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Structuring Effective Earnouts

I. Introduction

An "earnout" is an acquisition payment mechanism where some portion of the purchase price of the selling company (Seller) will only be paid by the acquiring (Acquirer) company if the seller attains agreed-upon performance goals after the closing. There are three key elements in creating a successful earnout. First, the earnout should be based on achievable performance goals that increase the value of the target in the hands of the Acquirer after the closing. Second, the seller's management team should receive adequate compensation for creating that value. Third, the earnout should provide the Seller's management with the resources and operating freedom necessary to achieve its performance goals.

Well-structured earnouts can allow emerging companies to increase their sales price. By contrast, ill-conceived or badly implemented earnouts can demotivate management, reduce the seller's value to the Acquirer, and result in litigation.

II. Why Use An Earnout?

There are three typical reasons why earnouts are used:

Pricing Bridge: The most common reason for using an earnout is to bridge the gap between the acquirer and sellers evaluation of the targets worth. When both parties agree that a higher Seller's valuation would be justified if it met future performance goals, they can make the differential between their valuations subject to an earnout. A company may want to do an earnout if it believes that its future performance will be substantially better than its historical performance.

Retention of Shareholder/Managers: Another reason for using an earnout is to induce key managers, who are also shareholders, to remain with the company after the sale. If a portion of the purchase price is subject to performance goals after the closing, the Seller's shareholder/managers have an incentive to remain with the company in order to participate in future payments.

Motivation of Shareholder/Managers: The third reason to use earnouts is to motivate the selling company shareholder/managers to continue the company's aggressive growth after closing the sale. Earnouts are most effective for this purpose if the seller can substantially increase its sales price by achieving its performance goals.

Earnouts are not necessarily limited to acquisitions. For example, a company may use an earnout structure to motivate and compensate managers asked to establish a new company product line. An earnout analysis can also be used to set the exercise price for a purchase option given by a company in a corporate partnering negotiation (joint venture/strategic alliance).

There are no "standard" earnout structures. Although every earnout must be structured to meet the specific needs of a given transaction, Agile Equity's intent is to highlight the major issues that the parties need to consider and resolve when negotiating earnouts.

III. What Are The Potential Problems With Earnouts?

Earnouts have enormous initial appeal to a selling management team. They automatically value the Seller on its future performance and give management an incentive to sustain its growth after the sale. When problems occur using earnouts, they generally fall into one or more of the following categories:

Integration of the Seller into the Acquirer: Earnouts are least likely to be effective when the seller is totally integrated into the buyer. The more Seller's operations are integrated into the Acquirer, the less control management will have over achieving performance goals. In an integrated company, revenue, expense and profit decisions may be made to benefit the combined entity instead of Seller's. To avoid this problem, we recommend choose performance goals that will not be adversely affected by integration or assure the sellers operating independence during the earnout period.

Complexity of Definition: It is difficult to create effective earnout formulas. While the earnout concept may be simple, objective numerical definitions can easily become complex. To avoid this problem, choose simple performance goals that are unambiguous, simple to track and easy to measure.

Overly Aggressive Performance Goals: In order to get the highest valuation, management may be tempted to base the earnout on overly aggressive performance goals. It should be remembered that emerging companies rarely can predict their future performance with any accuracy. To avoid this problem and to minimize demotivation and friction, goals should be realistic as well as ambitious.

Potential to Demotivate Management: Earnouts can demotivate a company's management if it becomes likely that they company will miss its performance goals. The earnout can have a similar effect if the buyer's post-acquisition policies appear to interfere with the Seller's ability to attain its goals. To avoid these problems, choose realistic performance goals, provide progress payments for partial performance and provide a fair mechanism to adjust performance goals to reflect changing business circumstances (a six-month evaluation after the transaction is ideal).

