MobileSolve

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Earnouts are commonplace in acquisitions, nevertheless they remain controversial. So how should earnouts be structured to avoid their potential pitfalls from the seller's point of view?

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MobileSolve is a boutique investment bank providing M&A, capital raising and financial advisory services to companies in the wireless and semiconductor industries.*

Each month we present a short article on an industry or transaction topic of current interest, and notable transactions in the wireless and semiconductor industries completed during the prior month.

This month's newsletter explains how to structure Earnouts and to avoid their pitfalls. We welcome your questions or comments.

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EARNOUTS: TREACHEROUS TERRITORY FOR SELLERS

*By **Steve Gaynor*** and ***Neeraj Baghel***

Earnouts are part of the structure of many transactions, especially acquisitions of emerging growth companies. Nevertheless, they remain controversial, especially among certain potential sellers who view them with suspicion as a way for buyers to avoid paying the full agreed price for the company. This article reviews the structuring of earnouts, and how to avoid their potential pitfalls from the seller's point of view.

Earnouts Defined

An earnout is essentially a financing arrangement that is negotiated as part of the purchase of a business. The seller finances a portion of the purchase price, and payment of that portion is contingent on achieving one or more predetermined performance benchmarks, often future revenues and/or earnings, or other measures that similarly capture the performance or value of a company such as free cash flow.

> The portion of the purchase price so financed varies widely, from ten percent to as much as forty percent of the total consideration to be paid. It is estimated about one-third of acquisitions of growth companies includes an earnout.

Unsurprisingly, buyers like them, especially for acquisitions of smaller technology companies, primarily for two reasons:

- If the acquired company fails to perform as hoped, and the earnout or a portion thereof is not paid, then the purchase price is automatically adjusted to a lower amount that is more nearly aligned with the company's current valuation; and
- The seller's management team is incented to stay with the company for the term of the earnout,

smoothing the transition of ownership and knowledge of the business, thereby reducing the buyer's integration risk.

Also unsurprisingly, sellers tend not to like earnouts, seeing them as treacherous territory replete with latent traps that will inevitably result in selling the company for a lower amount than agreed. They may be right in cases where the earnout is poorly drafted and does not work as originally envisioned. But to take a broader view, when properly done, earnouts may serve the purposes of sellers as well as buyers.

Advantages to Sellers

An earnout can play an instrumental role in attracting the attention of a buyer, and landing a deal. It does so in three ways:

Reduces the Buyer's Valuation Risk

It should be understood by sellers that uppermost in a buyer's thoughts while pursuing an acquisition are dozens of academic studies that demonstrate the performance of acquired companies in about two-thirds to three-quarters of announced M&A transactions involving public companies fail to meet the buyer's original expectations. Indeed, about half of announced deals ultimately result in a loss of value for the buyer's shareholders. From their point of view, the flexibility to have the purchase price adjusted downward if the acquired company's performance falls short is an inducement to make the deal in the first place.

Reduces the Buyer's Integration Risk

Acquisitions are driven by many reasons, and one of the more important is the potential for synergies; i.e., additional value created by combining the two companies. A successful integration is required to achieve them, and the continuance of the selling company's management team is crucial in that regard.

Sudden departures by senior executives can add to what is already an uncertain climate following an acquisition. Keeping them through a mechanism of receiving substantial payments on shares or options sold, and not just an employment contract, salary and new out-of-the-money options will mitigate the buyer's post-acquisition uncertainty, and induce reaching an agreement.

Demonstrates Confidence to the Buyer

A potential buyer uncertain of what she may be getting into when buying a closely-owned company will find a seller's willingness to consider an earnout highly appealing. It evidences confidence in the continued good performance of the company, and starts the all-important process of building trust between a buyer and seller who are tentatively planning to work closely together for at least the next several years.

In addition to the inducements to reach an agreement, an earnout may help close a gap between a seller's valuation goals and the amount the buyer is willing to pay. Negotiations that become stuck on valuation can possibly be closed with an earnout. Take the example of a seller who has a valuation expectation of $15 million, but the buyer thinks a purchase price of $12 million is more appropriate. The gap of $3 million might be bridged by an earnout. On top of the $12 million, the seller could get paid another $1 million per year, but only if a certain EBITDA target is achieved in each of the next three years following the sale.

