Duff & Phelps

August 2012

2012 Contingent Consideration Study

Earn-out Structuring and Valuation

Inside

Introduction

Prevalence of Contingent Consideration in Transaction Agreements

Making successful acquisitions has been more important than ever during the difficult economic times of the past few years. Contingent consideration, especially in the form of earn-outs, is an increasingly popular mechanism both for closing deals and for addressing post-transaction performance uncertainties. Contingent consideration:

- Closes the gap in expectations for the business between the buyer and the seller
- Allows the buyer to share the post-acquisition risk with the seller, by making some of the consideration contingent on future performance
- Allows the seller to participate in the upside post-transaction
- Incentivizes the seller to remain involved with, and help drive the ongoing success of the business

Perhaps for the above reasons, the prevalence of earn-outs in public company acquisitions of private targets has been growing. A study by the American Bar Association indicates that earn-outs were present in 19%, 29% and 38% of public company acquisitions of private targets that closed in 2006, 2008 and 2010, respectively.[1] This growth has occurred in spite of the adoption in 2009 of new Financial Accounting Standard Board (FASB) requirements for business combination accounting, to record contingent consideration assets and liabilities at fair value.[2]

Purpose of the *2012 Contingent Consideration Study*

An "earn-out" is a contingent consideration obligation of the acquirer.[3] The Duff & Phelps *2012 Contingent Consideration Study* leverages information on 120 transactions that included earn-outs and closed between 2009 and 2011. The primary objectives of the study are to:

- Characterize and report on the prevalence of various types of earn-out structures and durations
- Compare the magnitude of earn-outs to upfront payments, and report on various statistics related to the fair value measurement of earn-outs
- Investigate the evolution of the fair value of earn-outs, one year post transaction
- Identify differences in earn-out structures and valuation by industry
- Provide insights and observations regarding earn-out structuring and the impact of updating the fair value of earn-outs on the volatility of earnings

> "The Duff & Phelps 2012 *Contingent Consideration Study* leverages information on 120 transactions that included earn-outs and closed between 2009 and 2011."

In future years, Duff & Phelps' Contingent Consideration Study may examine trends in earn-out structuring and valuation, as finance executives and deal teams become more experienced with transactions involving earn-outs and with the implications of fair value accounting for earn-outs, and as the economic and deal environments evolve.

1. American Bar Association Business Law Section 2011 Private Target Mergers & Acquisitions Deal Points Study.
2. Adoption of fair value accounting for contingent consideration under FASB business combination accounting occurred for fiscal years starting on or after December 15, 2008. Adoption of similar rules under International Financial Reporting Standards (IFRS) business combination accounting occurred for fiscal years starting on or after July 1, 2009.
3. This study focuses on contingent consideration obligations of the acquirer, rather than also including contingent consideration obligations of the seller (i.e., clawbacks).

Highlights of Study Results

Highlights of *2012 Contingent Consideration Study* Results

Analysis of the 120 transactions with earn-outs in Duff & Phelps' *2012 Contingent Consideration Study* shows that:

- There is significant diversity in earn-out structuring, only some of which is related to differences in performance drivers by industry.
- Earn-outs tied to top line metrics (e.g. revenues, bookings, gross profit, or assets under management) were the most popular structure (60% of these deals).[4]
- Earn-outs tied to bottom line metrics (37%) and achievement of technical, R&D or regulatory milestones (26%) are also common structures.
- For earn-outs with an overall cap, the median acquisition-date fair value was 49% of the maximum possible earn-out.
- The median acquisition-date fair value was 20% of the total consideration transferred (upfront payment plus the fair value of the contingent consideration).
- One year after the acquisition, the median updated fair value (or resolution) was 107% of the acquisition-date fair value. However, there were often changes in fair value of 25% or more, with significant upside surprises in 19% and significant downside surprises in 17% of the cases for which information is available on updated values after one year.
- A larger percentage of the maximum potential consideration is contingent in life sciences transactions as compared to high tech industry transactions, on average. However, the average acquisition-date fair value of the earn-out as a percent of the total purchase price is about the same in both industries. This unusual combination of results occurs because, in life sciences, the acquisition-date fair value of the earn-out is, on average, a smaller percentage of the maximum possible earn-out.

4. Some earn-outs are tied to multiple underlying metrics.

Overview of Contingent Consideration

What is Contingent Consideration?

The Financial Accounting Standards Board defines contingent consideration as "an obligation of the acquirer to transfer additional assets or equity interests to the former owners of an acquiree as part of the exchange for control of the acquiree if specified future events occur or conditions are met. However, contingent consideration also may give the acquirer the right to the return of previously transferred consideration if specified conditions are met."[5]

Determining whether contingent payments to the selling shareholders should be classified as contingent consideration or post-combination compensation expense depends on a number of factors and can sometimes be a challenging exercise. Contingent payments made to shareholders who will continue as employees post-acquisition and that are tied to retention of those employees are often considered payments for future performance and classified as compensation expense.

However, payments contingent on future performance of the business that are paid in proportion to the share ownership percentage of the target pre-acquisition and that are not contingent on future employment are often considered to be additional purchase price and classified as contingent consideration. More broadly, the determination can depend on:[6]

a) The terms of continuing employment

b) Duration of continuing employment

c) Level of compensation of selling shareholders in comparison to other key employees

d) Incremental payments to selling shareholders who will remain as employees post-close as compared with other selling shareholders

e) Number of shares owned by the selling shareholders who remain as key employees versus those who will not remain as employees post-close

f) Linkage to the valuation of the acquiree versus resemblance to pre-acquisition profit-sharing arrangements

g) Whether the formula for the contingent consideration appears to compensate employees for services rendered

h) The terms of other agreements with selling shareholders

i) Other issues such as the income tax treatment of the contingent payments

5. ASC Master Glossary.
6. See ASC 805-10-55-24/25 for implementation guidance on making the determination of whether or not a contingent payment to selling shareholders should be classified as contingent consideration.

Overview of Contingent Consideration

Contingent consideration can be classified as a liability for potential payments to be made from the acquirer to the seller if certain conditions are met, as an asset for potential payments to be made from the seller to the acquirer (e.g., a clawback if certain expectations are not met), or as equity.[7] Classification of contingent consideration as equity, however, is not common. Even if payment of the contingent consideration obligation is in equity instruments such as shares, it will often be classified as a liability. For example, if the number of equity shares that the acquirer is obligated to issue to the sellers will vary with the future revenues or profits of the business, the contingent consideration arrangement would typically be classified as a liability.[8] The classification of contingent consideration as an asset/liability or as equity has implications for subsequent accounting and for earnings volatility, as will be discussed in the measurement section.

Measurement of Contingent Consideration under U.S. GAAP

ASC 805 requires that "the acquirer shall recognize the acquisition-date fair value of contingent consideration as part of the consideration transferred in exchange for the acquiree."[9] As a result, whether contingent consideration is classified as a liability, an asset, or equity, it must be measured at fair value as of the acquisition date.

