The Delancey Street Partners M&A Best Practices Whitepaper Series provides insight into key topics that are highly relevant in today's M&A market. From real-time market trends to exit planning initiatives, we explore ideas and concepts that can have a material impact on value and likelihood of a successful outcome in today's dynamic M&A environment.

This installment of our M&A Best Practices Whitepaper Series focuses on contingent payments, more commonly referred to as earn-outs.

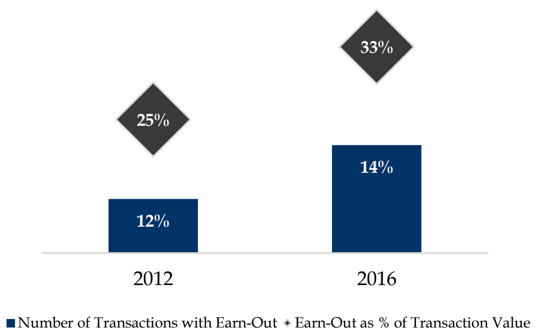
Overview

As readers may already be aware, an earn-out is an M&A structuring mechanism in which a portion of the purchase price is contingent upon future performance of an acquired business, typically over a specified period of time. Historically, earn-outs were employed to bridge valuation expectations between buyer and seller. In addition, earn-outs have been common in certain industries (e.g. biopharmaceuticals and medical devices) where the value of an acquisition is heavily dependent on binary events such as the approval of products. While the underlying economic principals can be relatively straightforward, how best to measure and govern an earn-out to align interests between buyer and seller can often be challenging to implement. As a result, the inclusion of an earn-out can complicate or lengthen the transaction negotiation process, with the suggestion of an earn-out eliciting negative reactions from both buyers and sellers.

For these reasons, over the course of our advisory careers, we have rarely utilized earn-outs. When we did, they were designed to address seller-specific challenges. In recent years we have seen an increasing number of proposals from buyers that have included an earn-out and have closed transactions with earn-outs. In these cases, the earn-outs were "sweeteners" offered by aggressive buyers looking to differentiate themselves.

As the M&A markets have become more competitive during the current cycle, buyers are turning to earn-outs as a tool to deliver additional value above an already full multiple at close, often in order to entice a high-quality target business to sell "early" ahead of expected growth. Delancey Street has advised on several transactions where substantial earn-outs were employed by buyers over and above attractive consideration at closing to pre-empt an eventual broader process. Such earn-outs are not only more frequent but represent significant additional value. Data from the broader market (from SRS Acquiom) echoes our firm's experience: excluding life sciences transactions, 14% of transactions in 2016 included an earn-out and earn-outs accounted for 33% of overall transaction value on average in 2016, up from 25% in 2012.

Trends in Earn-Out Prevalence and Size



Source: SRS Acquiom

About Delancey Street Partners

Delancey Street Partners is an independent, industry-focused investment bank. We serve CEOs, Entrepreneurs, Shareholders and Boards of Directors of high growth and middle market private and public companies. Our services include strategic advisory, capital raising and independent board advice. We advise on sell-side and buy-side M&A, growth capital financings and recapitalizations. Our focus sectors include Business Services & Technology, Healthcare, Industrial & Industrial Technology, and Infrastructure.

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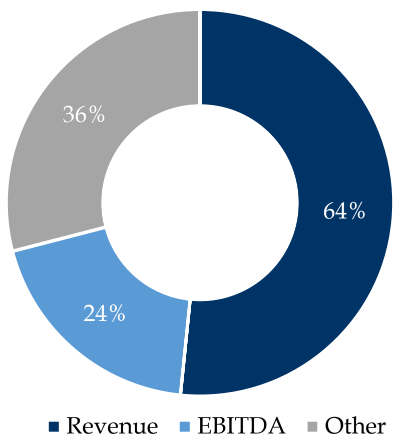
Measuring Performance ("Earning" the Earn-Out)

Typically, the value of an earn-out is based on the achievement of some type of financial metric, such as revenue or EBITDA, over a specified period of time. The economics of an earn-out can also be based upon achieving non-financial targets, such as product milestones. Some earn-outs employ a combination of financial and non-financial metrics. When structuring the economics of a potential earn-out, some key considerations include:

