
M&A earnouts and the impact of COVID-19



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Agenda

- Overview of earnouts
- Types of earnouts
- Earnouts in the COVID-19 environment
- Valuation of earnouts
 - Scenario based method (“SBM”)
 - Option pricing method (“OPM”)



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Overview of earnouts

- What is an earnout?
- Payment for future events or conditions being met
- Payment can take the form of cash (typical) or equity
- Some take the form of a clawback (rare)



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Why earnouts?

- Buyers and sellers many times have differing views of the future performance of a business
- Earnouts help “bridge the gap” in terms of pricing of the business given different future expectations



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Why earnouts? *(cont.)*

- Earnouts allow less cash up-front to purchase the business
- Earnouts also help control potential competition as sellers could “leave money on the table”



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Buyer advantages

- Less overpayment risk
- Less up-front cash
- Additional control over sellers



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Buyer disadvantages

- Additional payment may occur even if company performance is poor (think sales earnouts or earnouts paid just before start of pandemic)
- If seller has no chance of achieving earnout, may limit “handcuffing”



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Seller advantages

- Ability to share in upside potential after sale of company
- Helps close deals when large differences in future expectations
- May result in tax advantages (deferral)



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Seller disadvantages

- Company may struggle after sale, resulting in no or limited payment
- Payment may be a year or more
- Disagreements with buyers over definition of earnout achievement (is EBITDA adjusted or unadjusted?)
- “Locked-in” with company



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Typical earnout types

- EBITDA (most common)
- Revenue
- Gross profit
- Milestone

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Typical earnout structure

- **Cliff** – e.g., sales exceed target, earnout is paid
- **Tiered** – e.g., EBITDA is between to thresholds, get paid sliding scale
- **Binary** – e.g., Drug moves to clinical trials, get payout



VALUATION APPROACHES AND METHODS

Earnouts post-COVID-19

- Transactions down significantly during COVID-19
- Due diligence difficult due to travel and other restrictions
- Massive uncertainty regarding future financial results of the business



VALUATION APPROACHES AND METHODS

Earnouts post-COVID-19 (*cont.*)

- Anecdotally, seeing more deals in the pipeline with earnouts and a bigger part of the purchase price
- Many earnouts focused on EBITDA
- Without additional clarity, we expect the trend to continue



GUIDELINE PUBLIC COMPANY METHOD

Valuation of earnouts

- Two primary techniques
 - Scenario Based Method (SBM)
 - Option Pricing Method (OPM)



GUIDELINE COMPANY TRANSACTION METHOD

Scenario Based Method

- Probability weights future forecasts to estimate the earnout payment
- Significant difficulty to forecast the potential range of outcomes
- Discount rate determination tends to be very subjective as trying to determine risk of achievement vs forecast risk



GUIDELINE COMPANY TRANSACTION METHOD

Scenario Based Method (*cont.*)

- Advantages
- Ease of use
- Few scenarios to consider
- Disadvantages
- Generally overstates the value of the earnout
- Is not considered best practice



GUIDELINE COMPANY TRANSACTION METHOD

Option Pricing Method

- Earnout metrics (EBITDA, sales, etc.) are discounted to become “risk-neutral”
- Earnout payment forecast considers an extremely broad range of outcomes
- Counter-party risk more explicit in determination of value
- Better captures achievement risk



GUIDELINE COMPANY TRANSACTION METHOD

Option Pricing Method *(cont.)*

- Discount rate for earnout metric
- EBITDA – WACC
- Net income – Equity Rate
- Revenue – Adjusted WACC for variable vs fixed cost structure

Other Baker Tilly valuation services

| Valuation services | | | |
|---|---|--|--|
| Corporate transactions | Financial reporting | Tax reporting | Other |
| <ul style="list-style-type: none"> – Mergers, acquisitions and divestitures – Intellectual property – Joint ventures – Partner buy-sell | <ul style="list-style-type: none"> – Purchase price allocations (ASC 805) – Financial Services - Investment Companies (ASC 946) – Goodwill impairment testing (ASC 350) – Asset impairment testing (ASC 360) – Equity-based compensation (ASC 718) | <ul style="list-style-type: none"> – Deferred compensation (409A) – Gift and estate tax – IRS controversy | <ul style="list-style-type: none"> – M&A purchase price disputes – Shareholder matters |



Additional resources

Whitepaper

Valuation of contingent consideration:
AICPA Practice Aid

www.bakertilly.com/insights/valuation-of-contingent-consideration-aicpa-practice



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