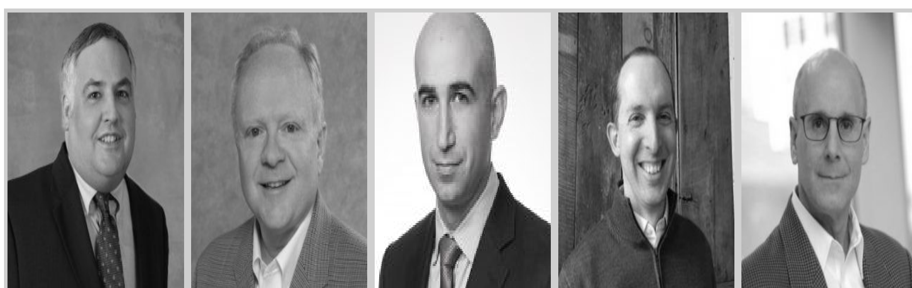
Should You Take an Earnout?

By Meghan Daniels (http://www.axial.net/author/meghan/), Axial | November 1, 2016



(http://www.axial.net/forum/should-you-take-an-earnout/attachment/scotthakala-3/) Scott Hakala, ValueScope Inc.

(http://www.axial.net/forum/should-you-take-an-earnout/attachment/kenneth-sanginario/) Kenneth Sanginario, Corporate Value Metrics

(http://www.axial.net/forum/should-you-take-an-earnout/attachment/henry-heinerscheid-1687-722x837/) Henry Heinerscheid, PWP Growth Equity

(http://www.axial.net/giff/) Giff Constable, Axial

(http://www.axial.net/forum/6-considera healthcare-ceos-deal/attachment/dexter-braff/) Dexter Braff, The Braff Group

An **earnout (http://www.axial.net/forum/earnout/)** is a common way to bridge the gap between a seller's expectation of business value and a buyer's willingness to pay. Earnout structure varies, but the basic idea is that a buyer will make additional payments to a seller post-close, dependent on the business achieving certain goals.

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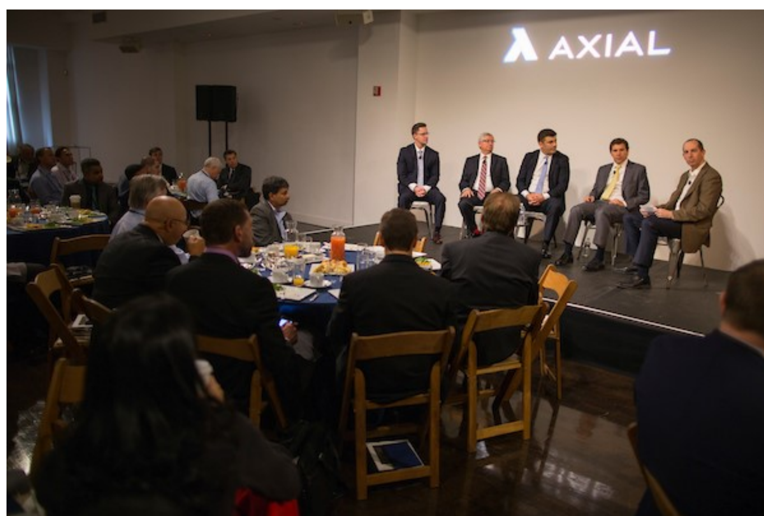
"When properly structured, earnouts can work — and when they work, they work really well," noted Kenneth Sanginario, Founder of **Corporate Value Metrics (http://www.corporatevalue.net/)**, during a recent panel at **Axial Concord (http://www.axialconcord.com/)**. But earnouts can also turn nightmarish in the case of misaligned expectations, unfriendly terms, and hidden stipulations.

"Earnouts for sellers who are going to exit are too often a disaster," said Scott Hakala, Principal at **ValueScope Inc (https://network.axial.net/a/company/valuescope-inc/)**. "The best earnouts incentivize the people who run the business. Earnouts for CEOs who are just standing back and collecting a paycheck often aren't good. Sellers always believe they're going to make the earnout, then are mad if they don't."

