# Working capital management: investment and financing policies

Lecture for Corporate Finance

SILESIAN UNIVERSITY
SCHOOL OF BUSINESS ADMINISTRATION IN KARVINA

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# Outline of the lecture

SILESIAN UNIVERSITY
SCHOOL OF BUSINESS ADMINISTRATION IN KARVINA

- Working capital
- Net working capital
- Working capital investment policies
- Working capital investment policy of Xiaomi
- Sources of long-term financing
- Sources for short-term financing
- Working capital financing policies
- Working capital financing policy of Xiaomi

# Working capital & Net working capital:

- Working capital = Current assets, that expected to be realized in the normal operating cycle or within 12 months after the reporting period; held primary for the purpose of trading; cash and cash equivalents

- Permanent Working capital – amount of current assets at the lowest point of the operating cycle (inventories, accounts receivable, cash, short-term financial investments)

- Temporary Working capital – those current assets (inventories, accounts receivable, cash, short-term financial investments), that fluctuating during the operating cycle because seasonality, peculiarities of the production process …..

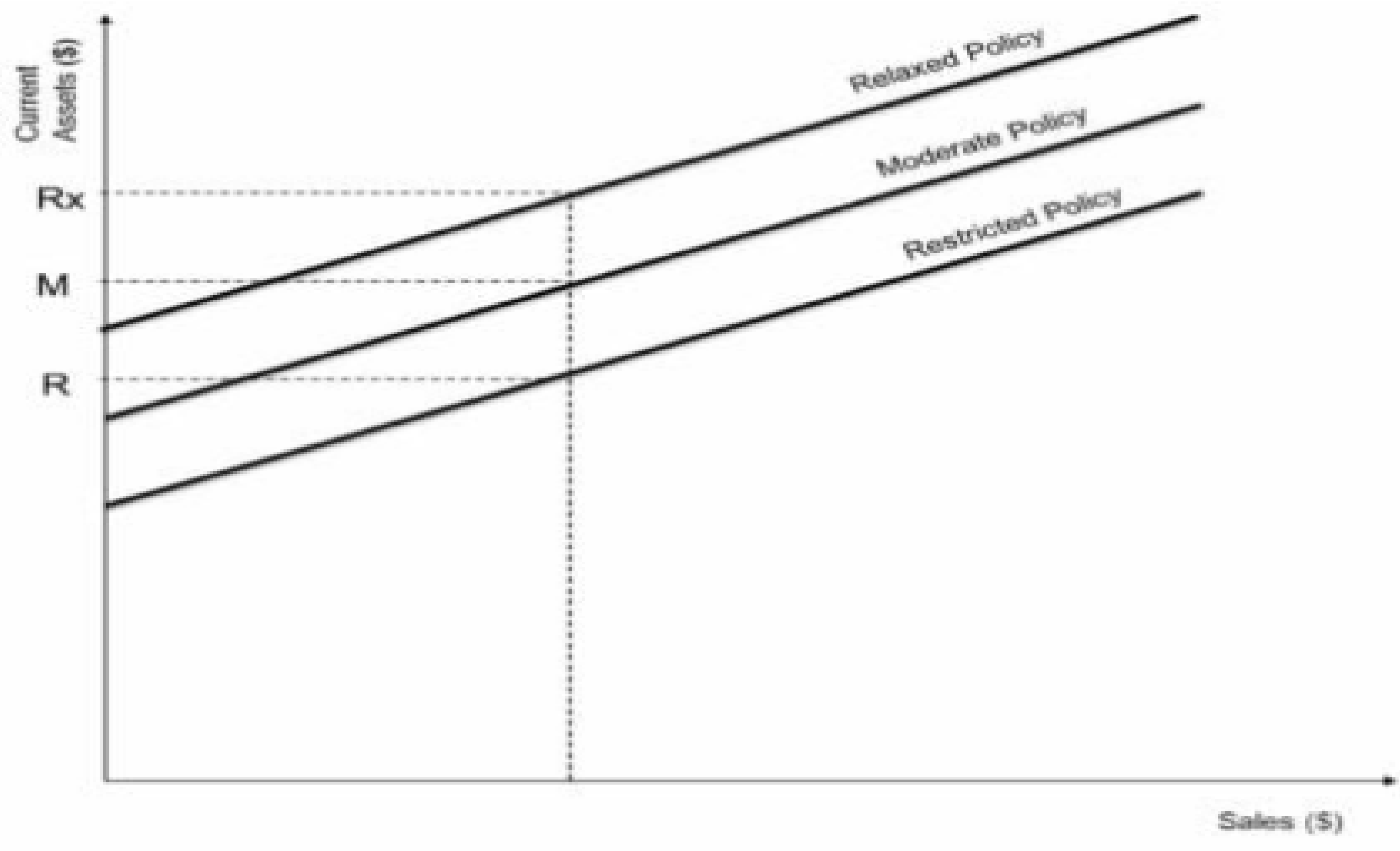
- Net working capital = Current assets – Current liabilities

