# AN EXPERT VIEW – CORPORATE FUEL

## PART 1:
## Working Capital in Merger & Acquisition Transactions

An explanation of why working capital is most often included in a business when it is sold.

In this segment, we are going to review why working capital is included in a business when it is sold.

Almost all Buyers propose to acquire a business that includes the working capital sufficient to operate the business immediately after closing. The list of Buyers that take this approach includes professional strategic Buyers as well as private equity firms.

The reasons this approach is used is for four principal reasons:

1. Working capital can be a significant component of the value of a business;
2. It is difficult for a Buyer to forecast the amount of capital that is required to support the operations of the business – as they often have imperfect information and they are not intimately familiar with the business. Many acquired companies might have liquidity issues just after closing if not for a disciplined approach that provides confidence in the sufficiency of working capital levels at closing;
3. If well-understood and appropriately constructed, the Buyer and Seller will be indifferent to the working capital ups/downs as well as the timing of the closing of a transaction – leading to higher levels of satisfaction by all sides after closing; and
4. Eliminates the games that might be played by Buyers or Sellers who might try to advantage themselves if not for such a disciplined process.

Most Buyers will express an interest in buying a business, by suggesting that their proposal is "on a debt free – cash free basis and with sufficient levels of working capital." This is a common approach whether the transaction is structured as an Asset Purchase or an Equity Purchase. Let's discuss what this actually means. Just prior to or simultaneous with the closing, the Seller is responsible for repaying the debt of the company and is entitled to all of the cash out of the business, save a small amount of operating cash in some circumstances. So, the business is delivered without any debt and cash, but it is delivered with a sufficient amount of working capital. Typical elements of working capital include current assets (e.g. accounts receivable, inventory and prepaid expenses) as well as current liabilities (e.g. accounts payable and accrued expenses.)

**Transaction Stages**

| Letter of Intent Stage | Due Diligence Stage | Closing Stage | Post Closing Stage | Settlement Stage |
|---|---|---|---|---|
| Agree that WC included in deal.<br>Agree on LTM* or other Method for determining the "Target" Scope, Measurement and other special circumstances.<br>(*Last Twelve Months) | Set Working Capital "Target" or "PEG". | WC estimated for Closing calculations.<br>(Estimated vs. Target) | Within 60-120 days of Closing, WC Reconcilliation Process.<br>(Actual Received vs.Target) | After Agreement on Reconcilliation, $ Settled betweeen Parties. |

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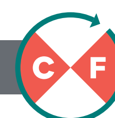

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The benefit of this approach for the Seller is that if the business increases its net working capital, a positive purchase price adjustment occurs in the reconciliation process. (This can be particularly important as in many cases the working capital of a growing or profitable business may increase during the 3 months covered by the exclusivity period of an LOI.) Or, if the business reduces its net working capital but increases cash, the increased net cash retained by the Seller would effectively offset the negative purchase price adjustment.

For the Buyer, the benefit of this approach is that there is predictability. In the event that net working capital delivered is less than anticipated, the purchase price is adjusted down in the reconciliation process. In the event that more net working capital is delivered at closing than is anticipated, the Buyer received more value for the higher level of net assets delivered and the purchase price is adjusted upwards in the reconciliation process.

Without an agreement on working capital, you can imagine that all sorts of bad behavior can occur in M&A transactions by parties who try to advantage themselves once the terms have been negotiated. Here are some examples:

- Buyers who try to be clever about how to determine the Target to their advantage
- Sellers who might accelerate the collection of accounts receivable just prior to closing
- Sellers who might extend payments to vendors just prior to closing
- Sellers who might work-down inventory levels to bare-bones levels just prior to closing

**“Without an agreement on working capital, you can imagine that all sorts of bad behavior can occur in M&A transactions by parties who try to advantage themselves.”**

**Find out how Corporate Fuel can help you realize the full value of your business.**

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