To lock or not to lock
An introduction to the Locked Box closing mechanism

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At a glance

Deal closings can be lengthy and difficult processes with many facets to consider.

The Locked Box mechanism negates the need for preparing and reviewing the final price adjustments post closing.

Pricing deals this way allows the buyer/seller to put resources into other aspects of the deal.

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Introduction

In an increasingly sophisticated deals market, specialist knowledge of the benefits and pitfalls related to the financial and accounting aspects of the sale and purchase agreement (“SPA”) can be the difference between a good deal and a great deal. In any transaction, the SPA represents the outcome of key commercial and pricing negotiations between parties. The financial aspects of the SPA are key to ensure that the Buyer is buying (and Seller is selling) what they expect, for the price they expect to pay (receive) and without undue risk.

*Traditionally deals have been closed across the Globe, using a **Closing Accounts** pricing mechanism under which, parties to the transaction agree a ‘cash free, debt free’ price (“Enterprise Value”) which is then adjusted post Closing for the actual Cash, Debt and Working Capital (or some other measure, e.g., Net Assets) in the Target business as at the Closing Date. In order to be able to determine these final price adjustments to Enterprise Value, Closing Accounts are drawn up and the adjustments are calculated based on the definitions and mechanism set out in the SPA and then subsequently negotiated and settled between the parties.*

*However, as the market continues to evolve, Buyers and Sellers are looking for ways to reduce the often lengthy process of preparing, reviewing and potentially disputing these final price adjustments derived from the Closing Accounts. And as a result, we are increasingly seeing more deals being completed under a **Locked Box** pricing mechanism.*