However, for contingent consideration classified as an asset or a liability, ASC 805 also requires remeasurement to fair value at each reporting date until the contingency is resolved. The resulting changes in the fair value of the contingent consideration asset or liability are typically recognized in earnings.[10] Contingent consideration that is classified as equity is not remeasured. Its subsequent settlement is accounted for within equity.[11]

The requirement to recognize contingent consideration at fair value on the acquisition date is a change from how contingent consideration was accounted for prior to the adoption of the revised Statement of Financial Accounting Standard for business combinations (SFAS 141R, now ASC 805), which took effect for fiscal years starting on or after December 15, 2008. Previously, contingent consideration usually was recorded when the contingency was resolved and the consideration had been issued or became issuable.[12]

7. ASC 805-30-25-6.
8. See ASC 480-10-25-14 for this specific point. More generally, see also ASC 480-10-25, ASC 815-40 and other applicable generally accepted accounting principles for guidance on whether contingent consideration paid in the form of equity shares should be classified as equity or a liability.
9. ASC 805-30-25-5.
10. The exception is a hedging instrument for which ASC Topic 815, as amended by ASC 805, requires the changes to be initially recognized in other comprehensive income. See ASC 805-30-35-1b.
11. See ASC 805-30-35-1a.
12. Financial Accounting Standard 141 as originally issued, paragraph 27.

Description of the Study Transactions

Description of Transactions Included in the *2012 Contingent Consideration Study*

The *2012 Contingent Consideration Study* leverages information about earn-outs, clawbacks, and pre-existing contingent consideration on transactions that closed in calendar years 2009 through 2011. The study reports on 120 such transactions that were accounted for under US GAAP. To make the interpretation of the results more straightforward, the study excludes pre-existing contingent consideration (i.e., unresolved contingent consideration from prior acquisitions by the target company). Also, while we do see contingent consideration *assets* (clawbacks) in about 5% of the transactions for which we have information, this study is limited to contingent consideration obligations of the acquirer (also referred to herein as earn-outs), which are classified as *liabilities* or, more rarely, *equity.*

It should be emphasized that the study analyzes only a portion of the transactions with earn-outs in the relevant timeframe. For this reason, the results discussed herein may not be representative of all transactions. In addition, our results may differ from studies of publicly available data because our study includes some private transactions and does not include all public transactions with earn-outs.

Figure 1 shows the breakdown by year of the transactions included in the study. Of the 120 study transactions, 37 (31%) closed in 2009, 30 (25%) closed in 2010, and 53 (44%) closed in 2011.

Figures 2, 3 and 4 provide descriptive information about the acquirers and targets for the study transactions. Figure 2 reveals that public companies were the acquirers in approximately three-fourths of the transactions, whereas approximately one-fourth of the transactions involved acquisitions by private companies. The median deal size (whether measured by upfront payment or by the amount of contingent consideration) is smaller for acquisitions by private companies, but just as for public company acquisitions, there is a wide range. Except where specifically noted in the text below, for the earn-out structure and valuation results reported herein, we did not generally see a major difference attributable solely to whether the acquirer is a public or private company. Almost all of the transactions involved private company targets.

Figure 1 – *Transaction Date*

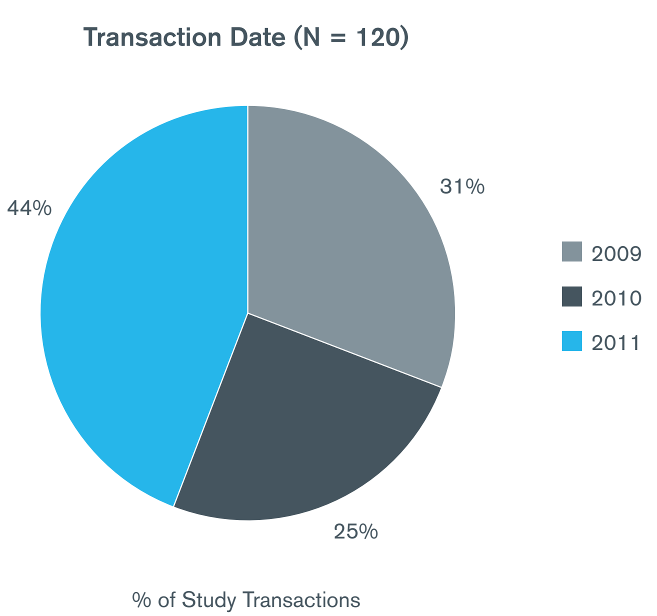
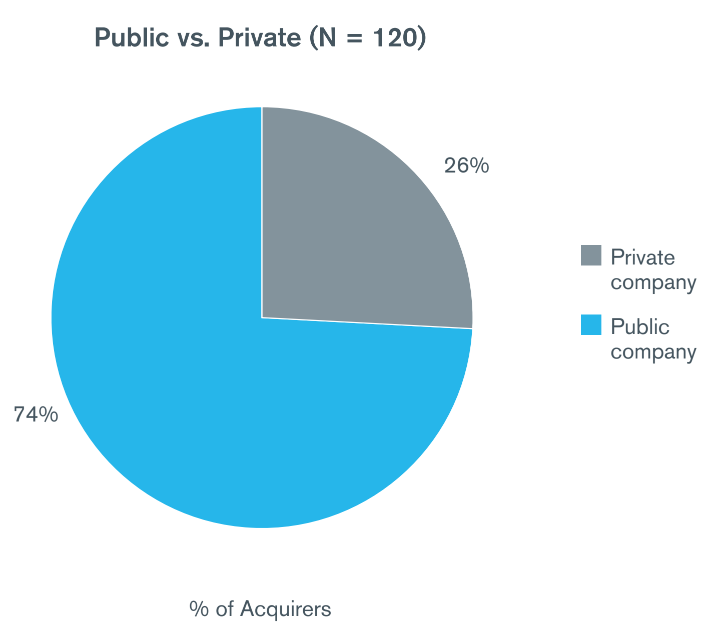


Figure 2 – *Acquirer Type Public vs. Private*



Description of the Study Transactions

Figure 3 provides a breakdown of the transactions by the acquirer's industry. The most common industries were life sciences (39%) and high tech (38%). The ABA's 2011 Private Target Mergers & Acquisitions Deal Points Study observed the same two industries as the most common in its analysis of public company acquirers of private targets, at 16% and 29%, respectively. However, our study, which focuses exclusively on transactions with earn-outs, observes a higher concentration in life sciences and high tech. This is not surprising, since transactions in these two industries disproportionately often involve young companies and/or new technologies.

Contingent consideration is a popular way to share risk and reward between the acquirer and seller in the life sciences industry due to the high uncertainty associated with reaching R&D milestones and achieving regulatory approval. In the high tech industry, contingent consideration is often used to share the risk associated with technology development, market adoption of new products, and the uncertainty inherent in markets with rapidly evolving competitive environments.

Figure 4 shows a breakdown of the stage of development of the target company for the study transactions. Approximately 12% of the transactions involved companies with only pre-market products, whereas 88% of the targets had launched products. Transactions with earn-outs involving targets with only pre-market products were much more common in the life sciences industry; acquisitions of pre-market companies represent 23% of the study's life sciences industry transactions versus only 4% of the study's transactions in other industries.

