

Q4 2017



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

MARKETPULSE

QUARTERLY SURVEY

FOURTH 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.

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The IBBA and M&A Source Market Pulse

SURVEY REPORT Q4 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 Pepperdine Graziado Business School.

The Q4 2017 survey was completed by 264 business brokers and M&A advisors, representing 36 states. Half of the respondents (51 percent) had at least 10 years of experience. Respondents completed 227 transactions this quarter.

FIGURE 1: MARKET SEGMENTS STUDIED

MAIN STREET	LOWER MIDDLE MARKET
Less than \$500K	\$2MM - \$5MM
\$500K - \$1MM	\$5MM - \$50MM
\$1MM - \$2MM	

EXPECTATIONS STRONG FOR 2018

As a whole, analysts tracking the M&A market are expecting a sizable uptick in deal activity in 2018. Business and financial leaders expect both the number of deals and the size of those transactions to increase significantly.

But it's important to realize that while deal activity stalled in the larger M&A market in 2017 (largely attributed to uncertainty over tax reform), the lower middle market remained active and Main Street deals were at an all-time high. According to BizBuySell's annual Insights Report, small business transactions set record highs in 2017, exceeding previous highs set in 2016 by 27 percent.

For 2018, then, activity in the smaller sectors will likely grow at a more measured pace compared to the larger market. Nevertheless, Main Street and lower middle market advisors remain optimistic for sector growth in 2018. For example, 73 percent of advisors predict the volume of small deals (under \$50 million) will increase in the next 12 months. Although most (49 percent) of advisors surveyed sold just one to three listings in 2017, they expect to close three to five engagements in 2018.

Compared to a year ago, optimism has grown, with advisors anticipating:

- Greater deal flow
- Increased business exit opportunities for sellers
- Opportunities for growth
- Better closing rates
- Improvement in general business conditions

Values remain strong, but a third of advisors still believe that multiples will climb much higher in 2018. Advisors reported no real difficulty in arranging debt financing in 2017. However, they do suggest that the new SBA rules lowering minimum down payments from 25 percent to 10 percent will have a positive impact on the market. Sixty-five percent of advisors say the new rule will lead to more sales this year.

"Small business owners should be bullish on sales in 2018," said Warren Burkholder, CBI, President of NEVRG, Inc. "With the corporate tax rate dropping to 21 percent and the repatriation of overseas capital, companies will have more capital to allocate to acquisitions. And with heavy competition in the marketplace, even more companies will be pursuing smaller market transactions."

"Global private equity funds raised \$453 billion in 2017, more than any year on record. Meanwhile, business optimism is high and corporations are stacked with cash. It's all going to drive competition," said Craig Everett, PhD, Director of the Pepperdine Private Capital Markets Project. "No one is going to back down, particularly private equity buyers who need to put that cash to work and have more flexibility to pursue creative deals such as minority investments."

"We're hearing from buyers in all sectors, and the top two things they're concerned about are high multiples and the lack of quality companies for sale," said Steve Boylan, President of Beacon Business Group, a Wisconsin-based Business Brokerage firm. "Fortunately for sellers, multiples aren't going to dip as long as competition is strong."

2017'S TOP INDUSTRIES

Looking at data for the whole year, personal services, restaurants, and business services led the Main Street market in 2017. In the lower middle market, manufacturing was the leader at 23 percent of all reported transactions, followed by construction and business services.

