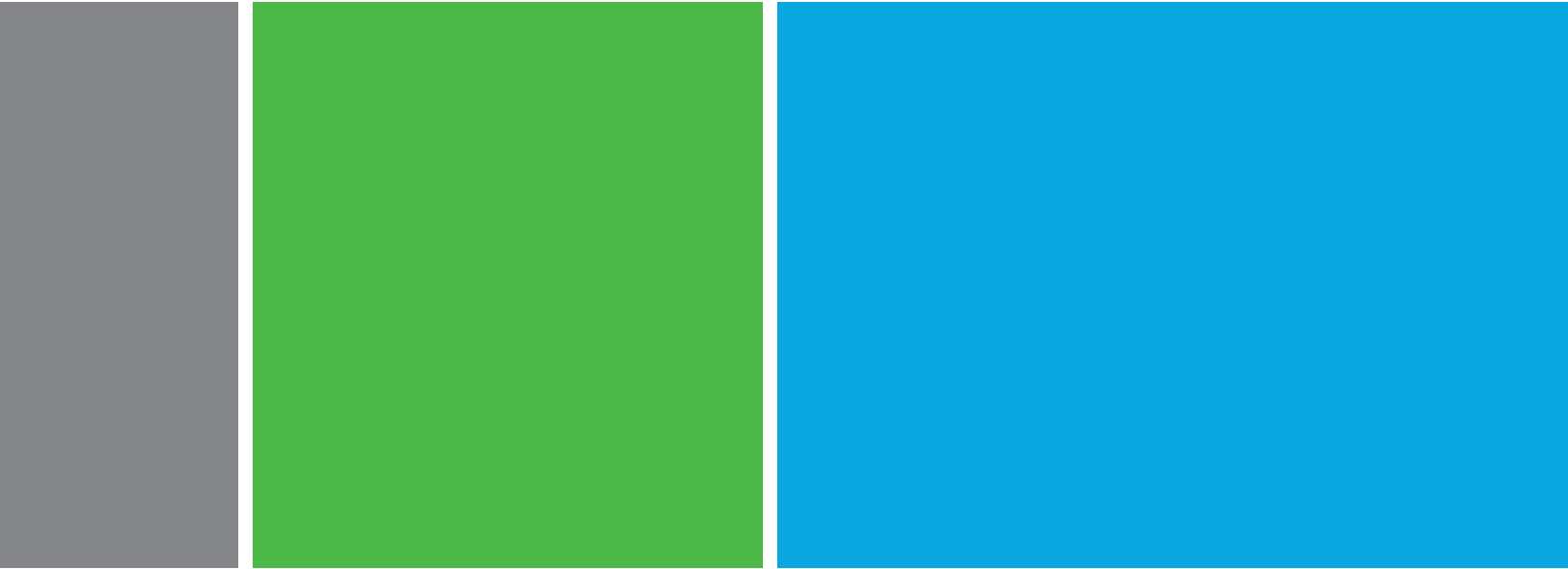


What you need
to know about
the advantages
and risks

CONTINGENT CONSIDERATION: A MEANS OF MEDIATION IN ACQUISITIONS



Contingent consideration, also known as an earn-out, is a form of consideration in an acquisition in which the acquirer agrees to pay additional cash consideration or equity interests to the former owners (sellers) if certain future events occur. In recent years, contingent consideration has become more prevalent in acquisitions, but what do you need to know to determine if it could work well for you?

Here are the answers to eight key questions that will help you make that decision:

Q: What does contingent consideration entail?

Contingent consideration is additional consideration (typically cash or shares) that will be paid to the sellers in the future if agreed-upon financial and operational goals are met. Using contingent consideration in a purchase agreement can help buyers and sellers more easily compromise on the acquisition price, balance out risk and gain important protections.

Q: When should I use contingent consideration?

Contingent consideration can benefit both the buying and the selling parties by mediating between what an acquiring company is willing to pay for a business and what a seller believes the company is worth. While companies in high-growth industries often use contingent consideration to balance a seller's optimistic growth projections with a buyer's more pessimistic outlook, it can be used successfully in any acquisition.

Q: What are the advantages of contingent consideration?

