



# INSIGHT

## Beauty is In the Eye of the Beholder

*When sellers and buyers differ about the value of the seller's company; earnout structures may be used to bridge that value gap.*

by Mark Working and Michael Newsome

**S**ellers have an advantage over buyers in terms of knowledge about their business and its prospects, potential, and risks. Sellers tend to be flush with confidence and expect that future results are already "in the bag." Naturally, buyers are skeptical about early stage business initiatives and leery of underestimating potential risks. The value of a business is the present value of its future *expected* cash flows. Therefore, the disparity between buyer and seller expectations regarding future prospects is often at the root of any value gap in sale negotiations.

When conflicting expectations emerge, the parties have two choices. Wait, as the future unfolds one way or another, or craft a structure, known as an earnout, that allows for the possibility of additional compensation if the seller's expectations of future performance are realized. Earnout structures are commonly used to span a value gap and complete transactions, but they do not assure that either or both parties will get what they bargained for.

### WHAT IS AN EARNOUT?

In essence, an earnout represents a contingent component of the total purchase price, together with a set of rules or a formula against which future performance will be measured in order to determine if and how much additional compensation will be owed. The seller believes that the earnout will result in a greater purchase price when the future is known. The buyer takes comfort in knowing that if the seller's rosy view is not realized, he has not overpaid. Conversely, if the seller's expectations are achieved, then a higher value for the business is justified.

### STRUCTURAL CHALLENGES

As appealing as an earnout can be conceptually, in practice, the devil is in the details. The challenges inherent to crafting an earnout begins with isolating the specific differences in future expectations between

### IN WHICH DIRECTION IS THE NW ECONOMY HEADED?

In an earlier issue of Insight this year, we noted unmistakable signs of robust business demand and investment and thought that capital would be readily available to support new initiatives. Since we last put in our two cents, many of the indicators that are used to monitor the day-to-day pulse of the economy haven't budged. The public equity markets have pretty much been treading water since the first of the year. Likewise, long-term (10-yr) Treasury bond yields have fluctuated in a relatively narrow band. At the same time, job creation reports have been tepid, the tech sector has missed profit estimates, and oil prices remain high.

The situation is a bit puzzling as much of the economic data that is being closely watched in an extraordinarily political year does not match up with the apparent mood of consumers, small businesses, homebuilders, and CEOs. Recent surveys of each of these groups paint a bright future for the economy. If business leaders are accurately assessing business activity, the economic news will turn up in the near future. Indicators such as record backlogs in the technology sector, high levels for capital spending and hiring plans of small businesses, and the new high in the home builder market index in August lend credence to the optimism.

We certainly don't style ourselves as skilled macro-economic analysts - amateur tea leaf readers is more apt. What we do observe is that business credit demand is up, competition among lenders is fierce, and pricing and terms are generous. Without hesitation, it is a great time to be a borrower. ♦

the two parties and applying the most appropriate economic metrics for measuring those disparities.

Sellers are interested in making sure that the new owners make every effort to achieve the earnout as quickly as possible, and have the wherewithal to make any payments. So, issues of liquidity and collateral are usually part of the negotiation. Sophisticated sellers are also concerned about the integrity of the earnout measurement system to protect against buyer efforts to manipulate the numbers to minimize or avoid payment. On the

.....  
**As appealing as an earnout can be conceptually, in practice, the devil is in the details. The challenges inherent to crafting an earnout begin with isolating the specific differences in future expectations between the two parties and the best metrics for measuring those disparities in economic terms.**  
.....

other side, the buyer really doesn't want to make future payments and is concerned that the earnout may negatively impact business strategy and/or financial flexibility. In the end, all differences relate to future performance (cash flow), but grow out of specific cost or revenue issues:

- Operational improvement initiatives are expected to result in lower costs, but are not yet evident.
- A key customer relationship is perceived to be either in jeopardy or not yet fully developed and business performance may vary depending on how the relationship progresses.
- A new product / service has been introduced, but success remains unproven.

