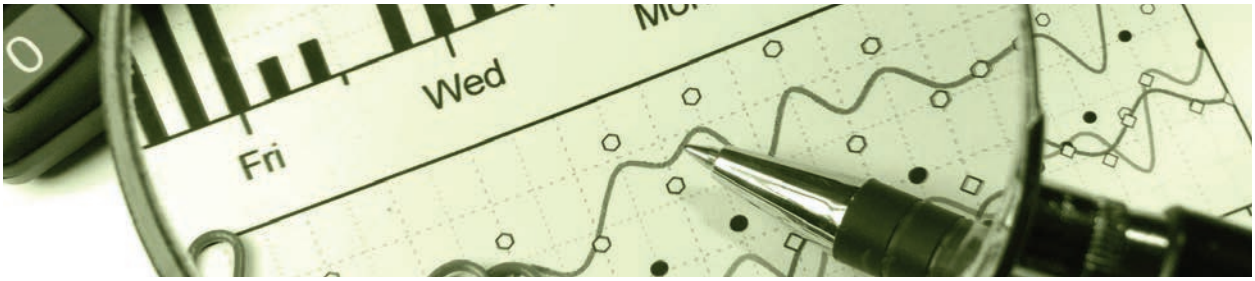
Negative Working Capital and Indian Corporates - A Conceptual Analysis



Working capital is important for smooth operation of day to day activities of a corporate. As working capital is defined as current assets over current liabilities, at the time of determination of working capital, quality of current assets especially size of debtors and inventory are important factors. Significance of working capital also increases, as it is directly associated to the liquidity position of the corporate. However, in some cases, current assets are lower as compared to current liabilities (known as negative working capital) then how can a firm manage the level of liquidity. Negative working capital arises in cash base business, efficient utilisation of resources and sound inventory management etc, which leads to minimum stock of inventory etc., and the overall impact is lower level of current assets. On the other hand, due to better contract and negotiations to the creditors and suppliers, they are extending more liberal credit, which enhances the level of current liabilities. Study of negative working capital is important to understand the efficiency of the corporate, which enhances the earning capacity. Concurrently, liquidity is also significant from short term solvency point of view, which does not exist in case of negative working capital. Keeping these views in mind, this research article explains the conceptual background of the negative working capital and how it affects profitability of the corporates. Leading FMCG companies are taken as a case, to analyse the negative working capital and its impact on the profitability and earning capacity of the firms. Finally, it is found that companies in which negative working capital exist, profitability is more and shareholders are getting more dividend and capital appreciation, which maximises the shareholders value in the long run.

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Introduction

The term working capital refers to current assets which may be defined as (i) those which are convertible in to cash or equivalents within a period of one year, and (ii) those which are required to meet day to day operations. "Working capital, also called net current assets, is the excess of current assets over current liabilities. All organisations have to carry working

capital in one form or the other. Working capital also gives investors an idea of the company's underlying operational efficiency. The efficient management of working capital is important from the point of view of both liquidity and profitability. Poor management of working capital means that funds are unnecessarily tied up in idle assets, thereby reducing liquidity and also reducing the ability to invest in productive assets such as plant and machinery, affecting the profitability"[1]. The working capital management refers to management of the working capital, or to be more precise the management of current assets.

Working Capital and Liquidity

When we are focusing on working capital, its main aim is to analyse liquidity position of the company. Liquidity plays a significant role in the successful functioning of a business unit. Liquidity refers to the ability of a concern to meet its current obligation as and when these become due. The short-term obligation is met by realising amounts from current, floating or circulating assets. The current assets should either be liquid or near liquidity. These should be convertible in to cash for paying obligations for short-term nature. Comparing them with short-term liabilities would assess the sufficient or insufficient current assets. If current assets can pay-off current liabilities, then the liquidity position will be satisfactory. On the other hand, if current liabilities may not be easily met out of current assets, then liquidity position will not be satisfactory.

The short-term creditor of the company like supplier of goods on credit and commercial banks providing short-term loans, etc. are primarily interested in knowing the company's ability to meet its current and short-term obligations. If the firm fails to meet such current obligations due to lack of liquidity, its goodwill in the market is likely to be affected beyond repair. It will result in loss of creditor confidence in the company and may cause the winding up of company. However, even a high degree of liquidity is not good for the company because, such a situation represents unnecessary excessive fund tied up in current assets and loss of opportunities to employ them outside the firm to get additional returns. It is important to maintain minimum liquidity position in the firm to enhance profitability as well as discharging of short term obligations.

