Permanent Working Capital Finance

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Contents

Page

Permanent Working Capital……………………………………………..….. 1

Current Economic Environment ……………………………………………. 1

Overtrading and Undercapitalization……………………………………….. 2

Differentiating Permanent & Cyclical Working Capital…………………..... 4

Assessing Finance Requirements …………………………………………… 4

Optimal Finance Structures..……………..………………………………….. 5

Financing Options………..…………..……………………………………… 5

Increasing Shareholder Value………………………………………………... 7

Summation ...………..……………………………………………………….. 8

Permanent Working Capital

Permanent working capital (also known as fixed working capital) is the minimum investment required in working capital irrespective of any fluctuation in business activity; a level of "Net Working Capital" ("NWC") below which the company has never or has rarely gone on any day during the financial year.[1] Permanent working capital is essentially the core level of investment needed to sustain normal levels of business or trading activity, such as investment in trade inventory and average level of trade receivables; with fluctuations corresponding to variations in the level of current assets and liabilities arising from normal business activities. Working capital in both its permutations can be viewed dynamically as an equilibrium between the resource-acquiring and income-generating activities of a enterprise (or company); in which case, it is closely linked to the operating cycle.[2]

The biggest challenge in working capital finance is in designing a structure that best meets a unique company's operating cycle and working capital (liquidity) needs. Many borrowers automatically think that all working capital finance should be structured in the form of a revolving line of credit; this is an appropriate structure when the working capital needs are truly short term in nature, and when borrowing is needed to fund temporary cash gaps. However, there are also a number of circumstances wherein working capital financing should be done on a longer-term; when working capital needs are indeed long term or "permanent". If a company exclusively relies on short term working capital finance, and it takes longer than a year to generate the increased revenues needed to cover the financed gap in the operating cycle, the company can find itself in a cash flow crisis when it comes time for annual repayment of their line of credit.

Lines of credit (LOC) provide a maximum amount of borrowing for a set period of time (typically twelve months), to support gaps in the cash conversion part of a company's operating cycle. Lenders typically require the outstanding principal balance to be repaid in full (or reduced to some stipulated minimum) at least annually. This form of finance is ideal for a company with cyclical needs that can be repaid from revenue; these lines of credit are best suited to meet short term working capital needs. It's advisable however for lower middle market companies to have sufficient working capital funding to cover at least three-to six months of operating expenses. Astute permanent working capital finance provides sufficient funding to accommodate both short-term working capital expenditures (e.g., operating and seasonal cash flow deficits) and long-term working capital expenditures (e.g., extraordinary nonrecurring expenditures).

Current Economic Environment

The current economic expansion is nearly a decade old, making it among the longest on record. While the US economy continues to stand on relatively firm ground, GDP growth has converged to its long-run trend of about two (2%) percent. This is in part reflective of manufacturing activity, which weakened further in August, with the purchasing managers' index dropping into "contraction" territory for the first time since 2016. This also aligns with data showing weaker investment growth and softer corporate profits, with the weakness seen in the manufacturing sector not yet spilling over into the rest of the economy. Trade policy uncertainty is a main reason for lower business sentiment, slowing growth, and increasing financial risks; however, while rising trade tensions have led to a reduction in business confidence, levels remain well above those seen during the last recession.

1 Net Working Capital (NWC) refers to Current Assets less Current Liabilities.

2 The operating cycle here refers to the entire life cycle of a business. From the acquisition of the raw material to the smooth production and delivery of the end products – working capital management strives to ensure smoothness, and it is one of the main objectives of the concept.

Notwithstanding, a handful of leading economic indicators have started flashing yellow, with the most publicized being the slope of the Treasury yield curve; in particular, short-term Treasury yields have risen above longer-term Treasury yields, a configuration known as an "inversion" of the yield curve. The most watched spread in the Treasury yield curve is the yield difference between the ten (10) Year and three (3) Month Treasuries; this gap has been negative for over two months, starting at the end of May. According to the Cleveland Fed, this measure inverted prior to each of the last seven downturns, with only two false alarms. Measures of manufacturing activity evidence the slowing, exacerbated by the deteriorating trade situation. The ISM composite manufacturing index has been decelerating, dropping from a value of 55.3 in March, to 51.2 in July, the lowest reading in nearly three years.

