A Net Working Capital Crash Course for Sellers

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Net Working Capital ("NWC") is a critical component of any transaction involving the sale of a private business. As a seller, it is important to understand the concept of NWC, its impact on a transaction, and how to navigate the common deal terms we see in the Lower Middle Market.

Keys to Remember

- *Buyers are ascribing an Enterprise Value for the full operating business, which includes a healthy level of NWC to fund continued operations.*
- *Sellers should operate their business in NORMAL COURSE leading up to a deal closing; NWC structures are designed to protect buyers from a seller mismanaging the Balance Sheet prior to closing.*
- *If negotiated in good faith with a full understanding of the structure, the NWC adjustment should be close to a "Net Neutral" event for buyers and sellers.*

Defining Net Working Capital

For its most basic definition, Net Working Capital ("NWC") represents the difference between a company's Current Assets and its Current Liabilities. In other words, it is the amount of cash or cash-like assets a company has on hand to cover its short-term obligations. Current Assets typically include cash, accounts receivable, inventory, and other short-term assets, while Current Liabilities include accounts payable, accrued expenses, and other short-term liabilities.

For day-to-day operations, NWC is an important metric for business owners to track in order to assess the health of the company's balance sheet. As we shift focus to NWC in a transaction, that same concept is true for buyers – they look to NWC as a way to assess the health of the balance sheet they are stepping into. One analogy we use often is buying a new car: when you leave the lot, do you expect your new car to have a full tank of gas? Buyers of private businesses expect the balance sheet to have a "full tank of gas" (i.e., a sufficient level of NWC) at closing to fund continued operations.

Common Deal Terms

There are a few key deal terms to focus as it relates to NWC mechanics. First, the purchase agreement definitions of "Net Working Capital", "Current Assets", and "Current Liabilities" are critical in determining which accounts will be included in the NWC calculations. Buyers may have different views on how certain accounts (e.g., Deferred

Revenue) are defined, and that can have a material impact on overall proceeds at closing if sellers are not focused of these definitions during the negotiations.

Next, buyers and sellers will agree to a “NWC Target” as part of the purchase agreement negotiations. This represents the amount of NWC that the company should have on hand at closing. If the Closing NWC is less than the target level, the purchase price is typically reduced by the shortfall. Conversely, if the Closing NWC is higher than the target level, the purchase price is typically increased by the excess. Targets are typically set using averages of the company’s historical balance sheet. For example, the Target can be set using the Last Six Month Average of NWC, as defined by the purchase agreement definitions.

Understanding the definitions and setting a target that is consistent with historical trends of a business is the best way for a seller to maintain a “Net Neutral” proceeds position at closing. As a result, sellers need to work with their M&A adviser to understand the key components of NWC and negotiate an appropriate NWC target level that reflects a healthy level of NWC for that specific business.

For further discussions on Net Working Capital and its potential impact during a transaction process, please contact the team at Founders Advisors.