Managers Don't Own Enough Company Stock: Earnouts may be ineffective if the Seller's key management doesn't own a lot of stock subject to the earnout. To avoid this problem, it may be necessary to provide additional incentive compensation for Seller's key managers.

Given the practical difficulties of earnouts, the parties may conclude that it is preferable not to use them. Even if negotiations lead to a non-earnout structure, earnout negotiations are still valuable and worthwhile. We find that earnout negotiations frequently bring the parties closer together on price, performance expectations, and operating philosophies.

IV. Who Should Consider Using An Earnout?

Although many companies pass through a phase where an earnout can offer pricing advantages, earnouts are **not** appropriate for every company that is being sold. The following types of companies are natural earnout candidates:

Early Stage Companies: A small, early stage company that has only a product prototype or minimal sales history may benefit from an earnout. When there is no historical basis for valuing the success of the product, or if a company anticipates explosive growth in the hands of a strategic buyer, an earnout may provide the best measure of the seller's value.

Separate Product Line: When an acquirer is buying a separate product line, earnouts are simpler to construct, less subject to manipulation and a good measure of the true value obtained by the buyer.

Turnarounds: If the seller has financial problems, its management may feel that its current performance is a poor indication of its future potential. In that event, management may feel that the potential for a higher valuation, based on future performance, justifies the risk of an earnout.

High-Value Deals: Companies in hot industry sectors, with seemingly inflated market valuations, are also good earnout candidates. Using an earnout allows the acquirer to only pay the premium price if the seller actually performs.

If a selling company fits any of these profiles, part of preparing for acquisition negotiations should include considering earnout structures. An earnout analysis can help test the seller's projections to see if they support the price being sought.

V. Structuring An Effective Earnout

What are the key elements to consider when structuring an effective earnout and what negotiating positions will the Acquirer and the Seller most likely will take?

A. Earnout Amount

The parties must determine what portion of the Seller's purchase price will be paid to its shareholders at closing and what portion will be subject to the earnout. Each will attempt to reduce its risk in the acquisition: Acquirer by trying to increase the earnout ratio; the Seller by trying to get more cash at closing.

The earnout percentage is usually a function of the negotiation price gap. This figure should then be adjusted to reflect both the *later* and *contingent* nature of the earnout payments. Given the added risk inherent in the earnout formula, it would be inappropriate to merely discount this price differential to its present value. Most earnout formulas take the time value of money into account implicitly. Many provide explicit interest or original issue discount on the deferred payments.

What is an appropriate balance between the payments at closing and the amount of the earnout? The answer depends on how strong Seller's position is, the total risk in the earnout, and the parties' objectives. There is little point to a small earnout if the earnout ratio would be less than 20%, it is preferable for the parties to continue negotiations until they agree on price. In contrast, if the earnout ratio would be more than 70%, the Seller may be assuming too much risk in the transaction and should reconsider the potential transaction. Our experience shows that most earnouts range from 20-70% of the total purchase price.

B. Earnout Period

Earnouts typically run for a period of one to five years, averaging three years. Like the earnout amount, the earnout period is usually determined by the negotiation price gap. As a rule of thumb, the larger the earnout ratio, the longer the earnout period. From the Seller's perspective, the longer the earnout period, the greater the risk that it will not attain the performance goals. As a consequence, the Seller should try to keep the earnout period as short as possible, therefore reducing its risk.

From the Acquirer perspective, a longer earnout extends the period that the Seller's shareholder/managers will be retained and motivated. The Acquirer also will want to ensure sustainable performance goals that meet its desired rates of return and comply with its accounting policies and earnings reporting practices. These factors help determine the length of the earnout period because they influence how much money the Acquirer can pay each year and what impact these payments will have on the Acquirer cash flow and reported earnings.

