

NEGATIVE WORKING CAPITAL – SIGN OF MANAGERIAL EFFICIENCY OR POSSIBLE BANKRUPTCY (A CASE STUDY OF HINDUSTAN UNILIVER LIMITED)

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ABSTRACT

Out of the total BSE 200 companies, 23 have negative working capital — their current liabilities or payables are higher than current assets or receivables. This essentially means the companies do not have to deploy their own capital or borrow from banks to carry out their routine business activities. It is actually very good to have negative working capital because this entitles companies to earn relatively better returns on capital and equity. This also shows the operational efficiency of a company. But just this would not be enough. The companies should also have good fundamentals. Such companies are preferred by investors as they reward shareholders relatively better. The BSE 200 companies have an average returns on capital and shareholders' funds at about 20 per cent, which is far less than the 32-35 per cent returns generated by companies with negative working capital. More important, the top ten companies with negative working capital have a dividend payout ratio of 62 per cent, which is far greater than the average 26 per cent of the BSE 200 companies.

All the studies on working capital generally states that for the improvement in profitability we should manage our working capital effectively and most of the studies recommended to have good amount of working capital in the organization. All the researches on this topic conclude that the companies should avoid under-investment in working capital if they want higher profit margins. With negative working capital there can be a danger of insolvency but it is not true forever. If the company is having a good image in the market and good relation with their creditors it can get the benefit from the negative working capital also. Hence, the question arises that having negative working capital is good for an organization or not and if a company is earning profit continuously with having negative working capital, can we say that it is a sign of managerial efficiency or there might be the chances of possible bankruptcy of the company? Keeping these views in mind, this research article explains the conceptual background of the negative working capital and how it affects profitability of the corporate. Leading FMCG Company Hindustan Uniliver Limited is taken as a case, to analyze the negative working capital and its impact on the profitability and earning capacity of the firms. Finally, it is found that the company's profitability is more as compared to its peers and shareholders are getting more dividend and capital appreciation, which maximizes the shareholders' value in the long run.

Key Words: Working Capital, Profitability, Liquidity, Bankruptcy, Working Capital Cycle.

INTRODUCTION

Working capital is important for smooth operation of day to day activities of a corporate. As working capital is defined as current assets over current liabilities, at the time of determination of working capital, quality of current assets especially size of debtors and inventory are important factors. Significance of working capital also increases, as it is directly associated to the liquidity position of the corporate. However, in some cases, current assets are lower as compared to current liabilities (known as negative working capital) then how can a firm manage the level of liquidity. Negative working capital arises in cash base

business, efficient utilization of resources and sound inventory management etc., which leads to minimum stock of inventory etc., and the overall impact is lower level of current assets. On the other hand, due to better contract and negotiations to the creditors and suppliers, they are extending more liberal credit, which enhances the level of current liabilities. Study of negative working capital is important to understand the efficiency of the corporate, which enhances the earning capacity. Concurrently, liquidity is also significant from short term solvency point of view, which does not exist in case of negative working capital. Keeping these views in mind, this research article explains the

conceptual background of the negative working capital and how it affects profitability of the corporate. Leading FMCG Company, Hindustan Uniliver Limited (HUL), is taken as a case, to analyze the negative working capital and its impact on the profitability and earning capacity of the firms. Finally, it is found that companies in which negative working capital exist, profitability is more and shareholders are getting more dividend and capital appreciation, which maximizes the shareholders' value in the long run.

Negative working capital is a reverse situation as compared to normal working capital. It is a situation in which current assets are lower as compared to current liabilities. A negative working capital is an indication of managerial efficiency in a business with low inventory and account receivables. This happens because customer pays in advance and so quickly, the business enjoys cash transactions; products are delivered and sold to the customer before the company even pays their suppliers and creditors. Negative Working capital doesn't always mean bad financial condition; it indicates that most of the day to day activities are funded by customers rather than company's own working capital. Some latest examples are movie theaters - customers are paying first and distributors are normally paid later on; Schools/ educational institutions- fees paid in advance by the students annually, whereas faculties are getting salary after one month. When an organization uses supplier's credit and customers' advance to fulfill their day to day needs, it leads to a situation of lower or negative working capital. Banks, financial institutions, distributors, retailers with cash business or advance payment contract have negative working capital. Normally, when we analyze working capital, it always refers to normal or positive working capital (excess or current assets over current liabilities). However, there are certain situations in which working capital is in negative form (excess of current liabilities over current assets). In that situation, how can a company manage liquidity with the negative working capital?

