TECHNICAL PRIMER

Valuation & Deal Financing

How to put a price on a small business, how that price gets paid, and how debt turns an ordinary company into a high-return investment.

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Entrepreneurship Through Acquisition at Indiana University Bloomington · October 2026

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HOW TO USE THIS PRIMER

Read each section in order; later sections reuse the numbers from earlier ones. Every formula is followed by a worked example. Work the examples yourself with a calculator or Excel before reading the answer, then use the interview questions at the end of each section to test yourself. Sections 2, 5 and 6 are the most common in technical interviews for investment banking and private equity. You are not expected to master every detail: the goal is a basic understanding of each concept, and the extra depth is here for when you want it.

A buyer of a small business has to answer two questions. What is the company worth? And where does the money come from? This primer covers both, in the order a deal actually works: define value, estimate it two ways, turn it into a price with terms, fund that price, and measure what the buyer earns.

Section	The question it answers
1. Enterprise value and equity value	What exactly is being priced?
2. Valuation by multiples	What do similar businesses sell for?
3. Discounted cash flow	What are this business's future cash flows worth today?
4. From value to price: deal structure	How much is paid at closing, and how much later or conditionally?
5. Financing the deal	Who provides the money, and what rules apply?
6. Leverage and returns	What does the buyer earn, and what can go wrong?

One illustrative company runs through the whole primer: a service business with **$650,000 of adjusted EBITDA** that a buyer acquires for **$3,000,000**. The figures were built for teaching and tie to the deal used in the ETA at IU Class 1 materials.

1. Enterprise Value and Equity Value

1.1 Two different numbers

> **Enterprise value (EV)** is the value of the whole operating business, regardless of how it is financed. **Equity value** is what belongs to the owners after the company's debts are paid and its cash is added back.

The two are easy to confuse because a company has both at once. A house is the simplest comparison. A house worth $400,000 is worth $400,000 whether the owner has a mortgage or not; that is the enterprise value. If the owner still owes $250,000 on the mortgage, the owner's stake is $150,000; that is the equity value.

FORMULA: THE BRIDGE

Equity value = Enterprise value − Debt + Cash

In larger companies the bridge also subtracts preferred stock and minority interests. For a small private business, debt and cash are almost always the only items that matter.

WORKED EXAMPLE

A buyer agrees to pay $3,000,000 for a company. The company owes $500,000 on an equipment loan and has $200,000 in the bank.

Line	Amount
Enterprise value (the agreed price)	$3,000,000
(−) Equipment loan repaid at closing	($500,000)
(+) Cash the seller keeps	$200,000
Equity value: what the seller actually receives	**$2,700,000**

Illustrative.

1.2 Cash-free, debt-free pricing

Most small-business deals are quoted **cash-free, debt-free**. The buyer agrees to an enterprise value. At closing the seller uses part of the proceeds to pay off the company's loans and keeps the cash in the bank account. The buyer receives a company with no debt and a normal level of working capital (Section 4.4). This is why a seller who hears "$3 million" may take home much less: the debt comes out of their check.

1.3 A real example: Microsoft and LinkedIn

In June 2016 Microsoft agreed to acquire LinkedIn for $196 per share in cash, a total of about $26.2 billion. That headline number is an **equity value**: share price times shares. LinkedIn also held several billion dollars of cash and investments and had convertible debt outstanding, so its enterprise value differed from the headline. Public-company deals are usually announced as equity value; private-company deals are usually negotiated as enterprise value. When you compare deals, make sure you are comparing the same number.

INTERVIEW QUESTIONS

Why do multiples like EV/EBITDA use enterprise value and not equity value?

EBITDA is earned before interest, so it belongs to everyone who funds the business, lenders and owners alike. Enterprise value is also the value to all funders. Matching a pre-interest measure to equity value would make two identical businesses look different just because one borrowed more.

A company has an enterprise value of $10M, $3M of debt and $1M of cash. What is its equity value?

$10M − $3M + $1M = $8M.

If a company raises $2M of new debt and keeps the cash on its balance sheet, what happens to enterprise value?

Nothing. Debt rises by $2M and cash rises by $2M, so they cancel. Equity value is also unchanged. Value only changes when the money is spent on something that changes the business.

