

How to avoid M&A disputes

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Agenda

- 1 Introduction by Wilfred van der Lee +/- 5 min.
- 2 Insights Grant Thornton international by Adam Azulai +/- 20 min.
- 3 Case studies by Ariën Oskam +/- 25 min.
- 4 Q&A +/- 10 min.

1 Introduction Grant Thornton

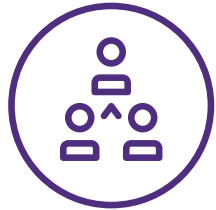
Fast facts Grant Thornton the Netherlands



Founded
late '40s



680
employees



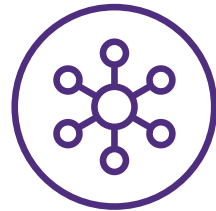
64
partners



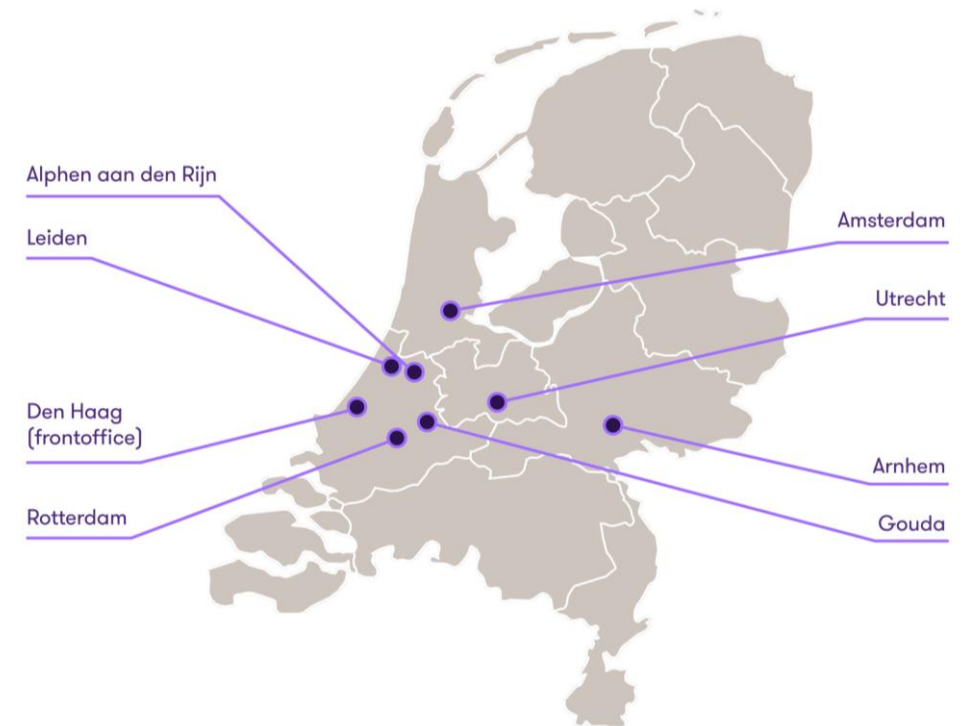
8
locations



95,2 million €
Turnover



International
network





Americas

44 markets

USD3.3bn revenue [+9.3%]

20,252 people

EMEA

86 markets

USD2.8bn revenue [+12.8%]*

27,685 people

APAC

19 markets

USD1.3bn revenue [+11.2%]