FIGURE 2: HOT INDUSTRIES - MAIN STREET

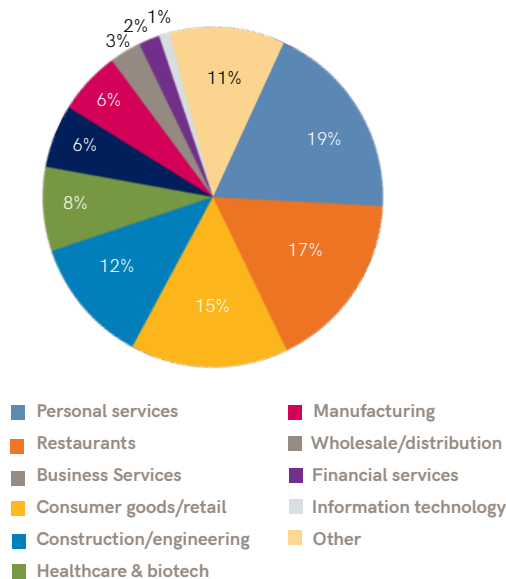
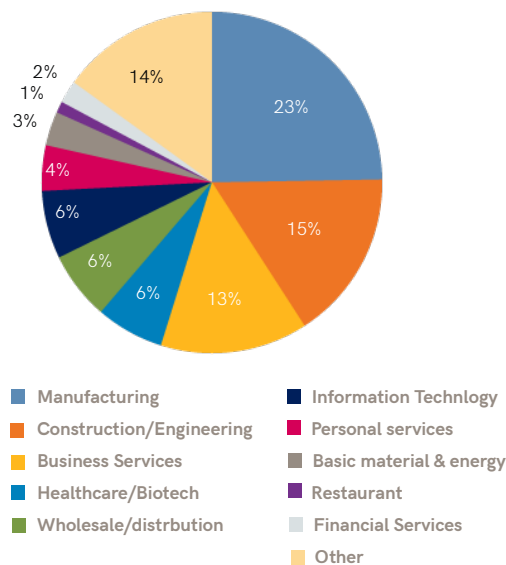


FIGURE 3: 2017 HOT INDUSTRIES - LOWER MIDDLE MARKET

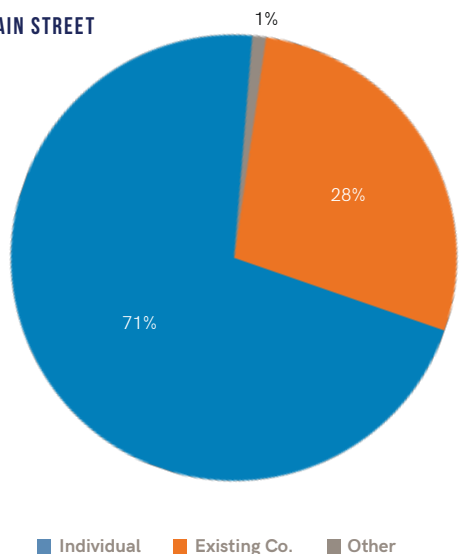


2017 ACTIVE BUYERS

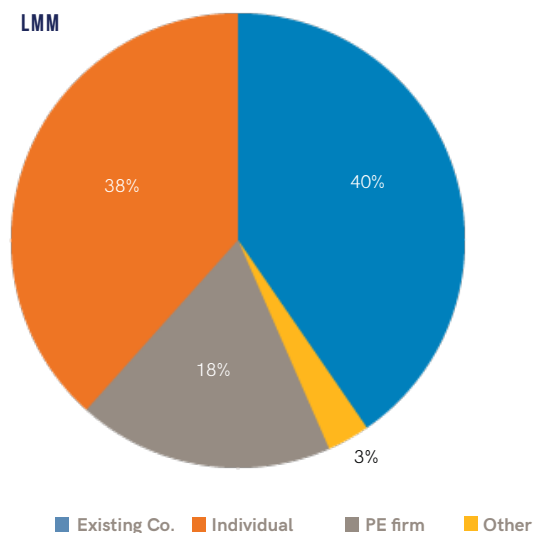
The Main Street market was dominated by individual buyers in 2017, with only 28 percent of acquisitions made by existing companies and minimal private equity activity. However, in the lower middle market, individual buyers competed right alongside existing companies for their share of the deals, with private equity accounting for 18 percent of acquisitions.

FIGURE 4: 2017 ACTIVE BUYERS

MAIN STREET



LMM



WHY ARE OWNERS SELLING?

Retirement continues to lead as the number one reason to sell across most sectors, followed by burnout.

