Published in

START-UP
Windhover's Review of Emerging Medical Ventures

October 2005
Volume 10, Number 9 • Windhover Information Inc. • windhover.com

Device Industry Exits

In Search of the Perfect Earn-Out

By Richard M. Ferrari

Earn-outs may make up a minority of liquidity events, but they provide an important exit alternative for entrepreneurs, investors, and acquirers during uncertain market conditions.

The purpose of an earn-out as a liquidity event is to share and balance the risk and return between the "acquirer" and the "acquiree" of a business venture. To that end, an earn-out structure can never really be perfect, but it can be fair and balanced and create a "win–win" situation for both parties. *The Dictionary of Small Business* defines an earn-out as "a clause in a contract between a large company that is buying the entire business of a small company. The clause may specify the small entrepreneur will realize additional money from the sale if the small company earnings exceed a specified amount after the buyout has occurred."

The widening gap between expectations of pricing between the buyers and sellers of emerging medical technology companies has increased the number of earn-out transactions. In this year alone, **Medtronic Inc.** agreed to acquire private **Transneuronix Inc.** for $260 million, and will make significant additional payments if revenue targets are met. And **Boston Scientific Corp.** exercised an earn-out option to complete its purchase of **CryoVascular Systems Inc.**, **TriVascular Inc.** and **Rubicon Medical Corp.**

Earn-out transactions are complex and need careful consideration to ensure that they benefit both parties—a poorly structured deal can lead to opportunistic behavior by the acquirer.

Over the last five years I have been involved in a number of medtech earn-outs, all of which have been different and offered varying degrees of risk and reward. But in all earn-out transactions, there are four stages that define the structure of the deal:

- Partner selection
- Value determination
- Structure identification
- Pay-out schedule

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Paying attention to each as you structure an appropriate earn-out liquidity event will result in a "win-win" for both sides.

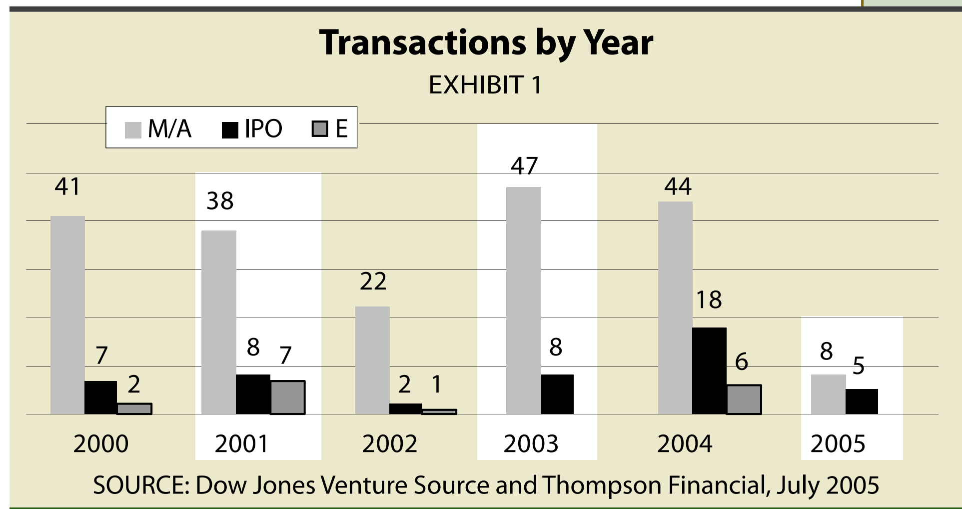
But first, some history. The earn-out as an alternative to an IPO and traditional M&A is not a new structure for acquisitions, but it has become more visible over the past five years. Since calendar year 2000, the number of earn-out transactions in the medtech industry has been fairly constant, averaging about five per year. In total, approximately 16 earn-out transactions have been completed compared to 48 IPOs and 200 traditional M&A transactions over the same period.

