STANFORD BUSINESS GRADUATE SCHOOL OF

Independent Study

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COVID-19 Impacts on Small Business M&A

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Executive Summary

As the world responds to the global COVID-19 pandemic, we sought to bring some added transparency to one small segment of the US economy: small business M&A market.

This study is designed as a snapshot, rather than a comprehensive analysis, of the industry. Data was captured from voluntary responses to an online survey.

From this data, it's clear that the transaction activity has declined amongst small businesses, and will likely stay below normal levels for the next 12 months. However, this sentiment was not universal; some brokers indicated that they may do more transactions than normal.

We were able to quantify the valuation gap between buyers and sellers, accentuated by bank underwriting issues and buyer uncertainty.

To fully utilize this data and inform the "so-what" for the broker community, we identified a series of additional questions which should be studied with additional data.

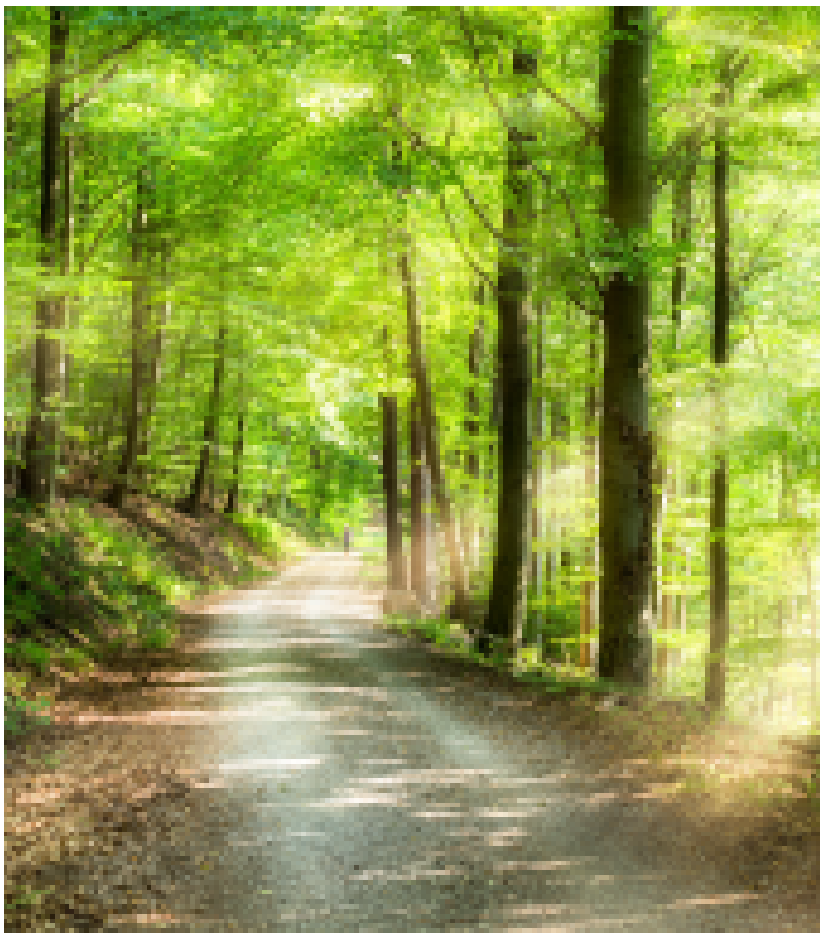
A thank you to our participants

Thank you to each of you who took the time to participate in this study, both by taking the survey and engaging in subsequent conversations.

At a time of division, fear, and anger, it's encouraging to see members of the business broker community contribute to this collective project.

My hope is that this information provides some level of insight into the broader Main Street / LMM market and help you navigate the uncertain future.

-Lowell Hays



Participant Overview

This study was developed through voluntary responses from 116 qualified participants in active transaction roles (business brokers, investment bankers, etc.) based in 39 different states and territories.

Study participants were identified through their presence on online broker directories and selected by the Study Coordinator to provide a representative sample group.

The study participants had spent a median of 10 years representing businesses for sale, with a minimum of under a year (.5 years) and a maximum of 45 years.

Participants represented a median of 5 transactions last year, with a minimum of 0 transactions and a maximum of 50 transactions. For future study, individual vs. firm-wide responses will be clarified, as it was clear participants saw some ambiguity in that question.

