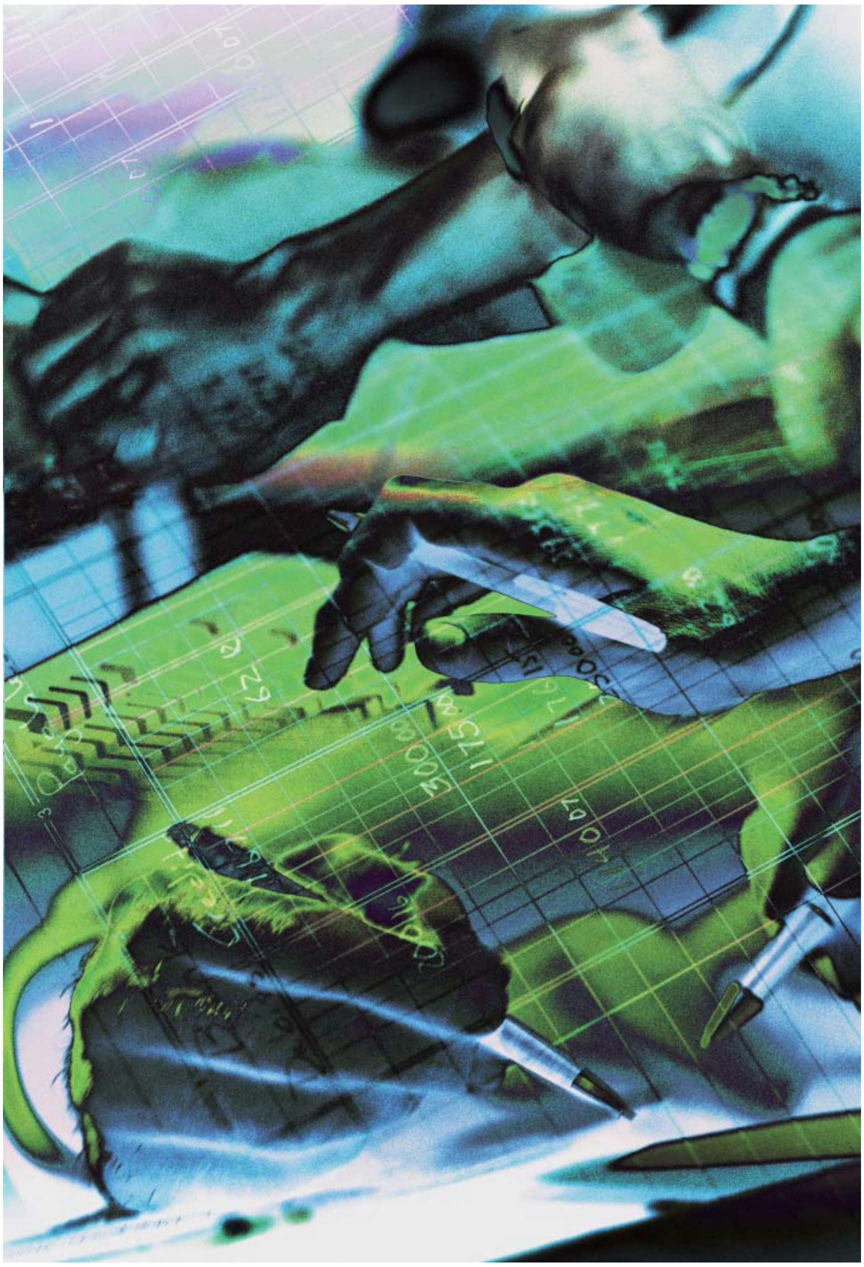
# Pricing mechanisms

## Locked box vs completion accounts

**Ronan O'Sullivan** and **Ross McNaughton** of **Paul Hastings (Europe) LLP** and **James Doe** of **PricewaterhouseCoopers LLP** compare the two main pricing mechanisms used to determine the value of a target business.

Illustration: Getty Images



One of the fundamental considerations when calculating the price of a target business in the context of private M&A relates to the agreed pricing mechanism in the sale and purchase agreement (SPA). The two mechanisms typically deployed are either completion accounts or a locked box. The choice as to which structure to use goes directly to the heart of how the equity price of the target is calculated and, to the unwary, can have a profound impact on the actual price paid or received.

