

Q2 2016



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

MARKETPULSE

QUARTERLY SURVEY REPORT

SECOND QUARTER 2016

THE IBBA AND M&A SOURCE MARKET PULSE SURVEY REPORT Q2 2016

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 Pepperdine Graziadio School of Business and Management.

The Q2 2016 survey was completed by 378 business brokers and M&A advisors, representing 38 states. Respondents completed 409 transactions this quarter and over half (55%) had at least 10 years of experience in the industry.

Figure 1: Market Segments Studied

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

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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CURRENT EVENTS

Presidential Election. Like many Americans, business brokers and M&A advisors are keeping a close eye on the presidential election. As the race is officially between Donald Trump and Hillary Clinton, Trump may benefit from public confidence in his position on economic issues. In the latest Market Pulse survey, advisors overwhelmingly agreed that Trump (68.3%) would be the more business-friendly president than Hillary Clinton.

While an important component to consider, advisors ranked the upcoming presidential election third in a list of four factors that could be impacting the current marketplace. Lack of quality sell-side opportunities (49% Main Street, 43% lower middle market) led among pivotal market factors, followed distantly by low interest rates (30%, 28%), the presidential election (14%, 17%), and the lagging stock market (8%, 12%).

“We see close similarity in how both Main Street and lower middle market advisors ranked these economic factors,” said Craig Everett, PhD, Director of Pepperdine Private Capital Markets Project. “Even though these sectors have different experiences in terms of deal volume and seller leverage, they’re still reporting a consistent view on larger market trend issues.”

Brexit. Meanwhile, following Britain’s vote to leave the EU, advisors anticipate that activity from foreign-born buyers will increase, but that Brexit will have little impact on domestic buyers and sellers. Notable for individual buyers (who are primarily Main Street buyers), more than one-third of business brokers report that the number of foreign-born first time buyers has increased in 2016 (36% reporting an increase vs. 59% reporting no change). Other first-time buyer categories showing growth signs include former corporate executives and buyers under 40. Buyers under 30 and women buyers remained relatively unchanged in the first half of 2016.

WHY ARE OWNERS SELLING?

Retirement continues to lead as the number one reason to sell across all sectors, followed most often by burnout and new opportunities.

