

Q1 2017



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

MARKETPULSE

QUARTERLY SURVEY REPORT

FIRST QUARTER 2017





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 and director, Pepperdine Private Capital Markets Project.

To become a member, please contact the IBBA and M&A Source headquarters at admin@masource.org or (404) 477-5810.

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THE IBBA AND M&A SOURCE MARKET PULSE SURVEY REPORT | Q1 2017

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 Q1 2017 survey was completed by 315 business brokers and M&A advisors, representing 37 states. Half of the respondents (55%) had at least 10 years of experience. Respondents completed 272 transactions this quarter.

Figure 1: Market Segments Studied

Main Street	Lower Middle Market
Less than \$500K	\$2MM - \$5MM
\$500K - \$1MM	\$5MM - \$50MM
\$1MM - \$2MM	

OPTIMISM DAMPENED BY RISING INTEREST RATES

The Federal Reserve raised its benchmark interest rate in March and additional increases are expected by the end of 2017. Advisors were asked to weigh in on how rising interest rates will impact the Main Street brokerage and lower middle M&A markets. Most (62%) believe the shift will impact the ability to finance transactions. Meanwhile almost half (47%) of advisors predict a decrease in valuations, and about 40% predict a decrease in the buyer pool.

“By raising interest rates, the Federal Reserve is signaling that the economy is improving and lender risks are decreasing. An interest rate increase should encourage lenders to initiate more loans, allowing them to gain a higher yield on their capital,” said Craig Everett, PhD, Director of the Pepperdine Private Capital Markets Project.

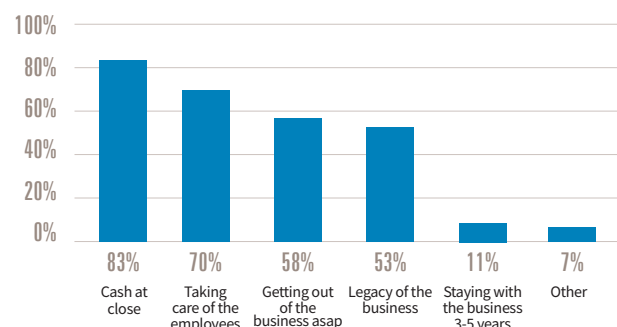
“However, rising interest rates also mean borrowing will become more expensive. That raises the total cost of a transaction, which is why advisors are somewhat pessimistic about getting deals financed at the current values,” Everett continued. “Either way, buyers and sellers who are looking to complete a transaction should accelerate their efforts now, before lending costs increase and values decrease because neither of these conditions are conducive to completing a transaction.”

Reflecting on other current events, most advisors (72%) do not believe that the Republicans’ failure to pass a new healthcare plan will impact market activity. Meanwhile, advisor optimism for new client engagements remains moderately positive, at 3.6 on a five-point scale. However, expectations for business valuation increases are more cautious at 3.1 across every sector.

NEGOTIATION MATTERS

When it comes to selling a business, owners care about more than just money. Advisors indicate that cash at close is a key desirable for sellers, as is taking care of their employees. Getting out quickly and leaving a legacy are also highly valued. Results indicate that a relative minority of sellers are interested in employment contracts and other deal structures that keep them active in business.

Figure 2: What Do Sellers Care Most About Besides Money?



Total number of responses = 315

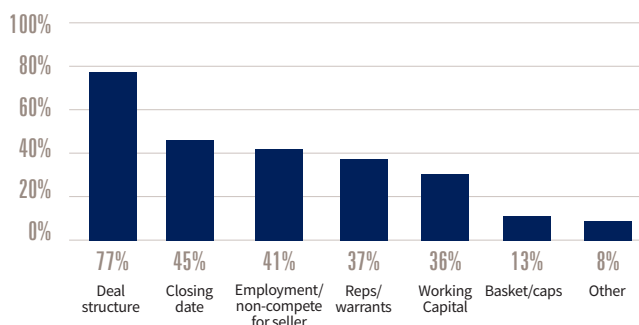
*Number is more than number of respondents as many respondents overlap into 2 or 3 areas.