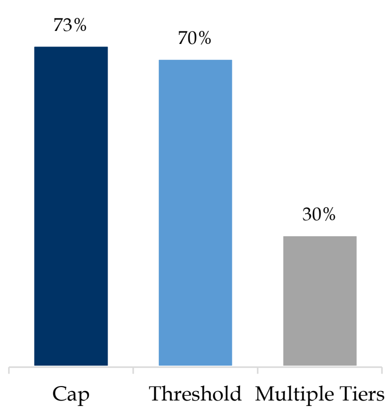
- Choosing the appropriate metric: For earn-outs tied to a financial metric, sellers often prefer to use revenue as it is least affected by any operational changes made by the buyer. In contrast, buyers prefer to use EBITDA or a similar profitability metric that is more reflective of the contribution of the acquired business.
- Complexity: Typically, earn-outs are structured as a percentage or multiple of revenue or EBITDA, or as a payment for reaching a specific milestone. However, other more complex features can be incorporated, such as minimum thresholds, caps on maximum payouts, tiered payment structures, etc. The more complex an earn-out, the more difficult it is to document and govern post-close. In these instances, revisiting an acceptable purchase price at close may be a better alternative.
- Duration: Based on data from SRS Acquiom, the majority of earn-outs (72%) resolve within three years of close with nearly 50% concluding within two years. An overly long earn-out period can interfere with the successful integration of an acquisition.

Earn-Out Calculation Metric



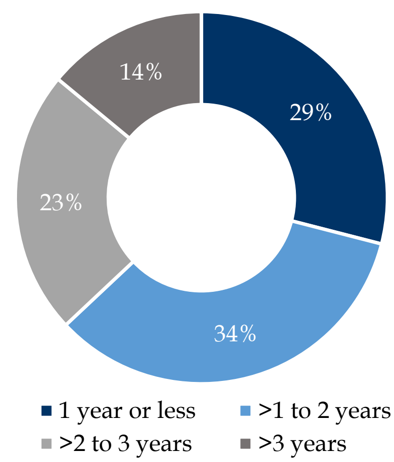
Source: SRS Acquiom

Prevalence of Complex Payout Features



Source: Duff & Phelps

Earn-Out Length



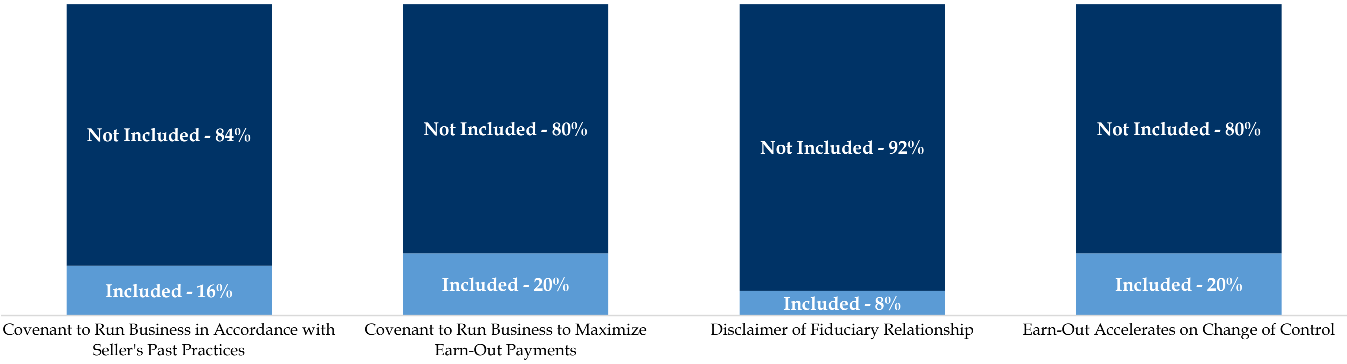
Source: SRS Acquiom

Governing the Earn-Out ("Rules of the Road")

A key challenge of earn-outs is balancing the desire of the buyer to fully integrate the acquired business with the seller's goal to maximize the value of the earn-out. In many instances, the seller retains no control of the acquired business, and is wary of the buyer implementing operational changes that may adversely impact the revenue generation or expense structure of the target. Conversely, the buyer's goal is to maximize the long-term value of the target as part of its platform, regardless of potential short-term impacts to metrics that determine the earn-out. As a result, there are number of considerations which are typical negotiation points in transactions containing earn-outs.

