What To Know Series: Earnouts & Holdbacks

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In this installment of the “What To Know” Series, we’ll discuss some critical items to consider when evaluating and considering Earnouts & Holdbacks. For those unfamiliar with these terms, Earnouts are contingent payments to the seller that are only paid after certain targets are achieved. Holdbacks are a softer term for Earnouts, but they are synonymous with one another.

Some buyers prefer to use the term Holdbacks, as it may be interpreted by sellers as an amount guaranteed to be paid post-close. However, that is not the case. Earnouts & Holdbacks are effectively the same mechanisms in which a seller isn’t paid unless certain metrics or criteria are met. These are incredible tools that help bridge valuation gaps among buyers and sellers and can be the difference between closing a deal and losing out on an opportunity to transact. They are not, however, vital to many transactions and should never be considered guaranteed payments from the buyer to the seller.

Most often, the purpose of Earnouts & Holdbacks is to shift risk from the buyer back to the seller. Buyers aren’t comfortable taking on certain financial or business risks relative to the total enterprise value or purchase price depending on the nature and financial position of the business at the time of the transaction. Earnouts & Holdbacks are often intended to either maintain or grow financial or operational levels. In today’s current M&A environment, it’s not uncommon for a seller to have some level of deferred purchase price such as rollover equity, Earnouts / Holdbacks, etc. The type and amount of this deferred purchase price is extremely important.

Earnouts / Holdbacks can be very simplistic or incredibly complex. They also don’t necessarily need to be tied to a financial metric. The actual calculation and language utilized in legal documents is critically important. There are infinite ways to structure and calculate these Earnouts / Holdbacks. Some are structured as an ‘all-or-nothing’ while others have a more flexible approach. As a result, the complexities and nuances, generating sensitivity analysis, and clear language which supports the spirit and intent of the mechanism makes the difference of whether or not a Seller ultimately receives these dollars.
Below are examples of financial and non-financial Earnouts / Holdbacks:

Non-financial Earnouts & Holdbacks Examples

1. Renewal of a customer or supplier contract;
2. Procuring a new customer or supplier contract; and
3. Executing an employee contract with a new or existing employee.

Financial Earnouts & Holdbacks Examples

1. Level of sales;
2. Amount of gross profit and / or gross margin; and
3. EBITDA and / or EBITDA margin.

In summary, Earnouts & Holdbacks are on some but not all transactions at various levels. There are appropriate and fair instances where they can and should be utilized to consummate a transaction. The calculation and nature of the Earnouts & Holdbacks can be complex, even if intentionally discussed as being simple.