Time is Money: Finding Your Working Capital Sweet Spot

Matthew Hill, PhD
University of Mississippi

Mark Krawczyk, CTP
Treasurer, Wilks Brothers, LLC

Jim Washam, PhD, CTP
Arkansas State University

(What goes on in Vegas, STAYS in Vegas!!!)
Today’s Agenda

- Introductions
- Typical Working Capital Theory
- What’s The Goal?
- What’s The Cost?
- Let’s Go To Zero
- Does Working Capital Hold Firms Back?
- Summary/Final Comments
Concept of Working Capital

• Gross working capital
• Net working capital
Gross Working Capital

• A generally accepted concept.
• It is the sum of the capital invested in total current assets of the business.
• Simply put,

\[ GWC = CA \]
Net Working Capital

• A more specific concept which considers both current assets and current liabilities of the business.

• It is the excess of current assets over the current liabilities of the business during a particular period.

• If CA > CL then it’s positive working capital

• If CA < CL then it’s negative working capital

• Simply put,

\[ \text{NWC} = \text{CA} - \text{CL} \]
Factors Determining Working Capital Requirements

- Nature or character of the business
- Size of business, scale of operations
- Production policy
- Manufacturing process / length of production cycle
- Seasonal variation
- Working capital cycle
- Rate of inventory turnover
- Credit policy
- Business cycle
- Rate of business growth
- Price level changes
- Earnings capacity and dividend policy
What’s The Goal?

• Primary Goal of the Firm
  – Maximize owners’ wealth
  – Maximize the stock price (shareholder value)
  – Minimize the cost of capital
  – Maximize the value of the firm

\[
\text{Value} = \sum_{t=1}^{n} \frac{\text{CashFlow}_t}{(1+r)^t}
\]
Factors That Determine Value

\[
\text{Value} = \sum_{t=1}^{n} \frac{\text{CashFlow}_t}{(1+r)^t}
\]

EBIT(1 – Tax Rate) + Depreciation – Capital Exp. – \(\Delta(\text{Net Working Capital})\)

WACC = f(Real Rate, Expected Inflation, Risk)
Cash Conversion Cycle

Days’ Inventory
Purchase of Resources

Days’ Receivables
Sale of Goods or Services
Collection of Sales Receipts

Days’ Payable
Payment for Resources

Cash Conversion Cycle
Cash Conversion Cycle

- Purchase of Resources
- Collection of Sales Receipts
- Payment for Resources
- Days’ Payable
- Collection of Sales Receipts

• Net Cash Flow from Operations
• Available Cash & Short-Term Investments
• Unused Credit Facilities
Working Capital Requirement

- \[ WCR = (A/R + \text{Inventory}) - A/P \]
- WCR is directly related to the firm’s Cash Conversion Cycle (CCC)
- As the WCR (and CCC) increase: 
  - Additional financing is required
  - Cash flow from operating activities is affected
## Working Capital Requirement

<table>
<thead>
<tr>
<th></th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>A/R</td>
<td>$ 6,828,000</td>
<td>$ 6,667,000</td>
<td>$ 6,971,000</td>
<td>$ 13,858,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>$ 5,643,000</td>
<td>$ 4,694,000</td>
<td>$ 4,958,000</td>
<td>$ 7,981,000</td>
</tr>
<tr>
<td>A/P</td>
<td>$ 2,772,000</td>
<td>$ 2,142,000</td>
<td>$ 2,320,000</td>
<td>$ 6,190,000</td>
</tr>
<tr>
<td>Working Capital Req</td>
<td>$ 9,699,000</td>
<td>$ 9,219,000</td>
<td>$ 9,609,000</td>
<td>$ 15,649,000</td>
</tr>
</tbody>
</table>

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<thead>
<tr>
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<th>2008</th>
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<tbody>
<tr>
<td>WCR as % of (Non-Cash) Assets</td>
<td>20.0%</td>
<td>19.5%</td>
<td>20.3%</td>
<td>14.5%</td>
</tr>
</tbody>
</table>
Working Capital Requirement

Working Capital Requirement

- A/R
- Inventory
- A/P
- Working Capital Req

- 2006
- 2007
- 2008
- 2009
- 2010
- 2011

- $18,000,000
- $16,000,000
- $14,000,000
- $12,000,000
- $10,000,000
- $8,000,000
- $6,000,000
- $4,000,000
- $2,000,000
- $-
Working Capital Requirement

Net Cash Flow

- Operating Activity
- Investing Activity
- Financing Activity
- Net Cash Flow


AFP Annual Conference
What’s the Cost?

- The firm’s working capital requirement must be financed with debt or equity.
- Suppose that the cost of financing the firm’s WCR is 5.0%.

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<tr>
<th></th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual Cost</td>
<td>$460,950</td>
<td>$480,450</td>
<td>$782,450</td>
</tr>
</tbody>
</table>
Gains from Reducing Working Capital

- The firm reduces the A/R collection time by 1 day:

\[ \text{A/R Balance} = (\text{Days Rec.}) \times \left( \frac{\text{Sales}}{365} \right) \]

New A/R Balance = (88.7) \times \left( \frac{56,409,000}{365} \right)

New A/R Balance = $13,708,160
Gains from Reducing Working Capital

- Reduction in A/R = $149,840
- At an interest rate of 5.0%, the annual reduction in interest expense is $7,492.
- Other ways to reduce working capital requirements
  - Reduce inventory times/levels
  - Increase accounts payable times/levels
Let’s Go to Zero

