Working capital appraisal

Banker's perspective

Presentation by
CA V.V.S. Rao
Retd. Vice President, ING Vysya Bank

I hear and I forget

I see and I remember

I do and I understand

Confucius
(551 BC – 479 BC)

The great Chinese Thinker & Philosopher

- Loan Appraisal
- What is Working Capital
- Working Capital – Operating cycle
- Sources for procuring Working Capital
- Regulatory framework of Working Capital Financing
- Management of Working Capital

Importance of working capital

Lack of working capital may lead a business to "technical insolvency" and ultimately to liquidation

Loan Appraisal

What is Working Capital

Working Capital – Operating cycle

Sources for procuring Working Capital

Regulatory framework of Working Capital Financing

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Loan Appraisal

Loan appraisal does not mean only analysing P & L and Balance sheet for sanction of loans by Banks

It is ….something beyond !!!

Then what is Loan Appraisal?

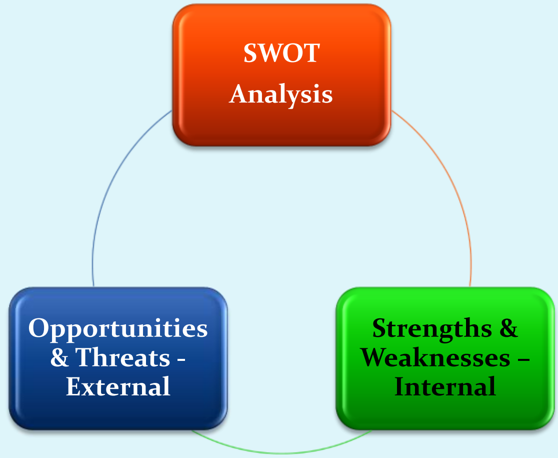
It is a structured analytical tool to take a credit decision

The basis for appraisal are to assess/ analyze the following and narrate them like a
STORY

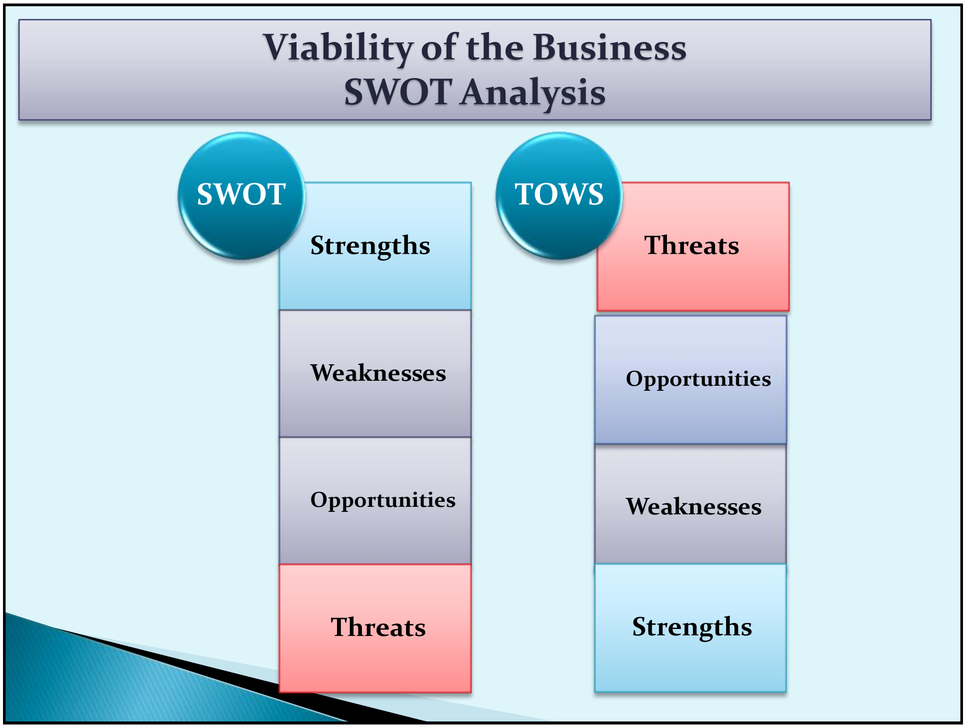
- The Promoters
- Viability of the business
  Macro & Micro Environment of the Business
- Business financials
- Various Risks & their mitigation

