

## Exploring Earnouts and Their Use in Search Fund Acquisitions

Earnouts are a post-closing contingency mechanism that can help facilitate a deal, but they are also filled with unintended consequences

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Search fund and entrepreneurship through acquisition (ETA) aspirants run through a gauntlet of obstacles on their race toward the acquisition finish line. Sourcing a deal, wooing the seller, juggling due diligence, plowing through legal documentation, negotiating a purchase price, and conjuring up the necessary debt and equity funding are all roadblocks that must be surmounted. It is a marathon race at the speed of a sprint. We empathize with search fund entrepreneurs because we have walked in their shoes. It is hard work and stressful at every step. While we have discussed many of these topics before in various notes, we have not yet covered earnouts, a popular tool ETA investors use to help finesse a deal closing when a little extra lubricant is required.

Earnouts are a staple in the deal-making business and not a notion conceived by ETA players. Instead, the search crowd has imported this mechanism from public market transactions and private equity trades. For example, in March 2025, PepsiCo, the New York-based purveyor of beverages and snacks, acquired the prebiotic soda brand Poppi for \$1.95 billion. According to a *Wall Street Journal* article reporting the transaction, “the deal also includes an additional potential earnout consideration depending on whether certain performance milestones are achieved in a designated period.”<sup>4</sup> Earnouts are common in private market transactions, too. In February 2025, One Equity Partners, a New York-based private equity firm, purchased Pennsylvania-based Wheeler Fleet Solutions “for up to \$230 million. The consideration includes \$140 million in cash at closing, a \$25 million seller note, and up to \$65 million in additional contingent consideration.”<sup>5</sup> In a report on contingent consideration in public-private deals, the law firm Sheppard Mullin cites that 23% of the deals analyzed in their data set included an earnout provision.<sup>6</sup> This is consistent with a recent SRS Acquiom report which indicates that, in 2024, 22% of non-life sciences deals had an earnout component.<sup>7</sup>

Typically, when a public company acquires a private enterprise or a private equity firm buys a private company, the legacy management stays in place and is highly incentivized to achieve the outcome. The leadership team has control and fully operates the business. This is in stark contrast to an ETA setup where legacy management is sidelined and a rookie CEO takes the helm. This introduces agency and control issues. We will explore these in greater depth below.

Before we press on, we should define exactly what an earnout is, at least in the ETA context. An earnout is a construct whereby the seller of a company is compensated by the buyer in some form for events that occur after the closing. An earnout can be for something as innocuous as the

operations manager still being employed by the company on the first anniversary of the deal closing. Alternatively, the earnout could be indexed to a future financial metric, such as a 50% increase in sales within 24 months of the close. Moreover, an earnout can be satisfied with cash, equity, or a note payable. The only limitation to architecting an earnout is the designer's imagination.

In simpler terms, an earnout is a mechanism used to address a post-closing contingency, which often reflects differing views on future events. Two parties, the buyer and the seller, want to enter into a transaction, but their perspectives on valuation and risk may differ. Sellers, with an informational advantage, are innately optimistic and believe everything is sunshine. Buyers, on the other hand, are skeptics and eschew risk. A post-closing contingency like an earnout is an elegant tactic to bridge alternative perceptions of the future. Buyer and seller are essentially saying, "We do not know what will happen tomorrow; let's wait and see what unfolds, and that will determine the next round of remuneration—and if there will be any further remuneration at all."

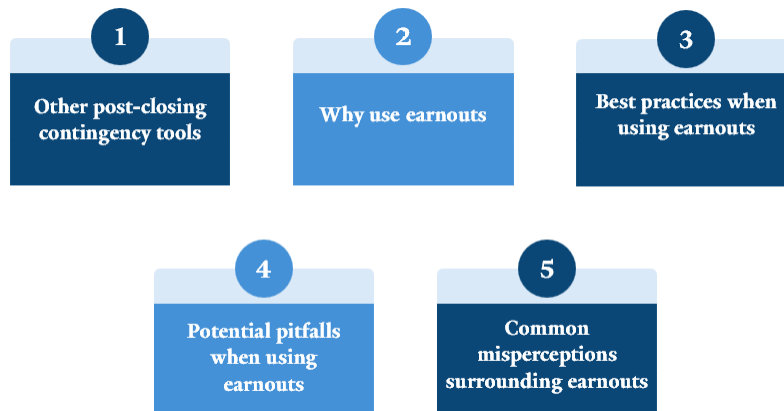
A simple example might be a seller with a business generating \$1 million in current earnings. However, they believe a promising new customer is about to bring in an additional \$250,000 in earnings. The ETA buyer is cautious and hesitant to pay the seller in advance for something that might happen but is not guaranteed. So, the buyer and seller could agree that the base business is valued at \$4 million without considering potential new customer earnings; this amount can be settled at closing. However, they also agree that if the new customer actually joins and provides an extra \$250,000 in earnings, the buyer will pay the seller an additional \$1 million. In this context, an earnout is a graceful mechanism to nudge something forward when the alternative is to simply agree to disagree (and nobody is happy). With the earnout, there is a path to bilateral satisfaction. In MBA negotiation jargon, the pie was expanded, and everybody is a winner.

This is as simple a plot as we can imagine, and it assumes both buyer and seller are savvy, rational, fair, reasonable, well-intentioned, and honest. The elementary scenario we describe can quickly become complex in reality, and we will discuss those twists and turns throughout the note. Earnouts are peppered with uncertainty; unexpected good and bad things can happen. There is a viscous cocktail of ambiguity, conflicts of interest, and money at play. This makes earnouts hard at times. *However, we must emphasize that despite the inherent headwinds, getting a deal across the finish line with lots of complications is still better than no deal at all.* ETA buyers intrinsically understand this, and despite the earnout slog, are willing to endure it for the privilege of ascending to the CEO throne and having a shot at a financial windfall.

Earnouts appear to be on the rise in ETA land. According to a recent poll of 41 search fund investors conducted by Instituto de Estudios Superiores de la Empresa (IESE), the prestigious business school in Barcelona, the use of earnouts is rising significantly in non-U.S. initial acquisition transactions. Unfortunately, because of its popularity, entrepreneurs may be using this tool prematurely without a full understanding of all the foundational dynamics underpinning the instrument. Like any tool, earnouts can be a smart choice in some situations and a poor one in others. Moreover, when used properly, a tool can add value, while when used poorly, it can be dilutive. We want our students, readers, and aspiring search fund entrepreneurs to better understand all the issues embedded in earnouts. This note aims to serve as a primer to help our audience quickly get up to speed and enter into the arena better equipped to win. Our note is neither a legal memo on earnouts, nor is it a comprehensive assessment.

In this note, we will discuss five cardinal topics related to earnouts (**Figure 1**). We hope students and entrepreneurs will simultaneously become more cautious and feel more confident, better prepared, and armed with actionable tools as they contemplate using an earnout in their ETA project. Let's dig in.

**Figure 1: The roadmap for this note**

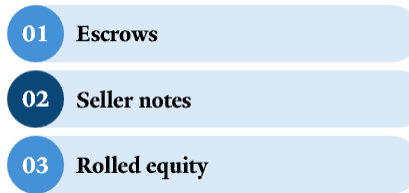


Before we jump headfirst into all things earnout, we are going to take a brief detour to introduce three proxy tools for earnouts. These are close substitutes that share features with earnouts but are not identical; they are adjacencies. We start here because when an ETA CEO is scrambling to close a deal, they should not immediately turn to an earnout without first exploring the alternatives. There may be simpler, smoother ways to achieve most goals with less complexity or counterparty tension. Additionally, some of the other approaches might involve fewer unknowns.

### Other post-closing contingency tools

While earnouts are one way to bridge valuation gaps and align incentives post-closing, they are not the only method in the ETA toolbox. Three of the most commonly used alternative instruments are escrows, seller notes, and rolled equity (**Figure 2**). These alternate pathways are not interchangeable substitutes, but they do have proxy features that are worth considering. Each has its own advantages and disadvantages, and their effectiveness depends on the specific dynamics and context of the transaction, the personalities involved, and the risk tolerances of the buyer and seller. Although this note is not a deep dive into escrows, seller notes, and rolled equity, we believe readers and entrepreneurs should at least be aware of these surrogate approaches. As we will discuss below, earnouts are complex and fraught with issues, yet they still help facilitate a deal closing when the next best pathway is to wallow in gridlock. We think the right question an entrepreneur should ask is, “Why should I use an earnout?” not, “Why shouldn’t I use an earnout?” These alternative tools can help alleviate the need to default to an earnout.

