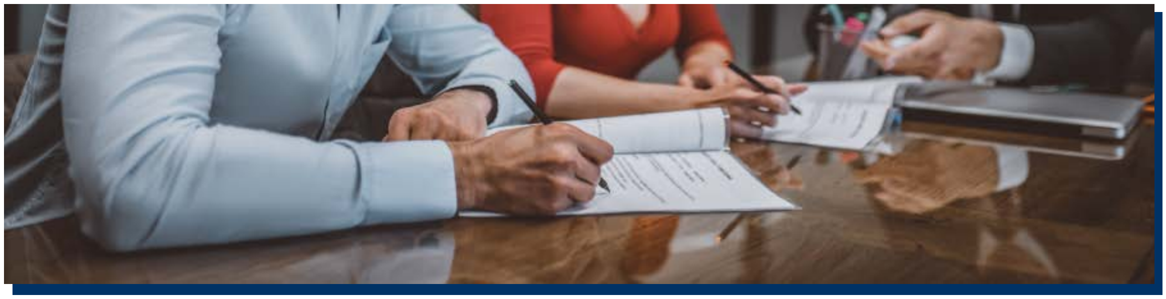
EARNOUT AGREEMENTS CAN BRIDGE VALUATION GAPS

By JoAnn Lombardi, President VR Business Sales / Mergers & Acquisitions



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VALUED REPRESENTATION

Acquisition talks are proceeding smoothly. Then the subject of price comes up. The buyer thinks the seller's asking price is based on overly optimistic financial projections. The seller believes the buyer's valuation of his company is far too low. Is the deal dead? Not necessarily.

An earnout agreement can help resolve a dispute when a buyer and seller disagree about the seller's business prospects. They are especially useful when dealing with the unknown — when the target is young and unproven, or it is emerging from a difficult financial situation. In short, earnouts offer a way for the parties to bridge expectation gaps.

UNDERSTAND THE BENEFITS

Once you decide an acquisition is the best, or only, way to reach your corporate goals, focus on finding the best target. Fit is important: If you're considering an acquisition based solely on opportunity, the deal is likely to result in disappointment.

Instead, ask how the target company will specifically support your strategic vision. Will new products, for example, be well received by your existing customers? And will your current lineup of products meet the target company's customers' needs? Are the cultures of the merging companies compatible? Depending on your goals, you might also consider the target's market reach, competitive landscape and customer satisfaction levels.

Your M&A advisors can help you structure your due diligence plan so that you spend the bulk of your time and effort scrutinizing only the target company's assets and financial details that are most relevant to your goals. For example, if you're acquiring a competitor to gain access to its research and development staff, it's unlikely that you'll want to devote excessive due diligence to its real estate holdings.

All components of an acquisition may carry future liability, however, so a thorough investigation is critical to accurately assess potential risks. Your business unit managers should assist in due diligence to ensure the review process includes the items they feel are most important.

STRUCTURE THE AGREEMENT SOLIDLY

Whether an earnout succeeds can depend on how well it's structured. An ill-considered and vague agreement can turn a dispute over valuation into a dispute about the agreement itself.

A common problem is drafting an earnout that covers an inadequate period. When this happens, the seller may try to quickly boost its earnings, even at the expense of the company's long-term financial health. By expanding the earnout period, the buyer can collect more data to evaluate the target's financial performance. Many experts say an earnout should reflect at least a year's worth of results and perhaps as much as three years' worth. Keep in mind, however, that the seller's business becomes increasingly influenced by the buyer's management — setting the stage for finger-pointing if the seller fails to meet the earnout's terms.

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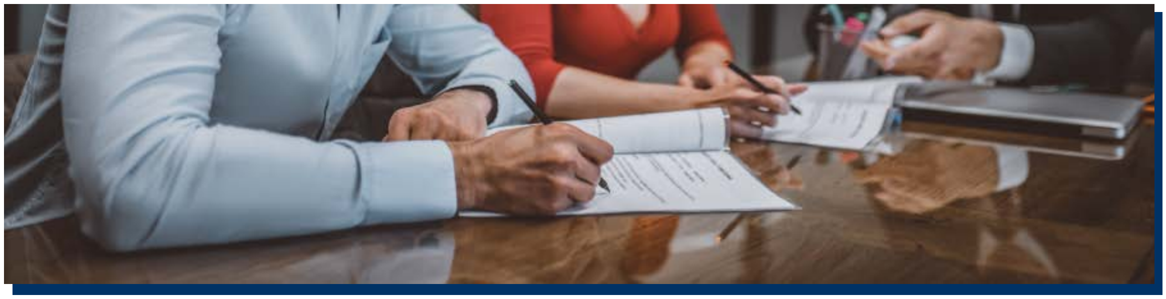

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The earnout also should include the right measures of financial success. Gross sales figures provide one popular measure because they're more difficult to manipulate than net sales. Net earnings, though a good long-term measure, are subject to many variables and can be misleading over a short period.

ACHIEVE CONSENSUS QUICKLY

Even the best-structured earnout needs occasional monitoring. A good way to keep the agreement on track and minimize the potential for later disputes is to include a provision for periodic audits. Audits help reassure the buyer the target is using appropriate accounting methods and operating its business professionally.

A poorly conceived earnout will fail to achieve a consensus between buyer and seller, who may interpret the same facts in vastly different ways. Thus, earnouts often include a dispute resolution mechanism, such as arbitration – a less expensive alternative to litigation.

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