Working Capital Considerations in Middle Market M&A

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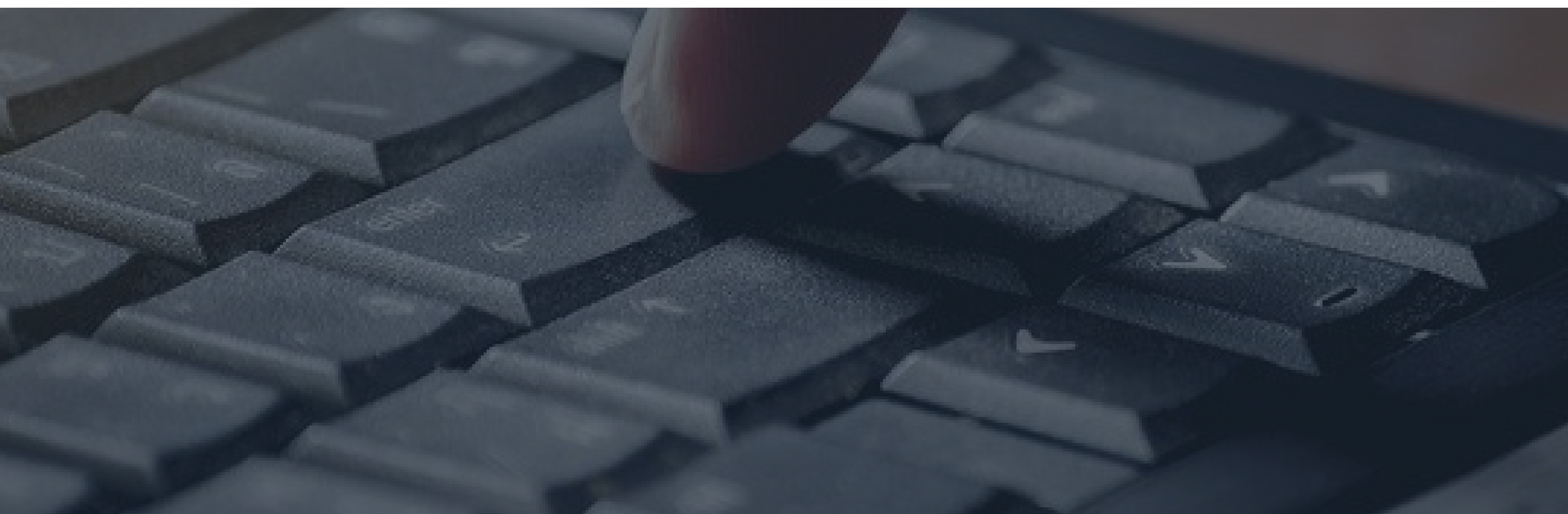
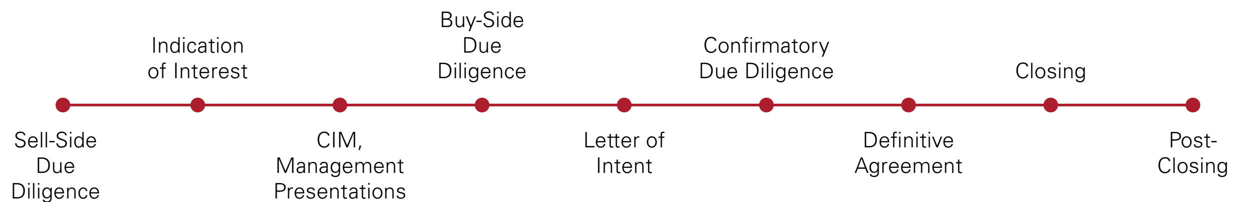


1. M&A Process Overview

From start to finish, middle market M&A transactions can take anywhere from a few months to over a year to get to closing. Events and steps that typically occur along the way are depicted in the timeline below.



The M&A process above is a generalized depiction for illustrative purposes. It is not all-inclusive, and the actual timeline of events depends on a variety of factors, including how and by whom the sell-side process is being run.

