

The Significance of the Interplay between

Net Working Capital (NWC) & Purchase Price Adjustments (PPAs)

in M&A Deals with example.



In the fast-paced world of mergers and acquisitions (M&A), where deals are often defined by intricate financial negotiations and strategic maneuvering, understanding the interplay between net working capital (NWC) and purchase price adjustments (PPAs) is paramount. This dynamic relationship holds significant implications for deal structures, negotiations, and post-closing outcomes, shaping the success and value creation of M&A transactions.

01 What is Working Capital?

Working capital refers to the difference between a company's current assets and its current liabilities. Current assets are those assets expected to be converted into cash or used up within one year, while current liabilities are debts or obligations due within the same period. Working capital is a measure of a company's liquidity and its ability to meet short-term financial obligations.

02 What is Net Working Capital (NWC)?

Net working capital, a fundamental financial metric, serves as a key indicator of a company's operational efficiency and financial health. It specifically refers to the difference between a company's current assets excluding certain specified items (such as cash, deferred tax assets, and assets not included in an acquisition) and its current liabilities excluding certain specified items (such as debt, deferred tax liabilities, and liabilities not included in an acquisition). NWC provides a more refined measure of a company's liquidity, focusing on the assets and liabilities directly related to its ongoing operations. It is often used in financial analysis and business transactions, such as mergers and acquisitions, to assess a company's operational efficiency and financial health. During M&A transactions, NWC analysis is critical for assessing a target company's liquidity, working capital management practices, and potential risks.

03 Working Capital Adjustments

Working capital adjustments play a crucial role in M&A transactions, allowing buyers and sellers to align the purchase price with the actual financial condition of the target company at the time of closing. These adjustments are based on the difference between the estimated NWC agreed upon during negotiations and the actual NWC determined at closing. If the actual NWC exceeds or falls short of the agreed-upon amount, adjustments to the purchase price are made accordingly to ensure fairness and accuracy in valuation. If the NWC determined at closing is more than the estimated NWC, the purchase price will be increased and vice versa. Working capital adjustments typically involve analyzing various components of NWC, including accounts receivable, inventory, and accounts payable, to assess the target company's liquidity and operational efficiency. By incorporating working capital adjustments into the deal structure, parties can mitigate risks associated with fluctuations in NWC and ensure a smooth and transparent transaction process.

04 The Mechanics of NWC Adjustments

Pre-Agreement Estimates: Estimating Net Working Capital (NWC) targets before finalizing an M&A deal entails a meticulous process that draws upon both historical performance and future expectations. This process begins with a comprehensive analysis of the target company's financial statements, including balance sheets, income statements, and cash flow statements, to discern trends and patterns in working capital components such as accounts receivable, inventory, and accounts payable. Seasonal fluctuations and cyclical patterns are also factored in. Subsequently, market and industry dynamics are scrutinized to anticipate future trends and challenges, informing financial projections that encompass revenue growth, cost trends, and capital expenditure plans.

Scenario analysis is then conducted to assess the impact of different economic scenarios on the company's working capital needs. Based on these analyses, a normalized NWC figure is calculated, reflecting the target company's ongoing operational requirements. Collaborative discussions between the buyer and seller ensue to negotiate and agree upon the NWC target, with terms documented in the purchase agreement or definitive documents to formalize the agreement. This comprehensive approach to estimating NWC targets ensures transparency, clarity, and alignment between all parties involved in the transaction, laying the groundwork for a successful deal closure.

True-Up Mechanisms: True-up mechanisms play a crucial role in M&A transactions, ensuring that the purchase price accurately reflects the true value of the business at the time of closing. Post-acquisition, adjustments are made to the initially estimated Net Working Capital (NWC) to align it with the actual NWC at closing. This process involves comparing the estimated NWC, agreed upon during the pre-agreement phase, with the actual working capital delivered at the closing date. If the delivered NWC exceeds or falls short of the estimated NWC, adjustments to the purchase price are made accordingly, either increasing or decreasing it to reflect the business's true financial position. If the delivered NWC at closing is more than the estimated NWC, the purchase price will be increased and vice versa. These adjustments are typically made dollar-for-dollar or based on predefined thresholds, ensuring fairness and accuracy in the final transaction valuation. The true-up mechanism provides both buyers and sellers with assurance that the purchase price is based on the actual financial condition of the business, mitigating the risk of overpayment or undervaluation.

05 Role of NWC in M&A Transactions

The process of estimating NWC targets before closing a deal involves a meticulous balance between historical performance and future expectations. While historical financial data provides valuable insights into a company's past working capital trends, projecting future NWC requirements requires assessing market dynamics, industry benchmarks, and business forecasts. Achieving this balance is essential for aligning the purchase price with the target company's intrinsic value and mitigating transaction risks.

M&A transactions conventionally adhere to a cash-free and debt-free framework. While debt typically encompasses obligations to banks or third-party lenders, repayable over stipulated periods with defined interest rates, its interpretation within a deal extends beyond this traditional notion. Audited financial statements commonly detail both short-term and long-term debts, accompanied by specific terms and future payment schedules outlined in the financial notes. While this information may initially seem adequate for inclusion in purchase documents as liabilities to be settled by the seller, a more thorough examination is often necessary to ensure both parties, buyer and seller alike, are cognizant of additional items that bear resemblance to debt.

Though the identification of debt-like items may involve a degree of subjectivity, a comprehensive assessment of a company's liabilities, encompassing such items, is imperative for successfully concluding a transaction and shielding both parties from unforeseen post-closure complications.

