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Working Capital Impact on Value of Business: A Study

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ABSTRACT

Working capital is one of the most crucial components for ensuring a smooth operation of any business. It is regarded as a useful financial tool that gives a fair idea about a business' short-term financial standing. Thus, businesses facing working capital deficits must take immediate measures to address the same. Working capital is a simple concept because it's all about freeing up the company's cash. Unfortunately, many organizations face serious internal challenges that can interfere with their ability to do so. As they've discovered, it's one thing to recognize the need for working capital improvement and quite another to understand what steps to take to improve cash flow.

Key Word : Impact Factor, Types and Essential & Managing

Backdrop

Defination of Enterprise Value

Enterprise value measures a company's total value, often used as a more comprehensive alternative to equity market capitalization. EV includes in its calculation the market capitalization of a company but also short-term and long-term debt and any cash or cash equivalents on the company's balance sheet.

Market cap: The total value of a company's outstanding common and preferred shares

Debt: The sum of long-term and short-term debt

Unfunded pension liabilities (if any): The amount of capital lacking to cover pension payouts or the amount a company needs to set aside to make pension payments in an unfunded plan. Can be added market cap if this value is present.

Minority interest: The equity value of a subsidiary with less than 50% ownership. It can be added to market cap for EV calculation.

Cash and cash equivalents: The total amount of cash, certificates of deposit, drafts, money orders, commercial paper, marketable securities, money market funds, short-term government bonds, or Treasury bills a company possesses.

Definition of Working Capital

Working capital is an indicator of the short-term financial position that measures the overall efficiency of an organization. It is calculated by subtracting current liabilities from current assets and listed directly in its balance sheet.

Current assets mean the money kept in a bank and assets that can be converted into cash in case if any situation arises. Current liabilities represent debt that an individual will pay within the prescribed year. Finally, working capital is the money left after subtracting liabilities from an individual's money in the bank. Current assets consist of cash, accounts receivable, and inventory. Current liabilities include wages, taxes, interest owed.

working capital is also used to measure the company's financial health. If there is a larger difference between what a company owns and what an individual owns for the short-term, the business will be healthier. If the company owes more than they own, they will have negative working capital, and their business might get closed.

Literature review

Hill et al. (2010) indicates that increases in sales growth and sales volatility cause companies to manage operating working capital more aggressively, they find limited support for a direct correlation between gross profit margin and WCR.

Raheman and Nasr (2007) used net operating profitability, and the results show that there is a strong negative relationship between variables of the working capital management and profitability of the company. In contrast, Lyroudi and Lazaridis (2000) in their study found that the cash conversion cycle was positively related to the return on assets and the net profit margin.

Nobanee and AlHajja (2009) suggest that managers can increase profitability of their companies by shortening the cash conversion cycle, the receivable collection period and the inventory conversion period.

While Nazir and Afza (2008) in their study utilized the working capital requirement as the dependant variable, the operating cycle of company, return on assets and Tobin's Q, have been used as the determinants of working capital management (independent variables, not like in the majority of the studies), because of the different objectives.

Siddiquee and Khan (2009) in their study analyze the working capital performances of 83 listed companies from seven different sectors of Dhaka Stock Exchange Ltd. The results show that significant

Working Capital Affects many Aspects of Business

Working Capital is an accounting term that may hold the key to your company's success. Working capital affects many aspects of your business, from paying your employees and vendors to keeping the lights on and planning for sustainable long-term growth. In short, working capital is the money available to meet your current, short-term obligations. To make sure your working capital works for you, you'll need to calculate your current levels, project your future needs and consider ways to make sure you always have enough cash. Working capital is a measure of liquidity that gives an indication of the short-term health of the company. Working capital is calculated by subtracting current liabilities from current assets. A company's level of working capital impacts value because changes in working capital impacts cash flow and valuation is inherently tied to cash flow.

Working Capital Impacts Pricing

Working capital levels are important in determining the value of a company. Typically, an analyst considers three methods to determine value: the income approach, the market approach, and the asset approach. -
1. An income approach considers future cash flows
2. A market approach considers the selling price of similar companies
3. An asset approach considers the assets and liabilities of the company.

the net cash flows for use in the income approach, the analyst will make an adjustment for the increase in working capital that the company will need in order to fund its expected growth.

if there is an excess or a deficit of working capital as of the valuation date, the analyst may add or subtract this to the value of total equity. To determine these adjustments, the analyst will look at trends in the company's historical working capital levels. The analyst will also compare the company's working capital levels with similar companies operating in the same industry.

Working capital impacts a company's cash flow, as it is a measure of liquidity. Also, several valuation methods use cash flows for calculation. Working capital is the difference between current assets and current liabilities, and it also indicates the short-term health of a company.

