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Earn-outs

In this article we explore so called “earn-out” deals: what they are; why they are used in private M&A transactions in the advertising and marketing industry; and some of the issues that they pose for both buyers and sellers.

What is an earn-out?

An “earn-out” deal is a transaction where all (or more usually part) of the consideration a buyer pays for a business is paid out after completion. Under an earn-out deal, a buyer typically pays some cash up-front, but the rest of purchase price is deferred and contingent on the future performance of the business.

The deferred payments are commonly based on some measure of the target’s future profit (such as earnings before interest, tax, depreciation, and amortisation or “EBITDA”). But they can also be based on revenue or any other type of commercial target, such as sales volumes.

Why use an earn-out?

Earn-outs are sometimes used where the value of the target business is hard to determine (e.g., because it’s a start-up with limited trading history and/or assets, but potential for high growth). However, they are popular in the advertising and marketing sector as the targets are “people” business – a large part of the value is often wrapped up in the founders/management team themselves and their relationships with key clients. A buyer therefore wants to incentivise and retain any key seller-managers for a set period, to ensure a smooth transition and integration of the target into its own business.

Benefits of earn-out deals

An earn-out deal offers several benefits for a buyer. It allows it to “test” its valuation of the target, protecting it from over-paying. It may also deliver cash-flow benefits – if the buyer doesn’t need to fund 100% of the purchase price upfront it may not need to borrow as much (if it is using debt funding) or it may allow it to utilise the cash it would otherwise have spent elsewhere.

And while these are benefits for a buyer, some may also be in sellers’ interests. Precisely because an earn-out allows a buyer to test its valuation, that may maximise the (potential) price a buyer is willing to pay (if it were paying 100% of the price upfront, it may otherwise discount for risk).

Problems with earn-out deals

The main problem with an earn-out deal is that it prevents the parties from achieving a “clean break”. It creates an immediate tension between the sellers (who will want to manage the target as they see fit during the earn-out period, to maximise their deferred payments) and the buyer (which will also want to manage the business as it sees fit from completion, in line with its overall strategy). It is this tension which can make an earn-out deal a lot more time-consuming and expensive to negotiate than a deal with a fixed upfront payment.

In particular, from the sellers’ perspective, if they sell 100% of the business on completion, they will be completely reliant on the contractual protections in the transaction documents to give them the control(s) they want during the earn-out period. Without such protections (often called, unsurprisingly, “earn-out protections”) a buyer would otherwise be able to take any action(s) it wanted to after completion, even if such actions(s) may impact the value of the deferred payments.

Earn-out deals are also, by their very nature, require post-completion measuring and monitoring, which further increases the time and cost (and the scope for post-completion disputes). And they are complex from a tax perspective (see “Tax” below).

Key negotiating issues

The key issues for the parties to negotiate in an earn-out deal are:

- what the performance criteria will be;
- how such metrics will be measured;
- how many payments there will be/how long the earn-out period will be;
- how the payments will be agreed; and
- how the business will be conducted during the earn-out period.

As noted above, the performance metric will typically be financial – often based on a multiple of earnings. However, it is often not straightforward to define the financial metrics,

which may well need be subject to a range of specific, contractual, accounting policies. For example, it might be easy to agree that that one-off, exceptional, items, which would otherwise distort the underlying profitability of the target (such as the disposal of substantial asset, for example) should not be included. But it might more complicated if the target is joining a large group and the buyer requires it to sign up to all the group's services, such as shared accounting, HR and legal services. If such services are more expensive than the target's current costs, then the sellers are likely to want a cap on these costs, so that the target is not forced to increase its outgoings (depressing its profits and therefore the earn-out payments). And if any such services constitute a cost which the target is *not* currently incurring, then the sellers are likely to insist such cost be excluded altogether for the purposes of the earn-out accounts.

Earn-out measurements range from the simple (paying out a percentage of profits achieved, for example) to the complex (such as a mechanic tracking the target's compound annual revenue growth rate against its earnings, and applying an earnings multiple based on a sliding scale). The more complex the measurements, the more time will likely be spent on the drafting and negotiating of such mechanics.

Earn-out periods in UK advertising and marketing M&A deals are typically around three years; however, they are sometimes longer (particularly where they are very high value). Sellers are likely to favour shorter earn-out periods, so they can cash-out more quickly; buyers are likely to favour longer ones, so they can test the valuation over a longer period.

The mechanics for agreeing the earn-out payments will, in the case of financial metrics, necessarily involve the preparation of accounts. If the earn-out period(s) can be made to align with the target's statutory accounting periods, then the parties may be able use the statutory accounts as the base for the calculation of the earn-out payments; if they cannot, then special purpose accounts will be required. Either way, the transaction documents will need to provide for preparation of the accounts (and who bears the cost); a period for the receiving party to review them; and a dispute resolution mechanism if the parties cannot agree on the final figures.

Finally, the conduct of business during the earn-out period is often one of the areas which can take up a significant amount of negotiating time, due the tension between the parties' conflicting interests, noted above. As such, these provisions are often quite lengthy and set out in a separate schedule to the share sale and purchase agreement. Assuming that the buyer is willing to let the sellers manage the target on a day-to-day basis, where a buyer has purchased all (or a majority) of the target's shares, it will almost certainly take a majority of the seats on the target's board. The sellers will therefore typically want to negotiate a wide range of contractual earn-out protections, to protect the value of their earn-out payments.

These might range from placing a general obligation on the part of the buyer not to undertake any action(s) with the object of avoiding or reducing any of the earn-out payments, to more specific restrictions, preventing the buyer from, during the earn-out period: removing any of the sellers (or other key managers) as directors and/or terminating their employment (other than for cause); forcing the target to incur costs (such as hiring expensive new seniors staff) which would otherwise have the effect of depressing the target's profits (thereby reducing the earn-out payments); and transferring key client accounts from the target to another entity in the buyer's group (which would again depress the target's profits and reduce the earn-out payments).

Tax

Earn-out deals are complex from a tax perspective. When sellers sell their shares in a company, they are normally expecting to pay capital gains tax or "CGT" on their sale proceeds (at the standard rate of 20%, for higher rate taxpayers). A tax relief called Business Asset Disposal Relief or "BADR" (formerly known as Entrepreneurs' Relief) may also be available for lifetime gains of up to £1m, subject to various conditions, reducing a qualifying seller's CGT rate to 10%.

However, capital treatment is by no means guaranteed and professional tax advice is essential on an earn-out deal, to minimise the risk of any earn-out payment(s) being treated by HMRC as income (and therefore taxable at much higher rates – at the time of publication 40% for higher rate taxpayers, and 45% for additional rate taxpayers). We consider the taxation of earn-outs in "Tax issues on Earn-outs" in this series.

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