Figure 3 – *Acquirer's Industry*

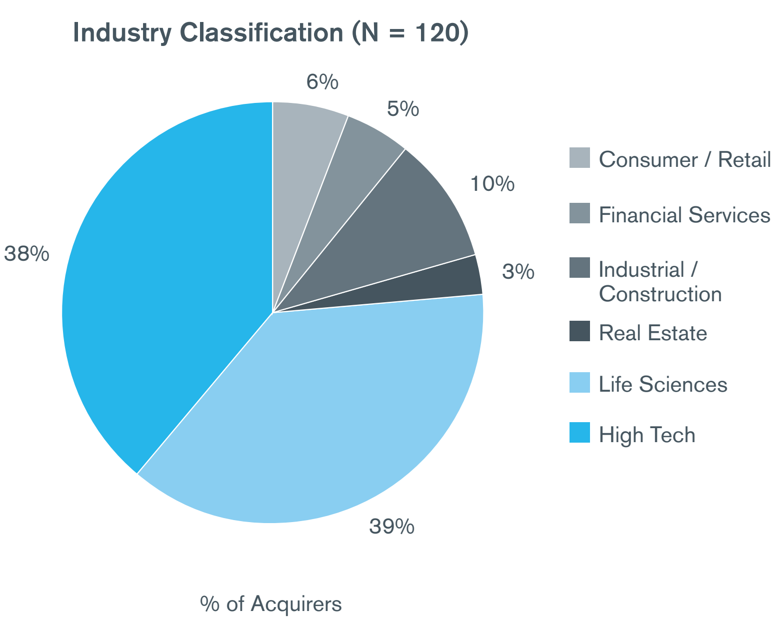
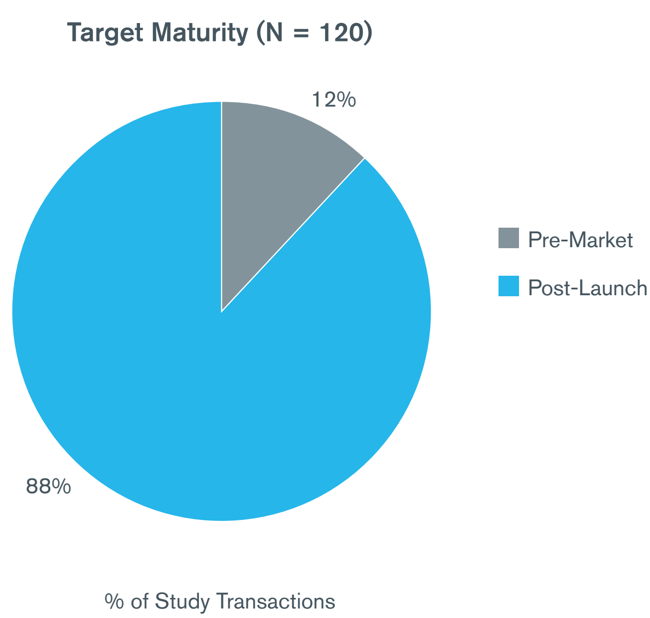


Figure 4 – *Target Maturity*

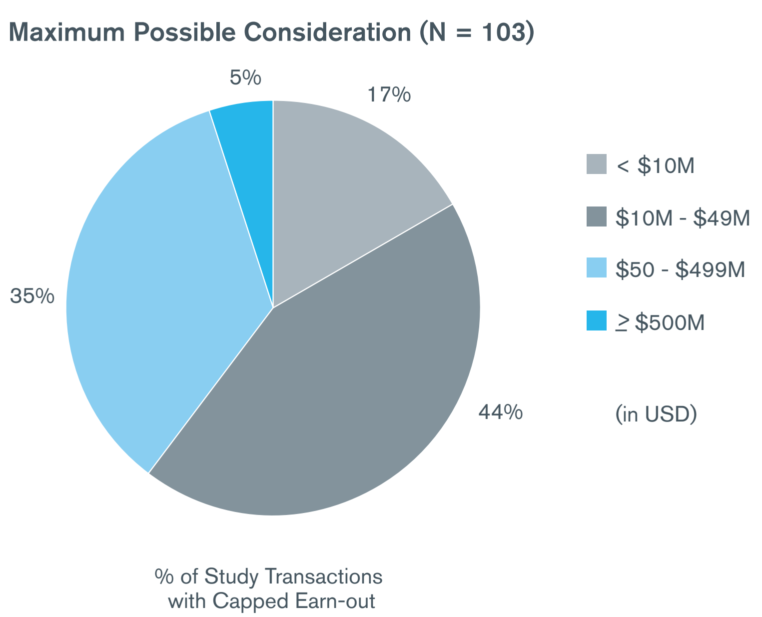


Description of the Study Transactions

Deal size for the study transactions can be characterized by (1) the amount of the upfront payment and/or (2) for deals with a cap on the earn-out, the total possible consideration (including both the upfront payment and the maximum possible earn-out). Among the 120 transactions with earn-outs in the study, the average upfront consideration transferred was $102 million, with a median of $20 million. Upfront consideration spanned a wide range, from over $2 billion to $0 (that is, the entire consideration was contingent).

Approximately 14% of the study transactions with contingent consideration did not have a maximum possible amount. This may occur, for example, when one component of the earn-out provides for royalty payments as a percentage of future revenue with no cap. Of the 103 study transactions with a maximum on the potential payment, the total possible consideration ranged from less than $2.0 million to over $2.5 billion, with an average of $147 million and a median of $36 million. Figure 5 shows the distribution of the maximum possible consideration, among these 103 study transactions.

Figure 5 – *Maximum Possible Consideration ($)*



Earn-out Structures

Prevalence of Contingent Consideration Metrics

Contingent consideration structures come in many different forms, designed to address the unique risks associated with each specific transaction. From the buyer's point of view, the parties should first seek to define metric(s) that will best align the rewards to the seller post-acquisition with the buyer's perception of the key driver(s) of long-term success for the post-combination business. The buyer and seller must agree on how to leverage those metrics to appropriately share the risks and rewards.

Contingent consideration tends to fall into three general categories: top line related, earnings-related, and non-financial milestones. Many of the study transactions had earn-outs with metrics from more than one of these three general categories.

As shown in Figure 6, 60% of the study transactions had an earn-out with a metric related to the top line, such as revenue. The most common type of top line-related contingent consideration metric is revenue, representing 48% of all study transactions. Other types of contingent consideration related to the top line include bookings, number of clients, gross profit, units sold, and assets under management.

For 38% of the study transactions, the contingent consideration was driven by an earnings-related metric. The most common type of earnings-related contingent consideration metric is EBITDA, comprising 23% of all study transactions. Other types of earnings-related contingent consideration metrics include Net Income, EBIT and EBT.

In the study sample, public company acquirers were less likely to use an earnings-related metric (33%) than were private company acquirers (52%). An earnings-related component is also less likely to appear in high tech (24%) or life sciences (30%) than in other industries (72% in aggregate for the other four industries, which include industrial, consumer products, financial services and real estate).

Finally, 26% of the study transactions had contingent consideration related to a non-financial milestone, such as a milestone related to R&D success or a software integration schedule. As shown in Figure 7, life sciences industry earn-outs were more likely to include non-financial milestones (54% vs. an average of 16% in all five other industries). Life sciences transactions often have milestone payments related to achieving success in pre-market clinical trials or to receiving regulatory approval.

