

MIDWEST BUSINESS BROKERS AND INTERMEDIARIES

BREAKFAST MEETING

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EARNOUT STRUCTURES

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A. Introduction

1. Appropriate for today's uncertain economic climate.
2. Addresses buyers' hesitancy of paying high prices without some assurance of future performance.
3. Appropriate for young, dynamic businesses with uncertain future prospects, especially service businesses.
4. Reflects the rise of intangible assets in deals.
5. Typically 10% to 25% of the purchase price.
6. Not appropriate when the target company will be quickly integrated into the buyer.

B. Definition of an Earnout

1. A performance-based component of the final price.
2. A variable pricing mechanism based upon the realization of certain predetermined parameters.
3. A method of triggering changes in the purchase price based upon future performance of the seller.

C. Parameters

1. Economic Milestones
 - a. Revenues
 - b. Gross Profit
 - c. Net Income
 - d. EBITDA
2. Buyer favored and seller favored
 - a. Sellers desire earnouts based upon the "above the line" earnings figures toward gross revenue since operating expenses and accounting determinations not in their control.
 - b. Buyers desire earnouts based upon "bottom line" earnings figures, toward net income.
3. Non-economic Milestones
 - a. New product launches

- b. Capacity utilization
 - c. New accounts
 - d. Website hits
 - e. Units produced
4. Time Frames
- a. Typically between one and three years.
 - b. Less than one year is a problem
 - (i) Seller chases numbers and revenue.
 - (ii) Lose focus on long term goals, such as credit of the customers and product quality.
 - c. Longer periods are problematic
 - (i) The performance of the acquired entity becomes increasingly based upon management of the buyer post-closing rather than pre-closing value.
 - (ii) Longer earnouts take on the attributes of debt or equity.
 - (iii) Less value in later years due to the time value of money.
5. Sliding scale payments based upon a percentage of milestones achieved.

D. Various Issues to Consider

- 1. Continued control
 - a. Management role played by seller.
 - b. Veto rights of seller on major decisions, such as hiring and firing and acquisitions.
 - c. Buyer wants to make ultimate decisions.
- 2. Buyout of Earnout
 - a. Normally a present value calculation
 - b. Seller desires this option upon a sale or merger, a change of control or the complete integration of the business into buyer.
 - c. Buyer desires this option to gain more flexibility over the acquired entity.

3. Independence of selling company
4. Accounting standards need to be defined
 - a. "GAAP consistent with past practices".
 - b. GAAP with adjustments to account for items such as bad debt reserves, inventory write-downs, capitalizations issues, depreciation methods and extraordinary items.
 - c. Allocation of overhead from buyer.
5. Competition by the buyer through know-how gained from seller or acquisition of similar businesses.
6. Audit rights of seller
7. Financial viability of buyer

E. Benefits of Earnouts

1. Spread some risk to the seller.
2. Creates incentive for seller and key employees to remain in place and commit to the business after the acquisition.
3. May result in more favorable tax treatment for the seller.
4. May help shorten the due diligence period.
5. Bridges the gap between the buyer's price which is based upon historical results and the seller's price which is based upon projected earnings.
6. Resolves difference of opinions on the valuation of the target.

F. Shortcomings of Earnouts

1. Prevents post-acquisition integration into buyer.
2. Complex definitions; may be difficult to administer.
3. Seller cannot leave the business.
4. May emphasize short-term profits over long-term growth.
5. Earnout payments generally accrue to goodwill.