Working Capital:
It is Important Regardless of the Deal

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Mike Adhikari Background

• Current
  • 1 Illinois Corporate Investments, Inc. - $1-100MM
  • 2 Business ValueXpress® - A Valuation and Deal Structure Software
  • 3 VC & PE investor 4 Start-ups

• Education & Experience
  – MBA (U. of Chicago), MSME (IIT, Chicago), MSEE (Cleveland), BSME (India)
  – CM&AA, M&AMI, CBI
  – 17 years, Operating Experience w/Fortune 500
  – 25+ years: M&A Advisor
  – 10+ years: Valuation Software

• Other
  – Northwestern’s Kellogg MBA: Guest speaker on M&A – 1994 to 2012
  – Wall Street Journal/U.S. Congress: Helped reverse Repeal of Installment Sales Tax
  – President – 2008 to current - AM&AA (Alliance of M&A Advisors)
  – Faculty member CM&AA (Certified M&A Advisor)
  – President - 2002 & 2003, MBBI (Midwest Business Brokers & Intermediaries Assoc.)
  – Board member of non-profit organizations
  – Frequent judge on business plan competitions and speaker at national conferences
Objective

- Enhance understanding of
  - What is Working Capital?
  - How WC impacts transactions?
  - How and when to include WC in a transaction?
  - Benefits of addressing WC.
- How to use WC knowledge to help close more, and larger, deals.
Outline

1. Mainstreet & Working Capital
2. What is Working Capital?
3. WC by type of transaction
4. WC inclusion in a Deal
5. Methods to include WC in an Offer
6. Benefits of addressing WC early
7. Components of WC
8. WC Protection
9. How to Quantify Target WC?
10. Examples of WC Language in LOI
1.0 Mainstreet & Working Capital

- WC is important regardless of deal size.
- Mainstreet is growing to larger deals.
  - Smaller Mainstreet deals are mostly B2C.
  - Larger Mainstreet deals are often B2B.
- Brokers have more experience with B2C than B2B.
- B2B deals, small or large, need more focus on WC.
- Going from B2C to B2B
  - It is common to treat B2B same as B2C i.e. expecting buyer to pay for WC in addition to value. This makes it easy to get a listing, but difficult to close.
1.1 Example of B2B treated as B2C

A Listing by a Mainstreet Broker (I was on buy-side)

- Business: Medical Products Mfg.
- Sales: 2,400 (no growth for many years)
- SDE: 450*
- WC: A/R = 200, Inventory = 500, A/P = 50
- Ask Price = 1,800 + A/R + Inventory = 2,500

Analysis:

- Broker priced at 4x SDE + A/R + Inventory
- Buyer perspective: 8x EBITDA (assuming 150 salary)

* During DD we found that the $450 k of SDE was overstated by $80 k.
2.0 What is Working Capital?

- WC definition
  - Transaction WC is different* than Accounting WC
  - Key* components of WC
    - WC = A/R + Inventory – A/P

- A/R is not cash (Frequent argument by many. How to convince otherwise?)

- WC is part of a transaction directly or indirectly
  - Seller’s net includes WC (at closing or after closing)
  - Buyer’s total cost includes WC (at closing or after closing)
  - Does value (or price) include WC?
  - Does buyer’s offer include WC?
  - Does broker fee include WC?
    * Details discussed later
3.0 WC by Transaction Type

- **B2C**
  - B2C businesses are mostly retail. Also, some service businesses.
  - In B2C, WC is primarily inventory.
  - Usually no A/R, Seller pays off A/P.
  - Most market data (multiples) include inventory.
    - Pratt’s Stats and IBA include inventory.
    - Bizcomps excludes inventory.
    - But …How much inventory? Does market data provide inventory amount?
  - Example: SDE = 100, Inventory = 100 for A, 150 for B
    - Which business would you buy if
      - Price is 300; it includes inventory?
      - Price is 300; it excludes inventory?
      - Would buyer make same offer for both?
3.1 WC by Transaction Type (con’d)

- **B2B**
  - B2B are manufacturing, distribution and most service businesses
  - Have A/R, Inventory and A/P.
  - Have better financials than a typical B2C business.
- **Price should include WC**
  - But brokers often only include inventory.
- **B2C + B2B**
  - Some businesses are both
    - Confectionary
    - Bakery
    - Printing
  - They should be treated as B2B
3.2 WC by Transaction Type (con’d)