10
Median
Years Experience

5
Median
2019 Transactions

116
Study Participants

39
States/Territories
Represented

Figure 1. Home States / Territories of Participants
Source: Survey Data

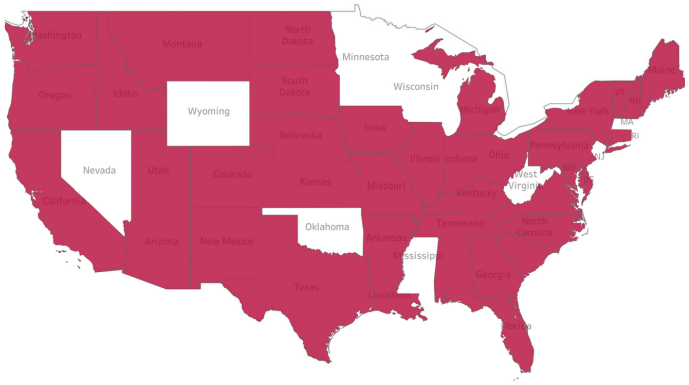
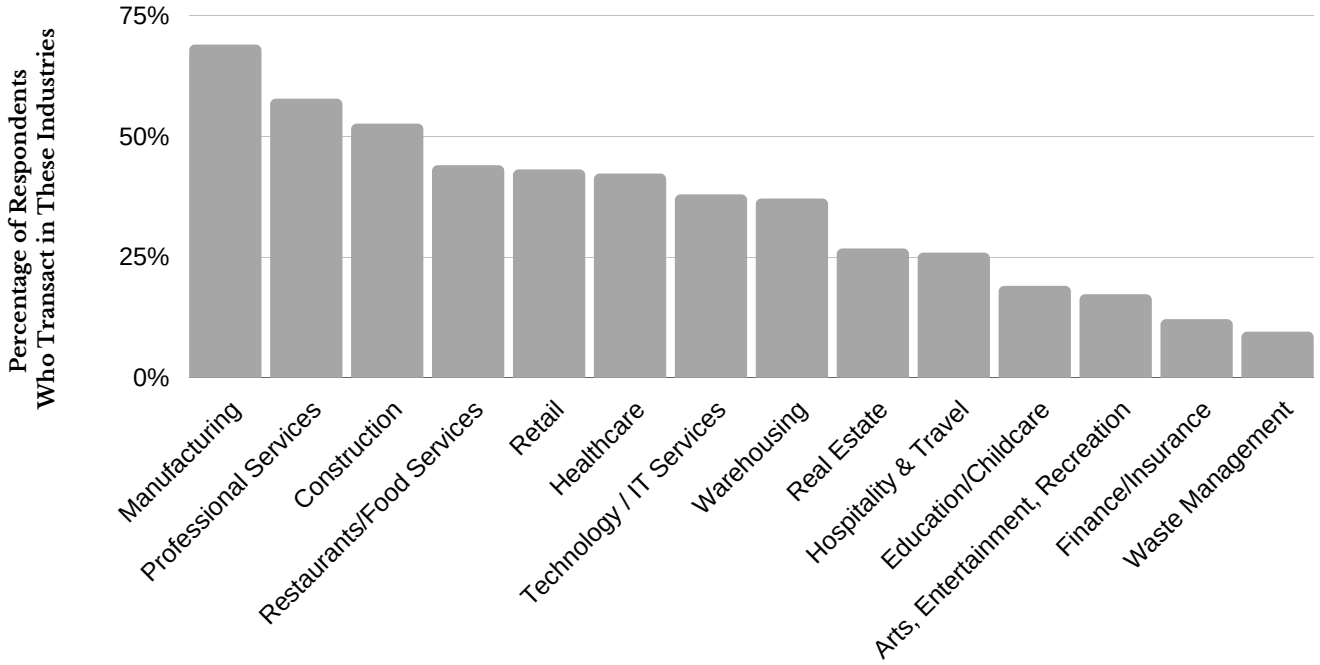


Figure 2. Industries Represented by Participants
Source: Survey Data



How COVID-19 is Affecting Today's Market

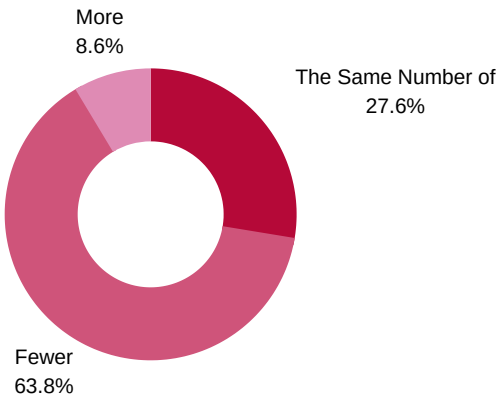
M&A activity has clearly slowed down in the Main Street and Lower Middle Market sectors. Nearly 2/3 of survey respondents indicated they were currently completing fewer transactions than normal.