Promoter evaluation

Viability of the Business



Viability of the Business
SWOT Analysis

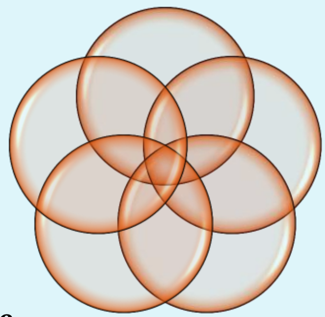

Viability of the Business
SWOT Analysis
SWOT
Strengths
Weaknesses
Opportunities
Threats
TOWS
Threats
Opportunities
Weaknesses
Strengths


Threats
Growing competitive pressures
Growing bargaining power of customers/ suppliers
Changing buyers needs/ tastes – Rising sale of substitute products
Adverse Govt Policies
Vulnerabi lity to recession/ business cycle

Opportunities

Industrial Scenario

Forward and Backward Integration



Faster market growth

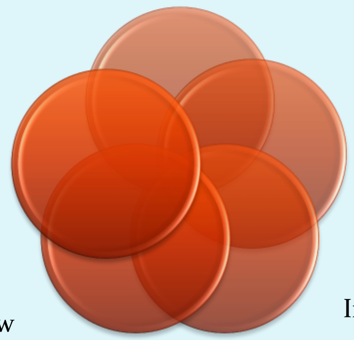
Expand product line

Enter new market/ customer segments

Weaknesses

- Lack of Management Depth/ Talent
- Deteriorating competitive position
- Newcomer with unproven track record
- Short on Financial Resources
- Technology Obsolescence

Strengths



- **Loan Appraisal**
- **What is Working Capital**
- **Working Capital – Operating cycle**
- **Sources for procuring Working Capital**
- **Regulatory framework of Working Capital Financing**
- **Management of Working Capital**

Definition of working Capital

- Working capital represent those funds which are required to manage day-to-day business operations

- These funds get locked in current assets such as
  - Cash
  - Debtors and
  - Inventories
  - Less short term liabilities like Payables etc

- Funds thus invested keep revolving from one to the other CA

- Working Capital is also known as revolving or circulating capital or short-term capital or Asset conversion cycle

Fundamental principle of considering various CA and CL

The Profit & Loss Account is based on "Accrual Concept"

To conceptualize the above:

Items to be taken into account:

a. Income earned during the year but not received
b. Expenditure incurred during the year but not paid

Items not to be taken into account:

a. Income which has been received but not earned
b. Expenditure paid but not pertaining to the current year

Various Current Assets

- Cash & Bank Balances
- Short term investments in Govt .securities etc
- Short term deposits with Banks
- Receivables & Installments of differed receivables
- Short term loans and advances
- Inventory
- Advances to suppliers
- Advance payment of taxes

Exclusions from Current Assets

- Investments in shares and advances to other firms & companies not connected with the business
- Unquoted investments and those in subsidiaries / associates
- Receivables outstanding for more than six months
- Non-moving or bad and doubtful receivables
- Deferred receivables maturing beyond one year
- Dead inventory i.e. slow moving or obsolete items

Various Current Liabilities

- Short-term borrowings from banks
- Bills purchased & discounted
- Advance payments / deposits from customers maturing within one year
- Sundry creditors
- Interest / expenses accrued but not due for payment
- Provisions for taxation and other expenses
- Dividends payable
- Installments of loans etc due within one year

