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Pepperdine Market Pulse Report

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2013 Q1 Market Pulse Report

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

MARKETPULSE

QUARTERLY SURVEY REPORT

FIRST QUARTER 2013

The International Business Broker Association (IBBA) and M&A Source present the *Market Pulse Quarterly Survey Report* with the support of the Pepperdine Private Capital Markets Project and the Graziadio School of Business and Management at Pepperdine University. 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 the Main Street market (values $0-2 million) and lower middle market (values $2 million to $50 million). The national survey was conducted with the intent of providing a valuable resource to business owners and their advisors.

MARKET SEGMENTS STUDIED

Figure 1

MAIN STREET	LOWER MIDDLE MARKET
< 500K	$2MM-$5MM
$500K-$1MM	$5MM-$50MM
$1MM-$2MM	

IBBA INTERNATIONAL BUSINESS BROKERS ASSOCIATION, INC.

M&A Source

PEPPERDINE UNIVERSITY Graziadio School of Business and Management

PEPPERDINE PRIVATE CAPITAL MARKETS PROJECT bschool.pepperdine.edu/privatecapital

KEY FINDINGS

PIPELINES GROWING:

Business brokers and M&A advisors around the country reported that client loads increased at a faster rate compared to any other quarter since the survey started in June 2012. In addition, more than 50 percent of respondents didn't lose a client in the first quarter.

"Trends show a growing number of businesses on the market, and we can expect listings/engagements will continue to increase as baby boomers look to retire and exit their businesses," said Jim Afinowich, president of Fox & Fin Financial Group.

For the second quarter in a row, retirement ranked as the number one reason driving business sales across all Main Street and lower middle market sectors (followed by burn-out).

CROWD SOURCING:

As a special to this quarter's survey, respondents were asked if they thought crowd sourcing would become a source of equity to get deals closed. The vast majority of respondents (90 percent) thought it was unlikely.

CLOSING RATIOS:

Respondents reported a 2012 closing rate of 64 percent for Main Street and the lower middle market combined.

"Other reliable studies have found Main Street closing ratios hover around 15 to 25 percent, with the lower middle market around 35 percent," says John Paglia, Ph.D., director of Pepperdine Private Capital Markets Project. "I believe Market Pulse numbers are so much higher than industry trends because the respondents are all IBBA and M&A Source members. With national networking, sharing of best practices, credential programs and first-rate continuing education—it's clear that association membership is a significant contributor to success in the M&A marketplace."

Of note, 55 percent of respondents have worked in the industry for 10+ years. In addition, 53 percent have taken multiple classes and passed the rigorous exams necessary to obtain their Certified Business Intermediary designation (CBI). And 13 percent have achieved M&A Master Intermediary designation (M&AMI), a combination of classes, testing, and real world success.

BUYER AND SELLER MARKETS:

Most Main Street brokers see a buyer's market right now. For deals valued at less than $500,000, a whopping 78 percent of respondents suggest supply and demand is in the buyer's favor. Leverage starts to balance out as the deals get larger, with respondents evenly split (50/50) over which side has the most leverage in the $2 million to $5 million sector. For businesses of $5 million to $50 million, the tables turn dramatically, with 65 percent of respondents pointing to a seller's market.

HOT INDUSTRIES:

For businesses valued between $1 million and $2 million, construction/engineering led at 21 percent of completed deals over the last three months, followed by business services, information technology, and manufacturing, all at 14 percent.

In the lower middle market, for businesses valued between $2 million and $5 million, closings were evenly distributed between wholesale distribution, business services, construction/engineering, manufacturing, and consumer goods/retail, all at 20 percent.

Businesses between $5 million and $50 million in value followed nearly the same trend, with basic materials/energy, construction/engineering, information technology, and manufacturing, all at 20 percent, followed by wholesale distribution and healthcare/biotech, both at 10 percent.

MULTIPLES:

Multiples stayed nearly flat for the fourth quarter, increasing slightly for businesses valued between $1 million and $5 million.

Figure 2: Multiples by Deal Size

MAIN STREET	SDE	EBITDA
Less than 500K	48% @ 1.75-2.5x	
$500K - $1MM	58% @ 2.5-2.75x	
$1MM - $2MM	54% @ 2.5-3.5x	66% @ 4.25-5.0x ↑
LOWER MIDDLE MARKET		
$2MM - $5MM		66% @ 4.5-5.75 ↑
$5MM-$50MM		70% @ 4.5-6.5

* Up and down arrows indicate notable movement over Q3 2012.

SDE = Seller's Discretionary Earnings
EBITDA = Earnings Before Interest, Taxes, Depreciation And Amortization

Transactions in the Main Street market are typically based on multiples of SDE, while those in the lower middle market are most commonly based on EBITDA. In some instances survey respondents reported multiples for both SDE and EBITDA.

New in the Q1 2013 survey, respondents were asked to indicate the type of multiple used to calculate purchase price. As indicated in the table below, the majority of lower middle market deals (60 percent to 70 percent) include working capital in price calculations. The survey also shows that a significant number of lower middle market buyers (nearly a third or better) are using the seller's trailing twelve months performance records. For the Main Street sector, SDE calculations (the vast majority do not include working capital in the value of the business) are the norm, as expected.

