LippesMathias LLP
ATTORNEYS AT LAW

# Which are the Current Opportunities and Challenges in Closing a Middle Market Deal?

By John J. Koeppel

June 13, 2016 | **CORPORATE**

Buyers are hungry for acquisitions in today's market.  Some statistics from the 2016 Pepperdine Capital Markets Report[1] provide a deeper dive into what investment bankers, sellers and buyers (both private equity and strategic buyers) are seeing in the current deal market:

- **Industries:** Private equity buyout respondents indicated a diverse range of industry targets, with the most targeted industries being Business Services (18%), Manufacturing (17%), Wholesale & Distribution (12%); Health Care & Biotech (11%); Consumer Goods & Services (9%); Information Technology (8%); and Financial Services & Real Estate (7%).
- **Number of Deals**: Approximately 69% of private equity respondents made between one and three investments over the last twelve months, and a similar percentage expect to do the same number of deals over the next twelve months.
- **Deal Size**: About two-thirds of buyout investments were in the range of $1 million to $10 million of EBITDA.
- **EBITDA Multiples**: Average deal multiples reported for buyout deals for the prior twelve months vary from 5.0 to 8.5+ times EBITDA depending on the size of the company.  Expected returns vary from 20% to 27.5%.
- **Market Issues**: Private equity respondents believe domestic economic uncertainty is the most important current and emerging issue facing privately-held businesses.  Other issues include: access to capital; government regulations and taxes; economic uncertainty (international); political uncertainty / elections; competition from foreign trade partners; and inflation.
- **Sellers Going to Market**: On the sale side, some of the top reasons cited by sellers for going to market are owner retirement (52% of survey respondents); desire for a recapitalization; desire for new opportunity / business expansion; and owner burnout.
- **Deal Hurdles**: According to investment banker survey respondents, the top three reasons for deals not closing were valuation gap (40%), unreasonable seller or buyer demand (21%), and lack of capital to finance the deal (9%).
- **Financing Hurdles**: Respondents indicated a general imbalance between companies worthy of financing and capital available for the same, with a reported shortage of capital for those companies with less than $5 million in EBITDA, but a general surplus for companies with $5 million in EBITDA or more.
- **Valuation**: When using multiples to determine the value of a business, the most popular methods used by respondents when valuing privately-held businesses were recast (adjusted) EBITDA multiple (59%), revenue multiple (13%), cash flow multiple (10%) and EBITDA (unadjusted) multiple (10%) approaches.
- **Valuation Gap:** Of those transactions that didn't close due to a valuation gap in pricing, approximately 35% had a valuation gap in pricing between 21% and 30%.
- **Other Deal Considerations**:  Approximately 35% of deals closed in the last 12 months involved a Contingent

Earn-out. Other common components of closed deals included Seller Financing / Seller Note (reported in 27% deals) and Equity Rollovers (24% of deals).

- **Strategic vs Financial Buyer**: Approximately 57% of deals closed over the past 12 months involved strategic buyers, while 43% involved financial buyers. While a number of respondents didn't witness any premium paid by strategic buyers, about half saw premiums between 1% and 20%. For financial buyers, about two-thirds of their recent deal flow were platform investments, with the remaining one third being follow-on investments.
- **Challenging Deal Sourcing**: In order to close a single deal, buyers reported the following median statistics:
  - review of 73 investment banker pitch decks on target companies,
  - followed by 11 target company meetings;
  - leading to 5 letter of intent (LOI) submissions; and
  - ending in 2 LOI executions (of which, half often did not make it to close).