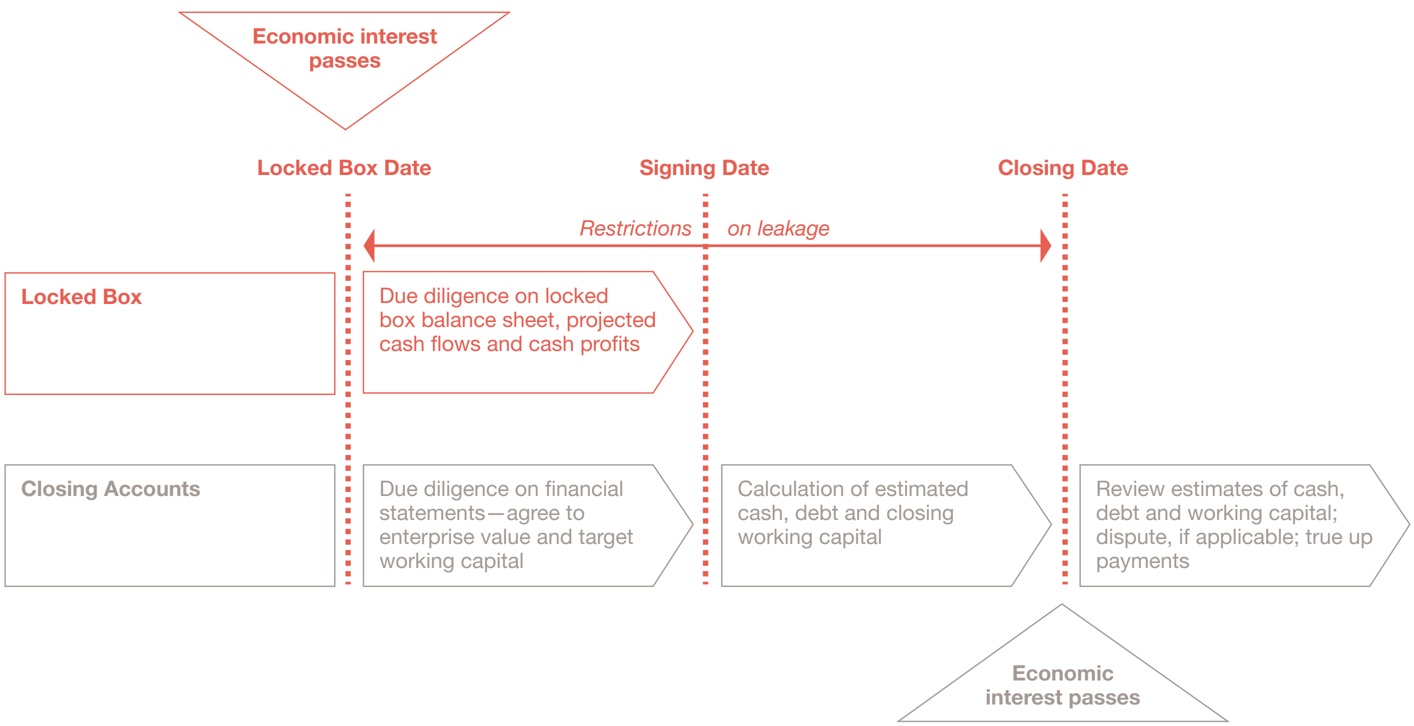
The Locked Box mechanism

A Locked Box deal in its simplest form is a fixed price deal. The Locked Box is the name given to a closing mechanism whereby **Equity Price** is fixed in the SPA at Signing, calculated based on an historical balance sheet (the "Locked Box Balance Sheet") at a pre-Signing date (the "Locked Box Date"). This fixed price for the shares of the Target business is negotiated based on the Locked Box Balance Sheet.

As Cash, Debt and Working Capital are known amounts at the Locked Box Date, the final adjusted price (Equity Value) is agreed between the parties and written into the SPA. Protection against Leakage of value from the Target business between the Locked Box Date and Closing is provided by the Seller through representations and warranties written into the SPA, usually supported by an indemnity. No Closing Accounts are required and therefore no adjustment is made to price after the Closing Date (subject to Leakage review).

As negotiated Equity Value is written into the SPA at signing; there is NO post Closing true-up for Cash, Debt or Working Capital, and therefore no Closing Accounts are drawn up

Figure 1. Illustrative time line of closing a deal under a Locked Box mechanism versus traditional Closing Accounts



A fixed Equity Price for the shares of the Target business is negotiated based on an historical balance sheet (the "Locked Box Balance Sheet")

The Locked Box pricing mechanism is used to close a significant number of transactions in the UK and Europe and this paper sets out how the mechanism works; the key benefits and potential pitfalls of using this mechanism; together with some practical considerations to be aware of when using a Locked Box mechanism to close a deal.

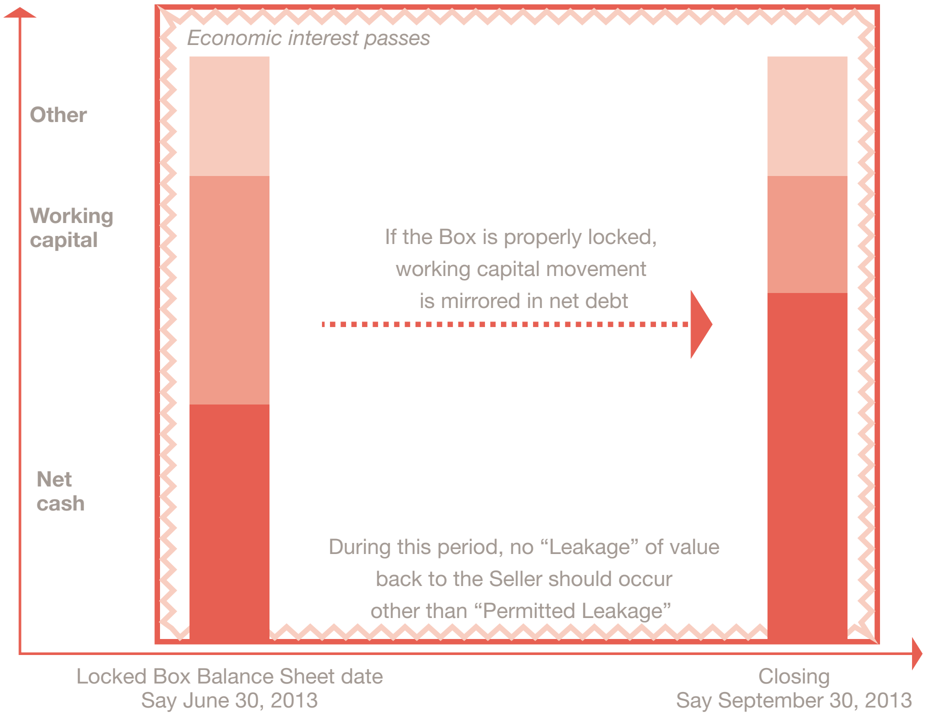
There are a number of key benefits to using a Locked Box mechanism, the most obvious being that it gives certainty of price for both Buyer and Seller at the time of signing the SPA, which explains why this mechanism is particularly favored by Private Equity and financial Sellers. It is also becoming increasingly popular in the Corporate Sector as well as they see this mechanism as a way of reducing some of the risks associated with Buyers using the Closing Accounts process to bridge some of the value gap through 'price-chipping' post Closing.

