

CJA PROFESSIONAL SERVICES

ACCOUNTING, TAXATION, BUSINESS VALUATIONS & GENERAL BUSINESS CONSULTING

Closing the “Cash Gap” on the Sale of a Business— Consider an Earnout

If you are in the process of buying or selling a business, or advising your clients on such, and you are finding that a deal can't be made because of a gap between the asking and offering price, don't fret! Get creative- consider an earn-out to bridge that gap.

An earn-out is intended to quantify the uncertainty between what a seller claims can be accomplished with the business and what the purchaser believes is reasonable. If the business being sold has had sales growth of 5% for the past 20 years, it's probably a tough sell for a potential purchaser to accept a seller's claim that sales growth will be 25% in the coming year. So, tell the seller to put his money where his mouth is. All other things being equal, a purchaser would likely be willing to pay more for a business with sales growth of 25% than a business with sales growth of 5%.

How does an earn-out work? In its simplest form, an earn-out would involve an agreed upon up front payment, and future payments based on certain variable(s), such as a percentage of sales or net income.

For example, the Purchaser of ABC Company would pay the Seller some upfront amount- say \$200,000. One year later, the Purchaser would pay the Seller an amount equal to 10% of sales for the past year. If sales were \$1,000,000, that would result in an additional payment of \$100,000, for a total purchase price of \$300,000. However, if sales were only \$750,000, the additional payment would only be \$75,000, for a total purchase price of \$275,000. All of the above factors can of course be fine-tuned to suit each particular situation.

This structure would provide advantages for both the purchaser and the seller and can bridge the “Cash Gap”. For the purchaser, this reduces the upfront payment required. For the seller, this ensures appropriate compensation based on the future performance of the business- so if 25% sales growth actually happens, the seller is laughing all the way to the bank! The earn-out also aligns both the purchaser and the seller's motivations- both want to see and have an incentive for the business prosper. Additionally, this gives the Seller an added incentive to assist with a smooth transition to the Purchaser.

However, earn-outs can get very complicated, depending on how they are structured- they work best in the simplest of forms. Also, they should never be used to make up for incomplete due diligence on the purchaser's part.

When structured correctly, an earn-out can help bridge a pricing gap between a purchaser and a seller so that a deal can be reached. If you or one of your clients are at a stalemate over price, exploring an earn-out with us may be worthwhile.

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About the Author:

Recognized in 2009 as one of the “Top CA’s Under 40” in Ontario, Chris is a Chartered Accountant and Chartered Business Valuator with more than nine years of finance and accounting experience working with organizations that have ranged from large publicly listed NYSE and TSX companies to small owner-managed businesses and individuals.

Chris earned his Chartered Accountant designation while working for Deloitte & Touche LLP in Toronto. In 2009, he was recognized by the Institute of Chartered Accountants of Ontario as being one of the “Top CA’s Under 40” in Ontario, being a recipient of the ICAO’s prestigious Award of Distinction.

Chris earned his Chartered Business Valuator designation while working for a boutique business valuation firm in Toronto. He is recognized by the Canadian Institute of Chartered Accountants as being a specialist in the field of business valuations.

Chris is involved in the training of new CA students as a seminar leader at the ICAO’s School of Accountancy. Chris has previously marked the practice and end of school exams for the School of Accountancy.

Chris also teaches part-time at the School of Business and Economics at Wilfrid Laurier University.

Chris is a board member and the Assistant Treasurer of the Oakville Parent-Child Centre, a charitable organization in Oakville focused on supporting, nurturing and empowering families, children and their caregivers.