The small business banker can help you better understand your working capital needs and what steps you may need to prepare for any situation. While you can't predict everything about running a company, a clear view of working capital can help you operate smoothly today — and set you up for long-term growth tomorrow.

Working Capital Essential?

The sole purpose of using working capital is to fund operations, meet the short-term obligation, and continue to have sufficient working capital. It's continuously paying its employees and suppliers to meet other obligations like taxes and interest payments even if they have any cash flow challenges. Working capital is also used to fuel business growth without incurring debt. If the company does not want to take a loan, they can qualify easily for loans or other forms of credit because of their positive working capital.

Several financial teams have mainly two goals in their mind:

- 1) To have a clear goal and view of how much cash is on hand at any given time
- 2) To work with multiple businesses and to maintain enough working capital to cover liabilities.

Working Capital in Business : Types

The types of working capital are mainly divided into different parts:

Variable Working Capital

Variable working capital can be defined as the capital invested for a temporary period in the business. Variable working capital is also called fluctuating working capital.

Gross Working Capital

Gross working capital is the total value of the company's current assets. Current assets include cash, receivables, short-term investments, and especially market securities.

The Gross working capital does not showcase the current liabilities. Gross working capital can be executed by calculating the difference between the existing assets and current liabilities.

Permanent Working Capital

Permanent working capital is the minimum amount of capital required to carry on the operations without interruption or difficulty.

Net Working Capital

Networking capital is the difference between the current assets and current liabilities of the company. If the company's assets are more than current liabilities, it indicates a positive working capital, and the company is in a financial position to meet its obligations.

Regular Working Capital

Regular working capital is the amount of funds businesses require to fund its day to day operations. For example, cash needed for making payment of wages, raw materials, salaries comes under regular working capital.

The Company Has Low Working Capital in Business

If the company has low working capital, it means that it is dealing with low current assets and more current liabilities. On the other hand, a low net capital does not indicate that company is dealing with losses. Working capital reflects short-term financial health and lower financial health means the company has invested major chunks of money into something that may give higher returns to them.

If a company has completed its financial obligations with insufficient working capital, it means that it is reliable and can manage finance optimally. Negative working capital means the current assets are less than current liabilities, and it can even lead to bankruptcy if it is continued for several months or years

How Change Working Capital

Credit Policy

A company tightens its credit policy, which reduces the amount of accounts receivable outstanding, and therefore frees up cash. However, there may be an offsetting decline in net sales. A looser credit policy has the reverse effect.

Collection Policy

A more aggressive collection policy should result in more rapid collections, which shrinks the total amount of accounts receivable. This is a source of cash. A less aggressive collection policy has the reverse effect.

Negative working capital

Business whose current liabilities that exceed non-cash current assets have negative non-cash working capital. This is a thornier issue than negative changes in working capital. A firm that has a negative working capital is, in a sense, using supplier credit as a source of capital, especially if the working capital becomes larger as the firm becomes larger. A number of firms, with Walmart and Dell being the most prominent examples, have used this strategy to grow. While this may seem like a cost-efficient strategy, there are potential downsides. The first is that supplier credit is generally not really free. To the extent that delaying paying supplier bills may lead to the loss of cash discounts and other price breaks, firms are paying for the privilege.

An estimation problem on your hand when forecasting working capital requirements for a firm that has negative non-cash working capital. As in the previous scenario, with negative changes in non-cash working capital, there is no reason why firms cannot continue to use supplier credit as a source of capital in the short term. In the long term, however, we should not assume that non-cash working capital will become more and more negative over time. At some point in time in the future, you have to either assume that the change in non-cash working capital is zero or that pressure will build for increases in working capital (and negative cash flows)

Managing Working Capital Helps the Selling Company Maximize Value

The management of the selling company can work towards maximizing value and preventing problems in M&A transactions in many ways. These include:

Management should also keep monthly records of working capital. They can avoid surprises during the sales transaction process by periodically analyzing their company's historical working capital trends.

Management should have a realistic expectation about the accounts receivable and investment in inventory needed as the company grows while projecting its future working capital.

Management should inculcate the habit of periodic reevaluation of their accounts payable and borrowing practices. They should also consider modifying them if needed.

They should also focus on reducing the requirements for inventory and the level of accounts receivables.

Management should not refrain from making tough decisions to improve the working capital situation, such as replacing a vendor.

Conclusion

Efficient working capital management is essential for the smooth running of a business. Additionally, it impacts the company's value at the time of exit. Business owners need to manage the working capital such that their organization remains attractive to prospective buyers and they maximize valuation. A firm that decides to adopt this strategy will have to compare the costs of this capital to more traditional forms of borrowing. The second is that a negative non-cash working capital has generally been viewed both by accountants and ratings agencies as a source of default risk. To the extent that a firm's rating drops and interest rates paid by the firm increase, there may be costs created for other capital by using supplier credit as a source.

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