Special serie COVID-19 - nÂ°9 Covid-19 - A comeback of earn-outs in M&A deals?


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In the context of the COVID-19 outbreak, most companies are currently facing unprecedented legal issues within their organisations. As a result, they have to adapt significantly their way of working to go through this unique time in the best possible and efficient manner. In order to assist you in this task, we have identified several hot topics, which we will present in a separate newsletter, to be published over the coming days and weeks, where we will provide you with practical hints to approach the situation efficiently.

Even before the Covid-19 crisis, balancing the risk allocation between the parties was a core principle of M&A deals. Most likely, risk allocation will become of paramount importance in shaping the parties' rationales to enter into a M&A deal in the aftermath of Covid-19, as the appetite for risk seems to be decreasing at the moment.

However, the appetite of the main protagonists on the market to strike new deals might be restored by an adaptation of the existing pricing mechanisms, supported as well by the proper protective contractual tools (on which we briefly touched upon in a previous newsletter) [1].

The financial component of risk allocation is now, more than ever, a cornerstone of every M&A endeavour, as challenges and uncertainties brought by the Covid-19 lockdown have been so dazzling that they will very likely reshape the customary practices for M&A deals, including in terms of pricing mechanisms. Parties might look more frequently at ways to defer the payment of the considerations, either in fixed or variable instalments, at later stages, in strict correlation with the achievement of certain (financial/business) milestones by the target.

From this perspective, the use of earn-out mechanisms might have a strong comeback in the M&A landscape by playing the role of the expected incentive for the parties. Earn-outs will aim at easing the risk bearing and the uncertainties, thus counterbalancing the effects on the value of the target and on the appetite for entering into a M&A deal altogether.

In this ninth newsletter, we will examine how the main features of an earn-out mechanism might be reshaped as to better respond to the current dynamics of the M&A market in the aftermath of Covid19.

Concept

Earn-outs are commonly known as the contractual mechanisms in which a portion of the consideration for a target is deferred and paid after completion, depending on the achievement of certain contingent financial or business milestones. While in case of other types of deferred payment mechanisms (such as completion accounts), the deferred payments may depend on various circumstances occurring prior to signing, the applicable contingencies in case of earn-outs are essentially related to the business reaching certain performance targets during a specific post-completion period.

The use of earn-outs has been highly debated in practice, not only due to the complexity of putting in place feasible and comprehensive earn-out mechanisms, but also due to the incidence of post-completion claims in case of their poor configuration.

Although earn-outs might be considered by some as concepts opposing (and excluding) the other main pricing mechanisms [2], the post Covid-19 context might be a good occasion to evidence that an effective earn-out structure can work alongside either a locked box mechanism or completion accounts. Thus, for a better risk allocation and hedging the overall adverse economic impacts, the use of other pricing mechanisms together with earn-outs might become more frequent in practice. Such a bespoke mechanism, will, however, entail specific provisions aiming to intertwine the specific concepts of the preferred pricing mechanism locked-box (such as leakage and value accrual for locked-box or defining the adjustment principles for completion accounts) with the earn-out mechanism.

Useful earn-out features for the aftermath of Covid-19

The intrinsic features of earn-outs make this mechanism a very useful contractual instrument, to be considered by the parties in the post Covid-19 world. When used properly, earn-outs can provide the parties with a useful tool to validate the headline price after completion and confirm the value for the business.

Due to their ability to cover the uncertainty gaps, while typically used in share deals, their comeback might also inspire the parties to use earn-outs for sales of businesses, even if designing such a mechanism might be indeed of significant complexity.

Metrics determination

The most common measure of earn-outs is earnings before interest, tax, depreciation and amortisation (EBITDA). EBITDA is a metric widely used in practice, as the enterprise value is determined based on an industry-specific multiple applied to EBITDA. One essential requirement to bear in mind upon drafting the sale-purchase agreement is to define EBITDA in a very clear manner[3] and to strictly itemize the components to be included and excluded within EBITDA.