2. Valuation by Multiples

2.1 The idea

A valuation multiple expresses price as a multiple of an earnings measure. If similar businesses have sold for about 5 times their EBITDA, a reasonable starting value for this one is about 5 times its EBITDA.

FORMULA

Enterprise value = Earnings measure × Multiple

For businesses with more than roughly $1M of EBITDA, the measure is usually **adjusted EBITDA**. For smaller owner-run businesses it is often **SDE** (seller's discretionary earnings), which adds back the owner's own salary. Primer 1 explains both. Never apply an EBITDA multiple to SDE: SDE is larger, so the result will overstate value.

2.2 What real deals trade at

Stanford GSB's 2026 study of search funds, the largest dataset on small-company acquisitions by first-time CEOs, reports a median purchase price of about $16 million, paid for companies with a median of about $8.1 million of revenue and $2.5 million of EBITDA. That is roughly **6.2x EBITDA** (as summarized by Five Experts). Smaller businesses, such as those bought with SBA loans, generally sell for lower multiples, because they are riskier: they depend more on the owner, a few customers or a few employees.

2.3 What moves a multiple up or down

Factor	Higher multiple when…	Lower multiple when…
Size	EBITDA is larger, so one lost customer matters less	EBITDA is small and fragile
Revenue quality	Revenue recurs under contract (service agreements, subscriptions)	Each sale must be won again
Customer concentration	No customer is more than about 10% of revenue	One customer is 30% or more
Owner dependence	A manager runs daily operations	The owner holds every relationship
Growth	Revenue has grown steadily for years	Revenue is flat or falling
Capital needs	Little equipment spending is required	Trucks or machines must be replaced often

WORKED EXAMPLE

Our company has $650,000 of adjusted EBITDA. Comparable small service businesses have recently sold for 4.0x to 5.0x.

Multiple	Calculation	Enterprise value
4.0x (low end)	$650,000 × 4.0	$2,600,000
4.6x (agreed)	$650,000 × 4.6	$2,990,000 ≈ $3.0M
5.0x (high end)	$650,000 × 5.0	$3,250,000

The buyer argues for the low end by pointing to risks (a large customer, an owner who handles all sales). The seller argues for the high end by pointing to strengths (ten-year customers, recurring contracts). They settle near $3.0 million, which is 4.6x.

Illustrative.

2.4 The danger in multiples: the earnings must be real

A multiple multiplies every error. If the seller reports $750,000 of EBITDA but a quality of earnings review (Primer 2) finds only $650,000 is real, at 4.0x the price should fall by $100,000 × 4.0 = **$400,000**. That is why buyers spend tens of thousands of dollars checking earnings before they close.

INTERVIEW QUESTIONS

Why might two companies with the same EBITDA sell for different multiples?

Because the multiple prices risk and growth. The one with recurring revenue, no customer concentration, a management team and steady growth is safer and will grow, so a buyer pays more for each dollar of today's earnings.

What are the two main types of multiples-based valuation?

Trading comparables (what similar public companies are worth today) and precedent transactions (what buyers paid for similar companies in past acquisitions). For small private businesses, precedent transactions are far more relevant, because public companies are much larger and more liquid.

Why do acquisition multiples usually exceed trading multiples?

An acquirer buys control: it can change strategy, cut costs and combine operations. It pays a control premium for that right.

3. Discounted Cash Flow

3.1 The idea

A discounted cash flow (DCF) valuation estimates the cash a business will produce in the future and converts it into today's dollars. It values the business on its own forecast, not on what other businesses sold for.

A dollar received in five years is worth less than a dollar today, because today's dollar could be invested in the meantime and because the future dollar might not arrive. The **discount rate** captures both. For a small private company, buyers use a high rate, often 20% or more, because the risk is high.

FORMULA

$$\text{Present value} = \text{Cash flow} \div (1 + r)^n$$

r is the discount rate and **n** is the number of years until the cash arrives. A DCF adds up the present value of each forecast year, plus a terminal value for everything after the forecast.

FORMULA: TERMINAL VALUE (GROWING PERPETUITY)

$$\text{Terminal value} = \text{Final-year cash flow} \times (1 + g) \div (r - g)$$

g is the long-run growth rate, which must be lower than r and should not exceed the long-run growth of the economy (about 2–4%). The terminal value is itself at year n, so it must be discounted back too.

