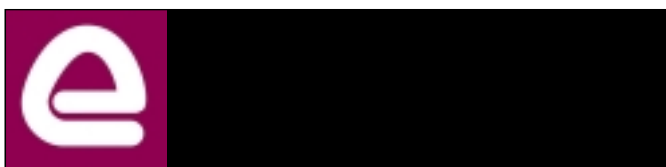




SETTING UP A SYSTEM WHEREBY THE COMPANY'S LIQUIDITY NEEDS COULD BE MANAGED CENTRALLY WAS MUCH TOUGHER THAN **GRAEME HANCOCK** OF ELECTROCOMPONENTS THOUGHT.

FOCUSING ON CASH MATTERS



Electrocomponents Plc is a major international distributor of electronic, electrical and industrial supplies. It consists of the RS group of companies (operating in 24 countries and serving more than 160 around the world through third-party distributors) and Allied Electronics (in the US and Canada). All companies in the group operate on the same business model, as follows:

- Each business issues a catalogue, on paper and CD-Rom, and via the internet, containing a huge range of products (over 300,000 worldwide).
- Same-day despatch is guaranteed for orders received up to a certain time (for example, with Allied up to 9pm).
- High levels of immediate product availability (99% of individual products ordered in largest companies).
- Twenty-four-hour, 365-day order-taking.
- Free technical information and advice to customers.

These high levels of service to 1.5 million customers worldwide differentiate us from high-volume distributors, and allow us to earn consistently high gross margins. The RS businesses typically have >50% gross margins from an average £80 order value.

The group has a centralising culture, with a number of group-wide processes, such as supply chain, information systems and the like, and, within this general culture, group treasury has been able to centralise significantly over the past few years. One specific area of this process has been in cash management.

Cash management in Electrocomponents at the end of 1999 was a decentralised affair. In the UK, there was a notional cash pool with the main clearing bank, in which sat all the UK operating and holding companies. Group treasury managed the balance on this pool with deposits/borrowings to/from the London money market. Some of the other overseas operating companies had cash balances (which, for various reasons, could be substantial) that they largely managed locally, albeit under guidance from the centre in terms of credit exposure. The borrowing companies were financed with a range of inter-company and external debt, again largely driven and managed locally. It was not very efficient at all. Not only was there a significant loss of interest, but there was also a loss of central control and a lot of local management time was being wasted. A process was initiated to review cash management, currency by currency, starting with the euro first.

IMPLEMENTING CASH POOLING

We tackled the euro first. The sizes of the gross euro cash/borrowing balances were easily the largest of any currency giving the greatest continuing interest opportunity cost, and we also thought any cash pooling implementation would be the hardest. (An earlier article in *The Treasurer*, 'Pooling Euro Cash from the UK', in June 2000 gives a more detailed review of our implementation.) In actual fact, the euro cash pool was one of our more successful implementations. After the euro we sought to continue the process with our other trading currencies: US dollar, Japanese yen, Hong Kong dollar, Singapore dollar, Australian dollar, Danish krone, Swedish krona and Norwegian krone. The aim was that this would ultimately leave just Electrocomponents' South African, New Zealand, Malaysian, Filipino and Chilean subsidiaries outside of centralised structures, all these subsidiaries being small and some in countries with fairly onerous foreign exchange (FX) restrictions. In addition, being a small treasury department of three based in the UK, all these pooling structures needed to be managed daily from the UK. After the relative ease of our euro pool, the later structures were more difficult, but the learning was much greater.

BANK SELECTION. This is the most important decision. Pick the wrong bank and your pooling structure, designed to make life easier, can become a nightmare.

One view is that the bank providing the local operational banking to your subsidiary should be the best pooling bank, as otherwise either the subsidiary will need to change bank or somehow liquidity will need to be moved regularly from the operational bank to the pooling bank. Getting subsidiaries to change operational bank is always difficult and you obviously have to be absolutely sure the new bank is going to provide a decent operational service. On the other hand, moving liquidity regularly makes the structure inefficient and awkward, even if some form of automated sweeping can be implemented. However, both these outcomes are preferable if the operational bank just does not have the capability to provide efficient pooling, in terms of implementation, systems, support and the like.

