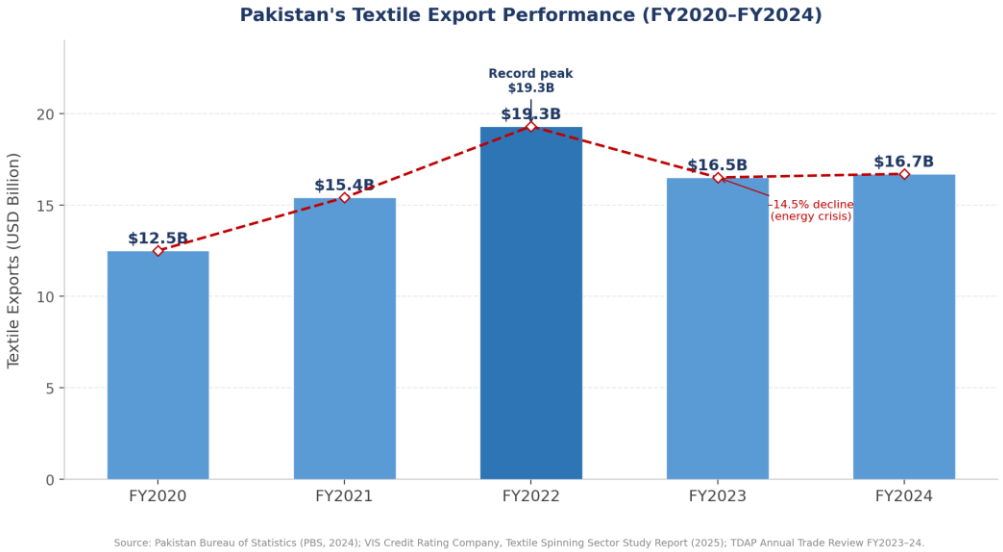
CHAPTER I
INTRODUCTION

1.1. Background of the Study

Working capital management (WCM) is a fundamental facet of corporate finance, critical for ensuring the short-term operational viability and long-term financial health of a firm. The textile industry remains the cornerstone of Pakistan's economy and its largest export-generating sector. The industry contributes approximately 8.5% to Pakistan's GDP, accounts for 46% of overall manufacturing, employs 40% of the industrial labor force, and generates over 60% of national export earnings. With around 13.4 million installed spindles, Pakistan ranks as the third-largest spinning base in Asia, producing 2.5 million metric tons of yarn in FY2024.

In terms of export performance, the sector experienced significant volatility during FY2020–FY2024. In FY2021–22, Pakistan's total textile exports reached a record high of $19.3 billion, which subsequently declined to $16.51 billion in FY2022–23, before recovering slightly to $16.68 billion in FY2023–24. The Nation Pakistan is the 12th largest exporter of textiles globally, with an export value of $16.69 billion recorded in FY2024. Nipa Peshawar These fluctuations were driven by the post-COVID demand surge of FY2021–22, followed by the severe macroeconomic pressures of FY2022–24, including energy shortages, currency depreciation, and constrained access to working capital financing. The energy and foreign exchange crises resulted in an estimated 700,000 job losses in the textile industry in 2023 alone.

Figure 1.1: Pakistan's Textile Export Performance (FY2020–2024)



Source: Pakistan Bureau of Statistics (PBS, 2024); VIS Credit Rating Company, Textile Spinning Sector Study Report (2025); TDAP Annual Trade Review FY2023–24 (https://tdap.gov.pk). All values in USD billion.

Textile exports peaked at a record $19.3 billion in FY2022 driven by post-pandemic global demand, before declining 14.5% to $16.5 billion in FY2023 due to energy shortages, currency depreciation, and constrained working capital access. A marginal recovery to $16.7 billion was recorded in FY2024, with Pakistan ranked as the 12th largest textile exporter globally.

Figure 1.3 contextualizes the export environment within which the sampled firms operated. The record export performance of FY2022 ($19.3 billion) created working capital pressures as firms extended trade credit to international buyers and held elevated inventory stocks to meet demand. The subsequent 14.5% decline to $16.5 billion in FY2023 reversed these dynamics, reducing receivables inflows, increasing financing dependence, and compressing profit margins. This trajectory confirms that fluctuations in export demand directly amplify or dampen the efficiency of working capital management, providing the macroeconomic context necessary to interpret the empirical findings reported in Chapter IV.

