Q4 2018

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

MARKETPULSE

QUARTERLY SURVEY REPORT

FOURTH QUARTER 2018

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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 2018

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 Graziadio Business School.

The Q4 2018 survey was completed by 319 business brokers and M&A advisors. Respondents completed 273 transactions this quarter.

FIGURE 1: MARKET SEGMENTS STUDIED

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

DEALMAKERS SAY M&A PACE WILL CONTINUE IN 2019, BUT END IS NEAR

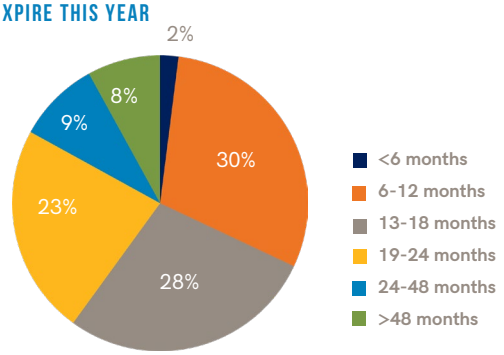
The intense pace of mergers and acquisitions that shaped Main Street and the Lower Middle Market last year is likely to continue into 2019. But advisors don't expect the run to last much longer.

If advisors are right, the year ahead could be marked by more deal flow and more businesses sold. However, they don't expect deal multiples, already at or near market peaks, to get any higher.

Advisors are slightly pessimistic that general business conditions will decline and margin pressure on businesses will get worse. And while they expect more deal volume in 2019, they anticipate that overall time to close will take longer.

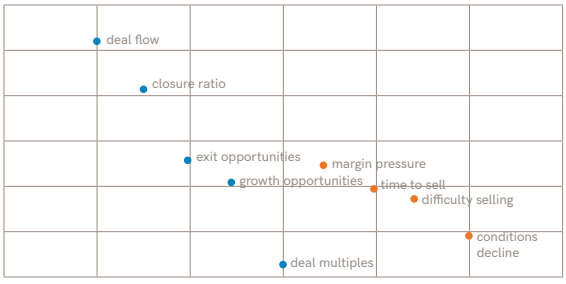
As for the future, most advisors (83%) say the strong M&A market won't last more than two years. Nearly a third (32%), predict the current seller's market will be over within the year.

FIGURE 2: ONE THIRD OF ADVISORS EXPECT STRONG MARKET TO EXPIRE THIS YEAR



"Increased deal activity is being driven by in part by the low unemployment rate which makes it hard for businesses to grow organically," said Craig Everett, PhD, Assistant Professor of Finance and Director of the Pepperdine Private Capital Markets Project. "There is an increasing trend of companies buying other companies in order to acquire their skilled labor force. This high demand for labor coupled with strong balance sheets, a positive lending environment, and historically low interest rates are all driving up deal flow and valuations. However, advisors aren't optimistic that the current climate will last through 2020. Considering that it's taking about a year to sell a business valued between $2 million - $50 million sellers should consider going to market before the market flips."

FIGURE 3: ADVISOR CONFIDENCE SCORE OF INDUSTRY INDICATORS



"Private equity is exerting considerable pressure on the market, competing with strategic buyers to drive demand," said Scott Bushkie, President of Cornerstone Business Services. "Business owners have more exit opportunities as buyers continue to offer a

whole range of deal structures, including 100 percent buyouts, majority recapitalizations that allow sellers to take significant chips off the table, and minority recaps which create new growth opportunities."

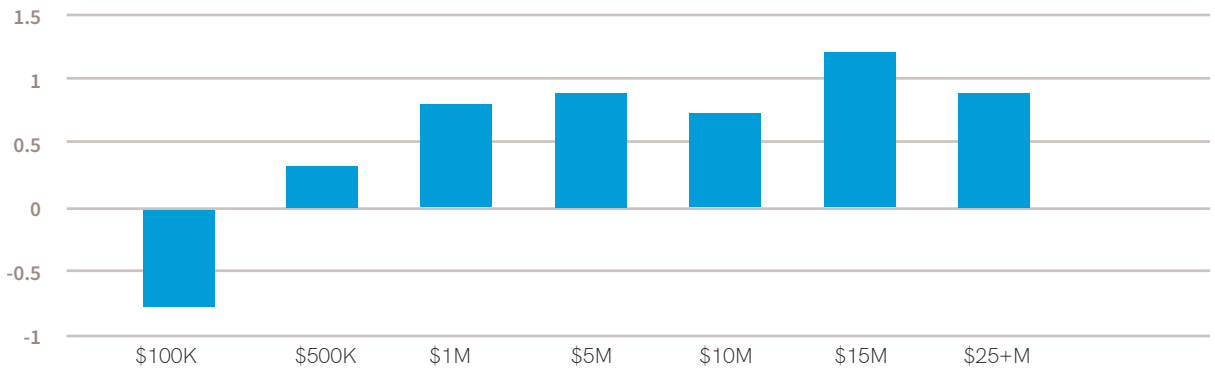
"Despite the high demand for quality businesses, we have dual forces increasing time on the market right now," said Neal Isaacs, Owner of VR Business Brokers of the Triangle. "Many buyer acquisition teams are operating at or near capacity, trying to evaluate available deals. If we want to ensure that all qualified buyers have had a look at an opportunity, we've had to slow the pace a bit."

