Advisor M&A Tip

What is Dry Powder?

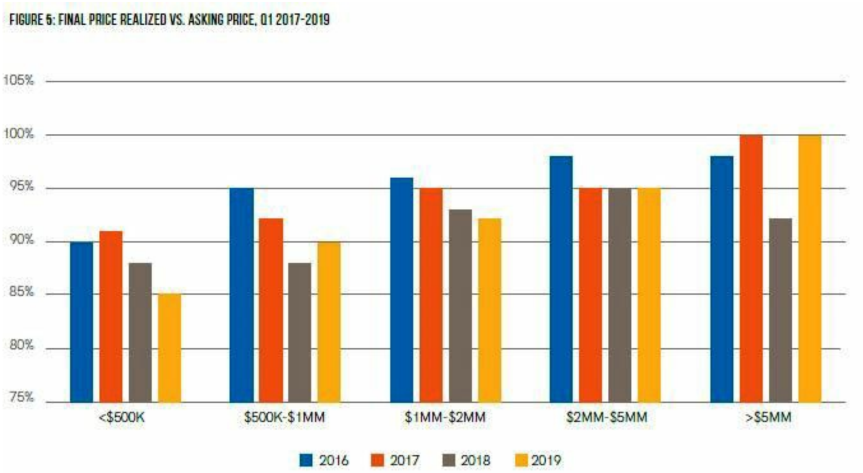
You may have heard about the unprecedented level of "dry powder" in the market. In the M&A world, we refer to dry powder as the cash reserves businesses keep on hand to fund acquisitions or future business investment. In the last few years, private equity firms have amassed record amounts of investor dollars, aka dry powder. These firms are under considerable pressure to deploy those assets and generate returns for their investors.

The more dry powder there is in the market, the more pressure there is to use that money (i.e., acquire businesses). This pressure increases competition and drives up multiples. And, it's created a wider buyer pool for businesses in the lower middle market as private equity firms shift their focus down market in order to find new opportunities.

Market Pulse Survey - 2nd Quarter 2019

Presented by IBBA, M&A Source and in Partnership with Pepperdine University

Where Are Business Values Trending?



"Private equity is extremely active in the lower middle market, and that's pushing values upward," said Craig Everett, PhD, director of the Pepperdine Private Capital Markets Project at the Pepperdine Graziadio Business School. "Industry reports suggest private equity has nearly $2.5 trillion in unspent cash right now. Many of them are shifting resources down to the lower middle market in order to maximize their chances of winning a deal and putting that cash to work.

Earnouts Can Benefit Both Buyer and Seller

When selling a business, an earnout is basically a commitment by the buyer to pay the seller a certain amount of money tied to future performance after a sale. While this method is a great way to boost the value of a company, it can be a dicey proposition for a seller.
Many times in the M&A world, earnouts are used as a last resort to bridge a value gap between the seller's expectations and what the buyer believes the company is worth. Below are a couple of examples where they can be useful:

- When there are contracts at risk of not renewing.
- New contracts where the seller wants a piece of the profit for his efforts in obtaining the contracts just before closing.
- When the buyer is concerned about major customers going away.
- Key employee/s loss.
- Projected revenue goals not being reached.

Sellers want to be paid. Buyers want to pay based on a realized value for the business. There are ways to structure deals to reduce seller risk, such as:

- Sellers don't want a deal to be tied to cash flow since the bottom line can be manipulated.
- Buyers don't want a deal to be tied to revenues because a sales team can rack up sales at razor thin margins.

We recommend tying an earnout to gross profit with a clear understanding of what is to be included in cost of goods. This way, the buyer is getting a firm margin while the seller has the assurance that the numbers cannot be manipulated. As a seller, the willingness to accept a reasonable earnout sends a sign of confidence to a buyer. This signal can reduce a buyer's fears and help get a deal across the finish line.

So if you hear the word "earnout," keep an open mind. It could be an opportunity to gain additional value in the company, especially if there are unique circumstances or it is believed there is an upside that would be great for the new buyer.

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