The governing principle

PETER MATZA AND **MARTIN O'DONOVAN** EXPLORE THE CASH MANAGEMENT CHALLENGE FACING TREASURERS.

It is not too dramatic to say that treasurers of businesses and organisations of all sizes have considerable challenges facing them. Funding, accounting, interest rate uncertainty – these and other factors are reflective of the continuing uncertainties in the business world. While some of this increased attention pre-dates the recent credit crisis there is no doubt that the volatility in the credit markets and the (Western) economic recession have impacted on liquidity. In the current economic climate a focus on risk management – in cash management terms – has posed numerous questions to treasurers, some old and some new!

- Where can I invest cash but ensure I get it back when needed?
- How can I be sure my working capital is managed efficiently when my debtors are under financial constraint?
- Where can I find funding for essential investment, research and development?
- What role will enhanced technologies play in the treasury industry?

Senior corporate management – and perhaps even some treasurers – have quickly realised that their perception of cash management as a dull, process-oriented, operational "factory" is misplaced. It is not that "cash is king" has become the mantra, more that, to précis Churchill and others, cash management is not just the best form of government for a business – but the only form of existence. In short, this is a dynamic field of treasury management, replete with a changing landscape of actors and one in which the contemporary treasurer needs to be active and positive about their role and their contribution to corporate health and well-being.

ALL CONCLUSIONS POINT TO MANAGING CASH

Cash management can involve a lot of attention to detail and fine-tuning of systems and forecasts but Gerry Bacon, ACT president, in presenting the keynote introductory session, started instead at the macro level reviewing the turbulence of recent financial markets to show that all conclusions pointed to managing cash, liquidity and funding. Volatility of equity prices and economies has to be accepted as the norm and businesses must plan on that basis. You cannot control the equity risk premium that is a driver of share price but you can aim to create a sustainable cashflow which feeds into the share price, so the message was work on that element.

Bond spreads have shown massive volatility over the past 10 years with margins far too low from 2004 to 2007 followed by an absurd overreaction in 2008 and 2009. Mobile phone company Vodafone calculated a fair price for credit using actual default data from the credit rating agencies and came up with a fair spread of 30-35bp for an A-credit. Borrowing at market levels at or below this makes sound sense but not when spreads are well over this level. So fund when you can at a fair price, do not leave it until you need to fund, and consider all forms of finance – bank loans, capital market debt and equity.

The latest bank of England GDP forecasts for the UK show a huge range of possible outcomes even just one or two years forward, as do the inflation forecasts. Different sectors can be affected differently so any cash planning must be run for a variety of scenarios and working capital facilities must be such as can cope with the range of inflation levels. Default levels will be up so keep an eye on customer credit control but there is a risk from failing suppliers too, in terms of risk to the continuity of the business.

With your company subject to risk and volatility, cash forecasting under multiple scenarios is a crucial task. Optimise working capital, fund early and fund long, and for the best results under pressure invest in high-quality people and systems.

THE INEFFICIENCIES OF HOLDING CASH

If it is a truism that we are all operating in an uncertain and volatile world then the corollary for treasurers must be that effective liquidity management is important and has grown in importance. Greg Croydon of engineering company IMI explained that, for a net indebted company, holding cash is inefficient at the best of times and even more so when funding lines are scarce and when cash in the system presents a credit risk from the counterparty.

At first glance borrowing costs are low so some inefficiency from the extra borrowings to fund spare cash looks not to be costly. But the true comparator is to look at the difference between borrowing costs and deposit rates and this has widened considerably. Cash sitting on the balance sheet introduces credit risk, is costly and for the

analysts comparing the net interest with the net debt creates a misleading impression of the firm's cost of funding.