24,921 people

2 Insights Grant Thornton M&A dispute survey

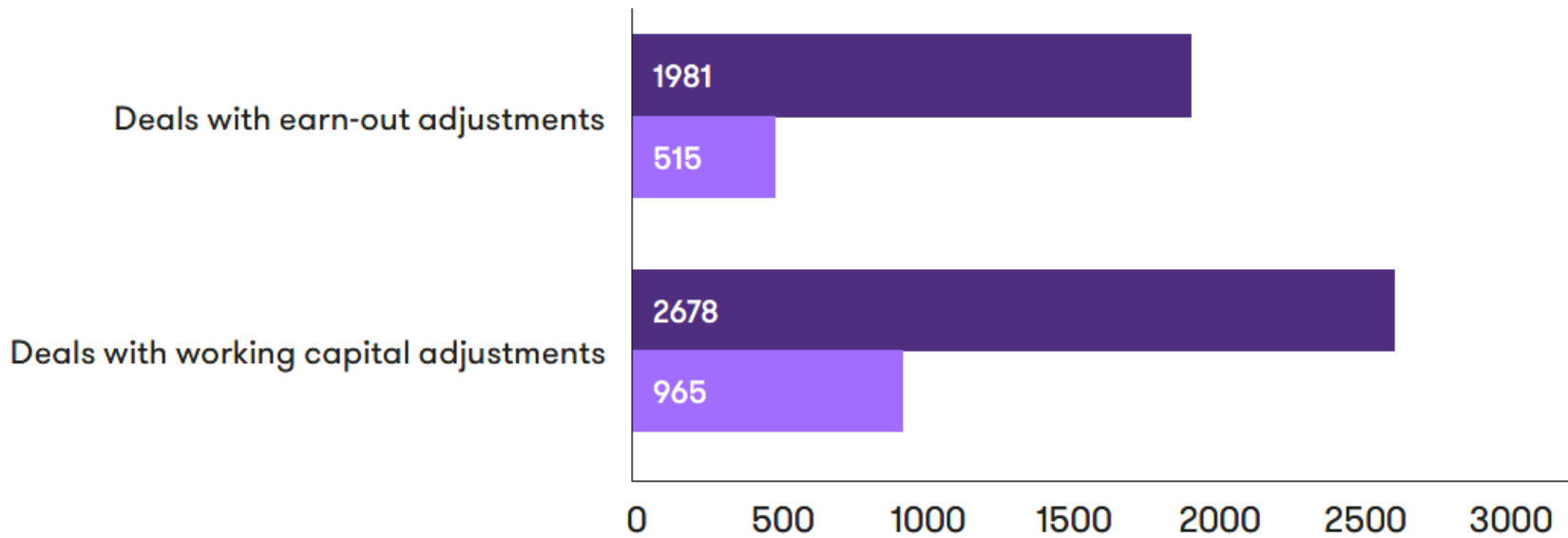
How to guard against M&A disputes

- Grant Thornton US survey
- 150 respondents, include:
 - M&A investment bankers
 - CFOs and corporate development teams
 - M&A attorneys and litigation counsel
 - Private equity investors
 - Professional services accountants
- In total 3,668 deals in 2022
- 61% of deals took place in the US
- Note: the survey is US centric and therefore completion accounts centric



Deals and disputes

● Number of deals ● Number of disputes



Percent of deals in the survey resulting in:

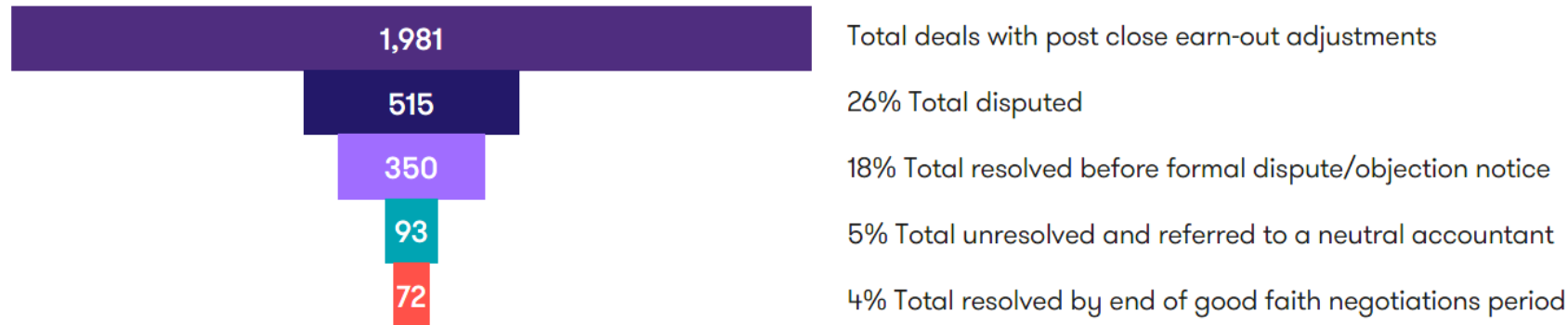
26%
Working capital dispute

36%
Earn-out dispute

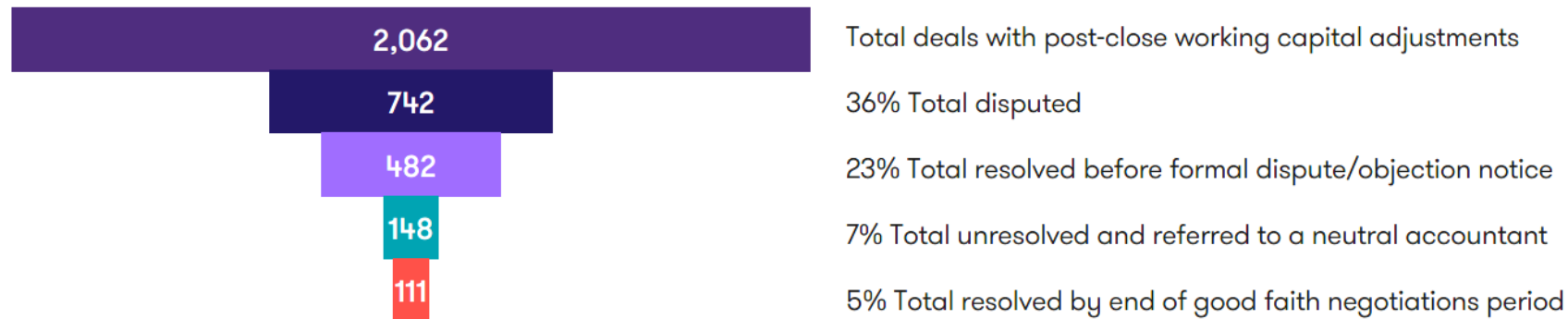
- The 1,981 deals with earn-out adjustments generated 515 disputes.
- The 2,678 deals with working capital adjustments generated 965 disputes.

Detail behind the disputes

Of deals in the survey with post-closing earn-out adjustments, how many became disputed?



Of deals in the survey with post-closing working capital adjustments, how many became disputed?



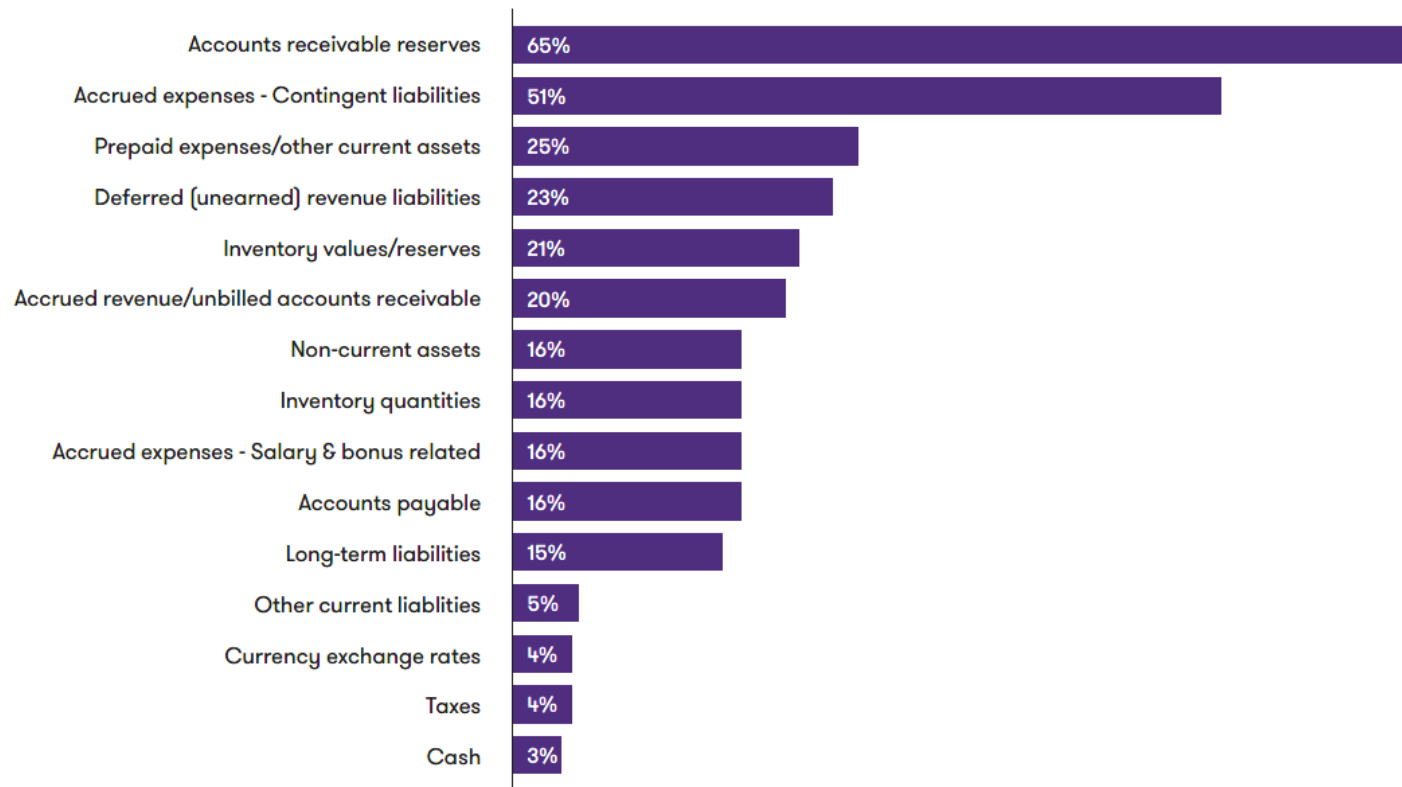
What increases the likelihood of a dispute?