The data in Exhibit 1 highlight the prevalence of M&A transactions over IPOs and earn-outs in the medtech industry since 2000. These should not be a surprise as they speak to the overall risk-reward profile inherent in any transaction. Traditional M&A is clearly favored because, once the transaction is complete, the full negotiated value is final with no additional market risks. The IPO alternative can also be very attractive, but the exit here is far more complicated as it is subject to specific regulatory requirements as well as to overall public market conditions. However, without a ready IPO market in 2003 for medtech companies, investors were required to extend the runway (time to liquidity) for their portfolio companies. This delay to exit made it necessary for portfolio companies to secure additional financing, which ultimately impacted the return on invested capital multiples as well as the vehicle of the liquidity event.

This brings us to the earn-out as an alternative exit to traditional M&A and IPOs. Earn-out transactions provided an alternative for medtech companies while the IPO window was closed in 2003. They have continued through 2004 and into 2005.

Why did earn-outs become part of the broader M&A transaction universe? Starting in 2000, the market requirements for a medical device IPO became much more stringent. Consequently, venture investors were facing a longer period of time before they could realize an exit. Exhibit 3 indicates the median length of investment (in years) for IPOs and M&A transactions. The average time for an investment to reach an IPO from 2000 – 2002 was 3.7 years compared to 4.5 years for M&A. However since no IPOs were completed in 2003, the average length of time to an IPO shot up to seven years in 2004, while time to M&A increased to an average of 6.1 years.

During this same time period, the structural relationship between the large cap acquirers and the early stage start-up companies (and technologies) did not change. Large cap acquirers still continued to seek out those companies that could impact their revenue and net income line. So what changed? The IPO requirements for a medical device company wishing to have a public offering had shifted from those companies showing promising, high-potential technologies to those demonstrating solid revenue and growth. The M&A criteria also shifted in a similar direction. These changes, plus more stringent requirements within the IPO and M&A markets, led to an increase in the length of time from investment to exit and subsequently gave rise to an exit alternative, the earn-out model.



Again, many early-stage medtech companies during this period had not yet proven that they had a viable, adoptable, or clinically significant technology that would result in revenues and earnings (the new criteria for a traditional M&A or IPO exit). Therefore, corporate acquirers needed to identify a structure that would permit the acquisition of these firms with minimum risk while the target firms' revenue models were being proven, but still allow them to acquire the firm once risk was satisfactorily reduced. The earn-out structure proved an ideal vehicle for achieving the goals of the acquirer as it reduced initial risk but still provided the call option to later fully acquire the target firm. Venture backers for the target firms were also looking for ways to generate a return, since their portfolio companies were now taking longer to reach a liquidity event and requiring additional capital to get there. As the venture community is structurally tied to achieving exits, extended time to liquidity and additional capital requirements for its portfolio firms during this period made the earn-out model attractive as an alternative exit.

The Structure of the Deal

1. Partner Selection

Appropriate partner identification is perhaps the most important element of a successful earn-out. Both the acquiree and the acquirer must be committed to the ultimate success of the merger, be patient and persistent to

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ensure the mutually agreed objectives will be met, and must also believe they are receiving fair treatment under the deal terms. For the firm being acquired, this applies to the investors as well as the firm's management and employees. Therefore, great care must be taken in identifying an earn-out transaction partner whose interests are closely aligned with the firm being acquired (e.g. meeting mutual objectives of product development and commercialization).

This identification process involves developing an understanding of how the acquiree's products or technologies fit into the long-term strategy of the acquiring firm and vice-versa. This fit of technology or product may not be obvious, but it must be strategic for a long-term relationship to be viable. Further, both parties must employ comprehensive due diligence. For example, the acquiree needs to examine closely the track record of the acquiring firm with respect to the relative success (to all parties) of previous M&As and earn-out transactions. Were the earn-out targets reasonable; were they met; were all projected payments made? Meanwhile, the acquiring firm should assess the management of the acquired firm in terms of ability to perform and meet new objectives—will management likely stay with the firm after the transaction?

