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THE IMPORTANCE OF NET WORKING CAPITAL TARGETS IN M&A TRANSACTIONS

A key component of M&A transactions, whether structured as an asset or equity sale, is the determination of net working capital targets at closing. Net working capital is generally a measure of a company's current assets *minus* current liabilities. Current assets are liquid assets, including cash or other assets easily reduced to cash (e.g. inventory and accounts receivable), used by the business for its operations within a year, as well as certain balance sheet items like prepaid expenses. Note that while cash is technically a current asset, it is typically excluded from the working capital analysis in **M&A transactions**. Current liabilities are short term obligations that become due within a year, as well as certain accrued liabilities on the balance sheet. Net working capital is a crucial measure of a seller's operational liquidity that a prospective buyer will study closely with its accountant and other transaction advisors during initial financial due diligence before submitting a **letter of intent to a seller**.

What is a Net Working Capital Target?

The net working capital target is negotiated between the buyer and the seller and agreed in the definitive purchase agreement. A common measure for the net working capital target is the target's monthly average of net working capital over the trailing 12 months. An analysis of the monthly average of net working capital over an extended, recent period of time helps to account for the seasonality of the business's normal cycle, depending on the particular industry, along with other fluctuations in net working capital to provide a more complete picture of the seller's financial health. Buyers want to ensure that sellers deliver sufficient working capital at closing to meet the business's ongoing operational needs, and want to prevent a situation where the buyer needs to infuse additional cash into the business post-closing. In this sense, a buyer wants to make sure there is enough "gas in the tank" to drive the business forward post-closing.

Why is a Net Working Capital Target Important?

An important aspect of the net working capital target is its effect on the transaction purchase price. Typically, the purchase price is subject to an upward or downward adjustment on a dollar-for-dollar basis depending on the difference between the net working capital target agreed to in the purchase agreement, and the actual net working capital delivered at closing, as determined post-closing. If the actual net working capital amount at closing is higher than the net working capital target, the seller delivered an excess, and would receive the difference from buyer as an upward adjustment to the purchase price post-closing. However, if the actual net working capital amount at closing is lower than

the net working capital target, the seller delivered a deficit, and would pay the difference to buyer as a downward adjustment to the purchase price post-closing.

The purchase agreement details the mechanics of the net working capital adjustment to the purchase price. Generally, the parties in working with their accountants will estimate the amount of net working capital right before closing, typically within 1 to 3 days. This estimate is a first adjustment to the purchase price that also takes into account any of seller's debt payoffs, transaction advisory fees, and other applicable adjustments, to calculate the purchase price for purposes of closing. The parties cannot know the exact amount of net working capital on seller's balance sheet at closing, thus the final purchase price is typically subject to a second adjustment within a negotiated period of time post-closing.

Prior to an agreed period of time post-closing, typically ranging anywhere from 30 to 120 days, the buyer will deliver to seller a closing net working capital statement detailing buyer's calculation of the final purchase price, indicating whether there is an upward or downward net working capital adjustment to the purchase price as of closing. The seller will have a period of time to review and either accept or dispute the buyer's calculation, the process of which would have been drafted, negotiated and agreed to in the purchase agreement by the seller and buyer, with the assistance of their respective legal counsel.

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The determination of net working capital targets, and the process surrounding a net working capital adjustment to the purchase price in an M&A transaction, involves a coordinated effort among the seller's and buyer's respective deal teams, including attorneys, accountants, investment banker, and other transaction advisors. Net working capital is just one of many important considerations of an M&A transaction, and there are other potential deal terms that may cause a purchase price adjustment post-closing.

The experienced **corporate attorneys** at JAH are here to counsel you through every step, whether you are contemplating a business sale or acquisition. **[Click here to contact a member of our Corporate Group if you are in need of assistance.](#)**

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