

Working Capital: Why Does it Matter?

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September 2010

You are selling your business, and all of your ducks are in a row. You hired an investment bank, they wrote an investment memorandum, solicited bids, and found a buyer willing to pay you a hefty sum for all of the blood, sweat and tears you invested in the business over the last umpteen years. You passed all of the tests during due diligence, and are negotiating the finer points of the purchase agreement. The finish line is in sight. And now you learn about the working capital peg.

The working capital target (also known as a “peg” or “true-up”) is an important part of an acquisition where millions of dollars are at stake, is poorly understood by many, and is typically left until later stages of the deal. Very often, sellers leave significant amounts of money on the table (to the benefit of the buyer) as a result of not understanding and addressing the working capital issue earlier in the acquisition process. In fact, sellers would be best suited to understand the impact of working capital well before they begin the process of selling their company. Below I explain the ins and outs of how working capital can have a big impact on how much cash you take home after you sell your business.

What is working capital?

This is not a trick question. We all generally know what working capital is. In general, it is a measure of operating liquidity available to a business at a given point in time, and is calculated as current assets less current liabilities. For practical purposes, there are typically four balance sheet accounts that represent the largest entries: cash, accounts receivable (“A/R”), inventory (“INV”) and accounts payable (“A/P”). I will dive into further detail on these four accounts, but will touch on other potential areas as well.

Working capital is required to run the day to day operations of a business. It is as essential to running a business as the employees and physical assets. While some businesses can operate on negative working capital (current liabilities greater than current assets), such as subscription-based media companies or other firms that require large up-front payments from their customers, most firms have positive working capital requirements that grow along with the business.

Most acquisitions are structured as acquisitions of stock or assets on a cash-free, debt free basis. In other words, the buyer acquires a business that typically has no financial debt and limited or no cash in the operating account. Buyers often require that a minimal amount of cash be left in the business so that short term needs can be met without drawing on an interest-bearing revolving facility or potentially delaying vendor payments or payroll. Net working capital (“NWC”) is working capital less excess cash.

Why does working capital matter?

From the buyer perspective, working capital has two important implications, one relating to the acquisition purchase price and the other relating to the ongoing cash flows of the business. I’ll handle the second issue first.

Cash Flow Implications

Working capital is a real investment in the business and, like the important machinery or computer hardware, cannot be fully liquidated without a serious negative impact on the business. Also, working capital accounts tend to grow as the company’s revenues increase.

For example, let’s assume that in year 1, I generated \$100 of revenue and \$20 of EBITDA, and I had \$30 of AR, \$30 of INV and \$20 of A/P, for NWC of \$40. That’s \$40 of value locked in NWC that I need for my business to run properly. Now let’s assume that in year 2, my revenues and EBITDA double to \$200 and \$40, respectively. What should I expect to happen to the NWC? All else equal, NWC should increase at a similar rate as revenues, so NWC should double to \$80. That’s an additional \$40 investment in the business. A/R and A/P should increase assuming that payment terms from customers and vendors have not

changed. Inventory levels typically increase in line with revenues as businesses require more stock to service their customers without risking stockouts. As a result, while revenues and profits have increased materially over the course of the year, one has to consider the impact of NWC to understand the cash flow result. So while I am now making \$40 in annual EBITDA, I had to invest an additional \$40 in NWC to get to that level. Staying at the same level in year 3 will not require additional investment, but it did cost me an investment in NWC to obtain the growth.

In light of the above, it is critical for business owners to understand the impact of working capital on their cash flows. Through monthly tracking of collections, payments, and inventory levels, business owners can minimize the amount of money locked up in working capital and obtain higher prices for their businesses. Sophisticated buyers will factor NWC needs into their models and, all else equal, will pay more for businesses that require less NWC.

Purchase Price Implications

In most all cases, net working capital stays with the business in an acquisition and is acquired by the buyer. A purchase price is determined at a certain point early in the negotiation, yet closing typically takes many months after that agreement on price. Working capital levels fluctuate over time for a variety of business reasons, such as seasonality, changes in customer demand, changes in payment terms, addition of new product lines, and geographic expansion, to name a few. The buyer wants to ensure that on the day of closing, there is sufficient working capital to run the business, and that there will not be a need to invest additional money into the business soon after closing as a result of irregular activity by the seller in the months leading up to closing.

The level of working capital in a business can change for legitimate business reasons as well as artificial manipulation by the seller. The goal of the working capital mechanism is twofold: (a) to ensure that the business had the appropriate level of working capital based on the average working capital needs of the business throughout course of a year, and (b) to prevent the seller from manipulating working capital accounts to drain the business of its critical NWC assets. Below, I walk through the major working capital accounts and what could cause a buyer to become concerned.

