$1,275,000

What is Seller Discretionary Earnings or SDE?

Simply put...it is the true financial benefit of ownership!

Seller's discretionary earnings is a cash-flow based measure of business earnings in an owneroperated business. It comprises the profit before tax and interest of a business before the owner's benefit, non-cash expenses, extraordinary one-time investments, and other non-related business incomes and expenses. This metric is used to measure the value of an organization in order to provide potential buyers with a better picture of their expected return on investment.

There is a substantial amount of real-world comparable data available from both Deal Stats and Biz Comps. This data in addition to over thirty years' experience provide us with a real-world indication of the market value of a business as a multiple of seller's discretionary earnings (SDE). If we know the business size, particular industry, location, and historical performance we can accurately predict the likely multiple of SDE.

The multiple of SDE increases as the size of SDE increases. Small businesses with SDE less than $100,000 sell for multiples in a range of 1 to 2.5, when SDE is greater than $100,000 we expect to see the multiples in a range of 2 to 3, and as SDE reaches and exceeds roughly $500,000 we see the range extend to 2.5 to 3.5 or more.

Two things happen as SDE approaches and exceed $1M; first, we are likely to redefine our SDE and begin using EBITDA (for the same business EBITDA is a smaller number than SDE), and the expected multiples grow to 3.5 to 5.5. We see multiples of 5 or larger as our EBITDA reaches and exceeds $2M.

While there may be range of multiples for any given SDE, we find that most opportunities sell near the middle of the range with very few actually selling at either extreme. Given the particular attributes of any opportunity it is relatively easy to understand where the business will fall within the range of multiples.

Attributes of the business that justify a higher multiple within the range:

- A consistent historical record of growth and profitability
- 10+ years in business
- Substantial hard asset value
- Owner retirement
- Absentee ownership
- Stable management team in place
- Long-term quality employees and customers
- A broad diverse customer base
- Apparent competitive advantages
- Proprietary or exclusive products
- Obvious opportunity for growth and/or obviously under-performing
- Very clean books and records
- Up to date assets and premises in superior condition
- Highly favorable lease terms or ownership of real property
- Desirable location
- A high demand enterprise (manufacturing, distribution, or business to business service)
- Favorable seller financing
- Easy to understand motivation for selling

Attributes of the businesses that justify a lower multiple within the range:

- An inconsistent record of historical profitability
- Less than 3 years in business
- Little if any hard asset value
- Owner critical to operations, professional practices, or consulting
- Substantial involvement of family or partners in operations
- Few employees or a high employee turnover
- Small customer base
- A few customers accounting for substantial percentage of revenue
- No apparent barrier for completion to enter the business
- No clear opportunity for growth and/or improvement in operations
- Questionable financial records
- Outdated assets in need of replacement or heavy maintenance
- Obvious deferred maintenance or capital reinvestment
- Premises in disarray and/or unsuitable for operations
- Unfavorable terms on leases
- Undesirable location
- A low demand enterprise (retail, bar, restaurant, or personal services)
- Unfavorable terms owner unwilling to finance, all cash required
- Questionable rationale for sale

Numbers from which the calculation was estimated:

	2018	2019	2020
Gross Sales	$550,000	$650,000	$750,000
Owner Compensation	$10,000	$10,000	$10,000
Interest Expense	$0	$0	$0
Depreciation Expense	$0	$0	$0
Amortization Expense	$0	$0	$0
Non-Recurring Expense	$0	$0	$0
Owner Benefit	$0	$0	$0
Equipment Expense	$0	$0	$0
Profit/Loss	$400,000	$500,000	$600,000
Rent Expense	$0	$0	$0
Total Seller's Discretionary Earnings	$410,000 33% $135,300	$510,000 34% $173,400	$610,000 33% $201,300

Buyers and lenders place top priority on the historical earnings of a business. Those earnings pay back the notes, provide the buyer a salary, buy new equipment and provide a return on investment.

Next...

The business owner was asked to select the prospective industry multiplier to calculate the asking price.

Resulting in a (rounded) value of: $135,300 + $173,400 + $201,300 = $510,000

Industry Multiplier: Brewery/Pub 2.5x

$1,275,000

JUSTIFICATION OF PURCHASE TEST

Often the most effective way to look at value is to make a reasonable assumption of value and attempt to justify or validate the assumption. We have provided a very basic Price Justification worksheet to assist in validating any assumed value or what we call a **reality check**.

1. Do the earnings cover the loan payments after a reasonable down payment?
2. Do the earnings provide the buyer a new, fair, livable wage?
3. Do the earnings provide the ability to buy new equipment when needed?
4. Do the earnings provide the buyer a reasonable return on investment?

All four questions must be a reasonable yes!

We use our expected value given typical terms of 20% down, compute the debt service on the remaining 80% (based on 5-year amortization, 6% interest), deduct the anticipated debt service, a realistic salary, a reserve for capital reinvestment, taxes and a reasonable return on cash investment (include working capital) from the available SDE. If the result is substantially greater than zero our assumed value is too low, if the result is zero our value is valid, and if the result is less than zero our assumption is high.

Asking Price	100%	$1,275,000
Down Payment	20%	$255,000
Financed Amount	80%	$1,020,000
Terms (Years)	5	
Interest Rate	6%	
Seller's Discretionary Earnings		$510,000
Annual Debt Service		$236,633
Debt Service Cushion (25%)		$59,158
Capital Expenditures Est.		$0
Equals Earnings Left of Buyer		$214,209

ASSUMPTIONS

- **A SALE IS COMMONLY AN ASSET SALE**
  Buyers will acquire a business and its tangible and intangible assets via an asset sale with the seller. The SDE does not include the cash, accounts receivable and accounts payable currently used in the business. However, buyers will sometimes negotiate working capital that will be included as part of the sale. The seller will receive an adjusted and higher purchase price to offset the working capital included in the transaction.

- **DEBT-FREE BUSINESS**
  A buyer usually does not assume any of the seller's debt and there are no interest payments calculated in the SDE. Interest expense paid by the seller was added back.

- **BUYER WILL WORK IN THE BUSINESS**
  The expectation is that a new owner will be a hands-on participant in the business and a full-time owner. This is very important, as absentee owners will need a full-time manager to run the business, which lowers the price they will pay due to added payroll costs post-purchase.

- **SELLER WILL PROVIDE THE FOLLOWING TO BUYER**
  A Covenant-Not-To-Compete covering all past, present, and future customers of the business. A reasonable transition assistance period, usually around 30 days, at no additional cost to buyer.

- **LEASE TERMS FOR BUSINESS**
  The buyer will have substantially similar terms to the current lease.

This is not an Appraisal or Conclusion of Value, but rather a tool for business buyers and sellers to test and estimate the selling price of a Business using a multiple of earnings method.

Had an actual Appraisal or Conclusion of Value been done on the subject company, a certified expert would have considered many more critical factors.