CORPORATE ANALYSIS

Working Capital

Working Capital is most important for any firm to operate, to function: Only its proper management ensures that raw material purchased or staff salaries and wages can be paid on time. To achieve this, an important part of Working Capital management focuses on the speedily collection of receivables, these are payments customers still owe to the firm.

Working Capital comprises components on both, the active and the passive side of a firm´s balance sheet: In Corporate Finance terms, Working Capital is in principle composed of a firm´s cash, receivables and inventory, as well as its payables. Therefore, Working Capital combines most positions of a firm´s current assets and current liabilities: For example, short-term debt – alas: short-term interest bearing liabilities -, would not be included. – When talking about Working Capital, frequently analysts and investors actually refer to Net Working Capital which is defined as Working Capital´s assets minus its liabilities.

To assess whether a firm´s Working Capital is being used efficiently, one may aim to look at how long each of its position is held, or in other words: turned over. This approach is useful, as in today´s environment firms aim to keep Net Working Capital low (at times, if feasible, even negative), as this position must eventually be funded.

For example, the collection period of a firm indicates how swiftly customers pay for goods delivered or services provided: Thereby, the firm´s revenues reflect goods and services delivered, and its receivables represent the amount customers are still required to pay. To calculate the collection period – or: the number of days outstanding -, one just may divide the firm´s receivables by the daily revenues of the firm. – Logically, the faster a firm collects cash from its customers, the better, and the sooner this cash can be used for other firm purposes. But there is also another advantage: The lower the number of days outstanding, the lesser funding is required. - Of course, number of days outstanding depends a lot on the industry a firm is operating in and its bargaining power vis-à-vis its customers: Whilst a super market chain may have a very short collection period (maybe just hours or minutes, as customers frequently pay in cash), such may stretch over many months in industries delivering complex industrial products.

On the other hand, if a firm can afford it, it may decide paying its suppliers as late as possible. - Now, such late payments can be regarded as suppliers actually providing credit – or loans – to the firm, with the additional benefit that this sort of loan does not bear any interest. In consequence, pursuing such strategy would further reduce the need of the firm for (interest bearing) funding from its commercial lenders. – Of course, also payment periods depend on the industry one is operating in and the bargaining power vis-à-vis suppliers. – The days payable – or firm´s payment period - is commonly defined by dividing a firm´s payables by its cost of goods sold per day. Whilst this may not be the most accurate approach, the underlying assumption is that most payables are linked to goods and services provided to a firm, which will then be further processed in its operations.

Finally, firms holding only smaller amounts of inventory are deemed to be more efficient: This would indicate that the inventory is turned over faster and, hence, – again - less funding will be required. The approximate number of days a firm´s inventory is bound can be calculated by dividing the inventory position by the cost of goods sold per day. As before, this calculation approach assumes that most of the raw material, semi-finished and finished goods – together forming the inventory - will be further processed within the firm´s operations.

WORKING CAPITAL

BALANCE SHEET

	+ CASH CASH EQUIVALENTS	PAYABLES	SUPPLIERS −
CUSTOMERS +	RECEIVABLES		
PRODUCTION PROCESS +	INVENTORY		

+ BINDS WORKING CAPITAL
= INCREASES FUNDING REQUIREMENTS

− RELEASES WORKING CAPITAL
= REDUCES FUNDING REQUIREMENTS