Transcription

Working Capital Management

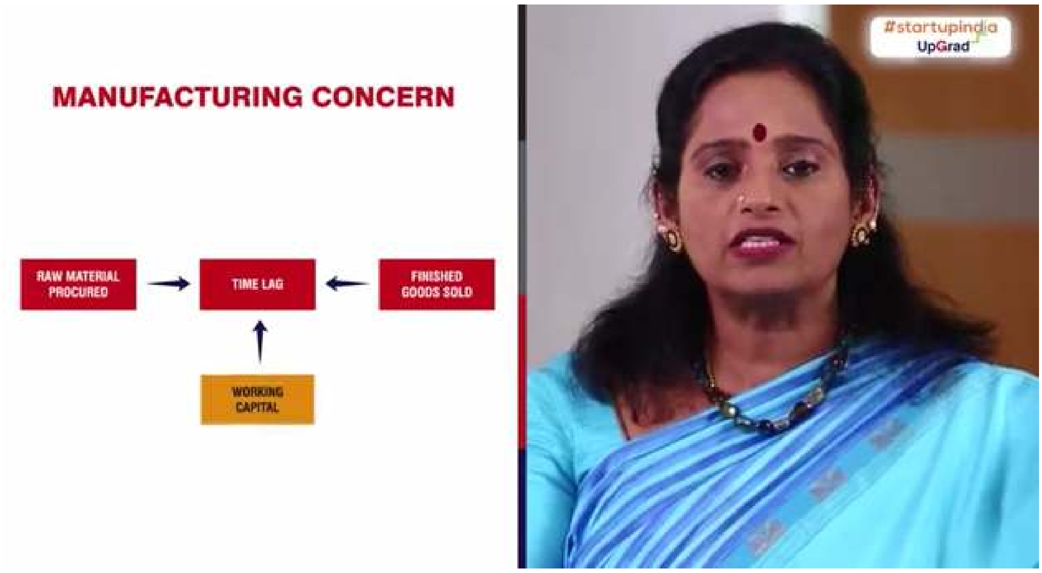
Introduction to Working Capital

Very often start-ups forget that your financing is great but one element they forget is working capital and I think we forgot that once and that was the only time we made that mistake where we calculated the amount of capital we needed, we raised exactly that amount of capital and we actually weren't burning any money at all. We were profitable and we still found ourselves in that situation where we said there is no money in the bank and we said why there is no money in the bank and then we said hang on our working capital cycle is off. We are paying in 30 days and receiving in 60 and that's how we don't have any money in the bank. It was a big shock to us and it seems trivial and small looking back because now we have improved at managing it but I have met many start-ups along the way who simply forget the factor how much money they need to keep the lights on and I think that's the crucial, that was our second big learning. Every time we raise capital factor, working capital and more working capital than you think you need and then sort of spend capital accordingly.

It was great to listen to Sahil Barua from Delhivery talk about the importance of working capital management. They were in the spot where they realized that their liquid funds were falling very soon and they required immediate short term working capital to sustain the business. Working capital is something that is very essential for entrepreneur to make sure that they can cover their daily expenditure. In this session we will understand the concept of working capital along with the aspects of financing and managing working capital. We are also to look at the operating cycle concept and vendor management and contracts in order to get a deeper understanding of the dynamics of working capital management.

So first let us start by our understanding what working capital needs,

Fixed assets provide the infrastructure for a business, the Working Capital provide funds for its day-to-day operations – like payment of employee costs, procurement of services etc. Without working capital, infrastructure will remain idle. Hence in a way, working capital provides a lifeline to its fixed assets.



In a manufacturing concern, there is a time lag between the times raw material is procured till the time money is realized on sale of finished products to the customers. Working Capital provides the funds during this time lag.

In accounting terms, Working capital is the amount locked up, at a given time, in the form of Inventories, Receivables (or debtors) and money kept in bank/ cash box. And if you remember, these items constitute current assets in the balance sheet. Working capital that considers only current assets is called Gross Working Capital. Unlike Fixed Assets which are meant for use of the business, current assets are meant for sale or conversion. Current assets keep fluctuating during the year and hence the name - Current Assets; and for this reason Working Capital is also called "Fluctuating Capital".

