

Calculating Cash Flow (appraiser vs. lender)

By: Neal Patel, CBA, CVA

Seller's Discretionary Earnings (SDE) is an integral cash flow stream for small businesses. SDE encompasses all cash flows paid to a single owner-operator, including an adjustment for owner's salary, discretionary expenses and nonrecurring income/expenses.

Below is a step-by-step explanation of how to calculate SDE for a typical small business. An extract of the first page of a liquor store tax return is included below:

Form 1065		U.S. Return of Partnership Income		OMB No. 1545-0123	
Department of the Treasury Internal Revenue Service		For calendar year 2015, or tax year beginning _____, ending _____		2015	
I n c o m e	1a Merchant card and third-party payments (including amounts reported on Form(s) 1099-K). For 2011, enter -0-	1a	0		
	b Gross receipts or sales not reported on line 1a (see instructions)	1b	2,211,481		
	c Total. Add lines 1a and 1b	1c	2,211,481		
	d Returns and allowances plus any other adjustments to line 1a (see instructions)	1d			
	e Subtract line 1d from line 1c	1e	2,211,481		
	2 Cost of goods sold (attach Form 1125-A)	2	1,732,334		
	3 Gross profit. Subtract line 2 from line 1e	3		479,147	
	4 Ordinary income (loss) from other partnerships, estates, and trusts (attach statement)	4			
5 Net farm profit (loss) (attach Schedule F (Form 1040))	5				
6 Net gain (loss) from Form 4797, Part II, line 17 (attach Form 4797)	6				
7 Other income (loss) (attach statement) STM. 02	7		82,156		
8 Total income (loss). Combine lines 3 through 7	8		561,303		
D e d u c t i o n s (see the instructions for limitations)	9 Salaries and wages (other than to partners) (less employment credits)	9		98,114	
	10 Guaranteed payments to partners	10			
	11 Repairs and maintenance	11		12,432	
	12 Bad debts	12			
	13 Rent	13		144,000	
	14 Taxes and licenses See ATT_PTL	14		15,166	
	15 Interest	15		30,105	
	16a Depreciation (if required, attach Form 4562)	16a	28,644		
	b Less depreciation reported on Form 1125-A and elsewhere on return	16b		28,644	
	16c			28,644	
	17 Depletion (Do not deduct oil and gas depletion.)	17			
	18 Retirement plans, etc.	18		Amortization	\$40,000
	19 Employee benefit programs	19			
20 Other deductions (attach statement) STM. 04	20		142,549		
21 Total deductions. Add the amounts shown in the far right column for lines 9 through 20	21		471,010		
22 Ordinary business income (loss). Subtract line 21 from line 8	22		90,293		

The EBITDA calculation is shown in the table below (this is similar to how a lender calculates EBITDA):

EBITDA Calculation	
Net income (loss) from financials	\$ 90,293
Add: Interest	\$ 30,105
Add: Taxes	\$ -
Add: Depreciation	\$ 28,644
Add: Amortization	\$ 40,000
EBITDA (unadjusted)	\$ 189,042

In order to arrive at SDE, the following adjustments are required:

EBITDA
+ Owner's Compensation
+ Normalizing Adjustments*
= Normalized Seller's Discretionary Earnings
<i>*Normalizing Adjustments</i>
<i>Nonrecurring Expenses</i>
<i>Non-Business Expenses</i>
<i>Owner's Perks</i>
<i>Rent Adjustment</i>

Using the table above, the liquor store's SDE is calculated in the below:

SDE Calculation		
	EBITDA	\$ 189,042
<u>Ref</u>		
1	Add: Owner's Compensation	\$ 15,000
2	Add: Non-Business / Non-Recurring / Owner's "Perks"	\$ 5,000
3	Add: Rent Paid to Affiliate Holding Company (EPC/OC)	\$ 144,000
	Less: Fair Market Rent	\$ (100,000)
	Seller's Discretionary Earnings (SDE)	\$ 253,042

