KDP KOMAREVSKI DIMITROV & PARTNERS

Completion Mechanisms

Completion Accounts vs Locked Box Accounts

Part 1

General Notes

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COMPLETION MECHANISMS
COMPLETION ACCOUNTS vs LOCKED BOX ACCOUNTS

A very basic question when structuring an M&A transaction is which completion mechanism[1] to use. In the article below, we touch upon the legal aspects of the two most widely used completion mechanisms in the acquisitions of private businesses: Completion Accounts Mechanism and Locked Box Accounts Mechanism. For the sake of good order, we've split our articles into several sections: (i) General Notes and Preliminary High-Level Summary; (ii) Completion Accounts Mechanism in details; (iii) Locked Box Accounts Mechanism in details; (iv) Detailed Practical Comparison.

Part 1. General notes. Preliminary High-Level Summary

Before diving into the details of the two mechanisms, it is worth warming up with several matters that explain the existence and influence the specifics of the two mechanisms.

Table 1

Adjusting EBITDA

in EUR '000	Target A	Target B
EBTIDA	7,800	7,800
none-core one-off costs	70	20
non-core one-off revenues	(870)	(320)
Adjusted EBITDA:	7,000	7,500

General notes

Enterprise Value: In a typical private equity transaction, the investor would determine the purchase price offer by first defining the enterprise value (the "**Enterprise Value**" or "**EnV**") of the target business (the "**Target**"). To do so the investor can use different valuation models. Among these models one very commonly used is the expected future cash flows, where Target's EBITDA from core business is multiplied with an industry average or a transaction specific multiple to arrive at the EnV. In practice, EBITDA often includes non-core, one-off revenues and/or costs. Accordingly, in those cases the EBTIDA has to be adjusted to clear the effect of non-core, one-off operations – as in the example of Table 1. Once the EBITDA is "adjusted", the investor's Enterprise Value model would be something like:

Table 2

Calculating Enterprise Value

in EUR '000	Target A	Target B
EBTIDA	7,000	7,500
multiplier	**7.5**	**7.0**
Enterprise Value:	52,500	52,500

Example: *Enterprise Value of 52,500,000 EUR, based on 7.5 times normalized FY'22 EBITDA of EUR 7,000,000.*

The effect of the multiplier used in this model is crystal clear – the higher the multiplier, the higher the EnV – see example in Table 2.

Equity Value: So far so good, but EnV based on future cashflows takes into consideration neither the means and level of financing of the Target, nor free cash generated, nor undistributed profit, etc. Equity of one and the same Target will have different value depending on whether it has loans, free cash in bank, accumulated undistributed profit, etc. These are among the most common reasons explaining the difference between the Enterprise Value and the Equity Value of the Target (the "**Equity Value**" or "**EqV**"). To reach the Equity Value, an investor would start from the Enterprise Value and would adjust it with the Target's cash, debt, and any deviations from the normal working capital level (Table 3). Sounds great in theory but in practice the seller would hardly give all the necessary data to make these calculations, without first having an attractive indicative purchase price offer from the investor. To produce such non-binding offer, the investor would have to rely on preliminary data from the seller to determine Target's Enterprise Value and would assume the Target's (a) debt-free and cash free position; and (b) normalized level of working capital[2]. Investor's non-binding offer would be usually something along the lines of:

Table 3

Calculating Equity Value

Item	Target A	Target B
Enterprise Value	52,500	52,500
Cash	**3,350**	
Debt	**(13,500)**	
WCA	15	
Equity Value:	42,365	52,500

Example: *Enterprise Value of 52,500,000 EUR on a cash free and debt free basis, and assuming a normal level of working capital.*

[1] Completion mechanisms are also referred to as pricing mechanism, price adjustment mechanism, settlement mechanism.
[2] In many transactions, fit-for-purpose condition of non-current assets is made to address the buyer's assumption that the Target has its non-current assets in a condition that allows continuation of business without immediate material extra capex.

