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Contents

Founder-Owned Businesses Are Attractive M&A Targets

Why nonbacked companies are preferred by dealmakers in the current environment, and why they are selling

PitchBook is a Morningstar company providing the most comprehensive, most accurate, and hard-to-find data for professionals doing business in the private markets.

Key takeaways

- M&A deal activity logged its second-best year in 2022. At the same time, large corporates and financial sponsors, while they are lining up as buyers, have significantly slowed their pace as sellers.

- The sharp divergence between buying and selling by the two main players in the M&A market begs the question: Who is doing the selling to support this near-record M&A activity?

- Our analysis shows that private founder-owned businesses have been the main feedstock for the M&A market, increasing gradually over the last seven years before surging over the last two years.

- The share of M&A deals with founder-owned companies as targets reached 61.5% in Q1 2023, up from 53.8% in Q4 2020. Their share of M&A value increased to 43.5% from 31.3% during the same span.

- Founder-owned companies have always been attractive targets for corporate and sponsor acquirers for a variety of reasons, the latest being the low inventory of motivated sellers in the current environment.

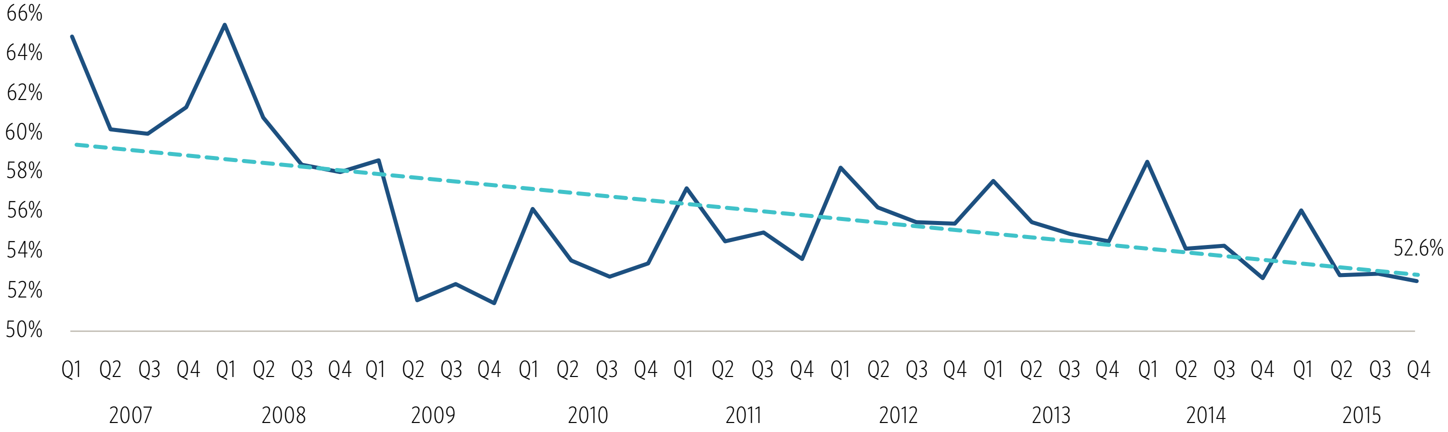
Introduction

PitchBook's database divides private companies into two broad categories: backed and nonbacked. Nonbacked companies have received no outside capital from PE or VC backers or angel investors, whereas the opposite is true for private companies categorized as backed. While there are some very large private firms in the nonbacked space that feature a broad private shareholder base or partnership structure, they are few and far between. The total potential universe of founder-owned businesses is massive. According to the Small Business Administration, there are an estimated 33.2 million small to medium-size businesses in the US, most of which have fewer than 20 employees and are founder-owned. This compares to fewer than 75,000 US companies with outside backing. The total investable universe of nonbacked private companies, including those with more than 20 employees, is approximately 2.6 million companies in the US and Europe, growing by approximately 50,000 annually on a net basis (new formations less companies that receive first-time funding or go bust). The large volume and wide variety of nonbacked companies makes them attractive targets for potential acquisition by corporate and sponsor buyers.