Or

- Net working capital = Equity + Long-term financing – Fixed assets

# Working capital investment policies:

The investment policy is about how many resources invests the company into the current assets (inventories, accounts receivable, cash, financial investments) in order to provide the targeted sales.



# Relaxed working capital investment policies:

- Relaxed Policy: the estimation of current assets for achieving the targeted revenue is prepared after carefully considering uncertain events such as seasonal fluctuations, a sudden change in the level of activities or sales, etc. After the reasonable estimates, a cushion to avoid unforeseen circumstances is left to prevent the maximum possible risk. The diagram represents the point Rx which uses the highest level of current assets for achieving the same level of sales.
- Companies with relaxed working capital policies assume the advantage of almost no risk or low risk. This policy guarantees the entrepreneur of the smooth functioning of the operating cycle. We know that earnings are more important than higher earnings. On the other hand, there is a disadvantage of lower return on investment because higher investment in the current assets attracts higher interest costs, reducing profitability.
- Profit $\downarrow$ = Incomes – Costs $\uparrow$ (including interest costs)
- Return on investments $\downarrow$ (assets or current assets or equity or …) = Profit $\downarrow$ \ investments $\uparrow$

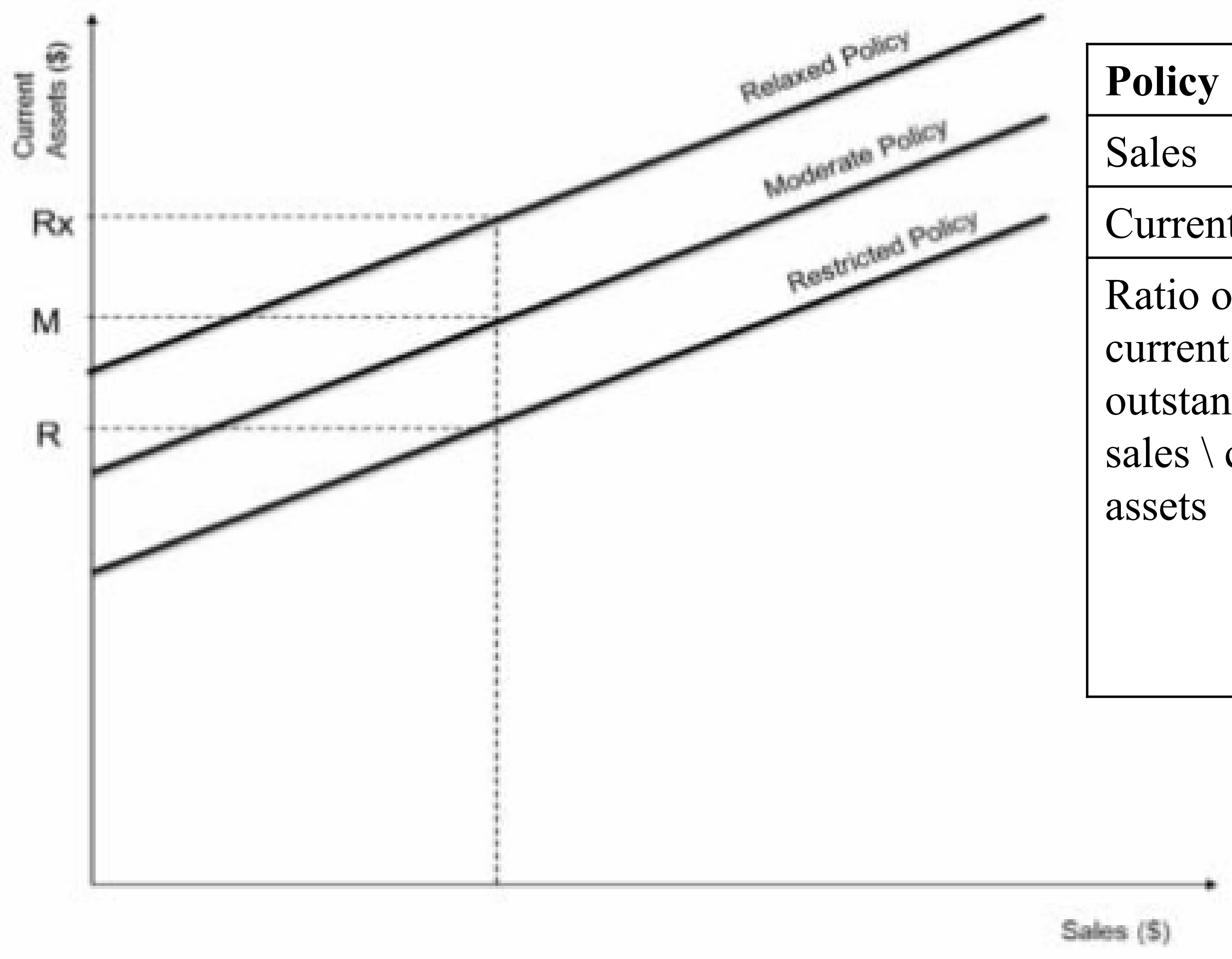
# Restricted working capital investment policies:

