FOCUS
Capital Partners

April, 2023

ARRIVING AT SHAREHOLDER EQUITY VALUE

Transaction Completion Mechanisms by Brian Barrett

The equity value paid to a shareholder of a business is invariably different from the headline price or ‘enterprise value’ agreed between the buyer and seller as part of a transaction. While the principles of calculating the equity value of a transaction are readily understood, the approach to deriving the final equity value for the seller can be both complex and subjective. Considering the many contentious areas in determining the final equity value, a buyer’s view of the final transaction price payable can be materially different from that of a seller. The negotiations between the parties of the equity value adjustments (including cash, debt, and normalised working capital) and the completion mechanism to be applied are critical elements in every transaction as these aspects can have a material effect on value.

Enterprise Value versus Equity Value

The enterprise value of a business is typically based upon a buyer’s expectations of the seller’s business’ current and/or future profits, equating to a normalised EBITDA (net income (earnings) with interest, taxes, depreciation, and amortisation added back). The implied EBITDA multiple applied to the business will vary due to many factors, including, inter alia:

- Risk and uncertainty;
- Sustainability and expected growth;
- Competitive sales process;
- Potential synergies for the buyer; and
- Valuations of similar businesses.

A buyer’s enterprise value will also be based on the following assumptions:

- The acquisition will be on a cash-free and debt-free basis; and
- The business will be acquired with a normal level of working capital.

To derive the final equity value for the seller, the above will require adjustments to the enterprise value to the extent there is cash or debt in the business and if there is a difference between the actual working capital and its ‘normal’ level at completion.

Cash-Free and Debt- Free

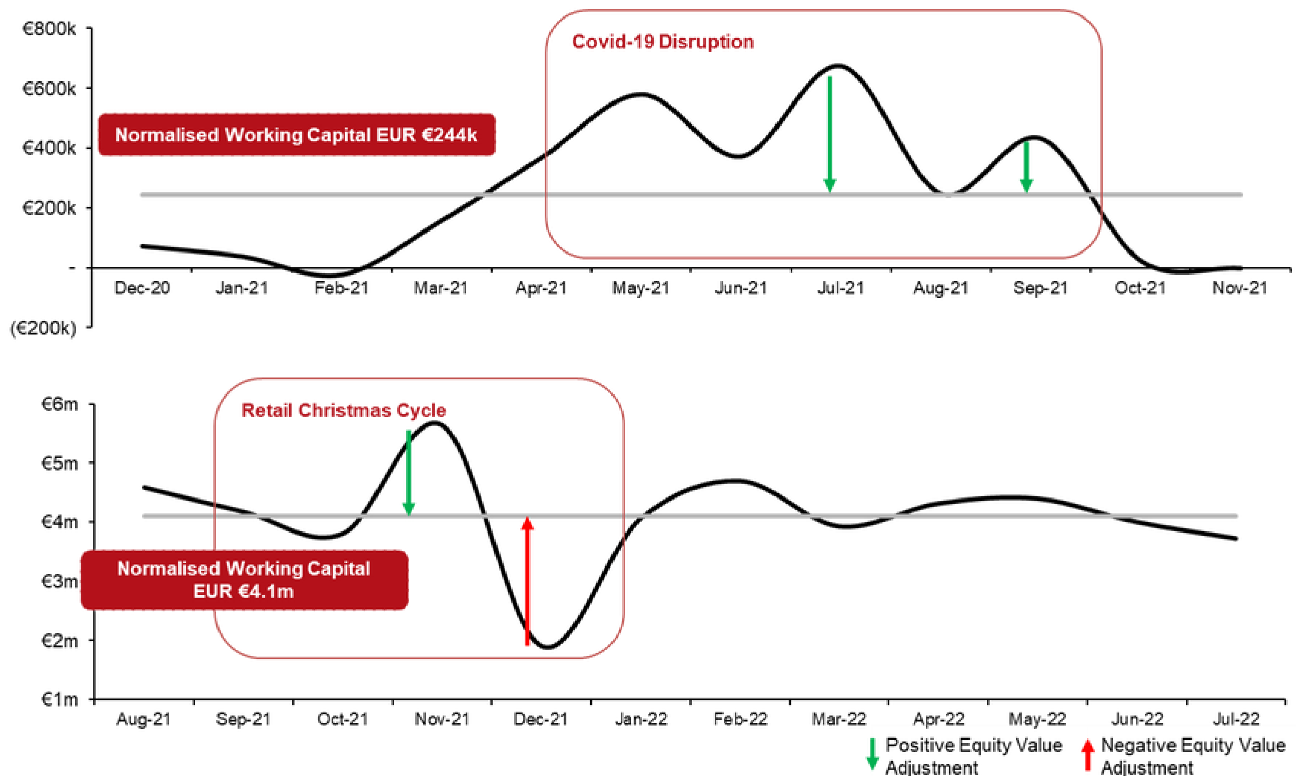
To the extent there is cash and/or debt in the business at completion, this will require an upward adjustment to the equity value in the case of the business having a net cash position or a downward adjustment to the equity value in the case of the business having a net debt position.