Markets are expecting a second rate cut by the Federal Reserve in September, and a third rate cut later this year.[3]. The Federal Reserve is gambling interest rate cuts can save the U.S. economy from a recession and drop in trade. Another obvious hope is that an interest rate cut will reduce the pain from the tariffs on Chinese goods. The European Central Bank (ECB) has chimed-in by also announcing a round of stimulus for the euro zone; stimulus that includes both a rate cut and quantitative easing.[4] It's the first time the ECB has changed the deposit rate since 2016

Meanwhile, as the increase in global credit flows continue to push down the cost of capital, it creates a perfect opportunity to enhance working capital liquidity as a reserve against the uncertainties of the upcoming slowdown. A "working capital liquidity reserve" is merely a layer of permanent working capital liquidity above regular working capital requirements; liquidity available for longer-term or unexpected situations. Historically low interest rates make the nominal cost of this type of assurance relatively negligible, and reserves of this nature will be beneficial during the next recession. Such provision will ensure that a company has sufficient liquidity to weather any slowdown or temporary disruptions. This type of provision also positions management to capitalize on the downturn, and quickly take advantage of opportunities to gain market share from less prepared and savvy rivals.

Overtrading and Undercapitalization:

Working capital plays the same role in the financial body of an enterprise, as the heart plays in the human body; sources of working capital are spontaneously generated (e.g., trade receivables, notes receivable, deferred income, trade deposits, trade payables, notes payable. short-term loans, the current portion of long-term debt, and normally retained profits, etc.) and circulated during the operating cycle in the normal course of production; evidenced mostly by changes in the company's current assets (transitioning from one form to another) throughout the operating cycle and ordinary course of business. Working capital essentially circulates within a business enterprise just like blood circulates within the human body, and when this circulation stops, the business becomes lifeless and potentially fails; while there are several presaging symptoms, the foremost is "overtrading".

Overtrading, also called "undercapitalization", occurs when a company is trying to support too large a volume of trade from too small a working capital base. Undercapitalization exists when there are

3 The Fed cut its benchmark rate by a quarter-percentage point in July, citing weak global growth, trade tensions, and muted inflation. Notably, the Fed cut the U.S. prime interest rate by 0.4% to 2.25% on 31 July 2019; this was the first interest rate cut since the Great Financial Meltdown of 2008

4 Euro zone interest rates were slashed 10 basis points to -0.5%, the lowest level ever and the bank said it will begin purchasing 20 billion euros of bonds a month starting in November to inject money back into the economy.

insufficient funds available to trade at a level which will produce a satisfactory rate of return on the capital employed. It is the result of the supply of funds failing to meet the demand for funds within an enterprise, and emphasizes the need for adequate (or increased) working capital liquidity. Even if a company is operating profitably, overtrading can result in a liquidity crisis, with the company being unable to meet its debts as they come due; essentially because cash has been absorbed by growth in non-current assets, inventory and trade receivables.

Overtrading is usually the result of sales growth expanding too quickly, without having the financial resources in place to finance the higher level of trade debtor, creditor, and inventory activity. It is typically a situation where a company is doing too much on too little a capital, with the expansion outstripping the available working capital. Increased sales give rise to more debtors and the necessity to carry increased trade receivables and inventory to meet customer demand. Signals of overtrading include: significant increases in the volume of sales, but lower gross and operating profit margins, as well as deteriorating trade debtors, with significant increases in the trade receivables, inventory, and payables turnover ratios. Increasing reliance on short-term finance and persistent use of overdraft facilities are also classic symptoms of overtrading.

Overtrading is financially disastrous for a business and, if suitable sources of finance are not obtained, can lead to business failure. Overtrading can be caused by a rapid increase in turnover (perhaps as a result of a successful marketing campaign where funding was not put in place for the necessary investment in non-current assets and current assets). It can arise due to extenuating inventory and trade receivables turn-over ratios, or from increase use of trade credit (increasing trade payables days) to finance current asset growth. Distinct signs of overtrading are declining liquidity, decreasing amounts of cash, and repetitive over advances on a revolving line of credit, as well as increasing bank overdrafts.

