Q3 2016

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

MARKETPULSE

QUARTERLY SURVEY REPORT

THIRD QUARTER 2016

IBBA INTERNATIONAL BUSINESS BROKERS ASSOCIATION, INC.®

M&A Source

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THE IBBA AND M&A SOURCE MARKET PULSE SURVEY REPORT Q3 2016

The quarterly International Business Brokers Association (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 Pepperdine Graziadio School of Business and Management.

The Q3 2016 survey was completed by 278 business brokers and M&A advisors, representing 38 states. Half of the respondents (51%) had at least 10 years of experience in the industry. Respondents completed 246 transactions this quarter.

Figure 1: Market Segments Studied

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

5 Business Improvements with Highest ROI

Ask any realtor—there are certain home improvements that provide the biggest bang for your buck in terms of resale. Affordable cosmetic changes like new siding, a steel entry door, and an upscale garage door are all reported winners. Unfortunately, when it comes to selling your business, the changes aren't always so easy. But thanks to this quarter's Market Pulse survey, we can now point to the five key weaknesses buyers care about most:

- Declining profits
- Declining sales
- Poor financial reporting
- Lack of management team
- Customer concentration

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@ibba.org or (888) 686-4222.

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"As a business owner preparing for a sale, you can either identify your company's weaknesses and fix them yourself, or let a buyer take on those challenges. What you decide to do depends on your energy, your finances, and what you want to net out of a sale," said Lisa Riley, CBI, Principal of LINK Business-Phoenix. "Sellers who focus their energies on resolving some, or all, of these key issues will see the biggest return at the closing table."

Managing Expectations

New this survey, advisors were asked about managing seller price expectations. Nearly all advisors (93%) get the seller to agree to a price range before going to market, and most (80%) will not take a listing if they don't believe they can meet a seller's expectations.

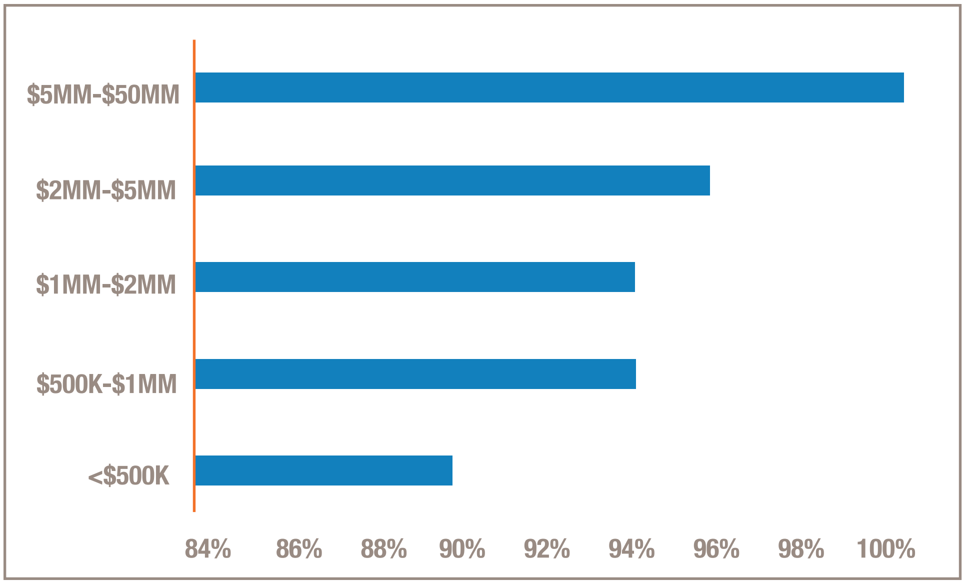
David Ryan, an advisor with Upton Financial Group in California, suggests this is why advisors in IBBA and the M&A Source (who are surveyed for this report) have closing rates that significantly exceed industry averages.

As reported in the Q3 survey, 54% of deals closed successfully, while 46% were terminated. Other commonly referred industry benchmarks put the closing ratio at 25% or less.

