2015 Q3 Market Pulse Report

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THE IBBA AND M&A SOURCE MARKET PULSE SURVEY REPORT Q3 2015

MAIN STREET

The quarterly IBBA and M&A Source Market Pulse Survey was created to gain an accurate understanding of the market conditions for businesses being sold in Main Street (values $0-$2MM) and the Lower Middle Market (values $2MM-$50MM). The national survey was conducted with the intent of providing a valuable resource to business owners, potential purchasers and their advisors. The IBBA and M&A Source present the Market Pulse Survey with the support of the Pepperdine Private Capital Markets Project and the Pepperdine Graziadio School of Business and Management.

The Q3 2015 survey was completed by 192 respondents, representing 20 regional and international business broker and M&A associations. Half of the respondents (50%) had at least 10 years of experience in the M&A industry. Participating advisors reported closing 214 transactions in Q3 2015.

Figure 1: Market Segments Studied

<table>
<thead>
<tr>
<th>Main Street</th>
<th>Lower Middle Market</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than $500K</td>
<td>$2MM - $5MM</td>
</tr>
<tr>
<td>$500K - $1MM</td>
<td>$5MM - $50MM</td>
</tr>
<tr>
<td>$1MM - $2MM</td>
<td></td>
</tr>
</tbody>
</table>

A full copy of the Market Pulse survey results is available to IBBA and M&A Source members who participate in each quarterly survey. This is a 100-plus page document of up-to-date relevant information on the state of the marketplace and compiled by Dr. Craig Everett, assistant professor of finance at the Pepperdine University Graziadio School of Business and Management and director of the Pepperdine Private Capital Markets Project.

To become a member, please contact the IBBA and M&A Source headquarters at admin@ibba.org or (888) 686-4222.

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Research Associate
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KEY FINDINGS:

This quarter’s report continues to see the pendulum shift to a seller’s market across all deal sizes. While buyers still hold the upper percentage for transactions valued at $1 million or less, the percentage is shrinking.

“Companies with strong earnings and good accounting and management records are wanted,” explains David Ryan, President Upton Financial Group. “Buyers are increasingly market educated and therefore know about more opportunities that are coming to market. They remain patient, but ready to act when a strong company is on the market.”

BUYER VS. SELLER MARKET

Figure 2: The Market Continues to Shift to a Seller’s Market

The recent volatility of the stock market did not prevent buyers from pursuing a business purchase, with 75% of surveyed advisors indicating there was no impact from the instability of the stock market. The findings also indicated that sellers did not feel a sense of urgency with the elections heating up in the news.

In Q3, advisors reported a subtle slowdown in new clients, indexing on a 5-point scale in which 5 represents a continued increase, but slower than last year at this time.
Chris Wozniak, CBI, M&AMI, The George Ryan Group LLC, proposes that “one reason for the downtick is that advisors are becoming more selective in taking on additional clients because they already have a sufficient amount of clients.”

Since the average experience of surveyed advisors was greater than 10 years the respondents tend to take on a smaller amount of higher quality clients rather than a large amount of low quality clients. “Advisors need to be selective in order to be successful and they should only take on clients that have the highest probability to sell,” continued Wozniak. Advisors who participated in the survey, as a group, reported a 50% better success rate in closing deals than the general public.

Retirement remained the leading reason that business owners went to market, which is understandable since baby boomers continue to retire in increasing numbers. The casual reader of this information might assume there was a stronger shift to a buyer’s market as the quantity shifts; however, the findings indicate that the market is slowly becoming a sellers’ market especially as transactions increase in size.

**Figure 3: Main Index of New Clients by Deal Size**

**Figure 4. Retirement Continues to Dominate Seller Motivations**
“The market is moving to a seller’s market in each sector especially as deals get larger,” said Cress V. Diglio, Transworld Business Advisors and IBBA Chair. “Business owners who are selling now are ‘ahead of the curve’ and are getting rewarded with very strong valuations. Eventually, as more and more baby boomers seek to retire and put their business on the market, there will be an oversupply of sellers and the market will most likely swing back to a ‘buyer’s market.’”

