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Bridging the valuation gap

Dealmakers faced significant challenges in 2022 as inflation and interest rates rose, economic growth weakened, energy prices soared, regulation was tightened and the M&A market corrected after frantic activity during the pandemic. Here, Dan Stafford and Alex Jobson of international law firm Sidley Austin outline some key issues to consider when structuring earn-outs in uncertain times.

As transaction activity weakened in the third quarter of 2022, the spotlight fell on valuations, particularly in the technology sector. Many buyers reassessed their M&A strategies, whether wishing to retain cash or concerned about the costs of raising acquisition finance as interest rates rose.

This year, however, we expect continued opportunities in certain sectors of the market. Likely buyers include private equity sponsors seeking to deploy their record amounts of dry powder, those executing buy and build strategies via bolt on acquisitions, and others looking for opportunistic, distressed investments.

Given the challenges already mentioned, buyers and sellers are more likely to disagree on the value of a target business. This problem is often addressed by deferred consideration mechanisms, where a portion of the purchase price is paid out in the years following completion. These mechanisms, such as earn-outs, can allow sellers to obtain the full value for what they consider a fundamentally robust business, though at the cost of a clean exit. Meanwhile, buyers can more accurately price targets, divest themselves of part of the risk of poor future performance and obtain the cash flow benefits from deferred consideration, particularly where an earn-out is funded using the target's retained profits.

However, earn-outs can be complex to negotiate and thus carry the risk of a future dispute. So, when structuring and negotiating earn-outs, sellers should carefully consider several factors:

- **Financial metrics** – Earn-outs are often based on the target business's future revenue or profits. Whichever metrics are used, the relevant provisions should be clear, objective and measurable, with input from both parties' financial advisors.
- **Earn-out period** – This is typically one to three years, with sellers usually pushing for shorter periods. The final length will depend on the relative bargaining power of the parties and the financial strength of the target.
- **Payment timing** – The frequency of any earn-out payments needs to be unambiguous, and the parties should agree on the means of payment (often based on tax considerations) and whether they are secured.
- **Earn-out protections** – The buyer will control the business after completion, so the seller will want to ensure that the buyer not only continues to run it largely as it was previously operated but also does nothing to reduce the value of any earn-out payments due. These terms will be heavily negotiated, as the buyer will want the flexibility to run the business in line with its own business plan.
- **Payment mechanics and dispute resolution** – The buyer and seller should consider the detailed mechanics for calculating the earn-out payments (often by reference to the target's annual audited accounts) and the means for resolving any dispute (usually by a suitably qualified firm of accountants).

Earn-outs can be an attractive way to structure a deal, particularly in uncertain market conditions. However, they are complex, and thinking the terms through carefully in advance – with help from professional legal and accounting advisors – can help to mitigate the risk of future disputes.

Contact us
RDarwin@sidley.com