"BizBuySell has 45,000 active businesses for sale, yet only about 1,800 of them close every quarter," said Ryan. "Our members consistently say that unrealistic price expectations are the biggest barrier to getting deals done. By helping sellers understand what's realistic, we're dramatically increasing their chances of selling and getting a return on all their years of hard work."

Notably, advisors report that businesses in the Main Street market obtained 90% or better of the established asking price. Meanwhile, businesses in the lower middle market—which typically aren't marketed with an asking price—received 96% and 100%, respectively, of the internal benchmark set by the advisor and seller.

Figure 2: Final Price Realized vs. Asking Price



The average time to close is 8.6 months, which is about average or a little faster than the norm. But for businesses valued at $5 million to $50 million, the average time to close is 12 months, longer than typical.

Figure 3: Largest businesses taking longer to sell in Q3 2016

	Q3 2016		Q2 2016	
Business Value	**Months to Close**	**Months from LOI to Close**	**Months to Close**	**Months from LOI to Close**
<$500K	7	2	6	2
$500K-$1MM	8	3	6	3
$1MM-$2MM	8	3	9	4
$2MM-$5MM	8	3	9	4
$5MM-$50MM	12	4.5	9	4

"Time to close also plays a factor in a successful business sale," said Ryan. "Sellers need to understand that the sale process, from choosing your advisory team to transitioning in a new owner, can easily take a year or more. Those who plan ahead and go to market before they burn out are better positioned to make it to a closing table."

WHY ARE OWNERS SELLING?

Retirement continues to lead as the number one reason to sell across all sectors, followed by burnout in the Main Street Market. Notably, for businesses valued at less than $500,000, retirement and burnout were nearly equal in terms of driving sellers to market, with only a 3-percentage point difference.

In the lower middle market, burnout was not a leading factor. Other forces such as family issues and recapitalization followed retirement.

Figure 4: Percent of Sellers Entering Market for Retirement

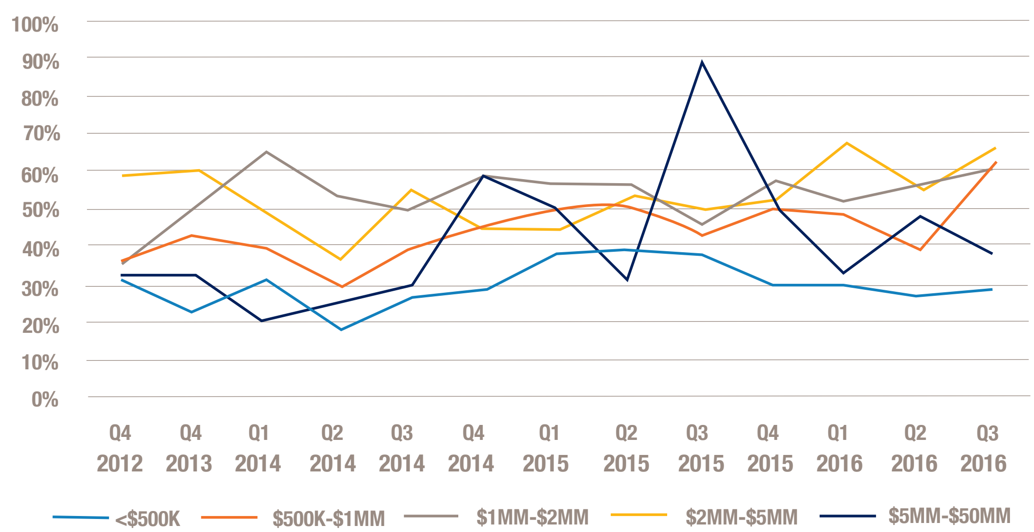


Figure 5: Top 2 Reasons Sellers Went to Market

Deal Size	#1 Reason	#2 Reason
<$500K	Retirement	Burnout
$500K - $1MM	Retirement	Burnout
$1MM - $2MM	Retirement	Burnout
$2MM - $5MM	Retirement	Family Issues
$5MM - $50MM	Retirement	Recapitalization

