Minimum Net Working Capital Threshold in M&A Transactions

When a business is bought or sold it is understood that the assets and certain liabilities shall include a minimum amount working capital at closing (the “Minimum Working Capital”, the “Working Capital Threshold” or the “Working Capital Target”).

This newsletter will shed some light on the elements to be included as part of the working capital calculation, on the importance of establishing the right amount of Minimum Working Capital (“**MWC**”) to be delivered as part of a sale transaction, on how it affects the purchase price, about games played by vendors and buyers, and best practices.

The Right Amount of Minimum Working Capital

The right amount of MWC should be equivalent to that required to run the business as a going concern without having to reinject funds to support revenues. In a mature or stable company, the amount of MWC should be based on the average working capital calculated on a full twelve-month historical cycle. In a growth situation where the valuation is partly based on future growth, the MWC will have to take into account that more funds will be needed to fund future receivable and inventory growth. For seasonal businesses, the survey sample period should sufficiently cover cyclical highs and lows so that the target MWC at closing can be set to the appropriate point in the cycle.

Purchase Price Adjustment for Minimum Working Capital

The aim is to ensure that the purchase price paid appropriately reflects the MWC at closing. If the actual working capital at closing is lower or higher than the target MWC, it is expected that the seller or the buyer will make up the difference on a dollar-for-dollar basis. Usually, the purchase price will be subject to an adjustment when the closing financial statements are published and accepted by both parties usually 60 to 90 days after the closing. It is not unusual to have a working capital holdback (or escrow) at closing to provide for the seller to cover any of the shortfall.

Games People Play

Less sophisticated vendors may try to reduce working capital at closing, to generate cash to take out of the business, by accelerating collection of receivables by offering discounts, selling inventories, delay paying suppliers or ordering of inventories to generate cash. With a properly drafted share purchase agreement however, all such attempts to affect the purchase price will eventually come to light and the tactic will have only resulted in aggravating the vendor-buyer relationship, which, to large extent, is based on trust.

Best Practice

Once the elements to be included in the MWC are agreed upon, M&A best practice indicates that the MWC’s calculation methodology should be agreed upon before signing the LOI. A detailed example of the methodology and mathematical calculation of a working capital adjustment to the purchase price that would have happened based on an historical balance sheet should be attached to the Letter of Intent.

The example should include all working capital accounts even if their balance was zero in the example. Each element of the working capital should be measured on a consistent manner with past practices even if they do not follow generally accepted accounting principles. Any liabilities not assumed by the buyer should be excluded from the MWC to avoid duplication. Another important consideration is that some companies wait until their fiscal year end to fully adjust certain balance sheet items; for such companies, the month-to-month trial balance working capital numbers may not necessarily reflect reality.

Finally, the parties should agree upon on a dispute mechanism with a provision for a third party expert or arbitrator.

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Working Capital Calculation:

Working capital is typically defined as current assets less current liabilities. Current assets generally include:

- Accounts receivable (this could include or exclude accounts of 90 days or greater depending on the industry)
- Inventories (must be saleable and not obsolete)
- Prepaid expenses (rent, taxes, insurance, etc.)
- Prepaid rent or security deposits paid out

Current liabilities typically include:

- Accounts payable
- Accrued expenses
- Prepaid rent or security deposits received
- Deferred revenues
- Vacation pay accruals
- Prepaid gift cards

Items that are not part of working capital are:

- Cash, term deposits and marketable securities (unless required to run the business in a consistent manner);
- Cheques in transit (these will hit the bank account after the transaction closes)
- Interest bearing debt (line of credit, banker's acceptances including short-term portion of long-term debt);
- Income taxes (payable and receivable)

Certain unusual items, 'one-offs' or add-backs could also be considered as part of the calculation. Calculations should be done on a consistent basis with past practice. This does not necessarily mean following accounting principles; consistency is preferred.

Your financial advisor should be in a position to help guide you through establishing and negotiating the minimum working capital and the sales price adjustment mechanism.

Cafa has successfully helped close scores of M&A transactions and our experienced team of advisors would be pleased to assist you with yours.

Recent Transactions:

Apex Precision

9392-3621 Québec Inc.
has acquired the shares of
Apex Precision Inc.

The undersigned acted as financial advisor to 9392-3621 Québec Inc. in this transaction

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PREVOST ALUMINIUM ARCHITECTURAL

A. & D. Prevost Inc.
A corporation controlled by
Capital régional et coopératif Desjardins (CRCD)
has been acquired by its management

The undersigned acted as financial advisor to Management for this transaction and its financing

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The Bagg Group

Garda Canada Security Corporation
a wholly owned subsidiary of
GardaWorld
has acquired
The Bagg Group

The undersigned acted as financial advisor to the shareholders of The Bagg Group in this transaction.

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