Earnouts, Collars and CVRs

In bridging differing views on valuation or the consideration to be paid, buyer and seller can save a deal by including pricing tools, such as earnouts, collars or Contingent Value Rights (CVRs).

An earnout formula is frequently used in M&A transactions involving private companies. It addresses the risk on the bidder´s side that the target fails to perform along expectations after the deal has been closed (i.e. risk of overpayment). An earnout ensures that the seller receives additional cash payments provided that the target performs as expected or certain financial (or other) performance milestones are achieved over a specified period of time post-closing. Hence, the tool can benefit sellers who have confidence in the long-term value of their business as well as buyers who want to ensure they get what they pay for.

If public companies are involved, however, then finding mechanisms to bridge valuation gaps is harder. One alternative to address valuation concerns is sharing risks: Instead of cash, the acquirer can offer shares to the selling shareholders (for all or part of the consideration). In this case, both sides will participate in the up- as well as downside of the combined company. At the same time, though, both sides may share concerns that the share price of the acquirer as well as that of the target fluctuate (perhaps even wildly) between signing and closing of the transaction. At the same time, also in this case, the acquiring shareholders may find that ultimately the target did not perform as expected.

Now, concerns related to share price fluctuations pre-closing can be addressed by collar mechanisms, for instance. They can be applied in stock deals with – more commonly used - fixed exchange ratios (number of shares issued known, transaction value unknown) as well as such with floating exchange ratios (transaction value known, number of shares issued unknown).

If a fixed exchange ratio of shares has been agreed (i.e. the transaction value is unknown), then a fixed price collar will ensure that selling shareholders receive a fixed compensation within a pre-defined corridor. Hence, within this corridor the transaction value will be known. Outside this corridor, however, the value of the consideration would go up or down along with the share price dynamics of the acquirer. In other terms: If the acquirer´s share price falls or rises within the defined range, the fixed exchange ratio of shares switches to a floating one.

On the other hand, if a floating exchange ratio of shares has been agreed (i.e. the transaction value is known and fixed), then a fixed exchange ratio collar will result in the selling shareholder to be exposed to changes in the ratio between the acquirer´s and the target´s share price dynamics within a pre-defined corridor. Hence, should the share price of the acquirer rise from the mid-point of the corridor, then selling shareholders would benefit. If the acquirer´s share price were to decline from that point, the acquirer would have to offer fewer shares and benefit from this dynamics. Outside the corridor, the transaction value would be fixed again.

A CVR is an earnout-like structure, hence: a post-closing instrument, and particularly suitable for transactions where public companies are involved: Target shareholders receive additional consideration (in cash or stock) if some time in the future a specified milestone or threshold is achieved, such as hitting an EBITDA benchmark or some other financial performance metric. Whilst CVRs can vary widely in terms, structure or size, with rights even lasting as long as a decade, related payments can be fixed amounts or be defined according to some formula. Similar to options, CVRs frequently have an expiration date. And, similar to unsecured obligations, CVRs aren't backed by any collateral: hence, payout is not guaranteed. Finally, CVRs can be structured as being transferable (if listed on an exchange) or non-transferable. – Among others, CVRs are widely applied in the pharmaceutical sector: There, the future value of a certain drug is often uncertain, contingent on events such as regulatory approvals or the outcome of clinical trials. Other frequent applications are constellations where the outcome of litigation procedures is yet unclear.

As CVRs become more common across various different industries, it is essential that payment triggers and its mechanisms can be easily determined. Besides appropriate covenants must ensure that the acquirer is not motivated to manage a business in a way to deliberately avoid triggering CVR-related payments.

Finally, walkaway rights are another deal provision that can be considered: They allow walking away from a transaction if, for instance, the acquirer stock price falls below a certain predetermined minimum trading price.

	PRE-CLOSING	POST-CLOSING
PUBLIC COMPANY	COLLARS	CVRS
PRIVATE COMPANY		EARNOUT

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