Liquidity-Profitability Trade-Off: A Game of Survival and Growth

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One of the fundamental truths of survival for a firm is that it should be liquid enough while simultaneously being consistently profitable to grow and create wealth. While survival is essential for growth, growth is, in turn, essential for survival. In other words, to maintain liquidity, the firm needs to keep sufficient resources idle, while to earn profit, it needs to invest the idle resources. Hence, the question then arises whether it is possible to remain liquid and avoid the chances of bankruptcy while simultaneously earning super-normal profits. Although the theory of finance states that both are negatively correlated and can't be increased simultaneously, a few organisations have proved this wrong with superior profits along with high liquidity. This makes the validity and applicability of the theory of liquidity and profitability a matter of debate. Some managers opine that proper negotiations with lenders and creditors to safeguard the organisation from bankruptcy will negate the need to block a huge amount of idle resources simply to maintain the required liquidity ratios. But again, the moot question is whether this implies that the right approach to earning more profits is by fully utilising resources, which is practically followed by many reputed organisations like Walmart, Dell, as well as many Indian companies. These companies operate for years with negative working capital while earning superior profits consistently. This is possible only with skilful management of receivables, payables and inventories. Finance experts argue that this situation is possible in FMCG companies, but not in manufacturing companies. However, analysis by the author indicates that many manufacturing companies, including ACC Ltd., have been profitable while operating with negative working capital consistently for a decade. Being able to enhance profitability while avoiding bankruptcy implies managerial efficiency.

The author, along with associates, has done a research study on the liquidity and profitability of the top five Indian pharmaceutical companies. The study's intent was to provide empirical evidence about the effects of working capital management on profitability for this sample of five listed pharmaceutical companies for the period 2011-12 to 2015-16. Although liquidity and profitability are inversely related in all cases, which coincides with the theory of finance, it was found that highly liquid companies were profitable. The assumption that all profitable companies suffered from lack of liquidity and all liquid companies suffered losses was not evident. In other words, a company need not forego liquidity to earn profit. The key aspect is to draw a balance in terms of the extent to which a company can forego liquidity to earn the desired profit, which is the ultimate trade-off between liquidity and profitability. While this is essential, there is no universally acceptable solution or rule to work out this trade-off. On the other hand, operating with negative working capital for the sake of greater profits is gaining popularity in today's corporate world; this is also a key parameter used to judge managerial efficiency. However, the author would caution finance managers to ensure that this method of functioning does not lead to financial bankruptcy of the organisation.

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This article is a research note based on full-length manuscript published in Journal of Economics and Public Policy.

The author recommends that pharmaceutical firms must hold sufficient cash according to their projected sales level to have sufficient bargaining power while making cash purchases, which would cut their costs. It is very evident that efficient working capital management and liquidity have a positive effect on a firm's profitability. This study clearly affirms that firms in the pharmaceutical industry in India have sufficient scope to improve their profitability by managing their working capital in more efficient ways. The inventory, if handled proficiently, can have a significant positive impact on the firm's profitability. Consequently, this study finds sufficient proof that a firm is likely to enjoy better profitability if it manages its working capital with better efficiency and focuses on inventory and cash position with greater care. The author believes this is applicable for all types of manufacturing firms. A firm can be very profitable if it translates the cash from operations within the same operating cycle. If this is not possible, the firm may need to borrow to support its continued working capital needs. Thus, the twin objectives of profitability and liquidity must be well-synchronised. Investments in current assets are inevitable to ensure delivery of goods or services to the ultimate customers, and proper management of the same fulfils the desired impact on both profitability and liquidity. If resources are blocked at different stages of the supply chain, this will prolong the cash operating cycle. Although this might increase profitability (due to increase in sales), it may also adversely affect the profitability if the costs tied up in working capital exceed the benefits of holding more inventory and/or granting more trade credit to customers.

Operating with negative working capital is as popular in India as with global companies such as McDonalds, Amazon.com, etc. Negative working capital indicates non-liquidity or low liquidity within the firm, which is not favourable at every stage of business. Numerous companies operating in India manage with negative working capital efficiently thereby creating shareholder value by way of higher EPS and higher market capitalisation. At the same time, companies with sufficient liquidity can expand their business and grow optimally. However, a company with higher working capital needs higher revenue to maintain a healthy operating ratio. A better credit management system will help these companies to generate higher ROCE in the long run. However, in every situation, lower level of liquidity is not preferable; a proper trade-off between liquidity and working capital is needed in the long run.

Financial experts remind us that the goal of working capital management is to enable a firm to maximise profits from its operations while meeting both short term debt and future operational expenses. In a normal situation, low or no working capital and large payables are a sign that the firm may be in serious financial trouble. Furthermore, negative non-cash working capital is often viewed by rating agencies as a source of default risk, which may lead to the firm incurring higher interest cost on its loans.

Gone are the days when negative working capital was considered as a risk of insolvency of the organisation. Presently, negative working capital is a sign of managerial efficiency in a business. It appears that the age-old finance mantra that “every company needs working capital” is gradually losing its relevance. Many of the past reasons for funding working capital are no longer valid and improvements can now be put in place that allow these funds to be used for more productive purposes. Hence, negative net working capital can be regarded as good for a firm. Since current liabilities are money owed but not paid, the firm is effectively using external funds to finance its day-to-day operations. In general, a major portion of the current liabilities constitute creditors. If credit periods can be negotiated suitably, the author believes that a firm need not maintain a large amount of current assets simply to bring the current ratio to the stipulated ideal of more than 2:1 and quick ratio of more than 1:1. As evident, idle funds can be productively invested and benefits of negative working capital can be obtained. Though the concept of negative working capital i.e. foregoing liquidity for the sake of profitability, is not yet incorporated in finance literature because of its validity, it may create a new revolution in the area of finance in future and so-called traditional theories may become obsolete.