Manage cash, manage change

MARTIN O'DONOVAN EXPLAINS HOW CASH MANAGEMENT IS INTIMATELY CONNECTED WITH CORPORATE SURVIVAL, CHANGE AND TRANSFORMATION.

In the aftermath of the financial crisis there are still benefits in looking back at the bigger picture in order to learn lessons before launching into the details and specifics of everything that comes under the broad heading of cash management. This was the view taken by David Swann, former BAT group treasurer, in opening the ACT's annual Cash Management Conference. The crisis has helped companies concentrate on what are or will be their main areas of focus. While in the past debt raising was equity's poor relation and simply taken for granted, now it is viewed more on a par by the board. Funding conditions are returning to normal but pressures remain for small and medium-sized enterprises (SMEs) and, of course, Basel III will be adding to the pressures for all.

Managing bank relationships is well worth the effort. Banks are less tolerant of "jam tomorrow", so improved visibility, control and management of those relations are in order. A renewed focus on counterparty risk is an obvious by-product of the crisis but many companies remain unsophisticated in this respect. The delegate survey showed that credit ratings are used for assessing counterparty risk by 55%, and 31% use a mix of ratings, CDS (credit default swap) pricing, internal or external credit analysis (see box opposite).

As ever, accurate cash forecasts are much sought after but tricky to achieve. For Swann, less can be more here. He believes an understanding of the dynamics of the business is far more important. So in looking at the key focus now, it comes down to positioning the treasury for the longer term:

- diversify funding;
- take ownership of banking relationships;
- invest in managing credit risk;
- implement pragmatic cash forecasting; and
- nurture the company's long-term memory.

WHERE MONEY'S TIGHT

If you are looking for good practice in cash management it pays to go to a company that does not have the luxury of being slack in any way. If the company financial structure is stretched to the limit, it simply has to run a tight ship in terms of cash just to survive. Paul Johns is director of treasury and tax at Impress, which is in just such a position and rated well down among the high-yield (the polite term for junk) bond range, with B1/B+ ratings. Impress is in the metal packaging business and has factories in 21 countries. It is highly profitable but private equity owned; as a result, it is heavily geared and forced to operate under financial covenants and constraints by its lenders. The company even discovered that a downgrade of its cash management bank put it below limits set by the lenders. The general principle for cash management at Impress is for centralised control but with decentralised management running three pools – for North America, Europe and Australasia. It has centralised supplier payments and multinational clients settling centrally to channel cash to the centre.

In 2009/10 Impress embarked on a new European cash management project, prompted by its existing French bank's reduced willingness to take a credit exposure to the group, culminating in the bank's complete withdrawal. Request for proposals (RFPs) were issued to six banks, with many points of principle emerging from the process. The key ones were that banks felt uncomfortable shouldering the risk of large credit exposures on their own but appreciated the potential for growth in business awarded. With the help of an independent project manager, Impress achieved its goal while vowing never to end up being so reliant on a single bank again.

ON TRACK

Treasury management in any company constantly evolves but always with a starting point based on some legacy arrangement for funding and liquidity management. Transport for London is trying to build private sector practices on the foundations of a public sector body that is officially a "local authority" for various statutory and regulatory purposes. TfL's power to borrow derives from the Local Government Act 2003 and is restricted to borrowing for capital purposes. It is mainly sourced from the Public Works Loan Board, but has moved to direct market borrowing too. It has a public rating of AA+/Aa1/AA to maintain and an impetus to make the company more financially responsible.

A minimum cash buffer of £250m is held for liquidity purposes – the business is vulnerable to market dislocation or terrorist attack. Cash has to be invested in accordance with the CIPFA prudential code, which prioritises security and liquidity over yield. Hence TfL has a portfolio of government gilts or bills, AAA money market funds and deposits with clearing banks.

While TfL's funding and liquidity has a public sector flavour, the business itself is working hard to move from an activity-based culture to a cash-based culture. Prior to 2009 the business plan had little focus on the accuracy and timing of intra-year cash movements; indeed, cashflow implications were considered only after the business plan had been agreed. In 2009 the emphasis changed so that activity was phased around the cash pinch-points in the plan. Now, a fundamental organisational review is addressing the need to improve cash management and forecasting throughout the organisation including the introduction of a 12-week rolling forecast. The aim is to identify regular fixed costs and to understand the underlying drivers such as delays in capital expenditure and the impact of the wider economy on changes in revenues.

THE RESULT IN RECENT MONTHS HAS BEEN AN ASTOUNDING AVERAGE OF OVER €600M SQUEEZED OUT OF THE SYSTEM.

MULTI-CURRENCY POOLING

For companies that enjoy ample funding at low rates it may simply not be worth the time and effort of building a sophisticated cash pooling system. A periodic sweep to minimise build-up of cash and overdraft may be enough. Any inefficiency can be measured by the difference in interest rates between cash and overdrafts in accounts around the world plus the cost of a central funding facility. Wolseley was one such company except that it ran a separate pool for each country and there was a six-monthly rebalancing at group level. The annual commitment fee on its main facility was just 6bps. But the world changed and the company's commitment fee is now 95bps a year.

