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

MARKETPULSE

QUARTERLY SURVEY REPORT

FOURTH QUARTER 2013

IBBA INTERNATIONAL BUSINESS BROKERS ASSOCIATION, INC.

M&A Source

PEPPERDINE UNIVERSITY Graziadio School of Business and Management

PEPPERDINE PRIVATE CAPITAL MARKETS PROJECT

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MARKET PULSE SURVEY REPORT
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The International Business Broker Association (IBBA) and M&A Source present the Market Pulse Quarterly Survey Report in partnership with ongoing research conducting by the Pepperdine Private Capital Markets Project at Pepperdine University's Graziadio School of Business and Management. The national quarterly 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 to $2 million) and lower middle market (values $2 million to $50 million). The survey was conducted with the intent of providing a valuable resource to business owners and their advisors.

The Q4 2013 survey was completed by 238 respondents, from 38 states. The majority of respondents (59%) had at least 10 years of experience in the M&A industry.

MARKET SEGMENTS STUDIED

Figure 1

MAIN STREET	LOWER MIDDLE MARKET
< 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 70-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 at Pepperdine University's Graziadio School of Business and Management and director of the 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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"It appears that 2014 is shaping up to be a perfect storm for M&A activity," said Scott Bushkie, president of Cornerstone Business Services. "Valuations are staying strong, sellers are gaining greater leverage, and boomer retirement is driving sellers to market. We're also seeing stronger support from traditional lenders, and that's enabling more corporations, PE firms and individual buyers to come to the table, increasing an already record-size buyer pool. Given the number of positive market indicators, it's not surprising that advisor sentiment is overwhelmingly positive for the upcoming year."

> *"Valuations are staying strong, sellers are gaining greater leverage, and boomer retirement is driving sellers to market."*

M&A ACTIVITY

When it comes to the number of deals closed, Market Pulse survey respondents generally did the same or better in 2013 than they did in any of the past three years. However, 2013 still appeared to fall short of deal volumes in 2008, the market's previous peak and surprisingly 2009.

Figure 2: Did Respondents Close More Transactions in 2013 Than Previous Years

	YES	NO	SAME	NOT PRACTICING
2012	41%	39%	16%	4%
2011	46%	37%	10%	7%
2010	43%	37%	10%	10%
2009	39%	40%	9%	12%
2008	28%	48%	10%	14%

The vast majority of respondents expect more deals to close in 2014, with 87 percent projecting an increase in their completed deals and only three percent expecting a decline. Likewise, the majority of advisors anticipate that overall deal volume will increase.

In the Main Street market, advisors expect deal volume to increase in the first quarter of 2014 at a 3:1 ratio versus those who expect it to remain stable or decline. In the lower middle market, that ratio dips to 2:1 for the number of advisors expecting increases.

While anticipation is high, fourth quarter numbers do seem to justify that optimism as respondents reported a notable increase in clients. On a five-point scale with 1 representing "greatly decreased" and 5 representing "greatly increased," respondents rated median scores of 3.5 to 3.8 across market sectors in fourth quarter 2013 compared to 3.1 to 3.2 for fourth quarter 2012.

BIGGEST HURDLES & BIGGEST MISTAKES

Advisors reported three common hurdles to getting deals closed in 2013:

- 27% pointed to valuation issues
- 19% cited financing issues
- 13% reported deal fatigue

Conversely, the biggest contributors to getting deals done this year were clear price expectations (33%), a larger buyer pool (26%), more sellers in the marketplace (13%), and more aggressive financing (11%).

These findings are particularly relevant in light of a related question in which advisors indicated the biggest mistake sellers make that hurt their chance of successfully closing a deal: unrealistic expectations (39%), poor financial records (14%), declining business sales (15%), and waiting too long/burnout (14%).

"According to our survey, the largest mistake sellers make is unrealistic expectations, and that's typically tied to valuations," said Steve Wain, chairman of IBBA. "This once again confirms the importance of sellers working with business brokers/M&A advisors who focus on continuing education and specialize in the industry; those who will tell the business owner not what they necessarily want to hear just to get a listing contract, with little chance of sale, but what they need to hear in order to make a well-informed decision as to whether now is the right time to go to market or not."

Wain goes on to say, "You typically only get one real chance to sell your business, and you want to make sure you do it right the first time."

> **“The largest mistake sellers make is unrealistic expectations, and that’s typically tied to valuations.”**

BUYER AND SELLER MARKETS

Again, we find that as the deals get larger, advisors are more likely to describe conditions as a seller’s market. And while the market is still clearly polarized, we are seeing a shift toward greater seller leverage in every sector, when compared to fourth quarter 2012.