3.2 Step-by-step DCF

WORKED EXAMPLE

The company produced $500,000 of free cash flow last year (cash after taxes and equipment spending). Assume it grows 5% a year for five years, then 3% a year forever. Discount rate: 20%.

Year	Free cash flow	Discount factor $1 \div 1.20^n$	Present value
1	$525,000	0.8333	$437,500
2	$551,250	0.6944	$382,813
3	$578,813	0.5787	$334,961
4	$607,753	0.4823	$293,091
5	$638,141	0.4019	$256,454
Sum of present values, years 1–5			**$1,704,819**

Terminal value at year 5 = $638,141 × 1.03 ÷ (0.20 − 0.03) = $657,285 ÷ 0.17 = **$3,866,382**.

Discount it to today: $3,866,382 × 0.4019 = **$1,553,812**.

Enterprise value = $1,704,819 + $1,553,812 = **$3,258,631**, about $3.26 million.

The multiples approach gave $2.6M to $3.25M. The DCF lands at the top of that range. When two methods roughly agree, a buyer can be more confident in the range; the final price still comes from negotiation.

Illustrative.

3.3 Sensitivity: why a DCF is a range, not a number

Small changes in the discount rate and growth rate move a DCF a lot. Bankers always show a sensitivity table.

Discount rate ↓ / Terminal growth →	2%	3%	4%
18%	$3.56M	$3.70M	$3.86M
20%	$3.16M	$3.26M	$3.37M
22%	$2.83M	$2.91M	$2.99M

Notice that almost half the value (about $1.55M of $3.26M) comes from the terminal value: years the forecast does not even show. That is the main weakness of a DCF for a small company, and the reason small-business buyers lean more on multiples and on whether the cash flow can pay the debt (Section 5).

INTERVIEW QUESTIONS

Walk me through a DCF.

Forecast free cash flow for five to ten years. Estimate a terminal value at the end of the forecast, using either a perpetual growth rate or an exit multiple. Discount the yearly cash flows and the terminal value to today at a rate that reflects the risk (for a large company, its WACC). The sum is enterprise value. Subtract debt and add cash to get equity value.

What happens to a DCF value if the discount rate rises?

It falls, because every future dollar is divided by a larger number. In the table above, moving from 20% to 22% cuts value by about $350,000.

Why must the terminal growth rate be below the discount rate?

The formula divides by (r − g). If g equals r the value is infinite, and if g exceeds r it is negative. Economically, no business can grow faster than the economy forever.

4. From Value to Price: Deal Structure

4.1 Price is more than a number

Two offers at the same headline price can be worth very different amounts to a seller. What matters is how much is paid in cash at closing, how much is paid later, and how much depends on future results. Structure is the tool buyers and sellers use to close the gap when they disagree on value.

4.2 Seller note

A seller note is a loan from the seller to the buyer: the seller accepts part of the price as an IOU, repaid over time with interest.

It helps the buyer finance the deal, and it keeps the seller invested in a smooth handover. In an SBA deal, a seller note on **full standby** (no payments, not even interest, while the bank loan is outstanding) can count toward the buyer's required equity (Section 5.3).

4.3 Earnout

An earnout is part of the price paid later only if the business hits agreed targets after closing.

WORKED EXAMPLE

The seller says the business is worth $3.5M because revenue is about to grow. The buyer will pay $3.0M based on current earnings. They agree on $3.0M at closing plus $500,000 in year 2 if revenue exceeds $5M.

Year 2 revenue	Earnout paid	Total price
$5.4M (target hit)	$500,000	$3.5M
$4.6M (target missed)	$0	$3.0M

The buyer pays the higher price only if the seller's forecast comes true. Because the buyer runs the company after closing, earnouts often cause disputes; the target must be simple and clearly defined. SBA loans generally do not permit earnouts in the purchase price, so they appear more in deals financed without SBA debt.

Illustrative.

4.4 Working capital peg

Net working capital (NWC) = accounts receivable + inventory − accounts payable. **The peg** is the normal level of NWC the seller must leave in the business at closing, usually the trailing 12-month average.

FORMULA

Price adjustment = Actual NWC at closing − Peg

Positive: the buyer pays more. Negative: the price falls. The peg stops a seller from collecting every receivable and delaying every bill just before closing, which would leave the buyer to refill the business with cash.

