

# Valuation of contingent consideration/ earn-out

July 2026



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Why EY?





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## Importance of **earn-outs in deal-making**





# Importance of earn-outs in deal-making



## What is contingent consideration?

In a transaction, the buyer and seller may have differing views on valuation, often due to differing forecasts or expectations. To facilitate deal closure, the parties typically agree on an overlapping valuation range. As a result, the total consideration is structured in phases; comprising an upfront payment and future payments based on a pre-agreed computation mechanism. The future payment, known as contingent consideration or popularly as 'earn-out', refers to the portion of the purchase price that may be paid in the future, contingent upon the occurrence of specific future events as outlined in the agreement.

## Objective of contingent consideration:

Mechanism to manage risk and rewards between the parties and bridge the gap between differing opinions to facilitate a hand-shake



The upfront consideration is fixed closer to the buyer's expectation, and additional pay-outs are determined upon achievement of pre-agreed milestones in the future



Reduces the risk of overpayment as additional pay-out is directly linked to achievement of milestones

## Contingent consideration versus deferred consideration

### Contingent consideration

- Contingent consideration is dependent on the happening of future events and the quantum of pay-out

### Deferred consideration

- Deferred consideration is fixed and simply payable on a future date and is not linked to any future event

## Extracts of disclosures for contingent consideration



### Example 1

The total transaction value for acquiring 100% ownership is US\$1,000 million, which comprises an upfront payment of US\$700 million, and an estimated earn-out of US\$300 million, subject to post-closing adjustments based on EBITDA performance and excess working capital.



### Example 2

The purchase consideration consists of cash consideration of US\$800 million for acquisition of 80% stake, plus US\$200 million to be paid out over three years through a performance and target-linked earn-out mechanism. The balance of 20% will be acquired after three years, based on future EBITDA targets.

Contingent consideration/earn-out payments are based on the achievement of any financial metric, be it revenue, EBITDA, and can include adjustments for cash, working capital, etc., on a future event / time period.



## Contingent consideration matters because of the following reasons:



### Informed decision-making

- Helps to understand the true cost of the deal
- Supports better negotiation and deal structure options



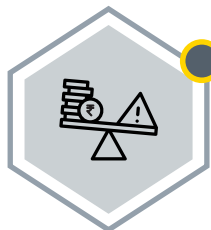
### Aligns incentives and maximizes value

- Enables payouts that are aligned with achievable metrics
- Drives businesses to deliver post-deal success



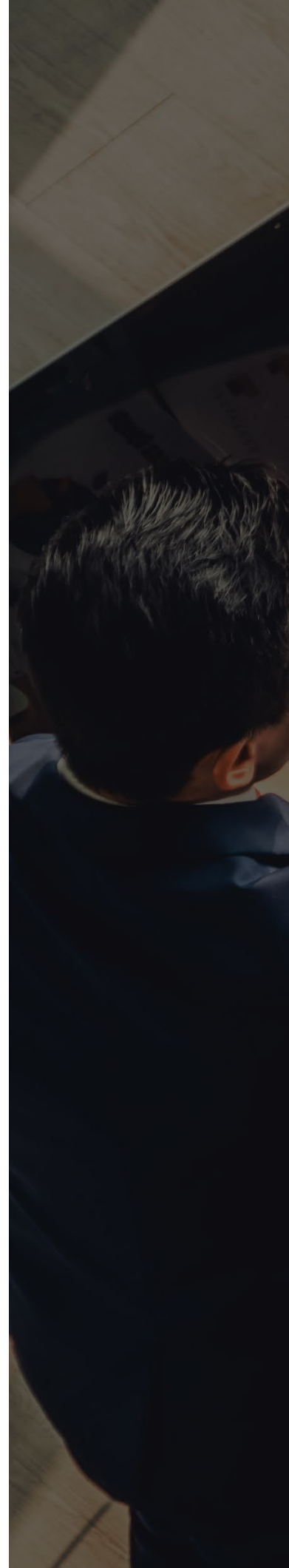
### Provides strategic visibility for planning cash-flow payouts

- Offers clarity on future payment triggers and associated scenarios
- Enables better forecasting, planning and investor communication



### Manages financial risk

- Quantifies the potential future obligation today
- Avoids unexpected hits to earnings







A close-up, slightly blurred photograph of a person's hands working at a desk. The left hand is on a laptop keyboard, and the right hand is holding a silver pen, poised over a document. The document features several colorful bar and line charts, suggesting a financial or data analysis context. The laptop screen in the background also displays a line graph. The overall lighting is soft and professional.

