

M&A; EXECUTION PROGRAM

PART 08 OF 12 · PART 2: WORKING CAPITAL & CLOSING MECHANICS

PART 8

BRIDGING THE GAP: EARNOUTS & ROLLOVERS

When buyers and sellers cannot agree on value, earnouts and rollover equity are the tools that close the gap. This session covers earnout design, milestone metrics, catch-up provisions, acceleration, and rollover equity structuring — including pari passu rights.

IN THIS PART

- Earnout structure and metric selection
- Catch-up and acceleration provisions
- Commercially reasonable efforts clauses
- Rollover equity mechanics
- Pari passu rights and waterfall position
- Earnout accounting under ASC 805

THREE CASE STUDIES

Each session includes one fully worked case study with detailed calculations, negotiating dynamics, and CFO-level decision frameworks.

■ SESSION 8: EARNOUTS AND ROLLOVER EQUITY

When the Numbers Do Not Meet: The Valuation Gap Problem

The most common reason M&A deals fall apart is not due diligence — it is valuation. The buyer and seller have different views of the business's future. The buyer anchors to current performance; the seller projects optimistic growth. When this gap cannot be bridged through negotiation alone, two structural tools become essential: **earnouts** and **rollover equity**.

Earnout Design: The Five Critical Decisions

1. Me tri c Se lec tio n	Revenue vs. EBITDA vs. Gross Profit vs. Milestone	Revenue: harder to manipulate but ignores margins. EBITDA: reflects full performance but buyer controls costs. Milestone: binary (FDA approval, contract signing) — clear but high variance.
2. Me as ur em en t P eri od	Annual vs. Cumulative vs. Both	Annual: simpler but allows sandbagging (buyer delays revenue into next period). Cumulative: prevents sandbagging but creates cliff risk. Both: most protective for sellers.
3. Ca tc h- Up Pr ovi sio ns	If Year 1 target missed, can Year 2 excess 'catch up'?	Without catch-up: Year 1 miss is permanent loss. With catch-up: seller can recover if cumulative target met. Buyers resist; sellers should insist.
4. Ac cel er ati on Ev en ts	IPO, change of control, buyer breach trigger full payment	Critical protection for seller. If buyer sells the business before earnout period ends, seller should receive all earnout proceeds immediately.
5. Co m me rci all y Re as on abl e Eff ort s	What operational obligations does buyer owe seller?	The most disputed clause in earnouts. 'Best efforts' (highest standard), 'commercially reasonable efforts' (market standard), or 'reasonable efforts' (lowest). Must be specific.

Earnout Accounting Under ASC 805

The buyer must recognize the fair value of the earnout as part of the total consideration at the acquisition date. This creates an initial liability on the balance sheet. As the earnout period progresses, the liability is remeasured quarterly based on changes in the expected payout, with changes recognized in earnings — creating P&L; volatility.

◆ EARNOUT ASC 805 ACCOUNTING

EARNOUT ASC 805 ACCOUNTING

Earnout maximum: \$15,000,000

Probability-weighted FV at acquisition date: \$9,200,000

JOURNAL ENTRY AT CLOSE:

Dr: Goodwill/Purchase Price: \$9,200,000

Cr: Earnout Liability: \$9,200,000

QUARTER 4 REMEASUREMENT:

Business outperforming; new FV estimate: \$12,400,000

Increase in liability: \$3,200,000

Journal Entry:

Dr: Earnout Expense (P&L;): \$3,200,000

Cr: Earnout Liability: \$3,200,000

→ \$3.2M hit to income statement this quarter

YEAR 2 — EARNOUT PAID: \$12,400,000

Dr: Earnout Liability: \$12,400,000

Cr: Cash: \$12,400,000

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CASE STUDY 1

OmniGen Biotech

FDA Milestone Earnout — \$20M Tied to Regulatory Approval

Background

OmniGen Biotech was acquired by PharmaCo Inc. for \$80M base price, with an additional \$20M earnout contingent on FDA approval of its lead compound within 36 months. The 'Commercially Reasonable Efforts' clause became the central dispute when PharmaCo reduced the clinical trial budget by 40% in Year 2 to conserve cash.

