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ALIGNING BUYER AND SELLER EXPECTATIONS: THE ROLE OF WORKING CAPITAL PEGS IN M&A

When buying or selling a business, managing working capital is crucial for a successful deal. One important tool in this process is the working capital peg ("peg") — a mutually agreed target level of working capital between the buyer and seller. The peg is essential for preventing disputes, aligning expectations, and safeguarding the financial interests of both parties. This whitepaper will delve into the concept of working capital pegs, their significance in M&A deals, how to calculate them, and provide a case study of a Quality of Earnings Analysis conducted by Sapling Financial Consultants, Inc. ("Sapling") that involved working capital peg analysis.

WHAT IS A WORKING CAPITAL PEG?

A working capital peg is the agreed-upon benchmark amount of net working capital ("NWC") that the business should have at deal close. Assuming a business is acquired on a cash-free, debt-free basis ("CFDF") , NWC is equal to current assets excluding cash such as accounts receivable, inventory and prepaids, minus current liabilities such as accounts payable and accrued liabilities. In an M&A context, NWC represents the liquidity needed to maintain normal operations. If NWC deviates significantly from historical norms or the agreed peg, it can disrupt the business, impacting cash flows and liquidity.

IMPORTANCE OF WORKING CAPITAL PEGS IN M&A

The working capital peg ensures that the buyer doesn't inherit too little working capital—leading to potential cash injections post-closing—nor does the seller leave excessive working capital behind without adequate compensation. Here are the key points that highlight its importance:

1. Protecting Buyer and Seller Interests

The working capital peg is crucial in protecting both buyer and seller interests by stabilizing liquidity expectations during an acquisition. A properly set peg ensures the target company has sufficient working capital post-close to avoid cash flow issues, while preventing overpayment for excess liquidity. Sellers benefit from the peg by ensuring they are compensated for any surplus working capital at the close, safeguarding their value. The peg is typically based on historical data, reflecting the company's normal operating needs, which is vital for estimating future cash flow and capital requirements. It also aligns both parties' incentives during negotiation, preventing buyers from forcing sellers to contribute excessive capital or inflating the peg, while ensuring fair compensation for the seller's working capital.

2. Minimizing Post-Closing Adjustments

M&A deals often involve working capital adjustments if the closing amount differs from the peg. If the actual working capital at closing is less than the peg, the buyer is compensated by reducing the purchase price. Conversely, if the closing working capital is higher than the peg, the seller can increase their proceeds by the excess amount.

Example: Normalized Working Capital			
Normalized Working Capital	**Actual**	**Normalized**	**Working Capital Adjustment**
Accounts Receivable	$4,000,000	$5,000,000	$1,000,000
Prepaid expenses	$50,000	$50,000	-
Inventory	$20,000	$20,000	-
Other Current Assets	-	-	-
Accounts Payable	$2,000,000	$1,500,000	($500,000)
Accrued Expenses	$250,000	$250,000	-
Deferred Revenue	$3,500,000	$4,000,000	$500,000
Sales Taxes Payables	$20,000	$20,000	-
Income Tax Payables	$34,095	$34,095	-
Net Working Capital	**($1,734,095)**	**($734,095)**	**$1,000,000**

Headline Purchase Price vs. Adjusted Price	
Headline Purchase Enterprise Value:	**$25,000,000**
(+/-) Working Capital Adjustment:	($1,000,000)
Adjusted Purchase Enterprise Value:	**$24,000,000**
(+) Cash:	$100,000
(-) Total Debt:	($2,000,000)
Purchase Equity Value:	**$22,100,000**

Exhibit A. Example of Working Capital Peg Analysis

For example, if the working capital peg is ($0.7M) million and actual NWC at close is ($1.7) million, there will be a downward adjustment of $1.0 million as there was insufficient NWC in the business (see Exhibit A). A clearly defined peg reduces post-closing disputes, providing a structured approach for adjustments. Reducing post-closing adjustments is crucial for quick integration minimizing distractions, enabling the buyer to focus on post-acquisition growth and operational efficiencies.

CALCULATING THE WORKING CAPITAL PEG

The working capital peg involves determining the appropriate accounts for working capital and adjusting these account balances to reflect normalized working capital levels.

a) Determining the Appropriate Accounts

Working Capital is defined as current assets fewer current liabilities. This definition does not translate to working capital peg analysis. For working capital peg analysis, certain accounts from current assets and current liabilities are included to determine the peg (see Exhibit B):

Working Capital Peg Accounts	Included in Analysis?
Current Assets	
Cash	**No**
Accounts Receivable	**Yes**
Prepaid Expenses	**Yes**
Inventory	**Yes**
Current Liabilities	
Accounts Payable	**Yes**
Accrued Liabilities	**Yes**
Deferred Revenue	**Yes**
Sales Taxes Payable	**Yes**
Current Portion of Long-Term Debt	**No**
Revolving Line of Credit	**No**
Current Portion of Operating Lease	**No**
Current Portion of Finance Leases	**No**

Exhibit B. Working Capital Accounts Included in Working Capital Peg Analysis

I. Current Assets
Current asset accounts related to operations including Accounts Receivable, Prepaid Expenses, and Inventory are incorporated. Cash and Cash Equivalents are excluded as it is considered a non-operating asset that is not directly involved in the day-to-day operations of the business.