“Sellers do come to the table with a Jerry Maguire ‘SHOW ME THE MONEY’ attitude,” said Teija Heikkilä, CM&AP, Principal, National Kennel Sales & Appraisals. “And although that is a number one concern as this is their life’s work in many cases, taking care of employees is a close second. I’ve personally seen many situations in which a business owner takes a lesser amount to work with a buyer whom they believe will protect employee jobs and maintain a consistent culture.”

“As a note to would-be-buyers, don’t assume it’s all about the cash. Ask the business owner what’s important to them and see how that fits with what you’re trying to accomplish for yourself and your organization,” Heikkilä continued.

Not surprisingly, deal structure is a negotiation factor in most transactions. That’s followed by negotiations over closing date, and an employment contract or non-compete contract for the seller. More than a third of deals include negotiations over reps and warranties as well as working capital.

Figure 3: The Most Negotiated Item in the Closed Deals Besides Purchase Price



Total number of responses = 315

*Number is more than number of respondents as many respondents overlap into 2 or 3 areas.

“Most sellers want cash at close. However, buyers and lenders like the seller to keep some skin in the game after the sale. And oftentimes the deal needs some form of seller financing, earn out, equity rollover, or other form of alternative financing to bridge the value gap between what the seller wants and what the buyer can bring to the deal,” explains Lisa Riley, CBI, Principal of LINK Business-Phoenix. “And in the end, debt doesn’t kill companies, lack of cash flow does. So buyers have to make sure they have a deal structure that allows them to cover cash flow and mitigate risk.”

“As for timing, many business owners contemplate selling for months if not years. Once they do finally make that emotional decision, they want to flip the switch and have it sold the next day,” said David Ryan, an advisor with Upton Financial Group in California. “In today’s competitive environment, especially in the lower middle market, if a buyer is more organized and ready to close sooner, that could be the difference between winning the deal or losing it to another party.”

“Representations and warranties can be another sticking point, especially for buyers and sellers working with inexperienced representation,” said John Howe, M&AMI, Director, Business Transition Strategies, M&A Source Chair. “You want a specialized M&A attorney who’s a deal maker. Otherwise your life’s work could go up in flames because someone didn’t understand what’s normal and customary to protect your interests while still remaining reasonable to the other side.”

WHY ARE OWNERS SELLING?

In Q1 2017, retirement continues to lead as the number one reason to sell across all sectors, followed by burnout and new opportunities.

Figure 4: Top Reasons Sellers Went to Market Q1

Deal Size	#1 Reason	#2 Reason	#3 Reason
< \$500K	Retirement	Burnout	New Opportunity
\$500K - \$1MM	Retirement	Burnout	New Opportunity
\$1MM - \$2MM	Retirement	Burnout	New Opportunity
\$2MM - \$5MM	Retirement	Tie (Burnout, Opportunity, Recapitalization)	
\$5MM - \$50MM	Retirement	Tie (Recapitalization, Family Issues)	

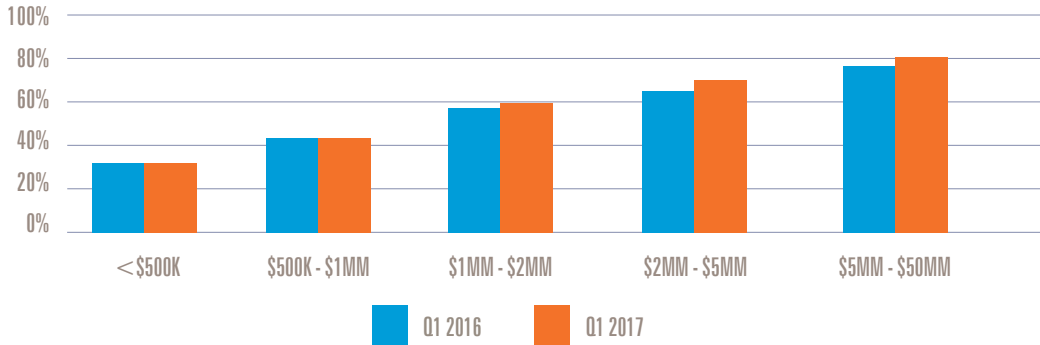
“We’re seeing recapitalization show up as a leading reason for sale more often. That tells me two things. One: We’re doing a better job of educating sellers on what a recap is and how it could benefit them. Two: I believe we’re seeing younger sellers take advantage of the good seller’s market today, cashing out the majority of their equity while working with experienced partners who will help them grow the business and get a second bite at the apple down the road,” said Kyle Madden, Partner, KLH Capital.