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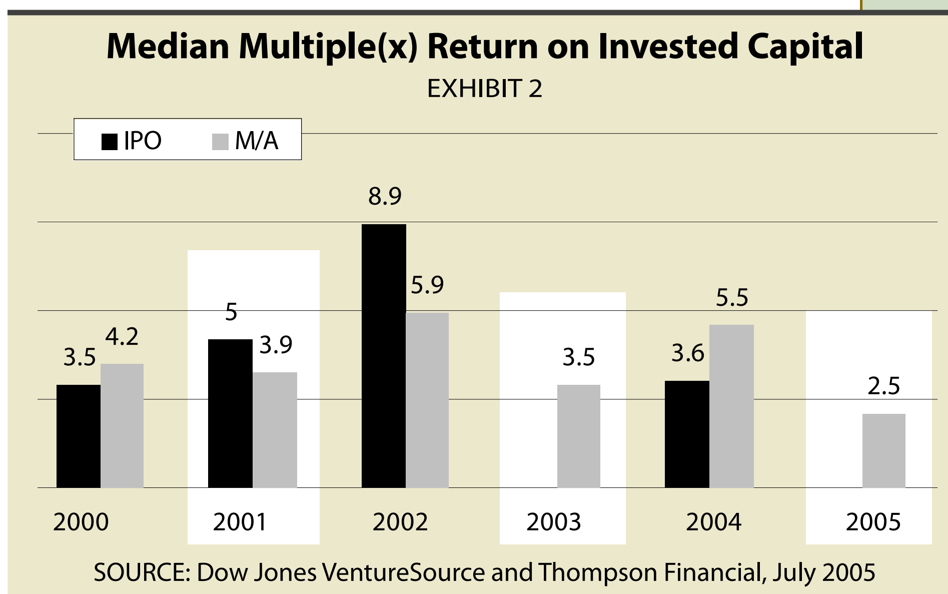
2. Value Determination

Perhaps the more difficult aspect of the negotiations is the value that will be attributed to the transaction. Once the value has been determined and agreed upon, the parameters of the payment are a bit more straightforward to establish. One of the positive aspects of the earn-out model is that the acquirer should be willing to pay market rates for execution. That means the remaining value is attached to execution and, if the milestones are achieved, then the acquirer should not be quibbling over the payments. The critical negotiation here is the establishment of market rates. There are a number of methods for reaching mutual agreement on fair value. One approach that can help establish a market-value range would be to involve investment bankers. Historically, investment bankers have played a valuable role by assembling the data to make comparisons and appropriately positioning the company with respect to the competitive landscape. Without data it becomes more difficult to set value. However, if you decide to opt for working with the acquirer, as the acquiree, you should have the acquirer present to understand how it derived value. The acquiree should also have its own models of how value was derived. Through this process, the two parties will at least have the full picture. For the most part, market value will be determined based on the clinical value, which relates to clinical impact and revenue.



3. Structure Identification

The structure of the earn-out can take many forms, but there are three primary components that require careful consideration from both parties:

- Up-front payments
- Milestone payouts
- Earn-out payouts

The up-front payment is a key component because it defines seriousness and the level of importance the acquirer places on the technology. The lower the up-front payment, the greater the risk that is shifted to the acquiree. This approach is particularly bothersome to the venture backers and shareholders, and requires a great deal of faith in the acquiring company and its ability to execute on the mutually agreed upon milestones that make up the earn-out portion of the acquisition. In reviewing the individual earn-out transactions since 2000, the vast majority had significant up-front payments in the range of 30 – 70% of the full transaction value paid at the time the merger option was exercised. As a point of reference, the last five transactions that I have been involved in included up-front payments that ranged from 20 – 65% of the full transaction value. (It is also worth noting that those transactions in which a higher percent of the deal was paid upfront were for products where value had already been partially established.) The key takeaway from my experience is that for technologies that are viewed as a real potential franchise with most of the risk already reduced (e.g. trials completed or sales commenced), more up-front dollars should be paid at the initial execution of the merger documents. This greater up-front payment for the proven technology then reduces the overall risk to the acquiree and its venture backers, as less of the transaction value is subject to those payments attached to the earn-out component of the deal.

