# 30 Second M&A Update: Business Values May Not Decline

### Market Pulse Survey - Quarter 1 2020
**Presented by IBBA, M&A Source & in partnership with Pepperdine University**

According to the Q1 2020 Market Pulse Report, advisors reported that of the small and medium businesses currently for sale, about 35% had closed, 40% were operating at partial capacity, 4% had benefited, and 21% remained unaffected by COVID-19. **READ MORE...**

Not surprisingly, the pandemic caused a delay in business sales. Advisors indicated 46% of lower middle market deals were delayed in Q1 and 11% were cancelled altogether.

Deal cancellations: 25% were attributed to sellers pulling their business off the market. 46% of the cancellations were due to buyers backing out, and 12% were due to changes in bank financing.

**Valuations.** The question now, as buyers move forward with acquisition plans, is what will happen with valuations. For those businesses that remained fully active, their valuations will likely stay solid. But even those businesses that partially closed or were negatively affected may find valuations remain consistent. Businesses that were essential or otherwise able to pivot to an online or contact-less business model will be attractive to buyers.

Declining cash flows typically impact business values, but we may see special pandemic considerations granted. Most business sales are calculated as a multiple of adjusted cash flow or EBITDA. A typical part of the calculations involves "normalizing" cash flow. That means making adjustments for one-time expenses and unusual events.

As buyers and lenders value businesses, they may apply the same normalizing adjustments to the financials for COVID-19, especially if the business recovered quickly in Q3 or Q4.

**Deal structure.** In terms of deal structure though, sellers who want to get full value from their business will likely have to carry more risk. Buyers may ask for more in seller financing, earn out, or equity rollover in order to lessen the risk of future declines. Here's what that might look like:

**Seller financing** is the bridge between a buyer's resources and the value they see in a business. Essentially, it's a loan from the seller, typically structured with monthly payments over a three to five year period.

In the past year, seller financing has hovered between 10-15% for Main Street deals, and 6% or less for deals over $5 million, per the Market Pulse Report. The larger the risk (e.g., COVID-19 closures), the more seller financing a buyer will request. So, I expect we'll see these numbers climb in the year ahead.

**Earnout** is a commitment by the buyer to pay the seller a certain amount of money tied to future performance after a sale. If the business meets certain benchmarks, the seller receives additional value. Earnouts, however, are not often used in conjunction with an SBA loan.

**Equity rollovers.** In this arrangement, the seller maintains an ownership stake in the business. The seller rolls a portion of his/her equity stake into the new capital structure in lieu of cash proceeds.

Financial buyers often want sellers to receive a portion of their consideration as equity. It's part of their typical financing model, and it's a sign the seller has faith in the business.

For sellers, an equity rollover means a second bite at the apple years down the road when the business sells again. In some cases, if the new owner has successfully grown the business, the minority stake could be worth as much as the original sale.

Deal structures will also be driven by lending activity in the months ahead. If lenders pull back, both buyers and sellers will be motivated to reach alternative financing agreements.


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