MARKETPULSE

QUARTERLY SURVEY REPORT **SECOND QUARTER 2013**

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 $0-2 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

Figure 1

MAIN STREET	LOWER MIDDLE MARKET
< 500K	$2MM-$5MM
$500K-$1MM	$5MM-$50MM
$1MM-$2MM	

PEPPERDINE UNIVERSITY Graziadio School of Business and Management

PEPPERDINE PRIVATE CAPITAL MARKETS PROJECT bschool.pepperdine.edu/privatecapital

KEY FINDINGS

BOOMER RETIREMENT:

More than half of the respondents (61%) agreed that baby boomers are beginning to exit their businesses in larger numbers than in the previous five years. This is consistent with survey metrics showing that retirement was the number one reason driving business sales across almost every sector. (For businesses valued at $500,000 or less, burnout ranked at the primary reason for sale, followed closely by retirement.)

The boomer retirement trend is consistent with predictions that more business owners will look to sell their companies in the coming year. Advisors predict deal volume will grow, versus stay the same, by a nearly 2 to 1 margin. In every market segment, 58 percent or more of respondents are predicting increases.

"As 10,000 baby boomers turn 65 every day, it comes down to a simple numbers game," says Dr. Craig Everett, director of the Pepperdine Private Capital Markets Project. "The boomer exits are finally letting this demand be satisfied, which could boost deal flow dramatically."

SUPPLY AND DEMAND ECONOMICS

Regarding supply and demand, Main Street sellers may still be at a slight disadvantage. For deals valued at less than $500,000, 68 percent of respondents suggest supply is in the buyer's favor. For deals valued at $500,000 to $5 million, however, advisors characterize the market as neutral.

Leverage shifts as the deals get larger. For businesses of $5 million to $50 million, the tables turn dramatically, with 68 percent of respondents pointing to a seller's market.

Overall, more than three quarters (76%) of advisors agree the M&A market does not have enough quality businesses for sale compared to the number of buyers, especially in the lower middle market.

Advisors agree, by a 3 to 1 ratio, that this is the best time for sellers to maximize the value of their business since the market peak in 2007-2008. In the lower middle market, less than two percent of respondents anticipate that values will decrease in the next quarter. Most respondents (75% or more) predict multiples will stay the same, with another ten to 24 percent predicting increases.

EXISTING COMPANIES GOBBLING UP AVAILABLE BUSINESSES

Existing companies (strategic buyers) dominated in acquisitions this quarter, showing up as the number one buyer type in every category except the smallest Main Street businesses.

Figure 2: Percent of Deals Closed by Buyer Type

MAIN STREET	#1 BUYER	#2 BUYER
Less than 500K	Individual 55%	Past Bus. Owner 33%
$500K - $1MM	Existing Co. 36%	Past Bus. Owner 29%
$1MM - $2MM	Existing Co. 42%	Past Bus. Owner 31%
LOWER MIDDLE MARKET		
$2MM - $5MM	Existing Co. 60%	(3 way tie)
$5MM-$50MM	Existing Co. 50%	PE Platform 21%

Compared to Q2 2012, strategic buyers appear to be edging out private equity firms for deals valued between $5 million to $50 million. Individual buyers also appeared to be losing ground in certain market segments.

In the $2 million to $5 million segment, for example, individual buyers (including past business owners) lost half their market share. They accounted for 50 percent of the deals in that section in Q2 2012 but only 26 percent in Q2 2013.

"Buyer trends tie back to the idea that there is a limited quantity of quality businesses available," says Scott Bushkie, president of Cornerstone Business Services. "Some strategic buyers were forced to move downstream and buy smaller businesses in order to meet their growth mandates. They're outbidding the individual buyers due to the synergies they can achieve that individual buyers typically cannot."

TIME TO CLOSE

The Q2 2013 study continues to confirm earlier findings that larger businesses take longer to close. In the smallest Main Street sectors (businesses valued at $1 million or less), the majority of companies (54% or better) sold in six months. For businesses in the lower middle market, the majority (54%-56%) closed between six months and a year.

