

FOR EXECUTIVES SEEKING TO BUY OR SELL BUSINESSES

Net Income, EBIT, EBITDA, SDCF

What is the right metric to use for business valuation?

The most commonly used “earnings figures” used for small to mid-market business valuation are Net income (NI), Earnings Before Interest and Taxes (EBIT), Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA) and Seller’s Discretionary Cash Flow (SDCF). With a variety of metrics to choose from it is natural for a business owner to ask “which is the right one to use for my business”. To answer the question, first we need a quick background on what these earnings metrics are.

- NI: NI is the net profit of the business after deducting all expenses of the business including all operational expenses, owners’ or officers’ salary, interest expense, taxes, etc. Some people consider this as the “true earnings” but for many small to mid market companies, which are on a constant quest to minimize taxes, this number can be grossly understated and is not a true reflection of the company’s earnings stream.
- EBIT: EBIT is the net profit of the business before factoring in financing and taxes. The rationale for using this metric is that tax payments are highly accounting and owner dependent and a pre tax view of the profits would be a better indicator of the profit stream. Similarly, interest payments that are a function of the company’s financing strategy and vary widely depending on the debt to equity ratio preferred by the ownership. The resulting leverage factor can artificially inflate or deflate the NI. EBIT shows an earnings number that is adjusted for these variables to reflect a truer picture of the earnings.
- EBITDA: The accounting treatment of Depreciation and Amortization for many businesses is substantially different from the real cash flow impact these elements have on the business. EBITDA allows for looking at the profitability of the business before factoring in these two items. One needs to be aware that this can be a highly misleading indicator based on the depreciation and amortization characteristics of the business and adjustments to EBITDA are almost always necessary to get a true picture of the earnings.
- SDCF: For smaller businesses, where the owner may see the business as a “job”, the true measure of profitability may be the sum of all the monies the owner derives from the business including salary, benefits and other perks.

Effectively,

- $EBIT = \text{Net Income} + \text{Interest} + \text{Taxes}$

- $EBITDA = EBIT + Depreciation + Amortization$
- $SDCF = EBITDA + Owner/Officer's Salary + Benefits + Perks$

So, the answer to the question, "Which earnings is the right one for my business?" depends on the nature and size of a business and an understanding of which metric may more accurately reflect the true earnings. For many mid-market businesses the appropriate metric is likely to be EBIT or EBITDA.

Once the correct metric is identified, the business owner needs to understand the range of multiples that may be applicable to the chosen metric. For example, the earnings multiples for most small companies tend to vary between 1 to 3 times SDCF and the earnings multiple for mid-market companies are more likely to be 3 to 5 times EBIT or 3 to 7 times EBITDA.

However, businesses tend to be more unique than typical and a multiple that is good for one business may be too low or too high for another. The more exceptional the business is, the more likely it is that the multiplier will be outside of the typical range.

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