Inside the Locked Box

An innovative approach to closing transactions can reduce uncertainty, release capital and free up management time for both buyers and sellers

Executives planning and executing deals continue to operate in a volatile and complex business environment. An alternative to the deal completion phase, called a “Locked Box” mechanism, can speed up and simplify deal completion. This technique is particularly popular among private equity sellers, who are always keen to finish a transaction as quickly as possible, extract maximum value and avoid subsequent adjustments. But it is also becoming more widely considered in corporate-to-corporate deals, particularly in Europe, indicating that Locked Box closing mechanisms are here to stay.

There are two main reasons for using a Locked Box mechanism. First, it provides greater certainty over the price that needs to be paid for a target business on completion, which for the seller frees up capital for reinvestment. Second, it removes the need for a post-completion “true-up” process, which is often disputed. This frees up management time, reduces costs and minimizes uncertainty around subsequent purchase price adjustments.

The classical approach

Typically, an equity purchase price is agreed at signing and paid at completion. This is often based on a multiple of EBITDA or discounted cash-flow valuation, minus net debt, adjusted for working capital and other factors, and based on the balance sheet at completion. Even after careful due diligence and a detailed sale and purchase agreement, this final stage can seem interminable and often concludes with one party feeling they have left significant value on the table.

But between signing the agreement and completing the transaction, the value of the business is likely to change. There will usually be differences between forecast and actual net debt and working capital. To reflect this, the parties enter a true-up process post completion to agree changes to the purchase price. This process is often disputed, which can consume a great deal of management time. It also delays the point at which the final price for the target business is agreed.

Moreover, the existence of a true-up phase adds further complexity to the sale and purchase agreement, as both buyer and seller will push for clauses and definitions likely to strengthen their negotiating hand. Again, there can be extra costs associated with these negotiations, and often, to the surprise of the parties involved, value can be lost in such processes.
How a Locked Box transaction works

A Locked Box transaction is different. The equity price is calculated based on a defined historical balance sheet date agreed by the parties – the “Locked Box date” – and this price does not change. However the buyer needs to compensate the seller for expected changes in net debt between the Locked Box date and completion (the value accrual).

There is no provision in the sale and purchase agreement for any adjustment or net debt true-up on or after completion (although there may be claims under warranties). From the Locked Box date onwards any economic risks or rewards flowing from the target’s performance effectively pass to the buyer.

Whether a Locked Box approach is suitable for a particular transaction will depend on the specific circumstances. The buyer will need comfort on two key points. First, the Locked Box must be firmly locked – they must have recourse for any leakage. Second, the financial information they have about the business must be complete and accurate enough for them to calculate an equity price, including an estimate for a value accrual.

Leakage

Some transactions are more prone to unexpected leakage. With a carve-out sale, for example, it is harder for the buyer to understand the trading relationships between the target business and other companies in its group. The greater the uncertainty, the more the buyer will want the seller to

The classical versus Locked Box approach

Completion accounts

- **Mar**
  - Vendor receives actual cash profit (via purchase price agreement)
  - Reference balance sheet
  - Headline equity price agreed

- **Jun**
  - Completion
  - Economic risks transfer to bidder
  - Equity purchase price paid (initial)

- **Aug**
  - Completion accounts prepared
  - Purchase price adjustments

Locked Box

- **Mar**
  - Vendor receives forecast cash profit (via the value accrual)
  - Reference balance sheet
  - Economic risks transfer to bidder (subject to any other protection in the sale and purchase agreement)

- **Jun**
  - Completion
  - Equity price paid (final)
  - Actual cash profits may be better or worse than expected – purchaser takes the risk

A Locked Box: The equity price is calculated based on a defined historical balance sheet date agreed by the parties – the “Locked Box date” – and this price does not change.
give warranties in the sale and purchase agreement and a broad definition of leakage. The seller may be reluctant to agree.

Quality of financial information
The quality of the financial information that the buyer needs will vary. The sector of the target and the buyer’s assessment of the business risks it faces will be highly relevant here. In a predictable, mature business, the buyer might feel comfortable with less information.

