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# Trends in Private Company M&A: Completion Accounts and Locked Box – Seller and Buyer Perspectives

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# Trends in Private Company M&A: Completion Accounts and Locked Box – Seller and Buyer Perspectives

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Completion accounts have been the traditional pricing mechanism used to deal with uncertainty in the valuation of a target company in acquisitions, but the locked box mechanism has become increasingly popular in recent deals.

Using the completion accounts mechanism, a price is agreed to be paid at completion, which is subject to adjustment after completion based on a set of accounts for the target company prepared after completion that confirm the exact financial position of the target on the completion date.

Using the locked box mechanism, the price to be paid on completion is based on the financial position of the target company as set out in a historical set of accounts for the target company. The target company is deemed a 'locked box' from the date of those historical accounts, and the seller agrees to reimburse the buyer in respect of leakage of value occurring between the locked box accounts date and the completion date (e.g. any value extracted by the seller from the target company, for example dividend payments, management charges, transactions at under/over value, etc.).

In terms of overall economics, the same valuation methodology may be applied using both approaches (e.g. earnings multiples, cash-free debt free, etc.).

The key difference is that the locked box approach sets the purchase price up front by reference to a historic position, whereas the completion accounts method relies on a price adjustment after completion referencing the position at completion.

## **Which method to choose?**

Every transaction is unique, and the appropriate pricing mechanism should be chosen on a case-by-case basis.

The following are some points that should be considered from a buyer's or seller's perspective in making this decision.

## **Completion Accounts: Advantages**

For a seller, the completion accounts approach can:

- Allow the seller to benefit from the trading of, and extract value from, the target company up to the completion date.
- Address concerns that may have been raised by a buyer on a target company's poor historical financial reporting procedures.

For a buyer, the completion accounts approach can:

- Provide comfort that the purchase price is a fair reflection of the value of the target company on completion, particularly where there is considerable uncertainty over what the financial position of the target company will be at completion (for example due to structural complexities in the target group, a reorganisation immediately prior to completion, etc.), or if the target is loss making.

### **Completion Accounts: Disadvantages**

For both the seller and the buyer, the completion accounts approach may:

- Lead to significant costs and lost management time through the process of preparing, reviewing and potentially disputing final price adjustments derived from the completion accounts.
- Be made more difficult in practice where the transaction completes mid-month, as the target company's systems may only be set up for determining figures at month end.
- Require significant discussion and negotiation on the practicalities of, and relating to the accounting policies, practices, and adjustments to be used in the preparation of, the completion accounts.

### **Locked Box: Advantages**

For a seller, the locked box approach can:

- Deliver certainty of price and shift the risk of current trading of the target company onto the buyer from the date of the locked box accounts, which can be particularly useful where the sale process might negatively impact trading or distract management from their day-to-day tasks.
- Provide a fixed pricing mechanism for auction/bid scenarios in order to better compare the economics of multiple bids.
- Lead to a cleaner exit with greater control over the final price paid, as the seller would typically have more control over leakage as opposed to completion accounts adjustments determined after completion.
- Present a quicker exit, as the absence of completion accounts mechanics can simplify negotiations, and it is less likely that escrow or deferred payment arrangements to accommodate potential adjustments will be required.

For a buyer, the locked box approach can:

- Shift the benefit of current trading of the target company onto the buyer from the date of the locked box accounts, where the target company is profitable.
- Reduce costs in terms of external fees and management time after completion by eliminating the completion accounts mechanism.

### **Locked Box: Disadvantages**

For a seller, the locked box approach may:

- Require an audit, or interim audit, on the accounts to be used as the locked box accounts.
- Necessitate significant negotiation on what constitutes leakage and what constitutes permitted leakage.
- Result in the buyer seeking more extensive warranty cover in respect of the locked box accounts and current trading since the locked box accounts date.
- Only be suitable for share sale transactions.
- Effectively restrict the seller from actions that would be considered leakage, as the seller would have to repay these amounts to the buyer after completion.
- Become unduly onerous if the target company is part of complex group arrangements and leakage is

not clearly identifiable.

For a buyer, the locked box approach may:

- Put time pressure on completing a transaction, as there is a greater risk of unprofitable trading by the seller the longer the gap between the locked box accounts date and the completion date.
- Be subject to an 'equity-ticker' or 'interest rate' on the target company valuation at the locked box accounts date in order to pass the benefit of the period between the locked box accounts date up to the completion date to the seller.
- Require greater reliance on financial due diligence.
- Need significant negotiation on what constitutes leakage and what constitutes permitted leakage.
- Limit the buyer's protection to leakage provisions and a claim for breach of warranties, and such provisions may not cover all scenarios where value is lost or they may be difficult for the buyer to recover under and subject to limitations.
- Reduce certainty on the level of debt and working capital of the target company that the buyer will need to finance in cash on completion.

It is important that the buyer understands the key due diligence needs under each mechanism. For example, when using the completion accounts mechanism to identify the accounting policies that are to apply, and when using the locked box accounts mechanism to test the balance sheet, scrutinise the forecast to completion, and consider the implication of permitted leakage.

Whether a buyer or seller, it will be critical to consider which price mechanism is to be used on a case-by-case basis to minimise valuation and execution risk.

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