To lock or not to lock?

An introduction to the locked box closing mechanism

March 2021

1 At a glance

Deal closings can be lengthy and difficult processes with many facets to consider.

The locked box mechanism negates the need for preparing and reviewing the final price adjustments post-closing.

Pricing deals this way allows the buyer/seller to put resources into other aspects of the deal.

Introduction

In an increasingly sophisticated deals market, specialist knowledge of the benefits and pitfalls related to the financial and accounting aspects of the sale and purchase agreement (SPA) can be the difference between a good deal and a great deal. In any transaction, the SPA represents the outcome of key commercial and pricing negotiations between parties. The financial aspects of the SPA are key to ensure that the buyer is buying (and seller is selling) what they expect, for the price they expect to pay (receive) and without undue risk.

Traditionally deals have been closed across the globe, using a **closing accounts** pricing mechanism under which, parties to the transaction agree to a "cash free, debt free" price, assuming a normal level of working capital (enterprise value) – where this price is then subject to estimates and a post-closing adjustment process for the actual cash, debt and working capital (or some other measure, e.g., net assets) in the target business as at the closing date. In order to be able to determine these final price adjustments to enterprise value, closing accounts are drawn up and the adjustments are calculated based on the definitions, principles and mechanism set out in the SPA, subject to dispute and if so, then subsequently negotiated and settled between the parties (or resolved in arbitration).

However, as the market continues to evolve, buyers and sellers are looking for ways to reduce the often lengthy process of preparing, reviewing and potentially disputing these final price adjustments derived from the closing accounts. As a result, we are increasingly seeing more deals being completed under a **locked box** mechanism.

A seller may favor a locked box mechanism for its ease of comparing bids, particularly in competitive processes, or for its offer of a clean break from the transaction as of closing. On the other hand, a buyer can differentiate itself by offering or accepting a locked box mechanism in a competitive process.

The locked box mechanism is used to close numerous transactions globally, with growing usage in the United States. This paper sets out how the mechanism works – the key benefits and potential pitfalls of using this mechanism – together with some practical considerations to be aware of when using a locked box mechanism to close a deal.