As an example of the challenges, we are aware of a situation in which a key salesperson unexpectedly left the firm shortly before a sale transaction was scheduled to close.

This put several important customer relationships in jeopardy. As a consequence, the deal was renegotiated and a meaningful portion of the price was allocated to an earnout. At the outset, the negotiations focused on compensation for the sales and gross margins specific to the at-risk accounts. In order to get a deal done, it proved necessary to work out a simpler arrangement that called for additional payments if total revenues exceeded an agreed threshold over a three-year period. The negotiation of the fine points of the earnout spanned several weeks and numerous drafts as the seller tried to assure that the buyer could not circumvent the spirit of the agreement, while the buyer fought to make sure that its flexibility to manage the business was not impaired. In the end, both parties were worn out and frustrated—ostensibly, the hallmark of a “fair” deal. The earnout was by far the most difficult aspect of the deal.

**THE LAW OF UNINTENDED CONSEQUENCES**

Earnouts are risky for both parties for a host of reasons, not the least of which is that a business is an organic entity operating in a dynamic, ever-changing environment. All of the factors and forces that will bear on a business in the future cannot be anticipated. Earnouts work best when based on a simple set

.....  
**Earnouts are risky for both parties for a host of reasons, not the least of which is that a business is an organic entity operating in a dynamic, ever-changing environment.**  
 .....

of variables, where the interactions among those variables are static. Unfortunately, the business environment isn’t static, and no formula can anticipate all possible outcomes.

Often, well-intentioned earnout formulas end up being frighteningly complex and invariably create unanticipated and abnormal economic incentives in the business.

**Specific Cost or Revenue Issues Related to Future Performance**

---



Operational improvement initiatives are expected to result in lower costs, but are not yet evident.

---



A key customer relationship is perceived to be either in jeopardy or not yet fully developed and business performance may vary depending on how the relationship progresses.

---



A new product / service has been introduced, but success remains unproven.

In the aforementioned example, unintended consequences surfaced after the deal closed. The business struggled a bit during the economic downturn as sales dropped off and margins tightened. For the first year, no earnout payment was required. Then, a revamped sales and marketing effort began to generate real success as the economy rebounded. Unfortunately, in a highly competitive market, margins never returned to the historical norm. The company now faces the quandary of robust demand for its products and the need to respond with additional capital investment. At the same time, the return from incremental sales (after earnout payments) does not justify further investment.

The company is in the unenviable dilemma of choosing to either step on the brakes with regard to growth in spite of surging momentum, or eroding long-term shareholder returns with additional purchase price obligations. On the other hand, the seller is faced with a potential loss of value due to the incentives to limit growth and some concern about the ability to pay any future obligations that are created.

**CONCLUSION**

One or both parties to an earnout may end up disappointed with the final outcome, which can spark fingerpointing and even litigation. Yet, so long as both parties recognize the risks inherent in predicting the future, a well-conceived earnout can allow a deal

.....  
**Bottomline, if a seller gets a little more or less than expected and a buyer pays slightly more or less than his value target, then the earnout mechanism did a reasonable job. No greater precision can be expected.**  
 .....

to occur that would not happen otherwise. The keys to a workable earnout and avoiding lasting brain damage are to keep it simple, short and measurable. In the final analysis, an earnout may be the best (albeit imperfect) way to match the risk/return attributes of both the buyer and seller. Bottomline, if a seller gets a little more or less than expected and a buyer pays slightly more or less than his value target, then the earnout mechanism did a reasonable job. No greater precision can be expected. ♦

## Personal Guarantees Build Character

*Personal guarantees seem a simple and easy way to achieve financing for your business, but when the guarantee involves millions of dollars the implications should be closely considered.*

by Mark Working

If ever there were a daunting legal document, the bank’s standard personal guaranty form would qualify. Based on even a minor technical default, it permits the lender to turn to the guarantor and demand repayment of the loan. When the guaranty covers millions of dollars of business borrowings, the personal implications to the guarantor can be alarming. The personal stock portfolio, children’s inheritance, family home, and even the retirement nest egg can be at risk. Even if signing on the bottom line is a necessity to

obtain business financing, the potential downside demands your attention.

