

WORKING CAPITAL CYCLE

WHAT IS WORKING CAPITAL CYCLE (WCC)?

Working Capital cycle (WCC) refers to the time taken by an organization to convert its net current assets and current liabilities into cash. It reflects the ability and efficiency of the organization to manage its short-term liquidity position. In other words, the working capital cycle (calculated in days) is the time duration between buying goods to manufacture products and generation of cash revenue on selling the products. The shorter the working capital cycle, the faster the company is able to free up its cash stuck in working capital. If the working capital cycle is too long, then the capital gets locked in the operational cycle without earning any returns. Therefore, a business tries to shorten the working capital cycles to improve the short-term liquidity condition and increase their business efficiency.

The working capital cycle focuses on management of 4 key elements viz. cash, receivables (debtors), payables (creditors) and inventory (stock). A business needs to have complete control over these four items in order to have a fairly controlled and efficient working capital cycle. Let us look at an example to enable a better understanding of the concept of working capital cycle.

WORKING CAPITAL CYCLE EXAMPLE

Let us assume following details for a company that is in the manufacturing sector.

- A company takes raw materials on credit and has to pay back to its creditors in few days (say 30 days in our example). This is also called as average payables period which is can be calculated as the ratio of creditors to credit purchases.
Average payable period = average creditors / credit purchases X 365.
This means that the company enjoys a credit period of 30 days on the purchase of raw materials used for the production of the final good.
- The company takes “x” number of days to sell off its inventory; the “x” here is nothing but inventory turnover ratio converted into a number of days instead of the number of times. Assuming average inventory of \$ 5000 and average sales of \$ 18000, the inventory turnover ratio amounts to $\$ 5000 / \$ 18000 \times 365 = 102$ days approximately.
- It takes some time for the company to convert its credit sales into cash due to the credit management policy incorporated by the company in terms of the credit period extended to customers. Assuming outstanding debtors of \$ 9000 and a total credit sale amounting to \$ 60,000 the average collection period can be calculated as
Average collection period = average debtors/ Total Credit Sales X 365

$$= \$ 9000 / \$ 60000 \times 365$$

= 55 days approximately

Based on the above information, we infer that

- The company has to pay back its creditors within 30 days.
- For inventory to convert to sales, it takes roughly 102 days
- Conversion of receivables (debtors) to cash, on an average, takes 55 days

WORKING CAPITAL CYCLE CALCULATION

The working capital cycle for the company can be calculated as given below:

Working Capital Cycle = Inventory turnover in days + debtors turnover in days –
creditors turnover

$$= 102 + 55 - 30$$

$$= 127 \text{ days}$$

This implies that the company has its cash locked in for a period of 127 days and would need funding from some source to let the operations continue as creditors need to be paid off in 30 days. Assuming the company had to make all cash payments for its raw material requirement, there wouldn't be any creditors and the working capital cycle would then be $102 + 55 = 157$ days.

Every company would like to keep its working capital cycle as short as possible. A shorter working capital cycle can be achieved by focusing on individual aspects of the working capital cycle. Let us see how this works:

HOW TO SHORTEN WORKING CAPITAL CYCLE?

A company can aim to shorten its working capital cycle by:

- Reducing the credit period given to its customers and thereby reducing the average collection period. Giving cash discount can also help improve the debtor's turnover ratio or average collection period amid various other ways.
- The company can try to improve/streamline its process of manufacturing and focus on various ways to increase sales to reduce the time taken for inventory to convert to sales. The earlier the stock clearance better is the working capital cycle.
- A better negotiation to increase the credit period from suppliers of raw material and goods required for production can also aid reduction in the working capital cycle. While the average collection period and credit period from suppliers aid in shortening the working capital cycle, the initial prime focus of the business should be to reduce the time taken for inventory to convert to sales. If the time taken is very long it could imply

that the business is not able to generate sales for the goods produced and more and more capital gets locked in inventory. Either the business should try and reduce the time or should reduce the amount of inventory thereby reducing the amount locked in working capital. In other words, if the business is not able to reduce its working capital cycle and has higher inventory levels, it should aim at reducing inventory levels and reduce the amount locked in the working capital keeping the cycle time length same.

Most businesses cannot finance the operating cycle (average collection period + inventory turnover in days) with accounts payable financing alone. This shortfall can be managed by the business either out of profits accumulated over time, borrowed funds or by both. Let us look at the sources of funding which can be used to manage the gaps in working capital cycle.

It can be useful to read about a similar metric Days of Working Capital.

SOURCES OF SHORT-TERM WORKING CAPITAL FINANCING

LINES OF CREDIT

The Company can borrow from banks for a short-term (usually 30 – 60 days) against a line of credit given by the bank. The same can be paid off once sales proceeds are collected from debtors.

TRADE CREDIT

Often good relations with creditors can be used for extending credit period as one of the cases in case of a large order and enable financing at a lower cost.

FACTORING

Factoring or discounting of receivables can shorten the working capital cycle and generate cash, however, this is usually at a higher cost.

SHORT TERM LOANS

Companies who may not be able to get a line of credit may look for the short-term working capital loan from a bank.

Having briefly known the sources of working capital financing, let us understand the nature of the working capital cycle:

The nature or the length of the working capital cycle differs from business to business and varies among sectors. Working capital cycle in a manufacturing company as seen above in the example is usually positive as there is a time lag between the goods produced and goods sold (time is taken for inventory to convert to sales). However, there is a possibility of a negative working capital cycle in specific businesses.

NEGATIVE WORKING CAPITAL CYCLE

Let us look at the business model of a supermarket or hypermarket chain. The customers who come to purchase pay by cash and hence there aren't any debtors or the collection period is 0 days. The business is a supermarket and hence, all items in the store are taken from vendors and have a credit period availability to be paid. So usually such businesses enjoy the huge cash and even may make interest earning on the cash till the money needs to be paid to the suppliers. Therefore, these companies have a negative working capital cycle.

Conclusion

Given that the working capital cycle can range from negative to large positive, one needs to answer the question as to what is the optimum level of working capital cycle. Basically, one cannot arrive at thumb rules as working capital cycle varies from sector to sector.

Comparison with peers in the similar industry is more meaningful when analyzing companies and its operating efficiency. Moreover, the working capital cycle may fluctuate depending upon the product manufactured, their seasonality, and shelf life along with many other factors. Sometimes poor forecasting, change in government policies and unexpected events may change the working capital cycles and add up to working capital financing problems.

Usually, a ratio of working capital to sales is used by companies to see if the business is moving in lines with the industry performance/benchmark. The level may also depend on the future plans, sales forecast, product diversification etc