Bridging the Gap with Contingent Earnouts
An overview of how earnouts can benefit both buyer and seller in certain situations

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Determining the future earnings of a business is the key component in establishing its worth. While this is usually relatively straight forward, in some cases future earnings may not be so easily assured.

This situation often arises if the seller is a key employee or if the business is dependent on services rather than products. In such cases, buyers may be concerned that the departure of one or more key employees could result in a loss of a significant portion of business. Turn-arounds, businesses with new products and uncertain sales or companies facing the threat of litigation are other common situations where earnings can be difficult to project.

Faced with such a situation either the buyer may offer a lower price for the business, in effect discounting the future earnings, or opt for a Contingent Earnout arrangement. Earnouts are used to bridge the gap when the buyer is having a difficult time predicting future earnings for a business.

Under an earnout structure, only a portion of the purchase price (generally tied to the buyer's lower expectations) is paid at closing. The remainder is paid if certain future earnings or other performance milestones are met (generally tied to the seller's higher expectations). If the earnout is successful, the seller is often able to achieve a higher price than would have been netted with all cash sale. The buyer, on the other hand, is able to shift some of the risks of future operations to the seller and reduce the initial cash outlay that would otherwise be required to acquire the business.

While earnouts do provide substantial benefits, like most things they're not a panacea. For instance:

- Earnout arrangements may conflict with the seller's plans to exit the business since they often require principles to remain closely involved in order to assist in achieving agreed upon milestones.
- The fact that the seller and the buyer now have a long-term relationship can prove problematic, particularly for sellers who are put in the position of now working for someone else in a business they once owned.
- The business may fail to meet its objectives due to actions on the part of the buyer, over which the seller has no control, or there may be economic downturns or market changes over which neither party has any control.

At any rate, an earnout arrangement can present a complex situation and negotiating the finer points of the agreement can prove difficult. The ongoing relationship necessitates a careful setting out of the milestones to be achieved, the time period and methodology of measurement, the associated payouts, and the guidelines on how the business is to be run during the period in question.

The more easily determinable and objective the metrics are, the lower the risk of future disputes. Advisors who specialize in M&A transactions of this sort should be considered. They can help guide you through the process of setting up an effective contingent earnout agreement and are your best bet for ensuring a smooth and successful transaction.

The structure of earnout agreements varies greatly. The one constant is that they must be carefully thought through and meticulously drafted.

Stay tuned for more on earnouts. We'll address the accounting and tax implications of earnouts in a future article.