Earn-outs can spread the risks, but there traps to avoid

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Last week, Deadpool star Ryan Reynolds provided a sobering reminder that selling a business isn't always as straightforward as signing on the dotted line, popping a bottle of champers and walking (or stumbling) away with the proceeds.

While we've never corresponded, Reynolds has confirmed the text of his new out-of-office email message:

"Thanks for your email. I am currently out of the office but will still be very hard at work selling Aviation Gin ... for quite some time, it seems.

"In related news, my lawyers just explained to me what an 'earn-out' is and how long it takes to achieve, so let me take this opportunity to apologise to everyone I told to go f..k themselves ... turns out I'm not as George Clooney as I thought."

Reynolds' original, widely reported email message was hastily dashed off last week after Diageo agreed to acquire Aviation American Gin from Reynolds and Davos Brands for $US610m ($820m).

The deal requires Diageo to pay $US335m in cash and Reynolds to remain as the public face of Aviation. Depending on the company's performance over the next decade, Diageo could pay up to an additional $US275m.

The second half of the deal, which is the potential $US275m down the line, is what Reynolds learned to be an "earn-out" — an important arrangement often negotiated by M&A lawyers.

When Reynolds' lawyers explained the term to him, they would have put it as simply as possible for a non-lawyer: an earn-out is a mechanism for a seller to receive future payments after completing a transaction, based on the business achieving specific performance milestones.

Typically, earn-out clauses written in sale agreements capture how the potential future payments will be calculated, when

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Actor Ryan Reynolds is the face of Aviation Gin

they will be made and the buyer's obligations during the earn-out period. The parties can include specific performance hurdles or thresholds that the business must meet for the seller to receive the additional earn-out payment.

In this way, the seller shares the post-deal business performance risk by accepting a lower up-front payment and betting on the future success of the business.

Earn-outs can be a useful tool in bridging the gap between what a seller thinks a business is worth and what a buyer is willing to pay.

While the picture of a business painted by the seller is often a combination of historical data and crystal ball projections, buyers generally prefer to base their price on hard historical data.

The optimal outcome for any seller is the highest price with no conditionality. An earn-out allows the seller to take away cash, unconditionally, but at a lower price point, while leaving open the potential opportunity to receive more if the upward curve of the projections is realised.

As far as the buyer is concerned the upsides of an earn-out are that it keeps the initial price lower and ensures the seller still has skin in the game when it comes to the future success of the business.

In this case, with Reynolds personal brand so closely associated with Aviation, his ongoing involvement was clearly worth a great deal to Diageo.

Often the risk/benefit analysis of an earn-out is far less straightforward.

It's the cliche of 2020 to say that it's difficult to predict the future for a business. But even in more normal circumstances than we find ourselves in right now, tying outcomes and payments to future events and triggers is tricky.

Earn-outs can align the interests of buyers and sellers, but they also create misalignments. They create distinctions between short-term rewards (to which earn-out triggers are linked) and long-term rewards (after the earn-out ends). Buyers and sellers are likely to feel very differently about investments or expenses incurred in the short term for long-term gain — hiring a bunch of people, running a marketing campaign, developing a new product.

There are also control issues with earn-outs. The buyer will have paid out a significant chunk of the purchase price, will have assumed the business risk, and should be making all the strategic decisions. But the seller will want to maximise the chances of meeting the earn-out thresholds.

There's also a personal element to the control issue. If an earn-out mandates the seller's continued involvement in, or even presence in, the business that they once managed, it can undermine a new owner or manager's status with various stakeholders, including employees.

Aviation's recent acquisition reminds us that there's a lot more to deals than price; that celebrity alcohol brands are lucrative; that delaying gratification is sometimes a necessary evil in an M&A deal; and that earn-outs are useful but complicated.

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