EBIT vs. EBITDA vs. Net Income: How to Answer Confusing, Arbitrary Interview Questions

Which Cash Flow Proxy Do You Prefer?

EBIT vs. EBITDA vs. Net Income

Yes, we’ve covered this topic before (a long time ago – one of the earliest videos in this channel)…

*…but the original presentation and examples were unclear, and some **accounting rules** have changed since then – so this one needed an update.*

EBIT vs. EBITDA vs. Net Income

Most common interview questions:

“Is EBIT or EBITDA better? What about Net Income? How are they different?

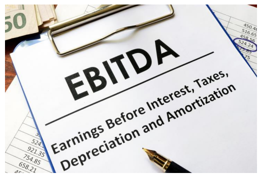
Which one(s) should you use in valuation multiples when analyzing companies?”

The Short Answer

- All these metrics (EBIT, EBITDA, and Net Income) measure a company’s **profitability** in some way

- **EBIT (Earnings Before Interest and Taxes):** Proxy for core, recurring business **profitability** before the impact of capital structure and taxes

- **EBITDA (Earnings Before Interest, Taxes, Depreciation, and Amortization):** Proxy for core, recurring business **cash flow from operations**, before the impact of capital structure and taxes



- **Net Income:** Profit after taxes, the impact of capital structure, and non-core business activities

The Short Answer

These metrics differ in **6 main ways:**

1. **To Whom is the Money Available?** – Equity Investors? Debt Investors? The Government? All three? Just one?

2. **Operating Expenses (OpEx) vs. Capital Expenditures (CapEx)** – Some metrics deduct both, some deduct neither, and some deduct one, or part of one

3. **Rent/Lease Expense** – Some metrics deduct the full lease expense; others deduct only part of it, and U.S. GAAP vs. IFRS creates complications (accounting changed in 2019!)

The Short Answer

These metrics differ in **6 main ways:**

4. **Interest, Taxes, and Non-Core Business Activities** – Some metrics deduct (or add) all of these, while others ignore them

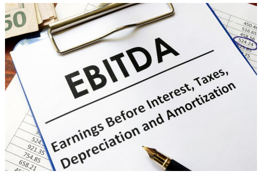
5. **Valuation Multiples** – Some metrics pair with Enterprise Value (TEV), while others pair with Equity Value (Eq Val)

6. **Usefulness** – Sometimes you *want* to reflect CapEx, and sometimes you want to ignore it or "normalize" it

How Do You **Calculate** Them?

- **EBIT (Earnings Before Interest and Taxes):** Operating Income on the Income Statement, adjusted for non-recurring charges

- **EBITDA (Earnings Before Interest, Taxes, and Depreciation & Amortization):** EBIT, plus D&A *always* taken from the Cash Flow Statement



- **Net Income:** Net Income at the *very bottom* of the Income Statement ("Net Income to Common" or "to Parent" sometimes)

- **Examples:** Target and Best Buy, both fairly "standard" companies – notice how we do *not* add back any non-recurring charges

Availability of the Money

- **EBIT and EBITDA:** Equity Investors, Debt Investors, Preferred Stock Investors, and the Government all have claims

- **Why:** Because no one has been "paid" yet! These metrics are both *before* Interest Expense, Taxes, etc., since they start with OpInc

- **Net Income (to Common):** Only Equity Investors have a claim because the Debt Investors received their Interest, and the Government got its Taxes… but no Common Dividends yet!

- **And:** Principal Repayments of Debt do **not** count as the investors "getting paid" – they're just payback of the initial amount

OpEx vs. CapEx

- **EBIT:** Deducts OpEx and the *after-effects of CapEx* (Depreciation), but it does not deduct CapEx directly


- **EBITDA:** Deducts OpEx, but no CapEx (both the initial amount and the Depreciation afterward are ignored)

- **Net Income:** Similar to EBIT, it deducts OpEx and Depreciation, but not CapEx directly


- **So:** EBIT and Net Income are more useful if you *want* to reflect a company’s capital spending

The **Rent or Operating Lease** Expense

- **EBIT:** Full deduction for Rent under U.S. GAAP; under IFRS, only the Depreciation element is deducted


- **EBITDA:** Full deduction for Rent under U.S. GAAP; under IFRS, *nothing* is deducted because both the Interest and Depreciation elements are added back!

- **Net Income:** Full deduction of the entire Rental expense under both major accounting systems

- **So:** Leases are tricky, and if you're comparing U.S. and non-U.S. companies, you should probably just use EBITDAR to normalize

Interest, Taxes, and Non-Core Activities

- **EBIT:** Completely ignores or “adds back” Interest, Taxes, and Non-Core Business Income

- **EBITDA:** Same as above

- **Net Income:** The opposite! Deducts Interest and Taxes, adds Non-Core Income, and subtracts Non-Core Expenses

- **So:** This is one big reason why Net Income is not so useful when *comparing* different companies – too many differences due to capital structure, side businesses, tax treatments, etc.

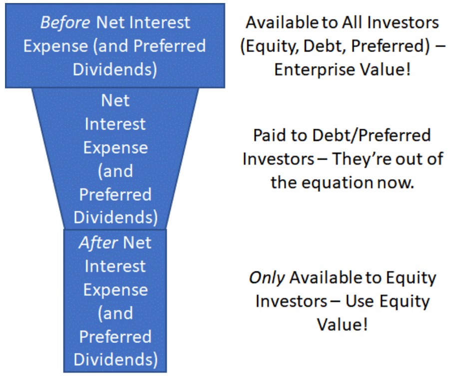
Valuation **Multiples**

- **EBIT:** Pairs with Enterprise Value to create the TEV / EBIT multiple (but be careful with this one and the Lease Expense under IFRS!)