Importantly, overtrading can occur even a business is profitable. It is an issue of working capital and cash flow and typically a problem of growth. However, ratio analysis can help to detect overtrading; the affected ratios are: the (i) current ratio, (ii) quick ratio, (iii) inventory turn, (iv) credit period allowed, (v) credit period taken, and (vi) return on capital employed ("ROCE"). Overtrading is most likely to occur if growth is achieved by making significant capital investment in production or operating capacity before revenues are generated, or if sales are made on credit, and customers take too long to settle amounts owed, or if there is a significant growth in inventories, or a long-term contract requires the company to incur substantial costs before payments are made under the contract. There are a couple of noteworthy strategies that are appropriate to deal with the advent of overtrading:

- Reducing business activity: a company can choose to level off or reduce the level of its planned business activity in order to consolidate its trading position and allow time for its capital base to build up through retained earnings. Indications that a company may be overtrading could include:

- Improving working capital management: overtrading can also be attacked by better control and management of working capital, for example by chasing overdue accounts. Since overtrading is more likely if an aggressive funding policy is being followed, adopting a matching policy or a more relaxed approach to funding could be appropriate.

[3 of 8]

For the best defense against overtrading, lower middle market companies need to have a definitive long-term (or permanent) investment in working capital, as well as the short-term or cyclical one. Cyclical working capital is best financed by short-term debt, since the seasonal build-up of assets to address

seasonal demand will be reduced and converted to cash to repay borrowed funds within a short predictable period. By matching the term of liabilities to the term of the underlying assets, short-term financing helps a firm manage inflation and other financial risks. Short-term financing is also preferable since it is usually easier to obtain and priced lower than long-term debt. Long term permanent working capital finance, in turn, will provide an ongoing positive net working capital position, allowing a company to operate with a comfortable working capital reserve, minimizing illiquidity risk.

Differentiating Permanent & Cyclical (or "Temporary") Working Capital

The prime reason for differentiating permanent working capital and temporary (or "cyclical") working capital is the decision relating to the financing mix, to finance the working capital gap. Once defining and quantifying the permanent aspect of working capital, a company can finance that part of the working capital mix with an appropriate long-term source of finance. Long-term sources are can on occasion be cheaper than short-term sources of finance. There are essentially two types of working capital, (i) Permanent (or "Fixed") Working Capital and (ii) Cyclical (or "Temporary") Working Capital; both are necessary to facilitate the sales and production process through the operating cycle

Temporary (or cyclical) working capital varies and fluctuates with the scale of operations; this is the variable working capital required over and above permanent (or fixed) working capital requirements. As seasons vary, temporary working capital requirement moves up and down, and thus can be appropriately financed by short term funds. Permanent working capital refers to the minimum amount of all current assets that is required at all times to ensure a minimum level of uninterrupted business operations (i.e., the minimum amount of trade receivables, finished goods, work-in-progress, and raw materials a business has to carry irrespective of the level of operations; working capital assets which have fundamentally permanent characteristics. This part of working capital is appropriately financed through long-term funds.

Assessing Finance Requirement

Determining the financing requirement in the case of fixed assets is simply the cost of the asset. Same is not true for current assets, because the value of current assets is constantly changing and it is difficult to accurately forecast at any point in time. The operating cycle offers the best insight, given that the it encompasses (i) the days required for an enterprise or company to purchase and receive inventory, (ii) the days required to sell the inventory, and (iii) the days required to collect cash from the sale of the inventory. A shorter cycle indicates indicates that a company will be able to recover its investment quickly, and possesses sufficient cash to timely meet obligations. A company with a long operating cycle will likely have a much greater financing requirement than a company with a short operating cycle.

While the length of an operating cycle varies based on industry, moderate operating cycles are typically in the 60-to-90-day range, with what are deemed “long operating cycles” in the 90-day range (an operating cycle greater than 90-days is unusual for most industries). A long operating cycle indicates a longer time required for the company to turn its inventory into cash; giving rise to the need for a working capital finance facility to bridge the gap. The “net operating cycle” (NOC), also known as the “cash conversion cycle”, is a good metric to use in assessing this finance need; the NOC is a measure of how long an investment is locked-up in production before turning into cash. The shorter the net operating cycle, the faster the company is able to free up its cash; if the net operating cycle is too long, then the capital remains locked in the operating cycle; again, requiring working capital finance to bridge the gap.[5]

Optimal Finance Structures

In order to establish an optimal working capital finance structure, management must first decide its attitude toward risk and reward; this will determine whether to use short term finance, long term finance, or a combination to fund working capital requirements. Aggressive and conservative levels of working capital sit at opposite ends of the spectrum; a conservative approach is a funding strategy which uses long-term funds to finance not only non-current assets and permanent current assets, but cyclical current assets as well. As there is less reliance on short-term funding, the risk of such a strategy is lower.