Although the two options seek to arrive at a similar value for the business, the commercial reality is that the choice of structure provides an opportunity for each party to seek to maximise value from the deal, and the parties therefore need to be alive to the fundamental issues surrounding these discussions, which go directly to price.

Completion accounts have historically been the default mechanism of choice and are generally regarded as buyer-friendly. However, in recent years, the use of locked box structures has become an established feature in the M&A arena. In the relatively buoyant market in the run up to 2008, there was a significant rise in the use of locked boxes and, although the trend was abruptly curtailed in the aftermath of the banking crisis, they have returned strongly

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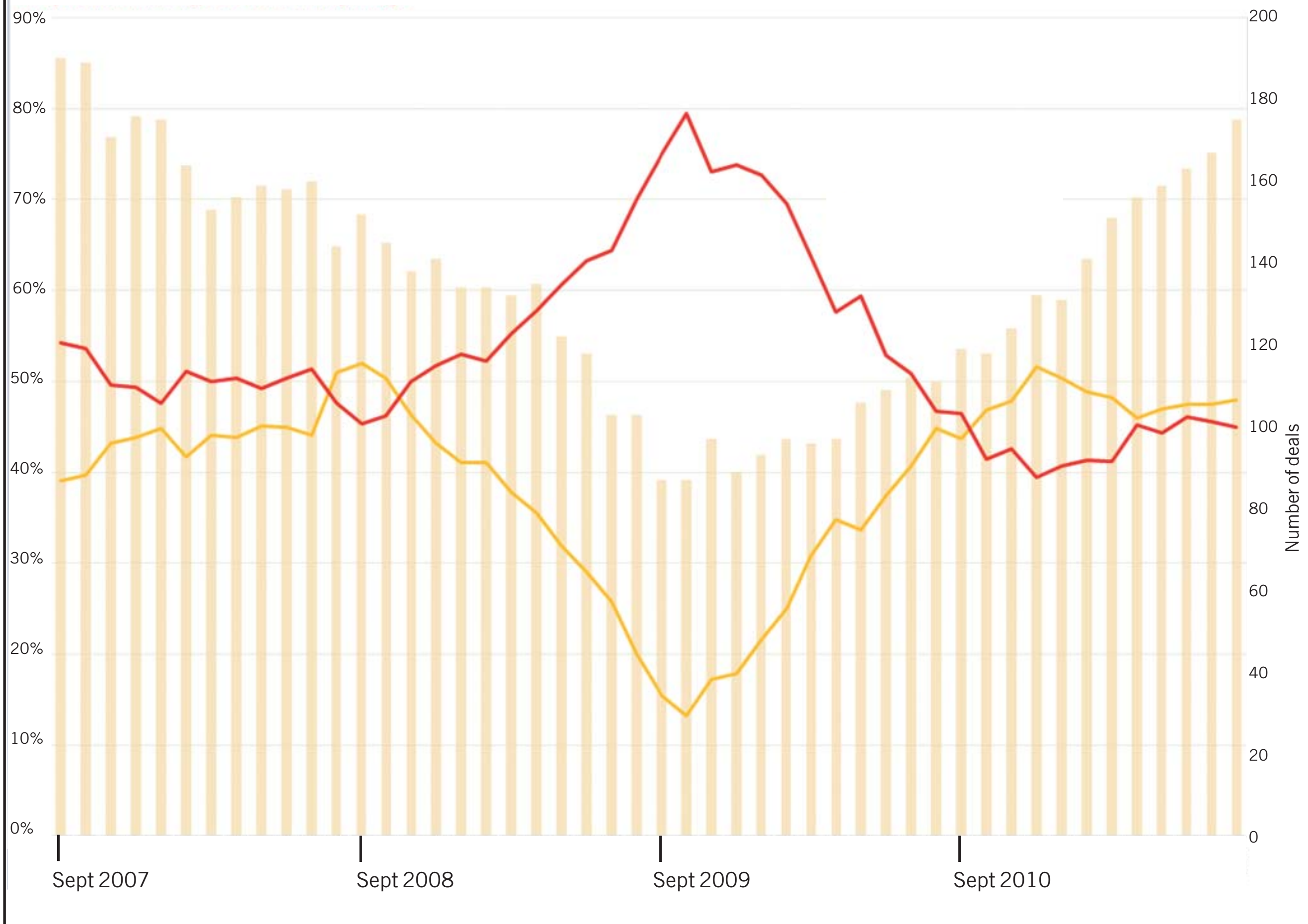
## Analysis of mechanism types: 12 month rolling averages