Figure 3: Types of Multiples By Deal size

	EBITDA + working cap.	TTM EBITDA + working capital	EBITDA	TTM EBITDA	SDE	SDE + working capital
MAIN STREET						
Less than 500K			6%		85%	8%
$500K - $1MM	6%		19%		69%	6%
$1MM - $2MM	7%	7%	7%		64%	14%
LOWER MIDDLE MARKET						
$2MM - $5MM	40%	20%	20%	20%	20%	
$5MM-$50MM	40%	30%	20%		10%	

SDE = seller's discretionary earnings; EBITDA = earnings before interest, taxes, depreciation and amortization; TTM = trailing twelve months

BUYER TYPES:

For the first time, individual buyers represented the largest buyer group until deals reached $5 million in value, running around 40 percent of buyers in all other categories. For deals over $5 million in value, the most common buyers were existing companies looking to grow through acquisition (40%), followed by private equity platforms at 30 percent, and private equity add-ons at 20 percent. (In the previous quarter, existing companies were the top buyers for all deals of $1 million and greater.)

Figure 4: Top Buyer Types

	MOST COMMON	2ND MOST COMMON
< 500K	Individual, 1st time buyer (47%)	Individual, prior business owner (43%)
$500K-$1MM	Individual, 1st time buyer (38%)	Individual, prior business owner (31%)
$1MM-$2MM	Individual, 1st time buyer (36%)	Company/strategic (21%)
$2MM-$5MM	Individual, 1st time buyer (40%)	Private equity add-on (40%)
$5MM-$50MM	Company/strategic (40%)	Private equity platform (30%)

A related survey question targeted buyer motivations. For sectors dominated by individual first time buyers, reasons such as "buying a job" and "better ROI than other investments" featured prominently.

"Regarding the larger percentage of first time buyers active in quarter one, that could be indicative of improving economic perceptions," says George Lanza, president of Plethora Businesses. "We might be seeing more high-net worth individuals transitioning from employees to business owners now that they feel more optimistic their endeavors will succeed."

Also of note is buyer geography. For companies under $1 million, most buyers were located either within the same metro area or same state as the selling business. International buyers made a strong appearance in this quarter's survey, representing 20 percent to 30 percent of buyers for businesses valued at $1 million and above. Previous reports (since Q2 2012) haven't seen international buyers exceed 8 percent in any sector.

Figure 5: Buyer Proximity

	IN CITY	IN STATE	IN COUNTRY	INTERNATIONAL
< 500K	49%	34%	13%	4%
$500K-$1MM	50%	25%	19%	6%
$1MM-$2MM	14%	21%	43%	21%
$2MM-$5MM	20%	40%	20%	20%
$5MM-$50MM		10%	60%	30%

DEAL STRUCTURE:

For deal structure in the Main Street market, buyer equity led every sector, followed by relatively equal amounts of seller financing and senior debt. For businesses valued up to $5 million sellers are holding around 20 percent to 25 percent in financing.

"These national trends confirm that seller financing continues to be a key component in getting a transaction complete," says Scott Bushkie, principal of Cornerstone Business Services. "Business owners who aren't prepared for that will have a much lower chance of successfully completing a sale."

For businesses valued from $5 MILLION to $50 million, senior debt led at 44 percent of financing, followed by buyer capital at 38 percent. Other deal structures for this sector were mezzanine debt (7 percent), earn outs (5 percent), and seller financing (4 percent).

New this quarter, respondents were asked to indicate the primary sources of buyer equity. In the smallest sector (values of <$500K), buyers funded acquisitions with available cash (73 percent), combined with retirement account rollovers (8 percent), and investor support (8 percent).

Investor percentage of buyer equity generally increased as the deal size got larger, peaking at 25 percent for deals valued at $5 million and above. Of note: the survey distinguished between general investors and family/friend investors. Taking family/friend investors into account, buyers in the $2 million to $5 million sector got the most outside support with 13 percent general investor funds and 25 percent family/friend funds. A very small percentage of buyers (less 6 percent in any sector) funded an acquisition with help from a home equity line of credit.

BROKER ADDENDUM

FEE STRUCTURE:

As deal size grew, the number of advisors collecting upfront retainers increased from a low of 24 percent for deals valued at less than $500,000 to a high of 51 percent for businesses between $5 million to $50 million in value.

	< 500K	$500K-$1MM	$1MM-$2MM	$2MM-$5MM	$5MM-$50MM
Commission	71%	66%	50%	39%	36%
Commission + Retainer	21%	25%	35%	36%	30%
Upfront Retainer	3%	4%	1%	2%	3%
Comm + Monthly + Retainer		3%	6%	11%	18%
Commission + Monthly Fee	3%	3%		7%	6%
Commission + Other	1%		1%	2%	3%
Other	1%		3%	4%	3%
Monthly Fee				2%	

GENERATING BUSINESS:

With all the different marketing tools available, referrals consistently lead the list as the number one way brokers and advisors get their best client—coming at 57 percent for Q1 2013. The second "best client" resource this month was networking at 10 percent.

As for the types of referral sources that generate new business opportunities, past clients led the list at 40 percent, followed by accountants at 24 percent, attorneys at 16 percent, and financial advisors at 9 percent.

A full copy of the IBBA and M&A Source Market Pulse Survey is available to IBBA and M&A Source members who participate in each quarterly survey. This is a 70-plus page report of up-to-date relevant information on the state of the marketplace compiled by the Pepperdine Private Capital Markets Project under Drs. John Paglia and Craig Everett.

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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