

# What Is SDE and Why It Drives Business Value

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## SBA Valuation Insights Series

Whether you follow business news through outlets like the Wall Street Journal, Barron's, CNBC, or Fox Business, you are constantly hearing about different earnings metrics—EBITDA, pre-tax income, free cash flow, and others.

### **One metric you will almost never hear discussed: Seller's Discretionary Earnings, or SDE.**

The reason for that is simple. Most of what is covered in the business media relates to larger companies. But in the SBA world, we are dealing with a very different type of business.

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Businesses are often grouped into a few broad categories based on size. These ranges are not exact, but they provide a helpful framework:

- **Main Street:** Generally, under \$10 million
- **Lower Middle Market:** Roughly \$10 million to \$50 million in revenue
- **Middle Market:** Roughly \$50 million to \$500 million in revenue
- **Large / Institutional:** \$500 million+ in revenue

These categories are not universally defined, but they are useful for understanding how businesses are typically analyzed and valued.

**In the SBA ecosystem, we live almost entirely in the Main Street world.** That distinction matters, because Main Street businesses are valued differently than larger companies, and the earnings metrics used reflect that.

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While there is no formal definition, Main Street businesses typically share several common characteristics:

- The business generates revenues generally below \$10 million
- The owner actively works in the business as an owner-operator
- The business operates out of a single location or within a defined region, with a primarily local customer base
- The buyer is typically seeking income replacement rather than passive income



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# What Is SDE and Why It Drives Business Value

**The last bullet point is critical**, because determining how much the owner of a Main Street business gets to keep is what drives value.

SDE combines the profits of the business and the owner's compensation into a single number, providing a clear picture of the total financial benefit available to a new owner. This includes:

- Salary
- Perks
- Distributions
- Dividends

**In essence, SDE represents the amount a buyer could expect to earn from operating the business.**

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When we are writing a report, we need to comb through the financials to determine what is included in the SDE calculation.

The SDE calculation is actually very similar to the calculation of EBITDA. If you are reading this article, then you are likely to know what EBITDA stands for (Earnings Before Interest Taxes Depreciation & Amortization).

**SDE is similar in concept to EBITDA, but it adjusts for owner compensation and other items to reflect the total benefit to a working owner.**

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The obvious biggest part of the SDE calculation is the salary that the owner pays themselves in many cases.

At first glance, it may seem like the owner's compensation does not matter, since it is added back to pre-tax earnings. However, a valuator should normalize the owner's salary to a reasonable figure.

In practice, this is generally in line with an operations manager or a chief executive officer considering the size, scope and industry of the business being valued. We will discuss later why that is important.

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But there are other items that need to be thrown into that calculation as well. This requires further adjustments and things can get confusing when determining the final figure.

**It is helpful to distinguish between business-level normalization adjustments and owner-specific adjustments** when developing Seller's Discretionary Earnings (SDE).



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Business-level normalization adjustments include items such as non-recurring or one-time expenses, discretionary expenses, and non-operating items. These adjustments are made to reflect the ongoing earning power of the business and would generally be applied regardless of whether the buyer is an owner-operator or a passive investor.

In contrast, **owner-specific adjustments** are those tied directly to the current ownership structure. These typically include owner compensation and owner-related benefits.

The percentage of the owner's health insurance premium paid by the company is part of this calculation. Additionally, the Company's contribution to the owner's retirement plan is also part of it.

That level of detail is often not visible in tax returns or even internal financials where more details are available. However, it is part of the equation and to not include it may understate the value of the business.

**The distinction is important because SDE is intended to reflect the total economic benefit available to a working owner**, whereas broader normalization adjustments are focused on the performance of the business itself.

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## **EBITDA is a more relevant earnings metric for a larger business.**

As businesses get larger, the role of the owner changes. In many cases, the business is no longer dependent on a single owner-operator but instead is run by a management team. Because of that, buyers are not focused on replacing the owner's income—they are focused on the performance of the business itself.

That is why EBITDA becomes the primary earnings metric. It reflects the profitability of the business before the impact of how it is financed, taxed, or structured, and it assumes that management is already in place at market levels.

**In other words, it shows what the business earns as a standalone operation, separate from any one individual.**

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As we discussed, if the owner salary portion of the SDE calculation is normalized to a reasonable level, the market will often price a business at similar values whether it is valued at an SDE multiple (usually  $\approx 3.0x$ ) or EBITDA multiple (usually  $\approx 4.0x$ ).

Of course, this is not always the case but more often than not.



# What Is SDE and Why It Drives Business Value

**At the end of the day, SDE is simply a way to measure what a Main Street business actually produces for a working owner.**

It brings together the profits of the business, the owner's compensation, and any reasonable adjustments into a single number that reflects the true earning power of the operation.

**Understanding that concept is critical in the SBA world**, because it is the foundation for how these businesses are valued, how deals are structured, and ultimately whether a transaction makes sense.

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