Giff Constable, Axial's VP of Product, goes even further. He recently emerged from a rollup that included multiple earnouts. "The more independent you keep an acquired company, the easier it is to put an effective earnout in place. The more tightly you want to integrate the two companies, the more troublesome they become."



(http://www.axial.net/wp-content/uploads/2016/11/1V1A3728.jpg?e1e745)
Photo by **Robert Caplin (http://www.robertcaplin.com)**

When Earnouts Go Wrong

Careful legal wording can protect against bad behavior, but even

this doesn't always work. Hakala told a story of an exited owner with a 3-year earnout who watched from afar as the "buyer changed gears six months in and basically tanked the company." He's also seen rollups in which buyers deliberately credited the wrong business with sales in order to avoid paying an earnout.

Henry Heinerscheid, Director of **PWP Growth Equity (https://network.axial.net/a/company/pwp-growth-equity/)**, said he tries to avoid earnouts even in cases where the CEO is staying on. "Earnouts can change the spirit of partnership between investors and management. It creates a misalignment of interests between the management team and other shareholders, which can lead to management making short-term decisions to try and maximize the earnout rather than trying to maximize shareholder value over the life of the investment."

Hakala agreed, especially in the case of quickly growing companies with uncertain prospects. "An earnout can be a way to bridge the gap and divide up the risk. But there's also an S curve where the more you grow, the harder it is to keep growing. There's a time when your natural momentum will start tailing down. That can mean that earnouts or incentives that assume continued growth at the same rate as in the recent past may be unrealistic."

Clawbacks and Earnout Alternatives

Hakala said he tends to prefer management incentive agreements over earnouts — "they're more long-term and sustainable." Incentive agreements should include assurances that if the company is acquired the owner won't be terminated (or will receive severance if they are).

Another alternative to an earnout is a clawback, noted Sanginario. "With a clawback, the seller might accept a lower valuation but agree that if the company grows to a certain level, they can 'claw back' equity — maybe 10-15% of what they gave up in the transaction." He said that the clawback can foster alignment between buyer and seller on a longer term basis than an earnout, though it has to be very carefully structured to avoid misunderstandings after the deal.

Advice for Sellers

If you do consider an earnout, it's crucial to "put in protective provisions and to make sure it's realistic," said Hakala. Work with an investment banker and an experienced M&A lawyer to make sure that your interests are represented.

Dexter Braff, founder of healthcare specialist investment bank **The Braff Group (https://network.axial.net/a/company/the-braff-group/)**, had a few pieces of advice for CEOs considering an earnout:

1. **"Make sure you have a cumulative clause for multiple year earnouts.** If you're short in the first year, but way long in the second, you should still get your earnout for year one," said Braff. "It shouldn't be about *when* you earned it but about *whether* you earned it."
2. **"Be wary of buyers factoring in basic risk of the industry into the earnout."** Said Braff, "the earnout is supposed to reflect things that aren't covered in the current valuation. You don't want the base valuation to get sucked up in the earnout and take on more risk than you need to."
3. **"If possible, base the earnout on revenues, not EBITDA.** The more calculations you have to do the more room there is for trouble," said Braff.

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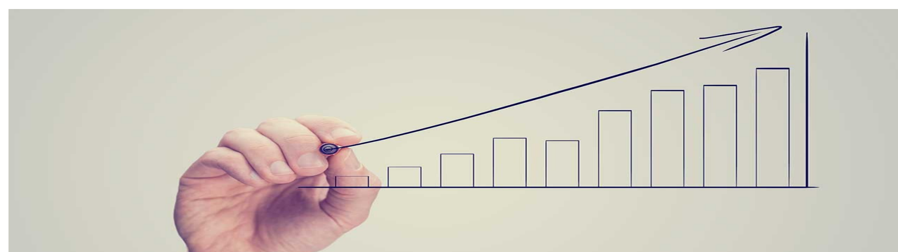

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During negotiations in an M&A deal, buyers and sellers look closely at several factors in order to agree on a price that properly captures a company's value. One of the closely examined metrics in this process is EBITDA, which stands for earnings

before interest, taxes, depreciation, and amortization. EBITDA is used as a way...

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