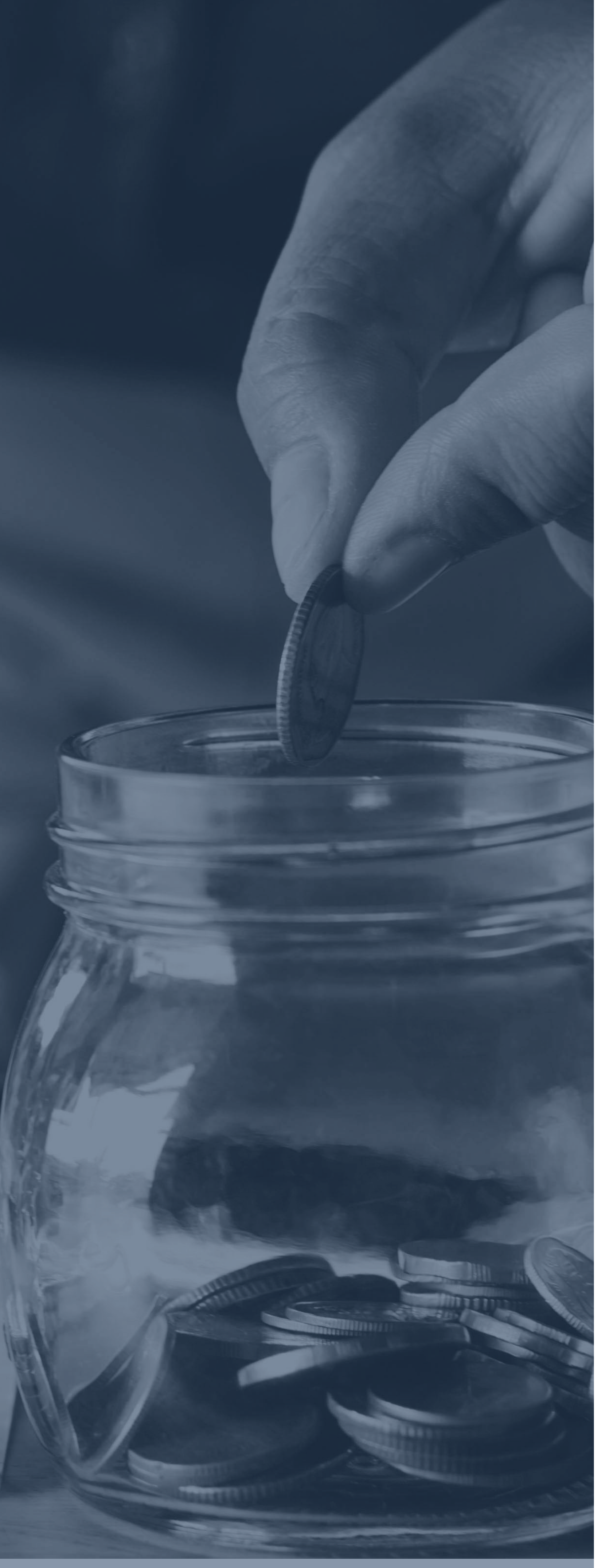


MOWERY & SCHOENFELD
Transaction Advisory

2022 ANNUAL LOWER-MIDDLE MARKET

WORKING CAPITAL SURVEY REPORT

WHY NWC?

At Mowery & Schoenfeld, our Transaction Advisory Services (TAS) practice focuses on deals in the lower middle-market, which we define as companies between $1M and $10M of EBITDA. About 80% of our engagements focus on supporting buyers of these businesses by providing quality of earnings engagements, transaction structuring, and other related advisory work. In those engagements, the one area consistently misunderstood between Buyers and Sellers is how to address net working capital.

There are various reasons for this. Some of the transactions we are involved with are proprietary in nature, such as when the Buyer reaches out directly to the owner of the business and negotiates the purchase and various terms. In those situations, there is no sell-side advisor (investment banker or broker) assisting the Seller with understanding the process, so our team expects some disagreement or further education required before they come to an understanding. In other situations, however, there is a sell-side advisor, yet there continues to be fundamental misunderstandings of the typical market terms for net working capital.

We conducted the survey to understand how sell-side advisors approach working capital in their transactions to both gain insight into diversity in viewpoints and offer suggestions to improve their use and understanding of net working capital.

