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TRANSACTION ADVISORY SERVICES

EARN-OUT PROVISIONS PROVIDE BENEFITS AND PROTECTION TO BUYERS AND SELLERS

Transaction stakeholders continually are seeking innovative ways to translate deal value into a 'win-win' situation for both the buyer and the seller. Among the mechanisms considered in structuring a deal has been the use of an earn-out in establishing deal value. This mechanism has gained significant traction over the past several years, particularly in middle market transactions. Please refer to Exhibit A below for a graph of small to mid-market M&A deals between FY 2013 to Q1 2017. The graph indicates 15.8 to 20 percent of total deal flow was comprised of some form of an earn-out in deal value.

A judge aptly described the nature of an earn-out in the court case Airborne Health, Inc. v. Squid Soap, LP (Del. Ch. 2009) as follows: "What an earn-out… typically reflects is disagreement over the value of the business that is bridged when the seller trades the certainty of less cash at closing for the prospect of more cash over time."indicates substantial impact on the operating model, this information may be leveraged during negotiations.

In essence, an earn-out is a transactional tool that allows the purchaser of a business the option to defer a portion of the purchase price to a later date, provided certain contractual obligations are met. This structure provides numerous pragmatic benefits to transaction stakeholders by aligning their interests. In this way, financial performance further may be maximized. Some of the benefits of an earn-out in a transaction could include one or more of the following:

- Permit the purchaser an alternative so as to mitigate substantial risks or uncertainties associated with the performance of an acquired entity post-close;
- Incentivize the seller to participate in the performance of the acquired entity post-close;
- Promote the retention and performance of key employees of the acquired entity;
- Provide alternative financing for the purchaser so as to potentially defer the payment of some of the purchase price; and
- Protect the purchaser from an overpayment for an acquired entity if future expectations are not met.

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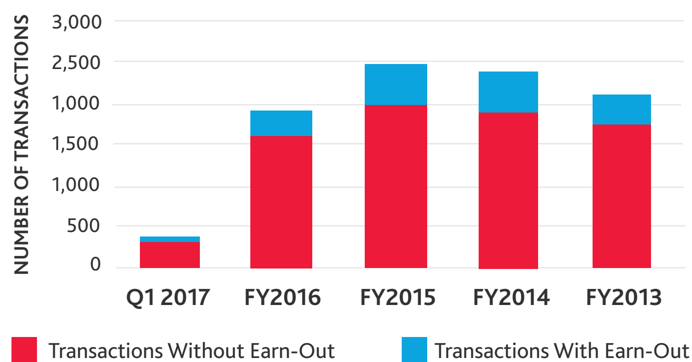
EXHIBIT A: Earn-Outs in Small to Mid-Market Transactions



Source: S&P Capital IQ

Structuring the Earn-Out

In structuring an earn-out into the purchase price in a contemplated transaction, purchasers and sellers may consider and negotiate various types of earn-out goals to meet the requisite needs of these same stakeholders. These goals may include one or more of the following:

- Financial targets for which an earn-out payment is triggered if and when certain levels or ranges of financial metrics are met over a stated period of time, such as for revenue, net income, or EBITDA (earnings before interest, taxes, depreciation, and amortization);
- Cumulative financial targets as to which cumulative levels of financial metrics (revenue, net income, or EBITDA) are met over a stated period of time;
- Market performance targets whereby an earn-out payment is tied to an achievement of certain levels or ranges of say an equity value, commodity price, or certain internal rate of return tiers; or
- Milestone accomplishment targets for which the completion of a milestone task could in each case trigger an earn-out payment.

These milestone accomplishments could include one or more of the following: (a) the approval of a phase of testing in the pharmaceutical industry, (b) the approval of a patent application, (c) the achievement of software integration, or (d) the successful launch of a product.

Revenue-related metrics generally are suited best for companies in which substantial uncertainties exist related to revenue performance. Revenue-related metrics could include the following: (a) annual revenue, (b) average revenue, (c) adjusted revenue, (d) revenue growth, or (e) revenue as a percentage of operating assets.

In contrast, earnings-related metrics typically are suited best for companies in which substantial uncertainties exist related to earnings potential. Earnings-related metrics could include: (a) gross margin, (b) annual/average/adjusted EBITDA, or (c) net income.

In addition, non-financial or milestone accomplishment targets generally are best suited for companies where regulatory approvals or proven technologies are necessary to make progress for product development and sales.

In structuring an earn-out, it is very important that experienced legal counsel and tax advisors are consulted and involved early and throughout the process so the letter of intent or the final agreement contain clearly written provisions. Disputes often occur if the transaction documentation does not clearly:

- Define the earn-out performance measurements;
- Describe how the amount of the earn-out payments are to be calculated; and
- State when the earn-out payments are to be made.

Other issues to consider with respect to the documentation of an earn-out are: (1) how the buyer plans to manage and operate the target or a combined entity post-acquisition; and (2) if there might be changes in accounting policies that could impact the expected financial metrics of the acquired or combined entity. The purchase agreement should cover these issues in fine detail.

Accounting for Earn-Outs

In the past, accounting for earn-outs involved an approach in which value had been recognized when earned and paid. In general, this resulted in an increase to accounting goodwill, an asset recorded on the balance sheet in connection with an acquisition. With the more recent implementation of revised accounting standards, earn-outs now are recorded at fair value at the date of acquisition. Subsequently, their fair value is re-measured at the end of each reporting period.

Valuation of Earn-Outs

In deriving the fair value of earn-outs, consideration may be given to the three general approaches to fair value: (a) the cost approach, (b) the market approach, or (c) the income approach. With respect to earn-outs, the income approach typically is the preferred method in determining fair value.

To determine fair value under the income approach, either of the following models may be used:

- A single scenario model, which in essence is an expected discounted cash flow model; or
- Multiple scenario models, which in essence are forms of decision trees which typically are comprised of a probability weighted expected return method, lattice models (binomial or trinomial models), or Monte Carlo simulations.

The more complicated the type and structure of an earn-out, the more complicated the fair value analysis is likely to be.

Conclusion

Earn-outs are most commonly used in transactions in which the owner or the management team of the acquired entity would continue to operate the acquired entity post-acquisition. In structuring an earn-out, it is important an experienced attorney and tax consultant be involved to represent each party in meeting and achieving their respective goals. If not structured and documented appropriately, the resulting amount of earn-out payments may not align with the expectations of the parties to the transaction. A misunderstanding such as this could lead to costly and time-consuming litigation.