What's new: Nonbacked privates move up the ranks of sellers

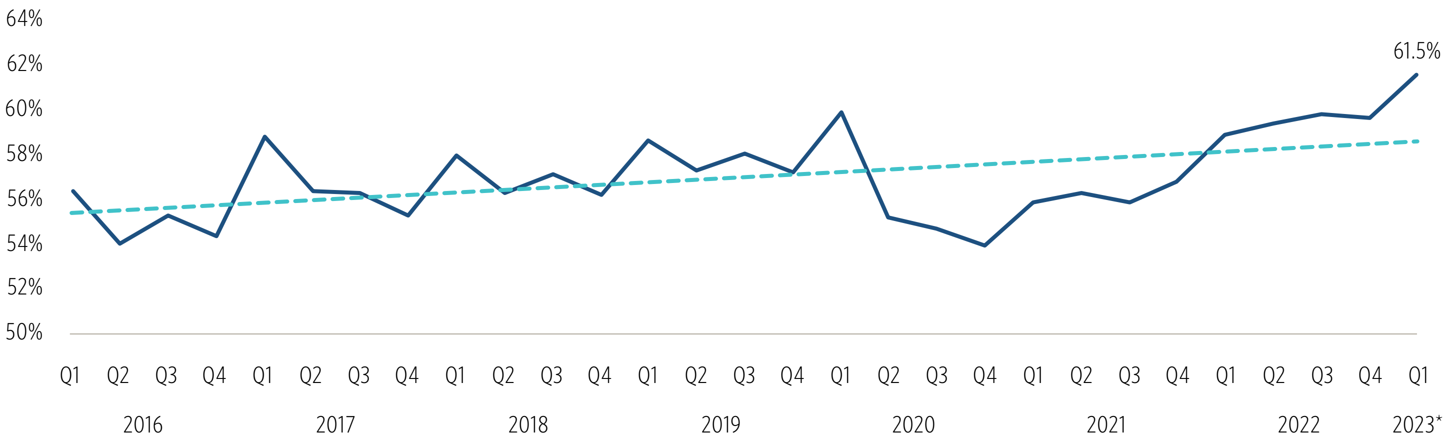
Due to the sheer size of the investable universe, nonbacked companies have always made up a large portion of M&A deal count, with the majority being founder-owned businesses. Nonbacked businesses made up 60.3% of all companies acquired in 2007, and that declined to 52.6% of all acquirees by the end of 2015. Since then, however, there has been a noticeable upswing in M&A featuring these companies as sellers. In Q1 2023, deals for nonbacked private companies hit 61.5% of all deals, the highest share seen since the global financial crisis. This supply of companies coming to the M&A window kept deal activity elevated in 2022, as M&A deal count was down only 13.5% from 2021's record-setting levels. While some of this can be traced to a shrinking supply of other seller types, as discussed below, intense add-on activity by PE-backed platform companies also helped boost the share of deals involving nonbacked companies, as they are often targeted. Meanwhile, the supply of PE-backed platform companies themselves has stopped growing, up by just 0.6% year to date, and they are simply not changing hands.

Deals with nonbacked sellers as a share of all M&A deal count (2007 to 2015)*



Source: PitchBook • Geography: Global
*As of March 31, 2023

Deals with nonbacked sellers as a share of all M&A deal count (2016 to 2023)



Source: PitchBook • Geography: Global
*As of March 31, 2023

Why sponsors and corporate acquirers are struggling to find sellers

The exit market has slowed because of market dislocation between buyers and sellers. Sponsor-backed companies in particular are balking at selling. Rather than lock into significantly lower prices and fund IRRs, PE and VC owners are attempting to hold through the cycle until better liquidity and valuations return. This dynamic can be seen in sponsor-backed M&A exits, which declined in value by 39.9% and in deal count by 20.1% in 2022. Meanwhile, selling by large corporates has also slowed. Divestitures and corporate asset sales declined in value by 33.1% in 2022, extending a six-year slide in divestitures' share of all deals from more than 20.0% in 2016 to less than 10.0% in early 2022 before bouncing back recently. Like sponsors, corporates are holding out for higher prices and a more favorable market for assets earmarked for divestiture.