FIGURE 5: TOP 2 REASONS SELLERS WENT TO MARKET

DEAL SIZE	#1 REASON	#2 REASON
<\$500K	Retirement 38 %	Burnout 21%
\$500K - \$1MM	Retirement 37%	(tie) Burnout, New Opportunity, Moving 15%
\$1MM - \$2MM	Retirement 55%	Burnout 13%
\$2MM - \$5MM	Retirement 62%	Burnout 14%
\$5MM - \$50MM	Burnout 38%	Retirement 25%

"As Boomers continue to own their business past the typical retirement years, it's almost inevitable that burnout will eventually set in," said Mike Camerota, Founder of Touchstone Advisors, M&A Source Chair. "Many just can't let go emotionally, and it's one of the most common mistakes we see, eventually leading to business decline."

"Unfortunately, buyers don't give you credit for what you did at your peak," Camerota continued. "What they value most is the last three years of performance, particularly the last 12 months. The fact is, burnout can substantially lower the value a successful company would otherwise get."

FIGURE 6: SELLERS TRIGGERED BY UNSOLICITED OFFER

DEAL SIZE	PERCENTAGE
<\$500K	1%
\$500K - \$1MM	0%
\$1MM - \$2MM	0%
\$2MM - \$5MM	5%
\$5MM - \$50MM	13%

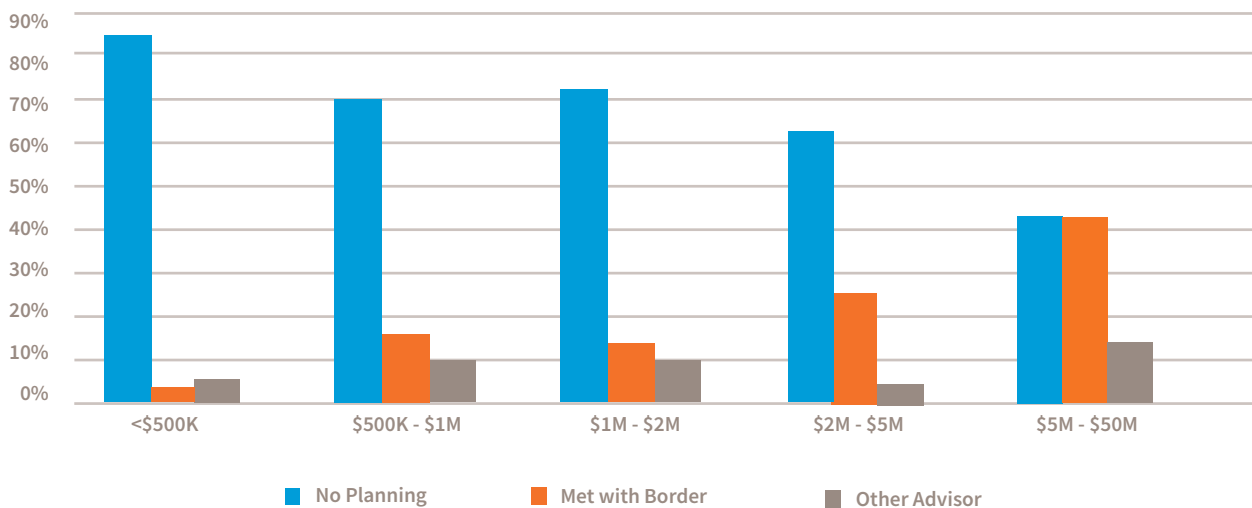
"There aren't enough quality opportunities in the lower middle market to meet buyer demand," said David Ryan, an advisor with Upton Financial Group in California. "Buyers are getting more aggressive about their acquisition strategy and searching out those passive sellers."

"Even if the fit seems right, we always encourage those sellers to seek professional representation through the negotiation process," Ryan continued. "Putting your business on the open market is the best way to determine fair market value, but sometimes a direct engagement makes sense, particularly when timing or burnout issues are at play."

EXIT PLANNING STILL LACKING

Even though retirement leads as the number one reason for sale, most buyers do not engage in a proactive planning process, particularly in the Main Street market. Advisors report that the smaller the business, the less likely the owners were to consult with a broker prior to their listing engagement.

