As seen in WASHINGTON BUSINESS JOURNAL

REPRINTED FROM THE WASHINGTON BUSINESS JOURNAL, OCTOBER 3, 2008

Earnouts: The Art of Building Bridges in M&A Negotiations

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Most middle market M&A negotiations involve a process characterized by a convergence and a divergence of interests. Initially, the seller and the various prospective buyers may have different goals in mind for the transaction. But as the negotiation process advances and a leading buyer is identified, both parties commit to the common goal of closing the deal. Then, once the deal closes, the seller's and buyer's interests again diverge. On the one hand, sellers want to receive all financial consideration due as soon as possible. On the other, buyers want to hold back payment as long as possible as a precaution against post-closing events that may reveal that the business they now owns is not the one for which they negotiated.

In essence, a buyer buys a business's future earnings. Hence, most M&A negotiations focus not only on the amount and growth potential of future earnings, but also on how likely those earnings are to be realized. Differences of opinion between seller and buyer as to the amount, growth potential and likelihood of the business' future earnings create contentious price negotiations. To keep negotiations from hitting a standstill and to bridge the perceived gap between the seller's and the buyer's respective projections, earnouts sometimes are used, particularly in the case of young companies.

An earnout is a contingent form of payment that is dependent on the acquired company's achievement of certain performance targets after the transaction closes. With an earnout in place, the buyer pays only a portion of the company's total purchase price at closing while agreeing to make subsequent installment payments as the company meets the agreed-upon targets. By definition, earnouts can be complicated to structure and can lead to opportunistic behavior on the part of buyers once they control the company. Indeed, earnouts can be and often are subject to abuse. As a result, each earnout, no matter how well crafted, can contain hidden risks.

Two types of earnouts – comfort earnouts and incentive earnouts – reflect the parties' respective motivations. Comfort earnouts are designed to bridge the gap between the seller's certainty and the buyer's anxiety concerning the business' immediate future performance. Incentive earnouts, on the other hand, are structured to motivate sellers, who remain involved with the business in some capacity, to exceed certain agreed upon performance targets.

On average, earnouts last between one and three years although some are structured for longer periods. However, it is important to note, that the longer the earnout period, the less likely it is that the earnout will be collected. For one thing, the earnout initially is calculated on the basis of the seller's pro-

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jections of what the business can do. And, as is usually the case, such projections tend to become less accurate with the passage of time. Also, as time passes, unforeseen events may interfere with the business' performance, making it more difficult to determine whether a given missed target was the result of conditions that could have been controlled by the seller or the buyer.

Once the seller and the buyer have agreed to an earnout, the parties' attention shifts to determining the performance metrics and respective targets by which the earnout will be earned. This may seem at first glance as a simple process, but it is not. Earnout targets that the business must achieve need to be structured in such a manner so as to prevent manipulation, whether intentional or otherwise.

For example, most sellers are reluctant to accept an earnout based on the business' future profits because the buyer's post-transaction control of the business creates obvious potential for manipulation. On the other hand, an earnout based on sales targets presents the opposite problem when the seller remains in control of sales following the transaction's settlement. Sellers in control may push for sales regardless of their profitability in an effort to hit earnout sales targets. Buyers in control may opt to accelerate expenses, potentially depressing profits and consequently causing the company to miss profit-based earnout targets.

Many investment bankers advise buyers and sellers alike to consider using gross margin or gross profit as a more neutral metric. This metric is far from perfect because it neglects to consider bottom-line earnings, the buyer's main consideration in seeking the earnout in the first place. But buyers and sellers may find that it constitutes the best compromise. Another approach to selecting earnout metrics involves blending two or three of these metrics (revenues, gross profits and net profits), although earnouts involving so many variables may be difficult to draft.

Earnouts' tax treatment is also a major consideration. A comfort earnout intended to be a part of the business' purchase price is treated as a lower taxed capital gain, but drafting mistakes in this regard may be critical. For example, an earnout that appears to be an extended employment contract may be construed as subject to significantly higher ordinary income taxes. Therefore, it is critically important that sellers engage experienced tax counsel.

Even though earnouts can be a useful tool in bridging the seller's and buyer's differences of opinion as to the business' future earnings performance, they must be approached with caution as they involve risks. Careful negotiation and documentation can go a long way toward minimizing or eliminating such risks while helping minimize the odds of legal disputes in the not too distant future.

About the Author: Enrique C. Brito is a partner and senior managing director of The Mclean Group, a national investment bank providing merger and acquisition, valuation and private equity financing services. He has over 17 years of corporate finance and investment banking experience and lectures nationally on the subjects of M&A and business valuation. He can be reached via e-mail at ebrito@mcleanllc.com or call 703-827-5093.

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