Figure 1

Typical transaction milestones

The Transaction Process: Both enterprise valuation and equity valuation require time and resources, but these are not the only time- and resource-consuming elements in a typical transaction process (see *Figure 1*). In a mid- or large- size private acquisitions the common milestones are:

(i) **NDA** – Executing a non-disclosure agreement – NDA (named also confidentiality agreement) formalizes the end the introductory period in which the parties establish contact, demonstrate interest in a potential transaction and agree of continuation of talks and sharing of information for the purposes of a potential transaction.

(ii) **NBO** – Accepting the investor's non-binding offer (NBO) marks the parties' non-binding agreement as to the most basic terms of the potential transaction and the timeline of the transaction process itself.

(iii) **Accounts Date for DD** – The due diligence review (which is next step below) would provide the investor with a snapshot of the Target as this date, which is of high importance for rest of the transaction.

(iv) **Due Diligence** – The due diligence review of the Target should give the investor a true picture of the Target's business, its financial, legal, tax, technology, commercial, HR, etc. condition – a sound basis for the real offering.

(v) **Negotiations** – Once the DD is over and the investor has a "picture" of the Target, the parties can engage in meaningful negotiations towards finalizing the terms of the binding transaction documents.

(vi) **Binding Agreement** – The binding agreement (below also the "**SPA**") fixes all terms and conditions of the transaction, commitments for next steps, rules for final price calculation, etc.

(vii) **Completion** – at Completion the seller would transfer title over the shares and control over the business to the investor - "**Completion**".

(viii) **Draft Completion Accounts** – Once Completion occurs, Draft Completion Accounts are made, but for transactions under the Completion Accounts Mechanism, these accounts are much more than opening/closing accounts.

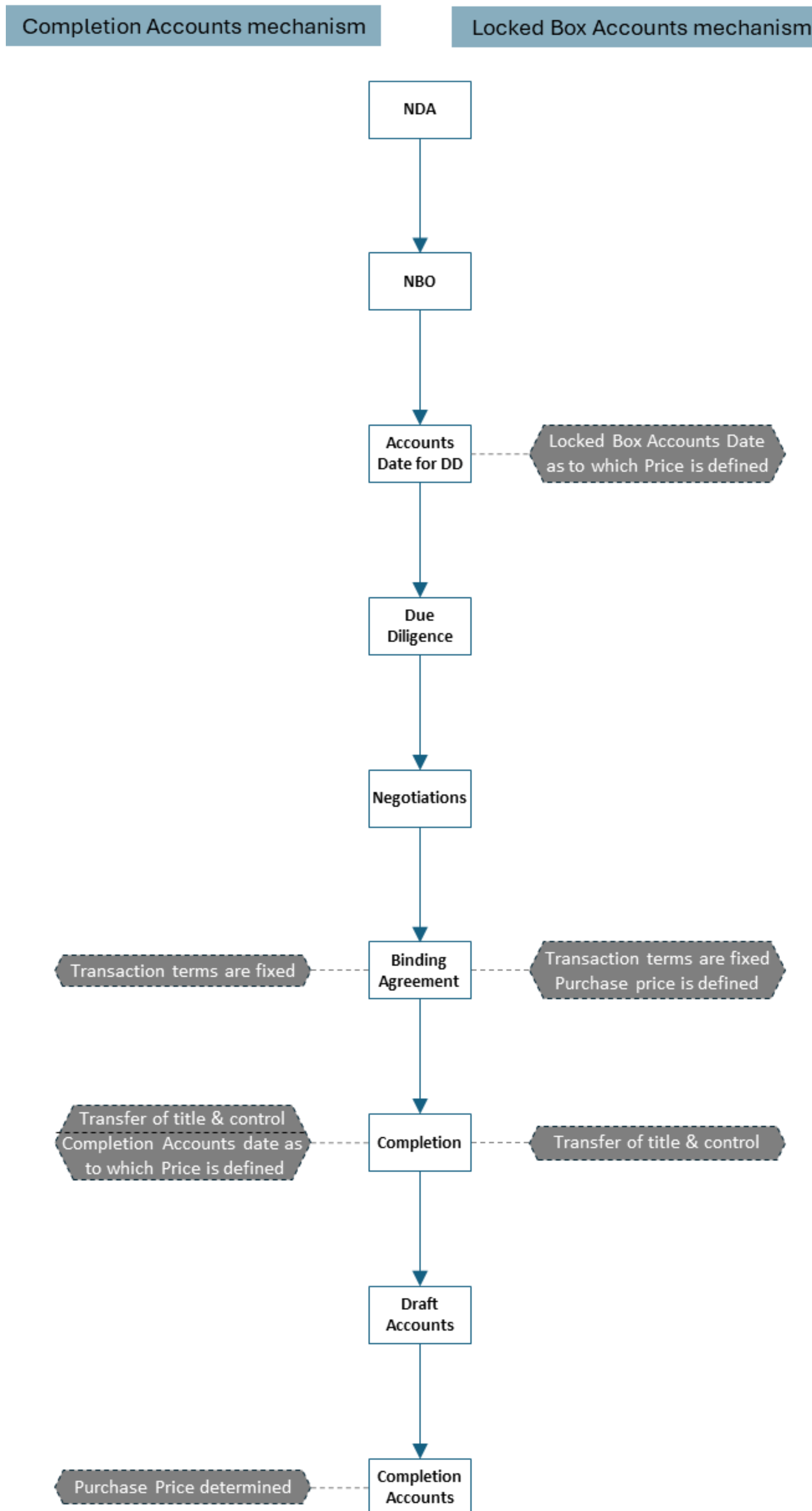
(ix) ***Completion Accounts** – Completion Accounts exists as a milestone only under Completion Accounts Mechanism, to indicate the final step in the transaction, in which the parties have agreed on the accounts, which determine the final purchase price.

