The amount of working capital (current assets less current liabilities) required to fund operations varies by owner preference (e.g. how quickly they pay vendors), by industry (e.g. seasonality or cyclicality of certain industries), and by business (e.g. how often inventory turns). A transaction can ultimately be derailed late in the process without a clear and proper definition early in the negotiations of the level of working capital to be transferred to a buyer.

**Developing a Working Capital Target**

In an acquisition, the required level of working capital needed to support the business must be carefully assessed. Commonly an average is determined – this is called a “peg” – and is included in the purchase agreement. However, between the time a buyer initially sets an offer price and the transaction closing date, variations can arise from fluctuations (sometimes significant) in the short-term assets and liabilities of the business. Regardless, setting a peg prevents a seller from managing current assets and liabilities in their favor (e.g. by delaying payments to suppliers, collecting receivables faster, etc.) and the buyer from benefiting if there is excess working capital at the time of closing.

Some of the more common approaches to determining the peg include:

- Using the working capital level as of the most recent financial period ended,
- Taking an average of working capital over a set historical time period (e.g. 12 months), or
- Applying a benchmark industry average working capital ratio to the seller’s operations.

**Effect on Purchase Price**

Once a final working capital calculation is performed as of the closing date, it is compared to the agreed upon peg. If actual working capital is higher than the peg, the purchase price is increased. If it is below the peg, the purchase price is decreased. Generally, either a dollar-for-dollar adjustment or a de minimus adjustment, also referred to as a “band,” is used. The band allows for the actual working capital to deviate from the target, or peg, by a specified amount. After that range is exceeded, the change in purchase price typically takes the form of a dollar-for-dollar adjustment. Since completed financial statements are typically not available at the closing date to calculate working capital, a true-up is required generally within 90 days after the close of a transaction.

**Common Challenges**

Unfortunately, defining working capital is more complicated than simply subtracting current liabilities from current assets. Items that should be given special attention include:

- **Calculation of current asset and liability categories.** It is not necessary that all current assets and liabilities be included when calculating working capital. For example, in many cases cash, short-term debt, and intercompany assets and liabilities are excluded. It is important that both parties agree in advance on which accounts will be used.
- **Seasonality.** Many industries experience seasonal business cycles which cause working capital to fluctuate significantly during the year. Acquiring a business as it is building inventory for a peak selling season may require a significant adjustment if the target working capital is based on a 12-month average. For this reason, using a specific month-end working capital value during this peak selling season might be more appropriate.
- **Strong growth.** As a company grows, it naturally requires a higher level of working capital to sustain the business. If a selling company has and is expected to continue to grow rapidly, an average of historical working capital may not be an appropriate target. In this case, it would be more advisable to forecast working capital necessary to fund the growth.

Every company and industry has unique characteristics for calculating and setting a working capital target. Although some are more complex than others, there will always be a plethora of details to consider. It is important to have a knowledgeable team of advisors to assist you through the process.
Cost of a Failed Sale Process – Higher Than You Think!

There are multiple issues that a business owner needs to consider when preparing for a sale of their business. One consideration that is often poorly understood is the cost of a failed deal - it can be enormous and overshadow any other deal costs incurred.

A sale process can fail for a number of reasons. The most common include:

- Financial and other key information on the business (e.g. key contracts) is incomplete or not accurate,
- Lack of management depth with no clear succession plan,
- Customer concentration is too high,
- The deal opportunity was poorly communicated to prospective buyers,
- Financial performance of the business deteriorates during the process,
- Financial and other advisors did not orchestrate an effective transaction process,
- Owner does not have a financial advisor and tries to run the sale process “in their spare time,” not giving it the required focus.

Some business owners say, “If the process fails, I can always try again.” Unfortunately it’s not that simple.

When a sale process fails and the owner subsequently decides to try again, approaching buyers a second time is a huge challenge. Prospective buyers have already formed a negative view of the business through their initial review of the opportunity (sometimes through no fault of the business, but rather through a poorly managed and communicated process).