1. Owner's Compensation is included in the *Salaries and Wages* expense (line 9 in the tax return). When dealing with an LLC (Form 1065) the appraiser must request the owner's W2 to ensure that this figure is accurate (*Guaranteed Payments to Partners* is different than a W2 salary). The owner's compensation in a C Corp (Form 1120S) or S Corp (Form 1120S) is listed under the *Compensation of Officers* line (line 7 or 12, respectively). It is important to include only the owner's compensation in this add-back, as there may also be non-owner officers included in this line item. Additionally, if multiple owners work, their salaries must be replaced with fair market replacement salaries, since the SDE earnings stream is for a single owner-operator.
2. Owner's Perks include owner's health insurance premiums paid by the company, included in the *Other Deductions* expense (line 20 in the tax return). Non-business related expenses (personal auto, owner's health/life insurance, salary paid to non-working family members, etc.) or nonrecurring expenses (broker's fee, extraordinary legal fee, etc.) must also be adjusted.
3. The owner of the liquor store in the example above also owns the real estate under a separate holding company (EPC/OC structure). Therefore, a rent adjustment is required, as a hypothetical buyer of the business will be required to pay fair market rent to the landlord. The appraiser must add back all rent paid to the real estate holding company (if any) to the earnings, and then subtract out a fair market rent, which can be based on a real estate appraisal or reasonable estimates of rent per square foot times total square footage. In the table above, fair market rent was estimated at \$20/psf multiplied by 5,000 square feet.

Although not shown in the example above, non-operating income must also be removed from the earnings (affiliate company income, interest income, insurance loss reimbursement, gain on sale of fixed asset, etc.).

As seen below, there are some significant differences between the appraiser's cash flow and lender's cash flow, namely the rent adjustment and the buyer's required draw.

Appraiser's Cash Flow	
Appraiser's Cash Flow Calculation	
EBITDA	\$ 189,042
Add: Owner's Compensation	\$ 15,000
Add: Non-Business / Non-Recurring / Owner's "Perks"	\$ 5,000
Add: Rent Paid to Affiliate Holding Company (EPC/OC)	\$ 144,000
Less: Fair Market Rent	\$ (100,000)
Seller's Discretionary Earnings (SDE)	\$ 253,042
vs. Lender's Cash Flow	
Lender's Cash Flow Calculation	
EBITDA	\$ 189,042
Add: Owner's Compensation	\$ 15,000
Deduct: Buyer's Required Draw	\$ (45,000)
Add: Rent Paid to Affiliate Holding Company (EPC/OC)	\$ 144,000
Cash Flow Available to Service Debt	\$ 303,042

Adjustment for market rent

Adjustment for fair market comp

Adjustment for buyer's draw

No adjustment for market rent

Although lenders may determine similar earnings streams as part of their underwriting processes, the adjustments lenders apply to arrive at their earnings streams are usually **specific to the deal terms and borrower's requirements**. Moreover, lenders will take into consideration factors such as a specific buyer's global debt service capability, personal revolving debt, among others – this may require a *Buyer's Required Draw*. Meanwhile, cash flows used by business appraisers are determined based on a **hypothetical transaction which assumes one owner-operator for the subject business**.

SDE is used in the transaction/market approach and is usually applicable for small businesses that are owner operated. EBITDA is used for larger businesses that are commonly absentee owned (operated by a general manager being paid fair market wages). As seen in the table above, the Adjusted EBITDA earnings stream removed the fair market replacement salary for the owner. Because a liquor store is typically owner operated, the EBITDA cash flow stream may not be as relevant in the appraiser's analysis.

For lenders, the proper calculation of these earnings streams in the context of business appraisals may be of particular importance when applying rules of thumb multiples to determine an initial estimate of value (for instance, to determine the reasonability of a purchase price). A more detailed discussion of reasonable valuation multiples will be included in the next SBAvalue™ article.

For more information regarding the calculation of cash flow, contact Neal at neal@reliantvalue.com or call 908-888-6030.