



The Art of Structuring Earn Out Agreements

WHY BUSINESS BROKERAGE EXPERIENCE AND TRANSACTION SPECIFICS ARE CRITICAL TO SUCCESS

Part 1

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Why Use an Earn-out?

The downturn in the economy in general and the technology sector in particular, has resulted in an ever-widening gap in business valuations between buyers and sellers. Buyers become less inclined to bet on future performance and instead focus on historic results of operations and other tangible factors. Conversely, sellers perceive their businesses as undervalued as a result of general market conditions and counter that an accurate valuation must account for future prospects. By addressing the risks of parties in an acquisition, a carefully constructed "Earn-out" agreement provides a mechanism for bridging the gap and making a deal possible. This is best left to experts.



What is an Earn-out?

An earn-out is a way for the buyer to condition part of the purchase price on the future performance of the

company. The buyer pays a portion of the purchase price up-front, and pays the rest if and when the company meets specified goals. For example, if the seller thinks the business is worth \$20 million and the buyer believes it is worth \$15 million, they could settle on an initial price of \$15 million, and the earn-out would provide the seller with another \$5 million if the seller meets the goals specified. Earn-outs tend to increase in popularity when interest rates increase because buyers can spread payments over several years. The earn-out period is usually 2-3 years, although it ranges from 1-5 years. Usually 15-30% of the total is contingent on an earn-out, but that number can be as high as 50% in some deals.

What are the Risks of Using an Earn-out?

The earn-out needs to be structured carefully so that sellers have a realistic chance of meeting the earn-out provisions. The first point of negotiation should be to negotiate the highest up-front payment as possible. Then, consider how the earn-out is to be measured: profits, revenue, or other criteria such as turnover, net assets or other appropriate financial measures.

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Structuring Earn Out Agreements

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Keep in mind that you're taking a gamble, and gamblers often lose. One industry observer notes that of the dozen or so Earn-out agreements he's observed, only one entrepreneur lasted more than a year. But sometimes gamblers win big. "You can allow the buyer to buy you out of the Earn-out three years into it if you're blowing away the numbers," one expert says. Now those are nice terms if you can get them.

An Earn-out allows the seller to obtain additional consideration based on the achievement by the acquired business of certain financial, operational or other specified objectives following the closing. But there are challenges in structuring, negotiating, drafting and implementing a successful Earn-out agreement.

The Advantages and Disadvantages of Earn-Outs

For buyers, the purchase price can be limited to the amount for which it is certain the business is worth, and pay any excess only if and when the company meets those

performance goals. In many cases, the future growth of the company provides a source of capital which it can use to pay the earn-out. One disadvantage for buyers is that earn-outs typically restrict the actions they can take with the target company during the earn-out period. This is because the seller needs to be able to retain enough of an interest to implement the strategies necessary for the promised growth.

"Earn-out agreements can last up to five years and are calculated at anywhere between 10 percent and 30 percent of the purchase price, with payment made in cash or stock."

For sellers, the seller is provided some breathing space in terms of timing and producing value. If the seller is certain that they can improve growth, then the earn-out allows them to receive value for that growth if and when it occurs. Many sellers mistakenly wait to sell because they want to book a great year of

growth, but the earn-out structure allows an earlier, more effective exit.

Tips for companies considering adding earn-out clauses to sales agreements:

Keep financial formulas simple

Some arrangements that are so complicated that they wind up backfiring because no one can figure out exactly what they're supposed to accomplish and how it will affect their payout. Keeping Earn-out agreements simple and measurable is important. You need to be very careful about the benchmarks against which the performance of the business unit will be evaluated."

Avoid long-term growth disincentives

"You've got to make certain the earn-out and its resulting pressure for short-term results don't discourage former owners from doing things like spending money on research and development, diversifying, or investing corporate funds in other ways that will produce results only over the long term," warns one expert.

Weigh the costs versus the rewards

"Earn-outs may produce exactly the wrong kind of results for you, depending on the type of company you're purchasing and your own financial goals," warns one industry observer. "If it's a fast-growing business, an acquiring company may want or need to plow all the cash back into growth, and may not actually care about short-term performance." In such cases, it makes better sense simply to negotiate a purchase price that satisfies all parties.

Earning Your Keep

Earn-out agreements can last up to five years and are calculated at anywhere between 10 percent and 30 percent of the purchase price, with payment made in cash or stock. Earn-out goals can be based on a variety of targets, including net income, gross revenue, new clients generated, cash flow and earnings.

Some experts encourage sellers to tie Earn-out contracts to unit sales or revenue instead of earnings, using earnings allows buyers to factor in high overhead expenses. Finding a good lawyer who understands the fine print is essential. ■

(To be continued...)

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