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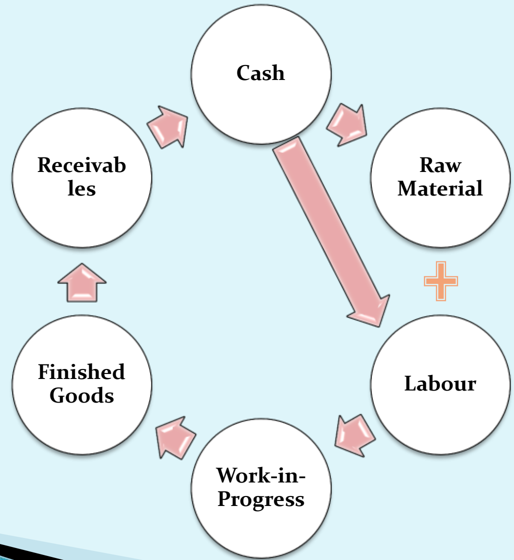
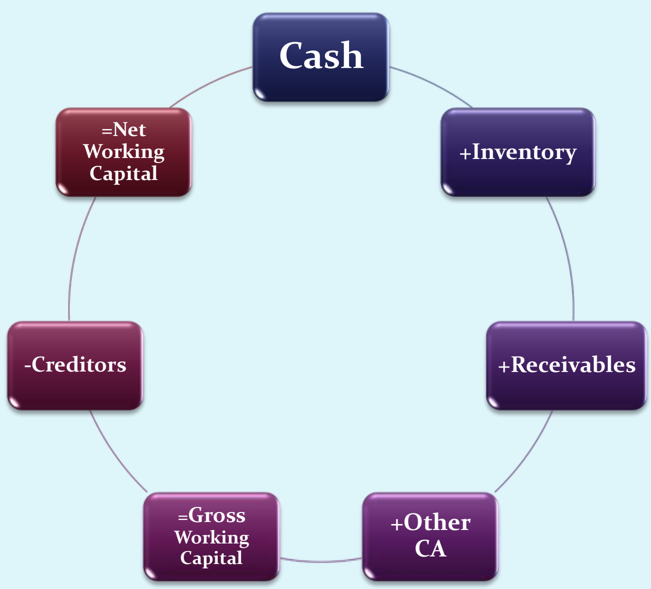
Working capital
Operating Cycle or Asset conversion cycle





Quantification of Working Capital requirement

	RM	WIP	FG	Dr s	Cr s	Total Months to be financed	Costs as % of sales say Rs. 5 cr	Cost in Rs	Max WC reqd Rs.
Avg holding (No of mts)	2	2	½	1 ½	1 ½				
RM	2	2	½	1 ½	1 ½	4 ½	50%	2.50	0.94*
Labour		2	½	1 ½		4	20%	1.00	0.33
Overheads		2	½	1 ½	1 ½	2 ½	10%	0.50	0.10
Profit							20%	1.00	
Total							100%	5.00	1.37

* 4 ½ / 12 x 2.50=0.94

Controllability of Stocks

- Lead time to procure RM
- Safety Level
- Variability of demand
- Production cycle
- Number of product lines

Inventory Turnover Ratio

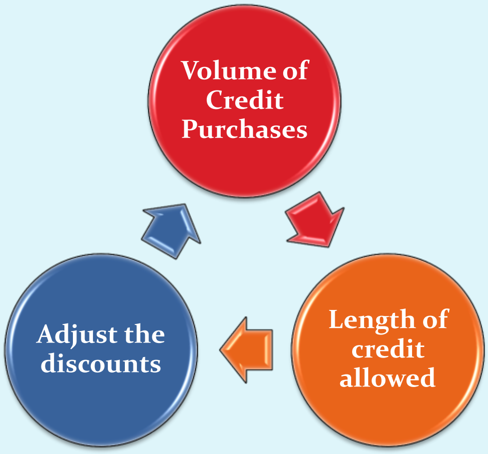
Inventory period in number of days = (Average Inventory / Cost of sales) x 365 days

Controllability of Debtors

Receivables Turnover Ratio

Receivables collection period in number of days = (Average receivables / Credit Sales) x 365 days

Controllability of Payables

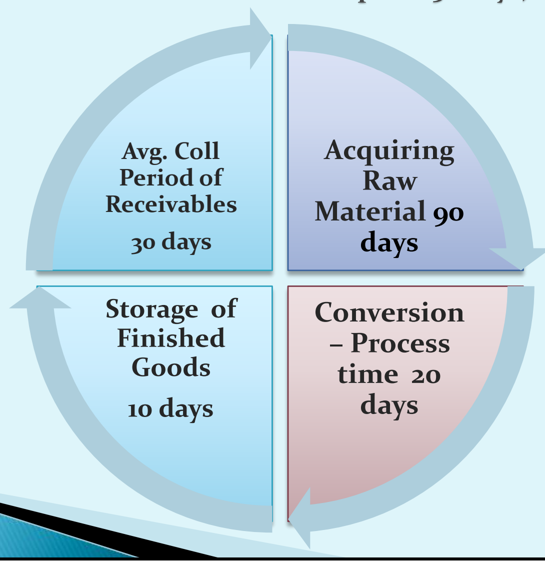


Payables Turnover Ratio

Payables period in number of days = Average Payables / Credit Purchases) x 365 days