Corporate finance is a critical function for commercial organizations (Kanwal et al., 2014). It involves the meticulous administration of current assets and liabilities to maintain an optimal balance between liquidity and profitability (Olunuga, 2022)

Efficient WCM ensures that a company possesses sufficient liquid resources to meet its maturing obligations while avoiding the costly over-investment in nonearning assets (Zhira et al., 2025). In the context of Pakistan, the textile industry stands as the cornerstone of the manufacturing sector, contributing over 60% to the country's total exports and employing a significant portion of the industrial workforce (Statistics et al., 2023). However, this sector operates in a challenging environment characterized by intense global competition, volatile raw material prices, energy shortages, and fluctuating demand (Huynh et al., 2025). These conditions render the efficient management of working capital encompassing inventory, receivables, and payables not merely an operational task but a strategic imperative for survival and growth. The delicate interplay between maintaining liquidity to buffer against shocks and maximizing returns on assets makes WCM a pivotal area of study for textile firms (Rahmiyati et al., 2024).

According to (Nimalathasan et al., 2013), any company's primary goal is to increase the value and earnings of its shareholders, but maintaining a suitable liquidity position is also crucial. Thus, a trade-off between risk and return is necessary to achieve these two goals. The risk of illiquidity is decreased when businesses choose to invest more in current assets, but profitability suffers since the excess investment in current assets prevents the businesses from making more money. On the other hand, bankruptcy could occur if the companies fail to preserve liquidity. These figures emphasize how crucial effective working capital management is. In Pakistan's economy, enterprises fund themselves in four ways: (i) Obtaining bank loans, (ii) issuing shares, (iii) issuing bonds or debentures, and (iv) Retaining earnings. Firms take bank loans to meet their working capital requirements, whereas the other choices are employed when medium to long-term financing is required. So, economic factors play an important part in making these selections. Furthermore, the success of the Pakistani economy is dependent on enterprises functioning in a variety of industries. They provide significant money to the government as well as job opportunities. Despite its paramount importance, the management of working capital in Pakistan's leading textile firms presents a complex challenge (Jalil et al., 2024).

Many firms struggle to strike an optimal balance, often exhibiting tendencies towards either aggressive or conservative working capital policies (Sulastri1 et al., 2023). An aggressive policy, minimizing investment in current assets, may heighten liquidity risk and disrupt production cycles. Conversely, a conservative policy, while ensuring liquidity, can lead to suboptimal returns on capital by tying up funds in idle inventory or lenient credit terms (Chang et al., 2025). This misalignment can directly erode profitability, measured through key indicators like Return on Assets (ROA) and Net Operating Profitability (NOP). Preliminary observations suggest that inefficiencies in inventory holding periods, receivables collection, and payables deferment are prevalent, yet the precise nature and magnitude of their impact on the profitability of leading, publicly listed textile firms in Pakistan remain inadequately explored (Lala Rukh et al., 2023).

The main objectives of working capital management are to reduce capital committed to working capital, maximize investments in current assets, and minimize current liabilities to boost return on capital utilized. In 2013, (Sandhar et al.,) Share offers, borrowing, and other company operations are the main sources of liquid cash, which is mostly represented as working capital. These funds are used to purchase raw materials and fixed assets in addition to paying creditors. Effective working capital management is critical to a company's growth and sustainability since it influences profitability. Working capital management consists mostly of inventory levels, accounts payable, accounts receivable, and the cash conversion cycle. The cash conversion cycle is a popular indication of working capital management, indicating the net length of time that passes between a company's real cash outlays for resource acquisition and its final cash recovery from product sales (Laughlin et al., 1980).

In the context of the study on Pakistani textile enterprises, the Cash Conversion Cycle (CCC) concept refers to the essential time interval between cash outflows for raw material payments and cash inflows from customer collections, functioning as a primary parameter of working capital efficiency (Yasir et al., 2014). The study specifically looks at how a shorter CCC—achieved by cutting down on inventory days, shortening the time it takes to collect accounts receivable,