Of course, there was a time when sellers could turn to public markets as an additional means of exiting companies and assets. That option all but disappeared in 2022 with the US IPO market's 94.8% collapse to $8.0 billion, a 32-year low.[1] With M&A the only game in town, companies that can afford not to sell are hunkering down with the goal of growing back into yesteryear's valuation—that is, expanding revenue and profits faster than multiples have contracted. In today's tough operating environment, this often translates to an inorganic strategy of buying up droves of smaller companies to spread acquired revenue over higher interest expense. We can see this strategy being aggressively pursued by financial sponsors. The share of add-on acquisitions of all US PE buyouts jumped more than 450 basis points in 2022 to a record 77.0%.

With so many potential sellers on the sidelines or lining up to buy, who is selling? The answer, almost by process of elimination, is the nonbacked, private business owner. These companies have always represented the bulk of the M&A market and are now in even greater demand. At the same time, market headwinds have caused deal sizes to shrink as financing big deals has become tougher, pushing PE firms and corporations further down-market. While interest rates remain elevated, sponsors and corporate buyers are likely to continue investing in smaller, nonbacked companies on an add-on or bolt-on basis as long as they are conducive to earnings growth and financing for large platform or strategic acquisitions remains scarce.

Drilling down on the founder-owned segment

Founder-owned businesses make up the vast majority of nonbacked companies, with the balance representing large private companies or partnerships where the business has outlived its original founders.

While there are variations within the founder-owned segment, these companies are typically controlled by a handful of founding employees or family members without any outside investors. "Bootstrapped" companies are often the same, only in a more tech-related startup context. The ideal bootstrapped company is heavy in IP but light in capital intensity and provides a break-through product innovation or disruptive technology that can get to market sooner with little upfront investment, thus allowing the business to become self-funding from day one.

While this is the ideal, founder-owned businesses are often years in the making—sometimes decades—before they achieve a solid financial footing. When it comes time to take money off of the table, decision-making can rest with a single individual or sometimes several generations of a single family. Still, there are far fewer moving parts and less complexity than other ownership structures, which have extensive capital tables and multiple classes of stock and associated voting rights, proxy requirements, and regulatory approvals. All things being equal, a fast-growing founder-owned business is a dealmaker's dream compared to a sponsor-backed or publicly held target of a similar size and growth trajectory.

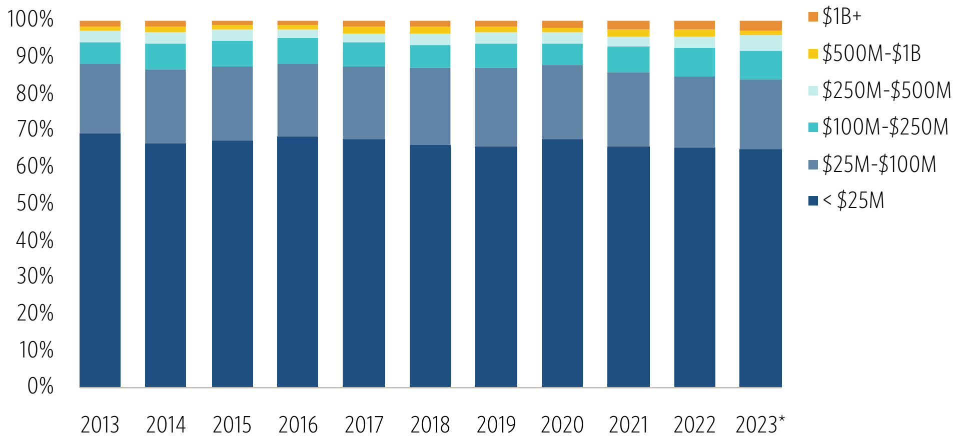
1: "US IPOs Are at a 32-Year Low," Axios, Dan Primack, December 15, 2022.

