Negative Working Capital – A Boon or Bane: An Empirical Analysis of FMCG Companies in India

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Abstract
Liquidity is the amount by which the current assets of an entity exceed the current liabilities of that entity. Every stakeholder has interest in the liquidity position of a company ascertained from the value of working capital. An efficient finance manager would ensure that too much capital is not circulating in the business in the form of working capital nor will he allow the working capital to fall below a particular level. Both the extreme situations will invite difficulties in the smooth and profitable functioning of the firm. Thus, an endeavour has been made in this article to analyze the working capital position maintained by the Fast Moving Consumer Goods (FMCG) companies in India. The analysis indicates that a few FMCG companies, within the sample, have negative working capital because of their strong brand loyalty which helps them to maintain a low inventory as well as generate speedy sales. This negative working capital, in turn, generates fund for growth of the company. Thus, keeping in mind both the factors of reduction in liquidity and generation of fund a company should adopt that policy by which it can comfortably balance risk with return without hampering the interests of any of the stakeholders.
Keywords: *Working Capital, Liquidity, FMCG, Free Cash Profile.*

1. Introduction

Liquidity, in finance or business, is the amount by which the current assets of an entity exceed the current liabilities of that entity. It can also be described as the ability of a corporation to meet its short-term obligations. Every stakeholder has interest in the liquidity position of a company. One can understand the liquidity position of a company by analysing the financial statements. The balance sheet of any company provides information on current assets and current liabilities and the difference between the two leads us to a term called *working capital*. Current assets are such assets which can be converted into cash within one accounting year (viz. stock, sundry debtors, temporary advances, investments, cash etc.). Current

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liabilities on the other hand are those liabilities which are to be liquidated within one year normally out of current assets or funds from operations (viz. trade creditors, bills payable, outstanding expenses, bank overdraft etc.). Conventionally, it is accepted that higher the positive working capital, better is the liquidity position. The rationale of this is that the company will always be at a position to pay off its short-term liabilities at any point of time. Investment in current assets may take three approaches. One of such approaches is *conservative approach* where a high level of investment is made to support a given volume of activity. Another is *aggressive approach* where for supporting the same volume of output a lower level of current assets is maintained. The last type is *moderate approach* where a firm decides to strike a balance between a very high level and a very low level of current assets.

The liquidity is a vital factor in business operations. An efficient finance manager would ensure that too much capital is not circulating in the business in the form of working capital nor will he allow the working capital to fall below a particular level. Both the extreme situations will invite difficulties in the smooth and profitable functioning of the firm. The demerits associated with shortage of working capital are reducing the rate of return, influencing the credit rating adversely, preventing attractive opportunities from materializing and influencing dividend policy adversely. In case the working capital is excessive it results in unjustified expansion, liberal dividend policy and total investment may be working inefficiently. Accordingly, it can be stated that to ensure optimum utilisation of working capital, it should be minimum in relation to output and the requirement of working capital by a firm should increase at a rate lower than that of increase in output.

Thus, an endeavour has been made in this article to analyze the working capital position maintained by the Fast Moving Consumer Goods (FMCG) companies in India. The remainder of the paper is organized as follows. *Section 2* narrates the objectives of the present study. *Section 3* deals with sample selection and research methodology. The findings of the case study are discussed in *Section 4*. Finally, summary and conclusion is given in *Section 5*.

2. Objectives

Each organisation will have its own set of norms for maintenance of working capital depending upon whether it is a manufacturing concern, a trading concern or a service provider and a plethora of external factors within which it operates. Though the ultimate aim of any company is to maximise profit but a company should always try to maintain a balance between profitability and liquidity. Sacrificing liquidity for earning higher profits can prove to be a risky and hazardous proposition for the overall financial health of a company in the long run.

Thus, an attempt has been made in this paper to form an idea on the working capital management of the sample companies. More specifically, the objectives of the study are—

(i) outlining the trend of working capital of the sample companies;
(ii) evaluate the management of working capital of the companies;

(iii) analyze the liquidity position of each company and determination of the effect on the overall fund of the company.