In modern business, the concept of negative working capital is significant for the following reasons:

- It indicates operational efficiency of a corporate. That means without or lowers current assets the firm is managing day to day operations in an efficient manner. Eventually, it reduces cost of working capital and maximum earnings for the shareholders, which is the ultimate goal of the financial management.
- Concept of negative working capital is important to analyze liquidity position of corporate. When current assets are lower than current liabilities, what about the liquidity position of the corporate, how are they discharging current obligations in the short period. Traditionally, liquidity ratios are the measurement of liquidity of a firm with the ideal standard of 2:1. Negative working capital indicates lower cost of working capital (another way is higher profitability), but at the same time, it indicates poor liquidity (worried situation for the creditors, etc.) or we can say company is overburdened with current liabilities, which is not good for any situation especially in a period of recession, etc.
- Another important impact of negative working capital is cash recovery or realization situation. Negative working capital indicates quick realization of cash recourses (conversion of debtors in to cash) or one can say working capital cycle is shorter (for a days or maybe less than that). At the same time, payable policy of the company is to take longer time for payment against creditor. It indicates significant variations in the credit policy towards suppliers and customers. To analyze, explain and focus on all these situations, a study of negative working capital and its impact on liquidity, profit earning capacity and overall impact on shareholders' value creation is important in the contemporary scenario.

Creation of Negative Working Capital

There are many ways to create negative working capital. Most important method is to minimize the size of current assets with favorable contract and agreement to the suppliers and other parties (to delay payments) and the same time, try to minimize credit facilities or maximize cash based business (collection of cash before the disbursement of actual payments to the

various parties). When maximum customers are paying in advance, low or negative working capital is created. Another way to minimize the size of current assets is to adopt efficient collection method or brand oriented collection policy. Many companies are trying to minimize their cash resources with efficient utilization of funds. Some companies are effectively using ERP system involving trade partners in planning and monitoring working capital items to reduce the level of working capital. Efficient cash collection and inventory management system provides an opportunity to run business with the negative working capital, because most of the suppliers are granting 30 days credit in general. Companies who are able to operate and maintain with negative working capital, have advantages to receive funds without cost as a form of credit from their suppliers which will enhance ROI in a significant manner. However, non-availability of liquid resources is not a good situation at any time (especially in the stage of growth and boom).

OBJECTIVE OF STUDY

Much has been written and studied about working capital management and profitability of the firm in different industries but this research is on a specific company of FMCG sector named HUL. It will benefit the top managers and policy makers of various companies regarding decision on optimum level of working capital, ways of managing it and overall policies on working capital management. And also it gives clear understanding about the relation between working capital components and corporate profitability. Besides, the study helps as a guideline for those who conduct their study on similar topic and it gives brief information for the shareholders, prospective customers and creditors of a firm regarding profitability in relation to efficient working capital management and policy. Finally, the study benefits the researcher to obtain new knowledge about the problem under study and gives clear picture about the discipline called research.

RESEARCH METHODOLOGY

In order to achieve the main research objectives quantitative methods have been adopted. The purpose of using such

approach is to gather data that help the researcher to investigate cause-effect relationships. In this particular case, the effect is the company's profitability and the research is targeted at identifying significant causes, i.e. determinants on profitability related to working capital. A brief explanation about the data collection and analysis method adopted is given below.

To gather data on working capital component and profitability, it is apparent to use survey of structured documentary review. Accordingly, to achieve its objective companies audited financial statement especially balance sheet and income statement was reviewed. Annual reports were thoroughly seen for all the details and schedules detailing the various important components such as assets, liabilities, sales, profit etc. Once data were found acceptable, data entry and process was made using Microsoft EXCEL. Analysis of data was undertaken with the help of ratio calculations and plotting of graphs.

