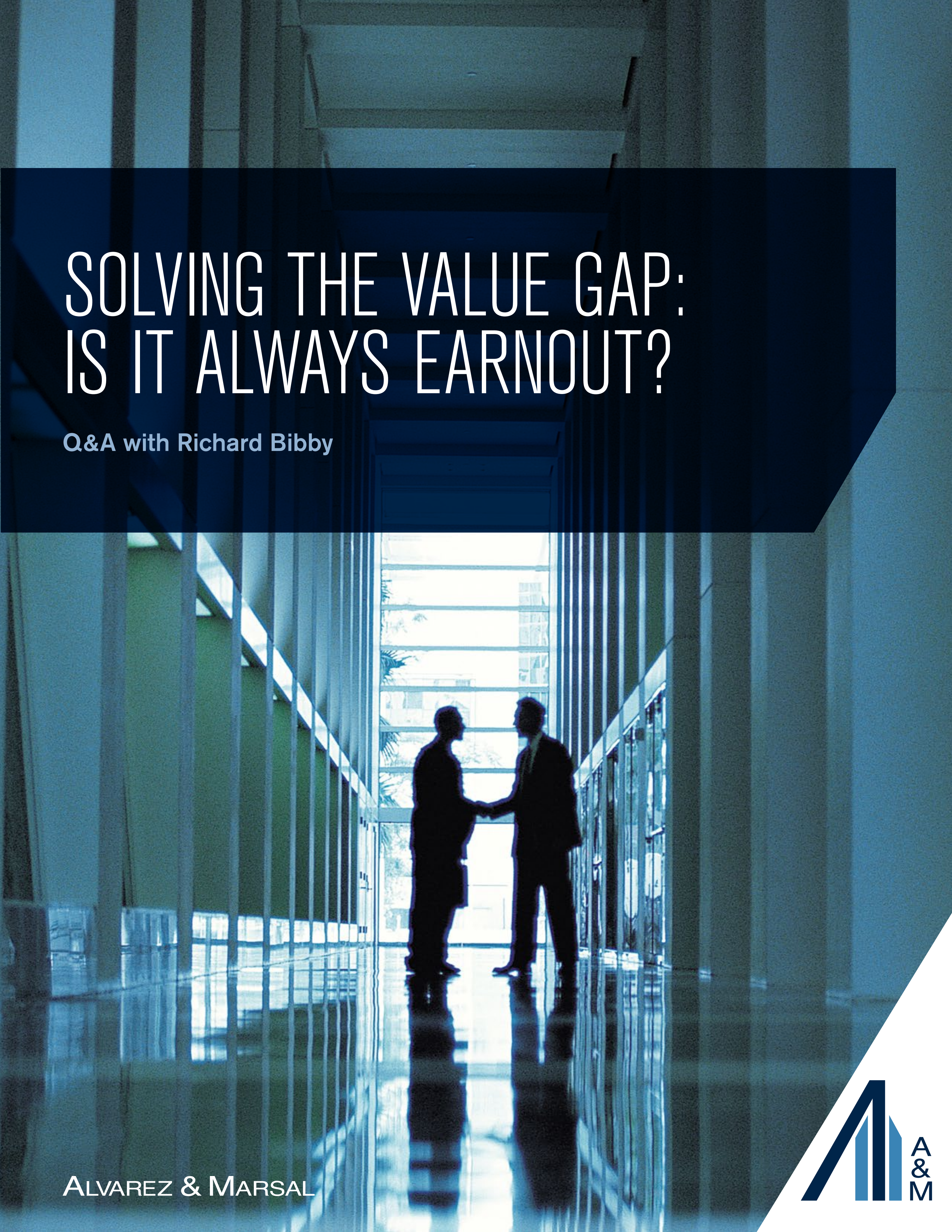

SOLVING THE VALUE GAP: IS IT ALWAYS EARNOUT?