3. Sample Selection and Research Methodology

A variety of statistical tools has been adopted to examine the above-mentioned objectives. The tools have been applied on various information and data collected from secondary sources which are summarized and tabulated in order to achieve the stated objectives. The case analysis has been conducted taking into consideration a ten year period commencing from 1st April 2004 to 31st March 2014. The study encompasses around 8 leading Fast Moving Consumer Goods (FMCG) companies in India. FMCG are products that have a quick shelf turnover at relatively low cost that do not entail a significant amount of thought, time and financial investment to purchase. Thus, such companies are always associated with high sales and high inventory turnover. Maintenance of a particular level of inventory at any point of time would have an impact on the liquidity of such companies. Accordingly, this study concentrates on the working capital and liquidity aspect of such FMCG companies. In order to select the sample, net profit figures of all the FMCG Companies in India for the period ending 31st March 2005 have been collected and arranged in the order from highest to lowest. The eight FMCG companies in India which have the highest net profit for that period have been selected as sample for the current study. The reason behind considering 31st March 2005 as the guiding factor for sample selection is that as the study covers a period of 10 years (from 1st April 2004 to 31st March 2014) with the base year as 2004-2005 so the companies which had the highest profit in that year have been selected. The sample includes companies (in order of their net profits figure) viz. Indian Tobacco Company (ITC), Hindustan Unilever Limited (HUL), Dabur India, Colgate Palmolive (India), Procter & Gamble India (P & G), Godrej Consumer, Marico and Emami. This would enable a proper analysis to be made on the working capital management of the sample companies within the above-stated time period.

For the purpose of establishing *objective (i)* detailed data on working capital of the sample companies has been collected from the Centre for Monitoring Indian Economy (CMIE) Prowess database. Such data is being compared over the different years across the sample companies to ascertain the level of working capital maintained by such companies. Accordingly, their average, standard deviation and co-efficient of variation (%) is computed to identify the trend of working capital movement. For deducing *objective (ii)* the trend of working capital, as indicated by the findings of objective (i), has been analyzed so as to identify the way by which such sample companies manage their working capital. As such companies are characterized by high turnover ratio accordingly, they need to manage their working capital efficiently so that they do not end up in carrying high levels of stock or in not meeting the customers' desires. In order to present *objective (iii)* the fund generating capacity of the sample companies have been determined to ascertain the impact of different levels of working capital on the generation of fund and accordingly, the growth of the sample companies.

4. Findings

The objectives and the research methodology ultimately lead us to the summarized information that is indispensable in order to deduce the ultimate conclusion.

For *objective (i)* the net working capital data are tabulated in *table-1* along with the calculation of standard deviation and co-efficient of variation (C. V.).

Table 1: Position of Net Working Capital of the Sample Companies (Amount in Rs. Crore)