<table>
<thead>
<tr>
<th>A/R</th>
<th>Inventory</th>
<th>A/P</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liquor Store</td>
<td></td>
<td></td>
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<tr>
<td>Laundromat</td>
<td></td>
<td></td>
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<tr>
<td>Vending Route</td>
<td></td>
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<tr>
<td>Stone Fabrication</td>
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<tr>
<td>Underground utility Svc.</td>
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<tr>
<td>DME distributor</td>
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<tr>
<td>Home Repair</td>
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<td>Home Health</td>
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<tr>
<td>Janitorial Svc.</td>
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<tr>
<td>HVAC Svc.</td>
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<tr>
<td>Appliance Delivery/Install</td>
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<td>FedEx Route</td>
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<tr>
<td>Car Wash</td>
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<tr>
<td>Landscape</td>
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</tbody>
</table>
4.0 WC Inclusion in a Deal

- Small or large, B2C or B2B …WC should be included in price.
- Even if seller uses cash basis of accounting.
- Buyer wants high WC.
- Seller wants low WC.
- Asset purchase vs. Stock purchase
  - Business needs same WC regardless of structure.
- Consider impact of accounting methods
  - How is inventory costed? Perpetual or physical? How frequently?
  - Changes in accounting methods
  - Revenue recognition
  - Cut-offs: month-end, year-end
5.0 Methods to include WC in an Offer

Buyers include WC in an offer in many ways:

1. Estimate “Target WC”* and include it in an offer.
2. No WC in offer, but restriction on cash management.
3. Offer describes a framework …This is the most common.
   1. “WC required to operate the business”.
   2. May define components of WC.
4. No WC in an offer.

Both 3 & 4 risks deal collapse
Example: A healthcare transaction

* How to quantify “Target WC” discussed later
6.0 Benefits of addressing WC early

1. Reduced risk of deal collapse.
2. Profit up to the date of Closing:
   1. Pre-closing profit to seller
   2. Post-closing to buyer.
3. No need to “manage” WC.
4. Frees up seller to run the business.
5. No need to “time” the closing.
6. Provides clarity on net proceeds to seller.
7. Provides clarity to buyer on total cost and financing.
8. Helps close seasonal businesses any time.
7.0 Components of WC

- **Accounting WC**
  - WC = Current Assets – Current Liabilities
  - Includes all CA (cash, non-trade A/R, etc.)
  - Includes all CL (Line of Credit, STD, CPLTD, taxes, etc.)

- **Transaction WC**
  - All debt is excluded
  - Taxes payable excluded
  - Excess cash excluded
  - Operating cash included …(this does not mean cash transfers from seller to buyer at closing)
  - Buyer assumes customer deposit with matching asset
  - “Benefit” theory (taught by Adhikari, to be published)
  - More …
8.0 WC Protection

Buyer and Seller need protection on WC

- Purchase price is adjusted at closing for differences between “Estimated Closing WC” and “Target WC”
- Purchase contract protects buyer and seller against
  - Difference between “Estimated Closing WC” and “Actual Closing WC”
  - Uncollected A/R or unbilled A/R
  - Obsolete inventory
  - Payments and bills received after closing
  - more
9.0 How to Quantify Target WC?

1. Most common method: Average of 12 months
   1. Last Fiscal Year
   2. Last 12 months (sounds great but difficult to pull off)
   3. Last 4 quarters
   4. Seasonal businesses may require EBITDA adjustment.

2. Projected WC on the day of Closing.
   1. Used for…
      1. Growing businesses
      2. Seasonal businesses

3. Operating Cash Cycle & Sales

4. If financials are inadequate…
   1. Industry average
   2. Other more complex methods
10.0 Examples of WC Language in LOI

Following slides show actual LOI language on WC

1. Asset sale: WC Quantified.
3. Asset sale: Framework for WC.
4. Asset sale: WC to be determined during due diligence. Concept of a collar.
Example #1: Asset Purchase. WC Quantified

(b) At the Closing, Newco will assume specified liabilities of Seller and Newco will pay a purchase price of $X.0 million, in cash (subject to adjustment as set forth below). The Liabilities assumed will include only those liabilities scheduled in the Definitive Agreement, but are expected to include only accounts payable, accrued liabilities and product warranty liability generated in the ordinary course of Seller’s business. For the avoidance of doubt, the Liabilities will not include: (i) lines of credit or bank debt (whether classified as current or long-term), (ii) notes payable, including any note payable to an Owner or one of his family members or affiliates, (iii) pension liabilities; provided, however, that Newco will take over responsibility for administration of any 401K or similar defined contribution pension plan, (iv) taxes payable by Seller, (v) tort liabilities, (vi) criminal or quasi-criminal claims, (vii) pending litigation and (viii) undisclosed liabilities.

