Net Working Capital in M&A Transactions

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Agenda

1. How working capital is defined in an M&A transaction
2. Ways that working capital is measured and determined
3. Why working capital is important to buyers and sellers from a financial standpoint
4. Illustrations of different working capital scenarios

What is Working Capital?

Accountant definition

- The total of current assets of a business (including cash) minus the sum of current liabilities of a business (including current debt).

M&A transaction definition (Private Company middle market space)

- The total of current assets of a business (excluding cash) minus the sum of current liabilities of a business (excluding debt).
- May exclude specific items from the transaction as agreed upon by both parties in the purchase agreement based upon due diligence.
- Purpose is to determine the "normal" amount of working capital required to run operations.

Working Capital Considerations

What is <u>NOT</u> Working Capital

- Cash available to cover operating expenses in the near term
- Net operating future cash flows, for the next month or two

Cash and Debt

- Transactions are typically cash free and debt free
- Sellers keep their cash
- Seller keep their debt (generally paid off at closing)

Working Capital Should be Defined

- Purchase agreement should list any inclusions and exclusions
- Should be considered as early as possible during the diligence process

Polling Question

How is Working Capital Determined?

Assets	Balance Sheet	Working Capital
Cash	$ 500,000	N/A
Accounts Receivable	1,500,000	$1,500,000
Inventory	2,300,000	2,300,000
Prepaid Expenses	10,000	10,000
Total Current Assets	$4,310,000	$3,810,000

Liabilities	Balance Sheet	Working Capital
Accounts Payable	$ 850,000	$ 850,000
Accrued Expenses	750,000	750,000
Line of Credit	1,500,000	N/A
Current Portion of Debt	200,000	N/A
Total Current Liabiliites	$3,300,000	$1,600,000

Net Working Capital (NWC)	$ 2,210,000

Why is the Peg Important?

- Deals are commonly signed and closed on two different dates.
- In between the signing date and the closing date, the seller maintains ownership and can control working capital.
- A working capital peg is necessary to ensure the proper amount of working capital is delivered at closing.
- The working capital peg should be set at the appropriate level to maintain operations under normal business conditions.
- Buyers want to ensure that the amount of working capital included on the closing date is sufficient to maintain operations or is at the level they considered when negotiating the overall deal.

How is the Peg Measured?

Determine the benchmark period

- Examine working capital over a historical period of time.
- Consider seasonality of the business and the timing of close.
- Consider state of the business.
  - Has the Company recently taken off?
  - A longer benchmark period might not accurately represent future “normalized” operations going forward.

Benchmark Period Scenario # 1

Net Working Capital Analysis $ 000's	Jan-23	Feb-23	Mar-23	Apr-23	May-23	Jun-23	Jul-23	Aug-23	Sep-23	Oct-23	Nov-23	Dec-23	Avg. last 12 months	Avg. last 9 months	Avg. last 6 months	Avg. last 3 months
Accounts Receivable	1,450	1,600	1,630	1,472	1,435	1,478	1,490	1,492	1,488	1,500	1,490	1,480	1,500	1,481	1,490	1,490
Inventory	2,300	2,348	2,350	2,250	2,235	2,280	2,290	2,295	2,355	2,400	2,300	2,200	2,300	2,289	2,307	2,300
Prepaid Expenses	10	11	9	10	10	11	10	10	10	12	10	10	10	10	10	11
Total Current Assets	**3,760**	**3,959**	**3,989**	**3,732**	**3,680**	**3,769**	**3,790**	**3,797**	**3,853**	**3,912**	**3,800**	**3,690**	**3,810**	**3,780**	**3,807**	**3,801**
Accounts Payable	810	950	940	845	799	825	845	835	840	822	860	825	850	833	838	836
Accrued Expenses	720	730	745	755	760	759	715	750	775	799	735	755	$750	756	755	763
Total Current Liabiliites	**1,530**	**1,680**	**1,685**	**1,600**	**1,559**	**1,584**	**1,560**	**1,585**	**1,615**	**1,621**	**1,595**	**1,580**	**1,600**	**1,589**	**1,593**	**1,599**
Reported NWC	**$2,230**	**$2,279**	**$2,304**	**$2,132**	**$2,121**	**$2,185**	**$2,230**	**$2,212**	**$2,238**	**$2,291**	**$2,205**	**$2,110**	**$2,210**	**$2,192**	**$2,214**	**$2,202**

Fact Pattern:

- Deal is being completed on a cash-free, debt free basis.
- Reported working capital excluding cash and debt can be used as the basis for the reported working capital.
- 2023's operations have been consistent and are expected to yield similar results in 2024 around the closing period.
- The seller's operations are not impacted by any seasonality and there were no diligence adjustments.

