

Crimson Cardinal *Healthcare Intermediary*

a division of Crimson Cardinal Realty LLC

SDE FOR SMALL HEALTHCARE OPERATIONS

This article discusses what seller's discretionary earnings (SDE) or discretionary earnings (DE) is, why is it important to small healthcare providers, and how it is used in determining most probable selling price (MPSP). The [International Business Broker Association](#) defines DE as the adjusted earnings before taxes, interest income or expense, non-operating and non-recurring income and expenses, depreciation and other non-cash charges prior to deducting an owner's or officer's compensation. In short, it is the "bundle of benefits," before taxes, the primary owner gets because she is the owner.

DE is much more than Income

We distinguish DE from income. Income is a term defined by tax regulations. Income varies based on the owner's tax strategy. For example, assume two owners with the same revenue and expenses purchase a piece of equipment for \$10,000. Owner A takes advantage of the IRS Section 179 deduction and expenses the equipment in her current tax year. Owner B elects to depreciate the same piece of equipment over several tax years. All else equal, Owner B will show higher pretax income than Owner A even though the economic value of the two operations is the same. DE is important to small operators because it forms the basis of how most buyers decide what operation to purchase. Buyers should not rely upon the income of an operation since that figure can get manipulated for tax purposes and not reveal the true, economic value of the operation.

DE is no EBITDA

Some analysts argue that one can use earnings before interest, taxes, depreciation, and amortization (EBITDA) as the basis for determining MPSP. This method, however, does not reflect the true total benefit the owner is receiving from the operations. It does not include the benefit to the owner of receiving salary and other earnings. Even if one adjusts for owner's compensation, EBITDA still neglects to include other owner perks such as discretionary travel and entertainment, health and life insurance policies, payment to family members, and non-essential discretionary expenses. EBITDA is better suited for comparing larger operations.

DE and MPSP

DE is used commonly to calculate the MPSP of a small operation. It is a common denominator for measuring a small operation's benefit-generating ability across industries. Some analysts use the ratio of sales and MPSP as the measure for determining selling price. For operations under \$1 million in revenue, DE is a better barometer of what sellers and buyers are negotiating in their transactions. Most people looking to buy small operations are looking for jobs. They are looking for sustainable personal benefits (e.g., a paycheck and perks), cash flow to pay their business debts, and a reasonable rate of return on their invested capital (i.e., investment return on their down payment to buy the business). Sales as a common denominator may be better suited for larger acquisitions or strategic purchases.

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Many business intermediaries use historical statistics on DE and MPSP from a number of proprietary databases. Surprisingly, the relationship of DE to MPSP has remained stable over the past 15 years even though the DE/MPSP ratio varies greatly by industry (e.g., NAICS or SIC code). The DE/MPSP ratio for adult care and family care homes is quite different than the ratio for home care agencies. One should analyze the median DE ratio, review the data dispersion for goodness of fit characteristics, and examine other transaction characteristic to get a reasonable range of MPSP for the subject operation. While rules of thumb are publicly published, they are not a reliable resource for determining a subject MPSP.

DE for Small Healthcare Operations

We assume small healthcare operations as adult care home less than 50 beds, family care homes, local home care agencies, and dental and medical offices with no more than a few local operations. DE for these operations might include some of these items:

- Primary owner's draw or W-2 income
- Primary owner's bonus
- Primary owner's payroll tax
- Profit-sharing
- Below-market or above-market rental for primary space (for operators that own their space, these are payments made to these passive real estate entity)
- Retirement contributions
- Car allowance
- Travel and Entertainment (home care agency, medical offices)
- Health and life Insurance
- Adjustment for family member on the payroll or not on the payroll (adult care and family care facilities)
- Non-essential operating expenses