OPTIMA CORPORATE FINANCE

A Guide to Earnouts

The Benefits and Pitfalls

A Guide to Earnouts

Anyone who has been involved in or heard about M&A deals in the recruitment industry is almost certain to have encountered earnouts. They are a well-established element of deal structuring which enable buyers to manage risk whilst offering sellers the opportunity to maximise the price they receive for their business.

It sounds simple, but structuring an earnout is complex and can be counter-productive if not carefully planned. Before exploring this topic in detail, here are some relevant definitions:

Consideration
The price paid to acquire a business

Deferred Consideration
A fixed amount payable at a specified time in the future with no upside but potentially open to reduction

Earnout
A payment of consideration in the future which will be determined by future performance

Initial Consideration
Amount paid on completion of a deal

Why use Earnouts in a Deal?

There can be many reasons why an earnout would feature in the terms of a deal:

Value subject to results

1. The buyer and seller don't agree on a valuation for the business, typically if the seller is expecting growth in the year or two following completion. The buyer may agree to pay a higher price if the growth is delivered, in which case they will pay an amount of Initial Consideration and will structure an earnout over an agreed period to reward the sellers. Failure to achieve the growth would result in no (or a reduced) earnout being paid.

Protection against downside risk

2. The buyer is concerned that staff or clients may leave the business after acquisition or there is a commercial concern such as a pending contract renewal. An earnout would enable the buyer to protect against loss of value by building this risk into the pricing of the deal.

De-risking position

3. The seller may not wish to exit the business yet but would like to de-risk their position by taking some cash out of the business immediately and agreeing terms to exit the business completely at a point in t he future. The seller can be incentivised to continue growing the business with an earnout.

Incentive to growth

4. The seller is receiving a material sum of Initial Consideration and the buyer is concerned that they may lose interest in the business. They can therefore be motivated to receive a further material sum if they deliver growth in the business.

It is generally the case that a buyer will look to restrict the level of Initial Consideration payable on an acquisition as this helps to manage risk. The buyer may therefore be the more likely party to instigate a discussion about an earnout in their proposed deal structure, but example 3 above would clearly be a case of a seller either suggesting an earnout or being happy to include this as part of the deal structure.

Benefits

So the headline benefits are that earnouts enable deals to be structured which manage risk for an acquirer whilst offering the opportunity for a vendor to increase the value they receive for their business.

Some vendors form the view that the only true value they will ever receive for their business is the Initial Consideration payable on completion of the deal and anything which they receive from an earnout would be treated as a bonus. We would never share this view and this would be symptomatic of a poorly structured earnout.

A well-structured earnout should be rewarding for both the buyer and seller, so that they are both hoping the earnout payment will be maximised. Interests should be aligned to maximise the value of the business. This might sound unrealistic but it is absolutely true. If the acquired business sees an increase in profitability which results in the payment of an earnout, a correctly structured deal will ensure that the buyer has bought the business on better overall terms, even though the absolute price has increased.

Example

A deal is agreed where a business making £500k EBIT (Earnings Before Interest and Taxes) is acquired as follows:

- Multiple of 5 agreed
- 60% of consideration payable on completion (Initial Consideration)
- 40% of consideration payable after 12 months (Second Consideration)
- Earnout payable as £3 for every £1 growth in profits over £500k in first 12 months (Earnout)

Profits for the year following Completion are £700k – growth of £200k.

£ 000s	Initial Consideration	Second Consideration	Earnout	Total
On Completion £500k x 5 x 60%	1,500	-	-	1,500
After 12 Months £500k x 5 x 40%	-	1,000	-	1,000
Earnout £200k x 3	-	-	600	600
Total	1,500	1,000	600	3,100
Total Consideration Payable	-	-	-	*3,100*
EBIT	-	-	-	*700*
Actual Multiple Paid				*4.43x*

So the acquirer paid an earnout but reduced the multiple of profits paid for the business they own at the end of the deal to 4.43x EBIT.
The vendor has received £600k more for the business than the value agreed initially.

Pitfalls

Having touched on why earnouts feature regularly in deals, they are by no means a perfect solution. In fact an earnout is in many ways counter-intuitive and contradictory to the basic principles of an acquisition. The table below sets out some examples:

Objectives of an Acquirer	Impact of an Earnout
Integrate the acquired business with existing operations as quickly as possible	Vendor will require an element of control over the business to protect the earnout
May wish to invest for medium and long term growth	Vendor will oppose any expenditure which will reduce profitability during the earnout period
Will wish to have decision-making powers	Vendor will wish to be involved in decisions
May wish to cross sell services	Potential conflict over allocation of revenue and profits
May wish to allocate central overheads to acquired business	Resistance to any additional overheads during earnout period

If an earnout is poorly structured and the acquirer is determined to avoid having to make additional payments, they are likely to be causing conflict and reducing the value of the asset they have acquired. They may believe that this can be rebuilt after the earnout period, but this is unlikely and would require significant effort.

Care should be taken by vendors to ensure that they have adequately contractual protection during an earnout period. This can be one of the trickiest aspects of negotiating a deal and advice should be taken. The matters referred to above are not intended to be exhaustive but are illustrative of typical issue which arise.

In conclusion, earnouts will continue to be a common feature of acquisitions in the recruitment sector and care should be taken to ensure that the terms are correctly structured to ensure they work effectively and that both parties are genuinely committed to a successful earnout.

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We are practical, hands-on advisors who seek to add value in each and every transaction on which we advise and are proud to have been awarded "Best Corporate Finance / M&A Provider" at the 2019 TALiNT International Supplier Awards.

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