Cohen & Co

M&A ESSENTIALS

The Purchase Price Adjustment

Purpose, Practices and Value Considerations

Cohen & Co®

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You recently sold your company. Your advisers have been paid, you've taken a long overdue vacation and the burdens of deal-making are behind you. Then, surprise! The buyer is claiming you have to "give back" a million dollars of the proceeds from the sale because the assets of the company were below agreed-upon targets.

Welcome to the world of purchase price adjustments.

The most common form of price adjustment in an M&A deal is known as the Net Working Capital Purchase Price Adjustment (PPA). The PPA is a mechanism included in most purchase agreements that protects both buyers and sellers in the event the balance sheet of the acquired company does not meet the expectations of either party at closing. The PPA is an important aspect of any deal, regardless of whether it is structured as an asset or a stock sale.

From a buyer's perspective, the acquired company might not have the net assets they had expected — perhaps it has more operating liabilities, such as accounts payable, or not enough operating assets, such as receivables and inventory. Alternatively, the net assets "left behind" by the seller might be more than what was required in the agreements.

The PPA is a "true-up" that occurs after the deal is closed to compensate either the buyer, if not enough net assets are transferred, or the seller, if net assets are greater than what was required. Either way, generally either the buyer or the seller transfers some amount of cash after the deal closes as an adjustment to the purchase price.

Many find this aspect of an M&A transaction confusing, but it doesn't need to be. Understanding the need for the PPA and its application is essential for a deal structure that is fair for buyers and sellers alike.

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Purpose of the Purchase Price Adjustment

The PPA is intended as a mechanism within the structure of a purchase agreement that aligns the value expectations of both the buyer and the seller. Specifically, the PPA has three primary objectives:

1 Ensure adequacy of capital required to operate the business post-closing.

Buyers of companies invest capital in the form of debt and equity to acquire operating businesses. They formulate an acquisition value with the objectives of servicing the debt while generating a return on the equity they invest in the deal. They want to ensure the net working capital they acquire at closing is adequate to operate the business immediately following the closing. If a business requires an additional equity investment soon after closing, it would be detrimental to the buyer's return on equity.

2 Protect both parties in a transaction.

The cash proceeds a seller receives from a sale should be a relatively fixed amount. So, for example, higher than anticipated net assets due to slow customer payments prior to closing should not be a windfall for the buyer, and profits generated up to the date of acquisition rightly belong to the seller, not the buyer.

3 Avoid manipulation of the purchase price.

The ideal price adjustment is zero, meaning buyers get the net assets they expected and sellers receive the cash they expected on the day of closing. This rarely happens, but with the proper mechanism in place, sellers cannot extract more cash from the deal as a result of actions taken prior to closing.

How the Adjustment Mechanism Works

To fully understand the PPA it's important to understand how the purchase price for a company relates to the cash proceeds the buyer actually receives at closing.

Most acquisitions are structured so that the buyer acquires the operating assets of the company and assumes its operating liabilities. Operating assets include inventory, accounts receivable and fixed assets; operating liabilities include accounts payable and accrued expenses. Typically, cash and debt are not considered part of net operating assets — in most cases buyers do not acquire the cash, nor do they assume the interest-bearing debt the company owes. Think about it in terms of selling a home: a buyer gets their own mortgage and the seller pays theirs off with the sale proceeds.

The illustrations and explanations below will help shed some light on the PPA in action.

Intersection of Purchase Price, Cash Proceeds & the PPA — Table 1 Breakdown

Table 1 - Purchase Price and Cash Proceeds ($000)

Purchase Price	$	12,000	"Enterprise Value"
Plus Cash		1,000	
Less Debt		(1,500)	
Net Cash Paid	$	11,500	"Equity Value"
Plus (Minus) PPA		?	
Before Tax Proceeds from Sale	$	11,500	

Let's take a look at a hypothetical transaction to show how the purchase price and the PPA interact. In Table 1 we assume the shareholder of this company has entered into an agreement to sell for six times its annual cash flow, or Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA). In this example the company generates EBITDA of $2 million. At a multiple of 6X, the purchase price is $12 million. This is also known as the Enterprise Value of the company.

The amount of cash the seller actually receives at closing is determined by deducting from the purchase price the debt that must be repaid by the seller, offset by the cash the seller retains.

As shown in Table 1, this company has $1 million in cash but also has a debt balance of $1.5 million. The Equity Value, or the $11.5 million of cash the seller actually receives from the sale, is determined by deducting from the Enterprise Value the debt that is repaid at closing while adding back the cash the seller retains.

One further adjustment, represented by the question mark in Table 1, must be calculated before the seller can determine the cash proceeds generated by the sale. Enter: the PPA. The final value of the cash proceeds depends on the amount of the company's net working capital at closing compared to the targeted net working capital agreed upon in the purchase agreement. Typically, the PPA is not known at the day of closing. The final calculation may be delayed for weeks, or even months, while an opening balance sheet is prepared.

