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Applying Lean Analytics to Performance Metrics in M&A Earnouts

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Abstract

Ever since the dawn of internet, a new wave of fast-growing software companies has emerged. To overcome the uncertain future in M&A of these companies, a contractual provision called earnout is often used. An earnout is a contractual provision in a M&A-deal that states the seller of the business is to obtain additional compensation in the future if the business achieves certain metrics.

The purpose of this study is to contribute to practice and nascent literature by exploring and evaluating metrics for SaaS-companies that can be used in earnouts. The study applies Lean Analytics to suggest a framework for choosing what metrics to use, and discusses how to avoid sub-optimisation and metric manipulation. The study combines a literature and thought leader review and interviews to explore certain areas, with a case study that applies the findings.

The study suggests that for acquisitions where the objective is to access talent, technology or accelerate product road-map, earnouts should in most cases not be used at all. If the acquisition is made based on financial objectives, Lean Analytics can be used to determine what stage the seller's company is in. The study suggests that the most suitable earnout metric for M&A based on financial objectives is monthly recurring revenue (MRR). The metric must be clearly defined so it cannot be manipulated. The reason why many other metrics from Lean Analytics cannot be used is that they are vulnerable to manipulation and can restrict the operating freedom for the entrepreneur.

Keywords: Lean Analytics, mergers and acquisitions, SaaS, earnouts, SaaS metrics, startups, technology, venture capital.

1 Background

Since the late 1990s, a new type of company has emerged: the fast-growing technology startup. These fast-growing startups are usually highly unprofitable and often show close to no revenue. Yet, what originally looked like ludicrous pyramid schemes with no signs of profitability, has turned into the hegemonic incumbents of the 21st century. As the venture capital funds, who are investing in these companies, seek to return money to their investors, the M&A activity for small and fast-growing technology companies has skyrocketed. Traditionally, the valuation of a company has been tied to its revenues, profits and cash-flow in combination with a market-based approach. However, this is not an applicable model when a company may have very low revenue but extremely high growth. A common way to overcome this problem in M&A is to use a mechanism called earnout. An earnout is a contractual provision in a M&A-deal that states the seller of the business is to obtain additional compensation in the future if the business achieves certain objectives or metrics. A very simplified example could be:

“A company gets sold at a valuation of £10M. The earnout provision then states that sellers will obtain an additional payment of £10M if they manage to grow revenue by 200% during the next twelve months. In this case annual revenue growth is the metric used in the earnout, 200% is the milestone and one year is the length of the earnout”

The core problem with earnouts is that they are designed for traditional profitable companies but applied for early stage technology businesses. Since a significant share of earnouts lead to disagreement over outcome, many argue that earnouts simply converts today's disagreement over price into tomorrow's legal litigation over the outcome. Clearly, the only parties benefiting from litigations are the lawyers who write the contracts and can earn additional fees. During the past 15 years, a new field of management literature has been written to help entrepreneurs manage the risk and high uncertainty that is in the nature of startups. Lean analytics is an expansion of the lean startup methodology focusing on the “measure” stage in the build-measure-learn cycle. The methodology focuses on finding the right and action-

able metrics that matter for start-ups and to provide a methodology for setting objectives. This dissertation, focus on using nascent startup literature to create a better way of valuating, selling and acquiring early stage software-as-a-service (SaaS) companies through the use of earnouts. In particular, it will focus on using tailored software metrics in earnouts as opposed to traditional accounting metrics such as: revenue, EBIT, EBITDA and profit.

2 Purpose

The main purpose of the thesis is to provide a framework for using earnouts in SaaS M&A that is fit for purpose and constructed for innovation rather than built from the traditional principles of accounting and finance. The objective is to provide a process for determining earnout metrics, to explore whether metrics from Lean Analytics can and should be used in earnouts, and to provide recommendations on how to avoid reaching the earnout metrics through sub-optimisation . By doing so the author hopes to give entrepreneurs, venture capitalists and corporate development teams a better way to use earnouts in the M&A process for SaaS-businesses.

3 Methodology

In order to answer the research questions, a qualitative, exploratory and abductive methodology was used. The study combines a literature review and interviews to explore certain areas, with a case study that applies the findings. The interviews were conducted in a semi-structured manner with people with insights into the M&A process for early stage technology companies, and the acquisition strategies of large technology incumbents. GetAccept AB was used as case study company, and their data was analysed both quantitatively and qualitatively. Finally, the findings from the literature review and the interviews were together with the empirical data from the case company applied to construct a fictional earnout for GetAccept.

4 Theoretical framework

The theoretical framework is used to get a thorough understanding of SaaS-metrics through Lean Analytics, as well as how earnouts work and the practical issues around using them.

Lean Analytics presents a framework of metrics that should be analysed depending on what stage the company is in. It is the foundation of the analysis of the case study company's empirical data. Key concepts include:

- *Monthly Recurring Revenue (MRR)* is the recurring revenue the company gets every month from active subscriptions

- *Churn* is the number of users, accounts or MRR that cancel the subscription and stop paying. Can be measured as percentage of total MRR, users or accounts.
- *Engagement metrics* is metrics concerning how much or often their customers use the product. Usually measured as a ratio of active to total users, or a ratio of daily to monthly active users.
- *Sales efficiency metrics* measure how much return on investment the company gets on every dollar spend in sales and marketing. Metrics include CAC:LTV, The Magic Number and CAC payback time.