Net working capital plays a crucial role in M&A transactions for several reasons:

- **Assessment of Business Operations:** Net working capital provides insight into the operational efficiency and financial health of the target company. It helps potential buyers assess the adequacy of current assets to cover short-term liabilities, indicating how effectively the company manages its working capital.
- **Valuation Considerations:** Net working capital can impact the valuation of a target company. Buyers may adjust the purchase price based on the target's net working capital at the time of closing to ensure they acquire a business with sufficient working capital to maintain operations post-acquisition.

Risk Mitigation: For buyers, assessing the target company's net working capital helps identify potential risks associated with liquidity and operational management. Adequate working capital can mitigate the risk of liquidity shortages and ensure smooth post-acquisition integration.

Negotiation Tool: Net working capital adjustments can be used as a negotiation tool in M&A transactions. Buyers may seek adjustments to the purchase price based on changes in the target's working capital, while sellers aim to maximize the purchase price by minimizing adjustments.

06 Purchase Price Adjustments (PPA)

Purchase Price Adjustments (PPAs) serve the critical objective of ensuring that the final purchase price of a company accurately reflects its actual value at the time of closing. These adjustments are calculated to align the agreed-upon purchase price with the real financial condition of the business, taking into account various factors such as debt, cash, and working capital variances from predefined targets. By incorporating PPAs into the transaction, buyers and sellers can mitigate the risks associated with discrepancies between estimated and actual financial metrics. Adjustments for debt and cash levels ensure that the buyer receives a fair deal, accounting for any outstanding obligations or excess liquidity. Moreover, working capital variances are meticulously assessed to reflect the operational health and liquidity position of the business accurately. Overall, PPAs play a crucial role in enhancing the transparency and fairness of M&A transactions by aligning the purchase price with the true value of the company at the time of closing.

Impact on Deal Structure: The inclusion of Purchase Price Adjustments (PPAs) in M&A transactions can significantly influence the deal structure, prompting adjustments to various components such as escrow arrangements, holdbacks, and earn-outs. Escrow arrangements, where a portion of the purchase price is held in a third-party account to cover potential liabilities, may be adjusted based on the outcome of PPAs to ensure adequate funds are available for any required adjustments post-closing. Holdbacks, which involve withholding a portion of the purchase price until certain conditions are met, may also be adjusted to reflect any discrepancies identified through PPAs. Similarly, earn-outs, which tie a portion of the purchase price to the future performance of the business, may be recalibrated based on the actual financial metrics revealed by PPAs. Overall, PPAs can lead to modifications in deal structures to address uncertainties and align the interests of both parties, ensuring a fair and mutually beneficial transaction.

07 Strategic Considerations for Buyers and Sellers

For Buyers: For buyers embarking on mergers and acquisitions, thorough due diligence is imperative to comprehend the intricacies of NWC components and their quality. This entails scrutinizing a target company's financial statements, including balance sheets, income statements, and cash flow statements, to gain insights into its working capital management practices. By understanding the composition of NWC, including accounts receivable, inventory, and accounts payable, buyers can assess the target's operational efficiency and financial health. Moreover, negotiating favorable terms for NWC adjustments is crucial to ensure a fair deal. Buyers may leverage their due diligence findings to advocate for adjustments that accurately reflect the target's true working capital position, mitigating risks and maximizing value creation in the transaction. Effective negotiation strategies involve conducting comprehensive financial analyses, identifying potential discrepancies, and collaborating with sellers to achieve mutually beneficial outcomes.

For Sellers: For sellers preparing for mergers and acquisitions, it's paramount to emphasize the importance of managing NWC effectively before the sale to optimize the company's valuation and streamline the transaction process. Efficient NWC management entails maintaining optimal levels of current assets and liabilities to support ongoing operations while minimizing excess or shortfall. By proactively managing NWC, sellers can demonstrate operational excellence and financial stability, enhancing their company's perceived value in the eyes of potential buyers. Additionally, a well-managed NWC can expedite the due diligence process and instill confidence in buyers, facilitating smoother negotiations and accelerating deal closure. Sellers should focus on optimizing working capital components, such as accounts receivable, inventory, and accounts payable, to showcase the company's financial health and maximize its valuation potential in the competitive M&A landscape.

08 Example

Adjustments to working capital in M&A transactions can occur under two primary scenarios:

Scenario 1

In the first scenario, if the working capital at closing exceeds the estimated NWC, the buyer (Company X) will end up paying a higher purchase price. For instance, if the estimated NWC is \$4.5 million, and at the close of the transaction, the actual NWC amounts to \$6 million, the excess net working capital represents the difference between these two amounts (\$1.5 million). In this case, the buyer (Company X) pays an increased purchase price of \$1.5 million because the seller (Company Y) provided a net working capital at closing that exceeded the agreed-upon NWC.

Scenario 2

Conversely, in the second scenario, if the working capital at closing is lower than the estimated NWC, the buyer (Company X) will pay a reduced purchase price. For example, if the estimated NWC is \$6 million, and at the close of the transaction, the actual NWC amounts to \$4.5 million, the shortfall in net working capital represents the difference between these two amounts (\$1.5 million). In this instance, the buyer (Company X) reduces the purchase price by \$1.5 million because the seller (Company Y) provided a net working capital at closing that was lower than the agreed-upon NWC.

Conclusion

In conclusion, the significance of the interplay between net working capital and purchase price adjustments cannot be overstated in the realm of M&A deals. By understanding and strategically navigating NWC dynamics and PPAs, dealmakers can enhance deal certainty, mitigate risks, and drive value creation in the dynamic and competitive landscape of mergers and acquisitions. Embracing transparency, diligence, and strategic insights is essential for achieving successful outcomes and forging mutually beneficial partnerships in the ever-evolving world of M&A.

About KNAV

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Please reach out to Viraj Bhogle at viraj.bhogle@knavcpa.com for more information on NWC and a copy of our redacted QoE report.

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