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Navigating earn-outs: bridging valuation gaps in M&A transactions

In a currently subdued M&A market, in which buyers are looking for favourable opportunities and sellers are longing for the peak valuations of 2021, the earn-out model is increasingly coming back into focus when acquiring growth companies. While earn-out clauses have been common in life sciences transactions for many years, we see a significant increase in the use of earn-out clauses in all private-target M&A transactions.

What is an earn-out?

When selling a business, the goal is to maximise the target company's value and achieve a fair price. Nevertheless, sellers and buyers have different ideas when it comes to valuing the target company and determining the purchase price. This is where an earn-out can be beneficial.

Earn-out clauses are a contractual provision and can be found in share purchase agreements as part of the purchase price provisions. An earn-out is a downstream additional and usually variable purchase price component, the payment of which is linked to an uncertain event occurring in the future. The earn-out provisions allow the seller to receive additional compensation if the business meets specified financial or other performance targets after completion. From the buyer's perspective, an earn-out mechanism ensures that the additional purchase price component is only to be paid in case the business meets such specified targets in a predefined period after the acquisition.

The aim of the classic structure of an earn-out clause is to appropriately record the economic success of the target company after the transaction has been completed to determine any subsequent purchase price depending on this success.

How does an earn-out work?

With an earn-out provision, the buyer pays an agreed sum at the completion of the transaction and a top-up amount afterwards. The top-up, referred to as the earn-out amount, is contingent on the company's performance post-transaction.

The buyer and seller agree on specific performance metrics to calculate the earn-out amount. These metrics could include financial performance indicators such as future revenue or profit, or specific milestones like launching a new product or completing a major project.

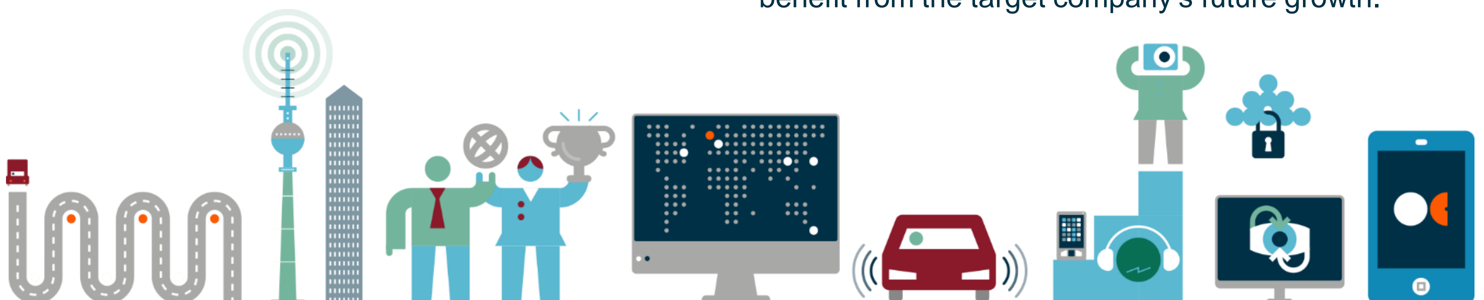
The earn-out provision will outline a defined period of ideally 2 – 3 years, potentially subdivided in further individual periods, known as the earn-out period, during which the target company must meet these performance targets. If the target company meets the agreed performance targets, the buyer pays the top-up amount at the end of the earn-out period. If the respective targets are not met, the buyer is not obliged to pay the top-up amount, limiting the final purchase price to the initial payment made at the transaction's completion.

Why use an earn-out?

Earn-outs are particularly useful when the buyer and seller have different assessments of the target company's performance, so that they cannot agree on the target's enterprise value. Earn-outs allow part of the purchase price to be calculated based on the company's performance after the transaction, providing a compromise that benefits both parties.

