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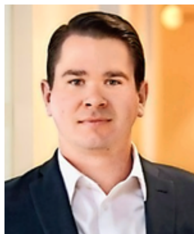
Working Capital and Deals: Lessons Learned in the Field



BY JESSE J. GILLETT

Working capital is an important consideration when performing due diligence, negotiating deals, and often in working out post-deal issues. Often defined as current assets minus current liabilities, working capital is more often than not defined a bit differently in a deal context. Many transactions are often done on a cash-free and debt-free basis. Related party balances may exist, and be excluded from the definition. Deferred revenue may gain special attention. And so forth.

Importantly, working capital carries cash flow implications, and if not properly considered (or if manipulated!), could significantly alter the return on investment and other economics of a deal. Below, we discuss various reasons to give careful review to working capital in a transaction context.

Jesse J. Gillett, CPA/ABV, CFE, a valuation specialist and financial consultant at the Boston firm Edelstein & Company, provides litigation, transaction, and corporate planning related business valuations. Mr. Gillett has also worked on post-acquisition disputes, financial due diligence, strategic planning, and other complex financial matters.

A key component to understanding cash flow

Understanding normal or required working capital levels is one of several components useful in determining cash flow. In a deal context, cash flow is often considered on an enterprise basis. Of course, deal-speak often includes multiples of EBITDA (earnings before interest, taxes, depreciation and amortization) as a way of interpreting value, but that is technically not cash flow. Cash flow computed on an enterprise basis is commonly determined as follows:

After-tax profits

(+) Depreciation

(-) Working Capital Investment

(-) Capital Expenditures

(+) *Interest, After-Tax*

Net Cash Flow

The cash flow derived above is the amount that is hypothetically available to compensate both debt and equity investors, which is therefore helpful in determining the market value of invested capital (i.e., market value

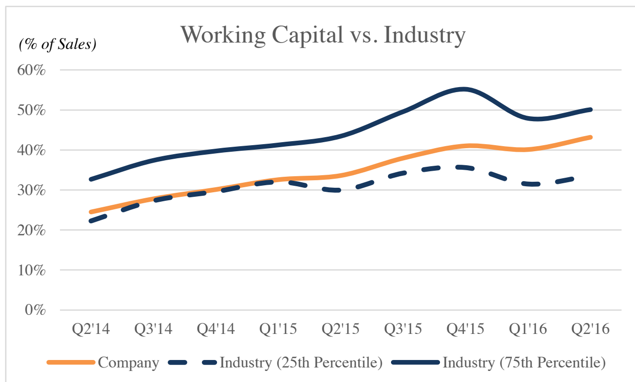
of debt and equity, or alternatively market value of net operating assets). In the above context, the working capital investment is derived from two components. One is the portion of accounting profit that is tied up in receivables, payables, and other such balance sheet accounts as opposed to actual cash profit. The second component would be some amount (if any) of additional cash reserve.

What is the right level of working capital?

Working capital is measured at a point in time, but constantly fluctuating over time. This might be driven by seasonal patterns, timing of accruing bonuses, the bankruptcy of a key customer, and many other things. Nevertheless, it should be possible to determine what a normalized level of working capital should be as of the valuation or transaction date. This may involve considering several points of view to come up with an overall assessment of what is normal. Those points of view might include:

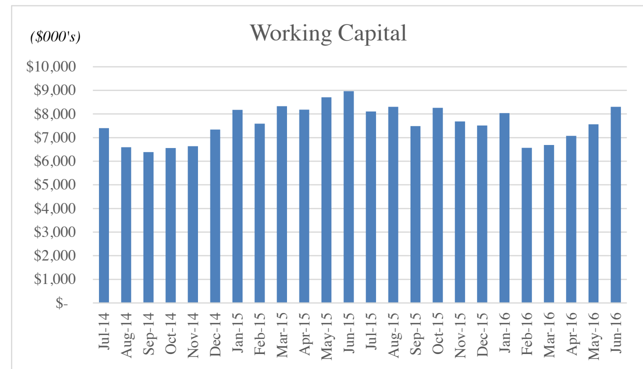
- Historical relationships observed within the working capital accounts of the target company
- Benchmark studies of companies in the industry vs. the target company
- Observations made of public peer companies vs. the target company

Below, we illustrate an example chart comparing a target company to benchmark statistics:



When available, it is often useful to analyze working capital by month. Buyers may be wise to pay close attention to the hypothetical chart below. We want to dissect certain observations and understand what is driving trends. For example, are June 2015 and June 2016 peaks due to seasonal trends, or something else? Whatever the reason, working capital targets may legitimately differ for a deal closing in February versus a deal closing in June.

Also, beware of differences in interim and year-end reporting. A classic example would be an employee bonus accrual. Some companies may accrue for such expenses throughout the year. Others may only do so once per year around the time where confidence in the estimate might be inherently higher than at other times of the year. Another example would be accounts receivable and/or inventory reserves. How frequently was the



seller critically examining and updating these reserves, and at what particular points in the year?

