Risk Mitigation with Contingent Earnouts in M&A: Review of 2022

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Acquirers in mergers and acquisitions (M&A) use contingent consideration, i.e., price protection and adjustment mechanisms, as a tool to manage post-closing risks with respect to the price offered for acquiring a target firm. The earnouts are deferred-contingent payments of the offer price based on the achievement of a target company's post-acquisition performance with respect to certain benchmarks based on future revenue or earnings. Such contingent payouts mitigate risks due to adverse selection and facilitate the transfer of the risk of overpayment from the acquirer to the seller (Kohers and Ang 2000; Caselli, Gatti, and Visconti 2006; Cain, Denis, and Denis 2011). For the sellers, such contractual mechanisms mitigate the risk of underpayment as they get additional payouts if their performance exceeds the contracted benchmarks. When acquirer and target firms differ in their assessment of fair value, such payouts also enable faster deal completion as part of the offer price is deferred and is to be paid on the achievement of some future performance target (Kohers and Ang 2000). For instance, in June 2022, Mondelez International Inc. announced the acquisition of energy bars manufacturer Cliff Bar & Co. for an upfront payment of USD 2.9 billion and a deferred payment of up to USD 2.4 billion if some profit-related targets are achieved in the future. This transaction is noteworthy, as the potential value of earnouts is over 45 percent of the initial offer price paid in cash. In another instance, in May 2022, the UK-based GSK Plc. announced the acquisition of the US-based bio-pharmaceutical company Affinivax Inc., whose key product is in the clinical stage, for an upfront cash payment of USD 2.1 billion. As reported by Refinitiv Eikon, Affinivax shareholders would receive earnouts up to USD 1.2 billion if the target achieves certain clinical development milestones in the future.

When there is higher uncertainty about the expected cash flows of a target firm, earnouts can help allocate the rewards and risks by deferring a part of the acquisition price to a later date when expected benchmarks are met or exceeded (Caselli, Gatti, and Visconti 2006; Cain, Denis, and Denis 2011). The risk mitigation in the M&A space is of considerable value in the current macro-economic scenario characterized by high uncertainties due to the long-global pandemic, inflation, the Ukraine war, and other developments on the geopolitical front. Thus, considering the relevance of risk-management tools in the current times, this article reviews the inclusion of risk-mitigation tools like contingent earnouts in the M&A deals announced between November 2021 to October 2022.

Table 1. Volume and Value of Mergers and Acquisitions Across the World							
Month	**Number of M&A Deals**	**Sum of Deal Value (USD, Billion)**	**Number of Completed deals**	**Number of deals with Earnouts**	**Sum of Deal Value - deals with Earnouts (USD, Billion)**	**Number of Completed deals with Earnouts**
Nov-21	2398	463.66	1687	111	17.93	79
Dec-21	2569	530.95	1743	83	24.42	65
Jan-22	1901	433.36	1391	73	10.09	55
Feb-22	1784	338.84	1361	69	12.59	50
Mar-22	2016	315.12	1423	63	12.43	50
Apr-22	1784	402.45	1246	57	10.81	37
May-22	1840	439.67	1215	81	18.02	52
Jun-22	1919	235.36	1242	61	17.43	38
Jul-22	1551	222.73	979	49	8.56	25
Aug-22	1547	225.15	893	54	12.81	29
Sep-22	1481	226.31	835	45	7.97	17
Oct-22	1095	182.52	481	49	12.30	22
Grand Total	**21885**	**4016.12**	**14496**	**795**	**165.36**	**519**

Notes: M&A deals announced from 1st Nov 2021 to 31st Oct 2022, with a deal value greater than or equal to USD 1 million. The deal value is in USD billion. The data includes announced M&A deals with the following deal status: Completed, withdrawn, seeking buyer withdrawn, intent withdrawn, dismissed rumor, pending regulatory, pending, partially completed, intended, status unknown. 21885 deals include the deals with earnouts, and 795 deals comprise a sub-sample of the deals which have used earnouts. The data was accessed on 3rd Nov 2022; thus, the deal status corresponds to the values updated till such time.