For a desirable founder-owned target that attracts multiple bids, selecting the right partner can often involve multiple variables. This is especially true given that founders will often stay on in C-suite roles for several years to bridge the gap to a new, fully integrated management team, picking up performance-related earnouts along the way. What it boils down to for the founder is a strong feeling of price and fit, or more specifically, that (1) the purchase price adequately reflects what is often a life's work and defining achievement, and (2) that the new owner will continue to nurture that life's work and take it to another level of growth and profitability that the founder(s) could not hope to achieve on their own.

Deal sizes and valuations of founder-owned deals

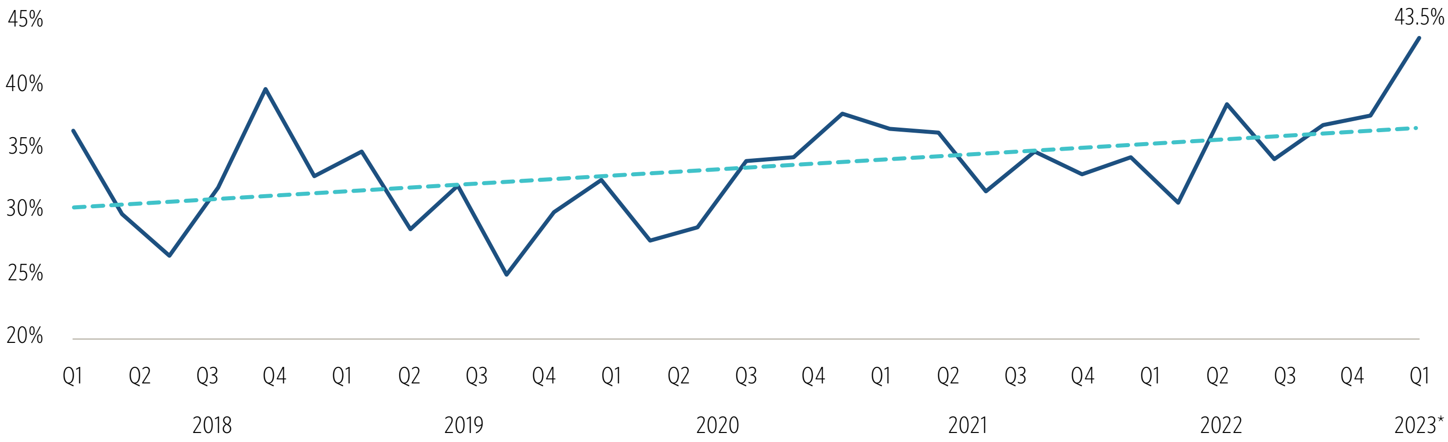
Deals involving founder-owned companies tend to happen at the lower end of the market ($100 million or less) and are often at a significant discount to larger corporate- or sponsor-backed deals. The vast majority (84.8%) of global M&A deals with no backing took place under $100 million in 2022. Businesses bought for less than $100 million have a much lower EV/EBITDA multiple than businesses in other size buckets. In 2022, the median EV/EBITDA multiple for firms under $100 million was 6.8x, while the next size bucket ($100 million-$250 million) posted a median multiple of 11.4x—a 40.3% differential. Although these deals make up the majority of deal count, their cheap valuations and smaller size add up to a much lower share of total deal value: 37.3% as of year-end 2022. However, this figure has been on the rise since the beginning of 2018, when nonbacked companies made up 31.7% of total deal value. This trend has continued in 2023, with nonbacked companies making up 43.5% of total deal value year to date.

Share of nonbacked M&A deal value by size bucket



Source: PitchBook • Geography: Global
*As of March 31, 2023

Deals with nonbacked sellers as a share of all M&A value



Source: PitchBook • Geography: Global
*As of March 31, 2023

Sectors where founder-owned businesses are found

The sectors with the highest proportion of deals involving founder-owned businesses as targets were the B2B, B2C, and financial services sectors. B2B topped the list with 66.6% of its total deal count originating from nonbacked businesses as of Q1 2023, followed by financial services at 63.7% and B2C at 61.7%. Conversely, and perhaps not surprisingly, IT was the sector with the lowest proportion of total deals from nonbacked sources. Because the tech industry has a strong presence in the VC and PE ecosystems, it can often see outside investment earlier in a business's life. B2B and B2C, in particular, are very fragmented industries, allowing smaller businesses to better compete for market share. According to the Small Business Administration, the industries with the highest number of firms and employees are subsectors of B2C and B2B, including the consumer-facing industry retail trade. There are endless products and services that founder-owned businesses can provide to businesses and consumers.

