Miami Herald

Look beyond the traditional valuation metrics when selling a middle-market company

May 22, 2020
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Economic uncertainty has increased for most middle market companies, with many owners weighing whether to sell their business. Even during this difficult time, some want to sell sooner rather than later, driven by concern about future prospects, the emergence of liquidity issues, or just because they're ready to move on. The question is whether there is a buyer willing to pay an acceptable price.

In today's environment, a successful sale means looking beyond traditional valuation metrics. Selling during the pandemic, and even the post-pandemic era, makes earnouts — promising the seller future consideration tied to predetermined financial goals — the best strategy for bridging the valuation gap and getting the best price. Used for years, earnouts will now become more prevalent.

For buyers prior to COVID-19, projections, along with trailing 12 months EBITDA — earnings before interest, taxes, depreciation, and amortization — or free cash flow, were in most cases the go-to performance metrics for establishing a company's value. Comparable transaction values were also considered. Today, these may not be as relevant.

Approaching the negotiation table, the typical seller may claim business will get back to "normal," pre-pandemic levels. But with most businesses having gone off a cliff in March and uncertainty helping to make historical metrics poor indicators, accurate projections are difficult to come by. Meanwhile, the savvy buyer has no guarantee if, or even when, business will get back to normal.

So, for the seller that has an interested buyer, earnouts and sharing the risk can bridge the valuation gap. But the devil is in the details when it comes to earnouts. Get them wrong and you could see trouble ahead. A great investment banker is a critical resource in getting them right, but here are some issues to consider:

- **What metric should you use?** Should you base an earnout on revenue, gross margins, EBITDA, or net profit? Sellers should push for the metric most likely to hit earnout goals.

- **Include parameters** outlining what the buyer must do to maximize the earnout, showing what operational procedures and expenditures made the company successful prior to the sale. Ensuring your consideration doesn't fall short may mean pushing for continued funding for R&D, products/services promotion, and/or other initiatives.

- **Include provisions** making the buyer keep separate books from their other businesses, while requiring they regularly provide financial information on the company you sold them.

- **Specify prohibitions** on the buyer selling significant company assets, charging fees for overhead, or on diverting assets to other businesses. Require that the business continue to run as it has historically.

- **Determine how the day-to-day operations** of the business will proceed and whether the seller will continue to operate the business.

- **Review all earnout tax considerations** to maximize the value received.

- **Establish appropriate**, reasonable periods for earnouts. With getting to the new normal expected to take some time, longer earnouts may be better.

- **Include provisions** for resolving disputes without litigation, with guidelines for hiring independent dispute resolution experts.

- **When defining rules** that establish if a buyer breached the contract, avoid standards that require proving the buyer's intent to reduce the earnout, which is hard to do.

- Finally, **a liquidated damages provision** may be appropriate, providing for an earnout payment if the buyer breaches the contract.

Given today's economy, with its uncertain future, earnouts are an effective means of bridging the valuation gap for a company sale. But availing yourself of this timely deal tool means thoughtful attention to details now, to avoid friction and/or litigation later, especially given courts often favor the buyer in earnout disputes. Specific, detailed, unambiguous terms are best. Play it right, and you will achieve a win-win where you get fairly compensated, and the buyer feels they got a fair deal with a shared risk profile.

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