Figure 6 – Prevalence of Various Earn-out Structures – Top Line vs. Earnings vs. Milestones

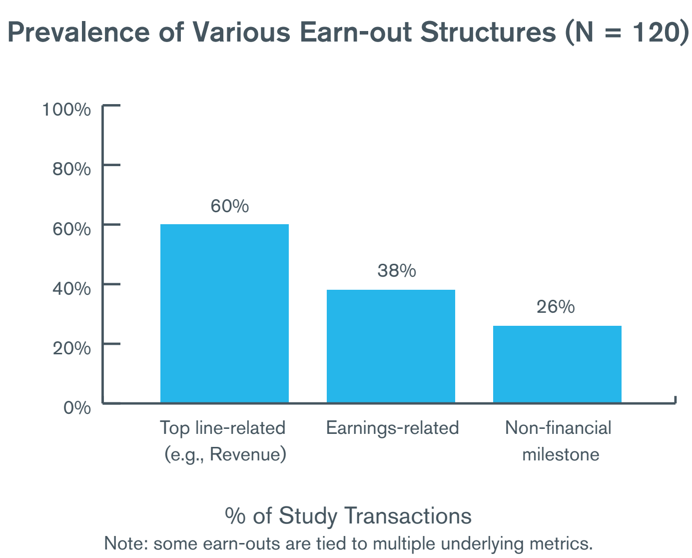
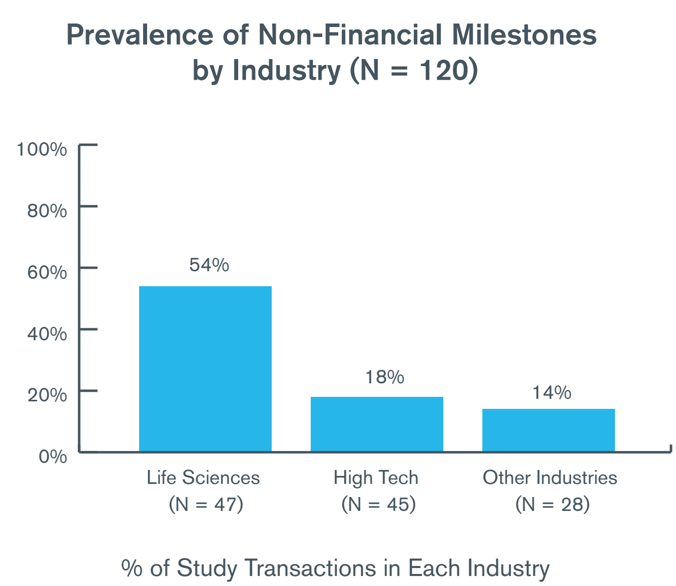


Figure 7 – Prevalence of Non-Financial Milestones by Industry



Earn-out Structures

Figure 8 shows a breakdown of some of the types of non-financial milestones that are most prevalent in the study transactions. 16% of these contingent consideration structures included a technical milestone, such as meeting specified software development schedules. 10% were milestones related to achieving regulatory approval, such as FDA approval. 8% included an R&D milestone, such as achieving Phase II success for a pharmaceutical company.

Occasionally, there are contingent consideration milestones related to employee retention. As discussed earlier, most payments tied to retention are classified as post-combination compensation expense rather than as contingent consideration.

However, there are certain retention-based structures that can be classified as contingent consideration, such as when all shareholders, including non-employees, will receive a lower payment if key employees leave and such payments are made in proportion to pre-close ownership shares.

Complexity of the Earn-out Structure

Once the metric is selected, there are numerous ways in which the success of that metric can be structured. Some earn-outs are structured as a straight percentage of revenues or earnings, or as a single milestone payment for meeting a specified regulatory goal. However, other earn-out designs are more complex.

As shown in Figure 9, of the 120 study transactions, 73% had a cap (maximum payment) on at least one metric with variable payments, 70% had a threshold (i.e., a minimum level below which the contingent payment would be zero) on at least one metric with variable payments, and 30% had multiple tiers with different payment rules when each of multiple thresholds are achieved (for instance, a different percent of earnings for the first $1 million, for the next $1 million, and for any amount above $2 million). Between caps on variable payments and milestones, a total of 103 of the 120 study transactions (86%) had a maximum total contingent consideration payment.

Figure 8 – *Types of Non-Financial Milestones*

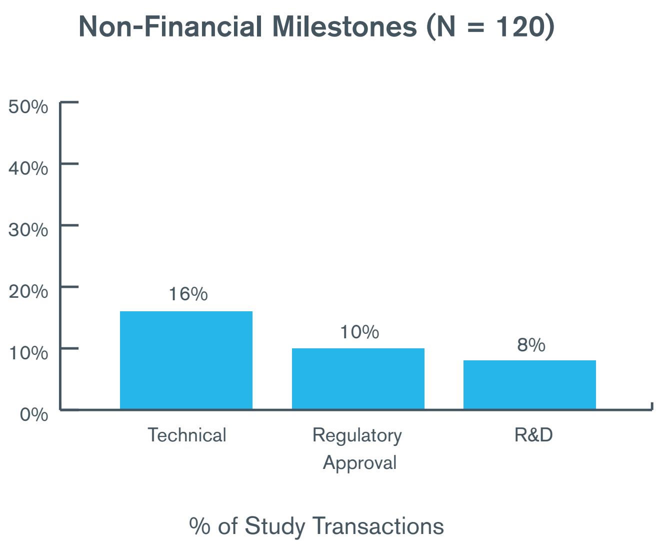
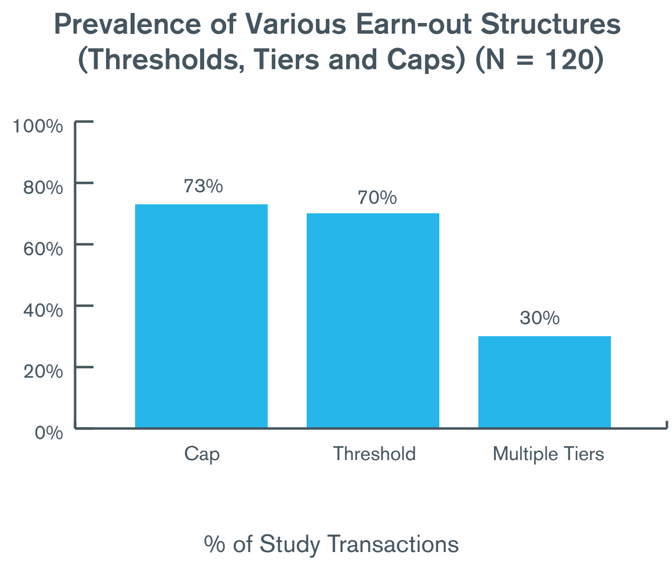


Figure 9 – *Prevalence of Various Earn-out Structures (Thresholds, Tiers and Caps)*



Earn-out Structures

Earn-out Duration

In addition to variations on the underlying metric, earn-out structures vary by duration as well. The average duration of the contingent consideration in the 120 study transactions was 3.6 years, with a median of 3.0 years. Duration ranged from a few months to 20 years, with approximately 18% of the transaction earn-outs exceeding 5 years in duration, as shown in Figure 10.