"This is the first time in many quarters that burnout did not rank as a top-two driver for the lower middle market," said Scott Bushkie, CBI, President of Cornerstone Business Services, Inc., IBBA Chair. "Exit planning is a hot topic among business consultants right now. The uptick in recapitalization activity could be an indicator that larger business owners are becoming more savvy about their exit planning options. They're exploring partnerships that enable them to exit out of the business in stages, and take a second bite out of the apple when they sell their remaining shares a few years down the road."

Looking back year-over-year, advisors saw an increase in new clients across most sectors, with the strongest growth among businesses valued at $5MM-$50MM. Meanwhile, optimism for new client engagements is modest. This is consistent with last quarter in which optimism for new engagements fell below actual client growth.

Figure 6: Mean Increase in New Clients (5-point scale)

	Optimism	Reported Increase	
BUSINESS VALUE	**Q4**	**Q3 2016**	**Q3 2015**
<$500K	3.5	3.5	3.2
$500K - $1MM	3.4	3.7	3.2
$1MM - $2MM	3.5	3.6	3.2
$2MM - $5MM	3.6	3.7	3.1
$5MM - $50MM	3.4	3.9	3.1

"We might attribute this kind of conservative outlook to election year uncertainty," Craig Everett, PhD, Pepperdine Private Capital Markets Project, Director. "Despite the positive market trends, business owners may be watching for the results of this year's presidential and congressional elections to get a read on market forces for the year ahead."

"Unfortunately, we don't recommend that sellers engage in 'one-more-year-itis' right now. The M&A market has had a very good run and it's only going to get worse before it gets better. You just never know when the next bubble will burst, but when it does your business has a lower value the very next day, even if your numbers haven't changed," continued Everett.

WHO HAS THE ADVANTAGE: BUYERS OR SELLERS?

Businesses in the smallest market sector are positioned in a buyer's market, although seller leverage is improving. Advantage shifts, however, as deals exceed $1 million in value. In the lower middle market, seller advantage sentiment declined year-over-year, yet remains solidly in the seller's favor.