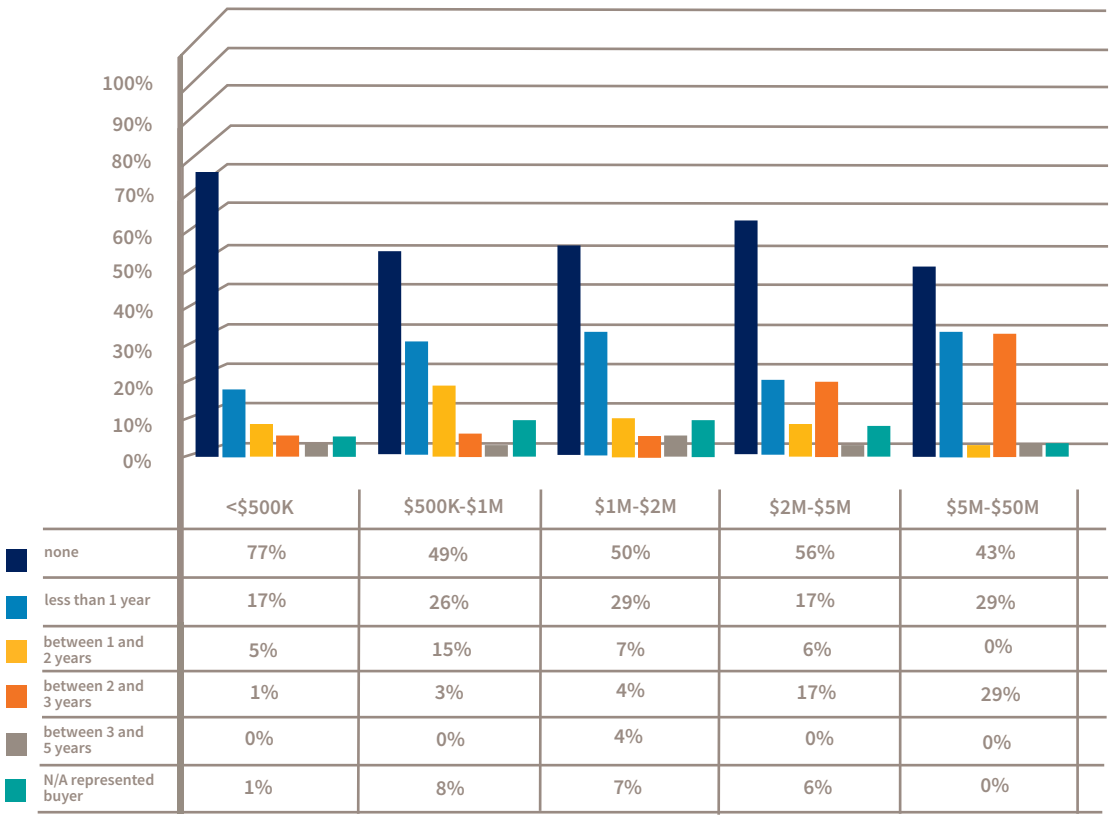
FIGURE 7: PROACTIVE EXIT PLANNING



“Even among higher value businesses of \$5 million or more, we’re still seeing a sizable number of sellers who aren’t engaging in a proactive planning process,” said Scott Bushkie, M&AMI, CBI, President of Cornerstone Business Services. “When sellers plan ahead, there are small and easy changes they can make to add value to their business. By failing to plan, many of these business owners are leaving money on the table.”

Planning Ahead. Of the sellers that do plan ahead, most are still moving through the exit planning process at a rapid pace, with less than a year between initial consultation and market listing. Only in the lower middle market, with businesses valued between \$5 million and \$50 million, do advisors report a meaningful number of sellers (29 percent) planning at least two to three years out. That still means that 71 percent of business owners are leaving a multimillion dollar event up to chance.

