

**Locking in Value**

A quick guide to Locked Box  
Closing Mechanics

You've agreed the headline valuation for the business and due diligence is progressing quickly. Before you know it, you're racing towards the deal completion, so what next?

Choosing an appropriate closing mechanism is a key decision.

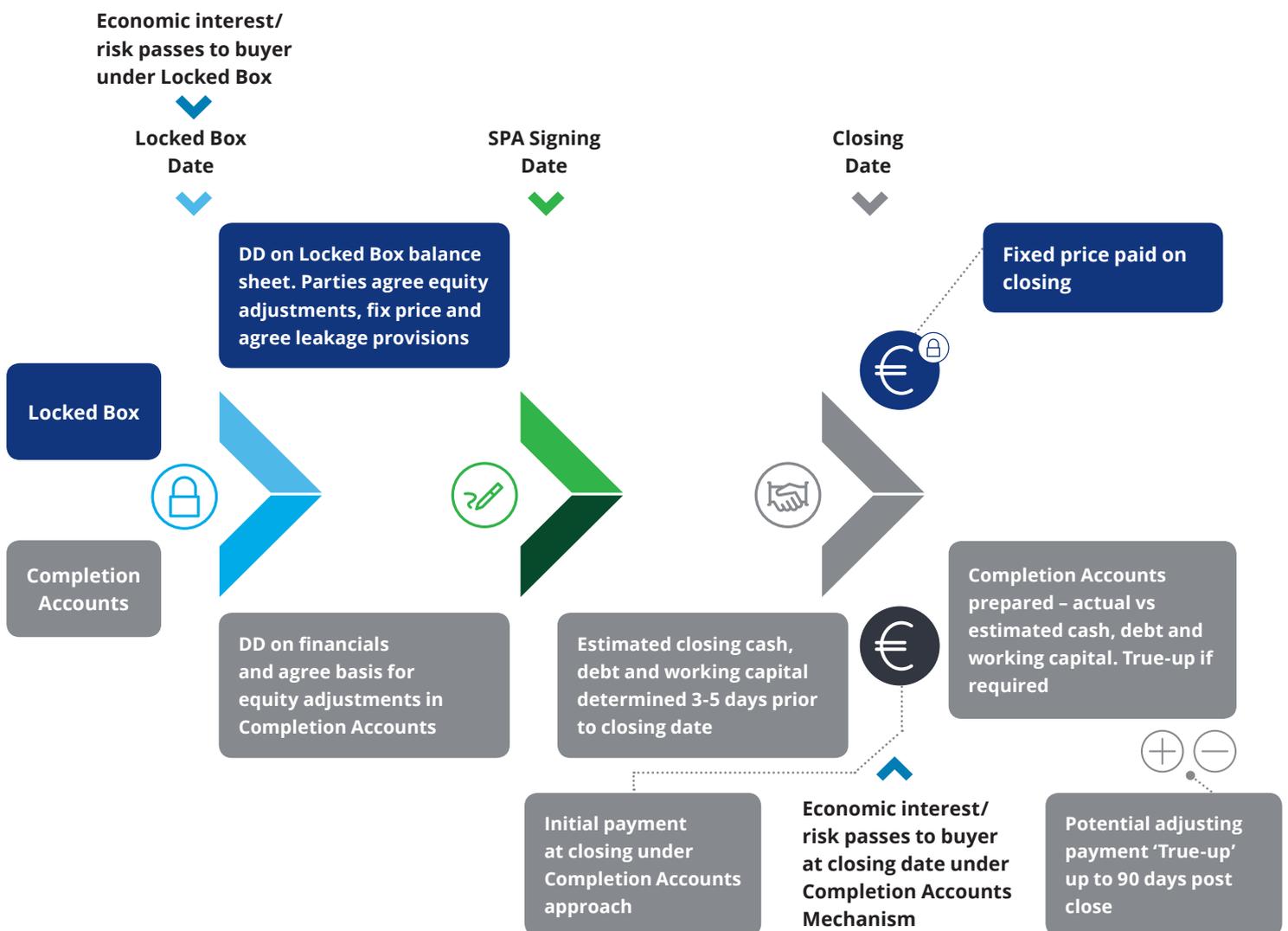
The Locked Box is a popular closing mechanism for M&A transactions across Europe, however, many sellers and buyers are still unfamiliar with the Locked Box mechanism.

Historically, many M&A transactions applied a Completion Accounts mechanism whereby the seller and buyer agree a valuation for the business (the "Enterprise Value"), on a 'cash free, debt free and normal level of working capital' basis. Post

transaction close, Completion Accounts are prepared and the enterprise value is then adjusted for actual cash, debt and working capital in the business at the closing date to determine the equity price (the amount actually paid to the seller), based on definitions set out in the Share Purchase Agreement ("SPA"). Neither party has certainty over the purchase price until the Completion Accounts have been prepared and reviewed by both parties.

The pricing considerations and enterprise value to equity value bridge (adjustments for cash/debt and working capital) are exactly the same under both Completion Accounts and Locked Box mechanisms. Put simply, the Locked Box approach removes price uncertainty for all parties as the seller and buyer negotiate a fixed price at signing the SPA based on the agreed Locked Box balance sheet.

### Locked Box V Completion Accounts





So here are the key steps to understanding and applying the Locked Box mechanism...

## 01 Understanding the mechanics

The Locked Box mechanism seeks to fix the equity price at the time of signing the SPA. The price is calculated using a recent historical balance sheet ("Locked Box Balance Sheet") where cash, debt and working capital are known amounts. Typically, the parties negotiate and agree the definition of these amounts outside of the legal documentation and agree on the fixed price to be inserted into the legal documents, simplifying the legal terms and definitions in the SPA. The net price is essentially agreed upfront.

