Turning to earnouts

A potential solution for negotiation stalemates

Sometimes merger and acquisition negotiations reach an impasse — even when both parties are committed to making the deal succeed. When buyers and sellers are at loggerheads over pricing, all of the transaction's benefits can fall to the wayside.

There may, however, be an alternative: an earnout. With an earnout agreement, the seller might remain with the company to operate it after it has been sold. The buyer agrees to make periodic payments to the seller if the company meets specific performance goals.

Incentives for everyone

An earnout can be a particularly effective way to bridge the gap when the buyer and seller disagree about the value of the company. The promise of future payments can assuage seller concerns that they're settling for a price that undervalues their business. And, assuming the seller remains in control of operations after the sale, earnouts help reassure the buyer that the seller will work hard to maintain the company's performance.

Keep in mind that earnouts are far more effective for sellers when, postmerger, the selling company continues to operate as a stand-alone subsidiary or the seller continues to manage it as a division of the acquiring company. If a target is intended to be immediately absorbed by the buyer, earnouts may not make sense. Sellers will have little control over the newly merged company's performance.

Negotiating the details

Although earnouts often provide a solution to difficult price negotiations, the process of agreeing on an earnout structure can prove challenging as well. The parties need to discuss the form that seller payments will take as early as possible, because this decision can have other ramifications. If, for example, a seller wants to be paid in stock, the parties must decide whether the stock will be valued as of the deal closing date, at some other date or by another measure.

The parties also must agree on the objectives that must be reached to trigger earnout payments and an acceptable accounting method (typically, Generally Accepted Accounting Principles) by which to measure achievement of these objectives.

Earnout objectives could include:

Sales. Often, sellers prefer that performance be measured by gross sales, because they provide a clear goal that management can directly influence.

EBITDA. If performance is measured by EBITDA (earnings before interest, taxes, depreciation and amortization), the seller will need to show that it's achieving a certain level of pretax cash flow. Earnout payments typically are a percentage or multiple of the amount by which the seller division's results exceed a set EBITDA figure.

Annual performance. The parties may agree to set an annual performance threshold based on revenues.

Nonfinancial. In some earnouts, payments are based on nonfinancial goals specific to the industry or business. A manufacturer, for example, may be required to successfully roll out a new product that is only in the development stage. Or a pharmaceutical company may need to obtain FDA approval to market a new drug.

Don't forget exemptions

Sellers typically request protections to ensure earnout payments regardless of the buyer's financial condition at the time they are due. Buyers, on the other hand, generally try to include language in the agreement that subordinates earnout payments to other obligations, such as outstanding loans.

Sometimes circumstances make it difficult for sellers to meet earnout goals. For sellers,

therefore, it's crucial to negotiate earnout exemptions. Sellers generally push for a widespread set of exemptions to ensure that, for example, future capital expenditures or the introduction of competing product lines doesn't erode their ability to achieve earnout goals.

For their part, buyers usually try to ensure the selling company's owners and executives don't maximize short-term goals at the cost of long-term profitability. For example, a seller might focus on selling large volumes of existing products while neglecting new product development.

But parties can bridge such differences in interests. A buyer might retain the right to take actions that could affect the seller division's sales or profits, but the financial impact of those actions will be excluded from the seller's earnout calculations.

Difficult but fair

Failure to agree on price is one of the most common M&A deal-breakers. Earnouts can introduce flexibility to a negotiation stalemate. The key to success is to ensure that both parties walk away from the table feeling they have achieved their most important goals.

When the seller needs to pitch in

If deal negotiations are breaking down because a prospective buyer is unable to secure adequate financing, you might consider seller financing. Not only does it get the deal going again, but it reassures buyers that sellers have faith in the company's future.

Seller financing can be accomplished in one of two ways:

1. Sellers purchase debt or stock from the newly merged company — in effect lending money to the buyer to acquire the seller's business.

2. Sellers agree to accept retroactive payments from the buyer. Typically in this scenario, the buyer makes a down payment, giving the seller a promissory note carrying interest for the balance. Notes usually cover between 25% to 50% of the overall purchase price.

This second strategy is particularly popular when a selling company is a little larger than businesses considered purchasable for cash, but smaller than those that typically attract deep-pocketed buyers. Retroactive payments are also often used when the seller's business is unusual or greatly affected by seasonal or market conditions.