Share purchase agreements

Purchase price mechanisms and current trends in practice

2nd edition
Undertaking a professional due diligence exercise has become an established part of the transaction process. The due diligence findings are typically taken into account either in the purchase price, including the price mechanism, or in the contractual terms. Incorporating purchase price mechanisms in share purchase agreements (SPAs) is a way of ensuring that the parties’ ideas and expectations surrounding the value of the target are reflected in the contractual framework. The challenge lies in defining a mechanism that is acceptable to both the buyer and the seller, while at the same time offering adequate protection against the risk of value changes during the sale process. This brochure has been compiled to give you an overview of the purchase price mechanisms most often applied in share deals. You can also find out more about the role of due diligence in defining such mechanisms. In this edition, we have updated and extended the study carried out by Ernst & Young on the same topic in 2008, providing valuable insights into the latest purchase price trends.

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Overview

Depending on how a transaction is structured, several weeks or even months can elapse between signing and closing. Besides the economic risk, the buyer is exposed to a significant risk of value leakage - for example, if the seller decides to withdraw funds from the target by paying out dividends or bonuses. During this period, the buyer is fully exposed to changes in the value of the target, but does not yet exercise sufficient control over business operations. The buyer can choose from a range of purchase price mechanisms to protect against value erosion and value leakage. There are a couple of basic options for determining the purchase price. The parties can agree a fixed purchase price (locked box mechanism) or they can set a preliminary purchase price that is to be adjusted subsequently using a price adjustment mechanism. From an economic perspective, a distinction is made between price adjustment mechanisms based on balance sheet accounts (price adjustment clauses) and those based on performance (earn-out clauses).

Price adjustment clauses

► Financial due diligence based on the last statutory financial statements as of 31 December 20XX (reference accounts).
► At the signing stage, a preliminary purchase price is defined, together with the price adjustment clauses.
► Closing accounts are compiled to determine the final purchase price.
► The preliminary purchase price is adjusted to reflect differences between selected balance sheet items in the closing accounts and reference accounts.
► Purchase price adjustments are typically defined in relation to specific target values at the closing date which generate one-for-one price adjustments.
► Risks and opportunities do not fully pass to the buyer until the closing date.
► The buyer assumes risks for items not covered by price adjustments on signing and will usually seek protection in these areas through “covenants of conduct” or “material adverse change” clauses in the SPA.

Locked box mechanism

► Financial due diligence based on the last statutory financial statements as of 31 December 20XX (reference accounts).
► Stipulation of a fixed purchase price based on the most recent set of audited financial statements or on equivalent interim financial statements (locked box date).
► Risks pass to the buyer as of the locked box date (unless protected by “material adverse change” clauses).
► The buyer will receive the benefits of the target company cash flows from the locked box date.
► Clauses in the SPA provide protection against potential value erosion and leakage between the locked box date and the closing date (anti-leakage and pre-completion covenants).
► Payment takes place on the closing date. The seller is typically “compensated” for the time lag between the locked box date and payment date by charging a form of interest on the purchase price for this period.
Earn-out clauses

► Financial due diligence based on the last statutory financial statements as of 31 December 20XX (reference accounts).
► A basic purchase price based on the reference accounts plus an additional, variable purchase price component.
► The basic purchase price is paid upfront on the closing date.
► The variable purchase price component is paid at a later date and depends on whether the performance indicators defined in the earn-out clauses are met.
► By including an earn-out clause, the seller continues to participate in the economic success of the company, even after the risks and rewards have been transferred.

Price adjustment clauses

Purchase price adjustments aim to protect the buyer against value erosion and value leakage at the target company until the closing date. At the same time, they should reward the seller for managing the business well between the reference date and closing.

Price adjustments are usually calculated on the basis of a target value. Target values are typically based on selected balance sheet items at the date of the last set of audited accounts (reference date) or on historical averages. These values are then calculated on the same basis at closing based on financial accounts at that date (“closing accounts”). The price adjustment is calculated as the difference between the target value and the actual amount at closing.

A number of price adjustment mechanisms are used in practice. Figure 3 indicates how different mechanisms can be used to cover different parts of the balance sheet.

The choice of mechanism needs to be carefully considered to avoid the risk of double-counting and reduce the possibility of manipulation.

Net debt clause

► A net debt clause typically involves agreeing that the net (financial) debt at closing will be deducted from the purchase price. The net debt target is then zero. This procedure is often referred to as the “cash free/debt free” mechanism.
► It can prove difficult to determine net debt (difference between cash and debt). Debt typically includes all interest-bearing financial liabilities. However, debt can also include debt-like items such as pension provisions, lease liabilities and customer advances. Determining which positions should be included in the definition of net debt is therefore an important part of the SPA negotiation process.