SELL-SIDE DUE DILIGENCE:

While certainly not a requirement, many sellers go through a sell-side or anticipatory due diligence process. This may focus heavily on financial due diligence, and in particular a Quality of Earnings, or QoE, analysis. Investing in a sell-side due diligence analysis offers the Seller a number of returns, including but not limited to: (i) identifying and mitigating material issues without buyer involvement; (ii) avoiding unexpected adjustments to reported earnings that sometimes upend transactions in the late innings; and (iii) gaining a firm grasp on working capital considerations. By performing this work on the front-end, it facilitates a more efficient process when the Buyer performs diligence later on and projects a sense of readiness and completeness. The improved perception can add value to the enterprise based on a sense of decreased risk.

INDICATION OF INTEREST:

In a M&A transaction, there usually are informal and high-level discussions that take place between a potential Buyer and Seller. Following those informal discussions a potential Buyer will indicate their willingness to move forward by proposing the terms of the transaction with a non-binding term sheet or IOI. This document qualifies the Buyer's level of interest and summarizes the proposed structure and purchase price. Where multiple suitors are involved, the IOI will also help the Seller with the down-select process.

CIM, MANAGEMENT PRESENTATIONS:

Where the Seller is represented by an investment banker or M&A advisor, a CIM will commonly be prepared summarizing important information for prospective buyers to consider about the Target, such as recent financial performance, the management team, overview of operations, facilities, customers, and forecasts. Meetings between prospective buyers and the Target's management team then follow, during which the key investment considerations laid out in the CIM can be further explored.

BUY-SIDE DUE DILIGENCE:

The Buyer conducts due diligence in order to gain clarity on the Target's historical and prospective financial information, valuation issues, strategic fit, corporate governance, compliance issues, etc. The Buyer's due diligence will address areas such as financial, tax, legal, contracts/customers, IT, and human resources. The depth and breadth of the analysis will depend on the nature of the Target's business, perceived risks, transaction structure (i.e., equity deal vs. asset deal), and other factors.

LETTER OF INTENT:

The potential Buyer will submit a more formal proposal (relative to the IOI) that incorporates adjustments to the valuation and addresses the inherent working capital assumptions. As well, the LOI commonly deals with workforce matters, potential purchase price adjustments, and other key deal issues discovered during the diligence process to date. The LOI may identify specific matters to be addressed during confirmatory due diligence. In addition, the LOI will typically set out an exclusivity period and a closing timeline.

CONFIRMATORY DUE DILIGENCE:

After the LOI is in place and before closing, the Buyer will continue its due diligence process. The specific focus areas may be wide-ranging or more narrow, depending on perceived risks and the Buyer's findings through prior diligence. This is a multidisciplinary analysis that may ultimately surface issues that may impact both valuation and risk allocation in the definitive agreement.

DEFINITIVE AGREEMENT:

Ultimately, the Buyer and Seller execute a definitive agreement memorializing the transaction. This may take the form of an Asset Purchase Agreement (APA), Stock Purchase Agreement (SPA), or Membership Interest Purchase Agreement (MIPA). In addition to the amounts and types of purchase consideration, the definitive agreement will include any conditions to closing, representations and warranties of each party, as well as numerous exhibits, attachments and disclosure schedules.

CLOSING:

When all the closing conditions are satisfied, the deal is ready to close and funds are exchanged. This is the moment when the transaction actually occurs.

POST-CLOSING:

The definitive agreement will lay out a period of time following the closing date (typically 90 days) during which certain loose ends get tied up. A process for resolving any disputed items will also be described.

One key financial and valuation consideration to be addressed during the M&A process is **working capital**, which is a measure of the Target's ability to fund operations and meet its short-term obligations. The general premise is that the Target will be delivered with adequate working capital to fund current operations. The general definition of working capital is **current assets** less **current liabilities**. Think of **current assets** as resources that can be converted to cash within 12 months from the balance sheet date, including but not limited to: cash and cash equivalents; marketable securities; accounts receivable; under-billings; inventories; prepaid expenses. Think of **current liabilities** as obligations that must be settled within 12 months from the balance sheet date, including but not limited to: short-term loans; lines of credit; accounts payable; accrued expenses; payroll-related liabilities; over-billings; deferred revenue.

Many transactions are negotiated on a cash-free and debt-free basis, in which case current assets will exclude cash and cash equivalents and current liabilities will exclude the current portion of interest-bearing debt, lines of credit, and other short-term loans. So going back to our M&A process illustration above … at what point does working capital come to the fore?

