

M&A; EXECUTION PROGRAM

PART 05 OF 12 · PART 2: WORKING CAPITAL & CLOSING MECHANICS

PART 5

THE NWC PEG & TARGET SETTING

The working capital peg is the most frequently disputed element in any M&A; closing. This session explains how to define NWC, set the target, identify excluded items, and avoid the most common mistakes that move millions of dollars at the closing table.

IN THIS PART

- Defining 'debt-free, cash-free' enterprise value
- NWC components and the 12-month trailing average
- Identifying excluded assets and liabilities
- Cash vs. debt-like items
- Seasonal businesses and NWC timing
- The NWC peg negotiation playbook

THREE CASE STUDIES

Each session includes one fully worked case study with detailed calculations, negotiating dynamics, and CFO-level decision frameworks.

■ ■ SESSION 5: THE WORKING CAPITAL PEG

What Is the Working Capital Peg and Why Does It Matter?

When a buyer and seller agree on an enterprise value, they are agreeing on the value of the business as an ongoing concern — delivered with a 'normal' level of working capital necessary to operate the business. The **working capital peg** (also called the NWC target or NWC reference amount) is the agreed-upon amount of net working capital that the seller is expected to deliver at closing. If the seller delivers more than the peg, the buyer pays more. If less, the buyer pays less.

This mechanism exists because enterprise value is quoted on a debt-free, cash-free basis (DFCF). The purchase price in the SPA will be the enterprise value plus or minus adjustments for cash, debt, debt-like items, and the NWC peg adjustment. Understanding each component is essential for the CFO to prevent millions of dollars from moving unexpectedly at closing.

The DFCF Bridge: From Enterprise Value to Equity Value

◆ DFCF BRIDGE TO CLOSING WIRE

DEBT-FREE CASH-FREE BRIDGE TO EQUITY VALUE

Agreed Enterprise Value (EV): \$45,000,000

ADD: Closing Cash (excess cash stays with seller):

Cash in operating accounts (above minimum): \$1,200,000

(minimum cash defined as \$500K in SPA)

LESS: Debt and Debt-Like Items:

Revolver balance: (\$800,000)

Term loan outstanding: (\$3,200,000)

Capital lease obligations: (\$450,000)

Unfunded pension liability: (\$620,000)

Unpaid transaction bonuses (seller's): (\$380,000)

Deferred revenue (if treated as debt-like): (\$290,000)

Total Debt and Debt-Like Items: (\$5,740,000)

NWC ADJUSTMENT:

NWC Peg (agreed target): (\$6,200,000)

Estimated Closing NWC: \$6,850,000

NWC Surplus to Buyer: \$650,000

EQUITY VALUE (wire amount at closing):

$\$45,000,000 + \$1,200,000 - \$5,740,000 + \$650,000$

= \$41,110,000

Setting the NWC Peg: The 12-Month Trailing Average

The NWC peg is typically set as the 12-month trailing average of normalized NWC. This averaging approach removes seasonal distortions and one-time events from the peg. The NWC components included in the peg are negotiated in the SPA definition section — and this is where many disputes begin.

Item	Typically Included in NWC?	Notes
Accounts Receivable (trade)	YES	At net realizable value; aged AR may be excluded
Inventory	YES	At lower of cost or market; obsolete inventory excluded
Prepaid Expenses	YES, with carve-outs	Prepaid insurance and deposits yes; prepaid M&A; costs no
Accounts Payable (trade)	YES	Stretched payables adjustment may be required

Item	Typically Included in NWC?	Notes
Accrued Liabilities	YES	Vacation/PTO accrual, warranty reserves, customer deposits
Deferred Revenue	NEGOTIATED	Often treated as debt-like item rather than NWC
Cash	NO — excluded	Cash is a separate DFCF line item
Revolver / Line of Credit	NO — excluded	Treated as funded debt in DFCF bridge
Current Taxes Payable	NEGOTIATED	Often excluded; treated as pre-close seller liability
Income Tax Receivable	NEGOTIATED	Pre-close refunds often excluded as seller asset

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CASE STUDY 1

Northgate Seasonal Retail

Q4 Close vs. Q2 Close — \$3.2M NWC Swing from Timing Alone

Background

Northgate Seasonal Retail operates specialty gift shops with 60% of annual revenue in Q4 (October-December). The deal was originally targeted to close in December (Q4), but financing delays pushed the close to June (Q2). This timing change had a massive impact on the NWC peg discussion.

