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Acquisitions

Closing the gap in valuations through “earnouts”

One of the most common stumbling blocks in negotiating the acquisition of a company is the difference between the vendor’s and the buyer’s perception of value. Sometimes, despite references to comparables, industry price multiples and asset valuations, the vendor and the purchaser just can’t seem to bridge the gap. Often this is either because the company has a high growth rate and there is disagreement over whether it can be maintained or in a turnaround situation where it is difficult to predict profitability. In such cases, the use of “earnouts” can be a useful tool in reaching a compromise.

What is an earnout?

An earnout forms part of the purchase and sale agreement and constitutes a binding obligation on the part of the purchaser to pay the vendor additional compensation in the event the acquired company achieves certain objectives. Typically these are quantifiable, financial objectives (sales, net profit or earnings before interest, taxes, depreciation & amortization or (“EBITDA”) but sometimes they can be more specific to the type of industry or business such as: customer retention over a period of time, renewal of certain sales contracts, asset size or the development of new products. The earnout clause usually specifies a maximum payout as well.

Key elements that should be included in an earnout clause include:

Clear & precise objectives

To avoid potential disputes, the formula on which the earnout is based should be clear and precise. In fact, both parties should use the KISS Principle (keep it simple, stupid) and avoid complex and arbitrary measurements. As important, the objectives should be realistic and attainable, just as in any performance incentive, otherwise the vendor will not be motivated. The vendor tends to prefer a formula based on revenues since he loses control to a certain degree over costs, interest expense and depreciation policies while the buyer prefers bottom line criteria such as EBITDA or net profits.

Length of the Period

Normally earnout periods cover from between one to five years. The longer the earnout period the more difficult it becomes to attribute the profitability due to normal evolution of the business (i.e. other acquisitions, consolidation of operations, new investment projects, etc.) However, where the earnout is very short, such as a year, the focus will be towards maximizing short term profits which may be to the long term detriment of the company.

Calculation

Earnouts are generally calculated once a year, based on audited results, and payable within a certain time period following the release of audited financial statements. In the earnout clause the parties need to state clearly the accounting method by which the transaction costs are treated, financing costs, allocation of corporate overhead (if applicable) as well as accounting policies. The clause should also spell out the manner in which any disputes will be resolved, although relying on audited statements should reduce significantly the potential for any disagreement.

The advantages and disadvantages of earnouts are as follows:

For the vendor:

- allows the vendor to participate in the future
- “upside” in the business
- allows the vendor to assure the purchaser that he believes in the business and is willing and motivated to stay behind and help make it work

For the buyer:

- reduces risk by basing the cash portion of the purchase price on historical results
- ensures that the vendor stands behind his future projections;
- represents a source of financing for the transaction

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Acquisitions (cont'd)

Ongoing Involvement of the Vendor

In the case of an owner-operated business, the vendor generally seeks to have an active role in the company after the transaction to ensure that the additional proceeds from the earnout are maximized. This can be countered by the purchaser's desire to have flexibility in how the newly acquired operation is managed and integrated. These opposing interests can sometimes create potential conflicts going forward. Furthermore, the purchase and sale agreement needs to anticipate future events such as the possible resale of the business during the earnout period or a change in control of the purchaser itself. There are incidents where unforeseen events can have a major effect on the earnout mechanism, as the following examples illustrate:

Case Study 1: A Quebec-based manufacturer was acquired by a large, publicly-traded multinational with the purchase price payable 50% in cash, 25% in shares and 25% subject to an earnout based on achieving pre-tax profits above a certain hurdle, for three years following the transaction. The deal was structured to motivate the vendor to remain with the company and operate the business on their behalf for at least the three year period. However, in this case, the price of the shares taken back by the vendor doubled within six months following the transaction. In the vendor's mind, he had achieved his target selling price and was no longer motivated to stick around. The vendor subsequently sold his shares, resigned from the company and the buyer found itself without anyone to manage the business.

Case Study 2: A Quebec-based manufacturer of products for the residential and home renovation market was acquired by a large, publicly-traded American company for $20 million plus an earnout of $8 million conditional on achieving annual pre-tax profits of greater than $4.3 million over the next three years. The ongoing involvement of the vendors was key for the US acquirors given the linguistic and cultural differences between the US and here. Three months following closing, the economy went into recession and the North American market for new construction and home renovation experienced a severe downturn. The vendors, realizing that achievement of the pre-tax profit objectives would be impossible given market conditions, elected to resign and subsequently invested in another business in a different sector.

Conclusion

These two examples illustrate how earnouts can sometimes fail due to completely unforeseen events. The best that both parties can do is to try and anticipate a number of potential scenarios during the life of the earnout to increase the chance that the earnout has the desired impact and both sides achieve their objectives.

Earnouts can be a useful tool in reaching a compromise when the vendor and the purchaser just can't seem to bridge the gap

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