In contrast, an “aggressive strategy” is one with a lower level of investment in working capital, in which the company operates with lower levels of inventory, trade receivables, and cash, for a given level of sales. This strategy uses short-term finance to fund not only temporary (or “cyclical”) current assets, but permanent (or “fixed”) current assets as well; it is a strategy that increases profitability, but also carries the greatest risk to solvency.

Alternatively, a “moderate policy” treads the middle path between the two approaches, using a “matched funding (or “hedging”) strategy” to finance temporary current assets with short term funds, and permanent current assets with long-term funds. While there are no absolute benchmarks of what may be regarded as aggressive or conservative, these characterizations are useful in determining working capital optimal finance structures.

Financing Options:

Working capital financing comes in many forms, each of which has unique terms and offers certain advantages and disadvantages. To remain competitive, lower middle-market companies have been increasingly seeking financing solutions that offer greater flexibility in structure and price, as well as certainty and ease of execution. Accordingly, a rising tide of new finance vehicles is giving lower middle market companies more options to enhance liquidity, and maintain a competitive edge. Both working capital lines of credit and term loans are offered by traditional financial institutions, as well as direct and specialty lenders; each has their own qualification criteria, interest rates and terms. The following is a select range of facilities currently available in the marketplace:

Lines of Credit

5 Net operating cycle measures the number of days a company’s cash is tied up in inventories and receivables on average. It equals days inventories outstanding plus days sales outstanding minus days payable outstanding. It is also called cash conversion cycle.

A line of credit (LOC) is an open-ended loan with a borrowing limit that the business can draw against or repay at any time during the loan term. This arrangement allows a company flexibility to borrow funds when the need arises for the exact amount required. Interest is paid only on the amount borrowed, typically on a monthly basis. The standard LOC term is one (1) year, with renewal subject to lender annual review and approval. Lines of credit can be either cash flow based, unsecured (with no specific collateral pledged for repayment), or secured and collateralized by specific assets such as accounts receivable and inventory; types of lines of credit available in the marketplace include:

- **Cash Flow Based Revolvers**

  Cash flow-based lending is a type of debt finance based on a company's forecasted future cash flows, and is usually structured as a revolver for working capital purposes. This form of finance allows a company to borrow money based on those expected future cash flows; it is a form of finance best suited to companies that maintain high margins on their balance sheets or lack enough in hard assets to offer as collateral. In addition to an established history of positive free cash flow, a strong credit profile is important in this type of finance.

- **Unsecured Revolving Lines of Credit**

  A traditional unsecured (no-collateral) working capital line of credit is a great way to bridge the gap between the important tasks you need to accomplish and the cash you need to get them done. A traditional unsecured revolving line of credit is typically used as short-term working capital to manage expenses such payroll, purchasing inventory, or to offset seasonal lapses in cash flow. (In an unsecured credit facility, the lender has a general claim on the assets of the borrower in the event of nonpayment.)

- **Supported Revolving Lines of Credit**

  A supported or secured line of credit refers to using collateral to "secure" the loan; in this form of finance, the lender has a specific claim on the assets of the borrower that constitute collateral. As such, secured lines of credit are lower-risk for lenders, and thus the interest rates and fees are normally more affordable. Advantages of this form of finance include generally being able to secure a higher line of credit, with interest rates that are usually more affordable.

- **Asset-Based Lines of Credit**

  Asset Backed Loan can offer the borrower an attractive alternative to a cash flow based revolving credit facility (RCF). Firstly, ABL is usually cheaper than an Revolving Credit Facilities, since, for working capital purposes, the Asset Backed Lender takes a priority security interest in the borrower's most liquid assets (receivables and inventory). While cash flows are considered when providing these asset based facilities, they are secondary as a determining factor.