Figure 2: Percent of Sellers Entering Market for Retirement

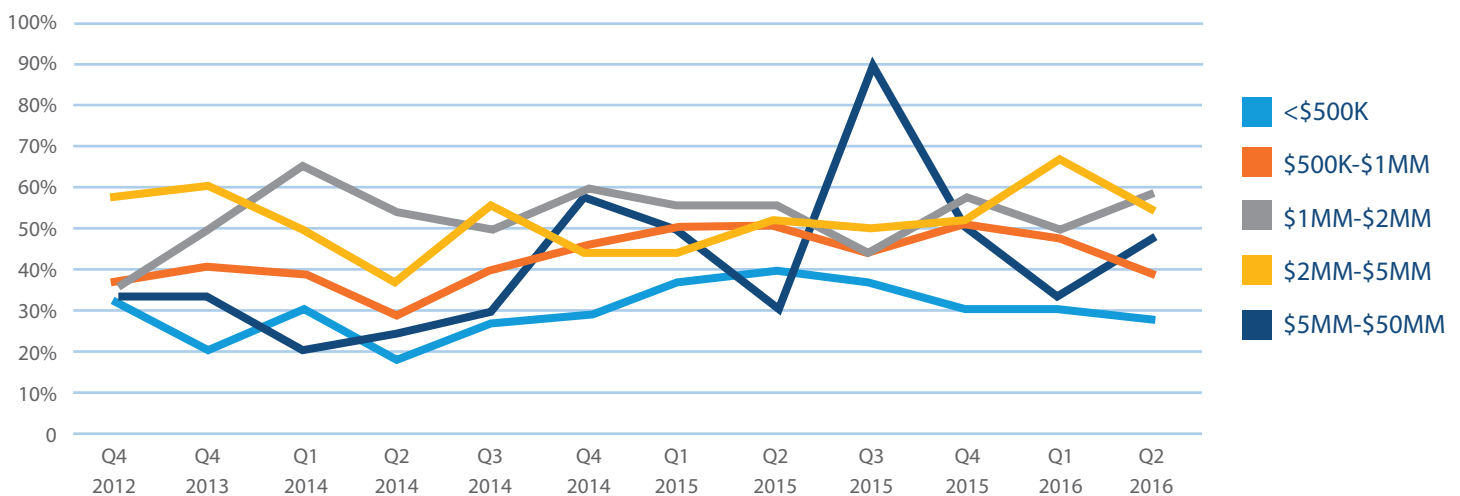


Figure 3: Top 2 Reasons Sellers Went to Market

| Transaction Size | #1 | #2 |
|------------------|------------|-----------------|
| <\$500K | Retirement | New Opportunity |
| \$500K - \$1MM | Retirement | Burnout |
| \$1MM - \$2MM | Retirement | Burnout |
| \$2MM - \$5MM | Retirement | New Opportunity |
| \$5MM - \$50MM | Retirement | Burnout |

“If we dig deeper into the numbers we see that sellers are two or three times more likely to sell because of burnout than health issues,” said Lisa Riley, CBI and Principal of LINK Business-Phoenix. “Obviously that’s a concern because burnout doesn’t happen overnight. By the time you decide you don’t have the energy or ambition anymore, your business is probably already feeling the downward effects. There’s a difference between sprinting across the finish line and limping across, and business values reflect that.”

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. In the same sector, however, optimism for new client engagements is modest with a mean of 3.3.

Figure 4: Mean Increase in New Clients (5-point scale)

| | Optimism | Reported Increase | |
|----------------|----------|-------------------|---------|
| | Q3 2016 | Q2 2016 | Q2 2015 |
| <\$500K | 3.6 | 3.5 | 3.3 |
| \$500K - \$1MM | 3.6 | 3.7 | 3.4 |
| \$1MM - \$2MM | 3.5 | 3.6 | 4.0 |
| \$2MM - \$5MM | 3.4 | 3.7 | 3.2 |
| \$5MM - \$50MM | 3.3 | 3.9 | 3.3 |

“Many advisors are uncomfortable right now with the number of market opportunities in the lower middle market,” says David Ryan, President of Upton Financial Group. “They’re pointing to a lack of quality opportunities as the number one factor impacting the market. Professional buyers, such as private equity groups and existing businesses, are the number one buyers in the lower middle market and seek well-prepared, quality businesses. Many of these businesses, however, lack timely accounting records and their owners have unreasonable expectations, terms and conditions, or are simply too emotionally tied to the business.”

WHO HAS THE ADVANTAGE: BUYERS OR SELLERS?

Year after year, advisor confidence in a seller's market is steady or increasing across all market sectors. Businesses in the smallest market sector (which represents roughly half of all businesses sold this quarter) are positioned in a buyer's market. Advantage shifts, however, as deals exceed \$1 million in value. In the lower middle market, seller advantage sentiment is strong yet remains 3 to 8 percentage points below peak since the Market Pulse survey began in 2012.

