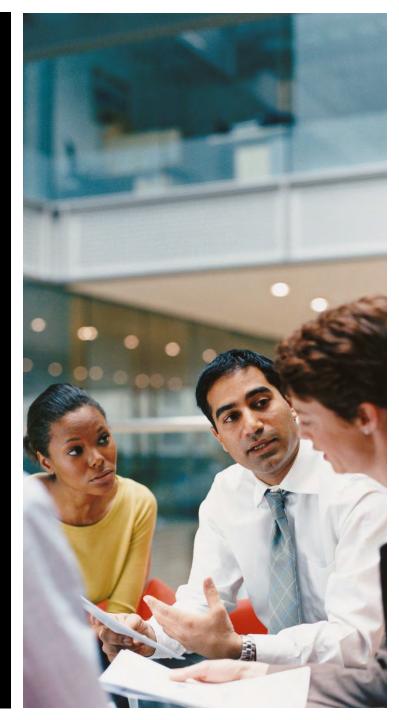
M&A earnouts and the impact of COVID-19



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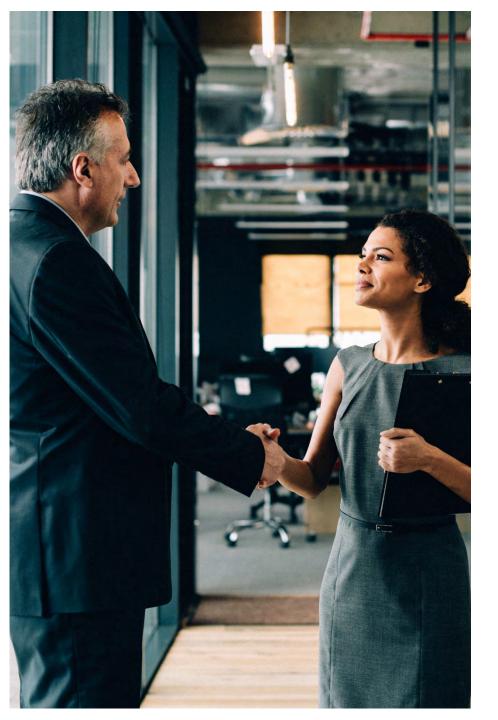
Agenda

- Overview of earnouts
- Types of earnouts
- Earnouts in the COVID-19 environment
- Valuation of earnouts
 - Scenario based method ("SBM")
 - Option pricing method ("OPM")



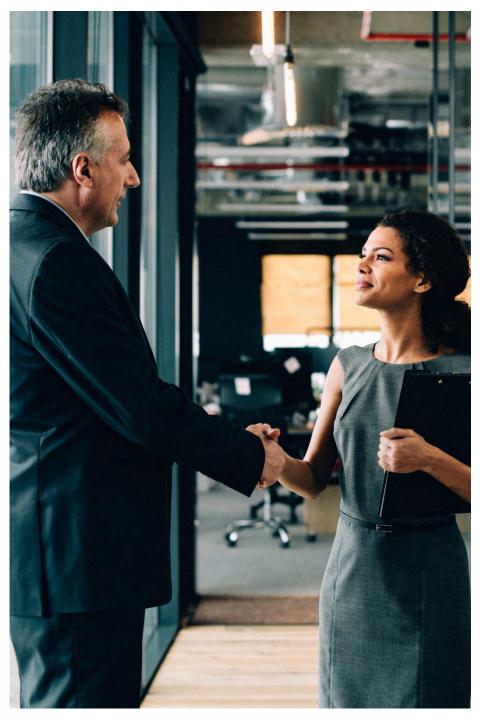
Overview of earnouts

- What is an earnout?
- Payment for future events or conditions being met
- Payment can take the form of cash (typical) or equity
- Some take the form of a clawback (rare)



