REBOUND & REMODEL

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

Payment structures and sector considerations

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 third paper in this three part series focuses on the structuring of earn-out payments and how earn-outs may be used differently depending on the sector a business operates in.

Structure of earn-out payments

Typically earn-out payments are structured to result in an increase to the purchase price that may be payable at a future date. This increase is 'earnt' by a seller if the acquired business' performance exceeds the agreed performance benchmark. We envisage that this approach will continue to be looked upon favourably by buyers in the current climate as it implies a lesser amount payable by the buyer at completion.

As part of considering the structure of an earn-out, parties will need to determine the payment thresholds and frequency. Generally, there are two options for parties to consider:

1. Frequent milestones and payments that are paid annually or quarterly.
2. Single milestone and bullet payment typically paid out at the end of the earn-out period.

Buyers will naturally prefer higher thresholds with a single milestone and bullet payment at the end of the earn-out period, however sellers will generally favour frequent milestones and payments. As a compromise, and particularly in environments like the one we currently find ourselves in, parties may construct a formula based on a sliding scale approach to paying out an earn-out rather than an 'all or nothing' approach.

Key considerations

— Earn-out payments can be structured to take into account concerns around business performance during and post COVID-19.

— Consider whether sector specific earn-out metrics are relevant to your transaction.

The risk of further waves of COVID-19 is another factor which will have an ongoing impact on earn-out calculation and payment dates. One possible way of addressing this may be for the parties to agree to defer upcoming earn-out payments if there is another wave of COVID-19 and a buyer may be more inclined to accept this if the deferral was given to the seller in exchange for a discount in upcoming earn-out measurements and payments. A motivated seller with leverage in the current environment may have success in negotiating such a deferral or alternatively negotiating the right to modify the earn-out calculation to mitigate the effect of any subsequent waves of COVID-19. This will need to be balanced against the desire to be paid, value certainty, integration plans for the acquired business in the buyer's group and the longer-term damage of having a disincentivised seller, which should not be overlooked.

Frequency of Earn-out Mechanism			
SECTOR	**2010–2018**	**2018**	**2019**
Banking & Finance	14%	7%	14%
Hotels & Leisure	9%	11%	27%
Energy & Climate Change	15%	11%	16%
Consumer Products	18%	24%	10%
Technology, Media & Communications	25%	40%	29%
Infrastructure & Projects	7%	25%	22%
Life Sciences & Healthcare	29%	43%	41%
Real Estate & Construction	12%	19%	10%
Industry	17%	22%	19%
Business (Other Services)	22%	18%	26%
CMS AVERAGE	**18%**	**23%**	**21%**

100% = all evaluated transactions of the respective industry

Consideration should also be given to the calculation window for each earn-out and whether, for example, it is possible to:

— Structure the earn-out such that there is a blackout period to account for the second or subsequent waves of COVID-19 should they arise;
— Ensure that the relevant accounting period is longer than a 12-month cycle to help neutralise effects of a rogue and volatile period; or
— Average out performance over the whole earn-out period or, where an average will be skewed dramatically by the COVID-19 impact, extend the earn-out period to help smooth out peaks and troughs.

The sale contract could be drafted to include a defined set of trigger events that unlock the agreed upon extraordinary measures or alternatively language could be included to insulate an earn-out from the impact of adverse extraordinary events in the current climate.

Sector considerations

Earn-outs tend to be more popular in Life Sciences & Healthcare and Technology, Media and Communications transactions. This overall trend demonstrates that earn-outs have historically been most applied in sectors that are innovative and creative, frequently involving individual owner managers. In the CMS European M&A Study 2020, we saw Life Sciences & Healthcare remain as the most popular sector for earn-outs at 41% of such deals, topping the table ahead of Technology, Media and Communications (down to 29%, a notable drop of 11% from the previous year). In terms of other sectors, we saw a marked difference in the increase in earn-outs in the Hotels and Leisure sector (rising from 11% to 27%) and a fall in the Consumer Products sector (10% from 24%).

In the first paper in this series, we set out examples of financial and non-financial metrics used in earn-outs. A common metric is earnings before interest, tax, depreciation and amortisation (EBITDA), which is a non-GAAP financial metric and accordingly must be clearly defined in the sale contract. Parties will need to consider how each component of EBITDA is to be calculated and whether any adjustments (such as for exceptional one-off items) are required. Earn-outs can be tied to more than one metric, which may reduce the opportunity for a buyer to manipulate the preparation of the earn-out accounts to the detriment of a seller.

When choosing an appropriate metric or combination of metrics for a particular transaction, sector considerations are often relevant too as earn-out metrics can be sector specific. Examples of common metrics used in certain sectors include:

— *Renewable Energy:* turnover, megawatt output, customer growth, production targets
— *Healthcare / Pharmaceutical:* regulatory approval
— *Real Estate:* net asset value or EPRA earnings
— *Infrastructure:* free cash flow
— *Telecoms:* EBITDA, free cash flow, customer "churn"

In all cases, it could be a result indicator that can be readily defined and is easily measurable. In the current climate, for businesses where employees are very valuable and are the main assets (for example, technology companies), earn-outs metrics could, in addition to any financial targets, be based on employee satisfaction whereby an independent survey is conducted and a score is achieved or, for a more objective test, employee satisfaction being determined by employee turnover or churn numbers calculated by reference to low industry turnover rates.

The ongoing fallout of COVID-19 may see the use of earn-outs increase across all sectors, as the M&A market, while remaining strong, shifts towards more buyer-friendly terms in the current climate. In this regard, parties should consider whether any sector specific considerations should be taken into account in earn-out discussions.

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Other papers of interest:

Earn-outs bridging valuation gaps

Retention arrangements, insolvency risk, creditor issues and dispute resolution