2013 Q3 Market Pulse Report

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Pepperdine University

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The International Business Broker Association (IBBA) and M&A Source present the Market Pulse Quarterly Survey Report with the support of the Pepperdine Private Capital Markets Project and the Graziadio School of Business and Management at Pepperdine University. 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 the Main Street market (values $0 to $2 million) and lower middle market (values $2 million to $50 million). The national survey was conducted with the intent of providing a valuable resource to business owners and their advisors.

**MARKET SEGMENTS STUDIED**

<table>
<thead>
<tr>
<th>MAIN STREET</th>
<th>LOWER MIDDLE MARKET</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt; 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>

Figure 1
KEY FINDINGS

The Market Pulse Third Quarter 2013 survey was completed by 192 respondents from 38 states. The majority of respondents (57%) had at least 10 years of experience as a business broker and/or M&A advisor.

BUYER AND SELLER MARKETS

When it comes to leverage, the market is polarizing. In the third quarter, 72 percent of Main Street brokers representing deals of $500,000 or less said they were operating in a buyer’s market. Meanwhile 79 percent of brokers representing deals of $5 million-$50 million categorized the current climate as a seller’s market. This is the strongest seller’s market sentiment we’ve seen in the lower middle market since the survey started.

Figure 2: Buyer verses Seller Markets

<table>
<thead>
<tr>
<th></th>
<th>Q3 2013</th>
<th>Q2 2013</th>
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</thead>
<tbody>
<tr>
<td><strong>MAIN STREET</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Less than 500K</td>
<td>72%</td>
<td>68%</td>
</tr>
<tr>
<td>$500K - $1MM</td>
<td>64%</td>
<td>52%</td>
</tr>
<tr>
<td>$1MM - $2MM</td>
<td>57%</td>
<td>50%</td>
</tr>
<tr>
<td><strong>LOWER MIDDLE MARKET</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>$2MM - $5MM</td>
<td>40%</td>
<td>47%</td>
</tr>
<tr>
<td>$5MM-$50MM</td>
<td>21%</td>
<td>32%</td>
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</table>

RETIREMENT DRIVING SALES

In every segment, retirement was the number one reason sellers put their business on the market. This would indicate that baby boomers are continuing to move into the market in larger numbers.

This finding is consistent with predictions that more business owners will look to sell their companies in the coming year. In every market segment, 50 percent or more of advisors predict deal volume will grow in the next three months, slightly higher than those predicting deal volume will stay the same. Less than 7 percent of advisors expect deals to decrease.

BUYING: A BETTER INVESTMENT

Buyers believe business acquisition is a good way to put their money to use. In the lower middle market, “better ROI than other investments” ranked first or tied for first as the reason buyers are active in the M&A market.

“Buyers in the lower middle market continue to gain confidence in the economy and in their ability to grow a business,” says Dr. Craig Everett, an assistant professor of finance at the Graziadio School of Business and Management and director of the Pepperdine Private Capital Markets Project. “They believe that buying a business is the best way to put their money to work, versus starting an operation from the ground-up or other investment opportunities.”

For Main Street buyers, the number one motivating factor was to buy a job and control their own destiny.

“When we look at the factors driving buyers and sellers into market, we can begin to understand why the market is polarizing,” said IBBA director Scott Bushkie, president of Cornerstone Business Services. “An increase in Boomer retirement should be creating more of a buyer’s market scenario in which supply outpaces demand.”
“But lower middle market buyers believe business acquisition provides the greatest opportunity for investment returns. So despite the higher rate of retirement across every sector, demand remains high and sellers still have the advantage for higher value deals.”

**BUYER TYPES**

Private equity firms jumped up this quarter to tie existing companies as the number one buyer for businesses over $5 million in value. Private equity acquisitions were divided equally as 50 percent platform deals and 50 percent add-ons. As in second quarter 2013, individual buyers dominated Main Street.

“We didn’t see substantial private equity activity until deals exceeded $5 million in value. One possible explanation is that PE groups have a lot of money they need to put to work and they’re targeting larger deals for efficiency’s sake,” says M&A Source chair Dora Lanza, Principal, Plethora Businesses. “That’s opening opportunities for smaller companies in the $2 million to $5 million sector—companies that might not be as competitive bidding against a PE firm.”

![Figure 3: Top Buyer Types](image)

**VALUATION MULTIPLES**

Multiples are markedly stronger in the lower middle market, correlating to a strong seller’s market sentiment and the presence of private equity firms in the buyer pool, as well existing companies poised for growth through acquisition.

