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PKF Corporate Finance

QUARTERLY INSIGHTS INTO KEY FINANCE MATTERS AFFECTING YOUR BUSINESS

ISSUE 15 ON CORPORATE FINANCE

PURCHASE PRICE ADJUSTMENTS:

MEASURED STEPS MAKE FOR A SMOOTH TRANSITION

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PURCHASE PRICE ADJUSTMENTS

Purchase price adjustments are a common feature of business sale transactions. The purchase price adjustment adjusts for differences in key accounts between the buyer and seller exchanging contracts and completion. The purchase price adjustment ensures a fair and equitable transaction that is consistent with the agreed contract terms.

In agreeing to the terms of the transaction, the total consideration for 100% of the shares in the target company will usually be determined as follows:

- The value of the business (Enterprise Value), which includes the working capital and plant and equipment required to operate the business;
- Any surplus assets to be acquired, such as property or investments are added to Enterprise Value; and
- Any non-working capital related liabilities to be assumed by the acquirer, such as debt or provisions, are deducted from Enterprise Value.

The most frequent working capital adjustments relate to working capital and net debt and are usually negotiated in all transactions. These are discussed below.

Normal Working Capital

Net working capital includes trade debtors, inventory and work in progress, and trade creditors. The Enterprise Value assumes that there is a "normal" level of working capital available for the business to deliver the projected earnings. A purchase price adjustment should be included in sale and purchase contracts to ensure that an appropriate balance of working capital is included which protects the interests of both the vendor and the acquirer. The table below presents some examples of events which may impact net working capital, and their impact on purchase price.

Event	Impact on accounts and working capital at completion	Impact on purchase price
A debtor does not pay its debts on time, and pays post completion	Increase in debtors and net working capital	Increase
A large shipment of inventory has been received and paid for prior to completion to meet forward orders.	Inventory and net working capital will be higher	Increase
The vendor has delayed making payments to suppliers.	Trade creditors will be higher and net working capital will be lower	Decrease

The two main ways to consider targeted working capital are detailed below:

- Average working capital. For a business with stable earnings from both a historical and forecast perspective, and limited seasonality, the average working capital balance may be an acceptable measure on which to base completion working capital.
- Forecast working capital. Where a business is set to experience growth, is contract or job based, or has seasonality in its earnings, completion net working capital should be forecast. The forecast net working capital should give consideration to forecast earnings, historical working capital ratios, and the impacts of any specific contracts.

It should be remembered that working capital has a close relationship with net debt which is considered below.

Net Debt

In addition to the net working capital adjustment, where cash and/or debt is to be taken on by the acquirer, a net debt (cash less debt) adjustment will also be included in the sale and purchase agreement. Acquirers will often take on debt such as asset finance when acquiring businesses and potentially stipulate a minimum level of cash to be left in the business. The net debt adjustment allows for the purchase price to be reduced/increased for any additional/reduced net debt to be taken on by the acquirer.

The key drivers that will impact net debt between the execution of contract and sale completion are set out in the table below.

Event	Impact on Net Debt
Business Earnings above target	Increase in Available Cash
Increase in net working capital	Decrease in Available Cash
Business Earnings below target	Decrease in Available Cash
Decrease in net working capital	Increase in Available Cash
Unplanned capital expenditure	Decrease in Available Cash/ Increase in debt

The intertwined relationship of net working capital and net debt, means that any variance in actual working capital at completion will usually be reflected in the net debt position if this is also included in the contract.

Completion net debt should be considered prior to signing the contract, and ideally forecast. If forecasts are not completed a number of events may occur that could adversely impact the vendor and purchaser, for example, specific capex or working capital investment made by the seller to deliver future contracts. As the acquirer will receive the benefits of the new capex, target net debt may be adjusted to reflect the required capex.

"Completion net debt should be considered prior to signing the contract, and ideally forecast. If forecasts are not completed a number of events may occur that could adversely impact the vendor and purchaser..."

Other Common Purchase Price Adjustments

To maintain the integrity and equity of the agreed transaction terms, the following purchase price adjustments may also be considered:

- Provisions, including warranties, and employee leave liabilities. These provisions are usually estimated in accordance with an agreed methodology and re-calculated at completion;
- Tax liabilities, in the event of a share acquisition, a purchase price adjustment is likely to include an adjustment for the actual tax liability at completion. Tax liabilities may also be included in the net debt calculation; and
- Plant & equipment, although assets to be transferred are usually addressed by the completeness of an asset listing.