Seeing the approach of the downturn, the company's treasury was charged with generating £100m of liquidity internally. So the search was on for a good multinational pooling system but with the objective of not disturbing the local banking arrangements. The solution reached was a two-pool system operated by Bank Mendes Gans (BMG). One pool was in euros, the other in US dollars, in the form of an overlay structure. Each country set up just one new local currency account with BMG, and the bank created a cross-currency pool using the European Central Bank (ECB) daily

The cash survey

Conference delegates were asked a series of questions about their cash management and general policies and used instant voting pads to record their responses.

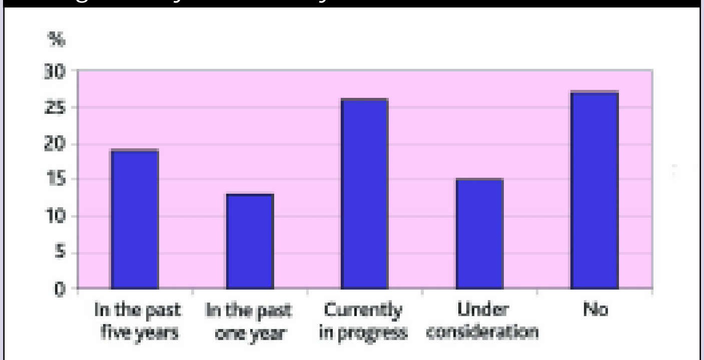
Credit risk was uppermost in minds during the financial crisis but, with conditions returning towards normal, had attitudes changed permanently or were treasurers' concerns abating?

The structure of the banking sector is up for review at the moment but maintaining banking stability was deemed most important by 80% as opposed to specific policy matters of increased bank competition or breaking up retail and investment banking.

For surplus cash, 41% favoured using money market funds and 49% preferred bank deposits – still a fairly even split. Surprisingly only 86% of delegates had an investment policy for cash in place, the remainder either not having one or currently working on it. With security of cash so crucial, one might have hoped for 100% coverage. The delegates did regard cash visibility as important, with 60% saying that for them cash visibility was up compared with last year; 36% thought it was the same while the balance thought it had decreased.

Compared to last year 26% had increased their counterparty credit limits; 28% had decreased them and 46% had kept them unchanged.

Has your company installed or updated its treasury management system recently?



currency rates, with the balance funded by or invested by Wolseley. The parent guarantees all participants and each participant guarantees the parent, which minimises the cross-guarantees and makes it easier to add subsidiaries to the system. Austria is an exception, with governance and financial assistance problems resolved by keeping Austria as a net borrower.

The result in recent months has been an astounding average of over €600m squeezed out of the system. At current levels of spread and fees, the savings come to approximately 3% of internally generated liquidity. So once again the financial crisis has prompted and made worthwhile some routine good housekeeping.

SEVEN OF THE TOP 10 BARRIERS TO SUCCESSFUL SYSTEMS IMPLEMENTATION ARE HUMAN FACTORS.

CONCENTRATING THE MIND

In very many companies the financial crisis served to concentrate minds on cash and working capital management. Those prepared to make the effort, like Wolseley, have reaped enormous benefits. In other businesses, particularly those that have evolved through merger and acquisition (M&A), groups have become complex and diversified. The challenge for the treasurer is to maintain effective and appropriate controls over uses of capital while still supporting this M&A activity – including the execution of the M&A strategy – and the subsequent integration challenges. Hewlett-Packard is a good example. Jonathan Traer-Clark, director of EMEA treasury, has had to look at adding value through enhancing cashflow while dealing with the question of how to manage multiple stakeholders.

To bring together the overlapping work of the global business units – such as credit and collections, sales, global supply chain and procurement, the financial controller function and treasury itself – the concept of a working capital council took shape. The council's executive team, which includes representatives from business units, sets working capital strategy, prioritises initiatives, aligns resources and is supported by a team led by the treasury department.

The key metric used to focus minds is the cash conversion cycle, a measure defined as:

days sales outstanding (DSO) + days of inventory (DOI) – days payable outstanding (DPO)

The economic value of one day's improvement is an amount that HP aims to imprint into minds and hearts to counter the typical barriers from those who see this as a purely finance job. There is the danger that staff do not understand the big picture and fail to see the relevance of working capital control. But with suitable effort and the backing of the council it has proved possible to change staff culture and behaviour, improve performance and to make the working capital requirements of the company relevant. With strong senior support and emphasis it is possible to make a difference. Already over 4,000 people in HP have been directly touched by the work of the council.

