1 Earnouts in Mergers & Acquisitions Transactions

1.1 Introduction

Reflecting the importance of mergers and acquisitions (M&As) in shaping the corporate sector, numerous studies attempt to examine whether M&As create or destroy value for the shareholders of the acquiring firms. In general, empirical evidence suggests that small acquirers earn significant value gains at the announcement of M&A deals while big acquirers suffer significant losses. Aiming to explain such divergent wealth effects, the vast majority of studies focus on the wealth implications of several factors pertinent to deal- and merging-firms specific factors and, in particular, the method of payment used to finance the deal. In light of the vast increase in the use of deferred payments, or earnouts, in the US and UK takeover markets, this report presents the dynamics of earnout-financing in M&As along with some newly emerged trends in their use and wealth effects.

1.2 Information asymmetry in M&A deals and the method of payment

In determining the likelihood of success of an M&A deal academics and market participants tend to examine the reaction of the acquiring firm’s stock price during the announcement period. The stock price movements at the announcement of an M&A deal should be the net of the premium offered [to the pre-announcement market value of the firm to be acquired] and the present value of the expected synergy gains. Assuming that the deal is to be completed according to the announced terms, if the expected synergy gains exceed the premium the acquisition is a positive net present value project, which should be reflected in an appreciation of the bidding firm’s stock price.

In order to achieve a successful acquisition post-transaction, valuation and the method of payment constitute the two most important deal-specific features. The interaction of these is driven by the extent of the information asymmetry between bidder and target firms. An array of theoretical models has been developed to explain the difference in the value gains to bidders in the two most prominent payment options, i.e. payment in cash and in stock (i.e. shares). In particular, for bidders in cash-financed M&As, and for both bidders and targets in stock-financed M&As, information asymmetry creates valuation risk and leads the involved firms in the deal to demand a discount to the apparent value of the target or the bidder. More specifically, valuation risk may result in bidders in cash transactions overpaying for their targets, ultimately resulting in lower value gains to their shareholders. In contrast, in a stock-financed M&A, the

target’s shareholders share the valuation risk with the bidder’s shareholders in the post-acquisition period as they become shareholders of the merged entity. Thus, bidders seeking to reduce valuation risk from information asymmetry are more likely, all else being equal, to make an offer in which the method of payment consists of shares of the acquiring firm, rather than cash. Nevertheless, target shareholders may suspect that the acquirer’s stock is overvalued and is being offered in order for the acquirer to capitalise on its overpriced equity. As a result, they may be reluctant to accept such an offer unless being offered a substantially higher premium.4

In light of the above, earnout provisions constitute an alternative method of payment, which may reduce information asymmetry and, hence, valuation risk for both bidders and targets, while enhancing the probability of realization of the expected synergy gains.

1.3 The earnout structure

An earnout is a contingent form of payment used to finance an acquisition and involves a two stage structure:

- an initial upfront (or first stage) payment to the target’s shareholders; and
- a second stage of payment, conditional upon the target achieving certain pre-agreed performance-related goals post-acquisition. (Of course, this second stage can involve multiple triggers/payments).

The first stage payment can be in the form of cash, stock or mixture of financing currencies, while the second stage payment is usually in the form of cash and amounts to roughly 30 per cent of the total deal value. The length of the earnout period will vary depending on the nature of the products involved and the target firm’s market. Nevertheless, a typical earnout period will usually last between one and five years.

The performance goals on which earnouts are based are usually indicators of financial performance, such as revenues, net income or earnings before interest, taxes, depreciation and amortization (EBITDA). Performance goals can also be based on a non-financial metric, such as the number of products sold or the launch of a new product. When a financial metric is used to measure performance, targets often prefer to use revenue as it is perceived to be less easily affected by the buyer’s stand-alone performance or its ability to influence profit more than revenue.

In contrast, buyers may often prefer to use net income because it provides a more complete picture of the acquired business’ performance and provides an incentive to the seller’s management to control expenses and to appropriately price products and services. As a compromise, the parties will frequently agree on the use of EBITDA, which reflects the cost of goods, selling expenses and general and administrative expenses, but does not further reduce earnings by interest, taxes, depreciation and amortization.

Overall, the target performance level, the metrics used for the determination of performance, the duration of the earnout period, and the currency of the deferred payment are the outcome of negotiation between the bidder and target during the deal process. Thus, earnouts facilitate the valuation of the target firm over a period of time during which more value-relevant information becomes available to the parties involved in the transaction. In so doing earnout-financing reduces the acquirer’s exposure to valuation while incentivizing the target’s management to maximize performance and receive the deferred payment.

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1.4 Earnout stylized facts

Several studies on the US and UK takeover markets indicate the usefulness of earnouts in addressing information asymmetries faced by mainly small acquirers in valuation-complex deals. This is due to the fact that small acquirers can least afford to absorb mis-values risk in the post-acquisition period, especially when the target firms are also small and, thus, more prone to increased earnings volatility.

