

Negative Working Capital: Good Sign, Red Flag, or Much Ado About Nothing?

How to Align the “Low IQ” and “High IQ” Finance Tribes

Negative Working Capital: What?

This video assumes you already know what Working Capital and the Change in Working Capital mean (see the previous coverage).

It goes into **the meaning** of these items in more detail and why most “explanations” are wrong.

Negative Working Capital: What?

If you want this tutorial in writing, along with screenshots, PDFs, and the Excel model, go to this URL (**pinned in the comments**):

<https://breakingintowallstreet.com/kb/accounting/negative-working-capital/>

The Short Answer...

- **Negative Working Capital:** Means the company's Current Operational Liabilities exceed its Current Operational Assets
- **“Operational”:** Excluding Cash, Debt, Investments, Leases, etc.; *some* longer-term items could be included (Deferred Revenue)
- **“First Wave” Explanations:** Negative Working Capital is “bad” because it means that companies cannot repay their short-term obligations with their short-term assets
- **“Second Wave”:** It depends on *why* WC is negative...



The Short Answer...

- **“Good Negative”**: The company collects cash from invoiced customers quickly, cycles through Inventory quickly, and has the market power to pay suppliers more slowly
- **“Bad Negative”**: The company’s sales are falling, leading to declining AR and Inventory, and it *can’t* pay its suppliers on time
- **REALITY #1**: Neither view is correct because WC matters much less than *the Change* in WC on the CFS
- **REALITY #2**: When WC “matters,” the issues are usually apparent from other metrics



The Short Answer...

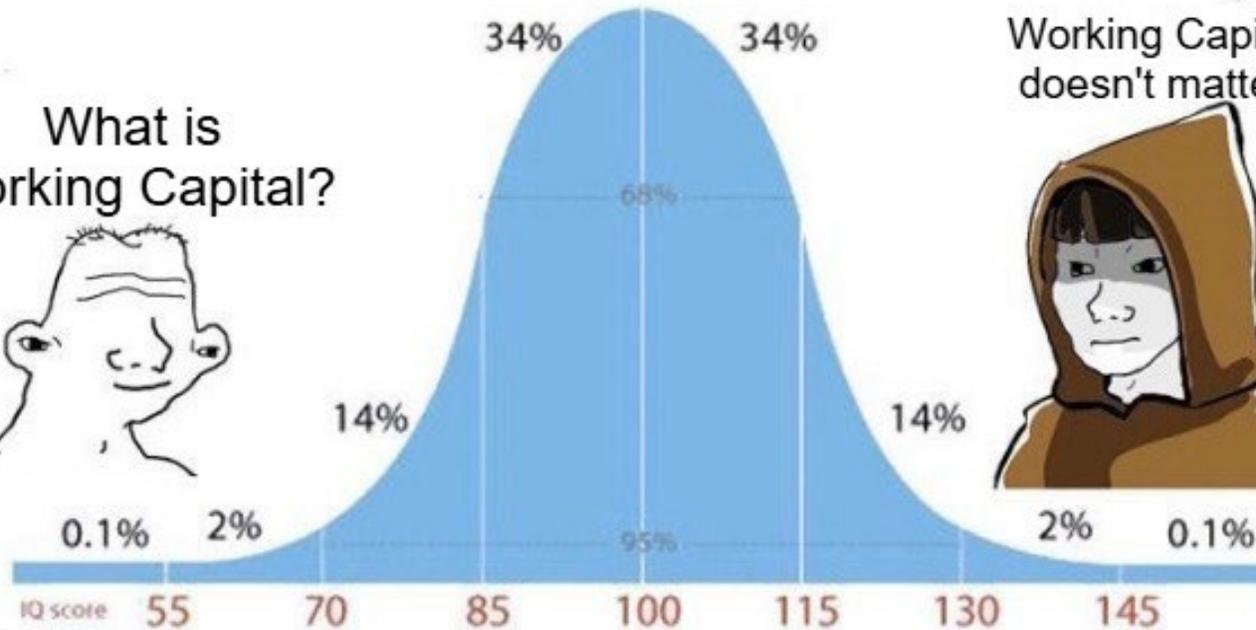
Negative Working Capital could be good or bad...



What is Working Capital?



Working Capital doesn't matter.



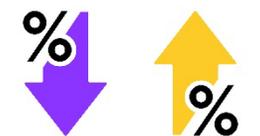
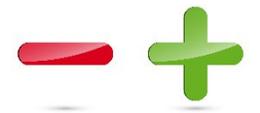
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Negative Working Capital: Outline

- **Part 1:** Dollar Tree vs. Walmart Comparison **4:35**
- **Part 2:** Positive and Negative Working Capital Examples **7:53**
- **Part 3:** OK, But *Can* Negative Working Capital Ever Matter? **12:05**

Part 1: Dollar Tree vs. Walmart

- **DEFINITIONS:** We tend to go by the Cash Flow Statement to determine *what's in* Working Capital, with minor adjustments
- **EX:** Lease Assets/Liabilities should not be counted because they're longer-term and unrelated to day-to-day cash flows
- **Signs:** Dollar Tree has positive Working Capital, while Walmart has negative Working Capital... but so what?
- **Walmart:** 35x the revenue of Dollar Tree with higher ROE/ROA/ROIC, a positive Change in WC, and **not** divesting a business segment (Family Dollar) currently



Part 1: Dollar Tree vs. Walmart

- **Interpretation:** “Working Capital Bros” would say, “Walmart is managing its Working Capital better since its huge Accounts Payable increases indicate its pricing/negotiating power.”
- **Response:** OK, but so what? That’s already evident from its **size**, growth rates, and returns metrics



Part 2: Positive/Negative WC Examples

- **Salesforce [CRM]:** Negative Working Capital due to its business model – subscription software with some upfront cash collection



- **BUT:** The Change in Working Capital is “mixed” (i.e., barely positive or negative), which far matters for valuation purposes!



- **Illinois Tool Works [ITW]:** Positive Working Capital and a mixed/negative Change in Working Capital



- **Why:** Industry norms for manufacturing companies with enterprise clients; nothing unusual here



Part 2: Positive/Negative WC Examples

- **McDonald's [MCD]:** Frequently has negative Working Capital
- **Why:** Largely a **franchise company**, so its AR, Inventory, etc., are lower than expected since it does not directly own all its stores
- **But:** Its Change in WC is negative, so its “Working Capital management” results in a lower valuation!



Part 3: Does Negative WC *Ever* Matter?

- **Case #1: Stressed and Distressed Companies** – More significant because negative WC may indicate cash flow, collection, and supplier issues
- **Case #2: Small Businesses and Startups** – Could run into cash-flow issues, even with high growth, due to poor WC management (e.g., cash collection takes too long)
- **More Validity:** “Case #2” companies because negative Working Capital gives you *additional information*; WC isn’t the first place you’d look to find a stressed/distressed company

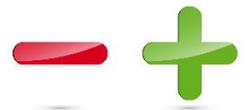


Recap and Summary

- **Part 1:** Dollar Tree vs. Walmart Comparison



- **Part 2:** Positive and Negative Working Capital Examples



- **Part 3:** OK, But *Can* Negative Working Capital Ever Matter?