Figure 3: Buyer versus Seller Markets

	Q4 2013		Q4 2012	
	BUYER	SELLER	BUYER	SELLER
<$500K	73%	27%	80%	20%
$500K-$1MM	56%	44%	78%	22%
$1MM-$2MM	49%	51%	67%	33%
$2MM-$5MM	40%	60%	45%	55%
$5MM-$50MM	27%	73%	37%	63%

REASON TO MARKET

Retirement was the number one reason driving sellers to market in all sectors; except within the $500,000 and under market in which burnout led. Burnout was the second most commonly cited reason for sale in all categories from $500,000 to $5 million. And within the $5 million to $50 million market, acquisition took second place at 14 percent, followed by health (9%) and unsolicited offers (9%).

“It’s always troubling when burnout sets in,” says Dr. Craig Everett, director of the Pepperdine Private Capital Markets Project. “We often see business performance decline or sellers are so clearly worn out that they lose their leverage in negotiations. Worst case scenario, they cannot hold on for an extended sale period and end up liquidating their assets at a discount.”

“But in the largest market segment, we see clear evidence of seller leverage based on the percent of sellers coming to market due to acquisitions and unsolicited offers,” Everett continued. “They are finding that a sale makes sense right now because of the surprisingly strong valuations driven by artificially low interest rates.”

MULTIPLES

Year over year, fourth quarter multiples stayed flat in every sector, except for deals valued from $5 million to $50 million, in which the median multiple increased by half a point. Figure 5 below shows median figures for the fourth quarter along with the most common multiple ranges.

Figure 4: Median Multiples, Year Over Year

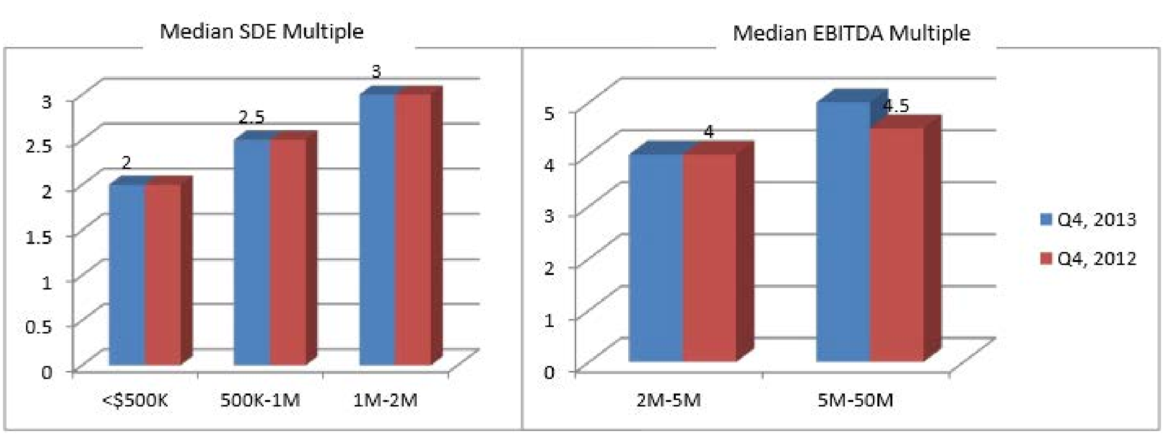
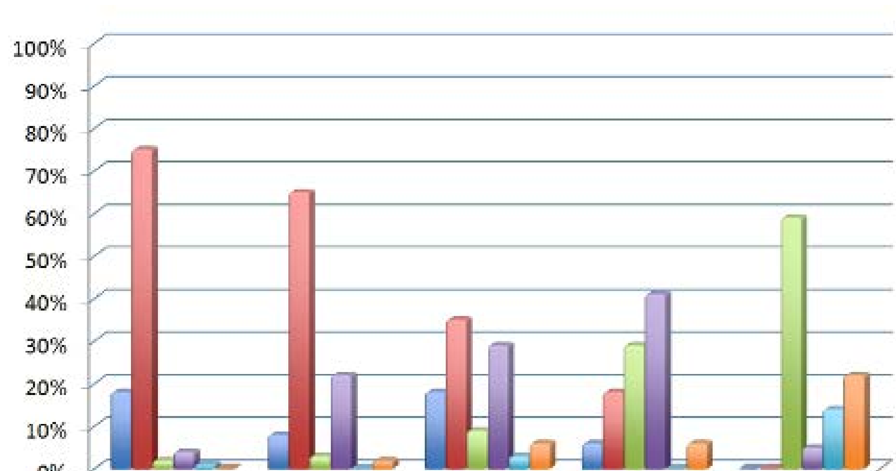