Fluctuating working capital can be due to the following reasons - (a) Seasonal - Due to seasonal changes, level of business activities is higher than normal during some months of year and therefore additional working capital will be required along with the permanent working capital. It is so because during peak season, demand rises and more stock is to be maintained to meet the demand.(b) Special – Additional doses of working capital may be required to face cut throat competition in the market or other contingencies like strikes, lock outs, theft etc.

For example, in Sugar industry, the raw material (stock of sugar cane) will be very high just after the harvesting season, but keeps reducing throughout the production cycle till the next harvest season. Similarly, in the consumer goods industry, the Finished Goods (FG) stock will gradually increase during the off-season due to decrease in sales. It will reach the peak at the beginning of the festival season and will drastically reduce at the end of the festival season. The need for working capital fluctuates from time to time.

However, to carry on day-to-day operations of the business without any obstacles, a certain minimum level of raw materials, work-in-progress, finished goods and cash must be maintained on a continuous basis. The amount needed to maintain current assets on this minimum level is called permanent or regular working capital.

The working capital requirement of a business is closely related to the

- Nature of the business
- Size of business
- Complexity of the production process/cycle

A service firm, such as the electricity utility or a transport corporation with a short operating cycle and sales predominantly on cash basis has a modest working capital as compared to a machine tool manufacturing business that has a long operating cycle and sells largely on credit to customers.

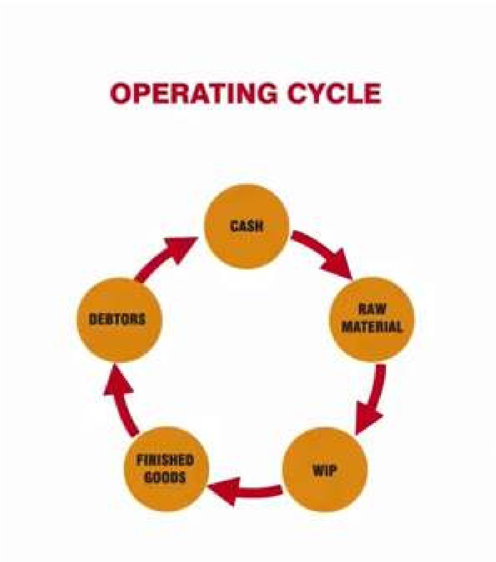
Similarly a large company with high investment in fixed assets will require higher quantum of working capital as compared to a smaller company belonging to the same industry.

A business in a highly seasonal industry (such as: Air conditioning or manufacturing of fire crackers) will have a high working capital build-up for the peak season sales. Business fluctuations may be in the direction of boom and depression. During boom period the firm will have to operate at full capacity to meet the increased demand which in turn, leads to increase in the level of inventories and book debts. The depression phase of business fluctuations has exactly an opposite effect on the level of the working capital requirement. If a firm can get easy bank facility in case of need, it will operate with less working capital. On the other hand, if such a facility is not available, it will have to keep large amount of working capital .Moreover, Full amount of cash profit is not available for working capital purpose. Taxes have to be paid out of profits. Higher the amount of taxes- less will be the profits for working capital. Hence, the size of the Working capital should correspond to the size of the business and peculiarity of the industry to which the business belongs.

Adequacy of working capital is an important criteria to be understood and met. Paucity of working capital not only impairs the firm's profitability but also results in production interruptions and inefficiencies and sales disruption. It may also be deterrent for exploiting favourable business conditions. For example, low level of finished goods inventory at the start of the peak season may result in losing market share to competitors. Similarly, as ‘current assets and idle funds’ do not earn any income and in fact represent blocked funds, excessive working capital is a sign of ‘inefficiency’ and lower profitability.

Operating Cycle

By now you must have realized the importance of working capital and how critical it is to ensure the smooth operating of a business. I think we should dive deeper now to understand how to estimate the working capital required for your business for which understanding the concept of an operating cycle is going to be very important.