Up-front payments can be structured in a variety of ways, but in my experience one of the best approaches is to negotiate for an up-front payment that has two components. The first should offset the ongoing operational

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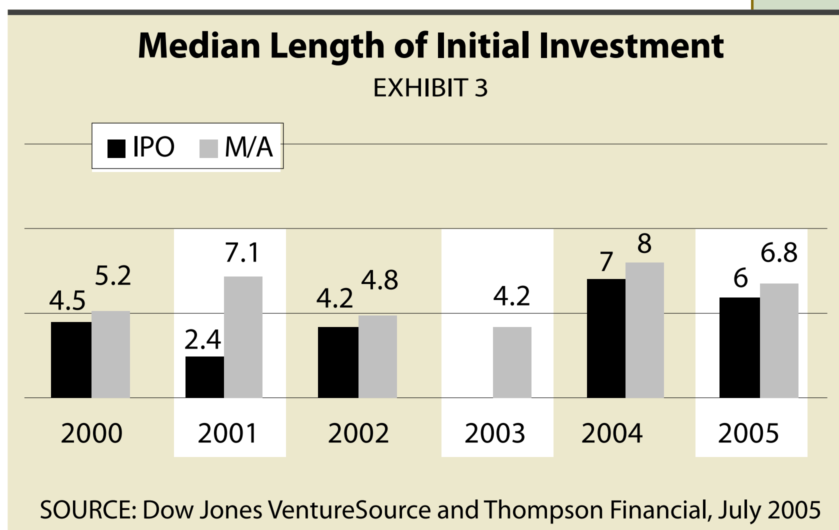
cost of the company (generally referred to as the "cash burn per month" to run the company to the execution point of the merger and acquisition agreement). In most companies at an appropriate stage of development to warrant earn-out discussions, this cash cost to the acquirer ranges from $500,000 to $1 million per month. The second component of the up-front payment should be just that—an up-front payment of cash, which is made at the execution of the merger and acquisition agreement. It provides a real sense of commitment and should be structured so that it can be paid out to the venture backers and other shareholders. In many earn-out transactions, this second component is paid at some key milestone that triggers the final execution of the agreement. The acquirer then exercises its option to acquire and take full control of the company and the earn-out payment phase begins.

There are several ways in which the up-front payment that offsets the operational expenses can be structured. A common approach is to have these payments made by the acquirer in the form of a loan through a line of credit. This line of credit can be milestone-based or draw-down as required. (A note of caution—in a milestone-based model, the milestones can slip. If they do, you may not have access to this source of cash.) Most often, loans from the acquiring company are structured as an offset to the initial payment made when the acquirer exercises the M&A agreement or to the back end earn-out payments. In a perfect earn-out structure, from the original venture backers' point of view, this line of credit would not have any provision for payback. Unfortunately, large cap investors have to make a return on these lines of credit, so they have to be paid back and, generally, at the going rate of interest. This is an important negotiating point in structuring the deal, but there are several other points to consider. For example, when, and how much of, this line of credit will be paid back, and are there provisions within this line of credit to increase it if mutually agreed changes to the business plan arise? With respect to the timing of the credit payback, my preference is to have it not come out of the first up-front payment to shareholders or the first earn-out payment, but rather the last earn-out payment.

If mutually agreed upon changes occur prior to the acquirer exercising its option to acquire (and they often do), some consideration should then be given to the line of credit payback. For example, based on certain market conditions, if manufacturing demands or clinical trial acceleration are not initially contemplated—but they are important for the overall benefit of the business, and additional capital is required and mutually agreed upon—then it is important to negotiate for the increase in the line of credit to be forgiven. In this scenario, the original portion of the line of credit is used and repaid but the additional amount is not. Both parties, then, would still benefit from decisions that could not be anticipated on the front end of negotiations but, in fact, make sense for enhancing the long term business. The acquiree does not have to pay back the full line of credit and the acquirer is enhancing its ultimate competitive and strategic position.



In another commonly used earn-out structure, the acquirer invests in the company and receives stock. This alternative may be organized to occur simultaneously with the structuring of the line of credit. In this scenario, the acquirer invests in the company for equity (similar to a venture round) and, like the line of credit, these dollars may be used for funding ongoing operations. Once again, it is important to understand how this equity will be treated at a later date; for example, when the first up-front payment is made to the company's shareholders. Here, you should negotiate for this equity (now held by the acquirer) to be excluded from any distribution of cash made to the shareholders of the company. If these shares were not excluded, the acquirer would not only be repaying themselves, but repaying themselves at presumably a solid gain in the equity.

