Selling a Recruitment Business: Surviving an 'Earn Out' and Maximising Value

By Tim Stead, Partner, Squire Patton Boggs

Mergers and acquisitions in the recruitment industry gathered pace steadily throughout 2014.

A survey conducted by BDO and published earlier this year suggested that 46% of all recruitment companies are considering growth through acquisition in the next three years and that 41% of respondents thought their business was likely to be sold in the next five years.

All of this indicates that recruitment companies that have access to acquisition and investment capital are now returning to the M&A market for bolt-on acquisitions as a strategy for growth.
When I talk to owners of recruitment businesses about a potential exit, I am routinely asked about how they can take steps to protect the Earn Out and maximise the price. For service or people businesses (such as those in recruitment or professional services), where much of the value of a commercial is tied to its key personnel, the majority of acquisitions will include some form of deferral of the purchase price contingent on the future performance of the business (known as an "Earn Out").

What is an Earn Out

An Earn Out is a mechanism used on an M&A deal whereby the purchase price is partially deferred, such that the price is determined by reference to the future performance of the business. Often, performance is measured during a 2 to 3 year period (the "Earn Out Period"), although a longer or shorter periods are sometimes encountered.

What's the risk for a seller?

A seller and buyer will have a common interest in maximising the profitability of the business during the Earn Out Period, but often that mutual interest ends there.

There is lots of scope for potential conflict between the buyer and seller, but the most common key areas of tension are: 1) operational control and 2) short-term investment and costs.
A seller will inevitably wish to boost the short-term profitability of the business by aggressively growing revenue and minimising investment and other costs. A buyer, on the other hand, is likely to want to invest in the business for long term growth.

Similarly, having left value invested in the business (via the deferred purchase price), sellers want to retain operational control during the Earn Out Period. Conversely, buyers want to impose their own management style and control.
Are there any up-sides?
There are several advantages to Earn Outs for sellers. Principally, they can help you get a compelling offer in the first place.
• If a buyer is nervous about maintaining a profit, an Earn Out gives it some comfort that the price will (at least in part) be measured by actual performance rather than historic or forecast numbers.
• Secondly, an Earn Out helps a buyer fund the deal – part of the purchase price is deferred, so he/she has to borrow less (or use less reserves) to fund the deal.
• Thirdly, if you sell to a larger group, your business may realise cost savings through synergies with the buyer's group, potentially increasing future profit and Earn Out.

10 Strategies to Protect Earn Outs for Sellers

1. Maximise your control and influence

Make sure the acquisition documentation reserves the day-to-day operational control of the company to you as far as possible. A buyer is unlikely to be willing to cede full autonomy to the seller, but the acquisition should seek to give the seller as much influence as reasonably possible.

2. Anchor your own position

The acquisition documents should seek to entrench your position as an executive director for the full duration of the Earn Out Period. It is vital that you remain in the business to protect your territory. Make sure that you can't be removed as a director or sacked as an employee (other than for gross misconduct).

3. Set accelerated payment triggers

Consider the circumstances in which a full acceleration of the Earn Out might need to be triggered. Circumstances might include a subsequent sale of the company by the buyer to a third party or a liquidation by the buyer.

4. Ensure the buyer can pay out

Make sure the buyer has sufficient financial strength that he will be able to fulfil payment obligations if the Earn Out is hit. Consider requiring some form of guarantee – either from a buyer's parent company or from the buyer's bank. Alternatively, sellers often ask for money to be put into escrow or for the buyer to grant security over the assets of the target company.

5. Choose your benchmark carefully

How will the Earn Out be calculated – will it be by reference to revenue, net fee income or EBITDA (earnings before interest, taxes, depreciation, and amortization)? The higher up the P&L your benchmark, the more difficult it is for a buyer to manipulate

the data through accounting treatment and provisions.

6. Fix the accounting policies

Irrespective of the financial metric that is used, the acquisition documents will include specific accounting policies governing how the Earn Out is calculated. As the seller of a recruitment business, you will want these to be as certain as possible.

7. Be realistic about value and forecasts

The Earn Out targets are likely to be fixed reference to (or at least heavily influenced by) the budgets and forecasts you have provided to a buyer at the beginning of discussions. So, stretch your forecasts by all means, but make them realistic and achievable.

8. Guard against competition

If you are selling to a trade buyer (as opposed to a Private Equity Fund), ensure that the acquisition documentation includes a means to protect your confidential information and prevent the buyer from directly competing against you to poach mandates or placements.

9.Keep the Earn Out period as short as possible

The shorter the Earn Out period the less you are exposed to potential fluctuations in performance, some of which will be outside your control. Protect against this uncertainty by keeping the Earn Out as short as possible.

10. Consider offering step-in rights

If the buyer is resistant to giving you the control you feel you need to operate the business during the Earn Out Period, then consider offering some form of step-in right, if performance slips below a minimum threshold percentage from budget or forecast.

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