Lower middle market companies gain several benefits with this form of finance, most notably, borrowing capacity automatically grows as sales grow; this automatic matching of “credit-increases” to “sales-growth” provides a ready means to finance expanded sales, which is especially valuable to fast-growing firms. One disadvantage of accounts receivable finance is the higher costs associated with managing the collateral, for which lenders typically charge a higher interest rate (and/or attendant fees).

Term Loans

Permanent working capital term loans are generally used to finance and provide “permanent” working capital liquidity, and typically range from three- to seven-year in maturity (and amortization) terms, depending on the lender; these term loans require monthly payments of both principal and interest, with the principal balance paid in full by the end of the loan amortization and maturity term.

- **Cash-Flow Based Term Loans**

  Cash-flow based term loans are based on a company’s projections and forecasted free cash flows, The lending limit is based on the enterprise value of a company, including its ability to generate cash, rather than the value its assets would garner if liquidated. To secure repayment, lenders typically utilizes covenants to restrict the amount of financial risk a company / borrower can take on during the term of the loan. Covenants are generally “set” are based on information contained in the company’s historic financial statements, projections, free cash flow forecasts, as well as the condition of the guarantors

- **Secured Term Loans**

  A secured working capital term loan functions just like a traditional term loan, providing lump sum funding up front, and requiring regular payments over a set time to pay back the loan plus interest to the lender. Working capital term loans generally have a higher cost and a shorter term because it is typically collateralized by intangible assets, with valuations based and often reliant upon company profitability. Because working capital terms loan are typically collateralized by a mix of fairly intangible assets, lower middle market companies will need to show established and uninterrupted profitability for a minimum of three (3) years, with strong balance sheets, a good credit profile, and a history of repaying lenders to obtain this form of finance.

Increasing Shareholder Value

A key objective of efficient working capital finance is to maintain an optimal balance between permanent (or “fixed”) working capital and temporary (or “cyclical”) working capital; optimal finance that unlocks and frees up cash for activities that can further fuel growth, and ultimately increase shareholder value. Such working capital optimization is increasingly on the radar of astute lower middle market management groups, as they look for opportunities to enhance shareholder value. Financing working capital in a more efficient manner can potentially provide greater liquidity for opportunities and uses that can help build shareholder value.

Summation

Some argue that the Federal Reserve's inability to convince us that either the rate cut last July and the prospective rate cuts this September and later this year are merely 'insurance' to protect against a future downturn. As any number of indicators now show — from weak purchasing managers' indices in the US, Spain, Italy, France and Germany, to rising corporate bankruptcies and a spike in US lay-offs — the global downturn has already begun. If you look at the numbers, all the indicators of where we are right now in the markets, they most resemble the periods around 1929 and 1999. The exact timing and duration of a recession matters less than being ready to seize the moment early, when there are more options. Getting ahead of the curve avoids the painful alternative of being forced to react hastily in amid a crisis.

Preparing now positions and enables a company to gain market share and maintain growth by grasping opportunities to gain market-share from less prepared rivals. Winners pulled away from losers during the last recession, and widened the profit and market-cap gap during the subsequent expansion. Inaction is the riskiest response to the current uncertainties; preparing now enables a company to take advantage of the historically low cost of capital, locking-in long-term financing. Even if central bankers hold rates low during a downturn to help stimulate their economies, rates will eventually rise, and the ensuing change in the interest rate environment will be a new regime for most management teams; an advent that should prompt astute managers to take a multiyear view of the adequacy of their working capital reserve and liquidity requirements.

The principals of Hermes Capital Partners (HCP) have deep expertise in structuring, placement and funding of effective permanent working capital finance solutions, across the full spectrum of loan types and functionality. We work closely with the institutional lender / investors with whom we partner, and use a disciplined approach to due diligence and efficient and timely execution of each transaction. As a partner and advocate for our clients, we work to secure financing that meets the individual needs and circumstances of each client-company. The principals of HCP have more than thirty (30) years experience in lower middle market lending and finance, and we have stable and significant sources of committed capital, that allow us to offer flexible, reliable, and cost-efficient financing solutions.

While this is neither an offer to sell nor solicitation to procure the services described herein, if the reader is interested in further exploring the potentials, we would welcome the opportunity to provide a "dry run" feasibility term sheet for your review and consideration; there is no cost or obligation for this service. Please do not hesitate to us at baxter@hermescapital.partners or at www.hermescapital.partners.