With greater focus on treasury issues and risks treasurers should be getting their cash housekeeping in order starting with a look at the role of cash in the working capital cycle. Here Bacon's startling assertion was that cash is not an essential part of working capital, although it is a way of measuring value and a lubricant in the system. It is poor or overpessimistic forecasts that lead to hoarding of cash as a buffer just in case the cashflow turns out too low. A lack of confidence that funding facilities will be available again leads to hoarding just in case. It is confidence in the availability of cash that is essential and will allow the company to hold less of it and that is where centralisation comes in.

Efficient mechanisms exist and are well tried for the pooling of cash by one means or another, nationally, cross-border and even (sometimes) cross-currency notional pools. The flip side of cash pooling will be inter-company loans, which in turn introduce complications on tax, transfer pricing and thin capitalisation. Indeed IMI found that even in the euro area there could be complications such as stamp duty, so for IMI an 80/20 approach picked up most of the benefits. For each of the IMI local businesses the cash pooling was not compulsory but rather the bank had to win the business through demonstrable benefits. Costs of gathering information to the centre and from transfers could build up, but that cost could still be justified in terms of better control and reduction in credit risk. Just because daily pooling was possible did not make it essential. For some businesses a periodic review of cash and a set of rebalancing payments might be quite sufficient.

Systems and technology could deliver pretty much live information but if two hours a day is spent gathering information simply to complete some tick box exercise, what is the point? Good visibility of cash makes sense only if it is used for something and in some cases IMI had determined that weekly information was adequate.

Information to feed a cash forecast and the importance of cash forecasts were a consistent theme throughout the day yet Croydon was sceptical of some forecasts where returns tended to be pessimistic since there was little previous experience of the sharp downturn of the last few years. The key to a good forecast is a feedback process with input from all sides and turning feedback into action by the people at the coalface, and being able to change habits.

Best practice and performance management on cash depend on the particular circumstance of the company. Those in retail might concentrate on converting coins and notes into a usable balance while for others the minimisation of "cash puddles" (cash balances otherwise too small to worry about) would be the aim. At IMI the target was minimising cash with a focus on inventory too. Squeezing suppliers was not acceptable. For other companies a range of performance measures could include:

- cost per payment;
- gross cash as a percentage of sales;
- accuracy of forecasting;
- net interest cost; and
- percentage of accounts which are pooled.

CHANGING CULTURE

The ACT cash management conference extends for two full days so there was time to review the higher level needs and polices around cash management before delving deeper into the specific techniques, systems and innovations. The conference heard about Etex, an engineering company with a divisional culture and a tradition of business unit independence, so getting units to join a cash pool was not easy. However, with the start of a somewhat changing group culture and using the financial crisis as an added justification centralised cash had become the norm, save where there were legitimate local circumstances like tax, FX controls, or access to cheap local finance, such as France, where the banks are very supportive of local companies.

Etex had adopted a pragmatic approach tailored to the circumstances rather than insisting on some dogmatic standard from the centre, but core to it all was a clear and formally stated policy on intercompany funding which gave the business units confidence that funding would be available. Normally the parent would not guarantee any locally raised loans but in that same pragmatic spirit John Holmes of Etex queried whether it would really be too bad a thing to do.

Fitting the systems used to the local circumstances had resulted in a variety of pooling arrangements dependent on territory. The centrepiece was a notional pool, cross-border and multicurrency covering Belgium, Germany and Poland, these also being the regions with the largest operations.

The centre insisted on and controlled the upstreaming of

cash and had even undertaken capital reductions to create distributable reserves which could be dividended up or used to create intercompany loans. At the near term Etex avoided a reliance on accurate short term cash forecasts by simply using cash to repay debt at the centre and keeping a range of debt maturities so there was always a maturity coming up.

While cash management was important it was not regarded as the be-all and end-all. A balance had to be struck with maintaining bank relationships to support funding activity. Although efficient cash management meant fewer banks, it was still possible to spread the payments and receipts business and other banking services.

This same point was a concern for IT supplier Sage, where its objective of central control over cash had to be balanced so as not to impact adversely on bank relationships and those key banks providing a syndicated credit facility to the group. More and more Sage was finding that banks were placing greater reliance on ancillary business, especially in their home countries, when it came to lending decisions.

