AN EXPERT VIEW – CORPORATE FUEL

PART 3:
Working Capital in Merger & Acquisition Transactions

Setting the working capital target and our recommendations on the best ways to document agreement on what constitutes working capital and the calculation methodology for the purposes of reconciliation

3

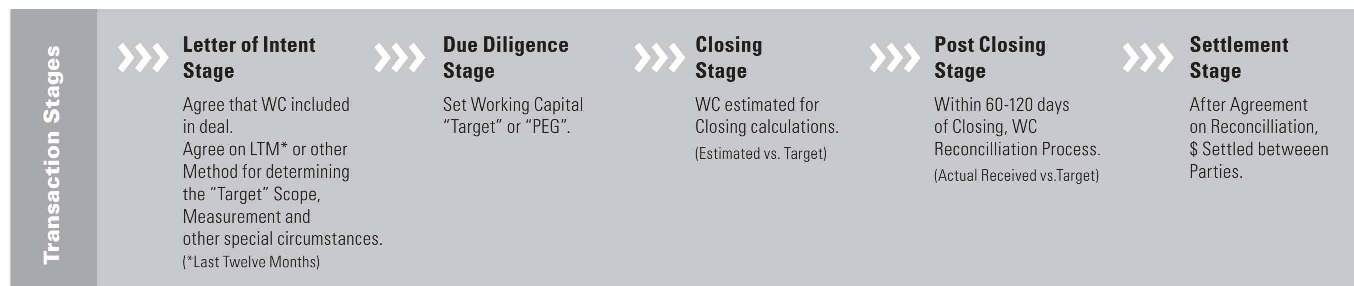
We continue with our series on Working Capital in M&A Transactions – Our expert views on how it works and what you can do to protect your interests through an M&A transaction.

In earlier parts of this series, we discussed why working capital is most often included in a business when it is sold and then covered the mechanics of including working capital and the impact of resulting changes on the Buyer and Seller.

In this section, we discuss the process of setting the working capital target, the typical and not-so-typical methods used and some of the potential risks of poor planning or lack of preparation.

Let us review the typical scope of an M&A transaction and the several stages of the transaction process and the related working capital activities. The typical scope of an offer made by a Buyer in a Letter of Intent to purchase a business is that it is on a "cash-free, debt-free basis and includes a normal level of working capital", sufficient to operate the business and its current activities.

At the time a Letter of Intent (LOI) is negotiated, you typically should agree on the scope of the transaction, how you will determine what constitutes a "normal level" of working capital and any special circumstances. Later, in the due diligence phase of the project, you typically set the Working Capital "Target" or "Peg".



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LTM (Last Twelve Months) Average Method

The most common method used to arrive at a Working Capital Target is to take the average month-end balances of each working capital account over the prior twelve months. Using the LTM average of each working capital account, you can then determine the Average Net Working Capital for that historical period. To be clear, you take the average of the current assets that are within the transaction scope and subtract the average of the current liabilities that are included in the transaction scope. The Target will an absolute number.
Here is an example:

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**

In this case, the LTM average of the Net Working Capital accounts is in the grey shaded area and the Target derived is \$3.609 million. That is, given normal operations, the Seller must deliver the business to the Buyer with at least \$3.609 million in working capital.

It is not uncommon that there have been changes in the business over the prior 12 months that make use of a LTM method somewhat problematic. For instance, if a business unit was sold 6 months earlier and the resulting change in the balance sheet profile was material, the parties may choose to adjust the approach. Another example might be if the business has adjusted its practices or activities in the prior twelve months, which materially impacted the balance sheet profile. For instance, what if a significant new client relationship was developed and the new client was awarded extended payment terms? Or, if management liquidated some aged and obsolete inventory, materially changing the inventory balance during the LTM period. All of these might cause the parties to adjust the methodology from a strict adherence to the LTM method. There is good reason to make the target as well-determined as possible. So, if there are reasons to make adjustments, do so and get agreement from your counterparty on the basis that it is the most accurate representation of the 'normal' level of working capital required to run the business at the time of the closing.

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We would recommend that you avoid three-month-average or six-month-average calculations, because they can mask seasonal or other working capital demands on the business. And, these shorter periods may inadvertently favor one party or the other.

It is not uncommon that in the sale of some smaller businesses, there are measurement and other special circumstances. That is, some smaller businesses do not adhere strictly to GAAP accounting standards, and the monthly balance sheets do not incorporate the necessary accruals and other liabilities that may be actual liabilities in the accounting sense. So, particular care should be taken to align the Target calculation with the methodology that is going to be used in the reconciliation process. For instance, if you set the target using balance sheets that don't include all of the necessary accruals, and then apply a GAAP standard in the reconciliation process – recognizing all of the necessary accruals, then the Closing Working Capital will be short of the Target, causing the purchase price to be reduced. We spend more time on these issues below, but they can have a material impact.

In the event that the business being sold is growing quickly, an alternative approach to the LTM method to set the Target may be used. In one approach, the amount of working capital at the end of each month over the prior 12-36 months is compared to the sales and costs of services/goods for each of those months. These percentages or factors are compared to the most recent month's sales/costs and a target is determined. The purpose of this approach is to most carefully align the amount of working capital delivered at closing with what is really required to support the business immediately after closing. If the LTM method had been used with a fast-growing business, it might have included old working capital levels and generally underestimate the amount of working capital that is currently used to support the business.

Our experience is that while there is good integrity in the use of this system, you must be careful to use an appropriate historical period when looking at building these statistics upon which you determine the Target. And, there can be no changes in accounting methodologies during the measurement period.

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

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