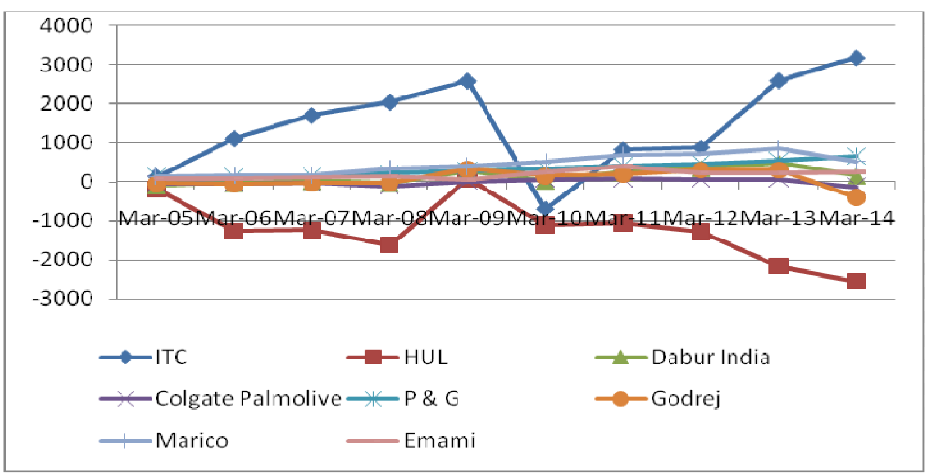
	ITC	HUL	Dabur India	Colgate Palmolive (India)	P & G	Godrej Consumer	Marico	Emami
Mar-05	129.38	-183.3	-81.82	-57.8	136.65	-45.41	141.08	78.27
Mar-06	1,102.50	-1,269.69	-38.44	-42.03	136.65	-48.87	155.96	77.12
Mar-07	1,695.22	-1,237.14	18.52	-40.56	163.7	-35.95	165.8	93.14
Mar-08	2,041.90	-1,621.20	-33.76	-104.68	210.68	-21.55	333.21	129.94
Mar-09	2,588.91	71.99	276.5	4.05	283.23	329.62	402.11	46.94
Mar-10	-706.17	-1,116.63	29.94	56.56	337.81	151.59	499.54	244.89
Mar-11	819.34	-1,059.01	242.9	78.05	402.6	202.53	687.27	410.88
Mar-12	875.65	-1,288.20	359.5	64.48	469.75	308.96	718.48	241.95
Mar-13	2,596.83	-2,165.18	473.3	59.86	549.21	304.94	850.58	238.67
Mar-14	3,181.26	-2,558.91	157.8	-134.68	665.22	-394.83	518.51	266.62
Average	**1432.48**	**-1242.73**	**140.4**	**-11.68**	**335.55**	**75.10**	**447.25**	**182.84**
Std. Deviation	**1213.74**	**790.91**	**190.6**	**75.67**	**183.74**	**227.74**	**252.66**	**115.91**
C. V. (%)	**84.73**	**-63.64**	**135.71**	**-648.14**	**54.76**	**303.24**	**56.49**	**63.39**

As can be seen from the above table, HUL is the company which operated over the entire sample period with heavy amount of negative working capital and accordingly the mean of the series is also negative. It is followed by Colgate-Palmolive (India) which also had negative working capital in the first 4 years of the sample period and again at the last year i.e. as on 31st March 2014. The average of the data series shows a negative figure. On the other hand, companies like P & G, Marico and Emami have maintained a positive working capital during the years taken for consideration. Dabur India and Godrej have a positive mean of their net working capital data however there are certain years in which these companies had showcased negative figures of working capital. ITC had a positive working capital throughout excepting as on 31st March, 2010.

With an analysis of the standard deviation and coefficient of variation statistics of the different sample companies over the time-series it is apparent that there are substantial fluctuations in the working capital figure as indicted by these statistics. Standard deviation measures the amount of variation from the mean or average. While, coefficient of variation measures the amount of variability in relation to the mean from one data series to another, even if the means are drastically different from each other. The higher the coefficient of variation, the greater is the level of dispersion around the mean. While standard deviation quantifies variability, coefficient of variation is known as relative variability. A comparison of the mean of the data series across the sample companies reveals that ITC had the highest average net working capital in comparison to other companies. When the standard deviation statistics is taken for consideration it can be seen that the deviation is least in case of Colgate-Palmolive (India) while it is the highest in case of ITC. However, when the calculated C.V. is observed from the above table it is evident that Godrej Consumer had the highest dispersion around the mean while it had the lowest positive mean of net working capital. Colgate-Palmolive and HUL have a negative C.V. in respect to its data series. ITC which had the highest standard deviation had showcased a considerably less C.V. When the results of companies like Marico, Emami and P & G are examined it can be observed that all the three have comparatively less C.V., the standard deviation is also within a range and the mean working capital is also significantly positive.