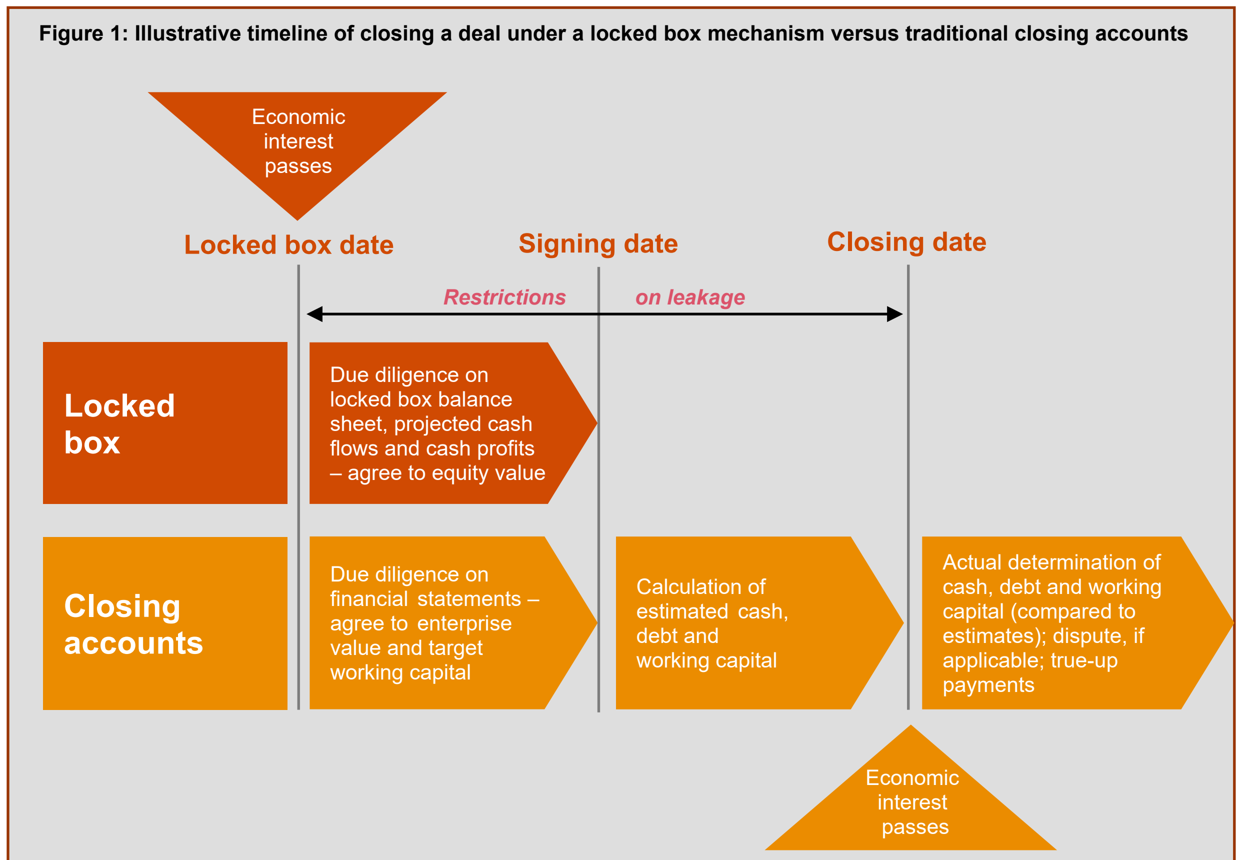
2 The locked box mechanism

A locked box deal in its simplest form is a fixed price deal. The locked box is the name given to a closing mechanism whereby **equity value** is fixed in the SPA at signing, calculated based on an historical balance sheet (the locked box balance sheet) at a pre-signing date (the locked box date). This fixed price for the target business is negotiated based on the locked box balance sheet.

As cash, debt and working capital are known amounts at the locked box date, the final adjusted price (equity value) is agreed between the parties and written into the SPA. Protection against leakage of value from the target business between the locked box date and closing is provided by the seller through representations and warranties written into the SPA, usually supported by an indemnity. No closing accounts are required and therefore no adjustment is made to price after the closing date (subject to a leakage review).

As negotiated equity value is written into the SPA at signing; there is NO post-closing true-up for cash, debt or working capital, and therefore no closing accounts are drawn up

Figure 1: Illustrative timeline of closing a deal under a locked box mechanism versus traditional closing accounts



A fixed equity value for target business is negotiated based on an historical balance sheet (the locked box balance sheet)