The big selling point for Sage when choosing its cash management structure was to use a UK-based bank's global liquidity system that worked with local partner banks throughout the world and that connected to the local bank cash pooling and overdrafts. Exceptions were made for the UK itself where a second clearer was used for cash netting, and for Canada and Asia where yet another clearer was proposed to be used, with both these exceptional systems feeding back direct to the UK group treasury itself.

Picking up on the overview from IMI earlier, John Swift of Sage agreed that the low interest environment did not negate the benefits of cash pooling and centralisation. The improved yield on consolidated balances would not of itself justify centralisation, so the decision for a group running with net cash would be marginal, but for Sage, with group net debt, the difference in borrowing and deposit rates fully justified the decision to centralise. It ran borrowings centrally drawn in the currencies of its various operations and in amounts in proportion to the operating cash surpluses generated, thus providing a natural hedge. Debt is typically rolled over monthly allowing the regular repayment of debt from cash from around the group.

MONITORING CONSUMPTION AND GENERATION

For electronics retailer DSG International, the focus was not so much on cash management systems but the general approach to monitoring business cash generation and consumption. A cash pooling system already existed but had not been that important while the group was cash-rich. That changed when it switched to being a borrower following share buybacks and the economic downturn. Treasury and the board wanted to increase the visibility of cash quickly and without any major IT projects and most importantly to use that visibility to drive the business performance.

The strategy to achieve this was relatively straightforward and taken step by step from the basics in the early months through to a powerful reporting, forecasting and monitoring of cash consumption and generation all achieved within nine months with a further three months or so to get all units good at it.

The basics started with a treasury operations framework distilled down to a two-page document explaining what was expected of the businesses and what their limits of authority were. Business unit finance directors were asked to sign a monthly letter of assurance of compliance with the framework – a simple checklist of yes/no questions about getting approvals for opening bank accounts, surplus funds and other processes. Visibility of actual cash was next and involved first compiling a register of bank accounts followed by a periodic report (generally weekly) to the centre of cash balances. If balances were visible through the electronic systems, that was sufficient. If not, then spreadsheet returns were made. From the cash visibility reporting a time series plot of cash floats was produced centrally so as to identify opportunities to centralise cash. To get this far took just two months with no real investment required.

> WE ALL KNOW THAT CASH FORECASTING IS DIFFICULT TO DO WELL, BUT EQUALLY WE ALL KNOW THAT IT IS ESSENTIAL THAT IT IS DONE.

The next stage of the new strategy was to introduce a simple but consistent methodology for a bottom up cash forecasts. To get this implemented two people from Deloitte were employed for a month to tour round the businesses and to start the comparisons of actual outturns with forecasts. Initial results were poor but quality improved with time and as the patterns for cash consumption and generation built up. With the information now flowing the next thing was to control or change the cash forecasts through enforced internal loan limits. A full reforecast every four weeks gave visibility of any potential problems and allowed time to control the forecast.

Group treasury was now in a position to provide a decent cash forecast quickly and easily based on historical records of daily funding from the group and enhanced by the bottom-up forecasts. The extra detail over and above the business plan and budgeting process allowed planning and control even to the extent of eliminating peak outflows by spreading payments or matching with units with inflow peaks. Overall

achievements included lower cash floats, lower operational risk, a better appreciation of cash and cash management, a useful set of metrics for business FDs and MDs, and a powerful tool for discussing headroom with external stakeholders.

BANKS STILL REQUIRED

Funding and bank relationships are all part and parcel of cash management. In 2009 the banking crisis and lack of bank lending capacity was an added impetus for those companies large enough to access the capital markets, and cement and aggregates producer Holcim was no exception. But even with diversification away from the bank market, loans from banks were still required and needed to be carefully managed as part of the overall relationship deal with the banks. The trade off between ancillary business and access to bank loans has always been an issue given that banks can make superior returns on capital through the non-lending activities, and treasurers are well aware of this. But quantifying those non-lending returns and ensuring a transparent and fair fee allocation is not easy.