![Figure 4: Average Multiples by Deal Size](image)

<table>
<thead>
<tr>
<th>MAIN STREET</th>
<th>SDE</th>
<th>EBITDA</th>
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<tbody>
<tr>
<td>Less than 500K</td>
<td>2.0</td>
<td></td>
</tr>
<tr>
<td>$500K - $1MM</td>
<td>2.75</td>
<td></td>
</tr>
<tr>
<td>$1MM - $2MM</td>
<td>3.0</td>
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<table>
<thead>
<tr>
<th>LOWER MIDDLE MARKET</th>
<th>SDE</th>
<th>EBITDA</th>
</tr>
</thead>
<tbody>
<tr>
<td>$2MM - $5MM</td>
<td>4.3</td>
<td></td>
</tr>
<tr>
<td>$5MM - $50MM</td>
<td>5.8</td>
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*SDE = Seller’s Discretionary Earnings  
EBITDA = 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.*
Most advisors think valuations will stay the same or grow in the next three months. In the lower middle market, less than two percent of advisors believe valuations are going to decline. The majority believe they will stay the same, with 20 to 25 percent expecting they will continue to grow from current peak. As the deals get larger there is greater confidence that values will continue to increase.

Figure 5: Average Multiples by Deal Size By Quarter

![Average Multiples by Deal Size By Quarter](image)

Multiples were up (or tied) in every market sector over second quarter 2013. In three out of five sectors, median multiples were at a high, or tied for high, over the previous year.

“The M&A market continues to move in the right direction,” says Tom Whipple, Principal, Falcon Advisors. “Even though our study shows more sellers are coming into the market, values are maintaining. Three out of five market sectors have continued to peak. One can assume there are still far more buyers chasing deals than the number of opportunities on the marketplace.”

**TIME TO CLOSE**

The third quarter 2013 study continues to confirm earlier findings that larger businesses take longer to close. In the smallest Main Street sector (businesses valued at $500,000 or less), the median time to close was four months. In the lower middle market, for businesses valued over $5 million, the median time to close was 10 months.

![Median Time To Close](image)
BUYER LOCATION

In the same way that larger deals take more time to close, they are also more likely to draw buyers from farther away. In third quarter 2013, 75 percent of the buyers for deals valued over $5 million came from outside a 100 mile radius of the seller’s location. For Main Street deals, 40 percent or more of buyers came from within a 20 mile radius.

Figure 7: Buyer Location

<table>
<thead>
<tr>
<th>DEAL STRUCTURE</th>
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As the deals get larger, seller financing declines but earn outs increase. Once deal size reaches $2 million and higher, seller retained equity and mezzanine debt comes into debt.

Figure 8: Creative Deal Structures

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<th>MISTAKES AND TERMINATIONS</th>
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According to the study, the primary reason for deal termination remains unrealistic expectations, across every market sector. This includes unrealistic valuations or unreasonable non-price demands.

“Unrealistic expectations, non-price, trended higher than past surveys,” said IBBA chair, Steve Wain, Principal, Calder Associates. “With valuations peaking in most categories, one could assume that the gap between buyer and seller price points would be shrinking, but we could be seeing seller expecting all cash at close or abbreviated transition time frames.”

Advisors representing Main Street business owners also reported significant issues with seller misrepresentation and poor seller preparation, ranking second and third for the most common reason deals failed to close. “Which really does highlight the need and value to work with an advisor and truly prepare one’s business for sale, “said Marcie Woolworth, Principal, MRW & Associates.

Lack of buyer preparation, personality conflicts, and minimal corporate structure all rank lower as reasons deals were terminated in the last three months.
A similar question asked advisors to rank the biggest mistakes seller’s make when selling their business. Results are relatively consistent with the reasons for deal termination.

**Figure 9: Biggest Seller Mistakes**

- Unrealistic Expectations: 47%
- Poor Financial Records: 14%
- Declining Business Sales: 12%
- Waiting Too/Long/Burn Out: 10%
- Emotional Ties to Business: 6%
- Non-Responsive: 3%
- Negative Attitude/Ego: 5%
- Nothing: 2%
- Other: 1%

**HOT INDUSTRIES**

Personal services, restaurants, business services, and consumer goods/retail ranked among the most active industries for the Main Street market. The construction/engineering and healthcare industries were also active. These figures are fairly consistent over second quarter 2103, although restaurant sales saw more activity this quarter.

In the lower middle market, for businesses valued between $2 million to $5 million, healthcare-related businesses led at 25 percent of completed deals over the last three months, followed by manufacturing and wholesale/distribution at 19 percent each. Manufacturing led the $5 million—$50 million sector at 31 percent, followed by wholesale/distribution at 13 percent.
A full copy of the IBBA and M&A Source Market Pulse Survey is available to IBBA and M&A Source members who participate in each quarterly survey. This is a 70-plus page report of up-to-date relevant information on the state of the marketplace and compiled by the Pepperdine Private Capital Markets Project under Dr. Craig Everett, an assistant professor of finance at Pepperdine University’s Graziadio School of Business and Management.

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