- Procedure for determining earn-out financial metrics: Typically the buyer and the seller will agree on a set of accounting principles to be applied during the earn-out period as a supplement to the usual financial statements, strictly for purposes of measuring the earn-out (i.e., procedures for determination of earn-out EBITDA).
- Operations of the business: There are a number of seller-friendly covenants that are sometimes contemplated when structuring earn-outs that have been on the rise in recent years: (i) covenant for buyer to continue operating the business consistent with past practices, and (ii) covenant for buyer to operate the business in order to maximize the earn-out. Conversely, buyers (especially those that are public) may limit their obligations to the seller by explicitly disclaiming any fiduciary obligation to the seller with respect to the earn-out. For example, buyers may attempt to negotiate the following or similar language:
    - "Seller agrees and acknowledges that the Buyer may from time to time make business decisions in a manner consistent with the best interests of the consolidated business operations of the Buyer and its subsidiaries, taken as a whole, including actions that may have an impact on the Earn-Out. Except as otherwise provided in this Agreement, the Seller shall have no right to claim any lost earn-out or other damages as a result of such decisions so long as the Buyer did not intentionally take such actions for the primary purpose of the payment of the Earn-Out"
    - "For the avoidance of doubt, Seller acknowledges and agrees that Buyer shall retain full and sole discretion as to the conduct and operation of the business of the Company, and in no event shall Buyer have any obligation (express or implied) to achieve or maximize the Earn-Out. Without limiting the generality of the foregoing, Buyer may make from time to time such business decisions and take such actions as it deems appropriate in good faith following the Closing, including decisions or actions that may have a negative impact on the Earn-Out."
- Acceleration of the earn-out upon a change of control event for the buyer during the earn-out period.

Prevalence of Selected Earn-Out Features



Source: SRS Acquiom

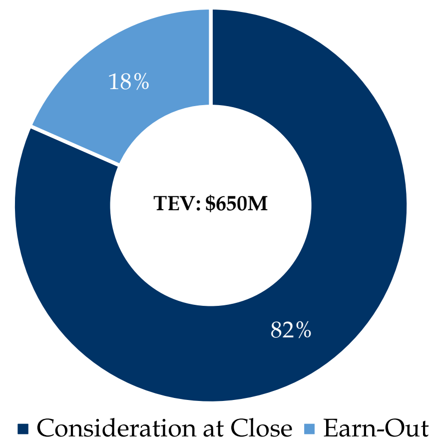
Regardless of any provisions and covenants the seller may be able to obtain, ultimately control of the business is being relinquished to the buyer. As a result, the value ascribed to an earn-out is greatly influenced by the level of trust between buyer and seller. Thus, while the overall cultivation of trust throughout is important in any M&A process, it becomes even more crucial in transactions that involve earn-outs.

Case Study: Acquisition of Symphony Healthcare by PRA Health Sciences

On August 7, 2017 PRA Health Sciences announced the acquisition of Symphony Healthcare, which subsequently closed on September 6

- $530 million cash consideration at close representing ~14x LTM EBITDA
- Additional earn-out opportunity (referred to as "Contingent Consideration" in public filings) structured as follows:
  - 2017 earn-out potential equal to difference between $530 million and 14x actual full year 2017 EBITDA
  - 2018 earn-out potential equal to 25% of realized 2017 earn-out plus an additional $50 million
- At close, a total of $541 million was paid to Symphony, inclusive of $530 million of cash purchase price and approximately $11 million of earn-out
  - Although the maximum earn-out potential is uncapped, PRAHS recorded a fair value of $109 million in contingent liability at transaction close
  - Implied total enterprise value of $650 million

Components of Consideration



Source: PRAHS Q3 2017 10-Q

- Selected earn-out governance provisions:
  - Covenant to run business in accordance with past practices (language from PRAHS August 7, 2017 8-K)

