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CURRENT TRENDS IN M&A NEGOTIATIONS

If the "locked box" mechanism is properly used during an acquisition, the mechanism can be acceptable for the buyer as well as the seller. And how the normalized net working capital can be used as a strategic item in purchase price negotiations.

A progressively buyer-friendly market environment creates room for the increased use of the "locked box" mechanism. A closer examination of this mechanism shows that it is not only in the interests of the seller but, as demonstrated in the following, can also be acceptable for the buyer if properly used. The existence of normalized net working capital (NWC) at the time of closing the deal also regularly plays a role for the buyer. This is recently being used more often as a means for reducing the purchase price and often leads to conflicts at a late stage in the transaction. The seller should prepare itself accordingly as described below.

Locking the Box

In the case of an acquisition of company shares, the preparation of closing accounts is still agreed in the majority of cases today. In this respect, the target company regularly prepares an effective date balance sheet as of the date of closing the deal, which is assessed by the buyer with the assistance of its advisers after closing. If there are any deviations from the previously agreed equity capital or NWC amounts or other agreed figures, the purchase price is adjusted accordingly. The mechanism for reviewing the effective date balance sheet by the buyer is subject to a deadline and leads to an arbitration opinion in the case of any disagreements between the parties as well as to complex and costly arbitration proceedings in individual cases. The logical approach adopted by the buyer through the closing accounts of obtaining security for the realization of the figures agreed on the date of closing the deal is achieved with relatively high implementation costs. This is particularly the case because the agreed figures are related to the effective date and not a specific time period. The figures are not intended to secure the profitability of the target company that is relevant for the enterprise value but should guarantee the basis for the unimpaired continued operation of the target company.

The adjustment of deviations therefore also only takes place on a euro-for-euro basis and not in consideration of the multiplier used by the buyer as the basis for determining the enterprise value. Against this background, buyers of smaller and medium-sized enterprises are often willing to forego the customary closing account mechanism and subject the closing accounts to the standard warranties for annual financial statements. After largely overcoming the financial crisis during which the use of closing accounts was particularly popular, there is again a greater tendency towards the locked box mechanism in the current sellers' market. This mechanism foregoes the preparation of closing accounts. The relevant effective date for defining the transaction is instead specified as the effective date of the last financial statements available for the target company, which can be the usual financial statements or even interim financial statements. In accordance with the transaction's structure, the buyer is entitled to the target company's profits as of the effective date, and the purchase price is subject to interest at standard market rates as of the effective date. The accuracy of the financial statements is guaranteed in the manner customary for financial statements.

In addition, the buyer is protected against the outflow of assets on a euro-for-euro basis between the effective date and the date of closing the deal in the seller's sphere of influence. The trick is to include all relevant asset outflows in the purchase agreement. This leads to relatively complex clauses in the purchase agreement in view of indirect asset outflows or initially only contractually agreed asset outflows, particularly when trying to properly determine the usual service relationships that are not to be taken into consideration between the seller's group and the target company. The purchase price for the target company is accordingly determined as at the effective date. Relevant asset outflows in the seller's sphere of influence are to be deducted from the purchase price. The interest on this reduced purchase price is to be added from the effective date up to the closing date. For its own protection, the buyer will also regularly demand a guarantee with respect to the target company's debt existing on the closing date and the existing NWC as of the closing date. If the seller provides such guarantees, the closing account and locked box mechanism begin to show signs of similarities.

Against this background, the statement heard time and again – that a decisive advantage of the locked box mechanism for the seller is the fixing of the purchase price to the effective date – is only correct to a limited extent. Thus, asset outflows within the seller's sphere of influence that are first discovered after the closing date can lead to direct adjustments of the seller's proceeds and any inaccuracies of the financial statements to indirect adjustments of these proceeds through the warranty regulations. This especially applies if the buyer has been given guarantees with respect to the debt of the target company or the NWC as of the effective date. Furthermore, if the locked box mechanism is selected, the seller is denied the opportunity to participate in any positive development of the agreed figures within the scope of the closing accounts mechanism. Careful consideration must therefore be given to the mechanism selected.

The locked box mechanism is thus primarily appropriate in cases in which the closing date and the effective date of the financial statement are close to each other or the business model solely expects cash flow fluctuations, which can be adequately covered by warranties with regard to the ordinary course of business between the effective date and the closing date. The locked box mechanism is more suitable in its pure form, i.e., without separate warranties concerning the level of debt and status of the NWC as of the closing date, in the case of bidding procedures in order to achieve a high degree of comparability between the received bids. In any case, the locked box mechanism ensures that the parties do not have to instinctively deal intensively with the actual adherence to the agreed figures as of the closing date, irrespective of the question whether a deviation actually exists which has a significant negative impact on the value of the target company. During mergers and acquisitions, the buyer is increasingly not completely unprotected even in the case of a locked box mechanism. The locked box mechanism offers advantages and controllable disadvantages for both parties.