Figure 2: Alternative approaches with substitute features for an earnout



### 01 *Escrows*

Escrows are the legal equivalent of “trust, but verify.” They function as a form of insurance for the buyer; if certain events occur after closing, the buyer can make an escrow claim to recover funds and reduce the purchase price. A portion of the purchase price, usually 1–10%, is held back for a specified period after closing, often between 6 and 24 months. These funds are typically managed by a neutral third party, usually an escrow agent, and act as a safeguard if the seller breaches a representation or warranty in the purchase agreement or if a specific post-closing issue arises, such as an uncertain tax liability like sales tax exposure. Unlike earnouts, escrows are not performance dependent; the funds are agreed upon and available but not fully released. Escrows are also clear in terms of timing and scope, with defined expiration dates and specific claims criteria.

From a buyer’s perspective, escrows provide a way for the buyer to claim funds if something the seller stated was false. From a seller’s standpoint, while it would be ideal to receive all the cash up front at closing, escrows are a common feature of deals, with the main negotiation point being how much money is held back and for how long. They represent the most guaranteed form of post-closing deferred consideration. A key concept in an escrow is that it can never increase for the seller. For example, if there is a \$1 million escrow, the most the seller will ever receive is \$1 million, and more than likely, the escrow will melt with some claims. Unlike seller notes or earnouts, an escrow requires the buyer to part with valuable equity upfront, which can have a significant impact on the equity returns generated by the project. Additionally, the escrow is akin to the seller receiving full proceeds and then lending some portion of the proceeds to the escrow (accruing nominal interest), where it is subject to contingent claims.

For more on the exciting world of escrows, see our note [Exploring and Understanding the Various Legal Documents in a Search Fund Project](#).

### 02 *Seller notes*

Seller notes are essentially IOUs. When a buyer agrees to purchase a business for \$10 million but only has \$7 million in cash, a \$3 million seller note can cover the remaining balance. The buyer agrees to pay a portion of the purchase price at a specified future date or over time, usually through fixed principal payments with interest to account for the deferred payment. To clarify, these are debt instruments, not equity instruments. They typically have a 3- to 7-year term, with interest rates usually ranging from 5% to 10%, and they are unsecured, meaning they do not have a primary claim on any of the assets sitting below the senior creditor.

Seller notes attract ETA buyers because they reduce the need for up-front cash and can offer a favorable financing buffer when lender appetite is limited. They typically have interest rates lower than lender rates, and unlike lender debt, they usually lack covenants. They serve as a valuable bridge, helping to ease

negotiations with sellers who may be fixated on a specific valuation but are flexible on funding timing and interested in current annual interest income.

Sellers favor seller notes because they represent firm obligations, are legally enforceable, rank above equity, and accrue interest. However, they also involve risks: Seller notes are usually subordinated to senior debt, and unlike earnouts, they tend to be longer in duration. Additionally, unlike escrows, they are not explicitly funded or held by a third party, and they sometimes include a forgivable component if certain representations and warranties are not true, providing an escrow-like protection for buyers. Ultimately, the best a seller can do is to get paid in full; there is no upside with a seller note.

### *03 Rolled equity*

Rolled equity occurs when the seller retains an ownership stake in the business after the purchase transaction. Instead of selling all their ownership, they shift a portion of their equity into the new ownership structure. For example, if a purchase has an enterprise value of \$10 million, the seller might roll \$3 million of that into the new entity. The amount of rolled equity is usually between 5% and 30%, and depending on how much the seller rolls, could include a governance role like a board seat, giving the seller some oversight over their rolled equity. If the seller has a key role in the business, such as sales or product management, they might stay involved to help grow the business and boost both their own and the company's overall equity value.

This is the most philosophically aligned form of post-closing contingency. The seller remains an owner and benefits directly from future upside or suffers if things do not work out. Unlike earnouts or seller notes, rolled equity has no expiration date and no performance deadlines. Of course, rolled equity comes with downsides. It entangles the seller in future business decisions and governance dynamics, and it can create tension hurdles. It is true skin in the game.





Buyers may prefer rolled equity because it keeps the seller engaged, both financially and psychologically. It signals confidence, as sellers are indicating that they can grow the business and generate more future value than a full cash-out. It can also assist with the transition of a new CEO and support post-close engagement, as the seller remains motivated to help drive the business's future growth and increase its equity value. Of course, there are downsides to this approach. The seller might want to meddle in overall strategy, capital allocation, or exit timing. The lack of a clean exit for the seller can lead to backseat driving, as they built a great business and want to ensure things continue to protect and grow their equity investment, resulting in awkwardness at best and a significant distraction or legal issues at worst.

### *Comparing the various instruments*

While earnouts, escrows, seller notes, and rolled equity mechanisms defer or make a portion of the seller's compensation contingent, they function quite differently in terms of risk, alignment, enforceability, and incentives. There is no perfect solution, and each vector has pros and cons. Escrows are legally secure but lack motivating factors. Seller notes are contractual but brittle. Rolled equity provides alignment but also creates entanglement. Savvy ETA players understand that these tools can be used in concert. For example, a deal might include an escrow for representations and warranties, a seller note to bridge the valuation gap, a small equity rollover to keep the seller engaged and allow them to participate in future upside, and an

earnout to compensate for future events. Blending these tools effectively is both an art and a science, forming part of the nuanced process that transforms a tentative seller into a committed partner. **Figure 3** summarizes the features of the tools we have discussed.

**Figure 3: A summary of the features, benefits, and risks of substitute solutions for earnouts**

 Feature	 Escrow	 Seller note	 Rolled equity
<b>Payment</b>	Claims tied to breach of reps/ warranties or other matters	Time-based repayment schedule, often a bullet payment	Liquidity event (e.g., sale, recapitalization)
<b>Seller risk</b>	<b>Low</b> , funds are withheld and may be clawed back	<b>Moderate</b> , subordinated debt, often behind senior lenders	<b>High</b> , full exposure to business risk post-close
<b>Buyer risk</b>	<b>Low</b> , funds are in escrow and accessible upon claims	<b>Moderate</b> , obligation to repay unless seller defaults	<b>Low</b> , no repayment obligation
<b>Time horizon</b>	<b>Short</b> , typically 6 months to 2 years	<b>Medium</b> , typically 2–5 years	<b>Long</b> , subject to the next liquidity event
<b>Seller incentive alignment</b>	<b>Low</b> , seller has no further upside participation and is at risk of a clawback	<b>Moderate</b> , seller may be helpful to ensure repayment	<b>High</b> , seller benefits from company success

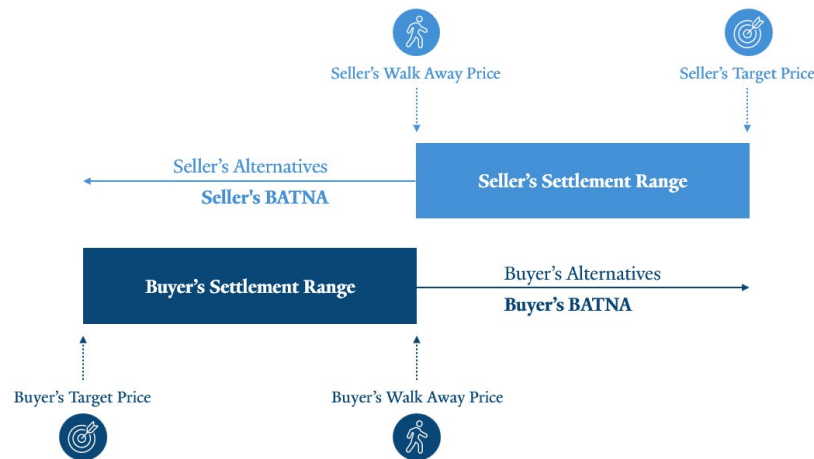
### Why use earnouts

We will now discuss why buyers and sellers are eager to use earnouts in the ETA space. To be clear, we are not advocating for their adoption (we will maintain a neutral tone throughout the note to allow our readers to form their own conclusions, although we do think earnouts can help close a deal when the alternative is no deal at all); rather, we are presenting the compelling reasons buyers and sellers use as a rationalization for employing earnouts.