THE REAL PRIZE

By this stage of the conference it was becoming clear that there are some very real prizes to be gained from working capital and cash control. To realise these in any organisation it is essential to involve the business units and to create a wide cross-functional team. With the next speaker, Tom Milligan, group treasurer of BMI, that message was repeated but in the context of cash forecasting this time.

The conference speakers

Peter Matza, head of publishing, ACT (chair)
Andrea Bowcott, head of group cash management, TUI Travel
Olivier Brissaud, MD, Volkswagen Group Services
Stuart Clarke, group treasurer, Fujitsu
Lai Wah Co, head of economic analysis, CBI
Harcus Copper, senior product manager, corporate payments and collections, cash and trade, Barclays Corporate
Simon Crown, partner, Clifford Chance
Royston Da Costa, assistant treasurer, Wolseley
Nick Dadswell, director, global business services, Invensys
Alex Fiott, treasury manager – market risk, AstraZeneca
Phil John, EMEA treasury director, Mars Nederland
Paul Johns, director, treasury and tax, Impress Group
Simon Kilonback, group treasurer, Transport for London
David Manson, head of liquidity management, Barclays Corporate
Tom Milligan, group treasurer, BMI
Martin O'Donovan, assistant director, policy and technical, ACT
David Swann, former group treasurer, BAT
Jonathon Traer-Clark, EMEA treasurer, Hewlett-Packard
Gerard Tyler, group treasurer, Severn Trent
Mike Verrier, group treasurer, Wolseley
Brian Welch, treasurer EMEAI, Valspar Corporation

Airlines are unusual in holding substantial cash balances, partly because they are required to do so by the regulator, the Civil Aviation Authority, and partly because of the extremely volatile nature of their business. But for BMI the cash pile has been run down and partially replaced by a revolving credit facility from its parent Lufthansa.

To improve BMI's cash forecasting the first step was to understand the business and key metrics: where cash comes from and the timings of receipts. Direct internet sales flow through quickly whereas agent sales or code share sales by other airlines take longer. The outflows include chunky amounts on aircraft and engine maintenance and, of course, the volatile fuel cost. Treasury had to educate the businesses on the importance of cash and engender an increased sensitivity to cash and at the same time communicate the needs of treasury. The basic cashflow model was a start, but a further objective was to create a flexible model so that sensitivity analyses could be overlaid to consider contingency planning and the impact of hedging activity. Finally, accuracy measurements and a continuous process improvement have been built in, comparing actuals to forecast and budget, and with regular reporting to the board.

NO HOLIDAY

Any improvements to cash and working capital management are complicated since there are so many parties involved and typically in different countries. Treasury cannot achieve its goals without the active help and involvement of the business units. For TUI Travel one might be excused for thinking the task was just too large. Formed through the merger of TUI and First Choice, TUI Travel has ended up with 3,400 bank accounts held at some 300 banks around the world. Some pooling of cash was happening but the real worry was a lack of visibility over the cash and investment position. Treasury had three systems for recording transactions, with the activity split between London and Hanover.

The initial priority was to improve visibility and group-wide reporting of cash; after that, making the best use of the cash would follow. Given the magnitude of the task and the worldwide distribution of accounts, a SWIFT solution was adopted. SWIFT (Society for Worldwide Interbank Financial Telecommunication) is owned by its member banks and at its most basic provides a secure financial messaging system. If every TUI group member could instruct its bank to report balances centrally via SWIFT, the consolidated cash would become visible to treasury. So began the mammoth task of gathering core information on every one of those 3,400 accounts – their IBANs and SWIFT codes, currency, their purpose, and pooling arrangements, if any. Each business had to instruct its local bank to report via SWIFT and at the same time central treasury was rationalising its treasury

management system (TMS). The result is that a daily report of worldwide cash can be created in 30 minutes.

From this informed position the next phase, which is ongoing, is to extend the proportion of cash that is pooled. Already non-pooled cash is down by 50%.The TUI case study shows the power of tapping into a tried and tested system that can be overlaid on the legacy banks and bank accounts. A perfect example for SWIFT connectivity.

ALL CHANGE

The vision for Mars Nederland was to target multi-currency notional pooling and its advice to the conference was to look to the people element. Treasury needed to go out and engage the businesses and, indeed, Mars brought in a dedicated presenter to help it do so. The project as a whole required top-level backing and a passion to create, share and own the vision. In the Mars case, the entire project from concept to completion has been spread over six or seven years, but the actual roll-out has been more concentrated.

The project team had to concentrate on the benefits for the business units and maintain clarity over the role of the units. Businesses were to remain responsible for timely payments and receipts but the cash management of cash balances was taken out of their hands. The team knew this would be a big deal for the units, which would resist change, and even fear it. Fear should be addressed early through open discussion of the issues and permitting units to talk to other business units that had already been through the process. Seven of the top 10 barriers to successful systems implementation are human factors such as inadequate sponsorship, unrealistic expectations or reluctance to change. To manage cash first, manage change.

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