And, that usually is the point. Although in some cases, the guaranty is designed to provide additional financial support, more often than not, the primary purpose is to align the interests of the owner/manager with those of the bank.

**THE THIRD “C”, CHARACTER**

Early in one’s career, the “the three C’s of credit”—Cash Flow, Collateral, and Character—are drilled into the heads of most

bankers. The risks associated with sustaining adequate cash flow entails quantitative and qualitative analyses of the business plan, the industry, the competitive environment, and a variety of other internal and external variables. Collateral adequacy boils down to an assessment of the value of the business assets under distressed circumstances, when cash flow is insufficient to repay the loan.

Character assessments are invariably subjective in nature. The objective is to determine whether the business owner will attend

## THE 3C'S OF CREDIT



**CASH FLOW**



**COLLATERAL**



**CHARACTER**

to the business if something goes wrong. This becomes especially important when the borrower's difficulties extinguish the owner's economic interest in the business. This is because realization of cash flow and collateral values are substantially dependent on innumerable managerial, logistical, and operational variables. The attitude of management is a significant factor influencing the practical reality of collecting a loan when the business is in distress.

Bankers know from experience that when the owner is personally "on the hook" the odds are that management's attention to the job at hand—loan repayment—will be enhanced. By putting at risk assets outside the business, the bank assures the guarantor's continued economic interest in the outcome.

**IS THERE NO ALTERNATIVE TO THE BORROWER?**

Competition, or the fear of it, is the only reliable lever for either deflecting the requirement for a guaranty or winning the release of an existing guaranty. Nevertheless, a lender's fixation with personal guarantees generally softens as the perception of the business as an independent stand-alone entity strengthens and/or the challenge of collection is reduced.

It is common knowledge that companies with a large shareholder base are less frequently subject to personal financial guarantees. Likewise, borrowing arrangements of larger companies usually are not supported by personal guarantees. In both cases, the shared characteristic is less reliance on owner-management and/or a small nucleus of key

people to manage the day-to-day functions of the business. Professional management, coupled with confidence in the firm's internal controls and systems, helps moderate the lender's perception of risk. In a sense, a competent, committed management team is the financial equivalent of an ISO 9000 designation. As management risk is mitigated, lenders will make underwriting decisions on the first two of the three "Cs".

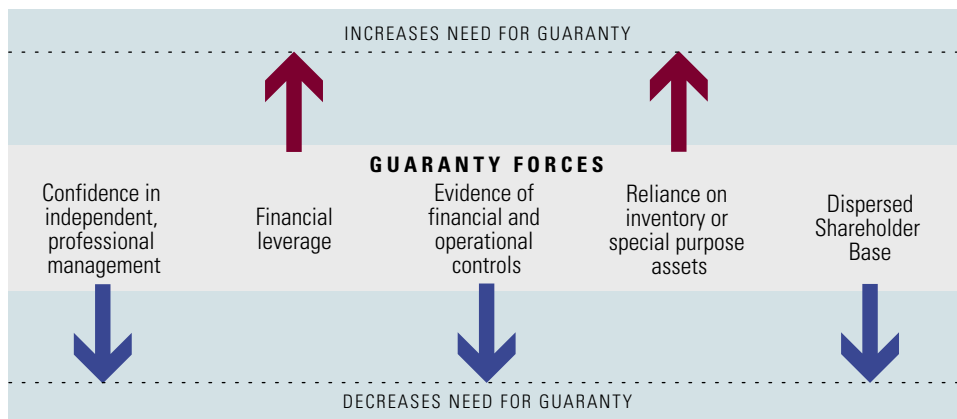
.....

**In essence, the guarantor is "investing" his personal assets in the business by putting them at risk.**

.....