The most basic reason earnouts appear in search fund acquisitions is that buyers and sellers can only agree partially on various deal points that affect valuation. For example, if a target acquisition has \$2 million of EBITDA,\* and the buyer offers to purchase the business for \$10 million, but the seller wants \$12 million, there is a \$2 million gap (**Figure 4**). Both parties agree on approximately 83% of the valuation, but they are unable to resolve the remaining 17%. This might be due to conflicting perceptions around future EBITDA performance or current EBITDA trading multiples. Regardless, there is no current zone of potential agreement (ZOPA) because the buyer’s and seller’s settlement ranges do not overlap at all. Accordingly, each party will pursue their best alternative to a negotiated agreement (BATNA).

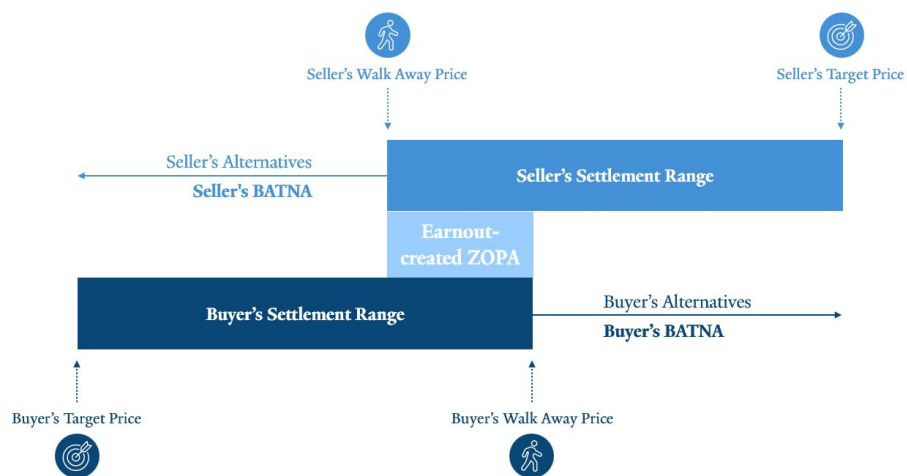
\* Earnings before interest, taxes, depreciation, and amortization.

Figure 4: Illustrative buyer–seller valuation expectations with a price gap (no ZOPA)



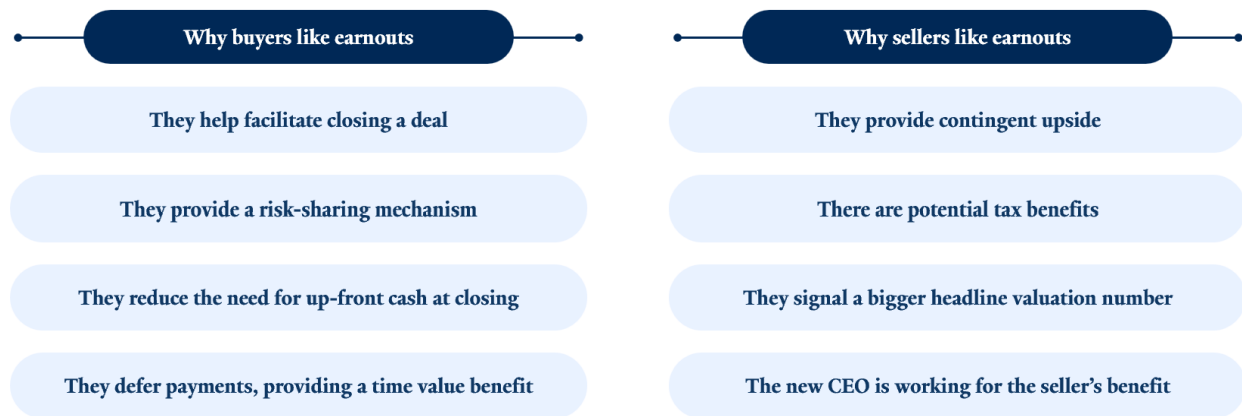
The buyer might be willing to pay \$12 million for a \$2.4 million EBITDA business but not for a \$2 million one. The seller might believe that meteoric growth is right around the corner and the firm will shortly have \$2.4 million in EBITDA, justifying an enterprise value of \$12 million. Instead of remaining at an impasse, the buyer can propose that if the business indeed swells to \$2.4 million in EBITDA within a specified timeframe, they would be willing to pay an additional \$2 million. A synthetic zone of potential agreement is thus created, where settlement ranges intersect and there is a pathway for the seller and buyer to both be satisfied (**Figure 5**). Voila, an earnout is born, providing a bridge to a deal closing with all parties happier and more aligned. Of course, the seller would only consent to the earnout if there were no \$12 million all-cash buyers or if they were intent on trading with the \$10 million cash buyer and willing to accommodate their valuation deficiency. Additionally, the extra \$2 million in consideration is not a sure thing, like a seller note payable might be. It is not a firm contractual obligation. Rather, it is a contract to perform if certain events transpire. Once again, the magic of an earnout is that it nudges a deal toward a close when the alternative option is a stalemate.

Figure 5: Illustrative buyer–seller valuation expectations with a synthetic earnout-created ZOPA



Of course, it is not quite that simple, and the lawyers will have plenty of language to protect and enforce the agreement. Furthermore, as we will discuss later, the devil is in the details here. However, there are plenty of logical reasons for buyers and sellers to pursue an earnout. We will now discuss the top motives why both buyers and sellers might be earnout enthusiasts (**Figure 6**).

**Figure 6: Top reasons why both buyers and sellers incorporate earnouts**



Since our primary audience is the search fund crew, we will start with the buyer's orientation and a focus on how earnouts are used at the acquisition entry point in ETA deals.

### 01 *They help facilitate closing a deal*

Closing a deal is hard, whether in month 6 or month 30 of a search. There are few wonderful businesses available to buy at reasonable prices, and sellers have built those successful businesses in part by being tough negotiators. Additionally, most searchers are not experienced at negotiating and often prefer accepting an earnout rather than pushing hard on valuation. When an ETA entrepreneur reaches their twentieth month of searching and has dwindling funds, a higher sense of urgency to close a deal may set in. So, if they are negotiating with a potential seller and a valuation gap exists, one simple solution is an earnout. If it helps finalize the transaction and get the entrepreneur back in the game, they are elated. This makes sense, especially when considering expected values. If the seller demands an unrealistically high valuation based on an optimistic series of events (such as earnings growth, new sales, or customer retention) that the buyer considers unlikely, the expected value is very low. So, why not consider an earnout that seems like a low-cost option?

The buyer sees a pathway to what they believe is a high-probability, high-expected-value event; they are pleased. The seller feels like they have not really given anything away. The bridge is built, and the deal is consummated. An earnout can seem like an extra sweetener for the buyer, providing just enough of a boost to close the deal. Furthermore, buyers rationalize the earnout by believing that either it will not come to fruition, or if it does, the company will be that much larger or better.



### 02 *They provide a risk-sharing mechanism*

Despite the hackneyed media portrayal of entrepreneurs as risk-loving adventurers, they actually abhor risk. They are always seeking ways to avoid or shift risk to others. Unfortunately, the ETA game is peppered with risk, and there is no greater minefield than negotiating and closing the initial acquisition. Entrepreneurs and investors are continually handicapping what they get in the purchased company compared to the proposed enterprise value. There needs to be plenty of cushion because risk abounds in this line of work. It takes a big leap of faith to purchase a squirrely \$2 million EBITDA business with a few dozen employees, some customer concentration issues, key personnel risks, and more. This is exacerbated by the fact that the seller has an informational advantage and is more comfortable with their firm that they have built and maintained. They view future cash flows as having the same risk profile as treasury bills. Entrepreneurs, and especially their investors, viewing these fragile and tenuous organizations, see potholes everywhere and discount future cash flows at a much higher rate than the risk-free rate the seller considers. Although discount rate perceptions inform EBITDA multiples as compared to EBITDA dollars, disagreement about discount rates still leads to misalignment around valuation.

One way to adjudicate the buyer's queasiness over risk is through an earnout. Instead of the buyer bearing all the risk if the key customer leaves post-close, an earnout can serve as a risk-sharing mechanism. The seller only receives certain levels of compensation if the customer remains engaged with consistent historical volumes. This elegant design provides the seller full compensation if things go as planned and represented, with the reassurance that the buyer does not take on all the up-front risk. Both parties can be satisfied, and the risk is not borne completely by the purchaser.

### 03 *They reduce the need for up-front cash*

ETA CEOs are a crafty lot. They cobble together deals without money, experience, or brilliant ideas, catapulting themselves onto the CEO throne shortly after business school. They access highly leverageable SBA 7(a) loans,<sup>†</sup> suppressing the need for precious equity dollars. They negotiate favorable loan covenants and amortization schedules with creditors, providing an opportunity for high debt levels and light repayment of principal. All of these moves can help boost returns and benefit the promoter.