All organisations have to carry working capital in one form or the other. Working capital also gives investors an idea of the company's underlying operational efficiency.

Negative Working Capital

Negative working capital is a reverse situation as compared to normal working capital. It is a situation in which current assets are lower as compared to current liabilities. A negative working capital is an indication of managerial efficiency in a business with low inventory and account receivables. This happens because customer pays in advance and so quickly, the business enjoys cash transactions, products are delivered and sold to the customer before the company even pays their suppliers and creditors. Negative Working capital doesn't always mean bad financial condition, it indicates that most of the day to day activities are funded buy customers rather than company's own working capital. Some latest examples are movie theaters - customers are paying first and distributors are normally paid later on; Schools/ educational institutions- fees paid in advance by the students annually, whereas faculties are getting salary after one month. When an organisation uses supplier's credit and customers' advance to fulfil their day to day needs, leading to a situation of lower or negative working capital. Banks, financial institutions, distributors, retailers with cash business or advance payment contract have negative working capital.

Normally, when we analyse working capital, it always refers to normal or positive working capital (excess or current assets over current liabilities). However, there are certain situations in which working capital is in negative form (excess of current liabilities over current assets). In that situation, how can a company manage liquidity with the negative working capital. In modern business, the concept of negative working capital is significant for the following reasons;

- It indicates operational efficiency of a corporate. That means without or lower current assets the firm is managing day to day operations in an efficient manner. Eventually, it reduces cost of working capital and maximum earnings for the shareholders, which is the ultimate goal of the financial management.
- Concept of negative working capital is important to analyse liquidity position of corporate. When current assets are lower than current liabilities, what about the liquidity position of the corporate,

[1] *Woolf ,Tanna and Karam Singh: Financial Management, MacDonld and Evans, Plymouth, first edition p.245*

how are they discharging current obligations in the short period. Traditionally, liquidity ratios are the measurement of liquidity of a firm with the ideal standard of 2:1. Negative working capital indicates lower cost of working capital (another way is higher profitability), but at the same time, it indicates poor liquidity (worried situation for the creditors, etc.) or we can say company is overburdened with current liabilities, which is not good for any situation (specially in a period of recession, etc).

- Another important impact of negative working capital is cash recovery or realisation situation. Negative working capital indicates quick realisation of cash recourses (conversion of debtors in to cash) or one can say working capital cycle is shorter (for a days or maybe less than that). At the same time, payable policy of the company is to take longer time for payment against creditor. It indicates significant variations in the credit policy towards suppliers and customers.

To analyse, explain and focus on all these situations, a study of negative working capital and its impact on liquidity, profit earning capacity and over all impact on shareholders value creation is important in the contemporary scenario.

Creation of Negative Working Capital

There are many ways to create negative working capital. Most important method is to minimise the size of current assets with favorable contract and agreement to the suppliers and other parties (to delay payments) and the same time, try to minimise credit facilities or maximise cash based business (collection of cash before the disbursement of actual payments to the various parties). When maximum customers are paying in advance, low or negative working capital is created. Another way to minimise the size of current assets is to adopt efficient collection method or brand oriented collection policy. Many companies are trying to minimise their cash resources with efficient utilisation of funds. Some companies are effectively using ERP system involving trade partners in planning and monitoring working capital items to reduce the level of working capital.

Efficient cash collection and inventory management system provides an opportunity to run business with the negative working capital, because most of the suppliers are granting 30 days credit in general. Companies who are able to operate and maintain with negative working capital, have advantages to receive funds without cost as a form of credit from their suppliers which will enhance ROI in a significant manner. However, non-availability of liquid resources is not a good situation at any time (especially in the stage of growth and boom).

Liquidity plays a significant role in the successful functioning of a business unit.

Shortcomings of Negative Working Capital

Apart from many financial gains, some adverse impacts of negative working capital are as follows:

1. Lower or poor working capital (or negative working capital) creates artificial pressure on a company to increase borrowings for day to day operations. Due to delayed payments to the creditors, in some cases ranking of such companies are treated as poor, which will affect cost of borrowings or capital (in the way of higher rate of interest).
2. In case of expansion and modification of business, negative working capital creates financial barriers (lower liquidity). It will create artificial hurdle for the growth of the organisation.
3. Due to poor liquidity, investors are behaving cautionly; it will create financial unrest among the general investors. They are worried about their investment as well as future returns.
4. At the time of business valuation, negative working capital creates hurdle for better valuation because of chances of bankruptcy risk in a short time.