Negative Working Capital: Indian FMCG Companies

In India, negative working capital is equally popular at par with the global companies such as; McDonald's and Amazon.com. In India, HUL and Nestlé are the Fast Moving Consumer Goods (FMCG) companies, having negative working capital for more than the last ten years. Now the question arises as to how they are managing day to day operations smoothly without sufficient liquidity. HUL is one of the leading FMCG companies having sound marketing network, distribution channels and strong brands which will aid financial benefits over competitors. As other FMCG companies such as, Britannia, ITC, Colgate, and Dabur, etc. belong to similar business segment mostly have positive working capital (except few years). Conventionally, the FMCG Companies are famous for negative working capital due to efficient supply chain management. This industry has lower level of debtors, which are usually financed by creditors or suppliers; this situation offers them some gains related to negative working capital. Another situational gains for FMCG industry is their turnover does not depend upon their production (like other Mfg. industry), it depends upon the

capability to sales in the competitive market, therefore maximum resources are utilized for marketing and promotion of product rather than manufacturing activities, etc. (because most of their products are manufactured by small companies under contract production agreement). Similarly development of SCM, ERP and JIT, etc. made effective management of inventory and resources, which will significantly minimize the size of current assets. In current assets nearly 50% part is in the form of inventory, but in FMCG companies due to efficient supply chain management and efficient inventory holding, level of inventory comes down to significant lower level as compared to other industry (such as manufacturing). Similarly due to the cash base of business, level of debtors are also lower which significantly decreases the level of current assets another important change in the nature of investors is, rational thinking about investment. Nowadays strategic investors are also focusing on working capital management of a company, because it is directly associated to earning capacity of the firm. A study of top Indian companies having higher return on capital employed shows many companies is having negative working capital.

Share Holders Value Creation

Shareholders value creation is the ultimate agenda for every corporate. There are two ways to create value for shareholders:

1. Higher dividend as compared to other corporate.
2. Higher value of shares in the open market (capital appreciation in the way of higher market capitalization).

Both these can be obtained by the company with higher profitability or reduced cost of capital, which will enhance overall efficiency in the day to day operations with the sound working capital management. HUL, Nestle and Godrej Consumers Products Ltd have ROCE in excess of 40%. The success of this high return is associated with the way these companies have managed their working capital management cycles.

Leveraging on Supply Chain

FMCG companies first sell their goods and later on pay their raw material suppliers. This is possible only when the companies are huge in size and account for the bulk of turnover for their suppliers. Strong brand loyalty of FMCG Sector helps them maintain a low inventory as well as generate speedy sales. In such a situation, they are always in a position to arm-twist the suppliers by taking more credit. Thus the products are sold to the customers and the cash generated even before the company pays its suppliers. The additional cash generated can be utilized for other purposes. Nestle collects its money from customers in just four days (average collection period), whereas it pays in 52 days to its raw material suppliers. HUL, which had a net negative working capital has been able to maintain its creditor days at 64 as compared to receivable days at 16. Godrej Consumer Products (GCPL) is another company with negative working capital maintains creditor days at 53, compared to average debtors of six days only.

The strong distribution and dominant position in the FMCG industry has made these companies to bargain with the debtors and creditors to expand the payment cycle in favor of the company. The FMCG companies have been able to keep their creditors almost equal to debtors and inventory, which have resulted in a lot of cash generation for these companies, which is again invested in the business. These companies also make investment in short-term papers and call money, which allows them to earn good returns. Traditionally, the FMCG companies are known for maintaining negative working capital which is leveraged on strong supply chain management. Since this industry accounts for very negligible amount of debtors, the whole trade is financed by creditors from the production side and vendors and dealers from the supply side.

Profile of Hindustan Uniliver Limited (HUL)

HUL is India's largest consumer goods company based in Mumbai, Maharashtra. It is owned by the British-Dutch company Unilever which controls

52% majority stake in HUL. Its products include foods, beverages, cleaning agents and personal care products. HUL was formed in 1933 as Lever Brothers India Limited and came into being in 1956 as Hindustan Lever Limited through a merger of Lever Brothers, Hindustan Vanaspati Mfg. Co. Ltd. and United Traders Ltd. It is headquartered in Mumbai, India and has employee strength of over 16,500 employees and contributes to indirect employment of over 65,000 people. The company was renamed in June 2007 as “Hindustan Unilever Limited”.

With over 35 brands spanning 20 distinct categories such as soaps, detergents, shampoos, skin care, toothpastes, deodorants, cosmetics, tea, coffee, packaged foods, ice cream, and water purifiers, the Company is a part of the everyday life of millions of consumers across India. Its portfolio includes leading household brands such as Lux, Lifebuoy,

Surf Excel, Rin, Wheel, Fair & Lovely, Pond's, Vaseline, Lakmé, Dove, Clinic Plus, Sun silk, Pepsodent, Closeup, Axe, Brooke Bond, Bru, Knorr, Kissan, Kwality Wall's and Pureit.

