

C L I F F O R D
C H A N C E

PURCHASE PRICE ADJUSTMENTS IN PRIVATE M&A
WHERE TO FOCUS?

THE BID LETTER – VALUATION APPROACH

IN AN AUCTION SALE, A SELLER WILL TYPICALLY REQUEST THAT BIDDERS STATE IN THEIR BID LETTER:

“The total cash consideration to be paid to acquire 100% of the equity interests in the Company. Your purchase price should be expressed as total enterprise value for an equity transaction, assuming a debt-free, cash-free balance sheet and a normalized level of working capital. Please provide details of how you arrived at your particular valuation and any assumptions you made in doing so.”

THE BID LETTER – VALUATION APPROACH

BIDDING ON A DEBT FREE, CASH FREE BASIS ALLOWS A BUYER TO BID BASED ON THE EQUITY VALUE OF A BUSINESS AND THEN ASSESS THE CASH AND DEBT POSITIONS DURING DILIGENCE AND NEGOTIATE APPROPRIATE VALUATION MECHANISMS IN THE PURCHASE AGREEMENT, E.G.:

“Our proposal values the Company at between \$1.2 billion and \$1.3 billion on a **cash-free, debt-free basis**. The purchase price will be paid in cash and will be subject to a **customary working capital adjustment** to ensure a normalized level of post-closing working capital consistent with the Company’s historical practices.”

THE BID LETTER – VALUATION APPROACH

IN A PUBLIC M&A DEAL, THE MARKET CAPITALIZATION OF A PUBLIC COMPANY IS GENERALLY THOUGHT TO BE A PROXY FOR EQUITY VALUE, SO THERE IS NO NEED TO BRIDGE FROM AN ENTERPRISE VALUE TO AN EQUITY VALUE. A BID LETTER WILL TYPICALLY STATE A PRICE PER SHARE BEING ACQUIRED, E.G.:

“Our proposal is to purchase all of the outstanding common stock of the Company for \$[x] per share in cash, subject to the terms and conditions of this bid letter.”

ENTERPRISE VALUE VS. EQUITY VALUE

The price a buyer is willing to pay for a privately-held target company is generally expressed as an enterprise value and not an equity value. If you think about enterprise value as a formula, in its simplest form it is:

$$\text{Enterprise Value} = \text{Equity Value} + \text{Debt} - \text{Cash}$$

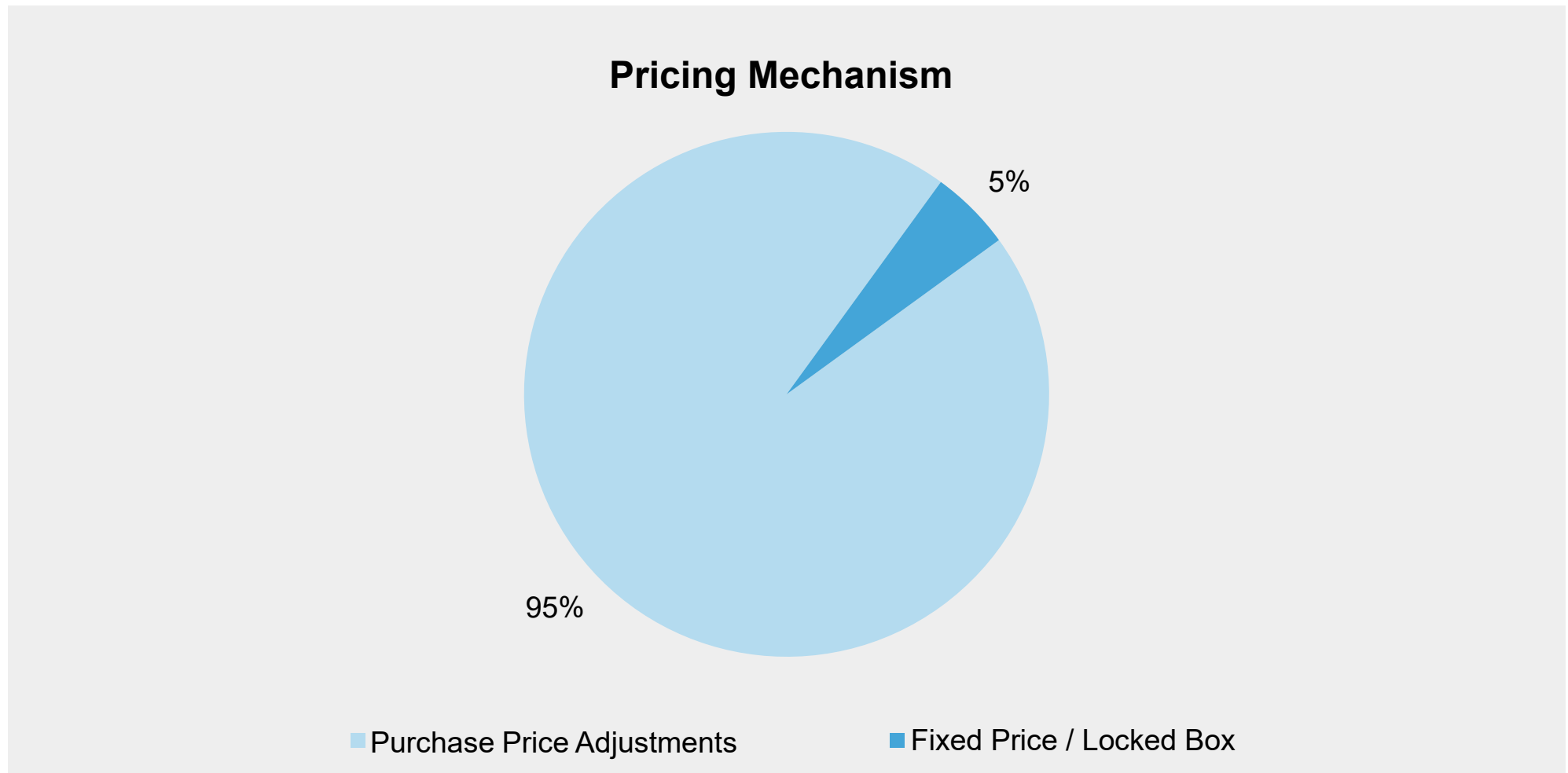
VS.