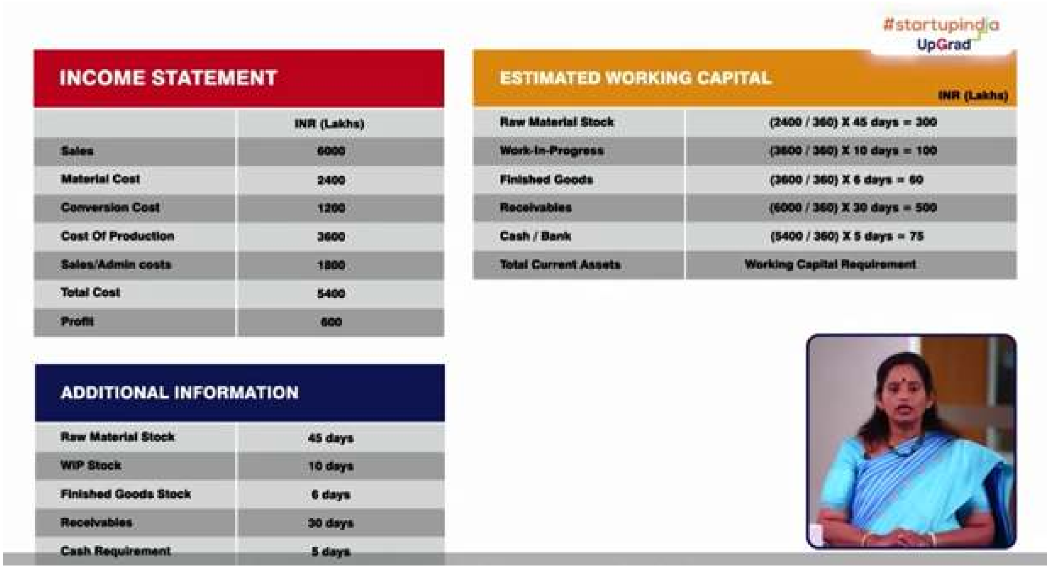
One easy way to understand the Working Capital is to compare this to a "wheel". At the beginning of this wheel is "Cash". The cycle rotates with the purchase of Raw materials by paying cash or through credit from suppliers. Then, the raw materials are converted to 'work-in-progress' and then to 'Finished goods' through value addition by adding employee costs, power, consumables, tools and also technology. The cycle moves on to the next stage when the finished goods are sold to customers on credit or for cash. The cycle ends with "cash" when the money is realized from the customers at the end of the credit period.

Another way to understand Working Capital is to view this as "Cash Machine" –like an ATM machine. Some money is stored in the Cash machine which is called the "Working Capital". Cash is drawn out of this machine to pay suppliers of goods and services; and also for purchases across the counter; Further cash is drawn for payment of salaries to employees, power etc. to add value to the input materials by using Fixed assets. The Cash machine is replenished with cash collected by selling the finished goods either across the counter or from customers who have been extended credit.

It will be useful to know about the length of the 'operating cycle' which is normally expressed in 'number of days'. In retail industry and restaurant business, the operating cycle is very short (may be a few days or even just one day) when the inputs are converted to finished goods and sold across the counter for cash. Hence, the working capital required is lower. On the other hand, some capital goods industries like building Power plants have long operating cycle extending to several months or even a year; customers will only pay after the power plant is commissioned and fully operational. Hence, Working capital required is higher. Irrespective of the length of the operating cycle, care should be taken to keep the pipeline in efficient condition. We will discuss this more on this later in section on "working capital management".

As an entrepreneur, you should be able to estimate the working capital requirement for your business using the 'operating cycle' concept. First you will estimate the size of the income and expenditure for a year and the resultant profit. If you are a start up, you should be able to compile this information from similar firms operating in the same industry and region. The next step is to estimate the average number of days of Raw Material, Work In Progress, Finished Goods, Receivables and Cash required for efficient running of the business. This can be compiled from the published financial statements of other businesses or from Industry associations

The key factor is to link each component of working capital to an appropriate base. For example, for estimating the number of days of Raw Material stock, the base is the "material consumption". Similarly for Work In Progress and Finished Goods stock, the base is "cost of production'"; for Receivables the base is "sales" and so on. Following example will give more clarity.



Dilip is running a garments business. The projected Income statement of this business for 2016 is visible to you. Assume 360 days in a year and all the amounts in lakhs.

Raw material stock = 45 days;

WIP stock = 10 days;

Finished Goods stock = 6 days;

Receivables = 30 days;

Cash requirement = 5 days

We need to estimate the working capital requirement for the garments business. You can see that the money value of raw material to be used in a year is Rs 2,400 lakh. If a year has 360 days, then for 45 days the monetary value of raw material to be kept would be Rs 300 lakhs. Similarly, the money value of Work In Progress to be used in a year is Rs. 3,600 lakhs. If a year has 360 days, then for 10 days the monetary value of WIP to be kept would be Rs. 100 lakhs. Likewise, we can find out the value of other current assets. For finished goods it will be Rs. 60 lakhs, for receivables it will be Rs. 500 lakhs and for cash, it will be Rs. 75 lakh the total requirement of working capital, thus, will be Rs. 1035 lakhs.

