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Earnouts:

1. What is an Earnout? It is a form of contingent payment from a buyer to a seller that is made upon the achievement of certain future metrics after the closing of the deal.
2. This mechanism is useful in attempting to bridge a difference in perceived value of a business between a buyer and a seller.
    - This difference in perceived value may be driven by:
        - general economic or market uncertainty;
        - the specific risks inherent in a certain industry or business due to cyclicality or volatility; or
        - early-stage or turnaround situations with significant future prospects that remain to be realized.
3. A **seller** may believe that the business has significant future prospects because of new products, new markets, new customers, new contracts, recent significant capital investment, a developing turnaround, etc. These prospects, however, will not be realized for some time. An Earnout gives the seller an opportunity to participate in the future upside if it materializes.
    - Seller receives a higher notional valuation than current operations would justify, but a portion of that value is attributable to the future prospects and is not paid until they are realized.
    - In exchange for this higher "notional" valuation and the prospect of realizing additional value in the future, the seller takes a lower value at close than would have been received in the absence of an Earnout.
    - There is risk to a seller in this structure, but an Earnout allows a seller that is confident of his future prospects to exit with the chance of receiving additional future consideration rather than settling on a fixed price at closing that may not meet his minimum expectations.
4. A **buyer** may not be as convinced of the timing, probability, profitability or size of these future prospects and may want to limit his risk up front by adjusting the purchase price at closing to a lower number and paying for the future results as they materialize. The benefits to a buyer are that an Earnout:
    - Lowers risk of overpaying for the company where the projections are aggressive relative to historical performance;
    - Reduces the cash required to close;

- Provides some protection in the event of due diligence surprises and failures in the representations and warranties of the seller after the closing; and
- If properly structured, the Earnout should incentivize the seller to perform and add value to the total enterprise.

5. The most important concept in the definition of an "Earnout" is that it is a "Contingent Payment". That means that the buyer may never have to pay it and the seller may never receive it.
6. Business owners should beware of friends who quote high prices that they received for their businesses. Frequently these "prices" include the Earnout portion which is contingent.
7. While Earnouts sound appealing in theory to many sellers, be aware that there are some disadvantages and risks:
    - As mentioned earlier, the price at closing will be lower with an Earnout than without it and the seller may never recoup the difference.
    - Many advisors view them as "full employment acts" for lawyers because so many of these provisions lead to disputes in the future; in spite of the best intentions and actions, it is very difficult to anticipate every eventuality that might occur to impact the future payments.
    - Negotiating an Earnout will add significant up-front legal expense to a transaction because it will involve complexity no matter how simple you try to make it; if you want to see what one of these actual agreements looks like, check out the eBay/Skype transaction. You can find it online.
    - The seller will have to spend significant upfront time developing a financial plan that can be used as a metric to calculate the amount to be paid under the Earnout.
    - The seller may find that his goals to earn the contingent consideration in the post-closing operation diverge from the buyer's goals to maximize the value of the overall enterprise for the longer term.
8. The main risks to the buyer are the disruption of the business because of misaligned goals, resolving disputes that may arise under the agreement, and having to pay a "windfall" to the seller because the Earnout metrics were too conservative.
9. There is no reliable database that has the statistics on Earnouts. Every deal is different. The following statistics are rules of thumb.
    - Larger deals (greater than $200 million) generally do not have them.
    - Historically only approximately 25% of all private company deals have Earnouts.
    - Earnouts become more common as the deal size gets smaller, particularly where a private equity group is the buyer.

- As the deal size declines below $25 million, the percentage of Earnouts increases significantly.