Net debt and net working capital clauses are two of the most frequently used adjustment mechanisms.

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- Net debt clause
- Capex clause
- Net working capital clause
- Net equity clause

Fig. 3: Possible price adjustments

Net debt agreement does not protect a buyer from changes in other balance sheet positions. Therefore, further adjustment mechanisms, such as the net working capital mechanism, should be used as well.

Financial due diligence work required:

► Identify all debt and cash positions.
► Identify “debt-like items”, such as pension liabilities or finance lease liabilities that could be included in the definition of net debt.
Net working capital clause

A net working capital clause is based on a target amount which should reflect the level required to operate the business. The target is often based on the amount at the reference date or on an average measurement, for example the average over the last twelve months.

► Variations from the target at the closing date lead to an increase/decrease in the purchase price.
► As with net debt, there is no standard definition of net working capital. For this reason, the process of determining which positions are included in the definition of net working capital forms part of the SPA negotiation process.
► The definition of net working capital should be used in conjunction with the net debt definition.

Financial due diligence work required:
► Identify relevant balance sheet positions that should be included in the net working capital definition.
► Understand the accounting policies and estimates used to calculate working capital items in the balance sheet.
► Conduct a comprehensive analysis of the working capital over time to determine the impacts of seasonality and the normal level of net working capital required to operate the business.
► Assist in quantifying the appropriate net working capital target, taking into consideration seasonality, changes in the underlying business and the anticipated closing date.
► Identify non-operating and/or one-off items impacting historical working capital in order to determine the appropriateness of including them in the definition of net working capital or net debt and the associated targets included in the SPA.

Capex clause

Price adjustments can also be used to control investment spending between signing and closing. Capex clauses typically restrict or require investment spending in line with agreed or budgeted amounts. The purchase price is then adjusted for the difference between the budgeted and executed investments. The capex clause therefore protects the buyer from the risk that the seller will optimize the level of net debt at closing by deferring investment spending.

Financial due diligence work required:
► Analyze historical and budgeted capital investments.
► Identify deferred investments which may require capital funding by the buyer post-closing.

Summary - price adjustment clauses

By combining the three purchase price adjustment clauses (net debt, net working capital and capex) most balance sheet positions can be protected up until closing. Where purchase price adjustment mechanisms do not cover all balance sheet positions at the closing date, the following risks should be considered:

► Certain balance sheet positions may be reclassified and therefore omitted from the price adjustment calculation; and/or
► Price adjustment clauses may be manipulated in order to change the price. For example, applying a net working capital clause without also including a net debt mechanism allows the seller to pay all creditors, leading to an increase in the net working capital without considering its negative effect on the net debt (i.e., less cash and cash equivalents).
Earn-out clauses

Earn-out clauses are another mechanism used in practice to determine the purchase price. Rather than paying the total purchase price on the closing date, the parties agree that the buyer will make an upfront payment plus an additional performance-related component.

Payments are generally due after an earn-out period of two to three years.

A distinction is made between financial and non-financial indicators, although the development of both types can affect the outcome of the earn-out payment. Possible financial performance indicators include revenue, EBITDA, EBIT, net profit and cash flow from operating activities. Examples of non-financial indicators might be official product approval or licensing, total incoming orders or the number of customers.

Locked box mechanism

As a fixed price mechanism, the locked box excludes the possibility of price adjustments at the closing date. One immediate advantage is the avoidance of disputes over price adjustments and the closing accounts upon which the adjustments are typically based.

Because there is no opportunity to adjust the purchase price after closing (except through indemnities for breach of warranty, or other breaches of contract), typical concerns regarding the quality of the acquired net assets and the risk that the target suffers value erosion between signing and closing must be considered by the buyer when calculating the purchase price.

Difficulties in monitoring for potential value erosion up to closing can occur if:

► The target company is unable to present reliable monthly financial statements, and/or
► The company is undergoing restructuring, and/or
► The transaction perimeter is not clearly defined (e.g. in a carve-out scenario).

The risk of value erosion between signing and closing is higher if the target’s management is not properly incentivized to continue producing results until closing.

Earn-out clauses are a particularly useful tool when the parties are unable to agree on a purchase price despite detailed financial due diligence (i.e. there is a “valuation gap”). Diverging opinions on price are often the result of differing assessments as to how the target company’s economic performance will develop.