Source: PwC SPA team data on mechanisms

to the current transaction marketplace (*see box "Analysis of mechanism types: 12 month rolling averages"*).

These trends underpin the commonly-held belief that locked boxes are very much the mechanism of choice for sellers. While, in theory, the chosen mechanism should not change the value that is paid or received for the business, in practice, it most certainly can.

This article outlines the fundamentals of the two pricing frameworks and their interplay with the valuation of a target itself, and considers some of the key issues as to how value can be won or lost between a buyer and seller.

### TARGET VALUATION

Before understanding what completion accounts and locked box structures are seeking to achieve, it is worth considering how a business is typically valued and how this interplays with the negotiation of the SPA.

### Enterprise and equity value

Although there are several valuation methodologies available to buyers, offers for target businesses are commonly made on a "cash-free/debt-free basis, and assuming a normalised level of working capital". Under this approach, the starting point is for the buyer to determine the "enterprise value" of the business (*see box "Enterprise value of the business"*). This would typically be a multiple of EBITDA (earnings before interest, tax, depreciation and amortisation) and would be predicated on the assumption that this measure is representative of the sustainable level of cash profit generated by the business.

Given its importance in determining the enterprise value, the calculation of an appropriate level of EBITDA is usually a focus of much debate between the buyer, the seller and their respective advisers. Since any calculation of EBITDA essentially represents trading performance before interest, depreciation and amortisation, it does not take into account the financing structure or the net asset strength of the business.

By way of simple example, company A and company B may both generate EBITDA of £1 million, but company A is financed entirely through equity and company B largely through debt. While the enterprise value of both is the same, the presence of debt in company B should affect how much a buyer is willing to pay because either the business would need to repay the debt over time through the profits it generates (thereby eroding the future profits available to the buyer), or a buyer would repay that debt on acquiring the business.

It is this inherent limitation in EBITDA which results in an enterprise value typically being presented on a cash-free/debt-free basis, which essentially requires that the buyer will pay for any cash left in the business and the seller will pay for any debt.



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## Enterprise value of the business

| | £ million | £ million | |
|---|---|---|---|
| **Initial enterprise value** | | x | Initial valuation (usually a multiple-based approach) |
| **Adjustments** | | (x) | Might "hard-wire" some adjustments into valuation of business. Examples might include pension deficits or capital expenditure requirements. |
| **Debt/cash-free price** | | x | |
| plus cash (£ for £) | x | | |
| less debt (£ for £) | (x) | | |
| Net debt adjustment | | x/(x) | |
| plus working capital | x | | |
| less normal working capital | (x) | | |
| Working capital adjustment | | x/(x) | Adjustments to price driven by sale and purchase agreement mechanics (the "equity bridge"). |
| Other adjustments, for example capital spent vs budget | | (x) | |
| **Purchase price (equity value)** | | x | Price actually paid to the seller. |

The other assumption typically associated with company valuations is that there will be a normalised level of working capital. In order to generate profit, every business needs a certain level of stock, debtors and creditors and the levels of those may change both through seasonality and business expansion (or contraction). The actual level of these balances at any given time will not be directly reflected in the calculation of EBITDA (although trends in working capital (for example as a result of increased or decreased profits) will be).

The agreed reference level of what is a "normalised" level of working capital will be a matter for negotiation between the buyer and seller and should, in theory, correlate to a level of working capital to support the sustainable profits of the business. Any offer assuming a normal level of working capital should only result in a price adjustment if the actual working capital is higher or lower than what is agreed to be "normal".