(c) The Definitive Agreement will contain a provision that increases or decreases the purchase price set forth in paragraph (b) above by the amount that current assets (cash plus accounts receivable net of allowances for doubtful accounts plus inventories plus investments plus prepaid assets and deposits) included in the Assets at the Closing exceed or are less than the sum of (i) the current liabilities (accounts payable plus accrued liabilities) included in the Liabilities and (ii) $1,678,687.
**Example #2** Stock purchase, WC quantified, Balance Sheet “marked up”

XYZ Equity Partners, LLC ("XYZ") is pleased to make this offer to purchase 100% of the stock of ABC, Inc. ("ABC"). This letter of intent outlines the basis for a transaction. A formal, definitive Purchase Agreement effecting the transaction will incorporate all of these terms.

**Purchase Price**
$XX,000,000 in cash at closing.

**Closing Balance Sheet**
The attached April 30, 20xx Balance Sheet has been "marked up" to illustrate the expected accounts that will be included and excluded in the Closing Balance Sheet. Excess land will stay in ABC, as will the Deferred Income Tax Liability.

**Closing Net Working Capital**
In addition to the transaction being dependent upon the inclusion/exclusion of specific balance sheet accounts, the Purchase Price is predicated upon a Closing Net Working Capital dollar amount equal to its April 30 figure of $3,494,000. Any increase or decrease in the actual Net Working Capital delivered at closing will result in a corresponding change in the Purchase Price.
**Example #3:** Asset purchase – LOI set a framework for NWC and its calculation

The parties agree to a target Net Working Capital (as defined below) (the “Target NWC”) equal to the average at the end of the past four quarters prior to the Closing. The actual Net Working Capital as of Closing would result in a dollar-for-dollar purchase price adjustment, up or down, based upon the deviation from the Target NWC. Net Working Capital would be defined as the sum of the Business Seller’s (x) collectible Accounts Receivable, plus (y) Inventory that is useable and saleable in the ordinary course of the Subject Business, and not excess or obsolete, less (z) Accounts Payable (the “Net Working Capital”), in each case calculated pursuant to Business Seller’s historical practices and as of the close of business on the day preceding the Closing Date.

Business Seller shall be obligated to repurchase those Accounts Receivable or portion thereof which are not fully collected by Business Buyer within 180 days of the date of invoice, in which event such uncollected receivables or portion thereof shall be transferred and assigned by Business Buyer to Business Seller.
Example #4: Asset sale. WC to be determined during due diligence. Concept of a collar.

The parties would agree on a target amount of Net Working Capital during Buyer’s due diligence review. The Net Working Capital target amount would reflect the Company’s historical average working capital ratios and an amount which supports the Company’s current and future expected operations to mutually be determined during the diligence process. The Purchase Price would be adjusted upward or downward, as applicable, on a dollar for dollar basis in an amount equal to the amount by which the actual Net Working Capital at Closing exceeds or is below the agreed upon Net Working Capital target level; provided, that no adjustment would be made if the amount is within a $50,000 “collar” (provided that this “$50,000 collar” remains to be verified as reasonable in conjunction with the establishment of the Net Working Capital target). The Net Working Capital at the Closing would be determined by Newco within 120 days of the Closing (subject to review by the Sellers and a dispute resolution mechanism to be agreed to by the parties). Any amounts due to the Company would be paid within 15 days after final determination of the actual Net Working Capital at Closing. Any amounts due to Sellers would be guaranteed by the Company and payable to Sellers in cash in equal monthly installments over a six-month period. As used herein, “Net Working Capital” shall mean the sum of accounts receivable, inventory, prepaid expenses and other current assets assigned to Newco (expressly excluding cash), less accounts payable and other current liabilities assigned to Newco, all determined in accordance with GAAP.