Q&A with Richard Bibby

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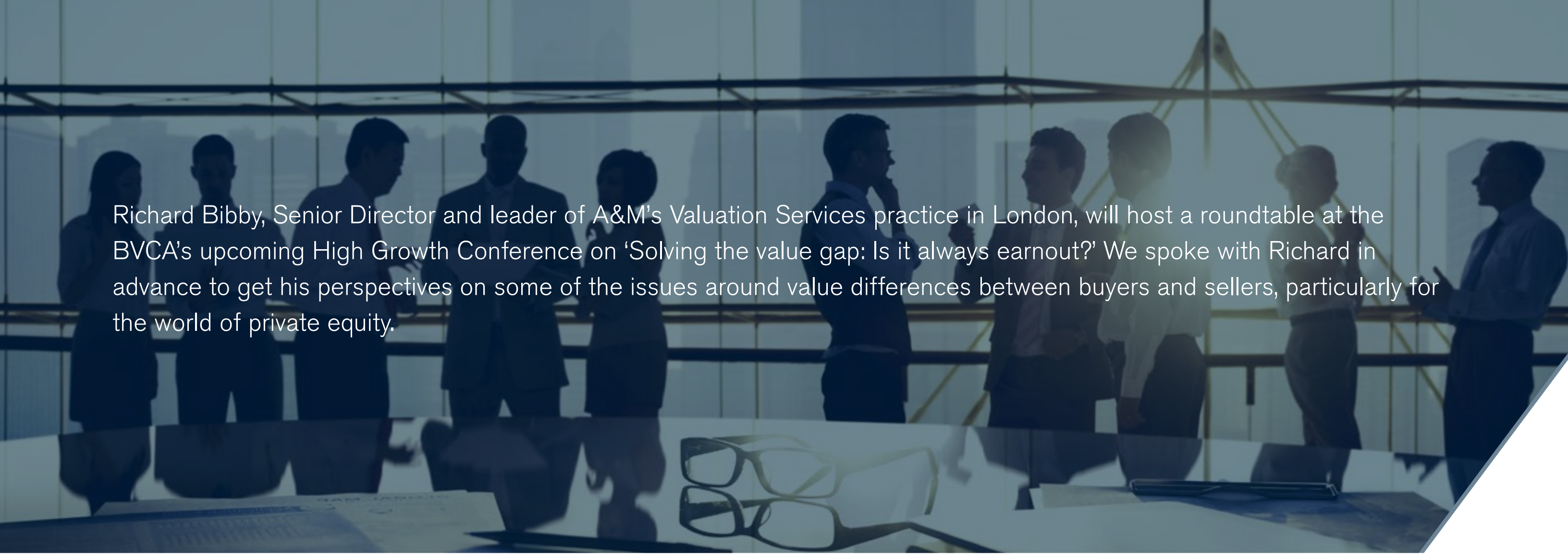

Richard Bibby, Senior Director and leader of A&M's Valuation Services practice in London, will host a roundtable at the BVCA's upcoming High Growth Conference on 'Solving the value gap: Is it always earnout?' We spoke with Richard in advance to get his perspectives on some of the issues around value differences between buyers and sellers, particularly for the world of private equity.

Q:

What are you seeing in the market at the moment that highlights the issues affecting valuation in an M&A context?

A:

Richard Bibby: From my experience with the valuation of investments and the pricing of transactions, what we are seeing is that there are certainly some dislocations in a number of markets that are driving differences in expectations between buyer and seller. Some sectors, including infrastructure and fintech, have experienced a dramatic increase in price expectations over recent years and whilst most investors can often rationalise these price movements, there can still be differences in expectations that are managed through the final periods of the M&A process.

Q:

So what does this mean for buyers and sellers?

A:

Richard Bibby: Pressures on buyers to get deals done can increase the need to bridge the value expectation gap. Often this can lead to earnouts or deferred settlements of transactions in order to get the closure needed on the deal whilst leaving a potential upside to the sellers. These deals of course have the advantage that the buyer can potentially use the profits or cashflow of the acquired business to fund the deferred purchase price, if necessary. However some agreements made in good faith at the transaction time can subsequently have unintended consequences for the buyer.

At Alvarez & Marsal we have unique insight from being involved with companies at every stage of their lifecycle, from pre-transaction advice, through the M&A process and with post-transaction implementation and advisory services. This can be in the form of purely financial assistance but where we really add strength is leveraging our deep operational experience which helps clients when they need it most.

Q:

What are the possible downsides?

A:

Richard Bibby: Valuing the earnout is now typically required for reporting on each acquisition. This involves unpicking the transaction and seeing what was intended or expected at the acquisition date. As part of this process, it is clear that earnouts can have unusual motivational drivers, especially for vendor management who remain with the business. Maximising the earnout target at the potential expense of the long-term stability of the business is a risk that is often overlooked at the crux of the M&A discussions.

Q:

What are the solutions you see clients doing to remedy these situations?

A:

Richard Bibby: The best transactions are those where both the buyer and seller are well prepared. This may be more time consuming than people may like and can involve additional diligence on the target entity, but the result is that buyers are clearer on the abilities of the target to generate the returns and sellers are more comfortable with the buyer delivering the transaction. Less of the purchase price, if any is subsequently subject to deferral.

Earnouts are not necessarily a poor mechanism for M&A – when done correctly they can drive teams towards mutual goals and can provide a degree of protection for the buyer from over-paying for a business where there are concerns over future growth. They do however create additional uncertainty and reporting requirements once the transaction has closed and this can cause additional headaches when it comes to calculating the payment unless simple, easily observable mechanics are used in the earnout clauses.

Richard Bibby
+44 (0) 207 715 5254
rbibby@alvarezandmarsal.com

Richard Bibby is a Senior Director with Alvarez & Marsal Valuation Services in London, with more than 18 years valuation experience across all industries.

He has worked on a variety of valuation assignments, focusing on advice to the asset management sector, in particular to private equity, infrastructure, real estate and corporate asset management firms.

Richard has been responsible for commercial, financial reporting and tax-related valuations and opinions across all sectors, including valuations for merger and acquisition activity, business combinations (IFRS 3 / ASC 805 / FRS 102), impairment testing, investment fair value reporting, share option-related valuations and related tax valuation advice, investment portfolio valuations as well as reports in cases of expert witness, disputes and determination.

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