**Consideration**

This section provides an overview of the mechanics of deciding the amount of the consideration and the methods of payment.

**Introduction**

The consideration to be paid for the business or the company is obviously a key issue which the parties will be interested in from the outset of a transaction (and the deal will not go much further if the parties cannot agree this).

When evaluating the value of a business a potential buyer can use a number of different valuation methods such as the **net asset value** or a valuation calculated by reference to the **earnings** of the business. The valuation is known as a “**enterprise value”.**

A number of assumptions will be made by the buyer when setting the enterprise value. It is necessary for a buyer to make these assumptions as, when making an initial offer, they have not completed detailed due diligence. A common assumption is that the company will be “**cash free/debt free”** and that the business operates with an appropriate level of **working capital**.

In reality, a company or business will not meet all of the assumptions made when calculating the enterprise value (ie the company might have no cash and a lot of debt). Therefore, the enterprise value needs to be adjusted to reflect the true state of the company and therefore, to arrive at a more accurate valuation. This is known as the "equity value". The calculation of the **equity value** from the enterprise value is known and the “**equity bridge**”.

In addition to deciding on the valuation of the company the parties will consider what form the consideration will take and when it will be paid.

The purchase price will often be paid at completion, but sometimes payment of an element of it is delayed until a date after completion **("deferred consideration").**

We will consider these different components of the consideration further in this topic.

**Valuation - Net asset value (NAV)**

The buyer may use the NAV of the target company, taken from the last set of **audited accounts**, or regular management accounts as a basis for its calculation of the purchase price.

This would generally be used where the target company has significant property or other tangible assets and is commonly found in certain sectors, such as property investment businesses. On a NAV offer, the buyer will want confirmation that this NAV has not changed since the relevant accounts were drawn up. However, the NAV will inevitably have changed since the date of the last set of audited accounts and the parties may therefore agree that the purchase price will, after completion, **be adjusted up or down**, as applicable, in order to reflect any material change, as shown by a set of completion accounts.

**Valuation - Earnings basis**

Where a target company’s value is not accurately reflected in the value of its net assets, valuation is more likely to be made on an earnings basis.  This is a common basis for valuation across many sectors, including for example research and development, services, technology companies or companies that have yet to turn a profit.

This is determined by taking the future maintainable earnings of the target multiplied by an appropriate multiplier (usually related to comparable quoted companies). Although the valuation is based on future earnings, an analysis of past earnings will usually be relevant as a guide to future prospects (where appropriate). The agreed multiple will usually be applied to earnings before interest and tax (**EBIT**) or earnings before interest, tax, depreciation and amortisation (**EBITDA**).

**Debt free/Cash free**

A common assumption for a valuation is on a “**debt free/cash free”** basis.

This means that the value of the target is set on the assumption that there is no debt or surplus cash in the target company at completion, which allows the buyer to concentrate solely on the value of the underlying business itself.

Using this standard can be helpful to be able to compare different bids, for example in an auction sale. This assumption also shows precisely how much money a buyer will need to raise ignoring these elements i.e. ignoring how the business is financed.

There is no universal standard definition of “debt free/cash free”, therefore, if the parties agree for the target to be valued on this basis is to be used, it is important to check that they both have a mutual understanding of what this means in the context of their deal - for example, the buyer may claim that certain cash held by an overseas subsidiary of the target cannot be distributed to the target without incurring tax or other costs and so a discount should be made for any such “trapped cash”. A debt free/cash free valuation seeks to determine the value of the target’s business ignoring how it is funded.

**Calculating Equity Value**

If company has been valued on a cash free/debt free basis it is very unlikely that it will be cash free/debt free in reality. It is necessary, therefore, to work out how much will be paid to the seller being the “**equity value”.**

If the target has debt outstanding at completion, then the amount payable to the seller will be reduced accordingly.

If the target has “excess” cash at completion then the amount payable to the seller will be increased, as that represents additional value in target.   
It is more common in practice to have a net debt position than a net cash position.

It is typical for a net debt adjustment to be combined with a working capital adjustment.

**Working capital** reflects the ability of a business to cover its business-as-usual operating costs. Different businesses need to operate with different working capital requirements.

**Completion accounts**

Whatever valuation mechanism is used on a transaction the parties will usually use one of two price adjustment mechanisms: **completion accounts or locked box accounts.**

The completion accounts mechanism gives the most accurate representation of the value of the target as at the date of completion reflecting all of the assets and liabilities on that date.

