Current Insights on Private Equity Deal Terms & Earnouts

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Generally speaking, 2021 was a remarkable year for M&A activity in the private equity (PE) space, with global PE volume increasing approximately 111% compared to 2020, ending the year at approximately $1.2 trillion worth of deals, according to the Harvard Law School Forum on Corporate Governance. While catalysts such as the availability of capital and low interest rates are expected to cool in 2022, significant ongoing competition from strategic buyers and the sheer amount of dry powder that PE firms have amassed are harbingers for a busy year ahead.

Even with the significant 2021 M&A activity, unexpected macroeconomic shocks, such as the pandemic, inflation and the war in Ukraine have changed the meaning of "standard" when it comes to M&A transactions. Due to uncertainty, some deal terms have taken on a greater or lesser importance depending on the buyer and seller, nature of the transaction, total deal size, subject company and market forces. A summary of certain prevailing trends is presented for consideration.

Earnouts

Earnouts have traditionally been a way for a buyer to offset immediate risk in a transaction by making a portion of the purchase price contingent on any number of metrics, while allowing a seller to participate in the future upside. Earnouts can be tied to a multitude of financial or non-financial metrics or events such as:

- Pre-tax earnings;
- Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA);
- Gross profit revenue;
- Employee retention; or
- Customer retention.

Earnouts are a useful way for any buyer to hedge against macroeconomic uncertainties that might impact a company's future growth. By tying the price of the business to future performance metrics, buyers mitigate the risk of overpaying at closing. The same logic holds true when a target company has a limited operating history and a buyer may wish to mitigate concerns about the target's ability to scale or retain customers after the closing of the transaction. An experienced buyer may use an earnout to "sweeten" the after-closing purchase price and further entice the seller to agree to the buyer's terms, while the experienced seller will agree to the terms of the earnout provided that he/she believes they can be achieved.

Earnout Risks

The challenge in crafting an earnout is balancing the parties' competing priorities and incentives. Though earnouts may sound like an equitable way to allocate risk between a buyer and seller, there is a reason why they are only half-jokingly referred to as litigation magnets. Earnouts are one of the most heavily negotiated (and often disputed) provisions in a private company transaction and must be carefully structured to avoid future disputes.

The State of Earnouts in 2022

According to a recent survey conducted by Sadis & Goldberg LLP, earnouts are more prevalent than ever in lower middle market transactions and are gaining popularity as middle-market buyers are competing for deals against larger buyers moving down through the middle- and lower-middle market.

The rationale for this is that as a group, lower middle-market companies – with transaction sizes less than $250 million – tend to have a more limited operating history; typically, the companies are not as financially strong as larger companies; often the companies' financial statements are unaudited; and many companies lack robust forecasts and budgets and have limited or relatively weak internal controls.

The aforementioned market volatility and uncertainty have also been catalysts for the uptick in earnouts. Buyers may, for example, be exceedingly wary of targets with over-complicated supply chains or exposure to certain regions and may push for an earnout to allocate risk.

Avoiding Earnout Disputes Through Sound Due Diligence

A proven way for parties to establish clarity and shape sound earnout terms is by completing a Quality of Earnings (QOE) review. QOEs reduce ambiguity by highlighting any working capital items that may become the subject of negotiation.

QOE reviews are likely to have an effect on the final price. According to the survey by Sadis & Goldberg, Purchase Price Adjustments (PPAs) were found in approximately 95% of deals where QOE reviews were conducted, thus indicating the importance of QOEs. The survey further indicated that approximately 92% of the deals reviewed used working capital as a QOE metric.

Parties should also note the importance of tax due diligence. It is imperative for parties to identify any incorrect or missing tax filings, as well as any past due payments. The benefits of tax due diligence can far exceed the cost by limiting buyer and seller exposure to unforeseen liabilities. Issues and outstanding items relating to taxing authorities could slow down or "kill" a transaction.

In addition, working with competent legal counsel may prove to be invaluable. Experienced counsel has its ear to the ground on a number of deals and can provide real-time insights on market conditions and standards.

While the terms and conditions in private equity and venture deals largely remain the same over time, they may vary depending on a particular buyer and seller, the market environment and the company. Provisions fall in and out of fashion, but parties to a transaction are ultimately motivated by their desire to limit risk, bridge differences and come to a meeting of the minds so they can close a deal.

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