CHAPTER 1

An Anatomy of Working Capital Management in Large Steel Companies in India
A firm’s capital comprises of fixed capital and working capital, the dominant contributors of the total capital of a developing country. Land and building, plant and equipment and many other such fixed assets are no doubt needed to provide a strong structural base. In many firms, current assets called working capital take up a remarkable part of total assets. It is a well known fact that due emphasis has ever been on the growth and efficiency of fixed capital, which is concerned with long term financial decision. The management of working capital has often been neglected, resulting in sub-optimal utilization of not only working capital but also fixed capital. Working capital is considered to be the life-giving force to an economic entity. It is all the more needed as a ‘motor force’ to make the fixed assets work and turn out what is desired by the company. The area of working capital has long been a step-child in the literature of corporate finance. Firms fail most often because they are unable to meet their working capital needs. Consequently, sound working capital management is a requisite for a firm’s survival. The overall success of a company depends upon its working capital position. Thus, the life-line of every concern, whether it is a manufacturing or trading or service enterprise, is working capital.

According to Cohen and Robins (1978), “working capital is the portion that is circulated from one form to another in the ordinary conduct of a business”. Working capital is an indicator of short-run solvency of a business. In today’s competitive business environment, sound working capital management is a pre-requisite for corporate success. Corine (1985) says that, “the inadequacy or mismanagement of working capital is one of the leading causes of business failure”.

A business organization cannot run effectively without sufficient quantity of working capital. According to Gitman (1982), “the goal of working capital management is to manage each firm’s current assets and liabilities in such a way that an acceptable level of net working capital is maintained”. In the words of Donaldson (1957), “the
manner of administration of current assets to a very large extent determines the success of operations of a firm. Constant management is required to maintain appropriate levels in the various working capital accounts”. A company with sufficient working capital is always in a position to take advantage of any favorable opportunity either to purchase raw materials or to execute a special order or to wait for better market position. Adequacy of working capital raises the creditworthiness of a corporation facilitating better credit terms, reduced cost of production on account of the receipt of cash discounts and favorable rates of interest on bank loans and the like. The ability to meet all reasonable demands for cash without inordinate delay is a great psychological factor to improve all-round efficiency of the business and to build self-confidence in persons at the helm of affairs of the company to carry out expansion programme and undertake research and innovations with much confidence.

Excessive working capital is the reflection of inefficient store-keeping, superfluous stock of raw materials and finished goods, delay in the flow of work-in-progress and lack of co-ordination in the enterprise. Inadequate working capital, On the other hand, thwarts the objectives of an enterprise and leads to failure. Therefore, the amount of working capital in every concern should be neither more nor less than what is required. Besides having an optimal level of working capital, a firm has to concentrate on efficient management of working capital as it facilitates maximization of profitability. Zenoff and Zwick (1969) observe that “Proper management of working capital is very important for the success of an enterprise. It aims at protecting the purchasing power of assets and maximizing the return on investment”.

1.2 Working Capital Management in Steel Companies

Steel form the backbone of any industrialized society. They are vital for India’s national security and economic well-being. Steel has no practical substitutes that can be used on a large scale as it is relatively cheaper compared to other alternative materials. Steel is crucial to the development of any modern economy. The level of per capita consumption of steel is treated as an important index of the level of socio-economic
development and living standards of the people in any country. It is a product of a large and technologically complex industry having strong forward and backward linkages in terms of material flows and income generation. All major industrial economies are characterized by the existence of a strong steel industry and the growth of many of these economies has been largely shaped by the strength of their steel industries in their initial stages of development. As per official estimates, the Iron and steel industry contributes around two percent of the Gross Domestic Products (GDP) and its weight in the Index of Industrial production (IIP) is 6.2 percent.

As a consuming market, India presents a high growth potential with low annual per capita finished steel. The domestic steel consumption grew by 9.8 to 29.82 MT during April-September 2010. According to the latest government figures available, during April-December 2010-11, total consumption of steel in India was 51.8 million tones. From the fledgling one million tonne capacity status at the time of independence, India has now risen to be the 5th largest crude steel producer in the world and the largest producer of sponge iron.

The share of India in global crude steel production has increased from 3% in 1998 to 4.1% in 2008. From a negligible global presence, the Indian steel industry is now globally acknowledged for its product quality. As it traversed its long history during the past 61 years, the Indian steel industry has responded to the challenges of the highs and lows of business cycles. With the opening up of the economy in 1992, the country experienced rapid growth in steel making capacity. Large integrated steel plants were set up in the Private Sector by Essar Steel Ltd, Ispat Industries, Jindal Group etc. Tata Steel also expanded its capacity.