If sell-side due diligence is conducted, working capital may be one of the items addressed. If sell-side due diligence findings are not shared with the Buyer or sell-side diligence does not include a working capital analysis, buy-side due diligence generally represents the first time the Buyer has the opportunity to assess the Target's working capital. When the LOI is executed, it may specify a working capital peg amount to be delivered by the Target at closing, along with the mechanics for any post-closing adjustments regarding same. Alternatively, the LOI may state that the working capital peg amount is to be determined through due diligence. At closing, the Seller will estimate the applicable working capital amount delivered for a preliminary adjustment against the contractually defined working capital peg amount. Subsequently a reconciliation or "true-up" occurs where the actual working capital delivered is compared to the estimated working capital included in the flow of funds document in order to determine any further purchase price adjustment.

II. Working Capital Calculations

The general purpose of setting a working capital peg amount and providing for a post-closing adjustment mechanism is to leave the Buyer with adequate working capital to run the business and to address changes in the Target's financial position that occur between the LOI and Closing.

The text-book definition of working capital is fairly straightforward (current assets less current liabilities), however in practice working capital definitions can be complex, ambiguous, and the source of conflict.

The working capital adjustment is used to compensate the Buyer/Seller for changes in working capital as measured at closing relative to an agreed baseline balance. Without such an adjustment, an increase in accounts receivable balances that did not convert to cash within the expected DSO metric would generate a windfall to the Buyer, while a build-up of accounts payable balances prior to closing would result in the additional capital outlay from the Buyer after closing. Although both parties typically agree to the theoretical and practical rationale underlying working capital adjustments during the negotiation period of the transaction process, post-closing disagreements are very common. Disagreements focus on what should or should not be included in the calculation, changes in accounting treatments and the impact of EBITDA adjustments from the quality of earnings. It is also important to consider how the working capital adjustment fits within the broader context of the definitive agreement. Common provisions such as the establishment of escrows and reserves, if not fully accounted for, could result in either party being unjustly penalized twice.

As the adjustment for working capital is based on the change from one level to another, it is important to ensure that the former is the appropriate starting point. A baseline level of working capital can be determined through various methods that reasonable professionals can disagree on. There are judgments about the time-frame of the look-back period, the impact of seasonality, adjustments from diligence, and definitional considerations. These levers can be pushed and pulled in either direction and it is critical that a professional is advising both parties to ensure that an equitable methodology is utilized.

In our experience, the following topics are typically the focus of negotiations of the working capital determination and structure.

WORKING CAPITAL PEG:

The Buyer and the Seller mutually agree on an amount of working capital the Target needs to maintain in its balance sheet at the time of closing. Any deviations on the working capital value at closing often result in a dollar-for-dollar adjustment in purchase price.

HISTORICAL PERIOD:

The time period utilized in determining the level of normalized working capital can vary from transaction to transaction. The goal is to develop a peg amount based on the working capital needs of the Target at the operational and financial activity level at the time of closing. The most common time-frame and the starting point of most negotiations is the TTM period. However, if the Target expanded (contracted) then working capital levels most likely increased (decreased) during this time period and it may make sense to isolate a shorter period to reflect the changing profile of the business. Conversely, if the Target's performance has remained relatively consistent over the past two years, then the working capital calculation may utilize a larger time period to diminish the impact of variations month-to-month.

If the transaction is scheduled to close at year-end, additional diligence should be performed to understand how year-end tax planning activities impact normalized working capital.

WORKING CAPITAL COMPONENTS:

As previously mentioned, working capital calculations typically exclude cash and interest-bearing debt, but the variations of working capital components do not stop there. The parties may determine that certain balance sheet accounts are not reflective of operating cash flow and should therefore be excluded from the calculation. Examples include loans due from employees or owners, tax-related balances, capitalized expenses, hedging agreements, certain receivables that may not be collectible within 12 months, and deferred rent.

REPORTED WORKING CAPITAL:

Reported working capital is based on the Target's internal financial statements prior to any diligence adjustments. If the analysis includes other than year-end balances, both audited and unaudited balances will be included. This will most likely be the case since most working capital analyses are performed using quarterly or monthly financials.