WORKED EXAMPLE

Month-end NWC averaged $400,000 over the last year, so the peg is $400,000. At closing: receivables $250,000, inventory $180,000, payables $80,000.

NWC = $250,000 + $180,000 − $80,000 = $350,000. That is $50,000 below the peg, so the price falls by **$50,000**.

Illustrative.

4.5 Escrow and indemnification

In the purchase agreement the seller makes formal statements of fact (**representations and warranties**), such as “there are no pending lawsuits.” If one proves false, the seller must repay the buyer’s loss (**indemnification**). To make sure that money exists, part of the price is held by a neutral third party (**escrow**), commonly for 12–24 months.

WORKED EXAMPLE

On a $3.0M price, $300,000 (10%) is held in escrow for 18 months. An undisclosed $80,000 tax bill appears. The buyer is paid $80,000 from escrow, and the seller receives the remaining $220,000 when the escrow ends.

Illustrative.

INTERVIEW QUESTIONS

A seller wants $10M and you think the business is worth $8M. How can you still reach a deal?

Pay $8M at closing and make up the gap with terms that only pay out if the seller is right: an earnout tied to future results, or a seller note that the business repays from its own cash flow. The seller gets their headline price only if the business performs.

Why would a seller accept a seller note?

It can get the deal financed and close, it may support a higher total price, and it earns interest. The cost is risk: if the business fails, the note may not be repaid.

5. Financing the Deal

5.1 The capital stack

The capital stack lists everyone who funds a deal in order of who is repaid first. Senior debt (the bank) is repaid first and takes the least risk; equity (the owner) is repaid last and takes the most.

Layer	Typical provider	Repaid	Risk and expected return
Senior debt	Bank, often with an SBA 7(a) guarantee	First	Lowest; earns interest
Subordinated debt	Seller note; mezzanine lender in larger deals	Second	Middle; higher interest
Equity	Buyer; search fund investors	Last	Highest; keeps all the upside

5.2 SBA 7(a) acquisition loans

An SBA 7(a) loan is made by an ordinary bank, but the U.S. Small Business Administration guarantees part of it. Because the government absorbs part of any loss, banks lend against a business's cash flow even when it owns little hard collateral, which is true of most service businesses. The rules sit in the SBA's Standard Operating Procedure: SOP 50 10 8 took effect June 1, 2025, and SOP 50 10 8.1 applies to loans numbered on or after October 1, 2026.

Rule	What it means in practice
Maximum loan $5M	Caps self-funded SBA deals at roughly a $5–6M total project
10% equity injection	The buyer side must fund at least 10% of total project cost
Seller note as equity	Counts only on full standby for the life of the loan, and for no more than half the injection
Personal guarantee	Anyone owning 20% or more personally guarantees the loan
DSCR at least 1.25x	Cash flow must be at least 1.25 times annual loan payments
QoE at $3M+	A third-party quality of earnings report is required at a price of $3M or more
10-year amortization	The business-acquisition portion is repaid over at most 10 years

These rules change. Confirm current terms with a lender or the current SOP before relying on them.

5.3 Sources and Uses

Sources and Uses is a two-sided table. Uses is where the money goes; Sources is where it comes from. The two totals must be equal, or the deal is not funded.

WORKED EXAMPLE

Uses	Amount
Purchase price	$3,000,000
Transaction costs (QoE, legal, SBA and bank fees)	$150,000
Working capital left in the business	$100,000
Total project cost	**$3,250,000**

Sources	Amount
SBA 7(a) loan (90%)	$2,925,000
Seller note, full standby (5%)	$162,500
Buyer cash (5%)	$162,500
Total	**$3,250,000**

Step 1. Required equity injection = 10% × $3,250,000 = $325,000.

Step 2. The standby seller note can cover up to half: ½ × $325,000 = $162,500.

Step 3. The buyer funds the rest of the injection in cash: $325,000 − $162,500 = $162,500.

Step 4. The SBA loan covers everything else: $3,250,000 − $325,000 = $2,925,000.

Check. $2,925,000 + $162,500 + $162,500 = $3,250,000. Sources = Uses.

Illustrative.

5.4 The loan payment

FORMULA: LEVEL LOAN PAYMENT

$$\text{Payment} = P \times r \div (1 - (1 + r)^{-n})$$

P is the loan amount, **r** the interest rate per period and **n** the number of payments. In Excel: =PMT(rate, n, −P).