Marcus Unternaehrer from Holcim demonstrated how to measure a good bank relationship and get the most from your banks. Service quality for each bank was assessed across each form of business – be that funding, advice or execution – and compared against other banks providing that product line. Banks had to tender for larger fee business and then annually were asked to report to the company on the business generated so that bank fees earned as a proportion of the total for the group could be compared against the proportion of credit being made available. Recognising the element of cross-subsidisation, Holcim predicted the development of a two-tier market for bank facilities – part bilateral facilities with core banks that gained other business, and part market rate facilities with no ancillary business and hence no cross-subsidisation.

PROVIDING LIQUIDITY

An alternative or supplement to holding committed bank facilities in reserve to meet future funding needs is to run with cash invested ready to provide liquidity. This was the strategy at energy company Centrica. With £3bn invested it has been an anxious time since exposure to financials can hardly be avoided even with the use of money market funds and a diversification of instruments. Credit risk down to a rating of A- was acceptable but the consequence was that LIBOR-plus returns should not be expected. Treasury policy was risk-averse and its stress-test on liquidity was to be able to survive for 18 months with no new sources of liquidity. With massive and volatile possible demands for cash from margining on gas contracts (swings of £1.7bn had been experienced in six months) the backup lines and cash balances were truly vast.

We all know that cash forecasting is difficult to do well, but equally we all know that it is essential that it is done. We can debate what level of accuracy is required or worth aiming for, since a company with ready access to bank facilities can simply use these to absorb any temporary inaccuracies. What becomes more critical is the longer term cash forecasts for business survival and growth. But for some companies, short term forecasts become essential for survival, as at department store Woolworths in the months before it collapsed. Things began to move rapidly with cash having to be allocated daily to where the need was most critical.

Lessons on the importance of cash can also be learnt from the structured finance environment. Alpha Trains is owned by a private consortium with the acquisition debt pushed down to the asset owning companies and subject to a raft of compliance and reporting to the various levels of ownership and to the lenders – be that senior debt, junior debt, PIK notes and so on. Forecasting and countless procedures have to be in place to confirm that any payment to shareholders is permitted. Quite rightly the higher leverage does mean greater transparency, control and management of cash and the need for a constant check for covenant compliance.

TECHNOLOGY AND SYSTEMS ARE CRITICAL

The process nature of cash management means that the implementation and use of technology and systems forms a critical feature of this aspect of treasury management. The principle is not about technology per se but about how the treasurer integrates treasury operations in a business using systems as an efficiency tool. This generic perspective of technology has, however, not always been adopted in the past by either private systems providers, commercial banks or even industry bodies. Treasurers have rightly been nervous about the investment required in systems and both presenters and delegates expressed varied views during both days on how best to manage selection and implementation

of technology projects.

The explosion of non-traditional web-based financial tools (for example where client/server electronic banking solutions have migrated to web portals), the impact of regulatory change (especially in the EU with the PSD and SEPA) and the impact of agreed technology standards (for example XML formats) has driven the opening up of cash management technology. In addition change in cash technology is increasingly prevalent elsewhere in the world such as recent steps towards monetary union by Saudi Arabia and some Gulf states or the impact of mobile banking in sub-Saharan Africa. By the same token corporates have moved towards looking for more seamless solutions involving straight through processing (STP) and choice in solution delivery – whether web or direct ("host-to-host", or H2H).

IN THEIR IDEAL WORLD, TREASURERS NEVER SEE TECHNOLOGY IN CASH MANAGEMENT AND BANKING AS A HINDRANCE, ONLY A BENEFIT. IN THE REALISTIC PRESENT, THAT IS OFTEN NOT THE CASE.

THE SIGNIFICANCE OF SWIFT

Most significant has been the development of access to SWIFT. The corporate perspective on this will be reported below but it is worth some brief history initially.

