Earnouts:

The Good, the Bad and the Ugly

Episode 5: Monetizing Your Business Podcast

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What is an Earnout

- A contingent payment based on future performance (akin to a "bet")
- Less eloquently: "A Buyer's risk allocation structure"

Let's Look at an Example:

- Seller wants $9 Million for his business.
- Buyer is comfortable paying 7.5 Million.
  - Business lost a large customer, replacement customer not yet mature; or
  - Business has a new product just being launched – no track record yet; or
  - Perceived industry risk; or
  - Seller has unrealistic valuation expectations; or ???
- The $1.5 Million gap, the difference between $9 and $7.5 million is the Earnout portion of the deal.
- The Earnout piece is paid based on some measurable performance of the business over some agreed time period.

Why and When to Use an Earnout

- Bridge the "gap" between what Buyer is willing to pay and what Seller is willing to accept
- Provide the Seller with additional upside if company performs (theoretically)
- Gives the Buyer downside protection against performance/transition issues
- Seller can get paid out for new or emerging products not yet vetted in the marketplace
- Seller can get paid out for new or unseasoned offices or branches
- Reward Seller and management teams for smooth transition, longevity on some other performance metric
- The list is literally endless, however use caution…

6 Key Elements of an Earnout Structure

- Total Purchase Consideration
- Amount or % of Total Purchase Consideration paid at close, the "Core Consideration"
- Earnout Amount or Contingent payment: can be fixed, capped or uncapped
- The Earnout period, months, quarters, years …
- Performance Threshold i.e. "How and what do we measure"
- Contingent payment formula i.e. "When and What do we get paid"

Strategies in Using an Earnout

All the following are subject to Negotiation:

- Most Common Performance metric is EBITDA – favors the Buyer
- Seller Performance Targets (as high up on the Income Stmt. as possible)
  - Best is Revenue
  - Next Best Gross Margin
  - Least Favorable for Seller – EBITDA (it can be easily manipulated)
- Consider Additional Purchase Price consideration to compensate for:
  - No interest earned on Earnout amount
  - No personal guarantee
  - Lack of UCC1 - Difficult to perfect a claim - legally
  - Does not insure against Buyer Incompetence or inability to perform
  - Risk is mostly with the Seller

Possible Alternatives to an Earnout

All the Following are Subject to Negotiation:

- Seller Note that may incorporate:
  - A limited claw back or offset provision
  - Flexible time or performance repayment schedule
  - Could incorporate interest, accrued or current pay
  - *Benefit: it is a <u>secured</u> legal obligation*
- Consider a Royalty or License Agreement

  In a Royalty or License agreement the Seller retains ownership of IP, technology or asset integral to company's operations and or performance

  - Seller receives payment from Buyers use of the IP, technology or asset
  - Depending upon terms – the payment may be capped or time limited
  - Ownership of the IP, technology or asset can transfer to the buyer once a payment threshold is reached
  - Seller's payment and security risk is greatly reduced

Earnout Example 1

FMV Valuation @ 5X Multiple	$	9,000,000
Total Purchase Consideration	$	9,000,000
Paid in Cash at Closing	$	7,500,000
Earnout Capped at	**$**	**1,500,000**

* current annual revenue $15,000,000
* current annual EBITDA $1,800,000 or 12% of Revenue

The Deal – Corporate Buyer, Business Diversification
Buyer Goal – Minimize Industry Downturn Risk

- $7.5 million of Purchase Consideration will be paid in cash at Closing.
- Maximum of $1.5 million in additional Purchase Consideration will be paid in an Earnout.
- For every dollar of annual revenue over $15 million, an Earnout payment of 50% of the annual revenues over $15 million threshold will be paid 60 days following the upon completion of each of the next 3 calendar years.

Earnout Example 2

2018-19 Avg. EBITDA $ 1,800,000	2021	2022	2023
Level 1 year over year EBITDA Growth	10%	15%	15%
Level 1 EBITDA Targets	$ 1,980,000	$ 2,277,000	$ 2,618,550
Level 1 Payout	**$ 700,000**	**$ 700,000**	**$ 700,000**
Level 2 year over year EBITDA Growth	5%	7.5%	7.5%
Level 2 EBITDA Targets	$ 1,890,000	$ 2,031,750	$ 2,184,131
Level 2 Payout	**$ 350,000**	**$ 350,000**	**$ 350,000**
Below Level 2 EBITDA Targets - Payout	$ -	$ -	$ -

The Deal – Synergistic Buyer

Buyer Goal – Growth and Seller Retention

- $8.0 million of Purchase Consideration will be paid in cash at Closing.
- Up to a maximum of $2.1 million in additional Purchase Consideration will be paid in an Earnout. $10.1MM consideration for a $9MM valuation.
- Meet or exceed level 1 or 2 EBITDA target in calendar year to receive stated payout.
- Buyer agrees to covenant there will be no allocation of buyer corporate overhead and outside expenses for EBITDA Target calculation.

Earnout Example 3
the Bad and the Ugly

2018-19 Avg. Revenue $ 15,000,000	Year 1	Year 2	Year 3
Target Revenue Growth	20%	10%	10%
Annual Revenue Targets	$18,000,000	$19,800,000	$21,780,000
Min. Annual EBITDA % Target	15%	18%	18%
Payout if Targets Achieved	**$ 1,000,000**	**$ 1,000,000**	**$ 1,000,000**
Revenue and EBITDA Targets Missed	$ -	$ -	$ -

The Deal – Disingenuous Buyer

Buyer Goal – Short the Seller and Pay below Market for the Business

- $5.5 million of Purchase Consideration will be paid in cash at Closing.
- Up to a maximum of $3.0 million in additional Purchase Consideration will be paid in an Earnout.
- Meet or exceed Annual Revenue and EBITDA target in calendar year and receive $1,000,000 payout. Miss either or both Targets receive zero Earnout for that calendar year.

In Summary

- Not all Earnouts are created equal, they can be wildly different.
- Work hard to Understand Buyer's Motivation.
- Need experienced M&A Advisors and Attorneys to evaluate, assess probabilities and negotiate the Earnout terms.
- Having multiple offers provides excellent negotiation leverage.
- Some Buyers (usually synergistic or industry), will sometimes make a deal that includes an Earnout that is worth much more than what the business will command today!
- When considering an Earnout, always ask the Buyer for references of deals that went well AND deals that had issues, i.e., did not go as planned.

We hope you enjoyed this presentation and learned some valuable information

- If you have questions or would like to set up a complementary confidential call to discuss your opportunity, or
- If you have comments or suggestions on how we can improve these type presentations, or
- Have topics that would be of interest to you. (Note: we will only pontificate if we have the experience and knowledge to do so. If we do not, we will interview folks who we know are a strong and trusted resource on the topic.)

Please Email Renae at: renae@uptonco.com

Thank you