With the significant economic slowdown caused by COVID-19 and the related shelter-in-place policies, this result is likely unsurprising. Perhaps more interesting, 8.6% of respondents indicated they were currently completing more transactions than normal. We will look further into all three groups throughout this study.

The data sample collected was not significant enough to evaluate geographic differences in great detail. This represents an important area of further study as we attempt to predict future M&A activity; understanding the importance of local vs. national health impacts would give us much stronger insight into whether there are specific micro-markets more likely see transactions than others.

Figure 3. I am currently completing (fewer, more, the same number of) transactions than normal

Source: Survey Data



Market Slowdown is affecting both new and experienced business brokers

Contrary to our hypothesis, experienced brokers seem to be facing the same level of challenge as newer brokers breaking into the industry and the industry veterans. While more experienced brokers carry experiences from prior recession markets, this data seems to suggest that those lessons have not been able to help them overcome today's challenges. We expect this is largely due to the unique uncertainty of predicting the extent and duration of health impacts from COVID-19.

We also attempted to study the effects across various brokerage sizes. Limitations in the data collected made this impractical; future studies should address this nuance to understand whether larger firms have been able to support their brokers during this time more effectively than smaller groups or independent brokers.

All Brokers

63.6%

of Participants are currently completing **fewer** transactions than normal

Brokers with < 10 Years Experience

60.0%

of Participants are currently completing **fewer** transactions than normal

Brokers with 20+ Years Experience

60.6%

of Participants are currently completing **fewer** transactions than normal

How COVID-19 is Affecting Today's Market

Operating Income and Debt Financing Are Major Inhibitors to Today's Deal Market

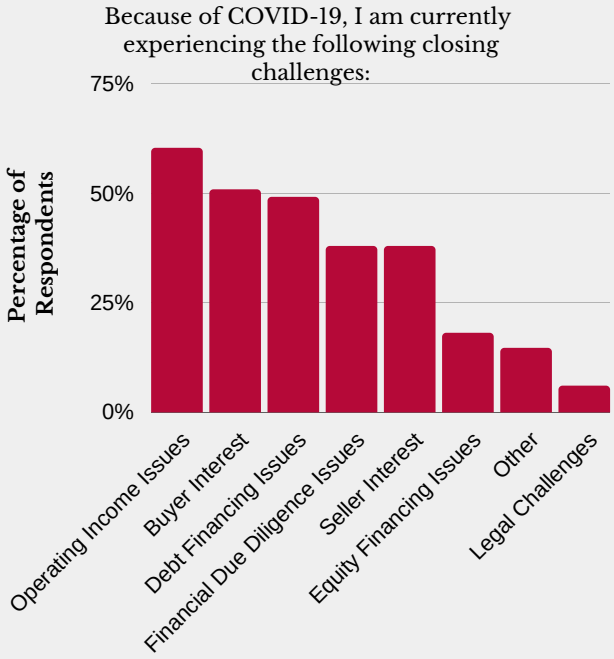
Our survey asked brokers to outline the closing challenges currently affecting their transactions.

Across the full set of participants, 2 categories were identified by greater than 50% of brokers as a current issue: Buyer Interest (51%), and Operating Income Issues (60%). Debt Financing (49%) was close behind.

It is reasonable to infer from this data that these issues are inter-related. Despite the broad activation of the US banking system via the CARES Act to provide liquidity to the US small business sector, it's clear that transaction debt - notably excluded from the CARES Act - is a challenge. The operating income issues, identified here, have clearly made underwriting a challenge.

