Deal Me In

The Importance of Working Capital Management in a Transaction

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One of the most difficult transaction advisory concepts to explain to an owner/seller is working capital and how it can influence the amount received in a sale transaction. Beyond the pure accounting definition of working capital, the working capital target or "peg" and associated true-ups can be confusing. Mostly, this is due to the inherent complexities that arise and that determining a peg is often more of an art than a science.

What Exactly is Working Capital?

> **From an accounting perspective, working capital is defined as current assets minus current liabilities, as derived from a company's balance sheet.**

Fundamental to this calculation is the appropriate classification of assets and liabilities as long-term or current. Perhaps the easiest way to think about this is that a current asset or current liability is expected to convert to cash or result in a cash outlay over the course of 12 months from the balance sheet date.

Accounts receivable and accounts payable; for example, are two common types of current assets and liabilities that would be expected to impact cash within a 12-month period. Items such as rent deposits need to be examined to determine whether a current classification is indeed appropriate.

The accounting definition; however, is just the starting point for calculating working capital in a transaction. Inherent in most deals that involve the sale of an owner's equity interest, is that the transaction is on a cash-free, debt-free basis. Thus, cash and funded debt are excluded from the calculation of working capital. That is, the buyer does not assume the seller's funded debt or keep any of the cash.

Other items that are commonly excluded from the transaction-based calculation of working capital (the "Transaction Working Capital") include any federal or state income taxes payable or receivable, amounts due the owner/seller, interest payable, amounts payable resulting from transaction-related costs or bonuses, and related party transactions or transactions which are not at arm's length.

> **One of the more complicated areas that can arise for technology companies is the treatment of deferred revenue.**

For subscription-based businesses, cash is typically received in advance of the obligation to perform a service. Although the seller will receive the cash, the buyer is nevertheless responsible for funding the downstream obligation created by the subscription agreement.

Buyers will frequently seek to have deferred revenue carved out of the working capital calculation and treated as debt. While it can be advantageous for the seller to treat deferred revenue as a component of working capital, compromise is often warranted. Ideally, whether treated as a component of working capital or carved out as debt (and paid for by the seller as a reduction of purchase price), the seller should seek to have the obligation reflect the actual cost of the future obligation as this may be a fraction of the deferred revenue balance.

Why Does Working Capital Matter?

> **A seller is typically expected to provide a buyer with a "normalized" amount of working capital as of the closing date of a transaction.**

This is important to the buyer as the working capital left by the seller will be used to support the operations of the business post-close. If a buyer does not have an adequate amount of net working capital, short-term needs must be identified and funded. While it is not unusual for a buyer to infuse some amount of cash into the business post-close, an inadequate level of working capital can effectively result in an additional cost for the buyer.

Calculation and Negotiation of the Peg

The starting point for the calculation of the peg is the accounting-based working capital calculation as adjusted for specific transaction-related impacts, such as the elimination of cash, current portion of funded debt, owner payables, etc. Typically, it is important to review the calculation on a month-over-month trailing 12-month basis, starting with the most recent month-end close and looking backward for a period of 12-18 months.

> **From a seller's perspective, anomalies should be identified, eliminated or normalized, inclusive of one-time transactions, unusual terms or conditions related to receivables/payables that will not be applicable to the buyer post-sale, etc.**

Also, it is crucial to examine the uniform application of the seller's accounting principles over this period because changes can potentially impact the working capital calculation. A rolling 12-month average is then calculated so that trends can be identified. Peaks or valleys may indicate that additional normalization is warranted or that the results are from normal seasonal flow, industry trends or business growth.

Regardless, further analysis may be warranted. Historical trends, as adjusted for the above, will create a basis for the establishment of the peg. Once the peg is established, the parties will include the definition of Transaction Working Capital and the peg amount in the definitive purchase agreement. A careful review of these provisions is warranted to ensure that the document adequately reflects the understanding between the parties. The clearer and more detailed the definition of Transaction Working Capital is and the items included or excluded in the calculation, the less likely a dispute or litigation will arise post-transaction.

> **From a deal perspective, it is advantageous for the seller to take the lead in establishing and negotiating the peg.**

Buyers will typically engage a firm to perform a Quality of Earnings analysis that will include an analysis of working capital. As is the case with many buy-side advisors, they will be highly incentivized to demonstrate value by identifying and driving a higher peg. Compromise will frequently be required as the two sides work together to reach an agreement on the peg amount.

After the peg is determined, changes in Transaction Working Capital relative to the peg frequently result in a timing difference versus a permanent impact on purchase price. For instance, an increase in sales volume may create higher than anticipated accounts receivable. This could result in working capital at close exceeding the peg and an increase to the amount paid at closing because the seller is delivering working capital in excess of the peg amount. While the buyer may be impacted at close, as the receivables are paid and cash is received post-closing, the buyer is placed in a cash-neutral position relative to the additional amount paid.

Close and Settle-up

In addition to the peg amount and definition of Transaction Working Capital, the purchase agreement will contain a mechanism to assess the impact of working capital at close and the ultimate settle-up of the working capital balance. Typically, to facilitate the close, a good faith estimate of Transaction Working Capital as of the close date is calculated by the seller, and the difference between the peg and estimate is treated as an adjustment of the purchase price. If the estimated Transaction Working Capital exceeds the peg, the excess is treated as additional purchase price. Conversely, if the estimated Transaction Working Capital is less than the peg, the deficit is treated as a reduction in purchase price.

> **Since the amount of Transaction Working Capital at the close is based on an estimate, it is standard practice for the purchase agreement to include a mechanism for the true-up of the balance once the amount of Transaction Working Capital can be definitively calculated.**

Some 60 or 90 days post-close, the buyer will prepare and provide the seller with a calculation of the actual Transaction Working Capital as of the close date.

The seller will have an opportunity to review the calculation and assuming it is in agreement, the delta between the amount of estimated Transaction Working Capital as of the close date and the actual Transaction Working Capital is paid to either the buyer or seller (paid to the seller if actual is greater than the estimate and paid to the buyer if actual is less than the estimate). Frequently, an escrow will be carved out of the purchase price to protect the buyer if the actual Transaction Working Capital turns out to be less than the amount estimated at closing.

As an alternative to, or in order to, limit the amount of escrow, a buyer and seller may negotiate a working capital collar. A working capital collar establishes a floor and ceiling amount. The floor represents the minimum amount that the seller is to deliver at close, and the ceiling is the maximum amount. This can be useful to facilitate the settle-up process. If the actual amount of Transaction Working Capital falls within the collar, no amount is due to the buyer or seller, and the escrow is released.

The Benefits of Working Capital Management

> **Effective working capital management can result in tangible benefits at the time of the sale.**

By promoting working capital management and improving the cash conversion cycle, the working capital peg can be minimized (and cash maximized), while also creating efficiencies within the business. Typical strategies include improving collections, payables and inventory management. Since trending in establishing the peg is a key consideration, effective working capital management should be initiated well in advance of the sale of the business. This exercise will also create additional value in the business that can be realized upon the sale.

How Can Schneider Downs Help?

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With a focus on middle-market organizations, our team has the collective business, industry and technical expertise necessary to help clients understand their options and achieve successful outcomes, whether the goal is buy-side, sell-side or post-merger integration.

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