



INTERNATIONAL BUSINESS BROKERS ASSOCIATION | M&A SOURCE | PEPPERDINE PRIVATE CAPITAL MARKETS PROJECT

# MARKETPULSE

QUARTERLY SURVEY REPORT

FOURTH QUARTER 2014

# THE IBBA AND M&A SOURCE MARKET PULSE SURVEY REPORT Q4 2014

## 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 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 Graziadio School of Business and Management at Pepperdine University.

The Q4 2014 survey was completed by 197 business brokers and M&A advisors, representing 39 states. Half of the respondents (50%) had at least 10 years of experience in the M&A industry.

This report represents the Main Street portion of the report, highlighting IBBA members active in this sector. Participating advisors reported closing 198 Main Street transactions in Q4 2014.

Figure 1: Market Segments Studied

| Main Street      |                |               |
|------------------|----------------|---------------|
| Less than \$500K | \$500K - \$1MM | \$1MM - \$2MM |

Market Pulse survey results are available to IBBA and M&A Source members who participate in each quarterly survey. This consists of two 100-plus page documents of up-to-date relevant information on the state of the marketplace and compiled by Dr. Craig Everett, assistant professor of finance at Pepperdine University's 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](mailto:admin@ibba.org) or (888) 686-4222.

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## KEY FINDINGS:

Over the past year, business sales have remained strong, and more deals are getting done. Fifty-five percent (55%) of advisors report closing more than one deal in Q4 2014, compared to 46% of advisors in Q4 the year prior.

Business brokers also report that deal volume increased in the last three months, with a mean score of 3.6 on a five point scale (with 2.5 being volume stayed the same). This is a slight uptick in growth trends reported in Q4 2013 when the mean averaged 3.5.

Meanwhile, expectations continue to rise. Of the brokers and advisors surveyed, 89% expect M&A activity to increase in 2015. Main Street brokers expect that business values will increase somewhat in the next three months, with optimism averaging a 3.2 on a five point scale.

### Main Street: Recent Trends and Expectations (on a 5-point scale):

- Actual Uptick in New Clients: 3.6
- Expected New Business Listings: 3.8
- Expected Business Valuation Multiples: 3.2

*“This information validates that the Main Street market is heating up, in tune with Middle Market upticks,” said Lisa Riley, CBI, Principal, LINK Business-Phoenix. “It’s been five or six years since the Great Recession and small businesses have had time to get back to normal. It’s a nice combo for sellers—increasing multiples coinciding with more successful deal closures.”*

## BARRIERS AND CONTRIBUTORS TO SUCCESS

Pricing issues remain the number one factor in whether or not businesses are sold, with brokers citing valuations and price expectations as the leading barrier and the leading contributor to deal success.

However, fewer brokers cited valuation challenges in 2014, down five percentage points over a year ago (22% Q4 2014 vs. 27% Q4 2013). This coincides with valuations multiples being at or near record highs. Meanwhile, financing dropped from the #2 challenge to #3, indicating that lenders are being more aggressive about financing.

### Top barriers for getting deals done

1. Valuation
2. Deal fatigue
3. Financing

### Top contributors to getting deals done

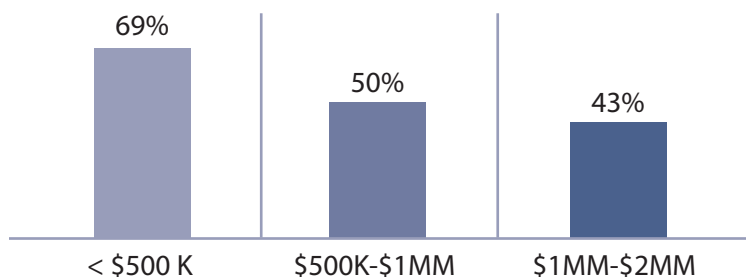
1. Clear price expectations
2. Larger buyer pool
3. More sellers

## ADDITIONAL FINDINGS

### BUYER'S MARKET

The smaller the business, the more likely advisors are to report a buyer's market. As business size grows, the buyer advantage declines. Of note, each Main Street sector dropped four percentage points or better in buyer's market sentiment compared to Q4 2013.