As pricing is based on the Locked Box Balance Sheet, which may have been subject to independent review, there is no drawn-out debate over which accounting policies and practices should be used in the preparation of Closing Accounts, nor is there such debate regarding the form of the Closing Accounts and the process by which these accounts will be prepared, reviewed and potentially disputed; thus resulting in potentially significant time and cost savings.

Locked Box SPAs are considerably less complex documents than those containing a Closing Accounts type mechanism as a result of the simplicity of the mechanism. In addition to cost savings, management time is freed up to run and/or prepare to integrate the Target business as opposed to their time being tied up in preparing and debating Closing Accounts post Closing.

The key to a successful Locked Box is making sure that the box is locked. The concept works on the basis that any movement in Working Capital will be mirrored in Net Debt and provided no value has 'leaked' from the target business back to the Sellers, and the Buyer is therefore indifferent to the fact that the Closing Balance Sheet will be different to the Locked Box Balance Sheet.

Figure 2. The Locked Box mechanism ensures that value remains with the Target business



Leakage comprises any form of value extraction from the Target business after the Locked Box Date that benefits the Seller

What do we mean by Leakage of value?

Leakage comprises any form of value extraction from the Target business between the Locked Box Date and Closing that benefits the Seller. For example this could include dividends (whether actual or deemed), management fees, transfer of assets at an under-value and the waiver of amounts owed/liabilities.

Permitted Leakage comprises any Leakage that is agreed between the parties and specified in the SPA prior to Signing. Permitted Leakage may or may not result in a reduction to price. For example, a dividend paid to the Seller after the Locked Box Date will result in a reduction to price, whereas salary payments made in the ordinary course of business to employees should not impact price.

Practical considerations: how does using a Locked Box impact the bidding?

Round one of bidding is the same whether using Closing Accounts or a Locked Box mechanism to close the deal. "Cash-free, debt-free" bids are submitted to the Sellers thereby setting their Enterprise Value expectations. Prior to the next stage of bidding, Sellers will often try to pre-empt potential Buyers price adjustments and use this to prepare counter arguments against potential deductions. Increasingly we are also seeing Sellers issuing their view of the Enterprise to Equity Value schedule in order to further "manage" Buyers' expectations of Cash, Debt and Working Capital adjustments.

Figure 3. Pricing considerations for a Locked Box are the same as for Closing Accounts, only the timing differs

Purchase Price (Enterprise Value)		x	Starting point—price/round 1 bids
Plus: $ for $ cash	x		
Less: $ for $ debt	(x)		
Net debt adjustment		**x/(x)**	**Price adjustments**—similar to the items that are adjusted for in a closing accounts mechanism, **except amounts are calculated based on the Locked Box Balance Sheet**
Plus: $ for $ working capital	x		
Less: Normal working capital	(x)		
Working capital adjustment		**x/(x)**	
Other cash-like and debt-like items		x/(x)	
Permitted Leakage		(x)	Defined in the Locked Box SPA
Purchase Price (equity value)		**x**	Price shown in the Locked Box SPA
Interest charge on equity value		x	Mechanism to extract profits
Total consideration		**x**	At the Locked Box Date

The Seller may also issue some persuasive "guidance" to Buyers regarding which deductions from Enterprise Value are acceptable to the Seller, and if it is a competitive auction process, which adjustments make their bids uncompetitive.

In order for a Buyer to be able to accept this concept of fixing a price for the shares based on a historical balance sheet, the Seller should offer (and the Buyer should require)a warranty representing that no Leakage has occurred since the Locked Box Date and this warranty should run to the Closing Date. This warranty is then often backed up by an indemnity such that the Seller will reimburse the Buyer for any Leakage that occurs on a $ for $ basis. Permitted Leakage is carved out of the definition of Leakage therefore it is imperative that the Buyer asks the Seller to schedule out the items of Permitted Leakage in as much detail as possible (payee, amount, timing) such that the items can be priced accordingly.

The SPA will then typically set out a time period post Closing during which the Buyer can diligence the books and records of the Target business to identify and claim for any Leakage that may have occurred. It should be noted that Leakage claims should be carved out of the de minimis and maximum thresholds applied to the general representations, warranties and indemnifications.