Normalised Working Capital

Typically, in a transaction, the buyer acquires the business with a normal (average) level of working capital. This principle will require adjusting the equity value to the extent that the working capital at completion is not 'normal'. The normalised working capital is usually calculated based on the preceding 12 to 24-month period.

Potential issues that may arise without a working capital adjustment, include, inter alia:

- Sellers may be incentivised to manage down the business's working capital (e.g., deplete normal stock levels, collect debtors faster, and/or delay creditor payments to suppliers).
- There might be an inherent cyclical nature to the business's working capital (e.g., Christmas/Summer periods). As such completion may occur at a high/low point in the working capital cycle, which would result in significant cash movements due to the timing of payments and receipts around the completion of a transaction. See below two different examples (manufacturing & retail) of the cyclical nature of working capital:



The two key considerations in determining the normal working capital target are:

- Establishing what is a normal level of working capital for the business
- The definition of working capital

All cash, cash-like, debt, debt-like, and working capital needs to be carefully considered and negotiated between the seller and buyer as part of the transaction process. Set out below is a list of examples of items typically captured in cash, debt, and working capital:

Cash

- Cash accounts
- Cash on hand (petty cash and cash in tills)

Cash Like

- Financial investments
- Company deposits
- Surplus assets (held for sale)

'Trapped' Cash
- Cash in subsidiaries
- Cash as security/deposits (underpinning guarantees, borrowings)
- Ring-fenced cash for regulatory or contractual reasons
- Cash held on behalf of customers or clients

Debt

- Bank loans, accrued interest, overdrafts
- Break costs
- Finance leases
- Corporation tax

Debt Like

- Invoice discounting/factoring
- Transaction costs
- Pension deficits
- Overdue tax liabilities

Maybe Debt-Like
- Deferred income/revenue
- Bonuses
- Dilapidation costs
- Underspent capex
- Derivatives
- Legal claims

Frequent areas of dispute!
Is there a cost to delivery? If yes, then it should be considered as a 'Debt-Like' item

Working Capital

- Stock
- Debtors
- Creditors
- Pre-payments
- Accruals
- VAT/Payroll taxes

Any current operating assets or current operating liabilities determined to be cash, cash-like, debt or debt-like should be excluded from working capital to avoid double counting

Other factors that may impact the final equity value of the business include:

Fixed Assets	Taxation	International Businesses	Law
Under/Over invested property	Usual tax structures	Working capital cycles may vary by entity and jurisdiction	Regulatory Compliance
Under/Over invested equipment	Accumulated liabilities across all tax heads (VAT/Payroll)	Foreign exchange movements (e.g. FX Swaps)	Environmental Compliance
Leases (Property/ equipment)	Deferred tax/ R&D tax credits		
	Tax benefits derived from transaction structuring		
	International Subsidiaries		

At FOCUS Capital Partners, we would highly recommend that a seller of a business should undertake a pre-transaction due diligence exercise to consider what issues may impact upon the potential equity value of their business.

Completion Mechanisms

In every transaction, a financial mechanism must be adopted to arrive at the final equity value payable by the buyer to the seller. There is more than one way of doing this and the outcome can be different depending on the approach taken. There are two widely accepted mechanisms for adjusting the enterprise value, completion accounts, or a locked box.