Financing and Management of Working Capital

Our idea was really good, but then we were way ahead of time. Less than 1 % of India had telephone connections in those days, imagine… Response was good. People really liked the idea, but the challenges that we faced was… we were not funded of course, and we had difficulties in getting phone lines even. So in those days, you had to apply for a phone line and wait for years to get a connection. So we would try to buy some premium phones with whatever little less capital that we had and we had a problem, challenge of you know further running the business. We had major working capital problem. We had various challenges. So finally, one day I decided like I was not the financing partner, so it was all my idea and brain child, but I felt bad for my financing partner who I suggested to gift my shares to him and move on with life. Because, by then things had come down to a situation where we couldn't take care of our own needs. So, it was a question of if you can't fill fuel in your bike, then you can't reach out to work. So, it was as bad as that.

We just heard VSS Mani of just dial talk about the various challenges he faced managing working capital management. As an entrepreneur, it is going to be very important for you to be careful when it comes to managing liquid funds you need to have an accurate estimate of what amount is required and then plan to have enough solvency for your business. Now that we understand how to estimate the working capital required based on the concept of operating cycle it is also going to be very important for us to further dig deeper to understand working capital planning and management.

After estimating the working capital requirement, the entrepreneur should find ways and means of financing the working capital. In other words, how to raise funds for working capital. Let us first understand how gross working capital is financed.

The cheapest and most efficient way of funding the working capital is by building up “current liabilities” in the form of Supplier Credit, Advances from Customers, Deferred Payables (for Utilities, Tax, Dividend, employee costs etc.) The entrepreneur should be able to negotiate the best the credit terms from the suppliers of goods and services. Credit period, once agreed with the supplier, should be honored at all times. This will increase credibility with the supplier and provide a base for even better credit terms in the future. Similarly, advances from customers is another important source of financing the working capital.

Wherever possible, this avenue should be explored especially in cases which have long working capital cycle (eg; Capital goods) deferred payable is another source where the maximum credit period allowed should be exploited without exceptions .As these current liabilities are incurred in relation to 'current assets', the current liabilities are reduced from current assets to show "Net Working Capital".

Hence the term net working capital (current asset – current liability) is used more predominantly in all context. Sometimes we come across businesses, though not very common often, where the 'current liabilities' fully funds the 'current assets'. This may be a very ideal case as 'current liabilities' do not entail any cost. In exceptional cases, the net working capital may become negative (-'ve) as 'current liabilities' are more than 'current assets'. While this phase might be temporary for a few months, prolonged –'ve working capital situations should be avoided to prevent misallocation of funds leading to risky situation of not being able to pay the current liabilities when they fall due.

After optimization of 'current liabilities' as a source financing the working capital, the balance of current assets , i.e. Net Working Capital should ideally be financed through a combination of debt and equity. A substantial portion of the working capital should be financed through 'owned funds' and the balance from 'long term' borrowed funds which generally carry a lower interest rate than bank borrowings. The amount involved as permanent working capital has to be meet from long-term sources of finance.Short term bank borrowings, as a source of financing the working capital, should be resorted to judiciously as they carry high interest rate. Normally, short term borrowings is used to address fluctuating working capital needs.

Simply put, efficient management of working capital is not rocket science. Keep the operating cycle free of blocks the see that current assets are liquidated into cash quickly to meet payments to current liabilities.

For example, watching out for Nonmoving and Obsolete inventories, uncollectable invoices (bad debts) etc., as these will constitute some portion of currents which cannot be liquidated to meet financial obligations. The second aspect is by increasing the efficiency of operating cycle

Let us see some pointers in this regard, As seen earlier, negotiating longer credit terms with suppliers and seeking advance payments from customers will significantly improve the efficiency of working capital. Receivables management is no less important. It should start with raising of sales invoice in a timely manner and following up with the customers to get the payment on due dates. Negotiating shorter credit periods with customers will reduce the need for costly bank borrowings to finance the working capital. Similarly, better inventory management of working capital through modern concepts like 'Just-in-time' supplies, improved process flow through latest technology, and optimized inventory levels by checking on slow moving or obsolete stock will show improved results.