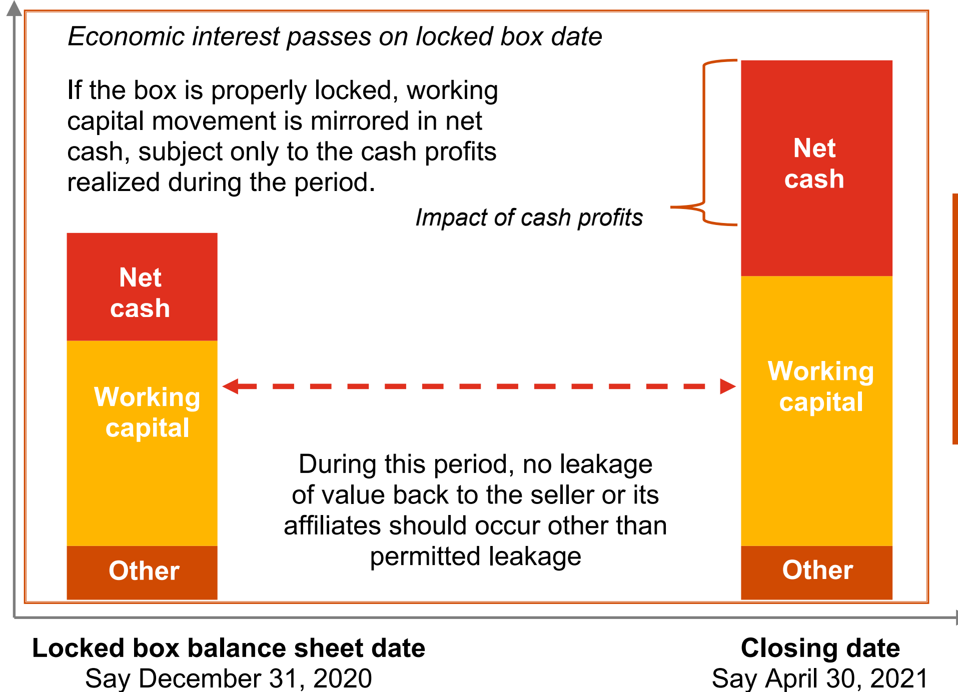
There are a number of key benefits to using a locked box mechanism, the most obvious being that it gives certainty of price for both buyer and seller at the time of signing the SPA, which explains why this mechanism is particularly favored by private equity and financial sellers. It is also becoming increasingly popular among corporate sellers as well as they see this mechanism as a way of reducing some of the risks associated with buyers using the closing accounts process to bridge some of the value gap through "price-chipping" post-closing.

As pricing is based on the locked box balance sheet, which may have been subject to independent review, there is no drawn-out debate over which accounting policies and practices should be used in the preparation of closing accounts. Nor is there such debate regarding the form of the closing accounts, the definitions around the elements of purchase price and the process by which these accounts will be prepared, reviewed and potentially disputed. This results in potentially significant time and cost savings.

Locked box SPAs are considerably less complex documents than those containing a closing accounts mechanism as a result of the simplicity of the mechanism. In addition to cost savings, management's time is freed up to run and/or prepare to integrate the target business as opposed to their time being consumed in preparing and debating closing accounts post-closing.

The key to a successful locked box is making sure that the box is locked. The concept works on the basis that any movement in working capital will be mirrored in net debt, provided that no value has leaked from the target business back to the sellers or their affiliates. The buyer is therefore indifferent to the fact that the closing balance sheet will differ from the locked box balance sheet.

Figure 2: The locked box mechanism ensures that value remains with the target business



Leakage comprises any form of value extraction from the target business after the locked box date that benefits the seller

3 What do we mean by leakage of value?

Leakage comprises any form of value extraction from the target business between the locked box date and closing that benefits the seller or their affiliates. For example, this could include dividends (whether actual or deemed), management fees, transfer of assets at an undervalue and the discount or waiver of amounts owed/ liabilities.

Permitted leakage comprises any leakage that is agreed between the parties and specified in the SPA prior to signing. Permitted leakage may or may not result in a reduction to price. For example, a dividend paid to the seller after the locked box date will result in a reduction to price, whereas salary payments made in the ordinary course of business to employees should not impact price. Both would still be considered permitted leakage in the SPA.

4 Practical considerations: How does using a locked box impact the bidding?

Round one of bidding is the same whether using closing accounts or a locked box mechanism to close the deal. “Cash-free, debt-free” bids, assuming a normal level of working capital, are submitted to the sellers thereby setting their enterprise value expectations.

Prior to the next stage of bidding, sellers will often try to pre-empt potential buyers’ price adjustments and use this tactic to prepare counter arguments against potential deductions.

Increasingly we are also seeing sellers issuing their view of the enterprise to equity value bridge in order to further “manage” buyers’ expectations of cash, debt and working capital adjustments.

