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2012 Q2 Market Pulse Report

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MARKET PULSE

QUARTERLY SURVEY REPORT

Q2 2012



The quarterly International Business Brokers Association (IBBA) and M&A Source *Market Pulse* Survey Report was created to gain an accurate understanding of the market conditions for businesses being sold in Main Street (values \$0-\$2MM) and lower middle market (values \$2MM and more). The national survey was conducted with the intent of providing a valuable resource to business owners and their advisors. The IBBA and M&A Source present the *Market Pulse* Survey Report in partnership with the Pepperdine Private Capital Markets Project and the Graziadio School of Business and Management at Pepperdine University.

Figure 1: Market Segments Studied

MAIN STREET	LOWER MIDDLE MARKET
Less than \$500K	\$2MM - \$5MM
\$500K - \$1MM	\$5MM and above
\$1MM - \$2MM	

A summary of key findings follows.

BUYER AND SELLER MARKETS:

Brokers working Main Street deals were far more inclined to describe conditions as a “buyer’s market” (>70%), while those in the lower middle market were slightly more likely to describe the market as neutral or favorable to sellers.

Time to close: Smaller Main Street businesses closed the fastest, with 77% of deals reportedly closing in less than seven months. As deal size increased, so did time to close. In the lower middle market, 84% of deals in the \$2MM-\$5MM range closed in 11 months or less. Most deals (85%) of \$5MM and above reportedly sold in six to nine months, although 8% took two or more years to close.

WHAT’S SELLING:

Hot industries varied by business size. In the Main Street market for businesses valued at \$1MM or less, consumer goods/retail, business services, personal services, and restaurants topped the number of closed transactions. For businesses valued between \$1MM-\$2MM, manufacturing (47%), health care and biotech (18%), and construction/engineering (12%) were trending.

In the lower middle market, in the \$2MM-\$5MM sector, wholesale distribution (29%), business services (21%), and construction/engineering (21%) accounted for most of the businesses sold. Businesses of \$5MM or more followed the same trend with manufacturing at 23% and wholesale distribution at 15%.

BUYER TYPE:

Not surprisingly, buyers in the Main Street sector were far more likely to be individuals while strategic (companies) and financial (private equity) buyers dominated the lower middle market.

For the smallest Main Street businesses of \$500K or less, 91% of the buyers were individuals. Of those, more than half (58%) were first time buyers and 33% were previous business owners. For all businesses in the \$1MM-\$5MM range, individual buyers dropped to around 50%. Around 40% of companies this size were purchased by another company, and 10% went to private equity.

Notably, in this survey, there were no individual buyers at the \$5MM-plus level. Of those businesses for sale, almost a third (31%) were purchased by other companies and 62% were purchased by private equity.

“It was interesting to see that private equity firms completed twice as many transactions as corporate buyers,” said Scott Bushkie CBI, M&AMI, principal of Cornerstone Business Services Inc. “Private equity had record capital raising years in 2006 and 2007 and time is running out to invest those funds and yield a return within their standard 10-year investment windows. They held back during the great recession, and now they’re looking to make up for lost time.”

REASON FOR SALE:

In both the Main Street and lower middle market sectors, sellers sold for three primary reasons: retirement, burn out, and to pursue a new opportunity. Of interest, while not primary drivers, “unsolicited offer” began appearing as a motivator at the \$1MM value and above, while concerns over possible tax increases showed up at only \$2MM and above.

DEAL STRUCTURE:

For businesses in the middle value ranges, buyers were more likely to rely on alternative financing sources—most often seller financing, but also mezzanine financing and earnouts to a lesser degree. For businesses valued at \$500K or less, brokers reported that 75% of deal funding came in the form of cash at close. That dropped to 54% for businesses in each of the \$500K-\$1MM, \$1MM-\$2MM and \$2MM-\$5MM ranges, before increasing again to 61% for deals of \$5MM in value and above.

“The smallest and largest sectors had the most cash at close. We expect that smaller deals probably had higher percentages due to the availability of SBA loans,” explained Pino Bacinello CBI, M&AMI, principal of Pacific Business Brokers Inc. and current chairman of the IBBA. “At the opposite end of the spectrum, for the largest deals, we know that corporations and private equity have more available cash than ever before, driving an increase in cash at close there as well.”

“As the deal got larger, it was interesting to see that earnouts became more prevalent as a tool to close the gap between buyer and seller expectations,” he added.

Figure 2: Financing Structures

DEAL SIZE	CASH AT CLOSE	SELLER FINANCING	MEZZANINE FINANCING	SELLER RETAINED EQUITY	EARN OUT	OTHER
<500K	75%	19%				7%
\$500K-\$999K	54%	20%	4%	9%		13%
\$1MM-\$2MM	54%	22%	1%	1%	6%	16%
\$2MM-\$5MM	54%	13%	7%	3%	10%	13%
\$5MM+	61%	3%	3%	11%	12%	10%

MULTIPLES:

The larger the business, the higher the multiples. The table below indicates the most commonly reported multiples for each market sector.

