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Mergers and acquisitions: bridging gaps in expectations and resources in 2023

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MAY 24, 2023

What is an earnout? What is a seller note?

In the world of mergers and acquisitions, business owners and their financial sponsor suitors are always looking for tools to bridge the gap on valuation issues. As revenues, multiples, and enterprise valuations are under pressure in an interest rate environment following inflation in the wrong direction (up), earnouts and seller financing are making a comeback as popular choices to help close deals.

Earnouts can be tied to such performance triggers as EBITDA, returns on equity, gross margins, revenue, specific contractual wins, or the like.

Given that these tools are being used more frequently, we look at how private equity buyers effectively use earnouts and seller notes and their associated benefits and challenges.

"Earnouts" are contractual agreements that allow the seller to receive additional payments after the closing of the transaction based on the achievement of agreed objectives. These payments are typically based on the acquired company's performance after the sale. This means that if the company performs well, the seller will receive additional payments, and if it performs poorly, the seller may not receive anything.

Earnouts are often used when there is uncertainty around the company's future performance, such as when the company is in a rapidly changing market, has a short operating history, or where there is a gap in expectations on price.

One benefit of using an earnout is that it can help bridge the gap between the buyer's and seller's valuation of the company. For example, if the buyer believes that the company is worth $100 million, but the seller believes it is worth $120 million, they may agree to a base purchase price of $100 million plus an earnout of up to $20 million where the seller can receive additional payments if the company achieves specific performance metrics.

This allows the seller to potentially receive the total $120 million they believe the company is worth, and at the same time, gives the buyer some protection in case the company does not perform as well as expected.

Another advantage to earnouts is their flexibility in any given deal situation. For example, earnouts can be tied to such performance triggers as EBITDA, returns on equity, gross margins, revenue, specific contractual wins, or the like (and, in some cases, a combination of these performance objectives).

Earnouts can also flex up or down to allow for partial payments based on the partial achievement of objectives, although in cases where such a provision is included, there is typically some minimum requirement of performance before such a flex provision would be triggered.

However, earnouts also come with a number of challenges for a buyer and a seller that warrant significant focus. For example, earnout obligations are often subordinated to the rights of secured creditors of the company, which could heighten the concern for sellers.

Seller notes are often used when an additional equity investment to pay the full purchase price upfront would make the investment return profile unattractive.

Buyers and sellers also frequently disagree on whether requirements should be written to ensure that the company is operated in the normal course, such that it maximizes the seller's ability to achieve the earnout payments. These issues and others can make earnout negotiations complex and, if not carefully thought through, can lead to disputes between the buyer and seller down the line.

Another tool private equity buyers may use to close deals involves subordinated financing, specifically, a "seller note." A seller note is a promissory note that the buyer agrees to pay the seller at a later point in time.

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Seller notes are often used when an additional equity investment to pay the full purchase price upfront would make the investment return profile unattractive. This allows the buyer to acquire the company and the seller to receive a significant portion of the purchase price upfront, with the remaining amounts paid at a later date (and, practically speaking, contingent on the performance of the business being sufficient to support the future payment).

Earnouts and seller notes are tools at the disposal of private equity buyers that help to close deals, in particular in shaky markets.

However, like earnouts, seller notes also come with their own set of challenges that require consideration. The obvious risk to a seller is that the buyer may default on the note and not pay the seller back. Additionally, the seller notes may have (and in a leveraged buyout, would almost certainly have) a lower priority than secured lender debt. A Seller may be subject to a subordination agreement that does not allow it to enforce its rights to collect unless and until the senior creditors are paid.

Despite the challenges, earnouts and seller notes are tools at the disposal of private equity buyers that help to close deals, in particular in shaky markets. Buyers and sellers alike need to consider both pros and cons of these tools carefully and align them with their risk tolerance ensuring that the transaction is structured in a way that results in the best possible outcome.

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This article was first published on Westlaw Today on May 24, 2023.

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