Even if new advisors are in place and a more complete information package is assembled, it remains a challenge to convince buyers to change their view. For the unfortunate company, the market has been “poisoned.” It becomes known in the market that the company “couldn’t sell” and rumors start to circulate that there must be problems with the business.

The business owner is now left to wait for a period of time (several years at least) for the negative sentiment to dissipate, until buyers are willing to take a fresh look at the opportunity.

At BCC Advisers, we understand that you have one chance at a successful sale process, so you need to get it right the first time. This means ensuring you have all the required information about your business prepared; an engaged, experienced and committed team in place (including company executives and external advisors); the right deal process; and the right market conditions. If you can do this, you will complete a successful deal, which in today’s market means a premium value.

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Co-authored with Doug Irwin, CapWest Partners

BCC Opens Cedar Rapids Office

In a geographic expansion into the eastern half of Iowa, BCC Advisers recently opened an office in Cedar Rapids, located in the historic Witwer Building. The new office will primarily offer M&A advisory services from this location initially, while also providing business valuation, litigation support, and real estate appraisal services through the support of our Des Moines headquarters. With abundant demand for BCC’s line of services, eastern Iowa was a logical market in which to have a physical presence.

Serving as Managing Director of the Cedar Rapids office, Jack Gonder has joined the firm. Jack’s background is strong in merger and acquisition advisory services, working with privately-owned business owners that want to sell their company or acquire other businesses. Jack works closely with the M&A team in Des Moines which includes Steve Jacobs, Tom Cavanagh, and Kyle Larson. He also collaborates with professionals in BCC’s additional core service lines to provide clients with business valuation, litigation support, and commercial real estate appraisal services.

Prior to moving to Cedar Rapids in 2014, Jack was with InterOcean Advisors, a boutique Chicago investment bank. He has led dozens of buy-side and sell-side engagements generating approximately $400 million in shareholder liquidity with companies in numerous sectors including industrial manufacturing, food, distribution, and professional services. For the last two years Jack worked in the commercial lending group at Cedar Rapids Bank & Trust, and previously held similar positions in Chicago with American National Bank and LaSalle Bank.
In a business ownership transfer, a business owner must be able to best meet their business, financial, and personal goals, whatever they may be.

Unfortunately, most business owners have not done sufficient succession planning to address these goals. Statistically speaking, one-third of business owners polled indicate they have done no succession planning, another third indicate they haven’t fully articulated and implemented a succession plan, and the remaining third indicate adequate planning. Of the third that indicates adequacy, closer evaluation reveals that the majority do not, in fact, have a comprehensive plan. Only 10% of private businesses in the U.S. have a clear and thoughtful succession plan (1).

Intuitively this makes sense: the focus of business owners is on running their company, not planning for the CEO’s departure or other ownership transfer options at some undefined point in the future. Uncertain variables like next generation family involvement (or noninvolvement), or management development (management buyout), often result in deferring any proactive planning.

As business owners continue to think about these issues, it is important to understand that the sooner planning starts the higher the probability of accomplishing a desired outcome. While a plan can be developed and implemented at any time, the negative consequences of short-term planning increase the closer to retirement a business owner gets.

There are many succession planning factors to consider, each as personal as the individual owner. The best sale strategy to employ will depend upon your primary goal:

- Do you want to preserve the legacy of a family business you or your family members founded?
- Do you wish to transfer ownership to the next generation of family?
- If family succession is not an option, do you want to sell to existing employees?
- Are your community and local residents dependent upon your business? (Is it important that the buyer keep the business in the community?)
- Would it be advantageous to consolidate with a competitor or strategic partner to take advantage of additional market areas, operational equipment, investment capital, or synergistic opportunities such as complementary products or services?
- Are financial considerations obligating you to obtain the highest value possible?
- Are you interested in running a confidential auction process to increase the likelihood a buyer will pay a premium?

