An Overview of Earn Outs

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What's an Earn-Out? An earn-out is that portion (generally 10-35%) of the purchase price for an acquired business that is contingent upon the acquired business achieving certain milestones during a specified time (typically 1-3 years) after closing. The contingent purchase price is "earned" when the acquired business achieves the milestone. If the milestone is not met post-closing, the buyer makes no earn-out payments to the seller.

Compared to Purchase Price Adjustments: Earn-outs are not the same as purchase price adjustments. Unlike earn-outs, a purchase price adjustment may increase or decease the purchase price.

When Earn-Outs Bridge the Valuation Gap:

- Turnaround situations where the seller will likely argue that historical financial results are not an accurate measure of the value of the business; very common in today's uncertain markets.
- Businesses that have developed new products lines that have not been proven in the marketplace.
- Hot market sectors where a difference in perception of value exists.
- Entrepreneurial stage companies where the entrepreneur has an inflated perception of value.

Other Advantages:

- If the seller continues in the business post-closing as the seller-manager, an earn-out incentivizes the seller to continue to be involved in the business and facilitates the transition to the buyer.
- Provides the buyer with a form of acquisition financing by reducing the amount of consideration delivered at closing, and thus eliminating the costs associated with third party financing.
- An earn-out gives the buyer a source of offset for future indemnification claims.

Disadvantages:

- The seller-manager may not have sufficient control to manage the business post-closing in order to achieve the earn-out, particularly if there is not separate accounting for the acquired business.
- From the buyer's perspective, the earn-out arrangement may incorrectly motivate the seller-manager to focus on short-term goals, as apposed to a long-term integration strategy of the acquired business.
- Earn-outs create opportunities for disputes and litigation surrounding the interpretation of earn-out terms or the operation of the acquired business during the earn-out period.

Structuring Earn-Outs

Earn-Out Milestones:

Earn-out payments are typically be based upon the business reaching post-closing financial milestones tied to one of the following "top down" income statement metrics: revenues, gross profit, EBITDA, pre-tax income, or net income. Because of control issues, sellers prefer the metric be towards the "top" of the income statement (e.g. revenues). On the other hand, buyers prefer the milestone be towards the "bottom" of the income statement in order to capture the costs associated in achieving the milestone.

Earn-out milestones can also be non-financial. For example, they could be tied to certain events like obtaining a patent, a new product launch, obtaining government approvals (e.g. Health Canada), reaching production levels, number of website hits, number of new accounts, or the opening of a new territory.

Earn-Out Formula:

The earn-out formula describes how payments are to be calculated once the earn-out milestone is reached. Earn-out formulas often include the following:

- The percentage of the milestone that is paid to the seller.
- The cumulative dollar limit over the term of the earn-out.
- The earn-out period.

Agreements

Here are some items to consider in drafting earn-out agreements:

- Define and describe what the expectations are of the buyer and the seller-manager during the post-closing operation of the acquired business.
- Provide a glossary that clearly defines milestone and formula terms, particularly generally accepted accounting principles (GAAP) as it is used in the post-transaction formula.
- Describe the post-closing accounting of the business acquired as a separate business segment.
- Spell out the tax consequences of the earn-out; i.e. additional purchase price or compensation.
- The security (if any) on payment of the earn-out, and if the earn-out is interest bearing.
- Require a third party Accountant to calculate the earn-out, should the parties disagree on the calculation.
- Set the method of dispute resolution surrounding the earn-out agreement.

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