On a completion accounts transaction prior to completion the parties will agree the headline or estimated price, the equity value, and the assumptions used to reach that price. The buyer will pay the estimated price to the seller on completion.

After completion a detailed set of accounts are drawn up which show the actual financial position of the target as at the date of completion. To the extent the actual position is different to the assumptions made (i.e. the level of NAV/net debt/working capital, as appropriate is different to the estimated price) the parties will make a balancing payment. E.g. if the buyer paid a price of £20,000,000 at completion and the accounts show the equity value is £21,000,000 then the buyer will pay a further £1,000,000 to the seller.

If the purchase price is to be adjusted, the parties may agree a cap on the amount of consideration that the buyer may have to pay in the event of an increase (or the seller may have to refund in the event of a decrease).

**Completion accounts in the acquisition agreement**

In a completion accounts transaction the acquisition agreement should specify the applicable procedure for preparing and agreeing the completion accounts including:

* a hierarchy or "waterfall" of accounting policies to be applied in drawing up the accounts and details of adjustments to be made in calculating the equity value;
* details of which party will draw up the accounts and the time by which the accounts must be delivered to the other party (‘Reviewer’);
* time period for the Reviewer to review and approve the accounts; and
* disputes process which will usually include a prescribed resolution period where the parties will attempt to resolve the matters in dispute by negotiation, and provision if the parties fail to agree. This commonly provides for the outstanding issues to be referred to an independent expert, typically an accountant, for determination.

If the purchase price is to be adjusted, the parties may agree a cap on the amount of consideration that the buyer may have to pay in the event of an increase (or the seller may have to refund in the event of a decrease).

**Task**

Extract from sale agreement:

1.1 The Purchase Price shall be adjusted as follows:

1. there shall be added the amount, if any, by which the Net Asset Value is greater than £10,000,000; and
2. there shall be deducted the amount, if any, by which the Net Asset Value is less than £10,000,000.

If the Purchase Price is agreed to be £11,000,000, please calculate how much should be paid (and to whom) in the following circumstances:

1. after the completion accounts have been finalised, the Net Asset Value is £10,100,000;
2. after the completion accounts have been finalised, the Net Asset Value is £9,900,000.

If the Purchase Price is agreed to be £11,000,000, please calculate how much should be paid (and to whom) in the following circumstances:

1. **after the completion accounts have been finalised, the Net Asset Value is £10,100,000;** If after the completion accounts have been finalised, the Net Asset Value is £10,100,000, the Buyer must pay an additional £100,000 to the Seller (meaning the total purchase price is £11,100,000).
2. **after the completion accounts have been finalised, the Net Asset Value is £9,900,000.** If after the completion accounts have been finalised, the Net Asset Value is £9,900,000, the Seller must refund £100,000 to the Buyer (meaning the total purchase price is £10,900,000.

The acquisition agreement would also need to ensure it dealt with the logistics of the timing and manner of repayment (i.e., to the parties’ solicitors).

**Locked box mechanism**

In a locked box transaction, instead of setting the purchase price by reference to completion accounts (which as noted above are drawn up some time after completion and could potentially be the subject of dispute), the parties agree to use accounts that are drawn up **prior to completion**, to calculate the net debt and working capital adjustments to the enterprise value. These are referred to as the "locked box” accounts.

A benefit of using locked box accounts is that the price can be finalised before signing, and this provides certainty to both parties. For this reason, locked box mechanisms are generally favoured by private equity sellers as it enables them to more quickly transfer the proceeds of the sale up to their investors.

As the price is finalised prior to completion, based on the locked box accounts, there is a risk that the seller could extract value from the target in the time between the date of the locked box accounts and completion, when the buyer will take control of the target. In addition, the locked box accounts are drawn up by the seller (often based on monthly management accounts) so the buyer will have less oversight of the preparation of the accounts

There will, however, be **no post-completion delay** where a locked box mechanism is used.

Locked box structures are generally inappropriate on business carve-out transactions where there is not a clear and identifiable target group prior to signing in relation to which locked box accounts can be drawn up.

**Locked box in the acquisition agreement**

To manage the buyer’s risk of value being extracted the seller will indemnify the buyer for any monies that have been taken out of the target for the benefit of the seller group, outside the ordinary course of business, after the date of the “locked box” accounts (and prior to completion). This is known as **leakage**.