Financial due diligence work required:

► Determine and calculate the performance indicators that will define the amount of earn-out payments to the seller.
► Analyze the development of business in the earn-out period.

A locked box mechanism may (in a “hybrid mechanism”) include price adjustments such as net working capital or net debt; however, these adjustments are determined on or before the signing date and are already part of the fixed price. This allows net working capital and net debt (usually the amounts at the locked box date) and their price impact to be part of the negotiation process without the need to specifically refer to them in the SPA.

Financial due diligence work required:

► Detailed due diligence analysis based on the locked box date, as subsequent purchase price adjustments are not usually possible.
► Current trading analysis from the locked box date until closing.
► Identify potential risks of value leakage such as dividend payments, repayment of company loans or additional management compensation to be covered by anti-leakage covenants.
Locked box: old book new cover?

The locked box mechanism is the natural result of efforts on the part of both buyer and seller to find a price mechanism that is straightforward and offers protection against unwelcome surprises. Agreement of a fixed price is clearly the simplest price structure. Historically, this has been the traditional method for determining the purchase price. Only recently, with the uptake of more sophisticated and complex due diligence exercises and what can be protracted transaction processes, have buyers found it increasingly important to ensure that value cannot leak out of the target between signing and closing. For a number of years, transaction specialists saw the price adjustment mechanism based on target values related to the balance sheet as a solution. However, as price adjustment clauses began to cause disputes between buyers and sellers, lawyers and financial advisors once again began to favor fixed prices. Since a return to the historical price method was not fully acceptable, improvements to the mechanism were first needed. And so the locked box was born. The difference between the locked box and the traditional method lies primarily in the fact that lawyers and financial experts have developed intelligent anti-leakage clauses, which, as far as possible, protect the buyer from value leaks at the target.
Purchase price mechanisms in practice

Ernst & Young analyzed the purchase price mechanisms in a representative sample of 109 SPAs from 1997 to 2011. With access to non-public data, we have been able to explore the way that purchase prices are actually determined in practice.

Developments in purchase price mechanisms

Below is a summary of the key developments in purchase price adjustment mechanisms between 1997 and 2011:

► Until 2001 the vast majority of SPAs we sampled applied a fixed price mechanism.
► The use of purchase price adjustment clauses in SPAs became increasingly popular from 2002 to 2006.
► Since 2006 we have observed a return towards the use of fixed price mechanisms. However, this development is accompanied by a tendency to use more sophisticated mechanisms - frequently the “locked box”.
► Earn-out agreements have also emerged as a growing trend since 2006.

Expert opinion

Question: Since 2006 the popularity of purchase price adjustment clauses has waned in favor of fixed purchase prices using the locked box mechanism. What is behind this change in direction?

Chris Tattersall: It is true that we have seen a shift towards the locked box mechanism over the last few years. In fact, I would say that the contractual parties have agreed a fixed price or locked box mechanism in most of the SPAs we have worked on over the past three years in particular. One reason for the growing significance of the locked box approach is the fact that private equity investors, and more recently strategic buyers, are keen to secure a competitive advantage by arranging this kind of agreement. Compared to locked box mechanisms, purchase price adjustment clauses are complicated, time-consuming and expensive to implement; the contractual parties are increasingly aware of this and moving away from the closing accounts process. The effort involved in purchase price mechanisms is generally not worth it for transactions under CHF 50m, although they can be an option for larger deals.

Price adjustment clauses in practice

► In the sample for 1997 to 2001, only one SPA provided for purchase price adjustments based on balance sheet accounts. This severely limits general applicability of the finding.
► While net asset / net equity clauses were common until 2005, these have given way to newer and more sophisticated purchase price adjustment clauses over the years.
► The use of net debt and net working capital adjustment mechanisms has increased since 2006.
► Capex price adjustment clauses are uncommon in practice.
Of the SPAs with a net debt clause, 70% also contained a net working capital clause – an increase of 9% compared to the study carried out by EY in 2008 (1st edition of this brochure). Back then, just 61% of the SPAs with a net debt clause also included a net working capital clause.

Where SPAs had a net working capital adjustment but no net debt adjustment, debt-like items tended to be included in the working capital definition or covered by some other form of adjustment mechanism.

Earn-out clauses in practice

The price component governed by earn-out clauses can be combined with adjustment mechanisms based on the balance sheet accounts or a fixed purchase price.

In almost 60% of the SPAs with earn-out clauses, the parties agreed a basic fixed price. The rest of the agreements provided for a basic price to be adjusted at the closing date via a purchase price adjustment.