From the above discussion, it can be inferred that HUL and Colgate-Palmolive (India) operate strictly under cash basis where final products are sold upfront on cash but the suppliers extend liberal terms in respect of their payments. Accordingly, the current liabilities tend to be higher than the current assets. As majority of the sales are in cash the amount involved in sundry debtors is negligible. Moreover, the inventory turnover being higher, in other words, sales being extensive, the value of stock is also much lower. Such a scenario indicates that the cash that is generated out of the process of sale is utilized for other long-term purposes. Accordingly, the result is working capital being negative. In respect to Godrej Consumer and Dabur India, there is no stability in the working capital over the different years as indicated by their high C. V. percentage. P & G, Marico and Emami have shown a comparatively stable position in this respect. ITC has a high standard deviation which shows that it does not have a consistent policy of maintaining its working capital.
The working capital figures when plotted on a line chart shows the following result—

Figure-1 Line Chart showing Working Capital Position of Sample Companies



As can be seen from the above diagram, that HUL and ITC have shown the maximum fluctuation in comparison to the other companies. This is as per the results indicated by standard deviation which shows that these two companies have the highest deviation. This, however only measure the quantitative aspect of the variation in working capital. When the C.V. percentage is taken into consideration these two companies do not show the maximum deviation. Thus, the working capital position is analyzed taking both standard deviation and C.V. (%) into consideration.

From the results of objective (i) the trend of working capital as maintained by the sample companies have been examined and interpreted for the purpose of *objective (ii)*. When the tendency of the working capital movement of ITC and HUL, being the two top FMCG companies in India, is examined it may be noted that in both the cases there are substantial fluctuations in the working capital figures. In case of ITC the working capital figure rose to Rs. 1102.50 crore in March 2006 from Rs. 129.38 crore in March 2005 as the short-term fixed deposits and inventory level were increased in March 2006. While in March 2010 the figure became negative as the provision kept aside for tax and dividend had increased by more than double than that in March 2009. In the last two sample years working capital position improved as cash and bank balance were retained for short-term purposes instead of being utilized for long-term usage. Thus, it can be inferred that the company operated mainly on cash basis as indicated by the balance of sundry debtors. But the cash generated from the sale of goods have been also used for purposes other than short-term obligations as reflected by the balance of cash in the different years. However, the company obtained goods from its suppliers on liberal credit terms. Thus, oscillations can be observed in the course of working capital due to increased current liability and maintenance of low cash and debtors balance.

In case of HUL, the company has insistently operated with negative working capital with heavy amounts outstanding to creditors. It being an FMCG company enjoys quick turnover of stock and conversion of stock into cash. Furthermore, the vendors are paid taking a little longer than the average time. The basic intention of this company is that it will reduce the holding cost of inventory and accounts receivable and at the same time carry over the creditors over a longer period. As such it can maintain negative working capital but still can manage to meet the short-term obligations thereby, increasing both return and risk.

Dabur India has maintained a more or less significant level of positive working capital over the different sample years excepting in the years ending March 2005, 2006 and 2008 due to increased provisions kept for tax and dividend and rise in the level of creditors. Colgate Palmolive (India) showed heavy fluctuations in its working capital trend as indicated by its coefficient of variation. The reason for it being gradual decline in the amount of sundry debtors during the initial sample years coupled with steady increase in creditors and provisions. Though the company managed to maintain positive working capital in the later part of the sample years but for the year ending March 2014 the figure of working capital was again negative owing to decrease in cash and bank balance and fixed deposits amount reducing to nil. Thus, it indicated the utilization of short-term cash for long-term purposes.

In respect to companies like P & G, Marico and Emami, the working capital amounts over the different sample years have been positive, with a comparatively better coefficient of variation indicating less fluctuation and a significantly less standard deviation as compared to other sample companies. In case of all the three companies, one point is common i.e. the cash recovered from the customers are being retained for short-term usage either in the form of cash and bank balance or fixed deposits or short-term loans and advances. The working capital of Godrej Consumer has also varied over the years as indicated by the high C. V. (%) with negative figures in some of the years. The main reason for the oscillation is deployment of cash for long-term purposes as a result of which the total value of current assets had decreased in respect to the total figure for current liability and provisions.

From objective (i) and objective (ii) it is evident that the various FMCG companies constituting the sample have reflected variations over the different years in respect to its working capital and except the companies like P & G, Emami and Marico the other sample companies had negative working capital figure. Theoretically, negative working capital implies that the company is inefficient in maintaining its short-term financial health which if continued over a long-term can lead to bankruptcy. However, when the sample FMCG companies' data are being analyzed it was perceivable that the companies operated on a strictly cash basis, enjoyed liberal credit terms from the creditors, had high stock turnover, very low debtors level and in many cases the cash realized from the customers and debtors were used for other than short-term purposes. Thus, in order to study whether a negative working capital is in itself deteriorating for the company a different viewpoint and technique has been adopted.