Another cagey move is for the entrepreneur to structure the deal with a heavily back-ended earnout. This can reduce the need for up-front cash and equity at closing. A large earnout, especially if the entrepreneur believes it is likely to be achieved, is effectively off-balance sheet seller financing. Creditors will likely view this as a contingent obligation and not include it in covenant testing. Furthermore, the creditor would need to explicitly approve any cash leaving the business to extinguish the obligation since the creditor is in a superior position. Compressing the up-front cash requirement is always a good fact, and earnouts (along with more traditional seller notes) are ways to achieve that.

### 04 *They defer payments, providing a time value benefit*

Let's build on the previous section about up-front cash requirements. When entrepreneurs use an earnout and defer payments, they benefit from the time value of money. For example, if an earnout is worth \$3

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<sup>†</sup> Please see our note [Exploring and Understanding the U.S. Small Business Administration 7\(a\) Loan Program](#).

million on a contingent basis and is not payable until the second anniversary of the acquisition, the entrepreneur benefits from the deferred payment scheme, especially if the buyer is enjoying increased interim cash flows. This is advantageous because most earnouts are settled for a nominal face amount and do not include an implied carrying cost.

Entrepreneurs would always prefer to expend cash in the future rather than today. With an earnout, they not only avoid needing to provide the cash up front, but they also benefit from an interest-free loan. Additionally, the implicit cost of the earnout obligation is lower than its face value. Sellers clearly know that earnout payments are deferred, but they might not take into account the time value of money dynamics on the contingent payments. Additionally, it is trade practice for earnouts to be satisfied at par without an interest cost.

We will now shift gears and review a foursome of reasons why sellers might enjoy an earnout design.

### *01 They provide contingent upside*

We love free options, and sellers of small businesses are no different. An earnout provides sellers with another chance to benefit if good things happen in the future. It can feel like a free option. If we were sellers, we would ask for earnouts because even if there is a low probability of the company doubling in size in twelve months, there is still some likelihood it will happen, and why not be compensated if that unlikely event occurs? This is the opposite of insurance, which benefits the insured when unlikely bad things happen. Earnouts pay off when good things happen. Buyers understand the free option dynamic and are smart enough to know that issuing free options is not a wise proposition. However, they are either offering the earnout prematurely in their haste to get a deal done, getting trapped into this concession to close, or most likely seeing the earnout as the grease that helps smooth out the closing process.

The only issue with this contingent upside is if a seller truly believes the company will double in value within a year and sees it as a guaranteed outcome. If that is the case, they will be very disappointed when it does not happen. However, sellers who are more realistic and do not see the last tier in an earnout ladder as certain can benefit from the chance of upside if something unexpectedly positive occurs. Sellers are typically optimistic about their companies and anticipate earning all the earnout opportunities. However, if they are unbiased, they are equally likely to be pleasantly surprised or disappointed.

### *02 There are potential tax benefits*

We are neither tax accountants nor tax attorneys, so we will take a high-level view of the seller tax benefits in an earnout scenario. When a seller receives cash in a sale transaction, that cash is taxed accordingly, most likely as a long-term gain. However, when part of the transaction is deferred, as it is with an earnout, the proceeds associated with the earnout are not eligible for taxation at the time of closing; they are only taxable when the cash is received and the earnout is fulfilled. This can potentially reduce the at-closing tax burden a seller incurs. This results in a temporary tax deferral but not a tax rate arbitrage.

An earnout that includes a capital gain may qualify for the installment method of tax accounting, which generally means that the tax on the deferred gain is paid when the payments are received. This can be a beneficial feature, as it spreads the tax burden over several years and helps maintain near-term liquidity. Alternatively, a seller can choose to opt out of the installment method and pay capital gains tax on the

earnout at the current capital gains rate. While the installment method is usually preferred, there is work involved in assessing the potential risks associated with it. The determination of what is taxable today and in the future depends on the total maximum proceeds of the contract. Tax basis is allocated over the total proceeds; therefore, a very high and potentially unreachable upside could offer a slim chance for additional earnings but would increase the tax basis in future earnings and raise current tax liabilities. If the earnout targets are not met and little or no cash is received later, the earnout might result in a capital loss in future years, which has annual limitations on its use (currently up to \$3,000 if a taxpayer has no capital gains to offset). Significant losses may take many years to fully utilize, and their value decreases over time due to the time value of money. However, if the seller elects to opt out of the installment sale methodology and pay taxes today, they eliminate the risk of higher future tax rates.

Due to these trade-offs, sellers should include earnout tax treatment in their overall financial planning. Important factors to consider are expected future income, the chance of realizing other capital gains to offset possible losses, and predictions about changes in capital gains tax rates. Careful planning can help ensure the chosen method maximizes after-tax proceeds from the deal.

### *03 They signal a bigger headline valuation number*

Many sellers and their brokers gravitate toward the headline number in a sales process. They want to know what they can tell their spouse and buddies at the country club about the sale of their business. Brokers love to boast about eye-catching numbers to reel in their next client. The simple rule here is that bigger is better. It might not matter that a \$25 million transaction is actually composed of a \$10 million seller note, with a \$5 million capped earnout, and at-close cash proceeds limited to \$10 million. In many sellers' minds, they sold their business for \$25 million and are counting on collecting 100% of the seller note and the contingent earnout.

If a seller needs to feel important by fixating on an inflated headline purchase price that will probably never pay out fully, that should be fine with ETA buyers. We are not advocating for deception or unethical behavior in any way. However, if the buyer negotiates an earnout with multiple high hurdles, it is probably not going to be realized in full. If the seller has psychological and egotistical needs to latch on to an inflated headline, that is okay with us. An earnout can help pad the headline number to stroke the seller's ego and positively shape how they feel about entering into the sale transaction.

### *04 The new CEO is working for the seller's benefit*

Our students and all ETA CEOs are quite impressive. They are over-credentialed and have a string of academic and professional successes by the time they arrive at a seller's doorstep. Despite these buyers' lack of operating experience, it can be quite compelling to have an elite MBA graduate who previously worked at a top-tier bank or private equity firm as the CEO of the seller's company. The seller might believe that this newly appointed CEO will be able to do things for the company that the seller alone could not have accomplished. In other words, the seller is gaining a chunk of exceptional talent to run the company and work very hard to make their earnout dreams a reality. This phenomenon is also true when a seller rolls forward equity.

We never want to underestimate sellers. They stood up a firm and created millions in equity value. They deserve respect and appreciation, not disdain or condescending scorn. However, many sellers, by the time an ETA buyer is snooping around, might be working fewer than 40 hours a week. They could be more interested in their golf game, their boat, or being on vacation. We do not judge; we are jealous. But these sellers might be excited about the prospect of holding an earnout with a new, hyper-smart captain of the ship in place, working for their benefit.

## Best practices when using earnouts

If earnouts were a physical tool, they would come with a warning label: “Handle with care.” While they can serve as solutions to valuation gaps and risk allocation, they can also bring complexity, friction, disappointment, or worse if they are not designed with intention and discipline. Below, we outline several best practices (**Figure 7**) to consider when designing and implementing an earnout structure in an ETA transaction.

We will start this section, however, with the fundamental idea that ETA CEOs had better understand the *incremental* valuation of the earnout. If the base business is being purchased at 6x EBITDA, what is the effective multiple of the earnout stub? We would hope it is either pro rata or less. CEOs need to consider the earnout valuation on a standalone basis, rigorously evaluate it, and not let the base deal subsidize the earnout on a blended basis. Basic rules of gravity and finance apply to earnouts and should not be ignored.

**Figure 7: Earnout best practices**

- 01 Carefully select the trigger metric
- 02 Consider the earnout currency mix
- 03 Determine the duration of the earnout window
- 04 Plan how the cash earnout component will be funded

### 01 Carefully select the trigger metric

The core of any earnout is the metric that determines whether the seller will receive the contingent payment. This trigger must be carefully selected to reflect the desired performance outcome while reducing ambiguity and potential manipulation. Although any metric can be used, the most common ones are revenue, EBITDA, and gross profit. The metric becomes even more important when the seller remains in the business and has sales or operating responsibilities. The earnout will incentivize behaviors, so ETA CEOs need to understand how seller actions will be influenced by metric formulations.