In practice, at any given time, a business will have cash and/or debt and a level of working capital which is unlikely to be "normal", in which case adjustments will need to be made to the enterprise value based on a reference balance sheet to arrive at the price that is actually to be paid for the business: the "equity value". The series of net cash or net debt and normalised working capital adjustments is sometimes known as the "equity bridge" (*see box "Enterprise value of the business"*).

### Cash and debt

For the purposes of SPA negotiations, "cash" and "debt" as defined terms are not always limited to cash appearing on the balance sheet or bank loans or borrowings, and there are a number of other liabilities which a buyer may view as akin to debt, including, for example, pension deficits, tax, and one-off liabilities. Buyers may also view some elements of cash as being trapped in the business (for example, for regulatory or legal reasons) and will therefore not wish to pay for them on a pound-for-pound basis.

From a seller's perspective there may be surplus assets or near cash investments for which they want pound-for-pound credit as akin to cash. These value items should form part of the negotiation regardless of the pricing mechanism chosen, but the choice of mechanism will determine how and when those value drivers are calculated.

## THE MECHANISMS COMPARED

The date of economic risk transfer is at the heart of the distinction between completion accounts and locked boxes (*see box "Timeline for passing of risk"*).

### Completion accounts

Under a completion accounts mechanism, the buyer will pay for the actual level of assets and liabilities of the target that the seller delivers to it on completion. What assets and liabilities are taken into account in the pricing adjustment (that is, net cash/debt, working capital and/or net assets) will depend on what is negotiated in the SPA (*see "Adjustment mechanisms" below*).

However, while the price is determined by the level of specified assets and liabilities at completion, the actual level of assets and liabilities of the business will not be known at the time the SPA is entered into or completion occurs (even on a simultaneous sign and close structure, given the lead time required to prepare accounts).

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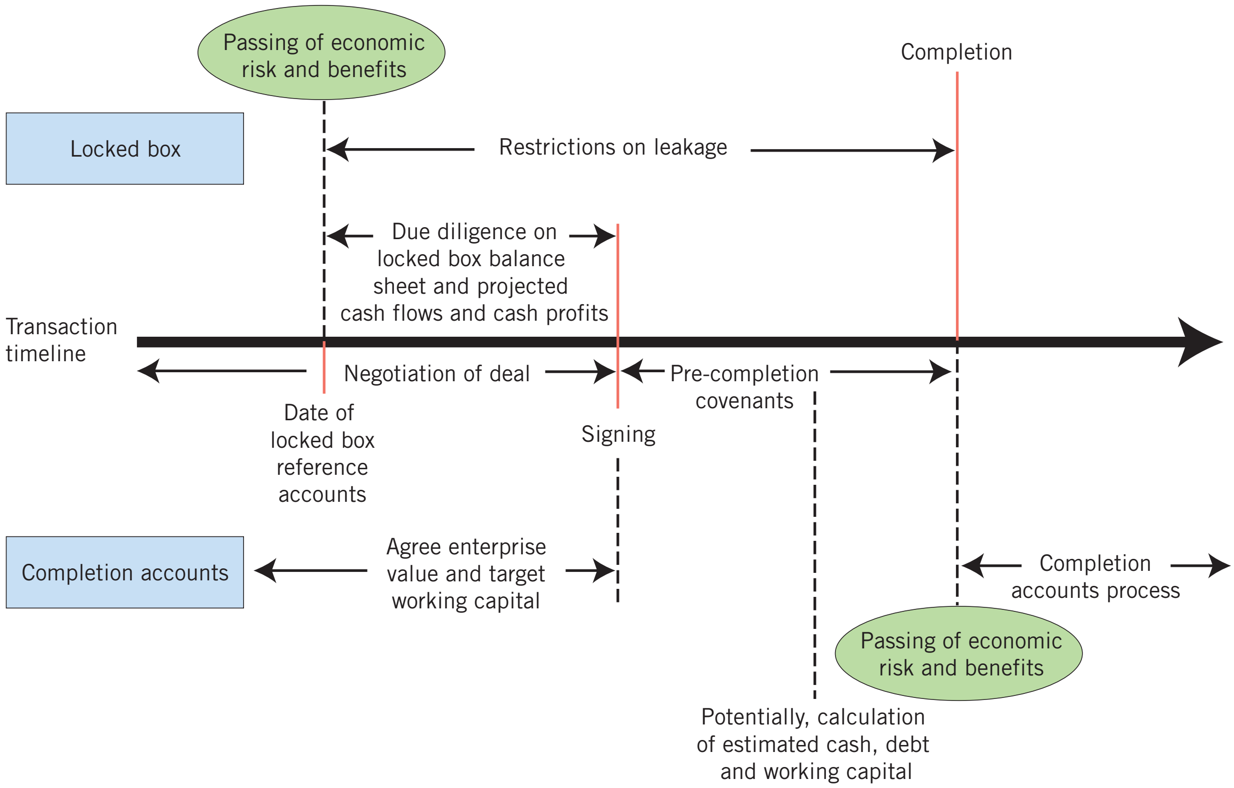
### Timeline for passing of risk




