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Earnouts

What's usually the most contentious issue when negotiating the terms and conditions of a business acquisition? If you guessed the purchase price, you are correct! In many cases however, this dispute can be resolved through the use of an earnout.

An earnout is an agreement where a percentage of the purchase price of an acquisition is contingent on the achievement of agreed upon targets after the transaction is consummated. A buyer may want to include an earnout in an agreement of purchase and sale for the following reasons:

1. **To resolve valuation disputes.** In situations where the seller believes the business is worth more than what the buyer is willing to pay, an earnout can break a deadlock in negotiations in order to reach an agreement.

2. **To retain and motivate target management.** In circumstances where target management will remain after the acquisition, the buyer may want to include an earnout to retain key employees and ensure they are motivated to achieve the targets agreed upon between the parties.

3. **To manage the buyer's risk.** No one wants to pay more for something than they have to. An earnout is a way for a buyer to mitigate this risk. And as long as the earnout is structured properly, it is in the buyer's best interest for a payout to occur. This is because a buyer's rate of return will be greater under this scenario.

Some of the issues a seller would need to consider include:

1. **Transfer of the buyer's risk to the seller.** If the value of the earnout equals the full purchase price discrepancy, a seller may argue that acceptance of all of the risk is unfair. One counter offer would be to increase the maximum earnout amount so that additional payments occur if the established targets are exceeded.

2. **Availability of financial resources.** Ideally, a seller would want the value of the earnout to be held in escrow until the earnout period expires or payments under the plan are made. Otherwise, the seller needs to satisfy itself that the buyer will have the financial wherewithal to make the scheduled payments under the plan in the future.

   In addition, the seller will want to ensure the buyer will provide the capital required to achieve its performance goals. It is common for the buyer to provide financing and charge the target's income statement for its cost of capital. If the buyer is not prepared to do this, it must allow the target to obtain financing elsewhere.

3. **Retention of operational control.** A seller will want to maintain as much operational control as possible, especially if the established targets involve net income or EBITDA. A seller should be wary about agreeing to an earnout tied to profitability if the buyer plans to integrate the seller's business into its own.

Both parties to an earnout will want to keep it simple and S.M.A.R.T. in order to motivate target management i.e.:

a. Specific - clearly defined and easy to understand;
b. Measurable - easy to calculate;
c. Actionable - within management control;
d. Realistic - achievable with hard work and adequate resources; and
e. Time Bound - deadlines are established with sufficient time to achieve the goals.

It is also imperative that an adequate mechanism is in place to resolve disputes under the earnout. The retention of a third party accounting firm to calculate the earnout formula can be used in cases where there are disagreements between the two parties.

Aries Advisory Group can assist you in designing a properly structured earnout that is fair and will be beneficial to both the buyer and seller. If you require assistance in designing an earnout agreement as part of a letter of intent or an agreement of purchase and sale, please contact us at info@ariesag.com or at (416) 467-7878 to see how we can help.