

Emerging Trends in Sponsor-Backed Companies

Earn-Out Structured as Equity



EQUITY-LIKE EARN-OUTS

A contingent consideration, or an earn-out, is a contractual agreement commonly employed in mergers and acquisitions that allows the buyer to defer a portion of the purchase consideration, making it payable contingent on the target company's performance within a specified time horizon. Earn-outs are typically structured to mitigate the target's uncertain or risky future performance from the buyer's perspective while allowing sellers to receive fair consideration for future performance if realized.

In the context of private transactions, where seller shareholders often serve in management capacities, contingent consideration can also be utilized to incentivize certain key selling personnel or management to remain with the acquired company post-acquisition, ensuring these individuals actively contribute to realizing the value upon which the acquirer has based its purchase price. However, it's worth noting that private equity sponsors typically have investment horizons of five to seven years as compared to the traditional one- to three-year horizon for earn-out payments. At a minimum, this distinction represents a midstream cash outflow from the portfolio company or private equity sponsor, but it may also present a misalignment in the ultimate upside participation that incentivizes company management to help the sponsor realize its return.

To address these challenges, private equity sponsors are increasingly linking earn-out payout structures to the performance of their equity investment, synchronizing the timing and incentives of both parties involved. These integrated arrangements may take the form of a particular class of equity or phantom equity that only participates after the sponsor realizes a specified return on capital invested. By structuring earn-outs as equity-like instruments, private equity sponsors align the duration of the performance period of the contingent consideration with their investment horizon. Additionally, these arrangements typically enable the settlement of the earn-out to occur directly from deal proceeds, eliminating the need for private equity sponsors to fund the earn-out's cash outflow in the middle of their investment horizons.

What is an example of a traditional earn-out?

If the company's EBITDA for the earn-out period is (a) equal to or greater than \$70,000,000, the earn-out payment shall equal \$20,000,000, (b) less than \$30,000,000, the earn-out payment shall be equal zero, and (c) equal to or more than \$30,000,000 and less than \$70,000,000, the earn-out payment shall be the amount equal to (i) \$10,000,000 plus (ii) the EBITDA for the earn-out period minus \$30,000,000, multiplied by 0.25.

This earn-out will pay \$10.0 million if the annual EBITDA is \$30.0 million and \$0.25 per dollar of EBITDA after that, up to a maximum payment of \$20.0 million. This payout structure is relatively common and typically used in practice. While the payout on the earn-out is directly associated with the EBITDA of the target business, the payout and performance period of the earn-out may not be aligned with the private equity sponsor's investment horizon or returns received over such investment horizon.

What is an example of an earn-out structured as equity?

From and after the receipt by the investors of aggregate proceeds in respect to the Class A units that exceed the product of (i) 2.50 multiplied by (ii) the investors' investment amount in the Class A units, at such time as there are proceeds actually paid, the buyer shall promptly pay to the sellers an amount equal to 25.0% of the available proceed until such time as the sellers have received an aggregate amount equal to \$20,000,000.

This earn-out will pay 25.0% of the amount by which the proceeds received by the Class A unit holders exceed a multiple of invested capital of 2.50x, up to a maximum of \$20.0 million upon a liquidity event. While this earn-out payout structure has historically been less common, it directly aligns the private equity sponsor's investment horizon and deal proceeds with the payment on the contingent consideration.

VALUATION CONSIDERATIONS

Structuring a contingent consideration as a class of equity in the portfolio company's capital structure alters the dynamics of the payout when compared to the more conventional earn-out structures based solely on revenue, EBITDA, or gross profits. When contingent considerations are structured as equity, they become integrated into the company's waterfall distribution, which affects the distributions available to other equity securities. Consequently, these instruments possess an economic resemblance to minority equity holdings rather than traditional earn-outs and place additional control in the hands of the sponsor. Whereas, in theory, company performance is within the control of management and may not be highly correlated with the company equity returns, a liquidity event is driven by the majority owner (i.e., the private equity sponsor). These arrangements ensure that payout only occurs when the sponsor has achieved a targeted return on its invested capital. This distinction highlights the stronger alignment between equity-based earn-outs and the sponsor's overall investment objectives, as they are tightly linked to the sponsor's ultimate financial outcomes and the control they exert over exit events.

While equity-based earnouts provide additional economic benefits to the sponsor, they may introduce additional complexities for the company's management team for financial and tax reporting purposes. It becomes more important to consider their position in the company's capital structure and their impact on the value of other equity instruments post-earn-out payment. While management teams may traditionally view their 409A analyses as separate from an earn-out valuation, valuing equity-based earn-outs may require considering the rights and preferences of all other instruments in the company's capital structure within a single, holistic valuation model. This approach may involve a more complex valuation process that entails additional modeling and valuation assumptions. However, combining the earn-out and 409A analyses may also streamline the valuation process, eliminating the need for two separate analyses.

HOW HOULIHAN LOKEY CAN HELP

Houlihan Lokey can help you with the pre-deal ***structuring of the earn-out to match your intended objectives and address the post-deal and ongoing valuation and reporting requirements***. Our team of accounting and valuation specialists has deep experience helping clients navigate complex financial structures and address management planning, financial, and tax reporting issues.

Houlihan Lokey's transaction expertise and leadership in the field of valuation inspire confidence in the financial executives, boards of directors, special committees, investors, and business owners we serve. We focus on our clients, addressing their financial and business needs quickly and efficiently. We support private equity sponsors and private-equity-backed management teams as they optimize portfolio company operations. Our cross-functional teams of technical accounting, quantitative finance, corporate valuation, and tax experts can help you navigate the challenges presented by complex reporting requirements and heightened regulatory scrutiny.

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