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If You Don't Price Risk, You'll Pay for It Later

David Deeds (University of St. Thomas)

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In ETA, the best deals align price and uncertainty through smart structure—not optimism. Structure is how risk—and money—actually moves between buyer and seller.

Fourth in a Series

Finding the right business and doing the diligence well gets you to the starting line. Structuring the deal determines whether you finish the race.

In Entrepreneurship Through Acquisition (ETA), deal structure is not a legal exercise or a financing afterthought. Many buyers treat deal structure as something to address after diligence is complete, once the "real work" of valuation is done. But, in ETA, deal structure is not an afterthought: It is a mechanism through which risk is allocated between buyer and seller, and it should drive price just as much as EBITDA does. Buyers who focus only on headline valuation miss the point. What matters is not what you pay in theory, but how much you pay and how much risk you assume in practice.

Setting a price tells you the what the businesses needs to deliver financially; risk determines what and how many surprises you'll actually face. If a buyer pays as if risk is low but then a lot of risk is silently transferred, that misalignment leaves little margin for error. Good deal structure forces alignment. Bad deal structure means the seller has a clean exit and you discover the true economics over time. You want to know them ahead of time.

A good deal is one where price, structure, and uncertainty are aligned. A bad deal is one where the buyer absorbs most of the risk while paying as if none exists.

Buying the Business Versus Buying the Assets

One of the first structural decisions is whether you are buying the business itself or its assets. This choice should affect price. If the buyer is assuming unknown liabilities, the price should be lower. If the seller wants a clean equity exit with minimal retained risk, they should expect either to accept a discount or to provide structural protections elsewhere in the deal.

Asset purchases are often attractive to buyers because they allow you to pick and choose what you acquire. You can leave behind unwanted liabilities, legacy legal exposure, and problematic contracts. Asset deals are also often tax efficient for buyers, allowing a step-up in basis and higher depreciation and amortization deductions, but they create tax liabilities for the current owners.

The tradeoff is friction: Assets must be retitled; contracts reassigned; licenses reviewed. In some businesses, particularly those with regulated customers or long-standing service relationships, this can introduce operational risk during the transition.

A simple example illustrates the difference. A buyer evaluating an IT services firm that provided custom systems and ongoing support to mid-sized manufacturers discovered during diligence that the company had unresolved warranty and service-level obligations tied to several legacy implementations. The issues were unlikely to surface immediately, but if they did, remediation would be costly and time-consuming. By structuring the deal as an asset purchase, the buyer acquired the core software licenses, customer contracts, and technical staff while leaving those contingent liabilities with the seller. Because the seller retained that risk, the buyer was willing to agree to a higher total price than would have been possible in an equity purchase where those obligations transferred at closing.

Equity purchases are cleaner operationally. You acquire the entity, its contracts, tangible and intangible assets, and history. Sellers often prefer equity sales for tax reasons, which can make them easier to negotiate.

But equity purchases transfer more risk to the buyer. You inherit what you know and what you do not. That makes representations, warranties, and indemnities more important, but it does not eliminate the underlying exposure.

Price Should Be Inseparable From Risk

Many first-time ETA buyers treat price and structure as separate conversations. They are not.

Price is simply the monetization of risk. When the buyer assumes more risk, the price should be lower. When the seller retains risk, through deferred consideration or contingent payments, the headline price can be higher.

An all-cash deal at closing is the lowest-risk outcome for the seller and the highest-risk outcome for the buyer. That structure should only occur when uncertainty is genuinely low: ehrn there are stable cash flows, limited customer concentration, clean operations. clear asset condition. If those conditions do not hold, paying a full multiple upfront is not confidence. It is mispricing risk. As a buyer, you should either require a significant discount in price to assume this risk, or you should walk away.

A brief example makes this concrete. A buyer evaluating a service business discovered during diligence that several key customer relationships were undocumented and managed personally by the owner. The seller resisted earn-outs and seller financing, insisting on cash at close. The buyer lowered the offer materially -- not as a negotiating tactic, but because the risk profile had changed. When the seller declined, the buyer walked. That was not a failed negotiation: It was discipline.

Cash at Close Buys Certainty, Not Value

Cash is appealing because it is simple. Sellers like it. Buyers like the lack of ongoing entanglement. But cash paid at closing is fully exposed capital. Once it leaves your account, you absorb all execution risk. If performance dips, the seller is unaffected.

Cash-heavy deals only make sense when risk is low and price reflects that reality. Using leverage or optimism to justify paying more cash upfront is backward. Structure should protect against uncertainty, not amplify it.

Bank Debt Transfers Risk to the Business

Bank debt is often the backbone of ETA financing. It is relatively inexpensive and widely available for businesses with stable cash flow. It also imposes discipline, which can be helpful for new owners.

But bank debt transfers risk to the operating company. Debt service is fixed. Cash flow is not!

Most bank loans come with covenants that constrain behavior. Common covenants include minimum debt service coverage ratios, leverage limits, restrictions on capital expenditures, and limits on distributions to owners. These covenants are designed to protect the lender, not to optimize the buyer’s flexibility.

For example, a buyer may see an operational improvement opportunity that requires short-term margin compression or upfront investment. Under a tight debt service coverage covenant, that decision may trigger a default even if the long-term economics are sound. In practice, this can force buyers to delay needed changes or to prioritize short-term stability over long-term value creation.

Banks also exert indirect control. When performance deteriorates, lenders gain leverage. Waivers come with conditions. Reporting increases. Strategic freedom narrows precisely when judgment and flexibility matter most.

Because of this, bank debt should be sized conservatively in ETA deals. Using leverage to stretch price increases fragility. Using leverage to support a disciplined price enhances resilience.