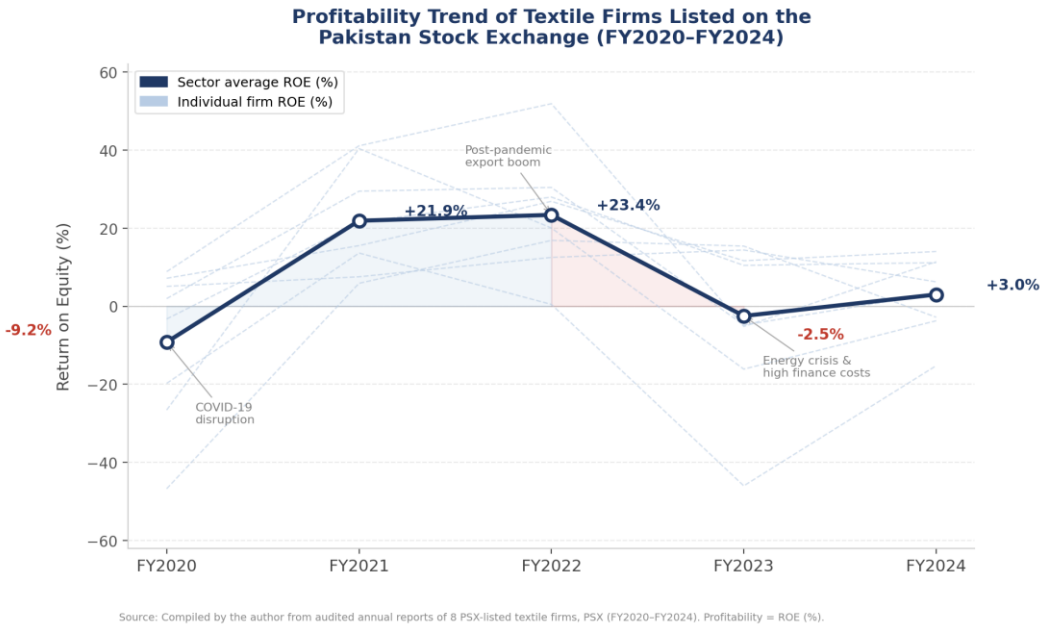
and maximizing payable deferrals directly improves profitability by releasing trapped liquidity, cutting financing costs, and lowering operational risks.

In Pakistan's capital-intensive textile sector, where firms frequently face volatile demand and tight cash flows, the findings typically reveal that aggressively managing the CCC is a strategic imperative: firms with shorter cycles demonstrate higher return on assets and net margins, as efficient working capital management reduces the need for expensive short-term borrowing and increases operational agility. Thus, the CCC emerges not only as an operational parameter, but also as a critical determinant of financial health, with deliberate compression driving profitability in a competitive and cyclical market (Kukeli et al., 2025).

The cited study on Pakistani textile companies, the term "cash effect of inventory turnover period" (ITP) refers to the crucial finding that an excessively long ITP a sign of slow-moving inventory creates a severe liquidity drain, effectively "locking up" cash in idle stock and thereby negatively impacting profitability (Bank, 2021). As the ITP lengthens, businesses must rely on expensive external borrowing to support operations, which reduces net profit margins, exposes them to obsolescence risks in a fashion-sensitive industry, and increases holding costs (Chatterjee, 2019). On the other hand, a shorter, optimized ITP has been demonstrated to function as a cash generating mechanism, increasing operating efficiency, lowering financing costs, and freeing up working capital all of which immediately increase profitability. Pakistan’s textile sector contributes about 60% of national exports and nearly 8–9% of GDP while employing around 40% of the industrial labor force. However, textile firms face serious operational problems including energy shortages, high borrowing costs, fluctuating cotton prices, delayed receivables from international buyers, and inefficient inventory management (Amad et al., 2024). These issues directly affect working capital components such as inventory turnover period, accounts receivable, and cash conversion cycle. Poor working capital practices increase financing costs and reduce profitability indicators such as Return on Assets (ROA) (Iqbal et al., 2024). Therefore, analyzing working capital management and its impact on profitability is critical for textile firms listed on the Pakistan Stock Exchange (PSX).

Recent financial reports show that profitability across textile firms fluctuates due to working capital pressures. For example, several leading textile firms reported ROA levels between 3% and 9% during the period 2020–2024. Rising input costs, export market volatility, and delayed receivables increased reliance on short-term borrowing, which directly affects profitability. These statistics strengthen the justification for examining working capital management in the Pakistani textile sector (Malik & Javeria, 2025).

Figure 1.2: Profitability Trend of PSX-Listed Textile Firms (FY2020–2024)



Source: Compiled by the author from audited annual reports of 8 PSX-listed textile firms (Masood Textile Mills, Nishat Mills, Nishat Chunian, Sapphire Textile Mills, Ghazi Fabrics, Shams Textile Mills, Pakistan Textile Mills, Gul Ahmed TM), PSX FY2020–2024. Profitability = ROA (%).

