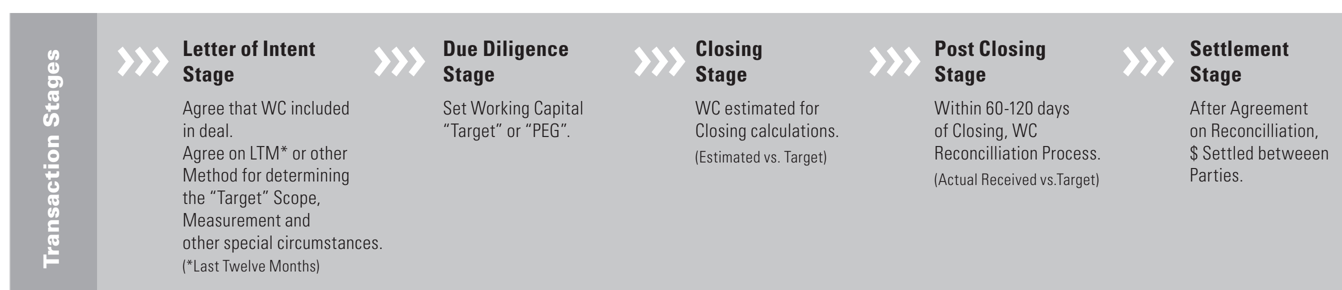
AN EXPERT VIEW – CORPORATE FUEL

PART 2:
Working Capital in Merger & Acquisition Transactions

An expert description of the mechanics of including working capital in an M&A transaction and how changes in working capital between a Letter of Intent (LOI) and Closing impact the Buyer and the Seller.



In an earlier part of this series, we explained that in most M&A transaction, the Buyer proposes a purchase of business, assuming a "cash free – debt free balance sheet and including a normal amount of working capital" that remains with the business at closing – all in an effort to allow the Buyer to predict the capitalization required to fund the acquisition and operate the business.

In this part of our series on working capital, we discuss the mechanics of including working capital in a transaction, making recommendations as we go on how to avoid disagreements and then we show a variety of illustrations that demonstrate how changes in working capital assets and liabilities between the LOI stage and the Closing may impact the Seller, and Buyers. (Typically, working capital is defined as the excess of current assets over current liabilities.)

Our firm's approach is not to advantage one party over the other in the determination, delivery and settlement of working capital. We are careful to remove all surprises and disagreements that might occur related to working capital so that the parties end-up with what they anticipated they would at the time they made the principal bargain on the business terms. The Seller gets the proceeds they anticipate and the Buyer gets a business with a fair and normal level of working capital. Most professionals involved in M&A abide by these principles. That said, inadvertent and costly mistakes by the un-initiated can be avoided by heeding our disciplined approach.

As is depicted in the table above, there are five principal stages in the process of conveying a business' working capital in an M&A transaction. In the Letter of Intent stage, the parties typically agree that a normal level of working capital is included in the business being traded. We recommend at this stage that the parties also agree on the method to be used in determining the "Target", the scope of what assets and liabilities are included, how they are measured and any other special circumstances.

In the Due Diligence stage, the parties agree on what constitutes a normal level of working capital and set a "Target" or "Peg" amount of total working capital that will be conveyed. If the parties have agreed in the earlier LOI stage the basis for determining the "Target", this is a rather perfunctory step. If the parties haven't agreed up front on the basis for determining the "Target", a second negotiation is required to take place between the Buyer and Seller which can derail a closing and create ill-will.

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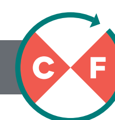

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At the Closing stage, a few days in advance of the closing the Seller estimates the level of working capital in the business and compares the amount to the "Target". The Purchase Price paid at the closing is adjusted to reflect the difference between the estimated working capital anticipated at closing and the "Target" agreed to in the earlier stage.

In the Post Closing stage, the Buyer counts all of the working capital that is received at closing, including all of the working capital assets and liabilities that become apparent with the passage of a couple of months' time. The actual working capital received is compared to the "Target" and any prior adjustment to the purchase price due to the estimated working capital at Closing.

At the Settlement stage, the Buyer shows the calculations and back-up to the Seller if there is some discrepancy between the Target and the actual working capital. If, by chance, there is disagreement amongst the parties regarding the working capital calculation or reconciliation, there is typically an arbitration process built into the purchase agreement. Once there is agreement, and if payment is due, one party settles the difference with the other through immediate payment.

