Ask the experts: Who should lead on working capital?

SHOULD IT BE TREASURERS, OR IS IT SOMETHING THAT BUSINESS UNITS SHOULD BE IN CHARGE OF, WITH TREASURERS PROVIDING STRATEGIC ADVICE? AT A BREAKFAST BRIEFING ORGANISED BY THE ACT AND SPONSORED BY BARCLAYS COMMERCIAL, **PETER WILLIAMS** LISTENED TO TREASURERS AND BANKERS DISCUSS HOW ORGANISATIONS CAN OPTIMISE THEIR WORKING CAPITAL IN THE PRESENT ENVIRONMENT.

Given the severity of the credit crisis, it is reasonable to suggest that working capital has become the flavour of the past few months. Treasurers in all businesses have been forced to look closely at their organisation to squeeze out those extra pounds. While corporates may be concerned by the problem of bank lending, their worries have been shared at the highest government level. One of the many unexpected outcomes of the credit crisis is how corporate lending is at the forefront of government policy.

The policy of quantitative easing is partly motivated by concern about corporate lending. That concern remains: on the very day of the ACT breakfast meeting, the Bank of England announced it was pumping another £25bn into the economy via quantitative easing, taking the amount spent to £200bn. The idea was that the Bank would buy assets from banks and others such as institutional investors and the latter would then seek to invest the resulting low-yielding cash balances in corporate paper. While this would directly benefit larger companies with access to the capital markets, in theory it should also free up lending capacity in the banking sector for smaller companies.

Across all sectors bank lending to corporates is weak but without quantitative easing the lending contraction could have been felt even more sharply. But the slowdown in lending is not totally the fault of the banks. Corporates appear to be changing their borrowing habits. Stephen Hestor, chief executive of RBS, when announcing the bank's results said that the bank had lent £45bn this year to corporate clients but that they had repaid almost the same amount, and that its business clients had £27bn in authorised but undrawn overdraft facilities. Are companies changing the way they fund themselves in the long term or is this a short-term phenomenon?

Either way it seems obvious that working capital management is playing a large part as businesses seek to rebuild their balance sheets. It is clear to bankers in the cash management space that businesses are managing their working capital like never before and banks can support clients as they look at best practice working capital techniques in their sector.

The general commercial environment (see Box 1) is keeping companies focused on meeting funding requirements and trying to free up cash on their balance sheets. Companies can take a series of immediate steps such as drawing down credit facilities, reducing capital expenditure, re-evaluating counterparty risk, shortening the duration of investments, increasing the security of investment instruments, making slower payments to suppliers and intensifying customer collection efforts.

Treasurers will understand that even in well-run companies the credit crisis has shown up weaknesses in systems and processes that need to be rectified but for which there are no quick fixes. Longer-term strategic initiatives include improving processes and systems (which often means getting better information about and access to cash balances in far-flung corners of the business), implementing stronger cash forecasting, co-ordinating vendor relationships and risk management programmes, re-examining supply chain finance and simplifying payment terms. But while the crisis may have highlighted deficiencies in systems this is not necessarily the best time to put in place solutions.

Optimising working capital relies on effectively integrating three distinct but related elements: payables, inventory and receivables. Inventory management is one area that requires treasurers to work in partnership with the business. Very few companies have stock that appreciates with age (fine wines and whiskies are notable exceptions), so the longer that management struggles to deal with excess stock the less it is able to turn it into ready cash.

The efficiency of supply chains needs to be scrutinised, especially the methods for forecasting demand. And sometimes assumptions need to be challenged. If you offer or accept early payment discounts, do they make financial sense? If you have never offered them, is it worth doing so at a time when suppliers may be desperate for cash? And if so, at what rates?

While there are working capital levers that treasurers can pull, some factors remain resolutely outside the control of companies. For example, treasurers can do little about the volatility that has swept many markets.

In such an environment business planning, such as cashflow forecasting, becomes extremely difficult. Treasurers have to help their organisations through the cycle, and core to this is improving access to internal liquidity. Although liquidity management is not strictly part of working capital

management, liquidity can be improved through disposals, particularly of non-core assets, plus the initiation of asset optimisation and cost and capital saving programmes. Liquidity management has traditionally been a core treasury activity that receives little attention from investors, but now corporates are finding investors are as interested in cashflow/liquidity issues as they are in the non-financial fundamentals of the business.

While treasurers have been preparing their companies for the downturn and getting into the correct position for this point in the cycle, little thought has been given to financing in a recovery. Treasurers may have met their short-term and medium-term liquidity requirements but what happens if the recovery is swifter and stronger than the anaemic growth path anticipated? Bizarrely, treasurers could then find themselves with too much liquidity.

While it is easy to see working capital management as numbers and ratios, it has an impact beyond the cashflow statement and the balance sheet. Working capital is a key component of the commercial relationship. But that relationship works two ways; for instance, suppliers have to invoice correctly if they wish to avoid bills being seen as in dispute and accordingly sent to the bottom of the payments queue.

As in comedy, timing is the secret of good working capital management. Hold off paying suppliers, especially small businesses, for too long and they could go out of business. Pursuing such practices in the long run has no advantages for suppliers or customers. This is where business practice meets business ethics. The treasurer's first duty is to his or her employer, but clearly one company does not act in isolation and every decision it makes will have an impact on others in the supply chain. And if treasurers rely on parties other than just trade creditors for working capital, then they have to make sure a good relationship is maintained. For instance, if companies have the support of trade credit insurers, then part of keeping that dialogue going is promptly sending the monthly management accounts.

Treasurers need to work with the business to understand what payments have to be paid when in the business cycle. To manage working capital, treasurers have to know customers and suppliers. In the case of the latter, their relative financial strength and importance to the business.

In this sense the constrained working capital environment is driving proper business disciplines. Perhaps one improved or changing discipline will be for working capital to be owned by the business and not seen as the responsibility of the treasurer. The treasurer should help colleagues focus on the issues and provide the measurement and the key performance indicators and suggest what tools can be used. Treasurers may have to dig into the guts of the organisation. Something as mundane as the speed at which invoices are cleared can have an enormous difference on how quickly cash is generated. This work is about changing behaviours.

Working capital is now seen by many as the cheapest and readiest source of finance around. Even so, there is strong evidence that there are still many companies operating with flabby working capital practices. And while the quest for competitive advantage continues, so companies will spend time and resource on improving their working capital management.

Box 1: The working capital context

A whole host of factors, many beyond the control of corporates, are driving the need for better working capital management. They include the following:

- **reduced liquidity/tighter credit markets;**
- **significantly higher borrowing costs;**
- **declining revenue and margins;**
- **lower yields on invested cash;**
- **increased supply chain risk;**
- **sharp drop in UK GDP, set to decline by 4.3% in 2009; and**
- **longest recession on record.**

Box 2: The experts

The meeting was chaired by Nick Mourant, former group treasurer of Tesco. Simon Hayes, chief UK economist at Barclays Capital, looked at cash and trade in the context of the economic downturn. Tom O'Donnell, head of sales, cash and trade at Barclays Commercial, analysed strategies for staying liquid. The treasurer perspective was delivered by Doug Smailes, group treasurer of Anglo American, and Gary Slawther, interim group treasurer of TDG.

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