

The LOI Decoded

A Dealmaker's Guide to Where Value Actually Moves

The Number That Doesn't Exist Yet

Every transaction starts with a number. It shows up in the pitch book, anchors the LOI, and eventually lands in the press release. Ask anyone involved what the deal was worth, and that number comes out quickly and confidently.

But it's not the real number. Not for the seller, and not for the buyer.

The seller's actual economic outcome is almost always lower than the headline purchase price. After net debt adjustments, working capital true-ups, escrow holdbacks, transaction expenses, and risk-weighted earnout components, the cash that hits the seller's account on Day 1 can look meaningfully different from the figure they celebrated when the LOI was signed.

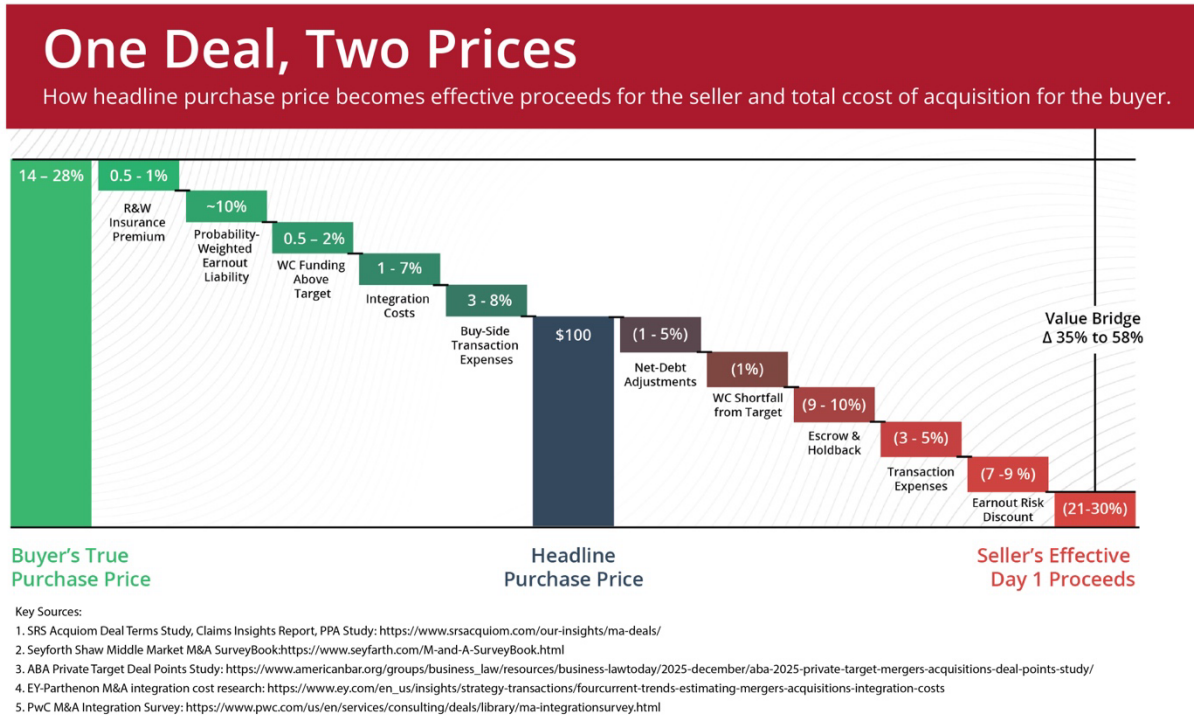
The buyer's actual cost is almost always higher. Layer in transaction expenses, integration costs, working capital funding above the target, probability-weighted earnout liabilities, and R&W insurance premiums, and the total capital deployed exceeds the headline by a margin that surprises most deal teams the first time they calculate it honestly. EY-Parthenon research across 236 transactions found that integration costs alone can range from 1% to 7% of deal value, with the degree of operational change, rather than deal size, serving as the primary cost driver.¹ PwC's 2023 M&A Integration Survey reinforced this finding: 59% of companies reported spending 6% or more of deal value on integration, up from 38% in prior survey periods.²

I've seen mid-market transactions where the spread between the seller's effective proceeds and the buyer's total cost of acquisition exceeds 25–30% of the headline number. The gap isn't a flaw in the deal process. It *is* the deal process. The LOI establishes a framework for pricing, not a final price. And the provisions within that framework collectively determine where value lands.