Figure 5: Seller's Market Sentiment Even and Up

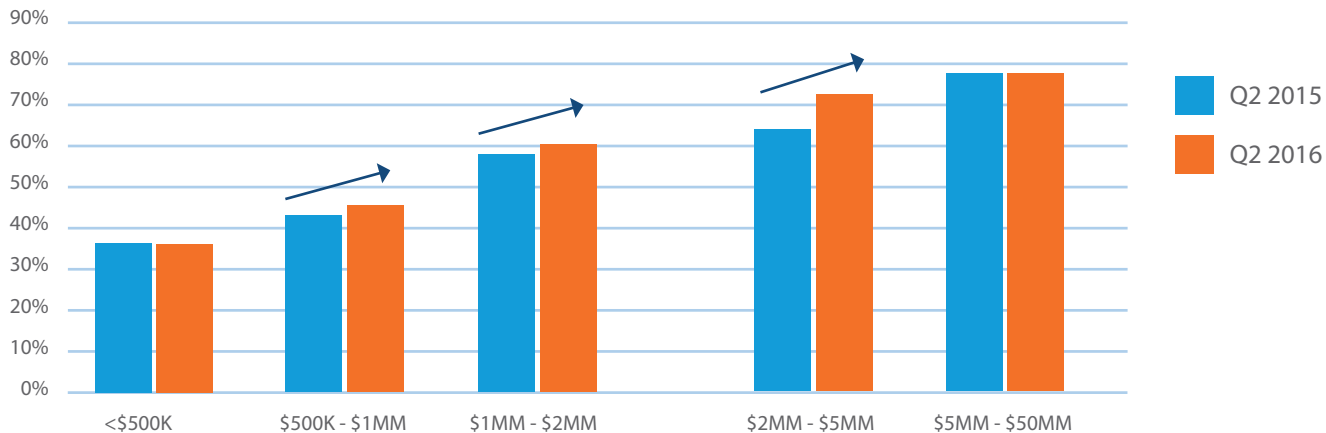
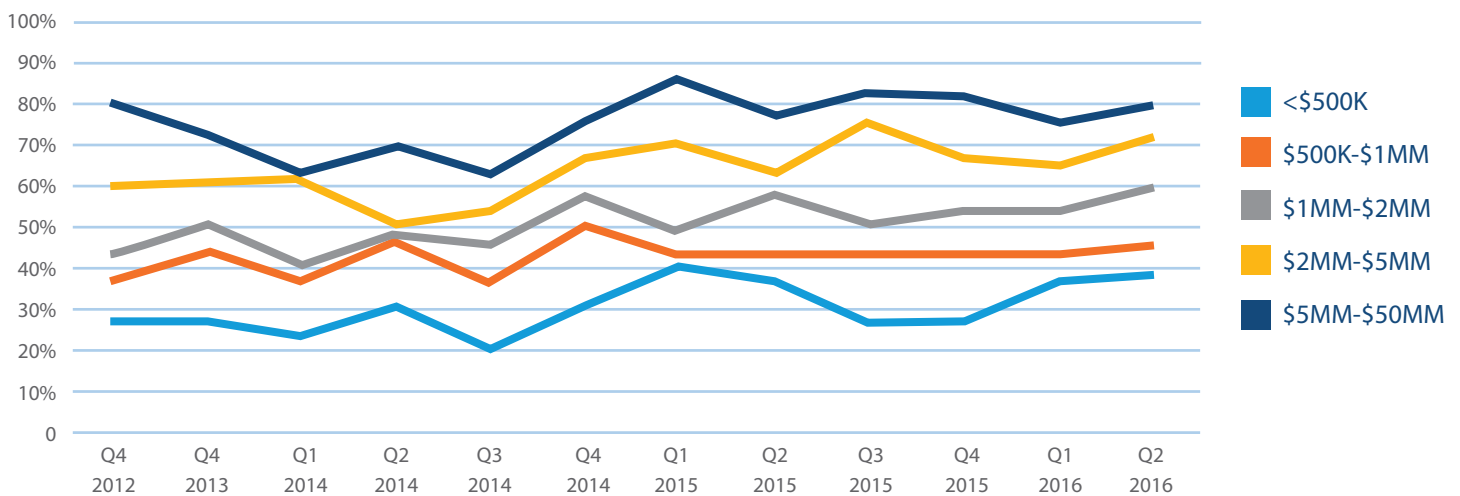


Figure 6: Seller Market Sentiment, Historical Trends



“Seller market sentiment peaked in early-to-mid-2015. And while many advisors still see a seller advantage, most assume that conditions aren’t going to get any better before they get worse,” said Scott Bushkie, CBI, President of Cornerstone Business Services, Inc., IBBA Chair.

“As brokers and M&A advisors who’ve been around for decades like myself, we know that good markets don’t last forever,” Bushkie continued. “We’re in the second longest bull run, only behind the bull run of the 1990s leading up to the dot.com crash. We have to assume market conditions will shift, but whether that’s six months or 3 years from now is anyone’s guess.”

WHERE ARE BUSINESS VALUES TRENDING?

