

Earnouts vs. Seller Financing Alternative M&A Structures for a Financing-Challenged Market

By Alan Mayer and Chris Hammond

In recent years, earnouts and seller financing were rarely discussed during acquisition negotiations. But the current constraints on debt financing and the economic downturn that created uncertainty about future performance have again brought these alternative structures to the forefront of M&A transactions. An earnout or seller financing can bridge the value gap, and each has its own pitfalls and advantages.

Earnouts

Loosely defined, an earnout is where a portion of the purchase price is paid after the closing, contingent in whole or in part on the target company's financial performance over a specified period of time. Earnouts are typically based on the projections that the seller prepares as part of the sale and/or due diligence process and are structured as a percentage of a mutually agreed upon financial metric, most often revenue, gross profit or EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization).

Earnout Negotiation Points

1. Target Metric: Revenue, gross profit, or EBITDA? Each represents varying levels of risk to each party in the transaction.
 - If tied to revenue, the buyer will argue that the seller can reduce product or service prices, thereby increasing revenue but at lower profit margins. This has the effect of increasing the probability of earning the earnout to the long-term detriment of the business.
 - On the other end of the continuum, if tied to EBITDA, the seller will argue that the buyer can increase expenses by adding non-essential personnel, equipment or "above market" perks that will reduce EBITDA.
 - An earnout tied to gross profit may be an appropriate compromise because it is easy to track and difficult to manipulate, but it may not be the most relevant metric in all cases.
2. Term: Most earnouts are structured over a term of one to three years.
 - One year may not be enough time for the business to prove itself.
 - Anything more than three years becomes cumbersome to track and exposes the business to many other variables that must be addressed. The sooner the business can meet the financial hurdles required to achieve the earnout, the better.
3. Cap: Should the earnout be subject to a cap?
 - The buyer will argue that the earnout should be capped at whatever amount the seller would be willing to sell the business for if 100% of the purchase price were to be paid at closing.
 - The seller will argue that if there is downside risk associated with under-performance, then

- there should be an upside reward for over-performance.
- In most cases, earnouts are capped at a pre-negotiated amount, oftentimes driven by the lender as a requirement to satisfy debt covenants but leaving the seller with some upside potential if the business exceeds its financial targets.

An Attorney's Perspective: Potential for future dispute

According to Matt Perkins, a corporate attorney with Davis Graham & Stubbs, "It is extremely important that any earnout be structured and documented carefully. You need to consider what may occur in the future and address, in detail, matters such as overhead allocations, management fees and precise decision-making authority. An issue that is often overlooked is how the earnout operates if the owner is no longer at the company, whether they were terminated or chose to leave prior to the expiration of the earnout period."

The Bottom Line

Earnouts and documentation can be very complex, but they are often the most flexible risk-sharing mechanism to bridge valuation gaps. It is important to be aware of, identify and negotiate the specific circumstances that impact the seller's ability to earn the earnout.

Seller Financing: Another Alternative

With the decrease in debt leverage multiples, buyers are increasingly asking sellers to finance a portion of the purchase price as a means of bridging the value gap. Seller notes are typically paid over a specified period of time at a pre-negotiated interest rate, with payments due monthly, quarterly, semi-annually, etc.

Seller Note Considerations

- While seller notes are less risky than earnouts, if there is a material decrease in the cash flow of the business, there may be inadequate cash to make timely payments on the note. Additionally, payments on the seller note are typically subordinate to the senior lender(s) in the transaction and may be suspended if cash flow diminishes to a pre-negotiated level.
- Typically, they are unsecured debt instruments (and, accordingly, have a higher level of risk than a senior lender), yet the interest rate is oftentimes similar to that of the senior lender, and
- Terms are generally three to five years.

The Bottom Line

If you have confidence in the future of the business and the buyer to whom you are selling, then seller financing can be an effective and less risky way to bridge the value gap than an earnout. The cost of lowering the risk is that you're agreeing to give up any potential upside.

These are just a few of the many issues associated with alternative structures in an M&A transaction. Clearly, seller financing and earnouts are inherently more risky than an all-cash transaction and certainly add another layer of complexity to the negotiations, but they may be required to complete transactions in today's M&A environment. It is critical that you understand these issues and review the pros and cons in detail with your advisors prior to entering into a sale process. To learn more about common components of transaction structures and valuation in the current economic environment, please contact us.

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