Seller Financing Aligns Risk and Price

Seller notes are one of the most powerful tools in ETA because they align incentives naturally.

When a seller carries part of the purchase price, they are implicitly vouching for the durability of the cash flow. That risk sharing justifies a higher total price because

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the seller only receives full value if the business performs.

Seller financing also provides the buyer with downside protection. If the business struggles early, the seller has capital at risk alongside the buyer, which often makes them more cooperative during transition.

Terms matter. Interest rates, amortization schedules, subordination to bank debt, and maturity all affect real risk allocation. But as a principle, seller financing is often a signal of deal quality. Sellers who believe in the business are more willing to defer payment.

Earn-Outs Trade Certainty for Disagreement

Earn-outs exist to resolve valuation disagreements about future performance.

When buyer and seller have different views on growth, margins, customer retention, or operational improvement, earn-outs allow both to be right, conditionally. If performance materializes, the seller gets paid. If it does not, the buyer is protected.

For example, a seller may believe that revenue will rebound once a temporary disruption passes. The buyer may be less confident. An earn-out tied to revenue recovery over the next two years allows the seller to capture that upside without forcing the buyer to pay for it upfront.

Another common structure ties earn-outs to EBITDA targets. If post-close EBITDA exceeds a defined threshold, the seller receives additional consideration. This shifts execution risk back to the seller while preserving incentives to support the transition.

Earn-outs justify higher headline prices precisely because they shift downside risk back to the seller. They should never be used to justify an aggressive base price. Earn-outs are upside sharing mechanisms, not insurance against overpayment.

Design matters. Earn-outs should be simple, based on metrics the buyer can reasonably control, and clearly defined. Complex formulas, ambiguous adjustments, or long time horizons almost always lead to disputes.

Outside Capital Changes Control, Not Just Economics

Outside capital can make deals possible that otherwise would not be. It also changes who ultimately controls the business.

Equity investors share risk, but they also share authority. Even minority investors often come with governance rights, reporting requirements, and expectations around growth and exit timing. Boards, approval thresholds, and investor vetoes can meaningfully constrain a buyer's freedom.

Loss of control rarely shows up immediately. It emerges over time, when priorities diverge. A buyer focused on steady cash flow and gradual improvement may find themselves pushed toward faster growth, acquisitions, or an earlier sale to meet investor return targets.

Debt investors reduce equity dilution but increase operational pressure. Equity investors reduce personal financial exposure but introduce strategic oversight. Neither is free.

ETA buyers should evaluate capital not just on cost, but on how it affects autonomy during the first two to three years. The wrong capital partner can turn a manageable business into a constant negotiation.

Retained Equity Is Deferring Payout

When sellers roll over equity, they are deferring part of the purchase price into future value creation. This can be powerful alignment.

Retained equity justifies higher valuations because sellers participate only if the buyer executes well. Buyers benefit from reduced upfront cash exposure and continuity during transition.

Governance must be clear. Shared economics without clear authority creates confusion. Minority equity works only when control is unambiguous and exit expectations are aligned.

The 7 Deadly Mistakes

Most failed ETA deals do not fail because the buyer misunderstood the business. They fail because the buyer misunderstood risk and paid for it anyway.

The mistakes below show up repeatedly, especially among first-time buyers.

Overpaying for Certainty You Do Not Have

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Paying a full multiple in cash at close when diligence surfaced real uncertainty is not confidence. It is denial. If customer concentration, asset condition, or management depth are unclear, risk should be shared through structure or reflected in price.

Treating Earn-Outs as Insurance

Earn-outs do not protect you from overpaying. They only work when the base price is disciplined and the earn-out reflects genuine disagreement about future performance. Using an earn-out to justify an aggressive upfront price almost guarantees disappointment.

Using Leverage to Stretch Price

Debt should support a conservative deal, not make an aggressive one possible. Buyers who use bank debt to justify higher valuations often discover that covenants, not customers, end up driving decisions.

Ignoring Covenant Risk

Debt service coverage ratios, leverage caps, and capital expenditure limits matter operationally. Buyers who do not model covenant headroom under downside scenarios are often surprised when lenders gain control during the first operational hiccup.

Underestimating Loss of Control from Outside Capital

Minority investors still influence strategy. Board seats, approval rights, and exit expectations can quietly constrain autonomy. If maintaining control matters to you, governance terms matter as much as valuation.

Accepting Seller Reluctance as Normal

Sellers who resist earn-outs, seller financing, or retained equity while demanding full price are signaling something. It may not be dishonesty, but it is always risk. That risk should be priced.

Confusing Clean Structure with Good Structure

Simple deals are attractive. Clean is not the same as smart. A well-structured deal may be more complex on paper but safer in practice.

In Entrepreneurship Through Acquisition, structure is where judgment shows up. When price, risk, and structure are aligned, deals hold together. When they are not, the problems usually appear after closing, when fixing them is hardest.

To Sum Up: Structure is Strategy

In ETA, deal structure is not a legal technicality. It is strategy expressed in contractual form.

Price without structure is meaningless. Structure without price discipline is dangerous. The goal is alignment: between risk and reward, between uncertainty and valuation, and between today's cash flow and tomorrow's performance.

A good business bought at the wrong price for the risk assumed is a bad deal. A well-structured deal gives the buyer time, flexibility, and margin for error.

In ETA, those are often the most valuable assets you can buy.

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How to Choose the Right Company to Acquire (https://eiexchange.com/content/how-to-choose-the-right-company-to-acquire)

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Buying a Business Means Inheriting its Stakeholders (https://eiexchange.com/content/buying-a-business-means-inheriting-its-stakeholders)

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