So logically, if a buyer is bidding on a “cash-free, debt-free” basis, then we have to take out the debt and add back the cash. So with a couple of tweaks to the formula for enterprise value, you create a formula for equity value, which again is the value of the seller’s interest in the target business. The equity value formula is:

$$\text{Equity Value} = \text{Enterprise Value} - \text{Debt} + \text{Cash}$$

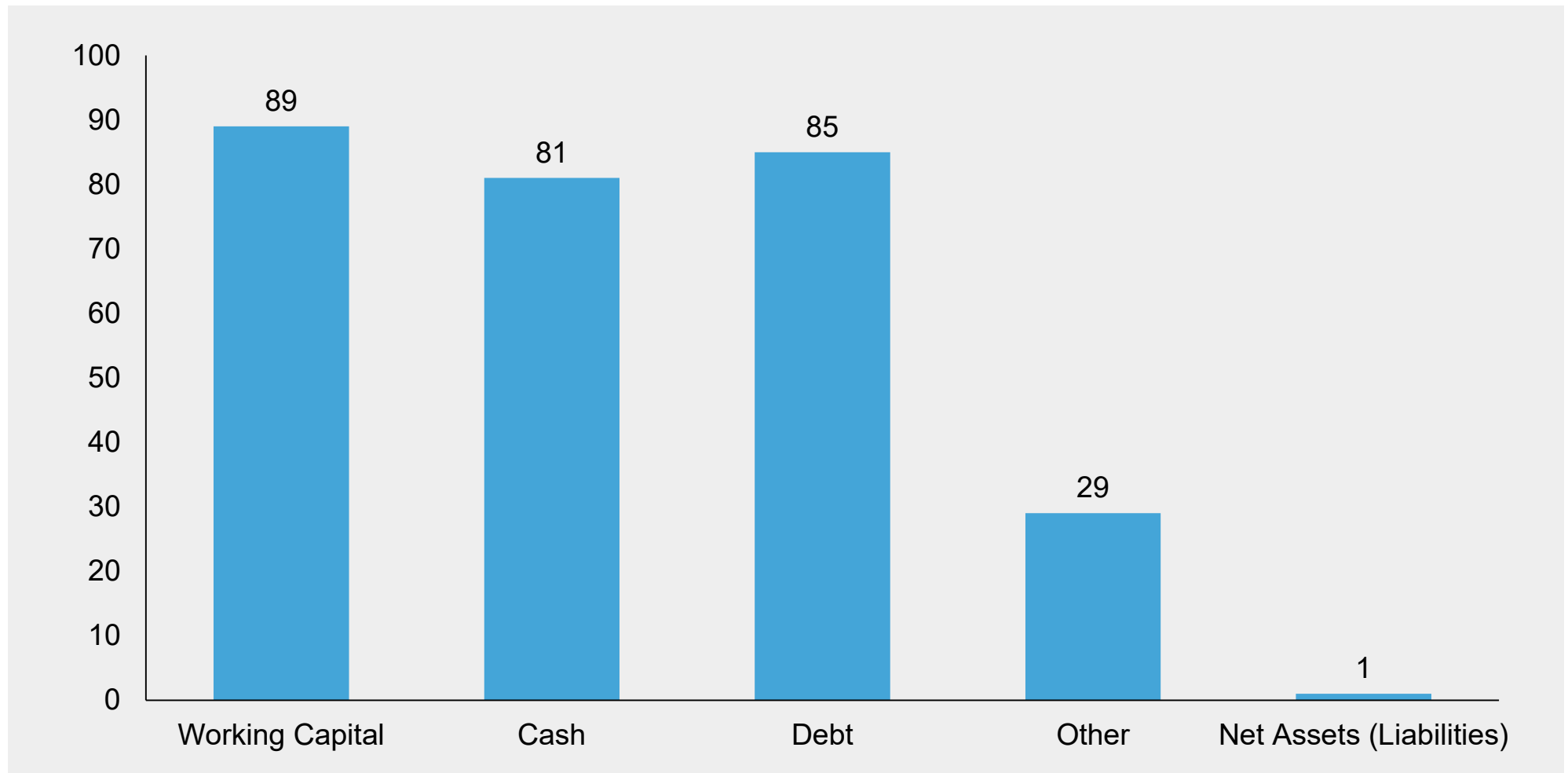
DOMINANCE OF PURCHASE PRICE ADJUSTMENTS

Latest ABA data shows that in 95% of 2019 U.S. private M&A deals purchase price adjustments were used.



PRICE ADJUSTMENT – COMMON COMPONENTS

Adjustment metrics 2019*



*Based on SRS Acquiom's Deal Term Study 2020

PURCHASE PRICE

Example definition:

The purchase price payable to the seller at the closing shall be an amount equal to:

Enterprise Value (which in any case is typically defined to be an actual number); *minus*



Indebtedness; *plus*



Cash; *plus*



the amount, if any, by which the Net Working Capital exceeds the Target Net Working Capital Amount; *minus*



the amount, if any, by which the Net Working Capital is less than the Target Net Working Capital Amount; *plus or minus*

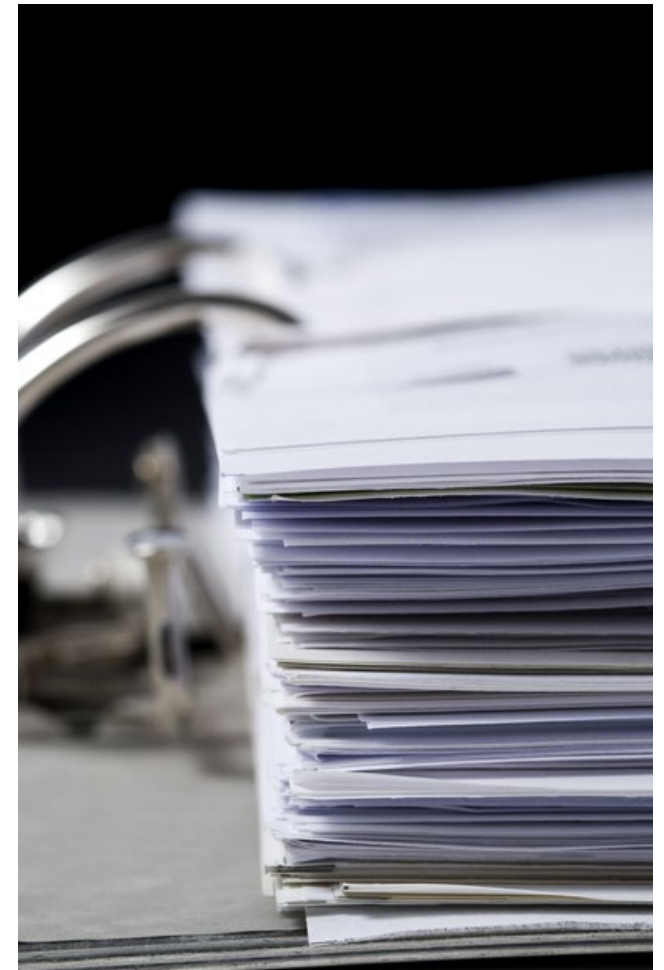


other transaction specific adjustments, if any, such as a downward adjustment for transaction expenses incurred by the target company in pursuit of the deal

CASH

Example definition:

“**Cash**” means, as of any time, all cash, freely marketable cash equivalents, checks, money orders, short-term instruments, bank and other depositary accounts, certificates of deposit, time deposits, deposits in transit, negotiable instruments, securities and brokerage accounts, funds in time and demand deposits or similar accounts. Cash shall (i) exclude uncleared checks and drafts written or issued by [target] or any of its Subsidiaries as of 00:01 a.m., New York time, on the Closing Date, (ii) include checks and drafts deposited for the account of [target] or any of its Subsidiaries and (iii) exclude any Restricted Cash.



DEBT

Example definition:

“Indebtedness” definition typically includes:

- indebtedness for borrowed money (principal and accrued interest), excluding intercompany indebtedness;
- obligations under leases that are required to be capitalized on a balance sheet prepared in accordance with US GAAP;
- pension deficits, severance payments, bonuses or other employee emoluments;
- obligations for the reimbursement of any obligor on any letter of credit, banker’s acceptance or similar instrument (to the extent drawn);
- payment obligations in respect of any derivative instruments, including interest rate swap, cap or collar agreements, interest rate future or option contracts, commodity or currency future or option contracts, currency swap agreements, take-or-pay agreements and similar agreements;
- declared but unpaid dividends;
- indebtedness secured by Liens on property;
- obligations evidenced by bonds, debentures, notes or other similar instruments; and
- guarantees in respect of the indebtedness or obligations referred to above.

