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SWISS M&A

Third Edition

Contributing Editors
Ueli Studer, Kelsang Tsün and Joanna Long

LEXOLOGY
Getting the Deal Through

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Pricing

Philippe Weber and Manuel Werder[1]

Introduction

Despite its relatively small size, Switzerland is home to many large and well-established international corporations spanning a diverse range of industries, from major banks and insurance companies such as Credit Suisse, UBS and Zurich Insurance, global food and healthcare players such as Nestlé, Novartis and Roche, and technology and industrial firms such as ABB and OC Oerlikon, as well as leading luxury goods and lifestyle groups such as Richemont and Swatch.

At the same time, Switzerland is home to many successful small and medium-sized and often internationally active businesses, 'hidden champions', which either are or have the potential to become leaders in their fields, and many of which are working through succession planning in the coming years.

All of this, combined with the typical features of Switzerland, including economic, political and legal stability, limited investment restrictions and a well-functioning financing market, makes Switzerland a fertile soil for an attractive M&A market to both Swiss and foreign investors. Notably, according to a recent survey, private equity was involved in more than a third of the deals involving Switzerland in recent years.

Against this background, this chapter focuses on the pricing mechanisms and methods that are primarily applied in connection with the acquisition of privately held (ie, not publicly listed) Swiss target companies and further focuses on share deals with a transaction value between 50 and 500 million Swiss francs.[2]

1 Philippe Weber and Manuel Werder are partners at Niederer Kraft Frey Ltd.

2 The pricing mechanisms described in this chapter generally also apply to larger Swiss private M&A transactions. However, with respect to certain pricing features, market practice would typically be different for larger transactions. For example, earn-outs are more typically found in small to medium-sized deals. Also, while locked-box deals have become very common for large deals, closing accounts mechanisms are still widely used, in particular when US or Asian buyers are involved.

Pricing mechanisms most commonly used in Swiss M&A transactions

The main pricing mechanisms commonly seen in Swiss M&A transactions are the 'locked-box' mechanism and the 'closing accounts' mechanism; sometimes these two mechanisms are combined into a 'hybrid'.

Locked-box deals have become increasingly popular in Europe, including in Switzerland. They provide a high level of pricing and deal certainty by locking in the price at signing; in turn, closing accounts can better reflect (but also expose parties to) changes between signing and closing.

According to a recent study, in recent years approximately 60 per cent of the M&A transactions in Europe (which matches our experience in Switzerland) applied the locked-box mechanism. This suggests an increase by some 30 to 40 per cent within the past years.

By contrast, closing accounts transactions have partly lost importance in the market and decreased by some 20 per cent to approximately 35 per cent in recent years.[3]

In certain cases parties choose a hybrid structure. For example, if the locked-box accounts are not sufficiently recent or if the locked-box accounts are only finalised or audited after signing, but prior to closing, the parties may agree on an adjustment of the purchase price in case the locked-box accounts are modified in the course of their finalisation or audit.

While the covid-19 crisis temporarily led to increased interest in closing account and other mechanisms seeking to mitigate the risks for buyers between signing and closing, this does not seem to have turned into more than a temporary trend away from locked-box deals.

The key difference between the locked-box and closing accounts mechanisms is the time when the economic risk and benefit in the target company passes from the seller to the buyer. In the locked-box mechanism the economic risk and benefit typically passes to the buyer at the locked-box date, while in the closing accounts mechanism risk and benefit will typically transfer at the date of closing.

Under both mechanisms, the seller and the buyer typically first agree on a valuation for the business of the target company (commonly called 'enterprise value') on a cash-free and debt-free basis and assuming a normal level of working capital. The parties are free in negotiating the ultimate purchase price and in choosing the method for the determination of the enterprise value. The most common valuation methods are multiple of the EBITDA or other multiples and discounted cashflow, but there are numerous other methods, such as net asset value, peer comparisons, etc.

In a second step the enterprise value is adjusted to reflect the actual cash, debt and working capital in the business to determine the 'equity value'.

The pricing considerations and enterprise value to equity value bridge (adjustments for typically cash or debt and working capital) are essentially identical under both closing accounts and locked-box mechanisms. In the locked-box mechanism, the seller and the buyer negotiate a fixed price at signing of the share purchase agreement (SPA) based on the agreed locked-box accounts, which removes price uncertainties for both parties, whereas in the closing accounts mechanism the adjustments for cash or debt and working capital are done only after the closing.