The majority of small business buyers (under $1 million deal size) made the acquisition to ‘buy a job’. Typically, these buyers are already employed and are looking for a compelling reason to leave that security and run a business of their own. The buyers of larger businesses, on the other hand, are making synergistic purchases to add depth to their existing business.

“Multiples remain strong because buyer groups are willing to pay for quality,” says Joe Lindsey, JLC, Inc. and M&A Source Chair. “Quality of management and reporting systems are more prevalent the larger a company becomes.”

WHO IS BUYING?

Figure 5: Who Are the Buyers?

<table>
<thead>
<tr>
<th></th>
<th>&lt;$500K</th>
<th>$500K - $1MM</th>
<th>$1MM - $2MM</th>
<th>$2MM - $5MM</th>
<th>$5MM - $50MM</th>
</tr>
</thead>
<tbody>
<tr>
<td>1st Time Individual</td>
<td>13%</td>
<td>3%</td>
<td>6%</td>
<td>0%</td>
<td>3%</td>
</tr>
<tr>
<td>Individual Who Owned a Business</td>
<td>54%</td>
<td>23%</td>
<td>32%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>Existing Company / Strategic Buyer</td>
<td>1%</td>
<td>21%</td>
<td>3%</td>
<td>48%</td>
<td>33%</td>
</tr>
<tr>
<td>PE Firm / Platform</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td>1%</td>
</tr>
<tr>
<td>PE Firm / Add-On</td>
<td>45%</td>
<td>0%</td>
<td>0%</td>
<td>70%</td>
<td>0%</td>
</tr>
<tr>
<td>Other</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
</tr>
</tbody>
</table>

Individual buyers likely still have a job (usually a management position); therefore they require and expect management reports and timely financial records. If these are not readily available, these buyers will often move on to the next transaction.

WHAT MOTIVATES THEM?

Figure 6: Motivation of Buyer Changes by Size of Transaction—Synergistic Buyers Kick in Above $1 Million

<table>
<thead>
<tr>
<th></th>
<th>Buying a Job</th>
<th>Growing an Existing Business</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt;$500K</td>
<td>51%</td>
<td>24%</td>
</tr>
<tr>
<td>$500K - $1MM</td>
<td>42%</td>
<td>26%</td>
</tr>
<tr>
<td>$1MM - $2MM</td>
<td>19%</td>
<td>48%</td>
</tr>
<tr>
<td>$2MM - $5MM</td>
<td>22%</td>
<td>39%</td>
</tr>
<tr>
<td>$5MM - $50MM</td>
<td>0%</td>
<td>70%</td>
</tr>
</tbody>
</table>
An increasing number of existing business owners are expanding through acquisition and want to thoroughly compare the potential acquisition against their current company. Since these buyers want to understand the ability to integrate the company into their own, they expect timely and accurate information to make these decisions.

**HOW LONG DOES IT TAKE TO COMPLETE A DEAL?**

*Figure 7: Medium Time to Close Continues to Increase*

Larger transactions take longer to close and this period of time continues to increase as buyers become more sophisticated. As Figure 7 shows, transactions over $1 million in value take an average of more than 8 months to close. Additionally, we found that in 32% of the responses, transactions over $1 million had taken 12 months or longer to close.

**VALUATION MULTIPLES**

By comparing data from the last five quarters, we can see that valuations are similar for all sectors. There is, however, a slight decrease in the $1 to $2 million valuation range. This tends to be the price range in which individual buyers are priced out and existing businesses owners are inclined to buy, but only when it can add to their current operations.

