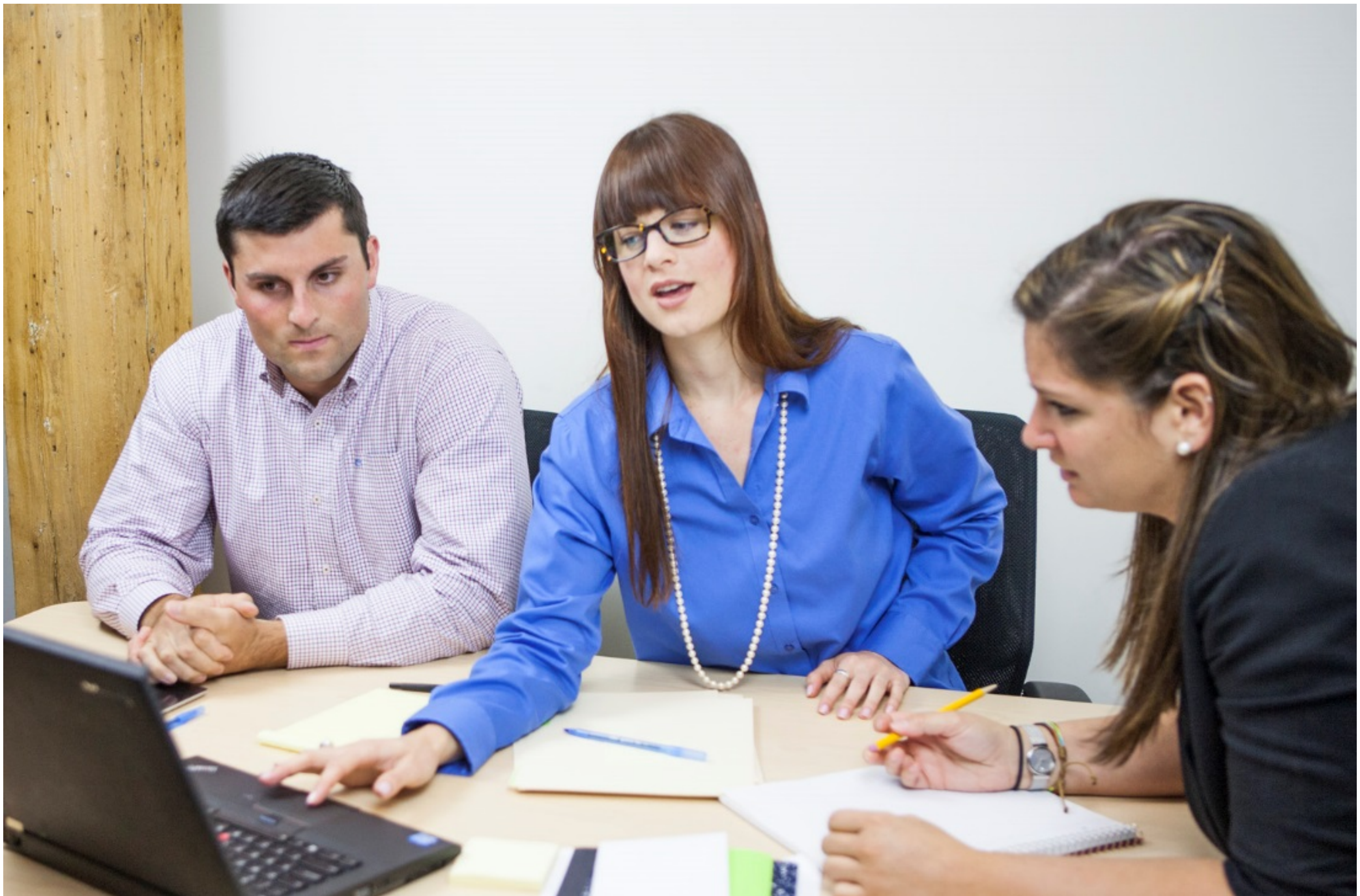

# The Complete Guide to Small Business Valuation

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# The 3 Magic Words of Small Business Valuation: Seller's Discretionary Earnings

If you're looking to buy or sell a small business and are wondering how to value it, you'll need to add a new acronym to your collection of financial buzzwords: SDE, also known as Seller's Discretionary Earnings. Why is SDE important? Because a good rule of thumb is that most small business sell for 1.5 to 3.75 times SDE.