A Look at the Balance Sheet Upon Closing — Table 2 Breakdown

Table 2 - Balance Sheet Reflecting NWC Elements ($000)

Cash	$	1,100	Notes Payable	$	1,600
Accounts Receivable		4,600	Accounts Payable		1,400
Inventory		2,900	Accrued Expenses		500
Other Current Assets		400	Current Liabilities	$	3,500
Current Assets	$	9,000			
			Common Stock	$	5,600
PP&E	$	1,600	Cumulative Earnings		600
Depreciation		(900)	Total Equity	$	6,200
Net PP&E	$	700			
Total Assets	**$**	**9,700**	**Total Liabilities and Equity**	**$**	**9,700**

Table 2 is the balance sheet for the company as of the closing date of the acquisition. The highlighted portions indicate the inclusion (blue) or exclusion (orange) from the calculation of net working capital.

As mentioned above, net working capital is the sum of operating assets minus operating liabilities. Cash and debt (Notes Payable in this example) are not included in the calculation because they are non-operating assets or liabilities the seller retained. Net working capital typically does not include longer term assets such as property, equipment and non-current liabilities. Capital account items, such as stock and retained earnings, are also not included.

Calculation of Net Working Capital — Table 3 Breakdown

Table 3 - Net Working Capital (NWC) ($000)

Accounts Receivable	$	4,600
Inventory		2,900
Other Current Assets		400
WC Assets Acquired	$	7,900
Accounts Payable	$	(1,400)
Accrued Expenses		(500)
WC Libabilities Assumed	$	(1,900)
Net Working Capital	$	(6,000)

In Table 3 we have calculated the net working capital of the company as of the closing date of the sale.

The net of these operating assets and liabilities, or net working capital, totals $6 million in our example.

The PPA is determined by comparing the actual net working capital of $6 million with the target that was agreed upon and included in the previously negotiated purchase agreement.

If, for example, the agreed-upon target was set at $6 million, the purchase price adjustment is zero and no further cash is exchanged. However, if the target was set at $5.8 million, the company's net working capital exceeds the target and the buyer must pay the seller an additional $200,000 to compensate the seller for the higher than expected working capital the buyer received upon closing. Alternatively, If the net working capital would have been less than the target, the seller would have to provide cash compensation to the buyer. It is important to emphasize the target is a *negotiated* element of the purchase agreement, in that there is no standard methodology commonly employed. Many factors are often considered, including changes over time (such as reductions in inventory levels due to efficiency), seasonality of the business and one-time events that might distort historical balance sheets.

How net working capital is calculated after closing will depend on the process the buyer and seller agreed on in the purchase agreement. Many agreements identify in detail which accounts to include in the calculation and may even include a calculation for a prior period as an example to avoid any disputes about methodology. Most disputes involving net working capital post-closing involve the valuation of inventory and reserves for accounts receivable. Purchase agreements generally specify that value should be determined using GAAP (Generally Accepted Accounting Principles), but it's often best to define and use the same methodologies as were used in the past, helping avoid any alternative interpretations of GAAP.

Setting the net working capital target is just as critical as defining and measuring the actual amount of working capital upon closing. There are many ways to calculate a target but all involve a negotiation given that buyers want the target set high while sellers prefer it lower. The net working capital target should be defined early in the negotiation process because the target may effectively result in a reduction or an increase in the purchase price. In any event, parties to a transaction should model the implications of a net working capital target to avoid unpleasant surprises after the deal closes.

Breaking Down the What Ifs

We've made the case why and how the PPA can significantly impact a seller's cash proceeds. Table 4 offers various scenarios to further highlight the workings and implications of the PPA mechanism. In each case the purchase price is constant, but the seller's cash proceeds vary based on different circumstances.

Base Case

In the Base Case we assume the buyer and seller set a working capital target of $6 million upfront in the purchase agreement. This target was based on an average of the monthly working capital balances for the prior 12 months. In the months after the target was set, and immediately prior to closing, the company was profitable and generated net earnings of an additional $200,000. The profits resulted in an increase in both cash balances and accounts receivable. As a result, the company had working capital that was $100,000 over the target and cash balances that grew by $100,000.

When the seller originally calculated net cash proceeds from the deal, $11.5 million was expected (see Table 1) but the closing amount of cash proceeds ended up being $11.7 million due to the profits earned in the interim period. Through the PPA mechanism, the seller was able to retain the profits the company generated from the time the working capital target was set until the time the deal closed.

"The working capital PPA is critical in any deal and must be defined carefully, but it should not be viewed independently of the other deal provisions."