NET WORKING CAPITAL

Example definition:

“**Net Working Capital**” means (i) all current assets (including all Accounts Receivable, inventory and prepaid expenses, but excluding Cash, any Restricted Cash, Regulatory Cash, and the portion of any prepaid expense of which Buyer will not receive the benefit following the Closing), of the Group Companies as of the Reference Time, minus (ii) all current liabilities (including accounts payable, accrued Taxes and accrued expenses, Accrued Vacation and all deferred revenue, but excluding Transaction Expenses and Indebtedness) of the Group Companies as of the Reference Time, in each case, determined in accordance with the Accounting Principles.



TRANSACTION EXPENSES AND OTHER ADJUSTMENTS

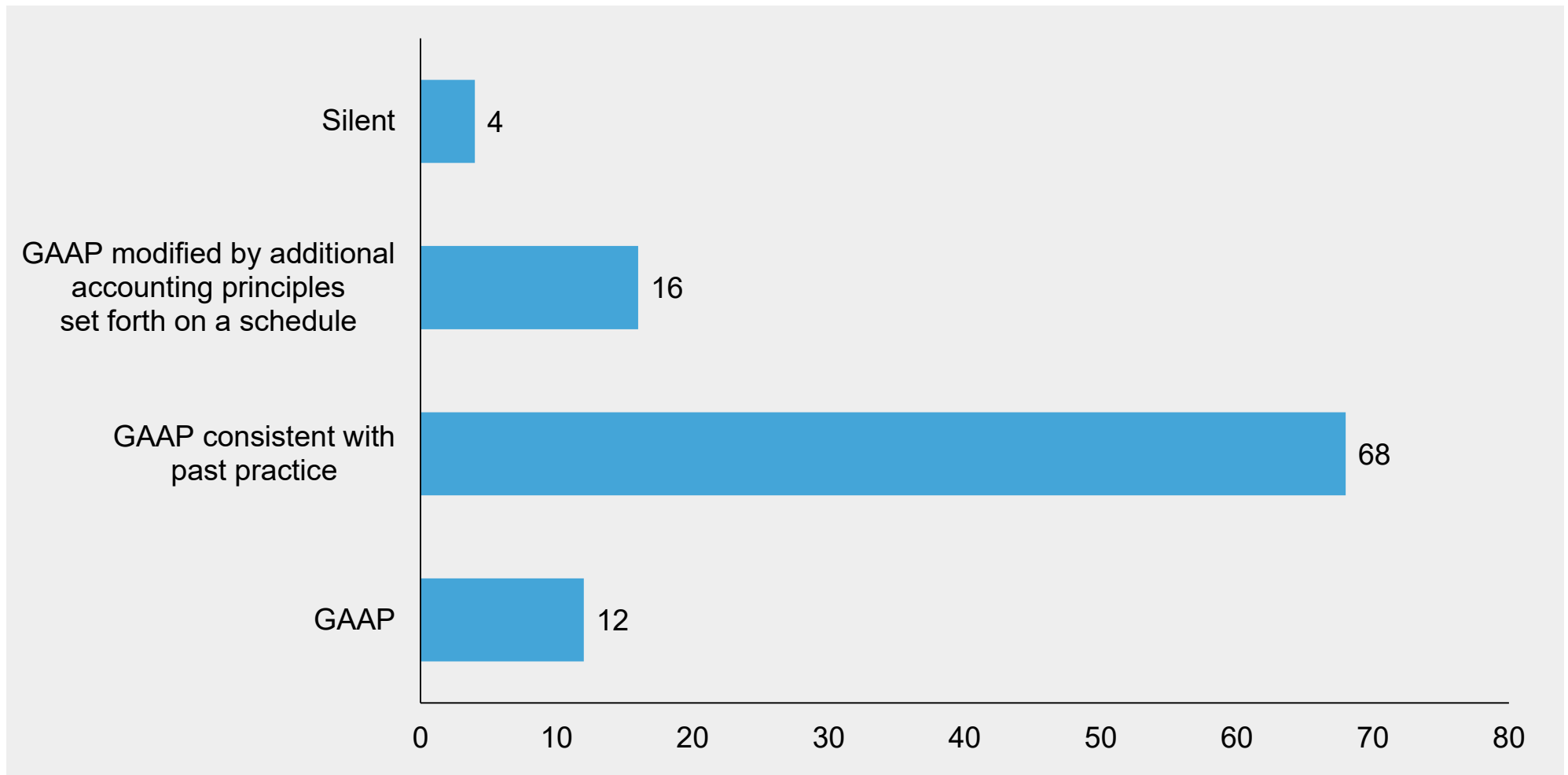
Example definition:

“Transaction Expenses” means the aggregate amount of all fees, costs and expenses incurred or to be paid by the Group Companies in connection with the preparation, negotiation, execution and delivery of this Agreement and the consummation of the transactions contemplated hereby on or before the Closing that are unpaid as of the Closing, (A) including (i) any known or unknown fees and expenses of the Group Companies incurred or payable by the Group Companies as of the Effective Time and not paid prior to the Effective Time payable to investment bankers, attorneys, accountants and other consultants and advisors, retained by any Group Company in connection therewith, (ii) the Change in Control Payments, and (iii) costs incurred or to be paid by the Group Companies attributable to the Reorganization.

Other adjustments may include:

- Transaction tax benefits (adjusted in favor of seller)
- Inventory
- Earn-outs
- Contingent value rights

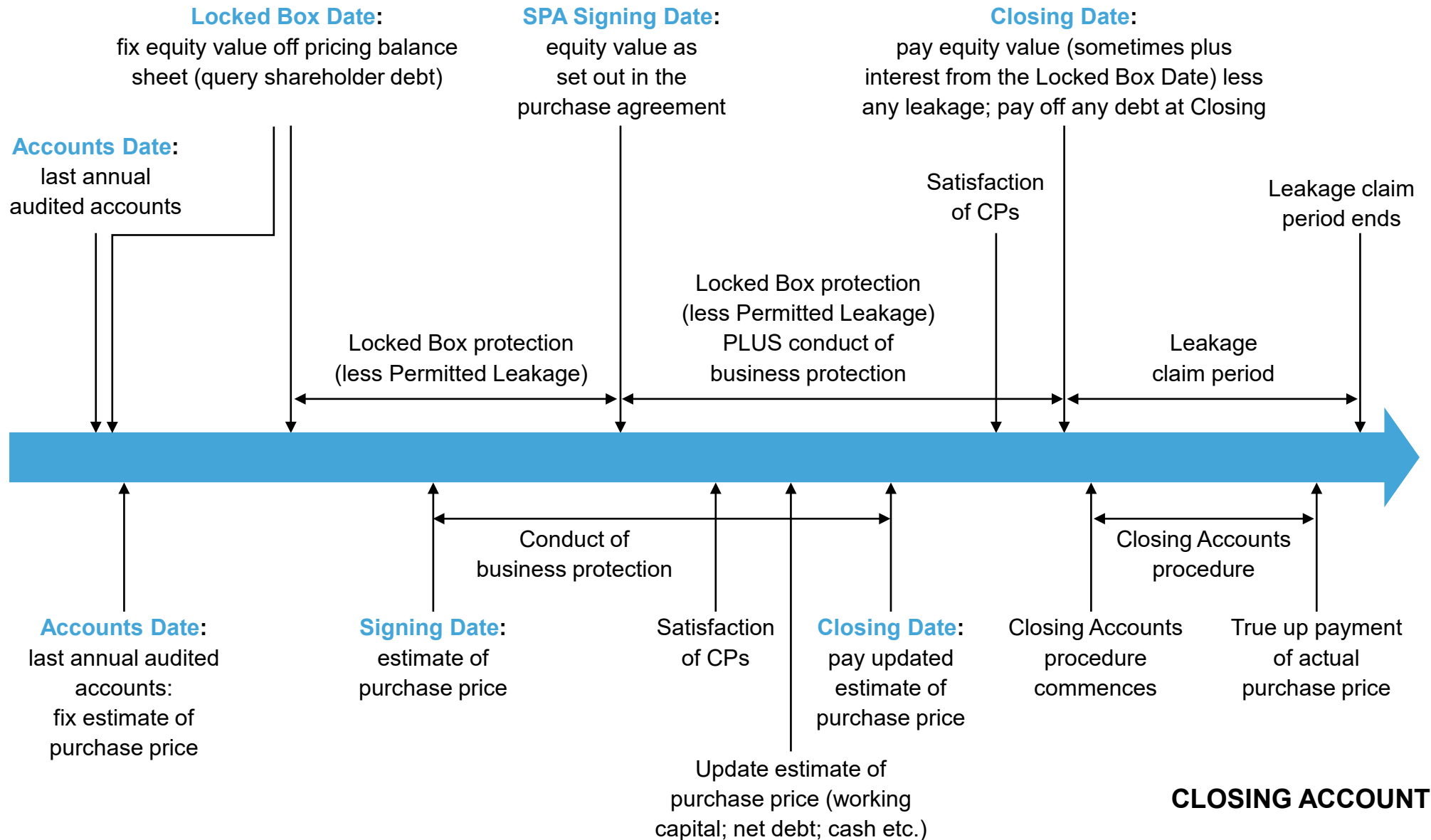
ACCOUNTING PRINCIPLES



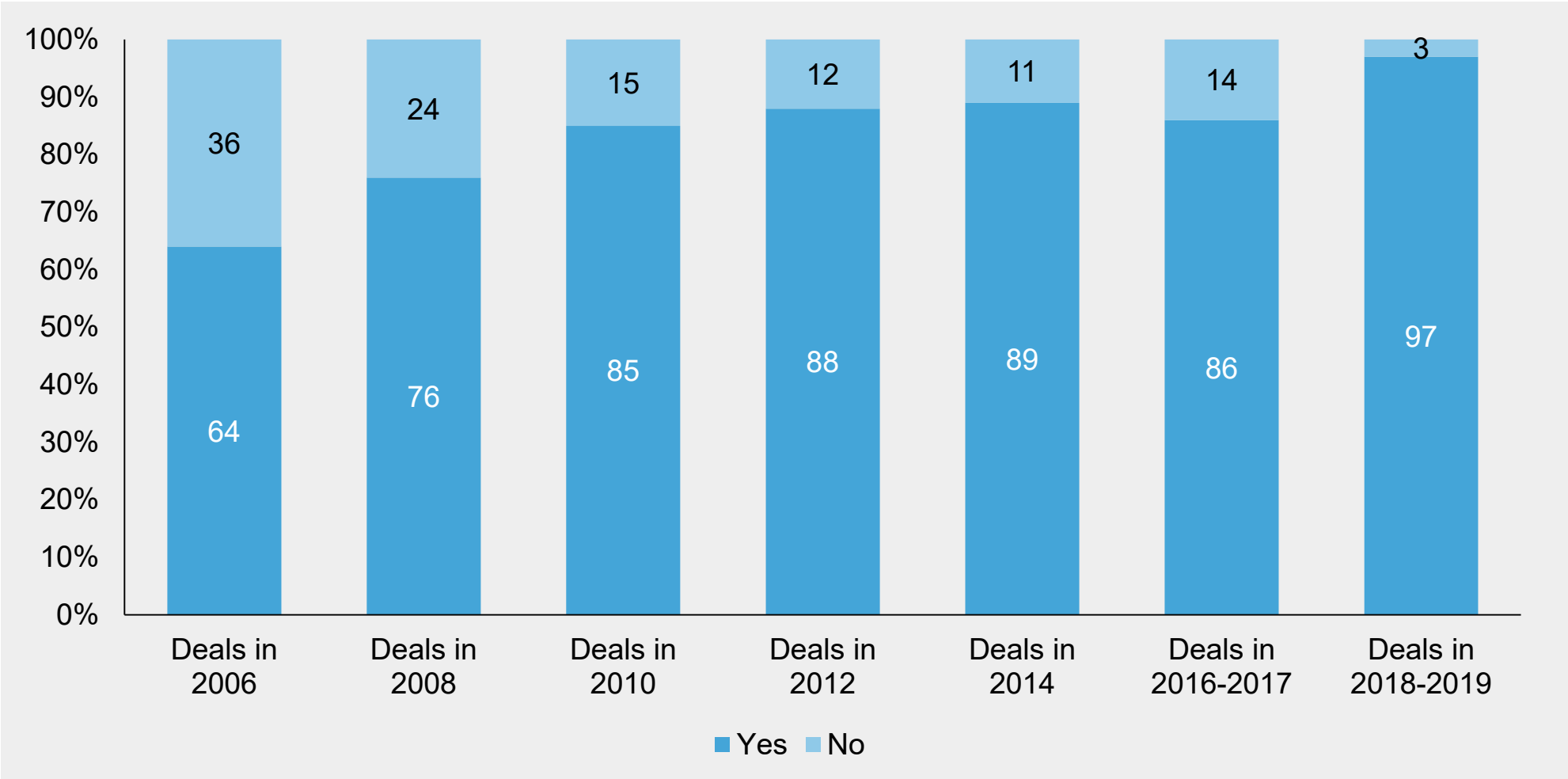
*Based on SRS Acquion's Deal Terms Study 2020

