

BUSINESS VALUATION UPDATE

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The SDE Market Method: 'User Beware'

By Jim Turner, CPA, CVA (Turner Business Appraisers)

A recent Louisiana divorce case, *Reinsch v. Reinsch* (2025), highlights a danger when applying the price-to-sellers discretionary earnings method (P/SDE method) to owner-operated businesses: the tendency to add the return on owner's labor into cash flow to value the enterprise. This article serves as a guide to assist the valuation analyst in balancing the use of the method with economic theory, which emphasizes that the hypothetical buyer expects a return on equity commensurate with risk.¹ The P/SDE method used in isolation can be unreliable. This article proposes that valuation analysts develop at least one other cash flow method to test the sanity of their P/SDE method. The intent is not to disparage the method but to advocate for its rational deployment.²

Background. The P/SDE market method is one of the primary methods business brokers, business valuation analysts, and lending institutions use to value small businesses at fair market value. It is referenced in numerous valuation publications as a viable method for valuing small businesses. Furthermore, the comparable sales databases BIZCOMPS, ValuSource (f/k/a IBA), DealStats, and PeerComps all depict the P/SDE ratio as a multiplier for valuation purposes. However, an inherent issue within this method needs to be considered so that

users of the P/SDE method recognize the pitfall—especially if it is the sole method developed.

Foundation of the P/SDE method. At the foundation of the P/SDE method is the presumption that cash flow includes normalized earnings before interest, taxes, depreciation, and amortization (EBITDA) plus one owner's compensation. While this might seem intuitive for valuing small, "Main Street" businesses, this calculation is often flawed. The issue arises from the fact that most small businesses rely upon the owner's labor to generate operating cash flow. Thus, if the owner-operator's compensation is added back to EBITDA to calculate cash flow, then the owner's labor is reflected in the enterprise value of the business. It is allocating profits plus owners' compensation to value the business enterprise.

Theoretical issues. From a financial perspective, the return on *human capital* (wages for managing operating) is distinct from a return on *equity capital* (profit attributable to ownership.) These two returns have unique economic meanings. Labor income is earned by working. Enterprise value should reflect only the return available to ownership after paying market wages. The P/SDE method adds back owner compensation without replacing it with market compensation. It effectively combines the return on human capital and the return on equity capital and capitalizes both. Thus, relying solely on the P/SDE method can result in an unreasonably high valuation.

1 Shannon Pratt, *Valuing a Business*, 5th ed., New York, McGraw-Hill, Inc., p. 174.

2 The case is *Reinsch v. Reinsch*, La. App. LEXIS 2402 (La. App. 3 Cir. Dec. 10, 2025). Available at www.bvresources.com/products/bvlaw.

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From a valuation standpoint, enterprise value should reflect the return available to ownership after paying market-based compensation for required labor. Adding back owner compensation without substituting a reasonable market equivalent can, therefore, overstate the cash flow available to a hypothetical buyer.

Illustration: Superman CPA. Consider “Superman CPA,” founded by Clarke Kent. Mr. Kent is in a marital

Exhibit 1. Normalized Income Statement for Superman CPA

NORMALIZED INCOME STATEMENT	Amount
Revenue	\$500,000
Cost of goods sold	-
Gross margin	\$500,000
Operating expenses	
Advertising	25,000
Depreciation	5,000
Insurance	5,000
Legal and professional	5,000
Other deductons	25,000
Owners' compensation	95,000
Rent	30,000
Utilities	10,000
Wages—employees	295,000
Total operating expenses	495,000
Net income or (loss)	\$5,000
CASH FLOW METRICS	
EBITDA: net income + depreciation	\$10,000
SDE: (EBITDA: plus owners' compensation)	\$105,000
Net after-tax cash flow 21% (Metropolis)	\$10,000

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Exhibit 2. Value Returned

Value Conclusion by Method	Methods			
	Description	P/SDE*	P/EBITDA*	COE Method (22% equity cap rate) 1/22%**
Multiplier		2.3	4.2	4.55
Cash flow by method		\$105,000	\$10,000	\$8,950
Enterprise value (inventory, FF&E, and intangibles)		\$241,500	\$42,000	\$40,682

*DealStats 23 asset transactions MVIC of inventory, FF&E, and all intangible assets

**Capitalization of earnings method (often referred to as the single-period capitalization method)

dispute with his wife, Lois Lane. He needs a business valuation for equitable distribution proceedings. An analysis of Superman, CPA's normalized income statement is depicted in Exhibit 1.

The inputs are:

- Gross revenue, \$500,000;
- Normalized officers' compensation, 95,000;
- Normalized EBITDA, \$10,000;
- SDE, \$105,000; and
- Normalized after tax cash flow to equity, \$8,950 (calculated by subtracting 21% tax from net income).