FIGURE 8: AMOUNT OF EXIT PLANNING



“In an ideal world, we want to connect with sellers three years ahead of a sale, especially in the lower middle market” explains Lisa Riley, CBI, Principal of LINK Business-Phoenix. “That gives us a reasonable amount of time to make meaningful changes to financial issues like working capital and audited statements. It’s also about the minimum amount of time necessary to develop key employees and shore up your leadership team. These things can make a critical difference in valuations.”



WHO HAS THE ADVANTAGE: BUYERS OR SELLERS?

Seller-market sentiment is on the rise in all five market sectors. The increase may be attributed to strong economic optimism and tax reform.

FIGURE 9: SELLER MARKET SENTIMENT CLIMBING

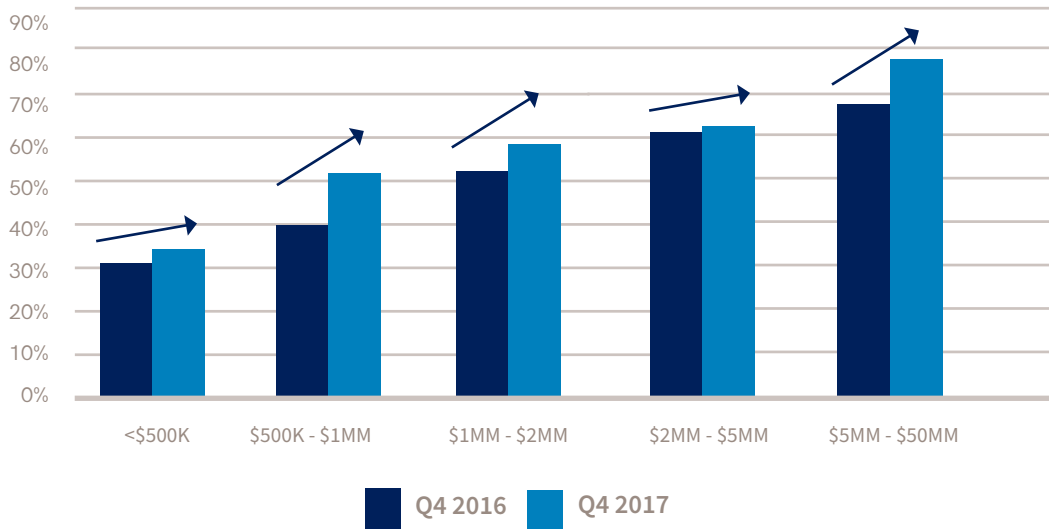
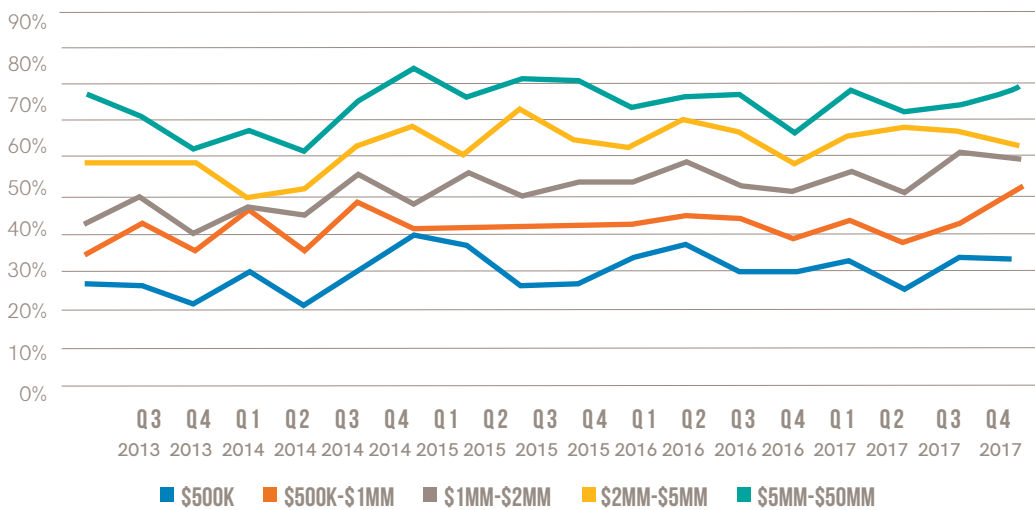


