SDE, EBITDA and Recasting

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SDE or EBITDA and what is recasting, basic ingredients for a valuation

Seller's discretionary earnings (SDE)

A seller's discretionary earnings are the **pretax and pre-interest profits** before non-cash expenses, one owner's benefits, one-time investments, and any non-related income or expenses. In addition, SDI may require that expenses be adjusted if a new owner will necessarily need to take on a new expense.

Seller's discretionary Earnings is a common cash flow-based measure of **business earnings** for owner-operator managed businesses. To determine the actual SDE, a recast is necessary to arrive at the right SDE.

EBITDA

EBITDA is essentially net income with interest, taxes, depreciation and amortization added back to it. EBITDA can be used to analyze and compare profitability among companies and industries as it eliminates the effects of financing and accounting decisions. EBITDA is often used in valuation ratios and compared to enterprise value and revenue.

EBITDA = Net Profit + Interest +Taxes + Depreciation + Amortization

Both SDE and EBITDA are the basic numbers to value any Business, SDE for owner / operators, while EBITDA is a base for managed Companies. It is not always a question of size as a $ 20 million company may be run by the owner, and a 5-million-dollar company as an enterprise with the owner removed from the day to day operation.

Recasting the Income Statement

To establish the business profitability potential, you may need to make some normalizing adjustments to the **income statement**. There are a number of items that frequently require adjustment.

Owners compensation adjustments

Adjust total owner compensation to the market rate of hiring a manager replacement. Note that the total owner compensation includes the owner salary, bonuses, profit sharing payouts and benefits. Adjust the working family and friends' compensation to the market rate required to hire a replacement to perform the same function.

Non-cash expenses

Regardless of the depreciation method used, you may need to adjust the depreciation expense to match the true economic value of the business assets.

Inventory normalization

If inventory accounting is reported on the LIFO basis, convert it to the FIFO basis. Simply add back the LIFO reserve which should be available from the financial statement footnotes or the

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company's CPA. The FIFO inventory reporting accurately reflects the company inventory costs and is a preferred choice when assessing gross margins.

Business rental expense adjustments
Adjust rents to the fair market rent values. This is important if recorded rent expense is above or below market rates. An example is the business owner renting personally owned property back to the business at above market in order to minimize the taxable income.

Adjust out any non-recurring items

- Factor out amounts from insurance claim proceeds and lawsuit settlements.
- Eliminate any one-time gains or losses from the disposition of assets. An example is selling autos or company owned real estate.
- Factor out one-time expenses such as the business moving expenses.

Unrecorded expenses

- Include the actual or potential business expenses that have not been recorded: Unrecorded accrued expenses. Examples are staff vacation or bonus pay.
- Check and adjust for bad debt expenses. Examples are uncollectible accounts receivable – check the receivables aging report.

Adjustments for expected future changes

- Factor in any potential changes such as an expected loss of a key customer. This should be accounted for in your cash flow projections.

Handling non-operating income and expenses

- Remove non-operating income or expense. Examples are non-business real estate income or expenses.

Why EBITDA is Not Cash Flow

There is a misconception in corporate finance that EBITDA (Earnings Before Interest, Depreciation, and Amortization) is synonymous with cash flow. The metric gained prominence with the arrival of the LBO industry in the 1980's as buyout firms used it to estimate how much debt a company could take on, a key component of the LBO strategy. As standardized as EBITDA has become in company valuation – purchase prices and loan covenants are often quoted as multiples of EBITDA – the metric is not uniformly defined under GAAP standards and its calculation varies from company to company, leading to disparities and misunderstandings about the true cash-generative abilities of a business.

EBITDA does not take into account any capital expenditures, working capital requirements, current debt payments, taxes, or other fixed costs which analysts and buyers should not ignore. The cash needed to finance these obligations is a reality if the business wishes to grow, defend its position, and maintain its operating profitability.

Here are three costs that are not included in the EBITDA calculation and by omitting tends to overstate operating cash flows:

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Capital Expenditures

Certain industries like heavy manufacturing, shipping, aviation, telecom, clean technology and oil and gas require heavy ongoing or up-front investments in equipment. EBITDA does not take into account capex, the line item that represents these significant investments in plant and equipment. Ignoring capital expenses to inflate EBITDA by $3.8B precipitated the bankruptcy of WorldCom. Essentially, the company capitalized operating expenses, allowing them to be depreciated over time, thus decreasing operating expenses and boosting EBITDA.

Depreciation

"The biggest problem I encounter is an over or underestimation of capital expenses for asset-heavy companies such as trucking. Adding back all depreciation for a company like this without leaving an allowance for capex can grossly overestimate the available cash flow. However, not adding back any depreciation can underestimate the cash flow, especially if the company uses accelerated depreciation," advises Axial Member Jaime Schell of Plethora Businesses. There have been more insidious cases of companies manipulating depreciation schedules to inflate EBITDA, such as Waste Management in the mid-nineties extending the useful lives of its garbage trucks and overstating their salvage value.

Working Capital Adjustments

Businesses need to invest revenue back into the company to keep expanding. EBITDA does not account for changes in working capital (current assets minus current liabilities) and the cash required to run the daily operating activities. Ignoring working capital requirements assumes that a business gets paid before it sells its products. Very few companies operate this way. Most businesses provide a service and get paid in arrears. Ideally a business collects up front for its services and pays in as much time as possible to remain as liquid as possible and to quickly reinvest cash into profitable investments like inventory purchases. This relationship between sources and uses of cash speaks to a company's ability to take on more projects such as higher debt payments in the case of an LBO.

While EBITDA is useful in that it allows for a back-of-the-envelope comparison of two companies with similar business models or in the same industry, a 2000 letter to Berkshire Hathaway shareholders written by Warren Buffet put EBITDA in its place: "*References to EBITDA make us shudder*…We're very suspicious of accounting methodology that is vague or unclear, since too often that means management wishes to hide something."

What is 'Cash Flow'

Cash flow is the net amount of cash and cash-equivalents being transferred into and out of a business. At the most fundamental level, a company's ability to create value for shareholders is determined by its ability to generate positive cash flows, or more specifically, maximize long-term free cash flow.