

AGGRESSIVE APPROACH

Panel B of Figure 16-1 illustrates the **aggressive approach** in which a firm finances some of its permanent assets with short-term debt. Note that we used the term "relatively" in the title for Panel B because there can be different *degrees* of aggressiveness. For example, the dashed line in Panel B could have been drawn *below* the line designating fixed assets, indicating that all the current assets—both permanent and temporary—and part of the fixed assets were financed with short-term credit. This policy would be highly aggressive, and the firm would be subject to dangers from loan renewal as well as rising interest rates.

The benefit to using short-term debt is overall lower interest rates since most of the time the yield curve is upward sloping. However, as many firms learned during the financial crisis of 2007, a strategy of financing long-term assets with short-term debt is really quite risky. As an illustration, suppose a company borrowed \$1 million on a 1-year basis and used the funds to buy machinery that would lower labor costs by \$200,000 per year for 10 years.¹ Cash flows from the equipment would not be sufficient to pay off the loan at the end of only 1 year, so the loan would have to be renewed. If the economy were in a recession like that of 2007, the lender might refuse to renew the loan, and that could lead to bankruptcy. Had the firm matched maturities and financed the equipment with a 10-year loan, then the annual loan payments would have been lower and better matched with the cash flows, and the loan renewal problem would not have arisen.

Under some circumstances, even maturity matching can be risky, as many firms that thought they were conservatively financed learned in 2007. If a firm borrowed on a 30-day bank loan to finance inventories that it expected to sell within 30 days but then sales dropped, as they did for many firms in 2007, the funds needed to pay off the maturing bank loan might not be available. If the bank would not extend the loan, then the firm could be forced into bankruptcy. This happened to many firms in 2009, and it was exacerbated by the banks' own problems. The banks lost billions on mortgages, mortgage-backed bonds, and other bad investments, which led them to restrict credit to their normal business customers in order to conserve their own cash.

CONSERVATIVE APPROACH

Panel C of the figure shows the **conservative approach**, with the dashed line *above* the line designating permanent current assets. In this approach, long-term capital is used to finance all permanent assets and also to meet some seasonal needs. The firm uses a small amount of short-term credit to meet its peak requirements, but it also meets a part of its seasonal needs by "storing liquidity" in the form of marketable securities. The humps above the dashed line represent short-term financings, while the troughs below the dashed line represent short-term security holdings. This conservative financing policy is fairly safe, and the wisdom of using it was demonstrated in 2007—when credit dried up, firms with adequate cash holdings were able to operate more effectively than those that were forced to cut back their operations because they couldn't order new inventories or pay their normal workforce.

CHOOSING AMONG THE APPROACHES

Because the yield curve is normally upward sloping, *the cost of short-term debt is generally lower than that of long-term debt. However, short-term debt is riskier for the borrowing firm for two reasons:* (1) If a firm borrows on a long-term basis, then its interest costs will

¹We are oversimplifying here. Few lenders would explicitly lend money for 1 year to finance a 10-year asset. What would actually happen is that the firm would borrow on a 1-year basis for "general corporate purposes" and then actually use the money to purchase the 10-year machinery.

be relatively stable over time, but if it uses short-term credit, then its interest expense can fluctuate widely—perhaps reaching such high levels that profits are extinguished.⁴ (2) If a firm borrows heavily on a short-term basis, then a temporary recession may drag down its financial ratios, causing a lender to choose not to renew a loan. In a weak financial position, the firm may not be able to find another lender and not be able to repay the loan, forcing it into bankruptcy. Had the debt been long-term, the company would not have faced having to renew the loan at the time.

On the plus side, *short-term loans can generally be negotiated much faster* than long-term loans. Lenders need to make a thorough financial examination before extending long-term credit, and the loan agreement must be spelled out in great detail because a lot can happen during the life of a 10- to 20-year loan.

Finally, *short-term debt generally offers greater flexibility*. If the firm thinks that interest rates are abnormally high and due for a decline, it may prefer short-term credit because prepayment penalties are often attached to long-term debt. Also, if its needs for funds are seasonal or cyclical, then the firm may not want to commit itself to long-term debt because of its underwriting costs and possible prepayment penalties. Finally, long-term loan agreements generally contain provisions, or *covenants*, that constrain the firm's future actions in order to protect the lender, whereas short-term credit agreements generally have fewer restrictions.

All things considered, it is not possible to state that either long term or short-term financing is generally better. The firm's specific conditions will affect its decision, as will the risk preferences of managers. Optimistic and/or aggressive managers will lean more toward short-term credit to gain an interest cost advantage, whereas more conservative managers will lean toward long-term financing to avoid potential renewal problems. The factors discussed here should be considered, but the final decision will reflect managers' personal preferences and subjective judgments.

SELF-TEST

Identify and explain three alternative current asset investment policies.

Use the DuPont equation to show how working capital policy can affect a firm's expected ROE.

What are the reasons for not wanting to hold too little working capital? For not wanting to hold too much?

Differentiate between permanent operating current assets and temporary operating current assets.

What does maturity matching mean, and what is the logic behind this policy?

What are some advantages and disadvantages of short-term versus long-term debt?

16-3 The Cash Conversion Cycle

All firms follow a "working capital cycle" in which they purchase or produce inventory, hold it for a time, and then sell it and receive cash. This process is known as the **cash conversion cycle (CCC)**.

⁴The prime interest rate—the rate banks charge very good customers—hit 21% in the early 1980s. This produced a level of business bankruptcies that was not seen again until 2009. The primary reason for the very high interest rate was that the inflation rate was up to 13%, and high inflation must be compensated by high interest rates. Also, the Federal Reserve was tightening credit in order to hold down inflation, and it was encouraging banks to restrict their lending.