- Vague language
- Purchase price adjustments
- Earn-outs

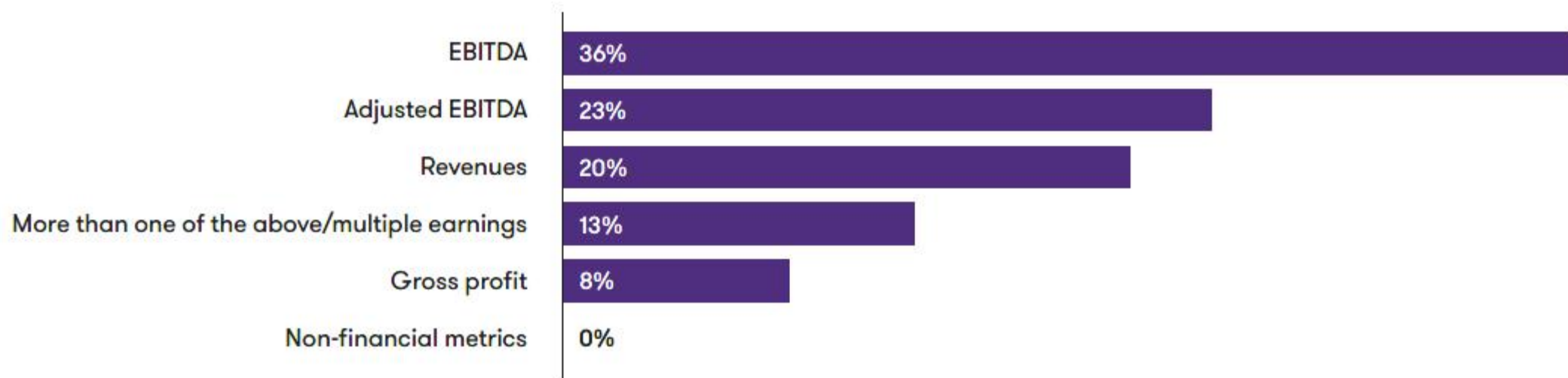


65% of respondents indicated that, among balance sheet items, AR reserves posed the most post-acquisition working capital disputes

Rank the top three balance sheet statement areas that pose the most post-acquisition working capital dispute?

