

Navigating tariffs and M&A transactions: bridging the valuation gap with contingent consideration

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Recent tariffs imposed by the Trump Administration have led to an abrupt slowdown in M&A transactions that has been eerily similar to the initial pause in dealmaking caused by the COVID-19 pandemic. Whether target companies will meet or exceed expected financial performance given the inflationary impact on the cost of goods globally is uncertain to say the least, and, as is often the case, this uncertainty is having a dampening effect on deals.

Indeed, public market instability, with the Dow Jones Industrial Average shedding over 4,000 points and the S&P 500 losing 12% of its value as tariffs were being rolled out, has also spilled over into private transactions (<https://bit.ly/4jtRiGL>). A lack of confidence in boardrooms and with executive teams has had the most chilling effect on dealmaking that we have seen since 2020.

That the Trump administration announced tariffs in the first few months of the presidency should not come as a significant surprise to corporate executives. Trump repeatedly suggested on the campaign trail that he would implement tariffs at the beginning of his presidency. Indeed, Trump had promised a baseline tariff of 10% to 20% on imports, with imports from China, Mexico, and Canada assessed at a higher rate.

Many financial and economic disruptions are caused by “black swan” events that are rare, unpredictable, and consequential. Examples in the 2000s include the 9/11 terrorist attacks, the 2008 global financial crisis, and the COVID-19 pandemic. The economic disruption caused more recently by tariffs is consistent with what some would call a “grey swan event,” or an event that, when it occurs, has a significant impact, but, while predictable, is often minimized or overlooked. Given Trump’s statements during his campaign, tariffs should have been predictable, and the reaction more muted, but consistent with “grey swans,” the fallout was mostly overlooked.

Notwithstanding that tens of thousands of M&A transactions are completed worldwide every year (approximately 36,000 in 2024, according to Statista, a global data and business intelligence platform (<https://bit.ly/3SbXE1v>)), most are actually very difficult to push over the finish line. Any one of a dozen issues specific to the parties, the business, the industry in which the business operates, or macroeconomic factors, among others, can derail any deal.

With that said, neither grey swan nor black swan events have to lead to an inevitable conclusion that deals should be put on hold, particularly when there are creative ways for parties to reach agreement on the value of the business being sold despite the uncertainty caused by macroeconomic events.

Divergent expectations create deal risk

In business transactions, it is not uncommon for parties to encounter a valuation gap that may result in stalled negotiations or, in the worst scenarios, the entire deal being put at risk. The conflict occurs when there is a material difference between the valuation expectations of the buyer and seller.

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Under ordinary circumstances, a company’s valuation and purchase price are usually the most contested elements of a business deal. The focus on purchase price only heightens during volatile economic times, where there is little froth in the market that masks overpaying.

Valuation gaps arise for many reasons, including different perceptions of risk and current market conditions. Encountering a valuation gap does not always need to lead to a busted deal. Instead, contingent consideration can be used to help bridge the disparities in valuations and risks.

Bridging the gap: contingent consideration

Contingent consideration is where some of the purchase price is tied to post-closing financial performance or post-closing

milestone performance. It is useful to rectify inconsistency in valuations and risks and allow flexibility in the structure of the deal.

Contingent consideration can benefit the buyer by reducing the initial capital used to acquire the target company and can provide an incentive for the company's management to be involved in the business after closing. Contingent consideration is a "win-win" given that it can also benefit the seller by achieving a higher purchase price if the company performs well or achieves certain metrics post-closing.

One of the most common contingent payments is an earn-out. An earn-out is a form of consideration in which the buyer agrees to pay additional purchase price value usually in the form of cash or rollover equity interests if the business that was sold achieves certain financial performance milestones or it achieves non-financial milestones, such as product development, key employee retainage, regulatory approvals, and ensuring new clients and innovations. Rollover equity allows the buyer to pay part of the purchase price by issuing equity to the seller in the buyer entity and allows the seller to benefit in the future potential value of the business.

Key considerations in structuring contingent consideration

There is no "market" approach to structuring contingent consideration. Rather, the terms of the earn-out are flexible and largely dependent on what works best in light of the size and nature of the business and the parties' main objectives and concerns.

While contingent consideration can benefit both the purchaser and seller by aligning interests, increasing coordination and mitigating each party's financial risks attributable to a potential gray swan event, it also adds complexity to the transaction and, if not done thoughtfully, increases the potential for disputes.

Therefore, it is important to: (i) be clear and objective in defining the performance metrics, (ii) have a robust dispute resolution mechanism, and (iii) involve financial and tax specialists early in the transaction.

The following should be considered when structuring an earn-out:

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- **Earn-out period:** An earn-out will be measured over a specific period — usually this is between one and three years following deal completion. It is important to identify a period that is expected to allow the performance metrics to be satisfied but that does not encourage short-term action, such as accepting low margin work to increase revenue or not investing in capital expenditure.
- **Performance metrics:** An earn-out will include a performance metric which, if satisfied, will result in the payment of additional consideration to the seller. The metric is typically financial — such as EBITDA, revenue or sales targets — but can also include other, non-financial metrics that are appropriate to the business. It is important that the parties are aligned on the performance metrics and how achievement will be measured.
- **Operations of the business:** If a portion of the up-front purchase price is reduced to bridge the gap on price and align interests of the parties, the seller will typically want to maintain some level of operational control of the business during the earn-out period.
- **Post-close retention incentives:** In addition to being a useful pricing mechanism, an earn-out is also often used to financially incentivize key employees to stay with the business during the transition period. If the key employee is an owner of the seller, it is important to properly analyze the tax implications.

Customizing the solution for each deal

Completing M&A transactions in any environment is difficult, and the difficulty is exacerbated in volatile economic times. With that said, creative deal structuring can help to bridge gaps, making it so that good deals with strong underlying fundamentals and potential do not have to be put on hold.

While the time-tested strategies to manage valuation gap issues can often serve as a starting point, more often than not they need to be adapted either to entirely unforeseen or extremely unlikely and unpredictable circumstances. Creating bespoke solutions inspired by time-tested techniques is key to seizing opportunities no matter the climate and positioning for long-term success.

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