Figure 2: Buyer's Market Sentiment



### TIME TO CLOSE

Most businesses sold in six months or less, with roughly a third selling right away within three months.

*“For Main Street deals, the last few quarters have been a strong buyer’s market, giving buyer an advantage at some level,” said Craig Evertt, Ph.D., Director, Pepperdine Private Capital Markets Project. “But it seems that the number of buyers may be catching up. Once you get past the smallest market sector, buyer advantage is definitely leveling off or actually switching to a seller’s market.”*

Figure 3: Time to Close

|              | % Closed in 3 months or less | % Closed in 6 months or less |
|--------------|------------------------------|------------------------------|
| <\$500K      | 46%                          | 71%                          |
| \$500K-\$1MM | 32%                          | 57%                          |
| \$1MM-\$2MM  | 30%                          | 63%                          |

### DEAL MULTIPLES

In each of the Main Street market sectors, deal multiples remained strongly concentrated within a two point spread. Multiples increased consistently as deal size grew.

Figure 4: Common Multiple Range

|              | Median SDE | SDE Range            | EBITDA              |
|--------------|------------|----------------------|---------------------|
| <\$500K      | 2.5        | 83% between 1.0-3.0  |                     |
| \$500K-\$1MM | 2.9        | 96% between 2.0-3.75 |                     |
| \$1MM-\$2MM  | 3.0        | 69% between 2.5-4.0  | 80% between 2.0-4.0 |



Of note, SDE calculations include working capital for the majority of deals in the smallest market sectors. But as deal size increased, working capital was less likely to be figured in to business value.

*Figure 5: SDE with Working Capital*

|              | SDE incl. Working Capital |
|--------------|---------------------------|
| <\$500K      | 67%                       |
| \$500K-\$1MM | 55%                       |
| \$1MM-\$2MM  | 29%                       |

## REASON TO SELL & REASON TO BUY

Retirement led as the number one reason to sell across all Main Street sectors. However, buyers in the smallest sectors were three times as likely to sell for a “new opportunity” than buyers in the largest sector.

*Figure 6: Reason to Sell*

|              |                |             |                     |
|--------------|----------------|-------------|---------------------|
| <\$500K      | Retirement 28% | Burnout 20% | New Opportunity 18% |
| \$500K-\$1MM | Retirement 45% | Burnout 19% | New Opportunity 19% |
| \$1MM-\$2MM  | Retirement 59% | Burnout 9%  | New Opportunity 6%  |

Buyers in the smallest market sectors were almost twice as likely to make an acquisition to “buy a job” than buyers in the largest sector.

*Figure 7: Buyer Motivation*

|              |                       |                       |                           |
|--------------|-----------------------|-----------------------|---------------------------|
| <\$500K      | Buying a Job 46%      | Horizontal Add-On 20% | Better Investment ROI 11% |
| \$500K-\$1MM | Buying a Job 45%      | Horizontal Add-On 16% | Better Investment ROI 13% |
| \$1MM-\$2MM  | Horizontal Add-On 44% | Buying a Job 26%      | Vertical Add-On 21%       |

## BUYER LOCATION

As deal size increases, buyers are sourced from a wider geographic area.

*Figure 8: Buyer Location (Relative to Seller)*

|              |          |           |             |
|--------------|----------|-----------|-------------|
| <\$500K      | City 38% | State 20% | Country 20% |
| \$500K-\$1MM | City 45% | State 45% | Country 10% |
| \$1MM-\$2MM  | City 24% | State 32% | Country 44% |

## TERMINATIONS & MISTAKES

Brokers reported as many as 54% of their Main Street transactions terminated without a closing in Q4 2014.

Termination rates declined consistently as business value increased, with termination rates of 22% for businesses valued between \$500,000 and \$1 million and 11% for businesses valued between \$1 million and \$2 million.

