

The second most important number in an offer to buy your business

By John Warrillow

When you get an offer to buy your company, the term sheet will outline what the buyer is willing to pay for your business. Most entrepreneurs fixate on the purchase price and the multiple of earnings used to calculate it.

There is a second number in most term sheets that is almost as important as the purchase price: the working capital calculation.

I was guilty of ignoring the working capital reference in the term sheets I received in the process of selling my research company last year. To be honest, I didn't know what exactly they meant by "working capital". I had two competing offers to evaluate and spent most of my time on the purchase prices being offered by both parties. I ignored the rest of the verbiage in the two offers. It was my accountant who pointed out the difference in the way the two offers calculated the working capital they were asking me to leave in the business. One was allowing me to take a generous amount of cash out of the business before closing, making the offer much more attractive than I had first thought. In fact, the way this party was offering to calculate working capital had the effect of increasing the cash value of the offer by a full 15 percent.

Working capital is the money you need to keep in the business to ensure your company can meet its day-to-day obligations. Whatever cash is left above the working capital requirement set out in a share purchase agreement can be taken out before you close. This has the effect of immediately increasing the purchase price by the amount of money you are able to pull out personally before the sale goes through.

The opposite is also true. If a buyer thinks it will need extra cash to absorb seasonal lows in cash flow or finance slow-paying customers, you will be asked to add back in working capital before closing the deal. This has the effect of lowering the overall cash proceeds you get from a sale. Savvy buyers have been known to get an entrepreneur's attention with a relatively high purchase price, only to take much of the premium away by asking the seller to keep more of its money in the business on closing day.

A smart owner with a plan to sell a business manages down working capital by focusing on cash flow. In short, s/he will charge customers as much as possible up front, collect quickly, pay slowly, and pull out any excess cash not needed to run the business from day to day. That way, you can legitimately argue to a buyer that the working capital needed to run the business is low, which will maximize your take from a sale.

John Warrillow is the author of ***Built To Sell: Turn Your Business Into One You Can Sell***. As a Scotiabank customer, you receive a \$5 discount when you order from BuiltToSell.com.