Polling Question

High Growth Scenario #2

Net Working Capital Analysis $ 000's	Jan-23	Feb-23	Mar-23	Apr-23	May-23	Jun-23	Jul-23	Aug-23	Sep-23	Oct-23	Nov-23	Dec-23	Avg. last 12 months	Avg. last 3 months
Accounts Receivable	1,450	1,523	1,599	1,679	1,762	1,851	1,943	2,040	2,142	2,249	2,362	2,480	1,923	2,364
Inventory	2,300	2,415	2,536	2,663	2,796	2,935	3,082	3,236	3,398	3,568	3,746	3,934	3,051	3,749
Prepaid Expenses	10	11	11	12	12	13	13	14	15	16	16	17	13	16
Total Current Assets	**3,760**	**3,948**	**4,145**	**4,353**	**4,570**	**4,799**	**5,039**	**5,291**	**5,555**	**5,833**	**6,125**	**6,431**	**4,986**	**6,130**
Accounts Payable	810	851	893	938	985	1,034	1,085	1,140	1,197	1,257	1,319	1,385	1,074	1,320
Accrued Expenses	720	756	794	833	875	919	965	1,013	1,064	1,117	1,173	1,231	$955	1,174
Total Current Liabiliites	**1,530**	**1,607**	**1,687**	**1,771**	**1,860**	**1,953**	**2,050**	**2,153**	**2,261**	**2,374**	**2,492**	**2,617**	**2,029**	**2,494**
Reported NWC	**$2,230**	**$2,342**	**$2,459**	**$2,582**	**$2,711**	**$2,846**	**$2,988**	**$3,138**	**$3,295**	**$3,459**	**$3,632**	**$3,814**	**$2,957**	**$3,635**

Fact pattern is the same as Scenario #1 except for the following items:

- Seller has experienced significant growth during the last twelve months in 2023.

Conflicting Perspectives

<u>Buyer Perspective</u>:

- Buyers are concerned that insufficient working capital will be delivered on closing date.
- If this is the case, then the buyer may need to infuse additional working capital shortly after taking ownership.
  - Effectively increasing the cost of the transaction.
- ***<u>Buyers</u>*** are incentivized to set the PEG as ***<u>high</u>*** as possible.

<u>Seller Perspective</u>:

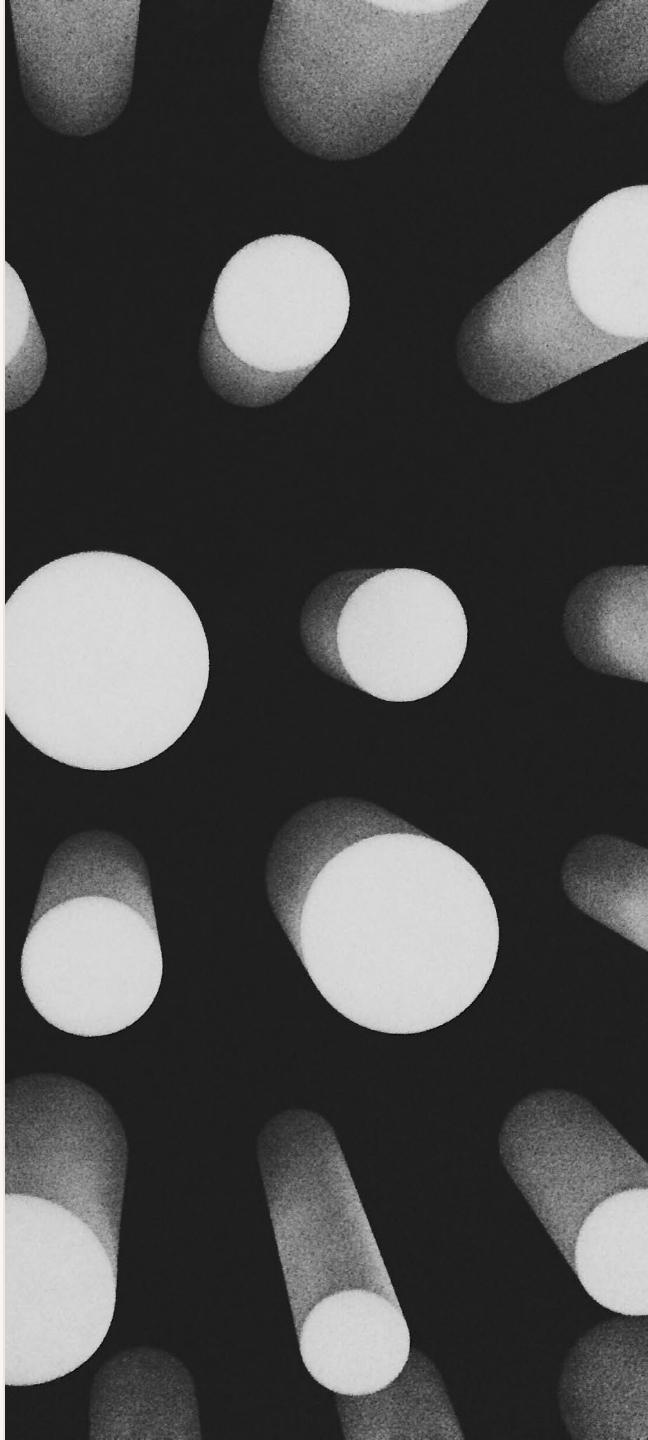
- Sellers are concerned about leaving too much working capital in the business as of the closing date.
- Excess profits may be trapped on the balance sheet due to timing.
  - E.g. - Slow paying customer right around the closing the date
- ***<u>Sellers</u>*** are incentivized to set the PEG as ***<u>low</u>*** as possible.