Figure 3: Pricing considerations for a locked box are the same as for closing accounts, only the timing differs

Base price (enterprise value)		**x**	Starting point—price/round 1 bids
Plus: $ for $ cash	x		**Price adjustments** – similar to the items that are adjusted for in a closing accounts mechanism, *except amounts are calculated based on the locked box balance sheet*
Less: $ for $ debt	(x)		
Net debt adjustment		**x/(x)**	
Plus: $ for $ working capital	x		
Less: normal level of working capital	(x)		
Working capital adjustment		**x/(x)**	
Other cash-like and debt-like items		**x/(x)**	
Permitted leakage		(x)	Defined in the locked box SPA
Purchase price (equity value)		x	Price shown in the locked box SPA
Interest charge on equity value		x	Mechanism to extract cash profits
Total consideration		**x**	At closing

Considerations around setting a target working capital for a locked box are the SAME as for closing accounts

The seller may also issue some persuasive "guidance" to buyers regarding which deductions from enterprise value are acceptable to the seller, and if it is a competitive auction process, which adjustments make their bids uncompetitive.

In order for a buyer to be able to accept this concept of fixing a price based on a historical balance sheet, the seller should offer (and the buyer should require) a representation at signing that no leakage has occurred since the locked box date and a covenant of the same should run to the closing date. This representation and covenant are then often backed up by an indemnity such that the seller will reimburse the buyer for any leakage that occurs on a dollar for dollar basis (that is often capped at the total purchase price).

Permitted leakage is carved out of the definition of leakage. Therefore, it is imperative that the buyer asks the seller to schedule out the items of permitted leakage in as much detail as possible (payee, amount, timing) such that the items can be priced as appropriate.

The SPA will then typically set out a time period post-closing during which the buyer can diligence the books and records of the target business to identify and claim for any leakage that may have occurred. It should be noted that leakage claims should be carved out of the de minimis and maximum thresholds applied to the general representations, warranties and indemnifications.

With that being said, in our experience, leakage claims are not common.

5 Should the seller be compensated for the period between the locked box date and closing?

The economic risks and rewards pass to the buyer from the locked box date. In contrast, the seller incurs an opportunity cost as they run the business on behalf of the buyer from the locked box date through closing while payment is not received at the locked box date but instead at the closing date.

In order to compensate the seller for this opportunity cost, interest is typically charged on the purchase price (equity value) for the period between the locked box date (excluding) and the closing date (including). To achieve such compensation, the seller typically demands either:

- an interest charge on the purchase price (equity value) between the locked box date and closing. This reflects the **opportunity cost** of the seller not receiving the proceeds from the buyer at the locked box date when economic interest passed; or
- a **proxy for the profits** earned (e.g., daily profit rate) as the seller will not have been able to extract this from the business since the locked box date.

The interest charge, whether proposed as compensation for the opportunity cost or proxy for profits, typically reflects the expected "cash profits" to be generated by the target after the locked box date, NOT the operating cash flow.

