REBOUND & REMODEL

The earn-out – Is this the new normal in M&A? (Part one)

Earn-outs bridging valuation gaps

The COVID-19 outbreak, almost overnight, unleashed unparalleled uncertainty, with concerns about a global downturn compounding the impact on the UK, European and worldwide M&A markets. A key factor contributing to the impact on the M&A market is the uncertainty surrounding business valuations and executing deals at the right price. Optimistic sellers will likely argue that a business should be valued on its pre-COVID performance, whereas sceptical buyers will argue that pre-COVID-19 performance indicators may not adequately reflect the pandemic's effects on the market going forward and may request a reduction to the purchase price.

Although the prospect of a COVID-19 vaccine is promising, trends are emerging where buyers and sellers implement commercial and innovative solutions to bridge valuation gaps. One of these trends is an increase in the use of earn-outs. The first paper in this three part series provides a refresher on earn-outs, common metrics and how earn-outs can be a valuable tool in bridging valuation gaps. We also explore dimensions to earn-outs brought about by COVID-19 and considerations that may be relevant for both buyers and sellers in earn-out negotiations, including tax and accounting considerations.

Background

Over the last decade, there has been a desire by parties to fix the purchase price at completion given that upfront valuations put forward by sellers have been well supported. However, as uncertainty surrounding business valuation will most likely increase due to concerns about the second and subsequent waves of COVID-19, an earn-out mechanism could be a very useful tool to bridge valuation uncertainty and execute deals. This was, in fact, a trend observed in the CMS European M&A Study 2008-2011 during the last financial crisis. While there are various forms, typically an earn-out requires a buyer to make additional consideration payments to a seller following the completion of a deal if the business achieves certain performance metrics in a time period following completion.

Key considerations

— Sellers and buyers are increasingly using earn-outs as a solution to bridge valuation gaps.
— Sellers and buyers should consider COVID-19 impacts on earn-out negotiations and metrics.
— Tax and accounting implications of an earn-out structure should be considered as early as possible.
— The interplay of the earn-out mechanism and other provisions like warranties, access to information and what happens in case of a dispute should form part of the structuring and negotiation.

Metrics

In the CMS European M&A Study 2020, we saw turnover narrowly overtake EBITDA as the most popular financial metric on which to base an earn-out. We expect that the rise in popularity in the use of turnover to determine the amount of an earn-out reflects the view that turnover is a more easily verifiable metric whilst EBITDA can be open to different accounting interpretations and manipulation. Where EBITDA is used, being a non-GAAP metric, input from accountants will be necessary to help clearly define the relevant concepts. Against the backdrop of COVID-19, we could also see the rise of other alternatives to these more traditional financial metrics, such as "EBITDAC" (EBITDA adjusted for the impact of COVID-19) and non-financial metrics such as the retention of key agreements.

Examples of possible metrics

1. Financial (GAAP): revenue, profit/loss for the year (net income), operating cash flow
2. Financial (Non-GAAP): underlying earnings, EBIT, EBITDA and Adjusted EBITDA, free cash flows, EPRA Net Asset Values (NAV), EPRA Earnings, rental yields, net debt and operating profit
3. Non-financial / operational: achievement of a specific project, regulatory approval (for example, for healthcare or pharmaceutical businesses), production targets, conversion of "pipeline", customer "churn" and employee satisfaction

As COVID-19 has generally caused a downturn in market conditions, this has naturally meant that buyers and sellers of companies are keen to ensure that the negative impact of COVID-19 is appropriately reflected in the valuation of the business. However, a less common counterfactual is that some companies have done exceptionally well during COVID-19. This period of high growth may be primarily driven by temporary conditions brought by COVID 19, such as strict lockdown measures imposed by governments, rather than signifying a sustainable growth trajectory for the company. If a COVID-19 vaccine is developed or as lockdown measures start to ease, it will be important to consider that the value of these businesses may be artificially inflated in the short-term which should also be factored into valuation considerations. Buyers and sellers may wish to query whether a metric like EBITDAC would be appropriate for companies which have performed well during COVID-19, as well as those companies which have seen their values drop.

Seller and buyer considerations

The position of both sellers and buyers needs to be considered to reach a balanced outcome in earn-out negotiations. We set out some issues that sellers and buyers may wish to consider in the context of COVID 19 and generally.