Operating Cycle

(Operating cycle is described as time gap between investment and realisation - in this example – 150 days)



Operating Cycle

(varies for each type of business)

Services Industry	Traders	Industry
Cash	Cash	Cash
Debtors	Stocks	Raw Material
Cash	Debtors	Semi finished goods
	Cash	Finished goods
		Debtors
		Cash

Factors determining Working Capital Assessment
Total Current Assets (TCA)

Raw material
- Lead time for sourcing RM
- Minimum quantity to be held at any time
- Pricing of RM
- EOQ - Economic order quantity

Work-in-Progress
- Process time
- Value additions made

Finished goods
- Distribution channels
- Logistics of moving goods to points of sale

Receivables
- Average credit period provided to buyers

Assessment of Working Capital Finance

Total Current Assets (TCA)

Creditors for purchases & Expenses (OCL)

Working Capital Gap (WCG) =
TCA minus OCL

Margin =
Long term sources minus Long term applications
Or
CA less CL
Also referred as
NWC in the system
(Net working Capital)

Working Capital Finance from Bank=
WCG less NWC
Or
WCG Less Margin from the system

Current Ratio

Current Assets / Current Liabilities
400 / 200 = 2:1
400+200 / 200+200 = 1.5:1
400-100 / 200-100 = 3:1
The numerator and denominator are increased or decreased with the same amount to see the impact on Current ratio

- Current ratio measures short term solvency
- The higher the current ratio, the larger would be the amount available to meet CL
- Higher ratio indicates greater safety of funds of short term creditors
- Even if the value of CA comes down, if Current ratio is higher, the entity can meet its short term obligations comfortably
- **Though ideal current ratio is 2:1, bankers would accept 1.33:1**

Acid Test or Quick Ratio

Quick Current Assets / Current Liabilities

- Quick ratio is a refinement of Current Ratio
- Quick ratio measures instant liquidity of the entity
- Quick current assets are those assets which can be converted into cash at very short notice e.g.
  - ✓Cash and Bank balances
  - ✓Short term marketable securities
  - ✓Debtors and Receivables
- Exclude : Inventories, Prepaid expenses etc
- **Quick ratio of 1 is considered as ideal**
- **A good Current ratio accompanied by a low Quick ratio indicates disproportionately high investment in stocks.**

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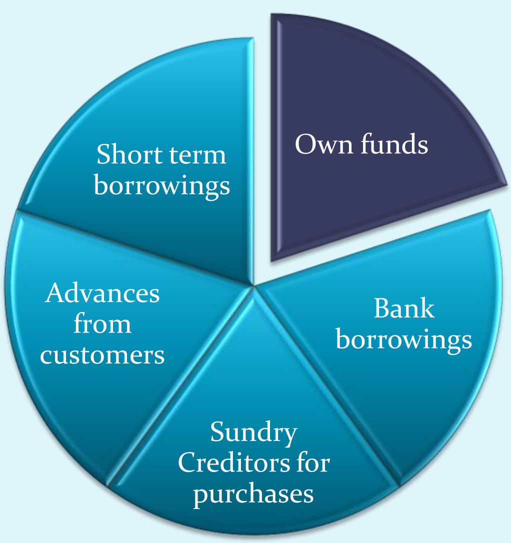
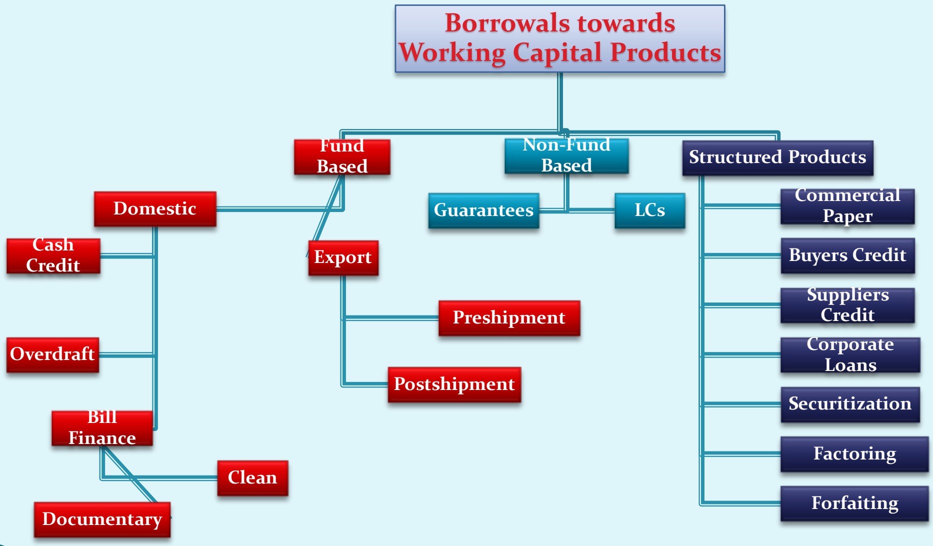
Sources of Working Capital