*Figure 8: Median Multiple Paid*

<table>
<thead>
<tr>
<th>Median Multiple Paid (SDE)</th>
<th>2015</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt;$500K</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>$500K - $1MM</td>
<td>2.5</td>
<td>2.9</td>
</tr>
<tr>
<td>$1MM - $2MM</td>
<td>2.8</td>
<td>3</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Median Multiple Paid (EBITDA)</th>
<th>2015</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>$1MM - $2MM</td>
<td>3.5</td>
<td>3.9</td>
</tr>
<tr>
<td>$2MM - $5MM</td>
<td>4</td>
<td>4.6</td>
</tr>
<tr>
<td>$5MM - $50MM</td>
<td>5.3</td>
<td>5</td>
</tr>
</tbody>
</table>

Sellers Discretionary Earnings (SDE)
Earnings before Interest Taxes Depreciation Amortization (EBITDA)
HOT INDUSTRIES

Service companies (professional and business) continue to lead market activity in Q3 for the companies in the $500k to $2 million range.

Figure 9: Top Three Industries by Size of Transaction

<table>
<thead>
<tr>
<th>Size of Transaction</th>
<th>Industry 1</th>
<th>Industry 2</th>
<th>Industry 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt;$500K</td>
<td>Restaurants</td>
<td>Retail</td>
<td>Personal Service</td>
</tr>
<tr>
<td>$500K - $1MM</td>
<td>Business Service</td>
<td>Personal Service</td>
<td>Construction Engineering</td>
</tr>
<tr>
<td>$1MM - $2MM</td>
<td>Construction Engineering</td>
<td>Personal Service</td>
<td>Business Service</td>
</tr>
<tr>
<td>$2MM - $5MM</td>
<td>Manufacturing</td>
<td>Healthcare Biotech</td>
<td>Wholesale Distribution</td>
</tr>
<tr>
<td>$5MM - $50MM</td>
<td>Manufacturing</td>
<td>Business Service</td>
<td>Information technology</td>
</tr>
</tbody>
</table>

“Corporate buyers tend to seek businesses that have valuable employees and a strong customer base,” says Craig Everett, PhD, Director of the Pepperdine Private Capital Markets Project. “They are often motivated by opportunities to cross sell products and services as well as reduce costs. Manufacturing companies are often synergistic purchases and were the top industry for business sales in the $2 million to $50 million category.”

“Smaller lifestyle companies such as restaurants tend to attract individual buyers looking for single location businesses within 20 to 30 miles of where they live,” said Scott Bushkie, CBI, M&AMI, President, Cornerstone Business Services.
ABOUT PEPPERDINE UNIVERSITY GRAZIADIO SCHOOL OF BUSINESS AND MANAGEMENT

A leader in cultivating entrepreneurship and digital innovation, the Graziadio School of Business and Management at Pepperdine University focuses on the real-world application of MBA-level business concepts. The Graziadio School provides student-focused, globally-oriented education through part-time, full-time, and Executive MBA programs at our eight campuses, as well as through online and hybrid formats. In addition, the Graziadio School offers a variety of Master of Science programs, a Bachelor of Science in Management degree completion program, Presidential and Key Executives MBA and executive education certificate programs.

The Pepperdine Private Capital Markets Project reports on the current climate for privately held companies to access and raise capital, as well as the conditions influencing the decisions of lenders and providers serving small businesses and the lower middle market. Our ongoing research engages in multiple survey research initiatives and publishes an annual Capital Markets Report, an annual economic forecast, the PCA Index Quarterly Report in partnership with Dun & Bradstreet Credibility Corp. and Market Pulse Quarterly Report in cooperation with the International Business Brokers Association and M&A Source.

ABOUT INTERNATIONAL BUSINESS BROKERS ASSOCIATION (IBBA)

Founded in 1983, IBBA is the largest non-profit association specifically formed to meet the needs of people and firms engaged in various aspects of business brokerage, and mergers and acquisitions. The IBBA is a trade association of business brokers providing education, conferences, professional designations and networking opportunities.

ABOUT THE M&A SOURCE

Founded in 1991, the M&A Source promotes professional development of merger and acquisition professionals so that they may better serve their clients’ needs, and maximize public awareness of professional intermediary services available for middle market merger and acquisition transactions.
The Certificate in Private Capital Markets (CIPCM) is a three-day curriculum-based training program led by Dr. Craig R. Everett, director of the ground-breaking research Pepperdine Private Capital Market Project and co-editor of the Journal for Entrepreneurial Finance.

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