KPMG

Valuation considerations in deal agreements

How SPAs signal the need for valuations expertise

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Foreword

Successful execution of any deal, and delivering the intended expected value, is dependent on the agreed objectives being effectively and robustly documented in the Sale and Purchase agreement ('SPA').

Clients commonly engage with our specialist SPA team at KPMG, who's main objective is to deliver robust agreements that ensure the price agreed is the price paid, ultimately driving better value deals for clients.

Deals can often be very complex and dealmakers are increasingly focusing on accounting and valuation implications of the transaction. A deal does not end when the SPA is signed or the deal completes, but rather there are several subsequent steps and processes which impact the target and buyer, which require specialist valuations team input. For example, the valuation of contingent or deferred consideration for financial reporting purposes, the purchase price allocation of the acquisition for financial reporting or for submission to tax authorities, or the execution of joint venture processes governing the contribution of assets, as well as put/call options or exit mechanisms.

Lack of forward planning of these processes early on during a deal, involving valuations team specialists, can lead to less-than-optimal approaches being followed, often in haste as reporting or tax deadlines approach. It is important to discuss and understand the valuation implications of these processes and consider an appropriate strategy or approach early on which can safeguard value.

As a specialist Valuations team, we are increasingly working alongside our SPA team colleagues, prior to signing, to advise clients on the valuation impacts of the deal they are signing up to, and ultimately provide robust solutions on the valuation implications of these processes to our clients.

Our intention in this piece is to shed light on the valuation implications of certain processes that can arise as part of a deal. We aim to demonstrate that addressing these proactively helps to convey any post-deal implications of the key decisions taken in a deal, and/or documented in an SPA.

Introduction

Valuation implications in relation to deals

A well-structured agreement, be that an SPA or a Joint Venture Agreement ('JVA'), that is crafted with valuation expertise brings the following benefits:

- i facilitates smoother post-transaction integration;
- ii reduces the potential for disputes in the future; and
- iii lays a robust foundation for sustainable business success.

Valuation implications of deals can be wide reaching. Exit clauses are one such example with clear valuation implications, that we commonly see included within JVAs.

KPMG Valuations team recently worked to draft a robust exit clause for inclusion in a JVA for one of our clients. The terms of this particular agreement required the inclusion in the JVA of a clause relating to how the exit value of the business could ultimately be determined in several year's time. Clearly there is judgement involved – there are several acceptable approaches to calculating the exit value of a business. In this case, the Valuations team focused their solution to reach the most beneficial approach (for our client) to calculating the exit value, drafting the clause with this knowledge at the forefront.

It is clear to see the impact that such provisions can have on the business going forward, sometimes several years into the future, when the initial deal completion is a distant memory. Therefore, agreements such as SPAs and JVAs should not be viewed only as a mechanism for getting a deal done, but rather one which needs careful consideration on the long-term impacts of some of the clauses included within it.

This is a specific example which may not be relevant to all circumstances. Nevertheless, other terms can have far reaching impacts for tax filings, as well as accounting treatment and discussions with auditors, which we will discuss in more detail later in this piece.

Engaging with any potential valuation implications of deals, and addressing them proactively, helps to address any post-deal implications of the key decisions taken in a deal.

Key categories of valuation implications

We discussed previously, one such example of the valuation implications of a JV deal specifically being wide reaching.

In this piece we discuss our view on clauses or signals that are sometimes included within SPAs with wide-reaching valuation impacts. We have classified these into different categories, as set out below. Separately, as a final fifth category, we discuss some insights specific to JV agreements.

