M&A INTELLIGENCE

BACKGROUND

DLA Piper recently launched the DLA Piper 2017 Global M&A Intelligence Report in New Zealand. The report analyses data from over 1,000 deals (over the last three years) including from New Zealand and Australia, and provides unique insights into current trends and global intelligence in M&A. One topic that provoked discussion was locked box mechanisms.

In the early 2000s, private equity investors became increasingly active in the global M&A market and began to explore new ways of transacting with the aim of delivering better results for their investors. Competitive auctions became popular and the "locked box" mechanism was born.

In terms of overall economics, a locked box deal is very similar to a traditional completion accounts one: ie it is often done on a debt free/cash free basis, subject to normalised working capital. The key difference is that the purchase price is fixed up front by reference to a historic net debt and working capital position, with no post-completion price adjustment.

Locked box deals have become a common feature of the European M&A market and are gaining in popularity worldwide (with the exception of the US). Although particularly prevalent in the context of auction deals, especially where the seller is a financial sponsor, locked box mechanisms are increasingly favoured by trade sellers and regularly feature in bilateral deals. Locked box mechanisms in trade to trade deals showed a 15% increase in 2016¹. We expect the use of locked box mechanisms to increase in the New Zealand M&A market.

WHY LOCK THE BOX?

The principal sell-side benefits of a locked box structure are perceived as:

Risk shifting

By avoiding a post-completion price adjustment, the seller shifts the risk of current trading of the target group onto the buyer. The potential for an M&A process to negatively impact a target group’s performance (as a result of uncertainty and management distraction) makes this particularly attractive.

Economics and certainty

In the context of an auction, a locked box mechanism results in bidders offering fixed pricing on an "apples to apples" basis. The seller can easily compare the economics of multiple bids, allowing it to maintain or even increase competitive tension (an essential component of any successful auction).

In contrast, the extent of any completion accounts-based price adjustment is heavily dependent on the precise

¹ Source: DLA Piper Global M&A Intelligence Report 2017 - drawing on data from over 1,000 private M&A deals over the last 3 years.
mechanics and definitions used, making it harder to compare bids with a similar headline price but different adjustment terms. Also, no matter how carefully drafted a completion accounts mechanism is, there is always room for different interpretations. Often there is a dispute, resulting in reduced price certainty for the seller.

**Accelerated returns**
The absence of a post-completion price adjustment can simplify negotiations, truncate the sale process and ultimately accelerate the return of sale proceeds to investors. Cumbersome escrow or deferred payment arrangements (to accommodate potential price adjustments) become redundant.

**Advantages - seller**
- Certainty as to price (negotiated up front), with reduced chance of post-completion disputes
- Less justification for a price hold-back (although buyers may still seek this for warranty/tax claims)
- Simplicity/reduced cost - no completion accounts process
- Competing offers can be compared on a like for like basis

**Disadvantages - seller**
- Only suitable for share deals
- Recent audited accounts (or interim audit) as basis for locked box will be more attractive to buyer
- Buyer may seek more extensive warranty cover in respect of current trading

**Advantages - buyer**
- If target group is profitable, obtains benefit of trading from locked box date - but see “Current trading” below
- Simplicity/reduced cost (as for seller)
- Management time not taken up with completion accounts process

**Disadvantages - buyer**
- Risk of unprofitable trading from locked box date (enhanced by a longer gap between signing and completion)
- Greater reliance on financial due diligence
- Limited protection - ie leakage provisions and warranties only; no post-completion verification or price adjustment
- No certainty on level of debt/working capital which the buyer needs to finance

**OVERVIEW OF MECHANICS**
A locked box mechanism is a means of fixing the purchase price payable on completion of a share sale by reference to the target group’s balance sheet position (ie its net debt and working capital) at an agreed point in the past (the "locked box date"). Effectively, the purchase price is fixed at, and the buyer takes the economic benefit/risk of the target group from, the locked box date (not from completion).

The most obvious buy-side concern is that fixed pricing can leave a buyer open to sell-side manipulation of the target group’s financial position. To deal with this, the seller undertakes not to extract value (in the form of cash, assets or other benefits, together defined as "leakage") from the target group in the period from the locked box date to completion (eg by way of dividends, repayment of shareholder debt, management charges, transactions at an under or over value, sale bonuses, etc), save for certain narrowly defined items specifically agreed by the buyer and expressly provided for in the acquisition agreement (referred to as "permitted leakage").
It is common for the categories of permitted leakage to be very specific and subject to financial caps. Unless they are seen as "business as usual" items for which value has been received, buyers will generally deduct them from the equity value they offer (see "Pricing the deal" below).

The acquisition agreement will usually provide that any non-permitted leakage will be repayable dollar for dollar by the seller on an uncapped basis, although typically any claim for repayment must be made within a relatively short period after completion (usually between 6 and 12 months).