Completion Accounts

With completion accounts, the final equity value adjustments are based on the actual balance sheet of the business at the date of completion, but prepared after the transaction has been signed. Completion accounts are prepared up to the date of completion to ensure all transactions prior to completion are captured within the business. Typically, completion accounts are prepared at a month-end, to align with the business's natural accounting / financial processes. The Share Purchase Agreement ("SPA") will set out the initial consideration payable at completion, typically an estimate, which is subject to a 'True-Up' adjustment post-transaction once the completion accounts are finalised and agreed upon between the parties. The completion accounts will show the net assets of the acquired business as of the date of completion, comprising a closing balance sheet, and may include a profit & loss account. Completion accounts are bespoken to a transaction and therefore the basis of their preparation should be clearly defined in the SPA.

In the SPA, the completion accounts are typically defined by way of the following principles:

- The accounting policies to be adopted in the preparation of the completion accounts;
- Who prepares the completion accounts (this can be either buyer or seller); and
- How disputes between the parties are to be resolved.

Accounting Policy

- Historical management accounts or financial statements can provide a reference point for the basis of preparation of the Completion Accounts
- Items not contained within the management accounts / financial statements that are specific to the Seller's business should be covered by specific accounting policies
  - It is advisable that the Seller & Buyer agree on specific accounting treatments of certain items to be adopted in the completion accounts

Examples of specific accounting policies

- Revenue
- Holiday pay accrual
- Staff bonuses
- Contract provisions
- Provision for Capex adjustment
- Provision for off-balance sheet liabilities
- Leases (e.g. onerous or a rent-free periods)
  Impairment provision
- Revaluation of property
- Deferred tax
- Other provisions (e.g. litigation, environmental)

Preparation

- Subject to the SPA, either the Seller/Buyer may prepare the draft completion accounts
  - For practicality purposes the preparation of the draft Completion Accounts should consider who is best placed to do so given ease of access to accounting records and personnel
- The SPA will set out the timeframe to which the Completion Accounts are prepared, reviewed and agreed, for example:
  - Preparation 30-45 business days
  - Review 10-15 business days

Dispute Resolution

- In order to narrow the scope and focus of negotiations and any subsequent disputes, items not specifically notified as disputed are deemed (through SPA clauses) to become final and agreed
- Any items not agreed within the specified negotiation period (which can be mutually extended) may be referred to an independent expert to determine

Examples of disputes

- Basis for preparation of completion accounts
- Accounting treatment of an individual item (e.g. accruals or deferred income)
- Provision for a liability of an uncertain amount
- Double-counting issues
- Revenue recognition/stock provision/bad debt provision.

Locked Box

With a locked box mechanism, the final equity value (including adjustments) is applied to a balance sheet prepared at a date prior to the completion of the transaction. The key benefit of the locked box mechanism approach is that it avoids time being spent post-transaction on the completion process and upfront calculation of the locked box brings certainty for both buyer and seller on the final equity value payable at completion.

The seller will typically warrant to the buyer the accuracy of the locked box accounts. The term 'Locked Box' refers to the fact that no value is permitted to leave the business between the locked box date and until the completion of the transaction – the 'box' is thereby 'locked'!

The buyer and seller agree on the equity value adjustments which are applied to the assets and liabilities at the locked box date and there is no further true-up to take account of their values at completion.

While for a locked box, no value is permitted to leave the business between the locked box date and until completion of the transaction, however, there are two critical considerations that need to be addressed – Leakage & Value Accrual.

Leakage

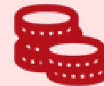
•'Leakage' refers to the extraction of value by the Seller or connected persons, such as dividends during the post-locked box period.

•Between the Locked Box and completion dates the Buyer will typically receive protection via the SPA against leakage.

•If, within an agreed timeframe post-transaction, the Buyer identifies leakage they can require the Seller to reimburse.

•'Permitted Leakage' can be documented in the SPA. Permitted leakage is to carve out of certain items from the leakage protection, which covers known leakage both parties are aware of and agree to prior to completion, which is factored into the calculation of the Equity Value at completion (e.g. capex).

Value Accrual/Ticker



•Value movement between the locked box and the completion date needs to be captured.

•Applying an equity value adjustment at the Locked Box date, the economic risks and returns effectively transfer to the Buyer at that date.

•For the Seller they may still be managing the business to generate profit and will have capital tied up until the completion date when the consideration is paid. Therefore the Seller may expect to be compensated for this via an upward adjustment to the Equity Value (assuming the business is profitable).