Revenue-based triggers are easy to calculate but might overlook cost structure and profitability. For example, a seller who stays in a sales role after closing a deal might reach a revenue goal, amplifying the top line but ignoring factors like pricing, payment terms, whether the contract is recurring or repeats, and margins. For instance, a seller aiming to meet earnout revenue targets might offer a customer discounted pricing on a \$1 million sale, resulting in a 50% gross margin compared to the company’s usual 70%, which decreases gross profit by \$200,000 and further affects EBITDA. However, for the seller, this helps them

get closer to reaching the revenue earnout target and the potential benefits of achieving it. They may not consider the profit impact of the revenue. The unintended incentive of this goal is clear: Generate revenue without regard to its effect on the bottom line. This shows that not all revenue is beneficial or aligned with strategic goals in some earnout trigger schemes.

EBITDA more accurately reflects profitability, including unit economics and cost structure, but it is vulnerable to disagreements between buyer and seller about post-close investment decisions. The new CEO might believe the business warrants investments such as new hires, marketing, and new systems to escalate future EBITDA, even if it temporarily lowers short-term earnings. Meanwhile, the seller, now without majority ownership or significant involvement, could see those costs as unnecessary and detrimental to the earnout's potential payoff. This creates a misalignment between what benefits the business in the long term and what the seller needs in the short term to meet their earnout, ultimately resulting in a misalignment of value creation.

Gross profit serves as a middle ground between revenue and EBITDA because it considers profitability and unit economics, but it does not include the selling, general, and administrative costs required to generate gross profit. Sometimes, non-financial metrics – such as customer retention or employee tenure – are used. These may align with seller priorities but are often harder to verify or audit.

Additionally, triggers with a cliff can be problematic. Imagine how a seller might behave if a \$2 million earnout payment depends on revenue reaching \$15 million and is currently tracking to \$14.9 million. They will do anything to increase that last bit of revenue to earn the additional \$2 million – and we do not blame them. Incentives and structure influence behavior. Be cautious of unintended consequences. Regardless of the metric, it must be clearly defined, measurable, reported on, and aligned with value creation. Both parties need to agree in advance on how the metric will be calculated, documented, and interpreted. No buyer wants to spend their first year as CEO arguing over the definition of adjusted EBITDA or worrying about one-time revenue drops once the earnout is achieved.

### *02 Consider the earnout currency mix*

Not all earnouts are paid in cash, and not all should be. Earnouts can be settled in various currencies: cash, equity, seller notes, or even a combination of these. The chosen form of payment can significantly impact returns, incentives, risk, tax implications, and control.

Cash may seem simple, but using cash generated from the business to pay an earnout has an opportunity cost. Cash used for an earnout cannot be used for growth, dividends, or debt extinguishment. If cash needs to be raised – whether through debt or equity – there are other considerations, such as the ability to secure those funds, the cost of capital, and the potential strain or dilution on the business.

Converting the earnout to equity can provide sellers with ongoing upside potential and defer taxes. However, the seller effectively faces a double earnout – one to reach the initial earnout target, and with the conversion to equity, reliance on the growth of a business they no longer control (and equity does not always appreciate). For buyers, converting to equity can be beneficial as it saves cash and aligns interests. Still, it can lead to dilution and create governance issues if the seller wants to participate at the board level, given their equity stake.

Converting the earnout to a seller note is similar to converting it to equity but offers more certainty for the seller. The seller and buyer agree on the payment amount, the term is fixed, and there is no equity dilution. However, the seller must wait longer to receive their cash, with some interest income as compensation. For buyers, besides involving higher interest payments, converting to a seller note can help conserve cash and provide inexpensive, deferred financing.

Entrepreneurs should select an earnout currency that balances buyer affordability, seller expectations, and the alignment of future interests. Importantly, the payment method should be as clear and well defined as the trigger itself.

### *03 Determine the duration of the earnout window*

The length of the earnout period affects commitment from both parties. A short timeframe (12–18 months) highlights immediate performance and reduces ongoing seller involvement after the deal. Additionally, shorter earnouts are more likely to be achieved (or clearly not), while longer ones often become uncertain and create tension, especially as personnel, strategy, or market conditions change. A longer period (3–5 years) may better support strategic initiatives or extended sales cycles but also increases the risk of conflict and unpredictability.

ETA buyers should resist the temptation to simply extend the timeline to satisfy a seller. A longer period is not automatically better; it just becomes harder to manage and may lead to more conflicts. For example, the buyer, now in control, could make strategic decisions that impact the likelihood of achieving the earnout. The appropriate duration depends on the specific performance metric, the industry context, and the business's operating rhythm.

### *04 Plan how the cash earnout component will be funded*

Even if an earnout is only payable upon reaching a performance hurdle, entrepreneurs should plan for its funding. If the earnout is paid in cash, it is important to consider where the money will come from—cash on the balance sheet, new debt, new equity, or a combination of these. Relying on balance sheet cash has clear opportunity costs: The cash could be used to further invest in and grow the business, which could generate higher returns. Additionally, the cash may be needed for daily operations, and using it for the earnout could create strain and push debt covenants closer to violation with less margin of safety.

If cash needs to be raised, whether through debt or equity, there are other implications. Too much debt is never ideal. CEOs should aim for the optimal capital structure and maintain some buffer for their debt covenants. Additional debt can reduce cash flow due to higher interest payments. Raising equity may be costly, and an unexpected raise—if investors were not aware they would need to help pay the earnout—could incur extra costs from investors, such as a higher liquidation preference or dilution of the CEO's equity, all of which can notably impact the ETA kingpin's economics. Funding an earnout with fresh equity or debt can have serious economic consequences. It will definitely dilute the CEO's potential gains, and the impact could be significant. In **Exhibit 1**, we provide an illustrative model detailing the implications of having no earnout, of funding an earnout with debt, and of funding an earnout with equity. In our imagined, but realistic scenario, the CEO's net proceeds drop from \$2.9 million with no earnout to \$1.7 million when an earnout is financed with new equity. We also assume that the new equity is issued on terms

identical to the legacy funds, meaning it could be worse. We use identically sized businesses in our various scenarios, assuming that a steely buyer can avoid the earnout completely, while a lackadaisical buyer hastily serves up an earnout in the negotiation process (an expensive sin).

Just because a business shows strong profit and loss statement results does not mean there is free cash available for a large contingent payment. Especially in capital-intensive businesses or those with aggressive growth plans that need cash for expansion, liquidity can be tight when the earnout becomes due. ETA buyers should model multiple scenarios—including full payout of the earnout—and assess how that obligation might impact debt covenants, operational flexibility, shareholder returns, and most importantly, their own economic vesting.

## Potential pitfalls when using earnouts

Although we do not believe we have painted earnouts as a cure-all, if we have, we have done our readers, students, and entrepreneurs a disservice. Earnouts, as we previously mentioned, are just one of many tools to consider in an ETA sojourn. They are not a panacea and are riddled with pitfalls in design, structure, and results. Earnouts are infused with unintended consequences and possible missteps. No matter how well-architected they are, and even when paired with the best seller and buyer intentions, there is a wide berth for things to go wrong. Unfortunately, this is inevitable when two parties and money are involved. For instance, buyers worry that they will do a lot of work to improve the business and end up paying a large earnout to the seller. ETA buyers want to avoid free-rider sellers who benefit unfairly from an earnout without making a contribution. Another concern from the seller's side is that the buyer might overinvest in the company after closing, resulting in suppressed profits, hoping to earn a windfall once the earnout period ends. Despite these concerns, earnouts bring parties together when they are at a logjam.

We are certainly not suggesting that earnouts should be outright avoided, but ETA participants must approach them with eyes wide open and a full grasp of the potential downsides. In this section, we will discuss a tetrad of pending pitfalls (**Figure 8**) that ETA CEOs face when embracing earnouts.

### Figure 8: Four likely pitfalls in the earnout realm

- 01 Having misalignment between buyer and seller
- 02 Being unprepared for potential time and financial costs
- 03 Not establishing clear operational control norms
- 04 Not having crisp dispute resolution protocols

#### 01 *Having misalignment between buyer and seller*

Earnouts are often portrayed as a win-win for both the buyer and the seller. However, once the deal closes and daily operations start, subtle and sometimes obvious conflicts of interest—both financial and operational—can emerge.

Financially, we have found that even the most carefully designed earnout structures, with nearly perfect triggers linked to both the income statement and the balance sheet, will likely still cause some misalignment between buyer and seller. Most earnout triggers are limited to the period right after closing, while CEOs and their boards mainly focus on long-term equity value creation.