From the mid-1990s to mid-2000s only a pioneering few corporates were able to really get traction on the system. Over the past few years, hundreds of corporates globally have been able to take advantage of increasingly simplified access to SWIFT (and with easier names!): MA-CUG, SCORE and Alliance Lite. While there is still some way to go before SWIFT is "just another system", the corporate treasurer – particularly of a multiregional/multicurrency business – should be in no doubt that this represents a step-change in managing their access to international banking reporting and cash management.

Future development in corporate SWIFT solutions including digital signatures, automating paper-based business flows and electronic bank account management (eBAM) can only enhance this tool for treasurers. It is not a panacea for all international banking issues, however: legal, regulatory, accounting and political risks remain. Treasurers will still have to manage their relationships and bankers (no change there!); however, SWIFT offers an opportunity to at least talk in a standardised language and to look for consistent levels of (electronic) service.

The presentation made by Julian Tasker, deputy treasurer of chemicals company Johnson Matthey, which detailed its approach to implementing a SWIFT solution was both a clear and detailed description of this process but also gave delegates some insight into the particular issues regarding a SWIFT project. In essence his project was designed to introduce automated banking to the JM treasury to include accounting, electronic dealing and settlement, bank account reporting and management and focus on the JM treasury management system as the core of treasury operations.

Tasker proposed a neat but effective matrix for evaluating between the various access methods (Alliance Lite, use of bureau or a bank-sponsored bureau) that are available to corporates. The Alliance Lite option is generally for more modest corporate user who needs a relatively simple "out of the box" process. Whichever of the two bureau options is selected will offer various different paths for the user to follow depending on the uses for which SWIFT is required (see Figure 1).

Tasker's analysis of the value of SWIFT to corporates was compelling, with numerous benefits available including improved operational flexibility using standardised technology and processes to improve security, concentration of access to multiple banks in multiple geographic regions, the clear advantages of a reduction in cost of liquidity across group operations and the scalability of the processes as a business grows in volume and location.

It is not entirely a one-way street, however, and care needs to be taken with certain aspects of an implementation project. If, for example, the corporate uses a bureau to access SWIFT, sharp eyes will be needed to ensure the documentation is clear on who shoulders the various responsibilities and potential liabilities for service provision. This applies particularly when considering the key issue of how, where and by whom financial movements are authorised and released. Lastly bureau service costs are subject to negotiation – the corporate doesn't have to accept the first offer and if using a bank-sponsored bureau should make keen use of the relationship!

Figure 1: Evaluating SWIFT alternatives

Key criteria	Alliance-Lite	Bureau	Bank bureau
1. Capability	Low	High	High
2. Security	Medium	High	High
3. Sociability	No	Yes	Yes
4. Bank independence	Yes	Yes	No
5. Liability	Medium	Medium	Low
6. Cost	OK to 250	Banded	Banded

Source: Johnson Matthey

THE HARD YARDS

That's all fine, but what happens if your treasury and business have been through a difficult reorganisation and life-saving refinancing while expanding geographically to meet the needs of customers? Oh, and somewhere in the middle a new CFO appears! Bente Salt, group treasurer of engineering company Acergy, talked through an early-stage treasury systems reorganisation involving just about all the moving parts that a treasurer can manage!

There is unfortunately no easy way to do the hard yards of review, analysis, comparison and decision. In Acergy's case an external consultant gave the research for the project some intellectual and emotional distance from daily operations. This is an interesting point for treasurers who can use this independence to add weight to their case for systems investment. Subsidiary companies and managements may also feel more inclined to be part of a solution that's not just a head-office diktat.

