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Original Article

EVA, not EBITDA: A New Financial Paradigm for Private Equity Firms

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Abstract

Private equity firms have boomed on the back of EBITDA. Most PE firms use it as their primary measure of value, and ask the managers of their portfolio companies to increase it. Many public companies have decided to emulate the PE firms by using EBITDA to review performance with investors, and even as a basis for determining incentive pay. But is the emphasis on EBITDA warranted?

In this article, the co-founder of Stern Stewart & Co. argues that EVA offers a better way. He discusses blind spots and distortions that make EBITDA highly unreliable and misleading as a measure of normalized, ongoing profitability. By comparing EBITDA with EVA, or Economic Value Added, a measure of economic profit net of a full cost-of-capital charge, Stewart demonstrates EVA's ability to provide managers and investors with much more clarity into the levers that are driving corporate performance and determining intrinsic market value. And in support of his demonstration, Stewart reports the finding of his analysis of Russell 3000 public companies that EVA explains almost 20% more than EBITDA of their changes in value, while at the same time providing far more insight into how to improve those values.

Citing Literature