Operationally, sellers may expect some involvement after closing in most deals, especially if earnouts are part of the agreement. The seller, who has built the business over many years, might think the best strategy is aggressive investment in sales, while the buyer may focus more on debt covenants and controlling costs as they settle into their role as CEO. If the seller believes that a major part of their job after closing is to boost sales with the derivative consequence of meeting the earnout, frustration and tension may develop in the relationship. Sellers often find it hard to let go emotionally and operationally, and the use of the earnout, almost by design, prolongs that challenging period. On the other hand, buyers should be cautious about relying on earnouts to keep sellers involved long enough for critical knowledge and relationships to transfer – once the chance of reaching the earnout goal decreases, CEOs might lose the interest of a seller who is still essential to the operation. We recommend that the specific handover period and necessary actions be contracted and compensated separately from the earnout terms.

One potential way to reduce seller misalignment is to avoid using an earnout and instead generously compensate the seller for specific services, such as sales. The CEO can establish normal guardrails and reject any unpromising prospects just as they would with any other salesperson.

As a mitigation, we believe it is worthwhile to invest considerable time up front to ensure full alignment not only on the numbers but also on operations, roles, and expectations after closing the transaction. It is essential to focus not just on the letter of the contract but also on developing a shared mental model of how the enterprise will be managed after closing.

The issues of misalignment and potential bad-faith behavior are not one-sided. While we root for ETA CEOs every day and believe most are well intentioned and trustworthy, CEOs have a strong incentive to avoid paying earnouts. For example, if a \$4 million earnout depends on hitting a \$2.4 million EBITDA threshold, up from the acquired \$2 million after two years, the CEO will likely try to get as close to \$2.4 million as possible without exceeding it. They might even frontload discretionary expenses to lower EBITDA and avoid paying the earnout – CEOs might even argue they have a fiduciary duty to their investors to use reasonable means to sidestep such payments.

### 02 *Being unprepared for potential time and financial costs*

Closing the deal can feel like reaching the finish line, but including an earnout in the transaction simply shifts negotiations into the earnout period. Unfortunately, it is really just the start of another race. Managing earnouts can be administratively and contractually burdensome. Performance needs to be monitored across various trigger metrics, and interpretations of impactful items and how to handle them consume managerial and mental resources and can strain relational capital with the seller, all of which could otherwise be used to grow the business.

Besides opportunity cost, there is often a real expense involved. There is a well-known aphorism in the search fund world that *an earnout is basically an agreement to sue each other later*. After all, a seller is likely to sue unless the earnout is fully met, following a strategy of believing that some settlement might be better



than nothing. If a pending earnout is worth \$250,000 and the buyer is balking at payment, the seller can easily invest \$10,000 in a legal claim hoping to recover something from the buyer to avoid litigation and operational headaches. In a 2009 opinion, Vice Chancellor Laster of the Court of Chancery of Delaware wrote, “since value is frequently debatable and the causes of underperformance equally so, an earn-out often converts today’s disagreement over price into tomorrow’s litigation over the outcome.” We advise CEOs to be aware of the risk of future litigation and the financial and emotional resources that might be needed to resolve such issues. Beyond legal costs, it is also common to see the ongoing need for service providers (like accountants, lawyers, and auditors) to assist with calculations and interpret the original deal terms.

We encourage ETA CEOs to consider earnouts as long-term financial commitments, allocate specific budgets for such additional professional services, and develop a clear plan with their boards on who will actively support the CEO through any future litigation that might occur.

### *03 Not establishing clear operational control norms*

Failing to establish clear operational control norms is possibly one of the biggest flaws when using earnouts in ETA. Historically, earnouts were mainly created and used in control private equity and growth equity deals, where the sellers and their management teams remained fully in charge after closing. The issue of operational control and decision-making was never in dispute, and the party expecting to receive the earnout almost entirely controlled decisions that could trigger the payout. In ETA, however, we often want the opposite by design. Most ETA deals depend on the new CEO quickly taking control, with the seller being operationally absent either before or shortly after the transaction.

When earnouts are part of ETA transactions, it is essential to clearly define the control and decision-making powers the seller will retain after closing. If at all possible, buyers should avoid letting sellers sit on the board of directors, have significant veto rights, or hold other influential roles over governance, hiring, investment, and operations. Once the transaction is complete, the ETA CEO, supported by their board, should be responsible for managing the business.

### *04 Not having crisp dispute resolution protocols*

Earnout disputes often happen not because people act in bad faith, but because the earnout language is vague or open to interpretation. Even the best-designed earnout will likely still have some gray areas, and when the amounts involved become large enough, the chance to simply compromise decreases.

We often tell CEOs regarding the process of drafting legal documents for closing a deal, “If you ever need to read these documents again, it’s because something’s gone wrong.” When it comes to dispute resolution on earnout payments, consider that the documents are unlikely to be re-read if everything has gone smoothly. More often, the documents are reviewed again because things have not gone as planned, which is exactly when CEOs want documents that are clear, concise, and designed to deliver a quick and fair outcome.

We recommend that searcher CEOs who are considering adding an earnout to their closing agreements consult experienced counsel familiar with such disputes. We also advise using clear and objective measurement metrics and definitions; pre-identifying a neutral or mutually trusted accounting and legal expert to serve as the final arbiter on earnout calculations; establishing clear timelines for raising, reviewing,

and resolving disputes; and deciding whether experts' decisions will be binding and how costs will be allocated in various cases.

Of particular emphasis is the recommendation to agree beforehand on neutral accounting and legal interpreters who can settle disputes without court cases. Naturally, the buyer's lawyers and accountants are representatives who will defend their client's interests. The same applies to the seller side. However, an unbiased third party might help resolve issues quickly and fairly. A well-drafted dispute resolution clause probably will not eliminate disagreements entirely, but it can help reduce the costs and emotional stress of long negotiations or full legal disputes.

## Common misperceptions surrounding earnouts

Despite their widespread use in ETA transactions, earnouts are often misunderstood—sometimes intentionally, sometimes accidentally. Misconceptions can distort negotiations, create false reassurance, and cause surprises after closing. We will examine four of the most common myths we encounter when advising or observing ETA entrepreneurs (**Figure 9**).

**Figure 9: A quadruplet of common misperceptions surrounding earnouts**

- 01 If the earnout is paid from the business, it is costless
- 02 The earnout does not impact the EBITDA multiple paid
- 03 The business is bigger so the earnout was worthwhile
- 04 Operationalizing an earnout will be easy

### 01 *If the earnout is paid from the business, it is costless*

Some buyers claim that when an earnout is funded entirely from the company's post-close cash flows, it is nearly free. This is an appealing but flawed belief. Every dollar paid to a seller in an earnout is a dollar not used for growth, debt reduction, or distribution to shareholders. It involves an opportunity cost, even if the funds come from within the company. Additionally, CEOs who use free cash flow to fund the earnout might put the business at risk, potentially requiring them to raise capital on more expensive terms.

Although the payment may not come directly from investors' dollars, it reduces the total cash flow available to the new owners that could have been used to grow or expand the business. Treating an earnout as costless is like assuming a credit card purchase is free because cash was absent—the bill still comes due, and it still decreases future spending power.

### 02 *The earnout does not impact the EBITDA multiple paid*

A common misconception is that because an earnout is contingent, it should be excluded from the articulated purchase multiple. In practice, sophisticated ETA buyers need to include it when assessing valuation. If the contingent amount is likely to be earned based on realistic projections, it is part of the true

purchase price. Ignoring it can make a deal appear cheaper than it really is, distort return calculations, and lead to overconfidence in post-close spending or debt decisions. An earnout is not a bonus price; it is deferred consideration, and if it is probable, it should be included in the headline multiple just as much as the cash paid at close.

For an actual example, a searcher pitching a 5.5x EBITDA acquisition to investors overlooked a three-year earnout that could lead to a payout. When the targets were achieved, the retrospective actual multiple increased to 7.1x EBITDA, surpassing precedent market transactions. The initial falsely favorable valuation had already triggered an aggressive capital program and an add-on acquisition, both of which strained liquidity. When the earnout was due, the company's returns appeared much less attractive than initially projected.

### *03 The business is bigger so the earnout was worthwhile*

Post-close growth can make an earnout seem justified, as the seller only received more because the business became larger or more profitable. This logic is appealing, especially when the headline numbers look impressive. However, just because the business is bigger does not automatically mean the earnout was a good deal for the buyer.