The question is whether both sides understand the mechanics well enough to manage them deliberately, or whether they discover the gap at closing and wonder where the money went.

The Value Bridge

One way to make sense of these dynamics is to map both sides of the transaction as a bridge from the headline number to the actual economic outcome.



The seller's bridge starts at the purchase price:

- Net debt adjustments (extending beyond funded borrowings into contested "debt-like items")
 - Working capital shortfall below the negotiated target
 - Escrow and holdback amounts (carrying time-value cost and counterparty risk)
 - Transaction expenses
 - Risk discount on earnout components
- = **Effective Day 1 proceeds**

The buyer's bridge starts at the same purchase price:

- + Buy-side transaction expenses (legal, diligence, financing fees)
- + Integration costs that wouldn't exist absent the deal
- + Working capital funding required above the target
- + Probability-weighted earnout liability

- + R&W insurance premiums
- = **Total cost of acquisition**

Placed side by side, these two bridges reveal the full economic architecture of the deal. A \$75M headline transaction might represent approximately \$63M in seller proceeds and approximately \$82M in total buyer cost. Neither number appears in the LOI. Both are real.

The bridge isn't just an analytical exercise. It's a planning tool. Each component corresponds to a specific LOI provision, and the quality of work done on each provision determines whether that component holds firm or shifts between LOI and close.

The Five Value Levers

Five categories of LOI provisions account for the majority of value movement between headline and outcome. Each one creates a tension between buyer and seller that can only be resolved with precise analysis and clear definitions.

Net Debt Definitions

“Cash-free, debt-free” is the standard construction for mid-market transactions. The concept sounds clean: the buyer gets the business free of cash and free of debt. But “debt” in an LOI rarely means just funded bank borrowings. It extends into a category of “debt-like items” that includes accrued transaction bonuses, deferred revenue obligations, unfunded pension liabilities, accrued PTO balances, and capital leases reclassified under ASC 842.

Each item included in the net debt definition reduces the seller's proceeds dollar for dollar. Each item excluded becomes an obligation the buyer absorbs post-close. The classification of a single item can move \$500K or more, and a typical mid-market balance sheet contains several items in the gray zone. The ABA's 2025 Private Target Deal Points Study, which analyzed 139 middle-market acquisition agreements with purchase prices ranging from \$25M to \$900M, now tracks how often transaction expenses are factored into post-closing purchase price adjustments, reflecting how central these definitional questions have become to deal economics.³

I worked on a SaaS transaction where roughly half of annual revenue was collected through renewals in the first three months of the year, and the business relied on third-party contractors for delivery. We were negotiating in August. The seller argued the working capital true-up should only reflect the prior three months, excluding the large payments received earlier in the year. The problem: major clients had prepaid in January for work still undelivered by August, and fulfillment would trigger contractor purchase orders. Under the seller's framework, the seller keeps the cash, and the buyer inherits both the delivery obligation and the vendor costs. The financial and operational diligence team caught it by tracing the revenue cycle against the delivery timeline. A compromise was reached, but without that analysis, the buyer would have funded delivery for revenue already collected by someone else.

The gray zone is where the real negotiation happens. Vague LOI language like “all other liabilities of a similar nature” gives one side discretion that the other side may not fully appreciate until the purchase agreement is drafted.

Working Capital

The working capital target ensures the business transfers with adequate operating liquidity. The concept is straightforward. The execution is not.

Most targets are set using a trailing average of monthly working capital, typically 12 months. But trailing averages can distort the picture in seasonal businesses, in companies with recent growth trajectories that shift the working capital profile, and in any business where one-time items (a large prepayment, a delayed collection, a COVID-era anomaly) skew the historical data. According to SRS Acquiom's 2026 study of over 1,500 deals valued at \$385 billion, working capital adjustments now appear in more than 90% of private-target M&A transactions, up from roughly 50% a decade ago.⁴

The methodology for setting the target matters more than the number itself. Whether the calculation uses GAAP or "consistent with past practice," which specific accounts are included, and how normalization adjustments from the QoE analysis feed into the target all determine whether the true-up process at closing resolves cleanly or becomes a dispute. According to multiple deal studies, working capital adjustments account for 50% or more of all post-closing disputes.⁵ SRS Acquiom's PPA study found that the average adjustment amount, when owed to buyers, is approximately 0.9% of transaction value.⁶ On a \$100M deal, that's \$900K moving to the buyer through a mechanism many sellers didn't fully understand when they signed the LOI. Both sides benefit from agreeing on methodology at the LOI stage rather than deferring it to the purchase agreement, because a number without a clear methodology behind it is just a future argument.

