‘LOCKED BOX’ MECHANISMS OPEN UP M&A - ARAOZ & RUEDA

Posted on 12/12/2013

Category: Corporate

Buyers and sellers are increasingly turning to these agreements for M&A transactions, but there are pros and cons to fixing the purchase price of an asset

Most M&A transactions are structured in a way that the price of an asset is agreed when the deal is signed. This price is often based on earnings before interest, taxes, depreciation, and amortisation (EBITDA) or cash-flow valuation, but excludes factors such as working capital, debt and net assets. These additional provisions are usually set at completion or post-completion, with the price being adjusted accordingly.

Risk and certainty

One of the risks for sellers of the typical model is that the value of a target could change considerably between the contract signing and completion, especially in complicated cases that involve regulatory clearance and can drag on for months, says Francisco Aldavero, M&A and Private Equity Partner at Araoz & Rueda. “This leaves both buyers and sellers vulnerable to losing out if prices went too far up or down.”

While the traditional ‘completion accounts’ model has been generally regarded as buyer-friendly, he believes that sellers are increasingly looking for certainty in M&A prices and that the traditional model is starting to be replaced in some cases with other innovations. “We are seeing ‘locked box’ mechanisms becoming a bit more popular in transactions, especially when the seller is a private equity firm and the buyer an industrial company.”

A locked box agreement is when a fixed price is agreed between a buyer and a seller using financial statements of the target referred to a date prior to the signing of the transaction. This price is worked out on the asset’s historic balance sheet – factoring in cash flow, working capital, debts, etc. – before finalising a share purchase agreement. This price generally does not change post-completion unless for leakages identified prior to or after completion.

The provision was originally developed in the US before spreading to the UK. Aldavero says the mechanism is now growing in popularity in Spain because it provides more certainty for a seller, especially for private equity firms that are not always involved in the day-to-day management of assets and looking to make returns to investors.

“Entering into such a fixed price regime requires additional consideration,” he explains. “During the negotiation phase, buyers need to be sure that they have undertaken rigorous due diligence and are in possession of fully audited accounts and independent reports on a target – buyers must ensure they are paying the right price.”

Friendly approach

Pedro Rueda, Corporate Partner at Araoz & Rueda, says that the locked box mechanism is a more friendly approach. “The post-completion price of an asset is usually a key point of dispute between parties. As such, having a fixed price at the signing negates the likelihood of litigation further down the line.”

Likewise, a post-completion price usually means the appointment of an independent third-party expert to determine the true value of a company. This can also be a timely and costly process and once again, an agreed price reduces that burden. “Generally, locked box agreements can be less precise for the buyer,” says Rueda. “They need to rely on projections of the value of the company at closing, which requires more sophistication and knowledge from a buyer.” Even so, many agreements include certain clauses to offset possible risks or depreciation of a business.

“Locked box agreements work best when the buyer fully understands the business,” Rueda observes. “The agreements can include provisions against so-called ‘value leakage’ of a target between the deal signing and completion. These usually involve the seller agreeing not to make any decisions that will materially affect the business.”

Examples of leakage include dividends payments, returns of capital, selling of assets as well as major changes to salaries, bonuses or fees that can affect the balance sheet. Other issues can be corporate-level alterations, changes to insurance, rent or other costs. Leakage provisions generally give a buyer the right to terminate the contract should considerable value leakage occur.

Aldavero summarises that while locked box agreements remain a minority mechanism in terms of deals, they are a popular trend. “There are, of course, advantages and disadvantages, but in the right situation, locked box mechanisms are a good way for buyers and sellers to get a deal agreed and completed quickly with a great deal of certainty,” he concludes.