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SELLING YOUR TECHNOLOGY COMPANY WHY EARNOUTS MAKE SENSE TODAY

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The purpose of this article is to present earnouts to sellers of technology companies as a method to maximize their transaction proceeds. Sellers have historically viewed earnouts with suspicion as a way for buyers to get control of their companies cheaply. Earnouts are a variable pricing mechanism designed to tie final sale price to future performance of the acquired entity and are tied to measurable economic milestones such as revenues, gross profit, net income and EBITDA. An intelligently structured earnout not only can facilitate the closing of a deal, but can be a win for both buyer and seller. Below are ten reasons earnouts should be considered as part of your selling transaction structure.

1. Buyers acquisition multiples are at pre 1992 levels. Strategic corporate buyers, private equity groups, and venture capital firms got burned on valuations. Between 1995 and 2001 the premiums paid by corporate buyers in 61% of transactions were greater than the economic gains. In other words, the buyer suffered from dilution. During 2002 multiples paid by financial buyers were almost equal to strategic buyers multiples. This is not a favorable pricing environment for tech companies looking for strategic pricing.
2. Based on the bubble, there is a great deal of investor skepticism. They no longer take for granted integration synergies and are weary about cultural clashes, unexpected costs, logistical problems and when their investment becomes accretive. If the seller is willing to take on some of that risk in the form of an earnout based on integrated performance, he will be offered a more attractive package (only if realistic targets are set and met).
3. Many tech companies are struggling and valuing them based on income will produce some pretty unspectacular results. A buyer will be far more willing to look at an acquisition candidate using strategic multiples if the seller is willing to take on a portion of the post closing performance risk. The key stakeholders of the seller have an incentive to stay on to make their earnout come to fruition, a situation all buyers desire.
4. An old business professor once asked, "What would you rather have, all of a grape or part of a watermelon?" The spirit of the entrepreneur causes many tech company owners to go it alone. The odds are against them achieving critical mass with current resources. They could grow organically and become a grape or they could integrate with a strategic acquirer and achieve their current distribution times 100 or 1000. Six % of this new revenue stream will far surpass 100% of the old one.
5. How many of you have heard of the thrill of victory and the agony of defeat of stock purchases at dizzying multiples? It went something like this – Public Company A with a stock price of \$50 per share buys Private Company B for a 15 x EBITDA multiple in an all stock deal with a one-year restriction on sale of the stock. Lets say that the resultant sales proceeds were 160,000 shares totaling \$8 million in value. Company A's stock goes on a steady decline and by the time you can sell, the price is \$2.50. Now the effective sale price of your company becomes \$400,000. Your 15 x EBITDA multiple evaporated to a multiple of less than one. Compare that result to \$5 million cash at close and an earnout that totals \$5 million over the next 3 years if



- revenue targets for your division are met. Your minimum guaranteed multiple is 9.38 x with an upside of 18.75x.
6. Strategic corporate buyers are reluctant to use their devalued stock as the currency of choice for acquisitions. Their preferred currency is cash. By agreeing to an earnout, you give the buyer's cash more velocity (ability to make more acquisitions with their cash) and therefore become a more attractive candidate with the ability to ask for greater compensation in the future.
 7. The market is starting to turn positive which reawakens sellers' dreams of bubble type multiples. The buyers are looking back to the historical norm or pre-bubble pricing. The seller believes that this market deserves a premium and the buyers have raised their standards thus hindering negotiations. An earnout is a way to break this impasse. The seller moves the total selling price up. The buyer stays within their guidelines while potentially paying for the earnout premium with dollars that are the result of additional earnings from the new acquisition.
 8. The improving market provides both the seller and the buyer growth leverage. When negotiating the earnout component, buyers will be very generous in future compensation if the acquired company exceeds their projections. Projections that look very aggressive for the seller with their pre-merger resources, suddenly become quite attainable as part of a new company entering a period of growth. An example might look like this: Oracle acquires a small software Company B that has developed Oracle conversion and integration software tools. Last year Company B had sales of \$8 million and EBITDA of \$1 million. Company B had grown by 20% per year. The purchase transaction was structured to provide Company B \$8 million of Oracle stock and \$2 million cash at close plus an earnout that would pay Company B a % of \$1 million a year for the next 3 years based on their achieving a 30% compound growth rate in sales. If Company B hit sales of \$10.4, \$13.52, and \$17.58 million respectively for the next 3 years, they would collect another \$3 million in transaction value. The seller now expands his client base from 200 to 100,000 installed accounts and his sales force from 4 to 5,000. Those targets should be very easy to hit. If these targets are met the buyer easily finances the earnout with extra profit.
 9. The window of opportunity in the technology area opens and closes very quickly. An earnout structure can allow both the buyer and seller to benefit. If the smaller company has developed a winning technology, they usually have a short period of time to establish a lead in the market. If they are addressing a compelling technology gap, the odds are that companies both large and small are developing their own solution simultaneously. The seller wants to develop the potential of the product and achieve sales numbers to drive up the company's selling price. They do not have the distribution channels, the resources, or time to compete with a larger company with a similar solution looking to establish the industry standard. A larger acquiring company recognizes this first mover advantage and is willing to pay a buy versus build premium to reduce their time to market. The seller wants a large premium while the buyer is not willing to pay full value for projections with stock and cash at close. The solution: an earnout for the seller that handsomely rewards him for meeting those projections. He gets the resources and distribution capability of the buyer so the product can reach standard setting critical mass before another large company can knock it off. The buyer gets to market quicker and achieves first mover advantage while incurring only a portion of the risk of new product development and introduction.



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10. You never can forget about taxes. Earnouts provide a vehicle to defer and reduce the seller's tax liability. Be sure to discuss your potential deal structure and tax consequences with your advisors before final negotiations begin. A properly structured earnout could save you significant tax dollars.

Smaller technology companies have many characteristics that make them good candidates for earnouts in sale transactions: 1. High growth rates, 2. Earnings not supportive of maximum valuations, 3. Limited window of opportunity to achieve meaningful market penetration, 4. Buyers less willing to pay for future potential entirely at the sale closing and 5. A valuation expectation far greater than those supported by the buyers. It really comes down to how confident the seller is in the performance of his company in the post sale environment. If the earnout targets are reasonably attainable and the earnout compensates him for the at risk portion of transaction value, a seller can significantly improve the likelihood of a sale closing and the transaction value.

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