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Earnouts—Bridging the Value Gap

With limited credit availability, sellers are financing more transactions.

by William S. Hanneman

In the current market of uncertain business performance and limited credit availability, businesses are harder to value and transactions are more difficult to finance. As a result, we are seeing more participation by sellers in financing transactions. The form of financing can be either a traditional note or a contractual earnout. Both approaches create challenges to deal completion.

An earnout is a deal-financing mechanism, where the buyer consents to make future payments to the seller if certain agreed-upon financial or operating targets are achieved post closing. Earnouts can be critical to getting a deal done when the parties' views on the value of the target business are too divergent to agree on a fixed price. In an earnout payment structure, additional payments (commonly in cash) are made based on future revenues or earnings of the target for a specified time period (typically one to five years) following the transaction.

Value and risk are two sides of the same coin. A business owner often judges his business to be low risk, which is understandable. After all, he knows the business and industry intimately and has had long relationships with his customers. A buyer, on the other hand, that doesn't have perfect knowledge of the business, tends to see ghosts behind every bush, and seeks protection from the unknown when structuring a transaction. A buyer's perceptions of uncertainty and risk, as compared to a seller's confidence built upon familiarity, can result in a value gap, even in the best of circumstances. With the heightened sense of uncertainty in today's economic climate, even modest differences in outlook can produce a significant "gap."

The buyer and seller can close the gap through compromise, whereby a contingent payment arrangement, or earnout, is put into place. In an earnout structure, the seller agrees to a fixed, up-front cash payment, together with a right to receive additional payments in the future, if the target's performance surpasses specific hurdles.

THE DEVIL IS IN THE DETAILS

The devil, as the saying goes, is in the details. Litigators tend to love these arrangements because post-closing disputes over earnouts are common. Disputes generally center around whether the earnout amounts were calculated correctly and if either party took (unauthorized) actions that impacted the achievement of the earnout. Because earnouts are a zero-sum game, where one party loses what the other party gains, disputes are generally hard fought.

Nevertheless, if crafted smartly, an earnout can work, and make the difference between success and failure in a purchase/sale negotiation. Designs that meet the efficacy test must provide the seller with reasonable certainty, while giving the buyer adequate comfort that he has not overpaid, if actual results fall short of expectations.

The formula should also contemplate potential contingencies, such as a force majeure event, the buyer's decision to sell the business before expiration of the earnout period, the target company's failure to receive anticipated regulatory approvals, and the departure of key personnel.

SELECT APPROPRIATE TARGETS

Performance targets must be measurable and relatively immune to manipulation. The targets can be as simple or as complex as the designers can imagine, but, typically, the measurement centers on the income statement and is denominated in dollars. Obviously, there are any number of measurement points on the income statement (P&L), from top-line revenue, to gross profit, operating income (EBIT), operating cash flow (EBITDA), and, finally, net income.

The farther down the P&L one sets the earnout metric, the more susceptible the results will be to accounting judgments and possible manipulation. On the flip side, as the test moves down the P&L, the correlation between actual performance and value tightens. As you might expect, buyers prefer to measure performance at the lower end (i.e., net income, operating income, or EBITDA), while sellers desire top-line targets (i.e., sales or gross profit).

CONSISTENT PRACTICES

Striking a balance that limits the parties' ability to tinker with future financial results and sets performance hurdles that reflect the generation of real business value requires going beyond simply specifying the use of the catch-all standard of "Generally Accepted Accounting Principles." No matter which metric is employed, disputes are minimized by using accounting methodologies for earnout measurement that are consistent with the specific objective. Further, it is possible to bypass much of the typical conflict associated with determining earnout performance by narrowing the calculation to specific general ledger accounts.

The stickiest points of dispute tend to revolve around whether post-closing business practices are consistent with past practices. There can be a host of business and accounting issues that require particular attention, including product pricing, depreciation and amortization, overhead imposed by the acquirer, R&D expense, capitalization policy, income or charges from extraordinary or nonrecurring items, insider transactions, or income derived from newly acquired operations financed by the buyer. Both parties have a common interest in limiting the number of issues to resolve and defining the earnout formula with specificity.

CONTEMPLATE CONTINGENCIES

Earnouts should be limited by time or amount, rather than remain open-ended. The formula also should contemplate potential contingencies, such as a force majeure event, the buyer's decision to sell the business before expiration of the earnout period, the target company's failure to receive anticipated regulatory approvals, and the departure of key personnel.

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UNDERSTAND HOW THE BUSINESS WILL BE OPERATED

Agreeing on the formula for calculating performance targets is often the simplest part of crafting an earnout. Because the ultimate price payable depends on future performance, the parties must enter the transaction with some understanding of how the business will be operated in the future.

Ordinarily, a buyer manages the business post-closing, while a seller will expect that, during the earnout period, the business will be operated in the ordinary course, consistent with past practice. A seller also may seek approval rights or other involvement in major business decisions, such as expansion plans, hiring or firing of key personnel, changes in capitalization and dividend policies, or combining the business with another company. Although the buyer will resist encroachments on his ability to manage the business, it is reasonable to agree on objective parameters for operations during the earnout period to protect both parties and eliminate fodder for later disputes.

An earnout that is crafted with a clear understanding of these complexities and negotiated with complete candor is a constructive tool in bridging a transaction value gap. ❖

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Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, please go to ZacharyScott.com.

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