

INSIDE THIS ISSUE:

Featured Article:
Understanding Earnouts

1 & 3

Expert Tips:
*Using Insurance to Facilitate
the Sale of Your Business*

1

Trends To Act On:
*Characteristics of Top
Buy-Out Executives*

2

Exit Planning:
*Defining Your Exit
Objectives*

2

UNDERSTANDING EARNOUTS

By Dennis Roberts

Most sellers would prefer to avoid earnouts but in our experience about 80% to 90% of the purchase price of a middle market business is paid in cash. The remaining 10% to 20% is composed of an earnout and/or buyer's stock. While earnouts should be approached cautiously there are occasions when the use of an earnout will allow a seller to actually receive a premium value, if the earnout terms are well constructed.

An earnout is a contingent form of payment that is dependent on the acquired company reaching certain performance targets after the transaction is initially settled. Earnouts can and are subject to much abuse and each earnout, no matter how well crafted, can contain hidden time bombs. Understanding the primary issues in earnouts may help to avoid these pitfalls. They are briefly discussed below:

Comfort earnout (a real earnout) versus incentive compensation?

Although often mischaracterized as earnouts, incentive compensation for a seller/manager in achieving for example higher sales for several years after the transaction is settled are not part of the purchase price of the business. These are akin to a sales commission or a management bonus, whereas a true earnout adjusts the purchase price of the business eventually paid.

A way of looking at a true earnout is that it is designed to allow the buyer and seller to comfortably close the transaction, each believing that if the business does what the seller says it can do then a purchase price adjustment will be appropriate. Understanding which of these is being proposed is a good starting point for analyzing and negotiating a buyer's earnout proposal.

(article continued on page 3)

EXPERT TIPS

USING INSURANCE TO FACILITATE THE SALE OF YOUR BUSINESS

The current market climate is leading to an increased level of scrutiny by buyers along with their unwillingness to accept undue risk associated with the transaction. This higher level of scrutiny by the potential buyer could pose a significant obstacle for the sale. In fact, the purchase and sell agreement will contain representations and warranties (R/Ws) made by the seller that if they are found inaccurate after the closing, the seller will be responsible for indemnifying the buyer for any losses incurred in connection with the misrepresentation.

Some ways for the seller to limit the potential liability include using a threshold claims amount and a limited survival period for the R/Ws. Another helpful strategy to consider is to transfer the risk of breach of the R/Ws to a seller-based reps and warrants policy that mirrors the terms of the transaction and mitigates the risks of both parties. The policy can be designed to match the purchase price and R/Ws liability cap (if any) and a deductible to match the R/Ws threshold. Under this model, the sellers pay nothing in the event of an unintentional misrepresentation, as the policy is structured to pay dollar-one after the threshold/deductible is exhausted. More importantly, realizing that R&W insurance is critical to bridge a potential gap in negotiations, the buyer may agree to pay part of the premium.

TRENDS TO ACT ON

Characteristics of Top Buy-Out Executives

Many senior executives are taking advantage of the economic conditions that make buying divested divisions or non-core operations of larger operations a viable career strategy. The following are some of the main characteristics of a successful management buy-out executive:

- Has specialized knowledge about the particular industry
 - Can build and keep a competitive advantage through sustainable differentiation strategies
 - Can build and keep barriers to entry involving customers, geographies, or products
 - Builds winning alliances and teams from a loyal and competent network of contacts
 - Has solid understanding of the financial repercussions of the economy on the particular industry
 - Works well with financial parameters
 - Has a documented history of specific industry success
 - Has survived several major failures
 - Realizes that doing an MBO is really just another logical career step
-

EXIT PLANNING

DEFINING YOUR EXIT OBJECTIVES

To ensure a successful and smooth transition, business owners must begin the process of exit planning with the definition of their exit goals and objectives. These exit objectives then become the foundation for all subsequent planning. In general, there are three main objectives common to most business owners:

1. Determining how much longer they want to remain active in the business
2. Determining how much income they need for the rest of their life after they leave the business and how do they want to receive the purchase price (lump sum or installments over many years)
3. Determining to whom should they transfer the business (child, key employee, outside party).