•There are 2 approaches to the Ticker:
i. Profit before depreciation and amortisation, after interest and corporation tax charges (this may also include capex).
ii. Rate of return (%) applied to the consideration (e.g. equity-return-based rate v lower debt-return-based rate)
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Summary of Completion Accounts versus Locked Box

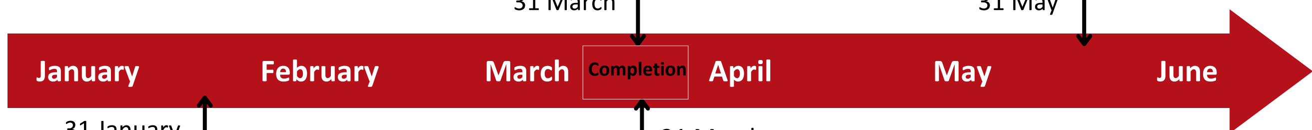
Completion Accounts

- Economic risk & returns transfers to buyers
- Initial equity price paid using estimated completion accounts

- Completion accounts prepared & agreed post-transaction
- Purchase price adjusted to arrive at final equity value

31 March

31 May



31 January

31 March

- Locked box accounts prepared & agreed.
- Economic risk & return transfers to the buyer.

Ticker adjustment to seller

- Final equity value paid based on locked box accounts, plus ticker and less leakage.

Locked Box Accounts

Other Adjustments to Equity Value

Retention

The buyer may insist on an element of the final equity proceeds to be retained by the buyer and only to be released subject to confirmation of the equity price adjustments once the completion accounts and the completion statement are agreed upon between the parties. The buyer will then pay the balancing figure once confirmed.

Escrow

Completion mechanisms may require the seller to return part of the consideration paid by the buyer. To protect the buyer and ensure the seller can make the repayment on a date following completion, an element of the final equity value may be placed into an escrow account in the intervening period. Any balance remaining after the finalisation of the completion statement is paid to the seller.

Escrows can also be used by buyers to protect against potential liability claims, indemnities, or warranty claims against the seller.

The quantum, duration, and cost of any escrow arrangement is a matter to be negotiated between the parties, the details of which are contained within the SPA and an Escrow Agreement.

Deferred Consideration

The payment of the final equity value may be split between an upfront payment and a deferred portion, known as deferred consideration. Again, to protect the buyer of the business a deferred consideration may be utilised to manage a number of contingent conditions linked to the performance of the seller, for example, the seller remaining with the business to ensure a smooth transition post-completion for a specified period (i.e., 6 to 12 months).

Earnout

While a buyer and seller may want to complete a transaction, they may not entirely agree on the valuation of the business. In this case, the parties may agree to employ an earnout strategy. An earnout is a contingent payment that the seller only receives from the buyer when specific performance targets are met, typically financial performance targets.

In this instance, the SPA needs to reflect the mechanism under which the contingent consideration is payable to the seller. Like completion accounts, earnout accounts must be produced for the earnout period so the results of the business can be compared with the agreed targets. The preparation of the earnout accounts will follow a similar mechanism as the completion accounts.

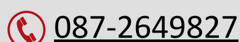
April, 2023

Conclusion

It is critical for the seller of a business to clearly understand the difference between the enterprise value of their business and the ultimate final equity value that they can expect to receive in a transaction. A buyer's view of the final equity value often differs from that of a seller.

There are many areas that require consideration by both parties. The seller and buyer need to negotiate and reach an agreement on the more subjective and contentious areas to avoid value erosion and future disputes. Engaging early and comprehensively in the completion mechanism process of the deal will help achieve a smoother and more efficient transaction for both seller and buyer. If you have more questions or would like to learn more about how we can help you design and implement effective completion mechanisms, please don't hesitate to get in touch with us today.

Brian Barrett
Associate Director



About FOCUS Capital Partners:

FOCUS Capital Partners offers a broad suite of corporate finance advisory and capital raising services, with a focus on Debt Funding, Equity Fundraising, Mergers & Acquisitions, Renewables & Infrastructure, and Tax. FOCUS has expanded into the United States by combining with Washington D.C.-based FOCUS Investment Banking to form FOCUS International, an international M&A services platform. The transatlantic firm provides sell-side, buy-side, and capital raising services to companies in Ireland, United Kingdom and the United States. We are a highly committed, outcome focused team of professionals who bring to each project a powerful combination of technical and financial expertise, extensive commercial experience, strong networks, and an entrepreneurial mindset. We deliver value by working in partnership with our clients and prioritising their needs.
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