Earnouts

Earnouts bridge valuation gaps by tying a portion of the purchase price to the target's future performance. They are meant to align incentives. In practice, they frequently create friction.

The design choices embedded in an earnout structure carry more economic consequence than the dollar amount. Revenue-based metrics are harder to manipulate but ignore margin. EBITDA-based metrics capture profitability but introduce definition risk around adjustments, add-backs, and cost allocation. Operational milestones reduce ambiguity but may not correlate with financial value creation. In 2024, 62% of earnouts used revenue as the primary metric, while only 22% used EBITDA, reflecting sellers' growing preference for metrics that are harder for buyers to influence post-close.⁷

Beyond the metric, the operational autonomy provisions matter enormously. If the buyer has full control over business decisions during the measurement period (pricing, headcount, capital allocation, customer strategy), then the seller's ability to achieve the earnout target is partially or fully in the buyer's hands. This creates an inherent tension that no amount of legal drafting can fully resolve.

The data on earnout achievement is sobering. SRS Acquiom's 2024 Claims Insights Report, analyzing over 850 private-target acquisitions valued at approximately \$168 billion, found that earnouts pay approximately 21 cents on the dollar across all deals with earnouts (excluding life sciences).⁸ Among the 59% of deals that paid anything, the median payout was roughly 50 cents on the dollar. Earnouts were contested at least 28% of the time, and 17% of deals that achieved some payout required renegotiation to avoid litigation.⁹ For a seller counting on a \$10M earnout to reach their target valuation, the market data suggests the expected value is closer to \$2.1M.

There's a cultural dimension here as well. An earnout requires sustained collaboration between buyer and seller during the measurement period. When the buyer's operating philosophy differs significantly from the seller's, the resulting friction tends to suppress the very metrics the earnout is designed to measure. A buyer who imposes rigid reporting and cost controls on a founder-led culture may be acting within their contractual rights while functionally undermining the earnout's purpose. This dynamic is predictable before the LOI is signed if both parties are honest about how they operate.

Escrow and Indemnification

Escrow and indemnification provisions allocate post-close risk. The buyer needs a funded recourse mechanism for breaches of representations, undisclosed liabilities, and working capital shortfalls. The seller needs to limit the duration and magnitude of post-close exposure to maximize certainty of proceeds.

Seyfarth Shaw's 2024/2025 Middle Market M&A Survey, analyzing over 150 acquisition agreements, found that the median indemnity escrow in non-insured deals rose to approximately 9% of the purchase price (up from 8% the prior year), with nearly half of such deals exceeding 10%.¹⁰ By contrast, in deals using R&W insurance, the median escrow dropped to just 0.3% of purchase price. The median escrow period held steady at 12 months across both deal types. On a \$100M non-insured deal, \$9–10M sitting in escrow for a year represents a meaningful time-value cost and concentration risk for the seller, even if the funds are ultimately released.

R&W insurance has reshaped this landscape over the past several years. The ABA's 2025 Private Target Deal Points Study found that 64% of deals referenced R&W insurance, recovering from a dip to 55% in 2023.¹¹ R&W premiums currently run approximately 2.5–3% of the policy limit, with retentions averaging 0.5% of enterprise value.¹² While insurance allows buyers to obtain broader coverage and sellers to achieve cleaner exits, the policies don't cover known issues surfaced during diligence, and the premiums and retention amounts add to the buyer's total cost.