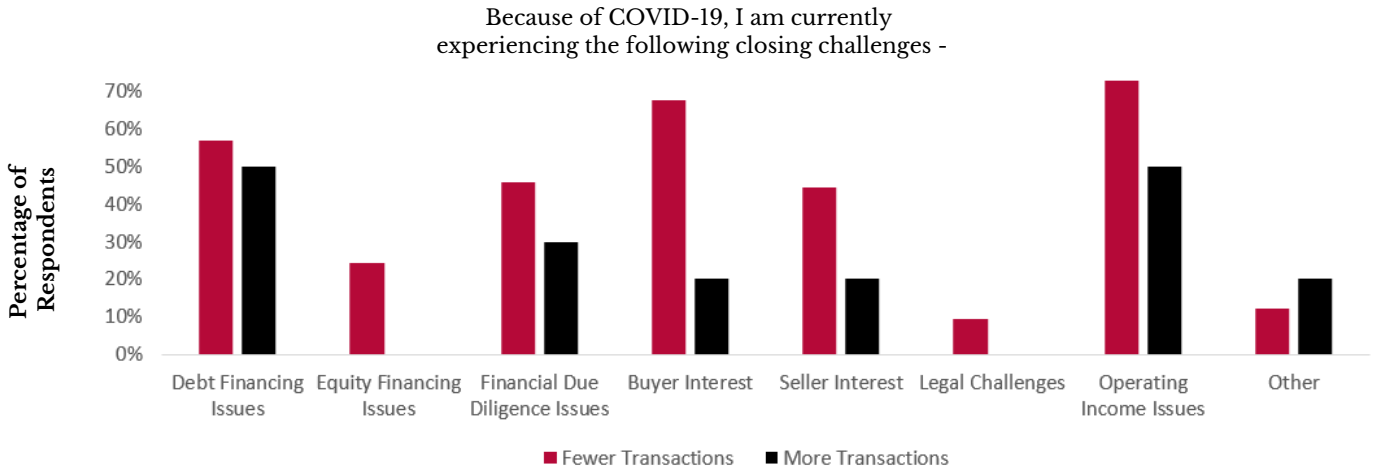
Together, they present a complex situation with both short-term financial impacts and long-term uncertainty add to the already-challenging process to complete a transaction.

Figure 4: Closing Challenges Today - ALL
Source: Survey Data



More Active Brokers are not immune to these closing challenges

Figure 5: Closing Challenges Today - Comparison of Respondents Completing "Fewer" vs. "More" Transaction Now
Source: Survey Data



Understanding Expectations in Today's Market

The implications of the financing and closing challenges seem clear: Equity requirements will go up, pressuring equity returns, reducing the pool of buyers, and ultimately, lowering the valuations buyers will pay. If sellers are anchored on 2019 valuation highs, the result could be be a recipe for broken deals and frustrated transaction processes.

We set out to test those hypotheses and understand how both buyer and seller expectations have changed from pre-COVID-19 levels.

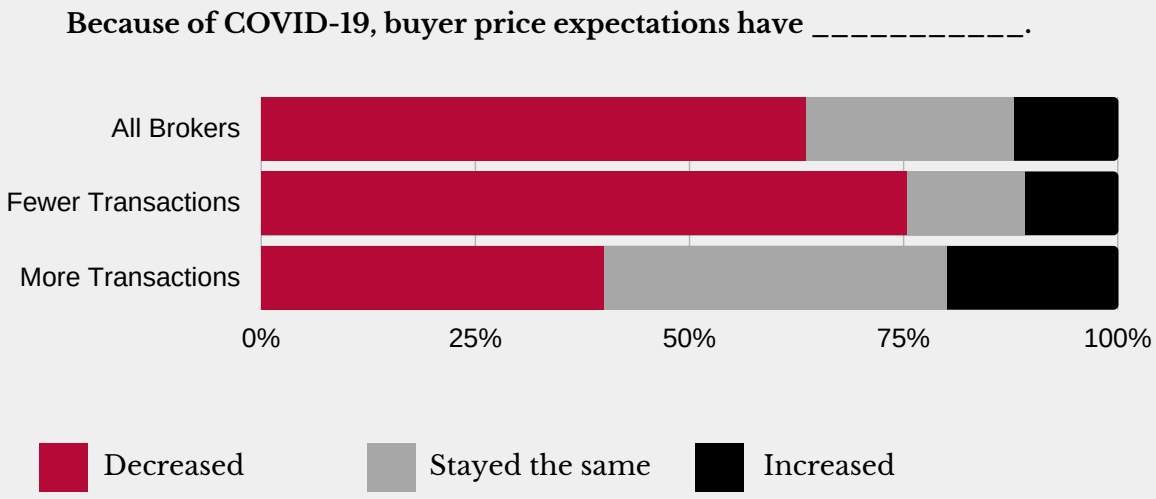
Buyer Expectations have dropped and appear to be a contributor to reduced transaction activity

A majority of brokers (63%) identified that buyer price targets have decreased since the pandemic began, as we expected. We then attempted to evaluate what role buyer expectations were playing in transaction activity by analyzing these results vs. their self-reported transaction activity (fewer, more, same as normal).

