Business Transaction Marketplace

Information about Business Valuations, Acquisitions, & Sales **September 2009**

Bridging the "Valuation Gap"

Business valuation is about assessing future operating cash flows. Buyers are buying it; sellers are selling it. In today's uncertain economy, it's no surprise that buyers are concerned about the future cash flows of the businesses they are looking to acquire. Sellers still seek to obtain the highest price based upon what they may see as a brighter future for their businesses. The result – a *valuation gap* in buyer and seller perceptions of business value.

In the March 2009 issue of *Business Transaction Marketplace*SM, we described three forms of non-cash consideration in business transactions – "earn-outs" being one of them. In this issue, we will discuss earn-outs is more detail as a tool in bridging the *valuation gap* in business transactions.

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Earn-Out Overview

What's an Earn-Out? An earn-out is that portion (generally 10-35%) of the purchase price for an acquired business that is contingent upon the acquired business achieving certain milestones during a specified time (typically 1-3 years) after closing. The contingent purchase price is "earned" when the acquired business achieves the milestone. If the milestone is not met post-closing, the buyer makes no earn-out payments to the seller.

Compared to Purchase Price Adjustments. Earn-outs are not the same as purchase price adjustments. Unlike earn-outs, a purchase price adjustment may *increase* or *decease* the purchase price. A discussion of adjusting the purchase price surrounding net working capital appeared in the February 2007 issue of *Business Transaction Marketplace*SM*.*

When Earn-Outs Bridge the V*aluation Gap*:

- Turnaround situations where the seller will likely argue that historical financial results are not an accurate measure of the value of the business; very common in today's uncertain markets.
- Businesses that have developed new products lines that have not been proven in the marketplace.
- Hot market sectors where a difference in perception of value exists.
- Entrepreneurial stage companies where the entrepreneur has an inflated perception of value.

Other Advantages:

- If the seller continues in the business post-closing as the seller-manager, an earn-out incentivizes the seller to continue to be involved in the business and facilitates the transition to the buyer.
- Provides the buyer with a form of acquisition financing by reducing the amount of consideration delivered at closing, and thus eliminating the costs associated with third party financing.
- An earn-out gives the buyer a source of offset for future indemnification claims.

Disadvantages:

- The seller-manager may not have sufficient control to manage the business post-closing in order to achieve the earn-out, particularly if there is not separate accounting for the acquired business.
- From the buyer's perspective, the earn-out arrangement may incorrectly motivate the seller-manager to focus on short-term goals, as apposed to a long-term integration strategy of the acquired business.
- Earn-outs create opportunities for disputes and litigation surrounding the interpretation of earn-out terms or the operation of the acquired business during the earn-out period.

Structuring Earn-Outs

Earn-Out Milestones.
Earnout payments are typically be based upon the business reaching post-closing financial milestones tied to one of the following “top down” income statement metrics: revenues, gross profit, EBITDA, pre-tax income, or net income. Because of control issues, sellers prefer the metric be towards the “top” of the income statement (e.g. revenues). On the other hand, buyers prefer the milestone be towards the “bottom” of the income statement in order to capture the costs associated in achieving the milestone.

Earn-out milestones can also be non-financial. For example, they could be tied to certain events like obtaining a patent, a new product launch, obtaining government approvals (e.g. FDA), reaching production levels, number website hits, number of new accounts, or the opening of a new territory.

Earn-Out Formula.
The earn-out formula describes how payments are to be calculated once the earn-out milestone is reached. Earn-out formulas often include the following:

- The percentage of the milestone that is paid to the seller.
- The cumulative dollar limit over the term of the earn-out.
- The earn-out period.

Agreements.
Here are some items to consider in drafting earn-out agreements:

- Define and describe what the expectations are of the buyer and the seller-manager during the post-closing operation of the acquired business.
- Provide a glossary that clearly defines milestone and formula terms, particularly generally accepted accounting principles (GAAP) as it is used in the post-transaction formula.
- Describe the post-closing accounting of the business acquired as a separate business segment.
- Spell out the tax consequences of the earn-out; i.e. additional purchase price or compensation.
- The security (if any) on payment of the earn-out, and if the earn-out is interest bearing.
- Require a third party CPA to calculate the earn-out, should the parties disagree on the calculation.
- Set the method of dispute resolution surrounding the earn-out agreement.

Marketplace Alert – SBA’s New Rules on Goodwill Financing

As was mentioned in the March 2009 issue of *Business Transaction Marketplace*SM, effective March 1, 2009, the Small Business Administration (SBA) put a cap on the financing of goodwill under the 7(a) program. The SBA changed these rules effective October 1, 2009 by the issuance of SOP 50 10 5(B), which provides the following guidance in the financing of transactions involving intangible assets:

- If a transaction includes $500,000 or less of intangible assets (including, but not limited to, goodwill, client/customer lists, patents, copyrights, trademarks and agreements not to compete), the loan request may be processed under the Preferred Lender Program (i.e. with a Lender having delegated authority to make the credit decision without SBA review of the loan).
- If the application includes more than $500,000 of intangible assets, then in order to use PLP processing, the borrower and/or the seller must provide at least 25% pf the purchase price in “equity”; equity being defined as any combination of borrower cash injection, plus seller financing that is on full stand-by for at least two years (i.e. no payments of principal and interest).
- If the loan amount includes more than $500,000, and the borrower/seller equity is less than 25%, the loan request may still be processed, but must be sent to the Standard 7(a) Processing Center, which requires SBA’s separate review and approval of the loan file.

Upcoming Darrell Arne Seminars

Succession Planning: Exit Planning for the Business Owner
Sponsored by: Pennsylvania Business Brokers Association
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Succession Planning: Exit Planning for the Business Owner
Sponsored by: International Business Brokers Association
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