Seller Financing or Earnout?

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You've decided to sell your business and are close to an agreement with a buyer as to the value of the company. In a perfect world, the buyer would be ready to pay for your business exclusively in cash. However, such cash only deals are rare. Instead, buyers and sellers often have to agree that a portion of the purchase price will be paid after closing in order to finalize the deal. Two options for bridging the cash gap are seller financing and an earnout.

Seller Financing – Risks and Rewards

With seller financing, the seller agrees to accept the buyer's promise to make future payments to cover a portion of the purchase price. Much like a mortgage or a car loan, seller financing provides the seller with predictability because the number, frequency and amount of the payments will be defined in advance by an agreement between the buyer and seller. On the other hand, seller financing limits the seller's upside because the buyer will only be obligated to pay the agreed upon amounts. In other words, if the business does very well financially under new ownership, the seller will not benefit from a corresponding increase in the purchase price.

A seller that finances a portion of the purchase price faces the risk that the buyer will default on its obligations to make future payments. To protect against such risk, the seller can require that the buyer's payment obligations be secured with a lien on the buyer's assets or a personal guaranty from the buyer or buyer's management. However, if the buyer also utilizes outside bank financing (which is very often the case), the seller's security interest in the buyer's assets will likely be subordinate to that of the primary lender.

Earnout – Risks and Rewards

With an earnout, the final amount of the purchase price is either wholly or conditionally contingent on the business's financial performance over a specified period of time following closing. Typically, the buyer will be obligated to pay the seller a percentage of an agreed upon financial metric, such as revenue, EBITDA, or gross profits. The percentage required by the seller is based on predictions about the business's future financial performance. If the business performs well relative to the agreed upon financial metric, the buyer will be obligated to pay the seller a higher purchase price. If the business performs poorly relative to the agreed upon financial metric, the buyer will be obligated to pay the seller a lower purchase price. As a result, an earnout is less predictable than seller financing.

Further compounding the risks associated with an earnout is the fact that the seller will no longer be running the business. As a result, the seller faces the risk that new management will be incompetent or that new management will attempt to game the metric to force a lower purchase price. The seller can attempt to minimize these risks by carefully selecting the earnout metric and negotiating the terms of how the metric is measured. For example, if the buyer prefers using EBITDA as the earnout metric, the seller should include specific clauses in the agreement to guard against expense manipulation.

Which is Right for the Sale of Your Business?

Seller financing is typically the preferred option where the seller can model future financial performance more accurately because the business has a history of steady income and profits. By agreeing to make specified payments in the future, the buyer is assuming the risk that the business will perform at levels exceeding the level required to repay the seller and to allow the buyer to recoup their investment.

By contrast, the seller's primary concern is the risk that the buyer will be unable to meet its payment obligations.

An earnout allows the buyer and seller to share some of the risk of the business's post-closing financial performance where future income and profits are difficult to predict. With a high growth business, an earnout can help a seller maximize the overall purchase price. However, the opportunity to be paid additional amounts based on the business's financial performance comes with the corresponding risk that the business will underperform, leaving the seller stuck with the lower purchase price.

If you have questions about selling your business, please contact Vaughn Ramsey at vramsey@tuggleduggins.com (336) 271-5234; Natalie Folmar at nfolmar@tuggleduggins.com (336) 271-5220; Jesse Anderson at janderson@tuggleduggins.com (336) 271-5208; or Spencer Krantz at skrantz@tuggleduggins.com or (336) 271-5221.

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