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Earn-outs

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An Earn-out is simply defined as a portion of the purchase price of the sale of a business, paid in the future, but only if pre-agreed milestones are achieved after closing.

What is a milestone?

What part of the purchase price?

How paid?

When paid?

Usually, the milestone reflects something that the business is reasonably expected to achieve, within a predetermined time frame. It could be a revenue milestone, a new client, a new product being released, a new process or technology being implemented that will reduce costs or increase revenues. It could be the successful hiring of a coveted employee, the successful negotiation of a new contract, a successful advertising campaign, the list goes on and on.

The portion of the purchase price allocated to the earn-out will depend on the significance of the milestone to be achieved and how the impact of achieving that milestone will affect the future profits of the business. To be candid the buyer doesn't really care how much money you made last year, or the years before, but rather how much he will make in the future. Remember that the true value of a business lies in its ability to earn a profit in the future, not how much it made last year. So if the base profit of the business has been fairly consistent over a period of time and sets the value of the business at 100 dollars, but if the milestone the owner has been developing/working on comes to fruition, and the profits increase enough to raise the price by, say 50 dollars, then it is probable that the purchase price will be 150 dollars with 50 dollars being established as an earn-out to be paid when the milestone has been achieved.

Occasionally the milestone is such that the future profit adjustment will result in a pre-agreed amount of price adjustment and other times the future profit cannot be easily forecasted in which case the earn-out then becomes a formula.

How an earn-out is paid is filled with variables; sometimes:

- a pre-agreed amount is simply paid at the appropriate milestone,
- paid as a percentage of future profits,
- a percentage of future profits in excess of a base line of profits,
- a percentage of gross revenues over a period of time (think of a royalty)
- a percentage of gross revenues in excess of a pre-agreed base
- a percentage of the company is not purchased until a certain point in time when the business is re-appraised.
- A new corporation is created to be the Purchaser and the Seller acquires a percentage of the shares in the new company, to then be bought out at a later date. Sometime known as a "Recap" …. used often when the Seller agrees to remain and operate the company for the Purchaser (often a Private Equity Group (PEG) will utilize this approach)

There is no standard formula, or method to construct an earn-out. Each one is unique. The common pieces usually are that:

- The Seller usually must remain with the business for a specified period of time,
- There must be clearly defined milestones,
- Most often, there is a time frame surrounding the terms of payment, usually 3 years, but 5 or 7 years could be linked to a long-term royalty payment.

A Seller must be comfortable that the Purchaser can in fact pay for a price increase, so often there is a question of what security ought to be in place to ensure the Seller is paid as agreed.

Reflecting over the foregoing, one can quickly conclude that earn-outs are complex agreements with countless variables and cannot be undertaken lightly. Anyone contemplating selling their business with an earn-out component needs to be surrounded by a competent team of advisors: An experienced M&A Lawyer; a Tax Specialist; an Accountant; an experienced Business Intermediary; and other specialists/experts with detailed operating knowledge to ensure the structure and terms of the earn-out meet the needs of the Seller. One must also be sure not to overlook the income tax treatment of an earn-out.

CASE STUDY

A recent client had begun the process of changing a significant supplier. The contracts were in place and the transition well underway. However a health issue incentivized the client to sell his business earlier than he wished. The Purchaser offered to pay a base price based on the average earnings over the past 3 years and to pay 50% of the increase in gross margin over the average gross margin during those past 3 years, for a period of 2 years, after closing. Payments were made quarterly.

CASE STUDY

A recent Partnership needed to be concluded for a number of personal reasons. One of the Partners really didn't want to sell, because he felt the business was about to grow significantly in both revenue and profit. He agreed to invest some of the proceeds of the sale of the Partnership into the Purchaser's company, and to continue as managing director of the business he sold. At the conclusion, he owned 25% of the purchasing company, a job with a decent salary, expenses, a profit sharing bonus and of course a dividend stream and the hoped for increase in value of his 25% equity to be purchased by the purchaser in 7 years, based on the valuation of the business at that time .

CASE STUDY

A letter of intent was successful negotiated in July of last year for an American firm to acquire a medium sized, profitable Canadian business with the transaction slated to be completed in September. A major contract was to be completed by the end of August which fit nicely with the completion of the transaction. The profits from that particular contract exceeded $250,000 and would belong to the Seller. However, the large contract was deferred for four months and the Seller wanted to delay closing until December 31. The Purchaser was integrating another division of his business with the client's and did not want to delay the integration. The resultant change in the LOI had the transaction closing before the completion of the large contract, with the Purchaser agreeing, provided the Seller stayed with the business, to pay to the Seller 75% of the profit on that contract as the contract was completed over the subsequent months. The payment of the profit was reflected as an increase in the purchase price, and was taxed as a capital gain rather than taxed as income.

CASE STUDY

A client's husband had created a patented industrial product that he manufactured in a small facility near Toronto. Net earnings averaged $300,000 per year. One day he suffered a fatal heart attack and his wife took over the business. Unfortunately, she did not have the necessary knowledge to operate the business and the profits quickly become negative. Her lawyer, banker, and accountant insisted she close the business to stop the losses, but a life insurance broker sent her our way. We quickly sold the patent, plus inventory, the equipment at book value, and collected accounts receivable. The patent was purchased by way of a royalty contract (with the patent exclusively assigned to the purchaser, and transferred at the end of the contract. Payments were made quarterly for 10 years, at 4% of revenue (audited) with a minimum payment of $25,000 per quarter (totaling at least $1,000,000.00).

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