Under a simple completion accounts mechanism, the buyer will pay the enterprise value at completion and this will be adjusted following the preparation and agreement (or in the event of dispute, the determination) of the completion accounts. In practice, the final equity price may not be known for months, even years, after the date of completion because the calculation uses a balance sheet which is not prepared until the information is available after the deal completes.

Given that adjustments for debt, cash and working capital may be significant, the parties may agree that the enterprise value will be adjusted based on an estimate of the balance sheet as at completion, usually provided a few days before closing. This use of estimates does not affect the ultimate equity price but attempts (in theory, at least) to ensure that the consideration actually paid by the buyer at completion is a reasonable approximation of the ultimate equity price.

#### Locked box

By contrast, locked boxes provide for an equity price to be calculated using a recent historical balance sheet of the target before the date of signing the SPA. The amounts of cash, debt and working capital are therefore known by the parties at the time of signing. It is somewhat simpler than a completion accounts process as there is no post-completion adjustment, other than for pre-identified and agreed claims for "leakage" (*see "Leakage" below*).

As this mechanism requires the buyer to price the target business off a historic set of accounts (the reference accounts), in respect of which it will have no ability to adjust after completion, the buyer will then rely on contractual protection to ensure that no value (or leakage) leaks out of the box between the reference date and completion. Essentially, this means that, in a locked box structure, the equity price is fixed, with the buyer's remedy generally limited to leakage and other contractual protections.

Although risk and reward pass at different dates under each mechanism, a seller will look to redress this through seeking an interest charge (*see "Interest" below*), and a buyer will seek to reflect the change of reference date in its valuation model so that the value of the business is not affected solely by the choice of mechanism.

## MAKING THE RIGHT CHOICE

Instinctively, the principle that the buyer compensates the seller for the level of net cash and working capital it actually receives at completion seems justified and fair for both parties. However, this is not always the case, and each mechanism has advantages and disadvantages for both sides (*see boxes "Principal pros and cons of completion accounts" and "Principal pros and cons of locked box mechanism"*). Some of the most important considerations as to which structure to use are drawn out below.

#### Diligence and timing

As noted above, from a legal and accounting perspective, a key difference between the two mechanisms is that, with completion accounts, economic risk and benefit in the target pass at completion, whereas with a locked box, economic risk passes at the agreed effective date before signing.



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## Principal pros and cons of completion accounts

| Pros: Seller | Pros: Buyer |
|---|---|
| • Speed of execution as buyer may need less comfort on balance sheet before completion. May speed up negotiations.<br><br>• Economic benefit in the business. Gets credit for running the business and receives profits right up until completion. | • Ability to true-up. Only pays for what it gets: price will be adjusted if business has deteriorated before completion.<br><br>• Ability to check completion accounts when in full control of business. |
| **Cons: Seller** | **Cons: Buyer** |
| • Potential for dispute.<br><br>• Less control over the adjustment process.<br><br>• Takes economic risk of business right up to completion.<br><br>• Delay in ascertaining final price and uncertainty in period between completion and preparation of the accounts.<br><br>• Costs of preparation/review and any potential dispute. | • Potential for dispute. The seller may be less likely to compromise after signing.<br><br>• Delay in ascertaining final price.<br><br>• Costs of preparation/review and any potential dispute. |