II. Current Liabilities
Current liabilities related to operations including Accounts Payable, Accrued Liabilities, Deferred Revenue, and Sales Taxes Payable are constituted into the Working Capital Peg Analysis. However, liability accounts related to financing, such as Current Portion of Long-Term Debt, Revolving Lines of Credit, and Current Portion of Financing and/or Operating Leases, are excluded as they are a financing decision that could change post-acquisition.

b) Normalize the account balances for the selected working capital accounts
Once the correct accounts have been included in the analysis, the analyst must then adjust the most recent period's balances for these accounts to reflect a normalized level of working capital. The following must be considered in the process of normalizing account balances:

I. Analyze Historical Trends
Review several years of working capital data to establish a baseline and identify any seasonal or short-term fluctuations. Analysis predicated on a working capital days basis assists in identifying irregular fluctuations of working capital balances. This ensures that the peg reflects the normal operating requirements of the business.

II. Consider Industry-Specific Factors
Industry norms can significantly influence working capital needs. Sectors with long inventory cycles or extended payment terms may need higher working capital pegs. Understanding these nuances prevents setting unrealistic targets.

III. Account for Future Changes
Consider whether the business is expected to grow or undergo operational changes post-transaction. A growing company may require more working capital, which should be reflected in the peg.

CASE STUDY: NORMALIZED WORKING CAPITAL DAYS AND NORMALIZED WORKING CAPITAL LEVEL

Sapling conducted a working capital peg analysis for a search fund buyer of an industrial automation company involved in large-scale equipment installations. This business typically recorded lower accounts receivable and larger deferred revenue balances due to the nature of their payment terms and contracts. Over the trailing twelve-month period, however, the company recorded a significant build-up of accounts receivable related to large installation contracts. Thus, determining a normalized working capital level for future periods was essential in deal negotiations.

Working Capital Peg Analysis						
Normalized Working Capital		**Mar-21**	**Sep-23**	**Dec-23**	**Mar-24**	**Jun-24**
LTM Revenue		**$12,984,487**	**$17,903,620**	**$19,711,051**	**$19,237,349**	**$18,592,145**
Accounts Receivable	**Norm. Avg.**	*Z-Score*	1.7x	1.8x	1.1x	0.3x
Days Outstanding (Sales)	19.0x		55.0 Days	57.2 Days	4.4 Days	20.1 Days
Override Period			Yes	Yes	No	No
TTM Sales			$17,903,620	$19,711,051	$19,237,349	$18,592,145
Accounts Receivable - Historical:			**$2,698,323**	**$3,086,681**	**$232,222**	**$1,021,909**
Normalized Level of Accounts Receivable		**$968,156**				

Exhibit C. Example of Sapling's Working Capital Days Approach to Normalizing Working Capital

To assess a normalized working capital level, Sapling began by identifying the working capital accounts to include in the analysis. Then it calculated a normalized working capital days figure for each of these accounts. The normalized figure was determined by calculating the average working capital days over the previous two fiscal years and the year-to-date, with adjustments made for periods exhibiting irregular balances. These irregular periods were identified as those with working capital day z-scores exceeding 1.65, representing a 90% confidence interval.

Normalized working capital days figures were then multiplied by their associated profit and loss ("P&L") accounts. For example, to calculate Accounts Receivable, the Days Sales Outstanding ("DSO") was multiplied by total sales and divided by 365 days over a year. This provided an estimate of the average working capital requirements (see Exhibit C).

The resultant normalized working capital balance was almost $2.0 million below the actual working capital balance meaning the seller would have been entitled to an additional $2.0 million working capital adjustment in the deal. This case is an example of the application of statistical analysis to determine the working capital peg.

SUMMARY AND CONCLUSION

Working capital pegs are a vital component of M&A transactions. By agreeing on a realistic working capital target, both the buyer and seller safeguard liquidity, reduce post-closing disputes, and ensure the business's true value is reflected in the deal. Understanding how to negotiate the peg can mitigate transaction risks and lead to smoother integration and long-term success. Sellers benefit by ensuring they are properly compensated for the working capital left in the business at closing.

Ultimately, the working capital peg serves as a bridge between the past performance of the business and its future needs, making it a fundamental part of deal structuring in any M&A transaction.

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