Earnout

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What is an Earnout

An earnout is a contractual provision stating that the seller of a business is to obtain additional compensation in the future if the business achieves certain financial goals, which are usually stated as a percentage of gross sales or earnings. If an entrepreneur seeking to sell a business is asking for a price more than a buyer is willing to pay, an earnout provision can be utilized. In a simplified example, there could be a purchase price of $1,000,000 plus 5% of gross sales over the next three years.

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BREAKING DOWN Earnout

Earnouts do not come with hard and fast rules; instead, the payout's level is dependent on a number of factors, including the size of the business. This can be used to bridge the gap between differing expectations from the buyers and sellers. The earnout helps eliminate uncertainty for the buyer as it is tied to future financial performance. The seller also receives the benefits of future growth for a period of time.

Key Issues

There are a number of key considerations, aside from the cash compensation. This includes determining the crucial members of the organization and whether an earnout is extended to them. The length of the contract and the executive's role with the company post-acquisition are two issues that also have to be negotiated.

The agreement should specify the accounting assumptions that will be used going forward. Although a company can adhere to generally accepted accounting principles (GAAP), there are still judgments managers have to make that can affect results. For instance, assuming a higher level for returns and allowances will lower earnings.

A change in strategy, such as a decision to exit a business or invest in growth initiatives may depress current results. The seller should be aware of this in order to come up with an equitable solution.

There are legal and financial advisors that can assist with the process. The fee typically grows with the complexity of the transaction.

A Hypothetical Example

ABC Company has $500 million in sales and $50 million in earnings. A potential buyer is willing to pay $250 million, but the current owner believes this undervalues the future growth prospects and asks for $500 million. To bridge the gap, the two parties can use an earnout. A compromise might be to an upfront cash payment of $250 million and an earnout of $250 million if sales and earnings reach $1 billion within a three-year window or $100 million if sales only reach $600 million.

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