



How Professional Buyers Value a Business

Introduction: How Business Value Is Determined

In the United States, the private M&A market sees tens of thousands of business transactions every year, ranging from small Main Street shops to large private equity-backed enterprises. Unlike public companies whose share prices are set by markets every second, **private business valuation is part art, part science** and it follows a structured process that sophisticated buyers use consistently. Because no public exchange sets the price, the value of a privately held company has to be built from the ground up, using comparable transactions, detailed cash-flow analysis, and a careful assessment of operational risk.

At its core, a buyer is asking one question: **What is this stream of future cash flows worth to me today?** The answer depends on how much cash the business generates, how reliable and growing that cash flow is, and what return on capital the buyer requires to justify the investment risk. Every valuation methodology whether EBITDA multiples, LBO model, discounted cash flow, or revenue multiples, is ultimately trying to answer that same question. In practice, the more predictable, diversified, and defensible that cash flow is, the more a buyer is willing to pay for every dollar of it.

This document explains the **three pillars of U.S. business valuation**: (1) EBITDA as the universal measure of operating profitability, (2) valuation multiples as the market-derived pricing mechanism, and (3) the step-by-step algorithm buyers apply to arrive at a final offer price. Each section that follows examines one of these pillars in turn, so that by the end you can see how a sophisticated acquirer moves from a set of financial statements to a concrete offer price.



EBITDA: The Foundation of Business Valuation

What Is EBITDA?

EBITDA stands for **Earnings Before Interest, Taxes, Depreciation & Amortization (D&A)**. It has become the dominant metric in U.S. lower middle market M&A because it approximates a business's operating cash generation independent of its capital structure (how it is financed), tax situation, and accounting choices around depreciation.

EBITDA Formula

$$= \text{Net Income} + \text{Other Expenses} - \text{Other Income} + \text{Interest} + \text{Taxes} + \text{D\&A}$$

Strips away financing and accounting effects to reveal true operating performance

For example, if Company A has \$10M in revenue, net income of \$800K, other expenses of \$100K, other income of \$100K, interest expense of \$200K, taxes of \$300K, and D&A of \$400K, **its EBITDA is \$1.7M** - the number buyers will price the business on.

Adjusted EBITDA ("Normalized" EBITDA)

In practice, buyers never use raw reported EBITDA. Instead, they require sellers to present **Adjusted EBITDA**, also called **Normalized EBITDA** or **Recasted EBITDA**. This involves identifying positive or negative addbacks - non-recurring, non-operational, or owner-specific items that artificially inflate or deflate reported expenses.

Adjusted EBITDA

$$= \text{EBITDA} + \text{Positive Addbacks} - \text{Negative Addbacks}$$

Addbacks adjust for owner perks, one-time items, and non-arm's-length transactions

Common Addbacks Include:

- Owner's compensation - in owner-operated businesses, the owner may take little or no formal salary; the addback normalizes compensation to a market-rate management salary.
- Personal expenses run through the business (vehicles, travel, insurance).
- One-time legal settlements, consulting fees, or restructuring costs.
- Non-recurring revenue or unusual gains/losses.
- Rent paid above or below fair market value to related parties.

Trailing Twelve Months vs. Forward EBITDA

Buyers typically anchor on Trailing Twelve Months (TTM) EBITDA, the most recent twelve months of actual performance, as the base. In fast-growing businesses, sellers may negotiate to also consider a blended TTM forward projection, particularly when recent investments in headcount or technology are expected to drive near-term EBITDA expansion.

The Role of an Experienced Advisor in EBITDA Negotiations

A highly experienced M&A advisor makes a critical difference on the EBITDA baseline used in negotiations. Without representation, the buyer defaults to the TTM EBITDA as the anchor, which ignores the forward trajectory of the business entirely. A skilled advisor reframes the conversation: they present the business on Forward EBITDA, documenting why earnings are growing, what investments are already made, and what the next 12-24 months will realistically look like based on existing contracts and customer momentum.