3 The numbers refer to share deals. By their nature, asset deals more typically use closing accounts structures.

Locked box

Description

The locked-box mechanism consists of a purchase price that is fixed at the time of signing the SPA. There is, except in the case of 'leakages' (see 'Protection against leakages'), no purchase price adjustment or true-up between the date of signing and the date of closing. Generally, changes in the balance sheet, in particular the fluctuation in the actual cash, debt and working capital of the target company between the date of signing and the date of closing, will not affect the purchase price, and there is no respective purchase price adjustment for these items.

The purchase price is calculated on the basis of recent historical financial statements, sometimes called 'locked-box accounts'. The date of these financial statements constitutes the agreed date of the locked box and is sometimes called the 'locked-box date'. Often the last audited financial statements as at the end of the last completed business year (or reviewed half-year financial statements) are used as locked-box accounts. However, the parties are free to choose financial statements as at any date that do not need to be audited as locked-box accounts. Experienced parties will normally be reluctant to rely on locked-box accounts that are older than three to six months and not at least reviewed.

As a consequence, the cash, debt and working capital positions as at the locked-box date are amounts that are known to the parties at the time of signing.

Economic impacts

When using the locked-box mechanism, the buyer takes the economic benefit and risk from the locked-box date until the closing date, unless and to the extent the buyer has obtained specific protection under the SPA, for example, in the form of a material adverse change clause or representations, warranties and indemnities that cover the period between signing and closing of the SPA. If the target company is a profitable business, the profit generated between the locked-box date and the closing date belongs to the buyer. In the case of a growing business, this mechanism can provide further significant potential upside benefit to the buyer. By contrast, if the business of the target company is loss-making, the buyer economically bears any negative development of the net cash and the working capital.

Key pricing issues in locked-box deals

Quality and date of locked-box accounts

Locked-box accounts are normally not older than six months. The more recent the locked-box accounts are, the better is the visibility of the buyer that at the date of signing the business of the target company is still essentially in a similar financial condition as shown in the locked-box accounts.

Since the locked-box accounts are key to the determination of the purchase price, the locked-box accounts are normally audited or, if they are not audited, they should at least be reviewed. In the absence of any audit or review the protection of the buyer against misstatements in the locked-box accounts would be limited to claims for misrepresentation or breach of warranty with respect to the locked-box accounts or specific indemnities, which may not offer sufficient protection.

The locked-box accounts should be prepared for the target business. If the business sold does not stand alone from other operations of the seller from an operational or accounting perspective, the locked-box mechanism becomes much more complex and requires bespoke drafting.

Protection against leakages

The buyer will require protection through the SPA against value being extracted from the target company in the period between the locked-box date and the closing date via an undertaking from the seller not to extract any value out of the business. Such extractions are commonly defined as 'leakage'. Leakages may, for example, consist of dividends, the payment of management fees, transaction and other bonuses to the benefit of the seller, any of its affiliates or any party closely related to or having a connection with the seller.

Leakage definitions are essential to preserve the value of the acquired business and therefore must be carefully drafted. They typically cover a broad range of forbidden acts, such as the transfer of cash, cash equivalents or assets, the assumption of liabilities, the waiver of claims, the provision of services, the granting of securities, payments made to third parties on the account of a seller, a seller affiliate or a related or connected party, etc.

Because the purchase price is directly affected, the buyer's obligation to compensate the seller for any leakage is normally not limited in amount (ie, it is structured as franc-for-franc clawback by way of indemnification without minimum or maximum limitations in amount). The duration of such clawback is a matter of negotiation.

The SPA normally provides for a list of exceptions (ie, value extractions that the parties specifically define as permitted leakage). Among the permitted leakages are typically payments made by the target company that are on arm's-length terms, payments in the ordinary course of business or payments that are specifically agreed and defined in amount, such as repayments of shareholder loans. Consequently, permitted leakages will be factored into the purchase price.