Table 4 - Cash Proceeds Scenarios					($000)
	Scenarios				
	Base Case	A	B	C	D
Cash at Closing:					
Purchase Price	$ 12,000	$ 12,000	$ 12,000	$ 12,000	$ 12,000
Plus Cash	1,100	1,100	2,100	2,600	600
Less Debt	(1,500)	(1,500)	(1,500)	(1,500)	(1,500)
Net Cash Paid at Closing	$ 11,600	$ 11,600	$ 12,600	$ 13,100	$ 11,000
Purchase Price Adjustment:					
Working Capital Assets	$ 8,000	$ 8,000	$ 7,000	$ 7,000	$ 8,000
Working Capital Liabilities	$ (1,900)	$ (1,900)	$ (1,900)	$ (2,400)	$ (1,900)
Net Working Capital	$ 6,100	$ 6,100	$ 5,100	$ 4,600	$ 6,100
Targeted Net Working Capital	$ 6,000	$ 7,000	$ 6,000	$ 6,000	$ 6,000
MWC PP Adjustment	$ 100	$ (900)	$ (900)	$ (1,400)	$ 100
Cash Proceeds from Sale	**$ 11,700**	**$ 10,700**	**$ 11,700**	**$ 11,700**	**$ 11,200**
Change from Base Case		**$ (1,000)**	**$ --**	**$ --**	**$ (500)**

Let's look at a few other scenarios to examine how the mechanism can work in different ways:

Scenario A — Setting the Bar Too High

Background: Assume the buyer insisted on a target net working capital of $7 million, based on the working capital balances for the past three months rather than the 12 months reflected in the base case. In this scenario, the seller's cash proceeds were $1 million less than the base case due to the higher target.

Takeaway: A seller that agrees to a target that might seem logical in the course of negotiations may leave substantial amounts of cash behind if they do not pay attention to the implications of the target for net cash received after the PPA is taken into account. This is especially true in companies with highly seasonal volatility of working capital.

Scenario B — Accelerating Efforts

Background: The seller wrongly assumed that generating additional cash by accelerating the collection of receivables prior to the deal closing would result in extra cash proceeds. The adjustment mechanism makes this a futile exercise. Even though greater cash is retained by the seller at closing, less working capital is delivered and the seller must "true up" post-closing to the tune of $900,000; the net cash proceeds are the same as the Base Case. In addition, the seller likely violated a common provision in most purchase agreements that requires the company be run in "the ordinary course of business."

Takeaway: Calling customers to have them accelerate payments, or doing anything of that nature, is a clear violation of a typical purchase agreement and could have serious implications for the seller.

Scenario C — Slowing Things Down

Background: This case is similar to the previous scenario, but, in addition to accelerating collections, the seller also slows the payments to vendors, thus generating cash while increasing operating liabilities. However, the implications are the same as in the previous case; there is no difference in cash proceeds compared with the Base Case.

Takeaway: Both Scenarios B and C demonstrate that an effective PPA mechanism makes any manipulation of working capital by accelerating collections or lagging payments ineffective. Generating cash by reducing net working capital simply results in a larger true-up post-closing. Mechanisms that have a variable target calculation or an established minimum and maximum target in which no settlement is required if net working capital falls within a specified range are also used, but those provide less certainty in a transaction.

Scenario D — Big Ticket Purchases

Background: Finally, in this case the company makes an extraordinary purchase of machinery of $500,000 after signing the purchase agreement and before the closing date. As a result, net proceeds are reduced by an equal amount because fixed assets were not included in the definition of net working capital, nor in the target PPA amount.

Takeaway: If large purchases are scheduled to be made, both parties should agree beforehand as to “who pays” and adjust the target accordingly.

Minimize the Element of Surprise

Now that you have a more in-depth understanding of the PPA, how it works and why it’s so important to your deal, the next time you find yourself considering, or in the midst of, an M&A deal, remember:

- For sellers, what matters most in an M&A transaction is net cash received. The working capital PPA is critical in any deal and must be defined carefully, but it should not be viewed independently of the other deal provisions.
- There is no reason to be surprised after a deal closes — modeling the structure of the deal and its adjustment mechanism is paramount.
- All parties to a deal should keep the objectives of the mechanism in mind. It is meant to protect both buyer and seller, lock in the value of a deal and eliminate any manipulation by either party.
- Determining the working capital target is an essential component of value. Failing to give it the attention it warrants in the negotiation process, or leaving it to be determined later, is a risk neither party should bear.
- As it relates to working capital definitions and measurement methodology, no level of detail in a purchase agreement runs too deep. Identifying specific accounts and calculation examples prevents post-closing misunderstandings.

A considerable amount of confusion over purchase price adjustment often envelopes M&A deals and jeopardizes their success. If you define the PPA and model it out correctly, you can eliminate any angst post-closing. At the end of the day, it’s simple math but the implications can be significant.

Contact Us for Help

Our M&A Advisory team combines the transaction experience of seasoned investment bankers with specialists in due diligence, tax and accounting to help optimize your M&A deal. We can consult on specific issues or coordinate your entire transaction process.

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