Buyers are willing to price future earnings, but only when those projections are credible, auditable, and professionally presented. **An advisor who can credibly defend Forward EBITDA with evidence can materially increase the value of the entire transaction.** This is frequently the single largest value driver in a sale process.

The EBITDA Multiple: Translating Earnings Into Value

What Is a Valuation Multiple?

Once Adjusted EBITDA is established, buyers apply a multiple to determine **Enterprise Value**. The multiple is a compression of the market's collective view on risk, growth potential, and business quality. **A multiple of 5x** means the buyer is willing to pay 5 years' worth of current EBITDA for the business.

Enterprise Value

= Adjusted EBITDA × Multiple

E.g., \$2M EBITDA × 6x = \$12M Enterprise Value

It is critical to understand what a multiple actually represents: it is **a simplified, shorthand approximation of a full fundamental valuation**, not the valuation itself. The multiple condenses what a buyer's LBO model or DCF analysis would produce into a single readable number. In practice, the buyer always runs the underlying model; the multiple is how they communicate the result and benchmark it against the market.

Even if another company in the same industry sold at a 5x multiple, that does not mean your company will have the same multiple. Every business differs in **size, growth, profitability, and management strength**, and each of these factors feeds directly into the fundamental financial model buyers use, so the multiple that model produces for your business may be higher or lower .

Key Insight: The Multiple Is the Result, Not the Starting Point

The model produces the business's value, its Enterprise Value, and dividing that Enterprise Value by EBITDA yields the multiple.

What the market quotes as '5x-7x industry range' is a statistical average of what those models produced across comparable transactions - not a guarantee of what yours will produce.

The multiple is not constant: it shifts based on growth rate, margin profile, capital intensity, revenue quality, and buyer competition. Two businesses in the same industry with identical EBITDA can trade at very different multiples.

Final price always comes from the underlying LBO or DCF model that uses your company's detailed financials.

How Buyers Actually Arrive at the Multiple: LBO Reverse Engineering

Private equity buyers approach valuation through **reverse engineering**. They start from their required return (typically 20%+ IRR over a 5-year hold), assume a financing structure (often 50% equity / 50% debt), model the business's projected cash flows and debt paydown over the hold period, and solve backwards for the **maximum entry price** they can pay to hit their return target. That entry price, divided by the EBITDA, produces their multiple.

The multiple may be used as an input during valuation analysis, but it **ultimately becomes an output of the underlying financial model**. Sophisticated sellers understand this distinction because it tells them exactly what levers to pull to command a higher price: grow EBITDA, improve margin, build recurring revenue, reduce customer concentration, and make the growth story credible.



The EBITDA Multiple: Benchmarks and Drivers

Industry Multiple Benchmarks in the U.S. (2025-2026)

Industry (EV \$10M-\$100M)	Starting Point	Size Adjustment	Growth Premium	Typical EBITDA Multiple
Manufacturing	4.5x - 6.5x	-1x to +1x	-0.5x to +1.5x	3x - 9x
Business Services	6x - 9x	-1x to +1x	-0.5x to +1.5x	4.5x - 11.5x

Note: EV stands for Enterprise Value.

Factors That Move the Multiple

The multiple is not a fixed number, it is **a negotiated range influenced by specific business quality factors**. Buyers evaluate each factor and adjust their multiple accordingly:

- **Revenue Concentration:** A business deriving more than 20% of revenue from a single customer trades at a discount; well-distributed revenue commands a premium.
- **Recurring Revenue:** Subscription, contract, or recurring revenue models earn 1x-3x higher multiples than project-based businesses of similar EBITDA.
- **Management Team:** If the business can run without the owner and has a tenured management team, buyers pay significantly more. Key-man risk is one of the largest discounts applied.
- **Growth Trajectory:** Businesses growing 10%+ annually command premium multiples vs. flat or declining performers.
- **Competitive Moat:** Proprietary technology, patents, exclusive contracts, or brand recognition add multiple premium.
- **Market Dynamics:** Buyers pay more when capital is cheap (low interest rates) and competition for deals is high. Rising rate environments compress multiples.