It is to be contrasted with any payments that the buyer and seller have agreed can be taken out of the target before completion. This will generally include ordinary course payments (e.g. salary to directors), arm’s length payments or other commercially agreed payments (e.g. transaction bonuses paid to seller management). Such expenditure is generally known as "**permitted" leakage**. This permitted will specifically be excluded from the leakage indemnity. The buyer will generally be comfortable with this exclusion provided the payments have been factored into the **equity bridge** (i.e. the adjustments from enterprise value to equity value mentioned above)

The leakage indemnity will usually cover only specific deliberate acts of the seller, the risk of a general downturn in trading after the finalisation of the locked box accounts falls on the buyer. It is for this reason that locked box accounts are more likely to be used where the seller is in a strong bargaining position and where the buyer has had the opportunity to carry out full financial due diligence on the target company. It is also worth noting that, subject to any profit ticker (described on the next page), the buyer will reap the benefits of any upturn in trading in the period from the locked box accounts to the date of completion.

As mentioned, in a locked box transaction the buyer will not usually have the same visibility in the preparation of the locked box accounts as they would have with completion accounts, when a locked box mechanism. It is, therefore, common for a buyer to require **warranties** that the locked box accounts have been prepared with **reasonable care** and on a basis consistent with the annual accounts and using reasonable assumptions.

Where a business is profitable and the seller wants to benefit from strong performance between the locked box date and completion a **“ticker”** may applied to the price. This amount may reflect interest or a daily profit amount, from the date of the agreed locked box accounts to the date that the proceeds are paid to the seller to reflect the delay in the seller receiving the proceeds.

There is no set “market rate” for these payments as each situation is different. The seller may view the payment as compensation for its loss of increase in the value of the business, in which case it should mirror the expected profitability of the target. The buyer, on the other hand, may argue that the seller benefits from certainty of price and any payment should be solely interest reflecting the fact that the seller has to wait for the money. A ticker may be used as a penalty for delays in completion and as a means of encouraging the parties to complete quickly.

**Price adjustment mechanisms - summary**

Completion Accounts

* Estimated price paid on completion.
* Accounts drawn up after completion as at the completion date.
* Buyer or seller to make balancing payments after final price determined.
* Takes time following completion and price is uncertain.
* Acquisition agreement to include:
  + Accounting policies;
  + Process for drawing up and agreeing accounts;
  + Caps on payment amounts (if appropriate).
* Traditionally seen as buyer-friendly.

Locked Box

* Final price paid on completion.
* Accounts drawn up before completion as at a date before completion the “locked box date”.
* Price is certain but risks to both parties if target under or overperforms.
* Seller will pay indemnity if any leakage extracted from the business.
* acquisition agreement to include:
  + Leakage indemnity;
  + Permitted leakage definition;
  + Profit ticker (if agreed).
* Traditionally seen as seller-friendly.
* Not appropriate for asset sale of a part of a company

**Deferred Consideration**

Deferred consideration is where **only part of the consideration** is paid on the date of completion, with the rest being paid at a particular time or times in the future.

The deferred consideration may also be contingent on certain conditions or milestones having been met. There might be a number of reasons why the parties agree to a deferred consideration including:

* The buyer wants to limit the risk of a high valuation so consideration is paid in tranches. This may be contingent on certain post-completion actions, e.g., closing a particularly valuable contract;
* The buyer may need additional financing to fund a higher purchase price and the parties agree to defer part rather than complete with a lower price;

For deferred consideration, the intention is that this is to reflect the valuation at completion. If the parties want to attribute value to future profitability they may use a type of deferred consideration known as an **“earn-out”.**

**Earn-outs**

An earn-out is dependent on whether agreed milestones are achieved in future.  A common example is whether a certain level of profits have been achieved.

Earn-outs are very bespoke in nature and are very tailored to the business and/or transaction.

Earn-outs have potential benefits for both the buyer and the seller(s). The buyer benefits from the delay in having to pay the consideration, and indeed, will only have to pay the further consideration if the target achieves certain targets (such as a certain level of profitability) during the period after it has changed hands.

If all goes well and the target achieves the relevant milestone after completion the seller may end up receiving more consideration in total than it would have done had it insisted on receiving all the consideration up front, at completion.  
Even though an earn-out may have potential benefits for both the buyer and the seller(s) and it may seem like a win/win situation, the drafting of the finer details of the earn-out provisions can become a source of conflict between the parties and is difficult to make work in practice.