C. Performance Goals

Earnout payments can be based on any number of measurable performance criteria. To be effective, performance goals must be clearly defined, mutually understood, attainable, and easily measurable. The following section lists common criteria used in earnouts and highlights issues Seller's should consider when evaluating the appropriateness of those criteria for its earnout:

Revenues: Many earnouts are based on the revenues earned on the Seller's product line or business. Revenue-based earnouts have the advantage of allowing the Seller to be integrated into the Acquirer business without interfering with the earnout. When using a revenue-based goal, the Acquirer may be concerned that a company will sell product at low margins in order to boost revenues. To avoid this problem, experienced Acquirer's usually will want the earnout formula to require that the Seller's business operations are profitable. The Seller may be concerned that the Acquirer infrastructure (manufacturing or distribution capacity) will not be sufficient to meet customer demand for the Seller's products or services. To avoid this problem, the Seller will want the formula to specify what resources the Acquirer must dedicate to support the Seller's revenue goals.

Gross Margin: Acquirer's may prefer to base the earnout on the Seller's gross margin because it forces the Seller to be profitable. However, if the Seller is subject to buyer's control, Seller's management may worry that an Acquirer will dictate its expenses to the detriment of the earnout. To address this concern, the earnout formula should specify how the parties would determine overhead, burden rate, purchasing requirements, and similar factors affecting gross margin.

Pretax Profit: Using pretax profit as the earnout measure requires the Seller's business to perform well in all respects. It also prevents any meaningful operating integration of the Seller into the Acquirer during the earnout period. To ensure that the Seller has a fair opportunity to achieve its earnout objectives, an earnout based on pretax profit needs to provide adequate operating freedom.

Cash Flow: In some cases, the Acquirer may want to base the earnout on the Seller's cash flow. Cash flow may be the suggested measure if the Acquirer is cash-short or if Acquirer wants to impose discipline on a Seller that has historically been a large cash consumer.

Milestones: Payment also can be contingent on the Seller attaining non-financial milestones, such as completion of some specified critical product development, product shipment, or contract execution. If the Seller meets those milestones, specific event-based payments can be made. Milestones also may be time-based, with partial payment to reflect the degree of completion.

Guaranteed Payments: Earnouts may contain guaranteed minimum payments, based either on the passage of time or on the absence of a negative event. For example, payment may be earned

if the Seller's senior management remains for one year. An interest-bearing promissory note is an even simpler form of a guaranteed payment.

Performance criteria generally are measured on an annual basis. A mathematical formula should be developed that determines the exact amount of cash or shares to be distributed to the Seller's shareholders.

If the parties want to incorporate multiple performance criteria into the earnout formula, they typically would assign separate weights, so that the goals can be achieved independently. For example, a two-year earnout, based equally on revenues and pretax profits, might be designed as follows:

- 25% of earnout payment based on Year One revenues;
- 25% of earnout payment based on Year One pretax profit;
- 25% of earnout payment based on Year Two revenues;
- 25% of earnout payment based on Year Two pretax profit.

D. Payment Limits

To balance risk and reward, the earnout should provide rewards for significant partial performance by the Seller, even if it does not completely meet its performance goals. This is a common mistake among Seller's.

Performance Below Goal: In most cases, the Seller should receive some partial payment if it attains at least 50% of the performance goal and the payment amount should increase linearly thereafter up to the performance goal.

Performance Above Goal: Some formulas pay bonuses (premiums) if a Seller exceeds its performance goals. Others may culminate any excess and allow the Seller to apply it to offset any periods in which it fails to meet its goals.

Cap on Payments: Because of the unpredictability of future performance, Acquirers almost always cap the payments that can be earned in an earnout. If the Acquirer caps the total payments that can be earned, the Seller should seek minimum annual payments and the right to bonus payments if it exceeds its performance goals.

E. Operational Integration

Another issue that affects the advisability of an earnout is the extent of desired operational integration between the Seller and the Acquirer. The contract must clearly define the business unit being measured and establish who will control the Seller's major corporate decisions. With extensive integration, it is likely that a Seller will blame an Acquirer if it fails to meet the earnout performance goals. Whenever performance goals become unattainable, friction and

possible litigation are likely to result. Integration of a Seller into the Acquirer is most likely to be a problem where the earnout formula is complex, the earnout period is long, or the Seller's performance goals are based on profit rather than revenues.

