Driving value from the M&A process
Purchase Price Mechanisms

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11 June 2015
Agenda

1. Introduction & current trends
2. Pricing structures & key value drivers
3. Pricing mechanisms
   • Completion Accounts
   • Locked Box
4. Warranties & Indemnities
Introduction & current trends
Current trends

- Active market across a range of sectors and jurisdictions
- More disposals, e.g. buy & builds, dual tracks
- More auctions and more locked boxes on private deals
- More of a seller’s market?
- Warranty & indemnity insurance
- Still seeing bad locked boxes
- Still seeing lots of completion accounts
Pricing structures & key value drivers
## Typical pricing structure

### Cash free / debt free mechanism (normal working capital)

<table>
<thead>
<tr>
<th>Enterprise value</th>
<th>€m</th>
</tr>
</thead>
<tbody>
<tr>
<td>Plus € for € for <strong>Cash</strong> 100%</td>
<td>X</td>
</tr>
<tr>
<td>Less € for € for <strong>Debt</strong> 100%</td>
<td>(X)</td>
</tr>
<tr>
<td>Plus € for <strong>Actual Working Capital</strong></td>
<td>X</td>
</tr>
<tr>
<td>Less <strong>Normal Working Capital</strong></td>
<td>Δ (X)</td>
</tr>
</tbody>
</table>

### Price payable for equity

<table>
<thead>
<tr>
<th>€Xm</th>
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Adjustments to enterprise value will depend on valuation assumptions

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Value issues: cash and debt

**Definition of ‘cash’**
- Cash not available? e.g. ‘Trapped cash’, cash held as guarantee, cash floats
- Group structure (non-wholly owned subsidiaries: 100% or MI%?)
- Nominal ledger versus bank statements

**Definition of ‘debt’ / ‘debt-like’**
- € for € deduction
- Any future cash costs excluded from EBITDA
- Provisions
- Tax – including deferred tax?
- Deferred consideration
- IFRS / GAAP does not recognise many liabilities until trigger point is reached
Examples of potential debt-like items

More Obvious

Less Obvious

Ultimately the appropriate treatment will depend on your valuation model.
Value issues: working capital

- Normal working capital is a key value issue
- For pricing purposes, the Purchaser wants to have a target as high as possible (more positive, less negative)
- Usually, the average of the latest 12 months
- Is the past any predictor of the future?
- Remove non-trade and one-offs
- Consider intra-month working capital
- Judgment areas:
  - Provisions and allowances (e.g. bad debt provisioning, inventory provisioning)
  - Revenue recognition: this can vary significantly in different countries and under different GAAPs
Price mechanisms
Completion Accounts vs. Locked Box

Completion Accounts

AFTER Completion
(SPA needs to include definitions and policies)

Locked Box

BEFORE Signing
Balance sheet is known at Signing – diligence on Locked Box balance sheet is crucial

Considerations:

- Shares v assets sales
- Pre-sale reorganisations: beware if paying fixed price
- Quality of asset/competitiveness: auction process
- Value of certainty for some (especially private) Sellers
- Adequate information for pricing: can you do it?
Completion Accounts Mechanism

Areas to watch out for

- Definitions of balance sheet captions (cash, debt, working capital)
- Omitting cash-type items from the mechanism (e.g. provisions, narrow working capital definitions)
- Price adjustment clause
- 3 step hierarchy & completion accounting policies
- Prepared “immediately prior to completion” (i.e. typically exclude transaction cash flows)
- Mid-month close
Completion Accounts Mechanism

Value GAAP – where the rules can get it wrong

- “Bad” assets e.g. capitalised debt issuance costs under IFRS
- Fair value accounting e.g. swaps, derivatives
- Unrecognised liabilities e.g. debt prepayment costs, transaction bonuses, capital commitments, capex underspend
- Impact of a change in ownership
- Judgmental issues: value in the eye of the beholder

Use accounting policies in the SPA to deal with the specific treatments rather than ‘GAAP’ alone (3 step hierarchy)
Locked Box Mechanism

Key principles

• Fixed price based on historical balance sheet
  – No opportunity to change the price post completion

• Enterprise value, debt, cash, working capital etc. all based on the same balance sheet (“Effective Date”)

• Interest on the Equity Price from the Effective Date to completion

• Buyer takes performance risk after the Effective Date

• Seller affirms “no leakage” after the Effective Date, except for “Permitted Leakage”
Warranties & indemnities
Warranties

• For the ‘unknown unknowns’

• E.g. if seller has not disclosed a tax investigation

• Damages = the difference between what was paid for the business and what would have been paid but for the undisclosed matter (so can be a multiple if it goes to recurring profits)

• So, the really valuable warranties are over items which form part of the valuation model and which you didn’t know about

• It’s tough and expensive to claim

• Sellers can limit their risk by referencing problems in the disclosure letter
Indemnities

• For the ‘known unknowns’

• E.g. if there is an existing court case of a potential tax liability

• Damages = the one-off loss

• Pretty easy to claim (weeks rather than months)

• Disclosure does not neutralise sellers’ risk
Questions?

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