Maximising the benefits from the euro

Andrew Smith of Diageo on the issues surrounding the removal of legacy currencies by 28 February 2002 and the impact the euro has had on the group.

Although the implications of euro conversion have been known for some time, it is only now with the withdrawal of legacy currencies between 1 January and 28 February 2002 that many companies are addressing the issues this change creates. The impact of the euro, both centrally and for operating subsidiaries, is wide ranging and research has shown that many companies have under-estimated the size and complexity of the conversion process.

Diageo's euro strategy

In Diageo, the planning for the introduction of the euro began immediately following the merger of Grandmet and Guinness in 1997. Diageo set up a centrally controlled project to review the impact of the euro both at a business unit level and centrally. Each business unit converting to the euro has a locally sponsored euro project team (to ensure local buy-in to the project) drawing on resources from finance, information technology, human resources, marketing, sales, legal and tax. This is complemented by a central co-ordination team. Communication has been essential throughout the project to ensure a consistent approach and to share learnings.

The final phase of the euro conversion strategy is now taking place with the transition of operating companies within the eurozone from legacy currency to euro as their functional currency. This will happen during the first half of 2001. The transition will have a number of implications for cash management.

The euro conversion project has run in parallel with a pan-European banking project, which encompassed cash management, operating company capital structures and business cash processes. This project resulted in a single cash management bank, Bank of America, being appointed in July 1998.

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The pan-European banking project ensured that the cash management benefits arising from the introduction of the euro were fully exploited.

The impact of the euro on cash management within Diageo, both since its introduction in January 1999, and as legacy currencies disappear, is in the following areas:

- centralised liquidity management;
- working capital funding;
- proactive capital structuring;
- access to in-country clearing;
- simplified intercompany balance structure;
- improved cashflow forecasting;
- automated banking interfaces;
- transaction hedging; and
- point of sale cash handling.

For a checklist of euro cash management issues and actions, see *Table 1*.

Centralised liquidity management

Prior to January 1999, Diageo managed legacy currency cash pools within each country. Because pooling across currency was not practical, each pool was managed individually. In many cases, the cash pool was with a different bank, as illustrated in *Figure 1a*.

The introduction of the euro has allowed all currencies within the eurozone to be pooled cross border to a central location. To maximise the advantage this created, a single pan-European cash management bank, Bank of America, has been used to replace local in-country bank relationships providing a simplified banking structure.

The centralisation of liquidity

DIAGEO

Diageo, the world-leading premium drinks company, has an outstanding portfolio of world famous global brands including Smirnoff, Johnnie Walker, J&B, Gordon's, Malibu, Baileys, Guinness and Tanqueray. Diageo was formed in December 1997 through the merger of GrandMet and Guinness.

In July 2000 Diageo announced its strategic intent to focus on growing its beverage alcohol business aided by the integration of its two drinks businesses United Distillers & Vintners and Guinness. In December 2000, Diageo and Pernod Ricard succeeded in a joint bid to acquire the spirits and wine business of The Seagram Company Ltd. ■