PART ONE: PARTICIPANTS

We identified sell-side advisors (investment bankers, business brokers, and other related professionals) to understand the typical market in which they focus and how they typically educate their clients on what acceptable terms for working capital should include. We wanted to ensure that the respondents had experience in the lower middle-market and specifically representing business owners seeking to sell their business.

The majority of participants had 10 years or less of experience (43%) and typically represent less than 10 sellers per year (69%). Of the industries sold, Services (25%), Manufacturing (22%), and Distribution (15%) were the top three recurrent industries.

PARTICIPANT DEMOGRAPHICS

We decided to focus on sell-side advisors. We looked at lower-middle market transactions ranging from $5 million to $10 million in annual revenue with typical annual cash flow between $500,000 and $1 million.

We selected this audience for two reasons. First, there is a growing pool of buyers looking to acquire or invest in owner-operated, middle-market organizations. Second, there is a growing pool of sellers. As Baby Boomers continue to age into retirement, many are looking for the opportunity to sell their business—even if this is a legacy transition to family, employees, or other known stakeholders.

According to the 2022 M&S Activity Outlook Survey sponsored by S&P Global Market Intelligence there were over 8,624 lower-middle market deals in 2021 equaling $1.24 trillion in transactions.

SURVEYED
1,300
SELL-SIDE ADVISORS

3%
response rate

WHOSE ***CAREERS*** INCLUDE

- **INVESTMENT BANKING**
- **BUSINESS BROKERAGE**
- **OTHER RELATED PROFESSIONS**

WITH A **FOCUS** ON

lower-middle market transactions

We gathered some demographics from our respondents to better understand the experience and knowledge they would be able to provide. Our respondents worked on approximately one transaction per month and had an average of 23 years of experience.

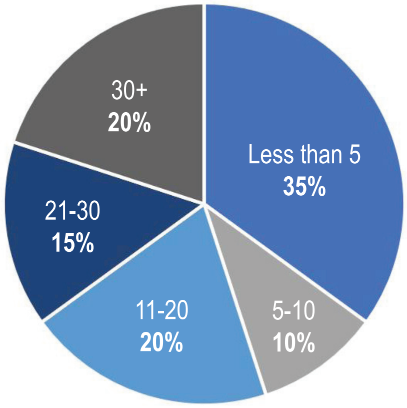
Not surprisingly given current market conditions, these deals were primarily in the services, distribution, and manufacturing industries. While we did not have outside representation in terms of deal industry for our results, it is also worth noting increasing demand in the middle-market transactions for technology and subscription-based organizations.

TRANSACTION BREAKDOWN

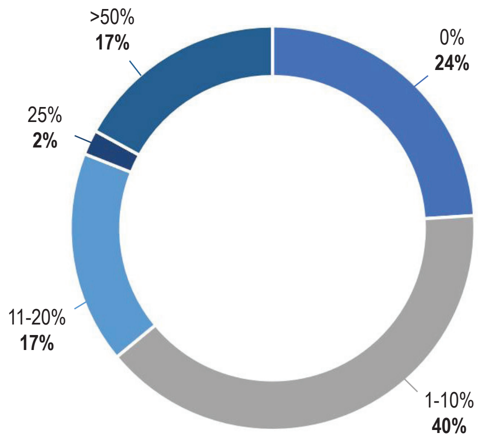
Generally, respondents were looking at completing a transaction in about 8 months from the point at which the sell-side advisor is engaging with the company through to investment.

As you can imagine, one of the challenges both buyers and sellers face is a lack of financial data. In our survey, respondents stated that in only 25% of their deals did the seller undergo an external audit or review. This lack of clean, historical financial data can make it more difficult for parties to agree on the net working capital calculation.

Transaction time *(months)*



Percentage of companies that require an external audit or review



Typical Revenue

Under $1 million	**7%**
$1-5 million	**27%**
$5-10 million	**49%**
Over $10 million	**17%**

Typical Cash Flow

Under $500k	**21%**
$500k - $1 million	**46%**
Over $1 million	**33%**

PART TWO: DISCUSSING NWC

Based upon our experience with transactions in this size range, we were expecting to see a range of responses with how working capital is viewed and positioned by sell-side advisors. The responses largely confirmed our expectations: there is a group of sell-side advisors that approach working capital in the customary manner, and another who views working capital to be something additive to the overall value of the business.

DISCUSSION TIMING

AT WHAT POINT IN THE **ENGAGEMENT** DO YOU DISCUSS ***WORKING CAPITAL CONCEPTS*** WITH SELLERS?

