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JUDGMENT CALL

Paucity of credit enables earnouts to take their star turn

Acquirers trying to fund buyouts have increasingly relied on creative techniques

BY ADAM R. MOSES

Although many factors coincided to produce the blistering pace of domestic M&A activity witnessed during the 2004-07 period, perhaps none contributed quite as mightily as the torrent of credit that washed over transaction participants as they struck deals at ever more stratospheric valuation multiples. When the credit markets later violently contracted, the boom period of elevated dealmaking activity came to an abrupt and unceremonious halt. Transaction volume plummeted as would-be buyers, staring down a disquieting dearth of available debt and seized by gnawing uncertainty about what the future might hold, dodged the splintering timbers of a once-sturdy financial system whose very structure appeared to be giving way all around them.

Even against this gloomy backdrop, deals continued to be executed. However, in order to complete transactions, purchasers had to—and, even though the debt markets have since stabilized, continue to have to—answer the central buyout question of the post-bubble period: In an environment of diminished credit, how are buyers to fund acquisitions? The response to this question comes easily for a select group of healthy strategic acquirers who need only tap an existing revolving line of credit or deploy cash already held in the corporate coffers. For other prospective acquirers—including many a financial buyer—the quest to fund buyouts has increasingly relied on creative techniques to stretch the value of their offers and reduce the amount of total acquisition consideration required to be financed by third parties.

One such technique that deserves particular attention is the earnout, a flexible form of consideration utilized in acquisitions of privately held targets. Earnouts appear to be riding the crest of a new wave of popularity and have figured significantly in a number of recent takeover transactions, including the acquisition this month of France's Novexel SA, a developer of antibiotics designed to overcome microbial drug resistance, by pharmaceuticals heavyweight **AstraZeneca plc** for up to $505 million, including an earnout worth as much as $75 million. In a deal announced this month, oil and gas contractor **Willbros Group Inc.** agreed to acquire **InfrastruX Group Inc.**, a provider of electric power and natural gas transmission services, in exchange for stock in Willbros and up to $485 million—$125 million of which is represented by potential earnout consideration.

Although the terms of earnouts can vary considerably from one transaction to another, under one common earnout approach, a portion of the purchase price for a private company is delayed and made contingent upon the attainment by the acquired company of specified financial performance milestones at one or more dates following the completion of the acquisition. Under this sort of earnout, the buyer and the seller share a measure of the risk of the target's future financial performance, with the buyer ultimately paying an increased purchase price only if the target achieves the agreed-upon financial performance benchmarks. An earnout reduces a buyer's funding obligations at closing and, as a consequence, lessens its reliance on third-party financing.

Earnouts can serve for both buyers and targets as an equitable, even elegant, solution to the challenges presented by the comparatively reduced amount of financing presently available to fund buyouts, but they tend to be memorialized in highly detailed provisions that require close negotiation, careful structuring, and perhaps even a measure of clairvoyance because good earnout provisions are designed to anticipate the occurrence of a broad range of potential future events.

As an example, one recurring challenge that arises in crafting earnouts to take account of future developments involves grappling with the possibility that the target will be merged or otherwise effectively combined with a similar unit or portfolio company of the purchaser following closing. A seller may well prefer that such a merger or combination be barred altogether during the earnout measurement period to avoid having to face what can be complex interpretive questions concerning how to appropriately disentangle the financial results of the target's legacy business from the business with which it has been integrated. A buyer, however, is likely to resist accepting any material limitations on its ability to integrate the target so that it can remain free to fuse the acquired company with its other business units in whatever way it believes will optimize the target's value and operational productivity.

If the parties ultimately resolve to permit the target to be amalgamated with another unit or portfolio company of the buyer, they will have to formulate a strategy to reliably segregate the financial performance of the target from the business with which it may be merged so that the parties will be able to determine whether earnout targets are attained following such a merger. Alternatively, the financial performance of the combined businesses may be prorated so as to allocate a portion of the merged enterprise's overall financial performance to the target. As this example illustrates, structuring an earnout often compels dealmakers to dedicate considerable attention to identifying and thoughtfully working through a veritable thicket of potentially thorny situations that may arise post-closing.

What's more, many of the terms of an earnout pit a buyer and a seller squarely against one another, laying bare their raw, competing incentives. Although no two transactions are precisely alike, it is frequently advantageous for buyers to seek the following characteristics in earnout structures: (i) very few, if any, constraints on how the acquired business will be run following closing; (ii) a capped earnout payment set in an amount that affords the purchaser the bulk of the potential upside associated with the acquired business; (iii) a longer earnout measurement period featuring a single look-back at the target's financial performance made at the conclusion of the period; (iv) a mechanism to prevent sellers from receiving earnout credit for advantages linked to buyers' ownership of the target following closing, such as a reduction in expenses resulting from staffing synergies with existing divisions or portfolio companies of buyers or earnings growth resulting from future add-on acquisitions completed by buyers during the earnout period; and (v) performance targets based on Ebitda or another earnings measure rather than revenue because, buyers will contend, revenue alone does not fully reflect the quality of the financial performance of an acquired target.

On the other hand, sellers may well seek to strike an entirely different balance when structuring an earnout, often negotiating to include some of the following features and concepts: (i) annual or even more frequent look-backs over a short earnout period, with earnout payments accruing on a sliding scale instead of on an "all or nothing" basis; (ii) acceleration of all or a portion of the earnout payment obligation upon the occurrence of specified material events, such as the termination of the senior management team or the sale of the target or any of its important assets or divisions; (iii) covenants designed to protect the ability of the acquired business to achieve earnout targets (for instance, a prohibition on a buyer diverting clients or business opportunities of the target to the buyer's other units or portfolio companies and a requirement that a buyer operate the target pursuant to an agreed-upon budget and business plan or in a manner consistent with past practice); (iv) access to the acquired company's senior personnel and books and records to review the calculation of financial measures underlying the determination of whether earnouts will be paid and in what amounts; (v) a prescribed method for asserting objections to the calculation of earnouts and a resolution mechanism to adjudicate any resultant disputes; and (vi) use of revenue as a metric for measuring the performance of the target during the earnout period instead of an earnings-based metric, which, sellers will contend, is more easily subject to gamesmanship at the hands of buyers through, for example, increased elective expenditures during periods that are strategically important in determining whether the earnout targets will be achieved.

If sellers relent and agree to use a metric based on earnings instead of revenue to measure performance during the earnout period, they generally prefer Ebitda to other earnings-based metrics and will also frequently seek to have Ebitda adjusted in a manner that safeguards the ability of the target to achieve earnout thresholds. Examples of these adjustments include: permitting allocation of overhead and other costs from a buyer's other businesses to the target business, if at all, only to the extent that such allocation coincides with an actual reduction in the costs the target would otherwise have had to incur; excluding from the calculation of Ebitda nonrecurring transaction expenses incurred by the target in connection with the acquisition and costs incurred that are of a type not contemplated by the projections on which the earnout targets were based; and accounting for each transaction between a buyer's other businesses and the target as having been effected on a basis no less favorable to the target than if such transaction had been undertaken at arm's length with an unrelated third party.

Despite the competing interests of buyers and sellers in the negotiation of an earnout, armed with realistic expectations and a measure of fortitude, they often see their way through what can be a pitched negotiation to a sound balancing of their interests.

In sum, while not without their complications, earnouts have emerged as an important complement to up-front cash consideration to aid strategic and financial buyers alike in filling the funding vacuum that has emerged in the post-bubble era. With the vigor that the credit markets displayed during the boom period now little more than a fleeting memory, earnouts stand poised to continue to serve as a useful tool of acquirers in the months to come. ■

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