Focusing on the knitting

Executive summary

- Four close and well-managed banking relationships enable mid-cap company Edinburgh Woollen Mill to achieve the high standards of a large-cap treasury operation despite the more limited resources available to it.

Edinburgh Woollen Mill group is a classic UK mid-cap company as far as its treasury function is concerned. Like any £150m turnover group, it has to cope with a plethora of treasury needs and issues on a daily basis. Yet a clear challenge for any mid-cap is to ensure its treasury function can match the exacting standards of larger corporates.

That was certainly my aim with Edinburgh Woollen Mill. I arrived at the company eight years ago after a three-year spell as Group FD of Dorling Kindersley, then a FTSE 250 company (now owned by Pearson). Dorling Kindersley's turnover was around four times that of Edinburgh Woollen Mill, with considerably more international operations but smaller scale is no reason to lower the standards of the treasury operations.

For me, the key treasury challenges we faced at Edinburgh Woollen Mill were debt management, cashflow management and risk management. They are all challenges that can be overcome through strong internal procedures, strong partnership banking relationships and reliable systems.

Debt management has been a key issue since the company's secondary buy-out from Rutland Fund Management in 2002. A primary treasury focus has been the reduction of the level and cost of our gearing, which we have successfully managed to achieve – from four and a half times EBITDA (earnings before income taxes, depreciation and amortisation) in November 2002 to less than one and a half times EBITDA currently. Indeed, we have used a substantial proportion of our free cashflow to reduce overall debt levels, which now stand at around £25m, although we aim to reduce this figure still further.

A refinancing in February 2005 eliminated the mezzanine and subordinated loans, which were the more expensive elements of group debt. The loans were replaced with a five-year £50m revolving credit and other ancillary facilities. Over the next two and a half years continued strong free cashflow allowed this debt to be further reduced. It also allowed the management shareholders to buy out a minority interest in October 2006 with a further refinancing, including a £60m revolving credit and other ancillary facilities.

Within a few months, £10m of this facility was cancelled as it was clear that it was not fully required, allowing us to reduce the non-utilisation fees. The revolving credit facility is subject to a £5m per annum amortisation, which places the group under no pressure.

In fact, our utilisation of the reduced facilities is rarely more than 50%, although we are content to incur the non-utilisation fees so as to be able to take advantage of any acquisition opportunities.

BANKING RELATIONSHIPS The strong relationship with our banks has helped us reduce our interest costs on the debt. A set-off facility on all our bank accounts ensures we are only charged interest against our net debt position; in effect, the bank acts as a quasi-treasury on our behalf, allowing us to reduce central costs as well as debt costs.

When refinancing in 2006 we took the decision to reduce our banking relationships to a small number of banks that understood us and our business. This reduction in the number of banks came despite the fact that our credit facility was actually increasing.

Barclays Bank, Alliance & Leicester Commercial Bank, Glitnir Bank and Bank of Ireland were our chosen partner banks. Barclays was our main clearing bank and had supported us as lead manager in the past and integrated well with our treasury needs; we had long-established cash and cheque handling arrangements with Alliance & Leicester; and Glitnir and Bank of Ireland had demonstrated their commitment to supporting the group in the past.

GROUP FINANCE DIRECTOR **DAVID HOUSTON** OFFERS AN INSIGHT INTO THE TREASURY FUNCTION OF A MID-CAP COMPANY.

CASH HANDLING IS VITAL We are a high-street retailer with a strong bias towards the 50+ consumer where cash and cheques as a means of payment is more prevalent. We are also located in many small market towns that serve rural and semi-rural communities, which again gives our takings a cash and cheque bias.

Branch staff can deposit cash and cheques at the local post office (which goes back to Alliance & Leicester's days as Girobank). While this may conjure images of vulnerable company staff stuck in the bank behind queuing customers, the truth is that we employ a fast-track service where the cash is immediately deposited; counting and reconciliation take place subsequently, with a 99.9%+ accuracy rate.

As a group we are highly focused on cash management, employing daily, weekly, monthly and quarterly cash reporting and variance analysis against prepared monthly forecasts. We undertake three-month forward cashflow forecasts each month against which the actual outcome is measured each week. Indeed, we spend a considerable amount of time and effort assessing our forward cash movements and ensuring as far as possible that such forecasts are met or indeed exceeded.

This requires a considerable amount of attention to detail, ensuring that all sources of cash and outgoings are accurately assessed before being included in the forecasts. Any variances are closely analysed to establish precisely why they have arisen.

This is a tough regime for a mid-cap, although we are aided by our partnership banks and modern cash management technologies. For instance, we have recently installed an enterprise resource planning system that gives instant access to sales information. The system – which networks all our stores, head office and distribution centre by means of ADSL broadband supplied by BT Expedite using NSB Retail software – is integrated into our retail store cash management reporting system, allowing us to ensure that all sales achieved are banked on time and accurately.

SUPPLY CHAIN MANAGEMENT A key objective of the treasury function is to maximise cashflow generation at all times, which includes a strong focus on the supply chain. The fact that a high proportion of our suppliers remain based in the UK allows us to work with them to maximise cash and product flow to the benefits of both ourselves and our suppliers. Given our strong cash generation, we have negotiated early settlement discounts with many of our suppliers. Indeed, while many larger companies prefer to stretch the outstanding days payable, we have chosen the early settlement discount route as we know it is what our suppliers want, while being consistent with our own objectives.

For our overseas suppliers we aim to reduce costs and enhance cashflow by moving towards open account trading relationships and away from documentary credits/letters of credit and their associated costs. This strategy relies on establishing long-term relationships with a solid core of suppliers. Given our payments track record, most are happy to move towards this method of trading.

RISK MANAGEMENT Foreign exchange risk is probably our most keenly felt risk as we source a significant amount of raw materials for our in-house manufacturing operations from overseas. Many suppliers are paid in US dollars, making the dollar/pound rate a matter of considerable interest to us.

We deal with this foreign exchange risk through three types of hedging mechanisms. Most commonly we use vanilla forward contracts, which simply guarantee a rate in the future at which to purchase the currency, although we are increasingly attracted to participating forward contracts. These contracts limit our downside while allowing us to share in any upside, a sensible approach given the volatility in the US dollar/pound relationship in recent times. A third, less frequently used technique is currency options, which – for a premium – allows us the option (but not the obligation) to purchase US dollars at a fixed rate at a point in the future.

This is another area where our relationship with the banks is important, with three of them regularly quoting and thereby ensuring that we gain the most competitive rates. Our main provider is Barclays, although we occasionally use Glitnir and are also talking to Alliance & Leicester; it's more evidence of the importance to us of a close group of relationship banks.

Despite our sophisticated approach to FX risk, there's nothing flashy going on at Edinburgh Woollen Mills. We aim to give customers what they want and deliver exceptional service across our 200 high-street stores, 32 destination sites and 70 general tourist stores. We "focus on our knitting" (a Scottish expression meaning that we concentrate on our core strengths and ensure they are consistently delivered to a very high standard).

In terms of treasury operations I believe we continue to achieve the standards of a large-cap treasury function, despite the more limited resources available to a mid-cap. Certainly, all our actions over a number of years have been based on creating good treasury disciplines and employing the most appropriate treasury tools to support organic and, if necessary, acquisitive growth.

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