There is also a tendency to assume that a global bank which provides efficient pooling in one jurisdiction can do so elsewhere. Again, a fallacy: implementation generally depends on local capability and if that is sub-standard, by however much – even with a global bank which pushes its local people – there will be problems, not just with implementation but with on-going maintenance.

Some considerations when choosing a pooling bank:

- Does the bank have a solid operational presence in the pooling jurisdiction concerned, and in particular is it well-rehearsed in operating cash pooling there?
- Is the bank in your home market also well-rehearsed in managing and co-ordinating cash pooling overseas in the pooling jurisdiction?
- Ideally, your local subsidiary will use the bank as an operational bank (and be happy with it). If not, do they at least have a positive view of the bank? It is critical to carry your subsidiaries with you.
- Do you have a strong relationship with the bank in your home market, and do you feel it has the ability and power and will to manage its local colleagues in the pooling jurisdiction? You will definitely need it to at some point.
- Are the bank's systems good? Does it have the capability of specifically dealing with and reporting cash pooling? Does it have the right back-up and help desk facilities in your home market that you will need?
- Will the bank allocate a specific implementations individual to implement the system agreed? Does that individual have the ability and power to co-ordinate local overseas colleagues? Will the bank agree a specific implementation plan?
- Make sure you get references.

STRUCTURE. There are two basic structures that can be used: notional pooling and zero-balancing. Essentially, with notional pooling a number of separate bank accounts have their balances netted together on a daily basis for interest purposes only, with interest being paid to the bank on the net balance. With zero-balancing, a number of separate bank accounts have their balances taken to zero each night, with transfers to and from a master bank account. Interest is