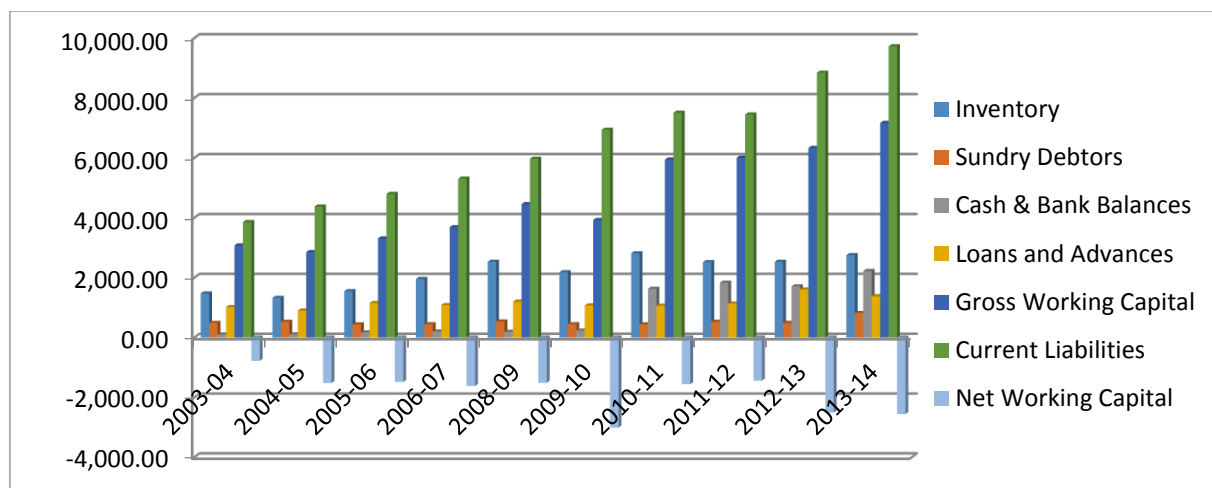
Negative Working Capital – Sign of Bankruptcy or Managerial Efficiency

The table below shows the component-wise analysis of the working capital of HUL from 2003-04 to 2013-14. The table shows that, the net working capital is negative throughout the study period. In any normal situation, a negative net working capital is a sign of company's probable bankruptcy or serious financial trouble. But the Return on Capital Employed (ROCE) shows good figures for all the years claiming that company has earned excellent returns even with negative working capital. This is possible only because of managerial efficiency of the organization.

Components of Working Capital of HUL (Rs. In Crores)							
Year	Inventory	Sundry Debtors	Cash & Bank Balances	Loans and Advances	Gross Working Capital (Current Assets)	Current Liabilities	Net Working Capital
2003-04	1,470.44	489.27	102.98	1,013.04	3,075.73	3,854.10	-778.37
2004-05	1,321.77	522.83	103.77	902.04	2,850.41	4,371.36	-1,520.95
2005-06	1,547.71	440.37	170.8	1,150.06	3,308.94	4,792.23	-1,483.29
2006-07	1,953.60	443.37	200.11	1,083.28	3,680.36	5,302.31	-1,621.95
2008-09	2,528.86	536.89	190.59	1,196.95	4,453.29	5,968.06	-1,514.77
2009-10	2,179.93	443.37	231.37	1,068.31	3,922.98	6,935.52	-3,012.54
2010-11	2,810.77	440.37	1,628.47	1,061.68	5,941.29	7,503.14	-1,561.85
2011-12	2,516.65	522.83	1,830.04	1,131.46	6,000.98	7,445.34	-1,444.36
2012-13	2,526.99	489.27	1,707.89	1,604.91	6,329.06	8,838.45	-2,509.39
2013-14	2,747.53	816.43	2,220.97	1,377.51	7,162.44	9,721.35	-2,558.91

Source : www.moneycontrol.com

Working Capital Analysis of HUL (Rs. In Crores)