PURCHASE PRICE ADJUSTMENT TIMELINE

LOCKED BOX

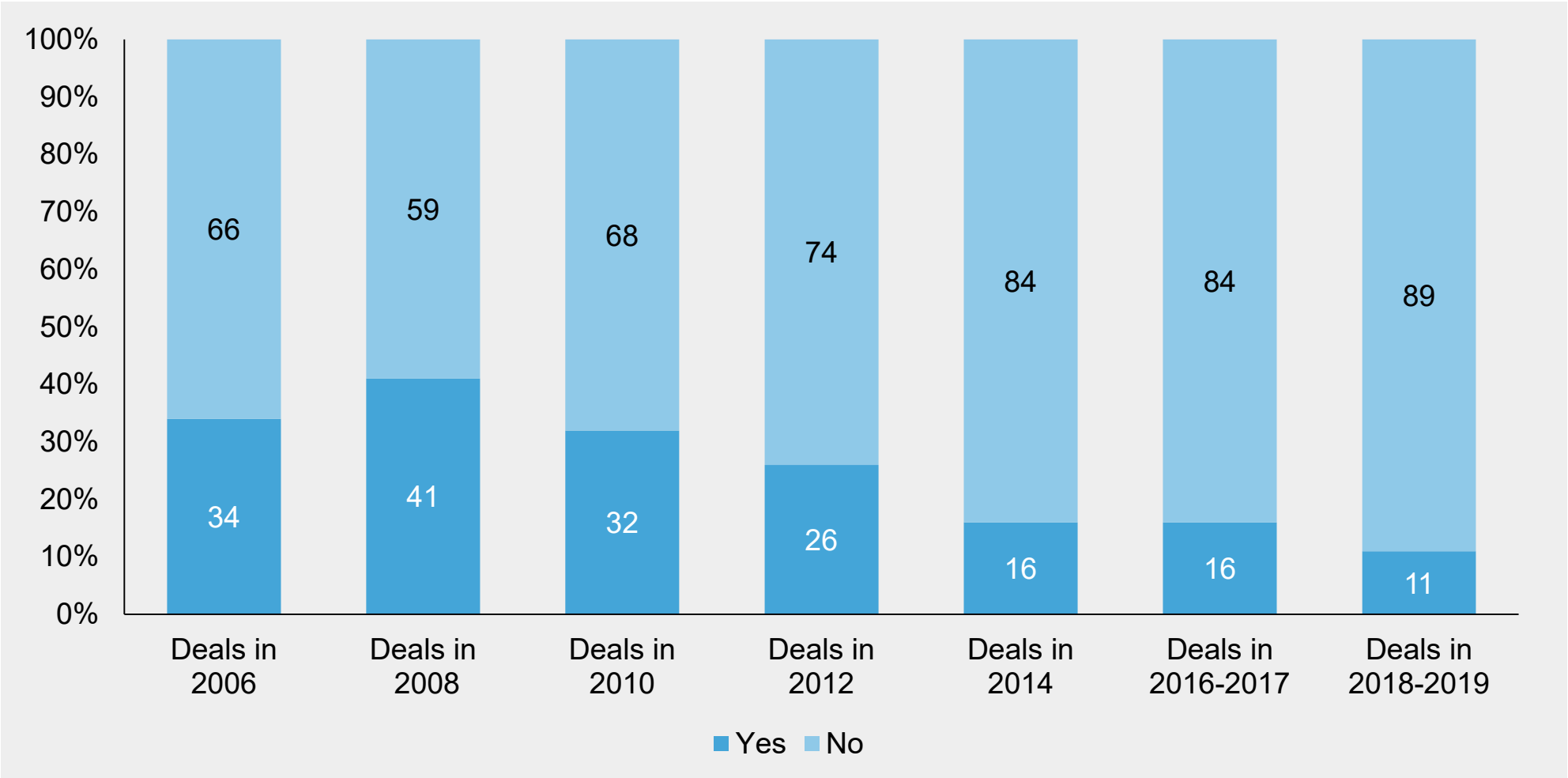


CLOSING PAYMENT BASED OFF OF AN ESTIMATE?