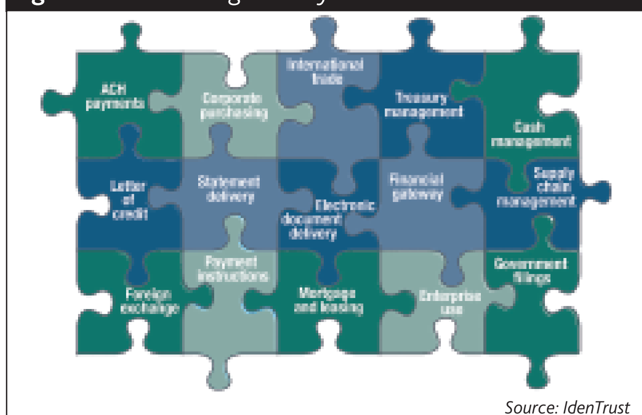
In short, Acergy needed to rationalise its group-wide transaction banking. It needed to implement an in-house banking and payment factory (including the design, build and operation of a new treasury management system), access to a SWIFT solution and creation of a cash pooling structure across the business.

Interestingly, the lessons from this painful and wearing process are not just about treasury and cash management:

- Treasurers will learn the principles (and pitfalls) of timeline and project management, skills helpful in more general management roles later in a career;
- Competition for its own sake is not always a virtue; the world of RFI and RFP can be avoided by using clear and straightforward negotiating positions with potential suppliers; and
- Given that there may be winners and losers in terms of services supplied and potentially more efficient interest rate and cash management, treasurers will need to pay careful attention to their banks/lenders especially where their regional or local impact will be diminished by enhanced technology and treasury systems.

In their ideal world, treasurers never see technology in cash management and banking as a hindrance, only a benefit. In the realistic present, that is often not the case. So when a solution such as SWIFT presents itself it is often viewed with suspicion and initially acceptance is grudging – often as much about the quality of the offering as about the likely acceptance. The opening of SWIFT with Alliance Lite and the bureau interfaces has pushed this technology over those barriers and into the realms of "why not?" rather than "why?" Digital identity is another technology whose time it would seem is now and is on the cusp of mass acceptance.

Figure 2: Establishing identity



Source: IdenTrust

John Bullard, the global ambassador for IdenTrust, is a passionate advocate for this technology. IdenTrust was founded by financial institutions in the late 1990s. It has become one of the premier providers of digital identity authentication services to the US federal government, numerous US state governments, the US Department of Defense as well as energy and supply chain markets.

In all aspects of life – not just corporate banking – treasurers are faced with questions of security, control and identity. The creation of a digital identity is an attempt to address these concerns. The principle that underlies a digital signature is that it is usable independently or as an integral part of business processes – whether purchasing, invoicing, accounting or making payments. Having absolute certainty about who you are interacting with, being able to check/validate that this is indeed the case, and having a transparent audit trail of who did what and when are critical to the confidence that users will need in a digital system. The range of applications is shown graphically in Figure 2.

Moving from the technology world to commercial practice is the necessary goal of any treasury systems project. With so much focus during the past two years on capturing corporate liquidity, it is no surprise that the opportunities for bringing these two aspects of treasury management together have been recognised, especially in the field of supply chain finance (SCF). Maria Malinowska, director, supply chain finance, at Barclays, gave a comprehensive picture of what SCF can be used for and how corporates could add value to their supply network through it. Thomas Light, principal finance manager at Vodafone Procurement Company, talked delegates through a system that Vodafone has designed and is ready to roll out through its supply chain.

SCF enables the financing of the buyer's supply chain at the buyer's – usually lower – cost of funds. SCF provides finance to the supplier by way of a discounted early settlement of the payments due to the supplier, and payments discounted to the supplier are without recourse. There are some assumptions in here of course; for example,

that the buyer has better credit access or that the supplier has constrained credit access. There is also a need to recognise that credit may not be the sole driver of an enhanced relationship between buyer and seller. There is scope in areas such as product development, joint marketing and so on which may also help the supplier develop but, as one delegate put it: "We're not here to run their business." In addition certain industry sectors where there is a high annual spend with regular suppliers in the UK and worldwide may benefit more from SCF provision.

