By **Jerome M. Hesch** & **Nainesh Shah**

The Business Sale With an Earnout

Structure drives the valuation

The negative impact of the COVID-19 pandemic has exacerbated the risk of using only a fixed price for the sale of a business. Many businesses have experienced a significant reduction in revenue that reduced their current values. Therefore, in the COVID-19 era, the gap between a seller's asking price and the price a buyer is willing to pay is likely to be more pronounced than ever before. The seller typically feels that the business will return to its pre-COVID value in the short run, while the buyer typically feels that it may take far longer or that revenues may never return to pre-COVID levels.

When a buyer and a seller can't agree on the value of a business, the use of an earnout formula is a practical solution. Typically, the parties agree on a minimum value and use a formula to provide additional payments based on future performance (contingent consideration). Using an earnout formula for future payments may be the difference between consummating the sale or walking away because the parties can't agree on a fixed price. With an earnout, the optimistic seller can feel comfortable that the value for the business will exceed the lower amount the buyer feels the business is worth. Conversely, the pessimistic buyer doesn't risk that the value for the business may never achieve the seller's perception.[1] Ultimately, the earnout stream becomes the asset on the seller's balance sheet, transferable to another party or to a trust for gift tax planning.

Using the earnout solution, both the buyer and the seller can share the risks of underperformance and the benefits of overperformance. The contingent consideration payable to the seller is triggered if the business later achieves the milestones incorporated in the earnout formula. And the buyer's risk, absent a decline in value below the fixed prices, is eliminated.

Let's discuss the earnout solution in three parts. We'll first address, through an illustration, how the earnout can be used when a seller and buyer can't agree on the fixed purchase price. Earnout formulas are varied and complex and need to be custom designed to fit a particular business and the objectives of both the buyer and the seller.

We'll next address payoff metrics, payoff structures and payoff settlements and how they're relevant to valuation. More specifically, we'll explore the relationship between earnout design and what valuation method is employed.

Finally, we'll explain why the income approach is the proper valuation method for earnouts. Payoff risk, payoff structure and payoff settlements all involve different levels of risk. We'll discuss the importance of risk in choosing which income approach method to use (scenario-based method (SBM) or options pricing method (OPM)), explore the basics of earnout valuation drivers and discuss the methodologies that analysts use to value earnouts.

How It Works

Following is an illustration of how an earnout can be used when the seller and the buyer can't agree on a fixed purchase price. In such cases, the earnout protects the buyer from overpaying for the business because the post-sale performance determines the final amount paid for the business. Similarly, the

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seller shouldn't be short-changed if the business is as valuable as the seller believed.[2] Here's an example of how an earnout can work.

Example: Seller believes the value of the business is $12 million because of the potential for future growth. Seller's valuation is based on projecting an average of $1.2 million of net revenue using a 10x price-to-earnings (P/E) ratio. Not agreeing with Seller's assessment of future growth, Buyer believes the value of the business is only $8 million based on an appraisal that used a 10x P/E ratio and applied a 10% capitalization rate to the $800,000 of current earnings. The parties agree on a fixed $8 million. In addition, they adopt an earnout in which Buyer will pay additional annual payments over the next 10 years equal to 50% of all income in excess of $800,000.

As shown in "Payout Calculation," this page, the earnout increases the reward for Seller, while Buyer doesn't have to commit to additional payments if earnings never exceed $800,000.

Payout **Calculation**
As excess income increases, the seller earns more

Year	Net income	Excess income over $800,000	Earned payment to the seller
1	$900,000	$100,000	$50,000
2	1,000,000	200,000	100,000
3	1,100,000	300,000	150,000
4	1,200,000	400,000	200,000
5	1,300,000	500,000	250,000
6	1,400,000	600,000	300,000
7	1,300,000	500,000	250,000
8	1,400,000	600,000	300,000
9	1,500,000	700,000	350,000
10	1,600,000	800,000	400,000

— Jerome M. Hesch

It turns out that Seller's assumption that the business profit will increase to $1.2 million wasn't overly optimistic, and the profitability of the business even exceeded Seller's expectation. So Seller's feeling that the business should have been valued at $12 million was substantiated.

A successfully executed earnout, such as the one in our example, serves the best interests of both the seller and the buyer. The buyer ends up with a viable business for which the seller has received fair value. This alignment of interests is particularly relevant if the buyer needs the expertise possessed by the seller. With contingent consideration hanging in the balance, the seller may be incentivized to stay active in the business. The efforts of the industry/business-savvy seller in achieving the milestones triggering the contingent consideration also benefit the buyer, who wouldn't likely have reached potentially lucrative financial milestones without the seller's participation. (Parenthetically, the seller's post-sale involvement in the business may raise some problematic tax issues—such as the earnout capital gains or compensation for services—a discussion of which is beyond the scope of this article.)

