Question That Came in the Other Day…

- “Can you explain what happens with an **earn-out** in an M&A deal?

- How do you model it, and how do you factor it into the Purchase Price Allocation, Sources & Uses, and other schedules?

- And where does it show up on the 3 financial statements?”

Your Crash Course in Earn-Outs

- **Point #1:** What They Are and Why You Use Them
- **Point #2:** How Earn-Outs Show Up on the 3 Statements
- **Point #3:** How Earn-Outs Impact Purchase Price Allocation and Sources & Uses
- **Point #4:** How Earn-Outs Affect the IS, BS, and CFS in a Merger Model

Let’s Start with the “What” and the “Why?”

- **What is an Earn-Out:** Instead of paying for a company 100% upfront, the buyer offers to pay *some portion* of the price <u>later on</u> – <u>if certain conditions are met</u>

- **Example:** “We’ll pay you $100 million for your company now, and if you achieve EBITDA of $20 million in 2 years, we’ll pay you an additional $50 million then.”

- **Very Common:** Acquisitions of private companies / startups in tech, biotech, and pharma

Real-Life Example: EA and PopCap Games

- **Deal Structure:** \$650 million in cash and \$100 million in stock, and… **earn-outs** as follows, depending on PopCap Games' earnings:

  - **2-Year Earnings < \$91 Million:** Nothing
  - **2-Year Earnings >= \$110 Million:** \$100 million
  - **2-Year Earnings >= \$200 Million:** \$175 million

  - **2-Year Earnings >= \$343 Million:** \$550 million (!)

Why Use an Earn-Out?

- **Typically:** Because buyer and seller have <u>very</u> different views of the seller’s value and financial projections

- **Buyer:** “There’s no way we believe your projections… but maybe you’ll achieve 50% of them.”

- **Seller:** “Watch us go to infinity and beyond!”

- **Buyer:** “Then let’s compromise and use an earn-out – if you’re right, you’ll make bank! If not, still get something”

Earn-Out Structures

- **Buyer:** Usually wants to base the earn-out on the seller's <u>standalone profitability</u> (i.e., Net Income)

- **Seller:** Usually wants to base the earn-out on revenue, or combined revenue, or "assisted revenue"

- **Compromise:** Often use EBIT or EBITDA targets

- **Tiers:** Can have *many* tiers and "levels", even more than in the PopCap example… sometimes over many years!

Earn-Outs on the 3 Statements

- **Balance Sheet:** Earn-Outs are recorded as “Contingent Consideration,” a Liability on the L&E side

- **Cash Flow Statement:** When the earn-out is paid out in cash to the seller, it’s a cash outflow here; also add back or subtract changes in Contingent Consideration value

- **Income Statement:** Record changes in the <u>value</u> of the Contingent Consideration

Earn-Outs on the 3 Statements

- **“Changes in Value”?:** Company continually updates probability of “paying out” that earn-out

- **Example:** Initially, they allot $100 million for the earn-out and assume $100 million will be paid out in 2 years

- **After Year 1:** Acquired company misses its financial goals, so buyer reduces Contingent Consideration value by 25% → 25% lower chance of paying that earn-out

Earn-Outs on the 3 Statements

- **Income Statement:** This is recorded as a <u>positive</u> $25 million since you're writing down a Liability

- **Cash Flow Statement:** Subtract back out that $25 million in Cash Flow from Operations – it's non-cash

- **Balance Sheet:** Reduce the Contingent Consideration by $25 million; Cash (due to taxes) and Retained Earnings (due to Net Income) will balance the change

Earn-Outs and PPA and Sources & Uses

- **Sources & Uses:** Earn-outs make <u>no impact</u> on the initial transaction S&U because they're not paid out in cash initially

- **PPA:** *Does* make an impact here since the Contingent Consideration is recorded as a liability – it will therefore impact Goodwill

- **Example:** One of our case studies – Jos. A. Bank and Eddie Bauer (Failed private company acquisition)

Earn-Outs in a Merger Model

- **Step 1:** Create the Contingent Consideration Liability in the PPA Schedule (previous step)

- **Step 2:** Factor in the earn-out on the Income Statement, Cash Flow Statement, and Balance Sheet

- **IS:** Tend to leave this blank unless you have a crystal ball

- **CFS:** *Should* factor in some type of future payout

Summary of Earn-Outs

- **Point #1:** What They Are and Why You Use Them
- **Point #2:** How Earn-Outs Show Up on the 3 Statements
- **Point #3:** How Earn-Outs Impact Purchase Price Allocation and Sources & Uses
- **Point #4:** How Earn-Outs Affect the IS, BS, and CFS in a Merger Model

Up Next…

- **Earn-Out Modeling:** We just scratched the surface in this short crash course

- **Next Time:** May look at modeling multi-year earn-out tiers, different revenue / EBITDA scenarios, or even how the buyer and seller might negotiate an earn-out

- (Let us know what you're interested in!)