"Beyond that, deals are taking longer in due diligence as buyers work hard to validate their investment and make sure what they're buying is worth the premium price today's sellers are commanding" Isaacs continued.

FINANCING DEALS IN 2018

Advisors indicate the lending market has been conducive to getting deals done, particularly for businesses with revenue of $5 million or more. Dealmakers are struggling however, to help buyers secure financing in the smallest Main Street sector.

FIGURE 4: EASE OF ARRANGING DEBTS IN 2018, BY COMPANY REVENUE (-3 TO 3 SCALE)



"We're still seeing considerable liquidity sitting on the sidelines, on both corporate balance sheets and private equity investment," said John Howe, M&AMI, Director, Business Transition Strategies. "Combine that with a generally positive lending environment, and we have the fuel we need to get deals to the closing table and keep momentum going."

"Some reports show buyers are not taking full advantage of the debt levels available to them in today's strong lending marketplace," said James A. Town, owner of Business Evaluation and Appraisal, Inc. "Many times, firms are opting for a lesser amount to have a better debt to equity ratio. While they could lose some returns, this puts them in a better place to do an add-on acquisition or to weather an upcoming recession if the market gets soft."

Cash at Close. Sellers continue to get the majority of cash at close. In this quarter, owners selling businesses valued between $2 million - $5 million received 78% 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.

FIGURE 5: PORTION OF SALE RECEIVED AS CASH AT CLOSE

	Q4 2018				Q4 2017			
	CASH AT CLOSE*	SELLER FINANCING	EARN OUT	RETAINED EQUITY	CASH AT CLOSE*	SELLER FINANCING	EARN OUT	RETAINED EQUITY
<$500K	85%	10%	1%	1%	85%	13%	1%	-
$500K - $1MM	82%	11%	2%	-	82%	17%	-	-
$1MM - $2MM	83%	10%	2%	1%	83%	10%	2%	1%
$2MM - $5MM	78%	10%	3%	4%	86%	14%	1%	-
$5MM - $50MM	82%	11%	2%	3%	83%	10%	4%	4%

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

2018'S TOP INDUSTRIES

Looking at data for the whole year, personal services led the Main Street market in 2018, followed by business services and restaurants. In the Lower Middle Market, manufacturing was the standout leader at 27% of all reported transactions, followed by construction and business services.

FIGURE 6: TOP INDUSTRIES: MAIN STREET IN 2018

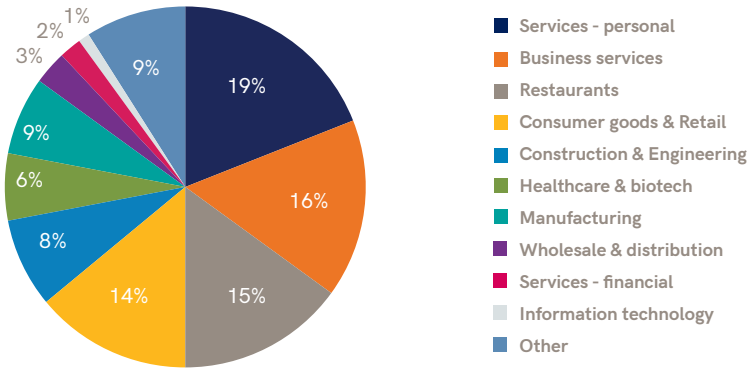
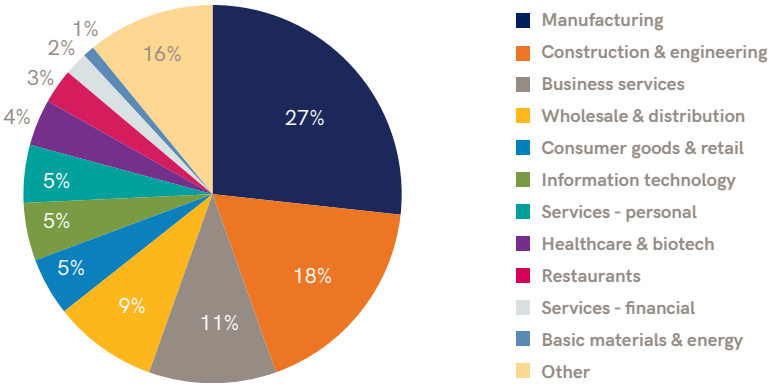