The sector average ROA plunged to −9.2% in FY2020 (COVID-19), surged to a peak of +23.4% in FY2022 (post-pandemic export boom), then collapsed to −2.5% in FY2023 due to energy crisis and high finance costs, recovering modestly to +3.0% in FY2024. Intra-sector dispersion ranged from −46.8% to +51.9%, underscoring heterogeneity in working capital practices.

Figure 1.2 illustrates the profitability trajectory of the eight sampled PSX-listed textile firms over FY2020–FY2024. Several critical patterns emerge. First, the sector average ROA declined to **−9.2%** in FY2020, reflecting the severe

demand shock attributable to the COVID-19 pandemic. Second, a sharp recovery ensued during FY2021–FY2022, with the sector average rising to a record **+23.4%**, driven by the post-pandemic global demand surge. Third, profitability deteriorated sharply in FY2023 to **−2.5%** as rising energy tariffs, a 22% State Bank of Pakistan policy rate, and the 2022 flood-induced cotton supply shock compounded financing costs (Business Recorder, 2023; Mettis Global, 2024). Only a modest recovery to **+3.0%** was recorded in FY2024. The extreme intra-sector dispersion visible in Figure 1.2—ranging from −46.8% to +51.9%—underscores the heterogeneity in working capital management practices across firms and reinforces the motivation for this study's empirical investigation of the working capital–profitability nexus.

Thus, the "cash paradox" emphasizes ITP's dual role: over time, it is a cash trap that damages financial health, but when managed properly, it becomes a critical engine of cash flow and profit in the capital-intensive textile sector (Hung et al., 2022).

In the study "Working Capital Management and Its Impact on Profitability: Evidence from Leading Textile Firms in Pakistan," the Cash Effect of Firm Size refers to the observed empirical relationship in which larger textile firms accumulate and hold significantly more cash and liquid assets than their smaller counterparts (Ali1 et al., 2016). This phenomenon is fueled by several factors inherent in the Pakistani textile sector, including larger firms' greater access to capital markets, their ability to generate significant internal cash flows from economies of scale, and their strategic need to maintain a financial buffer against sector-specific volatility in raw material costs, energy shortages, and fluctuating export demand (Asif et al., 2025). As a result, while this strong liquidity position improves financial stability and ensures the fulfillment of large-scale operational obligations, the study critically examines its impact on profitability, frequently discovering that excessive cash holdings can lead to suboptimal asset utilization and lower returns on investment if not managed dynamically within the larger working capital strategy (Sanga et al., 2025).

While many studies examine the direct link between working capital management (WCM) and profitability, there is a significant research gap

concerning the mediating role of firm liquidity, especially within Pakistan's textile sector (Sultan et al., 2020; Al-Haddad et al., 2024). Traditional research often overlooks how WCM components, such as the cash conversion cycle (CCC), first alter a firm's liquidity position before translating into financial performance (Ahmeti & Elshani, 2024). This study addresses this gap by utilizing recent financial data (2015–2024) from textile firms listed on the Pakistan Stock Exchange (PSX), a sector where efficient liquidity management is critical due to high operational costs and volatile market conditions (Tasrim et al., 2024).

According to the stated study on Pakistani textile companies, the "Cash Reality of Profitability" is the critical discovery that a company's formal profitability metrics, such as Return on Equity (ROE) and Return on Assets (ROA), are directly boosted by its cash conversion efficiency, or simply how well working capital is managed to produce liquid cash (Farhan, 2025). The research demonstrates that better working capital management (WCM) boosts operational cash flows without necessarily increasing sales or assets by reducing idle resources and accelerating cash inflows through improved inventory, receivables, and payments cycles. By increasing the numerator (profit) and/or optimizing the denominator (assets), higher cash liquidity reduces reliance on external finance, lowers interest costs, and improves asset utilization, all of which raise ROA. Simultaneously, higher earnings and lower debt boost ROE (net income/equity) by increasing shareholder returns (Salsabila, et al.2024). Thus, the "cash phenomenon" emphasizes the fundamental mechanism by which aggressive yet efficient WCM acts as a lever, converting operational liquidity into superior accounting profitability, which is critical for capital-intensive industries like textiles, where cash flow cycles are inherently tight (Masry et al., 2024).