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Characteristics of  
**contingent consideration  
and payoffs**





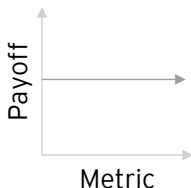
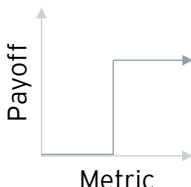
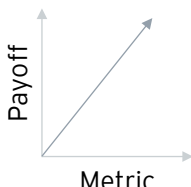
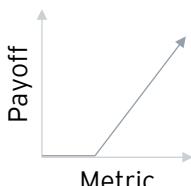
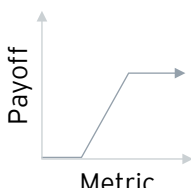
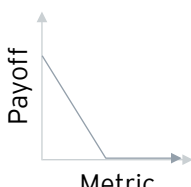
# Characteristics of contingent consideration

|                                     |   |                                                                                                        |
|-------------------------------------|---|--------------------------------------------------------------------------------------------------------|
| Conditional nature                  | » | Payment is conditional upon future events or performance metrics                                       |
| Deferred payment                    | » | Contingent consideration is not paid upfront                                                           |
| Underlying metric                   | » | Financial performance measured by revenue or profit targets; and non-financial performance such as R&D |
| Fair value measurement              | » | Initially recorded at fair value, even if payment is uncertain                                         |
| Remeasurement                       | » | Needs to be recognized at fair value on each reporting date until settled                              |
| Impacts post acquisition accounting | » | Change in fair value affect profit-and-loss account of the acquirer                                    |
| Influences deal structure           | » | Helps bridge valuation gaps between buyers and sellers                                                 |



# Payoffs

Payoff structures can be broadly classified under the following categories:

| Structure                                                   | Payoff                                                                              | Description                                                                                                                                                                                                                                                                                                                                                       |
|-------------------------------------------------------------|-------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Constant<br>(debt-like)                                     |    | <ul style="list-style-type: none"> <li>A fixed (deferred) payment</li> <li>The earn-out cash flow is only subject to counterparty credit risk</li> </ul>                                                                                                                                                                                                          |
| Milestone payment<br>(binary outcome)                       |    | <ul style="list-style-type: none"> <li>A fixed payment contingent upon achieving a future milestone or performance threshold</li> <li>Nonlinear payoff, where the risk of the earn-out cash flow depends on the risk of the underlying metric, the impact of the nonlinear structure and counterparty credit risk</li> </ul>                                      |
| Linear                                                      |  | <ul style="list-style-type: none"> <li>Payment is equal to a fixed percentage of the outcome for an underlying metric</li> <li>Linear payoff, where the risk of the earn-out cash flow is the same as the risk of the underlying metric and includes counterparty credit risk</li> </ul>                                                                          |
| Excess above a threshold<br>(call option)                   |  | <ul style="list-style-type: none"> <li>Payment is equal to a percentage of the excess of the underlying metric above a performance threshold</li> <li>Nonlinear payoff, where the risk of the earn-out cash flow depends on the risk of the underlying metric, the impact of the nonlinear structure and counterparty credit risk</li> </ul>                      |
| Excess above a threshold with a cap<br>(capped call option) |  | <ul style="list-style-type: none"> <li>Payment is equal to a percentage of the excess of the underlying metric above a performance threshold, with a payment cap</li> <li>Nonlinear payoff, where the risk of the earn-out cash flow depends on the risk of the underlying metric, the impact of the nonlinear structure, and counterparty credit risk</li> </ul> |
| Clawback<br>(put option)                                    |  | <ul style="list-style-type: none"> <li>Payment is equal to a percentage of the shortfall of the underlying metric below a performance threshold</li> <li>Nonlinear payoff, where the risk of the clawback cash flow depends on the risk of the underlying metric, the impact of the nonlinear structure, and counterparty credit risk</li> </ul>                  |

A person in a dark suit is seated at a wooden desk. Their right hand is raised, palm facing up, in a gesturing motion. On the desk, there is a white disposable coffee cup with a black lid. Several sheets of paper with financial charts are spread out. One chart in the foreground shows a bar graph with blue bars. Another chart to the right shows a line graph with multiple colored lines (red, green, blue) plotted against a grid. The background is softly blurred, showing a light-colored wall.

