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Getting the Price Right: Comparing the Locked Box and the Completion Accounts Approaches

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When a business is sold, vendors and buyers must agree on a purchase price. This price is often based on earnings multiples or cash flow–based valuations, and adjusted for factors such as debt and working capital. However, the true picture of a business's financial position can change between when a buyer agrees on a price and signs the deal, and when it takes control of the company.

As a result, both buyers and sellers should take steps to protect their position and maximize value. This article looks at two common methods for calculating the price of a target business: locked box and completion accounts.

In theory, these two methods should arrive at a similar value for the business. But in practice, the choice of method can affect which party maximizes value. This makes it important for buyers and sellers to be aware of the issues surrounding each approach.

This article also discusses the relationship between an initial business valuation and the final sale price.

The locked box method

A locked box transaction calculates the value of a business based on its balance sheet at a certain point in time. The price of the business is 'locked' from this date, and there are no adjustments after the deal has been completed. A buyer assumes all economic ownership, risks and rewards from the locked box date.

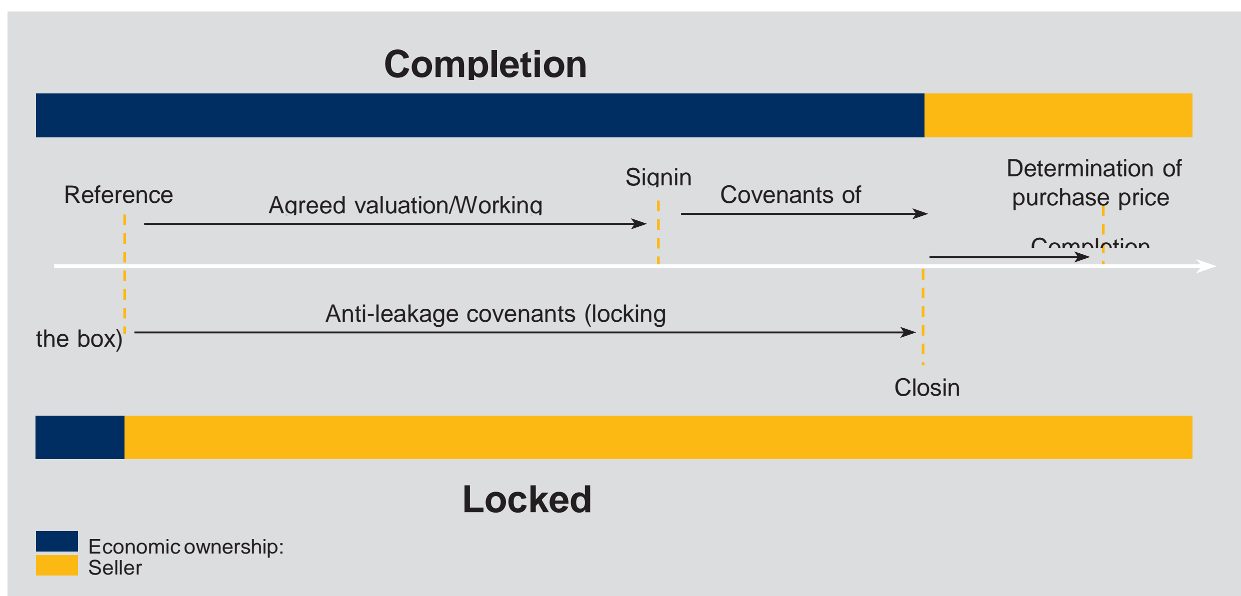
The advantage of this approach is that it gives buyers and sellers a fixed price, and no completion accounts or completion audits have to be undertaken. This can prevent disputes over the purchase price and reduce transaction costs.

Managing leakage in locked box transactions

However, because there is no adjustment process, the parties need to address the potential for value to 'leak' out of the business between signing the deal and its completion. These leakages include management payments, dividends and bonuses. Buyers will likely request covenants, indemnities and warranties to guard against this situation.

Of course, some leakages, such as wages, are unavoidable in the normal operation of a business. So buyers and sellers should agree on a list of permitted leakages. And a buyer must receive assurances that the seller will run the business properly between the locked box date and deal close.

Figure 1: Completion accounts and locked box



A particular issue can arise when a buyer intends to acquire a business that needs to be carved out from a larger entity. In this case, it may be hard for a buyer to identify the leakages specific to the individual business line.

In a locked box transaction, parties usually agree on a fixed period where a buyer can raise leakage claims. This period can be as short as a couple of months, and is typically shorter than a warranty period.

The completion accounts method

An alternate approach is to allow the parties to agree on a purchase price that is subject to adjustments after the deal has closed. This is known as the completion accounts method.

The final purchase price will include an adjustment to take into account factors such as cash, debt, working capital and assets. The precise factors will depend on the sale and purchase agreement negotiated between the two parties.

One issue with this method is that it can involve protracted talks – and disagreements – between buyers and sellers over the final purchase price. This could mean the ultimate price is not determined for months.

The differences between locked box and completion accounts are shown in Figure 1.

Continuing popularity of the locked box approach

Typically, completion accounts have been seen as a way for a buyer to protect its financial position during a transaction. This is because the buyer has recourse to negotiate an adjusted purchase price after the deal is closed. Despite these advantages, industry sources suggest around 50% of merger and acquisition transactions use the locked box method.