Unfortunately, few owners reach their objectives. Most often, they are too focused on their businesses on a day-to-day basis to even consider exit planning. In addition, they lack exit planning experience so they don't even know where to begin. Hence, business owners should start the exit planning process by working with experienced advisors who will help, not only in the definition of reasonable and attainable exit goals and objectives, but also in the design and implementation of action plans that will lead to a successful transition.

For more information on exit planning visit The McLean Group® Exit Strategies Institute [\[Click Here\]](#)

TMG OFFICES:

- Washington, DC
- California
- Illinois (Opening)
- Georgia
- Nevada
- Florida (Opening)
- Maryland
- Massachusetts
- Ohio
- Virginia

ABOUT THE McLEAN GROUP

The McLean Group is a middle-market investment bank providing merger and acquisition, business valuation, capital formation, executive advisory and litigation support services. Its focus is on serving middle-market businesses generating between \$5 million and \$300 million in revenues. The firm has a widespread practice with particular expertise in the IT services, technology, telecommunications, government contracting, staffing, and travel and hospitality sectors. Registered broker dealer.

CONTACT US:**THE McLEAN GROUP**

1660 International Drive
Suite 450
McLean, VA 22102

(703) 827-0200 *Phone*
(703) 827-0200 *Fax*
www.mcleanllc.com

UNDERSTANDING EARNOUTS

(CONTINUED)

The period of the earnout

On average earnouts last between one and three years although some can go longer. The longer an earnout goes on the less the likelihood that it will be collected. In evaluating earnouts we normally discount them as being worth less than cash for many factors that deal with their uncertainty, but at least one of these is the passage of time. A rough rule of thumb might be that a one year earnout is worth maybe 85% of cash and the likelihood of collection goes down about 15% for each year after that. So a three year earnout might be deemed as having only about 55% of cash equivalency.

This is true for two reasons. First an earnout is calculated initially on the basis of the sellers projections of what the business can do and projections are less accurate with the passage of time. The second reason is buyer remorse. No buyer totally understands what it is buying initially and with the passage of time at least an unconscious resentment tends to arise toward the seller as new things are discovered, creating a likelihood that the earnout calculation will be less generously applied.

The earnout targets, and who has control during the earnout period.

Earnout targets that the business must achieve are also a difficult issue to structure in such a manner as to prevent manipulation, intentional or otherwise. For example, most sellers are reluctant to accept an earnout around future profits as the business is usually in the control of the buyer post transaction with obvious potential manipulation opportunities. On the other hand, an earnout based on sales targets has the opposite problem where the seller stays in control of sales after transaction settlement. The proverbial fire sale that disregards profits is one outcome that a seller in control may be tempted by in order to hit his earnout sales targets. Gross margin or gross profit may be a more neutral metric. Another approach is a blending of two or more or all three of these targets although these can be difficult to draft with so many variables.

There are two forms of control. One is by contractual agreement (i.e. what the parties agree to allow in the earnout calculation) and the other of course is legal control. Unless there is a contractual agreement that measures performance in an agreed-on way, then of course the buyer will always be in control as it is his company after all.

Are targets cumulative or rolling?

The achievement of earnout targets may be either cumulative or all or nothing. For example; in a three year earnout where the target is exceeded or undershot in the first year, can the result be blended with that of the following years to determine if the earnout has been met?

Tax implications of an earnout.

A comfort earnout is intended to be a part of the purchase price of the business treated as a lower taxed capital gain but drafting mistakes here can be critical. For example, an earnout that seems to be an extended employment contract can be construed as subject to much higher ordinary income taxes. Careful drafting here by experienced tax counsel is imperative.

This brief article is by no means intended to be a thorough dissertation on earnouts. That could take a small book. Any reader wanting more information on this complex subject is welcome to contact the McLean Group.