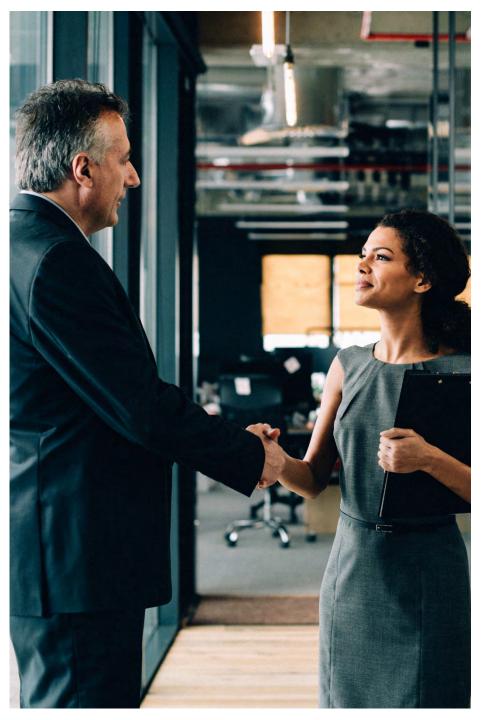
Why earnouts?

- Buyers and sellers many times have differing views of the future performance of a business
- Earnouts help "bridge the gap" in terms of pricing of the business given different future expectations



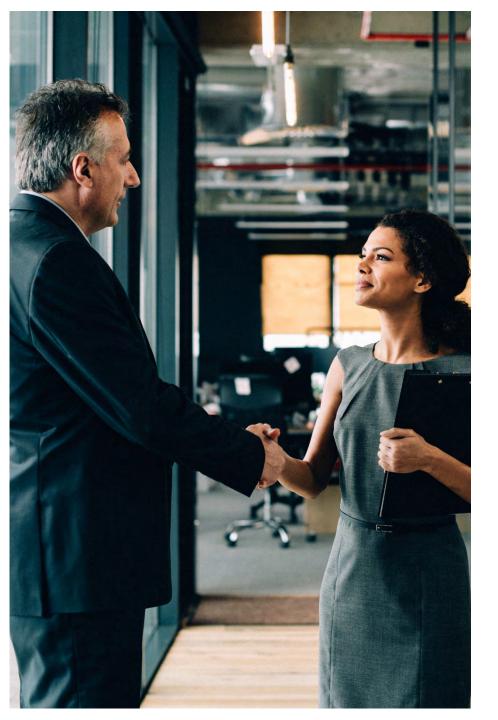
Why earnouts? (cont.)

- Earnouts allow less cash up-front to purchase the business
- Earnouts also help control potential competition as sellers could "leave money on the table"