LEVERAGE AND VALUATIONS

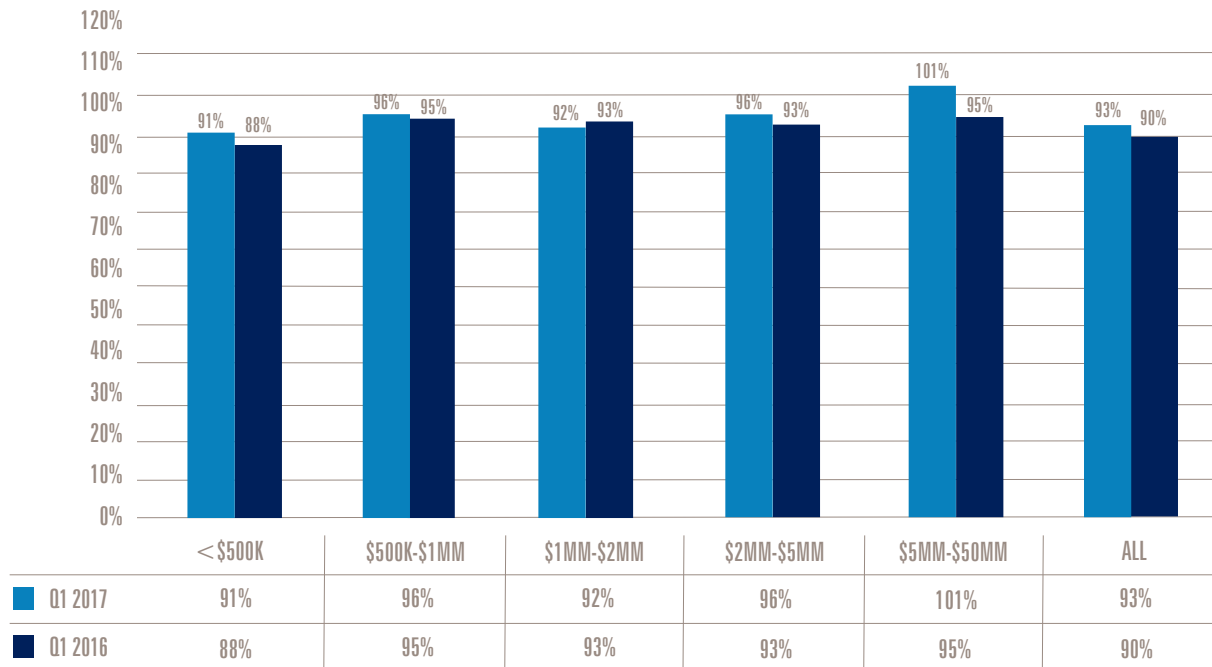
Year-over-year, sentiment did not increase for the two smallest markets.

Figure 5: Seller's Market Sentiment Improving



Year-over-year, final sale prices remain fairly consistent as a percentage of the pre-set asking price or internal benchmark. Final sale price increased in all categories except for the \$1MM-\$2MM range. Of note, however, is that premiums in the top sector, at 101% of benchmark, are significantly below premiums of 122% reported last quarter.

Figure 6: Final Price Realized vs. Asking Price



Seller market sentiment, which had seen a decline last quarter, is now back on a positive trend.