**Earn-outs – sectors**

Earn-outs are particularly appropriate in the **sale of service companies** that have been owned and managed by individual shareholders (e.g., founders). This is because much of the value of the target is likely to be directly linked to the shareholders, who will have very considerable knowledge of the target’s business affairs and will have close relationships with its customers and suppliers.

In such a situation a potential buyer of the target may well want to keep the seller/shareholders working for the target after the sale, at least during the initial handover period, in order to ensure a smooth handover and preserve relationships with customers and suppliers. An earn-out is a very good way of achieving this.  The earn-out is likely to help to **incentivise** the seller/shareholders, as, if profitability is the agreed milestone for example, the greater the profits of the target post-completion, the greater the deferred consideration they will receive.

Earn-outs are also often seen in scientific/biomedical companies where value is closely linked to matters such as product development, the launch of products or the obtaining of key licences or drug approvals. In these cases, these would be the milestones used to trigger payment of the deferred consideration.

Earn-outs can also be used when the seller is a company and tend to be seen where the target is a younger business which does not yet have an established record of profitability and therefore its future value cannot be agreed by the buyer and seller.

**Methods of payment**

As well as deciding the amount of consideration it also has to be decided how the buyer will pay this consideration. In other words, in what form. The main forms of payment are:

* Cash; or
* When the buyer is a company, an alternative to cash is payment in paper in the form of issuing shares or loan notes.

It should be noted that cash is, by far, the most common method of payment.

A buyer may offer a seller loan notes or shares in order to reduce the amount of cash they need to raise to complete the transaction. Payment in cash requires the buyer to use cash reserves, which they may want to use in other projects, or to get a loan to fund the purchase price. As you will learn if you study Debt Finance legal knowledge stream there are a number of costs associated with taking on additional debt.

Offering shares, in contrast, will result in a dilution of your existing shareholders, and will have an upfront cost but does not have the ongoing cost associated with debt.

**Methods of payment – shares/loan notes**

Shares

If the buyer wishes to pay the consideration in shares, the buyer will issue shares in **itself** to the seller in exchange for the transfer of the shares in the target which are owned by the seller. This is known as a share for share exchange.

**Practical point:** As a general rule, a seller will only be prepared to accept consideration in the form of shares in the buyer if the buyer is a listed company since then its shares will be freely marketable.

Loan notes

Alternatively, the buyer may issue loan notes to the seller. A loan note in its simplest form is a document that contains the terms of the buyer’s debt to the seller. If loan notes are to be issued, the terms of the loan notes will have to be negotiated (for example, when the loan notes will be repaid and how much interest is payable).

**Practical point:** If a seller accepts consideration in the form of loan notes it should require the loan notes to be supported by a guarantee from a bank (or a listed parent of the buyer) or by security over the buyer’s assets.

**Set-off**

Wherever part of the consideration is to be deferred (for example, if the consideration includes loan notes or an earn-out) the buyer may ask for the documentation to include a **set-off clause**. Such a clause allows the buyer to deduct from any payment of deferred consideration, **any sum which is due to the buyer** at the time the payment of the deferred consideration falls due. For example, after completion but before the payment of deferred consideration, the buyer may discover that it has a claim against the seller under an indemnity included in the acquisition agreement (including, in the case of a share sale, the tax covenant), or that damages are payable to the buyer as a result of a breach of warranty. A set-off clause allows the buyer to withhold the sum due when it pays the deferred consideration, and so pay a **reduced amount** to the seller.

This effectively strengthens the buyer’s hand in a warranty or indemnity claim forcing the seller to prove that the buyer’s warranty or indemnity claim is erroneous if the seller wishes to receive the full amount of the deferred consideration. Therefore, a seller may resist inclusion of a set-off clause, or at least try to limit severely the circumstances in which sums may be set off, for example to sums which a court has ordered to be paid, or which have been agreed in writing by both parties.

**Summary**

* A key issue for the buyer and the seller in an acquisition is deciding on the valuation of the target, the adjustments to be made to the consideration and how the price is to be finalised.
* Common adjustments include adjusting for net debt (to reflect the debt free/cash free valuation assumption) and working capital.
* Completion accounts are one method of adjustment where accounts are prepared after completion. This means the purchase price will have to be adjusted at a later date.
* The parties may use a ‘locked box’ mechanism instead of completion accounts. This mechanism depends on using existing accounts which allows the consideration to be finalised before signing.
* The most common method of payment is cash, although the issue of shares or loan notes is sometimes seen.