Figure 7: Seller's Market Sentiment Even and Up

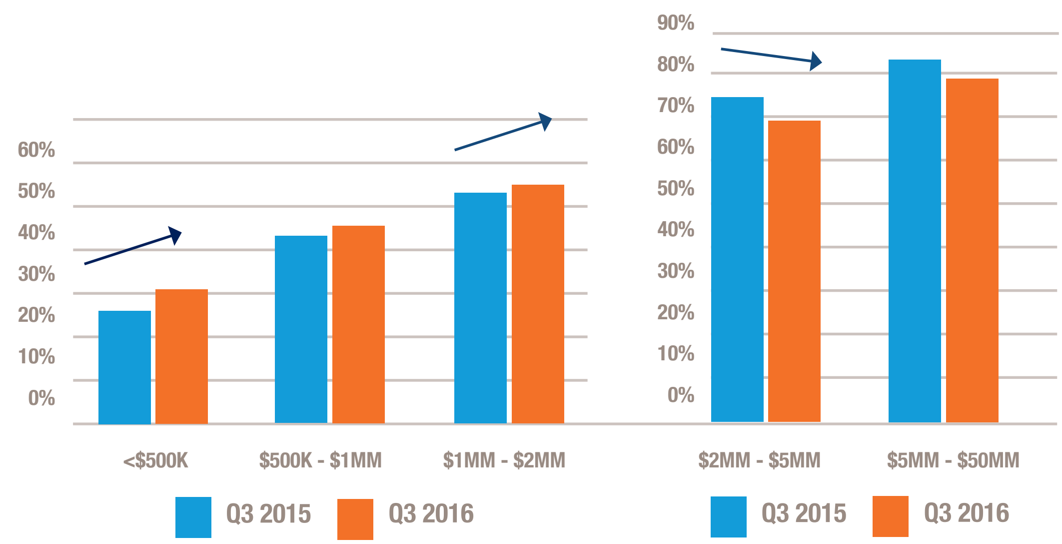
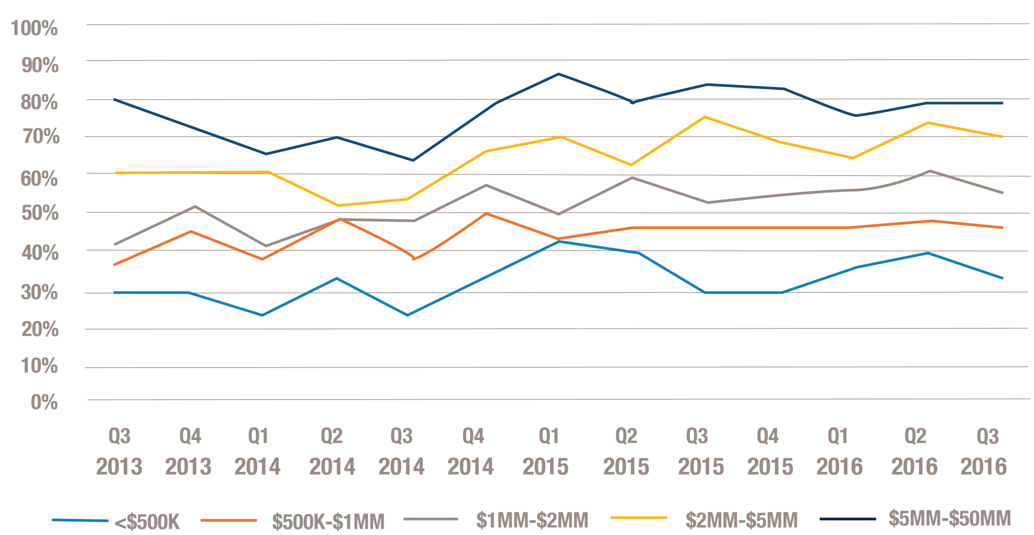


Figure 8: Seller Market Sentiment, Historical Trends



WHERE ARE BUSINESS VALUES TRENDING?

Multiples continue to remain strong in all categories, holding steady or increasing across all market sectors. The lower middle market saw the largest jumps, with businesses valued at $5 million to $50 million increasing 0.7 percentage points.

Figure 9: Median Multiple Increase for Businesses <$500K

	2016			2015				2014	
	Q3	Q2	Q1	Q4	Q3	Q2	Q1	Q4	Q3
Median Multiple Paid (SDE)									
<$500K	2.3	2.3	2	2	2	2	2	2	2
$500K-$1MM	3.0	2.8	2.8	2.5	2.5	2.5	2.7	2.9	2.5
$1MM-$2MM	3.3	3.3	3.0	3.3	2.8	3	3.3	3	3.3
Median Multiple Paid (EBITDA)									
$2MM - $5MM	4.5	4.0	4.0	4	4	4	4.5	4.6	4
$5MM-$50MM	5.8	5.1	5.5	5.1	5.3	5	4.9	5	5.1

Figure 10: Common Multiple Range

Common Multiple Range (SDE)	
<$500K	66% between 1.75-2.75
$500K - $1MM	69% between 2.5-3.5
$1MM - $2MM	64% between 2.75-3.75
$2MM - $5MM	78% between 3.0-4.25
Common Multiple Range (EBITDA)	
$2MM - $5MM	72% between 4.25-5.25
$5MM-$50MM	51% between 4.75-5.75

Figure 11: 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 captial
$1MM- $2MM	SDE w/o working capital
$2MM - $5MM	SDE w/o working capital
$5MM-$50MM	EBITDA incl. working capital

*SDE Sellers Discretionary Earning

*EDITDA Earnings Before Interest, Taxes, Depreciation and Amortization

"Although activity seems to be down slightly from over a year ago, multiples were notably higher in the lower middle market. This goes to show that the sellers who are moving now are getting ahead of the curve and taking advantage of supply and demand conditions," said Lou Vescio, CBI, M&AMI, Principal, Coastal Business Intermediaries, Inc. "There are fewer sellers than buyers in the lower middle market."