Non-Fund Products

- Can be used to reduce cost of borrowed funds
- Banks charge a small commission on Non fund based products as compared to interest on Fund based products
- Usage of these tools is subject to a mutual understanding between the buyer and the supplier
- Commonly used Non fund based products are:

Financial guarantees / Performance guarantees

Guarantee to discharge financial obligation or performance obligation of the applicant

Documentary Letters of Credit

Acts as a payment mechanism

Assurance of payment to seller

Assurance of required trade documents as desired by buyer

Standby Letters of Credit

Loan Appraisal

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Methods of Working Capital Finance currently in vogue

1. Maximum Permissible Bank Finance
   - MPBF – I Method
   - MPBF – II Method

2. Turnover Method

3. Cash Budget Method
   Receipts and Payments are projected and deficits indicate the required Bank Finance

Prior to Regulatory intervention in mid-60s

- The borrower decides how much to borrow
- Cash Credit advances, though repayable on demand by the banker, are generally rolled over and thus never fall below a certain level during the course of a year
- Business concerns employ bank funds on a quasi-permanent basis
- The bank credit is considered as first source of finance
- Amount of credit extended is based on the amount of securities available and not the level of operations of the borrower

Regulation of bank finance

Dahejia committee

- Implemented by RBI in mid 1960s
  - To discipline industrial borrowers
  - Redirect credit to the priority sector of the economy
- RBI has been issuing guidelines and directives to the banking sector toward this end

Tandon committee

- Reserve Bank of India setup a committee under the chairmanship of Shri P.L. Tandon in July 1974
- The practices of most of the banks are even now influenced by Tandon committee recommendations though financial liberalization occurred in 1990s

Tandon committee

Recommendations

- Norms of current assets in 15 industries
- End-use criteria
- Maximum permissible bank finance
- Emphasis on loan systems
- Periodic information and reporting system

Tandon committee

Maximum permissible bank finance (MPBF)

Three methods for determining MPBF

- Method 1: MPBF=0.75 x (TCA-OCL)
- ***Method 2: MPBF=0.75 x (TCA)-OCL***
- Method 3: MPBF=0.75 x (TCA-CCA)-OCL

TCA- Total current asset, OCL- Other current liabilities,
CCA- core current assets (permanent component of working capital)

Tandon committee

Current Assets Rs.(in lacs)

Raw material	18	
Work in process	5	
Finished goods	10	
Receivables(including bills Discounted)	15	
Other current assets	2	
(CCA = 20)	50	
Current Liabilities		
Trade Creditors -		12
Other current liabilities -		3
Bank borrowings (including Bills discounted)-		25
		40

MPBF for the above borrower as per above methods are:

Method 1: 0.75 x (CA-OCL) = 0.75 x (50-15) = Rs.26.25 lacs
Method 2: 0.75 x (CA)-OCL = 0.75 x (50)-15 = Rs.22.50 lacs
Method 3: 0.75 x (CA-CCA)-OCL = 0.75 x (50-20)-15 = Rs. 7.50 lacs

Method 2 is adopted

Tandon committee

COMPUTATION OF MPBF

METHOD I
- TCA
- OCL
- WCG
- NWC (25 % of WCG)

METHOD II
- TCA
- OCL
- WCG
- NWC (25 % of TCA)

NOTE : wherever more than the stipulated NWC is available in the system it should be retained and MPBF will come down to that extent. Similarly if NWC available is short than the required,the difference is to be brought in by the promoter otherwise limits are to be readjusted accordingly

Tandon committee

Working Capital Gap Method

	1st Method of Lending	2nd Method of Lending (MPBF)
CA	1000	1000
CL excl Bank	400	400
WC Gap	600	600
Min. Stipulated NWC	150 (25% of WC Gap)	250 (25% of CA)
Bank Finance	450	350