Multiples continue to remain strong in all categories. As Main Street seller advantage sentiment continues to improve, we're seeing a rare jump in median values for the smallest market sector, increasing from 2.0 to 2.3 for the first time in years.

Figure 7: Median Multiple Increase for Businesses <\$500K

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

Figure 8: Common Multiple Range

| Common Multiple Range (SDE) | |
|--------------------------------|-----------------------|
| <\$500K | 54% between 1.75-2.75 |
| \$500K - \$1MM | 70% between 2.0-3.0 |
| \$1MM - \$2MM | 67% between 2.75-3.75 |
| \$2MM - \$5MM | 62% between 2.5-4.25 |
| Common Multiple Range (EBITDA) | |
| \$5MM - \$50MM | 45% between 4.75-5.75 |

Figure 9: Deal Size Includes Most Common Multiple Type

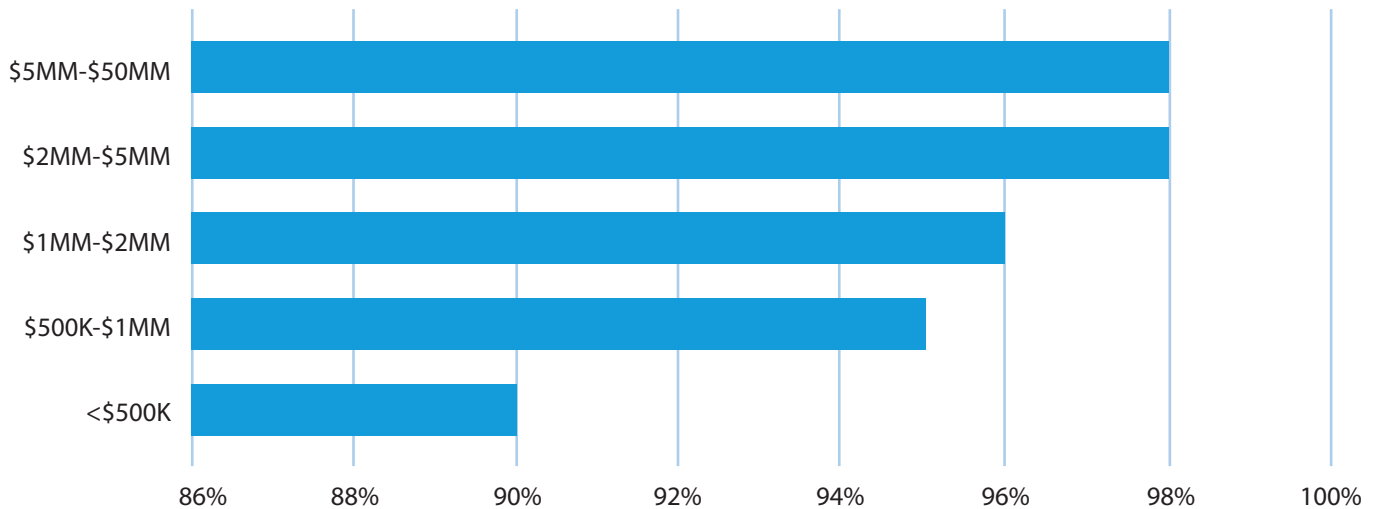
| Deal Size | Most Common Multiple Type |
|----------------|------------------------------|
| <\$500K | SDE w/o working capital |
| \$500K - \$1MM | SDE w/o working capital |
| \$1MM - \$2MM | SDE w/o working capital |
| \$2MM - \$5MM | SDE incl. working capital |
| \$5MM - \$50MM | EBITDA incl. working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

* SDE Sellers Discretionary Earning

* EDITDA Earnings Before Interest, Taxes, Depreciation and Amortization

Main Street businesses sold for approximately 92.5% of their asking price in Q2 2016. This reflects a slight improvement for businesses valued at less than \$500,000. Meanwhile, businesses in the lower middle market—which typically aren't marketed with an asking price—received 98% of the internal benchmark set by the advisor and seller.