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CASE STUDY 2

Pacific Medical Devices LLC*Debt-Like Items Hidden Below the Line — \$2.1M Surprise at Closing***Background**

Pacific Medical Devices had a clean balance sheet — or so the buyer thought. Three weeks before closing, the CFO's team identified four items that had not been disclosed as debt-like: an unfunded defined benefit pension obligation, excess deferred revenue from multi-year contracts, employee retention bonuses payable at closing, and environmental remediation escrow requirements.

◆ PACIFIC MEDICAL — DEBT-LIKE DISCOVERY

PACIFIC MEDICAL — DEBT-LIKE ITEM DISCOVERY

Agreed Enterprise Value: \$28,500,000

Items identified in final diligence (not disclosed in LOI):

Unfunded pension liability (actuarial): (\$880,000)

Deferred revenue (multi-year contracts): (\$420,000)

(buyer must fulfill \$420K of services at zero margin)

Employee retention bonuses (close-triggered): (\$540,000)

Environmental monitoring escrow (5yr): (\$260,000)

Total previously undisclosed debt-like items: (\$2,100,000)

REVISED EQUITY VALUE:

$\$28,500,000 - \$2,100,000 = \$26,400,000$

SELLER'S RESPONSE:

Disputed pension (argued it was known/disclosed): \$880K

Agreed on retention bonuses as seller-funded: \$540K

Deferred revenue: accepted as debt-like: \$420K

Environmental: agreed to escrow from proceeds: \$260K

FINAL RESOLUTION:

Pension dispute → buyer assumes; price +\$440K (split)

Other items: \$1,220K deducted from closing proceeds

FINAL WIRE: $\$28,500K + \$440K - \$1,220K = \$27,720,000$

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CASE STUDY 3

Heartland Grain Cooperative

*Excluded Assets — Defining What Stays and What Goes***Background**

Heartland Grain Cooperative is being acquired by an agricultural roll-up. The seller has three assets that are fundamentally personal to the owner and are being excluded from the transaction: a recreational aircraft used occasionally for business, an investment portfolio in a subsidiary, and an adjacent parcel of real estate leased to a neighboring farmer. Defining excluded assets with precision prevented a \$1.9M dispute.

◆ EXCLUDED ASSETS — SPA SCHEDULE

HEARTLAND — EXCLUDED ASSET DOCUMENTATION

Asset	Book Value	FMV	Excluded?
Cessna 182 aircraft	\$180,000	\$320,000	YES — excluded
Investment portfolio	\$840,000	\$840,000	YES — excluded
Adjacent 40-acre parcel	\$380,000	\$760,000	YES — excluded

Cessna 182 aircraft: \$180,000 \$320,000 YES — excluded

(owner's personal use; no material business function)

Investment portfolio: \$840,000 \$840,000 YES — excluded

(passive investments; not operating assets)

Adjacent 40-acre parcel: \$380,000 \$760,000 YES — excluded

(not part of operating business; separate lease)

TOTAL EXCLUDED ASSET FMV: \$1,920,000

WHY THIS MATTERS FOR NWC:

Investment portfolio generates \$42K/yr income

→ Must be removed from EBITDA calculation

→ Otherwise EBITDA includes non-operating returns

Acreage lease generates \$18K/yr rent

→ Also excluded from forward revenue

SPA LANGUAGE: Excluded assets schedule must itemize each excluded asset by description, book value, and FMV and cross-reference the EBITDA normalization