The buyer takes the economic benefit/risk from the Locked Box date to the closing date, which in a fast growing target business can provide significant potential upside benefit. The buyer will

seek protection through the SPA against value being extracted from the business (cash, assets etc.) in the period between the Locked Box date and closing (known as "Leakage"). The seller will undertake not to extract value from the business except for items specifically agreed between the parties and clearly defined in the SPA (known as "Permitted Leakage").

If the Box is appropriately locked, any movement in working capital between the Locked Box date and closing date will be matched by the movement in net cash/debt, so neither party wins or loses but the risk of post deal negotiations is removed.

## 02 When to adopt the Locked Box approach?

The Locked Box approach is particularly suited to transactions where the parties require economic certainty (e.g. private equity exits), rapid integration of the businesses is necessary or as a way of reducing risks associated with buyers trying to bridge a value gap through Completion Accounts adjustments (price-chipping).

However, the Locked Box approach is not suitable for every transaction scenario. Buyer confidence in the Locked Box balance sheet is critical. The strength of the seller's finance function and reporting will impact on the comfort that a buyer can obtain regarding the Locked Box. For example, in a complex carve-out situation where historical financials were not prepared for the carved-out business, a Completion Accounts mechanism may be more appropriate.

## 03 Determining the Locked Box date

As we've discussed, buyer confidence in the Locked Box balance sheet is key. The buyer will seek to minimise the time period between the Locked Box date and closing to minimise the risk of Leakage, but at the same time there needs to be enough time to prepare and diligence the Locked Box balance sheet. The target group's last financial year end is a common choice for the Locked Box date, with key deal metrics (working capital, net debt etc.) being determined from independently verified financials. If there is too large a time lapse between the last audited accounts and proposed closing date, the seller and buyer may agree on a more recent management accounts balance sheet to lock. The management accounts on which the Locked Box are based will be subject to thorough diligence to provide the buyer with sufficient comfort.



## 04 Leakage

The parties negotiate and agree what constitutes 'Leakage' and 'Permitted Leakage', in order to preserve the value of the business between the Locked Box date and closing. Leakage is essentially any transfer of value from the business to the seller or connected parties between the Locked Box date and closing – examples of Leakage and Permitted Leakage include:

<b>Leakage (recourse to the seller)</b>	<b>Permitted Leakage (no recourse to the seller)</b>
<ul style="list-style-type: none"><li>• Dividends and distributions</li><li>• Any other distributions or return of capital</li><li>• Ex gratia payments to directors or connected persons</li><li>• Transaction fees and expenses</li><li>• Transaction bonuses paid/payable to staff</li><li>• Non-commercial intra-group transfers</li></ul>	<ul style="list-style-type: none"><li>• Any amounts provided for in Locked Box accounts (factored into fixed price)</li><li>• Items agreed pre-exchange</li><li>• Payment of business costs in the normal course (e.g. staff wages)</li><li>• Arm's length intra-group payments in the normal course</li></ul>

The seller will typically provide an indemnity in respect of any Leakage between these dates. The indemnity may be further supplemented by covenants and warranties on the Locked Box accounts.

## 05 Per Diem or Interest rate

As economic interest passes from the seller to buyer at the Locked Box date, the buyer has the benefit of cash profits generated in the intervening period. The seller has an opportunity cost as they do not get the benefit of continued profit generation, instead receiving the transaction proceeds at closing.

A common mechanism to compensate the seller for the opportunity cost is to apply an interest rate or per diem rate for the period between the Locked Box and closing. There are two common approaches:

- Interest charge applied to the equity cheque to reflect the seller not receiving the proceeds at the date when economic interest passes; or
- A Per Diem (daily rate) as a proxy for cash profits earned that the seller will not have been able to extract from the business.

Both approaches should essentially reflect the cash profits generated by the target between the Locked Box date and closing.



**In Summary...  
Benefits and  
challenges of  
the Locked Box  
mechanism**

	<b>Seller</b>	<b>Buyer</b>
<b>Benefits</b>	<ul style="list-style-type: none"><li>• Fixed price certainty</li><li>• Simple transaction structure</li><li>• Greater control over process</li><li>• Cost savings due to no Completion Accounts review requirement</li><li>• Clean break on closing</li></ul>	<ul style="list-style-type: none"><li>• Fixed price certainty</li><li>• Simple transaction structure</li><li>• Cost savings due to no Completion Accounts review requirement</li><li>• Facilitates quicker integration post closing</li></ul>
<b>Challenges</b>	<ul style="list-style-type: none"><li>• May not receive full benefit of continued ownership/operation of the business between Locked Box date and closing</li><li>• Per Diem or interest rate, if any, may be too low to compensate seller for earnings in the intervening period (particularly in a rapid growth business)</li><li>• Requires a strong finance function etc.</li></ul>	<ul style="list-style-type: none"><li>• May require enhanced due diligence and reliance on warranties to gain comfort on the Locked Box balance sheet</li><li>• Buyer takes the risk of any business deterioration between the Locked Box date and closing</li></ul>



**Key to applying the Locked Box approach...**

01. Price considerations for a Locked Box are exactly the same as the Completion Accounts mechanism, only timing differs
02. A Locked Box approach requires buyer confidence – robust financial information and minimising the time lag between the Locked Box date and closing date is key
03. The Locked Box approach simplifies legal documentation for the transaction
04. For the buyer to protect value, definitions of Leakage and Permitted Leakage require careful consideration
05. An interest rate or daily rate for the period between the Locked Box date and closing will often be applied to compensate the seller for the cash profits generated in the intervening period which they are unable to extract

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