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Add Backs, SDE and Business Valuation

By John G. Hornblower, Owner of VR Business Brokers Office in Aspen, CO

One of the first steps in valuing a privately held business is determining the true profitability of the business. Unlike valuing a publicly traded company based on a simple metric such as a price/earnings ratio (the PE ratio), valuing a privately held business requires a deeper analysis of the business' profit and loss (P&L) statements.



The P&L statements, typically for the past three years of operating history of the business, are examined to identify both non-recurring expenses and other expenses which may have been taken to reduce the business' taxable income but are a form of in-kind income to the business owner. This valuation process starts with EBITDA (earnings before interest expense, taxes, depreciation and amortization), and then adjusts this figure for expenses that are a form of in-kind income to the business owner.

These adjustments are referred to as "add backs." The first add back is typically the owner's salary. This expense reduces the business' taxable income but is clearly a form of income to the business owner. Other add backs would include expenses from personal use of company vehicles, expenses from personal use of company technology such as computers and cell phones – the list of add backs can be extensive. Any expense that reduces the business' taxable income that is a form of in-kind income to the business owner is typically a legitimate add back.

Once the list of add backs is completed, the list is reviewed with the business owner to ensure that all add backs are legitimate and that any add back that isn't legitimate is not included. For example, a one-time expense to upgrade a company's technology platform that has already been accounted for in the depreciation figure would be double counted if it were listed as an add back.

The sum of the add backs are then added to the company's EBITDA figure. The sum of the add backs and EBITDA is the more accurate reflection of the company's true profitability. This sum is known as the seller's discretionary income, or SDE. SDE is also known as the total owner's benefit, or TOB of the business. The terms are interchangeable, but SDE is the more commonly used term.

Privately held businesses typically change hands at some multiple of SDE. The applicable multiple depends on a number of factors. The length of operating history of the business, the volatility of profits and losses over the past three to five years, whether sales and profits are growing or declining, any customer concentration such that the business might be vulnerable to the loss of a key customer, or the loss of any key employees – any number of factors will determine whether the appropriate multiple of SDE should be, for example, 4.5 or 1.5.

Our team at VR Business Brokers in Aspen, CO is ready to help you when the time comes to value and sell your privately held business.



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