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MBA-1-USQ/704

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1. Introduction

This report is prepared for the prior consideration of the Managing Director of K-Mart Sdn Bhd investigating the financial position and the projection of the company with the purpose to:

1.1 Explain the reasons for increasing overdraft over the past three years.
1.2 Appraise the company management of working capital
1.3 Analyze the present state of the company liquidity position and with the projection of the coming year.
1.4 Provide recommendation to the Managing Director in regards to the outcome of this assessment.

2. Company Background

K-mart Sdn Bhd is an old established plastics resin trading company. The company imports the material and re-sells to local plastics manufacturing company. Prior to 1998 the company operated as a sole proprietor, and in 1999 the company was taken over by another owner and registered as private limited company. The new management undertook an aggressive business strategy. They succeeded by registering a big leap in term of sales revenue.

2.1 Current State

The increase in sales had also contributed to the company profits. As reflected in the balance sheet the company finance their additional working capital though trade creditors and overdraft. For the past three years the company managed to expand its business although the revenue tapped towards the latter years. This was anticipated because the business was moving from embryonic stage to growing stage. The profits recorded were slightly reducing because of the aggressive pricing undertook by the company to penetrate new customers. The expectation of the company for the coming year was bullish but their plan to grow the business was limited by lack of liquidity to finance their further growth. The company had almost exhausted all the overdraft facility to finance it business expansion and they are looking for additional financing to finance their growth.

2.2 Future Plan

The company at certain degree was able to increase their market share but they anticipated continuing to expand their market share and maintaining their profit margin would be difficult. So in order to mitigate the erosion of profit margin, the company decided to differentiate themselves, they company decided to provided technical service to their customer. This required investment in technical equipment and technical manpower. In other to attract good technical staff, the company would be offering company vehicles as an incentive beside other perks. This also required additional investment for fix assets.

3. Analysis

3.1 Reasons for Increasing Overdraft

The business expansion undertook by the company required them additional cash for working capital and further fixed asset purchases and the company was seeking their banker to increase their overdraft facility to finance the said investment. Gallagher et all (2003, p 490) explained that the choice of the firm's working capital financing blend depend on the management desire for profit versus the degree of risk aversion. There were a big jump in fixed asset investment in 2002 and the company planned to invest another more in 2003 to support it business activities. In the past, the company took an aggressive approach by using short-term financing like overdraft to finance purchases of fixed assets. Being a small and private limited company, K-mart ability to secure long term financing was limited because bank normally required collateral as loan securities.

In addition to the company limited ability to secure long-term loan, the lower interest rates offered by short-term loan would have tempted the company to use overdraft as a source of financing. This approaches whilst promised a higher return, exposed the company with higher risks that might cause by fluctuation in interest rate and unforeseen business downturn. (Gallagher et al, 2003 p. 491)

The surge in sales revenue (75% in 2001) and followed by the gradual increase in the following year (29% in 2002 and 11% in 2003) required injection of additional working capital into the business to finance the increase in purchases, inventory and debtors.

The inventory policy of a trading company is strongly influenced by the nature of the demand for their goods (Holdren and Hollingshead, 1999). K-mart differentiated itself from their competition by providing good customer service, which, include shorter lead-time. This has succeeded the company to secure new business at the same time had caused the increase in inventory (83% in 2001, 31% in 2002 and 11% in 2003) and debtors (110% in 2001, 7% in 2003 and 11% in 2003). This policy were implemented to avoid stock-out which, if occur could cause the customer to switch supplier.

The increase in working capital and increase in fixed investment had caused the overdraft to increase from 30% in 2001 and 43% in 2002. In anticipation the cash inflows in 2003, the overdraft was expected to reduce by 16%.

3.2 Management of Working Capital

The surge of sales in 2001 had caused the increased of inventory and debtors. Though this increase of working capital was partly finance by trade creditors as shown in the increased in trade creditors in 2001, it was not sufficient to improve the liquidity of the company. The increased of debtor collection period from 30 days in 2000 to 37 days in 2001 added strain to the working capital position of the company. The company succeeded in stretching the creditors payment period but it was not significant to improve its liquidity.

In spite of the above development, the company we able to manage its stock as reflected in the stock holding period and stock turnover, although effort can be made to improve the numbers. The company was also able to improve the efficiency of it assets usage. The assets turnover has a big jump in 2001 in tandem with the increase in sales. Based on this figures, the stepped made the company investing in fixed assets were justified.

3.3 Present Liquidity Position

In the absent of industry benchmark, the state of liquidity of a company can only be measured based on year to year. The current ratio of K-mart over the year has shown some improvement. Refer Appendix 2. In contrary, the quick ratios were all less then one. This indicated that the company could not cover its liabilities in the short term without liquidating the stocks. Stock, sometimes it would required time to liquidate and if disposed in haste, the company might have to dispose below market price. These figures show that the company was in tight liquidity position and mainly contributed by over-trading.

The debt ratio hovering between 0.44 in year 2000 and 0.53 in year 2001 indicated that about half of the company assets were financed by debts. The debt to equity, which, increase from 0.78 in year 2000 to 1.13 in year 2001 and 1.01 in year 2002, may not be viewed well by potential creditors or bankers in securing credit to the company. The company could be viewed as to be over gearing and high credit risk. Debts coverage ratio of about 0.3 may be viewed by creditors that the company have limited cash available to repay debts.