Tandon committee

Emphasis on loan system

- Only a portion of MPBF must be cash credit component
- Balance must be in the form of WCDL

Tandon committee

MPBF - Limitations

- Represents position on a particular date
- Not tuned to Peak Time Assessment
- Not applicable for service industries
- In practice may differ with Drawing Power

Chore Committee (1979)

This committee was formed by RBI to review the cash credit system of banks

The important recommendations of the Committee are as follows:

1. The banks should obtain *quarterly statements in the prescribed format* from all borrowers having working capital credit limits of Rs. 50 lacs and above

2. The banks should undertake a *periodical review* of limits of Rs. 10 lacs and above

Chore Committee (1979)

3. Banks should *discourage sanction of temporary limits by charging* additional one per cent interest over the normal rate on these limits

4. The banks should *fix separate credit limits* for peak level and non-peak level, wherever possible

5. Banks should take steps to convert cash credit limits into bill limits for financing sales

Nayak Committee

Turnover method for SSI units

SSI units having working capital limits of up to Rs. 5 crore from the banking system are to be provided WC Finance computed on the basis of 20 percent of their projected annual turnover.

The banks should adopt the simplified procedure in respect of all SSI units (new as well as existing).

Nayak Committee

Turnover method for Technology and Software Industry

Technology and Software Industry units with working capital limits of up to Rs 2 crore, assessment may be made at 20 percent of the projected turnover

Nayak Committee

TURNOVER METHOD

- Used for assessment of working capital needs of **small trading companies**
- Not appropriate for manufacturing and big trading companies

Nayak Committee

TURNOVER METHOD

Projected sales should be

- justifiable
- reasonable
- achievable and
- falling in line with the past performance

Turnover basis Vs Traditional MPBF basis (Regulatory clarification)

- The assessment of working capital credit limits should be done both as per projected turnover basis and traditional method
- Sanction the limit which ever is higher
- This is because RBI guidelines stipulate bank finance at minimum of 20 per cent of the projected turnover
- If the turnover based limit (i.e. 20%) is higher than traditional method sanction 20% AND Reduce the same by unpaid stocks to arrive at Drawing Power

Cash-flow Method

- Prepare a cash flow statement for the next 12 months
- Arrive at the maximum requirement
- Obtain documents for the maximum amount
- Operation based on monthly requirements
- Monitoring at periodical intervals

Cash-flow Method

- Used in case of seasonal Industries with wide fluctuations in CA and CL
- Maximum gap between total revenues receipts and total revenue payments is the MPBF
- Disbursements are allowed based on monthly statement
- Mainly used for service sector companies
- Eliminates traditional requirement of Stock and Debtors for assessment

Loan system for delivery of bank credit

- In the case of borrowers enjoying working capital credit limits of Rs. 10 crore and above from the banking system, the loan component should normally be 80 percent
- Banks, however, have the freedom to change the composition of working capital by increasing the CC component beyond 20 percent
- Banks are expected to appropriately price each of the two components of working capital finance

Liberalization 1993-97

- The Maximum Permissible Bank Finance System (MPBF) was substantially liberalized in 1993
- Ultimately, in April 1997, the MPBF System was made optional to the banks
- Reserve Bank of India has permitted the banks to follow any of the three methods for assessing the working capital requirements of the borrower
  - MPBF method (Tandon / Chore)
  - Turnover method (Nayak)
  - Cash Flow method
- Thus sufficient operational flexibility has been given to the banks in their efforts to assess working capital needs

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Management of Current Assets

- Cash Management
- Management of Accounts Receivable
- Inventory Management

Cash & Bank Balances

Idle asset

Hence, to be maintained at the barest minimum level

A cash budget or Cash flow statement period-wise

Past experience is the best guide

Cash Management

- Preparation of cash budget
- Wherever possible, use "Auto sweep" facility
- Investment in near cash Items like Bank FD, Money Market Instruments, MFs etc
- Acceleration of Cash Inflow through…..(see following slides)
- Deceleration of Cash Outflow through……(see following slides)

Acceleration of Cash Inflow

- ECS and RTGS
- Discounting Cheques
- Factoring
- Stock Clearance
- Cash Discount to Debtors
- Discounting of Bills
- Disposal of Useless Assets/Brands