Likewise, they may be content with a looser approximation of the value accrual if they believe that the amount they arrive at is not going to be significant relative to the total price. By contrast, if they expect the business to experience a number of important changes during the Locked Box period, they are likely to want more complete and detailed information and greater assurance over its accuracy.
Key considerations for Locked Box transactions

1. Protecting the value of the business

As with a traditional transaction, the buyer doesn’t actually take control of the target business until the completion date. Under a Locked Box process, the value of the business is fixed long before this point; however, in the meantime the vendor may extract value from the business. Examples of this include dividend payments, undervalued asset disposals and management fees.

To address the risk of value leakage (i.e., non-approved, value extraction by the seller), the sale and purchase agreement should contain provisions to cover this. The seller will agree not to extract any value from the target business between the Locked Box date and the date of completion. The buyer will try to adjust the purchase price for approved leakage and expect an indemnity for any unapproved leakage they become aware of once they complete the transaction. Buyers almost always prefer to deal with the leakage in the purchase price, instead of subsequent efforts to claw back cash already paid. Typically, the buyer will have between three and six months to identify leakage and make a claim. While less common, the same (but opposite) would apply to any capital contributions or reverse leakage.

2. Reflecting accrued value

At the same time it’s also likely that the value of the underlying business will change between the Locked Box date (when the price is agreed) and the completion date (when the consideration is paid). This is due to the ongoing operating cash flows that are generated. The seller normally expects some compensation to reflect this.

Determining a reasonable figure for the value that has accrued in the business is a matter of calculation, commercial judgment and negotiation. The buyer and seller will have different perspectives. For the former, the accrued value represents the increase in equity value of the business. For the latter, it is either the lost increase in equity value or the interest (or return on investment) they foregone by receiving the purchase price some time after the date the economic risk was transferred. Both parties need to consider the other party’s perspective for maximum success.

There are different ways of expressing accrued value, of varied sophistication. Often the parties will apply a simple daily or monthly interest rate to the equity price agreed for the business, or a set daily/monthly amount to reflect forecast cash profits. If the completion date is known with certainty, they may just agree to include a lump sum in the

Avoid leaving value on the table

The method for reflecting accrued value must be done robustly. If it isn’t, either party may risk leaving value on the table, or worse, risk failing to complete the transaction or being outbid by another bidder.

Without a robust process, the seller may consider the value accrued as the inevitable return for not receiving the transaction proceeds at the Locked Box date. Both parties involved may then compare the effective interest rate arising to a reference rate (such as Euribor) plus a typical market premium.

While possibly a useful sense check, the parties need to be aware that this may not accurately reflect the business performance since the Locked Box date.
equity price. Sometimes they will opt for a mix of all these techniques.

Whichever method they use, the final figure will only be an approximation of the value that actually accrues in the business between the Locked Box date and completion. Hence before negotiating the equity price, both parties should try out different ways of calculating the value accrual. This will provide insight into what final consideration – i.e., equity price plus value accrual minus leakage – the other party or rival bidders might find reasonable. This insight will strengthen their negotiating position.

Whether buying or selling, it’s important to consider how changes affecting the business after the Locked Box date might affect accrued value. For example, there might be acquisitions or disposals that are not included in forecasts; trading updates might show that year-to-date earnings are above or below budget – is that a blip or a trend? Seasonality of earnings and cash flows can also be a factor. For example, what are the implications if net debt increases after the Locked Box date?

3. Setting a Locked Box date

Another important area where both buyer and seller need to exercise judgment is the choice of the Locked Box date. Selection of an appropriate date can reduce the risks associated with estimating a value accrual and lead to a better decision about equity price. Date selection is usually a trade-off between a desire for comprehensive and reliable financial data and the length of time between the Locked Box date and completion. For example, a longer time period could result in an increased likelihood of leakage and changes in the business performance or structure, as well as an increased significance of the value accrued. The company’s last set of statutory audited accounts are likely to offer the most accurate financial information, but they may be too old – a long gap between the Locked Box date and the completion date will increase risk for the buyer (and possibly also the seller).

There are ways of dealing with this. The seller can prepare special purpose accounts (which can potentially be audited) if the business has changed significantly since its most recent statutory accounts or if the time lag is particularly long. Management accounts could be used with management providing a warranty regarding the financial statements used to determine the Locked Box balance sheet for the transaction (for example, consistent preparation with the most recent audited financial statements). They may be reluctant to do this, but they could alternatively provide specific warranties on key items, such as the monetary amount of debt, cash and working capital at the Locked Box date.

In any case, the buyer should ask for regular management accounts and information on a regular basis ahead of the signing date. This will help to ensure any movements are as expected or can be explained. This might be onerous for the seller, but may be preferable to generating completion accounts, and will ultimately benefit the seller.