SDE is the small-business version of yet another financial acronym, EBITDA, defined as earnings before interest, taxes, depreciation, and amortization. Large and medium-size companies are often valued as a multiple of this number.

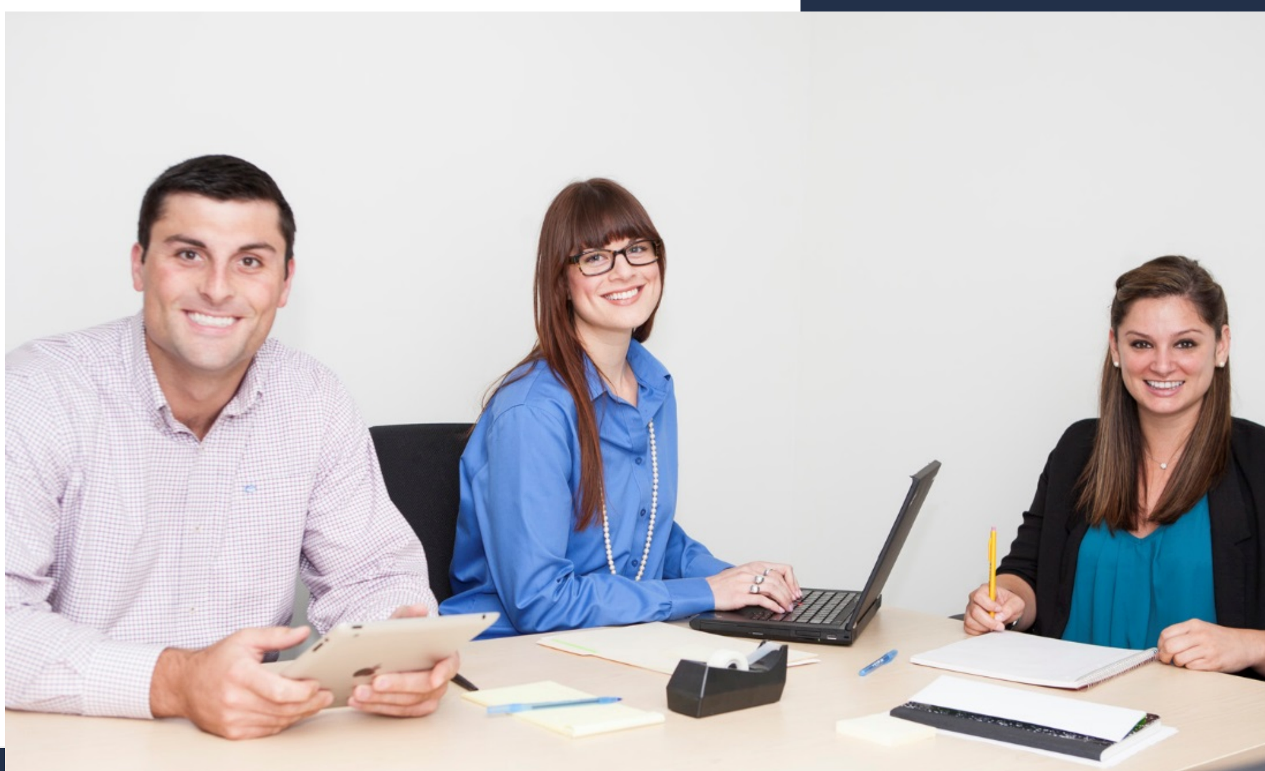
Although not always found in a company's financial statements, EBITDA is the mother of all financial expressions (and buyers and sellers of small businesses should understand its meaning). Wall Street deal-makers like it as a proxy for cash flow because it's easy to calculate: Take operating income from the income statement and add back depreciation and amortization from the cash flow statement.