This means that the financial due diligence required on a locked box deal will likely be more extensive than that required on a completion accounts structure, as the buyer will not have the opportunity to test the level of assets on which it has based its valuation once it has bought the business. As noted below, buyers will also need to conduct due diligence on the current trading performance of the business and projected cash profits between the locked box date and completion in order to verify the starting point of the real valuation model which will be at completion (*see box "Timeline for passing of risk"*).

In this regard, in considering whether to propose or commit to a locked box structure, it will be important from an early stage to identify what accounts are being used as the locked box accounts for pricing purposes. The locked box accounts can either be audited year end financial statements (although this is becoming less common), recently available management accounts or a pro forma balance sheet specifically prepared for the sale.

In any case, the seller should expect that the buyer will require a level of financial due diligence to be carried out on that balance sheet. In many deals, a seller's financial due diligence report is commissioned as a method of providing due diligence to bidders around a locked box balance sheet. Even if the reference accounts are audited and/or supported by a seller's due diligence report, in practice, a buyer will often want to undertake its own due diligence exercise, supported by appropriate warranty protection. Ultimately, the locked box balance sheet must be robust enough to allow a bidder to put forward a firm equity price.

As such, if speed to execution is key, then this would tend towards a completion accounts structure. The financial due diligence exercise that a buyer would typically do on a completion accounts deal may still be extensive, but if it is able to get some contractual flexibility in the SPA to adjust the consideration post-completion for the level of specified assets and liabilities actually received, then it may be willing to undertake a lower level of financial due diligence before signing.

Given that economic risk passes to buyers earlier under locked box deals, buyers will also need to take into account what risks there are to trading in the business after the locked box date. In periods of economic uncertainty, this may be a significant consideration.

### Certainty of proceeds

From a seller's perspective, one of the key concerns about completion accounts is usually that a buyer will use the completion accounts process to "chip" away at the price post-completion. The fact that locked box mechanisms do not allow for post-completion pricing adjustments (other than for leakage) makes them very attractive for sellers, particularly private equity sellers who may be able to remit the sale proceeds to their investors more quickly.

However, this certainty can also be an advantage for buyers, particularly those who do not wish to divert management time and resource into a subsequent preparation and negotiation of a post-completion true-up (that is, adjustment), or those who may wish to avoid the possible need to raise additional funds for post-completion payments.

Another key feature of a locked box from a seller's perspective is that, in an auction process, a locked box mechanism requires each bidder to submit the equity price it would be willing to pay for the target, which allows for comparability of bids. If used effectively, the resultant competitive tension arising out of an auction process may encourage bidders to adopt less aggressive po-

## Principal pros and cons of locked box mechanism

| Pros: Seller | Pros: Buyer |
|---|---|
| • Certainty of price.<br>• Increased control over process.<br>• Hard wires consistency of reference accounts policies with previous accounting policies.<br>• Simplicity. Management time not tied up debating completion accounts.<br>• Cost. No completion accounts mechanism results in cost savings. | • Certainty of price.<br>• Simplicity. Management time not tied up in preparing and debating completion accounts.<br>• Cost. No post-completion adjustment results in cost savings. |
| **Cons: Seller** | **Cons: Buyer** |
| • Will not get full benefit from continued operation of business in the interim period.<br>• Post locked box interest rate, if any, is often set too low to compensate seller for the earnings of the target. | • Increased reliance on warranties and comfort on balance sheet; enhanced due diligence often necessary.<br>• Risk of business deteriorating between locked box date and completion.<br>• Need to debate items such as debt and working capital earlier, with potentially less detailed knowledge. |

sitions than might otherwise be the case through completion accounts.

### Control

Under a locked box mechanism, the seller has full control over the information behind the locked box reference date accounts and it is for the buyer's due diligence team to seek to elicit as much of that information as possible. On a completion accounts mechanism, this dynamic is often reversed because, after completion, the buyer is the party with control over the financial information and, usually, personnel, which support its proposed completion balance sheet adjustments (assuming it prepares the first draft), leaving the seller to uncover and determine the accuracy or otherwise of its adjustments.

