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SDE vs EBITDA: Normalizing Owner Pay in Valuation

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Two earnings measures for two kinds of buyer

Small-business listings usually quote seller's discretionary earnings (SDE). Lower-middle-market teasers usually quote EBITDA or adjusted EBITDA. Both start from the same income statement. The difference is one question: who will run the business after the sale, and what will they cost?

SDE is built for a buyer who will replace the owner personally and take the owner's pay as part of the return. EBITDA, as used in acquisitions, is built for a buyer who will hire someone to do the owner's job. BizBuySell, a business-for-sale marketplace, puts the distinction plainly: "The primary difference is that the EBITDA valuation method doesn't exclude the owner's compensation," and "businesses with earnings over one or two million dollars will often use EBITDA as an evaluation metric because buyers rely on professional managers to run the operation" (BizBuySell, SDE overview).

A broker survey shows the same convention by deal size. The International Business Brokers Association (IBBA) and M&A Source Market Pulse for the first quarter of 2018, compiled with the Pepperdine Private Capital Markets Project, lists the "most common multiple type" as SDE without working capital for every deal-size band up to $5 million, and EBITDA including working capital for $5 million to $50 million (IBBA/M&A Source Market Pulse, Q1 2018, Figure 7).

Two caveats on both sources. They are trade and marketplace publications, not independent research. And the IBBA figure is from 2018; IBBA's public Market Pulse page lists no report after Q1 2022 (checked October 28, 2026), so we cannot say whether the bands have moved. Treat the boundary as a market convention, not a rule. What matters for an analyst is knowing which measure a number is, and converting between them explicitly.

This article describes conventions and published rules. It is not valuation, tax or lending advice.

How SDE is built

SDE starts from pre-tax net profit and adds back expenses that benefit the current owner personally or will not recur. BizBuySell's list of typical add-backs (SDE overview):

- the owner's salary, including perks such as health insurance, automobiles and fuel;
- expenses not necessary to run the business, such as trade shows, other travel and charitable contributions;
- one-time expenses not likely to recur;
- interest on loans the owner carries;
- payroll taxes on the owner's salary;
- depreciation and amortization.

The same page proposes three tests for an add-back: it should be incurred for the benefit of the owner rather than the business or its employees, be paid for by the business, and show as an expense on the company's tax returns and income statement. It also notes that "what passes as an add-back is open to dispute," with standard items (owner salary, depreciation) rarely contested and non-recurring or "non-essential" items often contested.

SDE therefore answers: how much cash would one full-time owner-operator take out of this business, before debt service, capital spending and income taxes?

How EBITDA differs: the replacement-cost step

EBITDA leaves owner compensation in the cost base. When an acquirer normalizes EBITDA for a founder-run company, the key move is not to delete the owner's pay but to **replace it with a market wage** for the work the owner actually does. Adjusted EBITDA then adds back only true non-recurring or non-operating items.

The bridge, in steps:

1. Start with SDE.
2. Subtract the fully loaded market cost of the role or roles the owner performs (salary, payroll taxes, benefits).
3. Remove any add-back that a non-owner manager would still incur (for example, travel needed to keep key customers).
4. The result is normalized EBITDA for a buyer who will not operate the business personally.

Illustrative example (fictional): Northgate Mechanical

Northgate Mechanical is a fictional commercial HVAC contractor with $3.0 million of revenue and one owner who acts as general manager. All figures are invented.

Line	Amount	Note
Pre-tax net income (per tax return)	$280,000	Starting point
Owner salary	+$180,000	Owner's W-2 pay
Payroll taxes on owner salary	+$14,000	
Owner health insurance	+$16,000	Paid by the business
Owner's personal vehicle	+$9,000	Not used for operations

Line	Amount	Note
One-time legal settlement	+$25,000	Non-recurring, documented
Interest expense	+$20,000	
Depreciation and amortization	+$46,000	
SDE	**$590,000**	For an owner-operator buyer
Reported EBITDA (net income + interest + D&A)	$346,000	Owner pay still in
Market cost of a general manager (salary $130,000, taxes and benefits $26,000)	-$156,000	Replacement step, applied to SDE
Normalized EBITDA	**$434,000**	For a buyer hiring a manager

The two routes reconcile. From reported EBITDA of $346,000, add the owner's compensation above market ($180,000 + $14,000 + $16,000 - $156,000 = $54,000), the personal vehicle ($9,000) and the one-time settlement ($25,000): $346,000 + $88,000 = $434,000.