Improvement of Negative Working Capital

A corporate who wants to improve the situation of working capital (reduction in the level negative working capital) can be use any of the following alternatives;

- Convert long term resources as current or short-term resources such as; issue of share/bonds for cash, which will enhance cash based current assets.
- They can dispose long term assets and generate cash resources to increases cash base/ liquid base assets.
- They can convert short term liability as long term liability such as; conversion of creditor or B/P as long term notes or bonds, which will minimise the level of current liabilities.
- They can retain maximum profit as a part of internal source so as to increase cash and liquidity of a firm.
- They can refinance short-term loans with long-term resources to minimise the level of current liabilities.

It is important to maintain minimum liquidity position in the firm to enhance profitability as well as to discharge short term obligations.

Negative Working Capital- A Case Study of FMCG Companies

In India, negative working capital is equally popular at par with the global companies such as; McDonald's and Amazon.com. In India, HUL and Nestle are the Fast Moving Consumer Goods (FMCG) companies, having negative working capital for more than the last ten years. Now the question arises as to how they are managing day to day operations smoothly without sufficient liquidity. HUL is one of the leading FMCG companies having sound marketing network, distribution channels and strong brands which will aid financial benefits over competitors. As other FMCG companies such as, Britannia, ITC, Colgate, and Dabur, etc. belong to similar business segment mostly have positive working capital (except few years).

Conventionally, the FMCG Companies are famous for negative working capital due to efficient supply chain management. This industry has lower level of debtors, which are usually financed by creditors or suppliers; this situation offers them some gains related to negative working capital. Another situational gains for FMCG industry is their turnover does not depend upon their production (like other Mfg. industry), it depends upon the capability to sales in the competitive market, therefore maximum resources are utilised for marketing and promotion of product rather than manufacturing activities, etc. (because most of their products are manufactured by small companies under contract production agreement). Similarly, development of SCM, ERP and JIT, etc. made effective management of inventory and resources, which will significantly minimise the size of current assets.

In current assets nearly 50% part is in the form of inventory, but in FMCG companies due to efficient supply chain management and efficient inventory holding, level of inventory comes down to significant lower level as compared to other industry (such as manufacturing). Similarly due to the cash base of business, level of debtors are also lower which significantly decreases the level of current assets.

Another important change in the nature of investors is, rational thinking about investment. Nowadays strategic investors are also focusing on working capital management of a company, because it is directly associated to earning capacity of the firm. A study of top Indian companies having higher return on capital employed shows many companies are having negative working capital. These companies are well known for good return to their shareholders both in terms of dividend as well as capital gains.

Negative Working Capital and Shareholders Value Creation

Shareholders value creation is the ultimate agenda for every corporate. There are two ways to create value for shareholders (1), higher dividend as compared to other corporates and (2) higher value of shares in the open market (capital appreciation in the way of higher market capitalisation). Both these can be obtained by the company with higher profitability or reduced cost of capital, which will enhance overall efficiency in the day to day operations with the sound working capital management.

To analyse the status of negative working capital and their impact on profitability, researcher has taken leading FMCG companies as a case study. Data for the last 11 years, were taken from 2001- 2011, to know the status of negative working capital and how it will affect the various earning variables such as ROCE, PAT, EPS and DPS of the FMCG companies. Out of leading companies; status of ITC, HUL, Dabur, Colgate, Nestle, and Britannia were analysed, to understand the nature and pattern of negative working capital and various aspect of earnings. Detailed analysis of negative working capital and various factors related to earning are as follows:

In case of ITC, out of the last one decade only once (in the year 2004) negative working capital arises (₹47.36 crore) and in the year 2010 lower working capital of ₹79 crore observed as compared to other years of the study. The impact of negative working capital is for the year 2004 and PAT, EPS and DPS all are higher as compared to previous years. Even average of the ROCE for the one decade is around 35% which is higher as compared to succeeding years. It indicates efficiency in the operation and lower cost of capital for working capital. Similarly in the year 2010 when working capital is lower (₹79 crore) PAT, ROCE, EPS, and DPS, etc. all are higher, indicating higher profitability. In summary, it can be said that lower or negative working capital indicates efficiency in the operation as well as minimised cost of capital, which is important for shareholders value creation.