4. Knowing what’s in the box

Buyers will not always have all the information needed to enter a Locked Box transaction in confidence. Ideally, they would have access to a detailed, up-to-date profit and loss account, balance sheet and cash flow forecast through to completion. That would enable them to form a view of equity value at the proposed completion date, which they could then compare against current trading and cash flows. But data of this quality is not always available.

Often, the seller will provide only a forecast balance sheet. This would show a buyer the forecast net debt – although possibly without sufficient detail – but it likely wouldn’t enable them to understand the reasons for any movements in net debt. Some provide only a forecast cash flow. This would help them to understand how and why net debt is changing, but it may be too simplistic.

In the most difficult scenarios, the buyer will just have a forecast profit and loss account to work with. They would need to translate accounting profits into cash flows and eliminate any that relate to debt and debt-like items. The number of adjustments and assumptions required can make this a complex task.
Ultimately, it's a business decision

Technicalities aside, commercial considerations are often paramount. This covers not just the ability to generate and review the necessary commercial information but also the accuracy of forecasts. 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.

For example, Locked Box transactions are especially popular with private equity firms and financial investors (as sellers) because they see it as simplifying the process, freeing up capital and allowing them to move onto the next deal. But equally, strategic corporate buyers and sellers will want to minimize: the amount of management time spent on completion accounts; post-transaction true-up negotiations; protracted negotiations as a result of complex sale and purchase agreements, which may lead to the deal collapsing; and 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. Our recent Global Capital Confidence Barometer survey shows that M&A market conditions are modestly improving and are the strongest they’ve been in a while, yet many executives remain fundamentally cautious about taking deals forward.

A Locked Box is one way to reduce some of the risks associated with a transaction and increase the likelihood that it will deliver the anticipated value.
Is a Locked Box right for your transaction?

The principles behind the Locked Box approach are sound, but whether this is the right process for a particular transaction will depend on the specific circumstances. Relevant questions include:

- How certain are you that the Locked Box is actually locked? Can the seller take value out of the business without recompense?
- Is the financial information you have about the Locked Box business sufficiently accurate and complete? What assurance do you have about that?
- How important is it for you, and the other party, to have up-front certainty about the final price for the business?
- How important is it for you, and the other party, to minimize management time and cost spent on post-transaction true-up work and corresponding uncertainty?
- How valuable would it be for your business if you could cut the time spent negotiating a complex sale and purchase agreement?

Locked Box: common questions

Shouldn’t the sale and purchase agreement have a mechanism for adjusting the price if cash, debt or working capital is different on completion?

No, there is no subsequent adjustment – that’s the point of a Locked Box mechanism.

Don’t we need a balance sheet just before completion so that we can adjust the price?

No, the price is fixed. Once the sale and purchase agreement is signed, the price is not adjusted. But an up-to-date balance sheet is nevertheless useful for funding purposes.

What happens if the mix of cash, debt or working capital is different on completion to what we thought?

This isn’t relevant for pricing, as the business being acquired has been locked – all value generated is captured in the business. The mix of cash, debt and working capital is only relevant for funding purposes.

What happens if trading after the Locked Box date turns out to be different from what is expected?

For the seller, nothing; this risk is passed to the buyer.

Shouldn’t we adjust for the shortfall in capex spend identified after the Locked Box date?

No, the box is locked. Any shortfall in capex would result in an increase in cash.
Your Locked Box checklist

1. Know the potential, alternative Locked Box dates that could be used
2. Review the balance sheet at the Locked Box date to determine net debt and “normal” levels of working capital (including adjustment to purchase price, if necessary)
3. Prepare and review the monthly financial information between the Locked Box date and closing (likely consisting of actual reporting and forecast)
4. Compare (where possible) the outcome of checkpoint 3 to your budget/forecast and prior year in order to understand business performance, analyze unusual developments and separately identify movement in net debt items
5. Identify any actual leakage since the Locked Box date and any specific leakage risks
6. Review the SPA to ensure appropriate clauses relating to the use of a Locked Box mechanism, including clauses to address any actual or possible leakage
7. Calculate the value accrual (absolute and as a daily/monthly percentage based on purchase price)
8. Perform a tactical assessment of the value to attribute to post Locked Box date cash flows, and consider how to present this

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