Inclusion of enterprise value to equity value bridge

Often the parties negotiate and agree on the fixed purchase outside of the legal documentation and therefore only state the fixed purchase price in the SPA without mentioning the enterprise value to equity value bridge. This simplifies the legal terms and definitions in the SPA.

However, in the section addressing the remedies regime describing the legal consequences of potential misrepresentation, breach of warranty and indemnity cases, the parties often agree that items that had been taken into account in the negotiation of the purchase price and that had resulted in a reduction of the purchase price are excluded from any damage and may not be claimed in the case of any misrepresentation, breach of warranty and indemnity. In the case of such agreement, the inclusion of the enterprise value to equity value bridge as annex to the SPA is recommendable and often done.

Interest or per diem payment

In Swiss locked-box deals it is quite common for the parties to agree on an additional purchase price component, which often consists of an amount per day between the signing date and the closing date or during another defined time period. This purchase price component can be justified as compensation for transferring the profit and benefit of increases in the net cash and working capital positions from the locked-box date to the closing date without the buyer having to finance its capital costs. Accordingly, sellers will typically expect this rate to be determined on the basis of expected results (in which the seller wishes to participate until closing) as opposed to mere interest (according to prevailing interest rates) on a deferred purchase price.

Such purchase price component may further incentivise the buyer to speed up acts it may have to take – in case it needs to take any such acts – for the fulfilment of the closing conditions, such as the making of filings to obtain merger control or other regulatory approvals, tax rulings, third-party consents, etc.

Restrictions on conduct of business between signing and closing

Unless signing and closing of the transaction occur simultaneously (which is the exception in medium-sized and large deals), the seller will continue to conduct the business of the target company until closing, while the buyer will already have assumed the risk of deterioration of that business. In order to protect the buyer, the SPA will therefore contain covenants of the seller to conduct the business in the ordinary course consistent with past practice and to refrain from taking certain actions specifically listed in the SPA that could materially alter the business. If permitted under applicable competition laws (ie, if not considered as jumping the gun), the parties may agree that such listed actions (or omissions) will require the consent of the buyer.

Closing accounts

Description

In the closing accounts mechanism the seller and the buyer agree at the signing only on the enterprise value and some key parameters of the enterprise value to equity value bridge. After the closing of the transaction, financial statements as at the closing (the closing accounts) are prepared. On the basis of the closing accounts the enterprise value is adjusted to reflect the change in these key parameters at the closing date to determine the purchase price amount actually owed to the seller.

In the closing accounts mechanism, the SPA will foresee a preliminary purchase price based on accounts as at a date prior to the date of signing or certain projections of the target company's financial statements at the date of closing. If the adjustment is solely made with reference to cash and debt or net working capital, the SPA will assume a certain net cash or net debt and a certain net working capital position. The preliminary purchase price is then adjusted on the basis of the actual relevant financial parameters at the date of closing.

The financial parameters that are most often seen as decisive for the calculation of the post-closing purchase-price adjustment are cash, cash equivalents and financial debt (ie, net cash or net debt), and trade receivables, inventories and trade payables (ie, net working capital). According to a recent survey, 76 per cent of all closing accounts transactions provide for a net cash or net debt adjustment and 53 per cent of all closing accounts transactions provide for a net working capital adjustment, normally in connection with a net cash or net debt adjustment.

Less often seen are adjustments for changes in the net assets (ie, all assets minus all liabilities). Only 16 per cent of all closing accounts transactions foresee a full net asset value adjustment. Even less frequently, the purchase price will be adjusted on the basis of earnings between signing and closing (regarding earn-out post-closing, see 'Earn-out clauses').

In the financial services industry, adjustments will often be made based on the level of net equity and assets under management (the latter as at closing or a subsequent date to protect the buyer against an excessive post-closing assets-under-management attrition rate as a result of clients leaving following a change of control).

Price adjustments can also be used to control the level of investment from the date of signing to the date of closing. Capex clauses usually require investments within an agreed or planned frame. The purchase price is adjusted by the difference between the planned and the made investments. However, the capex clause is rarely seen in practice.

The parties are free to choose any other financial parameters that they consider relevant for the determination of the final purchase price (eg, turnover, EBITDA, net profit). Equally, the parties are free to choose the date from which such financial parameters shall apply. The most commonly used date for this is the closing date, but in practice parties sometimes also choose a different date such as the last date of the month immediately preceding the closing date.