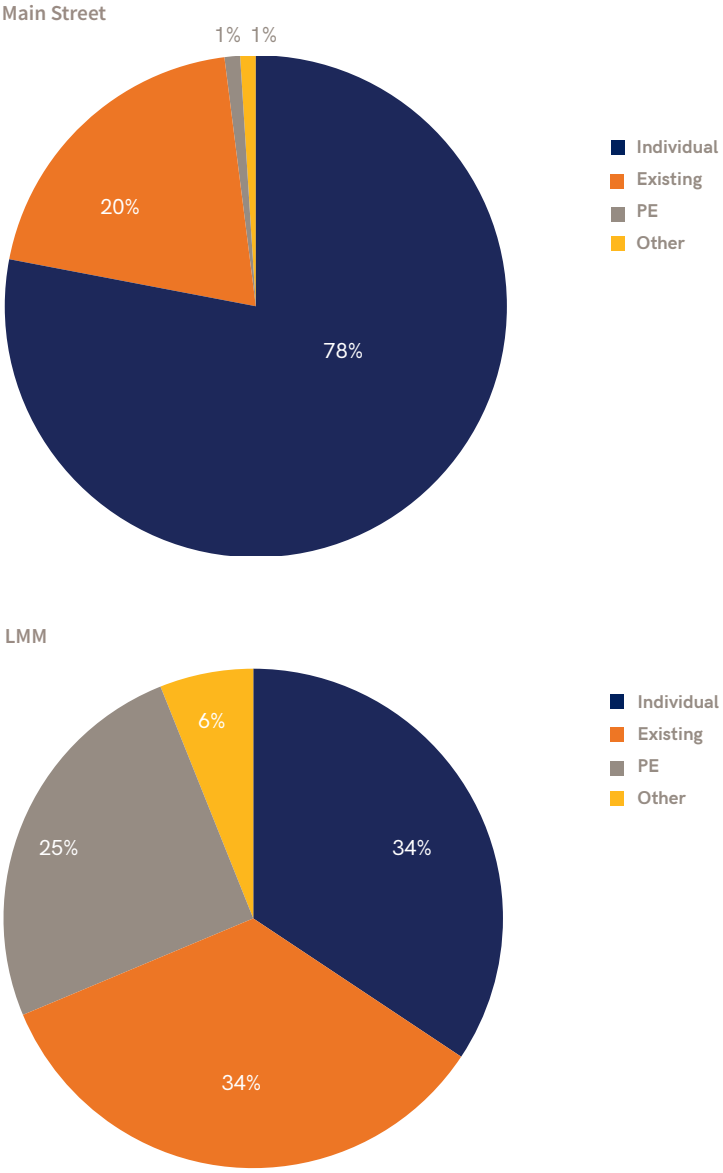
FIGURE 7: TOP INDUSTRIES: LOWER MIDDLE MARKET IN 2018



2018'S ACTIVE BUYERS

The Main Street market was dominated by individual buyers in 2018, with only 22% of acquisitions made by existing companies and minimal private equity activity. In the Lower Middle Market, however, individual buyers competed right alongside existing companies for their share of the deals, with private equity accounting for 25% of acquisitions.

FIGURE 8: 2018 ACTIVE BUYERS



WHY ARE OWNERS SELLING?

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

FIGURE 9: TOP 2 REASONS SELLERS WENT TO MARKET

$500K	Retirement 31%	New Opportunity 20%
$500K - $1MM	Retirement 42%	Burnout 17%
$1MM- $2MM	Retirement 80%	Burnout 10%
$2MM - $5MM	Retirement 50%	Burnout 17%
$5MM - $50MM	Retirement 39%	Recapitalization / Burnout 17%

"People are thinking about getting out, before the next recession," said Laura Ward, Managing Partner of Kingsbridge Capital Partners. "The business owners who made it through the last financial crisis haven't forgotten the pain and stress. They're looking ahead and telling us they don't have the stamina to work through another one."