*“When it comes to a business sale, size does matter,” said Don Hicks, CBI, , Daily Resources, Inc. “The smaller your business the less likely you are to reach a successful sale agreement.”*

While advisors weren’t asked to provide the specific reason deals terminated, they were asked to cite the top mistakes sellers make that hurt their chances of a sale. The top three mistakes were:

1. Unrealistic expectations
2. Poor financial records
3. Declining business sales

*“The good news is that the biggest mistakes are all under a seller’s control. It just comes down to proper planning and having the necessary guidance from a business broker,” said Cress Diglio, CBI, M&AMI, Transworld Business Advisors and Chair of the IBBA Board of Directors. “This ties right back to the leading factor in getting deals done—and that’s clear expectations about your company’s value in today’s market. That has direct impact on your chance of a successful sale.”*

## FINANCING STRUCTURE

Seller financing accounted for 14% or less of deal structure in Q4 2014. All sectors showed a decline in seller financing and a greater shift toward combinations of buyer equity and senior debt. This is consistent with other market indicators on small business lending, including news from the U.S. Small Business Administration indicating that FY 2014 was a record year for the organization, with a 12% increase in the number of loans and a 7.4% increase in dollar amount over 2013.

Also of note, more buyers are using their 401K to fund a purchase—at nearly double the rate of Q4 2013.

Figure 9: Seller Financing

|              | Seller Financing |         | Buyer Equity/Senior Debt |         | Buyer Equity 401K Rollover |         |
|--------------|------------------|---------|--------------------------|---------|----------------------------|---------|
|              | Q4 2014          | Q4 2013 | Q4 2014                  | Q4 2013 | Q4 2014                    | Q4 2013 |
| <\$500K      | 13%              | 17%     | 84%                      | 68%     | 9%                         | 5%      |
| \$500K-\$1MM | 14%              | 16%     | 85%                      | 72%     | 24%                        | 16%     |
| \$1MM-\$2MM  | 8%               | 17%     | 89%                      | 70%     | 18%                        | 10%     |

## LOWER MIDDLE MARKET

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 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 Graziado School of Business and Management at Pepperdine University.

The Q4 2014 survey was completed by 197 business brokers and M&A advisors, representing 39 states. Half of the respondents (50%) had at least 10 years of experience in the M&A industry.

This report represents the lower middle market portion of the report, highlighting M&A Source members active in this sector. Participating advisors reported closing 37 lower middle market transactions in Q4 2014.

*Figure 1: Market Segments Studied*

| Lower Middle Market |              |
|---------------------|--------------|
| \$2MM-\$5MM         | \$5MM-\$50MM |

### KEY FINDINGS:

Over the past year, business sales have remained strong, and more deals are getting done. Fifty-five percent (55%) of advisors report closing more than one deal in Q4 2014, compared to 46% of advisors in Q4 the year prior.

M&A advisors report that deal volume increased in the last three months, with a mean score of 3.4 on a five point scale (2.5 would indicate volume stayed the same). This is a slight downtick in growth trends reported in Q4 2013 when the mean averaged 3.75.

Meanwhile, expectations continue to rise. Of the advisors surveyed, 89% expect M&A activity to increase in 2015. Lower middle market advisors expect that business values will increase somewhat in the next three months, with optimism averaging a 3.2 on a five point scale.

#### **Lower Middle Market: Recent Trends and Expectations** (on a five-point scale):

- Actual Uptick in New Clients: 3.75
- Expected New Business Engagements: 3.65
- Expected Business Valuation Multiples: 3.2

*“This information validates that the lower middle market is very active, in tune with the rest of the middle market,” said Scott Bushkie, CBI, M&AMI, Principal, Cornerstone Business Services, Inc. “It’s a good deal for sellers—EBITDA is climbing due to increased business performance while market multiples are also rising overall. The rising tide lifts all boats.”*

## **BARRIERS AND CONTRIBUTORS TO SUCCESS**

Pricing issues remain the number one factor in whether or not businesses are sold, with advisors citing valuations and price expectations as the leading barrier and the leading contributor to deal success.