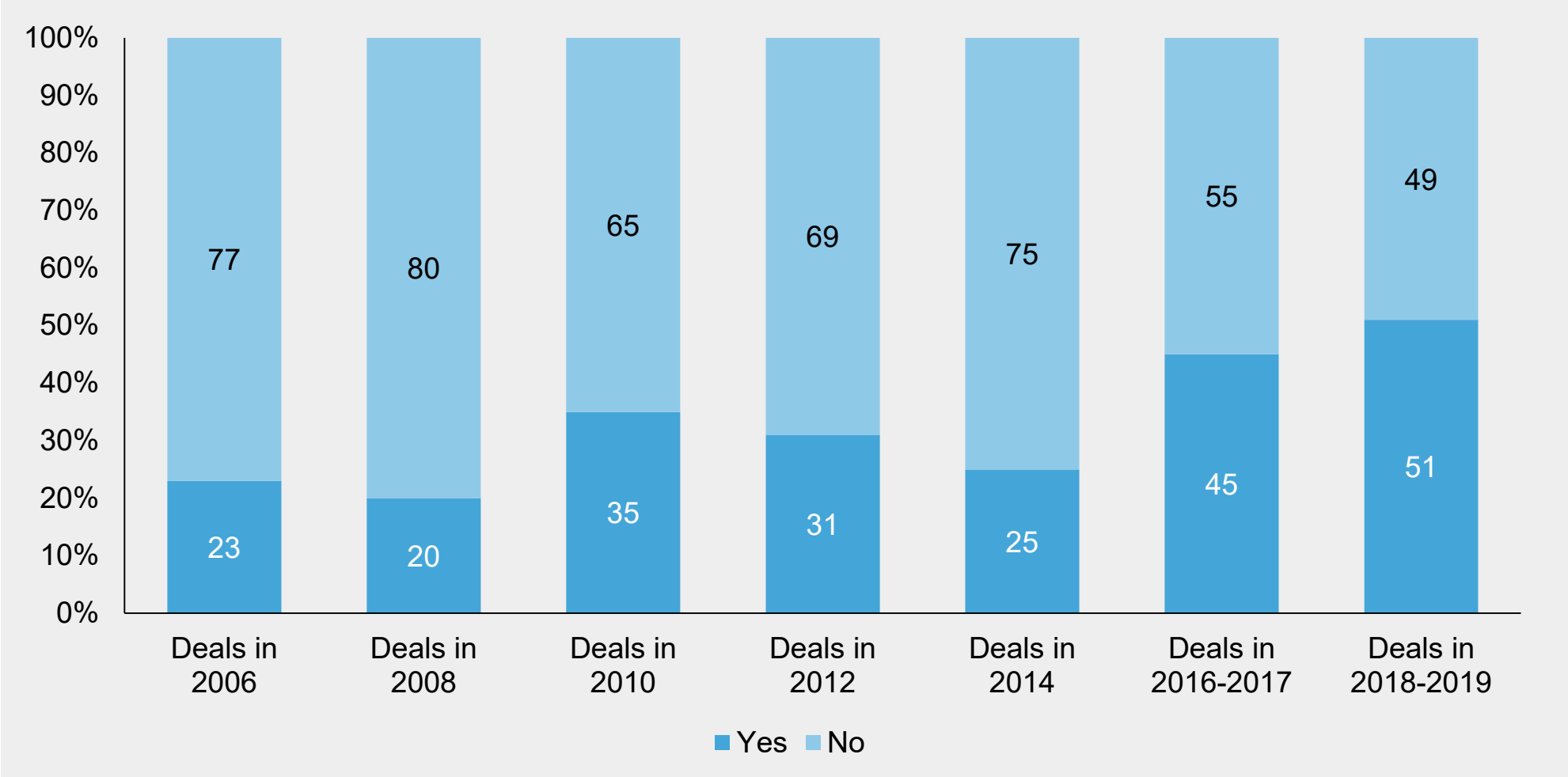
*Based on ABA Private Target M&A Deal Points Study 2020

DOES BUYER HAVE RIGHT TO APPROVE ESTIMATED PAYMENT AMOUNT?



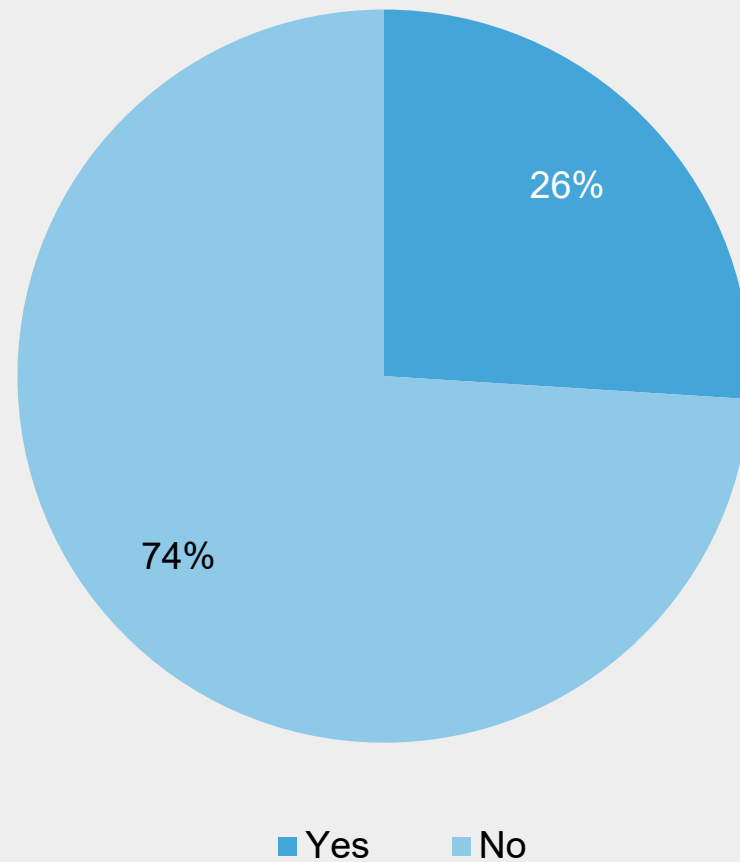
*Based on ABA Private Target M&A Deal Points Study 2020

USE OF ESCROW HOLD-BACK?



*Based on ABA Private Target M&A Deal Points Study 2020

SEPARATE ESCROW SOLE SOURCE OF ADJUSTMENT RECOVERY?



*Based on ABA Private Target M&A Deal Points Study 2020

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