Disclaimer: The data used in this article is filtered as per the criteria stated in the notes above. The use of this analysis is only for academic purposes.

The table is compiled by the author. Data source: Refinitiv Eikon.

The total value of M&A deals announced between Nov 2021 to Oct 2022 is over USD 4 trillion.[1] Although the deal activity has slowed down over the past twelve months compared to the prior period, the volume and the value of deals announced recorded a remarkable number (table 1). Of the total deals announced in this period, over two-thirds of the deals are completed, and over 29.57% of the deals announced are cross-border transactions.

The twelve months under consideration recorded 795 M&A transactions where earnouts are included in the consideration offered, and the total value of such transactions is approximately USD 165.36 billion (table 1). Acquirers may also resort to alternative mechanisms like using stock or convertible securities as the method of payment, acquiring a toe-hold stake, or entering a joint venture, etc., to mitigate the risks due to asymmetric information (Mantecon 2009; L. Barbopoulos and Sudarsanam 2012). Thus, the number of deals with earnouts is only a subset of transactions where a bidder has used a risk mitigation tool to address the risk of overpayment.

The inclusion of earnouts in M&A contracts can facilitate deal completion when the acquirer and the target disagree on the value of the deal (Kohers and Ang 2000). In the sample comprising deals with earnouts, over 65% of the deals (519 deals) are completed, although this feature is not unique to the earnout sub-sample as this number is very similar to the proportion of deals completed in the full sample where over 66% of the deals (14496) deals are completed.

For further analysis, I have filtered the data to include only completed deals, with or without earnouts, where the acquirer has acquired a majority stake, i.e., 50% or more, in the target company. A summary of the deal characteristics is presented in table 2.

The percentage of stake acquired in an M&A transaction could also influence the decision to include earnouts in the consideration offered (Reuer, Shenkar, and Ragozzino 2004). In fact, an acquirer could acquire a significant-yet-minority stake in a target firm to address the concern of adverse selection thereby making the target firm share the future risks. Such minority-stake transactions then serve as an alternative to a consideration structure that includes earnouts (Ragozzino and Reuer 2009). I observe that out of the 519

[1] Our sample comprises M&A with deal value equal to or more than USD 1 million announced between November 2021 to October 2022, including other filtering criteria mentioned in table 1. Note: The sample includes transactions that are pending completion.

completed M&A deals with earnouts, 97.11% of the deals (504 deals) are majority stake acquisitions. On the contrary, out of the 13977 completed M&A deals without earnouts, only 35.41% of the deals (4949 deals) are majority stake acquisitions. Furthermore, the average stake acquired in the completed M&A deals (where majority stake is acquired) with earnouts is 97.52%, and 466 out of 505 deals are the transactions undertaken for acquiring the complete 100% stake. Thus, if a deal structure contains use of earnouts, it is more likely to involve higher percentage of stake acquired.

Acquirers can also gradually increase their ownership stake in a target firm instead of acquiring a majority or full stake in the initial transaction. This approach can help an acquirer gain a better understanding of the risks in the target and lower the information asymmetries. Indeed, if the target is familiar, that is, when an acquirer already holds some stake in the target, then there will be less use of earnouts in such deals. Thus, deals that include earnouts are more likely to be transactions where the acquirer does not hold any stake in the target firm prior to the deal announcement. I observe that out of the 504 deals (majority stake completed deals) with earnouts, only 3 deals (0.60%) have acquirers already owning some stake in the target firms prior to its announcement. On the contrary, 152 deals (3.07%) out of 4949 regular deals have acquirers owning an equity stake in the target firm prior to the deal announcement.