HOT INDUSTRIES

Personal services led in the Main Street market, accounting for 29 percent of completed sales in the less than $500,000 sector and 19 percent of sales in the $1 million to $2 million sector. The business services and consumer goods/retail markets were also active. These figures are fairly consistent over Q2 last year, when consumer goods/retail, business services, personal services, restaurants, and manufacturing ranked in the top five.

In the lower middle market, for businesses valued between $2 million to $5 million, manufacturing led at 27 percent of completed deals over the last three months, followed by consumer goods/retail and wholesale/distribution, both at 13 percent. Manufacturing also led the $5 million to $50 million sector at 38 percent, followed by healthcare at 15 percent. (This is a significant increase in manufacturing activity versus the same time period last year when it accounted for seven percent and 23 percent of activity by sector, respectively.)

MULTIPLES

Multiples increased slightly in the Main Street market for Q2, but results were more mixed for businesses valued between $1 million to $50 million. Multiples appeared scattered across the range, varying from as low as 0.25x for distressed businesses to more than an 8x EBITDA.

Figure 3: Multiples by Deal Size

MAIN STREET	SDE	MOST COMMON	EBITDA	MOST COMMON
Less than 500K	63% @ 1.5-2.5x	22% @ 2		
$500K - $1MM	75% @ 2.25-3.00x	34% @ 2.5		
$1MM - $2MM	28% @ 2.25-2.5x	41% @ 2.5	41% @ 3.0-4.0x	17% @ 4
LOWER MIDDLE MARKET				
$2MM - $5MM			76% @ 2.25-4.5	38% @ 4
$5MM-$50MM			65% @ 3.75-5.5	15% @ 4, 5.5, 8

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. In some instances survey respondents reported multiples for both SDE and EBITDA.

Respondents were also asked to indicate the type of multiple used to calculate purchase price. As indicated in the table below, the majority of deals valued at $5 million to $50 million (71%) include working capital in price calculations.

The survey also shows that about one-quarter or one-fifth of lower middle market buyers reported using the seller's trailing twelve months performance records. (This is a marked decline from Q1 2013 when nearly a third or better used TTM numbers.) For the Main Street sector, SDE calculations (the vast majority without working capital) are the norm, as expected.

Figure 4: Common Multiple by Deal Size

MAIN STREET	MOST COMMON	2ND MOST COMMON
Less than 500K	SDE not incl. working cap (70%)	
$500K - $1MM	SDE not incl. working cap (52%)	
$1MM - $2MM	SDE not incl. working cap (40%)	EBITDA not incl. working cap (23%)
LOWER MIDDLE MARKET		
$2MM - $5MM	EBITDA incl. working cap (53%)	EBITDA not incl. working cap (13%)
$5MM-$50MM	EBITDA incl. working cap (41%)	TTM EBITDA incl. working cap (15%)

Typically, working capital is not included in business transitions, until deal size exceeds $2MM. For Main Street businesses with values up to $2MM, SDE is most common basis.

"Everyone likes to talk about their business being sold for '*X*' multiple. But the important question that's not often asked is what are you multiplying '*X*' by – SDE versus EBITDA, including or not including working capital, TTM EBITDA or some other formula," says Dora Lanza, principal of Plethora Businesses. "It can be very deceiving and dangerous for someone outside the M&A field to value a company, especially when people try to value their own business. Emotional issues can cloud their judgment."

DEAL STRUCTURE:

For deal structure in the Main Street market, buyer equity led every sector, followed by relatively equal amounts of seller financing and senior debt. For businesses in the lower middle market, seller financing dropped to 11 percent versus 20 percent to 25 percent in Q1 2013.

"With strategic buyers dominating acquisitions, it's not surprising to see seller financing decline," says John Johnson, principal of Bluestem USA. "With a strategic buyer, seller financing becomes a way of making sure the seller remains committed to the company's success. When you have more individual buyers at the closing table, it's often a necessary tool to bridge a larger gap in getting the deal financed."

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 compiled by the Pepperdine Private Capital Markets Project under Drs. John Paglia and Craig Everett.

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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