Furthermore, the interpretation of reserves may differ whether you are buying or selling. An example of two differing methods seen in the past is illustrated below.

Accounts Receivable Aging Report as of July 31, 2016

	Balance	Current	1-30	31-60	61-90	91-120	>120
Customer A	$ 123,840	$ 45,511	$ 78,329	$ -	$ -	$ -	$ -
Customer B	96,372	46,398	-	-	-	33,915	16,059
Customer C	27,235	27,235	-	-	-	-	-
Customer D	195,817	52,480	43,545	99,194	-	-	598
Customer E	104,377	8,055	96,322	-	-	-	-
Customer F	150,000	-	-	-	-	-	150,000
Customer G	146,749	73,741	73,008	-	-	-	-
Customer H	300,000	-	300,000	-	-	-	-
Customer I	199,721	68,532	66,752	64,437	-	-	-
Customer J	4,975	4,975	-	-	-	-	-
Subtotals	**$1,349,086**	**$326,927**	**$657,956**	**$163,631**	**$ -**	**$ 33,915**	**$166,657**

Seller's Method

The seller reserves 25% of receivables between 91 and 120 days old, and 75% of receivables greater than 120 days old. Under this mechanical method, the following net receivables balance results:

Accounts Receivable, Gross	$	1,349,086
Less: Reserve for Doubtful Accounts		(133,472)
Accounts Receivable, Net	**$**	**1,215,615**

Buyer's Method

The buyer may look at the seller's method as mindless or arbitrary. Alternatively, it's possible the buyer's diligence uncovers that Customer H's not-so-old balance of $300,000 is uncollectible as Customer H just filed for bankruptcy. And furthermore, Customer D's balance over 120 days ($598) represents a disputed charge. It is possible that these would be the items that the buyer would have reserved for using its specific identification method.

Accounts Receivable, Gross	$	1,349,086
Less Specific Reserves		
Customer H		(300,000)
Customer D		(598)
Accounts Receivable, Net	**$**	**1,048,488**

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Levels of Working Capital Impact Financing Needed , Rates of Return, Etc.

If the buyer manages to buy a business with inadequate working capital, without properly considering it or getting a purchase price adjustment on account of it, this will result in the buyer needing more capital than would otherwise be necessary. Below we show two scenarios which illustrate this point. On the left-side scenario we see the net assets purchased by the buyer (with the ''Market Value of Invested Capital'' bar representing purchase price). Now let's assume the operation would really require about twice as much inventory as it owns. On the right, we show this alternative scenario and the incremental investment which is represented by the ''Add'l Capital Required'' bar.

Net Assets Purchased

Assets | Liabilities & Equity

Current Assets | Current Liabilities

Fixed Assets | Market Value of Invested Capital (Market value of Debt & Equity)

Intangible Assets

Net Assets w/ Required NWC

Assets | Liabilities & Equity

Current Assets | Current Liabilities

Add'l Capital Required

Fixed Assets | Market Value of Invested Capital (Market value of Debt & Equity)

Intangible Assets

The right-side scenario above may significantly lower the rate of return achieved by the buyer when compared to the buyer's initial expectation. The impact will depend somewhat on the terms related to the additional capital. It will also depend somewhat on the assumptions and further consequences surrounding any decision not to fix the working capital problem.

Post-closing disputes

Working capital disputes often arise after a transaction has closed. For example, the buyer purchases ABC Co. from Seller and let's say the parties have agreed to deliver between $8 million and $10 million of working capital as of closing – anything short of $8 million will require that the parties reduce the purchase price, and anything above $10 million will require an increased purchase price. What if the closing documents reflect something between $8 million and $10 million as of close, but the buyer starts to notice various issues after the fact that lead it to investigate the records more closely, which then sparks a dispute?

Often there is very specific language in the parties' agreement defining how working capital is to be calculated, methodologies considered, and so forth. This language can be complex, confusing, and rather ambiguous at times.

Let's say that the buyer and seller agree that working capital is to be prepared in accordance with United States generally accepted accounting principles (''GAAP''), and consistent with a calculation prepared and reviewed by the parties thirty days prior to close. This could open up several issues, including the following:

- The parties later discover that the reference calculation was not compliant with GAAP
- The parties later disagree because accruals that were included at closing were not included previously
- The parties later disagree on assumptions used in calculating reserves
- The parties later discover that there may be some issue with the interim reporting

And of course there could be many more issues related to the duel requirement of consistency with both GAAP and some reference calculation.

Other issues may arise such as large deferred revenues originating shortly before close, in the context of a cash-free transaction. For example, the seller accepts an advanced payment on a huge contract days before close, but delivers none of the promised product or services prior to close. The seller then takes all the cash and leaves the buyer to deliver as promised.

The Last Word

The examples given in this article are not meant to be all inclusive. However, the purpose is to take real-world experience in disputes and valuations to get buyers and sellers alike to heighten their scrutiny of working capital in deal contexts.