To make these mechanics clear, allow us to provide an example of a manufacturing business that is the subject of an M&A transaction. For the purposes of this illustration, here is a summary of the transaction as described in the LOI:

Transaction Type: Asset Purchase and the Assumption of Certain Liabilities

Purchase Price: $35,000,000 Cash at Closing

Scope of Transaction: All assets of the business and the assumption of accounts payable and accruals
Debt Free & Cash Fee balance sheet with a normal level of working capital
Working capital to exclude payroll liabilities and taxes due for periods prior to Closing
Working capital target to be determined using LTM average method.

Project Sample Working Capital Analysis

Last Twelve Month Period ($ in thousands)	*Sept '19*	*Oct '19*	*Nov '19*	*Dec '19*	*Jan '20*	*Feb '20*	*Mar '20*	*Apr '20*	*May '20*	*Jun '20*	*Jul '20*	*Aug '20*	*LTM Average*
Working Capital Assets													
Accounts Receivable	$3,040	$2,900	$2,965	$3,355	$3,293	$3,642	$3,917	$4,211	$4,360	$4,238	$3,791	$4,059	**$3,648**
Inventory	1,010	1,056	1,210	1,350	1,015	1,250	1,300	1,020	1,157	1,140	1,200	1,012	**$1,165**
Total WC Assets	**$4,050**	**$3,956**	**$4,175**	**$4,705**	**$4,308**	**$4,892**	**$5,217**	**$5,231**	**$5,517**	**$5,638**	**$4,991**	**$5,071**	**$4,813**
Working Capital Liabilities													
Total Accounts Payable	$773	$566	$703	$1,312	$1,083	$972	$1,028	$1,327	$1,149	$873	$881	$1,102	**$981**
Total Accrued Liabilities	174	99	135	52	181	140	311	318	414	393	261	199	**$223**
Total WC Liabilities	**$947**	**$666**	**$838**	**$1,364**	**$1,264**	**$1,113**	**$1,339**	**$1,645**	**$1,563**	**$1,266**	**$1,142**	**$1,301**	**$1,204**
Net Working Capital	**$3,103**	**$3,290**	**$3,337**	**$3,342**	**$3,044**	**$3,779**	**$3,878**	**$3,586**	**$3,954**	**$4,371**	**$3,849**	**$3,770**	**$3,609**

The chart above shows the typical calculation of a Working Capital Target, by averaging the month-end balances for each of the working capital accounts over the last twelve-month (LTM) period. In this case, the average net working capital is $3.609 million, which would be the Target working capital to be delivered by the Seller at Closing.

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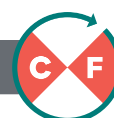

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Chart 1 – Example of the Comparison of Closing Working Capital to Target, with a negative adjustment

($ in thousands)	*Oct.2020*	*Target*	*Adjustment*
Working Capital Assets			
Accounts Receivable	$3,700	$3,648	
Inventory	1,010	1,165	
Total WC Assets	**$4,710**	**$4,813**	
Working Capital Liabilities			
Total Accounts Payable	$990	$981	
Total Accrued Liabilities	240	223	
Total WC Liabilities	**$1,230**	**$1,204**	
Net Working Capital	**$3,480**	**$3,609**	**($129)**

Assuming a closing of the transaction at the end of October of 2020, Chart 1 shows the determination of the Closing Working Capital and compared to the Working Capital Target. The result of this analysis is a $129 thousand reduction in the transaction purchase price due to the delivery of a shortfall of working capital.

Chart 2 – Example of the Comparison of Closing Working Capital to Target, with a positive adjustment

($ in thousands)	*Oct.2020*	*Target*	*Adjustment*
Working Capital Assets			
Accounts Receivable	$4,000	$3,648	
Inventory	1,010	1,165	
Total WC Assets	**$5,010**	**$4,813**	
Working Capital Liabilities			
Total Accounts Payable	$990	$981	
Total Accrued Liabilities	240	223	
Total WC Liabilities	**$1,230**	**$1,204**	
Net Working Capital	**$3,780**	**$3,609**	**$171**

Chart 2 shows the determination of the Closing Working Capital and the comparison to the Working Capital Target. The result of this analysis is a $171 thousand increase in the transaction purchase price due to the delivery of an abundance of working capital, which exceeds the working capital target.

