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ARTICLE

Earnouts: A Mechanism to Solve the Current Valuation Gap

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With the continued gap in expectations on valuation, it is no surprise that earnouts are on the rise. Once a term you wouldn't dare introduce in a competitive auction, earnouts are frequently mentioned as one of a handful of creative deal structures to overcome valuation or financing gaps in the current dealmaking environment.

WHAT HAPPENED?

Buyers and sellers alike are more hesitant to transact than in past years; buyers are more focused on diligence as they face greater scrutiny from lenders, insurers and their own investment committees, and sellers continue to have inflated valuation expectations from the market peak of 2021. Cash preservation is at a premium, particularly for private equity firms who pay close attention IRR on each investment.

SO, WHAT EXACTLY IS AN EARNOUT?

Generally speaking, an earnout is a seller's contractual right to contingent payments from a buyer of a business upon the achievement of certain financial or performance metrics or milestones during the post-closing period. Earnouts can be structured in a multitude of ways, but they tend to address the valuation gap identified during diligence or negotiations. Those metrics are often crafted in terms of revenue or Ebitda during one or more post-closing periods based on how the enterprise value of the business is determined. For example, in a software deal, where enterprise is based on a multiple of annual recurring revenue (ARR), any earnout may also be based on achievement of ARR thresholds.

Read the full article (see page 42).

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