# Earn Your Way Out of Investments (*Entrepreneur Magazine* – September 17, 2001)

The "harvest" strategy for any emerging-growth venture is always a major sticking point when putting together a financing deal. Funding providers want to have some reasonable assurances that the venture can eventually turn positive cash flow into an investment return on the original capital. When the business begins to spill profitability over the dam (meaning the vast majority of the essential growth plans have been funded and revenues are strong and reliable), many firms think an IPO is the next logical step in the life of the firm.

But proportionately nationwide, the number of firms that actually execute a successful IPO vs. the total number of companies doing business is infinitesimal. So when an entrepreneur states that his or her firm is planning to go public, investors recognize this is easier said than done. The most likely exit strategy for an emerging enterprise is either an acquisition for cash and/or stock by a larger firm in the same or related space in the market, or a stock buy-back. And the most popular form of a stock buy-back is called an earn-out.

A typical earn-out involves a 36- or 48-month window during which the firm has strong sales, predictable operating costs and a fairly reliable stream of pre-tax cash flow called EBITDA (earnings before interest, taxes, depreciation and amortization). The entrepreneur needs to calculate an acceptable level of internal rate of return (IRR) on the investors' capital over the time frame that includes the ramp-up to the beginning of the earn-out and the time period until the earn-out is completed.

For example, let's say that original equity investors have been "in" the venture for 50 months since launch. The firm is now in a solid position with respect to EBITDA, and essentially all the major growth projects have been funded, so the firm is competitively well-positioned for the next several years. If the firm envisions a 36-month period over which to buy back all or a large portion of the common stock from the original investors, the entire 86 months (50 + 36) are included in the IRR determination. The original invested capital is treated as the baseline present-value cash outflow in the model. The 50 monthly periods of zero cash inflow (the time up to the beginning of the earn-out) are then followed by 36 months of fixed cash payments made to the shareholders, during which predetermined numbers of shares are systematically transferred from the original investors to the company. (This could also be structured on a quarterly basis with 17 quarters of zero inflows to investors, followed by 12 quarters of fixed installments paid out.) The firm is going to "earn its way out" of the original investment by providing returns back to investors from internally generated cash flows.

The trick in getting this earn-out to provide an attractive IRR over the life of the entire investment horizon (the combined initial launch and ramp-up periods--the 50 months in the example--plus the earn-out distribution stage). A fixed quarterly or monthly cash outflow from the firm (cash inflow to investors) would be determined for the 36 months. This payment has to be large enough to support the targeted IRR that will provide incentive for the investors to agree to the offer, yet it also has to fit comfortably into the firm's operating margins between projected revenues and cost structure. This systematic buyback of stock provides liquidity for investors without an IPO, yet allows the firm to do it in stages that preserve the integrity of the operating margins and ongoing competitiveness of the firm.

Like any other deal, this will have to be negotiated through several rounds of give-and-take. But eventually, the earn-out can provide a very reasonable mechanism by which early-stage capital providers can realize liquidity on all or a portion of their investment, and the company (and the entrepreneur) can realize a recapture of a sizable amount of equity ownership through the transfer of shares over the earn-out period.