Financial and/or non-financial performance indicators can be agreed to determine the variable purchase price component in the earn-out period.

In practice, however, the performance indicators used to determine the earn-out payment were without exception of a financial nature. The additional variable purchase price component for subsequent years is calculated based on EBITDA in 50% of cases.

Expert opinion

Question: The number of earn-out clauses has been on the rise since 2006. Why are performance-related mechanisms increasingly important for purchase price adjustments?

Jvo Grundler: The private equity industry is exercising greater influence on the transaction market overall and I think this is one reason for the growing use of earn-out clauses based on fixed prices, although the impact has declined somewhat recently. As non-strategic buyers, private equity investors are often keen to retain the owner or seller at the company to ensure the transfer of know-how. Furthermore, it is in the interest of the seller to arrange a fixed purchase price (basic purchase price) payable on closing. On the other hand, it is the buyer who stands to benefit from an additional, performance-related purchase price component. Earn-out clauses therefore offer a good compromise, especially if the contractual parties do not agree on the company’s prospects for future success.

Question: Would you say that the growing use of earn-out clauses in combination with a fixed price component and the increased popularity of the locked box mechanism are indicative of a seller’s market, despite the current economic uncertainty?

Chris Tattersall: It is difficult to say whether it is a seller’s market or a buyer’s market at present. On the surface, the results of our analysis suggest a seller’s market (with so many locked-boxes) but my observations suggest otherwise. In the current environment of economic uncertainty, buyers are taking their time in analyzing and examining potential takeover candidates. Buyers have become more selective and taking longer to sign a deal. As project timelines stretch, audited financial statements often become available during the process. This promotes a switch to using a locked box mechanism.
Conclusions

When entering into a transaction to buy or sell a business consideration should be given to which type of price mechanism is most desirable to reconcile the various interests. The choice may be limited by the negotiation pressure that can be exerted. The agreed mechanism will influence, among other things, the likelihood of post-closing disputes, the level of resources required to manage the closing process, the timing of risks assumed and exposure to the risk of value erosion and value leakage. The analysis of more than 100 SPAs revealed that the locked box mechanism and earn-out clauses combined with a fixed price component have gained in significance.

Purchase price adjustment clauses

► In recent years, there has been a decline in the use of purchase price adjustment clauses based on a traditional balance sheet accounts approach.

► Purchase price adjustment clauses are more complicated than the other purchase price mechanisms explored in this brochure and often lead to prolonged negotiation periods or disputes between the contractual parties. That is why it is so important to ensure that the SPA precisely defines how the individual balance sheet items and purchase price components are composed.

► Parties also need to make sure that most of the balance sheet falls within the definition of one of the adjustment clauses - ideally by combining three purchase price adjustment clauses relating to net debt, net working capital and capex. Otherwise, buyers may find themselves exposed to the risk that sellers could skew the purchase price in their own favor by reclassifying certain items.

► Our study shows that net debt and net working capital are currently the most popular mechanisms for adjusting the purchase price based on balance sheet accounts. From the buyer's perspective, purchase price adjustment clauses are preferable to other mechanisms because they limit the buyer's exposure to potential value erosion before closing.

Earn-out clauses

► When it comes to target earnings, a gap in expectations can lead to diverging ideas on price. Earn-out clauses are a good way of bridging valuation-gaps and different opinions as to how the target company will develop.

► Our practice study confirms the growing significance of earn-out clauses. Under an earn-out clause, the buyer does not need to borrow as much to finance the purchase price upfront as some of it does not fall due until a later date. The variable component can then be settled using income from subsequent years. This financing effect is not to be underestimated, especially in times of economic turbulence and a climate of restrictive lending policies.

Locked box mechanism

► In general, the locked box mechanism can be seen as advantageous for the seller but associated with a certain element of risk for the buyer. By choosing the locked box approach, the seller benefits from price security. With no need to perform purchase price adjustments at a later date, the contractual parties are spared the costly and time-consuming purchase price adjustment process after closing.

► Buyers should only agree to a locked box mechanism if they can be sure that they have received sound qualitative information and figures on the target.

► Appropriate conduct of business clauses, applicable from the locked-box date, must be included in the SPA (in contrast to a price adjustment mechanism, where these terms often apply from the signing date only).

► The conduct of business clauses should include extensive anti-leakage covenants to prevent value leakage before the closing date. Anti-leakage covenants prohibit items such as dividend payments, additional management compensation or employee bonuses being paid without the prior consent of the buyer.
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