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## Valuation methodologies





# Methodologies



## Methodologies for the valuation of contingent consideration

The valuation of contingent consideration would depend on the nature of the contingency. Most contingencies would be linked to the financial performance of the target business, e.g., achievement of revenue or profitability. In some cases, contingency is linked to external factors such as government approval or successful trials for new products. Also, depending on the complexity of the contractual arrangement, one may have to choose the appropriate valuation methodology.



Scenario-based method (SBM)



Option pricing method (OPM)





#### Scenario-based method

- Uses multiple potential outcomes with assigned probabilities
- Fair value = Probability-weighted average of outcomes
- Ideal when performances are discrete and reasonably estimable



#### Where to apply:

- The risk of underlying metrics is diversifiable, i.e., achievement of diversifiable non-financial milestones like regulatory approval, completion of a project within a specified time, etc.
- Consideration has a binary payoff structure, i.e., with no thresholds, caps or carry-forwards.



#### Where not to apply:

- Highly complex or non-linear payoff structures
- Need to capture path dependency (e.g., contingency 2 dependent on contingency 1)



#### Key considerations:

- Time value of money
- Counterparty credit risk
- Required Metric Risk Premium (RMRP)



#### Option pricing method

- The approach treats contingent consideration as a financial option, a right to receive payment based on future outcomes.
- The payout resembles that of a call option, where the acquirer pays only if a performance “strike price” is exceeded.
- The approach applies option valuation techniques such as Monte Carlo simulations.



#### When to apply:

- Pay-out structure is non-linear.
- The risk of underlying metrics is non-diversifiable.



#### When not to apply:

- Lack of input data such as volatility or distribution of performance metrics
- Short-term earn-outs





### Monte Carlo simulation

- Monte Carlo simulation is a stochastic (randomized) modeling technique used to simulate thousands of potential future outcomes based on probability distributions of key variables (e.g., revenue, EBITDA).
- It is useful for complex, multi-variable contingent payouts where outcomes are nonlinear or path-dependent.
- Monte Carlo simulation produces a probability-weighted fair value of the contingent consideration by aggregating results from all simulations.



### When to apply:

- Payout based on multiple metrics and/or path-dependent outcomes
- Highly volatile or uncertain underlying metrics
- Nonlinear or tiered payout structures



### When not to apply:

- Simple, single-trigger earn-outs
- Short-term earn-outs with limited uncertainty



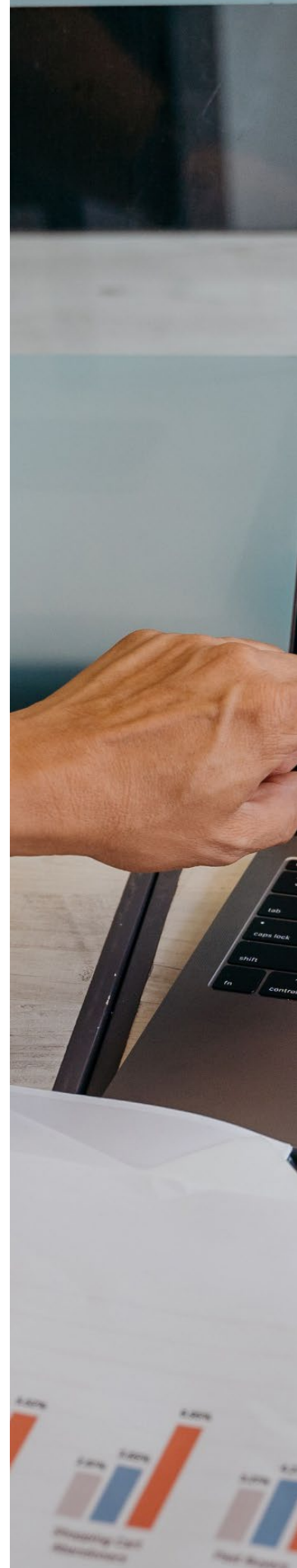
### Risk-neutral valuation – Required Metric Risk Premium (RMRP)

The option pricing model operates in a risk-neutral world. RMRP is a measure of the excess return above the risk-free rate that investors demand to bear the non-diversifiable risk associated with a metric.