"These may be the strongest multiples we've seen since we started the survey," said Bushkie. "Multiples definitely seem to have taken a jump, and it will be interesting to see where they go in the fourth quarter as the presidential election wraps up."

Sellers continue to get the majority cash at close. In this quarter, owners got 76% or more cash at close with the majority of the balance being seller financing, along with some earn outs to close the valuation gap. Seller financing amounted to at least 10% of financing across all market segments.

Figure 12: Portion of Sale Received as Cash at Close

	Cash at Close*	Seller Financing	Earn Out	Retained Equity
<$500K	83%	15%	1%	1%
$500K - $1MM	80%	17%	1%	
$1MM - $2MM	80%	12%	3%	3%
$2MM - $5MM	78%	12%	10%	
$5MM - $50MM	75%	8%	4%	5%

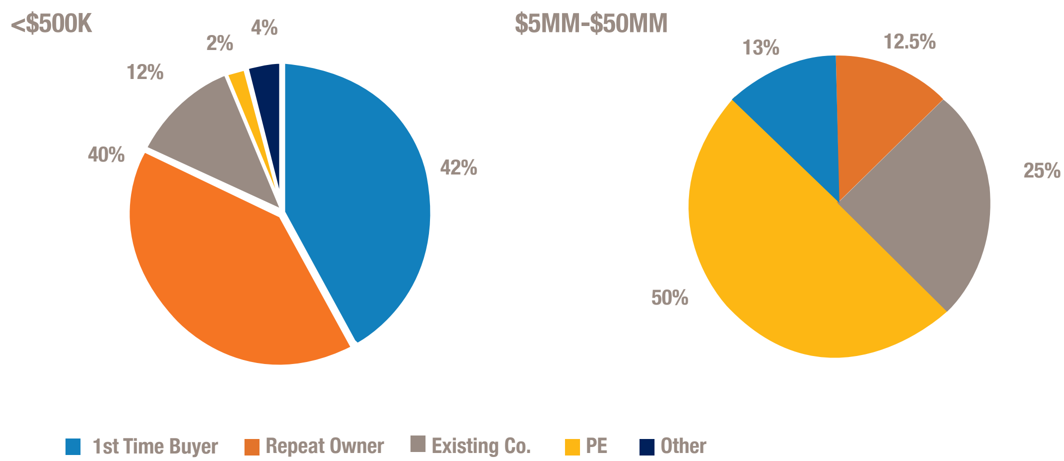
** Cash at close reflects a combination of buyer's equity and senior debt*

"This is not like selling a house and getting all your cash at close. The vast majority of deals use some alternative financing now to get across the finish line," said David Still, CBI, President, Capital Endeavors, Inc. "Sellers need to go into the sale process with their eyes wide open. They need to provide some level of buyer support in some form or fashion."

KNOW YOUR BUYER

In the smallest deal category (businesses valued at <$500K) first time buyers accounted for the largest buyer segment. In the largest deal category (businesses valued between $5 million to $50 million) private equity made up the largest buyer group while individual buyers accounted for only 12.5%, all of whom were repeat business owners.