F. Accounting Rules and Performance Measurement

Earnouts require a clear understanding of the applicable financial accounting rules. Acquirer's and Sellers frequently account for items differently before the acquisition and most Seller's will be required to conform it's the Acquirer's accounting system after the closing.

The acquisition contract needs to incorporate accurate and timely ways to monitor performance goal results. It should require an independent annual audit of the Seller and provide a method to resolve numerical disputes. Typically a subcommittee of the Seller's former board of directors, representing the Seller's shareholders, frequently will be asked to negotiate any disputes with the Acquirer during the earnout period. If this subcommittee and the Acquirer are unable to reach accord, the contract should provide for arbitration or determination by some independent accounting firm. Finally, time limits and procedures must be established for making earnout payments.

G. Payment Distribution

One of the critical issues in any earnout is ensuring adequate compensation to the Seller's continuing management.

Timing/Risk of Payment: Many earnouts are structured with the largest part of the payment on closing going to preferred stock investors. If the amount received at closing by the common shareholders (generally the employee/managers) is too small, Seller's management may not support the deal, objecting to the preferred investors receiving the bulk of the purchase price without any post-closing performance risk. To address this concern, the parties may need to adjust the distribution of the purchase price between the Seller's preferred and common shareholders.

Management Bonus Pool: If the Seller's key managers have little equity, the earnout may not provide sufficient motivation. In such event, an Acquirer may want to set aside a portion of the earnout amount as a management bonus pool. This helps to ensure that those whose efforts generate the performance results directly benefit from the earnout reward.

Management pools may range from 10% to 25% of the earnout amount. The amount set aside will vary with factors such as:

- the amount and distribution of the initial payment at closing;
- whether the total expected payment is greater than or less than the preferred stock liquidation preference;

- the perceived degree of risk in the earnout;
- the length of the earnout period; and
- whether the Acquirer has an existing employee bonus plans.

The amount of the pool may be adjusted if key managers leave the Seller during the earnout period. If the management pool consists of additional shares of the Acquirer stock, the Acquirer may require that the shares vest over time to help retain the Seller's management.

Compensation and Noncompetes: Seller's management also will need to negotiate the terms of their salary, bonus, and incentive plans. Naturally, the Acquirer will expect the Seller's senior management to sign non-compete agreements for a specific period of time after the closing (typically mirroring the time of the earnout).

VI. Additional Issues

Each earnout negotiation will generate its own set of issues, but the following are the most frequently ones encountered.

Availability of Financing: The Seller will want to ensure that the Acquirer can and will provide the capital need to achieve its performance goals. Frequently, the use of Acquirer capital results in an interest charge to the Seller's income statement when determining whether it met its performance goals. If the Acquirer will not commit to providing necessary capital, a Seller needs authority to obtain funds from outside sources.

Management Process: Both parties must agree on how the Seller will conduct business after the closing. The parties must establish an approval process for the Seller's annual operating plans. While this process generally will mirror the Acquirer's own business planning process, it is important to structure a planning process for the earnout period that will not adversely affect Seller's ability to achieve its performance goals.

Escrow of Earnout Amount: If the Acquirer is highly leveraged or a potential takeover candidate, the Seller may want to have the earnout amount held in an independent escrow account.

Effect of Acquirer Sale on the Earnout: The documentation should ensure that the sale of the Acquirer or its relevant business unit will not adversely affect the Seller's ability to obtain its future earnout payments. Alternatively, the formula might accelerate vesting of the Acquirer shares and deem performance goals met upon the sale of the Acquirer.