In relation the above adjustments, the future tax consequences of these assets and liabilities should also be considered.

WORKED EXAMPLE

Background

AJ Co Limited has made an offer to acquire the shares of MS Co Pty Limited. The Enterprise Value of the business is agreed to be $5 million, with target net working capital of $2 million. AJ Co has also agreed to take on net debt of $1 million and employee provisions of $0.5million from MS Co. Hence, the total consideration for MS Co is $3.5 million. The sale and purchase agreement was signed on 15 June 2016, with completion to take place on 30 June 2016.

Completion

At completion, MS Co has net working capital of $2.2 million, net debt of $1.1million and net provisions of $0.45 million.

Calculation of Purchase Price Adjustment

Step 1. Calculation of Purchase Price Adjustments

	Net Working Capital	Net Debt	Provisions	Net Adjustment to Purchase Price
Target per contract	2,000	(1,000)	(500)	
Actual at Completion	2,200	(1,100)	(450)	
Purchase Price Adjustment (positive is increase in purchase price/ negative is reduction in purchase price)	+200	(100)	+50	+150

Step 2. Completion Statement

	$'000
Consideration	3,500
Net Purchase Price Adjustments	+150
Completion Payment	3,650

The adjusted purchase price for MS Co is $3.65 million, an increase of $0.15 million (4.3%) on the purchase price.

Conclusion

The purchase price adjustment can have a material impact on the ultimate transaction consideration, however is a necessary requirement for sale and purchase agreements to protect the interests of both the buyer and seller. Sellers not dedicating appropriate time and resources to understand the adjustment mechanisms could realise substantially reduced proceeds. Conversely, if the purchase price adjustment is not appropriately documented, buyers may have to outlay significantly more capital to complete the acquisition and ensure that the target business is in a position to deliver forecast earnings. This increase in total investment, will also decrease the return on capital for the purchaser.

For these reasons it is recommended that financial and legal advisers are engaged in considering purchase price adjustments early in the sale process to understand, evaluate and document the adjustments in advance to avoid delays or surprises with transaction completion. ■

THE RIGHT APPROACH TO DUE DILIGENCE

Due diligence, is a process whereby a prospective acquirer has the opportunity to undertake a comprehensive review of a target business. A due diligence exercise is an opportunity to review and verify the target's assets and liabilities, evaluate the business risks and ultimately assess the impact of these (if any) on the value of the business. Conducted well, due diligence should improve the decision making and negotiation process. A due diligence process must be robust enough to adequately assess whether the commercial merits of completing a transaction are worthwhile and if so, assist with setting the terms upon which the transaction should be completed.

The framing of a due diligence process, the planning stage, can be the most important stage of a due diligence exercise. Taking a standard or "cookie cutter" approach to determining the best strategy can be dangerous given the main drivers, sensitivities and areas of risk may be industry and/or business specific. Accordingly, a tailored approach is warranted for each potential transaction. Due diligence should be contemplated from a number of different perspectives which may incorporate many of the facets summarised below:

Strategic Due Diligence

Often undertaken by management or corporate advisers. This aspect of the process considers whether the target business aligns with the strategic requirements or objectives of the acquirer. It is often concerned with markets, products and growth strategy as well as the extent to which the acquisition will be earnings accretive.

Operational Due Diligence

Most commonly undertaken by operational management to assess whether potential synergies may exist and to determine the integration processes required to ensure a smooth transition is possible post completion.

Financial Due Diligence

Verification of key financial metrics and performance as well as assessment of material balances, KPI's and revenue and profit drivers with a view to identifying any potential irregularities or risks. Financial due diligence is designed to analyse and validate all the financial, commercial, operational and strategic assumptions being made. It uses past trading experience to form a view of the future and confirms that there are no 'black holes'. Analysis of financial forecasts (earnings and cash flow), including an assessment of the reasonableness of forecast assumptions is a critical part of the financial due diligence process. Analysis of working capital requirements is important to determine target working capital levels for purchase price adjustment mechanisms at the completion of the sale. Sensitivity analysis assists with understanding key financial risks.

Legal Due Diligence

Review of key legal agreements and exposures. Should include fully understanding all of the obligations of the company: debts, pending and potential lawsuits, leases, warranties, long-term customer agreements, employment contracts, distribution agreements, compensation arrangements, and other key agreements.

