Strategic cash

MARK BEARD AND **KARIN FLINSPACH** EXPLAIN HOW GOOD CASHFLOW MANAGEMENT CAN DRIVE CORPORATE FINANCIAL PERFORMANCE.

Since the start of the financial crisis, treasurers have been keenly aware of the need to rethink risk management strategies, redesign cash management structures to centralise and optimise cash, and rebuild processes to increase automation and efficiency. Defining an optimal level of liquidity for the business and working out how to maintain it have become primary considerations for senior management, stakeholders and analysts alike. Treasurers have been tasked both with managing cashflow more efficiently and influencing the factors which contribute to working capital, from order-to-cash to purchase-to-pay.

Before the crisis, companies were penalised for holding large amounts of cash on the balance sheet. However, as the crisis unfolded, strong cash positions and companies' ability to self-fund were rewarded with strong investor interest. As economic confidence returns, liquidity is likely to remain a higher priority than in pre-crisis days, although other factors, such as cashflow efficiency, are likely to gain in importance. Treasurers need to be adaptable to changing market attitudes and maintain sufficient liquidity levels for the business while demonstrating cashflow efficiency.

SOURCES OF LIQUIDITY. Liquidity can, in theory, be accessed from a variety of sources. Before the crisis, treasurers typically looked to the capital markets even though they have always been a poor source of operating cash. When the capital markets dried up, companies became more dependent on bank facilities and embarked on a more consistent use of self-funding techniques, both to increase liquidity and to reduce their working capital needs.

As the markets rebalance, treasurers should seek to command a variety of sources of capital so they can finance both core (payables, capital expenditure, dividends, debt maturities) and discretionary (share repurchase and merger/acquisition) funding requirements.

A DIAGNOSTIC APPROACH. To achieve this, treasurers need to measure working capital needs objectively, manage liquidity levels and deploy cash effectively. One valuable way of gaining that perspective is to benchmark aspects of the business against industry peers, to obtain an objective view of best-in-class performance.

Citi has developed a comprehensive treasury diagnostics tool, which includes issues such as liquidity, working capital, risk management, subsidiary funding and repatriation, treasury policy and governance, systems and technology. This type of tool can give meaningful reference points across a large group of peer organisations, industries and geographies.

Taking a holistic approach across various aspects of financial performance can be very valuable. For example, treasury tends to concentrate on liquidity as one of its primary responsibilities but performance in creating working capital, which is influenced by a wider range of factors, may be at odds with this.

The diagnostics tool reveals significant opportunities for treasurers to improve on the key dynamics that contribute to working capital, as illustrated in Figure 1, which shows that, despite the crisis, many businesses have significant opportunities

to improve key practices. For example, while companies are frequently strong in governance, risk management and funding and repatriation, their performance is generally weaker in working capital, liquidity management and systems and technology. Measuring performance against best-in-class organisations does not necessarily mean that an individual treasury should seek to match or exceed optimal performance in every single respect. Rather, the process can help to identify priorities in order to achieve the company's specific treasury objectives.

There are some areas of universal applicability, however, and the treasury diagnostics process reveals that the order-to-cash component of working capital management often poses particular challenges. Whatever value the market places on liquidity, collecting cash in a timely fashion should always be a core treasury goal to increase cash predictability, boost working capital and reduce risk.

ENTERPRISE LIQUIDITY MANAGEMENT: A STRUCTURED METHODOLOGY. We recommend taking a structured approach to measuring and managing liquidity based on three key steps:

- liquidity planning and stress testing to find the right level of cash for the company;
- deploying global liquidity structures to find how to run the business effectively at a given cash level; and
- improving working capital to reduce the amount of cash required to run the business.