I strongly advocate that lines of credit should be paid back, with interest. It is a fair structure unless mutually agreed alterations to the plan occur. If that happens, both parties need to be logical and fair and arrive at a new understanding. I also believe that any equity investments made by the acquirer should also get paid back at face value, but should be excluded from payments made to the shareholders.

4. Pay-out Schedule

Once the total value of a transaction has been agreed upon and the structure of the relationship has been established, the next step is to decide how much up-front money will be paid as opposed to the final earn-out payments. It is this part of the earn-out model that generally creates the most concern for the acquiree, the employees, and the shareholders. Worries over whether or not the remaining earn-out payments will ever be

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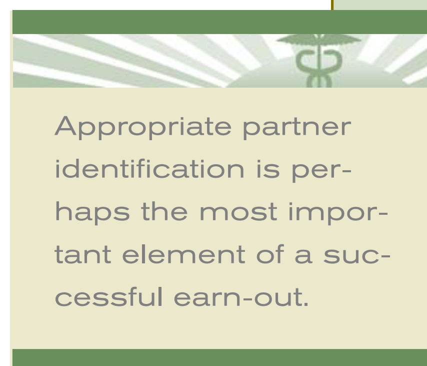
paid can be reduced significantly by picking the right partner and understanding its commitment and the plan on achieving the milestones that pay out during the earn-out period. As mentioned earlier, the more the acquirer has paid in from the beginning, the more likely the long-term outcome will be favorable. The structures in which these residual earn-out payments will be eventually earned can and have taken many forms. Over the last five years earn-outs have had an average of 60 – 70% of the full earn-out consideration paid in at the execution of the merger agreement. This still leaves a 30 – 40% residual earn-out payment to be achieved. It is how this residual amount is paid out and structured that requires careful thought by the acquiree. Without a good understanding of the market dynamics with respect to your product and the rationale behind why this acquisition makes sense to the acquirer in the long run, you may never realize the residual payments. In effect, the acquirer has acquired a solid technology and presumably purchased an IP position at a 30 – 40% discount from market.

To review briefly, once the structure and value have been successfully negotiated, the last remaining point is the pay-out itself which begins when the merger acquisition agreement is signed and the up-front payment is made. These payments have comprised anywhere from 20 – 65% of the full market value in those transactions in which I have been involved. Also keep in mind that when we reach this stage of the transaction the acquirer now owns the company. The exercise of the agreement is the seminal event; whenever possible have this trigger structured as a "put" to the acquiring company. In this structure, an agreed-upon milestone or milestones have been established and, once they have been achieved, the acquiring company must execute the merger agreement. In this case there is "no option" to acquire; there is an obligation to acquire. The acquisition trigger is the completion of the milestones and the "put" takes effect. The residual earn-out payments, however, are still subject to whatever milestones were agreed upon.

This brings us back to the actual earn-out payments themselves and how they will be paid out. Once again, in negotiating these payments a cap on the earn-out should be avoided. I believe a cap, in essence, defeats the beauty of the earn-out, which lets the product determine the value. If the value is achieved, then the acquirer should pay for it. A better methodology is to establish a time period for the earn-out vs. a cap on value. My preference here would be a time period of five years. However, the devil is in the details with respect to triggering these pay-outs.

The majority of the earn-outs over the last five years were structured with revenue milestones. One of the more problematic aspects to the revenue-based approach is the starting point for these sales milestones. The best approach to reducing risk of adoption and subsequent payment is to negotiate a relationship during the option period in which the acquirer is distributing your product. The acquirer then gains experience with the device and has the opportunity to create a strategy for a planned roll-out to its sales force. This, in turn, establishes a run rate on sales for the acquiree. Both parties benefit from the overall structure of this approach. The acquiree manufactures and transfers the product to the acquirer at an agreed-upon manufacturing cost, plus some margin. The acquirer purchases the product providing a margin and cash for the acquiree, but because it is selling the product, it is also making a margin. And both parties benefit by gaining valuable clinical and sales data.



