Driving value from the M&A process
Purchase Price Mechanisms

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Agenda

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3. Pricing mechanisms
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4. Warranties & Indemnities

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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

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Pricing structures & key value drivers

Typical pricing structure

Cash free / debt free mechanism (normal working capital)

			€m
Enterprise value			**X**
Plus € for € for **Cash**	**100%**		X
Less € for € for **Debt**	**100%**		(X)
Plus € for **Actual Working Capital**	Δ	X	
Less **Normal Working Capital**		(X)	
			X
Price payable for equity			**€Xm**

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

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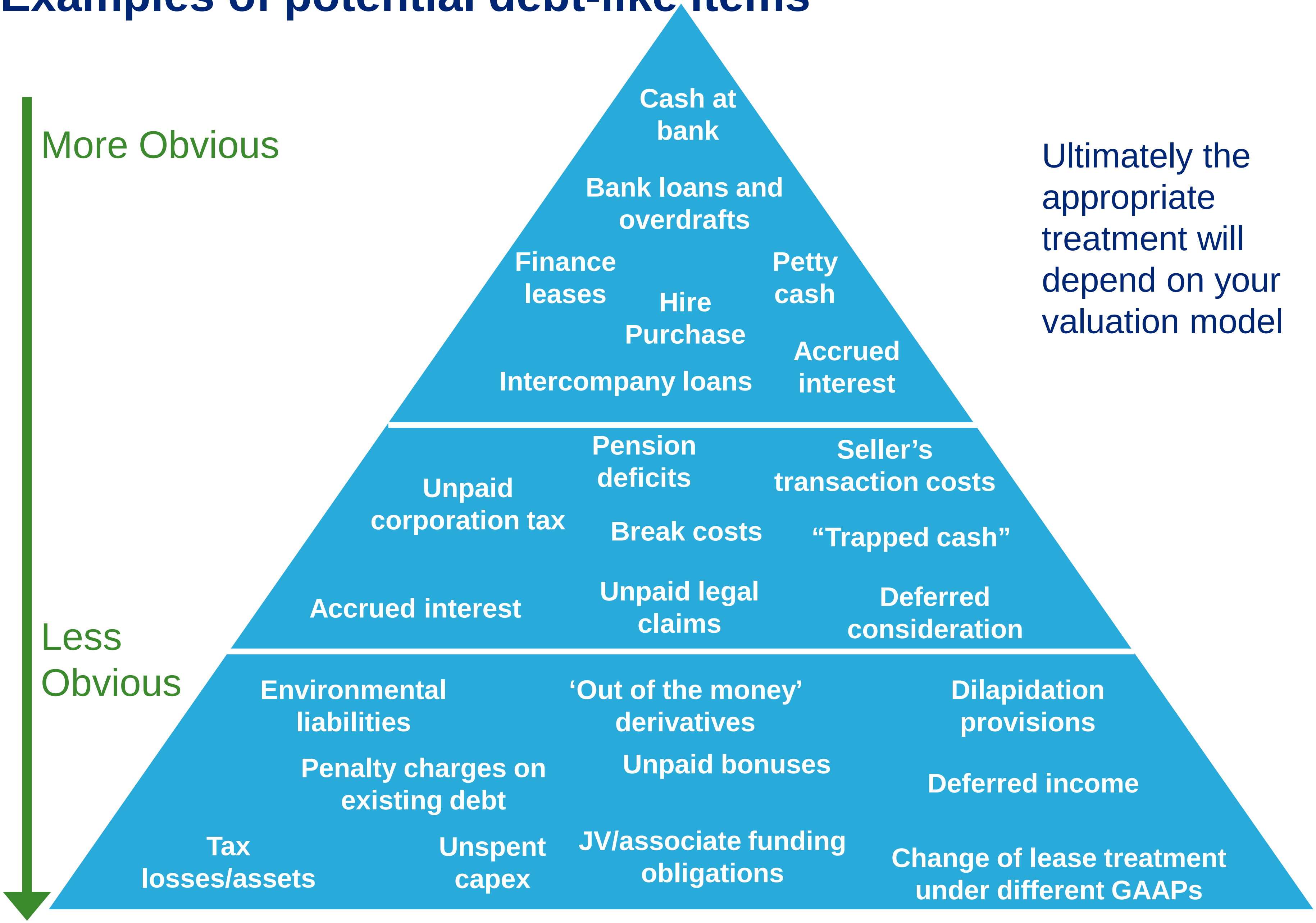
Examples of potential debt-like items



Ultimately the appropriate treatment will depend on your valuation model

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Value issues: working capital

‘Normal’ 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

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Price mechanisms

Completion Accounts vs. Locked Box

Completion Accounts	Locked Box
AFTER Completion (SPA needs to include definitions and policies)	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?

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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

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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)

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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”

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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 x 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

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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

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Questions?

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