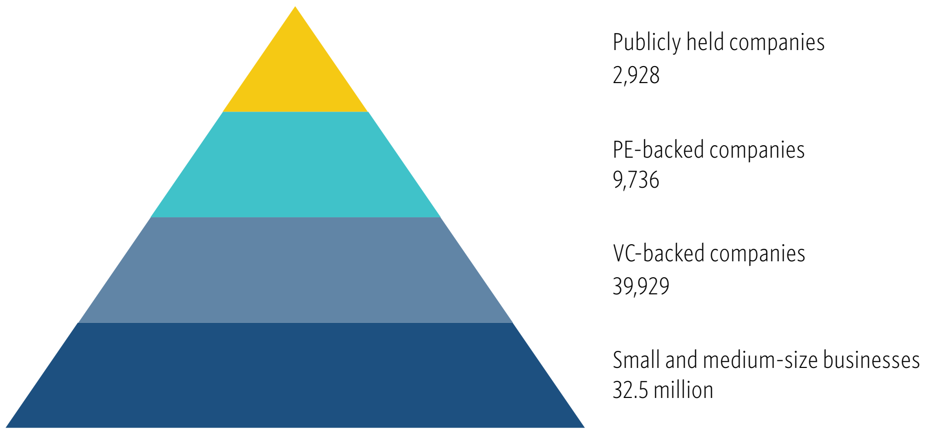
Why sponsors and corporate acquirers love founder-owned businesses

Founder-owned companies are highly prized targets for corporate and financial sponsor acquirers for a variety of factors that have taken on even greater importance in the current tough dealmaking and operational environment. Foremost among them, it can be easier to effect change and "professionalize" a founder-owned business, making it easier to extract growth. These companies have no previous funding from sponsors or other outside capital sources, meaning the new PE or corporate owners can start from a clean slate without any baggage from prior owners and conflicting cultures.

Acquirers of founder-owned businesses are also entering these companies closer to the ground floor in terms of value creation opportunities. Among those opportunities is to simply scale the business. Financial sponsors, in particular, provide ample opportunities for acquired companies to tap into entire platforms and centers of expertise across all utility functions—whether it is HR for enlarging its headcount with the very best talent, marketing and sales to turbocharge a go-to-market strategy, or financial control to identify savings and more buying power when negotiating with vendors.

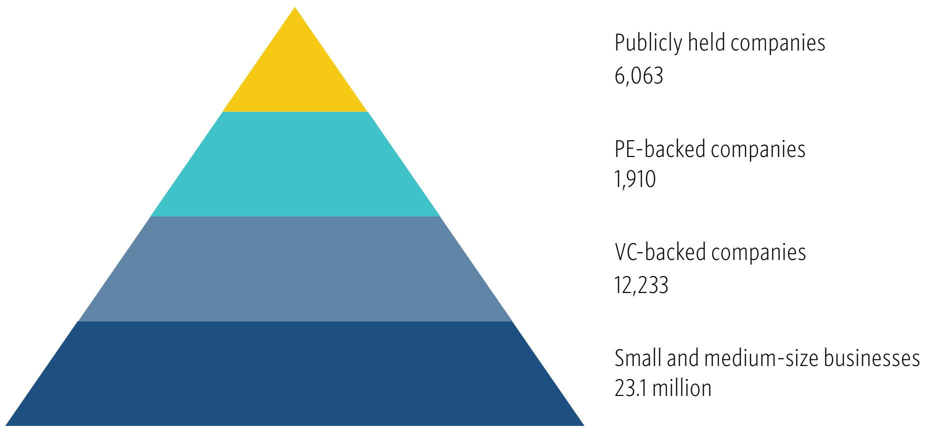
Many of these founder-owned businesses also carry very little debt on their balance sheets,[2] making them easier to lever up financially for purposes of acquiring other companies or funding a much-needed capital investment program. Any debt that is on the books can be potentially swapped out for cheaper debt, improving bottom-line performance.