Economic impacts

When using the closing accounts mechanism, the seller keeps the economic benefit and risk in the target company up to the closing date.

Key pricing issues in closing accounts deals

Calculation of purchase price adjustment

Since the cash or debt and net working capital position (or such other financial parameters agreed to determine the final purchase price) as at the closing date will only be known in final form after the closing, the SPA normally provides for the payment of a preliminary purchase price at closing on the basis of estimates and followed by an adjustment payment after closing once the final closing accounts have been prepared. For the preliminary purchase price the parties will normally rely on good-faith estimates provided by the seller shortly before closing. Given that the final purchase price will be determined based on closing accounts yet to be prepared, key issues for the SPA will be:

- the accounting rules according to which the closing accounts shall be determined; and
- the procedure for who will be responsible for the preparation of these accounts.

Swiss SPAs providing for closing accounts price adjustments will typically contain detailed definitions and rules about the applicable accounting rules, often supplemented by calculation examples in the annex to illustrate and record the respective understanding of the parties. In this context, critical negotiation items often include the treatment of debt and debt-like items such as accrued tax and other liabilities (eg, vacation, bonuses, etc), unfunded pension liabilities, lease liabilities, customer advances, etc, or cash and cash equivalents like trapped cash.

Even though this is often a matter of negotiation and contentious, the right to prepare the first draft of the closing accounts is more often granted to the buyer on the basis that following the closing the buyer will have better access to the target company's business and its financial records. The other party will then be granted a right to review (including access to relevant information and persons) and objection within a stated period.

Dispute resolution regime

State courts and even arbitration courts may often not be well suited to resolve disputes over purchase price adjustment clauses that often contain complex accounting questions. Examples are the treatment of liabilities that, although they have a financing character, technically may not constitute financial liabilities (debt-like items), or the assessment of acts that may have artificially affected certain financial parameters. Therefore, parties often agree that any dispute about the determination of the closing accounts shall be submitted to an accounting expert acting as independent appraiser for final resolution. In the event that the SPA is governed by Swiss law the appraiser will act in the capacity of expert arbitrator within the meaning of article 189 of the Swiss Federal Law on Civil Procedure.

The SPA should include sufficiently detailed rules about the applicable accounting principles, the parties' opportunities to make submissions and to see and comment on the other party's submissions, the timing of the resolution, the language of the submission, etc.

Restrictions on conduct of business between signing and closing

While compared with locked-box deals closing accounts may better protect a buyer against adverse financial developments between signing and closing, the buyer still has an interest to obtain contractual assurance from the seller that the business of the target company will be conducted in the ordinary course between signing and closing. In this context buyers will draw particular attention to ensuring that the seller will not be permitted to artificially inflate the cash or working capital positions (for example, by delaying the payment of suppliers or by accelerating the collection of receivables).

Advantages and disadvantages of pricing mechanisms most commonly used in Swiss M&A transactions

Locked-box mechanism

- The main advantage of the locked-box mechanism is its simplicity and the absence of any post-completion adjustment process. This saves the parties from spending financial means and human resources on post-closing calculations and review procedures.
- In auction procedures, the seller may easily compare the different bids that have been submitted. It further provides both parties with certainty on price.
- The risk of post-closing disputes concerning the purchase price adjustment may be minimised.
- There may be a mismatch between the economic risks and the responsibility to manage the business or the target company.

Closing accounts mechanism

- The closing accounts mechanism allows the risk and benefit with respect to the target company to pass to the buyer at the same time as the completion of the transaction takes place. The management and control of the target company corresponds to the economic risks.
- The purchase price closely corresponds to the enterprise value.
- The closing accounts mechanism may allow the parties to proceed faster to signing.
- Neither party has certainty over the final purchase price until the closing accounts are final. This uncertainty can be mitigated in part by providing for deductibles (ie, minimum amounts within which any difference between preliminary and final numbers will not result in an adjustment of the purchase price) and caps (ie, maximum amounts, by which the final purchase price can be adjusted).
- Purchase price adjustment clauses are often complex and their handling may be costly. For smaller transactions, it may be worthwhile to use a simpler purchase price mechanism.
- There is a higher risk of post-closing disputes concerning the purchase price adjustment.