- **EBITDA:** Pairs with Enterprise Value to create the TEV / EBITDA multiple (but there are some Lease issues, once again)

- **Net Income:** Pairs with Equity Value to create the P / E, or Price to Earnings, multiple

- **So:** Pretty simple test – if the metric *deducts* Interest Expense, pair it with Equity Value



Usefulness of These Metrics

- **EBIT:** Often closer to **Free Cash Flow (FCF)** for a company, defined as Cash Flow from Operations – CapEx, because both reflect CapEx in whole or in part (but watch out for Lease issues!)


- **EBITDA:** Often closer to **Cash Flow from Operations (CFO)** because both metrics completely exclude CapEx

- **Net Income:** Not great for comparisons *or* for approximating companies' cash flows; best as a *very quick metric*

- **So:** EBIT is best for companies highly dependent on CapEx; EBITDA is better for companies that are less so, or if you want to **normalize/ignore** CapEx and D&A

Operating Lease Issues

- **2019:** Accounting rules changed, and Operating Leases moved onto companies' Balance Sheets

- **Big Problem:** Rent is still Rent under U.S. GAAP, but under IFRS, it's split into "fake" Depreciation and Interest elements


- **So:** You must be *really careful* to deduct either the entire Rental Expense, or none of it, in these metrics

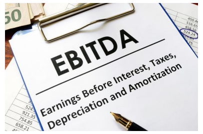
- **And:** If you deduct the entire Rental Expense, do **not** add Operating Leases to Enterprise Value; vice versa if you exclude or add back the entire Rental Expense




Annoying Interview Questions

- **So:** Which one is "the best"? This is a stupid question because it assumes that there is a "best" metric

- **Answer:** When valuing companies, you always look at a range of metrics – Revenue, EBIT, EBITDA, Net Income, FCF, etc.



- **Each one** tells you something different, which is why you want to look at more than one – to get the full picture

- **EBIT vs. EBITDA:** Depends on what you want to do with CapEx – completely ignore it, or partially factor it in (oh, and EBIT doesn't work under IFRS, so you're stuck with EBITDA there)

Recap and Summary

	EBIT	EBITDA	EBITDAR	Net Income
How do you calculate it?	Operating Income on Income Statement, adjusted for non-recurring charges.	Operating Income on Income Statement, adjusted for non-recurring charges + D&A, *always* taken from the Cash Flow Statement.	Operating Income on Income Statement, adjusted for non-recurring charges + D&A, *always* taken from the Cash Flow Statement + Rent/Lease Expense on IS.	Net Income on Income Statement (the *very* bottom one or "Net Income to Common," after Preferred Dividends and Equity Investment/NCI Net Income).
Corresponds to…	Enterprise Value (TEV)	Enterprise Value (TEV) (**including** Operating Leases in IFRS)	Enterprise Value (TEV) (always **including** Operating Leases)	Equity Value
U.S. GAAP vs. IFRS Differences	**Not a valid metric/multiple under IFRS because of how the Lease Expense is divided - must be adjusted if you use it.**	Under IFRS, you must add Operating Leases to Enterprise Value when calculating TEV / EBITDA.	Under both systems, you must add Operating Leases to TEV in the TEV / EBITDAR multiple.	N/A
Valuation Multiple:	TEV / EBIT	TEV / EBITDA	TEV / EBITDAR	P / E (Equity Value / Net Income)
Who has a claim on this money?	Equity investors, debt investors, and the government.	Equity investors, debt investors, and the government.	Equity investors, debt investors, and the government.	Equity investors.
What does it mean?	Proxy for core, recurring business **profitability**, before the impact of capital structure and taxes.	Proxy for core, recurring business **cash flow from operations**, before the impact of capital structure and taxes.	Proxy for core, recurring business **cash flow from operations**, before the impact of capital structure, leases, and taxes.	Profit after taxes, the impact of capital structure (interest), AND non-core business activities.

Recap and Summary

	EBIT	EBITDA	EBITDAR	Net Income
Deducts normal operating expenses?	Yes	Yes	Yes	Yes
Deducts rent/lease expenses?	U.S. GAAP - Yes; IFRS - Partial.	U.S. GAAP - Yes; IFRS - No.	U.S. GAAP - No; IFRS - No.	U.S. GAAP - Yes; IFRS - Yes.
Deducts capital expenditures (CapEx)?	Partial (via D&A from previous CapEx).	No	No	Partial (via D&A from previous CapEx).
Adds/subtracts interest income/expense?	No	No	No	Yes
Deducts taxes?	No	No	No	Yes
Adds/subtracts non-core business income/expenses?	No	No	No	Yes
***Can sometimes* act as a rough "proxy" for...**	Free Cash Flow (Cash Flow from Operations - CapEx).	Cash Flow from Operations.	N / A	N / A
Key Use Cases:	CapEx is more important and/or company is spending a lot to grow quickly and/or you want to **include** the partial impact of CapEx.	CapEx is smaller % of revenue, doesn't matter as much, and/or you want to normalize companies w/ very different CapEx and D&A.	You want to normalize between different lease accounting treatments, or you're comparing companies that use U.S. GAAP to ones that use IFRS.	Try to avoid it if you can... but sometimes it's still useful to look at and compare P/E multiples to others.