Figure 10: Final Price Realized vs. Asking Price



According to Joe Lindsey, M&A MI, CM&AP, CBI, M&A Source Chairman and President of JLC, Inc., “Before going to market, business owners would be well advised to consult an advisor to establish reasonable price and terms expectations. Regardless of what the business owner thinks his/her business is worth, prevailing market conditions dictate whether or not those expectations are realistic or attainable.”

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 11: Portion of Sale Received as Cash at Close

| | Cash at Close* | Seller Financing | Earn Out |
|----------------|----------------|------------------|----------|
| <\$500K | 77% | 19% | 3% |
| \$500K - \$1MM | 81% | 16% | 1% |
| \$1MM - \$2MM | 84% | 11% | 2% |
| \$2MM - \$5MM | 81% | 10% | 6% |
| \$5MM - \$50MM | 76% | 14% | 5% |

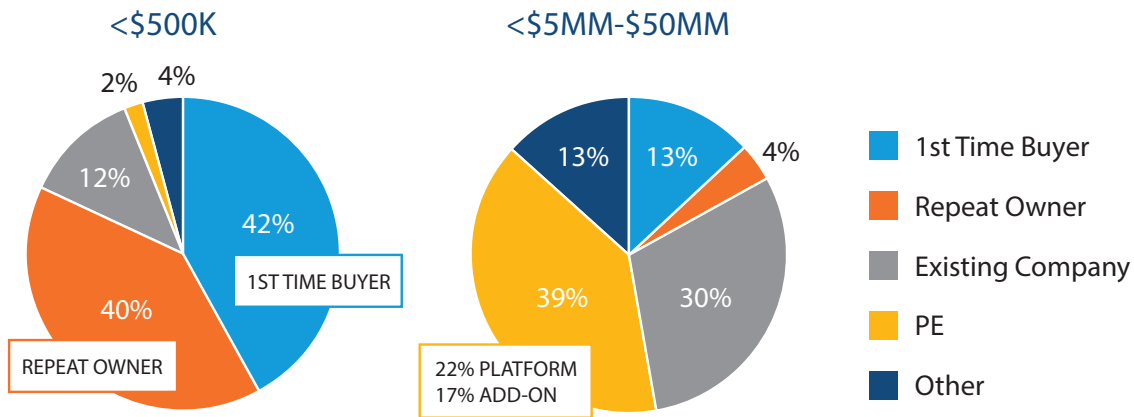
*Cash at close reflects a combination of buyer’s equity and senior debt.

“Buyers continue to use seller financing as a tool to lessen the equity they have to bring to the table. But more importantly, seller financing keeps the seller engaged after a sale,” says Andrew Rogerson, CBI, Rogerson Business Services. “Payments are typically made over a two to five-year period, so even if the seller doesn’t continue to work in the business, they will still do what they can to help the buyer succeed. It’s a big carrot to keep the seller vested in the future success of the business.”

KNOW YOUR BUYER

Active buyer types have remained relatively the same quarter over quarter. 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. Individual buyers accounted for only 17% (13% first time buyers, 4% repeat owners) of the larger sector.

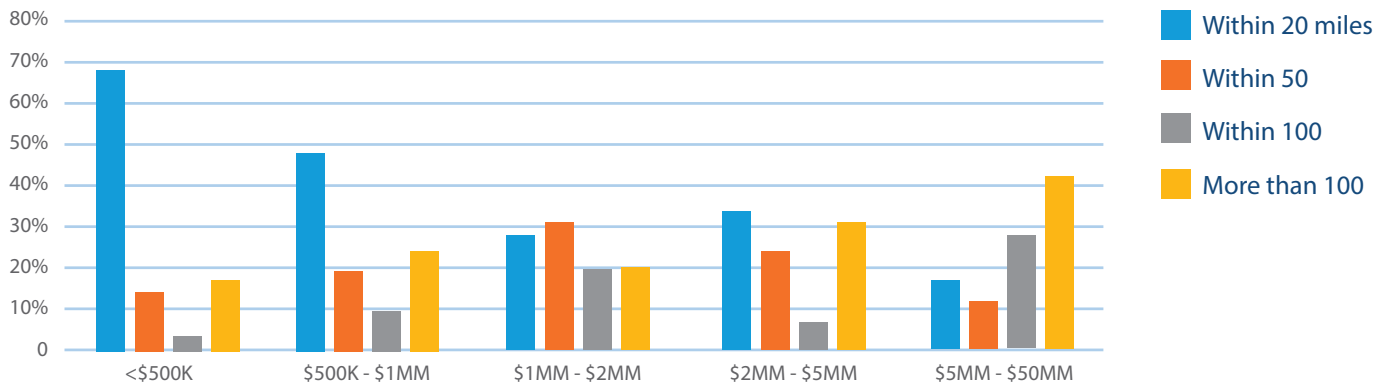
Figure 12: Buyer Comparison by Smallest/Largest Market Sectors



