WHEN WILL YOU WANT TO CONSIDER EARN-OUTS?

When is it a good idea to accept an earn-out? There are certain times when they can be effectively used to bridge a gap. Sometimes they can be a great fit and protect both parties.

No one will be surprised or shocked by the fact that today's acquirers seek to acquire companies based firmly on today's earnings and today's book values. Sellers, by contrast, want to sell their companies based on the expected earnings of tomorrow.

Potential acquirers are often accustomed to offering sellers five times EBIT or up to two and a half times book value. This is done by structuring the deal as follows:

-20% notes or consulting/non-compete agreements with the seller
-30% equity
-50% borrowed from the lender.

Quite unfortunately, however, this former conventional structure does not always win out with the acquirers.

Closely Examining the Earn-Out

It is, in fact, rather common for successful acquirers to go beyond the conventional norm when bidding for a company. For those acquirers which are public companies, the use of their publicly traded stock presents a clear advantage. Additionally, for those acquirers which are private companies there is considerable leverage in using the carrot to "pay up" for a given desired acquisition with an EARN-OUT.

> "**Acquisition and Corporate Development**" co-author James W. Bradley noted that the **earn-out** is a contingent purchase, one designed to facilitate deals that would have otherwise simply not taken place.

There are situations in which the only way to justify a seller's price is to factor in future earnings considerably above what the buyer can expect with any degree of certainty. In this situation, an earn-out can be used to help a deal successfully go through. It is important to keep in mind that under some circumstances earn-outs can qualify as non-taxable transactions.

No doubt earn-outs can be complicated both to structure and to monitor. That stated, earn-outs are most desirable under a few different scenarios. For example, let's imagine the following scenario.

Let's say the buyer has limited equity, the seller has substantial price expectations, there exists a considerable price gap between the buyer and seller, the acquisition involves a company introducing new products and finally the owner is willing to stay with the company from between two to five years. An example for an earn-out formula used by a very successful New York Stock Exchange Company is as follows:

a) Pay the owners one to two times book value at closing.
b) Then pay owners an additional percentage of Net After Tax (N.A.T.) over a five-year period.
c) The payment based on the multiple of book value (a) is finally deducted out from the earn out payment (b)
d) Sample of earn-out:

Year	Multiple	Net After Tax
1	X	15%
2	X	15%
3	X	20%
4	X	25%
5	X	25%

What are the Main Considerations?

Of course, there are considerations to factor into the equation. For example, the acquiring company usually places a maximum earn-out or "cap" on the deal. This is done as the acquirer will want to ensure that the income from the earn-out is derived from continuing operations and importantly, not from special, extraordinary, or onetime, non-recurring events.

A key reason that the earn-out works for both parties is due to the fact that the acquirer agrees to invest money in the acquisition, and this can come in many forms such as computer systems, etc. This is done to essentially accelerate the N.A.T. In short, while a definitive dollar amount is not pre-determined, the acquirer is in a position where he or she wants to take every step possible to please the owners, as the success of the next acquisition will be voiced by the owners of the last acquisition.

The above variation is just one example of numerous diverse possible alternatives. In fact, the most common benchmark for earn-outs is a percentage of Earnings Before Interest and Taxes (EBIT) with covenants regarding which party makes major decisions, what changes will be allowed, and if necessary, how to implement arbitration.

Ultimately, in the event that a seller is willing to accept an earn-out agreement then it is possible to formulate a more aggressive pricing strategy. In short, the objective of the earn-out is to essentially quantify uncertainty.

The proper utilization of an earn-out gives us a way to bridge the gap between an asking price and a bid price. Further, it also serves as a way to motivate the seller during the period of transition. Importantly, the seller must be satisfied with the initial down payment as compensation for the company, meaning that earn-out payments are perceived as additional bonuses if and when they arrive.

What Can We Learn from This?

Due to a limited number of customers, distributors or handful of suppliers, many manufacturers find themselves in an uncomfortable and vulnerable position. In such situations, acquirers must take steps to protect themselves with an earn-out agreement. It is also important to remember that there is a tendency to use earn-outs as a method of protecting the purchaser who has failed to perform proper due diligence.

Simply stated, earn-outs should be limited to two situations:

1. Offering solutions to legitimate differences
2. When a seller's major concern is to spread out income in taxable transactions with resulting tax benefits.

Creativity and a willingness to compromise are both necessary factors to the success of an earn-out. In the end, when used judiciously, earn-outs can be an invaluable tool.

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Our process is very structured, as experience has shown us that while each buyer and seller is somewhat unique, there are enough similarities that specific steps must be followed in order for transactions to close. Confidentiality is guarded throughout each step of the process.

3825 West Green Oaks Blvd, Suite 710, Arlington, TX 76016
(817) 615–8393
info@alamocorporategroup.com