WORKED EXAMPLE

P = $2,925,000; rate 10.5% a year, so r = 0.105 ÷ 12 = 0.00875 per month; n = 120 months.

$(1.00875)^{120} \approx 2.844$, so $(1.00875)^{-120} \approx 0.3516$, and 1 − 0.3516 = 0.6484.

P × r = $2,925,000 × 0.00875 = $25,594. Payment = $25,594 ÷ 0.6484 ≈ **$39,468 a month**, or about **$473,600 a year**.

Illustrative: fixed rate. Many SBA loans are variable rate.

5.5 Debt service coverage ratio (DSCR)

FORMULA

DSCR = Cash flow available for debt service ÷ Annual debt service

Annual debt service is every loan payment in a year, interest and principal. Lenders start from adjusted EBITDA or SDE and subtract the new owner's salary, taxes and required equipment spending. The SBA minimum is 1.25x: for every $1.00 of payments, the business must generate $1.25.

WORKED EXAMPLE

Cash flow available	DSCR	Result
$650,000	650,000 ÷ 473,600 = 1.37x	Meets the minimum
$592,000	592,000 ÷ 473,600 = 1.25x	Exactly at the minimum
$550,000	550,000 ÷ 473,600 = 1.16x	Fails: the loan or the price must shrink

A 1.37x deal is still thin. If cash flow falls about 9% (to $592,000), coverage drops to the 1.25x floor. That is why lenders, not only sellers, set the price a buyer can actually pay.

Illustrative.

5.6 Amortization

Each monthly payment is the same, but what it pays for changes. Interest is charged on the balance still owed, and the rest of the payment reduces the balance. Early on, most of the payment is interest; by the final years, most is principal.

WORKED EXAMPLE: MONTH 1

Interest = $2,925,000 × 0.875% = $25,594. Principal = $39,468 − $25,594 = $13,875. New balance = $2,911,125. Month 2 repeats the steps on the new balance.

Year	Interest paid	Principal repaid	Balance at year end
1	$298,874	$174,748	$2,750,252
2	$279,616	$194,006	$2,556,246
3	$258,236	$215,386	$2,340,861
4	$234,500	$239,122	$2,101,739
5	$208,148	$265,474	$1,836,265
6	$178,892	$294,730	$1,541,534
7	$146,411	$327,211	$1,214,324
8	$110,352	$363,270	$851,053
9	$70,318	$403,304	$447,749
10	$25,872	$447,749	$0

Illustrative. In Excel, =IPMT and =PPMT return each month's interest and principal.

INTERVIEW QUESTIONS

What happens if a deal's DSCR is below the lender's minimum?

The bank lends less. The buyer must lower the price, add equity, or move more of the price into a seller note or earnout.

Why can a buyer acquire a $3M company with only $162,500 of their own cash?

The SBA guarantee lets the bank lend 90% of the project, and a standby seller note covers half the required 10% injection. The catch: the buyer personally guarantees a $2.9M loan, and the seller must agree to receive nothing on the note for years.

Why is the seller note subordinated to the bank loan?

The bank provides most of the money and demands to be repaid first. Putting the seller behind the bank also keeps the seller motivated to help the business succeed.

6. Leverage and Returns

6.1 Measuring returns

FORMULA: MOIC

$$\text{MOIC} = \text{Total value received} \div \text{Total cash invested}$$

Multiple on invested capital: how much money you made. 2.0x means you doubled it.

FORMULA: IRR (SINGLE EXIT)

$$\text{IRR} = \text{MOIC}^{(1 \div \text{years})} - 1$$

Internal rate of return: how fast you made it, as a yearly compound rate. This shortcut works when all the money goes in at the start and comes out at the end. With cash flows in between, use Excel's =IRR() or =XIRR().

A 2.0x return over ten years is only about 7.2% a year; a 2.0x over three years is about 26%. Only IRR shows that difference, which is why investors quote both.

6.2 How debt creates equity returns

Leverage is using borrowed money to buy an asset, so the owner's return is earned on a small amount of their own money. A deal financed mainly with debt is a **leveraged buyout (LBO)**.

WORKED EXAMPLE: A SIMPLE LBO

The buyer runs the business for five years, uses its cash flow to make every loan payment, then sells for the same $3,000,000 they paid. No growth at all.