“The benchmark-to-final-price ratio could be attributed to more than market dynamics,” said Lou Vescio, CBI, M&AM, Principal, Coastal Business Intermediaries, Inc., IBBA Chair. “We may also be seeing a reflection of the IBBA’s strong education programs, influencing more advisors around the importance of accurate, realistic valuations. Far too often, uneducated brokers or sellers will pick a price based on what they need, or what sounds good, only to have the business sit on the market for years due to misplaced expectations.”

Multiples continue to remain strong in all categories, demonstrating a plateau in the Main Street market. Year-over-year, multiples saw the biggest gains in the \$2MM-\$5MM sector.

Figure 7: Median Multiple

	2017	2016				2015			
	Q1	Q4	Q3	Q2	Q1	Q4	Q3	Q2	Q1
Median Multiple Paid (SDE)									
<\$500K	2.3	2.3	2.3	2.3	2.0	2	2	2	2
\$500K-\$1MM	2.8	2.8	2.8	3.0	2.8	2.5	2.5	2.5	2.7
\$1MM-\$2MM	3.3	3.3	3.3	3.3	3.0	3.3	2.8	3	3.3
Median Multiple Paid (EBITDA)									
\$2MM - \$5MM	5.3	4.8	4.5	4.0	4.0	4	4	4	4.5
\$5MM - \$50MM	5.3	5.5	5.8	5.1	5.5	5.1	5.3	5	4.9

Figure 8: Common Multiple Range Q1

Common Multiple Range (SDE)	
<\$500K	61% between 1.75-2.75
\$500K - \$1MM	64% between 2.5-3.5
\$1MM - \$2MM	81% between 2.75-3.75
\$2MM - \$5MM	60% between 3.0-4.25
Common Multiple Range (EBITDA)	
\$2MM - \$5MM	57% between 4.5-5.25
\$5MM-\$50MM	63% between 4.25-7.0

Figure 9: Deal Size Includes Most Common Multiple Type

Deal Size	Most Common Multiple Type
\$500K	SDE w/o working capital
\$500K - \$1MM	SDE w/o working capital
\$1MM - \$2MM	SDE w/o working capital
\$2MM - \$5MM	SDE w/o working capital
\$5MM-\$50MM	EBITDA incl. working capital

* SDE Sellers Discretionary Earning

* EBITDA Earnings Before Interest, Taxes, Depreciation and Amortization

This quarter, SDE was used most commonly in all categories except for \$5 million to \$50 million. But typically, EBITDA is used as the multiple type throughout the entire lower middle market. SDE adds back one owner compensation to the bottom line, whereas EBITDA leaves a fair market salary in the P&L, as would be required to hire a CEO or general manager.

Lower middle market deals are taking longer to close, in both the sales and LOI stage.

