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WHAT'S IT WORTH?

For Business Owners, Corporate Officers, & Their Advisors

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Earnout Agreements Can Bridge a Valuation Gap

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Acquisition talks are proceeding smoothly. Then the subject of price comes up. The buyer thinks the seller’s asking price is based on overly optimistic financial projections. The seller believes the buyer’s valuation of his company is far too low.

Is the deal dead? Not necessarily. An earnout agreement may enable both sides to resolve the dispute and bring them back to the negotiating table.

Earnouts are helpful when a buyer and seller disagree about the seller’s business prospects. They can be especially useful when dealing with the unknown — for example, when the target is young and unproven, or when it’s emerging from a difficult financial situation. In short, earnouts offer a way for acquisition partners to bridge expectation gaps about the future.

Earnout benefits

In an earnout, a buyer makes a partial, upfront payment to the seller. With the payment comes a promise to pay the rest of an agreed-on amount if the target meets certain pre-established goals. Meeting these goals generally results in a higher price for the seller, while falling short of the goals may result in a lower price.

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A well-designed earnout carries advantages for both parties. For instance, the buyer can initiate a transaction with a relatively modest amount of cash. It can also avoid the risk of paying too much for a company unable to deliver on overly optimistic financial projections. Finally, an earnout can help make the transaction more valuable by significantly motivating the seller to achieve its promised results.

The seller, meanwhile, can use an earnout to help negotiate a better asking price. An earnout can be particularly helpful when the seller believes that the company’s future results are likely to be much better than its current ones.

Structure agreement solidly

Whether an earnout will succeed can depend on how well it’s structured. An ill-considered and vague agreement can turn a dispute over valuation into a dispute about the agreement itself.



A common problem is drafting an earnout that covers an inadequate period. When this happens, the seller may try to quickly boost its earnings, even at the expense of the company’s long-term financial health.

By expanding the earnout period, the buyer can collect more data to evaluate the target’s financial performance. Many experts say an earnout should reflect at least a year’s worth of results and perhaps as much as three years’ worth. Keep in mind, however, that the seller’s business becomes increasingly influenced by the buyer’s management — setting the stage for finger-pointing if the seller fails to meet the earnout’s terms.

It's also crucial to ensure the earnout includes the right measures of financial success. Gross sales figures provide one popular measure because they're more difficult to manipulate than net sales. Net earnings, though a good long-term measure, are subject to many variables and can be misleading over a short period.

Achieve consensus quickly

Even the best-structured earnout needs occasional monitoring. A good way to keep the agreement on track and minimize the potential for later disputes is to include a provision for periodic audits. The audits help reassure the buyer that the target is using appropriate accounting methods and operating its business professionally.

A poorly conceived earnout will fail to achieve a consensus between buyer and seller, who may interpret the same facts in vastly different ways. Thus, a well-designed earnout often includes a dispute-resolution mechanism, such as arbitration, which can be a less expensive alternative to litigation.



Do you own a business or advise a business owner? Contact Dave Moser to arrange a free valuation consultation.

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Meet the Valuation and Transaction Services Group

By: Dave Moser, Director Valuation & Transaction Services

I hope you have enjoyed our complimentary newsletter. **If you would like to add a client or friend to the distribution list, or join our monthly e-mail newsletter, please e-mail: dmoser@cj-pc.com** with "Subscribe" as the subject.

Our Valuation and Transaction Services team has over 60 years of combined experience involving more than 1,000 projects, and continues to be the largest and most experienced full time valuation group in East Tennessee. We understand the significant financial and emotional impact our services play in client's lives, and are excited to offer a full range of transactions services.

In addition to business valuations throughout North America and Internationally, we provide M&A advisory services for substantial private firms, as well as a host of real estate advisory services including: cost segregation studies, real property tax appeals, lease audit and negotiation, and feasibility analysis.

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David is a certified member of the American Society of Appraisers (ASA) and has over 38 years experience in the valuation profession. Before joining Coulter & Justus in 1996, he served as partner and director in charge of valuation with Ernst and Young and in management positions with two other international valuation firms. He has considerable experience in valuations, cost segregation studies, and as an expert witness.

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Renee has been valuing businesses full time for the past twelve years. She has valued businesses for purposes including estate, gifting, mergers and acquisitions, buy-sell agreements, purchase price allocations, bankruptcy, reorganization, and litigation. Renee joined Coulter & Justus, PC in 1999, is an Accredited Senior Appraiser of the American Society of Appraisers, a CPA, and is accredited in business valuation by the AICPA.

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Having closed several hundred thousand feet of real estate deals, Chris specializes in commercial real estate consulting, appealing real property tax assessments, and business valuation. Chris holds an MBA from the University of Notre Dame Mendoza School of Business, as well as the CCIM (Certified Commercial Investment Member) designation, and AVA (Accredited Valuation Analyst) designation.

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Sven has over 15 years experience in investment banking and business valuation, including mergers and acquisitions. He joined Coulter & Justus in 2003 and has an MBA with an emphasis in Finance from New York University's Stern School of Business and also holds the CM&AA (Certified Merger & Acquisition Advisor) designation.

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