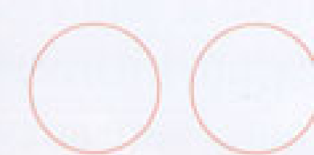
Emerging companies

Revolving door: Retaining the flow of customers



In the current market, it's hard to get more than minimal prices unless you're willing to go to some sort of earn-out situation

Rudy Weber, Lloyds Business Brokers

BUSINESS VALUATION

BUY NOW, PAY LATER

Earn-out periods are popular when businesses are sold, giving sellers a high price and buyers the surety of knowing good practices can be maintained. **Report: Jeanne-Vida Douglas**

● They are perennial business questions. How much value is contained in a business and how much walks out the door with the old owner when a business changes hands? How much value is contained in the existing processes and how much of it resides in the owner's management style and personality? Other ponderables include the extent to which customer loyalty is bound up with the brand and how vendors put a price on goodwill.

All of these questions are made more complex in turbulent financial times when sales forecasts are being reviewed downwards and customers are more inclined to shop around for new service providers at the slightest provocation.

For business brokers, this uncertainty is resulting in increasing pressure to make an earn-out clause part of the sale of a business.

These agreements are not unlike vendor financing, where the vendor of a business agrees to take an initial payment and receive the outstanding amount over months or up to three years after the sale. The earn-out period can result in the vendor playing a continuing role in the company until the purchaser is confident that the business will continue to operate successfully without the involvement of the original owner.

A potential problem area with earn-out arrangements is where the vendor agrees to forgo payment for a set period but lacks insight into how the company is being managed in the interim.

"Earn-out periods are an increasingly popular and elegant solution because the seller wants the highest possible price, while the buyer wants the reassurance that the business will continue to operate when the seller has gone," a director of Lloyds Business Brokers, Rudy Weber, says. "The flaws come when the business fails to meet the earn-out projections. That's when you can get issues surrounding allocation of blame."

Specialising in niche manufacturers and agricultural producers, where most transactions are valued between $2 million and $20 million, Weber recommends that earn-out clauses are part of most business sales because such agreements enable both parties to establish fully the value of the business.

Working with smaller businesses, a director of Jamieson Corporate Services, Paul de Rome, discourages earn-out clauses. He argues that many such agreements impose an unfair burden on the seller, especially if the end payment is based on earnings over which the vendor has no control.

"There's always a risk that the business might trade differently over the next 12 months and if the payout is tied to performance and trading and can be

Jin Lee/Bloomberg News

BUYING?	SELLING?
Understand the role of the business and the quality of management.	**Understand the risks of upfront versus deferred payments.**
Specify forecast performance and issues influencing these forecasts.	Ensure capacity to quantify and achieve forecast performance.
Research market competition.	**Outline performance metrics relating to the business.**
Undertake thorough due diligence: accounting, tax, legal and commercial.	Clarify the acquirers' expectations of management.
Specify management interest in future business performance.	**Specify process relating to a change of management.**
Specify forecast budgets and business-performance metrics.	Create contractual agreements concerning financial contributions.
Apply contractual mechanisms to limit earn-out manipulation by vendors.	**Ensure earn-outs are not disproportionately penalised by under-performance.**
Plan for a clear exit of vendor management and succession.	

Source: AG Coleman & Co

manipulated or controlled in some way by the buyer, the transaction actually discourages the buyer from operating the business effectively," de Rome says.

Buyers can effectively sabotage the earn-out clause by taking on excessive levels of debt, taking on too many employees or engaging in unnecessary capital expenditure, he warns.

"From the seller's point of view, they have to be careful of attaching the earn-out clause to something which accurately reflects ongoing trade," de Rome says. "It's often not a good idea to tie earn-out clauses to bottom-line profit because this is a figure which can easily be manipulated."

Lawyer and commercial counsel David Windsor agrees, noting that vendors who accepted earn-out clauses a year or so ago may face big reductions in final payments because of the general slowdown in business.

"Even businesses with a great historical record might now be facing a significant drop in sales and if you are waiting on the final payments as part of an earn-out clause your business is probably not worth anything like what it was worth two or three years ago," Windsor says.

"If you're selling a business because you want to retire, it can be very disconcerting to have to carry the risk of the business for another year or two before you can get your full payment."

On the upside, earn-out periods that feature involvement from the vendor can be a great way for business owners to get a good price and gain some reassurance that the business will continue to operate successfully in their absence.

When online entrepreneur Kylie Little sold her parenting-information business, Essential Baby, to Fairfax Digital in 2007, she was keenly aware of the high failure rate of independent websites when they become subsumed into larger media entities. Although economic factors played a part, a big motivation was her capacity to manage the handover and ensure that the company she had built from scratch would continue to be a success.

"The business was really at the point where it needed the support of a larger organisation behind it but there was a lot of distrust from the members," Little says. "When I sold the business, I effectively became a full-time employee of the website for a period of 18 months to ensure the transition went smoothly, and as a result we lost no traffic and lost no membership."

This type of earn-out clause, which features the involvement of the seller over an extended period, may be the best option for vendors given market conditions, Weber says.

"In the current market, there's a lot of fear about the future and it's hard to get anything more than minimal prices unless you're willing to go to some sort of earn-out situation," he says.

"If earn-out periods are to work, both parties need to clearly understand what is happening and staying on in a management capacity is a good way to gain that insight." BRW

● MARKETING + MEDIA

SHOEBRIDGE

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Cutting back is for wimps

Marketers are, in theory, experts at selling. The tough financial conditions are putting their expertise to the test, not only in terms of selling products and services but also in selling the value of marketing.

Every marketer knows the theory that a recession is a good time for companies to spend more on marketing: consumers are looking for brands they can trust and it becomes easier to reach an audience because there is less marketing clutter from the competition. However, selling this theory to chief executives and finance directors who are sceptical about the returns marketing generates has never been easy.

The downturn makes it an even harder sell: many senior business executives – with the obvious exception of the people running Pacific Brands – think cutting a marketing budget is a lot easier than closing a factory. It is easier, but this does not mean it is the right decision.

Companies that maintained or increased their ad budgets during the 1981-82 recession in the United States had 256 per cent higher sales over the next three years than companies that had cut their budgets, a McGraw-Hill study showed.

Consumers looking for brands they trust are easier to reach because there is less clutter from competition

Locally, some companies are pumping up their ad budgets this year: take a bow Lion Nathan, McDonald's and Woolworths. But many have frozen or reduced their ad spending as they wait to see which way consumers will jump or, in the case of some overseas-owned companies, await directives from their parents.

Australian marketers are not a particularly vocal bunch when it comes to extolling the benefits of what they do. Maybe they should take some tips from the president of the US ad-services technology company Spot Runner, John Gentry.

Writing for the website MediaPost earlier this year, he offered marketers advice on what to do in a downturn and what they can tell razor-wielding chief executives and finance directors. His points included:

- Remember that advertising is a key tool for increasing or maintaining market share. Do not make the mistake of seeing advertising as a cost; instead, evaluate the cost structure of the total company.
- Marketing plans need to be re-evaluated in the context of a downturn. Rather than waiting to see how a downturn affects marketing strategies and products, companies need to answer basic questions such as whether their products will deliver strong value when consumers are watching what they spend and ditching discretionary purchases.
- Focus hard on "accountable media". This does not necessarily mean directing more ad dollars to the internet but it does mean finding new ways to measure and track results from ad campaigns in "old" media such as television, radio and newspapers.