Figure 3: Multiples by Deal Size

	SDE	EBITDA
MAIN STREET		
Less than \$500K	81% @ 1.5-2.5x	
\$500K - \$1MM	83% @ 2.0-3.5x	66% @ 2.0-3.0x
\$1MM - \$2MM	67% @ 2.0-3.0x	75% @ 3.0-4.0x
LOWER MIDDLE MARKET		
\$2MM - \$5MM		70% @ 4.0-5.0x
\$5MM and above		76% @ 4.5-6.0x

SDE = seller's discretionary earnings EDITDA = earnings before interest, taxes, depreciation and amortization
Transactions in the Main Street market are typically based on multiples of SDE, while those in the lower middle market are most commonly based on EBITDA. In some instances survey respondents reported multiples for both SDE and EBITDA.

TERMINATIONS & MISTAKES:

Brokers and intermediaries pointed to a number of reasons why client companies did not sell and took themselves off the market in the last three months, the most common being a seller's unrealistic value expectations (33%). Lack of buyer preparation (15%), poor seller preparation (11%), unreasonable non-financial demands (9%) and personality conflicts (9%) were also cited.

In a different, but related question, survey participants were asked for the biggest mistake sellers make that hurt their chance of successfully completing a deal. Again, unrealistic expectations topped the list (50%), followed by declining business sales (16%), and poor financial records (15%).

MARKET SENTIMENT:

Brokers and intermediaries expect an upward swing in the M&A market in the next three months. Notably, among all sectors, only 4% or less expect new business listings to decline while 46% to 58% expect new listings to increase, with the Main Street brokers showing the greatest optimism.

Overall, most think valuations will remain the same, although Main Street brokers are slightly more likely to anticipate a moderate decrease. Lower middle market advisors anticipate a slight increase.

BROKER ADDENDUM

DEAL SIZE:

For transactions terminated in the last three months, there is a linear pattern showing that the smaller the deal size, the higher the chance the transaction will not successfully close. Of all the terminated deals, 25% were valued at \$500K or less, while only 6% of terminated deals were valued over \$2MM.

When asked about active deals on the table, respondents reported that there are about four times as many active deals at a valuation of \$500K or less. Yet when asked for the number of transactions currently in the escrow/accepted LOI/due diligence phase, this segment reported the lowest success ratio at 17%.

Figure 4: Closing Ratios

	ACTIVE DEALS	ACCEPTED OFFER	% IN ACCEPTED OFFER
MAIN STREET			
Less than \$500K	372	65	17%
\$500K - \$1MM	103	27	26%
\$1MM - \$2MM	70	18	26%
LOWER MIDDLE MARKET			
\$2MM - \$5MM	66	26	39%
\$5MM and above	49	16	33%

INDUSTRY EXPERIENCE:

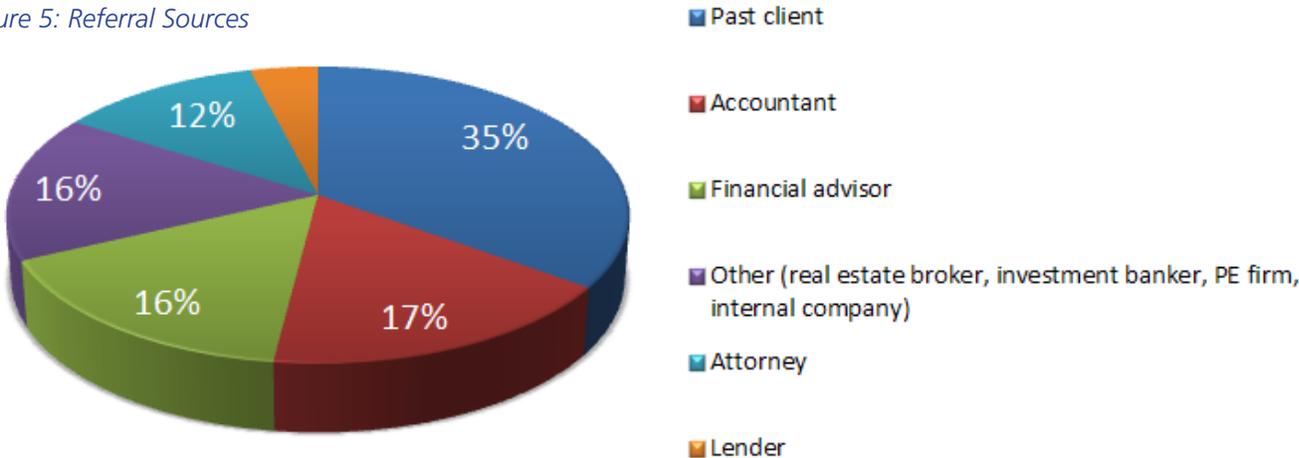
Roughly half (48%) of the respondents reported 10 years or more working experience in the M&A industry with a full 24% at 20 years tenure or greater.

LEAD GENERATION:

By far and away, brokers and intermediaries reported their best new clients had arrived by referral (57%). Other lead generation tactics such as networking (8%), targeted mailer (6%), company branding (6%), cold calling (4%), and general mailer (4%) lagged far behind .

Referral sources came most commonly from past clients (35%), followed by accountants (17%) and financial advisors (16%).

Figure 5: Referral Sources



A full copy of the IBBA and M&A Source Market Pulse Survey is available to IBBA and M&A Source members. This is a 70+page report of up-to-date relevant information on the state of the marketplace compiled by the Pepperdine Private Capital Markets Project under Dr. John Paglia. To receive your copy, please contact the IBBA and M&A Source headquarters at admin@ibba.org or (888) 686-4222.

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