Disadvantages to Sellers

The main disadvantage to a seller from an earnout is obvious; he may not receive the full purchase price originally bargained for, if the selected performance benchmarks are missed. And it is unfortunate, but there are unscrupulous buyers who will attempt to use earnouts to push on the seller all of the risk of the company's future performance, or even to use the earnout to acquire the company at a final total price below market. In other words, the risks of earnouts are real.

It is therefore incumbent on the seller and his financial advisor and attorney to tread warily in the treacherous territory of earnouts. Once they are offered to attract a buyer, to induce her to enter into an agreement and perhaps also to bridge a valuation gap, if necessary, they must be carefully structured to ensure in practice they work properly for the seller.

Structuring the Earnout

Proper structuring supported by the following steps will mitigate the risks to the seller inherent in an earnout.

Prepare Carefully for the Negotiations

Work with your advisor to develop three or five year projections for the business that you are comfortable with. The projections will provide guidance on the amounts related to the benchmarks that can be used to construct a favorable earnout. Don't merely extrapolate past performance; instead, be realistic about your backlog and sales funnel to determine the first couple years, and think through the industry trends that will affect the business in the later years of the business plan.

Keep the Formulas Simple

Anyone who has negotiated an earnout knows it is easy to begin the process thinking through all of the business goals and variables that should be accounted for without stopping at a reasonable place that can be understood by the parties, or even drafted by the attorneys. The inevitable result of such a process is an earnout formula too convoluted to be useful.

An earn-out formula is most effective when the determination of the payout to the seller is based on one or two simple variables. Such a structure is a better incentive because the goals and measurements are clear and easily calculated. This approach has the added benefit of shortening the negotiations and simplifying the resulting appendix to the purchase contract that governs the earnout.

Keep Control of the Earnout Variables

As a corollary to a simple earnout formula, be sure to control the variables that determine the earnout measurements. If one major variable is revenues, for example, make certain you control the marketing budget, and have some freedom to adjust it as may be necessary. If another is earnings in some form, you will likely need to control the full income statement.

In practice, this often works out to the seller running the business as before the sale. If so, the earnout contract should have the buyer's commitment to leave the business largely unchanged through the period of the earnout. An exception should be made for certain synergies, such as relying on the buyer for IT, accounting and other centralized services.

Other Earnout Considerations

"Ladder" the Payments: Create a graded payment structure, so the measurements that determine the payouts are proportional to the performance achieved. This will avoid getting no payment because the target was only slightly missed.

Balance Short and Long-Term Incentives: Earnout structures are naturally focused on measurable short-term goals. Doing so, however, may inhibit investment for the long term. Funding an acquisition or capital expenditures penalizes cash flow, which often is an important variable for determining the earnout payment. The proper solution is to agree in the earnout contract that acquisitions or R&D and extraordinary capital expenditures above a base line amount will be separate from the earnout.

Include Key Players: If other executives are integral to your company's success which led to the acquisition itself, and they almost always are, include them in the earnout so they stay with you through the contract period.

Create Contingency Plans: An earnout formula necessarily assumes the current state of the economy and industry will continue. Of course, that may not hold, and while every possible scenario cannot be accounted for, it is plausible to negotiate some kind of contingency such as a suspension in case an extraordinary event happens.

Buyer Covenants

In conjunction with the structuring, it is necessary, though tricky, to restrict the buyer's actions with respect to the acquired business during the earnout period. While the buyer may intellectually comprehend the need to protect the seller from unfair machinations, she may also understandably feel she has purchased the business for millions of dollars that are not the subject of the earnout, and should be free to manage the asset. Patient discussion may be required.

To protect the seller, the purchase agreement should include post-closing covenants that restrict the way in which the Buyer can operate the business during the earnout period. Such covenants might forbid these actions:

- Failing to continue to operate in the ordinary course of business;
- Conducting the business in a manner reasonably foreseeable to negatively and materially impact the business or its prospects;
- Changing the financial or accounting methods that would affect calculation of the earnout;
- Removing or selling assets ; and
- Terminating the employment of key employees.

