M & A PRICING MECHANISMS

UNLOCKING THE BOX

AN EVOLUTION CBS WHITE PAPER

Special points of interest:

- *The Choices*
- *Choosing the right mechanism*
- *Pros and Cons*
- *Leakage*

Author: Jonathan Williamson, Oury Clark

The pricing mechanism used to determine the value of a target business will clearly have a significant effect on the actual price paid.

Completion accounts have traditionally been used primarily as a way for a buyer to protect its investment. There has however, in recent years, been a move towards the use of a locked box structure.

Using a completion accounts mechanism, the buyer will pay a price based on an estimated value of assets and liabilities with that price being adjusted post completion once a full set of completion accounts have been prepared.

Depending on the accuracy of the initial estimated value, the agreed payment terms and the complexity of the target business, there is therefore potential for the final price to be materially different to the expectation of the parties and also not known for some considerable time after completion.

Using a locked box structure generally means that the price payable is based on a recent historical balance sheet of the target and will not be adjusted save in respect of any agreed items of "leakage".

Choosing the right mechanism

The choice between the two mechanisms will depend on many factors such as market and sector conditions, financial stability of the target and the relative bargaining strength of the buyer and seller.

It is not quite as simple as saying that the completion accounts mechanism is always buyer friendly and locked box seller friendly. Both mechanisms have pros and cons for each party.

Timing is a key issue when considering the choice. Essentially, if using completion accounts, economic risk and benefit in the target pass to the buyer at completion, whereas with a locked box, economic risk passes at the agreed effective date before signing.

From a buyer's perspective, this means a lack of certainty as to achieving total value for the price it is paying. Therefore, the level of due diligence carried out by the buyer and its advisors will need to be sufficiently detailed to give it the comfort that the historic accounts upon which the price has been based were accurate and that the projected financial performance is realistically strong.

Indeed it is not uncommon for the buyer to request the seller to provide a financial due diligence report as a precursor to the price being fixed.

A level of certainty in respect of the final price to be paid is obviously paramount for both buyer and seller.

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. This is why the use of a locked box mechanism is attractive for sellers as there will be no pot completion adjustment to the price save for pre agreed "leakage".

The Pros and Cons

Completion Accounts

Pros: Seller	Pros: Buyer
Speed of execution as buyer may need less comfort on balance sheet before completion Seller will receive value for running the business right up until completion	Only pays for what it gets: price will be adjusted if business has deteriorated before completion Ability to check completion accounts when in full control of business
Cons: Seller	**Cons: Buyer**
Potential for dispute Delay in ascertaining final price Costs of preparation/review and any potential dispute	Potential for dispute Delay in ascertaining final price Costs of preparation/review and any potential dispute

Locked Box

Pros: Seller	Pros: Buyer
Certainty of price Cost. No completion accounts mechanism results in cost savings	Certainty of price 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	Increased reliance on warranties and comfort on balance sheet; enhanced due diligence often necessary Risk of business deteriorating between locked box date and completion

Leakage

The parties will need to agree what constitutes "leakage" and "permitted leakage" in respect of the value of the business between the locked box accounts date and completion. Anything going beyond that will be dealt with by way of an indemnity from the seller to the buyer.

"Leakage" essentially means the transfer out of any value from the target business to the seller or its connected parties in the period between the locked box date and completion.

The most obvious example is probably dividends but even the more indirect leakages are relatively easy to identify and agree (large salary increases for shareholder directors and intra-group payments for example). Some payments, such as payment of staff wages and professional fees incurred in preparation for a business sale, may fall into a relatively grey area but it is usually possible to agree sensible "permitted leakages" which take into account the underlying reason for any payment.

In conclusion

Commercial considerations will often be paramount when making the decision on which mechanism to choose. The likely number of potential buyers interested in a transaction may affect the volume and quality of the information the seller is inclined to generate and release. Any risks or uncertainties about price or value accrued may be overtaken by the extent to which the buyer or seller values certainty at completion.

Buyers and sellers will want to minimize (i) the amount of management time spent on completion accounts; (ii) post transaction settling up negotiations; (iii) protracted negotiations as a result of complex sale and purchase agreements which may lead to the deal collapsing; and (iv) the risk of nasty surprises after completion.

More buyers and sellers can benefit from using a locked box, or from at least exploring what it might add to their transaction. With M&A market conditions modestly improving a locked box mechanism is one way to reduce some of the risks associated with a transaction and increase the likelihood that it will deliver the anticipated value.

About the Author

Jonathan is a Partner at Oury Clark Solicitors. His expertise covers mergers and acquisitions, joint ventures, corporate restructuring, private equity, IPOs, and other capital raising as well as general corporate advice.

jonathan.williamson@ocsolicitors.com

www.ocssolicitors.com