◆ OMNIGEN — CRE CLAUSE DISPUTE

OMNIGEN — FDA EARNOUT STRUCTURE

Base consideration: \$80,000,000

FDA Approval Earnout (milestone): \$20,000,000

Milestone: FDA NDA approval within 36 months

Required efforts: 'Commercially Reasonable Efforts'

YEAR 2 — PHARMACO REDUCES BUDGET:

Clinical trial budget cut from \$8M to \$4.8M

Estimated delay to FDA submission: 8-12 months

Risk: approval will not occur within 36-month window

SELLER'S CLAIM (CRE BREACH):

CRE standard requires spending consistent with

what a reasonable company would spend pursuing

a commercially valuable regulatory milestone

40% budget cut = failure to meet CRE standard

Seeks: injunctive relief + full \$20M earnout payment

PHARMACO'S DEFENSE:

CRE does not require any specific dollar amount

Business judgment applied; still pursuing approval

30-month window remains; delay not definitive loss

RESOLUTION (mediation):

Minimum annual R&D; spend covenant added retroactively

(7.5% of acquired revenue = \$6M/year minimum)

Earnout window extended by 6 months (to 42 months)

Partial payment (\$5M) made immediately as settlement

LESSON: Define CRE with specific minimum spend floors

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CASE STUDY 2

TechBridge Analytics

Rollover Equity — Structuring Pari Passu Rights for the Founder

Background

PE firm Crestwood Capital acquired TechBridge Analytics for \$90M, with the founder rolling over \$13.5M of equity (15% of total consideration). The rollover equity is structured as a minority stake in the new holding company alongside Crestwood's preferred equity. The founder's critical negotiation: ensuring pari passu rights on distributions to avoid being structurally subordinated.

◆ ROLLOVER EQUITY — PARI PASSU ANALYSIS

TECHBRIDGE — ROLLOVER EQUITY STRUCTURE

Total acquisition consideration: \$90,000,000
 PE equity contribution (85%): \$76,500,000
 Founder rollover equity (15%): \$13,500,000
 Senior debt (acquisition financing): \$45,000,000

WITHOUT PARI PASSU — PE PREFERRED STRUCTURE:

PE holds preferred equity with 8% PIK preferred return
 Preferred accretes: $\$76.5M \times (1.08)^5 = \$112,400,000$
 On exit at \$200M EV:
 Debt repaid: (\$45,000,000)
 PE preferred return: (\$112,400,000)
 Remaining for founder: $\$200M - \$45M - \$112.4M = \$42,600,000$
 Founder return on \$13.5M rollover: 3.15×

WITH PARI PASSU — COMMON EQUITY STRUCTURE:

All equity (PE + founder) participates equally in distributions
 No preferred accrual; straight common
 On exit at \$200M EV:
 Debt repaid: (\$45,000,000)
 Equity pool: \$155,000,000
 Founder's 15%: $\$155M \times 15\% = \$23,250,000$
 Wait — founder's equity is 15% of NEW holdco
 $\$13.5M / \$90M = 15\%$ of the TOTAL enterprise
 After debt: $\$155M \times 15\% = \$23,250,000$
 Founder return: 1.72× (lower absolute return)
 But at \$300M exit: PE preferred limits founder MORE
 At \$300M pari passu: $(\$300M - \$45M) \times 15\% = \$38,250,000$
 At \$300M preferred: $(\$300M - \$45M - \$112.4M) \times 15\% = \$21,390,000$
 PARI PASSU ADVANTAGE AT LARGE EXIT: \$16,860,000

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CASE STUDY 3

Vertex Industrial Holdings

*Catch-Up Earnout — How a Year-1 Miss Was Recovered in Year 2***Background**

Vertex Industrial was acquired for \$45M base with a \$10M two-year earnout tied to cumulative EBITDA targets. Year 1 performance missed the target by \$800K due to a supply chain disruption. The catch-up provision in the SPA allowed Vertex to recover this shortfall from Year 2 excess EBITDA.

◆ VERTEX — CATCH-UP EARNOUT

VERTEX — CATCH-UP EARNOUT MECHANICS

Earnout Structure:

Year 1 EBITDA target: \$8,500,000 → Pays \$5,000,000

Year 2 EBITDA target: \$9,500,000 → Pays \$5,000,000

Cumulative 2-year target: \$18,000,000

Maximum earnout: \$10,000,000

WITHOUT CATCH-UP:

Year 1 actual EBITDA: \$7,700,000 (missed by \$800K)

Year 1 earnout paid: \$0 (missed target)

Year 2 actual EBITDA: \$10,500,000 (beat by \$1,000,000)

Year 2 earnout paid: \$5,000,000 (hit Year 2 target)

TOTAL EARNED: \$5,000,000 (only 50% of maximum)

WITH CATCH-UP PROVISION:

Cumulative actual EBITDA: \$7,700K + \$10,500K = \$18,200,000

Cumulative target: \$18,000,000

Cumulative surplus: \$200,000 above target

FULL \$10M EARNOUT EARNED (cumulative target met)

CATCH-UP BENEFIT: Additional \$5,000,000

LESSON: Always negotiate cumulative catch-up provisions

Annual-only earnouts are structurally unfair to sellers

for businesses with quarterly or seasonal variation