Pumping up the cycle

Executive summary

- The ACT North West Regional Conference on the Working Capital Cycle, sponsored by Lloyds TSB Corporate Markets, looked at the corporate's response to the current economic outlook. A key theme was to suggest ways that treasurers should work with colleagues, banks, suppliers and customers so that appropriate working capital management policies are in place to ensure that businesses can weather the current economic storms.

As the economy plunges into recession and credit continues to be scarce for all sectors, the working capital cycle has become an important issue for all businesses. A packed regional ACT North West conference discussed the various dimensions to this important issue.

Conference chairman Gary Slawther, group treasurer at Speedy Hire, presented a working capital overview. Treasurers know that things are going to be extremely difficult over the coming year. "More companies are going to live by cashflow," he said. "In this environment, cashflow becomes much more important than profit and loss because you need the wherewithal to pay the wages and the bills. A good business doesn't become a bad business overnight, but all businesses can fail because of improper liquidity planning."

While it may be obvious to finance professionals that companies need liquidity to keep the business going, the reality of liquidity management does have to be explained and reinforced to other parts of the business. In particular, treasurers need to make it clear that funding comes at a cost, and the more unpredictable and volatile the funding source the more expensive it is. Avoiding such increased costs is sensible at all times but particularly when a company is facing other financial pressures.

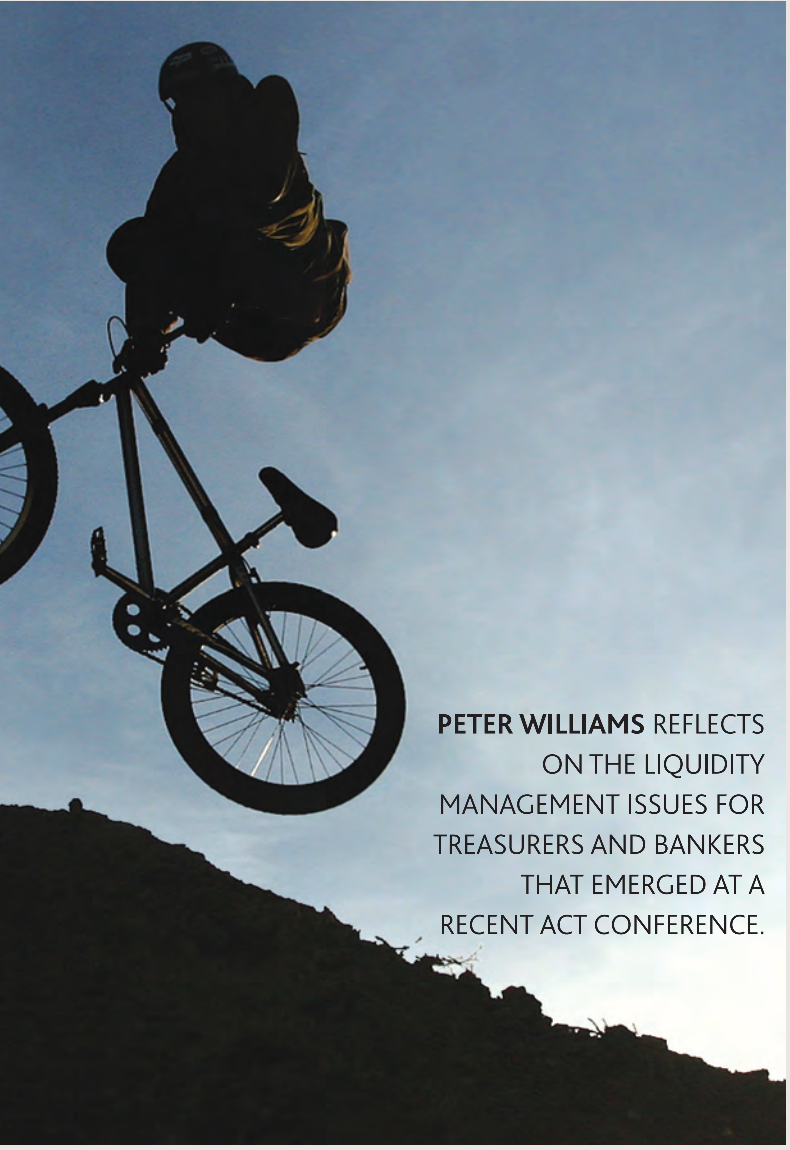
For instance, companies need to weigh up the overall cost to the business of working with different suppliers. Choosing a particular supplier based on price and payment terms alone may not represent good value if poor service or goods actually increase the overall cost of channelling orders to that supplier. Slawther gave the example of dealing with a haulage company and the significant difference for a customer of their goods being transported on reliable or unreliable vehicles. It is these sorts of issues that treasurers have to look at.

WITH RECESSION LOOMING AND WITH CREDIT IN SHORT SUPPLY, TREASURERS ARE GOING TO BE INVOLVED WITH URGENT WORKING CAPITAL MANAGEMENT ISSUES ON A DAILY BASIS.

