Earn-outs: Wherein both the Buyer and Seller get happy

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That little company you've had your eye on has just gone up for sale. Its reputation is solid, and, while its earnings in recent years have not been spectacular, its future looks promising. You're itching to buy, but you can't justify a $1-million price tag for a company with assets of $600,000. The present owner is forecasting a substantial earnings increase over the next few years, which he feels justifies the price. But what if he is wrong?

The best way to protect yourself may be to negotiate an earn-out – a technique designed to bridge the gap between what the seller is asking and what the buyer is willing to pay. This is done by splitting the transaction into two parts: a down payment that changes hands right away, and a series of contingent payments that the buyer agree to make at annual intervals if the acquired business either maintains or increases its earnings. In the above example, you might offer to pay the owner-manager $600,000 and under take to pay two installments of $200,000 each if earnings increase by $50,000 the next year and the year after.

There are two prerequisites for an earn-out. First, you have to make sure that the business you plan to buy can be operated as an autonomous subsidiary or division, or that its product line is distinct from those of the parent company. Otherwise, it would be difficult or impossible to determine the acquired company's profits. Second, the previous owner must be willing to continue to managing the company, and you must be prepared to delegate full authority to achieve the profits upon which the agreement is based.

Assuming you and the vendor can meet both conditions, you'll have to decide what kind of earn-out you want, how large a down payment you're willing to make and how much risk you're prepared to take. The portion of the purchase price that depends on future earnings can range from 20%-60%, and the period over which payments are to be made may range from one to five years. As for ways in which contingent payments are determined, you have a wide choice of options.

One option is a "base-period earn-out", in which the vendor receives additional payment each year that the business earns more than it did the year before he sold it. If for instance, the business earned $400,000 the year before you bought it and $450,000 during each of the following two years, the vendor would receive an agreed percentage of the extra $50,000 at the end of each of those two years. Or you could opt for an "incremental earn-out", which is based on year-to-year increases in earnings. This time the vendor would receive nothing the second year because there was no improvement over the year before. This is obviously a more hazardous position for the vendor, and, ideally, his share of any additional earnings should be that much more generous.

Then there is the "cumulative earn-out", which is based on the total earnings of the acquired business for the entire period of the earn-out. The advantage of this type of agreement is that it disregards annual fluctuations. The disadvantage, from the vendor's point of view, is that he will

not get anything other than the down payment until the end of the earn-out period – unless he can negotiate an advance to be credited against the total price that will be payable at the end of the period.

Finally, the “reverse earn-out” provides for the purchase price to be reduced in the event that earnings fall short of the agreed level. The difference between the purchase price and the down payment is deposited in a trust account and is released only as the vendor’s projected earnings materialize. The amount in the trust account represents the maximum to which the vendor may become entitled.

For the uninitiated, going the earn-out route has its pitfalls. For instance, since future earnings are the lifeblood of any earn-out agreement, you could be in trouble if you don’t spell out in advance the way earnings are to be calculated. It is not good enough to say that they will be computed “according to generally accepted accounting principles”. Rules concerning depreciation policy should also be clearly defined, as should remuneration that will be paid to executives and other employees.

In spite of the intricacies, earn-outs should prove an increasingly popular tool for reconciling the concerns of the buyer with the expectations of the vendor. They protect the buyer against earnings that may or may not occur and give the vendor the opportunity to get the price he feels his business is worth.

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