71% During the initial engagement process

19% When evaluating offers

10% When the Buyer brings it up during negotiations

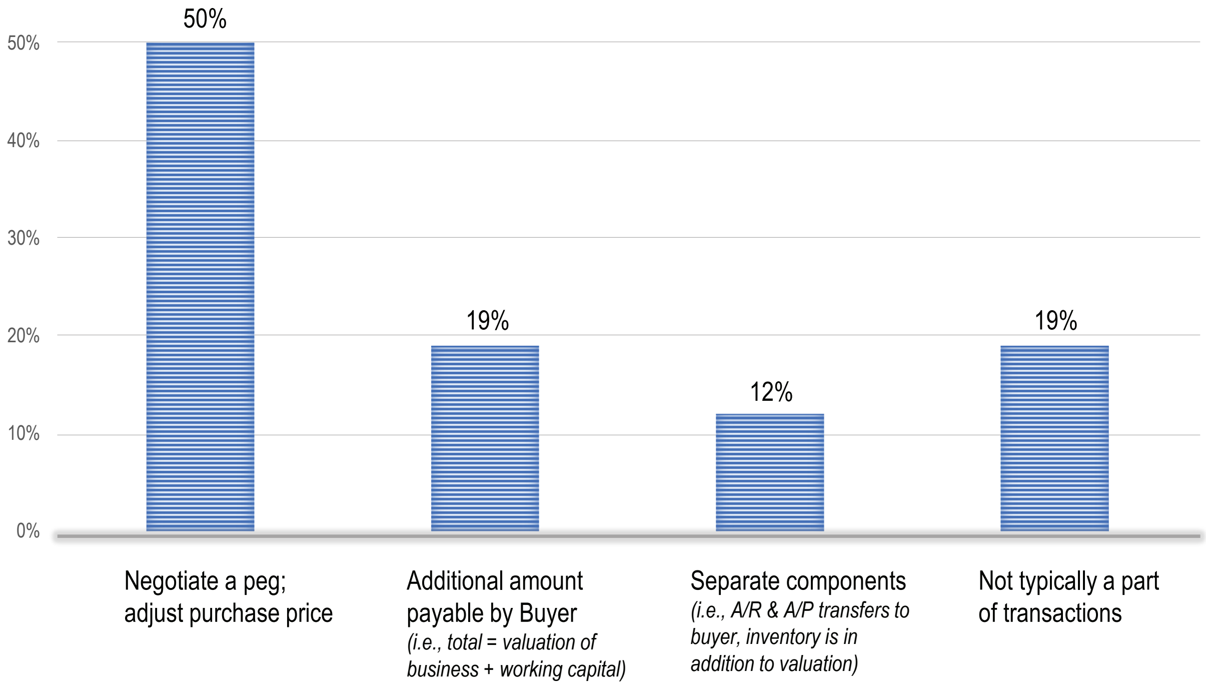
0% It never comes up

When surveying the advisors, we wanted to understand not only the participants themselves, but also the companies they typically work with. The majority of engagements (83%) were sell-side, and 31% of advisors we surveyed have never worked in a buy-side engagement.

When asked about the companies they represented, 40% of advisors reported that 10% or fewer of their clients have external audits, and 24% reported their clients have never had a review of their financial statements.

Nearly half (49%) reported typical company revenue in the $5-10 million dollar range. Similarly, 46% of advisors reported a typical cash flow of $500k to $1 million.

NWC TREATMENT



Half of the respondents are treating working capital as something other than a peg with a collar - which is traditionally the expectation of transaction professionals.

WORDS TO KNOW

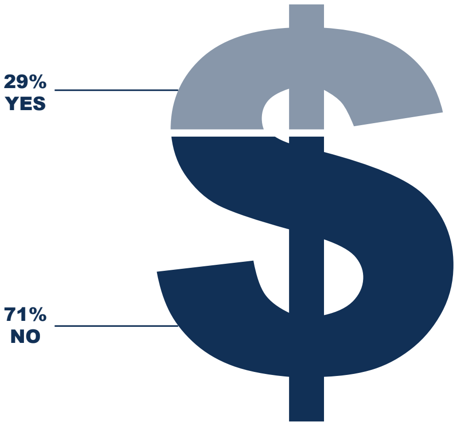
PEG /'pɛg / noun
The Net Working Capital "peg" is a benchmark or baseline amount of net working capital agreed upon by the buyer and the seller. It is usually determined toward the end of financial due diligence.