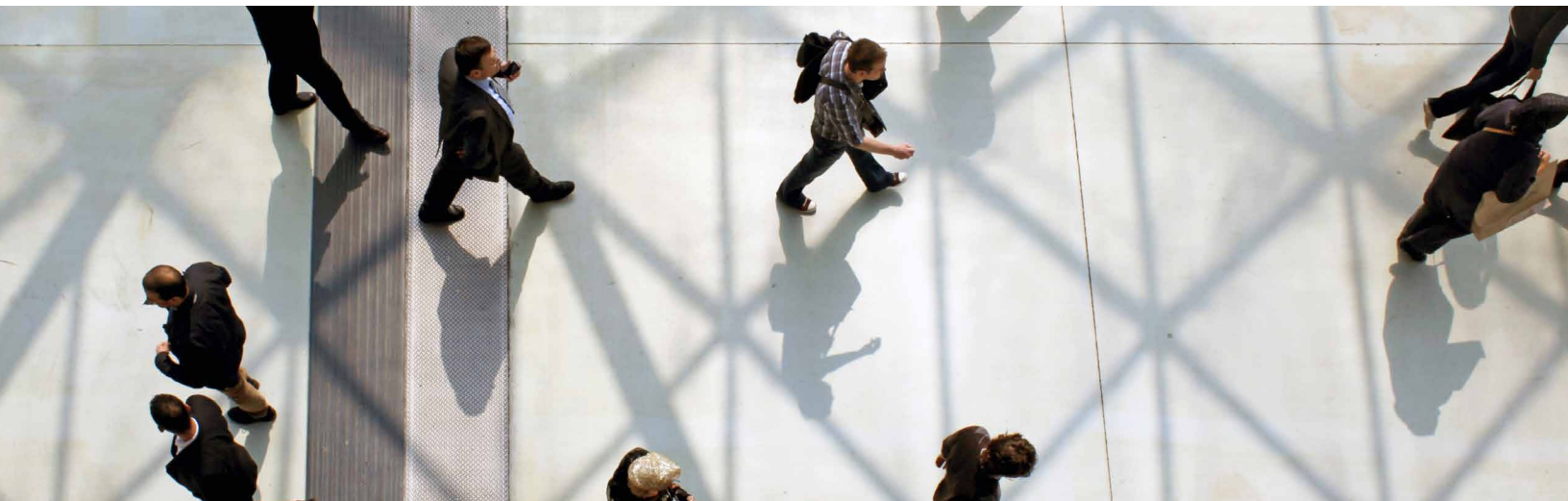


Figure 10: Largest Businesses Taking Longer to Sell in Q1 2017

Business Value	Q1 2017		Q4 2016		Q3 2016	
	Months to Close	Months from LOI to Close	Months to Close	Months from LOI to Close	Months to Close	Months from LOI to Close
<\$500K	7	2	7	2	7	2
\$500K-\$1MM	6	2	7	3	6	3
\$1MM-\$2MM	6	3	8.5	3	7	3
\$2MM-\$5MM	11	4	9	3	10	4
\$5MM-\$50MM	12	4	10	4	8	3

“Deals are getting done at strong values, but they’re taking longer to get done. Much of that could be driven by investors doing more diligence to make sure the business is worthy of the premium they’re willing to pay,” said Scott Bushkie, CBI, M&AMI, President of Cornerstone Business Services, Inc. “Others could be due to outside third parties needing time to do their work. For instance, we’re selling a manufacturing company with real estate and the lender needed a real estate appraisal, an updated ALTA survey, phase 1 environmental report, equipment appraisal, facility tour, a bank auditor review of books and processes, plus research on the buyer. And those were just the moving parts for the lender! You can see how that could drag out the process.”

Figure 11: Portion of Sale Received at Cash at Close

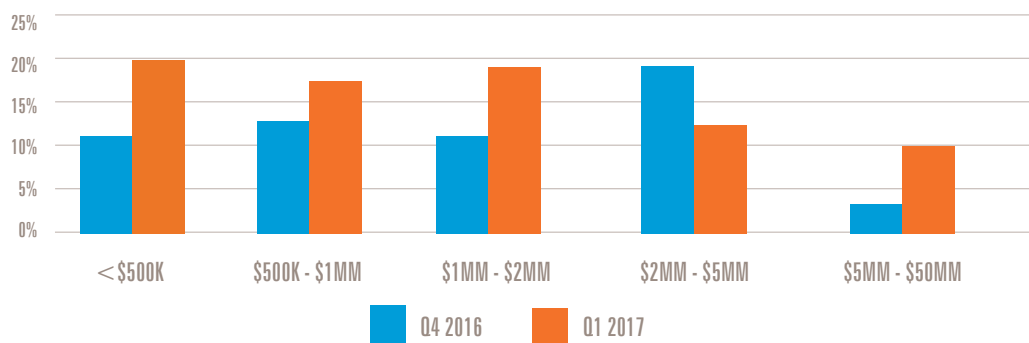
	Cash at Close*	Seller Financing	Earn Out	Retained Equity	Other
<\$500K	77%	20%	2%	1%	
\$500K - \$1MM	77%	18%	2%	1%	2%
\$1MM - \$2MM	75%	19%	2%		5%
\$2MM - \$5MM	82%	12%	2%	2%	1%
\$5MM - \$50MM	64%	15%	3%	14%	3%

*Cash at close reflects a combination of buyer’s equity and senior debt.