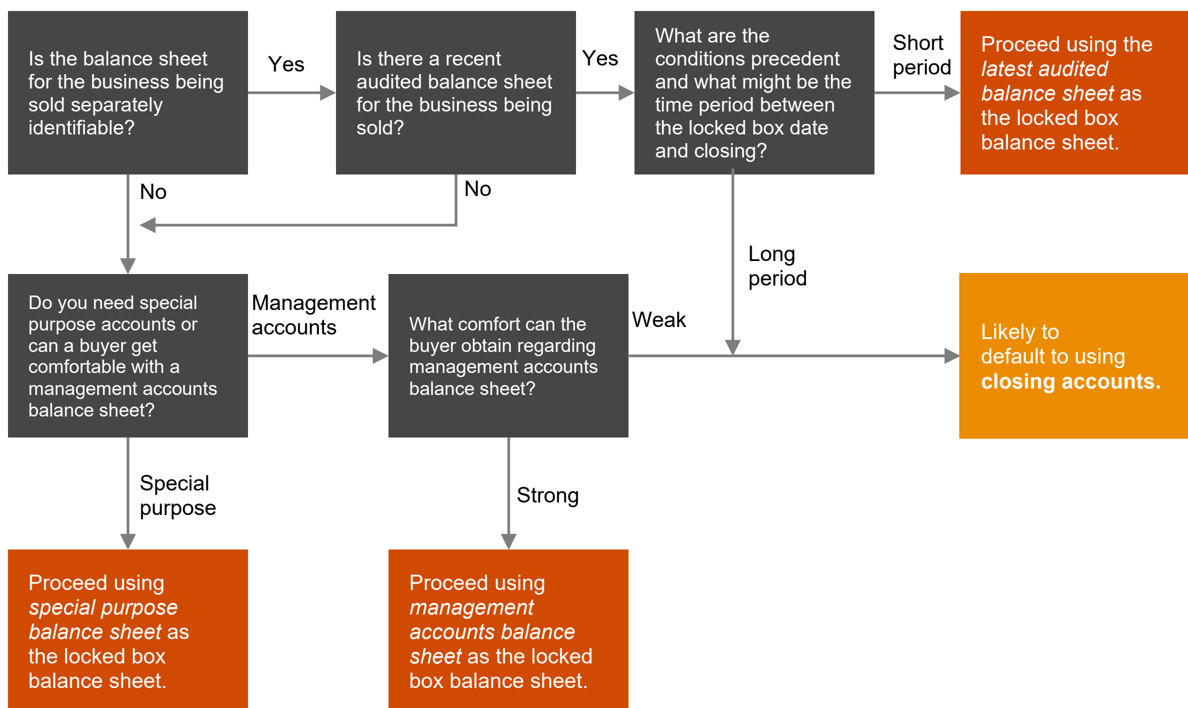
Regardless of the seller's rationale, the buyer should compare the amount payable under the interest charge with the expected cash profits to be generated between the locked box date and closing. Cash profits broadly represent the increase in net assets of the target between the locked box date and closing. We highlight that working capital movements are dealt with through the locked box mechanism itself and therefore do not impact the calculation of cash profits (i.e., assuming that the "box is locked" and there is no leakage, any increase in working capital would result in a decrease in cash or increase in debt). Some of the more common calculation pitfalls include:

- interest accrual being misaligned with the debt deduction;
- double counting of deductions or leakage items; and
- not taking into consideration the seasonality impact.

Seller may ask for an interest charge or daily profit rate in order to compensate them for the opportunity cost of operating the target business between the locked box date and the closing date

6 Which balance sheet should be "locked" for the purposes of pricing?

Figure 4: Buyer confidence in the balance sheet for the purposes of pricing and locking the box is key.



7 Pros and cons of using a locked box mechanism for both sellers and buyers

Although there are some obvious advantages to the seller in using a locked box mechanism (and hence the perception that this mechanism is seller-friendly), a number of these benefits will also benefit the buyer.

Provided the seller can offer appropriate comfort over the integrity of the locked box balance sheet; accompanied by relevant representations and warranties over the locked box accounts, this mechanism can also work for a buyer.

Figure 5: The Locked Box mechanism has pros and cons to both parties

	Pros	Cons
Seller	• Price certainty • Simplicity – no closing mechanism • Lower cost – management time not tied up post-closing • Increased control of the process • Less aggressive interpretations of price adjustments in an auction • Easier to compare bids in an auction • Hard wires accounting policies, ensuring consistency with historical practices	• Difficult to apply without an anchored balance sheet (carve-out) • Potential to lose out if interest charge set too low (unless already factored in the headline price)
Buyer	• Price certainty • Simplicity – no closing mechanism • Lower cost – management time not tied up post-closing	• Difficult to apply without an anchored balance sheet (carve-out) • No closing mechanism to exploit • Limited ability to get management on buyer's side for any post-closing disputes • Committing to price before exclusivity • Risk of business deterioration between the locked box date and closing • Need to debate price adjustments earlier with less knowledge • Risk of over-funding at closing

8 Considerations checklist for buyers

In order for a buyer to be able to accept closing under a locked box mechanism, adequate diligence to quantify adjustments is required and a buyer would need to seek comfort over the locked box balance sheet through strong representations and warranties over the locked box balance sheet and related accounts. In addition to sufficient comfort over the locked box balance sheet, it will also be key for a buyer to make sure that there are adequate systems set up within the target business to identify leakage, and that the buyer can themselves get comfortable that leakage can be identified for pricing purposes.