Seller considerations	Buyer considerations
Earn-out period	
Seller's preference will be to have a shorter period (one to two years), after which performance is less likely to be a legacy of Seller's ownership.	Buyer's preference will be to have a longer time period (two to three years), which may create more value certainty.
Metrics	
Seller may wish to have the earn-out linked to more than one metric (which may include non-financial metrics), to supplement the financial targets in the current climate and reduce the opportunity for manipulation of the preparation of earn-out accounts to the detriment of Seller.	If using non-GAAP metrics to determine the earn-out, Buyer will want to ensure that metrics are defined tightly to avoid disputes with Seller and that the selected metrics incentivise and motivate the right behaviour.
Valuation of business and integration	
Seller will want to ensure that it receives credit for any integration of the acquired business that enhances the value of Buyer's existing business in the earn-out.	Buyer will want to ensure that the earn-out is not over-valued by the integration and should consider any appropriate adjustments.

Seller considerations	Buyer considerations
COVID-19 impacts	
Seller will want to ensure that the value of the business reflects the true value and is not unfairly impacted by a contraction due to COVID-19.	Buyer will want to ensure that the value of the business is not overinflated in the short term due to COVID-19 driving strong demand.
Security for payment	
Seller's preference, to ensure certainty of payment, will be to have a retention or escrow account in place.	Buyer should resist security arrangements but may need to consider providing comfort by alternative means (e.g. a parent company guarantee or evidence of cash flow projections).
If Buyer resisting cash-based security, Seller may consider applying an interest rate on the earn-out payment.	If Seller is insisting on cash-based security, Buyer could seek an early payment earn-out discount.
Integration with buyer's business	
Seller's preference will be to impose restrictions preventing increased non-ordinary course costs in the business, interruption to supply chains or a reorganisation of the business within Buyer's group.	Buyer's preference will be to have the ability to freely run the acquired business and integrate it into Buyer's group to assist with realising synergies.
Seller should carefully scrutinise any Buyer proposal to adjust downward the earn-out for synergies, particularly if Seller has limited visibility or if there is difficulty in assessing the value of any synergies.	Buyer may want to reverse out synergies obtained as a result of being in Buyer's group as not reflective of the underlying business acquired from Seller.
Seller involvement in acquired business after completion	
Seller's preference will be to have oversight to monitor the performance of the acquired business in the current COVID-19 climate to maximise the chance of the earn-out being paid out.	Buyer's preference will be to place limits on the level of Seller's oversight and control to enable Buyer to make decisions efficiently in the current COVID-19 climate.

Tax considerations

The tax implications of a proposed earn-out structure should be considered as early as possible in a transaction process as the precise terms of the earn-out will determine the tax treatment of it for the parties.

The form of earn-out consideration (for example, cash, shares or loan notes) and the availability of business asset disposal relief (for an individual seller) or the substantial shareholdings exemption (for a corporate seller) will be relevant considerations for a seller in valuing its earn-out right for tax purposes and, in the case of an individual seller, making any related tax elections. If a selling individual is to remain with the business following completion, it will be important to consider the risk of the earn-out being treated as employment income.

The extent to which stamp duty is payable by a buyer on an earn-out will be determined by reference to whether the amount payable pursuant to the earn-out is ascertainable at completion and the existence of any minimum or maximum financial thresholds applying to the earn-out. Notably, if the amount payable pursuant to an earn-out is not ascertainable at completion and is capped at a certain amount, stamp duty will be payable by reference to this cap regardless of the amount actually paid pursuant to the earn-out.

Accounting considerations

There can be significant tax and accounting implications for both buyers and sellers depending on how the earn-out is structured, and, in relation to the accounting implications, whether the buyer accounts under IFRS or UK GAAP.

Both issues are broadly concerned with whether earn-out payments are treated as capital or income and there are separate tests from the accounting and the tax perspectives. Taking early specialist advice is highly recommended to ensure the earn-out is structured to minimise any adverse consequences.

Kristy Duane
Partner, Corporate
T +44 20 7524 6568
E kristy.duane@cms-cmno.com

Aaron Fairhurst
Partner, Tax
T +44 20 7367 2863
E aaron.fairhurst@cms-cmno.com

Kushal Gandhi
Partner, Finance Disputes
T +44 20 7367 2664
E kushal.gandhi@cms-cmno.com

Mariam Azzo
Senior Associate, Corporate
T +44 20 7367 3509
E mariam.azzo@cms-cmno.com

Corinna Lee
Senior Associate, Corporate
T +44 20 7367 2941
E corinna.lee@cms-cmno.com

Jason Todd
Senior Associate, Tax
T +44 20 7367 2068
E jason.todd@cms-cmno.com

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