"Burnout is a real problem for business owners, particularly as they near retirement," said Lisa Riley, Principal of LINK Business-Phoenix. "When a traditional employee burns out, it leads to inefficient decision making, absenteeism, and health issues. Business owners experience all of that — and more — and are highly likely to lose value in their business as a result."

"The key is to get out while you're still energized and feeling good about your business," Riley continued. "You want to exit on a high note, before stress and dissatisfaction hurt business performance."

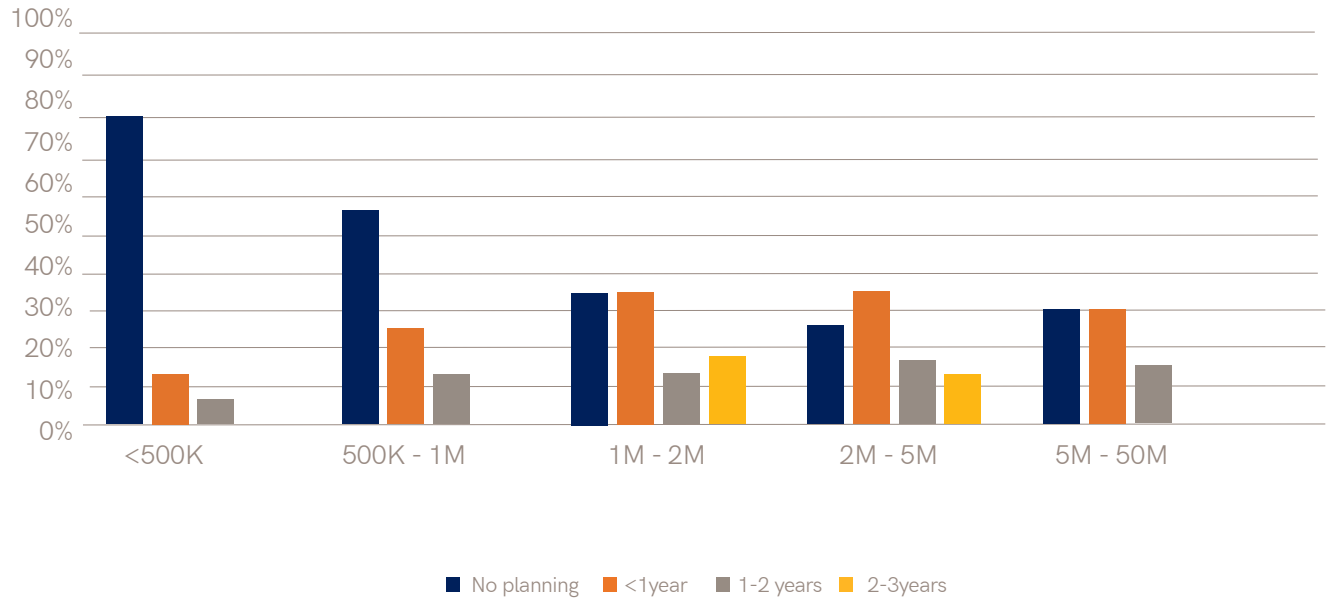
"Buyers will determine value based on your most recent years, not when you were in your prime. In fact, many buyers will put 100 percent of the value on the trailing 12 months," said Bushkie. "The truth is, if you're in business for 40 years, and you hang on 18 months too long, you could lose half the value in your company based on just four percent of your history."

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. Generally, the smaller the business, the less likely the owners are to do any advance planning prior to their listing engagement.

Of the sellers that 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.

FIGURE 10: PROACTIVE EXIT PLANNING



"The value in preparing a business for sale cannot be overstated," said Jeff Snell, principal of ENLIGN Advisors. "Tax planning is one important aspect. Without planning, you could end up owing far more than you'd have to. Business value is directly affected by how you organize your financials in the years leading up to a sale."

WHO HAS THE ADVANTAGE: BUYER OR SELLERS?

Seller-market sentiment is on the rise in most market sectors, with more advisors describing Q4 2018 as a "seller's market" than a year ago, in all but the $500,000 to $1 million sector. Of note, 2018 marks the first full year in which four of the five market segments have been described as a seller's market.