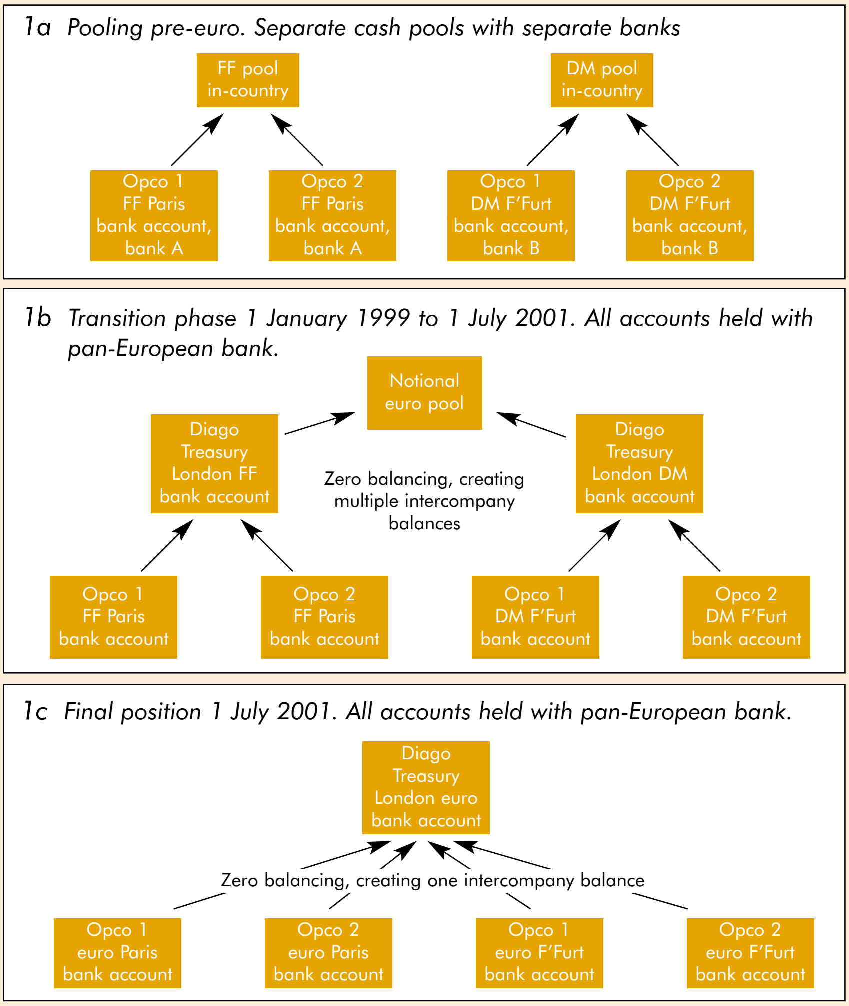
TABLE 1

Euro cash management checklist

Area	**Actions**
Liquidity management opportunities	Pool across eurozone Reduce number of cash pools Rationalise credit lines
Bank accounts	Determine whether existing account numbers can be maintained If not, plan early Inform customers and suppliers
Access to local clearing	In-country accounts must be maintained if there are significant volumes of receipts and payments in a country
Automated bank interfaces	Consider impact of rounding
Transaction hedging, convert legacy currency hedges to euro	Agree conversion date Obtain new settlement instructions and consider impact on intercompany accounts
Treasury processes, such as netting and factoring	Agree conversion date Obtain new settlement instructions
Cash handling	Familiarise staff with currency Install new cash handling/POS equipment
Simplify intercompany accounting	Consolidate legacy currency balances
Cash forecasting	Re-denominate systems to euro

FIGURE 1

Evolution of Diageo pooling structures



management has been achieved by the introduction of an automatic zero balancing cash pool structure. On a daily basis, funds are swept to and from operating company bank accounts. These bank accounts will remain denominated in legacy currency until operating companies change their functional currency to euro during 2001. The legacy currency zero balance pools are notionally pooled to create a single euro pool based in London (see *Figure 1b*). Zero balancing to a central location allows operating company surpluses and deficits across the eurozone to be netted at the group level.

When legacy currencies disappear in early 2002, euro bank accounts in each country will zero balance directly to an euro account based in London, as shown in *Figure 1c*.

Working capital funding

The zero balancing process described above creates an intercompany balance between an operating company and Diageo treasury. Effectively, the operating company bank account is replaced by an intercompany account. Working capital funding is provided by Diageo treasury at a lower cost than could be obtained via a local, external bank facility. This minimises euro funding costs and maximises the interest that can be earned on surplus balances. The process is fully automated. Zero balancing is initiated by the bank; the zero balancing transactions in the Diageo treasury bank account are uploaded into a treasury system via an interface with the bank. These transactions are then posted to an intercompany account with the operating company. The zero balancing structure is supported by an intercompany revolving credit agreement. These are currently denominated in legacy currency and will be re-denominated in euro as operating companies change functional currency.