FIGURE 10: SELLER'S MARKET SENTIMENT HISTORICAL TREND

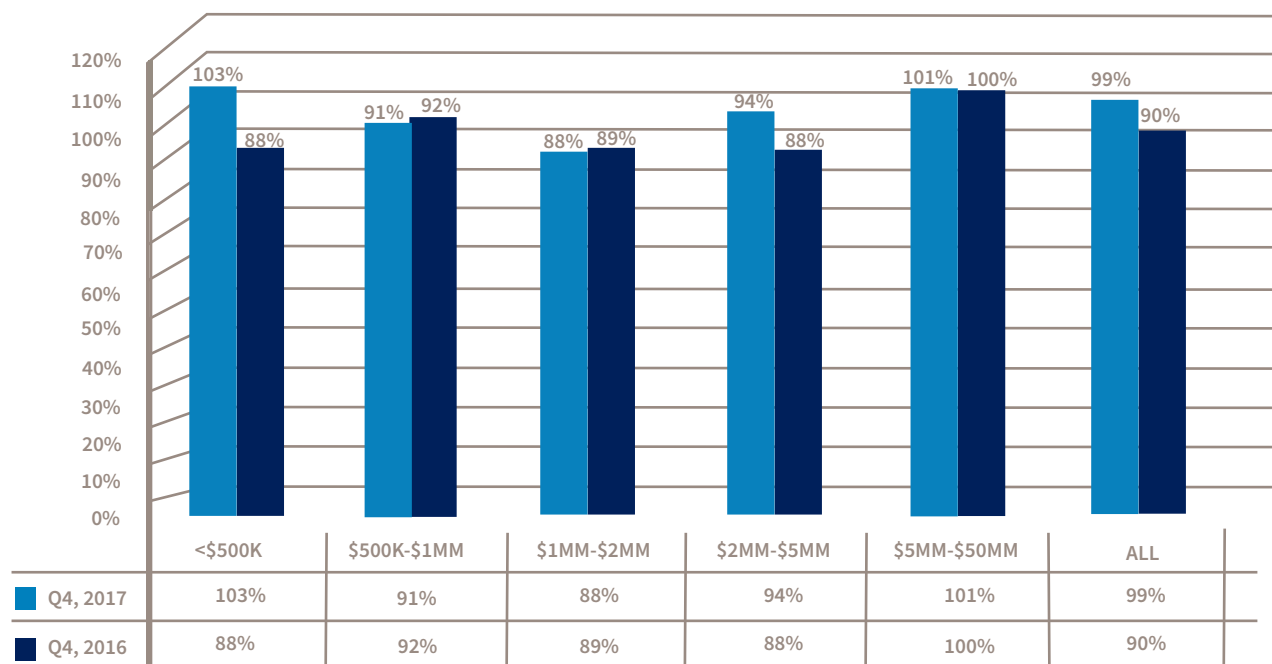


"As advisors, we know that tax reform is good news for small business owners looking to sell in the near future," said John Howe, M&AMI, Director, Business Transition Strategies. "But we know that some analysts are predicting a recession as early as 2019. We're at a pivotal period for selling right now. The window may not be open for long."

WHERE ARE BUSINESS VALUES TRENDING?

Year-over-year, final sale prices remained at or above the pre-set asking price or internal benchmark. Notably, advisors reported a premium for the smallest market deals valued at less than \$500,000.

FIGURE 11: FINAL PRICE REALIZED VERSUS ASKING PRICE



Multiples. Multiples continue to remain strong in all categories, although off market peaks seen in 2016 and early 2017. Year-over-year, multiples saw modest declines in all but the largest market sector, where multiples remained stable. Some advisors still expect growth in 2018, with 33 percent predicting an increase in multiples.