High tech transaction earn-outs are often of a shorter duration, as the determination of whether or not an acquisition is a success can often be made more quickly in the fast-moving high tech industry. The average earn-out duration for high tech deals was 2.5 years. As shown in Figure 11, 29% of high tech earn-outs last less than 2 years while only 13% last 4 or more years.

Life sciences transaction earn-outs, in contrast, frequently are of longer duration. It can take many years before it is known whether a new life sciences product under development will launch at all, let alone achieve market success. The average duration for life sciences earn-outs in the study was 4.5 years. 36% of these life sciences earn-outs had duration of 4 or more years, while approximately one in ten had duration of 10 years or more.

The earn-outs in the other four industries in aggregate had the same median duration as life sciences earn-outs at 3.0 years and a similar percent (39%) had a duration of 4 or more years. However, since these other industries rarely have earn-outs lasting more than 6 years, the average duration at 3.8 years is between that for life sciences and for high tech. Finally, earn-outs in these other industries were the least likely to be of short duration; in our study only 2 of these earn-outs had duration of less than 2 years.

Figure 10 – Duration of Contingent Consideration

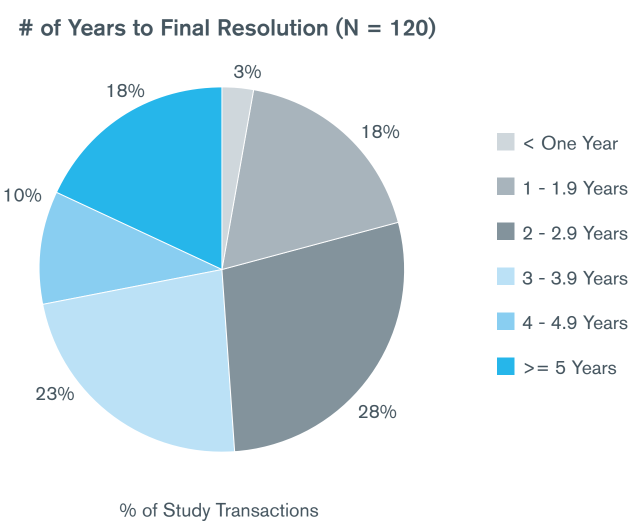
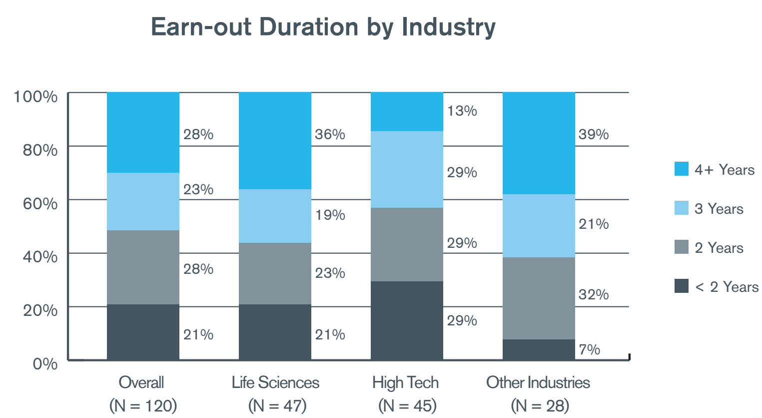


Figure 11 – Earn-out Duration by Industry



Earn-out Structures

Upfront Versus Contingent Consideration

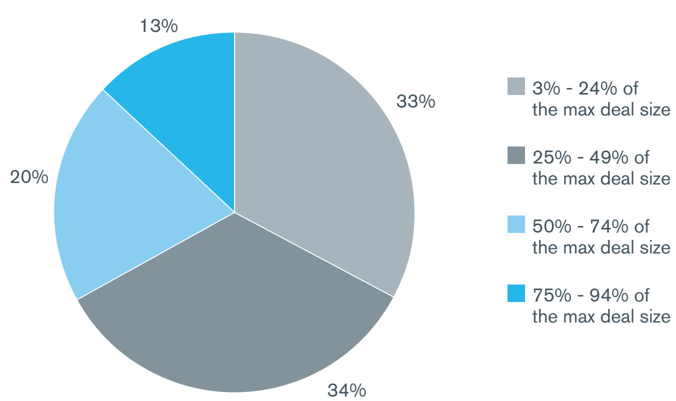
The study transactions also vary significantly as to how much of the transaction consideration was paid upfront versus contingent on future events or business performance.

Among the 103 study transactions with a maximum on the potential earn-out, the average upfront consideration transferred was $102 million, with a median of $20 million. The maximum possible contingent consideration on these 103 transactions ranged from $400,000 to over $500 million, with an average of $45 million and a median of $12 million. The percentage of total potential deal value that was contingent ranged from 3% to 94%, with an average of 41% and a median of 39%. As shown in Figure 12, approximately two-thirds of the time, a majority of the total potential deal value was provided upfront rather than via a potential earn-out.

For our study sample, as shown in Figure 13, the life sciences transactions are more likely to have a higher portion of the potential consideration being contingent than the transactions in high tech or other industries. For the study's life sciences transactions, a median of 46% of the maximum possible consideration was contingent and 42% of the transactions had total potential deal values that were more than half contingent. In contrast, for the study's high tech transactions, a median of 30% of the maximum possible consideration was contingent and only 21% of the transactions had total potential deal values that were more than half contingent. In aggregate, the other four industries had a median contingent portion similar to high tech (31%), but the percentage of the transactions with total potential deal values that were more than half contingent (33%) falls in between that for high tech and that for life sciences.

***Figure 12** – Maximum Contingent Consideration as a percent of Max Possible Consideration*

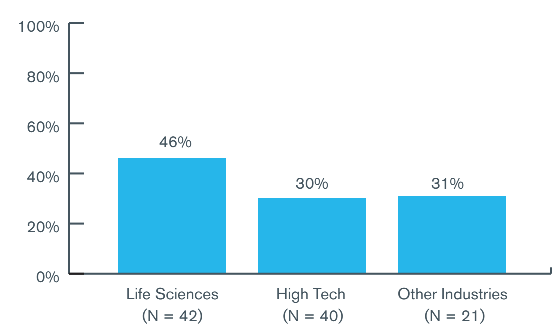
Maximum Contingent Consideration as a % of Max Possible Consideration (N = 103)



% of Study Transactions with Capped Earn-out

***Figure 13** – Comparison of Median of [Maximum Contingent Consideration as percent of Maximum Total Consideration]*

Max Possible Contingent Consideration as a % of Max Possible Total Consideration (Median for Each Industry)



% of Study Transactions in Each Industry

Valuation of Contingent Consideration

Acquisition-Date Valuation of Contingent Consideration

Among the 120 study transactions, the acquisition-date fair value of the contingent consideration ranged from $0 to over $300 million.[13] The average acquisition-date fair value of the contingent consideration was $19 million, with a median of $5 million.