Decelerating Cash Outflow

- Delay payment of insensitive items like utility bills, taxation
- Using multi-city cheques instead of Bank Drafts
- Using credit card and charge accounts without attracting Interest
- New loans in declining interest rate period and opting for floating interest rate loan
- In a period of increasing interest rate , opt for fixed interest rate loans

Inventory Management

- Material Budget
- Purchase Budget
- Inventory Levels
- Economic Order Quantity
- Control of Spoilage
- Plant proximity
- Just-in-Time Management

Management of Accounts Receivable

- Desirability of credit sales
- Establishing a credit policy for debtor evaluation, credit limit, cash discount
- Billing procedure: frequency of statement of account
- Raising finance through factoring, discounting bills of exchange
- Review of credit policy

Credit Monitoring Arrangement (CMA)

Form I	Particulars of Existing & Proposed Limits
Form II	Operating Statement
Form III	Analysis of Balance Sheet
Form IV	Comparative Statement of Current Assets & Current Liabilities
Form V	Computation of Maximum Permissible Bank Finance (MPBF)
Form VI	Funds Flow Statement

Some of the present practices

Emphasis on loan system

- Bulk of the working capital limit is in the form of working capital demand loan and only a small portion in cash credit component.

Financial follow up results

- FFR I- simplified form of form II (Operating Statement) used under Tandon -be submitted on quarterly basis
- FFR II- simplified form of form III (Analysis of Balance Sheet) - to be submitted in half yearly basis.

Factoring

Factoring means sale of receivables to outside agency specialized in the management of receivables

Factoring can be with or without recourse basis.

Advantages:
(1) A ready source of short term funds
(2) Simple procedures/ documentation
(3) Require lesser margins
(4) Off balance sheet financing (without recourse)

Factoring

- **A continuing arrangement between Factor and a "client" (seller of goods/services")**
- **It is purchasing the client's a/cs receivables - with or without recourse**
- **Maintenance of Sales Ledger**
- **Collection of Receivables from Customer**
- **Follow up *and* Sending of Statements, Adv Services etc**

Forfaiting

- "**Forfait**" is derived from French word "a forfait" which means *forfeiting* or *surrender of rights*
- It is a **mechanism of financing** exports
  - by discounting export receivables
  - evidenced by Bills of Exchange or PN
  - **without recourse** to the seller (viz exporter)
  - carrying medium to long term maturities
  - on a fixed rate basis (discount)
  - upto **100 per cent** of the contract value

Forfaiting Vs Factoring

Forfaiting	Factoring
Only for Intl trade	Both domestic or intl
100% Finance	Restricted to 80%
Pure financing arrangement	Package of services including follow up of receivables
Applicable for deferred transactions	Short term financing arrangement
Based on financial standing of the "Avaaling Bank"	Based on exporter's and Importer's standing
Always without recourse	May be with or without recourse

Structured Products

COMMERCIAL PAPER

Commercial paper is one of the oldest instruments for raising short –term finance

Some of the important guidelines issued by the RBI are as under:-

(1) Minimum TNW of Rs. 4 Crores.
(2) Has been sanctioned working capital limits by Banks/ all -India Financial Institutions
(3) Borrowal account must be standard asset.
(4) Minimum credit rating of P2 by CRISIL or equivalent.
(5) Maturity between 7 days to 1 year
(6) Issued in multiples of Rs. 5 lacs

Cheaper source of finance as compared to traditional bank finance

Structured Products

SUPPLIERS'CREDIT and BUYERS'CREDIT

Suppliers' Credit:
Short term loans where the credit for imports into India is extended by the overseas suppliers through a bank.

Buyers' Credit:
Short term loans for payment of imports into India is arranged by the importer from a bank or FI outside India.