Conclusion

Earnouts are widely used, but difficult to negotiate and draft in a purchase agreement. Although they appear to favor buyers, sellers can use them as well; in particular, to close a valuation gap and get a deal.

Once the decision has been made to use an earnout, the seller, financial advisor and attorney must work closely to ensure a simple, fair formula is used, and is articulately drafted in the purchase agreement. A standalone earnout agreement might be in order.

The buyer must, of course, also be comfortable with the earnout, and have a common understanding of the intent and meaning of its provisions. It is often best to negotiate an operating business plan for the earnout period to establish a base line from which future performance can be measured, and if necessary, exceptions made. With the principals of buyer and seller both participating in the negotiations, they will have a common understanding of the earnout contract which should serve to mitigate possible future disputes.

Source: MobileSolve Research

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Comments and Questions on the above articles are welcome.
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Transactions

The following are notable M&A transactions and capital financings announced or completed in the last month.

Notable **M&A Transactions**

Target	Target Industry	Acquirer	Transaction Value (in $ millions)	Transaction Highlights
Deep Forest Media	Mobile Ads	Rakuten	-	Deep Forest Media provides online and mobile advertising services
EAI Design Services	Wireless Solutions	ViaSat	-	EAI Design Services produce digital satellite communications, other wireless networking and signal processing equipment and products.
Feeney Wireless	Mobile Broadband	Novatel Wireless	49	Feeney Wireless is a full service systems integrator that develops and implements mobile broadband solutions.
Kili Technology	Semiconductor	Square	-	Kili Technology Corp is a fabless semiconductor company.
NAVX SA	Mobile Software	Oil Price Information Service	-	NAVX SA develops and markets mobile software applications.
Nexgen Wireless	Wireless Solutions	PCTEL	23	Nexgen Wireless, Inc. engages in the provision of software and engineering services for telecommunications.
Roundbox	Mobile Applications	QuickPlay Media	-	Roundbox provides mobile broadcast software solutions for mobile operators and handset manufacturers.
SugarSync	Mobile Cloud	j2 Global	-	SugarSync provides mobile cloud services.

Red Hot Labs	Mobile Gaming	Google	-	Google acquired Red Hot Labs, which provides infrastructure for mobile game developers.

Notable **Capital Financings**

Company Name	Industry	Amount Raised (in $ millions)	Total Amount Raised (in $ millions)	Business Description
Actelis Networks	Telecom Hardware	3	154	Actelis Networks provides ethernet over bonded-copper solutions.
AppsDaily Solutions	Mobile Apps	16	25	AppsDaily Solutions develops mobile phones applications.
Brite Semiconductor	Semiconductors	8	8	Brite Semiconductor provides integrated circuit design and ASIC solutions for electronics product customers.
Bugcrowd	Mobile Security	6	8	Bugcrowd provides crowdsourced security for mobile applications.
Char Software	Mobile Analytics	35	60	Char Software (Localytics.com) provides mobile usage data and analytics for the mobile market.
InAuth	Mobile Security	20	20	InAuth provides mobile security software applications to financial institutions.
Life On Air	Mobile Video	14	18	Life On Air (meerkatapp.co) operates an online mobile-to-mobiles live video platform.
Moonfrog Labs	Mobile Gaming	15	16	Moonfrog Labs develops and provides mobile games application services.
Remitly	Mobile Payments	13	23	Remitly engages in the provision of mobile money transfer services.
Snapchat	Mobile Messaging	200	814	Snapchat develops a text and photo based messaging application for mobile phones.
Vserv Digital Services	Mobile Ads	15	18	Vserv provides mobile advertisement applications.
XinLab	Mobile Video	-	35	Xinlab's Vuclip is the most widely-used mobile video search site in the world.
Xirrus	Wireless Networking	7	113	Xirrus, Inc. engages in the design and development of wireless networking equipment.

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