Diligence Adjustments

- Reported working capital and actual normalized working capital can result in various differences
- Some common diligence adjustments include:
    - Recognition issues
        - Monthly versus annual accounting
        - Cash basis versus accrual
    - Accounts receivable collection issues
    - Obsolete inventory
    - Understated or omitted accrued expenses
    - Overdue vendor payables
    - Related party transactions

Scenario #1 Adjusted

Assets	12-month avg.	Working Capital
Cash	$ 500,000	N/A
Accounts Receivable	1,500,000	$1,500,000
Inventory	2,300,000	2,300,000
Prepaid Expenses	10,000	10,000
Total Current Assets	$4,310,000	$3,810,000
Liabilities	**12-month avg.**	**Working Capital**
Accounts Payable	$ 850,000	$ 850,000
Accrued Expenses	750,000	750,000
Line of Credit	1,500,000	N/A
Current Portion of Debt	200,000	N/A
Total Current Liabiliites	$3,300,000	$1,600,000
Reported Net Working Capital (NWC)		$2,210,000
Diligence Adjustments	**12-month avg.**	
Uncollectible receivables	$ (150,000)	$ (150,000)
Total diligence adjustments	$ (150,000)	$ (150,000)
Adjusted Net Working Capital (NWC) Peg		$2,060,000



Polling Question

Closing Statement and the NWC Reconciliation

- Actual working capital is later calculated as of the closing date, 30 to 90 days post-closing when actual financial data is available.
- This process is referred to as the working capital reconciliation or true-up adjustment.
- Details of which accounts are to be included/excluded from the NWC calculation should be documented in the purchase agreement to avoid future disputes during this reconciliation process.

NWC Example A Reconciliation

Fact Pattern:

- Peg was set to $2,060,000 based upon the adjusted average NWC for last twelve months.
- Seller operated consistently with past practices.
- Seller delivered working capital greater than the targeted working capital due to an overall increase in accounts receivable and inventory at the closing.
- Payable balances were consistent.

NWC Example A Reconciliation

Assets	**Closing Balances**	**Working Capital**
Cash	$700,000	N/A
Accounts Receivable	1,400,000	$1,400,000
Inventory	2,425,000	2,425,000
Prepaid Expenses	10,000	10,000
Fixed assets, net	1,700,000	N/A
Goodwill	1,000,000	N/A
Total Assets	$7,235,000	$3,835,000
Liabilities	**Closing Balances**	**Working Capital**
Accounts Payable	$825,000	$825,000
Accrued expenes	750,000	750,000
Line of credit	-	N/A
Buyer equity	5,660,000	N/A
Total liabilities and Equity	$7,235,000	$1,575,000
Actual closing working capital		2,260,000
Target working capital (Adjusted example)		2,060,000
Due To (From) Seller		200,000
Plus Cash at closing		700,000
Net due to (from) Seller		$ 900,000

NWC Example B Reconciliation

Fact Pattern is consistent with Example A except for the following:

- Cash decreased to $200,000 at the closing period and accounts receivable increased to $1.9 million due to a customer not paying timely.
- This generated working capital significantly greater than the established peg.