1. **Cash:** Cash is typically excluded from the sale of the business, and the seller is permitted to take all cash out of the bank account some point prior to or at closing. Sometimes, the buyer may request that some amount of operating cash be left in the business for day-to-day needs. Cash is controlled completely by the seller until the day of closing, and relates to activities prior to closing, so is typically excluded from the purchase as well as from the working capital mechanism altogether.
2. **Accounts receivable:** A/R represents outstanding customer invoices. A/R typically rises and falls simultaneously with revenues, assuming static average payment terms from customers. If the business is sold in a particularly busy time of year, one would expect a higher level of A/R in the business; the converse is true for slow periods of the year. Sellers have the ability to pursue outstanding A/R more aggressively or offer discounts for quick payment in the interest of collecting more cash prior to closing, which would increase cash proceeds.
3. **Inventory:** A business typically has an equilibrium level of inventory required to provide a satisfactory level of service to its clients. Businesses typically increase inventory levels in advance of increases in revenue. A seller wishing to maximize cash proceeds would stop replenishing inventory stock in the weeks leading up to a closing so as to minimize the cash investment and maximize cash proceeds at closing.
4. **Accounts payable:** Accounts payable rise with overall business activity. A seller seeking to maximize cash could simply stop paying creditors, or pay more slowly than they would like, running the risk of damaging supplier relationships and being cut off from key suppliers.
5. **Other accounts:** There are also other accounts that are included in a working capital calculation, such as prepaid expenses, deposits, accrued expenses and accrued taxes, but they are typically smaller accounts and less likely to be manipulated. Depending on the type of business, they may be included or excluded, but often have a lesser impact on the negotiation.

The Working Capital Peg

In light of the ability of a seller to manipulate the various working capital accounts in the months leading up to a transaction closing, buyers insist on setting up a working capital target, or peg. A peg is typically a fixed dollar amount that is determined based on historical levels of working capital in the business. Shortly after closing, a third party is hired to assemble a closing balance sheet, and then the actual net working capital delivered at closing can be calculated. To the extent that the actual net

working capital exceeds the target, then the seller is owed the difference in a cash payment. If the business shows a deficit relative to the target, then the seller owes the buyer the difference. Due to unpredictable nature of sales, billing, and collections, there is always a payment one way or another, also known as the post-closing “true-up”.

The goal with a working capital peg is to determine the appropriate level of working capital that the business needs - no more, no less. Reasonable people can disagree about what is fair, but as a business owner, you know better than anyone what the business requires. The buyer, however, only has one source of reliable information – the monthly historical balance sheets that show what you actually booked over time. Therefore, the historical monthly accounts are used to set the peg.

However, there is still a lot of room for negotiation in two areas: how to define NWC, and how to calculate the peg. There is seldom controversy around the definition of NWC, but it should be carefully defined to exclude any accounts that are not current accounts or are not related to the ongoing business. It should also exclude interest-bearing liabilities, even if short term. Sometimes, buyers wish to exclude A/R over a certain age or old inventory that is no longer useful to the business to focus on what is most valuable to the buyer.

How to Set the Peg

There are a number of methods that can be used to set the peg, and, in general, the more detailed information you have, the better prepared you can be to agree on a fair peg. The most common method for determining a peg is a 12-month historical average. Looking at an average of the monthly NWC over the past year should give a fair view of the NWC required to run the business since this timeframe takes into account any seasonality and abnormally high or low individual months.

There are a few special cases where an annual average may not be appropriate:

- High growth businesses: If a business has been growing very rapidly, then taking a simple average of the latest twelve months may understate the amount of working capital needed to run the business. In that case, it may make sense to use a 12-month weighted average, or an average based on the latest 6 month period, or even latest 3 month period.
- Negative working capital businesses: In many publishing or media businesses, there is negative NWC, which grows more negative over time. In this case, the parties can agree to set the target at zero, with a true-up payment from the buyer to the seller post-closing to make up the difference.

Getting to a Fair Solution

As is the case with most deal points, the seller has the most leverage prior to LOI stage, when there are multiple bidders, and sellers lose significant leverage after granting exclusivity to a single buyer. Therefore, to the extent that some agreement can be obtained around the general parameters of the NWC mechanism upfront, that will avoid confrontation and/or value-loss down the road.

To stay ahead of the issue, a seller and its advisers should analyze historical monthly balance sheets and calculate rolling multi-month averages over the past 24 months. Calculate averages based on 2, 3, 4, 5, 6, etc, all the way through 24 month historical averages to see which averages result in the lowest (most favorable) and highest (least favorable) results. This way, you can control the negotiation and enter it knowing which methods will produce the most favorable results. Also, sellers should forecast the major balance sheet accounts to see how NWC is trending and what the true-up might be at closing. This will hopefully help you avoid surprises and keep you focused on maximizing your operating efficiency all the way through closing.