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Analysis

Why is Negative Working Capital Suddenly so Popular?

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Biography

Nick Hood is the Senior Business Adviser at the Opus Business Advisory Group (https://www.opusllp.com), the largest independent advisory, restructuring and insolvency firm in the UK.

Nick was a licensed Insolvency Practitioner, working in the business rescue market for 25 years. He is a committed internationalist, having created the largest global network of independent business rescue firms and having also worked overseas in Canada, Milan and Bahrain.

In his earlier career and after qualifying as a Chartered Accountant in 1970, Nick held senior executive positions in major companies in the construction, engineering and media sectors, as well as working for a boutique investment bank.

Nick's thought leadership and opinion blogs for Opus can be found at https://opusllp.com/resources/.

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Abstract

A significant percentage of companies across the UK economy now operate with greater short-term liabilities than their 'quick' assets. Some consider this to represent a higher commercial risk to the business itself and its stakeholders. In this article, the author looks at the scale of this phenomenon and why it is an issue that merits closer attention to financial risk than with more conservatively run companies.

Introduction – the quick assets ratio

Once upon a traditional time, one of the key liquidity measures in a company's balance sheet was the ratio between so-called 'quick' assets like cash, trade receivables and inventory and short-term liabilities, such as sums owed to suppliers, HMRC for VAT and payroll debts and the bank overdraft, which is of course repayable on demand.

The basic principle in the past was that current assets should always be greater than current liabilities. Anything less was considered a sign of financial weakness in many industries and companies. Now, it seems that anything goes in term of short term financial risk.

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The inexorable rise of negative working capital (NWC)

Suddenly, significant numbers of companies have current liabilities that exceed their easily realizable current assets. In June 2022 we carried out research to quantify the scale of the phenomenon and were shocked to find 178,000 such businesses registered in the UK, after applying a de minimis lower limit of £20,000 for the deficit to eliminate marginal instances. The number of NWCs had risen by 40% in the previous two years.

The combined deficits of the 178,000 NWCs added up to £300 billion, which is the potential shortfall for the creditor community in the theoretical scenario that all of the NWCs were to fail.

The spread of NWCs across the economy

As part of our regular programme of reporting on individual business sectors, we routinely look at the penetration of NWCs within each sector. The outcomes show that they are ubiquitous, featuring widely across the economy to one degree or another but they are never an insignificant percentage of the sector.

Figure 1: NWC sector penetration

Date	Sector	No of NWCs	% of all companies	Total Deficits £bn
July 2023	Residential Care	3,736	23%	-1.5
August 2023	Retail	19,758	14%	-16.3
September 2023	Hospitality	19,893	23%	-4.9
October 2023	Travel	782	13%	-0.2
November 2023	Logistics	3,813	12%	-0.8
December 2023	Manufacturing	12,194	16%	-21.1
January 2024	Construction	21,350	9%	-7.2

Source: Opus Business Advisory Group

Why a NWC deficit can be bad news

The current assets and liabilities sections in a balance sheet are where financial problems and, in particular, cash flow deterioration first manifest themselves, as cash dwindles or as receivables spawn bad debts and inventory becomes redundant if sales shrink. Equally, trade payables rise as payments to suppliers are delayed and HMRC debts grow as monthly payments are missed. If the net working capital position is negative to start with, it really doesn't take long for an initial problem to turn into a full-blown crisis.

The key issue is to what extent a negative NWC strategy is based on good cash flow and strong profit generation, which encourages short-term creditors to be supportive. If trading falters and cash starts to dry up, those attitudes can change.

Suppliers may tighten credit terms, trade insurers could reduce or withdraw cover, and lenders might become nervous about not just short-term facilities such as overdrafts but also longer-term funding through loans.

The outcome is growing cash pressure, a process that can develop at worrying speed leaving management struggling to take remedial action sufficiently speedily.

Is the Working Capital position quite what it seems?

Those who believe implicitly in the veracity and reliability of figures in a balance sheet are destined to suffer a rude awakening as the health of a business worsens, escalating into complete shock at what happens if the entity tips over into formal insolvency.

We have examined in detail the reasons behind the diminution of value of current assets[1] and the unforeseen rise in current liabilities[2]. These studies look at the worst case scenario of a formal insolvency, but these changes to values can also occur in a restructuring or even in a turnaround situation.

The main issues are covered below, again with the caveat that they look at worst case scenarios in a formal insolvency, which may not come to fruition, but which will be in the minds of all kinds of business stakeholders, whether they are suppliers, trade insurers, customers, landlords or lenders who are already doing business with a company or considering doing so.

Disappearing current assets

During the insolvency process there are so many factors which can comes into play, that the number of current assets which are in reality available, come under question. These include:

1. **Inventories –** This heading covers a wide range of items. Their realizable value depends on so many issues, not least whether the business is to be continued or terminated. If there is no ongoing trade, who will buy finished goods and even then, at what fraction of their cost? Raw materials and components are often subject to retention of title claims by unpaid suppliers and so cannot be sold. Work in progress may have no value at all if the customer refuses to accept further deliveries, if there are no funds to complete the finished product or if the completion costs are greater than the end value.