While the sample size for the "More" category is not large enough to statistically confirm, it does appear that brokers who have been able to increase their deal flow have experienced fewer buyers looking to drop their valuation targets. It's unclear whether this difference is due to ability of the broker, specific industries or geographies, or other potential factors.

Figure 6: Buyer Price Expectations

Source: Survey Data



Buyer Price Expectations Have Reportedly Dropped Between 10-30%

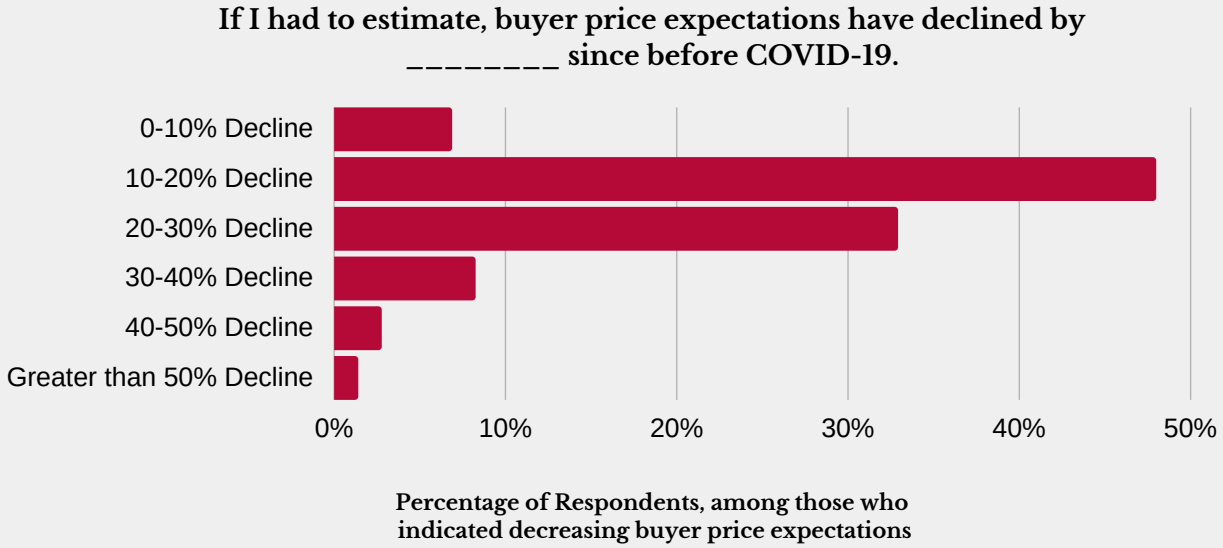
We asked respondents who indicated that buyer expectations have dropped from before COVID-19 to estimate the size of this decline.

Figure 7 shows the results, for the 63% of respondents who identified that buyers were seeking lower prices. 93% of these respondents indicated buyers are looking for greater than 10% discount to their pre-COVID expectations, with 12% stating that the expected discount was greater than 30%.

These results clearly support our Closing Challenges data; more buyer caution likely means buyers are seeking bargains with margin of safety to protect themselves from the economic unknowns of the next few years.

Figure 7: Estimated Buyer Price / Valuation Target Decline since pre-COVID-19, for respondents indicating that those expectations have declined.

Source: Survey Data



Some seller price expectations have declined, but not to the same degree as buyer price expectations

When asked about seller price expectations, the majority of respondents indicated no change (57.4%). While 42% of respondents did indicate sellers have decreased their price expectations, this falls short of the 63% who said buyers were looking for lower prices.

The disconnect between buyer and seller expectations is shown further in lower price reduction expectations of sellers, as reported by the brokers identifying declining seller valuations. Figure 9 shows that, in the opinion of the brokers, sellers are unlikely to reduce price by more than 20%, with 35.5% seeking a reset of under 10% (compared to 93% of buyers looking for a valuation reset of greater than 10%).