COMMODITIES A much publicised cost for companies over the past few months has been the sharply fluctuating price of commodities and raw materials. Mary Finn is treasurer of Burton Foods, which operates under private equity management and manufactures and distributes branded biscuits such as Maryland Cookies and Jammie Dodgers. Commonly traded commodities in the biscuit sector include oil, wheat, sugar, cocoa beans and milk, and the weather and politics can drive supply. As well as normal demand, companies such as Burton Foods have seen commodity prices rise because of demand from the BRIC countries (Brazil, Russia, India and China), the rise of bio-fuels (which require grain which otherwise would have gone to food consumption), and the increasing interest of speculators who see the possibility of making healthy returns. Finn said: "Commodity inflation is running at 30% in some cases and manufacturers have to put up prices to cope with these inflationary pressures."

The three-month wheat LIFFE (London International Financial Futures Exchange) price moved from around £70 a metric tonne at the beginning of 2005 to a peak price of nearly £200 in April 2008. And wheat was not alone: the price for three-month palm oil showed a similar price movement over the period. Finn said: "The recent price increases have hit beer, bread and other basic foods." The market does usually respond. For example, farmers have started growing more wheat in a bid to take advantage of the higher prices.

Companies use a variety of methods to source products they require, including commodity markets such as LIFFE, ICE (Intercontinental Exchange) and the London Metal Exchange, as well as specialist brokers. Finn explored how to manage commodity pricing including energy, a major cost for manufacturers as well as



PETER WILLIAMS REFLECTS ON THE LIQUIDITY MANAGEMENT ISSUES FOR TREASURERS AND BANKERS THAT EMERGED AT A RECENT ACT CONFERENCE.

Box 1: Short-term forecasting

One of the key issues that companies may need to get to grips with is short-term forecasting. David Reid, former group treasurer at Volex, explained how he had been developing cashflow forecast models, providing working capital facilities and introducing cash management methodologies to help ensure Volex has sufficient liquidity to support its operations around the world while keeping central borrowing at a minimum. For more details on his developed methodologies, see the Cash Management Supplement Winter 2008.

others. When energy prices show such volatility, companies are bound to struggle to cope. For example, one day in August 2008 the price of gas moved 15% with the news of possible problems with a pipeline.

Finn said: "This is the market in which we are trying to manage our exposure." Within Burton Foods, the gas price is split into five different elements: a wholesale price (about 80% of the total cost), transport, the onsite meter, the climate change levy and the supply margin. Each different element is booked separately to enable the price of each to be agreed independently and, when choosing a supplier, price flexibility is one of the main criteria.

In terms of the wholesale price the company looks at ICE to follow closely price movements so as to book in when they believe the price is right. The purchasing department holds weekly meetings to look at price and also assesses the stop loss levels. In April, when the prices were moving rapidly, the meetings turned from weekly to daily in order to manage the situation.

Finn said: "The purchasing department is constantly receiving updates from suppliers of where the price of gas is. Going forward, it has been decided we will use specialist energy consultants to advise us on the energy portfolio, and on specifics such as when we should lock into contracts and over what period."

Concluding her presentation, Finn said that it was important to identify and understand underlying commodity and currency exposures that exist within the business. Markets exist to protect most of the commodity and currency risks that a company may be exposed to.

Finn suggested that it was sensible move for treasurers to seek advice from relationship managers and others in the financial community who are able to offer guidance and solutions. "From time to time markets act irrationally, but if you have your hedges in place the ride will not be anywhere near as choppy," she said. "Here speaks someone who has experienced rough and calm waters, and calm seas are definitely preferable."

A TRADE FINANCE PERSPECTIVE Shara Galvin, head of trade transaction services at Lloyds TSB, looked at the issue of the working capital cycle from the perspective of trade finance. Despite the current problems caused by the slowdown of the world economy, international trade will continue to grow and companies will still need access to finance solutions to enable that trade to take place.

There are still opportunities for international trade, despite all the bad news. Of the trade between countries, 80% is on open account rather than through trade solutions such as letters of credit. Galvin said that in the current business climate, one of the issues that management will be acutely aware of is the risk of non-payment and therefore there may be a renewed interest in more traditional, secure methods of ensuring payment in overseas transactions.

Modern supply chains can be extremely complex, and treasurers need to work with their colleagues to take a holistic view of both the physical and the financial aspects. Galvin suggested treasurers may need to go back to basics so that when it is necessary to turn to banking partners for financing solutions they can demonstrate that they understand the chain and, in particular, the bottlenecks which are causing the problems. The basics of getting your house in order include understanding creditor and debtor cash days so that treasurers can work with banking partners at the earliest possible stage to put structures and solutions into place rather than trying to fix problems in the financial supply chain once it has broke down.

As well as using traditional tools, treasurers should be familiar with innovations in supplier finance based on technology solutions which can work to the advantage of both parties through exploiting the arbitrage between buyer and seller ratings which can provide credit at a lower cost. These tools can provide win-win situations for both parties.

Besides looking at the technical solutions in the working capital cycle, the conference also considered the wider business and ethical issues. Slawther talked about the need to communicate with all interested parties when cash was tight and Rachel Chan, chairperson of the Manchester and Construction North West branch of Chartered Institute of Purchasing & Supply, examined the need for best practice and fair payment in working capital. With recession looming and with credit in short supply, treasurers are going to be involved with urgent working capital management issues on a daily basis. Having a strategic approach in place should help when the heat is on.

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