As the global financial crisis began, use of the locked box method declined sharply as buyers sought protection against exposure to risk. (The locked box method traditionally favours sellers, as they can lock in a fixed purchase price and limit their downside risk.) However, during 2009 locked box transactions rose in popularity, especially in France, Germany, Belgium, the Netherlands, and Luxemburg due the rebound in confidence in these economies.

Key considerations in pricing approaches

There are a number of important considerations for buyers and sellers in determining a final purchase price on a business sale. For instance, a buyer wants to know that the target's financial statements are reliable and valid. Under either approach, a buyer is paying a price based on the business's value at a particular date. So it requires access to management to identify any pricing or resource issues.

In addition, a seller must ensure that, regardless of the pricing approach, the business's financial position is accurate and will not lead to a buyer resorting to litigation. The seller may also need to produce sound financial information in short timeframes – including in potentially complex carve-out situations.

Further, as part of a transaction, a seller may request a buyer pays interest on the equity value of a company, as it only receives payment after closing off the accounts. In a locked box deal, a buyer is entitled to the benefits of owning the business after the locked box date, and so it usually makes interest payments on the equity value of a company to the seller.

Deal example: equity valuation

To understand how the value of a company relates to its eventual purchase price, we have provided a worked example below (Figure 2). We will discuss the factors of bridging value to price, and positive and negative valuation adjustments.

Bridging value to price

In this example, a buyer has valued its target at US$27 million (the enterprise value). This value has been reduced by US$3 million due to valuation adjustments, which include unrecognized pension liabilities and adjustments to earnings.

Further, after the accounts have been closed off, differences may arise between the pricing parameters negotiated during the deal and the actual amounts. These adjustments – sometimes referred to as the 'equity bridge' – mostly relate to net debt, working capital and capex adjustments. They are grouped together as 'Adjustments finalized at completion accounts' in Figure 2.

Positive valuation adjustments

In this example, cash and current working capital balances add positively to the enterprise's value. For cash, the assumption is that cash balances are not trapped. Cash can be trapped where restrictions exist on remittances back to the parent company's country. In this situation, a buyer would discount the value of the cash on the balance sheet.

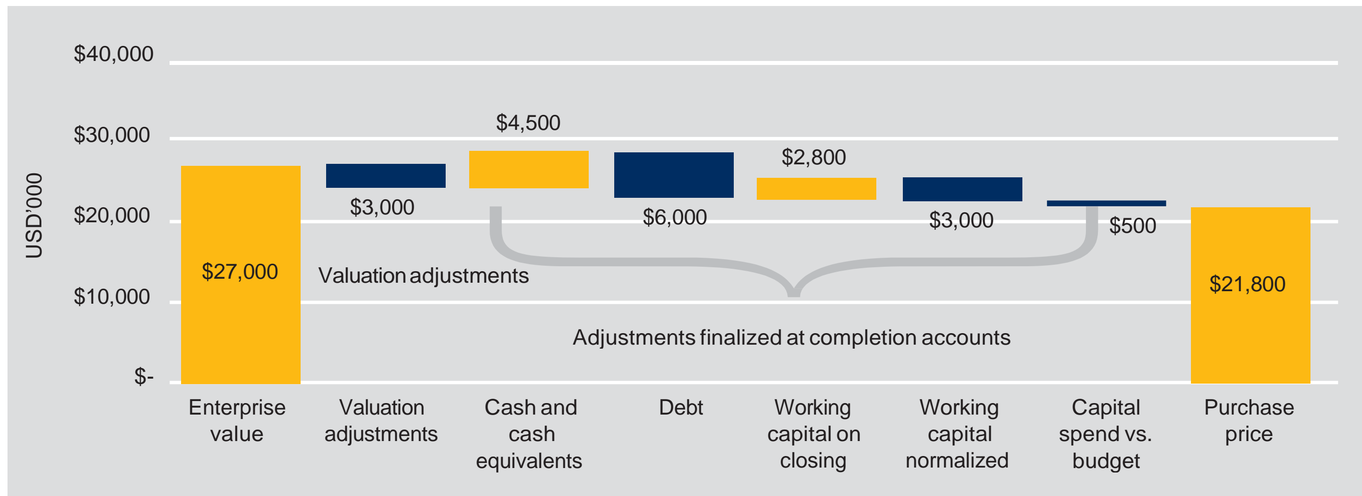
Negative valuation adjustments

A business's valuation will be dragged down by debt, shortfalls in the required level of working capital and unplanned spending.

In this example, working capital totals US$2.8 million on closing, while normalized working capital is valued at US$3 million. The buyer subtracts US$200,000 from the company's value as this amount must be invested by the purchaser to maintain required levels of working capital.

The working capital mechanism is based on a target working capital amount that a buyer intends to acquire in a deal, assuming that this amount of working capital is sufficient to operate the business. Any deviations from the

Figure 2: Equity valuation



target amount of working capital will lead to adjustments in the purchase price.

The working capital mechanism should be used in conjunction with a:

- net debt mechanism: which adjusts the purchase price for differences in actual net debt position compared to the target net debt position
- capex mechanism: which is used to control investment spending between the signing and closing of a deal.

By using these mechanisms, a seller can protect its balance sheet position right up to the close of a deal. For example, if a net working capital mechanism is applied without a net debt mechanism, a seller could pay all its creditors. This would lead to an increase in net working capital, but it does not take into account the negative impact on the debt position. In this way, it allows a seller to manipulate the purchase price.

Further, in the example, the buyer needs to include US$500,000 for delayed expenditures. Together, all these adjustments mean the purchase price is calculated at US$21.8 million.

For more information:

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