Figure 13: Buyer Comparison by Smallest/Largest Market Sectors



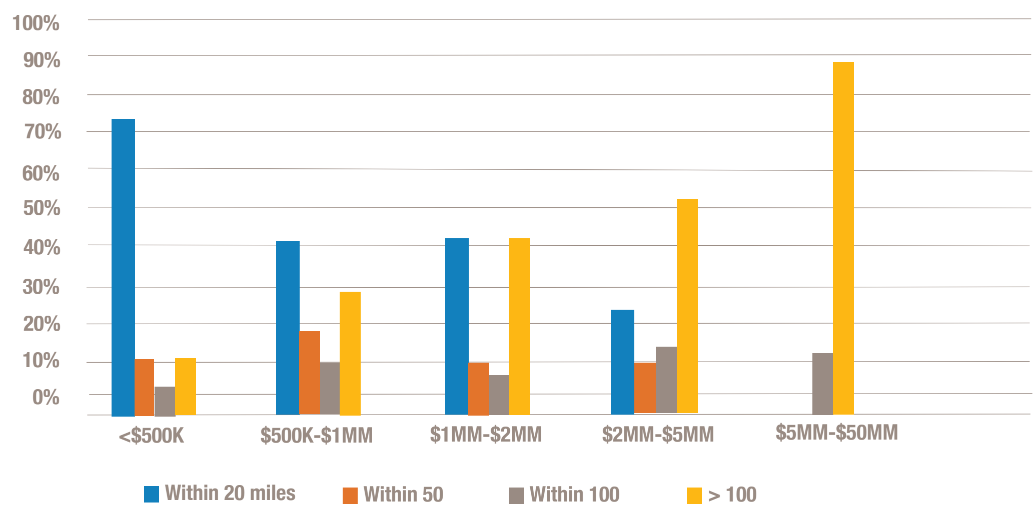
"It's rare to see a market segment with no first-time buyers, even among the $5 million to $50 million sector," concedes Joe Lindsey, CBI, M&AMI, CM&AP, and M&A Source Chair. "This could be indicative of how competitive the landscape is right now, and was validated by the increased multiples we saw this quarter."

"In the $5 million to $50 million category, activity from private equity and existing companies is usually pretty even. But this time, private equity activity was double that of existing firms," said John Howe, M&AMI, Director, Business Transition Strategies. "Fifteen or twenty years ago, there were very few private equity groups buying companies. Now they're a pivotal part of the market. It's a big reason why the landscape has changed so much. We have a lot of buyers with a lot of resources at the table."

WHERE DO THEY COME FROM?

Typically, buyers are sourced from a wider geographic area as deal size increases. This quarter bore that out as no buyers were sourced within a 50-mile radius for businesses valued at $5 million to $50 million.

Figure 14: Buyer Location (in miles - relative to seller)



WHAT MOTIVATES THEM?

Buyers in the Main Street market are most often motivated by a desire to buy a job. That is, the seller is looking to leave corporate America and be active fulltime in the business. Buyers in the lower middle market are more often expanding an existing business through a horizontal or vertical add-on.

Figure 15: Buyer Motivation Shifts with Transaction Size

Deal Size	Buying a Job	Growing an Existing Business	Better ROI than Other Investments
<$500K	55%	28%	9%
$500K - $1MM	41%	38%	12%
$1MM - $2MM	39%	20%	23%
$2MM - $5MM	31%	28%	17%
$5MM - $50MM		76%	

"Private equity activity was so strong in the $5 million to $50 million category this quarter, so the numbers above could seem misleading. The reality though is that many private equity groups are out there looking for add-ons to grow their existing platform businesses," explained Andrew Rogerson, CM&AP, CBI, Rogerson Business Services.

WHAT INDUSTRIES ARE HOT?

Looking at the overall market, manufacturing led among hot industries, followed by wholesale distribution, consumer goods, and personal services.

Figure 16: Top Industries by Market Sector

Deal Size	#1 Market Sector	#2 Market Sector	#3 Market Sector
<$500K	Restaurants	Consumer Goods	Personal Services
$500K - $1MM	Personal Services	Construction/Engineering	Business Services
$1MM - $2MM	Manufacturing	Consumer Goods	Wholesale Distribution
$2MM - $5MM	Wholesale Distribution	Manufacturing	Business Services
$5MM - $50MM	Manufacturing	Wholesale Distribution	Healthcare & Biotech

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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.

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. For more information about the M&A Source visit www.masource.org or follow The M&A Source on Facebook, LinkedIn, or Twitter.