WORKING CAPITAL CONSIDERATIONS IN MERGERS AND ACQUISITIONS - Dr.R.Maria Inigo & Mr.S.Senthil Kumar

A well designed and implemented working capital management is expected to contribute positively to the creation of a firm's value. A firm is required to maintain a balance between liquidity and profitability while conducting its day to day operations. Liquidity is a precondition to ensure that firms are able to meet its short-term obligations and its continued flow can be guaranteed from a profitable venture. The importance of cash as an indicator of continuing financial health should not be surprising in view of its crucial role within the business. Working capital management plays a critical role in a company's quest to maximize its shareholder value. A key component of shareholder value is the cost of capital, and credit risk is its driver.

Merger and acquisition (M&A) activities in developed countries once focused on strategic transactions for diversification or for vertical or horizontal integration. In planning for an acquisition, a decision needs to be made on whether the deal involves simply buying the target company's shares or actually acquiring the business itself. Though the distinction may at first glance appear to be a technicality, in practice its significance is considerable. This is because the acquisition of shares involves buying not only the underlying business of the target company, but also its assets, both tangible and intangible, fixed & currents assets and, crucially, its liabilities. In this respect, a share-based acquisition can carry higher risk for the acquirer, potentially exposing them to the risk of unforeseen skeletons in the closet.

In agency merger and acquisition discussions, balance sheet issues typically are the last to be dealt with. Whether characterized as tangible net worth or working capital requirements, the basic issue revolves around an important consideration in merger and acquisition discussions, which is the buyer's expectation of receiving a certain amount of working capital as part of the transaction. In a stock purchase, the buyer may expect to receive, in the classic definition of working capital, an agreed amount of current assets over current liabilities; or the buyer may be satisfied with an agreed amount of tangible net worth. Tangible net worth requirements encompass working capital consideration from a broader perspective. Tangible net worth requirements usually come into play in agency stock acquisitions. The basic theory in valuing an agency's tangible net worth is that if the agency's assets were liquidated, all of its assets should ultimately be convertible to cash, which in turn would be used to liquidate agency liabilities.

The due diligence effort in an M&A should include an analysis of historical balance sheet trends, the composition of significant balance sheet accounts and the quality of working capital. Normally, parties to a transaction negotiate a working capital peg in the Sale and Purchase Agreement. This means both parties agree that a minimum amount of working capital will be delivered at closing. If the amount of working capital comes in higher than agreed at closing, there is usually a purchase price adjustment favoring the seller. If it comes in lower than the peg, the adjustment usually favors the buyer. Pegs are usually set based on historical averages.

However, when negotiating the peg, a buyer should also consider such factors as GAAP adjustments, seasonality and recent business trends (e.g. increases in days sales outstanding and changes in customer/supplier terms). The expected timing of the closing should also be considered when determining the appropriate peg.

M&A has developed a pragmatic and results-oriented methodology for evaluating optimal working capital that incorporates lessons learned across many industries and a large number of successful assignments. Although strategic expansion will continue to be of interest, future M&A practice will likely focus on two completely different attractions:

- Underused liquidity on balance sheets, offering opportunities for the acquirer to redeploy cash in productive activities;
- Inefficient working capital management, leading to opportunities to improve the utilization of current assets and liabilities.

An array of areas needs to be considered to understand critical issues and improve performance in M&A or prior to engaging advisory services for acquisitions, divestitures, and recapitalizations. There are several other firms that support M&A analyses while assisting the new management to squeeze efficiencies out of the current asset and/or current liability portions of the balance sheet.

Accounts Receivable: This function is also known as credit control. In principal the task is to make sure that the money is collected in a time, and does not give too much credit to a customer. This task performs a credit check with an approved credit rating agency. At first, keep the credit limit small until customers are paying regularly and on time. The credit and collection process, no matter how aggressive, inevitably results in some uncollectible amounts. When faced with the cost of the credit review process, bad debt expenses, and the cost of credit and collections, some businesses outsource their collection activities to a factor. Factors purchase or lend money on accounts receivable based on an evaluation of the creditworthiness of prospective customers of the business calculated as a discount from the sale amount, usually at the prevailing interest rate.