2. **Trade receivables** – Outstanding invoices ought to be collectible, subject to normal bad debt issues. The reality post-insolvency is very different. Some debtors who can pay will hide behind disputes to resist settlement, or else demand discounts. Customers may have counter-claims if the invoice is under an ongoing supply contract, which cannot be fulfilled. Debtor receipts don't arrive by themselves, so that either existing staff will have to be retained and paid to chase them or independent collection agencies called in. Either way, there will be a cost to collect.

3. **Group receivables** – In a group scenario, both the parent company and its subsidiaries can have receivables owed to them by other group entities. Whether these are collectible is a highly complex issue, often complicated by offsetting creditor balances and liabilities under cross-guarantees to lenders or other stakeholders, such as landlords. Often, these group balances will have little or no value.

4. **Other receivables** – These can be a multitude of valuation sins, all sorts of items of which prepayments are most common. This is the part of a cost incurred in one year which refers to a later accounting period and so has no cash value. Realizations of other items will depend on circumstances, such as the eventual net position with HMRC in the case of a VAT refund due.

5. **Cash** – Cash should be straight forward but is often anything but. It could be funds held in a bank account as security against facilities provided by the same lender, or it could be a cash rent deposit against which a landlord has a claim. It also has a nasty habit of disappearing immediately ahead of an insolvency.

6. **Other non-current assets** – This heading could include tax repayments potentially receivable within 12 months, pension scheme surpluses or the value of hedging arrangements and other financial derivatives. Much of this accounting value could depend on a set of assumptions on future trading outcomes, which are no longer valid after a company has ceased trading.

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Escalating short-term liabilities

Additionally, there are a number of escalating short-term liabilities which must also be considered. These include:

1. **Trade payables** – There should be few surprises in this category if the business has good accounting systems and internal controls, but strange things can happen in the Twilight Zone immediately before a formal insolvency, especially if there has been sustained and severe cash flow pressures leading to an ostrich-like attitude to incoming bills. It is common for suppliers and service providers to have a quite different view of what they are owed, and it is almost never less than the company's records show and quite often more.

2. **Counter claims for damages** – Contracts with both customers and suppliers, which are interrupted by an insolvency, or the cessation of trading can generate potential claims for damages for the failure to comply with their terms. This is particularly prevalent in certain sectors, notably in the construction and the IT industries.

3. **Finance leases** – The requirement to make payments isn't ended by an insolvency filing and the failure to maintain those payments can trigger a range of penalties and other extra charges, plus claims for any shortfall between the value of the underlying asset and the balance owed.

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4. **Property leases** – Rent and service charges continue to mount up. The landlord has a duty to mitigate their potential loss, that does not mean that there can be a clean break with no additional liabilities, except in unusual circumstances. Even if the landlord is willing to agree to an early termination, there may be a substantial extra debt for dilapidations (repair, reinstatement, and redecoration costs) if the lease requires the tenant to return the premises to their original condition.

5. **Borrowings** – Interest continues to run despite the insolvency and facility documentation may entitle the lender to add on all manner of extra fees and charges in the event of default, making the original debt escalate at a dizzying pace.

6. **Inter-group liabilities** – In group scenarios, it is not unknown for parent companies to increase the amounts owed by an insolvent subsidiary by levying additional costs and charges to enable them to use set off to avoid paying any net amount due the other way.

7. **Financial instruments** – Interest rate and currency hedging strategies may unravel in the event of an insolvency, or else major instability in the relevant markets at or around the time of an insolvency event can create or radically alter liabilities under hedging arrangements.

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8. **Cross guarantees** – Where the insolvent company is a subsidiary or has associated businesses, it may have given cross guarantees to these connected entities' creditors. This can generate substantial additional liabilities, which may have been disclosed in the notes to the accounts of the insolvent company but will not have appeared on its Balance Sheet.

9. **Pension schemes** – Insolvency and the inability to either continue with contributions or to make good pension scheme deficits can increase an insolvent company's obligations to the pension scheme. In a group scenario, deficits in the group scheme can fall unequally on subsidiary companies.

10. **Tax liabilities** – The impact of an insolvency on a company's tax obligations can be considerable, sometimes increasing both current and deferred liabilities.

Risk awareness and risk appetite

There is no suggestion that every company with an NWC position is a commercial accident waiting to happen to its stakeholders, but it is not a factor that should be ignored.

Quite rightly, it is an issue that may reduce the score given by a credit rating agency, depending on the other circumstances of the company. Similar considerations will apply for trade insurers and the protection they will provide to its suppliers.

In tough economic times, engagement with an NWC company is a matter of risk assessment, risk appetite and balances commercial judgment.

Reference

[1] How current assets melt away in an insolvency situation (28 February 2023). Opus. Available at: https://opusllp.com/blog/how-current-assets-melt-away-in-an-insolvency-situation/

[2] How business liabilities can ballon during insolvency (6 March 2023). Opus. Available at: https://opusllp.com/blog/how-business-liabilities-can-balloon-during-insolvency/