By Brian Craig, J.D.,

and

Andy Smith, CMA, CPA/ABV, CVA

The Art of Earnouts

BOTH SIDES CAN WIN WITH THIS INCREASINGLY POPULAR M&A DISPUTE-RESOLUTION STRATEGY

When Moe, Larry, and Curly had a disagreement, it was usually nothing that a double-fingered poke in the eyes or tire-iron over the head couldn't solve. Earnouts, on the other hand, require a bit more finesse.

An earnout, in a merger-and-acquisition context, is an arrangement in which the buyer doesn't pay the entire purchase price up front but agrees to pay a certain amount now and more later depending on how well the business performs in the future. This technique is often used to resolve a disagreement between the parties about the future performance of the target business. Earnouts also provide an incentive for the seller to support and continue to build the business. If the acquired company meets its revenue or profit targets, the earnout will provide additional post-acquisition consideration.

ILLUSTRATION: BRYAN PETERSON/BPETERSON.COM

Recently one of our clients negotiated the sale of their business but could not agree on the final purchase price with the buyer. The buyer didn't believe the seller's projected information technology (IT) services revenues would total $25 million by the end of 2003. To bridge the gap, the seller agreed to receive part of the consideration contingent upon meeting the revenue target.

In the following tête-à-tête, two McLean Group investment bankers—Brian Craig, an attorney by training, and Andy Smith, an accountant by training—exchange their perspectives on the applicability, characteristics, and secrets of structuring effective earnouts.

EARNOUTS WORK BEST IN SITUATIONS WHERE THE ACQUIRING COMPANY PLANS TO HOLD THE ACQUIRED COMPANY AS A SEPARATE ENTITY AND PURSUE A HANDS-OFF MANAGEMENT APPROACH.

WHY ARE WE SEEING AN INCREASE IN EARNOUTS?

Brian: Earnouts amount to a head-in-the-sand approach to valuation. If there is a valuation gap between the buyer's and seller's expectations, and there always is, it is a way to bridge the gap. In all, they are useful "get the deal done" tools, but you need to be sure that they don't leave a bad taste in the mouth of the buyer or seller. In an uncertain economic climate, there may be more willingness to take the wait-and-see option offered by an earnout-structured acquisition.

Andy: When the financial accounting gods issued their new decree about business combinations in June 2001 (i.e., Statement of Financial Accounting Standards (SFAS) No. 141, Business Combinations), they killed the pooling-of-interest method of structuring and accounting for acquisitions. Earnouts weren't commonly used since they often prohibited treating the acquisition as a pooling of interest. Therefore, with pooling gone, we'll be seeing more earnouts.

WHAT ARE THE REASONS TO INCLUDE AN EARNOUT IN A TRANSACTION?

Brian: From the buyer's perspective, earnouts obviously reduce the initial cash payment and provide a level of insurance by minimizing the risk of overpaying for future revenues and profits. Just as important, they provide a method of motivating management. Earnouts typically work best in situations where the acquiring company plans to hold the acquired company as a separate legal and accounting entity and pursue a hands-off management approach after the acquisition.

Andy: From the seller's perspective, they are able to structure the transaction to realize the level of value that they think is in the business if it performs as they believe it will. It allows the seller to feel that they aren't leaving any upside on the table. Earnouts can also provide a vehicle to defer taxes.

WHAT ARE THE REASONS AGAINST INCLUDING AN EARNOUT IN A TRANSACTION?

Brian: From the buyer's perspective, integration issues should always be their biggest concern. Earnouts don't work if the buyer muddles too much in the affairs of the acquired business after the acquisition. But it becomes difficult to ensure that the managers of the acquired company who are focused on achieving the earnout keep their activities aligned with the acquiring company's plans. You don't want an earnout management team preoccupied with maximizing their personal earnout bonuses and not the value of the new company for its parent. Aligning these interests is the trick.

For example, the manager at a newly acquired IT services company with an earnout contingent upon meeting a $25 million revenue target might be tempted to enter into contracts with unfavorable terms or less than desirable margins just to meet the revenue target. Over the long term, this misalignment of interests will impair the value of the business.

Andy: From the seller's perspective, the seller is delaying their receipt of cold cash and is dependent on the financial health of the buyer. They also run the risk of unforeseen circumstances and disputes surrounding the earnout.

What are the keys to structuring an effective earnout?

Brian: Finding the balance between integration and hands-off management. Everything possible, from additional profit sharing to incentives for cross-selling, should be implemented to ensure integration proceeds while preserving the incentives for the earnout. Yet integration efforts must be balanced against the requirement that earnout managers be given enough room to meet targets. Earnouts become litigation fodder when earnout stakeholders can allege that the acquirer interfered with their ability to meet earnout targets.

Andy: Focus the earnout formula on the big picture—revenues or gross margin. The seller no longer has control of the bottom line and the costs that may be imposed by the parent company. At the same time, the buyer needs to prevent the risk of the seller entering into a fire sale just to boost revenues. Management should focus on building revenues and contribution margin. The buyer needs to have a control in place to make sure the management team of the acquired company isn't selling new work at prices/rates below plan.

IF THE ONLY PURPOSE OF THE **EARNOUT** IS TO PROVIDE A SIGNIFICANT PRICE GAP, BEWARE.

What are the pitfalls to avoid in structuring earnouts?

Brian: If the earnouts are missed, the incentive for the management team disappears. As the buyer, you must have another incentive compensation plan in place to keep management focused on the goals at hand. Sometimes resetting expectations on both sides can save the relationship.

Andy: In general, earnouts can be perceived by the parties in two ways: one that provides post-deal incentive compensation and one that provides a comfort level or compromise over price. If the only purpose of the earnout is to provide a significant price gap, beware. The problem here is one of expectation management—it guarantees only one winner and one loser. Both parties need the earnout to be based on a realistic goal for it to be a true win-win situation. The goal is to have an earnout that management can reach and that the acquiring company is happy to pay—which are the two litmus tests for a good earnout.

How do you minimize the risk of failure?

Brian: Earnouts are always a great source of work for attorneys. It can be a field day for the litigators if the many earnout variables aren't adequately defined and if expectations aren't managed.

Andy: It's all about the money. This is why it is critical to keep an accountant involved in structuring an earnout. The last thing you want is an earnout formula that is ambiguous or subject to change. Earnouts are all about the calculation of the future payment, which is based on accounting standards. If the buyer's company uses different accounting standards, the numbers may change. Earnout formulas must be properly defined—no detail is too small.

What unique characteristics are you seeing in earnouts?

Brian: We often see cumulative and additive provisions structured to allow excessively good periods to offset unusually poor periods. These provisions are often perceived as a friendly gesture and are usually done in the spirit of the overall earnout.

Andy: Call options—some buyers want to limit their downside risk if the acquired business completely takes off and the buyer subsequently owes a significant payout to the seller. Some agreements will allow the buyer to essentially buy out the earnout to accelerate a payoff, subject to different discounting formulas. ■

Brian Craig, J.D., and Andy Smith, CMA, CPA/ABV, CVA, are investment bankers at the McLean Group LLC, an investment bank serving middle-market businesses. Brian can be reached at bcraig@mcleanllc.com. Andy can be reached at asmith@mcleanllc.com.