EARNOUTS.
GREAT IN THEORY.
OFTEN LOUSY IN PRACTICE.
While not quite as ubiquitous as a Starbucks in Seattle, earnouts often make an appearance in mergers and acquisitions deal structures.

Theoretically, these payments, which are contingent on achieving certain financial or operating milestones, are intended to (a) bridge gaps in valuation between buyers and sellers or (b) provide sellers with incentives to sustain growth trends or execute on already identified but not yet realized performance-improving programs, contracts, or other initiatives (and theoretically, m&ms don’t melt in your hand).

So where do earnouts go off the rails?

All too often, earnouts are misused. Say you’re a health care provider, investor, or vendor (and if this somehow made it to your desk, you almost certainly are). You know that by its very nature, health care and risk go together like tongue depressors and “ahhh.” Reimbursement. Compliance. Fraud (intentional or not). Malpractice. Referral concentration. Collections. Because, despite what you may have heard, health care is complicated.

That’s why unless there is some change in health care economic policy or utilization that temporarily shines a spotlight (or throws some shade) on a particular health care niche,valuations of health care service businesses tend to coalesce around four to six times earnings.¹ That’s because as stated above, compared to, let’s say, treasury bills, investors require a much higher rate of return to take on the kind of exposure unique to health care.

But here’s the thing. It is not at all unusual for health care buyers to price companies at a sector specific, risk-adjusted multiple, AND finance part of said deal with an earnout. In doing so, they are “double dipping.” Paying the seller at a valuation that assumes they are taking on all the risk of the investment but dumping some of it right back onto the seller.

Clever, huh?

So, when are earnouts best used? As mentioned above, when sellers have laid down substantial groundwork on, as yet unrealized, value enhancing programs or initiatives. A branch soon to be opened. A contract that is onboarding its first patients. A technology that promises increased efficiencies and higher margins.

Sellers rightly want to capture some of the value of what they created.

Buyers rightly don’t know how to price it.

Enter the earnout.

When done properly, a win-win (if it’s in the money) or a lose-lose (if it’s not) but not a win-lose or a lose-win.

Got that?

How much money could an earnout earn if an earnout could earn out? Although it often may seem like contingent payment amounts are based upon the GIOOTA method (grab it out of the air), it doesn’t have to be that way. Earnouts can, and should be, at the very least, conceptually rooted in valuation and risk-return fundamentals.

Consider a situation where a buyer is trying to compensate a seller for a newly minted contract that is beginning to onboard new clients. Now consider that current revenues and EBITDA are $5M and $1M respectively. However, if the contract goes perfectly, it could generate another $200k in earnings. Lastly, let’s say that the “base” price being paid (before earnout) is $6M (six times earnings).

Should the seller receive an additional $1.2M (6 x the additional $200k) if the full potential is realized?

Probably not, as the buyer will play a significant role in gaining the business and should also realize a return on their efforts. It might be reasonable, then, to place a one-year earnout at $600k, apportioning half of the potential value (3x) to the seller that teed up the opportunity, leaving the buyer with upside arbitrage of (3x) for its role in execution.

If earned, then, the total package for the seller would be $6.6M.²

As a reality check, you take the total potential package and divide it by the base EBITDA—in this case $6.6M/$1.0M— to determine an imputed, growth adjusted multiple.

Then ask yourself the following question:

If a 6.0 multiple is market for a company with normal growth, would a multiple of 6.6 be reasonable for one with “out-sized” growth potential?

¹ Another way to look at it: An investor might be delighted to pay $100 for an annual return of 5.00 (5%), or 20 times earnings to purchase a “risk-free” treasury bill. But to take on the beast that is health care? They may require a return of 15-25% (or more), which loosely corresponds to earnings multiples of 4-6 x.

² Go to the head of the class if you realize that since the onboarding takes time and a full year’s impact won’t be realized in the first 12 months post-closing, that an earnout might best be based upon EBITDA for months 13, 14, and 15 following the transaction, annualized.
If you answer yes (as we would in this scenario), there is sound, risk-return logic built into the earnout.

If performance hurdles are poorly constructed, earnouts fail at hello. In order for earnouts to be paid when they should be paid and not paid when they shouldn’t, you’ve got to get the performance benchmarks right.

The default metric tends to be EBITDA – Earnings Before Interest, Taxes, Depreciation, and Amortization (or Earnings Before Inventive Theories of Deceptive Accounting, as buyers are wont to believe). After all, with buyers and sellers alike turning to multiples of EBITDA as the basis for valuation 99 and 44 hundredths percent of the time (the Ivory Snow standard), it’s a gimme for adjusting price based upon performance.

The problem, however, is that benchmarking against EBITDA has more faults than your mother-in-law’s opinion of you.

First off, from a valuation perspective, EBITDA is almost always some form of adjusted EBITDA. So, in crafting an earnout based on this metric, buyers and sellers alike must meticulously lay out exactly how these earnings are to be calculated and verified. Not so easy, for example, when it comes to unusual or one-time expenses which may look like one-time to a seller but regular (though less predictable) to a buyer.

Second, the EBITDA standard doesn’t easily allow for changes in how the business is operated. Say the buyer wants to invest in sales and customer service infrastructure to improve the long-term performance of the business. Although it might make perfect sense, since incremental revenues will likely lag the cost of the investments, a seller with an earnout based upon near-term EBITDA will cry foul.

Alternatively, it may seem reasonable to peg earnouts to revenues. But not so fast young Skywalker. A seller intent on achieving revenue targets may choose to do so by driving volume with reduced pricing. Good, perhaps, for the top line. But potentially disastrous for the line at the bottom.

Given all the above, earnouts are often best tied to gross profit dollar targets. While rarely used – or even considered for that matter – gross profit is often the best determinant of how well, or poorly, a business is likely to perform.

All or nothing or small but something. So, you were smart and chose a contingent payment based upon achieving X dollars of gross profit.

Coolio.

A year later, GP comes in at X minus one dollar.

Now what do you do?

The target was missed, so should the seller get nothing, a proportional amount of the “bogey,” 75%, 50%, a set of steak knives?

While there are no rules here, we favor a minimum achievement threshold: below which the seller receives nothing and above which, the seller receives a proportionate amount of the earnout.

But wait. There’s more (when it comes to issues with earnouts).

The long and short of earnouts. Let’s take a simple earnout where the seller gets $500k if the company generates $5M in gross profit in year one and another $500k if the company generates $6M in year two. The company generates $4M in year one, below the 90% threshold established for any proportional payout. However, in year two, the firm posts $7.5M in GP. In poorly constructed earnouts, the seller would receive zero in year one and $500k in year two.

But is that fair?

Sure, they were short in year one by $1M. However, in year two they were long by $1.5M. So, on a cumulative basis, the company exceeded the two-year gross profit target of $11.0M. That’s why we recommend so-called “catch-up” provisions that allow sellers to pick up unearned earnouts if the company exceeds cumulative targets.

While the above are the primary decision points in negotiating an earnout, not surprisingly, there are as many other factors that might merit consideration as there are variables informing pricing, deal structure, performance expectations, and buyer and seller risk tolerance.

Which leads us to one final comment.

Given all the complexities cited above, in certain situations the best earnout may be to avoid one altogether, relying instead on leveraging a comprehensive and strategically orchestrated process to surface proposals where future upsides are priced - at least in part - into the original valuation.

You know.

A buck in the hand being worth two earnouts in the bush. Or something like that.
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