Once you’ve determined what your goals are and can identify what a successful outcome would look like, you can then explore appropriate sales strategies to determine the most beneficial approach to selling your business. The owners of two equivalent companies may have vastly different approaches to an ownership transfer, depending upon what is important to them. There is no “one size fits all” approach.

Proper legal, accounting, and advisory services are critical to legacy preservation, maximizing financial results and positioning a company for future growth and prosperity. Sound a little daunting? Seeking counsel of a competent business transfer expert such as BCC Advisers is a great first step.

(1) 2013 Exit Planning Institute State of Owner Readiness Survey.
Effect of Election on M&A

To say the 2016 presidential race has been unique thus far would be a gross understatement. Some might liken it to a circus, but in any event it’s hard to recall a time in this country’s recent history when those in office have been further at odds and the populace so frustrated with its leaders. Nevertheless, there are many important decisions to be made by the next president that will affect the overall business climate.

The uncertainty of who that president will be and the decisions that he or she will make, has and will continue to impact M&A volume in 2016. According to Thomson Reuters, the number of middle-market transactions are down 33% through the first quarter with dollar volume of those transactions down 24%. In addition, GF Data Resources announced middle-market transactions among financial buyers in the first quarter declined 36% from the fourth quarter, higher than the 25% average decline between these two quarters over the past ten years.

What is it about an election year that causes uncertainty in the M&A markets? There are a variety of issues which can change a business owner’s willingness to sell or a buyer’s willingness to acquire.

- **Tax Rates.** Taxation of income and capital gains tends to be a focal point in nearly every election and can have a significant impact on net sale proceeds for a business owner. An expected rise in tax rates might pull forward M&A activity from those owners that are contemplating a sale. A pushout of activity might occur if rates are expected to decline under a new administration.

- **Industry Regulations.** The financial and healthcare industries have experienced significant regulatory changes in recent years. The Dodd-Frank Act, Affordable Care Act (ACA), and new fiduciary and overtime rules instituted by the Department of Labor have changed or will change the landscape of these industries and others. With some candidates running for office wanting to repeal certain of these regulations, most notably the ACA, affected companies may be reluctant to acquire until things shake out.

- **Economic Growth.** A new administration will bring about new economic growth policies that will shape the future of corporate profitability and interest rates. Although we can’t predict the ultimate path the economy will take, a downturn will almost certainly lead to slower M&A activity and tightening credit availability while economic growth is likely to continue to support the strong activity we have seen in recent years.

These are just a few of the many sources of uncertainty that can arise in the final year of a presidential cycle.

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<tr>
<td><strong>Some Recent BCC Advisers Transactions:</strong></td>
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<tr>
<td>Prepared a fair market valuation of a commercial construction company to assist in transferring ownership to the next generation.</td>
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<tr>
<td>Prepared a fairness opinion regarding the purchase of shares of a Midwest company by an ESOP.</td>
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<tr>
<td>Provided valuation consulting to a distribution company for possible ownership transition options.</td>
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<tr>
<td>Prepared a fair market valuation of a manufacturer for purposes of annual ESOP administration.</td>
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<td>Prepared a fair value purchase price allocation of a manufacturing company for financial statement reporting purposes.</td>
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<th>The Market Front</th>
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<td><strong>Some opportunities available through BCC Advisers:</strong></td>
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<td><strong>South American producer of agrichemicals</strong> – is seeking a buyer.</td>
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<tr>
<td><strong>U.S. industrial equipment manufacturer</strong> – is seeking a buyer.</td>
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<tr>
<td><strong>Midwest ESOP-owned company</strong> – is seeking to make acquisitions.</td>
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<tr>
<td><strong>European collectible card game accessories developer</strong> – is seeking a buyer.</td>
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<tr>
<td><strong>Israeli consumer goods manufacturer and distributor</strong> – is seeking to acquire a branded food manufacturer and distributor in the U.S.</td>
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