The methods for estimating RMRP can be divided into two broad categories:

- The top-down method: the estimated risk premium implied by the discount rate for long-term free cash flows to the firm, which is adjusted for differences in risk between the long-term free cash flows and the earn-out metric.
- The bottom-up method, the earn-out metric's beta is estimated, based on
  - the volatility in the growth of the metric relative to the volatility of a proxy for the market and
  - the correlation between growth in the metric and in the market.

Adjustments are then made to incorporate the portion of the additional risk premiums (i.e., size premiums, country-risk premiums and company-specific premiums) applicable to the earn-out metric.









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**Challenges**





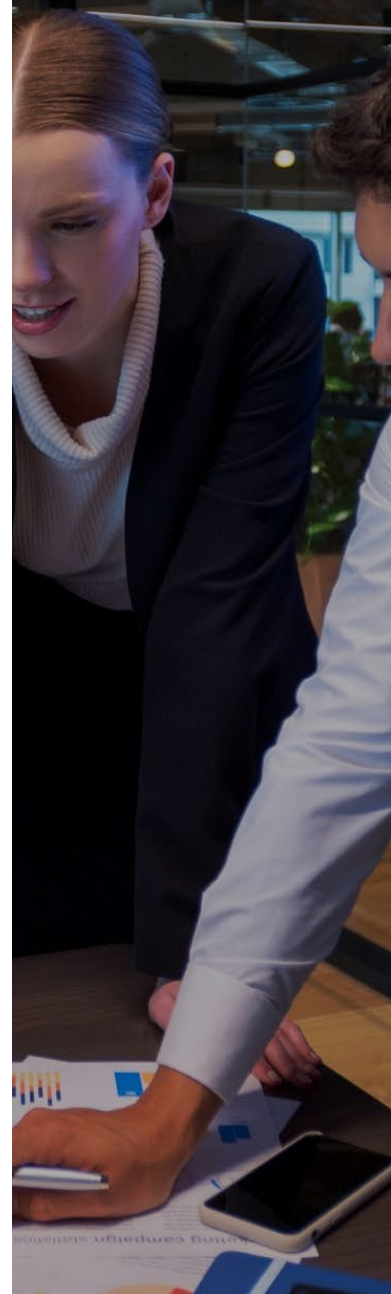
## Challenges in valuation of contingent consideration

- Subjectivity in forecasting
- Determining appropriate probabilities
- Complex or non-linear payout structures
- Risk adjustment and discounting
- Changes in assumptions post-acquisition
- Complex legal terms and ambiguities
- Option-like structures require sophisticated models such as Monte Carlo simulations or Binomial models



## Solutions and best practices

- Use of objective, auditable inputs
- Build scenario trees or simulations
- Legal clarity in agreements
- Documentation of assumptions
- Set caps and floors







The goal here is to verify and ensure capabilities. We want to ensure that the information given in the application form is true and correct and then understand that it is being used.



Percentage based display of international growth reporting, operational marketing and strategic capabilities. We warrant and confirm that the information given in the application form is true and correct and then understand that it is being used.



Our analysis suggests a healthy market which will welcome the strategic introduction of our new products. International growth regarding our products has been high and we propose introducing product line into several new global and local markets in the near future. The business is also ready to expand the brand into new brand extension areas with market exploration opportunities. This is the data and analysis from an actual market research conducted during the period listed above. The target market for specific companies analyzed in this can best illustrate how we market research to meet the specific requirements of our client.





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**Illustrations**









## Case study 1: Linear payoff

ABC Limited (buyer) entered into an agreement to acquire a 100% stake in XYZ Limited (target). The buyer is required to pay 30% of the acquiree's EBITDA earned over the subsequent one-year period, i.e., EBITDA for FY27. The payment is to be made within three months after the end of the year. The management has projected EBITDA for FY27 to be INR3,000 million.



### Objective:

To assess the fair value of the earn-out as at the transaction date (31 March 2026), which is contingent upon the EBITDA of a subsequent period.