The nature and liquidity of collateral has a bearing on the need for an outside guaranty. For example, significant reliance on inventory or other special purpose assets heightens the concerns of lenders. Most experienced commercial bankers know that they are ill equipped to realize the full value of these type of assets. Asset based lenders, on the other hand, often have greater confidence in the value of the collateral. Although their money may cost a bit more, a guaranty might be avoided.

There is no definitive formula or bright line that defines when a guaranty is to be required. It's subjective judgment. But, the pendulum swings in favor of the borrower as certain risk factors are minimized. The following table illustrates some of the concerns that are often relevant.



**SUPPORT FOR ADDITIONAL BORROWING**

At times, a company may need more credit than a lender can justify. An extra increment of financial support may be required. A personal guaranty from a well-heeled shareholder can bridge the gap. We sometimes get the sense that borrowers view guarantees as a free way to obtain more credit. After all, the possibility of failure is remote and the guaranty is assumed to cost nothing. It's an expedient way to get credit.

A personal guaranty is far from free. The difference between the amounts that can be borrowed with and without a personal guaranty is the equivalent of an equity investment. In essence, the guarantor is "investing" his personal assets in the business by putting them at risk. For that investment, an economic minded guarantor should expect the same level of return as an actual equity investor. Since an equity investor would require a return in the range of 20-25%, the guaranty is hardly free.

The truth is that lenders rarely conduct a quantitative analysis of the need for guarantor support. Therefore, a discussion should be pursued in order to craft the financial support in the manner most appropriate for the situation. The effort should be to define the amount of support needed and the mechanism appropriate to provide a stop-loss on further support. Possible alternatives to consider include:

- A pledge of additional internal or external collateral;
- A first loss guaranty (which requires the bank to exhaust collection efforts against the business assets before turning to the guarantor);
- A limited guaranty that ties or caps the amount of the additional support to a specific risk or potential shortfall;
- A net worth guaranty which requires guarantors to replenish losses with new equity or subordinated debt;
- Borrow the money personally and invest the proceeds in the company through subordinated loans and/or additional equity; or
- Negotiate specific performance thresholds or milestones that trigger the reduction or elimination of the guaranty.

**MORAL OF THE STORY**

Making loans to a company represents a business opportunity for both parties, but there is an inherent conflict of interest between the two. Lenders have legitimate risk issues that need to be addressed. On the other hand, business owners should limit the amount of outside capital invested in the business. From both sides, it's a risk and reward tradeoff.

The only way to arrive at a reasonable solution to this controversial issue is to quantify the amount and nature of the support required, investigate all possible alternatives to provide support with appropriate limits, and use market competition to test reasonableness of borrowing terms. ♦

# Investment Banking 101

*Understanding and learning how to use middle market investment banking services could help your company.*

by William Hanneman and Mark Working

The typical private middle market company owner or CEO infrequently uses the services of an investment banker. The reason may be a lack of understanding of what middle market investment bankers can do and when it is appropriate to call on their services.

## DEFINING INVESTMENT BANKING

The basic services of middle-market investment bankers fall into three categories: (i) obtaining capital for the business, (ii) monetizing equity value, and (iii) providing advice related to corporate development activities.

Investment bankers are experts in valuation and capitalization. Each business has unique characteristics as a result of its size, stage of evolution, industry, and market position. Likewise, the markets for capital, valuation issues, and corporate development alternatives are not the same for all companies. Accordingly, investment bankers specialize in knowing certain markets, industries, and types of businesses.

## OBTAINING CAPITAL FOR THE BUSINESS

In the middle market, commercial banks are the dominant capital purveyors. In most situations, borrowing arrangements are expertly handled by corporate CFOs and owners. However, when the need departs from the norm, an investment banker can be a great addition to the corporate finance team. Investment bankers must be intimately familiar with an array of business capital sources, as well as the risks that individual providers will accept and the returns that they demand. The challenge for investment bankers is to maintain a current roster of lenders and investors and the constantly changing appetites of each. Keeping track is a full time job.