Contingent consideration provides advantages for both buyers and sellers. It can help buyers:

- **Avoid overpaying.** Buyers doubtful of a seller's projections for the acquisition target may not be comfortable paying the full price upfront. Making part of the payment contingent on performance lowers the risk of overpaying for a company that may not meet expectations.
- **Reduce cash needs.** Delaying part of the payment to a future date when the buyer is better able to pay, or by structuring part of the payment in shares rather than cash, reduces the amount of cash buyers need upfront.
- **Provide an incentive to sellers to stay on.** By providing an opportunity for additional gain, contingent consideration can motivate the acquired company's management to stay with the business post-acquisition.

Conversely, contingent consideration offers sellers:

- **A fair price.** Sellers can feel confident they'll be fairly compensated if the company meets the designated goals.
- **Growth opportunities.** Beyond the initial purchase price, sellers have the chance to earn additional proceeds from the sale if the company reaches agreed-upon target goals.

CONTINGENT CONSIDERATION CAN PROTECT BOTH PARTIES IN A TRANSACTION AND HELP ENSURE A FAIR PURCHASE PRICE FOR BOTH.

Q: What are the risks of contingent consideration?

Sellers who agree to contingent consideration trade a higher upfront purchase price for potential future gains they may never see. Essentially, they're giving up "a bird in the hand" now for "two in the bush" later.

Buyers using contingent consideration risk owing the seller additional future payments. Some agreements include "clawbacks" that require the seller to repay some of the purchase price if goals aren't met, but this is rare.

Q: What are the different settlement method options?

Contingent consideration may be settled in cash, shares or (less often) a combination of the two. Each method has its advantages and disadvantages.

For buyers, granting shares has no risk aside from diluting share value. If the earn-out requirements are achieved, it won't cost the buyer any cash. Offering equity also keeps the seller invested in the company's performance, possibly even beyond the earn-out period. In contrast, cash settlements mean buyers must find the cash to pay the seller if earn-out goals are met.

Sellers who receive ownership equity enjoy the potential for greater future earnings as the company grows. However, shares in a private company may lack the liquidity sellers need to easily exit the position.

For sellers, cash provides immediate liquidity with no future downside risk, assuming there's no clawback clause. On the other hand, cash settlements offer no opportunity to benefit from equity appreciation.

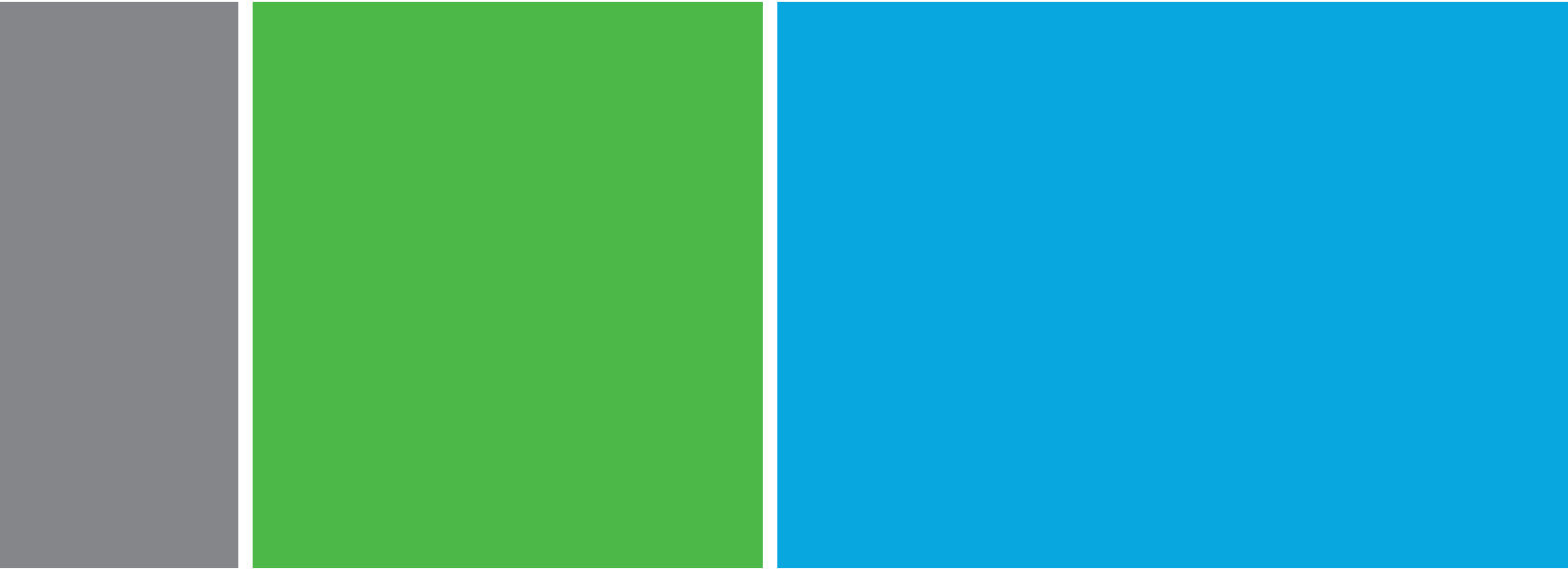
The choice of settlement method really depends on the buyer and seller's individual preferences, life stages and goals. For example, sellers who plan to retire or start a new company may prefer cash to shares that tie them to the acquired firm. Other sellers may prefer to stay with the acquired company and keep working with the buyers to help it grow.