Figure 5: Median Multiples and Multiple Range, Q4 2013

	MEDIAN MULTIPLE	COMMON RANGE
<$500K	2 (SDE)	1.5-2.5 – 71%
$500K-$1MM	2.5 (SDE)	2.0-3.5 – 80%
$1MM-$2MM	3 (SDE)	2.0-4.0 – 94%
$2MM-$5MM	4 (EBITDA)	3.0-5.0 – 75%
$5MM-$50MM	4.5 (EBITDA)	4.0-6.0 – 82%

The majority of Main Street deals valued at $1 million or less were defined by SDE, not including any working capital. No clear trends emerged for deals in the $1 million to $5 million range, as those deals were defined by a combination of SDE and EBITDA with and without working capital. For deals in the $5 million to $50 million range, the vast majority (72%) were defined by EBITDA, including working capital.

Figure 6: Multiple Type



	< 500K	500K - 1M	1M - 2M	2M - 5M	5M - 50M
SDE including working capital	18%	8%	18%	6%	0%
SDE not including working capital	75%	65%	35%	18%	0%
EBITDA including working capital	2%	3%	9%	29%	59%
EBITDA not including working capital	4%	22%	29%	41%	5%
TTM EBITDA including working capital	1%	0%	3%	0%	14%
TTM EBITDA not including working capital	0%	2%	6%	6%	22%

> ***"We often see business performance decline or sellers are so clearly worn out that they lose their leverage in negotiations. Worst case scenario, they cannot hold on for an extended sale period and end up liquidating their assets."***

DEAL STRUCTURE

With larger deals, lenders contributed a greater percentage of financing. In the $5 million to $50 million sector, mezzanine financing kicked in a noticeable way.

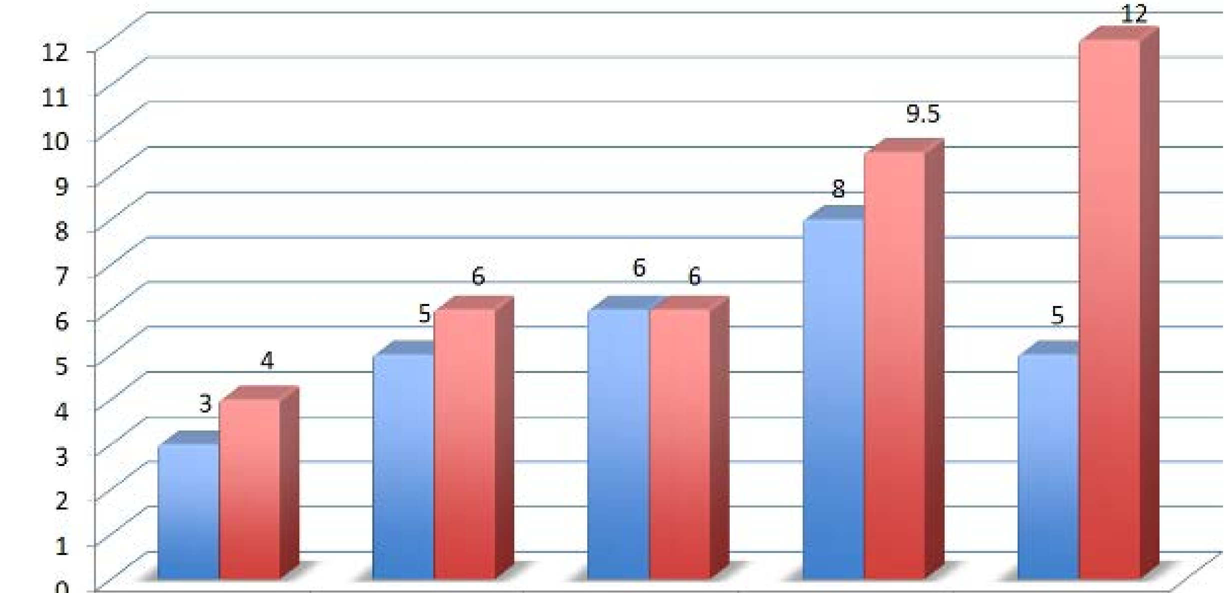
Figure 7: Deal Structures Q4 2013

	EQUITY	SELLER FINANCING	SENIOR DEBT	EARN OUT	SELLER RETAINED EQUITY	MEZZANINE	OTHER
<$500K	54%	17%	14%	4%	2%	-	10%
$500K-$1MM	44%	16%	28%	4%	-	-	8%
$1MM-$2MM	33%	17%	37%	3%	-	4%	5%
$2MM-$5MM	23%	24%	39%	2%	3%	4%	6%
$5MM+	40%	13%	15%	2%	5%	26%	-

TIME TO CLOSE

Year over year, deals closed faster in fourth quarter 2013. Analysis showed a sizable seven-month drop in the median close time for businesses valued at $5 million to $50 million and slight improvements in almost every other sector. Figure 9 below shows median figures for the fourth quarter along with the most common ranges in time to close.

