AN EXPERT VIEW – CORPORATE FUEL

PART 4:
Working Capital in Merger & Acquisition Transactions

Best practices and other important working capital issues to be mindful of in transaction management.

In this segment, we are going to review best practices and other important working capital issues to be mindful of in transaction management.

In earlier parts of this expert series of discussions, we addressed why Working Capital is often included in an M&A transaction, the mechanics of including working capital in a transaction and the setting of the working capital target and the calculations associated with the reconciliation just prior to closing and afterwards in the Post Closing stage.

Transaction Stages

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

To review, 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, you typically agree that a normal level of working capital is included in the business being traded. We recommend at this stage that you 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, you 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 you have agreed in the earlier LOI stage on the basis for determining the "Target," this is a rather perfunctory step. If you haven't agreed up front on the basis for determining the "Target," a second negotiation takes place between the Buyer and Seller which can derail a closing and create ill will.

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 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 prepares a closing balance sheet, "closing the books" as would done at the end of any regular accounting period and 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. (Unknown vendor liabilities or expense accruals may appear and a review of receivables and inventory may reveal uncollectable accounts or obsolete inventory.) 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.

AN EXPERT VIEW – CORPORATE FUEL

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, or if in the favor of the Buyer, by possibly reducing a pre-arranged working capital escrow account.

> **“Consider having the methodology used and the detailed working capital accounts included in the Target be incorporated in an illustration as an attachment or appendix to the Purchase Agreement.”**

In no particular order, here are some key issues to be mindful of when completing an M&A transaction that includes any element of working capital:

- Determine carefully whether all accounting practices used by Seller are in compliance with GAAP standard and if not, how is it different? This is extremely important. In almost all cases, the reconciliation and settlement are guided by a GAAP standard. So, if you set a working capital target based upon historical financial company presentations that are not in compliance with a GAAP standard and then guide reconciliation in accordance with a GAAP standards – you will inevitably confront an unintended result which will most often impact the Seller negatively;
- Ensure that the “Target” is determined using all of the accounts that will be included in the Estimated and Actual Working Capital; it is possible that a non-GAAP Seller gets caught here by not including all accruals in the working capital target. For instance, vacation accruals may impact Closing Working Capital, as not all small companies accrue for vacation benefits appropriately;
- If there are some working capital accounts that incorporate assets or liabilities that are influenced by affiliated or related-party relationships, be sure to consider these at the LOI stage, so that they are incorporated or excluded appropriately in the transaction scope and any target calculation. These may include non-operating items that are to be excluded from the transaction scope. So, they should be excluded from the calculation of the working capital target as well;
- In the event that the Seller has avoided reserving against uncollectible accounts or obsolete or slow-moving inventory, the Seller is best served to analyze the impact of recognizing these issues at the LOI stage and possibly excluding these items from the transaction so that they don’t inadvertently get caught at the reconciliation stage and reduce purchase price. (The obvious impact of recognition of a uncollectable account is that it might impact historical earnings which could be the basis of transaction valuation, so a thoughtful analysis is required.)
- Consider having the methodology used and the detailed working capital accounts included in the Target be incorporated in an illustration as an attachment or appendix to the Purchase Agreement. This is particularly important if the scope of what is included in working capital or if the Seller’s historical accounting approach is not entirely in accordance with GAAP standard. This is a simple but important technique that significantly reduces future disagreement;
- A Seller is best positioned to carefully prepare well in-advance and to review the variety of approaches for determining the Target, so that the discussions concerning the method and scope can be addressed in the LOI – eliminating any confusion or disagreement later in the process. We can’t recommend more strongly that this analysis is done by the Seller and its advisors before beginning the discussion of an LOI with a prospective Buyer;

AN EXPERT VIEW – CORPORATE FUEL

- While not strictly a working capital issue, be mindful of investments made in capital equipment between LOI and Closing, as it may diminish net cash proceeds retained by the Seller in a cash free/debt free transaction. This is one of most significant conflicts that exists between a Buyer and Seller. The more that is invested in capital equipment during the period of an LOI, the less cash proceeds that may be retained by the Seller. This is not necessarily what the Buyer wants, as the Buyer would desire the continued investment in what capital equipment is required to remain competitive. So, if there is a capital investment plan that incorporates a significant and unusual amount of capital expenditure, this should be discussed at the LOI stage and funded, in part by the Buyer;
- The presence of customer deposits (or prepayments for services to be delivered) and how to handle these through a transaction requires particular attention. It is not uncommon that a Buyer expects the customer deposit cash to be transferred to the Buyer at closing;
- Highly seasonal businesses, with working capital balances that fluctuate substantially, will require agreement on the treatment of working capital at the LOI stage. Unforeseen delays in closing should be anticipated in the transaction terms, if possible, so that the agreement can accommodate the varied seasonal closing outcomes;
- Challenges may exist if transaction scope includes cash or debt but not both. Our experience is that the M&A transaction is best contemplated where the funding decisions regarding the business do not impact the net proceeds to the Seller;
- While this may be self-evident to those who have read earlier parts of our series on working capital, it is very important that if there are assets or liabilities to be excluded from the working capital, be sure to exclude them in determining the "Target";
- Upfront work on impact of working capital prior to agreement on LOI tends to eliminate anxiety and consternation later in the process;
- If working capital target calculation and transaction scope are determined thoughtfully, the Buyer and Seller are generally indifferent to changes in these accounts and focus can be on future continuity of the business. Our experience is that transitions and transaction negotiations may have emotional moments. Any effort to moderate the impact of these challenges leads to a better outcome.

While this is not an inclusive list of best practices and considerations, it is a good start. We would welcome hearing about issues that other advisors and frequent transactors may have confronted in their experience and how we can guide those considering a transaction.

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

John C. Simons
Founder, Partner

646.572.0419
john@corporatefuel.com

Feel free to share this material with clients and friends.