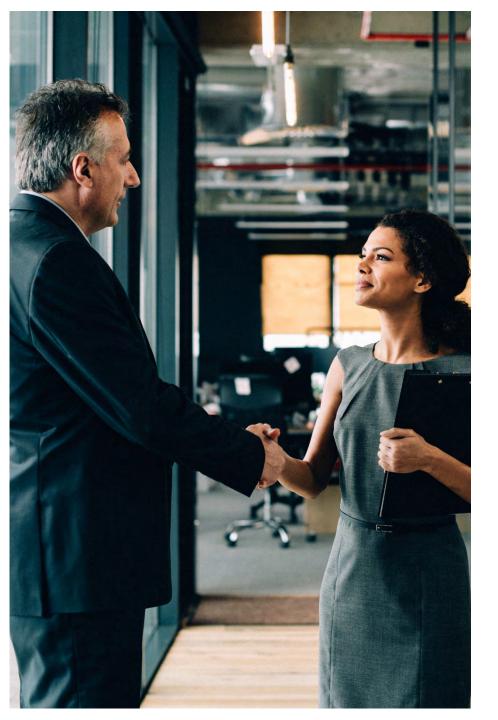
Buyer advantages

- Less overpayment risk
- Less up-front cash
- Additional control over sellers



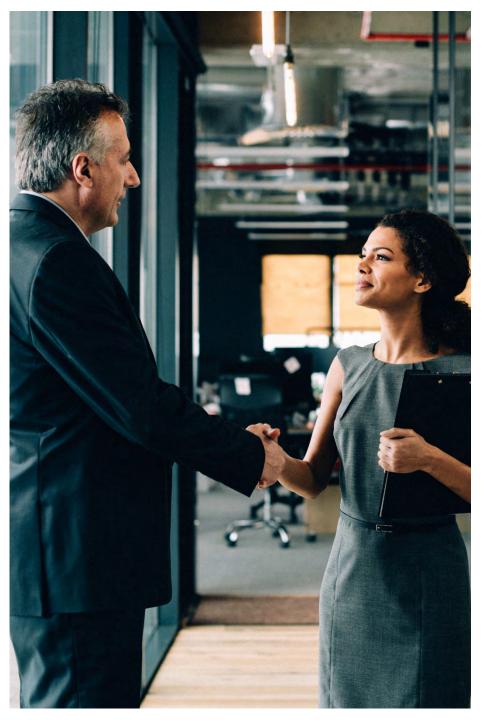
Buyer disadvantages

- Additional payment may occur even if company performance is poor (think sales earnouts or earnouts paid just before start of pandemic)
- If seller has no chance of achieving earnout, may limit "handcuffing"



Seller advantages

- Ability to share in upside potential after sale of company
- Helps close deals when large differences in future expectations
- May result in tax advantages (deferral)



Seller disadvantages

- Company may struggle after sale, resulting in no or limited payment
- Payment may be a year or more
- Disagreements with buyers over definition of earnout achievement (is EBITDA adjusted or unadjusted?)
- "Locked-in" with company



Typical earnout types

- EBITDA (most common)
- Revenue
- Gross profit
- Milestone



Typical earnout structure

- Cliff e.g., sales exceed target, earnout is paid
- Tiered e.g., EBITDA is between to thresholds, get paid sliding scale
- Binary e.g., Drug moves to clinical trials, get payout



VALUATION APPROACHES AND METHODS

Earnouts post-COVID-19

- Transactions down
 significantly during COVID 19
- Due diligence difficult due to travel and other restrictions
- Massive uncertainty regarding future financial results of the business



VALUATION APPROACHES AND METHODS

Earnouts post-COVID-19 *(cont.)*

- Anecdotally, seeing more deals in the pipeline with earnouts and a bigger part of the purchase price
- Many earnouts focused on EBITDA
- Without additional clarity, we expect the trend to continue



GUIDELINE PUBLIC COMPANY METHOD

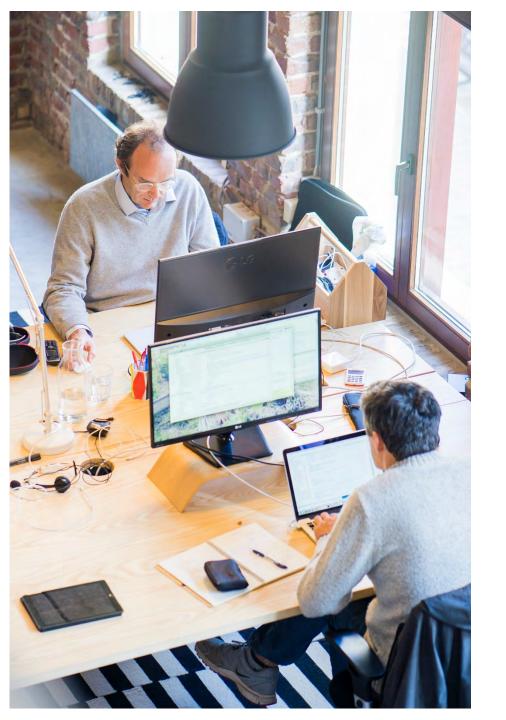
Valuation of earnouts

- Two primary techniques
 - Scenario Based Method (SBM)
 - Option Pricing Method (OPM)