10. What are the key moving pieces?

- <u>Performance Metrics</u>: The goal is to have performance metrics that are easily "audited". Clearly identifying the metric, payment formula and measurement process is imperative.
    - Financial — This is the most common form of measurement used in approximately two-thirds of the deals. Typical financial metrics include revenues, gross margin, EBIT, EBITDA, pre-tax income, etc. Metrics based on revenues are more popular with sellers because there is no "profitability" component—sellers don't have to be concerned about the expense side of the equation. Buyers will typically want the discipline of a formula based on some earnings metric—Gross profit, EBITDA or EBIT—to control expenses.
    - Events—Plant completion, successful product introduction, regulatory approval, patent issuance, customer contract, software rollout, R&D success, etc.
    - Units—Achieving a specific unit number or volume of production or sales.
- <u>Percent of total consideration in the contingent payment:</u>
    - The typical range of consideration that goes into the Earnout for a mature operating company is quite variable but a typical range is 15-25%.
    - Contingent consideration can be as high as 75%. The high end includes early-stage companies and turnaround situations where much of the upside remains to be realized.
    - The value of the "contingent" occurrence relative to the current value of the business will determine this percentage. Obviously the higher the Earnout percentage, the lower the price at closing and the higher the risk to seller.
- <u>Duration of the Earnout</u>
    - Earnouts terms are a function of the financial plan. They typically last from 1-5 years; one-third were one year or less in duration with about 75% being completed within 4 years. The median is 3 years.
- <u>Other Payment Decisions</u>
    - What is the frequency of the measurement period (quarterly, semi-annually, annually, multi-year, etc.)?
    - What happens if you earn the Earnout one period and miss it in another?
    - Is the Earnout cumulative, are there clawbacks, etc.?
    - Is the Earnout paid in a single payment or in multiple payments?
    - How does the buyer protect himself from being sandbagged by a conservative financial plan so he doesn't have to pay the seller a windfall? Should there be caps? If so when, how large, etc.?

    - How is the Earnout paid? Cash or stock? Payment in stock is much more complex.

- <u>Operating Control/Management</u>
    - While specific goals for the acquired business may be aligned, there is always a conflict between those goals and the goals for the overall enterprise.
    - How does the buyer integrate the acquired business into the total enterprise to realize his economies and efficiencies and still have an ability to measure the discrete contribution of the acquired business?
    - How do you balance the short-term goals of the seller to maximize the Earnout against the long-term goals of the buyer to maintain flexibility and maximize shareholder value in the future? If the seller is required to operate the business "in the ordinary course", will this allow him to maximize the Earnout?
    - The parties will operate at cross-purposes. Common issues include decisions on management, staffing levels, shared services, marketing budgets, the amount of capital expenditures and the cost of that capital, overhead expense allocation by the buyer, calculation of the financial metric, etc.
    - What role should the seller have in the overall governance of the buyer's enterprise? Does he sit on the board of directors? Does he have input into the broader budget decisions, etc.? Does the seller have access to critical financial information to see how the buyer is measuring his progress toward earning the Earnout?
    - How do you handle extraordinary events that occur during the period of the Earnout—primarily sale of the parent business? Is the Earnout accelerated and paid in full? In part?

- <u>Tax treatment</u>
    - There are a lot of tax issues surrounding Earnouts. From a seller's perspective, when is the gain realized? Sellers would like it recognized over the period of the Earnout--unless the business is sold at a loss—so-called installment sale treatment. Tax advice is important so that the contingent consideration is not treated as compensation (ordinary income rates) vs. sale of capital asset (capital gains rates). Buyers have their own tax issues to address.

- <u>Accounting Issues</u>
    - It is important to consult accounting experts and to specify relevant accounting principles in the agreement. Referencing GAAP may not be sufficient. Applying accounting principles consistent with historical practice will be important. Issues to be addressed include allocation of overhead, affiliate transactions/pricing, amortization of intangibles and goodwill charges, depreciation, capitalization of expenses, effects of extraordinary or non-recurring items, impact of additional leverage, etc.

11. What are the Takeaways?

- Establish a sense of value in your own mind for the business. This may require outside assistance.
- Determine whether that value is achievable without any contingent consideration.
- If contingent consideration is necessary, determine how much consideration you are willing to put at risk in an Earnout.
- The alternative, of course, is to delay the sale until you achieve (or come closer to achieving) the projected results.
- Have a well-thought out financial plan for the period of the Earnout before you enter the discussion. This will determine what the metrics and the term should be from the seller's perspective, how much the Earnout is worth relative to the cash at closing, and what the probability of success is.
- Beware of overenthusiastic projections about the business prospects early in the process because the buyer may pick up on these as the appropriate metrics for the Earnout.
- Beware also of sandbagging the projections to engineer a windfall. Buyers are sophisticated and will demand a "cap". Alternatively you may end up damaging the overall value of the business by projecting low growth.
- Determine what percentage of the value you are willing to put at risk and for what period of time. Bring this up early in the negotiation process if the buyer balks at your valuation.
- Establish the rules of governance, control and management up front.
- Figure out all the other pieces—how and when it is paid, etc.—and then decide if the potential upside is worth the trouble.
- It is always important to have outside advisors—investment bankers and lawyers—to assist in these decisions early on in the decision-making process.