With that being said, in our experience in the UK and Europe Leakage claims are not common.

Using a Locked Box mechanism, the Buyer prices the Target business at the Locked Box Date, however the Seller does not receive payment until Closing—should the Seller be compensated for this delayed payment?

Given that economic interest effectively passes to Buyer from the Locked Box Date, the Buyer has the benefit of the cash profits generated by the business from that date. In contrast, the Seller incurs an opportunity cost as they do not receive payment at the Locked Box Date but instead receive payment at Closing.

In order to compensate the Seller for this opportunity cost, interest is typically charged on the Purchase Price (Equity Value) for the period between the Locked Box Date and the Closing. To achieve such compensation, the Seller typically demands either:

- an interest charge on the Purchase Price (Equity Value) between the Locked Box date and Closing. This reflects the **Opportunity Cost** of the Seller not receiving the proceeds from the Buyer at the Locked Box date when economic interest passed; or
- a **proxy for the profits** earned (e.g., daily profit rate) as they will not have been able to extract this from the business since the Locked Box Date

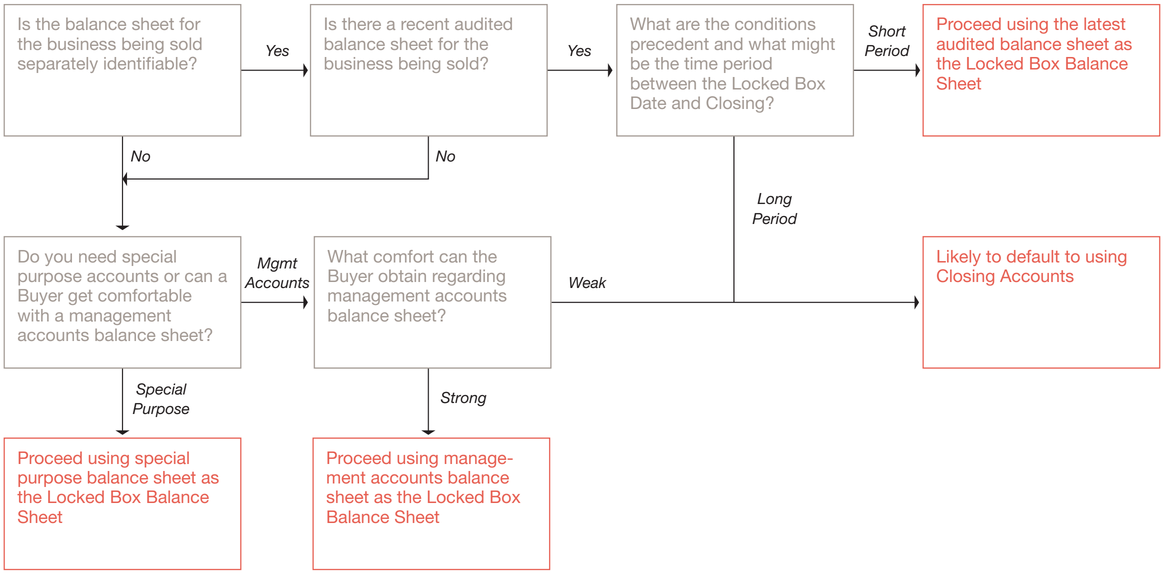
The interest charge whether proposed as compensation for the opportunity cost or proxy for profits, typically reflects the expected "Cash Profits" generated by the Target after the Locked Box Date, NOT the Operating Cash Flow.

Regardless of the Seller's rationale, Buyers should compare the amount payable under the interest charge with the expected Cash Profits to be generated between the Locked Box Date and Closing. Cash Profits broadly represent the increase in net assets of the Target between the Locked Box Date and Closing. We highlight that Working Capital movements are dealt with through the Locked Box itself and therefore do not impact the calculation of Cash Profits (i.e., assuming the "box is locked" there is no Leakage, any increase in Working Capital would result in a decrease in Cash or increase in Debt). Some of the more common calculation pitfalls include: i) the interest accrual being misaligned with the debt deduction; and ii) double counting of deductions or Leakage items.

Seller may ask for an interest charge or daily profit rate in order to compensate them for the opportunity cost of operating the Target business between the Locked Box Date and Closing

Which balance sheet should be "locked" for the purposes of pricing?