WHERE DO THEY COME FROM?

Typically, buyers are sourced from a wider geographic area as deal size increases. This quarter presented something of a surprise as highly localized buyers (within 20 miles) represented the largest buyer pool for businesses valued at \$2 million to \$5 million.

Figure 13: 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 14: Buyer Motivation Shifts with Transaction Size

| | Buying a Job | Growing an Existing Business |
|----------------|--------------|------------------------------|
| <\$500K | 51% | 25% |
| \$500K - \$1MM | 34% | 42% |
| \$1MM - \$2MM | 22% | 42% |
| \$2MM - \$5MM | 20% | 41% |
| \$5MM - \$50MM | 9% | 65% |

WHAT INDUSTRIES ARE HOT?

Looking at the overall market, manufacturing led among hot industries, followed by business services, personal services, and restaurants.

Figure 15: Top Industries by Market Sector

| | | | |
|----------------|-------------------|-------------------|--------------------------|
| <\$500K | Restaurants | Personal Services | Consumer Goods |
| \$500K - \$1MM | Business Services | Personal Services | Restaurants |
| \$1MM - \$2MM | Manufacturing | Personal Services | Wholesale Distribution |
| \$2MM - \$5MM | Manufacturing | Business Services | Construction/Engineering |
| \$5MM - \$50MM | Manufacturing | IT | (4-way tie) |

“Clearly, the study shows that if you’re a manufacturing owner and considering retirement, you should talk to your advisor now and consider your options,” says Mitchel Cox, Transworld Business Advisors.

HOW LONG DOES IT TAKE TO COMPLETE A DEAL?

The average time to close is nine months, which is about average or a little faster than the norm. But for several categories, the average time from LOI to close is four months, which is longer than reported in the past.

Figure 16: LOI taking longer in Q2 2016

| | Q2 2016 | | Q1 2016 | |
|----------------|-----------------|--------------------------|-----------------|--------------------------|
| | Months to Close | Months from LOI to Close | Months to Close | Months from LOI to Close |
| <\$500K | 6 | 2 | 6.5 | 2 |
| \$500K - \$1MM | 6 | 3 | 6 | 3 |
| \$1MM - \$2MM | 9 | 4 | 7 | 3 |
| \$2MM - \$5MM | 9 | 4 | 10 | 4 |
| \$5MM - \$50MM | 9 | 4 | 8 | 3 |

“Because we’re in a seller’s market for businesses with \$1 million to \$50 million in enterprise value, we can assume these deals are getting interest from multiple buyers, and buyers are paying a premium to secure these opportunities,” says Scott Mashuda, CBI, Managing Director River’s Edge Alliance Group. “But because buyers are paying a premium, they’re doing more due diligence to confirm they are indeed getting what they thought they were buying.”

“Several years ago, most transactions took 60 days to close, and now those same kind of deals are taking double the amount of time,” says Scott Bushkie, CBI, President of Cornerstone Business Services, Inc., IBBA Chair. “That can be both physically and emotionally grueling for sellers who are putting in extra hours for due diligence while dealing with the dual mental issues of anticipating a big payout and fearing the sale might fall apart.”

“What’s worse is when sellers think the deal is done and start spending that money in advance. For some of those sellers their dream comes with a rude awakening,” Bushkie continued. “As many advisors will tell you, the deal is never done until the check is in the bank.”

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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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