**Susan’s Lemon Stand**

FROM ENTERPRISE VALUE TO PURCHASE PRICE

Susan (Seller) will sell her lemon stand to Bea (Buyer). Susan has set up a corporation wholly owned by her and transferred all the assets and liabilities of the lemon stand to the corporation (Target).

Susan and Bea agreed on projections showing that Target will generate cash flows of $100 in each of the following five years. They also agree that:  
(A) Target will have a terminal value of zero and (B) an appropriate discount rate reflecting the alternative investment opportunities of Bea (3%) and the risk that the cash flows will be lower (7%) is in the aggregate: 10%.

Using the DCF valuation method the Enterprise Value of Target would be: $379.08. Using market comparables, the Enterprise Value would be $300. After some negotiations, Susan and Bea agree that **the Enterprise Value of Target is $350**. They also agree that Target will be acquired on a **debt free cash free basis assuming that at closing Target** should have a **working capital of $30** which they agree is the normal working capital for this business. The balance sheet of Target on the signing date is as follows:

**BALANCE SHEET AT SIGNING**

ASSETS:

Cash $10  
 Receivables from customers $20 (Target sells lemonade on credit!)  
 Inventory of Lemonade $20  
 Long-term asset (a table) $50

TOTAL ASSETS $100

LIABILITIES:

Current Payables for lemons $10 (the store extended credit to Target)  
 Long term debt payable to Mom $50

EQUITY:

Susan’s Book Equity in Target $40  
   
 TOTAL EQUITY PLUS LIABILITIES $100

*Based on the foregoing, what is the value of Susan’s equity in Target at signing?* [Remember that since EV= Equity + Net Debt Equity is equal to EV- Net Debt; Net Debt = Debt minus Cash].

*If EV is $350, what is Net Debt at signing? What is the value of Equity at signing?*

The value of equity at signing is NOT the purchase price to be paid at closing! To get to the purchase price, we need to apply the purchase price adjustment (keeping in mind the agreed target working capital of $30). Working Capital is defined as: receivables plus inventory minus current payables for lemons. Note that cash is not included as it is accounted for separately

DETERMINING THE PURCHASE PRICE

90 days after closing, Susan and Bea finally agree that the balance sheet of Target on the closing date was as follows:

**CLOSING BALANCE SHEET**

ASSETS:

Cash $10  
 Receivables from customers $30 (Target sells lemonade on credit!)  
 Inventory of Lemonade $20  
 Long term asset (a table) $40  
  
 TOTAL ASSETS $100

LIABILITIES:

Current Payables for lemons $40 (the store extended credit to Target)  
 Long term debt payable to Mom $50

EQUITY:

Susan’s Book Equity in Target $10

*(A) If Susan and Bea have agreed to apply a NY-style working capital purchase price adjustment, calculate what the adjustment will be? What will be the final Purchase Price?*

*(B) If Susan and Bea agreed instead to use a lock box approach will there be an adjustment if there was no leakage? What will be the Purchase Price?*

*What would be the Purchase Price and the indemnity payable to Bea if Susan paid herself a dividend of $10 between signing and closing?*