NWC Example B Reconciliation

NWC Reconciliation Example A

Assets	**Closing Balances**	**Working Capital**
Cash	$700,000	N/A
Accounts Receivable	1,400,000	$1,400,000
Inventory	2,425,000	2,425,000
Prepaid Expenses	10,000	10,000
Fixed assets, net	1,700,000	N/A
Goodwill	1,000,000	N/A
Total Assets	$7,235,000	$3,835,000
Liabilities	**Closing Balances**	**Working Capital**
Accounts Payable	$825,000	$825,000
Accrued expenes	750,000	750,000
Line of credit	-	N/A
Buyer equity	5,660,000	N/A
Total liabilities and Equity	$7,235,000	$1,575,000
Actual closing working capital		2,260,000
Target working capital (Adjusted example)		2,060,000
Due To (From) Seller		200,000
Plus Cash at closing		700,000
Net due to (from) Seller		$ 900,000

NWC Reconciliation Example B

Assets	**Closing Balances**	**Working Capital**
Cash	$200,000	N/A
Accounts Receivable	1,900,000	$1,900,000
Inventory	2,425,000	2,425,000
Prepaid Expenses	10,000	10,000
Fixed assets, net	1,700,000	N/A
Goodwill	1,000,000	N/A
Total Assets	$7,235,000	$4,335,000
Liabilities	**Closing Balances**	**Working Capital**
Accounts Payable	$825,000	$825,000
Accrued expenes	750,000	750,000
Line of credit	-	N/A
Buyer equity	5,660,000	N/A
Total liabilities and Equity	$7,235,000	$1,575,000
Actual closing working capital		2,760,000
Target working capital (Adjusted example)		2,060,000
Due To (From) Seller		700,000
Plus Cash at closing		200,000
Net due to (from) Seller		$ 900,000

NWC Example C Reconciliation

Fact Pattern is consistent with Example A except for the following:

- Seller convinced its customers to paydown their receivables early, resulting in more cash received and less outstanding receivables at the closing period.
- Seller decided to not replenish its inventory consistent with past practices.
- The seller also has not been paying their vendors back timely and has grown its accounts payable balance at the closing period.
- The seller delivered significantly less working capital at the closing versus the established peg.

NWC Example C Reconciliation

NWC Reconciliation Example A

Assets	**Closing Balances**	**Working Capital**
Cash	$700,000	N/A
Accounts Receivable	1,400,000	$1,400,000
Inventory	2,425,000	2,425,000
Prepaid Expenses	10,000	10,000
Fixed assets, net	1,700,000	N/A
Goodwill	1,000,000	N/A
Total Assets	$7,235,000	$3,835,000
Liabilities	**Closing Balances**	**Working Capital**
Accounts Payable	$825,000	$825,000
Accrued expenes	750,000	750,000
Line of credit	-	N/A
Buyer equity	5,660,000	N/A
Total liabilities and Equity	$7,235,000	$1,575,000
Actual closing working capital		2,260,000
Target working capital (Adjusted example)		2,060,000
Due To (From) Seller		200,000
Plus Cash at closing		700,000
Net due to (from) Seller		$ 900,000

NWC Reconciliation Example C

Assets	**Closing Balances**	**Working Capital**
Cash	$3,200,000	N/A
Accounts Receivable	400,000	$400,000
Inventory	1,425,000	1,425,000
Prepaid Expenses	10,000	10,000
Fixed assets, net	1,700,000	N/A
Goodwill	1,000,000	N/A
Total Assets	$7,735,000	$1,835,000
Liabilities	**Closing Balances**	**Working Capital**
Accounts Payable	$1,325,000	$1,325,000
Accrued expenes	750,000	750,000
Line of credit	-	N/A
Buyer equity	5,660,000	N/A
Total liabilities and Equity	$7,735,000	$2,075,000
Actual closing working capital		(240,000)
Target working capital (Adjusted example)		2,060,000
Due To (From) Seller		(2,300,000)
Plus Cash at closing		3,200,000
Net due to (from) Seller		$ 900,000

Polling Question

Key Takeaways

- There are different definitions of net working capital that exist
- Net working capital should be defined and considered early in the diligence process
- Buyers and sellers have different objectives for net working capital
- The net working capital peg should represent normalized operations
- The delivered net working capital versus the established peg impacts the purchase price

Questions?

Contact the Presenters

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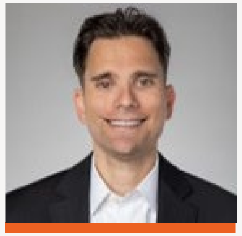

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