Table 2. Select Deal Characteristics of Majority Stake Completed M&A Deals

Panel I: Deals with Earnouts						
Month	**Number of M&A Deals**	**Sum of Deal Value (USD, Billion)**	**Average of Percentage of Shares Acquired in Transaction**	**Number of deals in the same industry**	**Number of Cross-border deals**	**Number of Public Targets**
Nov-21	77	12.87	98.41%	35	25	1
Dec-21	63	20.83	98.41%	22	24	2
Jan-22	53	8.85	96.43%	22	18	0
Feb-22	48	7.26	98.34%	25	19	2
Mar-22	50	6.90	98.16%	18	16	0
Apr-22	35	3.48	96.67%	20	12	0
May-22	50	10.38	94.74%	25	15	0
Jun-22	38	9.21	96.71%	22	11	0
Jul-22	23	4.64	98.57%	10	6	0
Aug-22	29	3.48	98.38%	15	11	0
Sep-22	17	0.68	97.65%	6	7	0
Oct-22	21	0.77	97.95%	12	3	0
Grand Total	504	89.34	97.52%	232	167	5

Panel II: Deals without Earnouts						
Month	**Number of M&A Deals**	**Sum of Deal Value (USD, Billion)**	**Average of Percentage of Shares Acquired in Transaction**	**Number of deals in the same industry**	**Number of Cross-border deals**	**Number of Public Targets**
Nov-21	650	208.03	93.16%	214	186	69
Dec-21	748	265.67	93.01%	276	200	54
Jan-22	456	106.63	92.82%	148	109	30
Feb-22	433	100.03	93.31%	138	115	36
Mar-22	451	127.66	93.14%	147	129	44
Apr-22	443	143.82	94.41%	144	108	32
May-22	387	112.51	93.88%	124	100	33
Jun-22	352	57.35	93.81%	125	96	27
Jul-22	346	40.62	94.33%	101	104	23
Aug-22	297	50.50	93.82%	86	61	17
Sep-22	241	19.36	92.77%	69	76	9
Oct-22	145	10.58	94.67%	59	50	2
Grand Total	4949	1242.77	93.48%	1631	1334	376

Notes: M&A deals announced from 1st Nov 2021 to 31st Oct 2022, with a deal value greater than or equal to USD 1 million. The data includes ***completed M&A deals where the percentage of stake acquired is greater than or equal to 50 percent.*** *Classification of the industries for the target and the acquirers in* ***related and unrelated industries is based on Fama-French 49 industry classification.*** *The table is compiled by the author. Data source: Refinitiv Eikon.*

Acquirers are more likely to face greater information asymmetries when evaluating target firms that are not public (Kohers and Ang 2000; Datar, Frankel, and Wolfson 2001). Consistent with this expectation, I observe that only 5 out of 504 deals with earnouts have public targets, whereas 376 out of 4949 regular deals have public targets. Acquirers are more likely to face greater uncertainties in evaluating firms in unrelated industries and are therefore more likely to use contingent payment in such deals (Reuer, Shenkar, and Ragozzino 2004; Datar, Frankel, and Wolfson 2001). In the sample of M&A deals with earnouts, around 55.60% of deals (table 2) involve cross-industry targets.[2]

[2] Classification of the industries for the target and the acquirers in related and unrelated industries is based on Fama-French 49 industry classification.

Indeed, cross-border transactions pose greater investment risks due to cultural, geographical, and institutional differences, and the inclusion of earnouts in such deals can reduce post-closing risks (L. G. Barbopoulos, Danbolt, and Alexakis 2018). I observe that approximately 33.13% of deals with earnouts (completed deals with majority stake), i.e., 167 deals out of 504 transactions, are cross-border deals. The proportion of cross-border deals in the regular sample (completed deals with majority stake) is comparatively lower at 26.95% (i.e., 1334 deals out of 4949). An alternative strand of empirical research suggests that the benefits associated with the inclusion of earnouts are more likely to accrue to the acquirers of domestic firms as compared to the acquirers of the targets across borders, as alternative mechanisms like JVs serve as a more effective mechanism of risk management in cross-country deals (Mantecon 2009). Additionally, it is also possible that target firms in cross-border deals are more reluctant to accept earnouts due to the possibility of moral hazard problems associated with the implementation of such contracts (Datar, Frankel, and Wolfson 2001).