Summary overview

	Locked box	Closing accounts
Pros	(Fixed) price certainty	Buyer 'pays for what it gets' (and seller keeps upside)
	High bid comparability	Alignment control or economic transfer
	Early transfer of risk (seller)	Potentially more bespoke (eg, if pre-closing restructuring or reorganisation of target intended)
	Simpler, faster and cheaper overall process	Potentially faster process to signing
	Seller controls preparation of balance sheet	Flexible (less dependent on balance sheet)
	Reduced risk of disputes	
Cons	Early transfer of economic upside (except to the extent compensated by way of per diem interest)	Reduced bid comparability
	Increased risk for buyer	Final price unknown
	Valuation risk	Unexpected price adjustments
	Mismatch control or economic transfer	Overall process longer and more costly
	Effect of process delays (balance sheet relevance, etc)	Higher dispute risk

Earn-out clauses

Description

The earn-out is a variable purchase price component, which is conditional upon the occurrence or reaching of pre-agreed performance measures (eg, turnover or milestones), typically during a limited period after closing.

In Switzerland, earn-outs are frequently used in smaller transactions and less so in medium-sized and large M&A transactions.

The parties are free to define the performance indicators for an earn-out. In the majority of the cases the parties use financial performance indicators, such as turnover, EBITDA, EBIT, net income or operating cashflow. The performance indicators may also be of a non-financial nature, for example, the achievement of certain milestones in the development of a product, product approvals obtained from governmental authorities, the sum of orders received, the intake of new customers, etc.

The use of earn-out clauses is particularly useful if, despite extensive financial due diligence, different price expectations remain between the seller and the buyer. Earn-out mechanisms are therefore often used to bridge a valuation gap between the seller and the buyer that may result from a diverging assessment of the future development of the target company's business. Earn-outs may also be used to ensure a seller's continued commitment to the sold business.

Earn-outs are sometimes combined with a deferred sale of part of the shares of the target business. Thereby, the buyer ensures that the seller still has some 'skin in the game'; conversely, by keeping a stake in the company, sellers keep a 'stick' with some (minority) rights helping them to ensure that the business will be operated as agreed.

The amount of the earn-out payments is normally capped. The agreed period for earn-out payments is usually one to three years.

Earn-out purchase price components are predominantly paid in cash and sometimes by alternative means such as shares in the buyer or the target company.

Economic impacts

When using an earn-out mechanism, the seller keeps all or part of the economic benefit and risk relating to the agreed performance indicators for the period after the closing date. The remainder of the economic benefit and risk regarding the business of the target group shifts to the buyer at or before the closing depending on the chosen transaction structure. Often, the seller does not obtain the entirety of the financial benefit generated by the achievement of the agreed performance indicator. As a result, there may be an alignment of interests between the seller and the buyer.

Key pricing issues in earn-out arrangements

Calculation of the earn-out

Earn-out clauses require detailed and careful drafting to precisely define the relevant performance indicators and the relevant time to achieve them, as well as the time and method of calculation of the earn-out. As discussed under 'Closing accounts', the SPA will need to provide the rules for the calculation of the earn-out and the preparation of the relevant financial statements and state the applicable accounting principles. In the case of non-financial performance indicators, the definition of the facts that evidence the fulfilment of the agreed conditions for the payment of the earn-out should be defined.

The SPA will further need to determine the responsibility for the preparation of the relevant financial statements, whereas this is predominantly, but not always done by the buyer. The SPA should also contain the possibility for a review procedure and provide for a dispute resolution mechanism in case of a disagreement or dispute over the achievement of the relevant performance indicators or the calculation of the earn-out (see 'Dispute resolution regime').

Risk of requalification of earn-out payment as taxable salary

If the seller is a Swiss-domiciled individual, capital gains on the sale of shares held as part of its private portfolio are usually tax-exempt in Switzerland. Individual sellers therefore have a strong interest to structure the pricing such that the sale will remain tax-free. If this type of seller, however, continues to work for the target company, there is a risk that all or part of the earn-out payment will be requalified as salary for tax and pensions purposes. Earn-out or similar pricing mechanisms involving Swiss-domiciled individual sellers therefore need to be carefully reviewed from a tax perspective.

