KRATOS CAPITAL
ONE CLIENT AT A TIME

White Paper: Earnouts Don't Get Any Respect

Takeaway: *Earnouts are hardly perfect, but they can be useful if all parties understand them.*

Understanding How An Earnout Works

Earnouts are used to bridge a valuation gap between a seller and buyer. This valuation gap is not a result of what multiple is being used, but rather what the company's earnings should be. That is why earnouts are often used for high-growth companies.

Let's say that a company has an average TTM EBITDA of $5 million, and the comparable indicate that a reasonable multiple should be 5X EBITDA. The company would therefore have an enterprise value based on historical EBITDA of $25 million. However, let us suppose that the company expects to hit its earnings out of the ballpark in the coming year to the tune of $7 million in EBITDA, perhaps because of additional industry activity, a new technology or new products.

Here is the problem: The buyer feels the business is worth $25 million based on the proven $5 million EBIDTA. While the seller knows, the company will do $7 million and should be worth $35 million. That leaves a price gap of $10 million.

Option: an earnout, the ultimate mediator. In this case, an earnout could be negotiated such that the last $10 million of the purchase price is contingent on the seller achieving EBITDA above $5 million all the way to $7 million.

"Seems reasonable, right?" Not so fast...

Why Earnout(s) Make Sellers (and Their Advisers) Cringe

So what is the problem with this seemingly simple solution?

Two words: Risk transfer.

When an earnout is in place, the onus is on the seller to deliver; the buyer refuses to "prepay" for performance that has not yet been delivered. The risk is squarely on the

seller, because a portion of the purchase price is contingent on actually meeting the projection. Buyers have a hard time believing a projection, because most projections are just "unbelievable." They most often settle on paying for real performance. They would rather compensate later if the future performance are achieved.

Now in fairness to the seller, earnouts are not usually seller friendly, especially if there really is a catalyst that is likely to drive performance higher. Earnouts are often structured on a one-for-one or two-for-one basis. This means that for every dollar above the EBITDA threshold, the purchase price gets increased by $1 of $2. This multiple may therefore not match with the multiple paid on the balance of the transaction.

There is also the time value of money to consider. Earnouts are paid out in the future and often don't earn interest (and they most certainly won't, if sellers engage a poor investment banker who doesn't think about these finer details). They are riskier than consideration shares or seller financing in that they get paid in the future, without the seller being compensated for the time or risk involved.

No wonder advisers cringe. They advise their sellers to avoid earnouts like the plague. Clearly, all the above noted reasons warrant this position!

OK. So clearly earnouts have their benefits - and problems. But are they really the WMDs of the M&A world? Can buyers pull them out like super-weapons to make a deal seamlessly come together?

Well... not really.

Buyers Cringe Too
The problem is that earnouts are not really buyer friendly either. At least, they are not friendly to the right kind of buyer. That's the kind who will work with the seller to build a company, one that's more valuable than the sum of its parts. Earnouts get in the way of that.

Here's how: The example company above may be able to hit $7 million EBITDA, but it might take $2 million in capital investment to do it - more equipment, a new distribution

center, additional facilities, additional working capital, etc. Now just where do you think that capital is going to come from? The buyer. How should the earnout be modified to account for this capital investment? This is where it starts getting complicated, and how the risk often slowly transfers back to the buyer. In the "buy and build" strategies often deployed by private equity firms, the highest levels of value creation happen when the use of resources (capital, human resources, infrastructure, distribution channels, facilities, ideas) is optimized.

The problem: earnouts discourage resource sharing. It may be that the only way our example company hits $7 million in EBITDA is if significant leverage is derived from the buyer's systems and processes. Should the buyer "charge" the seller for this? It's a recipe for disaster, and what usually happens is that the "buy and build" strategy gets delayed until the earnout period expires. Result: the buyer loses more on reduced value creation, integration, and general momentum than what it gains by having an earnout in place.

Plus: earnouts have implications for corporate culture. Because the seller has to remain somewhat isolated to allow it to achieve its earnout, cultural integration suffers. This is the No.1 reason why M&A transactions fall short of expectations according to most studies.

The bottom line?

Earnouts are hardly worth it for buyers most of the time.
So What's the Solution? Earnouts are hardly perfect, but they can be useful if they're understood by all parties. They have to be properly articulated with terms including not just the formula, but how resources will be shared and the impact of future capital investment on the formula itself. In other words, earnouts should just stand alone value delta, last ditch considerations.

When valuing companies, we prefer to incorporate the seller's performance risk into the multiple or discount rate used to value the company. Then, we estimate the company's recurring future cash flow, determine the level of risk associated with this cash flow estimate, and adjust the discount rate accordingly, totally avoiding earnouts if possible.

Overall, we don't particularly like earnouts and seldom use them. Our experienced bankers, on behalf of our clients, will exhaust all measures and options before considering an earnout, when structuring or negotiating a transaction.

Kratos Capital LLC is a privately held, transaction-oriented, M&A advisory firm. Our principals have experience in a variety of strategic liquidity solutions including sales, divestitures, and mergers. We also work extensively with companies committed to expansion through acquisition.

We are an experienced, highly effective firm specializing in managing transactions with capitalized values of $5 million to $200 million. The firm provides industry tailored investment banking expertise, in order to help owners maximize the value of their investment of time, money and hard work. Each of our clients are represented by seasoned bankers, who bring a wealth of knowledge and experience. Our bankers comprise an aggregate of well over one billion dollars in completed transactions on behalf of the private middle market.