

Normalizing Cash Flow and the Role of Replacement Salaries

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It's not uncommon to see one or more family members of the owner of a small business (whether they are shareholders or not) working or assisting within the operation in some capacity. Some may work more hours than others and some may not work at all but still draw a salary. So, when it comes to calculating discretionary cash flow how do you treat these individuals?

The Purpose of Normalizing Cash Flow



To normalize cash flow, you are removing items that are a benefit to the owner(s) or that the business does not need to operate (revenue or expense) on a day-to-day basis. These include typical owner benefits such as W-2 compensation, interest expense, auto, travel, insurance, rent (paid rent normalized to market rent), as well as non-cash items like depreciation, and amortization. You will hear terms like one-time expense (computer upgrades, legal fees associated with lawsuits, etc.), or more generic terms like “operating” or “non-operating” since normalizing cash flow requires separating the operating from the non-operating. Add all this up and you get what is referred to as Seller’s Discretionary Earnings or SDE, which is the primary cash flow stream used in pricing small businesses.

SDE v EBITDA

After calculating SDE, there is one more adjustment to consider: normalizing the owner's responsibilities. Because SDE includes owner's compensation, it reflects cash flow available to a hypothetical buyer before he/she pays someone to manage the business. To properly calculate EBITDA, (Earnings Before Interest, Taxes, Depreciation, and Amortization) you must deduct a replacement salary from SDE to account for the owner. Generally, EBITDA becomes more of a factor when a business generates more than \$500K in SDE; but calculating EBITDA is still a key component to valuing a business.

Replacing More Than Just the Owner

When there is only one owner working full-time and managing the business, you only need to account for the owner's replacement salary, but what if there are other shareholders, family members, or friends working within the operation – how do you normalize those positions? First, it's important to identify what responsibilities these individuals (other than the owner) have and their respective W-2 salaries. All W-2 salaries are added back to your cash flow calculation and then based on their responsibilities, corresponding replacement salaries for each of those individuals must be deducted from your cash flow calculation before SDE can be calculated accurately.

During this process you might find multiple people doing the same job, (positive to cash flow), where other positions are not being paid enough, or at all (negative to cash flow). Regardless, paid or not paid, each active position must be accounted for to calculate SDE accurately.

Determining the Right Replacement Salary

Adjusting for an active position within a company requires that replacement salary to reflect market compensation. Market compensation reflects: the position, industry, region, and to some degree, the level of contribution to the company (i.e. part-time vs. full-time). It is always important to consult with the owner or anyone else who has a decent understanding of the job market for a particular area or industry when it comes to selecting an appropriate market replacement salary for a specific position. Using employment publications, Bureau of Labor Statistics, or industry trade magazines are other good sources of market data. Regardless, the market salary must have some relevant data behind it to support the figure.

Absentee Owner

The valuation of a privately held business will always assume that a hypothetical buyer of that company will become an owner /operator and become its General Manager. So, what happens when the owner is not active in any capacity and relies on a General Manager to manage the operation? Under the assumption of an owner / operator managed business where the existing owner is absentee, the GM position becomes discretionary to a new hypothetical owner. In this case, your calculation of SDE will include any W-2 compensation paid to the owner as well as to the GM. Assuming the GM is not a shareholder, the replacement salary used to calculate EBITDA will be equal to the existing GM's salary, as this is an accurate reflection of market based compensation. If the GM and owner are related in some capacity, it's best to research market-based salaries to meet the GM's responsibilities and use that as your replacement to calculate EBITDA.

Getting it Right

Below is a basic calculation using different replacement salaries to determine the value of a business using both SDE and EBITDA calculations. The calculation assumes a 33% Cap Rate on SDE and a 25% Cap Rate on EBITDA.

	<u>2017</u>		<u>2017</u>		
Cash Flow Adjustments			Cash Flow Adjustments		
Interest expense	\$28,152		Interest expense	\$28,152	
Depreciation/Amort.	\$56,896		Depreciation/Amort.	\$56,896	
Owner #1 Compensation	\$89,568		Owner #1 Compensation	\$89,568	
Owner #2 Compensation	\$89,568		Owner #2 Compensation	\$89,568	
Replace Owner #2	(\$75,000)		Replace Owner #2	(\$100,000)	
Non-Operating Travel	\$29,447		Non-Operating Travel	\$29,447	
Owner Insurance	\$17,895		Owner Insurance	\$17,895	
Rent Paid	\$185,000		Rent Paid	\$185,000	
Market Rent	<u>(\$152,500)</u>		Market Rent	<u>(\$152,500)</u>	
Total Add Backs	\$269,026		Total Add Backs	\$244,026	
Cash Flow Calc.			Cash Flow Calc.		
Pre-Tax Profit +	\$154,000		Pre-Tax Profit +	\$154,000	
Total Adjustments =	<u>\$269,026</u>		Total Adjustments =	<u>\$244,026</u>	
Seller's Discretionary Earnings	\$423,026		Seller's Discretionary Earn	\$398,026	
Less Replacement Salary	<u>(\$100,000)</u>		Less Replacement Salary	<u>(\$125,000)</u>	
EBITDA	<u>\$323,026</u>		EBITDA	<u>\$273,026</u>	
33% Cap Rate (SDE)	3.33 X \$423,026	\$1,408,677	33% Cap Rate (SDE)	3.33 X \$398,026	\$1,325,427
25% Cap Rate (EBITDA)	4 X \$323,026	\$1,292,104	25% Cap Rate (EBITDA)	4 X \$273,026	\$1,092,104
Final Value		<u>\$1,350,390</u>	Final Value		<u>\$1,208,765</u>

It may seem trivial, but replacement salaries are a critical step in accurately valuing any privately held business. Replacement salaries **do** have a material impact on value and it's certainly not uncommon to see someone manipulate the value of a business by using a higher or lower replacement salary. By ignoring positions, you can overvalue a business; on the converse, lofty or highly paid positions without normalization can undervalue a business. It is always best to get it right.