Notably, fewer advisors cited valuation challenges in 2014, down five percentage points over a year ago (22% Q4 2014 vs. 27% Q4 2013). This coincides with valuations multiples being at record highs. Meanwhile, financing dropped from the #2 challenge to #3, indicating that lenders are being more aggressive about financing.

### **Top barriers for getting deals done**

1. Valuation
2. Deal fatigue
3. Financing

### **Top contributors to getting deals done**

1. Realistic price expectations (between owner and advisor)
2. Larger buyer pool
3. More sellers

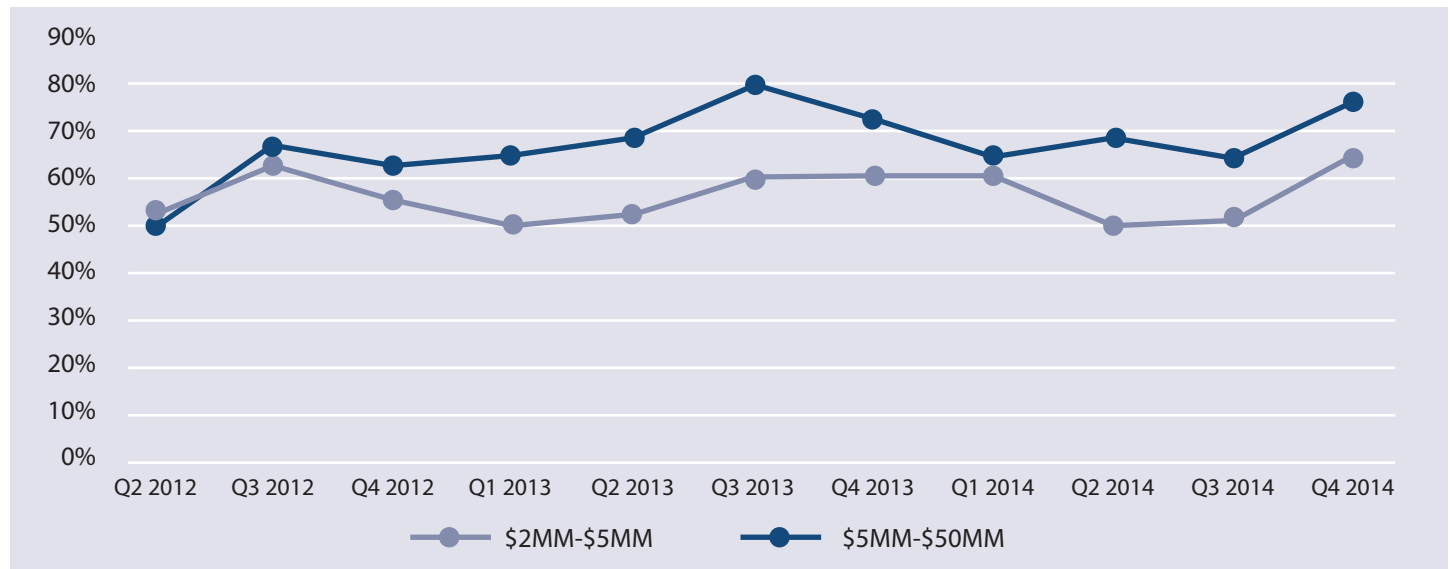
## **ADDITIONAL FINDINGS**

### **GROWING SELLER ADVANTAGE**

The lower middle market continues to shift to a stronger seller’s market. In Q4 2014, 65% of advisors described the \$2MM-\$5MM sector as a seller’s market, and 77% described the \$5MM-\$50MM market as such. This is at or near an all-time high for these sectors, since Q1 2013.



Figure 3: Seller's Market Sentiment



## TIME TO CLOSE

The median time to close was very similar to a year ago. Most lower middle market deals closed in eight months or less.