For the buyer, an earn-out reduces uncertainty by tying part of the purchase price payment to the future performance of the target company. This means, the buyer pays a portion of the business's cost upfront, with the remainder dependent on the target company meeting future performance targets.

For the seller, an earn-out offers the potential to benefit from the target company's future growth.



Structure of earn-outs

The structure of an earn-out can be very flexible and involves several key considerations beyond cash compensation. The main elements include how any future pay-outs will be calculated, and whether the seller or the team will stay on working in the business post sale. In addition, other typical components of an earn-out agreement are the length of the earn-out period and the way of measuring the target company's performance.

A share purchase agreement typically defines the metric for calculating the earn-out, for financial targets often an adjusted EBITDA is used. However, combining multiple metrics, such as revenues and profit metrics, can be beneficial. If the predefined targets are met, earn-outs are usually paid in cash after the relevant period, but they can also be paid (partially) in shares in case of share-for-share transactions.

What needs to be considered?

It is crucial that the earn-out clause is clearly formulated to prevent excessive room for interpretation, which can lead to litigation problems. It is important to explicitly define methods for calculating EBIT, (adjusted) EBITDA, gross profit, profit before tax, revenues, operating cash flow etc. to avoid uncertainty. The seller should ensure that they have information and control rights in the earn-out provisions to prevent the buyer from manipulating or influencing the earn-out targets (ring-fencing). Strict timelines for dispute resolution should be established, with clear, strict timelines within which a dispute must be resolved to avoid lengthy and costly proceedings. The triggers for the escalation of a dispute should also be clearly defined. The types of disputes that will be referred to an expert should be clearly outlined. The parties should specify who the expert is and who the replacement will be in case of a conflict of interest.

Advantages and disadvantages of earn-outs

Advantages

- **Staggered payments:** earn-outs allow for staggered, sequential payments over time rather than a single sum upfront, reducing the buyer's initial financial burden.
- **Risk sharing:** aligning the earn-out payment with the future business performance, both parties can share potential risks and benefits.
- **Security:** an earn-out can serve as security for the buyer if the buyer later has any (guarantee or indemnification) claims against the seller under the share purchase agreement.

Disadvantages

- **Extended involvement**: the seller may remain involved in the business for longer, potentially influencing operations to boost earnings.
- **Risk of lower payout:** if future earnings fall short, the seller (and employees) may receive a lower overall payout.
- **Litigation:** increased risk of post-M&A disputes.
- **Complexity:** earn-outs are often negotiated more intensively and thus lead to more complexity and a longer process.

The agreement should specify the accounting assumptions used going forward. Although a company can adhere to generally accepted accounting principles (GAAP), managers must still make judgments that can affect results. For instance, assuming higher returns and allowances will result in lower earnings.

It should also be made clear which types of disputes the expert may decide, and which must be brought to court to avoid uncertainty. Reference can often be made to the corresponding closing account provisions in the share purchase agreement, if such a purchase price calculation has been agreed.

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Any existing employee participation programmes should be examined closely, especially in relation to the definition of the exit proceeds and if it is explicitly agreed that any potential earn-out amounts are included in the definition. Typically, the terms and conditions of (virtual) employee participation programmes would include the provision that that in case the proceeds resulting from an exit are payable in several earn-out instalments, the cashout payment to employees usually becomes due in corresponding instalments. The handling of the payroll tax process should be inspected closely.

How are earn-outs treated for accounting purposes and how are earn-out payments taxed?

Under International Financial Reporting Standards (IFRS), the accounting treatment of earn-outs in business combinations depends on their classification. If an earn-out is considered part of the purchase price (consideration), it's measured at fair value at the acquisition date and included in the calculation of goodwill. If an earn-out is classified as compensation for post-combination services, it's treated as an expense in the post-combination financial statements and is not included in the calculation of goodwill.

