WORKING CAPITAL- AN IMPORTANT CONCEPT WHETHER SELLING YOUR BUSINESS

Let's define working capital. Working Capital is the net of **Total Current Assets less Total Current Liabilities** where current assets are generally seen as cash, accounts receivables, inventory and prepaid expenses less short term bank debt, account payables, accrued liabilities and customer deposits or deferred revenue. Classic business theory says that a good working capital position is where the ratio of total assets to total liabilities is 2 to 1.

The importance of Working Capital took on a new meaning to me about 6 years when I started *brokering* share deals for fire, guard and integration companies. Just when I thought a particular deal was all wrapped up, the buyer raised the issue of how much working capital was to be left in the company when the deal was closed. Truthfully I had not realized this was to be an issue and I certainly did not fathom just how complicated this issue could get. I now understand that working capital is not just important when operating a business but also when you go to sell. And as a Seller if you are not careful to be aware of this requirement but also that you can leave significant amounts of money "on the table" in working capital if you don't get the right advice.

Most of us realize how important adequate working capital is to *operating* a business successfully. Without working capital an owner may not be to pay his staff on time, buy the inventory necessary to run the business, pay his payables on a timely basis and on and on. Owners should take some or all of the following steps to ensure they have enough working capital:

- Make sure the business is properly capitalized in the beginning
- Go to the bank to get a line of credit
- Try to collect receivables faster

So common sense suggest that if working capital is important to owners operating their business, it is reasonable to assume that it will be equally important to a buyer when buying that same business.

The reality is that the amount of working capital to be left in a business when it is sold does factor into the selling process of most but perhaps not all deals. Sellers need to realize that they will most likely have to give up some or all of their receivables and inventory to cover their payables and accrued liabilities and give the buyer something extra WC to run the business. The key question revolves around just how much the seller has to give up.

Before we get into the actual amounts lets spell out with what kind of security companies working capital typically plays a factor in. My experience is it factors more when a sale of shares takes place than a sale of assets because in a sale of shares the buyer is taking over the complete business with staff and all assets and liabilities whereas in a sale of assets the buyer can pick and choose what he wants to buy and seldom buys existing liabilities.

Secondly working capital plays a bigger role in the sale of fire, guard and integration companies firstly because firstly share deals are done more often when you are buying any of the these 3 types of companies and secondly large amounts of extra working capital are often not required when buying alarm accounts. Alarm account deals are often structured so that the buyer does not have to take one that much extra expense.

However if the buyer is buying the shares of a fire or guard company, they do not want to have to write a big cheque the 2nd day he owns the business to provide working capital so the company can operate. This seems very fair but you would be surprised at how many owners are shocked when they are told that they have to give up a portion, sometime a large portion, of their receivables and inventory free of charge.

How much working capital has to be left in the company and what all is included in the definition of working capital. These are the two questions that buyers and sellers wrestle with in completing a deal. Having had to handle these 2 questions several times in completing deals I have this advice to all Sellers:

- Work towards setting a working capital target in actual dollars and try to get this issue settled as early as possible in the deal process. I.e. if possible before a Letter of Intent is agreed to.
- Deferred revenue and customer deposits are often included in the definition of WC and can be a tricky item in negotiating WC targets. Most buyers of alarm accounts will want all the deferred revenue as a deduction of the purchase. As a broker I try to bargain for my sellers that some not all of the deferred to be included.
- Don't let the Buyer talk you into using an average of what working capital was in the company over the last 12 months. An average amount has nothing to do with what is actually required. Most owners of small companies don't spend that much time optimizing their working capital. They leave extra cash in the company for months on end. They don't always collect their receivables as quickly as they could. They leave more money wrapped up in inventory than they need. Try to calculate what working capital is really required to run the business for a month or two- not what just happens to be there.
- The amount of working capital required to be left varies greatly on the type of business being sold. I sold an integration business doing $5 million a year in sales which had a large amount of Work in Process and the buyer was maintaining most of the Sellers staff and structure. The working capital required to be left in that business surpassed $750,000 whereas with an alarm company I recently sold the working capital requirement was $15,000 primarily because the buyer was taking on very few expenses from the seller.
- I have seen certain rules of thumb used to arrive at the amount such as 10% of sales or 2 months of expenses but even these are not as good as actually figuring out what really is required.

While the Seller should be wary of not leaving too much in the company when they sell, they should also not crater the deal but holding out too stridently for a certain WC number or create a lot of bad will early in the new ownership period over a few thousand dollars of working capital. The facts are buyers need working capital to run most businesses.

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