Damage calculation in M&A transactions

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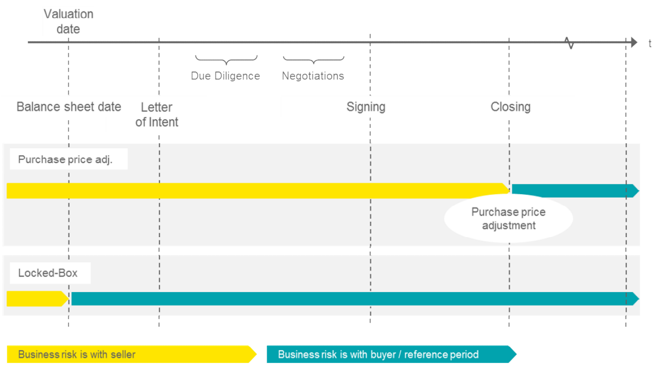
In M&A transactions the seller and buyer have to agree on the date (Closing) of the transfer of the rights and risks relating to the ownership of the company to be sold. The key question relating to this is how to deal with the business rights and risks in the period between the balance sheet date, which is the basis for the due diligence as well as the company valuation underlying the purchase price, and the Closing.

SPA mechanisms - Reference date and period

With a purchase price adjustment mechanism based on closing accounts the rights and risks relating to the target company's free cash flows (FCF) (i.e. earnings basis) do not transfer to the buyer until Closing. As a consequence, for the period between the balance sheet date and Closing, the share purchase agreement (SPA) should include clauses on net working capital, net debt and ideally capital expenditure (net asset basis).

With a locked-box mechanism, the buyer receives the full benefits of the target company's FCF from the balance sheet (locked-box) date. This means that the business rights and risks are transferred at the balance sheet date. Consequently, the SPA should provide protection against value erosion (earnings basis) and leakage (net asset basis) between the locked-box date and Closing.

For arbitration proceedings, it is important to understand the two different ways of transferring business rights and risks since the reference date and the reference period for the damage calculations are different. In a purchase price adjustment mechanism the reference period to determine the damage starts at Closing, whereas in a locked-box mechanism the reference period is the balance sheet date.



SPA clauses and breaches thereof

It is important to understand that the tighter the representations and warranties (R&W) and the protection through price mechanism are, the higher the valuation is, all else being equal. The better a buyer is protected, the higher the price that he is willing to pay.

A breach of an SPA clause can either impact the net asset basis (example 1 and 2) or the earnings power of a company, with the latter resulting in lower future FCF (example 3).

Example 1 | Net asset basis: A non-collectable account receivable, i.e. a loss of a receivable results in an equal reduction of the net asset basis (equity) which in turn equals the financial damage. In simple terms, one Swiss Franc not collected equals one Swiss Franc of financial damage suffered.

Example 2 | Locked-box and leakage: The same logic applies for example to a situation where the seller distributes a special bonus payment within the reference period. Again, one Swiss Franc distributed equals one Swiss Franc of financial damage suffered. In such a case one could even try to argue that the cash distributed could have been invested by the target company in net present value positive projects. However, such lost opportunities are usually hard to "prove" and a related financial damage is very hypothetical.

Example 3 | Earnings power: Quantifying the damage suffered by a breach of an SPA clause impacting the earnings power of the company is much more challenging and the application of valuation techniques is required. An example is how a buyer quantifies the damage suffered by a loss of a client contract (which was known to the seller before the reference date)?

Valuation techniques

One way to calculate the damage suffered is by applying the discounted cash flow (DCF) method. In our view, the DCF method is the only economically correct method. With the DCF method, a company is valued by discounting the expected FCFs with an appropriate discount rate.

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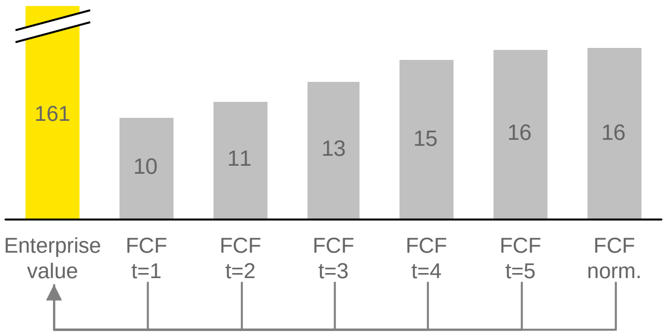
Typically, a FCF forecast covers the next five years followed by a terminal value. Current net assets form the basis to generate future FCF.



Discounting FCFs at an appropriate rate (WACC)

Incremental cash flow approach

Similar to a valuation of a synergy case in an M&A transaction, one can determine the base case including the FCF relating to the lost client and compare this to the loss case valuation excluding the FCF related to the lost client (incremental cash flow approach). In order to ensure that the potential damage suffered from the loss of the client is not larger than the purchase price paid, the percentage change between the base and loss case is applied to the purchase price negotiated, whereby the financial damage potentially suffered would be the reduction in the purchase price.

MEEM approach

From a valuation perspective, an alternative to this incremental DCF analysis is to value the client contract by forecasting the cash flows attributable to the contract and applying the so called multi-period-excess earnings method (MEEM). The MEEM is best practice in valuing client relations for accounting related matters under IFRS and/or US GAAP. However, note that in such an approach the link between the client relation ship valuation and the cash flow forecast underlying the purchase price and hence the negotiated purchase price is not as such given.

Incremental cash flow approach CHF m	Base case	Loss case
Enterprise value	161	132
- Net debt	28	28
= Equity value	**133**	**104**
Reduction in equity value		21%
Purchase price / adj. purchase price	113	89
Damage (i.e. reduction in purchase price)		**24**

Historical earnings approach

Last but not least, to cope with the uncertainty inherent in a FCF forecast one can also determine the financial damage by valuing the loss of a client based on historical operating profits earned with the client and comparing those profits to the company's total operating profit. The %-ratio of client's operating profit compared to total profit is then applied to the purchase price paid resulting in the hypothetical price paid for the client contract. This value then corresponds to the damage suffered by losing the client. In such a case, the valuation specialist has to thoroughly analyze whether historical operating performance is a good proxy for future performance.

Conclusion

There are several challenges that the valuation specialist has to deal with in the damage calculation: (1) A business valuation underlying the purchase price paid is usually not available (2) Is it feasible to establish a reliable FCF forecast that is supported by target company's historical performance as well as market data? (3) What period does the loss relate to (reference period)? (4) What is an appropriate discount rate? and (5) Have mitigation measures been taken into account?

Despite these challenges, if properly applied, a business valuation based on the DCF method is a practical instrument to calculate a damage suffered in an M&A transaction especially when the earnings power is affected.

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