The funding banks primarily depend on the credit worthiness of L/C opening bank

Cash & Fund Flow Statements

The cash flow statement provides information about:

- Cash Receipts (cash inflows)
- Uses of Cash (cash outflows)
- During a Period of Time

Inflows and outflows are reported for:

- Operating activities
- Investing activities
- Financing activities

Classification of Business Activities
Inflow and Outflow of Cash

Operating Activities

Cash Inflow

1) Cash Sales
2) Received from Debtor
3) Commission & Fees
4) Royalty

Cash Outflow

1) Cash Purchases
2) Payment to Creditors
3) Cash Operating Expenses
4) Payment of Wages
5) Income Tax
6) Manufacturing Expenses

Classification of Business Activities
Inflow and Outflow of Cash

Investing Activities

Cash Inflow

1) Sale of Fixed Assets
2) Sale of investments
3) Interest Received
4) Dividend Received
5) Working Capital Recovery

Cash Outflow

1) Purchase of Fixed Assets
2) Purchase of Investments
3) Working Capital

Classification of Business Activities
Inflow and Outflow of Cash

Financing Activities

Cash Inflow

1) Issue of Shares in Cash
2) Issue of Debentures in Cash
3) Proceeds from long-term borrowings

Cash Outflow

1) Payment of Loans
2) Redemption of Preference Shares
3) Payment of Dividends
4) Interest Paid
5) Repayment of Finance/ Lease Liability

Distinction between Cash flow Statement and Funds Flow Statement

Basis Of Difference	Cash Flow	Funds Flow
Basis of Accounting	It recognizes Cash basis Of accounting	It is based upon accrual Basis of accounting I.e Working capital
Significance	It is useful for short-Term financial planning	It is useful for long-term Financial planning
Schedule of Changes in Working Capital	Such a schedule is not Prepared for preparing Cash flow statement	Schedule of changes in Working capital is Prepared separately
Causes of Variation	It studies only the Causes of cash variation	It studies causes of Change in working capital

Fund-flow statement – Working Capital Basis

Details		
Net Profit	**6.6**	
Add back depreciation	6.0	
Working capital generated from operations		**12.6**
Issue of share capital		0.0
Long term borrowings		3.6
Sale of Fixed assets		4.0
Total Working Capital generated		**20.2**
Uses of Working Capital		
Dividends		5.4
Purchase of Fixed Assets		11.6
Repayment of Term Loan		1.2
Total Working Capital Used		**18.2**
Net Change in Working Capital		**2.0**

Changes in the Internal Content of Working Capital

Working Capital Account	31.03. 10	31.03.09	Working Capital Increase / Decrease
Current Assets			
Cash	2.00	1.20	0.80
Debtors	22.80	13.60	9.20
Inventories	21.00	14.40	6.60
Advances	1.00	2.00	(1.00)
Current Liabilities & Provisions			
Cash Credit	14..60	14.60	0.00
Bank Credit	5.00	5.00	0.00
Inter-Corporate Deposits	8.80	0.00	(8.80)
Trade Credit	15.00	12.00	(3.00)
Advances	4.00	2.60	(1.40)
Provisions	2.00	1.60	(0.40)
Working Capital (Net Change)			**2.00**

Base Rate

- All categories of loans will be priced only with reference to the Base Rate with effect from July 1, 2010.
- The Base Rate will be the minimum rate for all loans (except the exempted categories).
- There can be only one Base Rate for each bank.
- Banks have the freedom to choose any benchmark to arrive at a single Base Rate which should be disclosed transparently.
- The Base Rate will be reviewed by respective banks once in a quarter

Base Rate – Exempted Categories

The following categories of loans could be priced **without** reference to the Base Rate:

(a) DRI advances

(b) Loans to banks' own employees

(c) Loans to banks' depositors against their own deposits.

Base Rate – Clarifications

Clarifications with regard to loans where subvention is available:

Crop Loans
In case of crop loans up to Rs 3 lacs - as stipulated by the Government.

Export Credit

- Interest rates applicable for all tenors of rupee export credit advances will be at or above the Base Rate.
- Where subvention is available in terms of RBI circulars, banks will have to reduce the interest rate chargeable to exporters as per Base Rate system by the amount of subvention available.

Restructured Loans
In case of Restructured loans if some of the WCTL etc. need to be granted below the Base Rate for the purposes of viability

The above situations will not be construed to be violative of the Base Rate guidelines

Base Rate – Some more features

- Even after introduction of the Base Rate system, banks would have the freedom to offer all categories of loans on fixed or floating rates.

- Where loans are offered on fixed rate basis
  - notwithstanding the quarterly review of the Base Rate
  - the rate of interest on fixed rate loans will continue to remain the same
  - subject to the condition that such fixed rate should not be below the Base Rate.

- Wherever loans sanctioned prior to June 30, 2010 come up for renewal from July 1, 2010, the Base Rate system would be applicable.

Structuring the Borrowings for Working Capital