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Understanding the Net Worth Capital Peg in M&A Transactions

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Over the course of the sale process for a business, the buyer and seller will spend a significant amount of time negotiating the purchase price for the business.

Once both parties come to an agreement, there are additional wrinkles that are factored into the equation. Perhaps one of the most important, and often least understood, is the Net Working Capital Peg and how it impacts purchase price.

Most businesses are bought and sold on a cash-free debt-free basis. What that means is the buyer is looking to acquire the pure operations of the business: the employees, customer contracts, brand, equipment, intellectual property, and everything else that generates earnings. What is left is cash and debt. Cash is excluded as most privately held companies consider their bank accounts an extension of their own personal savings. Likewise, debt is excluded because buyers will establish their own financing resources to be used both for the purchase of the business as well as to provide for their own working capital needs. Further, from a practical perspective, most commercial debt arrangements will become due and payable upon a change in control of the business.

This is where understanding the role that Net Working Capital (NWC) and the NWC Peg plays in the M&A landscape becomes its most important. Simply put, NWC is a measure of a company's short-term financial health, calculated by the total of current assets of a business (excluding cash) minus the sum of its current liabilities (excluding debt). Current assets typically include accounts receivable, inventory, and prepaid expenses. Current liabilities typically include accounts payable, accrued payroll and other accrued operating expenses.

The NWC Peg is the agreed upon target NWC amount that the seller must deliver at closing so the business can function normally on day one under new ownership. It is often calculated by using a trailing 12- or 6-month average of NWC as adjusted for any one-time anomalies or business trends. For example, any unusually large customer prepayments or temporary delay in paying vendors would be removed or normalized. What is left is the resulting negotiated target NWC that both the buyer and seller believe reflects the normal amount of short-term financial liquidity that the business requires to operate. The NWC Peg is often a subject of negotiation between buyer and seller. Both buyer and seller will do their own calculation of the NWC Peg, then negotiate and agree upon a target NWC Peg that is incorporated into the purchase agreement. A poorly calculated and negotiated NWC Peg could result in leaving significant dollars on the table and can be one of the most heavily negotiated sections of the purchase agreement.

For closing, the seller's projected NWC as of the closing date is compared to the NWC Peg. If they match, no adjustment is made to purchase price. If the projected NWC is higher than the NWC Peg, the excess is treated as additional purchase price and belongs to the seller, which effectively increases the seller's total proceeds, dollar-for-dollar. If the projected NWC as of the closing date is lower than the NWC Peg, the shortfall reduces the purchase price dollar-for-dollar, protecting the buyer from inheriting a business that may be temporarily short on liquidity.

Since the amount of NWC at closing is based upon a projection or estimate (as the seller has not yet closed its books as of that date), a post-closing "true-up" is performed typically 60-90 days post close to adjust the purchase price based on the actual amount of NWC as of the closing date. Buyers will often require an NWC escrow to protect them from any significant post-closing adjustment. A detailed and well-defined working capital Peg is key to ensure that amounts are calculated in accordance with the agreed upon methodology. Typically, an exhibit to the Purchase Agreement will define NWC (what specific current assets or current liabilities are included or excluded from the calculation), and the Purchase Agreement itself will detail how the calculation is to be performed, the amount of the NWC Peg, and the true-up process.

A well-defined Peg also helps keep the deal fair - it helps ensure the buyer inherits a business with the liquidity it needs and the seller is paid appropriately. In practice, the NWC Peg may seem like a relatively simple concept, but it has significant implications, which is exactly why coming to an agreement between both parties earlier rather than later saves time and money for everyone involved.

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