Because each business has a unique set of risks, when it comes to corporate finance, one size doesn't fit all. In fact, the range of circumstances is quite broad. It is the banker's role to design a structure that offers the lowest cost of capital consistent with the need to maintain sufficient liquidity and flexibility to deal with the unexpected.

The investment banker can assist with analysis and communication. Oftentimes, the greatest challenge is to communicate the benefits of a business opportunity in a manner that can be understood and evaluated by capital providers. Because the investment banker understands how these decisions are made, he can help translate the business opportunity into terms that fit the lender's or

investor's lexicon.

Market knowledge and financial engineering, together with an ability to articulate the credit risk and/or investment return case to the market, are talents that the banker brings to the table. Companies facing situations where a significant change in the amount of external capital is required or in which a communication gap exists with capital providers, would be well served to investigate the benefits of retaining an investment banker.

## MONETIZING EQUITY VALUE

A distinctly separate segment of the investment banking trade involves planning and executing transactions to convert illiquid business equity into cash. The advice of an investment banker is sought to evaluate the alternatives for converting illiquid value, whether that be a sale, an IPO, or a recapitalization. The investment banker's job is to advise on the expected valuation, terms, conditions, process and time frame for accomplishing the objective.

If the objective is a sale, investment bankers know how to position a firm to maximize value. They also know that both the probability and degree of success are directly related to the extent of preparation and the precision in which the process is managed. The goal is to maintain a strong negotiating position throughout the process by eliminating surprises and minimizing delays.

A capable investment banker must be skilled in accounting and financial analysis, legal forms of transactions, the tax implications of different purchase and sale structures,

and creative negotiation. Moreover, he must have knowledge of the dynamics and economics of the business and its industry.

## CORPORATE DEVELOPMENT ADVICE

In most businesses, management is charged with the development of the strategic plan. Strategic planning is the process by which a direction is established to position the business to achieve a sustainable competitive advantage and create the greatest future value. On occasion, these plans involve the need to combine businesses (whether through acquisition or merger) or to divest businesses that no longer fit the core strategy.

An investment banker can provide insight into the implications of the business strategy on shareholder value, how the business would be viewed in the marketplace, and the alternatives for realizing value at some future date. The relevancy of these opinions is predicated upon the investment banker's knowledge of the client's business and industry. For precisely this reason, investment bankers often specialize in specific industries.

The addition of an investment banker to the corporate development team of a middle-market business is one way of gaining input on the value impact of a business strategy before actually embarking on it.

## THE RIGHT INVESTMENT BANKER

Beyond technical expertise, the best investment banker for a particular assignment will be the one who clearly understands the client's objectives, risk tolerance, values and objectives. Whether the objective is financing, making an important acquisition, or selling the business, the bankers will work closely with owners and / or managers over an extended time period. Accordingly, the ability to communicate with the banker and trust that the client's interest is the top priority are keys to a successful relationship. ♦

## ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, go to [ZacharyScott.com](http://ZacharyScott.com).

Mark Working  
206.224.7382  
[mworking@zacharyscott.com](mailto:mworking@zacharyscott.com)

William S. Hanneman  
206.224.7381  
[bhanneman@zacharyscott.com](mailto:bhanneman@zacharyscott.com)

Frank S. Buhler  
206.224.7383  
[fbuhler@zacharyscott.com](mailto:fbuhler@zacharyscott.com)

Michael T. Newsome  
206.224.7387  
[mnewsome@zacharyscott.com](mailto:mnewsome@zacharyscott.com)

Ray D. Rezab  
206.224.7386  
[rezab@zacharyscott.com](mailto:rezab@zacharyscott.com)

Doug Cooper  
206.224.7388  
[dcooper@zacharyscott.com](mailto:dcooper@zacharyscott.com)

500 Union Street, Suite 1000  
Seattle, Washington 98101



Zachary Scott

INVESTMENT BANKERS