US companies by backing type*



Sources: PitchBook, Small Business Administration • Geography: US
*As of March 31, 2023

European companies by backing type*



Sources: PitchBook, Statista • Geography: Europe
*As of March 31, 2023

2: "Who Will Inherit the Family Business? Often, It's Private Equity," The Wall Street Journal, Miriam Gottfried, September 17, 2022.

Other than the value creation opportunities they can gain, acquirers like the sheer diversity this category of companies provides for them. While the number of backed companies is in the tens of thousands, the number of nonbacked private companies is in the tens of millions—which provides corporate and sponsor buyers much wider variety, and if they need to tap a particular niche or subvertical to fill in their product offering, they are much likelier to find it in the founder-owned universe. As previously discussed, founder-owned businesses are also significantly cheaper to buy, making it easier to generate strong IRRs for LPs or accretive results for shareholders.

Lastly, with the universe of willing sellers shrinking, the large number of founder-owned businesses on sale in any given year is an important source of inventory for the many M&A buyers that remain flush with dry powder and highly motivated to do deals.

Why founder-owned businesses are motivated to sell in the current environment

Given their smaller size and lack of sponsor backing with deep pockets, founder-owned businesses are arguably more exposed to the tough economic and inflationary headwinds that have confronted companies of all sizes over the last year. Making matters worse, small and medium-size businesses tend to rely more heavily on credit provided by regional banks, and that credit is drying up in the aftermath of the Silicon Valley Bank collapse and the mini banking crisis that ensued. We believe that founder-owned businesses are being flushed out by these tougher liquidity conditions, accounting for their expanded presence in the current M&A environment as sellers, and that trend will continue throughout the year. In other words, liquidity and the squeeze on profits are likely to get worse before they get better for small and medium-size companies that are nonbacked and undercapitalized.

In addition, there is a growing population of aging founders, and many do not have a clear-cut succession plan for their closely held companies. The data available shows that when family-owned companies are handed off to the next generation, a small percentage of those transitions succeed. Just 30% of family-owned businesses survive the transition from first- to second-generation ownership, and 12% survive the handoff from the second generation to the third.[3] Partnering with a skilled PE buyer or investor can pave the way for a much more orderly transition and successful outcome for all involved. Founders typically have the option to stay on for several more years or beyond, and the same can apply to key family personnel. This can motivate an aging founder to sell rather than attempt a high risk or ill-conceived succession plan.

3: "The Family Business: Successes and Obstacles," Score, March 2, 2023.

Lastly, founders are motivated by the higher levels of performance and financial rewards their companies can achieve by partnering with a financial sponsor or corporate buyer. Often there are earnouts and other incentives that can be triggered in the period that follows in addition to the rollover equity that sponsors require. PE firms, in particular, are expert at achieving operational improvements in portfolio companies, and a founder-owned company that needs access to more capital or expertise to achieve its next level of growth is highly motivated as a result. The equity stake retained and rolled over by founders is typically around 20%, although it can range from as high as 40% to as low as 10%.[4] These rollover equity stakes are fully realized by the founder when the sponsor exits the investment, so founders can gain even greater economics than they originally bargained for should all go well with a PE's value creation plan.

Conclusion

Historically, companies with no backing have made up the majority of companies sought and acquired by major corporate and PE buyers. This has accelerated in recent years as the inventory of companies for sale has declined and interest in founder-owned companies has increased due to a greater focus on operational improvements in lieu of financial leverage to generate excess returns. We expect this trend to continue as conditions grow harsher for founder-owned businesses, encouraging them to sell, and assets of sponsor- and corporate-backed companies remain on the sidelines, motivating buyers to seek out nonbacked targets all the more intensely.

4: "What to Know About Rollover Equity Before Selling Your Business," Escalon, Kanika Sinha, December 14, 2021.