The earn-out payments are in the nature of a liability. Hence, the remeasurement of the fair value of the contingent earn-out is required at each reporting date.

### Intended approach:

**Underlying metrics:** EBITDA for FY27

**Payoff:** The earn-out is a linear function of EBITDA. Therefore, only the expected- case EBITDA is needed to estimate the expected future cash flow.

**Approach:** The scenario-based method (SBM) can be applied to linear payoff structures.

**Discounting:** The linear payoffs are discounted for a period of one year and three months at the risk-free rate, adjusted with the credit risk of the acquirer, to arrive at the fair value of the earn-out payment.



## Case study 2: Binary outcomes

ABC Limited (buyer) entered into an agreement to acquire a 100% stake in XYZ Limited (target). The buyer will be required to pay INR300 million if the target's revenue exceeds INR80,000 million in FY27. The payment is to be made within three months after the end of the financial year.



### Objective:

To assess the fair value of the contingent consideration as at the transaction date, 31 March 2026.

### Intended approach:

**Underlying metrics:** EBITDA for FY27

**Payoff:** The earn-out is a non-linear function of revenue. A probabilistic framework is needed to estimate the expected future cash flows. In this case, the earn-out payoff can be replicated as a call option with a strike of INR80,000 million.

**Approach:** An option pricing model (OPM) using the Black-Scholes Merton formula should be applied for the valuation of the earn-out having a non-linear payoff with a call option feature.

**Discounting:** The Required Metric Risk Premium (RMRP) discounting for revenue estimated using a top-bottom or bottom approach shall be used.

For the computation of the present value of an earn-out payment, the risk-free rate adjusted with the credit risk of the acquirer shall be used for the period of one year and three months.



### Case study 3: Non-linear payoff

ABC Limited (buyer) will be required to pay 30% of the excess of the XYZ Limited (target) annual EBITDA above INR200 million, plus 10% of the excess annual EBITDA above INR240 million over the subsequent one-year period, with a payment cap of INR20 million. The payment is to be made within three months after the end of the financial year.



#### Objective:

To assess the fair value of the contingent consideration as at the transaction date, 31 March 2026.

#### Intended approach:

**Underlying metrics:** EBITDA for FY27

**Payoff:** The earn-out is a non-linear function of EBITDA. A probabilistic framework is needed to estimate the expected future cash flows. In this case, the earn-out payoff can be replicated as a call option.

**Approach:** The option pricing model (OPM) should be applied for the valuation of the earn-out having a non-linear payoff with a call option feature.

**Discounting:** The Required Metric Risk Premium (RMRP) discounting for EBITDA estimated using a top-bottom or bottom approach shall be used.

For the computation of the present value of the earn-out payment, the risk-free rate adjusted with the credit risk of the acquirer shall be used for the period of one year and three months.





#### Case study 4: Multiple tranches for earn-out

ABC Limited (buyer) entered into an agreement to acquire a 100% stake in XYZ Limited (target) for an upfront cash consideration of US\$500 million as at 31 March 2026. Based on the agreement, the seller is also entitled to earn-out payments of US\$50 million as per the following tranches:

- 25% of the earn-out payment is payable upon achievement of a revenue of US\$300 million in FY27 as per the audited financial statements.
- 25% of the earn-out payment is payable upon achievement of an EBITDA margin of 8.0% in FY27 as per the audited financial statements.
- 25% of the earn-out payment is payable upon achievement of revenue of US\$350 million in FY28 as per the audited financial statements.
- 25% of the earn-out payment is payable upon achievement of an EBITDA margin of 9.5% in FY28 as per the audited financial statements.

The earn-out payment is to be made within 30 days from 30 September of the years ending FY27 and FY28, as the case may be.



#### Objective:

To assess the fair value of contingent consideration as at the transaction date (31 March 2026).

#### Intended approach:

**Underlying metrics:** Revenue and EBITDA margin for FY27 and FY28

**Payoff:** The non-linear (binary) payoff, where the payoff is dependent upon the achievement of certain milestones.

**Approach:** The Monte Carlo simulation method would be applied as the underlying metrics are highly volatile and uncertain, with a non-linear payoff structure.