1. Liquidity planning and stress testing. The starting point of a liquidity management strategy should be to determine just how much cash the company actually needs. This is not a simple exercise in subtracting liabilities from assets, as the figure is not necessarily the optimal level of cash to be able to fund liabilities while supporting strategic discretionary spend. Although current market attitudes favour larger cash balances, the long-term trend is to penalise cash surpluses. Since "just in time" manufacturing became popular during the 1990s, companies have been measured on their inventory levels, and it is accepted that well-run firms do not need high levels of inventory, which may reflect supply chain inefficiencies. Similarly, large cash balances may be the result of inefficiencies in the financial supply chain.

Calculating the right cash level is often based on a variety of factors, including evaluating the sources of cash versus the uses (see Figure 2), assessing the proportion of total cash that is accessible, as well as benchmarking against peers. Addressing inaccessible or "trapped" cash is an essential element of liquidity optimisation, as cash is only valuable if it is usable. Cash pooling is an important way to maximise the amount of cash that can be deployed, and by netting surpluses and deficits across the business, less cash in total is required and cashflow volatility is lower.

2. Deploying global liquidity structures to manage internal funds more effectively. Centralising cash management and the use of liquidity structures such as physical and notional cash pooling is not a new phenomenon among large multinational companies. Mid-size companies are also starting to introduce these techniques. The aim is to maximise the visibility of and access to cash, and to enable cash to be deployed where it is most needed. When cash is locally managed,

WHATEVER VALUE THE MARKET PLACES ON LIQUIDITY, COLLECTING CASH IN A TIMELY FASHION SHOULD ALWAYS BE A CORE TREASURY GOAL.

Figure 1: Diagnostics results show scope of challenge

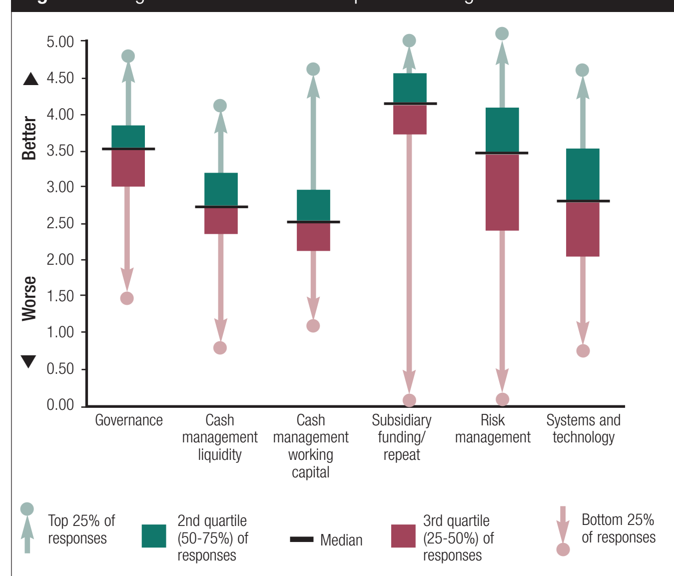


Figure 2: Determining the right cash level

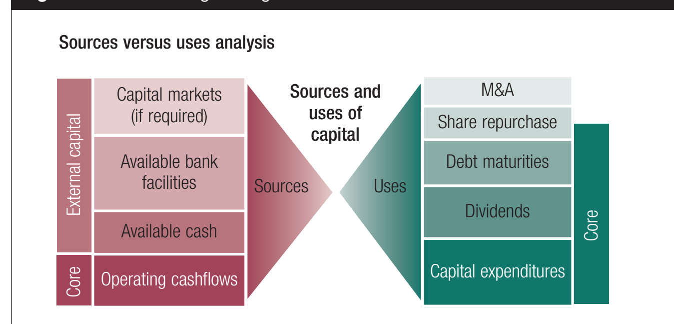
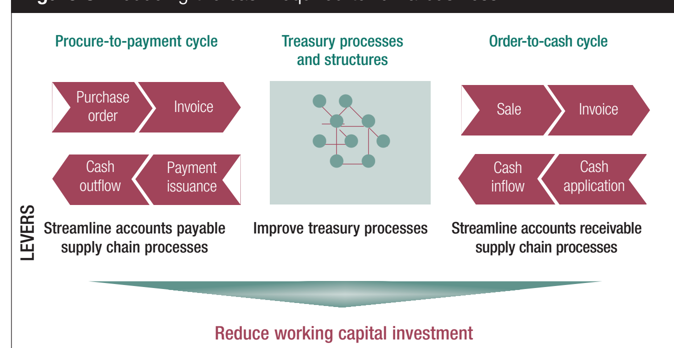


Figure 3: Reducing the cash required to run a business



cashflow volatility (and therefore the need for cash) can be significant. However, by pooling cash centrally, the effect of this volatility can be eliminated, resulting in a considerable reduction in the cash amount required by the business.

