EBITDA is Helpful but Discretionary Earnings are Optimal

EBITDA

In the past years there have been a number of articles criticizing EBITDA and a multiple thereof to determine a company's value. EBITDA is an acronym for:

"Earnings before* interest, taxes, depreciation, and amortization."

****Note: the word "before" can be read as "plus".***

It has been used extensively since the 1980's as a **quick measure of a company's profitability and cash availability** by investment banks, commercial banks, investors, and mergers and acquisition companies. This metric is **easily calculated, easy to explain, and the information is readily available from basic financial statements**. The calculation and usage of the EBITDA figure have always been criticized by business appraisers, but even banks and the Mergers & Acquisitions Industry recognize its shortcomings.

In determining the value of a company, **EBITDA is lacking some important elements that may lead to over/underpayment by a buyer or over/underpricing by a seller**. Some of these factors are:

1. **EBITDA is not cash flow**
2. **It does not show the actual cash available to service debt, pay owner salaries, etc.**
3. **It is not a good multiple in comparing companies as depreciation and amortization treatment can vary between companies**
4. **It does not include changes in long-term debt**
5. **It does not represent the amount of cash available to a hypothetical buyer interested in acquiring the subject business.**

There are others, but the key finding is that it **does not truly reflect the availability of cash and the ability of the company to service debt and sustain its operations and growth potential. At BizEquity, we utilize a much more robust measure of cash flow** in the form of **"discretionary earnings"** and a **modified "net cash flow"** as well as **EBITDA** to reach our conclusion of value.

Discretionary Earnings and Asset Sale Value

"Discretionary earnings" or "seller's discretionary earnings" (SDE) or "adjusted cash flow" (ACF), etc. is a more powerful measure of cash flow as it accounts for the **tax-minimizing behavior of private firm owners** and revolves around a **"return on owner's labor" paradigm** rather than a "return on investment" paradigm. SDE or ACF is calculated as follows:

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Discretionary Earnings

Normalized Pretax Profits (after eliminating non-recurring/non-operating items*)
+ Owner Compensation (salary, payroll tax burden of around 7% plus perks or other "discretionary" outlays)**
+ Non-Cash Charges (depreciation/amortization)
+ Interest Expense
Equals Discretionary Earnings***

These "non-recurring" or non-operating cash flow adjustments are made in the final two entries on Step 3. The line item described as "expenses" will increase the overall discretionary earnings and the line item described as "revenues" will decrease the discretionary earnings.

*****This amount should ALWAYS include the TOTAL ACTUAL COMPENSATION paid to the PRIMARY (single) OWNER-OPERATOR, whether it is a small amount or a large amount. When there are two owners, an adjustment must be made involving the comparison of what the second owner is ACTUALLY paid versus what a hypothetical buyer would have to pay for a replacement employee at MARKET COST. For example, a second owner may be paid around $200K in total compensation (salary, payroll tax plus benefits) but the incoming hypothetical buyer (who is replacing the work effort of the primary owner) must pay a new replacement employee only $100K to perform the same set of work. This "extra" $100K in future annual savings must be included in the total discretionary earnings figure used to value the business. This incremental $100K can either be added to the primary owner's compensation amount OR entered into the one-time expense line near the bottom of Step 3.***

If the business is "absentee operated" (no owner contribution to day to day activities), it is proper to include the top manager's compensation in the owner compensation line.

*******Also called "seller's discretionary earnings or SDE" or "adjusted cash flow" or "normalized earnings", etc.***

It is also important to recognize that **any estimate of value which is presented as a "multiple of discretionary earnings" will be an "asset sale value"** (inclusive of **inventory, FF&E plus all intangibles** such as tradename and customer base and goodwill). The average owner-operated business in the US sells for around 2.3 time's discretionary earnings, but the actual multiple for any given business will vary depending on industry, size of earnings, company risk factors, etc.

Accordingly, ***an* "asset sale value" does NOT incorporate cash and accounts receivables and other liquid financial assets NOR does it account for the liabilities** (both ST and LT). The **"equity value" DOES** incorporate and account for these other assets and liabilities, i.e.:

Equity Value = Asset Sale Value ± Cash, A/R, etc. - Liabilities (short and long term)

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DOFU 5-2024
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