

## A Guide to Earnouts – The Benefits and Pitfalls

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:

<b>Term</b>	<b>Explanation</b>
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. Some of the most common reasons are:

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.
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.
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 the future. The seller can be incentivised to continue growing the business with an earnout.
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.

£ 000	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
<b>Total</b>	<b>1,500</b>	<b>1,000</b>	<b>600</b>	<b>3,100</b>
<b>Total Consideration Payable</b>	-	-	-	<b>3,100</b>
<b>EBIT</b>	-	-	-	<b>700</b>
<b>Actual Multiple Paid</b>				<b>4.43x</b>

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:

<b>Objectives of an Acquirer</b>	<b>Impact of an Earnout</b>
<ul style="list-style-type: none"><li>• Integrate the acquired business with existing operations as quickly as possible</li><li>• May wish to invest for medium and long term growth</li></ul>	<ul style="list-style-type: none"><li>• Vendor will require an element of control over the business to protect the earnout</li><li>• Vendor will oppose any expenditure which will reduce profitability during the earnout period</li></ul>
<ul style="list-style-type: none"><li>• Will wish to have decision-making powers</li><li>• May wish to cross sell services</li></ul>	<ul style="list-style-type: none"><li>• Vendor will wish to be involved in decisions</li><li>• Potential conflict over allocation of revenue and profits</li></ul>
<ul style="list-style-type: none"><li>• May wish to allocate central overheads to acquired business</li></ul>	<ul style="list-style-type: none"><li>• Resistance to any additional overheads during earnout period</li></ul>

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.

**Philip Ellis - Director**

**Optima Corporate Finance**

107 – 111 Fleet Street, London EC4A 2AB

T: +44 (0)20 7164 6664

M: +44 (0)7973 625 211

E: [philip@optimacf.com](mailto:philip@optimacf.com)

W: [www.optimacf.com](http://www.optimacf.com)