When contemplating closing under a locked box mechanism, the buyer should assess the following:

- For the purposes of identifying leakage, who is a "seller" or a seller's "affiliate" or "related person" (seller parties)?
- Are systems set up to identify all transactions between the target and the seller parties between the locked box date and closing date?
- Is there sufficient control over potential leakage in distant territories or business operations?
- Consider requiring a specific definition of "permitted leakage."
- Consider which of the identified permitted leakage items are items to be disclosed for legal reasons, with no impact on price, or whether there are items which need to be factored into price.
- Consider whether the form of the leakage representation and warranty is sufficient, on a dollar for dollar basis and carved out of the other warranty limits and thresholds.

In a locked box mechanism, the buyer forgoes the ability to true-up price post-closing. As such, there is increased importance and reliance on the locked box balance sheet and whether diligence and access have been sufficient.

9 Summary of key characteristics of the two main types of pricing mechanisms

Closing accounts	Locked box
Enterprise value agreed, but equity value subject to post-closing adjustments.	Equity value is fixed.
Definitions of cash, debt and working capital are agreed prior to signing.	Price adjustments for cash, debt and working capital are agreed prior to signing.
Target working capital is agreed prior to signing.	Target working capital is agreed prior to signing.
Adjustments for cash, debt and working capital are based on a closing balance sheet prepared post-closing (which is often as of a mid-month period).	Price adjustments for cash, debt and working capital are based on a historical balance sheet (locked box balance sheet) (which is almost always as of an accounting period end).
The concept of leakage is irrelevant.	Seller provides an indemnity that there will be no leakage of value from the locked box date back to the seller parties.
The SPA will contain "conduct of business" provisions.	The SPA will contain "conduct of business" provisions.
The process for preparing, reviewing and agreeing final closing accounts is negotiated and set out in the SPA.	No closing accounts nor associated review process, as there is no adjustment to purchase price after closing (other than the leakage review).

10 To lock or not to lock?

In summary, the pricing considerations and mechanics underlying a locked box mechanism are not intended to result in a different equity value, price or economic result from the traditional closing accounts mechanism. The intent is only to ***simplify*** the closing mechanism.

Ultimately, the buyer will write a check to the seller comprising the equity value (i.e., enterprise value adjusted for cash, debt and the difference between target working capital and working capital).

Value can be lost under either pricing mechanisms if the key financial drivers between enterprise value and equity value are not negotiated and treated appropriately.

In contrast to a typical closing accounts process, negotiations over these balance sheet items occur while the auction process is still ongoing, rather than when the buyer has exclusivity. A seller can therefore use the locked box mechanism to take control over the divestiture process.

11 Contact us

For a deeper discussion on the Locked Box mechanism or other pricing concepts, please contact the PwC Contracts and Closing Mechanisms (CCM) team, who have extensive experience in these areas:

Melanie Fry

Principal, PwC Deals
melanie.j.fry@pwc.com

Jill Jackson

Managing Director, PwC Deals
jillian.m.jackson@pwc.com

Ceyda Bobus

Managing Director, PwC Deals
ceyda.bobus@pwc.com

General mailbox:

US_CCM@pwc.com

PwC Directors Ada Yi, Andrea Mazur and Shiman Batra contributed to this publication.

© 2021 PwC. All rights reserved. PwC refers to the US member firm or one of its subsidiaries or affiliates, and may sometimes refer to the PwC network. Each member firm is a separate legal entity. Please see www.pwc.com/structure for further details. This content is for general information purposes only, and should not be used as a substitute for consultation with professional advisors.