> Correctly choosing the underlying earnout metrics is critical because it defines the earnout payoff risk.

The Complexity of Earnout Design

The preceding discussion lays out the benefits of an earnout structured business sale, which is particularly useful in the current COVID-19 era. Yet despite the conceptual attractiveness of earnouts, adopting the appropriate structure to achieve the proper valuation can't be understated. The earnout design used in establishing milestones is complex, and prospective sellers, buyers and their advisors should evaluate the design early in the negotiation process.

Once the sales contract has been executed and the sale of the business has occurred, the seller now has two valuable assets under the custom-designed earnout formula: (1) the right to fixed payments, and (2) the right to contingent payments. Because the earnout is a separate asset, the seller may now desire to use the earnout as part of the seller's estate plan. Therefore, it's necessary to value the earnout. A valuation of earnout is far more complicated than valuing the closely held family business that will be

transferred to a family trust using estate-planning techniques.

Payoff Metrics

Correctly choosing the underlying earnout metrics is critical because it defines the earnout payoff risk. Importantly, diversifiable and non-diversifiable risks associated with financial milestones are assessed differently. Financial milestones include the revenue or gross sales (usually favored by the seller), gross margins, earnings before income and taxes, earnings before interest, taxes, depreciation and amortization (EBITDA), net income or net profits (usually preferred by the buyer) and number of units sold and occupancy rate (applicable to hospitality or real estate businesses). The risk associated with those metrics is non-diversifiable as it relates to the broader economy and the market. For non-diversifiable risk, the discount rate includes the risk of achieving the metrics in addition to the obligor's risks.

Another complexity added to the earnout structure is the presence of multiple underlying metrics.

Non-financial milestones include regulatory approval (for example, Food and Drug Administration approval), contract execution, customer retention, future transaction closing and technical milestones (product launch, product development, software integration and finishing a construction project). These milestones reflect a diversifiable risk driving the discount rate for valuation.

Another complexity added to the earnout structure is the presence of multiple underlying metrics. An analyst must consider each metric's forecast and risk characteristic and the correlation among the metrics. When there are multiple underlying metrics, a Monte Carlo[3] simulation may be necessary. For example, a large software company buys a smaller design-related software company and agrees to pay the seller an extra $10 million if post-closing revenue exceeds $200 million and EBITDA exceeds

$70 million. Revenue and EBITDA are the underlying metrics in this case. Revenue and EBITDA are correlated, and, thus, the earnout probability changes due to this interrelationship. Generally, financial metrics tend to be correlated, whereas non-financial or milestone metrics aren't correlated.
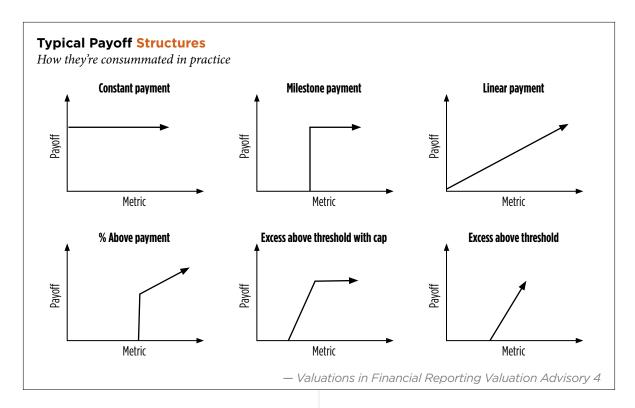
Payoff Structure

A simple payoff structure is usually linear and can be a fixed percentage of underlying metrics such as EBITDA or revenue. On the other hand, a complex payoff structure is a non-linear function of the underlying metrics. This type of payoff can have a minimum threshold, maximum cap, a tiered rate per unit of improved performance or a carry-forward provision such as linking one period to another. The payoff structure drives risk, degree of leverage and discount rate. Those characteristics, in turn, drive the valuation of the earnout payoff. "Typical Payoff Structures," p. 30, shows how these structures are consummated in practice.[4]

Also, note that the valuation of the earnout can change if the earnout is path-dependent; this can be problematic for an analyst's underlying valuation technique. For example, a paint manufacturer sells a business, and the buyer agrees to pay 50% of EBITDA over $50 million for the first year and 20% of EBITDA over $52 million for the second year, with an overall cap of $20 million for the entire earnout. In this case, due to the payment cap, Year 2's earnout depends on Year 1's earnout. As this example illustrates, path-dependency means that contingent payments in subsequent years are dependent on contingent payments made in earlier years. That is, if the Year 1 contingency isn't met, it may be impossible to meet subsequent year contingencies. Path-dependency can be affected by the time frame of an earnout—long or short and certain measurements based on single or multiple periods. Thus, path-dependency and other earnout characteristics that drive an analyst's underlying valuation technique can be problematic.