- Restricted Policy – the estimation of current assets for achieving targeted revenue is done very aggressively without considering any contingencies and provisions for any unforeseen event. After deciding, these policies are forcefully implemented in the organization without tolerating any deviations. In the diagram, point R represents the restricted policy that attains the same revenues level with the lowest current assets.
- Adopting this policy would benefit the lower working capital requirement due to the lower level of current assets. This saves the interest cost to the company, which produces higher profitability, i.e., higher return on investment (ROI). On the other hand, there is a disadvantage in the form of high risk due to a very aggressive policy.
- Profit ↑ = Incomes – Costs ↓ (including interest costs)
- Return on investments ↑ (assets or current assets or equity or …) = Profit ↑ \ investments ↓

# Moderate working capital investment policies:

- Moderate Policy
- The moderate policy balances the two policies, i.e., restricted and relaxed. It assumes the characteristics of both policies. To strike a balance, moderate policy assumes the risk to be lower than restricted and higher than conservative. In the profitability front also, it lies between the two.

# Working capital investment policies:




| Policy | Relaxed | Moderate | Restricted |
|---|---|---|---|
| Sales | 1000 | 1000 | 1000 |
| Current assets | 500 | 400 | 300 |
| Ratio of current assets outstanding = sales \ current assets | 1000\500 = 2 times per year current assets transfer into the revenue (sales) | 2.5 times per year current assets transfer into the revenue (sales) | 3.33 times per year current assets transfer into the revenue (sales) |

# Working capital investment policy of Xiaomi:

# Sources of long-term financing:

- Depreciation funds
- (Financial) Leasing
- Long-term bank credit
- Issued bonds
- Equity (issued shares)

# Sources for short-term financing:

- Net working capital = Equity + Long-term debts – Fixed assets **or**

Net working capital = Current assets – Current liabilities

- Trade payable
- Other accounts payable
- Consignment
- Factoring
- Sort-term bank credit
- Other current liabilities

# Working capital financing policies:

Working capital financing policy - is about what type of capital and how many of it we attracted in order to finance company's assets.