DILIGENCE ADJUSTMENTS:

The quality of the components of working capital is equally important to the level established. In many cases, a quality of assets analysis is performed in conjunction with the QoE, and there can be an interplay. Adjustments to reported working capital may include components of various balance sheet accounts that are not reflective of normal operations. A common adjustment relates to payables and/or prepaid balances associated with the transaction itself for professional services, financing, or investment bankers.

Other examples of potential adjustments to working capital could include:

- changes in the Target's business
- aged accounts receivable balances
- related party transactions
- treatment of unbilled receivables or deferred revenue
- non-recurring events, year-end tax planning anomalies
- practices that fall outside normal industry practices
- timing of bonus expenses
- reclassification of assets/liabilities between current and non-current
- inventory counts/obsolescence
- other diligence adjustments

These adjustments are typically identified during the diligence process and will be the subject of negotiations between the Buyer and Seller as to their impact on the valuation and the calculation of working capital. Based on the results of its analysis, the Buyer will prepare a schedule outlining the Target's adjusted working capital during the Historical Period, which often paves the way to establishing the working capital peg.

SEASONALITY:

By utilizing a longer time period when determining the working capital peg amount, the impact of seasonality should be diminished. However, the actual working capital delivered at closing could be greatly dependent on the time of year or stage of the Target's recurring business cycle. If a significant portion of the Target's revenue or activity occurs during a set period of time each year, the working capital calculation could be adjusted to reflect the changes. This can be done by applying adjustments to the overall working capital balance or by restricting the time period of the working capital analysis to the season in which the transaction is expected to close.

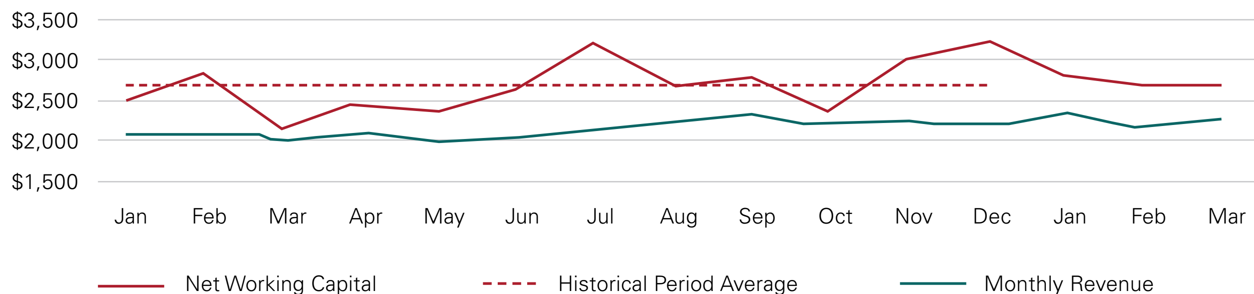
ACCOUNTING BASIS:

Working capital is traditionally measured utilizing GAAP but, there are times when the Target does not utilize GAAP and reports their financial statements on a cash-basis. Other times, the parties have differing interpretations of GAAP. Each of these items should be addressed during the negotiation process to reduce the possibility of a post-closing dispute or adjustment.

III. Examples

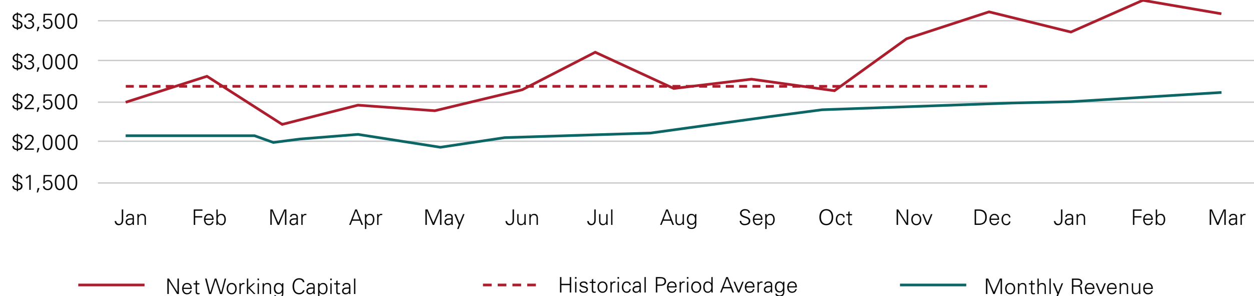
Let's walk through a few example fact patterns to help drive home some of the points discussed above. For each of Fact Pattern #1 and Fact Pattern #2 we will assume a LOI was executed on December 31, the Historical Period is the year ended December 31, and closing occurs on March 31 of the subsequent year. We will further assume that the Buyer and the Seller agreed on a working capital peg amount based on the average monthly net working capital during the Historical Period.