COLLAR /'kälər / noun
The Net Working Capital "collar" is a reasonable range greater than or less than the net working capital target (or peg) that may occur at the time the deal closes.

NWC V. CASH AT CLOSE

About 30% of the time, NWC is left out of the negotiation completely and instead is replaced with a specific amount of money to be left in the business at close.

This is often a preferred method, as both the buyer and seller can clearly understand and discuss an amount of cash to be left in the business to cover all payroll and payables for a set amount of time.



COLLAR INCLUSION

Additionally, very few advisors see a "collar" included in the working capital negotiations. Experience tells us the lack of clean financial data has a direct impact on the use of a collar in a transaction. When both parties can agree on a reasonable range for working capital, then a collar can be an excellent tool to provide reasonable guard rails for the amount of working capital expected at close.

73% of respondents stated that for those transactions that include a working capital peg, they <u>do not</u> include a collar for limiting variability in NWC's impact on price.

NWC TRUE-UP PERIOD

For those transactions that include a working capital peg what is the typical post-closing true-up period that you message to your Sellers as a reasonable market expectation?

30 days	**15%**
60 days	**34%**
90 days	**46%**
120 days	**2%**
>120 days	**2%**

Nearly half of all respondents said the expectation for the post-close true-up period is less than 60 days. Again, the need for an extended true-up period often goes to a lack of available and clear financial data.

This is yet another example of the need for good accounting and bookkeeping practices prior to selling a business may result in a more favorable outcome for sellers.


Dear Sir Mr. or Miss
Subject Contract information

PART THREE: BEST PRACTICES

While the goal of this survey was to report on current activity in lower-middle market deals, we felt it important to call out some trends and takeaways that became apparent in our research. For each of the three best practices, we defined tactical and unique steps for those on the buy-side and those on the sell-side of these transactions.

KEY TAKEAWAYS

1 UNDERSTAND THE LEVERS OF NWC

2 AGREE ON AN APPROACH TO NWC

3 COMMUNICATE ABOUT NWC EARLY

#1 UNDERSTAND THE LEVERS

FOR BUYERS

1. Conduct detailed modeling to understand impact of NWC variability on operating cash flows
2. Understand key customer and vendor contracts along with the decision-making authority of key sales and purchasing functions
3. Be prepared to backstop a valuation gap via structure

FOR SELLERS

1. Seek to understand the business levers that control how much cash flow may be captive in working capital
2. Ensure you can thoughtfully articulate how you manage working capital
3. Be prepared to help Buyers understand what is a “normal” amount of working capital during any point in the business cycle or season

#2 DEFINE FRAMEWORK

FOR BUYERS

1. Review the overall principle of working capital as early in the process as possible, even before an LOI is in place
2. Come to an agreement on whether or not working capital should have a *material impact* on the purchase price
3. Set an expectation that – outside of unique performance circumstances – there should not be any surprises related to NWC at closing

FOR SELLERS

1. As the business is preparing to go to market, understand how your historical financial reporting is going to depict working capital trends
2. Cleanse the historical balance sheets of non-operating current assets and liabilities
3. Review revenue recognition policies and determine if any deferred revenue liabilities will be at issue in the business cycle or seasoncycle or season

#3 COMMUNICATE EARLY

FOR ALL PARTIES

1. As one of the most misunderstood concepts between buyers and sellers
2. Can cause deals to fall apart very late in the process
3. Both buy- and sell-side advisors should make it a point to discuss NWC openly and with specificity very early in the transaction process
4. Confront difficult valuation conversations early

ABOUT THE FIRM

Mowery & Schoenfeld is an accounting, advisory, and IT services firm with offices in Lincolnshire and Chicago, Illinois. Made up of 19 partners and over 130 total employees, Mowery & Schoenfeld ranks among the top ten firms in Illinois. Our organization is focused on providing personalized service to each client and building a lasting and trusted relationship. We offer comprehensive tax, assurance, transaction advisory, outsourced accounting, wealth management, international onboarding, business advisory services, and technology services.

In 2016, Michael Kidd started our dedicated Transaction Advisory practice with a key focus on helping business entrepreneurs through a successful search process. Since that time, we have worked with over 250 searchers in successfully finding, purchasing, and operating a business.

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