More specifically, certain types of target firms are more likely to suffer from valuation risk than others, thus rendering the use of earnouts more appealing. These mainly consist of small private firms, firms operating in young industries, high tech firms and firms that hold highly intangible assets. For such businesses, future cash flows are more difficult to forecast, which increases the likelihood of valuation error during the deal process. As a result, when the involved firms in an M&A transaction agree over the potential synergies to be created but disagree over the price, earnout-financing offers a reliable solution.

The use of earnouts may also be motivated by the bidder’s intention to retain the target firm’s management since it may be critical to realizing and enhancing the potential value of the target. Management retention is a particularly strong motivation, especially in acquisitions where the target firms hold highly intangible assets, such as human capital, goodwill and patents. Therefore, retention of skilled and/or experienced managers provides a significant source of value enhancement during the post-acquisition period. As the size of targets in earnout-financed deals is predominantly small, these managers are highly likely to also be the owners of the firm. Thus, earnout-financing offers them the incentive to remain in control and heighten performance in order to receive the second-stage payment. Lastly, another motivation could be to ‘lock in’ the target firm’s management and thereby prevent it from setting up a rival business.

1.5 The downside of earnout-financing

Despite the inherent advantages of earnout-financing identified above, parties in such M&A transactions often find themselves in dispute. In particular, one of the most commonly litigated disputes relates to the level of support that the buyer is required to offer to assist the acquired business achieve its earnout objectives.

More specifically, the achievement of the earnout thresholds is often dependent on the implied duty of ‘good faith’, ‘fair dealing’, as well as the doctrine of the acquiring firm’s ‘implied obligation to use reasonable efforts’ in order to support the target firm achieve the deferred payment’s conditions. Such support can include guaranteed levels of working capital, marketing assistance, and/or sales force which increase in significance in case the target is partially integrated and does not operate as a fully stand-alone firm post-merger, or in case changes need to be made in its processes and operations, as part of its integration with the buyer.

In case the acquiring firm’s performance during the earnout period does not permit the adequate support of the acquired firm, the earnout is likely to fail and, potentially, lead to litigation. As a result, it is not rare for courts to impose liability on acquirers for failing to support acquired businesses, for example noting that:

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8 Such changes can include potential bundling of the target firm’s products to those of the acquirer.
Earnouts all too often transform current disagreements over price into future litigation over outcome.

1.6 A shift in the dynamics of earnout-financed deals

In essence, earnouts allow buyers to mitigate valuation risk while positioning sellers to benefit from company growth and receive additional payments provided certain specific goals are achieved. Nevertheless, earnouts constitute complex payment instruments whose inherent intricacies may offset the implied benefits. In particular, the acquiring firm’s ability to facilitate the achievement of the earnout thresholds constitutes a significant factor that may result in failure or a legal dispute.

Nevertheless, over the past five years the M&A market has experienced a rise in the size of buyers using earnouts. In particular, earnout provisions have increasingly been employed by larger acquirers, as opposed to mainly small bidders, seeking to mitigate valuation risk. Similarly, the total value of earnout-financed deals has also risen as these instruments are more frequently observed in “megadeals” (i.e. M&A deals that exceed $10 billion in transaction value). This is reflected in the 2014 earnout-financed acquisition of Maker Studios by Disney, whose market value reached $179.5 billion in May 2015 and the 2015 acquisition of Visa Europe Ltd. by Visa Inc., at €21.2 billion in deal value, €4.7 billion of which constituted the prospective earnout payment.

Evidently, as earnouts are mostly employed in valuation-complex deals, big acquirers should be better able to accommodate the target’s need for assistance during the earnout period as well as take specific actions to support that target firm achieve the earnout goals in case of divergence from the earnout thresholds. Ultimately, the above would enhance the probability of realization of the expected synergy gains.

In addition, empirical evidence suggests that big acquirers suffer losses at the announcement of M&A deals, while small firms enjoy significant gains. One of the explanations provided for this phenomenon relates to the managerial hubris hypothesis as managers of large firms tend to be overconfident regarding the expected synergy gains from M&A deals. As a result, they offer larger acquisition premiums than small firms and enter acquisitions with negative or low synergistic opportunities. Therefore, the risk-mitigating properties of contingent payments are likely to signal, when employed by bigger acquirers, the absence of managerial hubris that may be present in big firms and deteriorates the synergy gains from M&A deals.

1.7 Concluding remarks

While managing earnouts can be difficult, in some cases it is the most effective tool to bridge the gap in valuation differences between the buyer and seller. Accordingly, the above reflect the increased applicability of earnout-financing in large deals involving big acquirers. Ultimately, the selection of earnouts by such firms is expected to lead to significant value gains during the announcement of the deal, reflecting the effectiveness of this two-stage payment structure in securing the realization of the expected synergies and limiting the potential for managerial inefficiencies (e.g. overconfidence) to result in valuation error.

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9 See e.g. Airborne Health, Inc. v. Squid Soap, LP, 984 A.2d 126 (Delaware Chancery court, 2009).
10 Potential additional factors that may have contributed to this shift in the frequency of earnout-use by large acquirers relate to the residual effects of the 2007 credit crunch and the subsequent decline in corporate credit availability.