The level of commitment which may be devoted by acquirers to each of the stages can be constrained by various factors, the most common of which are time, budget, extent and quality of information available from the target business. A consistent approach to undertaking the due diligence process is summarised below:

1. **Planning Phase –** This involves assembling the due diligence team which typically comprises lawyers, accountants and other advisers. The key outcomes for this stage are to identify the main value drivers of the target business, the key assumptions upon which the acquisition decision is based and the key risks associated for acquisition. A detailed scope should be prepared for each due diligence work stream. Effective and timely communication of issues identified and progress between all due diligence team members is critical to ensure nothing "slips through the cracks" and all potential implications of issues are considered.

2. **Data Collection and Analysis Phase –** Execution of the due diligence plan including discussion of information required with the target's management, analysis of information, Q&A sessions and ongoing processes with management and discussion of key issues amongst the due diligence team.

3. **Preparation of Due Diligence Reports –** Summarise key findings from the due diligence process, including recommendations of how to address key issues and risks through the structure of the acquisition, indemnities and warranties or action to be taken post acquisition.

4. **Drawing conclusions from data and using them to complete the transaction –** Uses the deliverables and risks identified in the report and throughout the due diligence process as inputs into the completion process (and sale contract) to mitigate risk and facilitate the target businesses integration post completion.

> "Conducted well, due diligence should improve the decision making and negotiation process."

Due diligence is an interactive and dynamic process that is best completed with a proactive and cohesive team. Bringing together a team that have aligned objectives is key to completing a successful due diligence and extracting maximum benefits from the process.

Investing the appropriate time and resources in the planning stage is important. Appointing someone that has the requisite experience in running a due diligence process, to drive it from the outset and facilitate communication and co-operation amongst the team, whether it be an internal champion (management or external chairman) or an external adviser (corporate adviser, accountant or lawyer) can often determine the level of success of the process. ■

SELLING YOUR BUSINESS – IS IT THE RIGHT TIME?

The sale of your business will be one of, if not the biggest, financial transaction you will complete in your lifetime. Coupled with the fact that it will often be timed with your exit from the work force it is likely to be the most transformational non-family issue in your life. The unique characteristics of businesses, and relatively small numbers of buyers (in comparison to property or listed shares) means that timing can have a material impact on the chances of a successful sale and/or the quantum of proceeds received.

We have outlined a number of common factors that can influence whether the time is right:

- **Financial Performance.** A business that has been delivering year on year growth in earnings indicates the optimal time to commence a sale process (for sellers). This upward trend demonstrates the strong position of the business in its market, quality of management while still providing upside for acquirers. Conversely, there will be greater difficulties in finding buyers and lower valuations for businesses with declining earning or margins.
- **Capital Market Trends.** Positive industry trends or focus may create an opportunity to sell, with a more competitive sale process and higher valuation multiples. Clearly, these factors are beyond your control, so being prepared to commence a sale process is key.
- **Industry trends.** Wider industry trends in which your business operates can impact the perception and appetite of investors. For example, if an industry is exposed to price pressure as a result of imports (Australian steel) or outsourcing (professional services) or servicing a declining market (Service and Capital Goods providers to the mining industry) the number of investors interested is likely to reduce, irrespective of the performance of your business.
- **Management Team.** A stable, competent and motivated management team will make the business more attractive to (most) potential purchasers. The quality of the management team will provide confidence to purchasers that the business can and will function without you. Management teams may also participate with investors as part of a Management Buy Out (MBO).
- **Personal Situation.** Whilst maintaining or growing the business cannot be guaranteed, does the sale of your business meet your lifestyle and financial requirements? The key factors that need to be considered are:
  - Will the capital provided from the sale of the business provide the required income to support your lifestyle;
  - Are you ready to give up work; and
  - Are there alternate employment options that you would consider noting there is likely to be reduced income and flexibility?
- **Unsolicited approaches.** The cost to complete a competitive sale process can be expensive with no guarantee of finding an immediate buyer. If an unsolicited approach is received from a "logical" buyer it may be your "white knight" and worth pursuing. It is recommended to engage corporate and legal advisers in this instance to set a framework around the process, maintain confidentiality, protect your interests and negotiate on your behalf.

The common thread for all successful business sales, and the ability to maximise the proceeds is being "prepared". Good record keeping and strong management reporting enables you to move swiftly to capitalise on market opportunities and respond to unsolicited approaches without compromising value. If selling your business is part of your overall financial strategy it is recommended that prior to being ready for sale you identify corporate advisers who can work with your existing advisory team. The established relationship will minimise the stress in selecting an adviser in the event of an unsolicited offer, and open dialogue and communication so that you are in a position to capitalise on market opportunities. ■

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