The elements factored in upon determining the EBITDA should be revisited in the aftermath of Covid-19 in order to make sure that they remain relevant, both in terms of deal practicalities and market reshaping. As such, the parties may agree to exclude some items from EBITDA determination, in case these areas have been heavily affected/triggered by Covid19, irrespective of whether these are distinguished as costs or revenues[4]. A tailored selection of the applicable indicators might be the right incentive for the parties to strike a deal and to use their joint efforts for steering the business towards a profitable position.

Earn-out period

The length of an earn-out period is highly variable and dependent on the type of business operated by the target. Generally, it has been considered that the longer the period, the more it becomes debatable whether the performance of the business is still linked to the vendor's stewardship (and the less predictable it is). Thus, we might see in practice lengthier earn-out periods, aiming to maximize the chances of the target to overcome not only the normal post-acquisition disruptions, but also the disruptions triggered by Covid-19.

Vendor involvement

Earn-outs can also incentivise vendor management, who remain involved with the business for a transitional period after completion. Apart from having the inside information needed to optimally drive the business, vendors' involvement is key to deliver further growth or profits to the benefit of both themselves and the buyer. Thus, a sensitive item on the negotiation list between the parties is usually the management agreement and the balance which the vendor and the buyer will need to achieve when weighing their interests.

Vendor involvement after Covid-19 might also imply a use of complex earn-outs, which, for risk allocation purposes, will accommodate not only the vendor's involvement in management, but also a staged transfer of ownership over the business. Thus, while the buyer will acquire control over the target upon completion, the vendor will maintain a certain "skin in the game" from a shareholding perspective. In such case, the earn-out features might also imply not only performance-based deferred payments, but also further sales of the vendors' minority shareholding in the target up to full exit.

Financing/security

Another feature that makes earn-outs interesting post Covid-19 is their ability to bridge the uncertainty gap of the future performance of the target business. Used in the past for targets expanding on new business for which the full potential has not been discovered before completion, earn-outs might be of general use to accommodate any business which was affected by Covid-19 and whose profitable performance is questioned on the short-, mid-, or long-term run.

Use of earn-outs can also be a feasible option for buyers experiencing hardship in securing finance for the post-deal integration, as it will help them bridge the period elapsed between completion and the dates when earn-out payments should be made.

Earn-out disputes

A commonly accepted downside of earn-outs is that, when not drafted consistently and prudently, they can be the source of post-completion claims between the parties. Such claims will not only create conflicts and further costs for the parties, but it will also directly harm the business, as earn-out mechanisms are intrinsically linked to the business performance of the target. In case of reshaping the use of earn-outs as a tool for addressing the Covid-19 hardship, it will be paramount for the parties to ensure that the earn-out provisions are comprehensive, clear, realistic, and reasonably anticipative of potential pitfalls.

Thus, the earn-out provisions should include clear definitions for the used concepts and what should be included/excluded from the calculation, preferably illustrated by way of a pro-forma earn-out calculation. The chosen accounting policies and benchmark historical results of the target (by reference to an historical set of audited accounts or management accounts) should also be clearly indicated, in order to avoid dealing with areas open to interpretation. At the same time, it is important to include in the agreement the procedure to be observed for disputes resolution, including the rules for expert determination.

Conclusion

Through their diversity, earn-outs seem to be naturally designed to accommodate a wide span of deal structures by catering as well for an optimal allocation of the risk between the parties. Used boldly but thoroughly (from a financial and legal perspective), the beneficial effects of earn-out mechanisms can be the incentive needed by market participants for restoring the pace of the global M&A markets.

[1] *Special series COVID-19 newsletters - n°7 - How is the COVID-19 crisis likely to impact the negotiation of M&A transactions in the future?- https://www.pwclegal.lu/en/publications/special-serie-covid-19-num-7.html;*
[2] Locked-box mechanisms and completion accounts.
[3] EBITDA is not defined in the accounting standards used customarily. In addition, not having a comprehensive EBITDA definition to rely upon, parties face the high risk of dealing with post-completion disputes.
[4] For instance, certain costs and exposures incurred by the target to face Covid-19 challenges, such as employees remote working, investment in IT hardware, material contracts termination might be deemed as exceptional expenses and could be excluded from EBITDA determination.