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A Voice of Authority in Mergers & Acquisitions

QUESTION FROM A BUSINESS OWNER:

SHOULD I DECIDE TO SELL MY BUSINESS IN THE NEAR FUTURE (AT SOME POINT I MUST FACE MY AGE), WHAT WOULD HAPPEN TO FUTURE OPPORTUNITIES THAT I HAVE INITIATED NOW BUT HAVE YET TO GENERATE MUCH PROFIT AND OPPORTUNITIES THAT ARE ONLY IDEAS AT PRESENT?

ANSWER FROM A BUSINESS INTERMEDIARY:

Simple question, with a simple answer …. an Earnout. However, Earnouts are not a simple topic.

The theory for using an Earnout is to reward the Seller for future growth/profits that have not been factored into the purchase price. The Purchaser bases the value of a business on the business's ability to earn a profit in the future which has been calculated based on historical facts and trends and is used to forecast the future profit. This forecasted profit is the present value and is multiplied by an earnings multiple for the Purchaser to calculate an anticipated return on investment (ROI).

The Earnout formula is used when the Seller has initiated/acquired a new product/service, acquired new customers or employees who have yet to perform, acquired new equipment that has just been installed and has yet to show improved efficiencies/productivity, or has initiated something that has still to perform and is not factored into the purchase price.

The use of Earnouts is as old as farming:

- If you have the idea to plant seeds on your farm, that would be an interesting idea
- If you have acquired the seeds, but have yet to plant them, that would be an asset, and would have some value
- If you have planted the seeds, but they still have to germinate, that would be an asset with work in process and have more value
- If the seeds are growing but still need to be harvested, that could be considered some form of share cropping and a percentage *(to be determined)* of the profit would be shared (an Earnout)

Earnouts come in countless structures (like the number of blades of grass in a park), each crafted to meet the circumstances of the business situation and the goals and objectives of each party. Each structure has pros/cons for each of the parties. Some structures would share:

- A percentage of future profits for a number of months or years *(to be negotiated)*
- Future profits in excess of a base number for a period of time *(to be negotiated)* or a percentage *(to be determined)* of those profits

- A percentage of gross margin for a period of time *(to be negotiated)*
- Or a percentage *(to be determined)* of those profits
- A percentage of revenue *(to be determined)* in excess of a base number *(to be determined)* for a period of time
- A percentage of
  - revenue
  - gross margin or
  - profit, on a particular product or service for a period of time *(to be negotiated)*

Due to the many variables and outcomes, it is critically important to carefully look at the future outcome that may be realized and the number of factors that will impact that outcome. Earnouts have had some great benefits for bridging a price gap between a Purchaser and a Seller, but many wind up in court because the Earnout is poorly crafted, and the Purchaser *(in the eyes of the Seller)* has operated the business in a way considered detrimental to achieving the outcome anticipated from the Earnout.

We strongly recommend that all Earnouts, no matter how simple one may appear to be, have a dispute mechanism included in the Earnout contract. It is critically important that a competent lawyer with significant experience in Earnouts prepare the Earnout agreement.

CASE STUDY

We recently sold a business for $10M that included a $2M earnout. Revenues were $8M with an EBITDA of $1.6M. The purchaser said it was worth $8M, the seller wanted $11M. Projections indicated that revenue would grow at 10% per year with the gross margin on the increased revenue to be 45% resulting in an increase of EBITDA of $360K in year one, $756K in year two and $1.19M in year three.

The purchaser had valued the business based on the last 3 years performance.

However a future discounted cash flow valuation brought the value in at just over $10M. The Purchaser offered to use an earnout to close the offered/expectation price gap of $2M to be paid based on two things:

- Revenue increasing as projected
- Gross margins on increased revenue exceeding 40%

The Seller agreed and further accepted a two-year consulting agreement to oversee the revenue growth.

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