The country has acquired a central position on the global steel map with its giant steel mills, acquisition of global scale capacities by players, continuous modernization and upgradation of old plants, improving energy efficiency, and backward integration into global raw material sources. Global steel giants from across the world have shown interest in the industry due to its phenomenal performance.
Steel Industry has been supplying various grades of steel for construction of projects of National importance which include Metros, Power Sector and Bridges, Nuclear complexes, Automobiles, Housing and several others. The global recession has affected the Indian steel industry especially stainless steel, but steel industry is trying to offset the negative effect of the recession by focusing on improving its profitability by identifying innovative use of steel to various sectors, cost cutting measures are adopted to reduce unwanted expenses and wastages, exploring new markets for sustenance. This calls for identification, analysis and quantification of interfering constraints in achieving full utilization of the capacities, and thus opens a vast field of proper management of various aspects of business. One such important activity which calls for major attention of the business executives’ is management of funds especially working capital.

Steel companies are capital intensive due to modernization, requiring huge funds. Increase in administrative expenses, growth in the need for supporting infrastructure facilities and desire to fulfill social responsibility are some of the key issues found very much instrumental in increasing the financial burden of steel companies. Professional excellence, therefore, is needed for effective management of finance in steel companies. Financial health of any steel company depends on the efficient asset-fixed as well as current-management system. A special focus on the management of working capital in steel companies hence becomes imperative. Funds are needed for steel companies to purchase raw materials and to meet establishment expenses as well as to settle short-term obligations as and when they mature.

Working capital, if not properly managed, results in liquidity crunch and a steel company cannot meet its current liabilities when they fall due for payment, leading to loss of financial credibility. Too much investment in current assets affects the profitability of steel companies and too little investment leads to short-term insolvency. Hence, there must be right size of working capital which balances liquidity and profitability.
1.3 Statement of the Problem

Fixed capital investment generates production capacity whereas working capital facilitates utilizing such capacity. Empirical research carried out in India on working capital management is concerned with manufacturing industries as whole while studies' specifically relating to particular industry is scanty. Studies on working capital management of steel companies in India are far and few. The size of working capital differs from company to company. Analysis of the size of working capital helps to know whether the existing level is adequate or inadequate for the requirements of a steel company. According to Kennedy and McMullen (1969), “working capital should be sufficient in amount to enable a company to conduct its business without financial stringency and to meet emergencies and losses without danger of financial disaster”. Since working capital is an important aspect of financial management, there is an unavoidable need to study working capital policies adopted by steel companies as it has an effect on profitability. This analysis will provide a base to judge whether the prevailing policy of management with regard to liquidity is satisfactory. A study on working capital performance is essential as it has a direct effect on liquidity. The liquidity level of an enterprise has an impact on the profitability of a concern. Several questions are therefore to be addressed. What is the size of working capital in Indian Steel Companies? Is the existing level of working capital sufficient for income generation and meeting operational expenses? What is the composition of working capital? In which component of current assets more investment is made? Do most of the steel firms follow aggressive working capital as a method of maintaining working capital? Do significant differences exist in working capital policies across steel firms? Do these steel firms maintain stability in their policies over a period of time? Is there any relationship that aggressive investment policy is followed aggressive financing policy in the firms?

Efficient management of various components of working capital is necessary to ensure smooth running of a firm. Sufficient amount of working capital is required for sustaining the desired level of operating income. Inadequate working capital impairs a firm’s liquidity, while profitability is hampered by excessive working capital. Yadav
(1986) establishes that ineffective management of working capital is one of the important factors that trigger industrial sickness. Accordingly, an attempt is made in this study to examine if steel companies are successfully managing their working capital. Do they utilize the investment in current assets effectively? Do firms differ in terms of liquidity? Do the Steel companies have shorter cash conversion cycle? How many times the inventories are turned over to generate cash inflow? Do the steel companies’ debtors turned over more time? Do they have longer payment period of trade creditors.