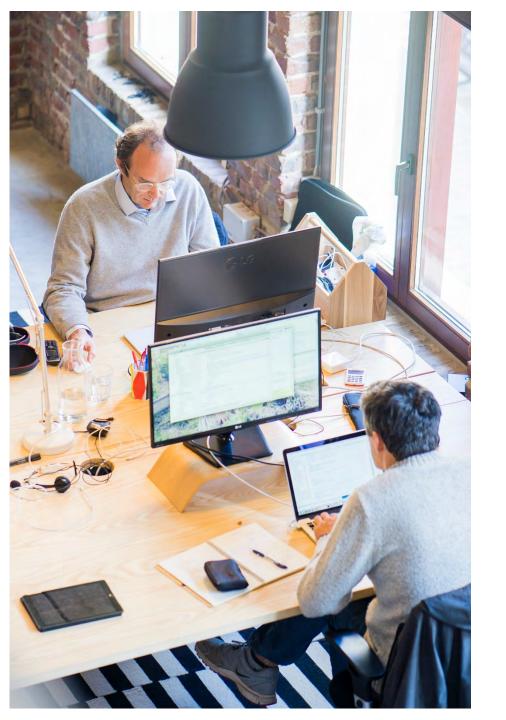
Scenario Based Method

- Probability weights future forecasts to estimate the earnout payment
- Significant difficulty to forecast the potential range of outcomes
- Discount rate determination tends to be very subjective as trying to determine risk of achievement vs forecast risk



Scenario Based Method (cont.)

- Advantages
- Ease of use
- Few scenarios to consider
- Disadvantages
- Generally overstates the value of the earnout
- Is not considered best practice



Option Pricing Method

- Earnout metrics (EBITDA, sales, etc.) are discounted to become "risk-neutral"
- Earnout payment forecast considers an extremely broad range of outcomes
- Counter-party risk more explicit in determination of value
- Better captures achievement risk



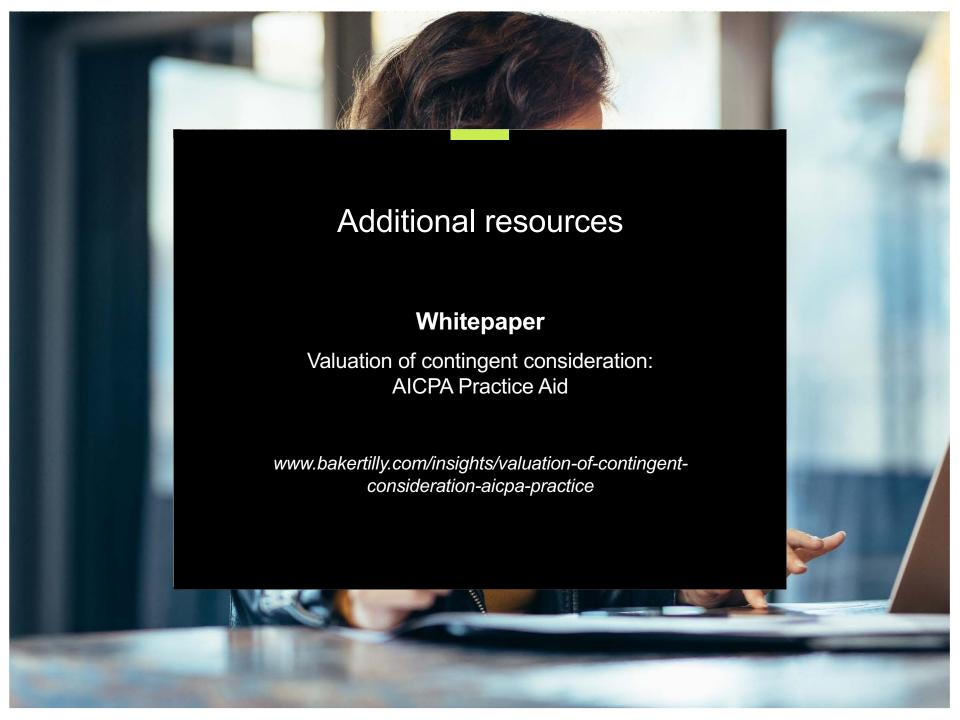
Option Pricing Method (cont.)

- Discount rate for earnout metric
- EBITDA –WACC
- Net income Equity Rate
- Revenue Adjusted
 WACC for variable vs
 fixed cost structure



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