

Eva Davis Discusses Why Middle-Market PE Firms Are Using Earn-Outs to Salvage Deals Post COVID-19

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With low visibility on company revenue and the timing for an economic recovery, middle-market private equity firms are turning to earn-outs to get transactions across the finish line. Earn-outs provide sellers an incentive to demonstrate their effect on future performance: the better the performance, the larger the sale price.

Eva Davis, Co-Chair of the firm's Private Equity Practice and a Managing Partner of the Los Angeles office, tells *Mergermarket* the private equity funds with the strongest track records since the financial crisis of 2008 to 2010 were the ones that were willing to be creative with deal structures, and earn-outs are especially common in the middle market. She shares, "It's the inability to value companies and allocate risk that kills deals. But private equity firms want to get deals done."

Eva shares that she is seeing an increased number of earn-out provisions to get deals to the finish line. Sometimes the earn-outs are based on revenue or EBITDA and the time period varies.

Eva negotiated several earn-outs in March looking out three to six months. More recently, the earn-outs she is negotiating are through the full year 2020 or for 12 months because there is little visibility about the duration of the pandemic. Most earn-outs she has negotiated are for transactions below USD 300m.

By way of example, Eva shares that a transaction that might have been USD 100m, with 75% debt and 25% equity before the crisis might now be worth USD 80m and include a USD 25m equity check, USD 35m in debt and a USD 20m earn-out. Before the pandemic, middle-market PE deals might get financed at 4 to 6 times EBITDA, "now it's 2 to 3 times", Eva said.

PE buyers in a post COVID-19 deal-making environment like the protection earn-outs provide against overpaying for a company that doesn't live up to their expectations.

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