Exhibit I: ITC – Working Capital and Profitability Trends (₹ in crore)

Particulars	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
WC	1426	947	767	**(47.36)**	506	1584	2432	2587	3456	**79**	1621
PAT	1006	1190	1371	**1593**	2191	2235	2700	3120	3264	**4061**	4988
ROCE(%)	38.60	38.21	37.61	**35.41**	31.89	34.52	35.37	35.70	32.78	**40.65**	43.4
EPS	4.1	4.81	5.54	**6.43**	7.36	6.07	7.18	8.28	8.65	**10.64**	6.45
DPS	1.00	1.35	1.50	**2.00**	3.10	2.65	3.10	3.50	3.70	**4.50**	2.80

Source: Calculated and compiled from annual reports of ITC from 2001 to 2011.

HUL is a leading company in FMCG sector. During study period all the year they have negative working capital with the variation from ₹(75) to (1834) crore. One important observation is, whenever they are having higher negative working capital (such as year 2005, 2006, 2007, and 2009-10) profitability parameters such as PAT, ROCE EPS and DPS etc. are higher as compared to other years. Again lower cost of capital (less financial burden for working capital finance) and efficiency in the operations are key factors for higher profitability. Even with the lower liquidity they are able to maintain earnings in the last one decade.

Exhibit II: HUL – Working Capital and Profitability Trends (₹ in crore)

Particulars	2001	2002	2003	2004	2005	2006	2007	2008	2009-10	2011
WC	(75)	(240)	(369)	(409)	**(1355)**	**(1353)**	**(1834)**	(183)	**(1365)**	(1305)
PAT	1541	1731	1804	1199	**1355**	**1540**	**1743**	2501	**2103**	2153
ROCE(%)	62.4	59.4	60.2	45.9	**68.7**	**67.0**	**78.0**	107.5	**103.7**	87.5
EPS	7.46	8.04	8.05	5.44	**6.40**	**8.41**	**8.73**	11.46	**10.10**	10.58
DPS	5.00	5.16	5.50	5.00	**5.00**	**6.00**	**9.00**	7.50	**6.50**	6.50

Source: Calculated and compiled from annual reports of HUL from 2001 to 2011.

Dabur is another truly Indian company having substantial share in the FMCG market. In the last decade they don't have negative working capital but level of working capital is lower such as in the year 2004, 2005, 2006 and in 2008 with ₹46 crore, ₹8 crore, ₹35 crore and ₹42 crore respectively. The impact of lower working capital is their PAT, ROCE, EPS and DPS all are higher as compared to the remaining period when net working capital is higher. It clearly indicates minimisation of cost of working capital and over all efficiency in the day to day operations of the company.

Exhibit III: Dabur – Working Capital and Profitability Trends (₹ in crore)

Particulars	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
WC	235	322	281	**46**	**8**	**35**	189	**42**	146	186	395
PAT	19.5	12.6	16.1	**28.6**	**31.3**	**39**	45.7	**45.6**	39.4	45.7	33.2
ROCE(%)	19.5	12.6	16.1	**28.6**	**31.3**	**39.0**	45.7	**47.6**	39.4	45.5	33.2
EPS	2.7	2.3	3.0	**3.7**	**5.4**	**3.7**	3.3	**3.9**	4.5	5.8	3.3
DPS	1.0	0.5	1.4	**2.0**	**2.5**	**1.8**	1.42	**1.5**	1.75	2.0	1.3

Source: Calculated and compiled from annual reports of Dabur from 2001 to 2011.

Britannia is also an important FMCG company in Indian market. They are having negative working capital in the year 2005 (₹49 crore) but for other two years i.e. 2004 and 2006 net working capital is very low ₹4.3 crore and ₹31 crore respectively. The impact is for the same period their PAT, ROCE, EPS and DPS are comparative higher as compared to other years of the study. Again it indicates lower cost of capital for working capital and efficiency in the operations of the company is the factor for higher earnings.

Exhibit IV: Britannia – Working Capital and Profitability Trends (₹ in crore)

Particulars	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
WC	26	59	75	**4.3**	**(49)**	**31**	60	207	116	44	22
PAT	71	203	99	**119**	**149**	**146**	108	191	180	117	145
ROCE(%)	27.35	46.73	27.00	**39.22**	**49.00**	**35.94**	19.11	26.95	27.36	14.26	22.44
EPS	25.27	75.54	38.26	**44.16**	**60.59**	**59.96**	45.06	79.95	75.51	9.75	12.16
DPS	5.48	7.47	9.69	**11.00**	**14.00**	**15.00**	15.00	18.00	40.00	5.00	6.50

Source: Calculated and compiled from annual reports of Britannia from 2001 to 2011.