Figure 4: Time to Close

|              | % Closed in 8 months or less |
|--------------|------------------------------|
| \$2MM-\$5MM  | 79%                          |
| \$5MM-\$50MM | 85%                          |

## DEAL MULTIPLES

In the lower middle market, deal multiples remained fairly consistent over a year ago, although the median multiple for businesses valued between \$2MM-\$5MM jumped by 0.6 points over Q4 2013.

Figure 5: Common Multiple Range

|              | Median EBITDA | EBITDA                |
|--------------|---------------|-----------------------|
| \$2MM-\$5MM  | 4.6           | 58% between 3.25-4.75 |
| \$5MM-\$50MM | 5.0           | 48% between 3.75-5.25 |

Of note, EBITDA calculations include working capital for the majority of deals.

Figure 6: EBITDA with Working Capital

|              | EBITDA incl. Working Capital | TTM EBITDA incl. Working Capital |
|--------------|------------------------------|----------------------------------|
| \$2MM-\$5MM  | 42%                          | 11%                              |
| \$5MM-\$50MM | 42%                          | 14%                              |

## REASON TO SELL & REASON TO BUY

Retirement led as the number one reason to sell across both lower middle market sectors, followed by burnout.

Figure 7: Reason to Sell

|              |                |                      |                   |
|--------------|----------------|----------------------|-------------------|
| \$2MM-\$5MM  | Retirement 44% | Burnout 22%          | Family Issues 17% |
| \$5MM-\$50MM | Retirement 58% | Recapitalization 16% | Burnout 11%       |

Buyers in the lower middle market are most likely to make an acquisition as part of a horizontal or vertical add on. However, a third of buyers in the \$2MM-\$5MM were in a position to buy a business as a means of acquiring a job. In other words, these buyers are high net worth individuals looking for career independence and the opportunity to control their own destiny.

Figure 8: Buyer Motivation

|              |                       |                     |
|--------------|-----------------------|---------------------|
| \$2MM-\$5MM  | Horizontal Add-On 39% | Buying a Job 33%    |
| \$5MM-\$50MM | Horizontal Add-On 58% | Vertical Add-On 16% |

## BUYER LOCATION

As deal size increases, buyers are sourced from a wider geographic area.

Figure 9: Buyer Location (Relative to Seller)

|              |          |           |             |                   |
|--------------|----------|-----------|-------------|-------------------|
| \$2MM-\$5MM  | City 33% | State 11% | Country 44% |                   |
| \$5MM-\$50MM | City 5%  | State 16% | Country 68% | International 11% |

## TERMINATIONS & MISTAKES

Advisors reported that only 7% of their lower middle market transactions terminated without closing in Q4 2014. That compares to termination rates as high as 54% for Main Street businesses valued at less than \$500K.

*“Termination rates decline consistently as business value increases,” said Joe Lindsey, CBI, M&A MI, Dailey Resources, Inc. and Chair of M&A Source. “When it comes to M&A, size does matter. The smaller your business the less likely you are to reach a successful sale agreement.”*

While advisors weren't asked to provide the specific reason deals terminated, they were asked to cite the top mistakes sellers make that hurt their chances of a sale. The top three mistakes were:

1. Unrealistic expectations
2. Poor financial records
3. Declining business sales

*“The good news is that the biggest mistakes are all under a seller’s control. It just comes down to proper planning and having the necessary guidance from an M&A advisor,” said David Ryan, Principal, Upton Financial Group, Inc. “This ties right back to the leading factor in getting deals done—and that’s realistic expectations about your company’s value in today’s market. That has direct impact on your chance of a successful sale.”*

## **ABOUT PEPPERDINE UNIVERSITY GRAZIADIO SCHOOL OF BUSINESS AND MANAGEMENT**

Founded on the core values of integrity, stewardship, courage, and compassion, Pepperdine University's Graziadio School of Business and Management has been developing values-centered leaders who advance responsible business practice since 1969. Student-focused, experience-driven and globally oriented, the Graziadio School offers fully accredited MBA, Masters of Science, bachelor's completion and non-degree executive business programs for business professionals, entrepreneurs, managers and senior executives at all stages of their professional and personal development.

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.

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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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