Table 3. Industry Classification of M&A Deals with Earnouts

Target Industry (Fama French Classification)	**Count of SDC Deal Number**	**Sum of Deal Value (USD, Billion)**
Business Services	114	26.35
Computer Software	99	6.71
Pharmaceutical Products	23	11.14
Trading	23	4.96
Healthcare	22	2.02
Construction	12	1.67
Retail	12	1.05
Transportation	11	5.00
Medical Equipment	9	1.89
Precious Metals	7	2.08
Printing and Publishing	7	1.25
Insurance	6	1.39
Others	159	23.82
Grand Total	504	89.34

Notes: M&A deals announced from 1st Nov 2021 to 31st Oct 2022, with a deal value greater than or equal to USD 1 million. The data includes ***completed M&A deals with earnouts and where the percentage of stake acquired is greater than or equal to 50 per cent.*** *Classification of the industries for target firms is based on Fama-French 49 industry classification. The table reports statistics for target firms' industries. The table is compiled by the author. Data source: Refinitiv Eikon.*

I classify the industry of a target firm based on the Fama-French 49 industry classification and report the number and the value of M&A deals with earnouts (majority stake completed transactions) in table 3. Business services and computer software industries have recorded 114 and 99 deals, respectively, with a total deal value of over USD 33 billion. Notably, the value of deals completed for target firms in the pharmaceutical products industry is over USD 11 billion. The total value of deals in the three industries is over 49% of the total deal value in the sample of 504 deals. The three industries are likely to have a large value of intangibles and higher chances of disagreement among bidders and sellers about the potential value of cash flows associated with such assets. Empirical research also suggests that for firms operating in industries where the value of the firms is tied to the intangibles and the growth options (like services or technology industries), the use of earnouts will be of special relevance (Reuer, Shenkar, and Ragozzino 2004; Kohers and Ang 2000; Datar, Frankel, and Wolfson 2001).

It is pertinent to note that earnouts, tools that help mitigate post-closing risks, may introduce further risks like litigation and default risk (Battauz et al. 2021). The target firm receiving the earnouts bears the risk that the bidding firm may face adverse financial conditions like financial distress or bankruptcy, which may hinder the release of contracted future payments. Also, since the acquirer has significant control over the target firm, the target firm cannot monitor the former and ensure that the company achieves the contracted performance targets. In cases where the target firm retains control of assets, there is a possibility that it may resort to short-termism to achieve performance targets and forego opportunities that create long-term value (Datar, Frankel, and Wolfson 2001). Notwithstanding the limitations and the moral hazard problems associated with the implementation of such contracts, earnouts continue to be used as risk mitigation tools that facilitate the transfer of the risk of over-payment by an acquiring firm while mitigating the risk of under-payment for the target firm.

Conclusion

Acquirers in M&A transactions often use different types of risk mitigation techniques which help them address the problem of adverse selection and facilitate deal closure when the parties to the transaction disagree on the value of the target firm. Contingent earnouts are contractual mechanisms that enable part-payment of the deal value on the completion of a transaction and allow the additional payment to be paid at a future date(s) when the target firm meets certain operational or performance benchmarks. The article has reviewed the use of contingent earnouts in the twelve months spanning November 2021 to October 2022. The sample of completed majority stake M&A transactions comprised 504 deals with earnouts. The total value of the earnouts used in these deals is approximately USD 21.12 billion. Over 97% of the completed M&A transactions, where earnouts are included in the consideration structure, have offered to acquire the majority stake in target. Earnouts are included in domestic and cross-border deals but largely involve non-public target firms. Business services, computer software and pharmaceutical industries have witnessed a record number of M&A deals that involve contingent payment in the form of earnouts.

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