FINANCIAL EXECUTIVE

Linking Global Finance Leaders

By
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Contingent consideration is doing the job it was intended to do — protecting the buyer against downside risk, allowing the seller to share in upside potential and letting both sides meet in the middle.

Contingent consideration, especially in the form of earn-outs, is an increasingly popular mechanism to address post-transaction performance uncertainties. It helps close the gap in expectations, shares future risk and rewards between the buyer and seller and incentivizes the seller to drive the ongoing success of the business.

The 2011 Private Target Mergers & Acquisitions Deal Points Study, by the American Bar Association Business Law Section, shows that earn-outs were present in 19 percent, 29 percent and 38 percent of public company acquisitions of private targets that closed in 2006, 2008 and 2010, respectively.

Many lessons have been learned in estimating the fair value of contingent consideration since revised financial reporting requirements for business combinations took effect in 2009. The following discusses results and insights derived from valuing contingent consideration under U.S. generally accepted accounting principles for 120 transactions with earn-outs that closed in 2009 through 2011.

The maximum deal size, including the maximum potential earn-out payment for the 120 transactions analyzed, ranges from $1.6 million to more than $2.5 billion, with a median of $36 million. While the median upfront consideration transferred was $20 million, it ranged from $0 — that is, the payment was entirely contingent — to more than $2 billion.

Almost all of these transactions involve private targets, while 74 percent of the acquirers are public with 26 percent private. Most of the targets were established companies, but approximately 40 percent were pre-revenue companies or had recently launched their first product.

Contingent consideration, like targets and transactions, comes in all shapes and sizes. While contingent consideration assets (clawbacks) are seen in about 5 percent of the transactions in a broader dataset of transactions with contingent consideration, the focus here is on earn-outs. The median earn-out period for these 120 transactions is three years. The maximum potential earn-out for the 103 deals in the dataset with a cap on the maximum earn-out payment (86 percent of deals with earn-outs) varies from $400,000 to $550 million and from 3 percent to 94 percent (the median is 39 percent) of the maximum deal size.

The 120 transactions span a wide range of industries, with concentrations in industries where future performance depends heavily on the success of product development and new product launches, i.e., primarily in life sciences and in high tech, but also in industries such as industrial products, consumer products and financial services. Life sciences industry earn-outs are often tied to R&D and regulatory milestones. High-tech earn-outs are more likely to have thresholds, tiers and caps.

Deal Structures Align Interest of Buyers and Sellers

A best practice in structuring earn-outs involves designing the terms to best align the interests of buyers and sellers post-transaction. Because every deal is unique, there are a wide variety of deal structures.

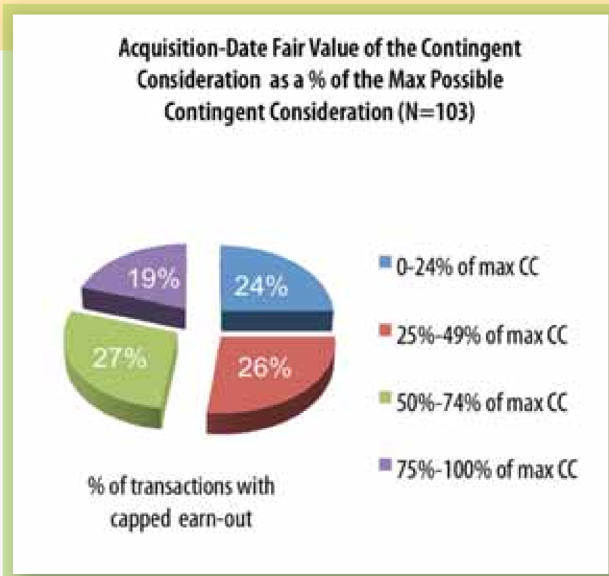
Approximately one-quarter of the 120 transactions had earn-outs based on achieving technical, R&D or regulatory milestones. The likelihood of success for R&D or regulatory milestones can span a wide range. However, technical milestones, such as integrating the target's and buyer's technologies in a timely fashion, often have a high probability of success — exactly because the buyer believes they will do their job of incentivizing high levels of effort post-close.