The fair value of the contingent consideration as a percentage of the maximum possible contingent payment can vary significantly based on the purpose of the earn-out. Some earn-outs are based on stretch goals, to incent management to drive the business to meet lofty targets. Other earn-outs are designed to be relatively easy to achieve, as long as some reasonable amount of effort is made by the sellers. Such “easy” earn-outs may be put in place to ensure, for example, that a post-acquisition integration effort will be completed in a timely fashion, or to delay payments to satisfy cash flow concerns of the buyer.

There are 103 transactions in our study for which there is an overall cap on the maximum possible contingent consideration. For these transactions, Figure 14 shows that there is no “typical” value for the acquisition-date fair value of the contingent consideration as a percent of the maximum possible contingent payment (the “earn-out cap”). For 24% of these transactions, the acquisition-date fair value of the contingent consideration was less than one-quarter of the earn-out cap, while for almost as many transactions, the acquisition-date fair value of the contingent consideration was more than three-quarters of the earn-out cap. Both the average and the median acquisition-date fair value of the contingent consideration were 49% of the earn-out cap.

High tech earn-outs tend to have a higher fair value as a percentage of the earn-out cap. This may be due to the relatively shorter duration of a high tech earn-out (see previous discussion on earn-out duration) and the high probability of achievement of the types of technical milestones that are common in this industry, such as meeting software integration schedules. On average, high tech earn-outs have an acquisition-date fair value of 58% of the earn-out cap, with a median of 61%.

As shown in Figure 15, life sciences and other non-high tech industry earn-outs tend to have a lower acquisition-date fair value as a percentage of maximum contingent consideration, with an average of 44 and 42% and a median of 40 and 39% for life sciences and other industries, respectively.

Figure 14 – Day 1 Fair Value of Contingent Consideration as Percent of Maximum Possible Contingent Consideration

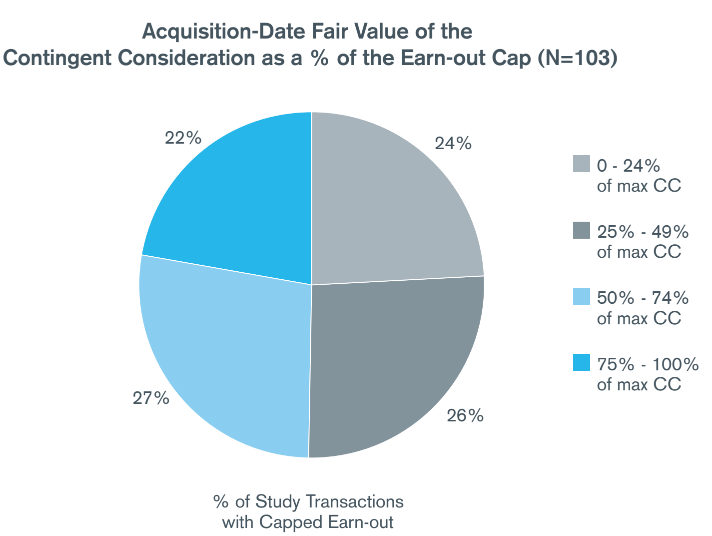
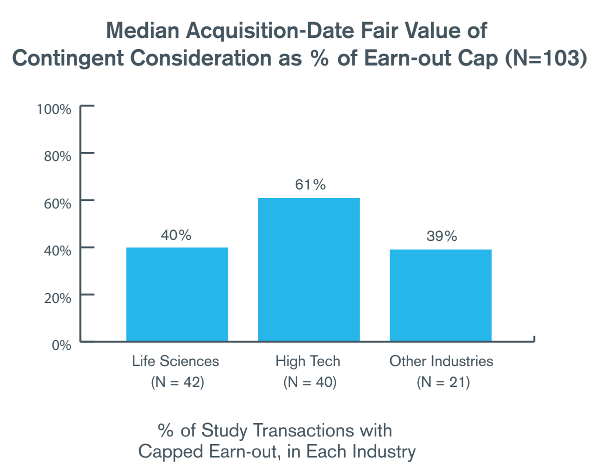


Figure 15 – Median comparison of Day 1 Fair Value of Contingent Consideration as Percent of Max by Industry



13. A fair value of zero is not common. It can occur if the probability of achievement of the earn-out is remote, or the resulting probability-adjusted payment is small enough that the result rounds to $0.

Valuation of Contingent Consideration

Overall for the 120 transactions, the acquisition-date fair value of the contingent consideration was approximately one-fourth, on average, of the overall consideration transferred (upfront non-contingent consideration plus the fair value of the contingent consideration), with a median of approximately one-fifth. As shown in Figure 16, the contingent consideration represents less than one-quarter of the value 59% of the time. In only 13% of the study transactions did the contingent consideration represent at least half the acquisition-date fair value of the deal.

As shown in Figure 17, the median acquisition-date fair value of the contingent consideration as a percentage of the total consideration transferred is similar for life sciences and high tech. This is surprising given that for other metrics related to the relative size of the contingent consideration (the fair value as a percentage of the maximum contingent consideration, and the maximum contingent consideration as a percentage of the total possible consideration), this percentage is different for life sciences vs. high tech. On the other hand, in aggregate for the other four industries, and particularly for consumer products and real estate, the acquisition-date fair value of contingent consideration tends to be a smaller portion of the overall consideration transferred, with a median of 11%. It should be noted, however, that the mean of 21% for these four industries is not as far from the mean for the high tech and life sciences industries (which average 27 and 25%, respectively).

***Figure 16 –** Day 1 Fair Value of Contingent Consideration as Percent of Total Consideration*

Acquisition-Date Fair Value of the Contingent Consideration as a % of the Fair Value of the Total Consideration (N=120)

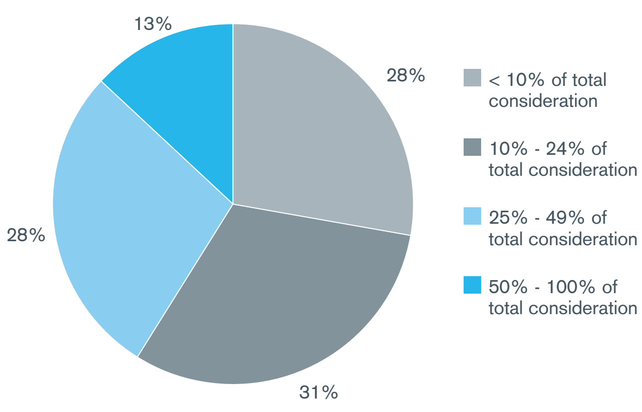
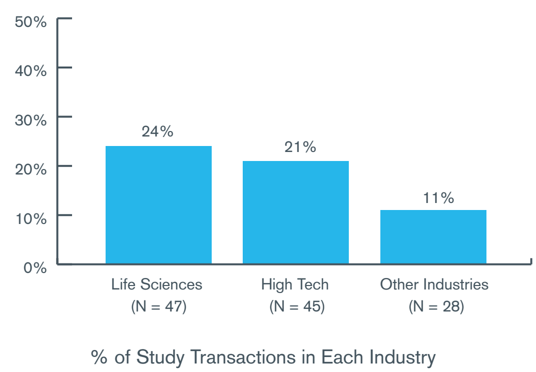


***Figure 17 –** Comparison by Industry of Median of Day 1 Fair Value of Contingent Consideration as a Percent of the Total Consideration*

Median Acquisition-Date Fair Value of Contingent Consideration as % of the Fair Value of the Total Consideration



Valuation of Contingent Consideration

Remeasurement Value of Contingent Consideration

As described in the Overview of Contingent Consideration section, contingent consideration classified as a liability or asset must be remeasured to fair value at each reporting period, with the changes in fair value usually flowing through earnings. In general, the fair value of contingent consideration liabilities can increase or decrease significantly over the course of time, for the very reason that the earn-out was put in place – the outcome is uncertain.