The essential question is whether the buyer could have achieved the same upside without the contingent obligation. If the growth was inevitable—simply a result of purchasing a strong business, market tailwinds, or operational momentum already in place—then the earnout may have just shifted value back to the seller that the buyer would have gained anyway. If sellers knew this or had market power, they would demand the earnout or higher valuations; however, many buyers might be impetuously offering an earnout when it is not necessary. Likewise, if the upside mainly came from buyer-led initiatives, such as launching new products, improving sales processes, or making capital investments after closing, then the seller's additional payment was essentially earned through the buyer's own efforts.

Additionally, when buying a business, buyers estimate projected cash flows that incorporate some built-in growth expectations. This is reflected in the initial valuation. Entering into an earnout that pays the seller for achieving the already assumed growth results in a double benefit. The earnout should only reward growth that surpasses the expected amount.

In these situations, the earnout changes from being a risk-sharing tool to basically a retroactive price increase. Size alone does not prove value creation for the buyer; it can just as easily mean overpayment.

### *04 Operationalizing an earnout will be easy*

On paper, earnouts can seem simple: Define the metric, set the time period, measure, and if the metric is met, make payment. The logic is clear, the math looks neat, and PowerPoint slides reassure everyone that this is a mechanical, low-friction process. However, in practice, operationalizing an earnout is rarely so straightforward. Both buyers and sellers may see it as deferred consideration without realizing it could actually be deferred litigation.

External market factors and post-close strategic shifts can all make calculating the agreed-upon metric more complex than envisioned. For example, metrics such as annual recurring revenue (ARR) can be muddled by late renewals, bundled pricing, or one-off service revenue.

These complications are amplified by human dynamics. A seller accustomed to full control may see changes in strategy as efforts to reduce the likelihood of the earnout, while a buyer might view the seller's push for certain inclusions as opportunistic. Even minor differences in trust, communication style, and decision-making speed can turn routine metric discussions into prolonged debates. Without careful planning to address these friction points and proactive relationship management to preserve goodwill, the earnout period can shift from cooperation to conflict, requiring more executive attention than anticipated.

### Mini profile



Jacobo Vera Artazcoz (INSEAD 2021) grew up in Pamplona, Spain, and moved to the United States at age 18 on a soccer scholarship to Penn State University, where he earned a degree in economics. After a decade in consulting, he pursued his MBA at INSEAD, where he developed a passion for the search fund model. In January 2022, he launched Arcadio Investments and, after an 18-month search, he acquired [Libnova](#), a SaaS company specializing in digital preservation solutions, in July 2023.

When we negotiated the Libnova deal, the seller was insistent that his optimistic growth projections be reflected in the price. I understood that paying for uncertain future performance up front was risky, so an earnout became the clear compromise. It allowed him to realize the value he believed existed without forcing us to overpay initially.

Still, reaching an agreement on the earnout remained difficult. We initially linked it to EBITDA, but I quickly recognized that would cause too much operational interference. We then switched to annual recurring revenue, but even defining the thresholds was contentious. The first year's target was met easily. The second year revealed the challenges: Projections were overly optimistic, and the seller struggled with the loss of control after fourteen years as the main decision-maker.

The earnout was crucial in securing the acquisition, and I would use one again. Looking back, however, I would have negotiated stronger legal protections, especially concerning non-compete and non-solicitation clauses, and established a minimum transition period separate from the earnout. The experience reinforced an important lesson: If the seller is the key to the business and possesses most of the operational knowledge, an earnout can be very risky. It's essential to plan the divorce terms alongside the marriage from the start.

### Conclusion

There are many valid reasons why both buyers and sellers might embrace earnouts in an ETA transaction. Fundamentally, earnouts are a way to agree to disagree today, wait and see what the future brings, and then true up accordingly. However, earnouts also come with pitfalls such as seller misalignment, being unprepared for the earnout period, financial costs, unclear operational control norms, and a lack of dispute

resolution procedures. Despite what might seem like a simple and graceful way to share risk and bridge valuation gaps, earnouts are complex and need to be crafted with care and forethought to prevent future conflicts. Buyers should carefully consider the trigger metric, the currency used to satisfy the earnout, the duration of the earnout, and how the cash portion will be funded. Approaching these terms conscientiously will likely improve the chances of success.

Earnouts are not a panacea. They can help close a deal, but ETA CEOs should not mistakenly believe that satisfying the earnout from the business's free cash flow means it is free, or that an earnout does not impact the effective EBITDA multiple paid. Additionally, operationalizing an earnout will likely be challenging.

We hope this note has provided a foundational introduction to all things earnout. Earnouts can be a useful tool, but we strongly encourage entrepreneurs to proceed with caution and even a little trepidation.

Good luck with your search fund acquisition. If you decide to use an earnout, we hope it goes smoothly, simply, and successfully. We wish you happiness and fulfillment in your ETA CEO role, and as always, we are enthusiastically cheering you on!

Exhibit 1: Illustrative earnout math implications under various scenarios<sup>‡</sup>

Returns To Investors						Acquisition Assumptions		
	Year 1	Year 2	Year 3	Year 4	Year 5			
<b>MOIC</b>								
Scenario 1 - No Earnout Paid	1.5x	1.9x	2.4x	2.9x	3.6x	Entry Multiple	5.0x	
Scenario 2 - Earnout Paid With Debt	1.5x	1.5x	1.9x	2.4x	3.0x	Enterprise Value	\$10,000,000	
Scenario 3 - Earnout Paid With Equity	1.5x	1.3x	1.6x	2.0x	2.4x	Debt %	50%	
						Equity %	50%	
						Interest Expense	7.5%	
<b>IRR</b>								
Scenario 1 - No Earnout Paid	47%	38%	34%	31%	29%	<b>Operations Assumptions</b>		
Scenario 2 - Earnout Paid With Debt	47%	21%	24%	25%	25%	Acquired EBITDA	\$2,000,000	
Scenario 3 - Earnout Paid With Equity	47%	21%	22%	22%	22%	EBITDA Growth Rate	10%	
						FCF Conversion (Pre-Interest)	50%	
<b>Searcher Economics</b>								
Scenario 1 - No Earnout Paid	454,233	966,324	1,586,803	2,284,854	2,906,684	<b>Earnout Assumptions</b>		
Scenario 2 - Earnout Paid With Debt	454,233	210,091	671,169	1,288,144	1,890,061	Earnout Value	\$3,000,000	
Scenario 3 - Earnout Paid With Equity	454,233	210,091	629,509	1,187,105	1,720,709	Earnout Year	Year 2	
<b>Financials</b>								
(\$)	At Acquisition	Year 1	Year 2	Year 3	Year 4	Year 5		
EBITDA	2,000,000	2,200,000	2,420,000	2,662,000	2,928,200	3,221,020	<b>Exit Assumptions</b>	
EBITDA Growth Rate		10%	10%	10%	10%	10%	Exit Multiple Increase	0.25x
							Liquidation Preference	1.00x
Enterprise Value	10,500,000	12,100,000	13,915,000	15,972,000	18,301,250	20,936,630	Preferred Return	8%
Exit Multiple	5.25x	5.50x	5.75x	6.00x	6.25x	6.50x	Searcher Common Ownership	25%
							Searcher Common subject to Net Investor I	33%
							Performance IRR Lower Band	20%
							Performance IRR Upper Band	35%

Scenario 1 - No Earnout Paid							
(\$)	At Acquisition	Year 1	Year 2	Year 3	Year 4	Year 5	
Total Debt Invested	5,000,000	5,000,000	5,000,000	5,000,000	5,000,000	5,000,000	
Total Equity Invested	5,000,000	5,000,000	5,000,000	5,000,000	5,000,000	5,000,000	
Total Invested Capital	10,000,000	10,000,000	10,000,000	10,000,000	10,000,000	10,000,000	
<b>Enterprise Value</b>		<b>12,100,000</b>	<b>13,915,000</b>	<b>15,972,000</b>	<b>18,301,250</b>	<b>20,936,630</b>	
(-) Debt		(5,000,000)	(5,000,000)	(5,000,000)	(5,000,000)	(5,000,000)	
(+) Cumulative Free Cash Flow		725,000	1,560,000	2,516,000	3,605,100	4,840,610	
<b>Equity Value</b>		<b>7,825,000</b>	<b>10,475,000</b>	<b>13,488,000</b>	<b>16,906,350</b>	<b>20,777,240</b>	
(-) Searcher Economics		(454,233)	(966,324)	(1,586,803)	(2,284,854)	(2,906,684)	
<b>Equity Value To Investors</b>		<b>7,370,767</b>	<b>9,508,676</b>	<b>11,901,197</b>	<b>14,621,496</b>	<b>17,870,556</b>	