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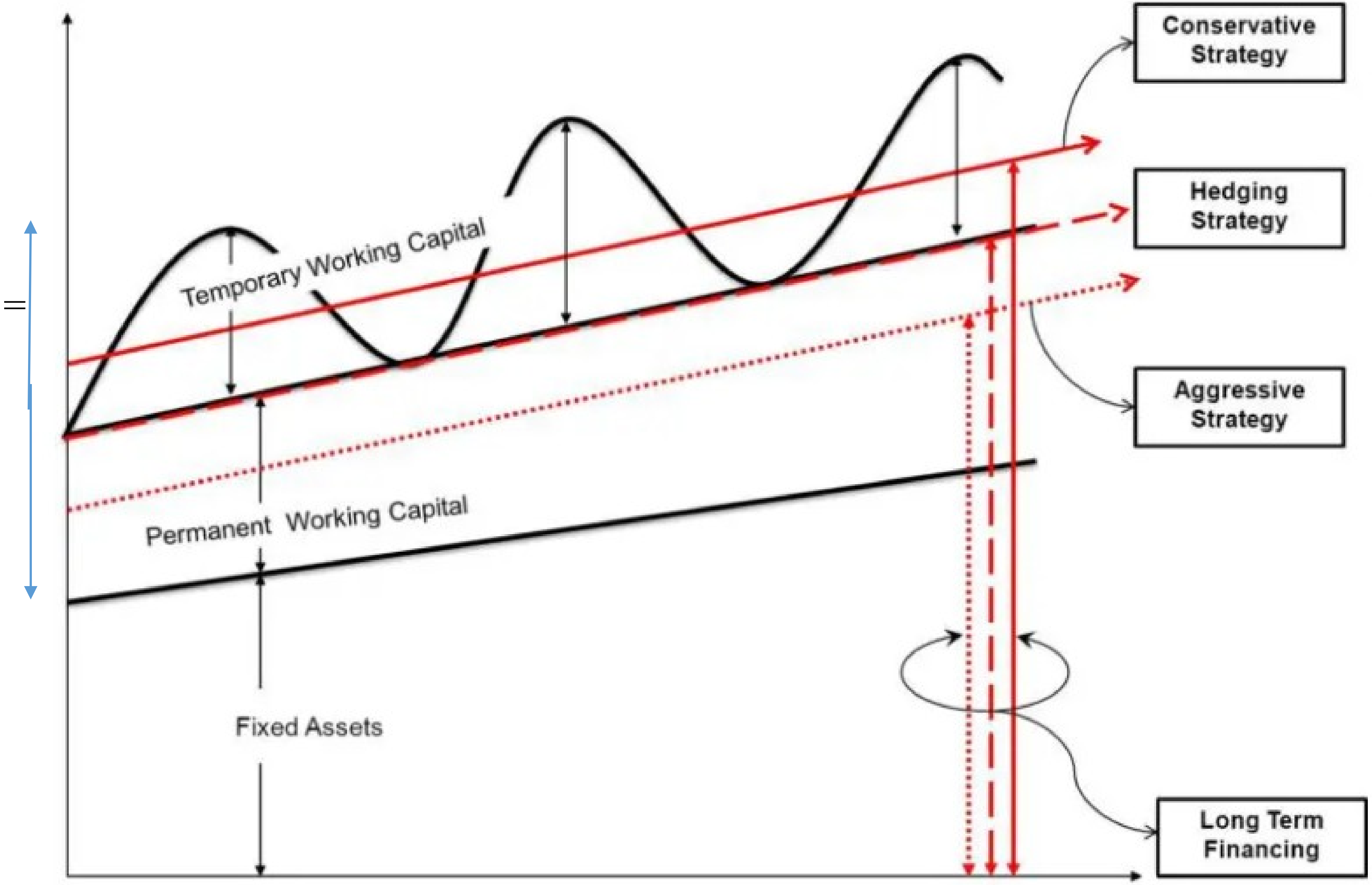


- **Conservative Strategy**:

Long Term Funds will Finance >>
Fixed Assets + Permanent Working capital + Part of Temporary Working capital

Short Term Funds will Finance >>
Remaining Part of Temporary Working capital

- **Hedging (Maturity Matching) Strategy:**

Long Term Funds will Finance >>
Fixed Assets + Permanent Working capital

Short Term Funds will Finance >>
Temporary Working capital

- **Aggressive Strategy:**

Long Term Funds will Finance >>
Fixed Assets + Part of Permanent Working capital

Short Term Funds will Finance >>
Remaining Part of Permanent Working capital + Temporary Working capital