Note what changed and what did not. The $156,000 gap between SDE and normalized EBITDA is not a disagreement about the business; it is the cost of the owner's labor, which one buyer supplies personally and the other buys in the market.

Two common traps in this step:

- **The owner does more than one job.** A founder who is also the lead estimator and the main salesperson needs more than one replacement. Subtracting a single manager's wage overstates EBITDA.
- **The owner is underpaid.** If the owner takes a salary below market and draws the rest as distributions, reported EBITDA is overstated before any adjustment. The normalization then reduces EBITDA.

Normalizing owner compensation: a market-wage test

What is the "market cost" of the owner's role? There is no single official answer, but the IRS offers a useful framework from a different context. S corporations "must pay reasonable compensation to a shareholder-employee in return for services that the employee provides to the corporation before non-wage distributions may be made," and the IRS lists factors courts have used to determine reasonable compensation (IRS, S corporation compensation and medical insurance issues):

- training and experience;
- duties and responsibilities;
- time and effort devoted to the business;
- dividend history;
- payments to non-shareholder employees;
- timing and manner of paying bonuses to key people;
- what comparable businesses pay for similar services;
- compensation agreements;

- the use of a formula to determine compensation.

The IRS page is about employment tax: it addresses whether payments should be treated as wages or distributions, not how a business should be valued. But the factors are a sensible checklist for the valuation question "what would we pay someone else to do this?" Two of them carry most of the weight in practice: duties and time actually spent (from interviews, calendars and org charts), and what comparable businesses pay (from salary surveys or recent hires in the same market). Record the source for each.

A related point for S-corp targets: an owner who has paid themselves a low salary and large distributions may have done so for tax reasons. The IRS notes it "has the authority to reclassify payments made to shareholders from non-wage distributions... to wages." That is a tax diligence topic for counsel and accountants, but it also tells an analyst that reported salary in an S-corp is not a reliable proxy for the market cost of the role.

Why multiples are not interchangeable

Because SDE is larger than EBITDA for the same business, the same price produces a lower multiple of SDE than of EBITDA. BizBuySell says so directly: "SDE will generally be higher than EBITDA. But the multiples applied to SDE calculations are typically lower than those involved when an adjusted EBITDA is used" (BizBuySell, SDE overview). The IBBA report publishes median multiples for SDE and EBITDA as separate series for the same reason (IBBA Q1 2018).

Arithmetic, not a market claim, on the fictional Northgate numbers: a $1.5 million price is about 2.5 times SDE ($590,000) and about 3.5 times normalized EBITDA ($434,000). Same deal, same price, two different "multiples."

The practical errors to avoid:

- **Applying an SDE-based benchmark to EBITDA** (or the reverse). A benchmark quoted as "x times cash flow" needs a definition before it is used.
- **Mixing working-capital conventions.** The IBBA table distinguishes SDE "without working capital" from EBITDA "including working capital." A price that excludes working capital and one that includes a normalized level are not comparable without adjustment.
- **Comparing seller SDE to buyer EBITDA in a bid.** A seller who hears an offer as a "low multiple" may be comparing the buyer's EBITDA-based price to SDE benchmarks. Show both measures side by side.

For one dated reference point on the small-business side, BizBuySell's Q3 2026 Insight Report, built from closed transactions that brokers report voluntarily, gives average cash flow multiples of 2.30x for businesses that sold below $1 million and 3.73x for those above, against a market-wide median sale price of $350,000 (BizBuySell Insight Report, Q3 2026, read October 28, 2026). The report page does not define its cash flow measure, so check it against your own SDE build before comparing. Multiples vary by period, size, sector and method; treat any single quarter as context, not a price.

A one-page earnings bridge to request

When a teaser or broker package quotes a single earnings figure, the fastest way to remove ambiguity is to ask for a bridge that shows every step from the tax return to the figure quoted. A template a buyer can send with an initial information request:

Line	Amount	Source document	Who prepared it
Pre-tax net income, per filed tax return		Return, by year	Seller's accountant
Interest, depreciation and amortization		Return, fixed-asset schedule	
Reported EBITDA		Calculated	
Owner compensation (salary, payroll taxes, benefits, perks), itemized		Payroll records, W-2	
Other owner-benefit expenses, itemized		General ledger detail	
Non-recurring items, itemized with a one-line reason each		Invoices, agreements	
SDE		Calculated	
Market cost of each role the owner performs		Named salary source, date	Buyer
Related-party adjustments (rent, family payroll)		Lease, payroll	
Normalized EBITDA		Calculated	Buyer

Three rules make the bridge useful. Every line is shown for at least the last two full fiscal years plus the trailing twelve months, so one-time items can be seen not recurring. The seller's lines and the buyer's lines are kept apart, so each party's judgment is visible. And no line is netted: an owner who is underpaid shows a negative adjustment, not a smaller add-back.

