ShareVault Primer

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Understanding Working Capital in M&A Transactions

In most M&A transactions, the parties arrive at a purchase price by multiplying the target company's earnings before interest, taxes, depreciation, and amortization (EBITDA) by an agreed-upon multiple. While this is generally true, it's only part of the story. Buyers will also typically include certain protections such as indemnification provisions, a third-party escrow or other holdbacks, and very often a requirement for a minimum amount of "working capital" on the balance sheet when the deal closes to ensure there are no immediate liquidity issues. Working capital is critically important in the operation of a business and is often implicit in determining a company's value.

Working capital is calculated by subtracting a business' current liabilities from its current assets **(current assets – current liabilities = working capital)**. For example, if a company has $60,000 in current assets and $20,000 in current liabilities the working capital of the business is $40,000.

Working capital can also be presented as a ratio. To calculate a working capital ratio, the company's current assets are divided by its current liabilities. For example, if the company has $60,000 in current assets and $20,000 in current liabilities then the business' working capital ratio would be 3. **This ratio represents how many times the company can pay off its current liabilities using its current assets and is often used to measure the short-term financial well-being of the business.** A company with a low ratio (close to one or less) may be experiencing financial difficulties.

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Negotiating working capital in an M&A transaction requires two basic elements. First, the two parties must agree on the working capital amount. Second, they must agree on the formula for calculating working capital at closing and in the true-up.

The process may seem simple, but it can actually be quite complex. Buyers and sellers often negotiate an acquisition on a cash-free, debt-free basis. In these cases, cash, lines of credit and notes payable are all excluded, so the purchase agreement must fully define which current assets and liabilities are being acquired that will comprise the deal's working capital. These assets and liabilities might include, but are not limited to, bank overdrafts, loans due from owners, officers or employees, prepaid investment banker fees, customer deposits, deferred revenues and deferred taxes.

CALCULATING WORKING CAPITAL

Working capital can be vary greatly different for different companies, even those in the same industry. For instance, a business that relies heavily on seasonal sales might have far different working capital at the time of closing than it did when negotiations began or when the letter of intent was executed. As a result, working capital is often calculated by analyzing the firm's working capital over the trailing twelve months and taking an average.

However, a twelve-month average may not fairly represent the working capital needs of a rapidly growing company. With business growth, receivables and inventories may increase each month, requiring working capital to grow as well. In these cases, it may be more appropriate to calculate working capital based on an average of only the last three months.

It's also possible for a business to have negative working capital. **Negative working capital is when a company's current liabilities exceed its current assets.** This means that the liabilities that need to be paid within one year exceed the current assets that are monetizable over the same period.

Generally, negatives are bad, but with working capital it doesn't have to be. If a company typically receives payment before a product or service is delivered, the company may operate with negative working capital. Dell Computers used this business model for years, collecting cash up-front, but paying suppliers later. However, when a business operates with negative working capital, there are often more discussions during negotiations about some, or all, of the cash being left in the business at the time of the sale.

One more complexity when calculating working capital is when working capital is erratic. **Working capital numbers can be erratic when customers change payment habits or terms, customer payments are large and infrequent, companies acquire inventory in large lots, or there are changes in payment patterns to vendors.**

Here are some things to consider when establishing a working capital target:

- What is normal for the industry?
- What is working capital as a percentage of sales?
- What special circumstances cause the company's working capital to vary from normal levels?
- How significantly does inventory vary on a month-to-month basis?
- How is working capital affected by seasonal sales?
- AreIs the business and its working capital needs growing?

Working capital is a critical component in the operation of a business, works as a barometer of the company's health, and is often a significant factor in determining a company's value. However, the textbook definition of working capital (current assets - current liabilities = working capital) is modified in most deals. **Negotiating all the details of the working capital definition and adjustment is complex and often creates difficult negotiations and complicates the closing process. Sometimes the final settlement is just left to resolution after the sale when dispute mechanisms are employed.**