Analysis of the balance sheet reveals adequate working capital and current assets equal current liabilities. There is no long-term debt.

As shown in Exhibit 2, the value the P/SDE method returned was \$241,500. The development of the P/EBITDA method yielded a value of \$42,000, or 475% less than the P/SDE method.

The capitalization of earnings (COE) method returned a value of \$40,682, which is in line with the P/EBITDA method. Thus, it appears the P/SDE method would overvalue the business.

To underscore the unreasonableness of the P/SDE valuation, the return on equity (Exhibit 3) for the P/SDE value is 3.70%, which is less than the risk-free rate of 4.63%.³

The principle of risk and reward. In valuation, risk and reward are positively correlated, meaning the higher the perceived risk, the higher the required return. Thus, it is a generally accepted valuation principle that the return on equity for a small private business should exceed the returns on small-cap publicly traded stocks, which have averaged approximately 14% to 15% annually since 1926.⁴

The return of less than 4% from the P/SDE method shows the magnitude of the error an analyst would make by relying on this method to value Superman CPA. A hypothetical buyer would not accept a return lower than the risk-free rate. In contrast, the returns calculated using the P/EBITDA of 21.31% and COE of 21.83% appear reasonable.

A court weighs in. In *Reinsh v. Reinsh*, a Louisiana appellate court affirmed a decision the trial court made that normalized wages of a business owner should not be added back to determine cash flow to the enterprise. The marital dissolution case arose from an equitable distribution dispute between the

³ Kroll Cost of Capital Navigator, Feb. 19, 2026, by subscription only.

⁴ Ibid.

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Exhibit 3. Return on Equity

Return on Equity	Method		
	Description	P/SDE	P/EBITDA
Value indicated by method (rounded)	\$242,000	\$42,000	\$41,000
Net after-tax cash flow	\$8,950	\$8,950	\$8,950
Return on equity	3.70%	21.31%	21.83%

couple, who owned a small electrical services business. The husband was the only licensed electrician the company employed, and the wife was the bookkeeper prior to the parties' separation.

Each spouse hired a valuation analyst. The wife's valuator developed the P/SDE method and utilized a rule of thumb to value the business. He calculated SDE cash flow between \$203,333 and \$220,000. Using an SDE multiple of 3x, his conclusion was a fair market value between \$610,000 and \$660,000. The comparable sales data were obtained from BIZCOMPS.

The husband's valuation analyst developed an income approach and a market approach. He normalized the officer's compensation using the RCReports' compensation database. The adjustment, which averaged \$114,874 per year, significantly reduced normalized cash flow leading to a lower value. The equity conclusion of value the husband's expert developed was \$73,500.

The court of appeals affirmed the trial court's valuation of the business at \$73,500. The opinion included a critique by the husband's valuation analyst, which sheds light on the primary issue. "In doing his valuation...[he] added back Mr. Reinsch's salary to his cash flow number, and by doing that, there's nobody to run the company. Instead of subtracting he should have left the salary in there, and he should have added some more to it which would have brought his cash flow number down, and that's the main difference."

To sum up, the court did not reject market-based methods such as SDE multiples. Rather, it accepted the husband's expert's analysis because it incorporated a normalization adjustment for reasonable compensation—based on market data (RCReports)—reflecting the economic reality that a buyer would need to replace the owner's labor.

Fair market value. The fair market value standard is a hypothetical construct between a hypothetical and willing buyer and a hypothetical willing seller neither under any compulsion to act and both aware of all material facts. While actual transactions provide important empirical evidence, observed prices do not necessarily equate to fair market value when participants lack complete information or rely upon unconventional pricing models. When pricing metrics imply returns inconsistent with risks inherent in ownership of small private businesses, valuation analysts should consider whether the observed transactions reflect investment value or imperfect market conditions rather than fair market value. Furthermore, if the P/SDE pricing metrics result in a value at which level the buyer will not receive a return commensurate with the risks of small business ownership, then the valuation analyst should consider whether the resulting value from this method is at the investment standard of value (value to a specific buyer, based on their individual expectations (rational or not)).

Conclusion. The P/SDE method is a generally accepted method to value small businesses, but the results should be used with caution. It is prudent to test the reasonableness of this method with the P/EBITDA market method or an income approach. If the value

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arrived at using this method is too high, then the return on equity will be less than the rate a hypothetical buyer requires.

The *Reinsch* case underscores the importance of understanding the deficiencies of the P/SDE method. This case supports the valuation principle that a hypothetical buyer requires a return on the operating enterprise exclusive of the return on labor. Although market data are collected from actual transactions, observed prices do not necessarily equate to fair market value when participants lack complete information or rely upon heuristics. If implied returns are inconsistent with

the risks inherent in small-business ownership, the market data may reflect transactions at the investment standard of value or imperfect market conditions. ♦

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