MOIC	1.5x	1.9x	2.4x	2.9x	3.6x
IRR	47%	38%	34%	31%	29%

Scenario 2 - Earnout Paid With Debt							
(\$)	At Acquisition	Year 1	Year 2	Year 3	Year 4	Year 5	
Total Debt Invested	5,000,000	5,000,000	8,000,000	8,000,000	8,000,000	8,000,000	
Total Equity Invested	5,000,000	5,000,000	5,000,000	5,000,000	5,000,000	5,000,000	
Total Invested Capital	10,000,000	10,000,000	13,000,000	13,000,000	13,000,000	13,000,000	
<b>Enterprise Value</b>		<b>12,100,000</b>	<b>13,915,000</b>	<b>15,972,000</b>	<b>18,301,250</b>	<b>20,936,630</b>	
(-) Debt		(5,000,000)	(8,000,000)	(8,000,000)	(8,000,000)	(8,000,000)	
(+) Cumulative Free Cash Flow		725,000	1,560,000	2,291,000	3,155,100	4,165,610	
<b>Equity Value</b>		<b>7,825,000</b>	<b>7,475,000</b>	<b>10,263,000</b>	<b>13,456,350</b>	<b>17,102,240</b>	
(-) Searcher Economics		(454,233)	(210,091)	(671,169)	(1,288,144)	(1,890,061)	
<b>Equity Value To Investors</b>		<b>7,370,767</b>	<b>7,264,909</b>	<b>9,591,831</b>	<b>12,168,206</b>	<b>15,212,179</b>	
		<b>1,100,000</b>	<b>2,310,000</b>	<b>3,641,000</b>	<b>5,105,100</b>	<b>6,715,610</b>	

MOIC	1.5x	1.5x	1.9x	2.4x	3.0x
IRR	47%	21%	24%	25%	25%

Scenario 3 - Earnout Paid With Equity							
(\$)	At Acquisition	Year 1	Year 2	Year 3	Year 4	Year 5	
Total Debt Invested	5,000,000	5,000,000	5,000,000	5,000,000	5,000,000	5,000,000	
Total Equity Invested	5,000,000	5,000,000	8,000,000	8,000,000	8,000,000	8,000,000	
Total Invested Capital	10,000,000	10,000,000	13,000,000	13,000,000	13,000,000	13,000,000	
<b>Enterprise Value</b>		<b>12,100,000</b>	<b>13,915,000</b>	<b>15,972,000</b>	<b>18,301,250</b>	<b>20,936,630</b>	
(-) Debt		(5,000,000)	(5,000,000)	(5,000,000)	(5,000,000)	(5,000,000)	
(+) Cumulative Free Cash Flow		725,000	1,560,000	2,516,000	3,605,100	4,840,610	
<b>Equity Value</b>		<b>7,825,000</b>	<b>10,475,000</b>	<b>13,488,000</b>	<b>16,906,350</b>	<b>20,777,240</b>	
(-) Searcher Economics		(454,233)	(210,091)	(629,509)	(1,187,105)	(1,720,709)	
<b>Equity Value To Investors</b>		<b>7,370,767</b>	<b>10,264,909</b>	<b>12,858,491</b>	<b>15,719,245</b>	<b>19,056,531</b>	

MOIC	1.5x	1.3x	1.6x	2.0x	2.4x
IRR	47%	21%	22%	22%	22%

<sup>‡</sup> A special thanks to Jake Wasserstein, an Associate at Peterson Partners, for building the mathematical model.

Exhibit 2: An earnout checklist

**1 Do I believe I truly need an earnout to win the deal, or am I offering it to avoid a difficult conversation?**

**2 Have I explored other possible instruments to bridge a valuation gap?**

- Can a paid consulting agreement serve a similar purpose?
- Could we raise the price slightly and pay it off over a longer period using a seller note?
- Can we better align incentives by allowing the seller to roll equity alongside me and my investors?

**3 What am I aiming to solve with the earnout?**

- Am I solving for a valuation gap—meaning, is the seller asking for it?
- Am I trying to incentivize ongoing support from the seller—that is, am I the one who wants it?
- Am I just trying to delay payment to free up some cash flow?

**4 What metric should I use, and why?**

- Can I tie the earnout to a specific action I want from the seller, such as converting on-premises software to the cloud or renewing a particular contract?
- Will the metric support sustainable long-term value creation?
- Does the metric consider both income statement and balance sheet factors? For example, what specific margin must revenue meet and within what timeframe must it be collected?
- Are other balance sheet actions, such as raising additional debt or conducting M&A, clearly included in my trigger mix? For example, does acquired EBITDA or revenues count or not, and are we allowed to raise debt to reach the triggers?
- Who will control the metric in question? Will I control it, or will the seller? Have we clearly defined post-closing roles and responsibilities?
- Would the seller be comfortable handing over full operations, given the chosen metric?
- How could this metric create potential conflicts of interest between me and the seller, and possibly with my board?
- Does the metric pose a potential moral hazard for me?
- Do I have a metric with a steep cliff, or have I created a smooth payoff curve?
- Have I considered the ways in which the metric is imperfect and the ways in which it can be manipulated by the seller?
- Have I discussed a clear conflict resolution approach with the seller, and are we aligned on it?
- Are my selected metrics clear, objective, measurable, and unambiguous?
- Is my earnout window clearly defined, and does that time period make sense? Have I opted for the shortest possible period?

**5 How will I finance the earnout?**

- Is the earnout fundable from free cash flows? In which scenarios might it not be?
- How will the earnout be paid if not from free cash flows?
  - Have I arranged a debt standby facility?
  - Has the seller agreed to accept a seller note or delayed payment if the earnout becomes due?
  - Would the seller be open to accepting equity as payment for the earnout value if needed? If yes, have we agreed on the valuation methodology?
  - Under what conditions could I raise additional equity from my investors if needed? Do I have clear anti-dilution provisions up to a specific equity amount?

**6 How long will it take to measure and verify the earnout trigger? Can I make the trigger measurement subject to an audit that will provide more time to generate cash flow?**

**7 How will we track the trigger and process?**

- Will the earnout trigger be discussed at each board meeting?
- Can I designate a board member to help with earnout negotiations to prevent my first year as CEO from being spent arguing with the seller?
- If this becomes a battle, can we agree on simple settlement methods, even if they are costly?
- Am I prepared for the emotional, financial, and time toll this will take if it becomes a disputed payment? Do I have advisors and board members who have experienced such a scenario and can offer support?

**8 All things considered, am I better off using a simpler and clearer form of post-closing contingency, such as paying a little bit more but using a vendor note instead of an earnout?**

This case has been developed for pedagogical purposes. The case is not intended to furnish primary data, serve as an endorsement of the organization in question, or illustrate either effective or ineffective management techniques or strategies.

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## Endnotes

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<sup>2</sup> Niel Wyma is co-founder and partner of Ambit Partners, a global institutional investor in search funds. He is also a lecturer on Entrepreneurship through Acquisition at the University of Cape Town's Graduate School of Business and the University of Pretoria's Gordon Institute of Business Science (GIBS).

<sup>3</sup> A. J. Wasserstein is the Eugene F. Williams, Jr., Senior Lecturer in the Practice of Management at the Yale School of Management.

<sup>4</sup> Jacob, Denny. "PepsiCo to Buy Prebiotic Soda Brand Poppi for \$1.95 Billion." WSJ, The Wall Street Journal, 17 Mar. 2025, [www.wsj.com/business/retail/pepsico-to-acquire-prebiotic-soda-brand-poppi-for-1-95-billion-94b8f773?mod=Searchresults\\_pos1&page=1](https://www.wsj.com/business/retail/pepsico-to-acquire-prebiotic-soda-brand-poppi-for-1-95-billion-94b8f773?mod=Searchresults_pos1&page=1).

<sup>5</sup> McNulty, John. "One Equity Carves Wheeler Fleet from Publicly Traded VSE." Pepprofessional.com, 21 Feb. 2025, [pepprofessional.com/2025/02/one-equity-carves-wheeler-fleet-from-vse/](https://pepprofessional.com/2025/02/one-equity-carves-wheeler-fleet-from-vse/).

<sup>6</sup> Igarashi, Linda, and Eugene Choi. Practical Guidance<sup>®</sup>: A Practical Guidance<sup>®</sup> Practice Note by Section on Recent Earn-Out Litigation Developments Market Trends 2021/22: Earn-Outs in Public-Private Deals.

<sup>7</sup> SRS Acquiom 2025 M&A Deal Terms Study.