FIGURE 1
EURO POOLING STRUCTURE

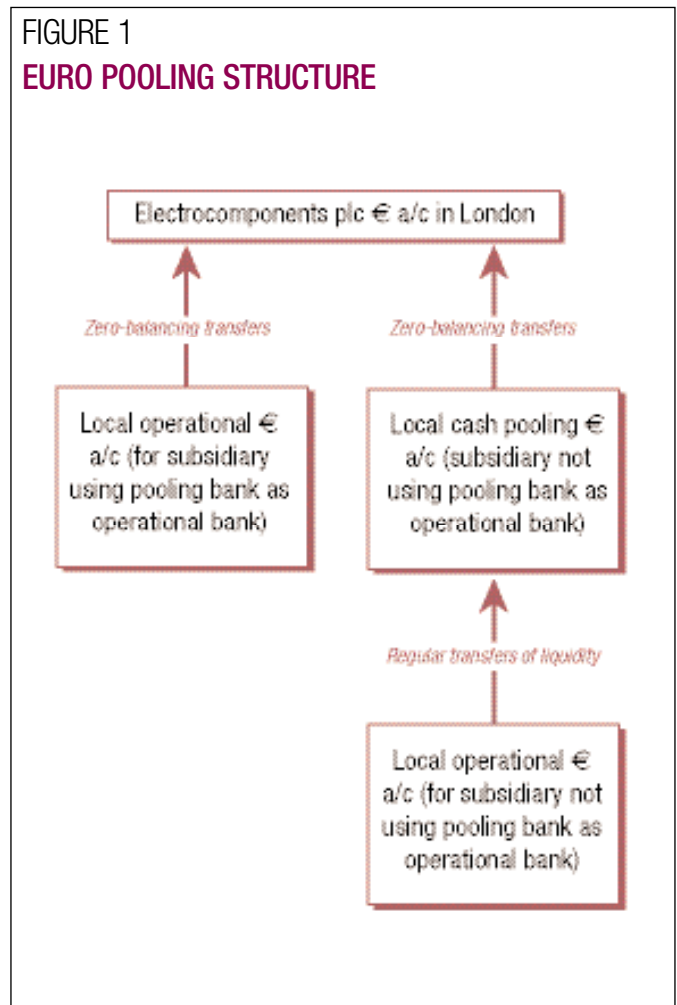
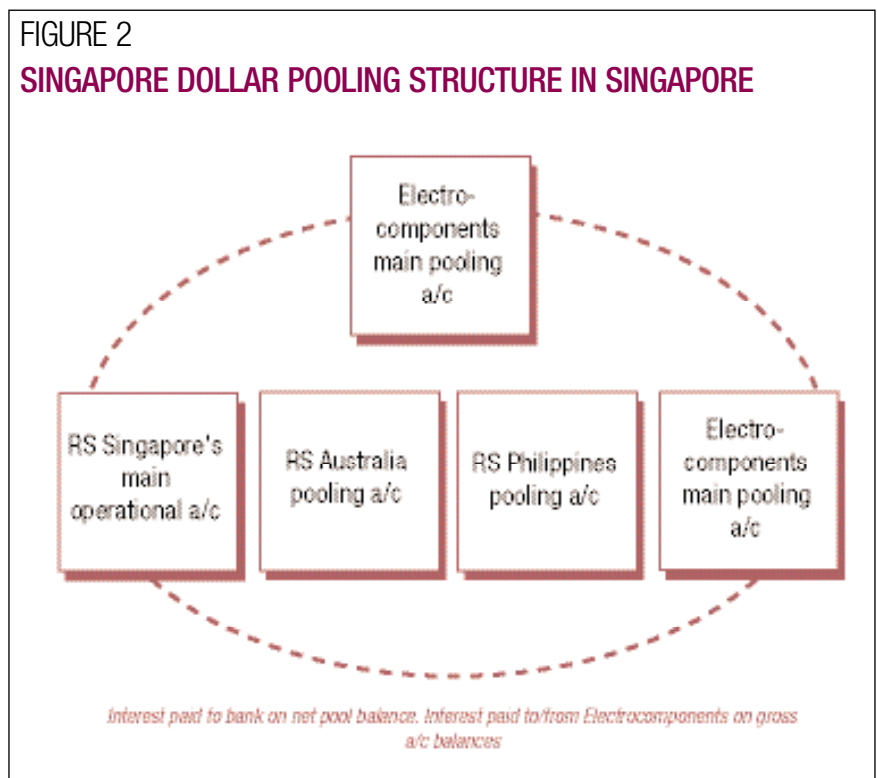


FIGURE 2
SINGAPORE DOLLAR POOLING STRUCTURE IN SINGAPORE



then paid to the bank on the master account balance. We always prefer notional pooling structures because there is less day-to-day interference with the subsidiaries. Generally, we have been driven to have zero-balancing by the legal, regulatory or tax framework applicable in certain jurisdictions. Currently, we have zero-balancing structures in place for euros and US dollars, and notional pools for the other currencies.

With euros, if a subsidiary uses the pooling bank as its operational bank, then first of all its local operational accounts are zero-balanced into one local account, and then that account is zero-balanced into an Electrocomponents account in London. If a subsidiary uses another operational bank, then the subsidiary is tasked to move liquidity from this local bank to an account in its name set up with the pooling bank in its jurisdiction on a regular basis. This latter account is then zero-balanced to the Electrocomponents' London account as well.

Originally moving liquidity from operational bank to pooling bank was manual and this works reasonably well but obviously requires continual central monitoring and local effort. Over time, we have therefore sought to automate this sweeping process between local and pooling bank. (Banks have resisted doing this however – the pooling bank would like the local operation to use it as the operational bank, the operational bank does not like losing liquidity to the pooling bank!) All zero-balancing can take place with back value if necessary. The pool ensures that virtually all euro liquidity is transferred to Electrocomponents in London, where it can then be invested/borrowed on the London money market daily.