Payoff Settlements

Another complexity added to the earnout structure is various forms of settlements, for example, forms of payment other than cash, such as stock. Each type of settlement has its own risk and correlation with other

Typical Payoff Structures

How they're consummated in practice

— *Valuations in Financial Reporting Valuation Advisory 4*

metrics used in the payout structure. Although rare, a buyer or seller may have an open-ended payout structure allowing either the buyer or seller to choose between different ways to settle. In many instances, depending on how the choices are structured, a straightforward settlement can become more complex. For example, a large automobile dealership purchases a GM car dealership providing a 5% of EBITDA payment in each of the five years. Each year, the seller has the option to continue the payout arrangement or terminate the payout for a $500,000 cash payment.

Non-monetary considerations, such as transferring other assets, like the seller's stock, can further complicate the valuation. For example, settlements involving the transfer of the seller's stock can be either a fixed number of shares or a fixed dollar amount of shares. Whereas monetary consideration is quantitative, non-monetary consideration, for example, assets or stock, are susceptible to valuation swings that may drive the expected value of the business.

Which Valuation Method?

The earnout must be valued as a stand-alone instru-

ment apart from the perspective of the buyer, who may or may not be in the same industry or business as the seller. For example, a buyer in the same business or industry as the seller may evaluate risk differently from an investor such as a private equity firm or a hedge fund buyer. All synergies relevant to the payoff, including buyer-specific synergies, are relevant in valuing the earnout.

After assessing the payoff risk, payoff structure and payoff settlements, the next step is to determine the appropriate valuation method. For a fair market valuation, there are three approaches: (1) income; (2) market; and (3) cost. Because an earnout isn't driven by business assets and contingent consideration is non-marketable, the income approach is the appropriate one to use.

Within the income approach, the SBM and the OPM are the two most applicable methods for earnout valuation. In support of these methods, a Monte Carlo simulation or binomial lattice model can be used. Significantly, there's no single method that's appropriate in all earnout valuation scenarios.

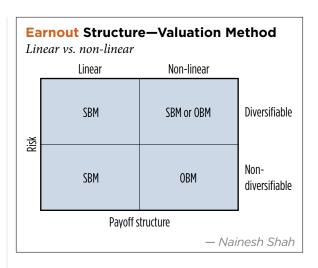The valuation process entails forecasting the

probability distribution of underlying metrics, the expected outcome, how the market participant diversifies risk and the discount rate mandated by the payoff structure. Also, it requires an understanding of leverage to underlying metrics. Additionally, any risk specific to the business post-acquisition should be included in the valuation calculation. For example, if a new product launch (which is a non-financial milestone) is used as an underlying metric, a potential buyer may be significantly more concerned with the product launch's volatility than the underlying business' volatility.

> A critical aspect in computing the discount rate is identifying whether the earnout metrics are subject to diversifiable risk.

Analyzing the Factors

Risk analysis. In applying the income approach, risk analysis is an essential factor in choosing the SBM or OPM model. If the risk is diversifiable because of product development milestones, SBM is the best method. SBM is also appropriate if the payoff structure is linear, for example, if it's a fixed percentage of revenue or EBITDA. On the other hand, OPM is ideal when the underlying metrics are subject to non-diversifiable risk, and the payoff structure is non-linear due to thresholds, caps or tiers. When the payoff structure is path-dependent, as in the carry-forward feature, catch-up provision or multi-year cap, either SBM or OPM is appropriate, depending on the individual situation. "Earnout Structure—Valuation Method," this page, shows the appropriate method to use depending on the diversifying ability of the payoff structure's risk and linearity.

Just as equity entails greater risk, the greater the company's level of debt (due to leverage), the imposition of a threshold on a non-diversifiable metric like revenue or EBITDA increases the riskiness of the earnout cash flow. Understanding discount rate when leveraged debt is involved isn't intuitive.

Earnout Structure—Valuation Method
Linear vs. non-linear

	Linear	Non-linear	
Risk	SBM	SBM or OBM	Diversifiable
	SBM	OBM	Non-diversifiable

Payoff structure

— *Nainesh Shah*

Therefore, it's difficult to determine the impact of the payoff structure on the discount rate in many real-life examples. This is the main reason for the use of an option-based valuation model.

