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Darrell V. Arne, CBI, CPA, ASA

Arne & Co. Albuquerque, NM

### **Multiple of EBITDA or SDE: A Car With or Without the Gas (and the Driver)**

The basic formula to value a business is: **Value = Earnings x Multiple**

This is also the most commonly used "market method" business intermediaries use in determining the Most Probable Selling Price (MPSP) for a business that will be marketed for sale. It seems simple enough, but the MPSP is often miscalculated and therefore miscommunicated, because an incorrect level of earnings is applied against an incorrect multiple. The purpose of this article is to compare and contrast two levels of earnings, two types of market multiples and the resulting two and quite different - MPSPs.

Let's assume a seller wants to sell his/her business. The metaphor used to represent the business is a car, parked in a secure lot. Potential buyers can only gain access to the lot to inspect the car by the lot attendant (the business intermediary). A buyer can purchase the car, but also needs fuel in the tank - gas - to power the car, and a driver to drive it out of the lot. So the buyer of the car has two options - buy it with the gas and the driver, or, without the gas and the driver. Now, using that metaphor to represent an asset purchase in a business transaction:

#1 - Car with the gas: [Inventory + Fixed Assets + Good - will] + Working Capital (the gas)

#2 - Car without the gas: [Inventory + Fixed Assets + Goodwill]

**Option #1:** If a buyer wants to purchase the car, the gas, and include the driver as well, then MPSP #1 is determined by the following valuation formula:

**MPSP #1 = EBITDA x (EBITDA Market Multiple)**

Adjusted Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) are the company's operating cash flows, that "includes" a deduction for reasonable owner/manager compensation (the driver).

Adjusted EBITDA is the easiest to quantify in the valuation formula; selecting the appropriate market multiple is more difficult to quantify. EBITDA multiples are impacted by three factors: business risks, growth and financial leverage. A range of market multiples can be found through published databases for closed business sales. EBITDA market multiples often fall within the range of 3 to 6.

*Note: Another challenge is to determine an adequate amount of working capital (the gas) that is included as part of MPSP. Although this is a topic for another discussion, clearly any "excess" working capital remaining with the business should be added as an additional asset to the computed MPSP #1.*

*Conversely, any "deficiency" of working capital required to operate the business should be subtracted from the computed MPSP #1.*

**Option #2:** If a buyer wants to purchase only the car, then MPSP #2 is determined by the following valuation formula:

**MPSP #2 = SDE x (SDE Market Multiple)**

Seller's Discretionary Earnings (SDE) are the company's operating cash flows, it "excludes" a deduction for reasonable owner/manager compensation (the driver). Therefore, the two levels of operating cash flows can be stated as follows:

**SDE = EBITDA + (Owner/Manager Compensation)**

Again, adjusted SDE is the easiest to quantify in the valuation formula, while selecting the appropriate market multiple is more difficult to quantify. SDE Multiples are impacted by the same three factors as EBITDA Multiples. Likewise with Option #1, a range of market multiples can be found through published databases for closed business sales. Here, SDE Market Multiples often fall within the range of 1 to 3. So the question becomes, why the difference in the range of EBITDA and SDE Market Multiples? Because of two obvious reasons:

1. The multiples are applied against two different levels of earnings.
2. One calculated MPSP is with the gas, the other one without the gas.

Here's how an unrealistic pricing expectation is "imbedded" in the mind of the seller. Compute a MPSP (without the gas) by mistakenly applying an EBITDA Multiple against SDE. If this miscalculation goes uncorrected, one of the following is likely to happen: the car never sells, the buyer gives the car back to the seller, the bank repossesses the car, or the car ends up in the junkyard. In summary, when the business intermediary calculates and communicates the MPSP for a business, the market multiple must always be carefully matched to the level of earnings to which it applies. Otherwise, you get junk!

Darrell V. Arne, CBI, CPA, ASA

Arne & Co.

Darrell Arne can be reached at: [darne@arne-co.com](mailto:darne@arne-co.com)