FIGURE 11: Q4 2018 MORE OF A SELLER'S MARKET THAN YEAR AGO ADVISORS SAY

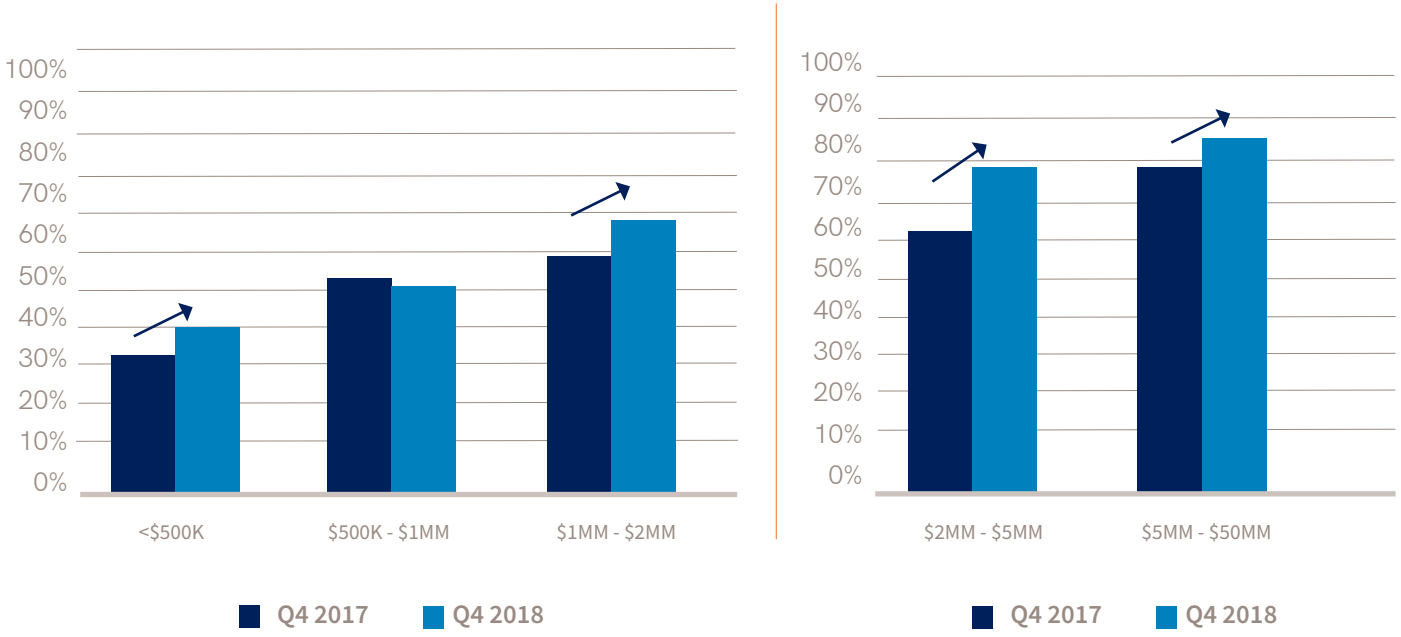
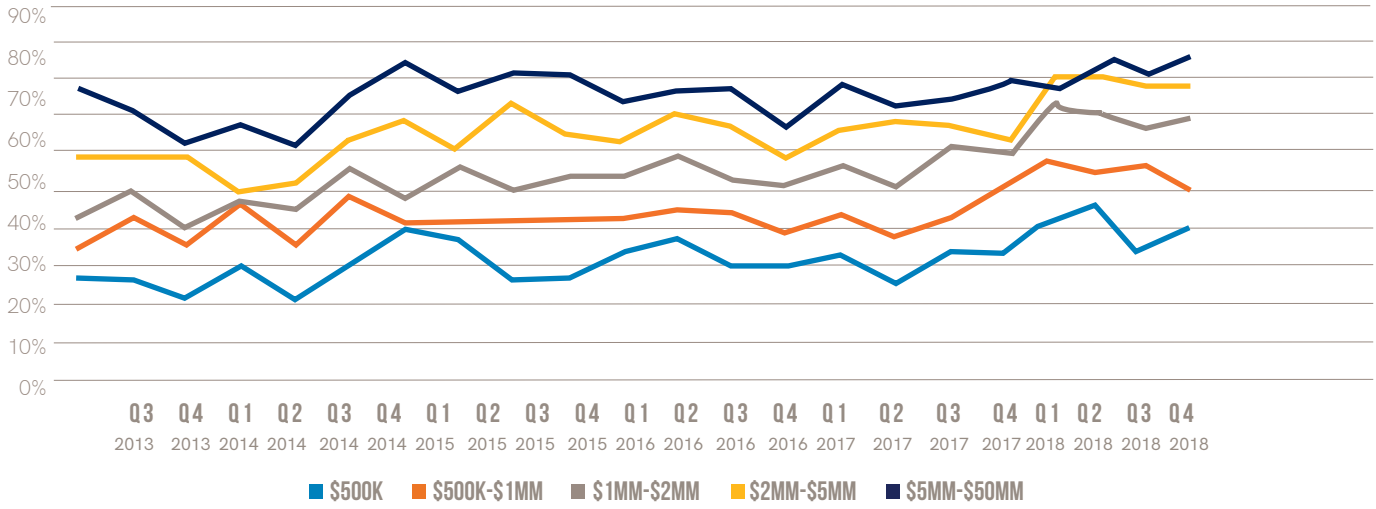