In this quarter, owners got 77% or more cash at close. The majority of the balance came from seller financing, along with some earn outs to close the valuation gap. Sellers in the largest sector kept a portion of equity, consistent with recapitalization being a key reason for sale in this sector.

Of note, seller financing played a larger role this quarter, representing 12% to 20% of deal structure. This is a notable increase over last quarter.

Figure 12: Seller Financing Jumps in Most Sectors



Year-over-year, sellers are being asked to hold a larger percentage of the seller note. This trend is consistent with increases to the final purchase price.

“A seller note is an obligation to pay, regardless of how the business does. But seller financing sits in a second position behind senior debt. That means if things go wrong, the primary lender has a right to the tangible assets before the seller,” explained David Ryan, an advisor with Upton Financial Group in California. “Yet seller financing is still more secure than an earn out, which is tied to performance.”

KNOW YOUR BUYER

Using the Market Pulse survey results, we can identify common buyer personas for each industry segment.

< \$500K

Buyers in this market segment tend to be first-time business owners looking to “buy a job” by acquiring a business that can provide sufficient income/owner’s salary. These buyers are usually located within 20 miles of the business they acquire.

- Buyer type: 1st time: 50% | serial entrepreneur: 34%
- Location: within 20 miles: 75%
- Motivation: buy a job: 53%

\$500K - \$1MM

Buyers in this segment also tend to be first-time owners, looking to buy a job, within 20 miles of their home. About a quarter of these buyers, however, will be serial entrepreneurs and another quarter will be existing businesses looking to grow through acquisition.

- Buyer type: 1st time: 46% | existing business: 26% | serial entrepreneur: 22%
- Location: within 20 miles: 56% | over 100 miles: 20%
- Motivation: buy a job: 38%

\$1MM - \$2MM

Buyers in this segment are still most likely to be first-time owners, followed by serial entrepreneurs and existing businesses. Their motivations cross three consistent themes: buying a job, better ROI than other investments, and growth through acquisition. Again, most of these buyers will be sourced within a 20-mile radius of the seller.

- Buyer type: 1st time: 38% | serial entrepreneur: 32% | existing business: 26%
- Location: within 20 miles: 50% | over 100 miles: 29%
- Motivation: strategic growth: 35% | investment: 29% | buy a job: 29%

\$2MM - \$5MM

Buyers in this segment are most likely to be existing businesses looking to grow through acquisition. However, first-time buyers still represent a quarter of the buyers. Buyers here are just as likely to be sourced locally as farther afield.

- Buyer type: existing business: 29% | 1st time: 24% | private equity: 24%
- Location: within 20 miles: 35% | over 100 miles: 24%
- Motivation: strategic growth: 53% | investment: 24% | buy a job: 18%

\$5MM - \$50MM

Buyers in this segment are split between existing businesses (strategic buyers) and private equity firms. These buyers target businesses that represent strong investment opportunities and/or strategic growth opportunities through vertical or horizontal add-ons. Most of these buyers are based 100 miles or more away from the seller.

- Buyer type: private equity: 38% | existing businesses: 38%
- Location: over 100 miles: 56%
- Motivation: strategic growth: 57% | investment: 25%

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A leader in cultivating entrepreneurship and digital innovation, Pepperdine Graziadio School of Business and Management 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 five Southern California locations and at Silicon Valley and Santa Barbara 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, and the Presidents and Key Executives MBA, as well as executive education certificate programs. Follow the Graziadio School on [Facebook](#), [Twitter](#) at [@GraziadioSchool](#), [Instagram](#) and [LinkedIn](#).

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 and Market Pulse Quarterly Report in cooperation with the International Business Brokers Association and M&A Source.

ABOUT INTERNATIONAL BUSINESS BROKERS ASSOCIATION

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. For more information about IBBA, visit the website at www.ibba.org or follow the IBBA on [Facebook](#), [Twitter](#), and [LinkedIn](#)

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