BY TAKING A STRATEGIC APPROACH TO CASH, LIQUIDITY AND WORKING CAPITAL … TREASURERS CAN DIRECTLY INFLUENCE THE AMOUNT OF CASH AVAILABLE TO ENHANCE THE COMPANY'S COMPETITIVE POSITION.

3. Reducing working capital requirements. Treasurers have become increasingly familiar with the drivers of working capital over the past two years, such as the purchase-to-pay and order-to-cash cycles, and they increasingly have an oversight role in addition to their more traditional cash and liquidity management responsibilities (as shown in Figure 3 on the previous page). Many companies have streamlined elements of the purchase-to-pay cycle and centralised their payments processing into a shared services environment. This is typically an easier area to manage than collections, as both the payment processes and the timing are brought within a company's control. The launch of the euro was also a catalyst for centralising cash management.

The most recent trends are first, to reduce trapped cash, and second, to optimise the order-to-cash cycle, an area of particular challenge for many corporates. Looking at the top 500 or 1,000 companies globally, there are major differences in days sales outstanding (DSO), including significant variations (up to 10 days) within an industry. In an environment of constrained credit, even an improvement of one day in the DSO could allow a business to reap substantial benefits. While DSO is not a new measure, it is now a higher priority, due to an increasing need to manage working capital more closely and the availability of efficient collections technology.

Another issue relating to collections is cash application. It is not uncommon for only 40-60% of cash items to be applied automatically as part of the reconciliation process, compared with the best-in-class figure of 95-97%. There are various reasons for this, many of which may appear, initially at least, to be outside the company's control:

- There may be inadequate/truncated remittance information as data is passed between systems.
- Each item may have a variety of identifiers, such as invoice numbers, references etc, making it difficult to reconcile.
- Customers may make partial payment if there are quality or non-delivery issues.
- Electronic duplicate invoices are often slightly different from the original.
- There may be too little magnetic ink character recognition (MICR) on a commercial cheque for an automatic match.
- The letter of instruction (LOI) with the company's bank may not permit sufficient keystrokes to process exceptions quickly.

These issues do not simply create a technology and administrative overhead, but inaccurate, untimely cash application results in restrictions in available cash and customer relationship/supply issues if credit lines are incorrectly utilised or collections chased in error. There are ways of addressing the challenges of DSO, unapplied cash and lack of visibility over the collections process, including centralisation of collections, enterprise-wide processes and reporting, standardisation of integration formats and introduction of more sophisticated reconciliations technology. The business case for optimising collections and reducing trapped cash or leakage is compelling. Addressing typical issues by establishing common visibility over pricing and payment terms, aligning credit conditions, introducing performance metrics and centralised, standardised processes can result in significant acceleration in revenue recognition, a reduction in trapped cash and increased cash collection.

Treasurers are under increasing pressure to engage in the processes that contribute to working capital. While the treasurer's focus has been on certain balance sheet and income statement measures, understanding and optimising performance across a wider range of working capital dynamics can be a vital way of adding value and reducing risk.

Citi has developed a sophisticated and comprehensive approach for clients to measure and enhance performance, both in traditional areas of treasury, but also in the wider order-to-cash and purchase-to-pay processes. By taking a strategic approach to cash, liquidity and working capital, such as optimised banking and cash management structures, analytics, benchmarking and decision support tools, treasurers can directly influence the amount of cash available to enhance the company's competitive position.

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