FACT PATTERN #1 ($ in 000s)



The Target had stable revenue and net working capital levels throughout Historical Period and no major changes occurred from LOI to Closing. Average monthly net working capital during the Historical Period was $2,668,000 and the Closing amount was $2,700,000, resulting in a relatively minor purchase price adjustment.

FACT PATTERN #2 ($ in 000s)



Target net working capital levels rose significantly toward the end of the Historical Period, driven in large part by increases in revenue. Net working capital remained at these higher levels from LOI to Closing. Average monthly net working capital during the Historical Period was $2,754,000 and the Closing amount was $3,590,000, resulting in a substantial purchase price adjustment.

Actual deal situations will of course be more complicated and nuanced than the fact patterns illustrated above, and proper due diligence should serve to avoid major working capital surprises. The thing to remember is that working capital fluctuates and can be influenced by a host of factors. Buyers and sellers alike are well-served by minding the details and monitoring the trends continuously through closing.

IV. Working Capital Negotiations

Discussions will typically occur between the Buyer and the Seller throughout the diligence process. There may be disagreements about how working capital should be calculated and what adjustments should be made to reported balances. The LOI is the vehicle by which the Buyer may propose the structure of the working capital calculation and the working capital peg. If the LOI does not set out the working capital peg, it is often determined through due diligence. Regardless, the Seller and Buyer will sometimes continue to negotiate (or renegotiate) the working capital peg as the closing date approaches. By hook or by crook a working capital peg is agreed to. At closing, the Seller will prepare an estimated working capital analysis that includes current balances in the accounting system of working capital components. The estimated working capital is measured against the negotiated working capital peg to determine the purchase price adjustment at closing.

V. True-Up Process and Disputes

While some deals we see do not include a purchase price adjustment with respect to working capital, the vast majority do. Where a working capital adjustment is provided for in the definitive agreement, it provides a true-up mechanism to address changes in the Target's balance sheet between deal signing and closing. The adjustment may be dollar-for-dollar or there may be a range within which no payment is required (the rationale being that it may not be worth the time of the parties and professionals to finalize a post-closing working capital adjustment for a small amount of money). To the extent the Target's actual net working capital at closing is greater than the net working capital peg, a purchase price adjustment in the Seller's favor is made. Conversely, if the Target's actual net working capital at Closing is less than the net working capital peg, a purchase price adjustment in the Buyer's favor is made (often funded by an escrow).

Net working capital at closing may be determined by the Buyer or by the Seller depending on what the definitive agreement calls for, but we commonly see the Buyer having this responsibility since they have post-closing control of the Target's accounting systems. In certain situations, the definitive agreement may call for the closing balance sheet to be audited.

So how does the process work? As mentioned above, the Seller typically will submit an estimate of the Target's net working capital in connection with the closing. Then within a specified post-closing time-frame, the responsible party will submit the actual Closing net working capital calculation. After that, the other party has a specified period of time to accept or dispute the calculation. In the event of a dispute, the definitive agreement typically would describe a dispute resolution process. Such a dispute resolution process will vary from deal to deal, but oftentimes an accounting neutral is brought in.

While the calculation of working capital may seem straight-forward, there can be any number of complicating factors that lead to a post-closing dispute. A few examples are described below.

ACCOUNTING CLOSE:

For some businesses, the quarterly accounting close may be a more rigorous process than the monthly accounting close. And the year-end accounting close may be a more rigorous process than the quarterly accounting close. Year-end balances may also be audited or reviewed by external accountants. Further, the year-end audit or review may result in a significant amount of adjustments. Given these dynamics, the varying quality of the Target's financial information could result in uncertainty or inconsistency in working capital calculations.

