HERE'S THE DEAL: M&A INSIGHTS

Net Working Capital Peg in a Round Hole

By Spencer Rees

BT BENNETT THRASHER LLP

Cash-Free, Debt-Free, Tax-Free

Net Working Capital (NWC) is one of the most contentious points in a deal process and a topic that is frequently ignored on the front end of a transaction. NWC is derived from a company's balance sheet and represents current assets, less current liabilities at a given point in time. However, in the context of a transaction, NWC typically adjusts for the removal of cash, short-term debt and income taxes payable. The reason NWC is reported cash-free, debt-free and tax-free is because these assets and liabilities are the rights and obligations of the seller and customarily, are not agreed to transfer to a buyer upon the closing of a transaction. In fact, NWC and cash left in the business are often confused as one in the same. It is important to note that the NWC target is not the same as cash left in a business. However, depending on the closing date, cash sometimes needs to be left in the business to fund operations. For example, if a transaction is closing mid-month and the company's payroll cycle is bi-monthly, the parties may want to leave enough cash in the business to cover employee salaries to be paid as a part of the next payroll run. The last thing a new business owner wants is to purchase a business where the employees are unhappy with the acquirers because of a glitch in payroll processing. Remember, any cash left in the business is traditionally reimbursed by the buyer on a dollar-for-dollar basis. With all of this in mind, the following article will highlight various aspects of NWC within the deal process including its multiple uses, how the value is calculated and perceived by a buyer or seller, complexities impacting certain industries and various adjustments typically noted in the diligence process.

Multiple Sources & Uses of NWC

NWC serves multiple purposes in the deal process including: (1) as a key input used in the free cash flow (FCF) calculation, which is used in the discounted cash flow (DCF) model for purposes of computing a company's intrinsic value; (2) as a metric used to help determine cash needed to float the daily operations of a company; and (3) as a representation of the total net current asset or liability value, also referred to as the NWC peg, to be transferred to the buyer upon the closing of a transaction.

CONTACTS

Spencer Rees
Senior Associate
Transaction Advisory Services
770.635.5012
spencer.rees@btcpa.net

Vijay Vaswani
Managing Director
Transaction Advisory Services
678.990.2855
vijay.vaswani@btcpa.net

Highly Subjective Calculation

Parties generally like to say that the NWC calculation should be perfunctory and neither party should benefit from the establishment of a peg one way or the other. While the NWC analysis is objective in the sense that the peg hinges on proper accounting treatment that is consistently applied in the post-closing environment, the approach used by the parties involved can be subjective based on whether they are the buyer or the seller. Generally, the buyer wants to set the NWC peg as high as possible, so a higher net current asset value is delivered at close and the buyer doesn't have to infuse capital to float the business or fund a shortfall post-closing. Conversely, the seller wants to set the NWC peg as low as possible, so they are committed to delivering the minimum amount of value needed to support the business and they can remove any excess asset value from the business as a part of closing or through the post-closing true-up mechanism. Therefore, it is critical to have the right adviser identifying NWC issues early and throughout the deal process.

Historical Averages Not Always a Best Practice

Using historical averages to calculate a NWC peg, while customary, is not always best practice as this method does not take into consideration changes in working capital due to recent business developments, seasonality of the business or potential for future transactions to impact NWC between the historical period and the date the transaction is closed. As part of the diligence process, transaction accountants will analyze both historical NWC trends while also promoting suggestions, or other considerations, that could impact future NWC targets.

Industry-Specifics Need to be Considered

In general, an increase in NWC results when current assets are growing larger in comparison to current liabilities, while a decrease results in the inverse trend. A company that is experiencing high growth year-over-year typically experiences a corresponding increase to NWC, due to increases to asset accounts such as accounts receivable or inventory, as a company purchases more product and generates more sales due to increased customer demand. With that said, companies in certain industries may exhibit unique NWC trends that result in negative monthly balances. For example, negative NWC is often seen with technology-based service providers, as these companies typically receive payments for such services up front prior to the completion of their service commitment. Depending on the payment cycle and service term, or seasonality of a business, this may result in larger liability balances on a consistent basis as the deferred revenue is amortized over the service period. In these situations, negative NWC is often viewed as a debt-like item due to the fact a company still has outstanding performance obligations associated with the deferred revenue, but cash related to such revenue has already been received by the seller in an earlier period, leaving the buyer with a potential shortfall and "cash-less" revenue that needs to be serviced subsequent to the closing of a transaction.

NWC Adjustments

To prevent unnecessary conflict in negotiation and closing of a transaction, best practice is to stipulate a NWC peg, or at least an agreed-upon methodology for calculating such peg, when the letter-of-intent (LOI) is issued. As part of the due diligence process, transaction accountants gain an understanding of the daily operations of a business and review many aspects of a company's balance sheet, including the underlying transactional level details of significant general ledger accounts, to tease out potential adjustments to calculate a NWC target. Examples of some NWC adjustments identified as part of the diligence process include the following:

- Stale receivables that are a collection risk and stale payables due to the pending transaction.
- Obsolescent inventory that is unsellable due to age, impairment or other factors, but has not been covered by a company's inventory reserve.

- Non-transferable prepaids or deposits which include such items that have been paid by the seller, but which will not transfer to the buyer post transaction.
- Related party receivables or payables as these balances generally do not support ongoing business operations and will be paid off by transaction proceeds at time of closing.
- Intercompany receivables or payables that have not been eliminated in consolidation.
- Short-term capital leases that are capitalized as a liability on the balance sheet as the structure of the lease is such that a company in theory purchased the asset. As a result, capital leases are generally treated as debt-like in nature, due to future payment obligations, resulting in settlement of outstanding balances at closing of a transaction.
- Other non-operating current assets or liabilities.

Outside of these common adjustments, during the diligence process, it often becomes apparent that a business may have improperly recorded certain balance sheet accounts or did not record certain accruals altogether. While this risk is reduced for companies that receive an annual audit, it is prevalent for companies whose financial statements are not opined upon by an independent accountant. With this said, even if a company is audited and the financial statements are presented on the accrual basis of accounting, the focus is mainly on the year-end periods. Monthly account balances are often not recorded properly on an interim basis, which has a material impact on monthly NWC calculations and could skew the establishment of a NWC peg. For these reasons, adjustments to both year-end and monthly account balances may be needed to ensure NWC is calculated appropriately.

Fitting a Square NWC Peg in a Round Hole

Given the importance NWC has on both determining the potential value of a company, as well as the expected consideration to be received by a buyer from a seller to support on-going business operations at the closing of a transaction, it is crucial that NWC is analyzed and normalized by transaction accountants as part of a due diligence process. Buyers or sellers that do not put an emphasis on this analysis may find themselves in situations where they must transfer cash back to the other party through a NWC true-up. This results in a transaction that, while appearing to be a good deal on the surface when factoring in EBITDA adjustments, could actually be less accretive to a buyer and ultimately end with a transaction that did not meet projected expectations.

Spencer Rees is a Senior Associate in our Transaction Advisory Practice. Spencer helps strategic acquirers, ranging from private organizations to publicly traded companies, perform financial due diligence for various investment opportunities. He also supports financial sponsors, including private equity firms, mezzanine funds, family offices, and minority investors with broader transaction assistance in both buy-side and sell-side engagements. Within transaction advisory, Spencer focuses on quality of earnings, net working capital, and net debt analyses.

BT BENNETT THRASHER LLP

ABOUT BENNETT THRASHER

Bennett Thrasher, a top 100 accounting firm in the U.S., provides comprehensive tax, accounting, assurance, technology and consulting services to clients throughout the United States and internationally.