

Expert Guide

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Earn-out: Friend or Foe?

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Good news... Middle market M&A is active... But it could be better! There is literally hundreds of billions of dollars in both debt and equity seeking to fund deals for companies with revenues between \$5 million and \$1 billion, the large majority of which are less than \$150 million. In the U.S. there are approximately 300,000 companies that fall within this segment, primarily owned by baby boomers, Gen Y'rs and private equity funds.

The Value Gap

Here's the challenge - most of the companies on the lower-end of the middle market are not prepared for a transition of ownership or to accept institutional money. This manifest itself as a disconnect between the value expectations of the owners and the market value assessed by institutional and corporate investors. To some degree this problem has existed for many years, but this "value gap" has been exacerbated recently.

The root cause of this disconnect is multifaceted and likely includes the lack of alternate investment options post-transaction for the current owners; inability of the company to generate a return greater than its real cost of capital; inadequate re-investment by the current owners to assure the relevancy of their business in the future; and sub-industry operating performance. Of course there are others.

This value gap is a real impediment to getting deals done and continuing the flow of capital and job creation within our economy. On a long-term company-by-company basis, it can be addressed and rectified (at least in many cases), but in the short-run what can you do when you have an active deal and need to get movement; and how do you bridge or close the gap to get a seller to say yes and to mitigate the risk of over-payment for the buyer?

Let us assume that those involved in selling a company are doing the basic blocking and tackling in the sale process, and have multiple parties at the

table to assure a competitive situation. From an external perspective – and on the front-end of the selling process – owners should seek to understand their post-transaction investment plan. This will help define the after tax needs of the owner and increase their confidence by quantifying their walkaway point. In many cases, this planning step needs to be coupled with a clearly articulated growth strategy and investment opportunity for the buyer. If the growth strategy is not fully implemented and evidenced in the current financials, the buyer will not want to pay in advance for what might happen. Thus part of the value gap.



The Earn-out

A common technique (as part of a total solution) to bridge the value gap is implementation of an earn-out. In a sale transaction, an earn-out is contingent consideration based on some future performance of the business or upon achieving certain milestones. Unfortunately, earn-outs have gotten a bum-rap, in part, because they have been improperly structured. No question that there are risks associated with them. Nonetheless, they provide a practical way to capture some of the unrealised future performance of a company. To make the earn-out really beneficial, it is helpful to directly align it with the growth strategy and expected performance of the company.

Take for example a scenario whereby a company has made an investment to enter a new market or expand into a new geography. This type of investment usually results in a hit (or reduction) to operating income in one year (probably the trailing



12 months prior to the sale) with expected future revenues and profits that have not been realised. There is likely a pipeline of identified opportunities or other sales activity to evidence the investment. In some instances the negative impact to the income statement can be negotiated-out as part of adjusted EBITDA, but it still does not capture the positive impact to the value of the business. A solution might be to structure an earn-out based on realisation of anticipated revenues represented in the pipeline.

Structure

The structure of the earn-out can make the difference between a negotiating throw-away and realising actual value as part of the transaction. An earn-out should be structured so that both the buyer and seller win as the performance of the selling company is achieved. Here is a list of key concepts and practical suggestions to keep in mind;

1. Earn-outs generally work when the key personnel (who are owners) of the company will be actively involved in the operations of the business post-closing. The event or performance metric used in the earn-out should be under their control and scope of responsibility after the deal.

2. In general, use of a metric that is higher-up the income statement is better. A revenue-metric is usually better than a net income or EBITDA metric because net income and EBITDA can be manipulated (intentionally and unintentionally) by the buyer or circumstances. A compromise might be the use of gross profit as a measurement, providing clear delineation of what is attributed to costs of goods or services. Alternatively, use of an operational metric vs. a financial metric may be easier to track and more meaningful.

3. Set the beginning level of the measurement relatively low and realistic. A key to successfully negotiating this element of the earn-out is to understand how the buyer is valuing the company and what assumptions he made. The earn-out needs to

be attainable on the low-end and provide for additional consideration in the event of higher performance.

4. Provide for scaled or linear earning of the earn-out so that achievement is not "all or nothing". The exception to this is inclusion of what might be deemed a binary event; such as winning a major contract that has already been bid before closing and the win-determination will not be known until after closing. There may be both strategic and financial value in such a win that should partially accrue to the seller.

5. Make the earn-out period relatively short. One to two years is typical; much beyond this becomes speculative.

6. Schedule payments against the earn-out at least annually, or more frequent if possible. This allows early resolution of any misunderstandings in the calculation and interpretation of the earn-out, and gives a sense that the earn-out is real; hopefully providing continued motivation to improve operating performance and increase the likelihood of success of the acquisition.

7. Include a written commitment that requires the buyer to allocate resources to support the operating activities needed to achieve the earn-out. A simple way to implement this is to negotiate the post-closing operating budget for the business and include it in the definitive documents.

8. Assure that the financial accounting treatment of the metrics pre and post-closing are consistent in their application for purposes of calculating the earn-out. A technique to eliminate confusion is to include an example earn-out calculation in the definitive documents.

9. Have the earn-out accelerate in the event of a change of control of the buyer.

10. Tie the earn-out to the employment agreements of the key personnel of the seller. If they are terminated without cause, the earn-out accelerates and is due and payable in full.

Keep in mind that whether selling the entire company, raising a tranche of growth capital (in the form of debt or equity), or pursuing a recapitalization. What you are really selling is the future cash flow of the business. While past performance provides credibility to management's claims, future cash flow is the foundation for valuation and usually the primary reason for buying or investing in a company. A successful earn-out will embrace this core concept.

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AM&AA (Alliance of Merger & Acquisition Advisors)

AM&AA Overview presented by Michael Nall, Founder

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