HOW AN EARN OUT CAN IMPACT THE SALE OF YOUR BUSINESS

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How an Earn Out can impact the sale of your business

By Bob Cohen and Sam Sacco

Some friends with the best of intentions who have sold their business in previous years may advise you to get as much as you can for your business for as long as you can and others will say get as much as you can up front because you may never see any more money down the road. Granted, these are fairly extreme positions, so how do you decide what is best for you.

Selling your staffing business may be the single largest transaction of your career. And there is no dress rehearsal. Most business owners have only one opportunity to sell a business, so it’s important to get it right.

WHAT IS YOUR RISK TOLERANCE?

Generally speaking, in a transaction buyers want to share risk going forward and sellers fear risk sharing without control. Buyers are cautious when sellers who know far more about their businesses than the buyer knows are reluctant to share future risk. Sellers fear that buyers will bring about changes in their business that may make it difficult for the seller to collect on that shared future.

How do these seemingly polar opposite views meet? The answer lies in that space where transactions take place, somewhere in the middle.

When either party or their professional advisors try to eliminate all risk going forward, deals do not get done.

METHODS OF SHARING RISK

Sharing the risk in a transaction could involve an Earn Out as part of the deal. An Earn Out is a contingent payment based on the future performance of the business. It could be for 1-3 years and it will be typically based on attaining a pre-determined level of achievement typically of gross profit dollars or earnings.

Another form of risk-sharing could involve notes, which are promises of future payment(s) not contingent on performance and typically carrying an interest rate. The value of the note is totally dependent on the financial strength of the buyer.

If the buyer has a strong Balance Sheet the likelihood of the seller receiving payment of the note is very high so the risk of accepting a note in this case is very low. If the buyer does not have financial strength the risk of accepting their note is much higher for the seller.

Stock is less often used as a currency in transactions these days than in the mid-late 1990's when stock was widely used as an element to fund acquisitions.

As experienced Staffing Industry Advisors we are often asked by Sellers how they can maximize the proceeds they receive on the sale of their business.

SHARE THE RISK

The simple answer is to share the risk going forward with the buyer of your business. However, how that risk is shared can make all a huge difference in the total proceeds the seller receives. Finding that middle ground where both buyer and seller have a tolerable level of risk will allow the deal to move forward.

SELLERS PREFER CERTAINTY

Many Sellers' of staffing firms would prefer to receive all cash at closing from a buyer. Certainly this would be nice and clean, if such a structure was available, however the value of the proceeds would be significantly reduced by the amount of risk the buyer is accepting at closing.

In a deal with all cash at closing, the seller is transferring 100% of the business risk to the buyer upon closing the transaction. In order to induce the buyer to accept all of the risks going forward, the seller will be required to accept a deeply discounted value for their business in order for the buyer to have a significantly improved upside to compensate for their increased risk.

So even if all cash at closing is used it will generally be for a much lower value.

BUYERS PREFER RISK SHARING

Buyers would also prefer certainty however they understand that we live in an uncertain and volatile world community. Sellers in many markets who sold prior to 9-11 locked in a value unavailable for several years after those tragic events. Our world in general and business in particular has never been more uncertain and more influenced by events far beyond our control.

Most buyers' today are reluctant to offer all cash at closing transactions as their preferred model for acquisitions. The vast majority of buyers we encounter will not consider any deal without some risk sharing going forward.

There are of course exceptions, often when a buyer believes they will be using the base of business acquired as a jumping off point and the business will grow primarily from the buyer's investment in additional staff, marketing or technology, the buyer in this case prefers retain the upside potential of the business. However, buyers of is type are rare in today's market.

The hard earned acquisition lessons of the past five to eight years have caused more acquirers and their lenders/shareholders to insist on more risk sharing on deals to get approval for those transactions from the holders of the purse strings.

Buyers are applying lessons learned to ensure they make better transactions in the future. More attention is being paid to cultural fit and integration issues and a great deal more sensitivity is being applied to the human side of the equation.

Successful staffing businesses are based on relationships between customers and the staff of the service firm. Allowing those relationships to blossom further has been a key ingredient for successful transactions. More and bigger is not always better in the customer's eyes; acquirors that have learned to move slowly in introducing their services have been more successful in strengthening those relationships than buyers who impose change because "it is better for them" do.

However, where legal compliancance dictates change, buyers who do it as fast and as painlessly as possible have the easiest transitions.

Buyers have learned the hard way that if they "blow up" the acquired business they will not get approval for future transactions.

They have realized that it makes no sense to impose their style of business upon the acquired company's customers if the end result creates a poor return on their invested capital. Such moves have harmed many a career, some fatally.

SELLERS NEED TO ACCEPT SOME RISK TO MAXIMIZE PROCEEDS

Sellers unwilling to accept a reasonable level of risk in a transaction will have a difficult time selling their business in today's environment. Understandably, risk tolerance is defined by the eye of the beholder. One seller's risk level accepted may seem too high for another seller's comfort. Other sellers believe in their business, their staff as well as the buyer and their ability to succeed even more with all of the buyer's resources available to them in the future.

The key may be to carefully examine what level of risk you can handle and then minimize the risk factors as much as possible and practical.

It stands to reason that the more risk you accept the greater the payout you should receive. Buyers are generally comfortable paying for everything they receive, they just don't want to overpay up front and spend many years trying to get a return on their invested money.

An experienced staffing industry M & A Advisor can help you to determine your risk tolerance and match you with an appropriate buyer.

Sellers need to consider what buyers have learned the hard way, suitability and style compatibility determines the ultimate payout on a transaction. Sellers do themselves a disservice focusing too much energy solely on the multiple.

The only issue that matters is what you can successfully collect on the proceeds of a transaction –that is how many after-tax dollars you ultimately receive not some moving target multiplier.

Take some risk to get a deal done and to maximize your proceeds for your business. Look for a win-win situation.

Sam Sacco and Brian Kennedy operate R.A. Cohen Consulting, a trusted M&A Advisory service that caters exclusively to the staffing industry. Since 1991, we have advised on hundreds of successful transactions.

Call us at 910.769.4057 or 416.229.6462 respectively.

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