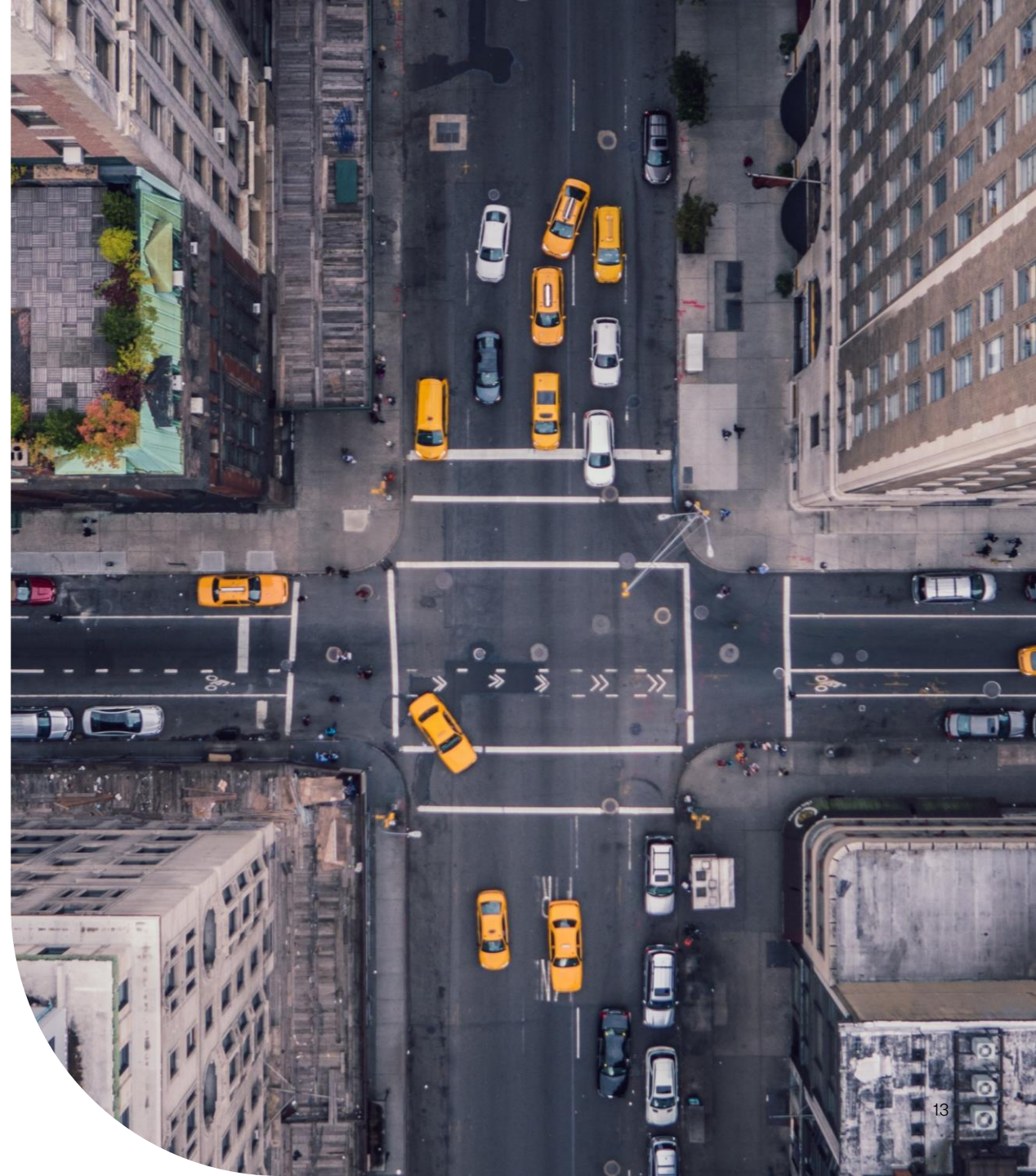


What do you typically use as the measurement basis for earn-outs



How to guard against disputes

1. Clarify your methodology
2. Provide an example
3. Manage earn-out timing, targets and metrics
4. Choose reasonable access
5. Use a locked box mechanism



Locked box mechanism

Based on your experience, which approaches would have resulted in fewer disputes in your deals?