Line	Amount
Sale price (enterprise value)	$3,000,000
(−) SBA loan still owed after year 5	($1,836,265)
(−) Seller note repaid at sale	($162,500)
Equity value to the buyer	**$1,001,235**
Buyer's cash invested at closing	$162,500
MOIC = $1,001,235 ÷ $162,500	**6.2x**
IRR = $6.16^{(1 \div 5)} - 1$	**about 44%**

The business did not grow, and the buyer still made about six times their money. The business's own cash paid down $1,088,735 of loan principal ($2,925,000 − $1,836,265), and every dollar of debt repaid became a dollar of the owner's equity.

Illustrative. Ignores the owner's salary, taxes, selling costs and interest on the seller note.

6.3 The three ways equity value grows

Driver	What happens	Example
Debt paydown	Cash flow repays the loan, moving value from the lender to the owner	The example above
EBITDA growth	Better pricing, new customers or lower costs raise earnings	EBITDA rises from $650K to $800K; at 4.6x, EV rises by about $690K
Multiple expansion	The business sells for a higher multiple than was paid	Bought at 4.6x, sold at 5.5x because it now has a manager and contracts

6.4 The other side: leverage magnifies losses

If earnings fall and the business sells for $2,000,000 instead, equity = $2,000,000 − $1,836,265 − $162,500 = about $1,235. The buyer's $162,500 is essentially gone. If the business cannot make its payments before then, the buyer can lose everything and still owe the bank under the personal guarantee.

The same pattern appears in the largest deals. In 2005, KKR, Bain Capital and Vornado acquired Toys "R" Us for about $6.6 billion, financed largely with debt. Interest on that debt consumed cash the company needed to compete with Amazon and Walmart, and in September 2017 it filed for Chapter 11 bankruptcy. Heinz shows the opposite approach: when Berkshire Hathaway and 3G Capital bought it in 2013 for about $28 billion including

debt, much of the return plan relied on cost cutting, and the later Kraft Heinz combination took a $15.4 billion writedown in 2019 when brand value fell. Debt and cost cuts can raise returns; neither replaces a healthy business.

INTERVIEW QUESTIONS

Walk me through a basic LBO.

A buyer purchases a company using mostly debt and a little equity. The company's cash flow pays interest and repays the debt over the holding period. At exit the company is sold, the remaining debt is repaid, and the rest goes to equity. Returns come from debt paydown, EBITDA growth and multiple expansion, and are measured with MOIC and IRR.

What makes a company a good LBO candidate?

Steady, predictable cash flow to service debt; low capital spending needs; a defensible market position; room to improve operations; and a realistic exit. The same traits make a good ETA target.

Paper LBO: you buy a company with $10M of EBITDA at 8.0x using 60% debt. EBITDA grows to $13M in five years, all debt is repaid, and you exit at 8.0x. What is your MOIC and approximate IRR?

Price = $80M; debt = $48M; equity = $32M. Exit EV = $13M × 8.0 = $104M, with no debt, so equity = $104M. MOIC = $104M ÷ $32M = 3.25x. IRR = $3.25^{0.2} - 1 \approx 27\%$. (Rule of thumb: 2x in 5 years ≈ 15%, 3x ≈ 25%.)

KEY TAKEAWAYS

1. Enterprise value is the whole business; equity value is what owners keep after debt. Small deals are priced cash-free, debt-free.

2. Multiples are the main pricing tool for small businesses, and they only work if the earnings are real.

3. A DCF values the business on its own cash flows, but it is very sensitive to the discount rate and the terminal value.

4. Structure (seller notes, earnouts, the working capital peg, escrow) is how buyers and sellers bridge disagreements on price.

5. In an SBA deal, the lender's DSCR test often sets the maximum price the buyer can pay.

6. Leverage turns modest cash flow into high equity returns, and turns modest declines into total losses.

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7. Berkshire Hathaway and 3G Capital / H.J. Heinz Company, merger announcement, February 14, 2013
8. Toys “R” Us, Inc., Chapter 11 filing announcement, September 18, 2017; acquisition by KKR, Bain Capital and Vornado Realty Trust, 2005
9. Standard finance methods (enterprise value bridge, multiples, discounted cash flow, loan amortization, MOIC and IRR) are general concepts, not tied to a single source.

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