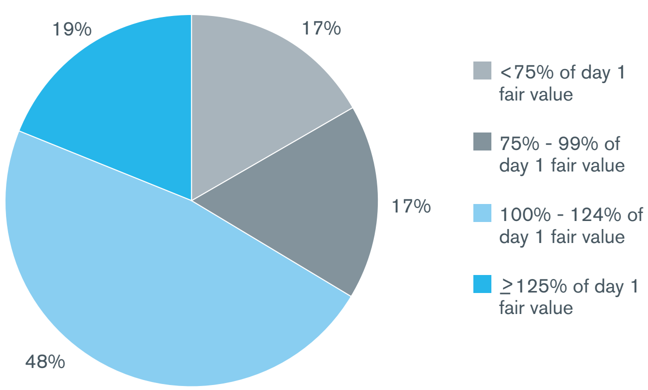
For 42 of the 120 study transactions, we have information on the fair value of the contingent consideration one year after the close of the deal. Due to the effects of discounting, as the time to payment decreases, we would expect the fair value of the liability to increase slightly (assuming the underlying uncertainty remains unchanged). As of one year post-close, the median fair value of the contingent consideration was indeed 107% of the acquisition-date fair value – just about what one would expect from accretion alone. On average, the updated fair value was 97% of the acquisition-date fair value. This result appears to be due to a handful of outliers on the downside that were not offset by corresponding outliers on the upside.

We get similar results when we examine the median remeasurement fair values for each of the three industry groupings (high tech, life sciences, and other industries).

Though on average the future may have unfolded roughly according to expectations, the updated fair value of the contingent consideration ranged from 4% to 148% of the acquisition-date fair value. The width of this range serves to emphasize the degree of uncertainty inherent in assessing future business performance for the kinds of companies – typically young companies – for which the deal teams feel that earn-outs are required. Indeed, as illustrated in Figure 18, 36% of the time there was a significant surprise (an increase or decrease in fair value of at least 25%) one year later, with approximately an equal number of upside and downside surprises.

***Figure 18 –** Updated Fair Value 1 Year Later as Percent of Day One Fair Value of Contingent Consideration*

Update Value of Contingent Consideration after 1 year as a % of Acquisition-Date Fair Value (N=42)



% of Study Transactions with Updated Fair Value Estimate After 1 Year

Insights

Insights Related to Contingent Consideration Structuring

Best practice in structuring earn-outs involves designing the terms to best align the interests of buyers and sellers post-transaction. Because every deal is unique, we see a wide variety of deal structures. We do observe, however, that earn-outs tied to top line metrics such as revenues seem to be the most popular (60% of the study transactions with earn-outs). Discussions with finance executives and deal teams indicate that top line-based earn-outs are often easier to define with clarity. Sellers may perceive that it will be easier for them to impact, drive and control post-acquisition performance on top line metrics than on bottom line metrics. Buyers may perceive that growth in revenues, number of customers, etc., will build long-term value in the business and/or strengthen the synergistic value with other parts of the buyer's business.

On the other hand, top line metrics often do not fully align the interests of buyers and sellers. Particularly in industries where revenue can easily be increased by sacrificing profit margins, it may be desirable to include a profitability component for the earn-out, perhaps in conjunction with a revenue component. Discussions with finance executives and deal teams suggest the importance of being explicit about the buyer's commitments to investment and expense targets when structuring a bottom line-based earn-out metric, to reduce the risk of disputes down the road.

Another concept that we have seen with some regularity in multi-period earn-outs is the catch-up provision, which allows the sellers to recoup earn-outs not earned in, say, the first year, by significantly outperforming targets in later years. Such provisions can keep incentives high in situations for which improved performance is still possible, but has been delayed.

Insights Related to Valuation of Contingent Consideration

The fair value of an earn-out is often developed in part using management assessments of the likelihood of meeting milestones, of the occurrence of triggering events, and/or of achieving various upside and downside scenarios. Such management assessments are generally obtained through rigorous elicitation procedures. The task of assessment is made more difficult by the high degree of uncertainty that surrounds the estimation of future performance of the acquired business – especially for a business for which there is enough risk and/or a large enough gap in expectations between the buyer and seller that an earn-out is put in place. It is somewhat surprising, therefore, that the median fair value one year later for the study earn-outs is in the same ballpark as the acquisition-date fair value plus accretion. Finance executives and deal teams are often reluctant to estimate the likelihood of alternative outcomes in situations of high uncertainty. The takeaway from this result, however, is that management on average does seem to make reasonable assessments.

> "Best practice in structuring earn-outs involves designing the terms to best align the interests of buyers and sellers post-transaction. Earn-outs tied to top line metrics are often easier to define with clarity, are perceived as more straightforward to drive post-close by the seller, and are important to building long-term value for the combined business for the buyer."

Insights

Insights Related to Earnings Impacts

The remeasurement of contingent consideration has the ***opposite effect*** on earnings from the direct effect of the change in business performance. For this reason, a well-designed earn-out can not only transfer risk from buyer to seller, but also can buffer future earnings from the ups and downs of the business.

One key to using an earn-out to reduce the acquirer's earnings volatility is to define the terms to ensure that the earn-out amount does not exceed two times the change in earnings associated with achievement of (or failure to achieve) that earn-out. For example, consider an earn-out based on 3 times the amount of EBITDA over and above the expected-case EBITDA for year one post-close. Such an earn-out might actually increase the volatility of earnings for that one-year time period, as shown in Table 1.

However, the situation is more complex for multi-year earn-outs. On the positive side, a multi-year earn-out can help to mitigate the impact of certain negative changes in business outlook. For example, consider a situation in which during the first year post-close ("Year One") not only is business performance below expectations, but there is also a significant decline in future prospects for the acquired business. The sub-par business performance reduces earnings for Year One, and the reduced earn-out payment associated with that year can help buffer that impact. However, the decline in business prospects might also reduce the value of an IPR&D asset or trigger a need to test goodwill for impairment. Thus, any gain recorded from the reduction in fair value of the liability for the remaining years of the earn-out due to the decline in longer-term prospects might offset, to some degree, those impairments in goodwill or IPR&D asset values.

Of course, if the future prospects for the business improve in the first year post-close, there may be an increase in the fair value of the liability for the remaining years of the earn-out. Unfortunately, the corresponding increase in earnings will not occur until those subsequent years – and therefore will not be able to offset the impact at the end of that first year due to the remeasurement of the contingent consideration liability. In this case, the volatility of the acquirer's earnings may be increased, depending on the relative magnitudes of the Year One impact and the impact of the remeasurement of the fair value of the earn-out.