One frequently misunderstood mechanic is the distinction between a **deductible basket** and a **tipping basket**. Under a deductible basket, the buyer can only recover losses that exceed the basket amount, and only the excess. Under a tipping basket, once losses exceed the threshold, the buyer recovers from the first dollar. On a \$50M deal with a \$500K basket, the difference between these two structures can represent hundreds of thousands of dollars in seller exposure. The distinction is often buried in legal language that neither the buyer's nor the seller's principals have read closely.

Non-Priced Terms

Several LOI provisions don't carry explicit dollar values but have quantifiable economic implications.

Non-compete agreements restrict the seller's ability to operate in the same space post-close. The scope, duration, and geographic reach of the restriction affect the seller's future earning potential. Enforceability varies significantly by state, and the evolving regulatory environment (including FTC scrutiny of non-competes) adds uncertainty that both sides should evaluate.

In cross-border transactions, these terms take on additional complexity. In jurisdictions with strong labor protections, including much of Europe, parts of Latin America, and Japan, non-competes and severance restrictions may be unenforceable as written or may require mandatory payouts that materially change the deal economics. Buyers who draft these provisions based solely on U.S. norms risk inserting terms that either won't hold up legally or will drive a seller toward a competing bidder who offers more reasonable constraints. There's also the risk of misreading seller intent: a founder who wants a clean break and would have accepted lighter terms willingly may instead walk from a deal where the non-compete feels like a cage. The provision is meant to protect the buyer's investment, but when calibrated poorly, it can undermine the very outcome the buyer is trying to secure.

Rollover equity, where the seller retains a minority stake in the acquired business, serves dual purposes. For the buyer, it aligns the seller with post-close performance. For the seller,

it represents a concentrated, illiquid bet on the buyer's ability to create value. The tax treatment, governance rights, and liquidity provisions attached to rollover determine its real economic value, which may differ substantially from the stated percentage.

Exclusivity periods carry opportunity cost for the seller (off-market while the buyer conducts diligence) and sunk cost risk for the buyer (significant capital deployed on diligence that may not close). Duration and break-fee structures affect both sides' risk exposure during the period.

The Role of Financial and Operational Diligence

The LOI is shaped by the full deal team. The investment banker structures the terms and negotiates valuation. The transaction attorney drafts the definitive agreements and manages legal risk allocation. The tax advisor optimizes the transaction structure.

The financial and operational diligence provider plays a different role: populating the deal's economic terms with defensible numbers and evaluating the operational dynamics that affect sustainability of earnings, integration complexity, and go-forward cost structure. The quality of earnings analysis feeds directly into the working capital target, the net debt schedule, the earnout baseline, and the risk assessment that informs reps and indemnification. The operational assessment identifies risks and dependencies that pure financial analysis may miss: customer concentration, key-person reliance, vendor fragility, technology debt, and process scalability.

The diligence provider doesn't negotiate the deal. But the deal's economic terms don't hold up without the diligence team's work product. A working capital target without normalized analysis is a guess. An earnout baseline without validated adjustments is a future dispute. A net debt schedule built from management estimates rather than independent analysis is a liability. The diligence team is the connective tissue across all five value levers, translating balance sheet, income statement, and operational analysis into the inputs that every other member of the deal team relies on.

Economic Clarity Meets Cultural Clarity

Those familiar with our earlier work on cultural due diligence will recognize a parallel. In that series, we argued that cultural misalignment between buyer and seller is a hidden risk that compounds during integration. The same principle applies to economic alignment at the LOI stage.

When both parties and their deal teams understand the mechanics of each provision, negotiate from defensible numbers, and address ambiguity early, the 60–90 days between LOI and close become a collaborative process. When they don't, those same 60–90 days become adversarial, and value gets destroyed rather than allocated.

Economic clarity and cultural clarity are parallel disciplines. Both require honesty over optimism. Both reward the participants who invest in rigorous analysis early rather than discovering gaps late. And both are best served by advisors who understand the full picture rather than just their own lane.

The Blueprint

The best LOIs aren't just agreements on price. They're blueprints that give both buyer and seller a shared map for the diligence and negotiation ahead. Every provision discussed here is a component of that blueprint. When each one is defined with precision, supported by analysis, and understood by both sides, the transaction moves forward with clarity. When they aren't, the gap between headline and reality widens, and both parties end up somewhere they didn't plan to be.

The headline number is where the conversation starts. The value bridge is where it finishes.

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