Normalized Net Working Capital as a Purchase Price Factor

It has often been seen recently that the buyer is using the "normalized" NWC of the target company as an argument for reducing the purchase price. This often first takes place at the end of a transaction. In the letter of intent or term sheet agreed between the parties, only the amount of the purchase price is regularly agreed as well as its adjustment on a "cash-free/debt-free" and "normalized net working capital" basis. Prior to completion of the financial due diligence, the buyer is not sufficiently familiar with the target company in order to commit to specifying its expectations with regard to the normalized NWC.

This results in the discussions concerning the NWC first taking place relatively close to the end of the transaction. The parties are regularly in agreement that the NWC is a measuring value for the operational liquidity of an enterprise and represents the difference between the current assets and current liabilities. In the absence of a statutory definition, there are, however, often different ideas concerning which items of the balance sheet or the business assessment are to be included in the original or adjusted form. This especially applies for the question of the "normality" of the NWC on a certain date. The NWC can be significantly different between companies. It can be influenced by the type of enterprise, the seasonality of the business, its growth or special circumstances. There are typical adjustments of the NWC when it comes to adjusting it for the omission of future overhead payments of the target company to the parent company or taking into consideration any extraordinary circumstances that are not likely to reoccur (for example, the insolvency of a major customer, a substantial liability to a supplier for a new machine, or a high inventory level due to a machine breakdown). If the buyer is able to recognize that the value of the normalized NWC on the relevant effective date will be lower than the annual mean value, the buyer will aim to negotiate NWC that is based on an average of the last period. If a growing target company is concerned so that the need for NWC increases, the buyer will try to negotiate NWC that adequately takes the future growth into consideration.

In the interests of the seller, the lowest possible NWC, which can be achieved by the effective date with certainty, is regularly to be agreed.

On the other hand, the buyer regularly endeavors to agree the highest possible NWC, which secures the operating requirements of the target company to the greatest extent possible. The resulting conflict of interests can be met in the individual case by agreeing an earn-out, which creates an interest of the seller in sufficient NWC. If a cash-free/debt-free adjustment of the purchase price takes place at the same time in addition to an adjustment of the NWC, the purchase price will also be adjusted for the net debt of the target company, i.e., the debt after deduction of cash. If the net debt is positive, which therefore means that the debt of the target company on the effective date is higher than its cash, the purchase price will be reduced accordingly or vice versa. The discussions of the parties are complicated by the simultaneous adjustment of the purchase price to account for the NWC and net debt positions. This is because the NWC and the net debt regularly but not always behave synchronously depending on their definitions. If the NWC increases by the effective date, this is regularly connected with a corresponding increase of the net debt and vice versa. If, for example, inventory is purchased using the credit limit, the NWC and net debt will both increase to the same extent. Their effects on the purchase price cancel each other out in such cases. Depending on their definitions, a synchronization of the NWC and net debt is, however, not always achieved. If, for example, the cash is defined as part of the NWC and the target company increasingly collected receivables prior to the effective date, only the net debt will be reduced due to the increased cash item, however, the NWC will instead remain constant due to the asset swap (receivables against cash). In this case, the purchase price would have to be increased by the collected receivables, which would create an incentive for the seller to correspondingly influence the business development of the target company up to the effective date.

The definition of NWC and net debt requires particular attention for this reason. Hypothetical calculations can provide clarity concerning the effects associated with them. Once the parties have reached an agreement on the definition of NWC and net debt, these should be attached as an annex to the purchase agreement in order to avoid any later uncertainty. As a precaution, the possibility of taking adjustment effects into consideration twice should also be contractually excluded in any case. If the seller is willing, as is normally the case, to continue negotiating the transaction on the basis of a discussion of the normalized NWC that is to take place at a later date, the seller should inform the buyer at an early stage of the type of calculation that it considers appropriate. If this is connected with a hypothetical calculation, the direction of the seller's expectations will be clear for the buyer early on and the buyer can take this into consideration when submitting any different proposal. This helps to avoid significant conflicts at the end of the negotiations. The aim should be to reach an agreement in this regard as early as possible during the process. This is clearly in the interests of both parties.

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