### Pre–sale restructuring

If any complex restructuring or hive-out is contemplated by the seller pre-closing (but after the locked box reference date), it is generally more challenging for a buyer to get comfortable with the financial implications of this. This is because a buyer needs comfort that the pricing balance sheet represents the actual business being acquired. Sellers in these circumstances should be alive to likely buyer concerns and how these could be mitigated; for example, through the use of pro forma data, detailed step plans or moving the locked box reference accounts to a date after any restructuring or hive-out.

### Deal conditionality and timing

Given that a buyer will be concerned about leakage and current trading (as well as that forecast to completion), in practice, most buyers will not want to use a balance sheet more than six to nine months old when using a locked box mechanism. As such, to the extent that there is a significant period between signing and closing, or if conditionality may lead to delays to completion, a buyer will be less likely to accept the locked box mechanism.

## COMPLETION ACCOUNTS: SPECIFIC ISSUES

There are some particular issues to consider if using completion accounts, which are discussed below.

### Accounting policies

As noted above, one of any seller's key concerns with a completion accounts mechanism is the perceived risk of price renegotiation. While this risk can never be eliminated, one of the best ways to mitigate any undue price adjustments post-completion is to achieve as much certainty as possible in relation to the manner in which the completion accounts will be prepared. Generally, there are no prescribed legal or accounting requirements as to the form and content of completion accounts (unlike statutory accounts) and the SPA will set out the agreed policies that should apply.

Concerns over price-chipping can be particularly prevalent where the accounting treatment of assets or liabilities is open to subjective interpretation under relevant accounting policies. To meet this concern, the parties are likely to seek to include specific policies that would be applied in relation to assets or liabilities. Items which are commonly the subject of specific policies include stock valuation, work in progress and long-term contracts. Equally important is the need to make sure that the completion accounts themselves include only those balances that should go to calculating the ultimate equity price.


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## Examples of leakage and permitted leakage

| Leakage | Permitted leakage |
|---|---|
| • Any "transfers of value" to seller.<br>• Dividends and distributions.<br>• Other distributions or returns of capital.<br>• Payments to directors and their connected persons.<br>• Fees and expenses incurred in connection with the sale put through the target.<br>• Deal bonuses paid to staff.<br>• Waiver of amounts owed by sellers.<br>• Non-ordinary course intra-group payments or payments for services. | • Intra-group payments in the ordinary course of business and on arm's length terms.<br>• Identified items which are agreed pre-exchange and factored into the consideration (for example, dividend strips and monitoring fees).<br>• Any payments provided for in locked box accounts (and therefore priced) or indemnities.<br>• Payment of staff wages in the ordinary course of business. |

For these reasons it is very important that the policies that are to apply to the process are set out in the SPA with as much certainty as possible, which will require significant input and co-ordination between the accountants, financial advisers and lawyers drafting the SPA.

### Adjustment mechanisms

In most M&A transactions, cash, debt and working capital are the principal value drivers in the calculation of equity price and, consequently, are usually the subject of any completion accounts true-up. However, traditionally, completion accounts calculated all of the net assets of the business (that is, they also took into account long-term fixed assets and long-term liabilities, and not just current assets and liabilities as would be caught in a working capital adjustment).

While there are certain sectors (for example, banks and property-based deals), where a full net asset adjustment is still normal market practice, often net asset mechanisms present a risk that the ultimate equity price is adjusted for items which should not go to value (for example, upward or downward revaluation of fixed assets). As such, a seller may feel more comfortable agreeing to a completion accounts mechanism with a net cash/debt and working capital adjustment, rather than a full net asset adjustment.

### Caps and collars

Although less common, another structure sometimes used to meet the seller's concerns as to undue post-completion price reductions is to incorporate a de minimis level (or collar) and/or a cap on any post-completion consideration adjustments either from the seller to the buyer or vice versa.

