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Why does Warren Buffett rely heavily on Net Working Capital analysis as his principal method of valuing businesses? Do you agree? Warren Buffet is influenced by Benjamin Graham, the famous Investment Advisor in 1930's . 1From Graham, Buffett learned the margin of safety approach -that is, use strict quantitative guidelines to buy shares in companies that are selling for less than their Net Working Capital. The Idea is that in case of liquidation (closure of the company) Investor of the company would at least get back money to the extent of NWC. Thus buffet would be interested in those companies whose Market value is less than its NWC by certain margin percentage (the prevailing rate of Government bonds).

What is meant by Net Working Capital? Net Working Capital (NWC) is Current Assets minus Current Liabilities. Current Assets include Cash and Cash Equivalents, Receivables, Inventory and other current Assets. Current Liabilities include all Short Term Borrowings. Net working Capital is also defined as that part of Current Assets that is financed by Long term Funds. This definition of the NWC is useful for the analysis of the trade-off between Profitability and risk. The Greater the amount of NWC, the greater is the liquidity of the business, lesser the risk. Thus, if the company's goal is increasing profitability, it can be achieved by increasing risk, which again is measured by the lower level of Net Working Capital. The important elements of decision making during the process of purchase of a business are Profitability and Risk. Both these elements can be analyzed using Net Working Capital. Net Working Capital can be improved by infusing new funds in to the business in terms of Capital or long term finance. Similarly, NWC can be deteriorated by purchase of Long Term Assets. Any increase in

Current Assets of the company which has a corresponding increase in current liabilities would not effect the NWC of the company.

The value of the business is determined by its intrinsic value. Intrinsic value of a business can be determined by Long term Assets minus Long term Liabilities. The other way of measuring the intrinsic value of the business is Current Assets minus Current Liabilities, which is measured by Net Working Capital.

2In a net-net situation, an investor estimates a liquidation value for a company, then tries to pay a fraction of that value in the market. Ben Graham loved these types of situations, defining the net-net value as:

Cash and short-term investments + (0. 75 * accounts receivable) + (0. 5 * inventory) - total liabilities

Graham would invest in companies which are available at a price which is two-thirds of the NWC of the company, the one-third portion is the margin of safety which would protect the investor against un-predictable circumstances

The operating efficiency of a company can be known by comparing the NWC of the company from one period with another. Thus if a company’s funds are lying in Inventory and Receivables for a longer period of time, it would result in increase in NWC, which indicates that the operational efficiency of the company has decreased.

Net Working capital Analysis is a very effective tool in valuing a business. Even lenders of a business would conduct Net Working capital Analysis to determine the liquidity, profitability and risk perception of the company.

Although, Warren Buffet is dependant on the Net Working Capital Analysis

for valuation of business, he also conducts various other financial and non-financial study of the company before he reaches the decision to buy the company. Thus, Warren buffet uses Net Working capital analysis heavily for arriving at the value of the business and not for making the decision to invest or not in a business.

Bibliography:

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