Similar adverse tax consequences may apply if the sale is refinanced by the assets of the target company, namely, if shares representing at least 20 per cent of the share capital of a company are sold from the private assets of an individual investor (or a group of individual investors) to the business assets of a corporate or individual buyer, and the target distributes current assets not needed for business operations out of distributable profit or reserves within a period of five years after the sale of the shares with the cooperation of the seller.

Avoidance of manipulation

Earn-out clauses may be subject to manipulation. The earn-out clause should therefore restrict the target company from taking certain acts that may have a manipulative effect on the agreed performance indicators. Such list of restricted acts may be similar to those disallowed between the date of signing and the date of closing. However, the restricted actions should not interfere with the ordinary course of business.

The earn-out clause should principally address the consequences of potential restructurings (such as mergers, demergers, sale or purchase of material assets or parts of the business or other types of reorganisation), the declaration of dividends or other types of distributions, capital increases or capital reductions, etc. In addition, any change to the nature of the target company's business, any entering into of any joint venture, partnership or other similar profit-sharing arrangement, and consolidation with the buyer and any winding-up should be restricted. Most importantly, in the absence of any a specific permission in the SPA or the consent of the seller, there should be no diversion by the buyer of any business or opportunities of the target company away from the target company to the buyer and no transaction between the target company and the buyer that is not on arm's-length terms.

Depending on the agreed performance indicator, the inclusion of further restricted actions may be appropriate or warranted.

Advantages and disadvantages

The earn-out mechanism may bridge gaps in purchase price negotiations between the seller and the buyer and potentially align economic interests.

Earn-out arrangements and related restrictions may delay the integration of the target company's business into the buyer and the realisation of synergies. Earn-out arrangements may further lead to the target company's business being conducted with a view to maximise the earn-out payments rather than the long-term development of the business.

Depending on the complexity of the individual arrangement, earn-out arrangements bear some risk of litigation.

Further variances

Deferred purchase price or vendor loan

Parties sometimes agree to deferred purchase price components that are not subject to any conditions, but are paid at a later stage. For examples, the buyer may be granted the right to pay the purchase price in instalments. The same result can be achieved via vendor loans. Both structures provide the buyer with a security to enforce potential post-closing claims against the seller, provided that the buyer's legal set-off rights have not been contractually excluded.

Deposits

Deposits are sometimes stipulated in case of complex closing conditions or anticipated challenges in enforcing the buyer's obligations to consummate the transaction and pay the purchase price at closing (ie, in the case of foreign-based buyers, SPVs or individual persons).

Escrow

The payment of part of the purchase price into an escrow account of an independent escrow agent is quite common if a foreign-based seller, a private seller or multiple sellers are involved in order to secure any potential post-closing claims of the buyer against the seller. For certain types of buyers, for example, buyers that are subject to capital export restrictions in their home jurisdiction or who will require foreign investment approvals abroad, sellers of Swiss target companies sometimes require a down payment into an escrow account at signing.

Escrows are uncommon if the seller is a listed entity domiciled in Switzerland or in another OECD country.

Appendix 1

About the Authors

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Philippe Weber is a partner at Niederer Kraft Frey. He often represents Swiss and international clients in some of the largest and most complex corporate/M&A, capital markets and banking transactions in Switzerland and regularly counsels public companies on how to successfully navigate critical governance and compliance matters.

Philippe also regularly advises companies, boards and other parties on takeover law, governance and compliance and represents clients in such matters before regulators, including the SIX Swiss Exchange, the Swiss Takeover Board, the Swiss Financial Markets Supervisory Authority FINMA and other Swiss and foreign regulators.

Manuel Werder
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Manuel Werder is a partner at Niederer Kraft Frey. His practice focuses on corporate law and M&A, including private equity and venture capital transactions, often with an Asian aspect. He has expertise in large, complex, cross-border acquisitions, mergers, divestitures and corporate restructurings. His M&A expertise crosses all industries, including financial, industrials and services.

Manuel advises Swiss and international financial institutions and corporations active in different industries in M&A, corporate, commercial, contract, securities and stock exchange law. His expertise also includes investment and shareholders' agreements, joint ventures, commercial contracts and employment law.

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