Malinowska's perspective was that treasurers should seriously weigh all the benefits of SCF against wider commercial drivers but that corporates and their suppliers should have this "tool in the cash management box". These benefits for the buyer can be:

- enhanced working capital through improved terms;
- lower supplier pricing;
- standardised payment terms and improved Days Payables Outstanding (DPO);
- better supplier relationships through the offer of a financing option at lower cost;
- the retention of liability on balance sheet as trade payable up to due date (i.e. not debtors).

For the supplier these benefits can be seen as:

- reduced financing costs and more predictable cash flows;
- early payment option to reduce Days Sales Outstanding (DSO);
- alternative source of liquidity.

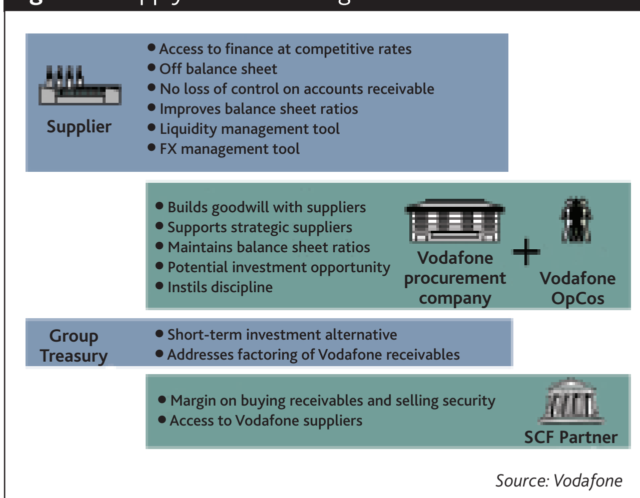
While these can be seen as the classic benefits, Light suggested that Vodafone saw SCF as part of a wider procurement project and a corporate financing review. For example, the company was keen to reduce or eliminate invoice factoring by suppliers, which could have a negative impact on Vodafone's credit ratings. And as well as improving the overall procurement model by moving to automated processes, the principles can be scalable across the whole Vodafone business over time (see Figure 3).

The final corporate speaker of the conference was Martin Gries, treasury director at cleaning products and personal care company Reckitt Benckiser. The approach to cash and treasury management that he described gave delegates food for thought, bringing together many of the discussions over both days of the conference, whether on technology, cash management, SCF or liquidity investment.

In particular Gries emphasised some of the basic principles on which Reckitt bases its treasury activity:

- **Understand your cashflow.** Gries's view is that while cash forecasting is an essential tool and discipline, it is generally wrong! This is not necessarily a "bad result" providing treasurers are aware of the degrees of accuracy and take steps to measure and improve the process. The advice is to take appropriate caution and always over-deliver.
- **Net working capital (NWC).** This key metric should be managed at all times and must have focus in the business, both in treasury as the "owners" and in operations (in Reckitt it is a feature of management remuneration!)
- **Be prepared.** Are your sources of credit committed and are they adequate? As regards supply chain, remember to look both ways when crossing the road – a customer or supplier failure can hurt, recession or not! And, unthinkable only a few years ago: are you confident that the banks you use will be there tomorrow morning.

Figure 3: Supply chain financing: Evaluation of benefits



Source: Vodafone

DYNAMIC SERVICES INDUSTRY

Cash management and banking is no longer an "ugly sister" in treasury terms. The pace of IT change, whether internal to a corporate or external to the industry, is driving business process development. The constraint in credit markets is driving business value development. The opening up of the banking landscape – whether through SWIFT, the PSD and SEPA or other regulatory and environmental factors – is creating a dynamic service industry increasingly attuned to corporate customer needs. Treasurers need to have confidence and grasp these opportunities to drive their organisations and the industry forward.

Peter Matza is head of publishing at the ACT.
pmatza@treasurers.org

Martin O'Donovan is assistant director, policy & technical at the ACT.
modonovan@treasurers.org
www.treasurers.org