Dr. Charles W. Mulford, Director, Georgia Tech Financial Analysis Lab and Matthew Madsen, Research Assistant in their research journal '*The Free Cash Profile: Insight into the Cash Flow Implications of Growth- An analysis using 2013 data*', identified the term *free cash profile* as the measure of the ability of the company to generate free cash flow as revenues grow. According to them, a company with negative operating working capital can effectively borrow from its vendors or customers as they grow, since it is being financed with customer funds. Having negative operating working capital is rather a prerequisite to having an exceptional free cash profile, the reason being the company delays payments to its creditors and obtains cash quickly from its customers. The Free Cash Profile is reported as a percentage of revenue. A firm with a positive Profile will produce increasing amounts of cash flow as it grows. A firm with a negative Profile will generate less cash and may require other sources of cash to support growth. It comprises of a few components viz. core cash profile, operating cushion percentage and operating working capital percentage. *Core Cash Profile* measures the capacity of a firm to generate core operating cash flow as it grows. Operating cash flow is cash flow provided by operations, but excludes non-core sources of cash flow, financing costs and taxes. It is computed as the difference between operating cushion to revenue percentage and operating working capital to revenue percentage. *Operating cushion* is the percentage of operating profit to revenue from core operations. Operating working capital to revenue percentage is the percentage calculated of operating working capital to revenue from core operations.

Operating working capital is determined by taking the difference between inventory and accounts receivables on the one hand and accounts payable on the other. From the core cash profile, tax measured as a percentage of revenue and capital expenditure measured as percentage of revenue is deducted to obtain the value of free cash profile. It incorporates taxes and capital expenditure into consideration, as these two expenditures are typically expected to grow with revenue. The value of free cash profile that is obtained will be available for meeting the cost of financing—both interest and dividend. In simple terms, the calculation goes as follows—

Core Cash Profile= Operating Cushion percentage – Operating Working Capital Percentage

Free Cash Profile= Core Cash Profile – (tax as percentage of revenue + capital expenditure as percentage of revenue)

Accordingly, the free cash profile has been computed (as shown in *table*-2) for all the sample companies over the different years to ascertain whether negative working capital, in turn, leads to enhancement of cash flow as the revenue of the company grows.

Table 2: Free Cash Profile (as % of revenue) of the Sample Companies

	ITC	HUL	Dabur India	Colgate Palmolive (India)	P & G	Godrej Consumer	Marico	Emami
Mar-05	2.86	18.11	69.76	14.89	14.03	25.27	0.79	-34.01
Mar-06	10.71	20.84	73.92	26.63	19.78	22.11	-12.72	-10.63
Mar-07	4.10	20.17	95.32	31.61	-8.99	15.98	-3.89	3.18
Mar-08	0.30	22.03	51.15	30.80	32.52	20.26	-0.37	6.78
Mar-09	4.08	17.18	14.12	33.04	5.83	22.33	0.34	-52.23
Mar-10	-0.58	19.76	49.39	36.06	33.07	10.93	-7.71	12.42
Mar-11	16.39	19.16	-115.6	28.70	13.05	-24.56	-15.53	8.67
Mar-12	9.81	19.74	-47.89	25.25	21.68	-10.20	-6.44	10.18
Mar-13	8.10	22.25	23.32	28.27	13.41	17.44	-26.72	9.08
Mar-14	9.49	22.00	24.28	22.60	10.64	20.57	8.89	12.12
Average	6.53	20.12	23.78	27.79	15.50	12.01	-6.34	-3.44
Median	6.10	19.97	36.84	28.49	13.72	18.85	-5.17	7.73