A bridge in this form also anticipates what a lender or quality-of-earnings provider will ask for later, which shortens diligence rather than duplicating it.

How lenders look at the same adjustment

SBA 7(a) lenders financing an acquisition meet owner-pay adjustments directly. SOP 50 10, version 8.1, effective October 1, 2026 (SBA SOP 50 10 page), sets these rules in Appendix 15 (SOP 50 10 8.1):

- Historical debt service coverage is defined as **EBITDA** divided by post-transaction debt service, and the minimum for an Initial Acquisition is 1.25:1. The lender's base metric is EBITDA, not SDE.
- Lenders may adjust cash flow for items including "Seller discretionary expenses" and "Ownership Compensation," but must justify each adjustment in the credit memorandum; "adjustments to cash flow without the Lender's supporting analysis and justification will be ineligible."

- "Adjustments made to ownership compensation must also be substantiated by a global cash flow analysis" meeting "the 1:1 DSC on a global basis," and the buyer's compensation "must be sufficient to support their current obligations and living expenses."
- For Initial Acquisitions and Business Expansions with a purchase price of $3 million or more, the lender must obtain a quality of earnings report that documents "above- or below-market owner compensation" among other adjustments, and must use the QoE earnings in the DSC calculation.

In other words, the lender performs the replacement step from the buyer's side: if the buyer intends to run the business and draw a salary, that salary must cover the buyer's own obligations; if the buyer will hire a manager, the manager's cost comes out of cash flow. Either way, an SDE figure does not pass through to the coverage test unchanged.

Common add-back errors and a verification checklist

The errors that recur

- **Owner pay added back with no replacement.** The single most common way an EBITDA figure is overstated in founder-run companies.
- **Family members on payroll.** A relative paid above market (add-back candidate) or below market or unpaid (negative adjustment, because the work still needs doing).
- **"One-time" items that recur.** Equipment repairs, legal costs or recruiting fees that appear every year under different labels.
- **Personal expenses with no paper trail.** If an expense is described as personal but cannot be traced to the ledger and tax return, it is a claim, not an adjustment.
- **Related-party rent.** If the owner owns the building and charges below-market rent, normalized EBITDA should fall to reflect a market lease after the sale.

Illustrative example (fictional): add-back review log

Add-back claimed	Amount	Evidence requested	Status
Owner salary above market	$54,000	Payroll records; role description; two salary benchmarks	Supported
Owner's personal vehicle	$9,000	Lease contract; mileage log; general ledger	Supported
Legal settlement	$25,000	Settlement agreement; ledger entry; three-year legal expense history	Supported, one-time
"Discretionary" travel	$18,000	Trip list with purpose; customer list	Not supported: trips were customer visits a manager would continue
Spouse's salary (no role)	$40,000	Payroll; interviews with staff	Needs more evidence: staff report the spouse runs billing

The point of a log like this is that each add-back carries its evidence and its status. "Needs more evidence" is a valid answer and should stay visible until resolved.

Checklist

- Tie net income to the tax return before any adjustment.
- Identify every role the owner performs and price each from a dated, named source.
- Classify each add-back as owner-benefit, non-recurring or non-operating, and attach documents.
- Recompute EBITDA by both routes (from SDE and from reported EBITDA) and confirm they reconcile.
- Check related-party rent, family payroll and owner-paid expenses for negative adjustments.
- State which measure any multiple or benchmark uses, and its working-capital convention.

Using the metric in sourcing screens

Origination screens rarely have earnings data. Most screens filter on revenue estimates, headcount, locations or licences, and the earnings question is answered later, from the seller's financials. (For the screening side, see estimating private company revenue.)

Two implications:

- **Do not infer SDE or EBITDA from public data.** Payroll filings, permits and job postings can support a size estimate. They cannot tell you what the owner pays themselves or which expenses are personal.
- **Record the owner-dependence question early.** Whether the business needs one replacement manager or three changes normalized EBITDA more than most add-backs. A note on how many roles the owner appears to fill, with its source, is useful long before financials arrive. For founder-run, owner-operated businesses, that profile is part of the screen, not just part of diligence.

Docket's agents record facts like these as typed answers with the quoted source page behind each one, and leave unanswered items visibly open.

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Links cited in this article, in order of first appearance. Full addresses are provided for readers using extracted text.

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