# Earnout Agreements Can Bridge Valuation Gaps

*by Peter C. King, CEO VR Business Brokers/Mergers & Acquisitions*


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 the 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.

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## Understand the Benefits

In an earnout, a buyer makes a partial, upfront payment to the seller. With the payment comes a promise to pay the rest of an agreed-on amount if the target meets certain pre-established goals. Meeting these goals generally results in a higher price for the seller. However, falling short of the goals may result in a lower price.

A well-designed earnout carries advantages for both parties. For instance, the buyer can initiate a transaction with a relatively modest amount of cash. It also can avoid the risk of paying too much for a company unable to deliver on overly optimistic financial projections. Finally, an earnout can help make the transaction more valuable by significantly motivating the seller to achieve its promised results.

Meanwhile, the seller can use an earnout to help negotiate a better asking price. An earnout can be particularly helpful when the seller believes that the company's future results are likely to be much better than its current ones.

## 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.

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 disputeresolution mechanism, such as arbitration – a less expensive alternative to litigation.