Year	Current Ratio	Inventory Turnover Ratio	Debtors Turnover Ratio	Number of Days In Working Capital	Return On Capital Employed (%)
2003-04	0.80	6.97	20.95	-6.56	45.08
2004-05	0.65	8.57	22.12	-40.83	67.66
2005-06	0.69	8.02	25.42	-36.37	65.89
2006-07	0.69	7.2	31.41	-42.05	138.72
2008-09	0.75	9.26	41.83	1.58	118.59
2009-10	0.57	8.99	29.24	-22.62	106.78
2010-11	0.79	7.02	24.34	-24.09	102.66
2011-12	0.81	8.79	27.27	-25.37	95.4
2012-13	0.72	10.21	34.13	-38.69	163.59
2013-14	0.74	10.2	33.96	-36.35	147.56

Source : www.moneycontrol.com

From the table above, we can see that the Current Ratio (CR) of HUL has moved in between 0.57 to 0.81, during the period of study. This is much below the ideal current ratio of 2:1. This indicates that HUL has current liabilities much more than its current assets which led to an earning of high rate of return. The company has been able to generate cash so quickly, and customers paying upfront that the business have no problem raising the cash. Hence profitability could not be linked to the net working capital. Instead, a negative working capital proves to be a sign of managerial efficiency in their business with low inventory and accounts receivable (which means they operate on an almost strictly cash basis). The company tries to attack the growth in Working Capital sensibly, not by focusing on absolute value which in some previous years was impacted by double-digit inflation, but by targeting days covers for

inventories, accounts receivable and accounts payable.

HUL is a good example which proves that negative Working capital doesn't always mean bad financial condition; it indicates that most of the day to day activities are funded by customers rather than company's own working capital.

FINDINGS

After the analysis of trend of negative working capital and various components of profitability it is clear that:

- FMCG companies are having trend to use negative working capital to minimize the cost of borrowing for working capital.
- Whenever they are having trends of negative working capital, profitability is

always higher (because of lower cost of interest and borrowings).

- HUL is one of the leading FMCG companies in India, regularly using negative working capital for their day to day operations.
- An important observation is, rather than negative impact of poor working capital (negative working capital) FMCG companies are having greater advantages because of brand image and lower operating cost for their product (because of strong influence of brands).
- In FMCG companies early cash realization and minimum chances for bad debts (due to lower level of debtors) are the key areas responsible for higher profitability.
- Brand image of the products (intangible assets) enhances marketing efficiency and profitability (higher demand for the product).
- Another important area of advantages is; in FMCG Company's contribution of intangible assets are more than 90% of the market capitalization that will provide them unique opportunity to enhance market share of the product.
- Intangible assets such as brand, internal operation methodologies, strong supply chain network and strong customer base etc. are the key areas responsible for lower requirement of working capital

RECOMMENDATIONS

Negative working capital creates many financial gains but at the same time it has some adverse impacts

- Lower or poor working capital (or negative working capital) creates artificial pressure on a company to increase borrowings for day to day operations. Due to delayed payments to the creditors, in some cases ranking of such companies are treated as poor, which will affect cost of borrowings or capital (in the way of higher rate of interest).
- In case of expansion and modification of business, negative working capital creates financial barriers (lower liquidity). It will create artificial hurdle for the growth of the organization.

- Due to poor liquidity, investors behave with caution; it will create financial unrest among the general investors. They are worried about their investment as well as future returns.
- At the time of business valuation, negative working capital creates hurdle for better valuation because of chances of bankruptcy risk in a short time.
- Negative working capital position only works when the company is growing revenues (such as General Motors that used it for several years until revenues began declining). When the company's revenues are declining the positive effect of a negative working capital position reverses and it immediately starts needing annual working capital investment during a time when the company can least afford .

The companies working on negative working capital should keep an eye on the above impacts of negative working capital. If the companies can overcome the over shortcomings they can employ the advantages of negative working capital.

CONCLUSION

Negative working capital indicates non-liquidity or less liquidity within the firm which is not favorable at each and every stages of business. Companies operating in industry like FMCG are able to manage negative working capital efficiently, creating shareholder value by way of higher EPS and higher market capitalization. At the same time, companies with higher working capital are having sufficient liquidity, are more successful because of liquidity and they can expand business and grow up to maximum possible extent. However, a company with higher working capital needs higher revenue to maintain their healthy operating ratio. A better credit management system will help these companies to generate higher ROCE in the long run (HUL is the live example). However, in each and every situation lower level of liquidity is not preferable; a proper tradeoff between liquidity and working capital requirement is needed in the long run.

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