Earnouts theory is an important part of the theoretical framework that presents key issues to be considered in the construction of earnout provisions such as the earnout metric, the amount, the calculation mechanism, post-closing control, accounting measures and dispute resolution and litigation. The theory around earnouts is used to understand how to avoid metric manipulation as well as the practical implications

5 Empirics

The empirical data consists of both insights into acquisition strategies from interviews as well as data from the case study company GetAccept.

The interviews are meant to augment the theoretical framework with additional insights. One of the key take-overs from the interviews is that acquisition of early-stage technology companies generally happen for three reasons: Talent, Technology or Traction.

- *Talent* is M&A where the objective is to access specialised knowledge or a great founding team, also called "acqui-hires".
- *Technology* is M&A where the objective is to accelerate product road-map, access a specialised IP or data.
- *Traction* objectives include revenue growth, market access, reference cases, access to certain users and more.

Metrics from Lean Analytics are calculated for GetAccept. These metrics are later used in the analysis to understand what stage the company is in and decide upon an appropriate earnout metrics, should the company be sold today. GetAccept is a three-years old early stage SaaS-company selling horizontal software for salespeople, with more than 100 000 USD in monthly recurring revenue.

6 Conclusions

The process for determining metrics should start with the buyer's acquisitions strategy. For acquisitions where the objective is to access talent, technology or accelerate product roadmap, earnouts should in most cases

not be used at all. If the acquisition is made based on financial objectives, Lean Analytics should be used to determine what stage the seller's company is in. Understanding what stage the company is in is crucial as the type of metrics that matter differ depending on stage. The appropriate earnout metric depends on what stage the company is in. If the company does not have high engagement, traction acquisitions are per definition very unusual. If both the engagement rate and churn rate is high, churn rate can be used as earnout metric. If the churn rate is low but sales efficiency is low, *the magic number* could in some cases be an appropriate earnout metric. If the business has high engagement, low churn and favourable sales efficiency, monthly recurring revenue (MRR) is the most suitable metric. Generally, traction acquisitions are per definition more common in the later stages which is why MRR usually is the best metric.

The metric must be clearly defined so it cannot be manipulated. The reason why many other metrics from Lean Analytics cannot be used is that they are vulnerable to manipulation and can restrict the operating freedom for the entrepreneur. Metrics that involve cost allocation, such as bottom line growth or sales efficiency metrics, should generally be avoided. If they are used, the definition must be clear and both parties aware of how costs are to be allocated during the earnout period. The metrics should not be qualitative or subjective, and both parties must agree upon clear definitions and accounting principles. Furthermore, metrics that build on assumptions should not be used

Some metrics from Lean Analytics can be used as metrics in earnouts. However, most of them are easily manipulated and too complicated which can lead to an increased risk of disagreement over outcome and legal litigation. The MRR metric, Simple Churn Rate, and the Magic Number can be used in earnouts depending on what stage the company is in. Simple Churn and the Magic Number are only suggestions, however, for metrics that can be used in very special occasions situations. MRR would in most cases be an appropriate metric to replace the traditional revenue, EBIT or profit metric. Even if Lean Analytics' metrics are not used as earnout metrics, they should be used to determine what stage the seller's company is in, which in turn is an important part in determining the right metric.

7 Academic contribution

The academic contribution of this study is to combine several academic disciplines such as innovation engineering, financial accounting, corporate finance and law to be able to better suggest appropriate metrics to use in M&A earnouts. The study is interdisciplinary and contributes to academia by synthesising a broad range of disciplines. This study also aimed to make early stage

transactions easier which would de-risk entrepreneurship. The author hopes to bridge the gap between traditional corporate finance and management scholars, and the practitioners that have learned by experience

8 Discussion & Reflection

The conclusion builds on very broad simplifications of what acquisition strategies in M&A look like. The reality is much more nuanced and complex than three types of acquisition strategies. The objective of the acquisition is usually a mix of different aspects which makes it difficult to categorise them into one field. Most acquisitions are based on perceived synergies between the entities and have specific integration goals in mind. The acquisitions strategy also depends on who the acquirer is.

It is also important to assess the practical feasibility of using Lean Analytics' metrics in earnouts. The more complex metrics become, the easier they are to manipulate. One of the key problems with earnouts is how frequent they lead to legal litigation and disagreements over the outcome. This is often due to a lack of clarity around metric definition and calculation. Many metrics from Lean Analytics are conceptual. They ought to be used as a mental model to understand the fundamentals of the business model. Those metrics are not suitable to be used in earnouts.

Using complex metrics over long earnout periods may also restrict the entrepreneurs' operating freedom. It is important that the entrepreneurs have the freedom to iterate, pivot and refine their hypothesis before reaching product market fit. Optimising over one or a few metrics with disregard to other areas is rarely a good idea since reality is much more nuanced than just improving upon a couple of KPIs. By putting constraints on the entrepreneurs' freedom to develop the business, earnouts can actually hinder innovation.

More research is needed to understand the practical implications of this study. The thesis would be well-complemented by additional research from the legal perspective to understand the practical implications of Lean Analytics in earnouts.

A Sources

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"Applying Lean Analytics to Performance Metrics in M&A Earnouts" (Lund University, 2018).