From a tax perspective earn-out provisions can result in adverse tax consequences for the seller. In case the seller is still working for the target company post-transaction, the tax authorities might (re-)qualify earn-out payments not as part of the purchase price but as other income (in particular: salary or freelance remuneration). This would result in a higher tax burden for the seller as capital gains are subject to a more favourable taxation than other income: a seller being an individual pays effectively up to c. 28.5%[1] personal income tax on capital gains (as 40% remain tax-exempt) and a seller being a corporation pays effectively c. 1.6% combined corporate income tax and trade tax on capital gains (as 95% are tax-exempt). In case the earn-out is considered as other income the effective personal income tax rate is up to 47.5%.[2]

In case of a (re-)qualification as other income in the form of salary the target company as employer – and therefore economically the buyer – is liable for the wage tax due. The requalification risk cannot be mitigated by selling through a personal holding vehicle as the tax authorities look through this vehicle to its (individual) shareholder.

Considering the above, earn-out provisions need to be drafted carefully to prevent adverse tax consequences:

- Earn-outs should be paid or at least offered to all sellers. In case earn-outs are only paid/offered to sellers who continue to work for the target company post-closing this indicates the existence of remuneration for work.
- The earn-out should not have to be "earned" through a certain activity period and should also not lapse based on conditions relating to the work of the seller.
- The earn-out should serve as a mechanism to eliminate valuation uncertainties during the negotiation phase of the transaction. Therefore, the earn-out should be linked to the target company's objective key performance indicators (e.g., EBIT, (adjusted) EBITDA, gross profit, profit before tax, revenues, operating cash flow, grant of patents, product launch, customer onboarding).
- Sellers who continue working for the target company post-transaction should receive an arm's length salary for such work.

The target company can file a wage tax ruling request regarding the qualification of an earn-out from a tax perspective with its competent tax authority.

[1] Personal income tax and corporate income tax rates including solidarity surcharge but – in case of personal income tax – without church tax (if any). Social security contributions are not considered as the individuals involved usually already reaches the respective thresholds with their regular salary.

[2] In case of freelance remuneration generally also VAT becomes due.

In case the earn-out qualifies as part of the purchase price the earn-out payment is generally a subsequent change of the originally agreed purchase price which is to be referred back to the time of the transaction, i.e., the relevant tax assessment is adjusted. There are specific earn-out constellations which are to be assessed differently, i.e., as income in time of actual payment of the earn-out which could lead to adverse tax consequences for the seller under specific circumstances. This is, however, generally only the case if the earn-out is profit- or revenue-based and is uncertain both in terms of reason and amount – such scenarios are in practice quite uncommon (usually the amount is predefined in the earn-out provisions and only the reason is uncertain).

In case an earn-out is not paid in cash but in shares the seller should be aware of the resulting "dry income": Although no liquidity flows, the (fair market) value of the shares is subject to taxation according to the principles described above. The tax is then to be paid from available funds (e.g., fixed part of the purchase price).

Conclusion

To summarise, an earn-out is a contractual clause in case of an exit that ties part of the payment to the future performance of the target company. It is intended to help bridge valuation differences between the buyer and seller.

To avoid disputes, it is particularly important to define clear earn-out conditions that are not open to too many possible interpretations. Maximum periods for earn-outs should ideally be 2-3 years, if necessary subdivided into 2-3 individual periods. Sellers should ensure that they have information and control rights to prevent the buyer from manipulating or influencing the earn-out targets. Employees who have (virtual) shares in the company should be aware that in case the exit proceeds are payable in several earn-out instalments, the cashout payment usually becomes due in corresponding instalments.

Earn-outs also have different tax implications for the seller and potentially the target company depending on whether the payments are classified as (subsequent) purchase price and thus, capital gain, or as other income (in particular: salary or freelance remuneration).

Your experts

Maximilian Vocke
Partner

T +49 30 7262 18031
maximilian.vocke@osborneclarke.com

Ann-Kristin Lochmann
Counsel

T +49 405 5436 4288
annkristin.lochmann@osborneclarke.com