3.4 Present Profitability Position

K-mart undertook and aggressive approach in their business and they have succeed in increasing the revenue. All the profitability ratios in Appendix 2 registered healthy increase in year 2001. In 2002, although gross profit reduced by 1.4%, the net profit plunged by 4%. This was mainly contributed by depreciation from fixed asset and increase in other expenses. The gross profit and net profit for the subsequent years were stabilized. The reduction in net profits had affected the ROA, ROE and OIRI in year 2002. These changes in profitability ratios should be expected because the business was going through a period of rapid growth and heavy investments were made to support the growth. The big fluctuation of the numbers might not give a true reflection of the situation. A meaningful of the analysis could be made with the availability of the industry benchmark.

3.5 Future Projection

The Malaysian plastics industry growth rate increased moderately from 0.5% in 2001 to 5% in 2002 and it contributed to 2.5% of Malaysia's GDP. The moderate increase was largely due to a strong performance by domestic-oriented sectors such as the automotive and construction sectors. Exports of plastic products manufactured in Malaysia continue to register a growth of 6%. Malaysia exports of plastics products enjoyed a strong growth of more than 20% in the past five years before slowing down in 2001. Total export of plastics products in 2002 reached U.S. $1 billion, an increase of 6% compared to 2001 (MPMA, 2003). Based on the above report, K-mart certainly would have bullish future in term of the revenue growth. Apart from their business strategy and efforts, their revenue growth was also contributed by the industry growth. The forecast sales growth of 11% would be in line with the potential growth of the industry.

5. RECOMMENDATION

K-mart is involved in a growing industry. The future and potential to develop the business looks bright. In view of this the company should take a long-term and balance approach in term of financing its business. The company needs to evaluate the available business financing taking into consideration of its cost-risk factors.

The author would like to make the following recommendations to K-mart to address it problem on working capital.

5.1 Long term Loan

The company is recommended to blend it business financing using long-term loan. In view of the company being a small private limited company, the available long-term loan available could only limited to mortgage, hire purchase and leasing. Other long term loan would require collateral as securities. But the company may try to convince the bankers based on its future business potential based on the projection earnings and industry trends. This type of loan is more expensive then the short-term loan but the fixed rate provided by long term loan are less susceptible to market rate fluctuation.

5.2 Short term Loan

The company should explore other short-term loan like factoring. Factoring involves a process where a specialized firm or finance company assumes the responsibility for the administration and collection of the account receivable for its clients. It can be considered a form of short-term commercial financing based on the selling of trade credit at a discount, or for a prescribed fee plus interest (Forman and Gilbert, 1976).

5.3 Inventory Management

Since inventory contributed a major portion of K-mart working capital, the company should look into the effective management of inventory. Holdren and Hollingshead, (1999) pointed that in any inventory made up of a number of items, there is usually considerable variation in the unit value, quantity of demand, and character of demand for the individual line items. Resources may be conserved if the inventory can be segmented based on some important criteria and managed on a priority basis. He explained that gross sales revenue is a key factor in determining an inventory line item's importance. It gives a better indication of the item's economic contribution than counting units sold and it is easily calculated from readily available information. If a multiple-item inventory is ranked according to gross sales, it will usually become apparent that a small number of inventory line items account for a vast majority of the firm's total revenue. Because of their greater contribution, these items should receive particular attention by the company. With this K-mart would be able to optimize it financial resources to maximize the value its business.

5.4 Lean Management.

Rafuse (1996) insisted that drawing on some of the techniques of "lean production" are far more effective, to those seeking working capital reduction. Ensuring a no waste, "right first time", and standard process must be established initially. Prevention-based controls are then implemented to maintain the process within these limits. This systematic approach to process management is not essentially different from controlling an operation in a business. Greatly improved transactional systems have been achieved in a number of cases, for example with auto industry suppliers in Japan, the USA and the UK.

6. Conclusion.

Based on the above analysis, the author concluded that K-mart was operating with tight liquidity and this symptom of over-trading was partly contributed with lack of fund to finance their growth. K-mart may not continue to grow and realize the potential of their business without managing its working capital well. Gallagher (2003, p 487) pointed that most business especially the growing business like K-mart would experience in fluctuation in current assets. These fluctuations would have an impact to the working capital of the company. The company needs to establish a working capital policy which taking into consideration the balance between the company objectives on liquidity versus profitability. (Gallagher, 2003, p 489)

Aggressive financing approach taken by K-mart might work with conducive business environment in short-term. To accommodate occasions need for immediate cash to fulfill it short-term obligations might tempted the company to resort to unpopular move to stretch payment to creditors, This desperate move could hurt the company reputation and rating to secure credit from trade creditors and bankers and this is not an healthy factor for a growing business. Rafuse (1996) argued that improvement of working capital by delaying payment to creditors is an inefficient and ultimately damaging practice, both to its practitioners and to the economy as a whole.

7. Reference.

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8. Appendix

Appendix 1 - K-Mart Sdn Bhd , Profit & Loss Statement, Balance Sheet Statement and Cash Statement

Appendix 2- Ratios & Operating Changes.