Vendor Contracts

So far we understood the importance of working capital management and why is it critical for an entrepreneur to manage it effectively for the sustenance of the business. We looked at some key concepts like operating cycles and also got some tips on how to efficiently manage the working capital. Now it is going to be very important for us to understand vender contracts in order to make sure that we can manage our liabilities very well. So let us dig deeper to understand what are the various terms and conditions that are used in a vendor contract.

Key terms to look out for in Vendor contracts –

For an entrepreneur, probably commercial or financial parts of a contract are the most critical ones. These would of course vary with each contract. From a financial point of view, one should look at the following general clauses in these agreements –

Fees, Costs and Expenses – as would be key for any contract, you would want to lock in the payments amounts you need to pay. Generally the fees negotiated should be an all-inclusive one, but in certain cases, there are some expenses that are allowed to be billed over and above, these are called out of pocket expenses. You should ensure that any such expenses should be mentioned clearly in the agreement to be either inclusive or exclusive, and put limits to the extent of such expenses.

Payment Terms- defining the payment terms properly helps in two ways – it ensures you are paying only once services are rendered, or goods are delivered, and it also can be used as a tool to manage your working capital. Negotiating credit period in the contract will help you reduce your working capital needs. And hence you are in control of when is the outflow plan to happen.

Applicability of Taxes being the other one – you need to ensure what kind of taxes are applicable on the transactions you are entering into. Is there VAT, service taxes or any other taxes which are applicable? Just identify those and put it in the contract, whether they are prices inclusive or exclusive need to be mentioned. Also there would be withholding taxes that might be applicable on the transaction and must be recorded in the document that you would be deducting withholding taxes out of the amount mentioned in the contract. This normally is not mentioned in the document sometimes and becomes the dispute point at the time of settlement of the dues. So while mentioning in the contract it becomes part of the commercial negotiations and it is better to have it there, so that there is clarity upfront.

The Scope of services being the next which has to be linked to the consideration. Getting value for money means optimizing the ratio between value and cost. Depending on how precisely the quality of services can be quantified – that is, whether metrics are predominantly numerical or not – it may be possible to express the value/cost ratio very precisely. In other circumstances, the concept of value may be more subjective. Just to give you an example, if you are entering into a service agreement with a consultant and you know you are going to engage him for X number of hours per month and X months. What you can exactly do is to link the payments to the number of hours you engage and the number of months you are engaged with. On the other hand if there is a general deliverable which has to be provided, which cannot be broken up in specific measurable terms. It might be difficult for you to link your payment to the deliverables. One way normally you would do in such situation would be the percentage completions of such deliverable and link the payment accordingly.

It is also important to track actual benefits achieved and costs against what was planned, to ensure that the right level of resource has been assigned to a service. One should ensure that the Liability to pay should stop once work stops / contract is terminated. This is again very critical from finance point of view. Also in typically financing contract Look for any financial covenants to be complied with (applicable in financing contracts specifically) – examples of financial covenants may include – maintaining asset coverage ratio on loans guaranteed against equity shares, if the aggregate value of such shares go below the permissible limit – you may either required to repay the loan in full or in part, or you may have to top up the security in order to continue with the loan. These have to be understood and agreed upon earlier such that they don't come as surprise later

Summary – Working Capital Management

This was a very interesting session where we understood the importance of working capital management for an entrepreneur. It is going to be very important to be careful as an entrepreneur to accurately estimate your working capital requirements and plan for them accordingly so that you maintain enough solvency for your business Then we went on to understand what are the key factors involved in accurately estimating your working capital requirements i.e.

- Nature of the business,
- Size of the business,
- Production cycle,
- Type of industry,
- Business fluctuations,
- Access to banking facilities
- Profits and taxes.

We also saw the concept of operating cycle and then took an example to learn how you can effectively estimate working capital requirements. Then we also saw the various sources from which you can get your working capital financed and how you can strategically manage it. We saw that the various sources are

- Owner's funds,
- Short term borrowings and
- Long term borrowings. Then we went on to understand the vender's contract which are very important to make sure that you are effectively managing the working capital and have great vender relationships. It was great meeting you for this session, and I look forward to see you again soon.