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TECHNOLOGY ACQUISITION UPDATE

Six Keys to Successful Earnouts

More frequently, technology companies are selling early in their lives and earnouts are becoming more prevalent. Earnouts can be a flexible technique for bridging the price gap in an acquisition. This article discusses when to use an earnout, traps to avoid and six rules for successful earnouts.

Earnouts can be versatile tools for structuring acquisitions. An earnout may be a sensible way to bridge the price gap between what a seller thinks his company is worth and what the buyer is willing to pay. However, earnouts can put a strain on the new working relationship if not structured properly.

What is an earnout? An earnout is a mechanism in which part of the purchase price is contingent upon future performance. A typical earnout might include payments to the seller every year for three years based on a percentage of operating income that exceeds a certain threshold.

Why are earnouts used? Earnouts can bridge the gap when the buyer and seller cannot agree on price and terms. The parties often have different views about the degree of certainty of achieving future objectives. Earnouts allow the seller to receive full compensation for creating value, especially if much of the value has yet to be realized and the buyer is unwilling to pay the total amount up-front.

In the technology arena, many companies are acquired after they have created valuable technology, but before they have had time to prove that value in the marketplace, through revenues and profits. New technologies are often developed by small, innovative companies and sold to larger firms with the marketing resources and distribution channels to capitalize on the opportunity.

Technology acquisitions are often difficult to value because the profits and revenues may be minimal or nonexistent. An earnout may be a way to obtain a higher purchase price by proving the market value of their technology to the buyer. One drawback with earnouts in the technology sector is that they often tightly integrate technology acquisitions with the buying company, making earnout measurements more unwieldy.

Earnout discussions can be fruitful even if an earnout is not included in the final transaction structure. Exploring a possible earnout will flesh out many issues in more depth than might otherwise be the case.

Earnouts can provoke a number of questions, such as "What is the marketing budget for this division? Who will control spending decisions? What are the gross margin objectives? Are we sacrificing long term objectives for shorter term profits?" This discussion may bring the parties closer together on price.

When Earnouts are Appropriate

When should an earnout be used? Earnouts can be a good structure when the buyer and seller cannot agree on the price to pay for the upside potential of the acquired company. If a large portion of the value depends on future events, such as the completion of a product line, an earnout may be appropriate. Earnouts are most successful when the operating entity continues to be independent after the acquisition.

Earnouts should not be used when the operations are tightly integrated. It is too difficult to determine if objectives were achieved because of the entrepreneur's efforts or because of the buyer's salespeople, distribution channels or other assets. Earnouts should not be used when the new owner wants to operate the acquired business his way.

Structuring Tips

Earnouts can be based on revenues, operating income, development goals, or any number of factors. A good negotiator will uncover as much as possible about each side's risk preference, needs and motivations in order to structure an earnout that meets each party's objectives.

The performance goals should be obtainable, not pie in the sky. Gross profit is probably a better measure than net profit since it is less subject to non-operating influences. Graduated payments are better than an all-or-nothing scheme. The time frame for the earnout should be one to three years -- any longer than that and the mechanism becomes too burdensome.

Traps to Avoid

Definition problems can plague an earnout. How is operating income or profit calculated? How are net sales defined? Should depreciation or non-recurring events affect the measurement? What about technology that is only a small part of a product?

Most problems in earnouts stem from control and budget issues. The biggest trap to avoid is agreeing to an earnout without having sufficient control over the division and its marketing budgets. The entrepreneur must make sure that he will have full access to the resources needed to run the division, in both dollars and people. The marketing budget or development budget should be definitive.

Six Rules

1. Use easily measurable milestones. Revenues are easier to measure than profits. The payout should be directly associated with the performance of the acquired. Make sure the calculations for the earnout formula are straightforward. Complex calculations can muddy the water, create bad blood and take a manager's focus away from running the business. Keep it simple.

2. Management should have the operating freedom and the resources necessary to achieve their performance objectives. Management must have control over the division's operations.

3. Commit to a budget, especially a marketing budget. Be sure the needed resources are under the control of the manager.

4. Put a time cap on the earnout. At some point operations will become integrated and it will make sense to eliminate the trouble of earnout calculations.

5. Do not put a dollar limit on the earnout. This makes eminent philosophical sense, but in practice it can be difficult to overcome the emotional element in buyers who think "How could we pay that much for this company?" It is somewhat analogous to the salesman earning more than the president -- it makes sense but is a little hard to swallow.

6. And, lastly, try to structure the transaction without an earnout. Life will be much simpler down the road. There is enough to worry about in most high tech growth companies without compounding the problem with a complicated earnout structure.

The buyer can always add normal incentives, such as stock options and bonuses, as part of the employment agreement. One transaction we structured included an up-front payment in stock combined with an employment agreement that included a sizable bonus. The bonus depended one third on certain product development goals, one third on the performance of the division, and one third on the financial performance of the parent.

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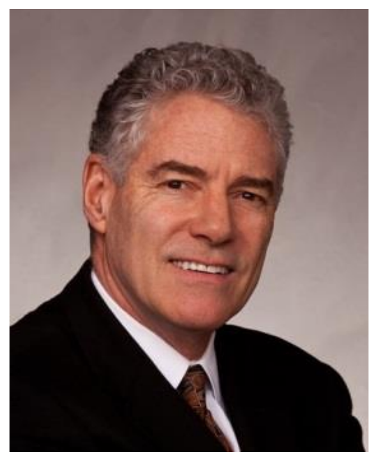

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Seattle, Washington
206-779-7707
www.tvmetz.com