Those same deal makers also like it because the metric eliminates the effects of financing and accounting decisions, so companies can be compared more easily. EBITDA does have its shortcomings, to wit: It ignores changes in working capital and capital expenditures.

Small businesses typically don't sell for an EBITDA multiple; they sell for a multiple of SDE.

**SDE = EBITDA**
**+ owner's salary**
**+ owner's perks**
**+/- other expenses/income.**

***Please note***: *In order to establish your bona fides when speaking with white shoe financiers, be sure to pronounce EBITDA correctly: It's strictly pronounced as two words with three syllables, that is, /ē-bit dah/. Opting for a clearly greenhorn pronunciation like /ēbiduh/ or /ehbiduh/ will irrevocably expose you as an amateur and earn you the scorn of any investment banker worth his weight in designer neckties.*



# SDE vs. EBITDA

When negotiating the sale of a business, the buyer and seller might not agree on what goes into the SDE calculation, but the concept is nonetheless helpful to both parties because they can speak in the same context. The three adjustments to EBITDA are made because:

1. Tax considerations often determine owner salary as well as other expenses/deductions,
2. There could be expenses in the income statement that a new owner wouldn't take, for example, overpriced summer jobs for the boss's two unqualified, college-age daughters (but also extraordinary charges like a one-time lawsuit), and
3. Additional expenses might need to be added to the cost structure; for example, the current owner might have a sweetheart deal on rent that will be unavailable to the new owner.

# SDE for Buyers & Sellers

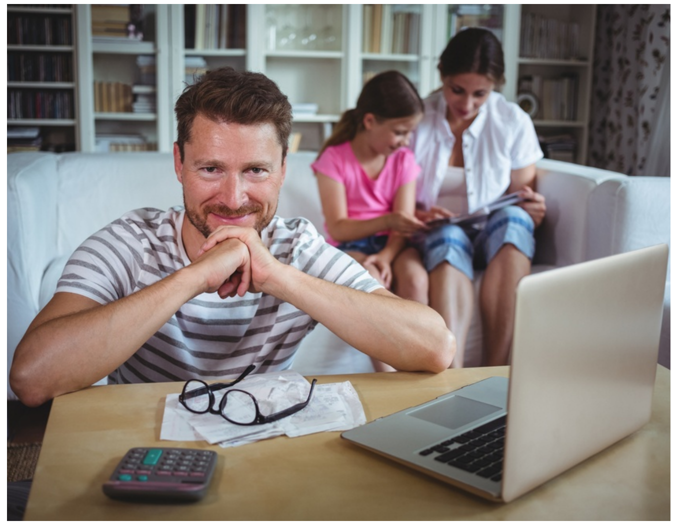
**For buyers**, SDE is helpful because it removes from earnings unusual or idiosyncratic behavior from the current owner in order to give buyers an idea of how much cash the business produces to pay for:

1. The new owner's salary (or whoever else will run the company),
2. Financing charges on the on the pro forma capital structure (e.g., interest or preferred dividends),
3. Capital expenditures, and
4. A return of capital on the owner's investment.

**Number 4 is an important consideration.** If there's no return to the owner beyond the reasonable salary he will pay himself, then the new owner has effectively bought a job, not made an investment.

**For sellers**, SDE is helpful because minimizing the business's taxable income and enjoying the perks of ownership (in the latter case, deducting trips of questionable business value or giving crazy Uncle Joe a do-nothing job, for example) depress income but aren't necessarily representative of how a new owner will run the operation. So converting EBITDA to SDE will help sellers position their businesses.