CHOOSING THE LOCKED BOX DATE

The most common choice of locked box date is the target group’s last financial year end. This allows its audited accounts to be used as the basis on which to "lock the box", with net debt and working capital being determined on the back of independently verified numbers.

If the target group’s last available audited accounts are too historic (eg more than 6 to 12 months old), the seller may opt for (or the buyer may insist on) a more recent locked box date. This would typically be a quarter or half year end, underpinned by management accounts and vendor financial due diligence commissioned by the seller. Where historic management accounting is not entirely reliable, or in the absence of financial due diligence, the seller might also commission an interim audit of its accounts. The veracity of the accounts used to "lock the box" and the strength of comfort given by the seller to support them are key issues for buyers, so sellers are best advised to consider the implications of their choice of locked box date at the outset of any sale process.

STANDING BEHIND THE FIXED PRICE

As pricing is fixed on the basis of the accounts as at the locked box date, the buyer will expect the seller to stand behind the accuracy of those accounts. The nature and extent of the comfort offered/expected will depend on the reliability of the accounts being used (particularly, whether they have been audited).

Given the enhanced risk profile for the buyer, more extensive warranties may also be sought in respect of the period from the locked box date to completion, perhaps covering the level of net assets, levels of working capital and/or debt, consistency of debt collection and payment of suppliers, and on any areas of concern that would otherwise have been addressed through completion accounts (such as bad debts or stock valuation). Sellers tend to resist these warranties as being dilutive of the fixed price concept behind a locked box, so a buyer will find it harder to secure this protection in a competitive situation.

PRICING THE DEAL

The buyer undertakes due diligence in order to get comfortable with the target group’s financial position. It will then typically make a final offer calculated by reference to the target group’s accounts as at the locked box date. The starting point is the enterprise value ascribed to the target group, often calculated as a multiple of profits before tax. The buyer then adds cash, subtracts debt (and other debt-like items) and adjusts for variances to normalised working capital, all as at the locked box date. The result is the equity value it is willing to pay for the target group, and it is this figure that is set out as the purchase price in the acquisition agreement. The adjustments made to enterprise value in order to calculate equity value are commonly referred to as the "bridge".

In determining the equity value that it is willing to pay, a buyer will take account of similar adjustments to those flowing from completion accounts (so as to achieve a purchase on a debt free/cash free and/or normalised working capital basis). Debt-like items and the calculation of normalised working capital are the issues most often debated. The fundamental differences are that:

- everything is negotiated and agreed before signing by reference to the locked box date (not completion);
- the buyer takes the economic risk of trading from the locked box date (not completion); and
- there is no post-completion verification or price adjustment mechanism (either for the position at the locked box date or at completion).

CURRENT TRADING

When locked box deals first appeared, they usually involved an attempt by sellers to charge interest on the purchase price in the period between the locked box date and completion. Interest rates at that time were attractive for sellers and the justification was that, as the deal had been priced at a historic point in time, the seller should be treated as having sold at that point and should benefit from interest on the proceeds from that point up to actual receipt.

When interest rates fell post-GFC, sellers shifted their argument. It became one of compensation for profit or cash generated by the target group in the period from the
locked box date to completion (which, given the fixed price nature of the deal, would otherwise fall to the buyer). This is sometimes expressed as interest on equity value, but is often characterised as a daily charge. In both cases, it is usually calculated by reference to free cash flows generated by the target group’s business in the period from the locked box date up to completion.

Either way, buyers need to be wary not to pay twice for this interest/profit element (to the extent it is already wrapped up in their enterprise valuation), and will want to diligence current trading before agreeing to any interest or profit payment (given the fixed price nature of the deal).

If it is agreed that interest/profit will be charged, this will typically be rolled up into the purchase price set out in the acquisition agreement, unless there is a gap between signing and completion (in which case the acquisition agreement may include notional interest/profit provisions to cater for that period). If a long gap between signing and completion is anticipated, it may be harder for the parties to agree a pre-determined profit or interest payment (given the uncertainty as to future trading). In this scenario, the buyer and seller sometimes agree a true-up of the interest or profit element based on actual performance between signing and completion, although sellers are reluctant to open the door to this, as it dilutes the fixed price nature of the deal.

DEBT REPAYMENTS

When the target group’s debt is being repaid or refinanced on completion (as is often the case), the buyer has limited certainty regarding the amount of funding it will require. While the purchase price payable for the target group (ie the equity value) is fixed, the amount required to repay/refinance the target group’s existing debt is not. If the debt has gone up since the locked box date, then the buyer must still repay/refinance the increased amount on completion. Consequently, this is of greater concern to buyers using leverage to fund the purchase, as it is harder for them to pin their financing needs/costs down.

However, assuming a profitable business, if there is increased borrowing on one part of the balance sheet (eg a larger working capital facility), there should be corresponding assets elsewhere on the balance sheet (more stock, debtors, work in progress) to make up for it so this should be neutral for a buyer, other than from a cash flow perspective.
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