01 Consideration

02 Allocation of purchase price

03 Employees

04 Disputes

05 JVA considerations

Key categories of valuation implications

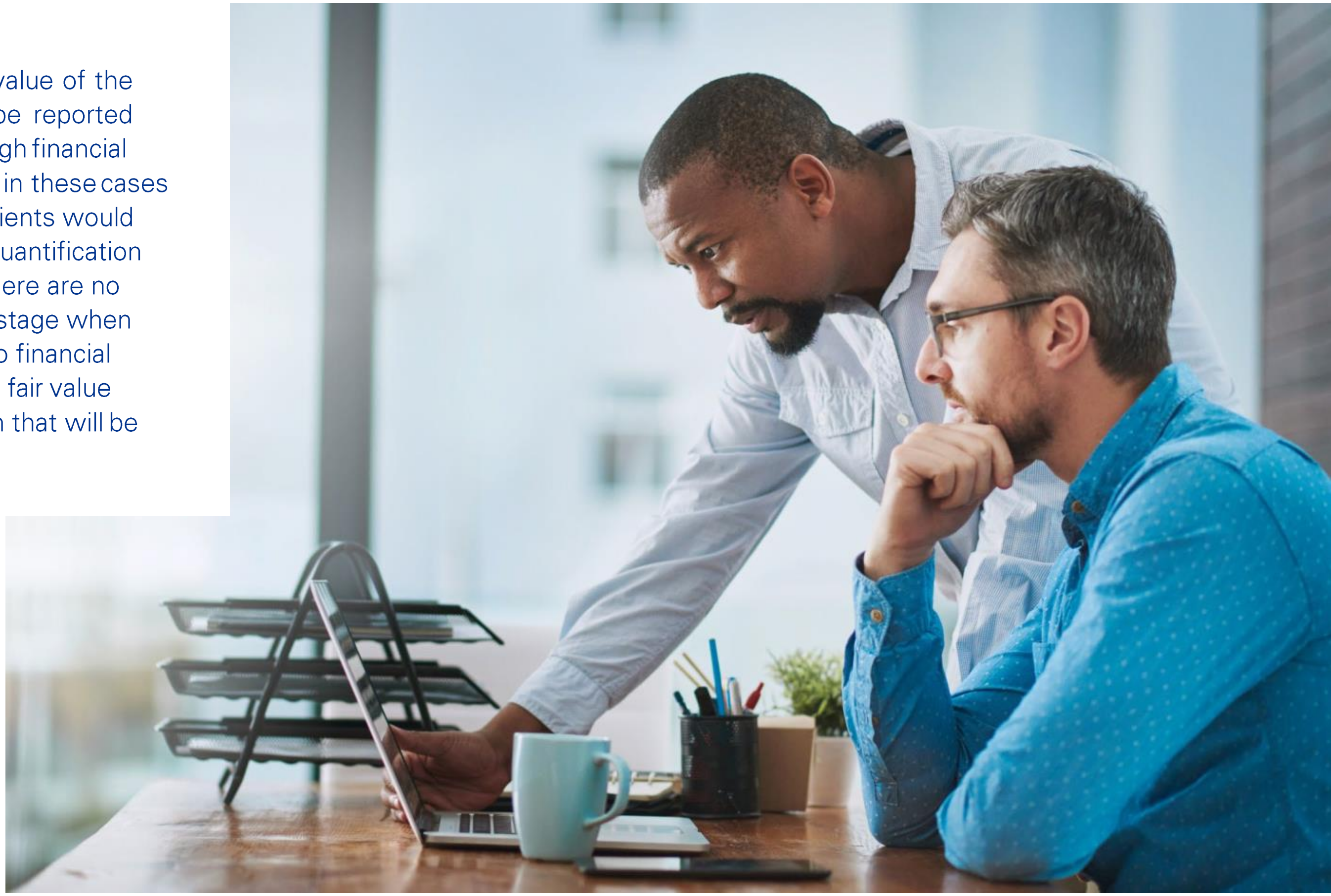
01
Consideration

Consideration

For acquisition accounting purposes, if the transaction consideration has a i) contingent element or ii) any non-cash element, this will need to be fair valued and included in the total consideration for accounting purposes.

- A **contingency element** of consideration may be drafted in the SPA, where additional consideration may be paid in the event of meeting certain targets.
- Any **non-cash or non-standard consideration** could refer to any element of the consideration that does not have a fixed value, for example: shares in a listed entity, or an option to acquire/sell a further percentage of holding in the target.

Ultimately the fair value of the consideration will be reported to the market through financial disclosures, and so in these cases in our experience clients would benefit from early quantification of this, to ensure there are no surprises at a later stage when the market reacts to financial statements and the fair value of the consideration that will be disclosed therein.



Key categories of valuation implications

02

Allocation of purchase price

Requirement to allocate purchase price

A requirement to allocate purchase price is relatively common in most jurisdictions and is known as a '**purchase price allocation**'. On the one hand, this is an accounting requirement. It is usually conducted post-deal and may not impact on the drafting of the SPA or have any impact on doing the deal. On the other hand, there are circumstances where clients would benefit from thinking about the purchase price allocation earlier in the process e.g. during the drafting of the SPA and prior to signing of the deal.

For example, firstly to understand earlier the impact from the deal on KPIs such as earnings per share, and secondly, for tax structuring, which may already be relevant during the drafting of the SPA.

Trade and assets transfers, or their equivalent, remain a prime example where parties quite often want to agree values of their assets and liabilities to go into their tax returns within a specific time frame (which can be pre deal). Asset transfers are occasionally referred to within the SPA, such as tax values for asset deals. Another example is a combined asset and share deal, where the total purchase consideration needs to be allocated to the various assets and equity shares and documented as such in the SPA.

This triggers an exercise (similar to a pre-deal purchase price allocation) that many dealmakers may already be very familiar with. As a result of these clauses, we have observed circumstances in large, multi-jurisdictional deals where tax values need to be ascertained and agreed.

Tax may be imposed by relevant authorities, levied on the 'value' of the assets being transferred, and there can be differing implications for buyer and seller – meaning that such an exercise can quickly turn into a negotiation over the optimum 'value' ascribed to the assets by either party.

KPMG Valuations team have recently assisted a large US-based client in determining robust valuations under such circumstances, allowing our client to negotiate with a strong position. Raising this issue as early in the process as possible helps to provide defendable valuation for further negotiations.

Furthermore, if there is a clause that specifies a fixed value (plus ticker, for example) or percentage allocation between assets, this should be looked at in case it impacts the reporting requirements. If there is any intellectual property in the target, it may be ringfenced and required to be transferred, for example to a newly set up company, therefore requiring a valuation of the asset being transferred.