Why two alternative completion mechanisms? The fluctuation of Target's Enterprise Value over time, on the one hand, and on the other hand, the duration of the transaction process (which most often exceeds 6 months) are the main reasons to practically explain the existence of different completion mechanisms. The alternative mechanisms reflect the efforts of the parties to address the change in the Target's Equity Value over the period starting from the NBO until the purchase price is defined.

Preliminary high-level summary

Under both completion mechanisms the transfer of title and control over the Target happens upon Completion. The differences between two mechanisms (see *Figure 2*) originate from difference in:

- The date as of which the economic benefit is transferred;
- The date when the purchase price is agreed.



The date as of which the economic benefit is transferred:

Under the Locked Box Accounts mechanism, Enterprise Value and Equity Value of the Target are determined based on the accounts presented in the due diligence phase of the transaction process. These are the accounts used in the Locked Box Accounts Mechanism to determine the purchase price and therefore they are referred to as the "**Locked Box Accounts**". Since the purchase price is determined at the date of these accounts, the economic benefit from the Target is also deemed transferred by the seller to the investor as of the same date - the "**Locked Box Accounts Date**".

Under the Completion Accounts Mechanism, Target's Equity Value, and accordingly the purchase price, is determined based on the Completion Accounts, and the economic benefit from the Target is deemed also to be transferred as of the same date.

The date when the purchase price is finalized:

In transactions governed by Locked Box Accounts Mechanism, purchase price is determined based on data as at the Locked Box Accounts Date, but the parties can negotiate on the various elements involved in price formation by the moment they sign the Binding Agreement. So, the date of the Binding Agreement is the date when the purchase price is finalized.

In transactions governed by the Completion Accounts Mechanism, the purchase price is determined based on the Completion Accounts, but in fact these are subject to approval by both parties. The Parties often engage in some true-up and post-true-up negotiations, so purchase price is deemed finalized once Completion Accounts are approved by the parties to the transaction. In practice at the date of the Binding Agreement, the investor would typically pay certain percentage of the expected purchase price, even though the purchase price will be finalized once the Completion Accounts are agreed between the parties.

At first glance, it seems that in transactions governed by Locked Box Accounts Mechanism, purchase price is finalized earlier than in transactions governed by Completion Accounts Mechanism. The Completion Accounts Mechanism has longer history of "serving" the transactional business, however. For this reason, when discussing the completion mechanisms in detail, we focus first on the Completion Accounts Mechanism.

Please reach out to us if you want to discuss!

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