This study aims to deeply examine the intricate relationship between working capital management (WCM) practices and corporate profitability within the context of Pakistan's vital textile industry, with the goal of determining how efficiently managing short-term assets and liabilities—such as inventory, receivables, and payables affects the financial performance and bottom-line returns of leading firms in the sector. By empirically investigating this relationship, the research serves the

dual purpose of providing actionable, evidence-based insights for financial managers to optimize their working capital policies thereby enhancing liquidity and operational efficiency without sacrificing profitability and contributing to the broader academic and industrial understanding of effective financial management in an emerging economy characterized by specific market volatilities and capital constraints. Finally, by providing strategic advice, the findings aim to assist these important companies in navigating economic problems, enhancing their competitiveness, and achieving sustainable growth through prudent financial management.

1.2 Research Questions

1. Is there a significant relationship between Cash Conversion Cycle (CCC) and profitability (ROA) in textile firms listed on PSX?
2. Is there a significant relationship between Inventory Turnover (ITO) and profitability (ROA) in textile firms?
3. Is there a significant relationship between firm liquidity (Current Ratio) and profitability (ROA)?
4. Does firm liquidity (Current Ratio) mediate the relationship between working capital management variables (CCC and ITO) and profitability (ROA)?

1.3 Research Objectives

1. To examine the relationship between Cash Conversion Cycle (CCC) and profitability (ROA) in textile firms listed on PSX.
2. To analyze the relationship between Inventory Turnover (ITO) and profitability (ROA).
3. To determine the effect of firm liquidity (Current Ratio) on profitability (ROA).
4. To evaluate the mediating role of firm liquidity (Current Ratio) in the relationship between working capital management variables (CCC and ITO) and profitability (ROA).

1.4 Research Purpose

The purpose of this study is to investigate how working capital indicators influence profitability in textile firms operating under similar economic conditions. By comparing multiple firms rather than focusing on a single case, this research aims to provide a broader understanding of how differences in management approach, production structure and operational integration influence financial outcomes. The study also aims to help decision-makers understand how improving specific working capital components may lead to better liquidity and higher Profitability.

1.5 Benefits of research

It is expected that this study will have the following benefits:

1. Theoretical Support

This study contributes to theoretical knowledge in the following ways:

1) Empirically tests core theories — including the Trade-Off Theory and the Cash Conversion Cycle (CCC) model — in the specific context of Pakistan's textile sector, an emerging economy facing distinct macroeconomic challenges such as inflation, currency volatility, and energy crises
2) Determines whether universally taught financial models hold true in this context or whether sector-specific circumstances demand theoretical adjustments
3) Bridges the gap between general finance theory and sector-specific application in a developing country
4) Provides a nuanced theoretical framework that accounts for industry- and country-specific variables influencing the working capital–profitability nexus

2. Practical Aspects

a) For Companies

1) Uncovers industry best practices and inefficient areas by studying working capital components (inventory, receivables, and payables) of leading PSX-listed textile firms

2) Enables companies to benchmark their performance against top peers on key questions:
    - Is inventory too high, resulting in excessive carrying costs?
    - Is the credit policy too lenient, leading to costly receivables accumulation?
    - Is supplier credit being utilized optimally?
3) Provides evidence-based guidance to help managers reduce the Cash Conversion Cycle, releasing trapped cash and lowering reliance on costly short-term borrowing
4) Directly supports improvements in profitability and liquidity — critical for survival in a capital-intensive sector with thin margins

b) For Academic Institutions

1) Provides current, locally relevant case studies and empirical findings that can be incorporated into business and finance curricula in Pakistan and comparable emerging economies
2) Converts abstract textbook concepts into concrete examples drawn from a significant domestic industry, improving learning outcomes and student engagement
3) Enables executive education programs to develop customized working capital management modules tailored to the textile and manufacturing sectors
4) Identifies important research gaps, guiding academics and students toward pertinent and significant future research questions
5) Strengthens the institution's role as a center for the generation of applied, industry-relevant knowledge

c) For Scholars

1) Provides a robust analytical framework — including financial ratio analysis and panel data regression models — that can be replicated or adapted for other industries (e.g., cement, pharmaceuticals) or other emerging economies

2) Highlights detected gaps and unexpected outcomes that serve as springboards for future research, including:
    - Long-term consequences of working capital management decisions
    - The influence of macroeconomic policy changes on working capital efficiency
    - Cross-country comparative studies
3) Offers a reliable reference dataset and established findings, saving future researchers time in literature review and methodological development
4) Accelerates the pace of academic discovery in corporate finance research within developing economy contexts