Key categories of valuation implications

03
Employees

Employees

SPAs occasionally include **clauses in relation to pension valuations or incentive plans** that may require valuation.

Clearly value can affect pension reporting and the valuation of final pension may impact the consideration payable.

Awards of shares to management will require a fair value for tax and financial reporting purposes, depending on the jurisdiction in which the company operates. Any existing share plans may be specifically treated in the consideration calculation and any share issuance/options in relation to a management incentive plan set up may also be need to be thought through thoroughly.

04
Disputes

Disputes

Clauses which attempt to govern how any **future dispute** may be resolved are occasionally included with SPAs.

In relation to potential dispute clauses, whilst a valuation in itself may not be completely necessary at the point of signing, bank valuation dispute provisions can potentially result in long, expensive and unpredictable processes when disputes are realised. As such, it is important that such clauses are drafted with substantial thought given to protecting the business long into the future.

Key categories of valuation implications

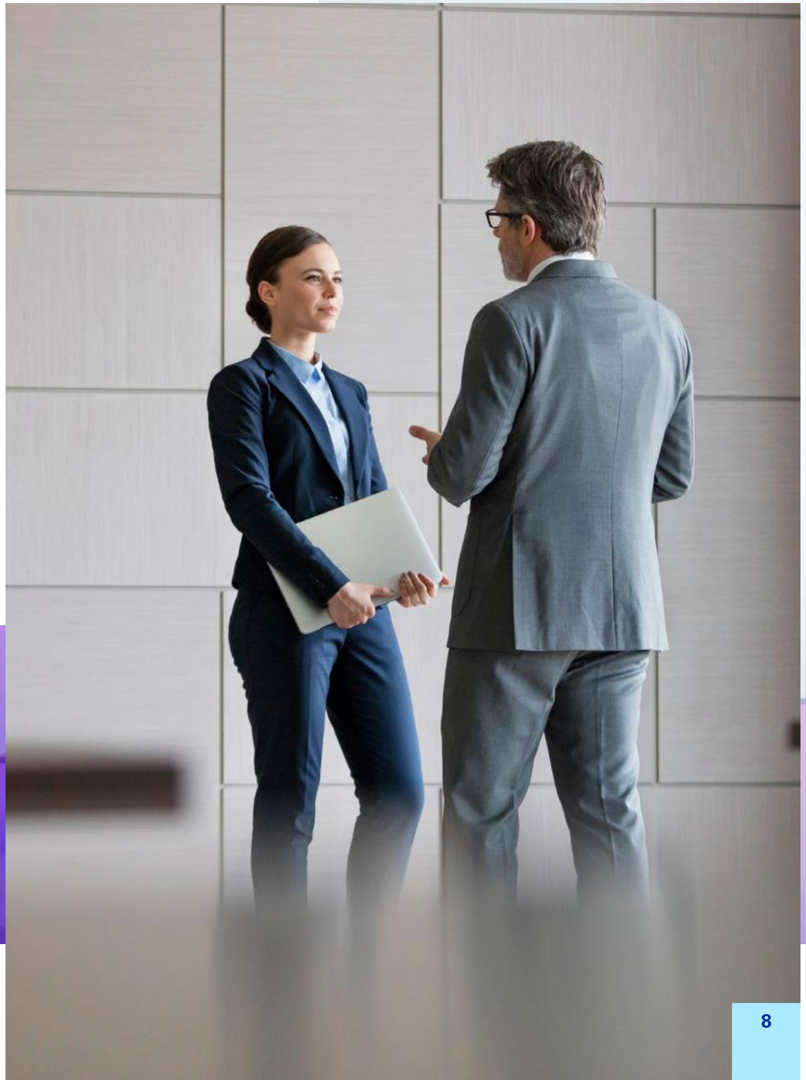
05
JVA considerations

Specific considerations for joint venture ('JV') agreements

In this category, there are immediate and obvious valuation-related subjects such as value and contribution, which most dealmakers realise, such as clauses relating to the determination of values of assets to be transferred into the JV as well as the equalisation mechanism.

But there are some **'hidden' valuation clauses** that should be considered. A key example is how any exit is structured and how valuation procedures in the event of an exit are defined, as discussed in the introduction.

Similar to disputes clauses, drafting such clauses with careful consideration and clarity to both parties helps to avoid unnecessary, convoluted, expensive and unpredictable processes in the future.



Closing remarks

We recognise that inthis modern age, deals are negotiated and completed at breakneck speed. It is all too easy for dealmakers to miss the valuation implications of certain decisions taken when negotiating and signing a deal.

Many are well versed in thinking through the implications of these clauses while negotiating the deal, but not necessarily protecting themselves against the potential far-reaching impact these can have on a business long into the future.

Our intention in this piece was to shed light on the valuation implications of certain processes and occasionally clauses that are sometimes included in agreements such as SPAs and JVAs; demonstrating that addressing these proactively helps to convey any post-deal implications of the key decisions taken in a deal.

Our Valuations team specialists are happy to share their latest views and experiences to help you navigate through, and provide further insight into, the increasing complexities surrounding valuation considerations in deals.

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