Figure 8: Seller Price Expectations

Source: Survey Data

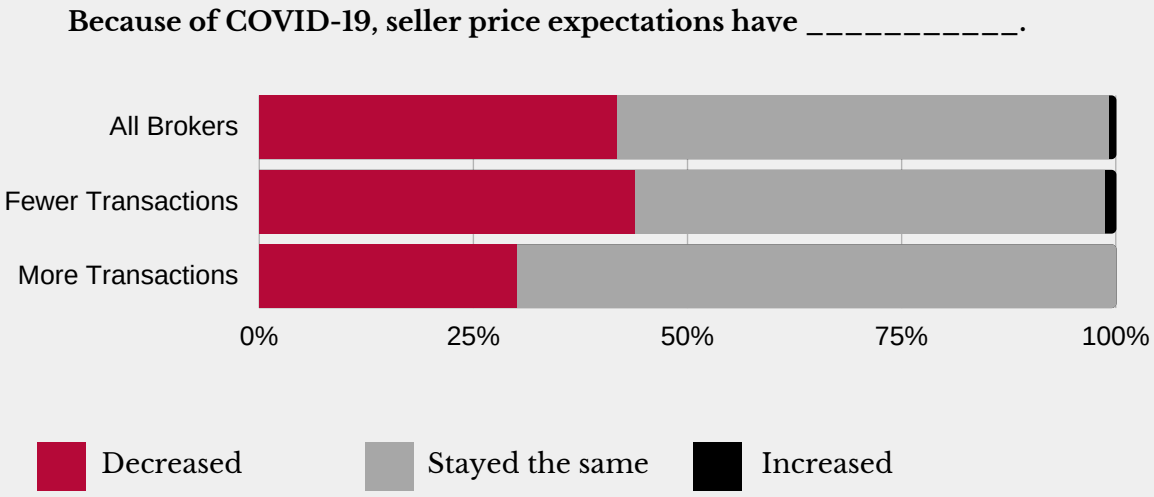
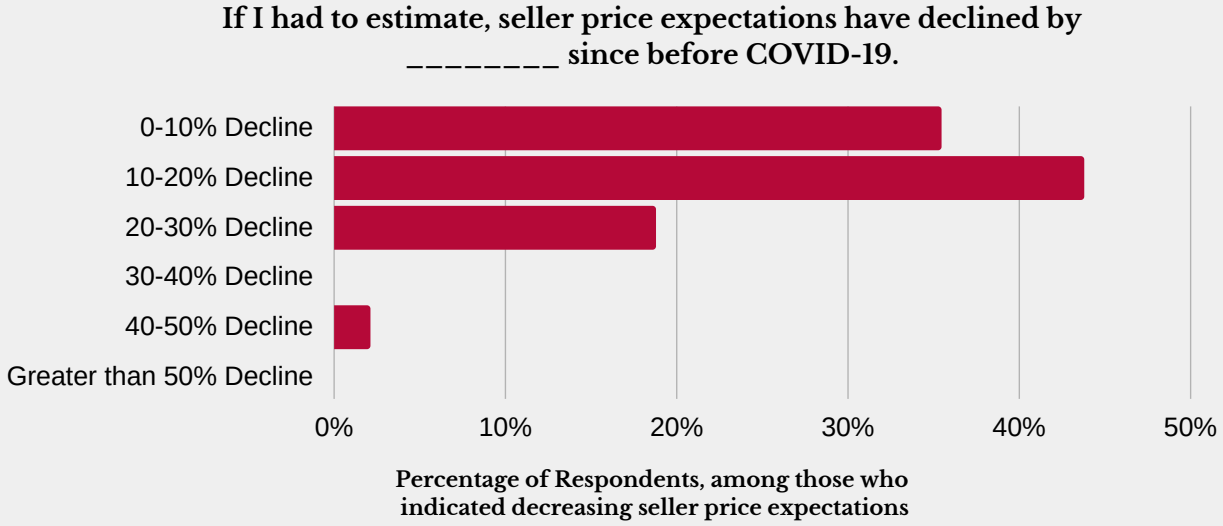


Figure 9: Estimated Seller Price / Valuation Target Decline since pre-COVID-19, for respondents indicating that those expectations have declined.

Source: Survey Data



Analyzing COVID-19 Impacts by Industry

The study results spark several interesting questions regarding the impacts to specific sectors. A few specific questions worth studying:

- Is the general decline in activity felt universally across industries?
- If not universal, which specific industries are maintaing activity? Which industries are increasing M&A activity?

The structure of the present survey does not allow for such industry-level analysis. Future studies should address this question to help business brokers focus their outreach efforts as well as to enable business owners to better understand industries where likelihood-of-close is still strong.