GAAP VS. CONSISTENCY:

At times the Target's historical accounting policies will be GAAP-compliant. Other times the Target may have an accounting policy that is not GAAP-compliant but is consistently applied. As between those two scenarios, in the context of a working capital dispute GAAP generally would be expected to prevail. Note, however, that sometimes the definitive agreement will mandate consistency with the Target's prior accounting practices for specified financial statement line items (i.e., an accounting carve-out).

BUYER GAAP VS. TARGET GAAP:

As we all know, GAAP is not always a right-or-wrong proposition. What happens if the Buyer uses "different GAAP" than GAAP consistently applied by the Target? Which takes precedence when a post-closing working capital dispute arises? These questions are not easily answered, but in our experience the Target's consistent use of an accounting policy acceptable under GAAP typically prevails over the Buyer trying to impose "it's GAAP" on the Target. To prevent disputes around this point, the definitive agreement may define prevailing GAAP.

SUBSEQUENT EVENTS:

When there is a disagreement over working capital between the Buyer and Seller, a question may arise as to what type of post-closing information should be considered, if any. A "subsequent event" is a defined term under GAAP, and there are two types of subsequent events. "Type 1 subsequent events" provide additional evidence about conditions, facts, and circumstances that existed at the balance sheet date and affect the estimates inherent in its preparation. The balance sheet typically would be adjusted for any changes in estimates resulting such events. "Type 2 subsequent events" provide evidence about facts and circumstances that did not exist at the balance sheet date but that arose after that date. Type 2 subsequent events should not typically result in any adjustments to the balance sheet. As compared to the preparation of financial statements in the normal course of business, consideration of subsequent events in the M&A context can be more complicated.

Hopefully for your M&A transaction the working capital true-up process will be a simple, well-defined, and uncontested process. Whether you're the Buyer or the Seller, when it comes to working capital calculations knowledge is power. It is prudent to expect the best and prepare for the worst.

VI. Recommended Tips

No two M&A transactions are alike. Having said that, when it comes to working capital and its impact on purchase consideration, there are some core principles that apply in most situations. Here are some of our recommended tips based on the transactions we've been involved with over the years.

01 **Details matter.** Understand working capital at a general ledger account level early in the M&A process. To the extent Buyer and Seller can be on common ground from a definitional standpoint, it should facilitate a smoother working capital negotiation.

02 **Trends matter.** Determine an appropriate measurement interval and analyze as many relevant data points as possible. Consider trends leading up to the LOI and expectations for the Target through the closing date.

03 **Leave no doubt.** Including an illustrative working capital calculation in the definitive agreement can help avoid ambiguity. It may also minimize the possibility for a post-acquisition dispute.

04 **Get help.** Involve your key advisors early in the M&A process. Every deal will have a unique risk profile. Whether the key risks revolve around legal, accounting, IT, operations, human resources, short-term capital needs, or other issues, get the appropriate advisor on board as soon as it makes sense to do so.

VII. Abbreviations and Defined Terms

Certain M&A transaction-related terms used in this document are defined below.

Term	Definition
Buyer	The entity that acquires the Target (purchaser, acquiror)
CIM	Confidential Information Memorandum
GAAP	United States Generally Accepted Accounting Principles
Historical Period	The analysis period for financial due diligence, which will typically include the TTM period as well as one or more prior fiscal years
IOI	Indication of Interest
LOI	Letter of Intent
M&A	Merger & Acquisition
Purchase Price	The amount paid to acquire the Target, which may reflect cash, contingent consideration, seller financing, and post-closing working capital adjustments
QoE	Quality of Earnings
Seller	The entity that sells the Target
Target	The business enterprise being acquired/sold (acquiree)
TTM	Trailing Twelve Months

VIII. Contact Us

Working capital considerations play an important, yet sometimes overlooked, role in most M&A transactions. Every deal is different, and buyers and sellers can have their own unique perspectives. Whether it's comprehensive buy-side or sell-side due diligence support, a narrowly focused working capital analysis, or helping to resolve a post-closing dispute, Aronson LLC can provide a solution that makes sense for your transaction.

Contact our team today to start the conversation about how we can assist you with your due diligence process and other transaction advisory services.

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