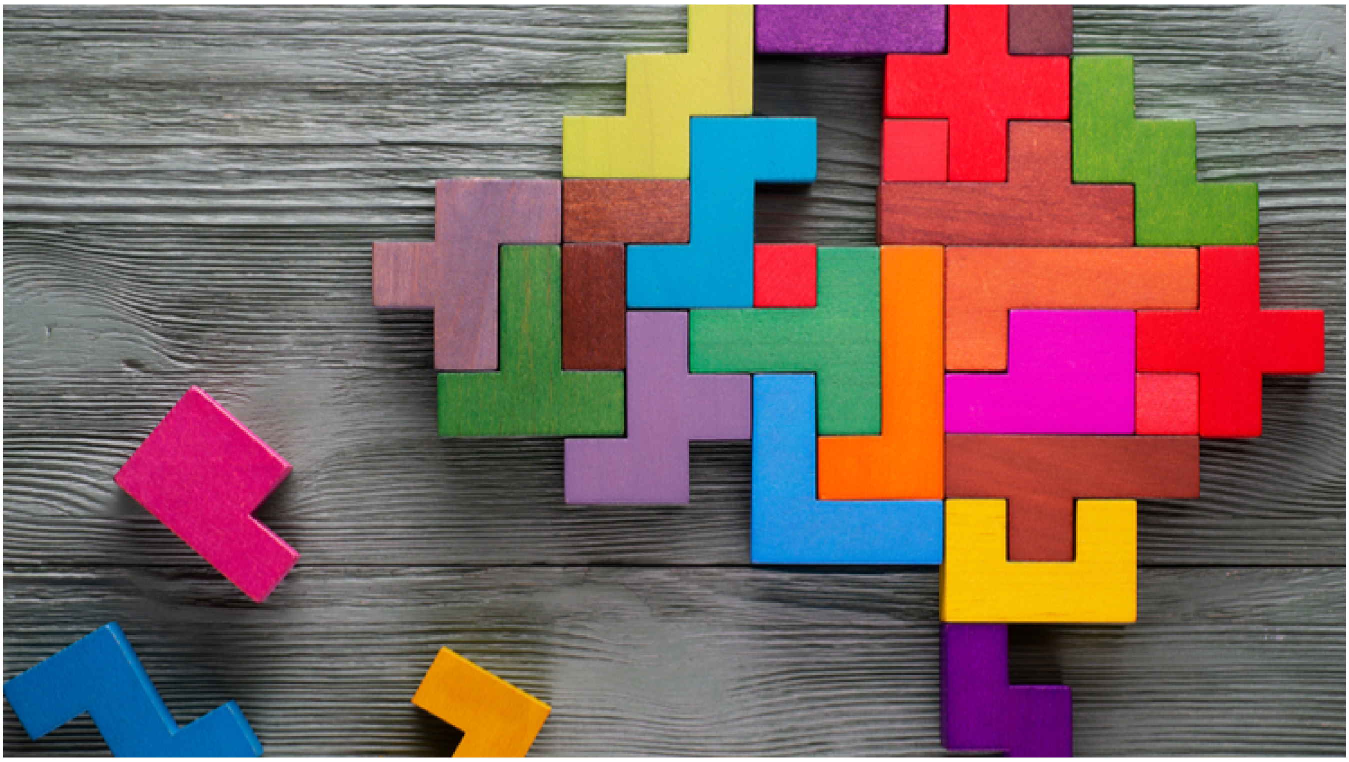

EBITDA, or earnings before interest, taxes, depreciation, and amortisation, is one of many ways to assess a company's financial health. It can be a useful formula for investors wanting to use an alternative to net income when comparing one business to another. EBITDA allows analysts to generate insightful comparisons between companies, project a company's long-term profitability and gauge its ability to pay off future financing. However, it can also be misused as stripping out the cost of capital investments like property, plant and equipment makes a company's earnings appear greater than they really are.

Put another way, EBITDA is capital-structure neutral, meaning it doesn't account for the different ways a company may use debt, equity, cash, or other capital sources to finance its operations. The usual shortcut to calculate EBITDA is to start with operating profit, also called earnings before interest and tax (EBIT) and then add depreciation and amortisation. As with profit, the higher EBITDA figure, the better because the company is making more money. Unlike terms like 'net profit' or 'net earnings', EBITDA is not an official accounting term.

While EBITDA is a handy tool for normalising a company's results to evaluate the business more easily, it should not be a substitute for other metrics such as net income. Investors must not lose sight of the fact that many items excluded from EBITDA – such as interest, taxes, and non-cash expenses – are still real items with financial implications that should not be dismissed or ignored. High-profile investor Warren Buffet has a particular dislike for this metric based on it not accounting for the depreciation of a company's assets.