Understanding the Strategic Use of Working Capital

By Gregory Milano

Many executives, especially those with a finance background, push for lower working capital balances. In other words, they seek lower accounts receivables by setting shorter payment terms and hounding customers who are late with their payments. Work-in-process and finished goods inventories are kept low by embracing just-in-time management processes, among other strategies. And accounts payable are stretched by instating longer payment terms to suppliers, in some cases as long as 120 or 180 days from the date of the invoice. These practices are beneficial, as they reduce the amount of capital tied up in the business, which improves the return on capital employed.

My firsthand experience with this came over 30 years ago when I worked in the business analysis group for an aircraft manufacturer. As a predominantly profit-and-loss-focused company, it was perhaps not surprising that other prime aircraft manufacturers carried far less net working capital per dollar of sales. We instigated a working capital improvement program whereby the company meaningfully reduced capital employed during a six-month initiative.

As would be expected, we improved collections, eliminated surplus stocks of aluminum and other materials and extended some accounts payable. Additionally, by breaking each aircraft down into a series of smaller deliverables, such as wings, tails and a cockpit, we were able to be paid more money more quickly.

Understanding Metrics

Many companies have had similar experiences to mine. These days, some companies put metrics like accounts receivable days on hand and inventory turnover in executive compensation programs to emphasize the importance of reducing working capital. Though many companies have bloated inventory and overextended customer payments, is reducing net working capital always a good idea?

In a recent issue of the *Journal of Applied Corporate Finance*, my coauthors and I published our capital market research showing that companies using economic profit (EP) outperformed their peers on annualized total shareholder return by an average of 4.7% per year while beating the S&P 500 by 7%. What's more, their EBITDA margins were 3% higher. Separate research published by Matthew Louis Bell in 2004 showed that companies adopting EVA, a form of EP, "outperformed the rest of the market by 25.66%" over the three years after adoption.

In addition, my colleague and I interviewed several EP company executives, and working capital management was frequently raised as an important driver of capital productivity. But interestingly, the best path was not always to drive lower net working capital. For example, to strengthen customer relationships during the pandemic, Kimball Electronics increased inventory to mitigate potential parts shortages. As CFO Jana Croom explained this decision, "Customers are more than welcome to use our balance sheet, provided they are willing to pay for it."

Working Capital

So, there *are* times when having more working capital is better. Indeed, in a business world littered with companies obsessed with their profit and loss statement, almost without regard for their balance sheet, having the ability to make trade-offs between profits and working capital can be an advantage. At times, it's worth giving up a bit of profit to significantly reduce capital employed. In other situations, it's better to employ a bit more capital to achieve higher profits.

To make this work in practice, managers should consider their relationships with customers and suppliers to find opportunities for working capital improvement. If a customer procurement specialist seems to be only concerned about price, maybe concede some price in exchange for very quick payment terms or even deposits in advance. I've noticed the construction industry frequently gets paid deposits before work begins. Or maybe a supplier is looking to push product in December to meet production quotas or earnings budgets. To buy in advance of your need adds to inventory, but if the supplier sufficiently lowers their price, it could be profitable enough to more than compensate for the cost of carrying the extra inventory.

Measuring Economic Profit

I think the ideal solution is not to hand out working capital reduction goals but to use a more comprehensive measure that captures profit and capital implications and encourages the proper trade-offs. This takes us back to the concept of EP mentioned above, which by definition, measures profit or cash flow less a charge for capital deployed. With EP, reducing net working capital reduces the capital charge and EP rises. But, at the same time, it's okay, for example, to invest in higher inventories as long as you receive enough incremental profits to exceed the incremental capital charge.

You must decide to use either an accrual or cash version of EP. I prefer cash-based EP measures as my own capital market research shows improvements relate better to movements in share prices. Calculate earnings before interest, taxes, depreciation and amortization (known as EBITDA), and subtract operating taxes. The result is *gross cash earnings,* and from this, we need to subtract one more cost: the cost of capital.

Since we ignore depreciation, capital employed must add back accumulated depreciation. To this, we add net working capital, excluding cash and short-term debt, and net long-term operating assets. We call this *gross operating assets*. The average balance is multiplied by a required return on capital, which I've found for most companies is 8% to 10% now, to determine the capital charge, which we subtract from gross cash earnings to get what we call *residual cash earnings*.

There are three ways to improve any measure of EP.

1. You can invest in new assets to grow the business as long as the incremental gross cash earnings more than cover the added capital charge.

2. You can operate better by improving pricing and cost efficiency, as well as capital productivity such as the working capital improvements discussed above.

3. Lastly, you can dispose of assets that show no ability to earn their required return.

Improved working capital management is just one benefit of using economic profit in goal-setting, planning, allocating resources, making decisions and measuring performance. Management seeking to create more value and increase their share price may want to consider adopting EP.

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