How Buyers Model Value: LBO and DCF Explained



The LBO Model (Private Equity Buyers)

A **Leveraged Buyout (LBO)** model is the primary valuation tool for private equity firms. The mechanics are straightforward: the buyer acquires the business using a mix of equity (their own capital) and debt (borrowed from banks or credit funds), operates and grows the business over a 3-7 year hold period, then sells it, ideally at a higher multiple, and repays the debt, keeping the equity upside.

A typical lower middle market LBO structure in the U.S. today involves an approximately equal split between debt and equity. The PE firm targets a 20-25%+ **Internal Rate of Return (IRR)** on their equity invested. The model works backwards: given the projected exit value and the required IRR, what is the maximum price they can pay to enter?

LBO Valuation: Simplified Mechanics

- Structure: ~50% equity from the PE fund, ~50% debt from lenders (senior bank debt + mezzanine/subordinated notes).
- Hold period: typically 5 years.
- Target return: 20%+ IRR on invested equity (often 2.0x-3.0x MOIC - Multiple on Invested Capital).
- Key model inputs: revenue growth, profitability, capital-expenditure needs, and the amount of debt the business can support.
- Maximum entry price: back-solved from the required IRR.

Enterprise Value

$$= \text{Adjusted EBITDA} \times \text{Multiple}$$

This is Enterprise Value, not Equity Value, the two are commonly confused

Equity Value

$$= \text{Enterprise Value} - \text{Net Debt}$$

Net Debt = Debt - Cash. Lower middle market deals are usually done on cash-free debt-free basis; the seller repays the debt and keeps the cash at closing

The DCF Model (Strategic Buyers)

A **Discounted Cash Flow (DCF)** analysis is the primary tool for strategic acquirers (corporations buying competitors or complementary businesses). The DCF does not rely on leverage. Instead, it asks: what is the present value of all future free cash flows this business will generate, discounted at my cost of capital?

The DCF is theoretically the most rigorous valuation method, but it is highly sensitive to assumptions, particularly the **terminal growth rate** and the **discount rate (WACC)**. Small changes in these inputs produce large swings in value, which is why practitioners treat DCF as a sanity check and a range of values, not a precise number.

A dollar today is worth more than a dollar tomorrow. A DCF projects the business's future free cash flows and discounts them back to today at the Weighted Average Cost of Capital (WACC), the blended cost of its debt and equity, then adds a discounted terminal value, to estimate what the business is worth today.

If the LBO valuation is higher, the business likely has strong cash flow, low capital requirements, and significant debt capacity, making it especially attractive to private equity buyers. If the DCF valuation is higher, the business's value is driven more by long-term growth than by near-term cash generation, or it may require substantial capital investment or have limited leverage capacity, reducing the price a financial buyer can justify paying.



Estimate Your Enterprise Value

Apply these valuation principles to your own business.



Use Meliora's Valuation Calculator



The Buyer's Valuation Algorithm: Step-by-Step

Sophisticated buyers, private equity firms, family offices and strategic acquirers, follow a **structured algorithm** to arrive at their offer. Below is the **standard 6-step process** used in U.S. lower middle market M&A:

	Stage	What Buyers Do
Step 1	Calculate Reported EBITDA	$EBITDA = \text{Net Income} + \text{Other Expenses} - \text{Other Income} + \text{Interest} + \text{Taxes} + \text{D\&A}$.
Step 2	Calculate Adjusted EBITDA	Adjusted EBITDA = Reported EBITDA $\pm$ adjustments, for example, owner's salary above or below the market rate, one-time expenses, personal expenses run through the business, and non-recurring revenue or costs.
Step 3	Determine the Base Multiple	Research comparable transactions (comps) in the same industry and size range. Use M&A databases (PitchBook, Capital IQ, BizBuySell, IBBA data) to establish a baseline multiple range. Note: the multiple is preliminary, the final price is derived from the LBO or DCF model.
Step 4	Apply Quality Adjustments	Adjust the multiple up or down based on: customer concentration, recurring revenue percentage, management team strength, growth trajectory, market position, proprietary IP or defensible moat, and geographic diversity.
Step 5	Calculate Enterprise Value	Enterprise Value (EV) = Adjusted EBITDA $\times$ Adjusted Multiple. This is the initial reference point. PE buyers then validate through an LBO model; strategic buyers validate through a DCF. Ultimately, the buyer's financial model determines the price they can pay.
Step 6	Validate with LBO (PE buyers) and DCF (Strategics)	PE buyers run an LBO model: typically 50% equity / 50% debt financing, targeting a 20%+ IRR over a 5-year hold. They back-solve the maximum entry price from that return requirement. Strategic buyers run a DCF: project free cash flows 5-7 years, apply a terminal value, discount at WACC. Both methods act as a ceiling on what the buyer will pay.

Earnouts: Bridging the Valuation Gap

When buyers and sellers disagree on forward earnings expectations, they sometimes use an **earnout**, a contingent payment tied to the business achieving specific future performance milestones (e.g., "We will pay an additional \$1M if EBITDA exceeds \$2.5M in Year 1 post-closing"). Earnouts are common in deals where the seller projects aggressive growth and the buyer is unwilling to pay for it upfront. They come with significant complexity around definition of metrics, accounting treatment, and management control, and are frequently litigated. Buyers should approach earnouts with clear legal drafting; sellers should understand that earnouts are never guaranteed. Well-structured earnout can bridge a genuine gap in expectations and keep a deal moving forward, while a poorly drafted one often becomes a source of post-closing disputes, so the precise wording of the milestones, the accounting definitions, and the degree of control the seller retains over the business all deserve careful attention before any agreement is signed.



Conclusion:

What Sellers Need to Understand

Business valuation is **not a single formula but a structured process** combining financial normalization, market-derived multiples, balance sheet adjustments, and risk assessment. The highest purchase prices go to businesses that demonstrate clean, audited or reviewed financials, high and growing Adjusted EBITDA, recurring revenue with diverse customer bases, strong management teams that reduce key-person dependency, and a strategic rationale for the buyer. Sellers who understand the buyer's algorithm are better positioned to prepare their businesses for sale, negotiate effectively on multiple determinants, and avoid surprises during due diligence. Engaging a **quality of earnings (QoE) accountant** and an **experienced M&A advisor** before going to market typically adds more to the final sale price than their fees cost because both sides are ultimately negotiating on the same data, and preparation determines who controls the narrative.

Key Takeaways

- EBITDA is the universal measure of operating profitability; adjust it (positive and negative addbacks) before applying any multiple.
- The EBITDA multiple is a simplified approximation of a full fundamental valuation; the real price is derived from an LBO or DCF model.
- Seeing a 5x industry multiple does not mean your business is worth 5x; the final multiple is the output of the buyer's financial model applied to your specific numbers.
- PE buyers use LBO models (50/50 debt-equity, 20%+ IRR target), strategic buyers use DCF (WACC-discounted free cash flows) - both set the ceiling on price.
- Enterprise Value = Adjusted EBITDA x Multiple, Equity Value = EV – Net Debt (Debt – Cash).
- An experienced advisor repositions negotiations from TTM EBITDA to Forward EBITDA and that single shift is frequently the biggest value driver in the process.

Sources & References: PitchBook M&A Data, IBBA Market Pulse, Duff & Phelps Valuation Handbook, Damodaran Online (NYU Stern), Investment Banking by Rosenbaum & Pearl (3rd Ed.)



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