Historically, the S&P has traded at about 11x EBITDA. By contrast, small businesses typically sell for 1.5x-3.75x SDE (once SDE hits about $1mm, buyers and sellers switch to EBITDA-based valuation or some other yardstick). For any given business, SDE is greater than EBITDA, so multiples based on the former will naturally be lower, but SDE multiples for small businesses also reflect significantly greater risk vs the S&P 500. Among the typical characteristics for lower SDE-multiple companies are:



•Small: The smaller the business, the less margin for error and the greater the chance of issues like customer concentration (as a rule, the greater the SDE, the larger the multiple, which makes sense: With a higher SDE, there's more money available to finance the purchase price)
•Minimal growth prospects or little room for operational improvement
•Low operating margins
•Key man risk, that is, the business's success is heavily reliant on one particular person
•Short operating history
•Not much hard asset value
•No barrier to entry
•Sloppy financial records

# An Example of an SDE Valuation

At right, we use a small company's balance sheet (with help from the cash flow statement) to calculate both EBITDA and SDE. You'll see that SDE includes an add-back for owner and family salaries as well as boondoggle-ish travel and auto expenses. At $225k of SDE, this is a small company (albeit with decent margins), so we've used a 2.5x multiple. In reality, a potential buyer would adjust the multiple up or down based on how the company looks when considering the above bulleted attributes.

| Income Statement ($) | |
|---|---|
| Sales | 1,100,000 |
| COGS | 440,000 |
| Gross profit | 660,000 |
| Operating expenses | |
| Salary expense | 407,000 |
| Advertising expense | 100,000 |
| Other expenses | 100,000 |
| Restructuring charge | 20,000 |
| Total operating expenses | 627,000 |
| Operating income | 33,000 |
| Interest expense | 30,000 |
| Pre-tax income | 3,000 |
| Income tax expense | 840 |
| Net income | 2,160 |

| EBITDA add-backs ($) | |
|---|---|
| Depreciation & amortization | 16,500 |
| Interest expense | 30,000 |
| Restructuring charge | 20,000 |
| Income tax expense | 840 |
| EBITDA | 69,500 |

| Seller's Discretionary Earnings ($) | |
|---|---|
| Owner's salary | 120,000 |
| Family member salary | 30,000 |
| Travel | 5,000 |
| Auto expense | 1,000 |
| SDE | 225,500 |
| SDE multiple | 2.50 |
| **Value of business** | **563,750** |

# SDE Multiple Method vs. DCF Approach

The MBA set might wonder: How does the SDE multiple method compare to a discounted cash flow ("DCF") approach? Below, we show a DCF with pretty simple (and maybe simple-minded) assumptions that produces a similar valuation: three-year projection horizon (growth of 10%, 9%, and 8%), no working capital changes, capex slightly higher than current D&A, 22.5% WACC, 2% terminal value growth rate. We also assume that the owner and family salaries were replaced by one person paid $75k.

| **Simple DCF ($)** | | | | | |
|---|---|---|---|---|---|
| Earnings before interest and taxes | 33,000 | | | | |
| Add-back: | | | | | |
| Restructuring charge | 20,000 | | | | |
| Travel & auto expense | 6,000 | | | | |
| Salary savings (120+30-75) | 75,000 | | | | |
| Adjusted EBIT | 134,000 | | | | |
| Tax expense | 37,520 | | | | |
| Net operating profit less adjusted taxes | 96,480 | | | | |
| Depreciation & amortization | 16,500 | | | | |
| Less: Capital expenditures | (18,000) | Yr 1 | Yr 2 | Yr 3 | Terminal Value |
| Unlevered free cash flow | 94,980 | 104,478 | 113,881 | 122,992 | 611,958 |
| Annual growth rate | | 10.0% | 9.0% | 8.0% | |
| Present value cash flows | | 85,288 | 75,889 | 399,806 | |
| Weighted average cost of capital | 22.5% | | | | |
| Perpetuity growth | 2% | | | | |
| **Value of business** | **560,983** | | | | |

There's often a valuation debate when a small business is sold. The discussion can be conducted a bit more easily if both sides are at least speaking the same financial language. In the above example, a buyer would argue for a low valuation by pointing out that the company only produced $2,160 of net income on $1.1mm of sales (a lousy 0.2% net income margin). The seller would understandably respond that net income isn't the appropriate measure of the company's value.

**For many small businesses, focusing the discussion on SDE and the appropriate multiple will allow both parties to address what's most important: What is the current normalized cash flow of the business and how valuable are the business's future cash flows?**