Impact of "Cash-Free, Debt-Free" Calculation

It is most common that the transaction scope is described to include a balance sheet that is "cash free" and "debt free". This is purposeful, as it allows the Seller to benefit from incremental cash earnings and repayments of debt between the date of the LOI and closing. It reduces the impact of timing or short-term delays in Closing. In addition, the Buyer is indifferent as to how the Seller finances the business during the period, relying on invested cash or external debt.

It is important that the Seller look at the net cash/debt balance in conjunction with the working capital analysis above, as the changes might offset the net purchase price proceeds analysis completed after the closing working capital is determined.

Chart 3

($ in thousands)	*Oct.2020*	*At LOI*	*Difference*
Cash Balance	$750	$600	
Debt Balance	($350)	($350)	
Net Cash Balance	$400	$250	**$150**

In the case illustrated in Chart 3, we show the possible changes in the Net Cash Balance between the agreement of transaction terms in an LOI and a closing at the end of October. In this scenario, the business earned income over the period and, as a result, increased its cash balance. This ultimately benefits the Seller, as the cash proceeds of the transaction to the Seller is increased by $150 thousand. The Seller will retain this additional $150 thousand.

Chart 4

($ in thousands)	*Oct.2020*	*At LOI*	*Difference*
Cash Balance	$600	$600	
Debt Balance	($300)	($350)	
Net Cash Balance	$300	$250	**$50**

In this scenario, illustrated in Chart 4, we assume the business maintained its cash balance but reduced the debt balance by $50m through a scheduled payment. Again, the Seller benefits here as the cash proceeds of the transaction to the Seller is increased by $50 thousand. The Seller will retain this additional $50 thousand. So, in a cash-free, debt-free transaction, repayment of debt does not negatively impact a Seller.

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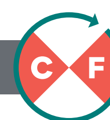

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Common scenarios and the likely impact for Buyer and Seller

1. Business earns income during the period between execution of the LOI and closing and reinvests in higher A/R balance or inventory balance. Leads to higher working capital delivered at Closing

a. *Buyer impact:* Receives more working capital at closing and must fund higher adjusted purchase price

b. *Seller impact:* Delivers more working capital at closing and receives higher adjusted purchase price and transaction proceeds

2. Business earns income during the period and it results in higher cash balances at Closing but the same Working Capital balance as the working capital target

a. *Buyer impact:* Receives anticipated working capital and funds anticipated purchase price

b. *Seller impact:* Seller retains higher cash balance, increasing its net total transaction proceeds

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3. Business retains cash and allows accounts payable to build up. The working capital delivered at closing is reduced as a result of the increase in accounts payable balance and is below the working capital target.

a. *Buyer impact:* Receives less working capital at closing than anticipated, so the purchase price is adjusted down as he/she will be required to fund additional working capital to operate the business normally;

b. *Seller impact:* The Seller has a higher cash balance due to the cash-free, debt-free construct, but this benefit is offset by the downward adjustment in the purchase price.

4. Business invests in assets such as capital equipment or other asset not included in working capital while the net working capital balance remains constant

a. *Buyer impact:* Receives the benefit of these additional investments

b. *Seller impact:* Cash balance is reduced without a corresponding increase in the purchase price, so there is a negative impact on net proceeds to the Seller in spite of doing what may be in the best interests of the long-term health of the business. (While this is not strictly a working capital issue, the impact is understandable in this context. There is value in addressing unusual capex plans prior to the execution of an LOI.)

5. Business decides to ship an order to a company in financial distress to generate revenue and it is ultimately determined during the working capital reconciliation process that a reserve needs to be set aside because the collection of the receivable is in doubt. The net working capital balance determined after reconciliation is below the working capital target

a. *Buyer impact:* Receives the benefit of a reduced purchase price

b. *Seller impact:* The Seller receives a reduced purchase price

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6. During the working capital reconciliation process, it is determined that $200k of the inventory delivered at closing is obsolete or not usable. As a result, the net working capital balance is determined to be below the working capital target

a. *Buyer impact:* Receives the benefit of a reduced purchase price, but may have to invest in working capital to support normal operations

b. *Seller impact:* The Seller receives a reduced purchase price

7. During the working capital reconciliation process, the Buyer determines that the Seller didn't appropriately accrue for certain payroll liabilities, like vacation accruals. As a result, the net working capital balance is determined to be below the working capital target

a. *Buyer impact:* Receives the benefit of a reduced purchase price, but may have to invest in working capital to support normal operations

b. *Seller impact:* The Seller receives a reduced purchase price, even though the operational aspect of the business delivered to the Buyer is no different than at the time of the LOI.

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