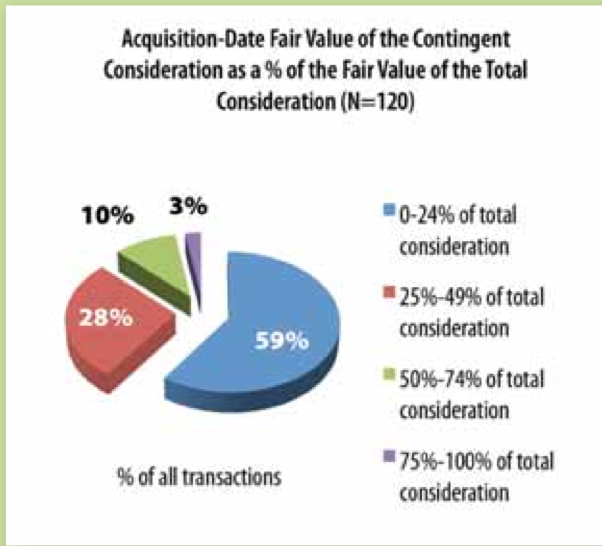
Approximately 60 percent of the 120 earn-outs were designed to drive top-line growth via incentives tied to revenues, bookings, gross profit or assets under management, and 37 percent had payments tied to earnings metrics — most often EBITDA — designed to fully align the interests of the buyer and seller.

Although earnings-based metrics may seem to align the interests of buyer and seller perfectly, unfortunately this can be a misleading illusion. Such metrics tend to encourage short-term performance rather than building the business for the long haul. In addition, these metrics may be more likely to lead to disputes down the road.

On the other hand, in industries such as professional services where revenue can easily be grown by sacrificing profit margins, it may be desirable to include a profitability component for the earn-out, perhaps in conjunction with a revenue component. In any event, if bottom line metrics drive an earn-out, it is important not only to clearly define the terms but also to be explicit about the buyer's commitments to investment and expense targets. Though this may seem obvious, in practice earn-out provisions have sometimes been so vague that when it came time to assess the likelihood of achievement, it was challenging for management to know what situations would actually trigger the payment.

Contingent consideration classified as a liability or asset must be re-measured to fair value at each reporting period, with the changes in fair value flowing through earnings. Therefore, it is important to consider the effect that the structuring of the earn-out will have on future earnings. In general, the re-measurement of contingent consideration has the opposite effect on earnings from the direct effect of the change in business performance.





Well-Designed Earn-Out Buffers Future Earnings

A well-designed earn-out can therefore buffer future earnings from the ups and downs of the business. For instance, an earn-out of a flat 50 percent of earnings will reduce the volatility of the buyer's earnings while allowing the seller to participate in upside potential.

However, an earn-out of more than two times earnings will increase the volatility of earnings. Deals have even been based on multiples that would result in the buyer having to pay out more than $5 for every $1 in incremental profit above the base case generated during the earn-out period. Assessing the impact of the earn-out on future earnings volatility is highly recommended, prior to finalizing any deal.

Estimating the fair value of contingent consideration, as is required for financial reporting purposes, can be challenging. Buyers sometimes propose that an earn-out can be valued simply by applying the earn-out formula to the expected cash flows in the deal model. Unfortunately, unless the contingent consideration is a flat percentage of revenue or earnings, this approach will often yield a materially wrong answer.

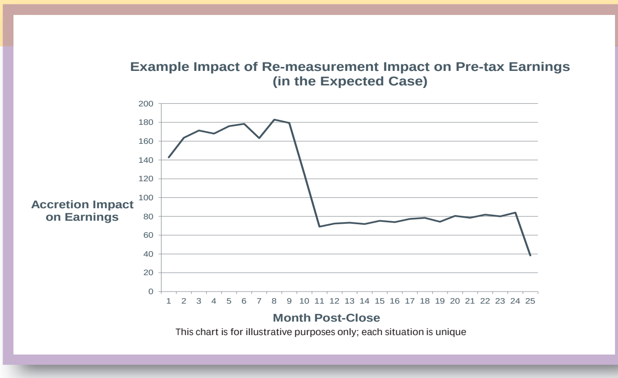
In practice, most transactions do not have such simple structures. Approximately three-fourths of the 120 earn-out transactions had a threshold (minimum below which no payment is made) and/or a cap (maximum payment). About 30 percent had multiple tiers of payments (different rates of payment for different levels of performance). Note: The dataset may disproportionately exclude simple earn-out structures, as companies may value these internally. When the earn-out structure has a threshold, cap, tiers or milestones, the valuation methodology must consider a range of alternative outcome scenarios, in order to arrive at the correct estimate of the expected earn-out payments.

