

## Crossing the Value Chasm

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As a dealmaker working with buyers and sellers of businesses every day, I see firsthand how investors' perceptions of value depend on whether they are buying or selling. When discussing value, a business seller usually espouses the extraordinary value of its loyal customer base, stellar reputation, irreplaceable goodwill and boundless growth prospects. Yet when that same business owner wants to acquire another company, his or her thoughts quickly turn to how slim profit margins, new competition and economic uncertainty make these intangible assets and goodwill worth almost nothing. Transactions normally occur when buyers and sellers meet between these two extremes.

Fortunately, most investors agree that value is derived from the reasonable expectation of future financial returns. Unfortunately, economic uncertainty is the enemy of forecasting. Buyers (and lenders) are justifiably basing valuations on current performance and conservative projections. Sellers are understandably clinging to how well the business performed a few years ago and pointing to signs that the economy is rebounding.

This natural gap between buyer and seller expectations of revenue, earnings and value, is now more of a 'chasm'. How can they agree on a price in this uncertain economy? The "earn-out" is a deal-making tool that can bridge this gap.

**Earn-Out Defined:** An "earn-out" provision in an acquisition means that a portion of the consideration paid is contingent on the financial performance of the business over a specified post-closing period. The purchase agreement contains an earn-out formula based on an agreed performance measure.

**Measurement:** The financial measure used can be Revenue, Gross Profit, EBITDA, EBIT, EBT, net operating income, or something else agreed upon by the parties. Sellers usually prefer to keep the measure simple and unambiguous, and as close to the top line of the income statement as possible, i.e. revenue. Buyers usually prefer a bottom line measure, or close to it, since they are ultimately after net earnings and dividend paying capacity. Simplicity usually carries the day.

**Formula:** The earn-out formula specifies that a percentage of the chosen financial measure be paid to the seller. As a simple example, say a seller of a business is to receive \$800,000 cash at closing, plus 20% of company revenue over \$1 million in the first 12 months after closing. If company revenue is \$2 million in that year, the buyer will pay \$200,000 on the earn-out, for a total of \$1,000,000. Agreements frequently specify a minimum or maximum or both.

**Payout:** The \$200,000 in the above example can be paid in a number of ways, e.g. monthly over the earn-out period, in a lump sum without interest at year-end, in equal monthly payments amortized over the subsequent 36-month period with interest, etc. For tax purposes the parties can agree to treat the \$200,000 as additional purchase price, compensation to the seller(s) individually, etc. Security for payment of the earn-out should also be defined.

**Advantages:** Besides making a sale happen, the obvious advantage of an earn-out to sellers is that they attain a higher selling price if expectations are met. Buyers gladly pay more when those expectations are met, but also pay less when expectations aren't met. Also for buyers, an earn-out paid over time is a form of acquisition financing, and something to offset against if undisclosed liabilities should arise.

**Concerns:** Because one or both parties won't have complete control of the company during the earn-out period, earn-outs require mutual trust and confidence. A good earn-out formula and payout plan aligns the interests of the parties. Operational restrictions put in place should balance short term results with long-term company health. Earn-out provisions that lack sufficient detail can lead to disputes. Experienced business transaction attorneys should help craft earn-out provisions to mitigate risk and prevent misunderstandings. In my experience, keeping earn-out periods short and selecting performance measures close to the top line generally leads to fewer disagreements.

In addition to addressing economic uncertainty, earn-outs are often used in other post-closing contingency situations, such as: (a) new/unproven products, capabilities or markets, (b) risk of losing major clients with whom the seller has close personal ties, (c) winning a new major customer contract after closing, (d) major impact (positive or negative) if a proposed government regulation is enacted, and more.

Years ago, a seasoned transaction attorney and friend told me, "there is no such thing as a risk-free transaction, for a buyer or a seller". That's more true today than ever. As our economy breaks out of recession, we expect buyers to become more confident in proceeding with acquisition plans; but we also expect many deals to continue to contain some component of financial risk and reward sharing in order to reach value equilibrium.

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Al Statz is President of Exit Strategies Group, Inc., a business brokerage, mergers, acquisitions and valuation firm serving closely-held businesses in California. He can be reached confidentially at 707-778-2040 or [alstatz@exitstrategiesgroup.com](mailto:alstatz@exitstrategiesgroup.com).

**Earn-Out Agreements Must Specify:**

1. A clear, objective basis of calculation
2. A process through which the amount payable is to be determined
3. A dispute resolution process if the amount cannot be agreed
4. Timing and method of payment
5. The maximum payment (if applicable)
6. Security for non-payment (if applicable)
7. Restrictions on how the business is to be managed during the earn-out period
8. An effective forum to handle differences of opinion on operational issues that may impact the earn-out, without the need for litigation.

*Courtesy of Simon Inman, Business Attorney with Carle, Mackie, Power & Ross LLP, Santa Rosa*