A collar would give the seller comfort that only a particularly material difference in the completion balance sheet compared to the level of estimated cash, debt or working capital would result in an adjustment to the purchase price, and a cap would ensure that it had certainty as to the minimum level of consideration that it would receive for the business through the completion accounts process.

In the event that a collar or cap is set on the completion accounts adjustments, a buyer will need to ensure that it is sufficiently protected against any adjustments to the completion balance sheet under the collar or above the cap, as it will not have any means of recourse through the completion accounts process in those circumstances. The seller will likely argue that the buyer is sufficiently otherwise covered by the conduct to completion covenants and warranty package in the SPA. These will therefore become key, and will need to be carefully reviewed to ensure that they adequately protect against any pre-completion extraction of value from the business.

## LOCKED BOX: SPECIFIC ISSUES

As a locked box requires a buyer to negotiate an equity price based on a historic balance sheet and bear the risk and rewards of economic ownership from the locked box date to completion, there are three particular features of a locked box deal that are likely to be heavily negotiated between the parties.

### Leakage

The parties must agree what constitutes "leakage" and "permitted leakage" as, in order to preserve the value of the business between the locked box accounts date and completion, the seller will provide an indemnity in favour of the buyer in respect of any leakage between these dates. The indemnity will provide the buyer with pound-for-pound recourse against the seller in the event that there is any leakage, other than permitted leakage.

This will be supplemented by various undertakings and covenants in the conduct to completion provisions in the SPA, along with an appropriate suite of warranties on the locked box accounts themselves.

"Leakage" broadly encompasses any transfer of value from the target business to the seller or its connected parties between the locked box date and completion (including, for example, dividends and other distributions, management payments and bonuses, transaction expenses put through the target, and so on) (*see box "Examples of leakage and permitted leakage"*).

Certain categories of payments may be required to allow the business to operate in the ordinary course. There is, therefore, a separate category of items and events constituting "permitted leakage", which commonly includes, for example, intra-group payments on arm's length terms consistent with past practice, any agreed amounts which are factored into the valuation (for example, dividend strips and monitoring fees), and payment of staff wages.

The list of events that will constitute leakage and permitted leakage in the SPA should be the subject of focus and scrutiny by both parties as it ultimately forms the principal protection for the buyer against the seller stripping value out of the business, and provides the contractual basis on which the seller will be able to make ordinary course payments and extract any agreed value between the locked box date and completion.

As well as considering the definitions themselves, both parties should consider how practical it is to establish if leakage has occurred. In the case of an asset deal or hive-out where the business being acquired is not already sufficiently distinct and separate from the seller's group (particularly if it does not maintain its own cash book) the reality is that leakage may not be effectively identifiable. This should be carefully reviewed, particularly by buyers.

### Limitation on claims

Locked box structures commonly include a time limit on the buyer's ability to bring a leakage claim. This is usually shorter than the warranty limitation period in the SPA, and, historically, was in the region of 18 months from completion, but has recently been reduced to as low as three months. The market norm would be not to include a de minimis level of claims under the leakage indemnity (in contrast to the normal position for warranties). Whether there should be a cap on recovery for leakage and, if so, at what level, will be the subject of negotiation between the parties.

### Interest

In a locked box mechanism, the target business is priced as at the date of the reference accounts, which is ultimately the date on which economic risk and reward in the target business passes to the buyer (*see box "Timeline for passing of risk"*). However, while in principle the seller is disposing of the business as at a date in the past and before signing, it will not receive payment for the sale proceeds until completion and will continue to run the business up to that date.

As such, sellers may ask for a specified rate of interest on the equity price or some form of daily profit charge running to completion to accrue from the date of the locked box balance sheet to the date of payment at completion. This is likely to be of particular importance to the seller when disposing of a profitable business (given that the level of profits generated up to completion would remain in the business, unless it was otherwise specifically agreed that they could be withdrawn by way of dividend beforehand).

The level of interest that should be payable will also be the subject of negotiation between the parties. It is common for the seller to seek to include provisions for an interest charge on the equity price, although this will be subject to scrutiny by the buyer in the context of the overall ecomonics of the deal and valuation attributed to the business.

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