5. Summary and Conclusion

An analysis of the Free Cash Profile of the sample companies shows a different result in comparison to the working capital position. From *table-1* it is apparent that companies like HUL, Dabur India and Colgate Palmolive (India) had showed fluctuating working capital figures and in many cases the net working capital figure was negative which was associated with high standard deviation and a greater level of dispersion around the mean as shown by the coefficient of variation percentage. This indicated that the companies, preferred to operate with negative working capital which reduced their cost of holding inventory and accounts receivable and at the same time could retain the creditors for a longer duration. When Free Cash Profile is computed, which denotes the level of cash generated during the operation of the company those companies with negative operating working capital scored well in this respect. All the three companies HUL, Dabur India and Colgate Palmolive (India) had high free cash profile with significant mean. Colgate Palmolive (India) has the highest average of free cash profile with 27.79% of revenue. In case of Dabur India, the operating working capital for the year ending March 2011 and March 2012 was significantly positive and accordingly the free cash profile is negative. On the other hand, companies like Marico and Emami which had consistently positive working capital over the different sample years reported negative and a widely varying cash profile over the years with a negative mean. ITC, though had a high average of working capital in comparison to other sample companies, but the free cash profile in the different years is quite low as the company had positive operating working capital.

This comparison between working capital and free cash profile underlines the fact that there are certain companies which generate cash as they grow rather than requiring cash for growth. They work with negative working capital by way of which they enhance the availability of funds in the business. The inventories are converted into cash while supplies are obtained on credit which needs to be paid after a significant time. This leverage helps in funding the growth with the help of customer's funds. This has been typically possible for an FMCG company where the stocks are generally sold for cash and there is a high turnover of stock, owing to the type of goods that are being dealt with. Thus, the company is able to create funds that are required for its growth rather than depend on other sources for funding its growth. A company with positive free cash profile generates cash flow as it grows. While a company with negative free cash profile requires cash to support its growth. Thus, a company can increase its return by reducing its current assets and utilize the funds for increasing revenue that become free for reduction in the carrying cost of inventory and accounts receivable. However, in order to take advantage of this positive free cash profile the companies need to have a proper planning by way of which they can efficiently and effectively utilize the time gap between receipts of cash by sale of goods on the one hand and payment to the creditors on the other.

In this respect it may be mentioned that liquidity plays a vital role in the survival of a business. The study clearly indicates that companies like HUL, Dabur India and Colgate Palmolive (India) had resorted to highly aggressive financing mechanism. This mechanism invariably has a positive impact on the profit position of the company but, in turn, increases the associated risk factor. Though by internally generating funds in the form of positive free cash profile a company can significantly improve growth but at the same time the liquidity is affected. Utilizing such highly aggressive fund management can prove to be detrimental in the long run. Thus, the companies with negative working capital should put some stress on the maintenance of liquidity and also safeguarding the interest of creditors. Keeping negative working capital and taking the advantage of leverage between payments to the creditors and receipts from the debtors is a profitable financing option but should not be the only means of financing the growth of a company. There should always be a balance in respect to liquidity and profitability. Importance of maintaining sufficient liquidity cannot be overemphasized. At the same time one fact cannot be ignored that typically large companies tend to have a consistent negative working capital since they have the brand image and can demand longer credit periods from their fragmented suppliers. They are also able to make sales in cash or collect payments within a few days. Such companies find themselves in a beneficial position with negative working capital as it results in positive free cash profile and increased growth.

Specifically, FMCG companies have negative working capital because their strong brand loyalty which helps them to maintain a low inventory as well as generate speedy sales. Since these large companies have a high bargaining power, they are also able to extract favourable terms from their suppliers. The products are sold to the customers and the cash is generated even before the company pays its suppliers. The additional cash generated are utilized for other purposes. Thus, keeping in mind both the factors of reduction in liquidity and availability of positive free cash profile the company should adopt that policy by which it can comfortably balance risk with return without hampering the interests of any of the stakeholders. In other words, if a company can effectively manage the risk-return aspect even with negative working capital then it can utilize such financing mechanism by way of which it can create fund for its growth by keeping its inventory and debtors at a lower level. Thus, though liquidity is essential for the survival of a business it can be compromised by keeping the risk factor into consideration and thereby creating positive free cash profile and enhancing growth.

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