Proactive capital structuring

The proactive monitoring of the intercompany accounts created by the zero balancing structure provides an early warning signal for future capital structuring issues. For example, the build up of a large positive balance triggering the payment of a dividend or a negative balance requiring further investigation which may result in an injection of equity or core debt.

Access to in-country clearing

Although the euro has provided the opportunity to rationalise the number of bank accounts a company maintains, some accounts must be retained, as outlined below.

Many Diageo operating companies make payments and receive funds in a number of countries within the euro-zone. Where this occurs, business units hold bank accounts in the country where these transactions take place. An in-country account will still be required to take advantage of making payments and receiving funds via the local low value/giro payment systems in each country. This also applies for cheque payments and collections, where holding an account outside the country of origin of the cheque can result in a substantial increase in cost and clearing time. Diageo will maintain this account structure until such time as true pan-European clearing systems are in place. Where operating companies have transactions in countries not in the euro, for example sterling, the operating company holds a bank account in that currency. All non-euro accounts are included in the same zero balancing structure described above, ensuring that all funds are managed in a single location.

Simplified intercompany balance structure

Where operating companies maintain bank accounts in a number of legacy currencies in different countries, the existing legacy currency zero balancing structure creates a separate intercompany account with Diageo treasury, as shown in *Figure 1b*.

By re-denominating bank accounts as euro the intercompany accounting structure can be simplified. A number of legacy currency intercompany balances for each operating company are replaced with one euro intercompany account (see *Figure 1c*).

Improved cashflow forecasting

Using a single pan-European cash management bank has enhanced short-term cashflow forecasting, in the euro and other currencies. The bank provides a five-day forward forecast of bank balances based on payments that have been sent to the bank for processing and receipts dated with a forward value. Effectively, all short-term euro cashflow information is consolidated by the bank and is based on definite cashflows. This provides accurate information upon which to base short-term liquidity decisions. Before the introduction of the euro, gathering this information would have been more complex, relying on information from a number of banks. Longer-term cashflow forecasts are submitted by operating companies to treasury.

> The removal of legacy currencies in December 2001 will provide further opportunities to simplify processes and provide further efficiencies

Automated bank interfaces

Where bank statement information is automatically downloaded into business accounting systems for posting and reconciliation, re-denominating an account as euro may prevent automatic reconciliation during the period between switching to euro and the phasing out of legacy currencies in early 2002.

This may arise when euro invoices are issued but the receiving customer has not yet converted to euro. The customer must convert the invoice back to legacy currency for processing. The invoice will be paid in legacy currency and the bank will then convert this to euro for credit to a Diageo bank account. The conversion by the customer from euro to legacy currency, and subsequent settlement in legacy currency, may create a difference between the euro amount recorded in Diageo systems and the euro amount actually received on settlement and therefore is likely to produce reconciliation errors. A possible solution during the transition period is to open a new euro account and phase the transition of customers paying by euro.

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Transaction hedging

Operating units are responsible for identifying and managing their own currency transaction exposures. These exposures are hedged centrally with group treasury.

Currently, hedging requirements are submitted by operating companies in legacy currency. Any existing legacy currency hedges maturing after 31 December 2001 must be converted to euro, and at an agreed date all new hedges will be undertaken in euro. After this date, operating company hedging procedures will be simplified by reducing the number of hedges required. The conversion process must be carefully co-ordinated to ensure that when hedging is switched to euro, settlement details via intercompany or bank account are also changed at the same time.

Point of sale cash handling

Diageo deals directly with consumers in its Burger King restaurants and Häagen-Dazs Cafes. Both businesses have implemented new point of sale systems, including cash handling equipment to accommodate euro requirements. Staff training is being planned to familiarise employees with euro notes and currency and anti-fraud procedures.

Making life simpler

Diageo has gained significant cash management benefits following the introduction of the euro. The achievement of these benefits was simplified by the introduction of a pan-European banking structure. The removal of legacy currencies in early 2002 will provide further opportunities to simplify processes and provide further efficiencies. ■

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