WORKING CAPITAL: WHEN LESS CAN BE MORE

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PACIFIC M&A AND BUSINESS BROKERS LTD.

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WORKING CAPITAL: WHEN LESS CAN BE MORE

While actively operating a business, most small business owners monitor their working capital levels in a manner more consistent with their personal preferences rather than with the view of maximizing value at the time of sale. Common ways to express this style preference are management of inventory on hand, collection of receivables, and settlement of payables. A conservative business owner may ensure that they always have enough inventory for any conceivable order size (even if this would be a record sale), collect their receivables immediately, and settle their payables as soon as they come due with no reliance on credit from their suppliers. A less conservative owner may allow their receivables to stretch beyond original terms with favoured clients, let inventory run to nearly zero before receiving a shipment, and demand longer payment terms from their suppliers. Although each business and transaction differs, it is likely that neither of these approaches best smooths the transition process and creates the greatest possible for the shareholder.

Consider the following two businesses:

INCOME STATEMENT

	Business A	Business B
Revenue	$ 2,500,000.00	$ 2,575,000.00
Cost of Sales	$ 1,600,000.00	$ 1,660,000.00
Gross Profit	$ 900,000.00	$ 915,000.00
Depreciation	$ 100,000.00	$ 80,000.00
SG&A Expenses	$ 450,000.00	$ 459,000.00
Operating Profit	$ 350,000.00	$ 376,000.00
Income Tax	$ 52,500.00	$ 55,000.00
Net Income	$ 297,500.00	$ 321,000.00

BALANCE SHEET

	Business A	Business B
Cash	$ 100,000.00	$ 1,021,000.00
Accounts Receiveable	$ 600,000.00	$ 420,000.00
Inventory	$ 800,000.00	$ 400,000.00
Current Assets	$ 1,500,000.00	$ 1,841,000.00
PP&E	$ 400,000.00	$ 320,000.00
Total Assets	$ 1,900,000.00	$ 2,161,000.00
Accounts Payable	$ 10,000.00	$ 150,000.00
Due to Shareholder	$ 200,000.00	$ -
Retained Earnings	$ 1,689,800.00	$ 2,010,800.00
Share Equity	$ 200.00	$ 200.00
Liabilities + Equity	$ 1,900,000.00	$ 2,161,000.00

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The table states that Businesses A and B have very similar profitability metrics and revenues, but very different balance sheets (and therefore working capital). Business A has extended more credit to its customers in the form of accounts receivable and carries double the inventory, whereas Business B presumably funds more of its operations with cash as it carries far more on its balance sheet. On the liability side, Business A appears to have been paying all of its bills promplty as there is only $10,000 in accounts payable on the balance sheet. Business B has taken advantage of a little more credit from its suppliers, and has $150,000 in accounts payable. In addition, the shareholders have financed Business A to the tune of $200,000 vs. $0 in the case of Business B.

So what does all of this have to do with working capital target levels and maximizing shareholder value? Let's take a step back and remember the single most important consideration when determining a business' value and transactional price: profitability. Without going into excessive detail and for the purpose of brevity, assume that each business transacts for a simple 4x multiple of TTM EBITDA.

The following total consideration applies:

	Business A	Business B
Net Income	$ 297,500.00	$ 321,000.00
Add Back: Depreciation	$ 100,000.00	$ 80,000.00
Add Back: Income Tax	$ 52,500.00	$ 55,000.00
EBITDA	$ 450,000.00	$ 456,000.00
4x Multiple	$ 1,800,000.00	$ 1,824,000.00

As you can see, the businesses sell for a very similar price, despite having very different working capital structures. Assuming that no cash or shareholder loans are transferred at the time of sale and that current working capital levels are indicative of the negotiated target, the buyer of Business A will be taking on $1,390,000 in working capital and the buyer of Business B will be taking on $670,000 in working capital. In this case, the seller of Business A has barely received more than asset value (NWC of $1,390,000 + PP&E $400,000) whereas the seller of Business B has received considerably more. This demonstrates that the required levels of working capital negotiated at the time of transaction can have a major effect on the amount in excess over asset value, or "goodwill", that the seller receives.

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But what if the level negotiated based on balance sheet values is not indicative of the true amount that a business requires to operate: for example, what if Business A is carrying excess working capital required for operations and it could operate more like Business B? Lowering working capital levels would free up excess cash, making it distributable to shareholders. In actuality, all that Business B represents is Business A after on fiscal year and considerable working capital reduction – these are actually years 1 and 2 of financial statements.

The following statement of cash flows connects the two balance sheets:

STATEMENT OF CASH FLOWS

Net Income	$ 321,000.00
Plus Non-Cash Charges	$ 80,000.00
Plus Change in Non-Cash WC	$ 520,000.00
Total Change in Cash	$ 921,000.00

As you can see, the business has accumulated much more cash than net income of $321,000 in year 2, with most of this cash funded through changes win working capital levels. The business has now tightened on its receivables, lowered inventory to a reasonable 3 months, increased its credit from suppliers, and paid off the loan to shareholders. In all, assuming the business can now be transacted with current levels of working capital of $670,000 and that these are the true required levels, the shareholders have benefited approximately another $1,100,000 by holding onto the business for another year ($1,002,000 in distributable cash Y2 - $100,000 cash Y1+ $200,000 shareholder loan repaid). This is a greater than 50% return on the original selling price of $1,800,000.

Working capital management is a complex and ever-shifting task, yet as this exercise has demonstrated, paying attention to what a business actually requires rather than how it is currently operating can deliver greater returns in the time of sale. At Pacific M&A and Business Brokers, we attempt to determine the true level of required working capital rather than what the balance sheet says: This helps ensure that you are not leaving any money on the table and that a deal will not flounder when a buyer decides during due diligence that the negotiated level of working capital is too low. Our working capital estimations include analysis of the income statement, balance sheet, and statement of cash flow to ensure that price that you go to market at is inclusive of a working capital level that is reasonable, fair, and defensible – and that accurately portrays the liquidity needs of your business.

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