Assessing Broker Sentiments - A Momentary Slowdown or Beginning of A New Normal

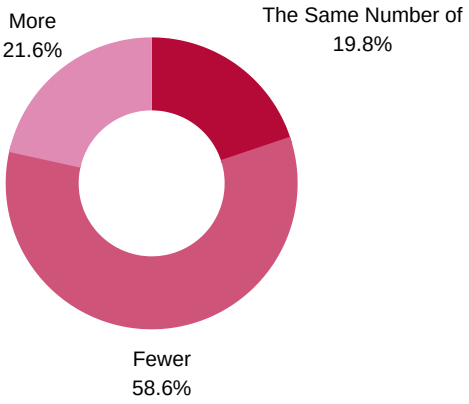
Lower Activity seems to be the expectation for the next 12 months, although pockets of optimism exist

As commentators debate the shape and speed of recovery, we wanted to know how brokers expect the small business M&A market to recover. The data is largely pessimistic, with more than half (58.6%) of respondents expecting to complete fewer transactions over the next 12 months than normal.

Similar to the data on current transaction activity, this expectation of lower activity is shared by more experienced and less experienced brokers (see below).

One area of optimism is the increase in brokers expecting to complete more transactions over the next 12 months vs. the same responses on today's activity (21.6% vs. 8.62%). Future studies should dive further into these respondents to identify the characteristics driving this optimism vs. the majority.

Figure 10. I expect to complete (fewer, more, than same number of) transactions than normal over the next 12 months.
Source: Survey Data



All Participants

58.6%

of Participants expect to complete **fewer** transactions than normal over the next 12 months

Participants with < 10 Years Experience

56.4%

of Participants expect to complete **fewer** transactions than normal over the next 12 months

Participants with 20+ Years Experience

57.6%

of Participants expect to complete **fewer** transactions than normal over the next 12 months

Summarizing Insights & Future Areas of Study

Structural financing challenges, buyer fears, and a mismatch of buyer-seller price expectations are holding up small business M&A activity

Our data clearly shows that M&A activity has declined, that brokers expect it to stay in decline for at least the next 12 months, and that there is not a simple solution to restarting normal activity.

Traditional bank underwriting processes (SBA and non-SBA) are not designed for the types of immediate and significant revenue declines experienced by businesses in Q2 2020. With public health outcomes still uncertain until a COVID-19 vaccine reaches mass adoption, tracking bank sentiment will be one of the critical leading indicators of M&A activity.

Once public health outcomes are more known, the next underwtiting challenge will be determining the appropriate adjustments to business performance from this period. Future analysis should investigate how buyers can best position potential acquisition targets with loans officers (SBA and non-SBA loans) to reduce this friction.

Fundamentally, buyer-seller valuation expectation is the core element of a transaction market. With sellers anchored on all-time high valuations from 2019 and buyers both unable to obtain debt and uncertain of potential future COVID-19 outbreaks, there is a wide gap for brokers to overcome.

There is no guarantee of a quick health or economic response to COVID-19. With a large number of Baby Boomer-owned businesses still in need of transition, it remains to be seen how long these owners will be willing to wait until transacting. Creative deal makers and those with specific industry knowledge will be at a competitive advantage to find ways to meet seller valuation expectations while navigating the financing and future performance challenges we've identified.

Market sentiment is changing daily. Future industry studies should monitor these results over time and further search for leading indicators and pockets of activity.

The data provided here provides a snapshot of the small business M&A market today. However, it does not answer a multitude of important questions. We hope further studies will look at these questions to help brokers, buyers, and sellers better see through the "fog of war" caused by COVID-19.

A few of those questions:

- **Industry Impact**: Are brokers seeing particular industries experiencing more/less activity?
- **Geography:** Are there geographic areas (region, rural vs. urban) which are more likely to see transactions over the next 12 months than others?
- **More Activity Approaches:** For brokers expecting to complete more transactions, what is driving that belief? How are these brokers bridging the valuation gap identified here?
- **Deal Structures:** For deals currently being completed, how are earn-outs, seller debt, and owner involvement post-close being used to bridge valuation gaps?
- **Public vs. Private Markets Sentiment:** With the stock market's continued strength, why has this market seen such a sharper decline in activity/valuation?
- **Bank Uncertainty over Time**: How are banks viewing future COVID-19 risks on business performance? How does that feeling change over time?

The End.