(Percent of respondents indicating that an option would result in fewer disputes)



Locked box mechanisms are not without contention

- Carefully set the historic date
- Review leakage
- Use a 'value accrual' (or ticker) to reflect the changes in the balance sheet
- Avoid significant gaps between signing and closing



2 Case studies

M&A Disputes: Introduction cases

- Share Purchase Price (partly) non-fixed >>> SPP Adjustments
- Earn out agreements
- Multiple on Key Figures (based on Closing Accounts or Locked Box Financial Information)
- Closing Accounts or LBFI based on Accounting Manual > IFRS
- Specific arrangements (certain parts of revenue, CGU or other Key Figure)
- Closing Accounts or LBFI prepared by management of Purchaser or Seller
- Matters in Dispute
- Binding Advice

Case 1: Construction company (1/6)

- Share Purchase Price based on Locked Box Date Financial Information
- Matters in dispute:
 - Accounts receivable at Balance Sheet Date 31 March 2022
 - Gross margin of (construction) Projects (WIP) at BS Date
- SPA Clause:

“In case of a dispute between the Parties as to the content of (...) the Locked Box Date Financial Information the following applies: (...) To the extend that the Parties are unable to reach an agreement, the remaining difference shall be resolved by an Accounting Firm. (...) The Accounting Firm shall act as an expert and not as an arbitrator and shall, based on the provisions of this Agreement, in particular the IFRS Accounting Principles, decide whether and to what extent the LBDFI requires adjustment”
- Binding decision on IFRS matters



Case 1: Construction company (2/6)

I. Accounts receivables reserves

- Recognition of bad debt provision
- IFRS 9: expected credit loss (risk of non-collection of trade debts)
- *> 360 days outstanding should be provided, unless explicitly rebutted*



Measurement of expected credit losses:

- An unbiased and probability-weighted amount, by evaluating a range of possible outcomes
- Time value of money
- Reasonable and supportable information about past events, current conditions and forecasts of future economic conditions

→ **Estimations!**



Case 1: Construction company (3/6)

II. Gross margin of (construction) Projects (WIP)

- IFRS 15 Revenue from contracts with customers
- Percentage-of-completion: ratio between contract costs up to balance sheet date, compared to the estimated total contract costs as of the balance sheet date
- Example:
 - Contract costs up to balance sheet date = 800
 - Estimated total contract costs = 1.000
 - Percentage of completion = 80% (800/1.000)
 - Estimated total revenue is 2.500
 - Estimated gross margin = 1.500 (2.500 -/- 1.000)
 - Gross margin to be recognised in LBDFI = 80% x 1.500 = 1.200
- IFRS Accounting Manual: technical and economic risks should be included in estimations based on an *impact/probability matrix*.
- Events after reporting period: Information available prior to preparation of LBDFI should be taken into account.

→ Estimations!

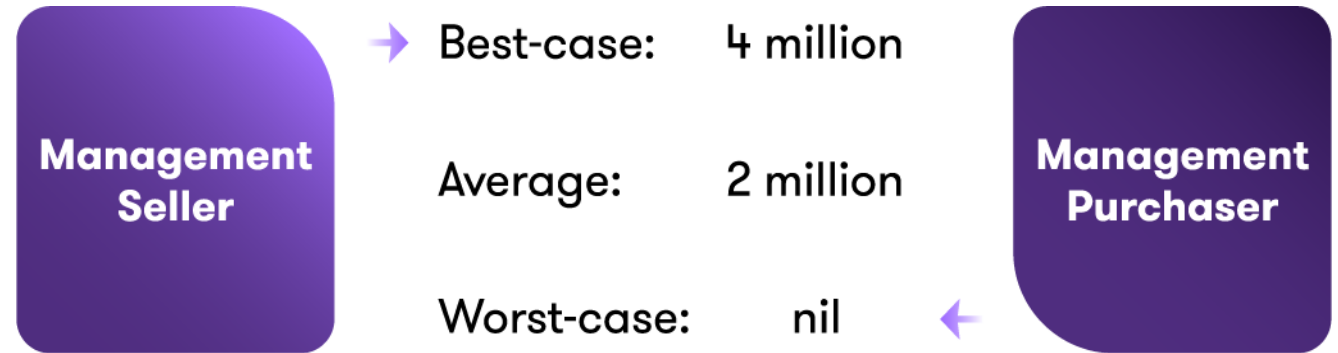


Case 1: Construction company (4/6)

Example different management estimations

Information:

- building contract with Client X
- Payments become due after delivery
- X has credit rating B+
- Outstanding 4 million at Locked Box Date
- No collection issues at Locked Box Date
- No overdues at Locked Box Date
- Overdue at Closing Date: 2 million



“ 'B' ratings indicate that material default risk is present, but a limited margin of safety remains. Financial commitments are currently being met; however, capacity for continued payment is vulnerable to deterioration in the business and economic environment ”

Case 1: Construction company (5/6)

II. Gross margin of (construction) Projects (WIP)

Project	Project issue / matter in dispute	Binding decision
A & B	Building permits not obtained, known risk at BS Date, provision estimated at 25%.	Adjustment 1.8 mio
D & E	Projects in sanctioned areas. Adjusting events. Known risk at BS Date, provision estimated at 75%	Adjustment 3.6 mio
F,G,H	Bad credit rating (B+), no substantial credit risk (not sufficiently proven), no provision	No adjustment
C	Settled between parties after start of engagement GT	N/A



Case 1: Construction company (6/6)

➤ Results binding advice

Overview decision on matters in dispute						
Matter in Dispute	Project title	Seller position (EUR)	Purchaser position (EUR)	Difference (EUR) = Dispute	Decision GT on Difference	Amounts in LBDFI after decision GT
		Trade & other receivables				
Trade receivables	A	12.000.000	10.000.000	2.000.000	0	12.000.000
		Project Gross Margin				
Project Gross Margin	A	35.000.000	31.500.000	3.500.000	1.800.000	33.200.000
Project Gross Margin	B	10.500.000	4.400.000	6.100.000	3.600.000	6.900.000
Project Gross Margin	C	<i>N/A (settled)</i>	<i>N/A (settled)</i>	<i>N/A (settled)</i>	<i>N/A (settled)</i>	<i>N/A (settled)</i>
Project Gross Margin	D	4.200.000	-2.000.000	6.200.000	3.100.000	1.100.000
Project Gross Margin	E	1.600.000	-800.000	2.400.000	1.200.000	400.000
Project Gross Margin	F	3.400.000	1.000.000	2.400.000	0	3.400.000
Project Gross Margin	G	5.000.000	0	5.000.000	0	5.000.000
Project Gross Margin	H	5.000.000	0	5.000.000	0	5.000.000
	Total:	76.700.000	44.100.000	32.600.000	9.700.000	67.000.000

Case 2: IT provider company (1/3)

- Share Purchase Price based on Earn-Out agreement
- Recurring Revenue, with a minimum amount (threshold) of EUR 20 million.
- If revenue in period t+1 and t+2 is lower, deduction of Share Purchase Price
- Revenues from new clients after closing and non-recurring revenues are excluded from Recurring Revenue
- Change in administrative system by Purchaser
- Difficulties in analyzing revenue per customer, due to different administrative systems
- Calculation of Recurring Revenue of t+1 by the Purchaser

Case 2: IT provider company (2/3)

Overview positions of parties on earn-out calculation			
Matter in Dispute	Seller position (EUR)	Purchaser position (EUR)	Difference
Revenue t+1	27.000.000	27.000.000	0
Minus: new clients	-4.000.000	-5.000.000	1.000.000
Minus: non-recurring	-2.000.000	-4.000.000	2.000.000
Recurring Revenue	21.000.000	18.000.000	3.000.000
<i>Minimum Recurring Revenue</i>	<i>20.000.000</i>	<i>20.000.000</i>	
Deficit	N/A	-2.000.000	

Case 2: IT provider company (3/3)

Results:

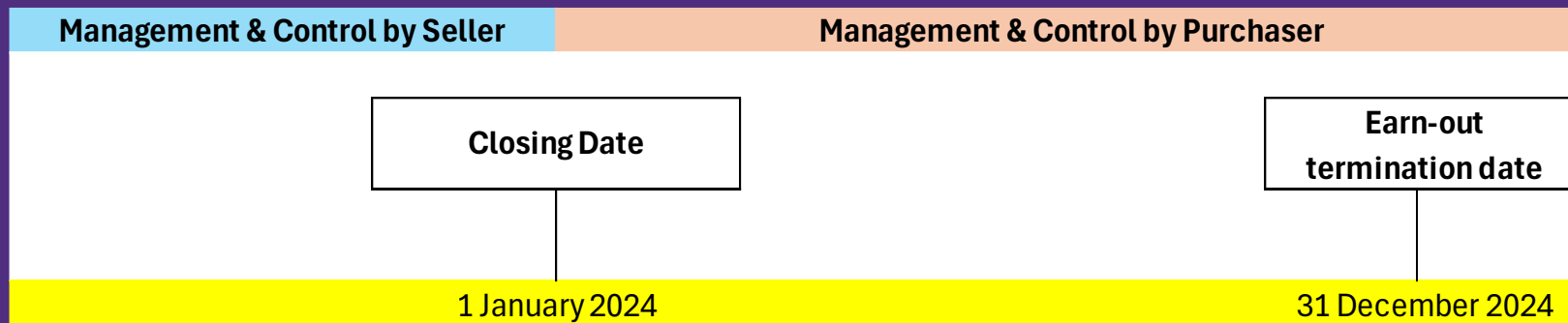
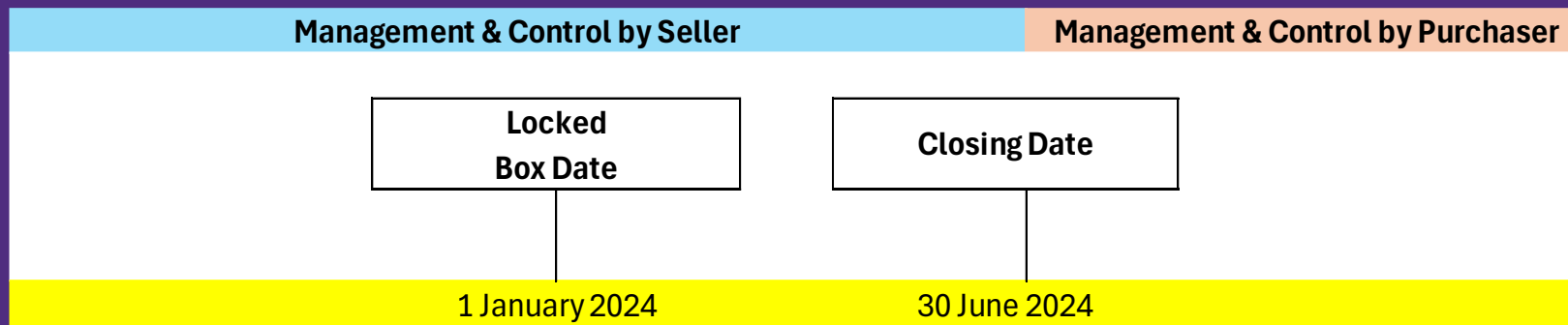
- i. New clients: 4 million as substantiated by Seller confirmed.
- ii. Seller failed to substantiate that the 4 million revenue adjustment for non-recurring should only be 2 million revenue adjustment. Purchaser provided substantiation and Purchaser position to be followed on non-recurring.

Overview decision on earn-out calculation			
Matter in Dispute	Seller position (EUR)	Purchaser position (EUR)	Binding decision Grant Thornton
Revenue t+1	27.000.000	27.000.000	27.000.000
Minus: new clients	-4.000.000	-5.000.000	-4.000.000
Minus: non-recurring	-2.000.000	-4.000.000	-4.000.000
Recurring Revenue	21.000.000	18.000.000	19.000.000
<i>Minimum Recurring Revenue</i>	<i>20.000.000</i>	<i>20.000.000</i>	<i>20.000.000</i>
Deficit	N/A	-2.000.000	-1.000.000

Lessons learned

1. Estimations (to be) made by management is a key element!
2. Management of Target Business (appointed by Seller or Purchaser?)
3. Information assymetry

Timeline examples:



How to avoid disputes

1. Limit uncertainties caused by estimations
2. Transparent and settled estimation process
3. Involvement of financial advisors upfront
4. Arrange for mutual management decisions on estimations
5. Close the information gap

- a. Selection of estimation method
- b. Formulate significant and appropriate assumptions upfront
- c. Calculation examples
- d. How to deal with estimation uncertainty
- e. Information to be obtained

Questions?

Thank you for
your **attention!**





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