Figure 4. Buyer confidence in the balance sheet for the purposes of pricing and locking the box is key. Steps to Consider:



There are a number of pros and cons of using a Locked Box mechanism for both Sellers and Buyers…

Although there are some obvious advantages to a Seller in using a Locked Box mechanism (and hence the perception that this mechanism is Seller-friendly), a number of these benefits will also benefit the Buyer. Provided the Seller can offer appropriate comfort over the integrity of the Locked Box Balance Sheet; accompanied by relevant warranties over the Locked Box Accounts, this mechanism can also work for a Buyer.

Buyer	Seller
Pros	**Pros**
Price certainty	Price certainty
Simplicity—no closing mechanism	Simplicity—no closing mechanism
Lower cost—management time not tied up post-closing	Lower cost—management time not tied up post-closing
	Increased control of the process
	Less aggressive interpretations of price adjustments in an auction
	Easier to compare bids in an auction
	Hard wires accounting policies
Cons	**Cons**
No closing mechanism to exploit	Difficult to apply without an anchored balance sheet (carve-out)
Limited ability to get management on side for post Close disputes	Potential to lose out if interest charge set too low
Committing to price before exclusivity	
Risk of business deterioration between LB date and closing	
Need to debate price adjustments earlier, and with less knowledge	
Risk of over-funding at closing	

Considerations check-list for the Buyers

In order for a Buyer to be able to accept closing under a Locked Box mechanism, if the Locked Box Balance Sheet has not been subject to an audit, or to independent review, a Buyer would need to seek additional comfort over the Locked Box Balance Sheet through stronger representations and warranties over the Locked Box Balance Sheet and related Accounts. In addition to sufficient comfort over the Locked Box Balance Sheet, it will also be key for a Buyer to make sure that there are adequate systems set up within the Target business to identify Leakage; and that the Buyer can themselves get comfortable that Leakage can be identified for pricing purposes.

As a Buyer, when contemplating closing under a Locked Box pricing mechanism we suggest that you should assess the following:

- Who is a "Seller" or a "related person" for the purposes of identifying Leakage?
- Are systems set up to identify all transactions between the Target and the Seller/ related persons between the Locked Box Date and Closing?
- Do you have sufficient control over potential Leakage in distant territories?
- Consider requiring a definition of "Permitted Leakage."
- Consider which of the identified Permitted Leakage items are items to be disclosed for legal reasons, with no impact on price, or whether there are items which need to be factored into price.
- Consider whether the form of the Leakage warranty is sufficient, on a $ for $ basis and carved out of the other warranty limits and thresholds.

In summary, the pricing considerations and mechanics underlying a Locked Box are the SAME as for those underlying the traditional Closing Accounts, but the timing and level of certainty will differ

Summary of key characteristics of the two main types of pricing mechanism:

Closing accounts	Locked Box
Enterprise Value agreed, but Equity Price subject to post closing adjustments	Equity Price is fixed
Definitions of Cash, Debt and Working Capital are agreed prior to signing	Price adjustments for Cash, Debt and Working Capital are agreed prior to signing
Adjustments for Cash, Debt and Working Capital are based on a closing balance sheet prepared post Closing	Price adjustments for Cash, Debt and Working Capital are based on a historical balance sheet (Locked Box Balance Sheet)
The concept of Leakage is irrelevant; the SPA is however likely to contain ‘conduct of business’ provisions	Seller provides an indemnity that there will be no Leakage of value from the Locked Box Date back to the Seller
The process for preparing, reviewing and agreeing final Closing Accounts is negotiated and set out in the SPA	No Closing Accounts and associated review process, as there is no adjustment to purchase price after closing

To lock or not to lock . . . ?

In summary, the pricing considerations and mechanics underlying a Locked Box are the SAME as for those underlying the traditional Closing Accounts. Ultimately, the Buyer will write a check to the Seller for the shares that comprises an Equity Price (i.e., Enterprise Value adjusted for Cash, Debt and the difference between Target Working Capital and Working Capital). Value can be lost under both pricing mechanisms if these key financial drivers between Enterprise Value and Equity Value are not negotiated and hence treated appropriately.

In contrast to a typical Closing Accounts process, negotiations over these balance sheet items occur while the auction process is still ongoing, rather than when the Buyer has exclusivity. A Seller can therefore use the Locked Box mechanism to take control over the divestiture process.

Acknowledgements

If you would like further information and advice on the Locked Box mechanism please contact the PwC Contracts and Closing Mechanisms (CCM) team who have extensive experience in this area:

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