Figure 8: Median Time to Close (Months)



	< 500K	500K - 1M	1M - 2M	2M - 5M	5M - 50M
Q4, 2013	3	5	6	8	5
Q4, 2012	4	6	6	9.5	12

Figure 9: Median Time to Close in Q4 2013

	MEDIAN (MONTHS)	COMMON RANGE
<$500K	3	2-6 months – 72%
$500K-$1MM	5	3-12 months – 80%
$1MM-$2MM	6	2-12 months – 88%
$2MM-$5MM	8	7-18 months – 72%
$5MM-$50MM	5	4-11 months – 82%

BUYER LOCATION

In the same way that larger deals take more time to close, they are also more likely to draw buyers from farther away.

"When it comes to marketing, it's helpful to know where to target your efforts. If you're a small company, you have almost a 75 percent chance of finding your buyer within a 50-mile radius," said Bryce Degroot, president of Compass Advisors. "And if you're a seller in the $5 million to $50 million sector, you have only a 10 percent change of finding a buyer in that radius."

Of note, 49 percent of sellers in the $500,000 or less sector found their buyer in the same city, while none of the buyers in the $5 million to $50 million sector came from the seller's hometown.

Figure 10: Buyer Location

	WITHIN 20 MILES	50 MILES	100 MILES	>100 MILES
<$500K	60%	14%	4%	21%
$500K-$1MM	32%	19%	24%	24%
$1MM-$2MM	38%	26%	3%	32%
$2MM-$5MM	24%	24%	12%	41%
$5MM-$50MM	5%	5%	14%	77%
	WITHIN CITY	**STATE**	**COUNTRY**	**INTERNATIONAL**
<$500K	49%	33%	12%	6%
$500K-$1MM	19%	49%	30%	3%
$1MM-$2MM	44%	21%	35%	-
$2MM-$5MM	18%	35%	47%	-
$5MM-$50MM	-	14%	86%	-

BUYER TYPES

The market was dominated by individual buyers this past quarter, most of them first time business owners. Existing companies had the strongest presence in the $2 million to $5 million sector at 41 percent, but were still trailing behind individual buyers at 47 percent. In the $5 million to $50 million sector, private equity groups were the primary players, representing 60 percent of closed transactions.

Figure 11: Leading Buyer Types

	#1 BUYER TYPE	#2 BUYER TYPE
<$500K	Individual 85%	Existing Co. 15%
$500K-$1MM	Individual 70%	Existing Co. 30%
$1MM-$2MM	Individual 73%	Existing Co. 18%
$2MM-$5MM	Individual 47%	Existing Co. 41%
$5MM-$50MM	Private Equity 60%	Existing Co. 35%

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Given that individual buyers dominated the market, it is not surprising that advisors cited "buying a job" as the number one reason driving Main Street buyers to market in the fourth quarter. In the $2 million to $5 million sector, horizontal add-on was the leading driver at 47 percent, followed by buying a job at 23 percent.

HOT INDUSTRIES

Figure 12: Hot Industries

	#1	#2	#3
<$500K	Personal Services & Restaurants – 20%		Business Services – 18%
$500K-$1MM	Personal Services – 22%	Wholesale/Dstr – 16%	Business Services – 14%
$1MM-$2MM	Health Care – 21%	Retail, Construction, **Manufacturing – 15%**	
$2MM-$5MM	Manufacturing – 41%	Retail – 18%	Wholesales/Distr & Healthcare – 12%
$5MM+	Retail – 23%	Manufacturing & Business Services – 18%	

ABOUT PEPPERDINE UNIVERSITY GRAZIADIO SCHOOL OF BUSINESS AND MANAGEMENT

Founded on the core values of integrity, stewardship, courage, and compassion, Pepperdine University's Graziadio School of Business and Management has been developing values-centered leaders who advance responsible business practice since 1969. Student-focused, experience-driven and globally oriented, the Graziadio School offers fully accredited MBA, Masters of Science, bachelor's completion and non-degree executive business programs for business professionals, entrepreneurs, managers and senior executives at all stages of their professional and personal development.

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

ABOUT INTERNATIONAL BUSINESS BROKERS ASSOCIATION (IBBA) AND THE M&A SOURCE

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.

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.