Q: What are the payoff structures and their pros and cons?

The possibilities for structuring earn-out payments are nearly infinite. Common payment structures include all-or-nothing payments (or binary payments) and percentage of future performance payments.

All-or-nothing payments reward the seller for reaching a metric threshold. Sellers who don't reach the threshold receive nothing; however, there's no extra payment for exceeding the threshold.

The percentage of future performance payments method sets a minimum threshold and most often contains a maximum ceiling for performance metrics. One such example is sellers who receive a percentage of the maximum payment that rises in a linear fashion as performance increases. The seller gets a bigger reward for surpassing performance goals, while the buyer is protected by a payment cap.



Earn-out payments can be based on a wide variety of performance metrics, including but not limited to revenue, gross profit, EBITDA, EBIT, net income, margins, meeting regulatory requirements, developing new products and other KPIs related to operational efficiency.

Contingent considerations can be structured for months or years; they may include one milestone or many. Sellers may be required to reach certain performance goals in the first year or lose the consideration, or they may have "catch up" options that allow them to make up for prior misses in future years.

One element that's consistent in almost all earn-out agreements is a maximum payment, which protects the buyer from unlimited liability.

Q: What are the risks of failing to configure the payoff structure correctly?

Properly structuring contingent consideration is a complex situation that can be fraught with risk. Buyers who don't correctly structure the payoff may underestimate how much they'll pay for a company. For example, some buyers set a cap on earn-outs, assuming they'll never hit that maximum. Pre-deal, an experienced valuation partner can help buyers more accurately calculate their estimated earn-out payment in different scenarios. This can help buyers adjust the contingent consideration criteria to minimize their exposure.

Similarly, on the sellers' side, working with an experienced valuation partner can provide insight into the pre-deal estimated earn-out payment. Knowing what they're more likely to receive can give sellers stronger negotiating power to achieve their financial goals for the deal.

The acquiring company must also record the earn-out at fair value at the time of acquisition. If the contingent consideration is classified as a liability for accounting purposes, it must also be reported at fair value at each reporting period until the earn-out is settled. Misvaluing the earn-out poses the risk of overstating or understating liability exposure for the company.

Q: Where can I get more information on contingent consideration?

Contingent consideration can protect both parties in a transaction and help ensure a fair purchase price for both. However, properly structuring and valuing a contingent consideration option can be complicated, and errors can expose you to unnecessary risk.

Consulting an experienced valuation specialist can help. RSM's complex financial instrument valuation team specializes in valuing and providing insight on expected earn-outs to help buyers and sellers reduce bias, mitigate risk, prevent overpayment or underpayment, and determine how they want their deal structured. They help both buyers and sellers design contingent consideration criteria that meet their needs.

To learn more, visit rsmus.com/valuation.

+1 800 274 3978
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