We recommend that the acquirer assess the impact of a proposed earn-out on future earnings volatility, prior to finalizing the transaction.

Table 1: *Earn-out Impact Illustrative Example (Units are in US$ Thousands)*

Acquisition Date Purchase Price Accounting Assessments:	
Year 1 expected EBITDA	$10,000
Illustrative earn-out acquisition-date fair value[14]	$ 2,000
Earn-out Results After One Year:	
Year 1 actual EBITDA	$13,000
Earn-out payment	$ 9,000
Impact on Earnings:	
Change in business performance vs. original expectations	$ 3,000
Impact on earnings of resolution of earn-out uncertainty	**($ 7,000)**
Net impact	($ 4,000)

14 The acquisition-date fair value in this example is merely illustrative. For a real transaction, the fair value of such an earn-out depends on the distribution of potential outcomes and other factors.

Appendix: Quick Accounting Reference Guide

Contingent Consideration

Master Glossary Usually an obligation of the acquirer to transfer additional assets or equity interests to the former owners of an acquiree as part of the exchange for control of the acquiree if specified future events occur or conditions are met. However, contingent consideration also may give the acquirer the right to the return of previously transferred consideration if specified conditions are met.

Initial Recognition and Measurement

805-30-25-5 The consideration the acquirer transfers in exchange for the acquiree includes any asset or liability resulting from a contingent consideration arrangement. The acquirer shall recognize the acquisition-date fair value of contingent consideration as part of the consideration transferred in exchange for the acquiree.

Subsequent Measurement

805-30-35-1 Some changes in the fair value of contingent consideration that the acquirer recognizes after the acquisition date may be the result of additional information about facts and circumstances that existed at the acquisition date that the acquirer obtained after that date. Such changes are measurement period adjustments in accordance with paragraphs 805-10-25-13 through 25-18 and Section 805-10-30. However, changes resulting from events after the acquisition date, such as meeting an earnings target, reaching a specified share price, or reaching a milestone on a research and development project, are not measurement period adjustments. The acquirer shall account for changes in the fair value of contingent consideration that are not measurement period adjustments as follows:

a. Contingent consideration classified as equity shall not be remeasured and its subsequent settlement shall be accounted for within equity.

b. Contingent consideration classified as an asset or a liability shall be remeasured to fair value at each reporting date until the contingency is resolved. The changes in fair value shall be recognized in earnings unless the arrangement is a hedging instrument for which Topic 815 requires the changes to be initially recognized in other comprehensive income.

805-30-35-1A Contingent consideration arrangements of an acquiree assumed by the acquirer in a business combination shall be measured subsequently in accordance with the guidance for contingent consideration arrangements in the preceding paragraph.

Classification

805-30-25-6 The acquirer shall classify an obligation to pay contingent consideration as a liability or as equity in accordance with Subtopics 480-10 and 815-40 or other applicable generally accepted accounting principles (GAAP). For example, Subtopic 480-10 provides guidance on whether to classify as a liability a contingent consideration arrangement that is, in substance, a put option written by the acquirer on the market price of the acquirer's shares issued in the business combination.

805-30-25-7 The acquirer shall classify as an asset a right to the return of previously transferred consideration if specified conditions are met.

Appendix: Quick Accounting Reference Guide

Implementation Guidance Regarding Classification as Contingent Consideration

Arrangements for Contingent Payments to Employees or Selling Shareholders

805-10-55-24 Whether arrangements for contingent payments to employees or selling shareholders are contingent consideration in the business combination or are separate transactions depends on the nature of the arrangements. Understanding the reasons why the acquisition agreement includes a provision for contingent payments, who initiated the arrangement, and when the parties entered into the arrangement may be helpful in assessing the nature of the arrangement.

805-10-55-25 If it is not clear whether an arrangement for payments to employees or selling shareholders is part of the exchange for the acquiree or is a transaction separate from the business combination, the acquirer should consider the following indicators:

a. Continuing employment. The terms of continuing employment by the selling shareholders who become key employees may be an indicator of the substance of a contingent consideration arrangement. The relevant terms of continuing employment may be included in an employment agreement, acquisition agreement, or some other document. A contingent consideration arrangement in which the payments are automatically forfeited if employment terminates is compensation for postcombination services. Arrangements in which the contingent payments are not affected by employment termination may indicate that the contingent payments are additional consideration rather than compensation.

b. Duration of continuing employment. If the period of required employment coincides with or is longer than the contingent payment period, that fact may indicate that the contingent payments are, in substance, compensation.

c. Level of compensation. Situations in which employee compensation other than the contingent payments is at a reasonable level in comparison to that of other key employees in the combined entity may indicate that the contingent payments are additional consideration rather than compensation.

d. Incremental payments to employees. If selling shareholders who do not become employees receive lower contingent payments on a per-share basis than the selling shareholders who become employees of the combined entity, that fact may indicate that the incremental amount of contingent payments to the selling shareholders who become employees is compensation.

e. Number of shares owned. The relative number of shares owned by the selling shareholders who remain as key employees may be an indicator of the substance of the contingent consideration arrangement. For example, if the selling shareholders who owned substantially all of the shares in the acquiree continue as key employees, that fact may indicate that the arrangement is, in substance, a profit-sharing arrangement intended to provide compensation for postcombination services. Alternatively, if selling shareholders who continue as key employees owned only a small number of shares of the acquiree and all selling shareholders receive the same amount of contingent consideration on a per-share basis, that fact may indicate that the contingent payments are additional consideration. The preacquisition ownership interests held by parties related to selling shareholders who continue as key employees, such as family members, also should be considered.

f. Linkage to the valuation. If the initial consideration transferred at the acquisition date is based on the low end of a range established in the valuation of the acquiree and the contingent formula relates to that valuation approach, that fact may suggest that the contingent payments are additional consideration. Alternatively, if the contingent payment formula is consistent with prior profit-sharing arrangements, that fact may suggest that the substance of the arrangement is to provide compensation.

g. Formula for determining consideration. The formula used to determine the contingent payment may be helpful in assessing the substance of the arrangement. For example, if a contingent payment is determined on the basis of a multiple of earnings, that might suggest that the obligation is contingent consideration in the business combination and that the formula is intended to establish or verify the fair value of the acquiree. In contrast, a contingent payment that is a specified percentage of earnings might suggest that the obligation to employees is a profit-sharing arrangement to compensate employees for services rendered.

h. Other agreements and issues. The terms of other arrangements with selling shareholders (such as noncompete agreements, executory contracts, consulting contracts, and property lease agreements) and the income tax treatment of contingent payments may indicate that contingent payments are attributable to something other than consideration for the acquiree. For example, in connection with the acquisition, the acquirer might enter into a property lease arrangement with a significant selling shareholder. If the lease payments specified in the lease contract are significantly below market, some or all of the contingent payments to the lessor (the selling shareholder) required by a separate arrangement for contingent payments might be, in substance, payments for the use of the leased property that the acquirer should recognize separately in its postcombination financial statements. In contrast, if the lease contract specifies lease payments that are consistent with market terms for the leased property, the arrangement for contingent payments to the selling shareholder may be contingent consideration in the business combination.

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