**Discounting:** The Required Metric Risk Premium (RMRP) discounting would be applied to revenue and EBITDA for FY27 and FY28 to arrive at risk-neutral underlying metrics as at the measurement date. For the computation of the present value of the earn-out payment, the risk-free rate adjusted with the credit risk of the acquirer shall be used for the period of 30 days from 30 September of each year.



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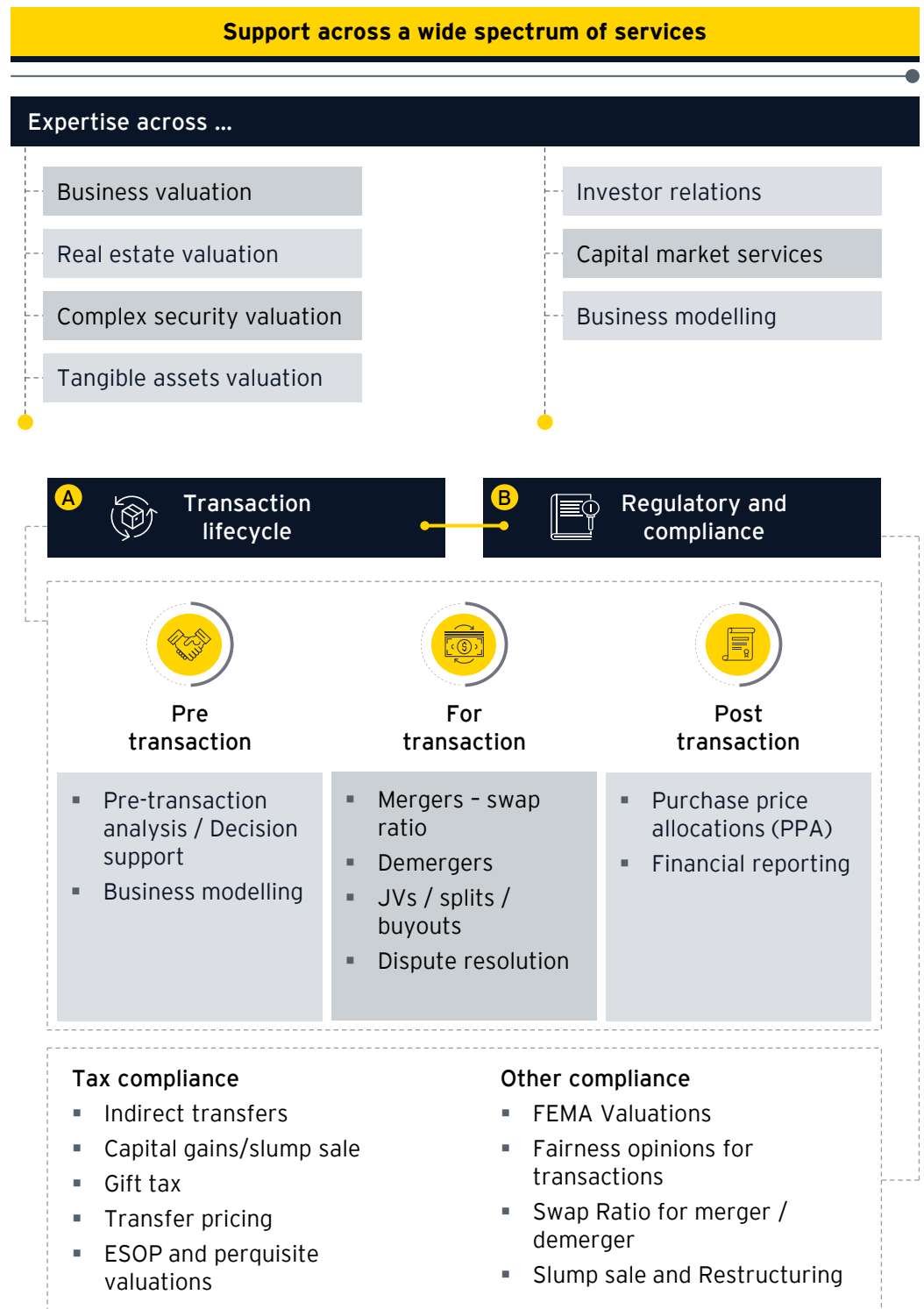
Why EY?







# How we can help- Our services



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Economics, EY India



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