    "Parent shall use commercially reasonable best efforts to assist the Surviving Corporation in achieving the aggregate Contingent Consideration and shall not knowingly take (or knowingly cause any of its controlled Affiliates to take) any action for the primary purpose of preventing the achievement of the aggregate Contingent Consideration and shall use commercially reasonable best efforts to operate the business in the ordinary course until December 31, 2017"
  - Disclaimer of fiduciary duty to seller (language from PRAHS August 7, 2017 8-K)

    "(i) Parent and its Affiliates will be entitled to effect the integration of the Surviving Corporation and its Subsidiary and their business, assets and personnel with Parent and its Affiliates, (ii) Parent and its Affiliates shall have the right to direct the overall operations and strategy of the business of the Surviving Corporation and its Subsidiary and may make all management decisions with respect to the Surviving Corporation and its Subsidiary and their business (including all decisions with respect to the research, development, marketing and sale of its products and services), (iii) the Contingent Consideration (including whether and the extent to which some or all of it may be achieved) is speculative, and there is no assurance that the Sellers will receive any Contingent Consideration, (iv) neither Parent nor any of its Affiliates owe a fiduciary duty or express […] or implied duty to the Sellers, the Sellers Representative or any other Person in respect of the Contingent Consideration (and any such duty that may exist is hereby knowingly, voluntarily and irrevocably waived)"

Final Thoughts

Earn-outs are potentially useful constructs to help bridge a gap in valuation between buyers and sellers, facilitating a transaction that may not be possible through purchase price at close alone. In the past, earn-outs have been viewed warily by sellers as attempts by buyers to inflate a below-market offer with "funny money." In the current environment, buyers are increasingly turning to earn-outs as a way of delivering an above-market value at close or to give sellers credit for significant future growth that is anticipated post-close.

Information on Delancey Street Partners

Senior Leadership

B. Andrew Schmucker
Managing Partner
484.533.6313
aschmucker@delanceyllc.com

Patrick E. Dolan
Managing Director
484.533.6311
pdolan@delanceyllc.com

William J. Filip
Managing Director
484.533.6312
wfilip@delanceyllc.com

David K. Allebach
Director
484.533.6315
dallebach@delanceyllc.com

Jacques H. Fu
Vice President
484.533.6316
jfu@delanceyllc.com

Recent Transaction Experience

- HealthStrategiesGroup has been acquired by Water Street — Advisor to Seller
- Onsite Innovations has been acquired by Pivot Physical Therapy, a portfolio company of CI Capital Partners — Advisor to Seller
- Coen Energy has been acquired by Sprague — Advisor to Seller
- Biotix, a portfolio company of Fisher Frisman & Company and Grotech Ventures, has been acquired by Mettler Toledo — Advisor to Seller
- Colorado Boxed Beef Company — Majority Recapitalization with Private Equity — Special Advisor to Company
- SPT, a portfolio company of L2 Capital, has been acquired by Branford Castle Partners — Advisor to Seller
- Execupharm has been acquired by Parexel — Advisor to Seller
- Troemner has been acquired by Mettler Toledo — Advisor to Seller
- Valiant has completed a majority recapitalization and growth equity financing with PeakEquity Partners — Advisor to Seller
- Project Spider — Advisor to Seller
- Driving Dynamics has been acquired by Intuitis Long-Term Investors — Advisor to Seller
- Lone Star has been acquired by Kiely — Advisor to Seller
- Alegis has been acquired by Mednax National Medical Group — Advisor to Seller
- Williams Oil Company, Inc. has divested certain assets of Williams Oil & Propane and WOC Energy Services to Energy Distribution Partners — Advisor to Seller
- Aetrium has divested Reliability Test Products to Cascade Microtech — Advisor to Seller, Fairness Opinion
- GEO The GEO Group, Inc. (NYSE: GEO) has divested GEO Care in a Management Buyout — Advisor to Independent Committee, Fairness Opinion

Five Tower Bridge, Suite 420
300 Barr Harbor Drive
West Conshohocken, PA 19428
www.delanceystreetpartners.com

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