Inventory: If inventory is not managed properly it will increase the cost of consumption besides affecting working capital. Over stocking on the shelf will make a business to find that money from somewhere to finance its other payments. Further more inventories will require more space to store it. There is also the risk of spoilage and obsolescence in some products. JIT would be suitable for some business which has to be exercised with care. Just-in-time (JIT) requires that required materials be in the place of manufacture or assembly at the appropriate time to minimize excess inventory and to reduce wastage and expense. JIT succeeds when there are: a limited number of transactions; few "disturbances" due to unscheduled downtime, depending instead on periodic maintenance; the grouping of production processes to reduce the movement of work-in-progress; and a significant focus on quality control (QC). QC minimizes downtime and the holding of buffer or safety stock to replace defective materials. In traditional JIT, the company owns the inventory of components and parts, assuring access as the next production operation begins.

JIT as currently practiced places the materials at the manufacturing or assembly site, but title remains with the vendor until production begins. This relationship requires suppliers to optimize the stock of inventory, holding only those items that have been specified or are known to be required based on a statistical analysis of purchasing history. Both the provider and the user of materials are forced to develop a strong partnering attitude and minimize the adversarial stance often observed between purchasing counterparties.

Accounts Payable: The objective of management of payables is to be smooth on payments so that payments are made in line with how the cash flows into business. It is quite common for businesses that are not managing working capital effectively to lean on suppliers to fund shortfalls. This manifests itself as not having the cash available to pay the supplier on time. On the other hand inefficient payables pervade business. Invoices presented for payment should be matched against purchase orders and receiving reports to determine that the vendor has met the terms and conditions of the order, and those materials were received in good condition and in the correct amount. In practice, invoices are often paid without ascertaining that all requirements have been met. Inadequate policies regarding appropriate purchasing and accounts payables practices may turn to be a costly affair.

M&A Vs. WC

Global investors will be looking at companies with the following characteristics while they make deals on M&A.

- A high current assets-to-revenue relationship, particularly where the current ratio exceeds the average for the industry.
- A cash and near-cash hoard that is not likely to be applied to business operations and is unlikely to be used for dividends or stock repurchases;
- A proven income stream that should provide adequate cash flow to pay down borrowings used to provide partial financing for an acquisition.
- Furthermore, there is a trend toward M&A that is not strategic within an industry, meaning that a hostile or friendly approach can come from anywhere at any time. Many companies hoard cash while waiting for capital projects with superior returns. In fact, those opportunities may never appear.
- Review current working capital requirements based on internal processes impacting receivables, payables and inventory, as well as external and strategic drivers such as the, Geographic footprint, Product mix, and sales channels, Regulatory and financial covenants, and Strength in the value chain.
- Organizational review of the management of working capital through policies, processes, systems, people and metrics.
- Conduct a risk assessment of the quality of the receivables, inventory and payables; and
- Provide guidance of potential cash flow opportunities through improved working capital management strategies and operational effectiveness.

Conclusion

Financial analysts are beginning to recognize that worthwhile capital investments are unusual and are likely to be short-lived. In other words, the reality of international competition shortens any competitive advantage a company may gain, unless protected by patents or other exclusive arrangements. It is a basic principle of economics that positive NPV investments will be rare in a highly competitive environment. Therefore, proposals that appear to show significant value in the face of stiff competition are particularly troublesome, and the likely reaction of the competition to any innovations must be closely examined. Savvy outsiders can analyze the financial statements – working capital efficiency of targeted companies and take friendly or hostile action to seize a financially inefficient business. Successful buyers must be fully prepared to back up their valuation with realistic data and a solid action plan, knowing the only way to win a deal is to understand a target's business sooner and more completely than the competition. The circumstances and reasons for every merger are different and these circumstances impact the way the deal is dealt, approached, managed and executed. .However, the success of mergers depends on how well the deal makers can integrate two companies while maintaining day-to-day operations. It would be wise for the buyer company to find out the closing working capital and the date of closing for acquisition. Above all considerations on the net working capital and excess of working capital is very important to finalize the M&A deal