VII. Acquisition Structure

Use of an earnout does not preclude flexibility in structuring acquisitions. Earnouts can be included in tax-free and taxable transactions and in mergers, stock-for-stock acquisitions, or asset acquisitions. The earnout can be paid in stock or in cash.

Tax Issues on Use of Stock in Earnout

Stock is frequently the means of payment in an acquisition. The Acquirer may want to use its stock to conserve cash and to provide the shareholder/managers of the Seller with a continuing interest in the growth and prosperity of the buyer after the closing. Any cash will, of course, be taxable, so Seller's may want Acquirer's stock because its receipt can be tax-free. When structuring an earnout as a tax-free transaction, Seller's should consider the following:

Stock-for-Stock Acquisition: In a tax-free stock-for-stock acquisition, all of the consideration paid must be in stock.

Stock-for-Assets Acquisition: In a tax-free stock-for-assets acquisition, consideration in the form of cash or the assumption of liabilities must be less than 20% of the total consideration.

Merger: In a straight or forward triangular tax-free merger, at least 50% of the total consideration paid must be in stock. In a reverse triangular tax-free merger, at least 80% of the total consideration paid must be in stock.

VIII. Shared Vision

Nothing is more necessary yet less understood than the need for mutually agreed-upon objectives in an earnout. An earnout requires greater mutuality in negotiation than does a sale where the relationship ends at the closing. If earnout negotiations become confrontational, it will be more difficult for a Seller to meet its performance goals. The success of an earnout depends on the chemistry of key both parties key managers. Both sides must believe that they will be truly better off if the earnout succeeds. Earnout performance goals should be founded on shared objectives for the Seller's ongoing operations.

A major difficulty in negotiating earnouts is reaching agreement on earnout performance goals. To elicit best offer, the Seller will try to persuade the Acquirer that it can attain the highest feasible level of future sales and profits. Earnouts, however, should be based on lower, more achievable performance goals. Major changes in a Seller's projections during negotiations can destroy the Seller's credibility. Companies can avoid this problem if they identify themselves as a natural earnout candidate early in the process.

IX. When Should You Propose an Earnout?

Sellers should ask itself early on whether it will be saleable at the price desired by its management. If this appears unlikely, an earnout structure may be necessary to attract a buyer. In that event, a Seller should prepare its financial projections with an earnout in mind.

If the perceived valuation differential is small, the Seller still may want to propose an earnout. Earnout discussions are often a way to reach agreement on price. Earnout discussions test a Seller's resolve and confidence in its future. A convincing earnout negotiation may persuade the Acquirer that the Seller will attain its promised future performance. In that event, an Acquirer may elect to pay the entire purchase price at the closing, since a successful earnout inevitably raises the cost of the acquisition.

Most buyers propose an earnout structure, either because it wishes to buy the Seller, but refuses to commit to Seller's asking price, or because it desires to retain and motivate the Seller's shareholder/managers.

X. Proposing the Earnout Structure

To ensure that an earnout proposal meets the financial and operating needs of each party, each issue raised in this online booklet should be analyzed. The Seller should propose the earnout structure and carry the initial design burden, with the Acquirer editing or reacting to the proposal. As with most transaction structures, the advantage in an earnout negotiation resides with its proposer.

There are three paramount considerations when designing an earnout proposal.

Simplicity: Keep it simple. If negotiations shift toward a non-earnout transaction, the effort to develop complex formulas will have been wasted. If the earnout formula is retained, the Seller will want it to be clearly defined, mutually understood, and easily measurable.

Focus on Key Issues: Focus on the few critical issues. Many earnout negotiations fail because both sides press their positions on all points. Save a Seller's strongest efforts for its key value issues.

Be Realistic: To maximize the earnout's chance of success, Seller's must be realistic and have a detailed understanding of how it will operate within a bigger company. Performance several years into the future is always difficult to forecast. Consider upside and downside scenarios. Discuss appropriate limits and memorialize them in legal agreements.