Working capital management assumes tremendous significance in corporate finance as it directly affects the liquidity and profitability of a company. Deloof (2003) is of the view that profitability can be improved by reducing the period of outstanding accounts receivables and downsizing investment in inventories. Shin and Soenen (1998) and Lazaridis and Tryfondis (2006) feel that reduced cash conversion cycle results in increased profitability. Raheman and Nasar (2007) have established a strong negative relationship between variables of working capital management and profitability. JohnSizer (1979) states that value addition – wealth created by an enterprise – are an alternative approach in recent years, to measure operational efficiency. Wealth creation depends on efficient use of fixed and current assets. Proper utilization of current assets reduces unnecessary blocking of funds in inventory, prevents delay in debt collection, increases inflow of funds and thus fosters value addition. Amir Jafar and Debasish Sur (2006) have found a significant positive relationship between efficient management of working capital and profitability. Against this backdrop, it would be interesting to know if there is any association between efficient management of working capital and profitability in steel companies? Does efficient working capital management increase/decrease profitability? Which component of working capital affects profitability more? The focus of this study is to seek answers to these questions.
1.4 Objectives

Following are the objectives of the study:

i. To analyze the size and composition of working capital.

ii. To examine the working capital policies of select steel companies in India

iii. To assess the working capital performance and

iv. To examine the inter relationship between working capital and profitability.

1.5 Methodology

Secondary data have been used for the study. Corporate database, ‘PROWESS’, maintained by the Center for Monitoring Indian Economy (CMIE) Pvt. Ltd, Mumbai, India and CAPITALINE PLUS of Capital Market Publishers India Pvt. Ltd, Mumbai, India, are the sources of data.

1.6 Period of Study

The study covers a ten-year span from 2001-02 to 2010-11.

1.7 Sample

Six hundred and twelve steel companies in India are listed in the Bombay Stock Exchange. Out of these, twenty six steel companies pertain to large steel companies category. Only the large steel companies are selected for the study. But the sample size had to be restricted to twenty three-(88 percent of the population) due to the non-availability of data for a ten-year period.

1.8 Framework of Analysis

Accounting ratios and statistical tools are used to analyze the data. Accounting ratios, percentage analysis and growth rate are used for measuring size and composition
of working capital. To examine the working capital policies, ratios, rank correlation and regression are used. Further ratios, Motaal’s “Ultimate Test of Comprehensive Liquidity” and Bhattacharya’s Efficiency Index model is used for assessing the effectiveness of working capital management. Relationship between efficient management of working capital and profitability is examined using correlation, regression and stepwise regression. Mean, coefficient of variation, coefficient of determination, t-test and ANOVA are also used at appropriate places.

1.9 Significance of the Study

Steel companies in India are witnessing an amazing growth on account of the demand from new avenues. Increase in demand for steel globally enables the country to build up foreign exchange reserves. Consequently, there is a dire need to effectively manage working capital to keep operating cost in firms at bay. Corporate managers can make use of the results of this study to reformulate their strategies to achieve cost reduction through better management of working capital. This helps Indian steel companies to fix competitive prices against companies in foreign countries.

Efficient management of working capital promotes value addition which in turn facilitates a better return to the shareholders. Foreign institutional investors would also evince interest to invest in Indian steel industry, if these companies do well on account of proper management of working capital.

Individual investors too stand to gain out of the results of the study. They can understand liquidity-profitability linkage and accordingly decide about investing in steel companies. Any decision to invest, based on profitability, could also be validated using the results of the study.

Bankers and financial institutions expect their borrowers to have a good financial discipline. Short-term solvency is a barometer of financial soundness of an organization. As such, lenders can bank upon the results of the study while sanctioning loans.
1.10 Limitations of the Study

Data used in the study are taken from databases, which compile the data based on the financial statements published by the companies. Hidden inconsistencies in financial data collected from such database, however, are not probed into. Some of the companies report data for a period lesser or greater than 12 months, but such data have been annualized which may not reveal a true picture of the financial position.

1.11 Chapter Scheme

The thesis is presented in eight chapters.

The first chapter spells out the nature of the problem, objectives, methodology, sampling, period of study, framework of analysis, significance of the study and limitations.

Studies conducted abroad and in India are reviewed in chapter two. Data and sources of data, sampling procedure, description of sample steel companies and tools used are presented in the third chapter.

Size and composition of working capital are examined in the fourth chapter. Working capital policies of steel companies are studied in the fifth chapter. Effectiveness of working capital management is examined in the sixth chapter. Interrelationship between working capital and profitability is tested in the seventh chapter. Association that may exist between select working capital ratios and profitability is found out in this chapter.

The last chapter summarizes the findings of the study. Suggestions to enhance efficiency of working capital management are included here. Areas for future research are also given.
References


Donaldson, E. F., (1957), Corporate Finance, New York: Ronald Press,