Probability analysis. An important factor in valuation is probability. The payment or non-payment of an earnout is based on potential outcomes. Therefore, it's necessary to assess the probability of each earnout scenario coming to fruition. The analyst's risk and probability assumptions must be appropriate. The metrics forecasted for the business analysis and the earnout analysis should be consistent. There must be an understanding that the business valuation and the earnout valuation are driven differently. For example, an event such as a product launch or the creation of a new partnership may not impact the value of the business but may have a significant impact on the earnout value.

An earnout valuation incorporates probabilistic models and full probability distribution. Critically, in valuing the earnout, except for linear structures, the expected cash flow from earnout is usually not the same as the payoff associated with an expected value of the metrics. For example, an independent registered investment advisor (RIA) sells their practice to a mutual fund company. The earnout with payoff is any EBITDA over $5 million. The expected EBITDA for the RIA is $5 million, with a probabilistic forecast as shown in "Earnout Payoff,".

In the above example, the expected value of EBITDA is $5 million, but the earnout payoff's

Earnout Payoff
The valuation incorporates probabilistic models

Scenario	Probability	EBITDA ($ millions)	Earnout payoff (Max (EBITDA - 5), 0) ($ millions)
1	6.0%	$8.00	$3.00
2	11.0%	7.00	2.00
3	15.0%	6.00	1.00
4	37.0%	5.00	0.00
5	14.0%	4.00	0.00
6	10.0%	3.00	0.00
7	7.0%	2.00	0.00
Expected value	100.0%	5.00	0.55

EBITDA: Earnings before interest, taxes, depreciation and amortization

— Nainesh Shah

expected value is $0.55 million and not zero.

Discount rate. A critical aspect in computing the discount rate is identifying whether the earnout metrics are subject to diversifiable risk. An earnout with diversifiable risk includes non-financial metrics such as regulatory approval, legal disputes, a construction project, software integration or new product development. In such a case, the required rate of return is the risk-free rate plus the counterparty risk. However, earnouts employing metrics directly connected to financials such as revenue, EBITDA, number of units sold and rental occupancy rates, use the Capital Asset Pricing Model to calculate discount rate.[5]

The risk of the payoff structure may affect the discount rate if the metric is non-diversifiable. Usually, in simple earnouts with a linear payoff, the risk is the same as the underlying metrics. In contrast, the risk can diverge significantly from the underlying metrics in a complex earnout structure with a nonlinear payoff. Also, in an earnout with nonlinear payoffs, the time remaining until the payoff impacts the risk and the discount rate.

The issue of determining the impact of the payoff structure on the discount rate in many real-life examples can be resolved by removing the non-diversifiable risk from the cash flow and calculating the risk-neutral framework valuation. The risk-neutral framework is instrumental in arriving at the required metrics risk premium.

In the final analysis, assessing probabilities, risk and discount rates come together in determining the valuation of the earnout.

Bottom Line

In this COVID-19 era, earnouts are likely to be more prevalent than ever before in the sale of businesses. The payoff risk, payoff structure and payoff settlements associated with earnouts involve different levels of risk. The assessment of these risks is essential to the valuation of the business. Because earnouts aren't asset-based and lack the marketability of contingent consideration, the income method is the appropriate valuation method. Using an SBM or OBM, the two main methods used in earnout valuation depend on the risk-diversifying ability and payout structure of the earnout. Due to the complexities outlined in this article, including valuing the earnout as a separate asset for estate-planning purposes, advisors should actively engage with clients early in the earnout design process.

Endnotes

1. The following articles evaluate the income tax issues that need to be addressed in structuring the earnout: Jerome Hesch and Stephen Breitstone, "Aligning Interest in the Sale of a Business: Financial and Income Tax Traps Estate Planners Need to Know" (Part 1), 35 *The Practical Tax Lawyer* 13 (May 2021); "Aligning Interest in the Sale of a Business: Financial and Income Tax Traps Estate Planners Need to Know" (Part 2), 35 *The Practical Tax Lawyer* (forthcoming September 2021); Jerome Hesch and Stephen Breitstone, "A Financial and Income Tax Analysis of Earnouts," 58 *Tax Management Memorandum* 42 (Jan. 23, 2017).
2. If the seller remains associated with the business, an earnout can induce the seller to ensure the business's continued success.
3. Monte Carlo simulation performs risk analysis by building models of possible results by substituting a range of values—a probability distribution—for any factor that has inherent uncertainty. It then calculates results over and over, each time using a different set of random values from the probability functions.
4. The Appraisal Foundation, "Valuations in Financial Reporting Valuation Advisory 4: Valuation of Contingent Consideration," *https://appraisalfoundation.sharefile.com/share/view/sbbc7740b2294701b*.
5. Discount rate can be calculated in multiple ways depending on data availability.