FIGURE 12: SELLER MARKET SENTIMENT, HISTORICAL TRENDS

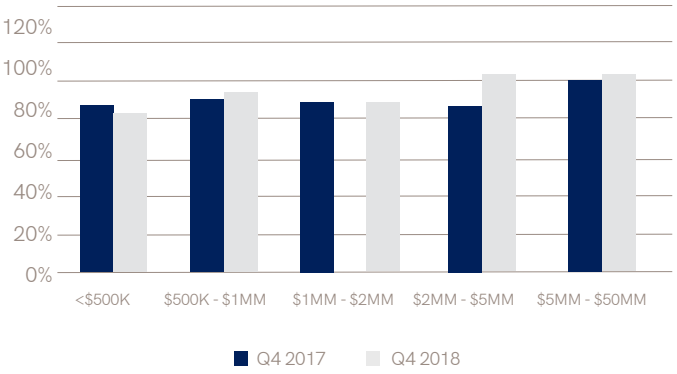


"Demand is outstripping supply, particularly in the Lower Middle Market, and it's preventing many prospective buyers from executing their growth plans," said David Ryan, Advisor with Upton Financial Group in California. "We're seeing multiple offers whenever a high-performing business comes on the market, and buyers are dealing with heavy competition."

WHERE ARE BUSINESS VALUES TRENDING?

In the Lower Middle Market, final sale prices remained above internal benchmarks, outperforming Q4 2017. Excluding the smallest market sector (deals valued at less than $500,000) sellers received an average of 97% of the benchmark. This is a full 15 percentage points higher than the smallest market sector — which also was the only market sector where advisors still say that buyers have the advantage.

FIGURE 13: FINAL PRICE REALIZED VS. ASKING PRICE



Multiples. Multiples continue to remain strong in all categories, at or near market peak in some sectors. Year-over-year, multiples were generally stable or increasing in most market sectors. Advisors do not predict additional multiple growth in 2019.

FIGURE 14: MEDIAN MULTIPLE OFF PEAK

	2018	2017	2016	2015	2014
	Q4	Q4	Q4	Q4	Q4
MEDIAN MULTIPLE PAID (SDE)					
<$500K	2.0	2.0	2.3	2.0	2.0
$500K-$1MM	2.8	2.5	2.8	2.5	2.9
$1MM-$2MM	3.3	3.1	3.3	3.3	3.0
MEDIAN MULTIPLE PAID (EBITDA)					
$2MM - $5MM	4.4	4.3	4.8	4.0	4.6
$5MM - $50MM	5.8	5.5	5.5	5.1	5.0

FIGURE 15: DEAL SIZE INCLUDES MOST COMMON MULTIPLE TYPE

DEAL SIZE	MOST COMMON MULTIPLE TYPE
$500K	SDE w/o working captial
$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
*EBITDA Earnings Before Interest, Taxes, Depreciation and Amortization

Time to Close. The average time to close is 9.3 months, which is trending slower than normal. Months from LOI to close showed improvement over Q4 2017 but is still higher than the three-month average from Q4 2015.

FIGURE 16: TIME TO CLOSE ON SLIGHT UPTICK IN Q4 2018

	Q4 2018		Q4 2017	
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	7	3
$1MM - $2MM	9	3	9	3
$2MM - $5MM	10.5	4	10	4
$5MM - $50MM	12	4	11.5	5.5

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