• If reductions in working capital reduce financing costs and increase cash flow, why not go to zero?
• Factors that determine the firm’s optimal working capital position.
• Does working capital actually add value?
Empirical Evidence on the Value of WC

- WC assets are valued by shareholders
  - Cash, A/R, Inventory

- But, value is conditional on
  - Financial constraints
  - Product market conditions
  - Corporate governance
Description of Sample Firms

• Samples consist of firms that were publicly-traded over the period 1970-2010
  – Panel datasets
  – ~50,000-100,000 observations
  – ~10,000 unique firms
  – Mean asset base is $2.4B and average annual revenues equal $2.1B

• Industry coverage
  – Non-utility and finance industries
Methodology Used to Estimate Market Value

• Multivariate regression model that specifies excess returns as the dependent variable
  – Faulkender and Wang, 2006

• Control variables account for investment and financing policies

• Relatively “clean” coefficient estimates that have “nice” interpretations
Benefits and Costs of Holding Cash

• Benefits
  – Transactions
  – Precautionary
  – Speculative

• Costs
  – Opportunity costs
  – Agency costs
Market Value of Cash Holdings

- Shareholders value cash (Faulkender and Wang, 2006)
  - Additional $1 held in cash is worth $0.75
- The MV of cash drops as cash is accumulated. Why?
  - A one standard deviation increase in prior period cash holdings reduces the MV of an additional $1 in cash by $0.17
Value Drivers for Cash: Financial Constraints

• Value of cash increases with financial constraints (Faulkender and Wang, 2006)
  • Proxies for financial constraints include dividend payout ratio, firm size, bond rating, and commercial paper rating

• Takeaway: Shareholders recognize that internal liquidity is beneficial for firms with weaker access to external capital
Value Drivers for Cash: Financial Constraints

<table>
<thead>
<tr>
<th>Payout Ratio</th>
<th>Firm Size</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Constrained</strong></td>
<td><strong>Constrained</strong></td>
</tr>
<tr>
<td>$1.67</td>
<td>$1.62</td>
</tr>
<tr>
<td><strong>Unconstrained</strong></td>
<td><strong>Unconstrained</strong></td>
</tr>
<tr>
<td>$1.07</td>
<td>$1.12</td>
</tr>
</tbody>
</table>
Value Drivers for Cash: Financial Constraints

**Bond Ratings**
- Constrained: $1.71
- Unconstrained: $1.34

**Commercial Paper Ratings**
- Constrained: $1.69
- Unconstrained: $0.71
Value Drivers for Cash: Governance

- Improved governance increases the value of cash (Dittmar and Mahrt-Smith, 2007), as cash allows managers to avoid capital market scrutiny
  - MV of Cash = $0.42 for a poorly governed firm
  - MV of Cash = $0.84 for a well governed firm

- Takeaway: Weak governance implies an increased likelihood of managers misusing cash (i.e., overpaying for acquisitions or undertaking unnecessary projects). Subsequently, shareholders discount the value of cash for firms w/ poor governance.
The Value of Cash Evolves Over Time

<table>
<thead>
<tr>
<th>Decade</th>
<th>MV of Cash</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980s</td>
<td>$0.61</td>
</tr>
<tr>
<td>1990s</td>
<td>$1.04</td>
</tr>
<tr>
<td>2000s</td>
<td>$1.12</td>
</tr>
</tbody>
</table>

• Variation over time is due to increased CF variability and credit risk
• Bates, Chang, and Chi, 2013
Benefits and Costs of Extending Trade Credit (TC)

• **Benefits**
  – Sales growth
    • Constrained customers
    • Product quality guarantee
  – Interest income (forgone discounts)
  – Reduced operating expenses

• **Costs**
  – Financing and opportunity costs
  – Carrying costs (i.e., bad debt expenses and administrative costs)
Market Value of Extending TC

- Shareholders value receivables (Hill, Kelly, and Lockhart, 2012)
  - Additional $1 of receivables is valued at $0.45, which is significantly less than for the value of cash

- Takeaway: **TC allows suppliers to form profitable B2B relationships w/ cash constrained customers.**
Value Drivers for Extending TC

- **Value of receivables varies with product market conditions**
  - **Industry Affiliation**: MV of additional $1 in A/R is worth an extra $0.10 if the firm sells differentiated products
  - **Competitiveness**: MV of receivables increases for firms with lower market shares
  - **Sales Variability**: MV of A/R increases for firms with more volatile sales

- **Value of A/R increases for financially constrained firms**
  - Consistent with shareholders viewing receivables as “near cash”
Value of Inventory and WCR

• Shareholders value inventory for certain firms (Beauchamp, Hardin, Hill, and Lawrey, 2013)
  • Operating and financing conditions effect the MV of inventory

• Shareholders value increases in the WCR (Kieschnick, LaPlante, and Moussawi, 2013)
  - Each component of WCR is valued by investors
Limitations of These Studies

• Sample firms are large

• “Coarse” WC Data
  – Lack of data on access to LOCs
  – Composition of cash
  – TC terms
  – Only observe “window dressed” values

• Internal analysts can examine more interesting questions!
Does WC Destroy Shareholder Wealth?

• Not according to various academic studies. But, the value of WC is conditional on firm characteristics.

• Implication: **Benchmarking WC policies wrt to industry-year medians/means may lead to suboptimal decisions.**
  • Example: Your most important customer just informed you that they need extra time to repay their current payables balance. You have additional borrowing capacity via your LOC, but your client is financially constrained. Your DSO is slightly higher than the current average industry DSO. What do you do?