Colgate is another important company having many branded products for oral care and day to day activities. They are also having negative working capital since 2005 to 2009 between the ranges of ₹14 crore to ₹133 crore. In these five years PAT, ROCE, EPS and DPS all are higher as compared to the previous years. Their PAT increases from ₹113 crore to ₹290 crore, ROCE increases from 70.66% to 156.76%, EPS increases from 8.33 to 21.34 and DPS also increases from 7.00 to 15.00. All these data indicates that when they are having negative working capital, earnings are showing better results as compared to other years.

Exhibit V: Colgate – Working Capital and Profitability Trends (₹ in crore)

Particulars	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
WC	31	57	30	37	**(63)**	**(50)**	**(66)**	**(133)**	**(14)**	39	61
PAT	63	70	89	108	**113**	**138**	**160**	**232**	**290**	423	403
ROCE(%)	42.07	44.87	52.84	61.70	**70.66**	**50.17**	**71.13**	**175.85**	**156.76**	147.05	136.22
EPS	4.6	5.13	6.52	7.94	**8.33**	**10.12**	**11.78**	**17.04**	**21.34**	31.12	29.60
DPS	8.25	4.25	4.25	6.00	**7.00**	**7.50**	**9.50**	**13.00**	**15.00**	20.00	22.00

Source: Calculated and compiled from annual reports of Colgate from 2001 to 2011.

Negative working capital is a reverse situation as compared to normal working capital. It is a situation in which current assets are lower as compared to current liabilities.

Nestle is another company after HUL having always negative working capital for more than one decade. Their negative working capital continuously increases from ₹23 crore to ₹841 crore with slight fluctuations. Especially in the last five years 2007 onwards size of negative working capital is higher as compared to the earlier years. Similarly as size of negative working capital increases their PAT also increases from ₹414 crore to ₹962 crore, EPS also increases from ₹42.92 to ₹99.73 and DPS also increases for ₹33 to 48.50. It indicates even with the negative working capital (poor liquidity) their profitability and earnings are very higher, and it shows

effective management of working capital as well day to day operation.

Exhibit VI: Nestle – Working Capital and Profitability Trends (₹ in crore)

Particulars	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
WC	(23)	(63)	(128)	**(260)**	(223)	(234)	**(320)**	**(387)**	**(566)**	**(624)**	**(841)**
PAT	173	207	263	**252**	310	315	**414**	**655**	**534**	**819**	**962**
ROCE(%)	66.07	87.80	114.40	118.33	127.37	112	138.11	151.78	149.76	128.13	60.47
EPS	18.00	20.90	27.29	**26.13**	32.11	32.68	**42.92**	**55.39**	**67.94**	**84.91**	**99.73**
DPS	N/A	18.00	20.00	**24.50**	25.00	25.50	**33.00**	**42.50**	**48.5**	**48.50**	**48.50**

Source: Calculated and compiled from annual reports of Nestle from 2001 to 2011.

Specific Observations

After the analysis of trend of negative working capital and various components of profitability it is clear that:

- FMCG companies are having trend to use negative working capital to minimise the cost of borrowing for working capital.
- Whenever they are having trends of negative working capital, profitability is always higher (because of lower cost of interest and borrowings).
- HUL and Nestle are the two leading FMCG companies in India, regularly using negative working capital for their day to day operations.
- An important observation is, rather than negative impact of poor working capital (negative working capital) FMCG companies are having greater advantages because of brand image and lower operating cost for their product (because of strong influence of brands).
- In FMCG companies early cash realisation and minimum chances for bad debts (due to lower level of debtors) are the key areas responsible for higher profitability.
- Brand image of the products (intangible assets) enhances marketing efficiency and profitability (higher demand for the product).
- Another important area of advantages is; in FMCG companies contribution of intangible assets are more than 90% of the market capitalisation, that will provide them unique opportunity to enhance market share of the product.
- Intangible assets such as brand, internal operation methodologies, strong supply chain networkand strong customer base etc. are the key areas responsible for lower requirement of working capital.

Conclusion

Negative working capital indicates non-liquidity or less liquidity within the firm which is not favourable at each and every stages of business. Companies operating in industry like FMCG are able to manage negative working capital efficiently, creating shareholder value by way of higher EPS and higher market capitalisation. At the same time, companies with higher working capital are having sufficient liquidity, are more successful because of liquidity and they can expand business and grow up to maximum possible extent. However, a company with higher working capital needs higher revenue to maintain their healthy operating ratio. A better credit management system will help these companies to generate higher ROCE in the long run (HUL is the live example). However, in each and every situation lower level of liquidity is not preferable; a proper trade off between liquidity and working capital requirement is needed in the long run. ■

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