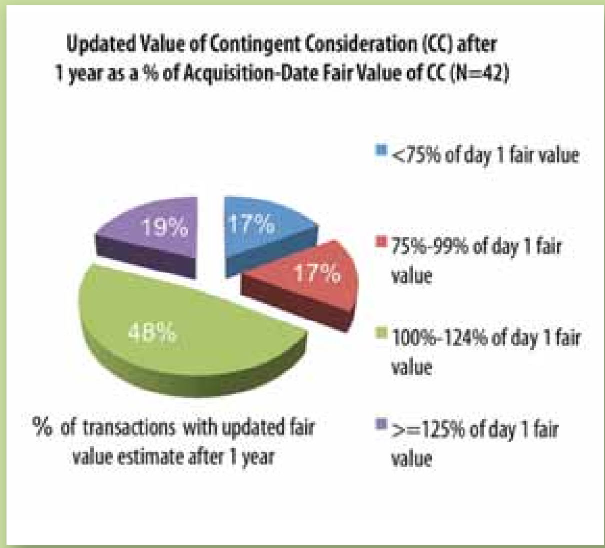
Robust Process Mitigates Biases And Errors

Methodologies that may be appropriate for valuing contingent consideration include discounted cash flow and real option methodologies. The former requires assessment of the likelihood and timing of various possible outcomes, which is not always a natural task for finance or deal team personnel.

A robust valuation process can mitigate the potential for biases and errors in these assessments. Observable inputs such as historical adoption rates, sales of comparable products, R&D success rates and other industry, acquirer or target historical data can provide support for the projections and probability estimates. Decomposition, de-biasing and cross-validation techniques can improve the reliability of probability assessments, provide transparency for the auditors and simplify the task of updating for subsequent re-measurements.

The choice of discount rate can also be challenging. Although the industry-weighted average cost of capital might be a reasonable starting point, one should consider the degree to which the earn-out is correlated with the market (achievement of technical milestones





might be uncorrelated with the market), the risk of default on the payment and whether the earn-out is more or less risky than typical industry cash flows.

Real option methodologies avoid the issue of choosing a discount rate but face their own challenges. One must still consider the degree to which the earn-out is correlated with the market, and in addition an assumption must be made about the volatility of future outcomes.

That volatility can be estimated using (a) management assessments of the likelihood of alternative future scenarios, as for a discounted cash flow approach, or (b) if target-specific volatility drivers do not overly distort comparability, the volatility of related metrics for comparable companies observable in the market.

No matter which methodology is selected, for financial reporting purposes, it is important to ensure consistency with the assumptions used in valuing the intangible assets. For instance, if the buyer's expected cash flow projections are used for valuing intangible assets, it would be inconsistent to value the earn-out using expected cash flows obtained by weighting the buyer's projections at 75 percent and the seller's projections at 25 percent. Unfortunately, this exact inconsistency has been seen in practice.

The charts on the previous page summarize the analysis of the distribution of acquisition-date fair value. For the 103 earn-outs with a cap, the median acquisition-date fair value was 49 percent of the maximum possible earn-out and varied with the duration of the earn-out (decreasing as duration increases due to the time value of money). For all 120 earn-outs, the median acquisition-date fair value was 20 percent of the total consideration transferred (i.e., the upfront payment plus the fair value of the contingent consideration).

In general, the fair value of contingent consideration liabilities can increase or decrease significantly over the course of time, for the very reason that the earn-out was put in place — the outcome is uncertain. Milestones either are achieved or they aren't, so the probability-weighted "expected" case for a contingent milestone never comes to pass. Unless there is an unusually high or low probability of achieving the milestone, there would often be a significant change in the fair value over time.

For continuous performance-based metrics, however, if there are no surprises and the expected outcome comes to pass, the change in fair value over time is related to the passage of time (accretion). The earnings impact chart above provides an example of the impact of accretion alone on earnings in a sample case, even if events unfold exactly as expected. In this sample case, the uncertainty regarding a portion of the earn-out is resolved after nine and 24 months.

What really happens after the first year? For the 42 earn-outs for which the dataset has fair values or resolution one year later, the median updated fair value was 107 percent of the acquisition-date fair value — not far off from what would be expected due to accretion alone. However, the updated fair value ranged from 4 percent to 148 percent of the acquisition-date fair value. As illustrated by the chart on the left, approximately 36 percent of these earn-outs experienced a significant surprise, with a change in fair value of 25 percent or more (17 percent of earn-outs decreasing and 19 percent increasing by this amount).

In summary, earn-outs are increasing in popularity. They come in many forms and, if structured with care, can help close deals, incentivize post-acquisition success and reduce earnings volatility for the buyer.

Real-world experience shows that valuations relying on management's assessments of future outcomes appear, on average one year later, to be spot on. Furthermore, the outcomes are just as uncertain as one would expect, spanning a very wide range and with significant surprises 36 percent of the time.

Contingent consideration is thus doing the job it was designed to do: allowing sellers and buyers to meet in the middle, while protecting the buyer against downside risk and allowing the seller to share in the upside potential.

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