# Conservative financing policies:

| | |
|---|---|
| Temporary Working capital<br>TWC = 200 | Short Term Funds (current liabilities: short-term bank credit, account payable) = 90 |
| Permanent Working capital<br>PWC = 400 | Long Term Funds = 1010 =<br>Equity 700 +<br>Long term debts 310 |
| Fixed Assets FA = 500 | |

Long Term Funds will Finance >> Fixed Assets FA + Permanent Working capital PWC + Part of Temporary Working capital TWC

Short Term Funds will Finance >> Remaining Part of Temporary Working capital

Net working capital = Current assets – current liabilities = 400+200 – 90 = 510 **or**

Net working capital = Equity + Long term debts - Fixed Assets = 700+310 – 500 = 510

# Moderate financing policies:

| | |
|---|---|
| Temporary Working capital TWC = 200 | Short Term Funds (current liabilities: short-term bank credit, account payable) = 200 |
| Permanent Working capital PWC = 400 | Long Term Funds = 900 = Equity 700 + Long term debts 200 |
| Fixed Assets FA = 500 | |

Long Term Funds will Finance >> Fixed Assets + Permanent Working capital

Short Term Funds will Finance >> Temporary Working capital

Net working capital = Current assets – current liabilities = 400+200 – 200 = 400 **or**
Net working capital = Equity + Long term debts - Fixed Assets = 700+ 200 – 500 = 400

# Aggressive financing policies:

| | |
|---|---|
| Temporary Working capital<br>TWC = 200 | Short Term Funds (current liabilities: short-term bank credit, account payable) = 500 |
| Permanent Working capital<br>PWC = 400 | |
| Fixed Assets FA = 500 | Long Term Funds = 600 =<br>Equity 400 +<br>Long term debts 200 |

Long Term Funds will Finance >> Fixed Assets + Part (small or even 0) of Permanent Working capital

Short Term Funds will Finance >> Remaining Part of Permanent Working capital + Temporary Working capital

Net working capital = Current assets – current liabilities = 400+200 – 500 = 100 **or**
Net working capital = Equity + Long term debts - Fixed Assets = 400 +200 – 500 = 100

# Working capital financing policies:

| Factors | Conservative | Aggressive | Hedging |
|---|---|---|---|
| **Liquidity** = Current assets \ Current liabilities | Liquidity is **high** because of the heavy usage of long-term funds. It can take advantage of sudden opportunities.<br><br>Current ratio = (400+200)\90 = 6.7 | Liquidity is **low** due to greater dependability on short-term funds, even for a part of long-term assets. It does not keep idle funds and therefore saves interest costs on them. Current ratio = 1.2 | Liquidity is **balanced,** i.e., neither high nor low. It attempts to strike a balance between liquidity and the cost of idle funds.<br><br>Current ratio = 3 |
| **Profitability** | Under normal circumstances, profitability is less in this strategy because of too much idle and costly funds. Higher rates and a bigger magnitude of interest costs reduce the profitability. | Higher profitability is obtained since the interest cost is minimized in this approach. | Because of cut to cut management, a balance is achieved between interest cost and loss of profitability. Moderate profitability is maintained here. It is greater than conservative and lesser than aggressive |
| **Risk** | There is a very low risk of bankruptcy as this approach maintains a higher level of liquidity in the business. | There is a high risk of bankruptcy due to maintaining an extremely tight liquidity position. | The risk is balanced here. The firm will bow down to bankruptcy only in an extremely bad situation |
| **Asset Utilization** | Too high level of current assets makes its utilization ratio low. | Similarly, too low a level of current assets makes the utilization ratio high. | Moderate |
| **Net Working Capital** = Current assets – Current liabilities | There is a requirement for more working capital to execute the conservatism. Higher working capital avoids all risks. NWC = 510 | Very low working capital is maintained. Low working capital increases risk but saves the interest cost. NWC = 100 | Moderate working capital is maintained to stay somewhere between conservative and aggressive strategies NWC = 400 |

# Working capital financing policy of Xiaomi