By creating a distribution relationship prior to the exercise of the option to acquire, you now have a baseline established for sales. Most earn-outs that are tied to sales are usually some multiple of sales. Establishing a baseline prior to the actual earn-out significantly reduces risk to reaching full value. The other approach, which I do not advocate, is, once the merger agreement is signed the earn-out begins without the benefit of any planned roll-out or field sales experience. This approach will result in a much slower pay-out since the acquirer will be learning as it goes with no prior experience with the product.

Further dissecting earn-out payments, many are structured with the following parameters:

1) First year of sales a multiple of 1x or 2x is paid. For example, if the first year of post-acquisition sales were $15 million, then $15 million or $30 million would be paid.

2) Years 2 – 5 generally have a multiple structured as 2x the incremental growth in sales. For example if year 2 sales increased to $25 million or $45 million from $15 million in first year sales, the multiple paid would be on the $10 or $30 million in growth or another $20 or $60 million in pay-out. This approach continues until the final year of the earn-out time frame is reached, or the cap on value is reached.

3) One additional feature worth considering, especially if a cap structure is in place, is that over the earn-out payout period, if sales truly accelerate much faster than anticipated, then an additional earn-out kicker could be paid.

All in all, these types of agreements can be structured to be very lucrative and beneficial for all parties involved.

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Cases in Point

While I have detailed important elements in the structure of an 'earn-out' transaction, it is perhaps best to describe a couple of cases in which I was directly involved to better illustrate the process.

The first company was structured as a "put" and the agreement was structured with payments to offset operational expenses paid for by the acquirer. This agreement had three distinct triggers; the first was the signing of the merger agreement and the payment which amounted to a third of the full acquisition value. This provided the investors and employees with some initial return. The second trigger was completion of the clinical trial and submission of a PMA. And the final trigger was the PMA approval when the final payment was made. The full transaction value was $150 million and structured in a very clean and objective way.

The second company was also structured as a "put." However, no initial up-front payment was made, but the acquirer offset operating expenses to run the company. The key "put" trigger and realization of full value was tied to the completion of the clinical trial and PMA approval. There are two reasons why both of these cases exemplify preferred earn-outs. First, the acquirer must complete the transaction once the key milestone is achieved. This reduces risk to the seller since the merger is complete once the milestone is achieved. Second, the milestones in these structures are very clean, concrete, and generally primarily in the control of the company being acquired.

However, the more traditional earn-out agreements are structured as a "call" or option to acquire. This option to acquire must have a date in the future at which the acquirer has to make a decision to go forward or not. Usually these types of agreements will have a provision to extend the time for decision; this extra time should not exceed six months and, if the time period is extended, then the acquirer should be willing to invest more dollars into the deal. If the acquirer chooses not to execute the option, you must have a provision within the line of credit or some other approach whereby the acquirer will continue to provide the necessary cash to run operations for at least a year. Remember, if for whatever reason the acquirer chooses not to exercise its option, it places you in a very difficult financing scenario. I have only had this experience in one situation so this outcome is not the norm, but it must be contemplated.

Where Do We Go From Here?

The earn-out model, while still only used in a minority of M&A events, provides a useful alternative for the acquisition of a company whose true market value may not yet be known, but which is still an attractive or even necessary acquisition for a more financially stable firm. The key consideration at the end of the day is the selection of an appropriate partner for either party. Both firms must demonstrate commitment to the success of the acquisition. This is particularly relevant to the firm being acquired as it is often sold at a significant discount to current market value in terms of an initial pay-out. The earn-out model can provide a "win-win" if both parties are committed to the transaction, set realistic milestones, and cooperatively work to achieve those milestones. In fact, the earn-out model may provide an additional incentive for cooperation between the acquiring and acquired firm over the traditional M&A model as the employees and investors in the acquired firm must still perform and meet objectives to receive maximum compensation in the deal. This incentive is not implicit in the traditional M&A. ●

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Comments?

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