FIGURE 12: MEDIAN MULTIPLE OFF PEAK

	2017				2016				2015	2014
	Q4	Q3	Q2	Q1	Q4	Q3	Q2	Q1	Q4	Q4
MEDIAN MULTIPLE PAID (SDE)										
<\$500K	2.0	2.0	2.0	2.3	2.3	2.3	2.3	2.0	2.0	2.0
\$500K-\$1MM	2.5	2.5	2.3	2.8	2.8	3.0	2.8	2.8	2.5	2.9
\$1MM-\$2MM	3.1	3.1	3.3	3.3	3.3	3.3	3.3	3.0	3.3	3
MEDIAN MULTIPLE PAID (EBITDA)										
\$2MM - \$5MM	4.3	4.5	4.3	5.3	4.8	4.5	4.0	4.0	4.0	4.6
\$5MM - \$50MM	5.5	5.0	5.4	5.3	5.5	5.8	5.1	5.5	5.1	5

FIGURE 13: 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

“For deals in the lower middle market, working capital is a contentious issue. It’s rare that buyers and sellers agree on working capital without negotiation,” said Monty Walker, Principal of Walker Business Advisory Services. “But if working capital isn’t positioned properly, the business owner may be selling at a discount, without realizing they’re leaving money on the table.”

Time to Close. The average time to close is 8.7 months, which is a little slower than normal. Months from LOI to close continues to increase, up from 3 months in Q4 2016.



FIGURE 14: LARGEST BUSINESSES TAKING LONGER TO SELL IN Q4 2017

BUSINESS VALUE	Q4 2017		Q4 2016	
	MONTHS TO CLOSE	MONTHS FROM LOI TO CLOSE	MONTHS TO CLOSE	MONTHS FROM LOI TO CLOSE
<\$500K	6	2	7	2
\$500K - \$1MM	7	3	8	3
\$1MM - \$2MM	9	3	8	3
\$2MM - \$5MM	10	4	8	3
\$5MM - \$50MM	11.5	5.5	12	5

“The due diligence process is taking longer as we see more private equity groups move downstream. These savvy buyers are used to doing larger deals, but they are continuing to use their rigorous due diligence process on smaller companies,” said Laura Mavers Ward, M&AMI, CBI, CM&AP, Managing Partner, Kingsbridge Capital Partners. “With this new reality, sellers should be working with the M&A advisors to perform due diligence before going to market. This could include a customer concentration analysis, a quality of earnings report, and a working capital analysis.”

“While pre-due diligence is an investment of time and money for both the business and their advisors, we believe these resources are worth every penny. The goal of the selling team should be to prevent the buyer from uncovering unknowns on the backend,” Ward continued. “Negative surprises can significantly lower the price a buyer is willing to pay a seller, or worse, it can stop the deal from ever closing.”



Cash at Close. Meanwhile, sellers continue to get the majority of cash at close. In this quarter, owners got 83 percent or more cash at close with the majority of the balance being seller financing, along with some earn outs and retained equity to close the valuation gap. This is the first time since the survey began in 2013 that sellers in every market sector received 80 percent or better in cash at close.

FIGURE 15: PORTION OF SALE RECEIVED AS CASH AT CLOSE

	Q4 2017				Q3 2016			
	CASH AT CLOSE*	SELLER FINANCING	EARN OUT	RETAINED EQUITY	CASH AT CLOSE*	SELLER FINANCING	EARN OUT	SELLER FINANCING
<\$500K	85%	13%	1%		85%	11%	1%	
\$500K - \$1MM	82%	17%			83%	13%	1%	
\$1MM - \$2MM	83%	10%	2%	1%	87%	11%	1%	
\$2MM - \$5MM	86%	14%	1%		77%	19%	4%	
\$5MM - \$50MM	83%	10%	4%	4%	83%	4%	1%	3%

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

"Obviously cash at close is a key desirable for sellers," said Lou Vescio, CBI, M&AMI, Principal, Coastal Business Intermediaries, Inc. "These high cash at close values are a reflection of heavy buyer competition and the strong lending market."



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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.

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