Ask a VR Intermediary

Greg Hedgebeth, Owner
VR in Cincinnati, OH

How Can an Earn-Out Strategy Resolve the Differences Between a Buyer and Seller?

In a business transaction, it's not uncommon for buyers and sellers to be worlds apart on a purchasing price. As publicized as they are, you will seldom see transactions involving mid-market and large companies, where a buyer can make use of publicly-traded stock. In most cases, it's a matter of an aspiring or experienced entrepreneur looking to purchase a small business, where the issue of how the sale will be paid for and where the funds will come from is always going to be present.

Buyers want to focus on past and present earnings and book value of a business, while sellers want to focus on future expected earnings. As a buyer, one way to satisfy both parties is to utilize the earn-out strategy.

An earn-out is a contingent purchase that allows a business sale to go through regardless of the obstacles that may be in place. In some instances, the seller's asking price is such that the sale can only be justified by the buyer at the levels of future earnings much higher than what they can realistically expect.

Earn-outs can be complicated to put together, but they are preferred under the following situations:

- The buyer lacks or has limited equity;
- The seller has very high expectations regarding asking price;
- The gap between the seller's asking price and the buyer's offer is significant;
- The purchase of a service business;
- Introduction of new products by the business;
- The seller is willing to remain with the business for two to five years.

One way of utilizing an earn-out formula as a buyer is to pay the seller one to two times the book value of the business at closing. Then, over a five-year period, pay the owners an additional percentage of Net after Tax. Based on the multiple of book value, the payment is then deducted out from the earn-out payment.

Coming to Terms

A big reason why the earn-out can work for both parties comes from the buyer agreeing to invest their capital in such areas as computer systems and marketing plans to help accelerate the N.A.T. A more aggressive pricing strategy can be formulated usually if the seller is willing to accept an earn-out arrangement.

The most common benchmark for earn-outs is a percentage of Earnings Before Interest and Taxed (EBIT) as well as stipulations that detail what major decisions will be made by the buyer and the seller and what changes will be allowed.

An earn-out helps quantify uncertainty, bridging the gap between the asking and the bid price as well as helping to motivate the seller during the period of transition. The seller must approve the initial down payment as compensation for the company.

Remember that earn-outs should be used only for offering solutions to genuine differences between the buyer and the seller, or when the seller's primary concern is to spread out income in taxable transactions with resulting tax benefits. Earn-outs will be successful only through the principals' creativity and ability to compromise.