With US dollars, where possible, each subsidiary with a flow in the currency has an account with the pooling bank in the US. Each of these accounts is then zero-balanced daily into a master account in the name of Electrocomponents at the same US bank branch. Group treasury can then invest/borrow onto the money market from this master account.

Zero-balancing pooling creates daily fluctuating inter-company loans between each participating subsidiary and Electrocomponents. We download the pooling information into our treasury management system (TMS) to produce inter-company statements, to which we then apply inter-company credit/debit interest rates. In each case, we then ensure that interest physically flows between the accounts each month.

Figure 1 shows the basic structure of the euro pool.

The Japanese yen, Singapore dollar, Hong Kong dollar, Australian dollar, Norwegian krone, Swedish krona and Danish krone pools are notional pooling structures, in each case comprising operational accounts for the local subsidiary, any other subsidiary with flows in the relevant currency and Electrocomponents.

These notional pools are located, if at all possible, in the relevant currency centre and treasury manages flows into/out of the Electrocomponents' account within the pool to keep the net pool balance close to balance. We either provide the pooling bank with monthly debit and credit interest rates for them to apply to the gross daily balances within the pool, or we again download the pooling information and produce interest statements ourselves. Interest is then physically moved on a regular basis.

Figure 2 shows the basic structure of our Singapore dollar notional pool.

With both the notional pooling structures and the zero-balancing structures, we were able to eliminate all other sources of financing for our subsidiaries, both local and inter-company, and to prune local bank relationships, greatly aiding central control and significantly reducing local time and effort invested in cash management.

IMPLEMENTATION. Once a bank has been awarded the business, it is important the structure is then implemented efficiently and on time. The best implementations have usually proceeded with an agreed implementation plan, with a specific accountable implementations manager, who can co-ordinate and organise the various groups throughout the bank, and with a general relationship manager who keeps control of the process. If possible, negotiations on pricing and service should be with your relationship manager, rather than the overseas branch. The cash pooling documentation should be standardised.

TIME-ZONE ISSUES. We want to manage all our structures daily from the UK. We are able to do this on a same-day basis for US dollars, euros and sterling only. All the other pools have a day or two days lag between effectively getting bank information and dealing to manage it. The cost of this is still much smaller than the savings being achieved by the centralised pooling, but it is frustrating as it does cause a degree of confusion.

SUBSIDIARIES. It is important to carry your subsidiaries with you and that requires an internal selling process. Generally, though, we had relatively few issues in Electrocomponents, in implementing cash pooling across the group, despite requiring subsidiaries to cancel their existing local facilities, prune the number of their bank accounts, give up the process of cash management to central treasury and, in some cases, change banks altogether. This reflected the centralised nature of the group and the relative newness of its overseas subsidiaries. I assume it may be harder in more decentralised, well-established and larger groups!

TAX MATTERS. Cross-border cash pooling, both notional or zero-balancing, has important tax implications. Obviously, specific advice should always be sought, but here are some general rules of thumb:

- to avoid transfer pricing issues, have a carefully documented and signed inter-company interest policy. Generally, this should specify that all balances will be chargeable at arm's length interest rates and should specify the method and frequency on which those rates are set and the frequency of interest flows; and
- complete all relevant tax treaty documentation to minimise potential withholding taxes and ensure interest can be paid gross.

A CENTRALISED SET-UP

Virtually all the group's liquidity is now managed centrally on a daily basis from the UK. This has achieved significant interest savings, helped the group in its process of centralising and rationalising global bank relationships, eliminated the need for local cash management resource and bank funding, and greatly aided central control. However, it has taken a lot more effort than we originally thought. The key learning for us has been that it is critical to pick the right bank with the right system and the right approach to implementation. Obviously, ensure you have the right structure, depending on the legal, regulatory and tax environment, and, finally, always make sure you carry your subsidiaries with you.

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