Earnouts: Friend or Foe

By Kenneth B. Collins

I recently made the point that the market value of any business depends on its ability to produce future profits in the context of the many risks and opportunities associated with achieving those financial results.

Increasingly, therefore, buyers are reluctant to pay the full purchase price at closing. And if the seller views even the best offer as below market or below his minimum expectations, then there may be an option to structure part of the purchase price as an earnout based on a formula or the achievement of certain financial (and often non-financial) objectives.

In most cases where the seller is also the chief executive, he will continue to manage the business through the term of the earnout. An employment agreement typically spells out his authority, responsibilities and compensation as well as any restrictions such as non-competition.

Earnouts – or earnups – can range from a relatively small payment on top of the amount paid at closing to significant dollars that, if earned, may even comprise the lion's share of the total purchase price. At a minimum, the earnout might be based on sales or profit goals over the next 2 or 3 years and amount to simply "topping up" the price paid at closing.

Earnouts can be much richer and more complex. In more than one case, I have represented a seller who wanted not only to "take some money off the table" at closing, he was also interested in pursuing a second and potentially larger payment down the road. One option was to sell a major share of the company to a private equity firm and then monetize his remaining equity when that PE firm re-sold the company in 3 to 5 years. This approach solves the first payday issue but it offers no leverage for the second payday.

We advised the client to consider a different option. Early indications were that the market value of his business was as much as $16 million (8.0x times $2.0 million EBITDA). Good numbers, but all agreed they could be substantially higher given the strong growth potential of the business.

Working with that client, we identified a strategic buyer with similar products and services (and deep pockets) but who served a related market. The buyer viewed my client's business as a low-risk opportunity to enter a new market with new customers while upgrading his own technology base and adding a skilled management team.

Both sides understood the many synergy benefits that could be realized by integrating the two businesses. Market leadership meant upselling existing customers and adding new accounts, resulting in higher sales revenue overall; and integrating many of the back-office functions offered millions of dollars in cost savings.

In the end, my client agreed to sell his company for $12.8 million in cash at closing; plus an earnout plan, which in this case was based on the future financial results of the combined businesses. The seller was to be paid 25% of the amount by which total combined operating income over the following four years exceeded the *pro forma* operating income of the combined businesses in the 12 months prior to the closing date. The earnout payments were made annually, and because they were treated as part of the purchase price they were taxed as capital gains. In the end, the earnout itself was more than $10 million, and the total purchase price exceeded $23 million – well above the option of accepting $16 million at closing.

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