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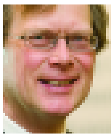

THE CFO STRATEGIES INDIA FORUM HELD IN MUMBAI IN SEPTEMBER STRESSED THE IMPORTANCE OF OPERATING CASHFLOW TO CORPORATE HEALTH AND WELL-BEING. **JAMES LOCKYER** REPORTS FROM THE EVENT.

The CFO Strategies India forum looked at operating cashflow in the context of the wider business, and its importance relative to external sources of funding such as bank debt and leasing. The dimensions of operating cashflow were described, particularly the need to understand the relationship between cash and profit, and the distinction between cash (in other words, immediately available funds) and liquidity (access to cash). The latter leads on to the concept of liquidity risk – a company's inability to access cash in the amount, currency, place and time it needs.

The value of some simple measures of cashflow was debated, such as cash conversion ratio, cash conversion cycle and working capital intensity in helping to measure and benchmark a company's operating cashflow performance. The forum also touched on the need to integrate plans for the short, medium and long term, highlighted some parameters for consideration when formulating liquidity risk management policies, and outlined a selection of risks that these policies might cover.

It was clear from the wide-ranging discussions at the event that while ratios are good in theory, a shortfall in comparable data means that they can be difficult to use reliably for actually benchmarking performance. Some businesses have difficulty in finding a meaningful comparator company for external benchmarking, although internal benchmarking is possible, using similar divisions in different territories, or against history. However, internal benchmarking alone gives little indication as to how a company should be performing compared to its peers, and at risk of criticism from lenders or promoters.

The availability of liquidity from external sources provoked lively debate. Some delegates were confident that their lenders remained willing to lend, and to lend more to fund expansion. But others reported a reluctance among banks to lend, particularly where a bank had entered into a facility agreement some time ago, with terms the bank now felt were "too cheap".

LENDING MARKET TIGHTENS Although bank lending in India seems much more accessible than in UK or Europe, recent increases in Indian interest rates have seen banks looking to renegotiate historic fixed rate facilities and loans. And banks are becoming more cautious about new loans and paying more attention to operating cashflow and know your customer (KYC) requirements. These factors emphasise the importance of regularly revisiting operating cashflows, not just in the immediate future/current year but across the next few years with strategic plans in mind. That way, longer-term funding operations can be planned and executed in advance rather than the business simply relying on new funds to be readily available when needed.

Despite the high nominal interest rate, a number of delegates felt that real interest rates (i.e. excluding inflation) in India were in reality negative at present, making the real cost of debt (including margin) significantly cheaper. Although this sounds like good news for borrowers, it is only so to the extent that the company can grow its profit margin

BANKS ARE BECOMING MORE CAUTIOUS ABOUT NEW LOANS AND PAYING MORE ATTENTION TO OPERATING CASHFLOW AND KNOW YOUR CUSTOMER REQUIREMENTS.

at the rate of inflation; and negative real interest rates cannot last for ever. A company which geared up to take advantage of cheap debt in real terms could come seriously unstuck when (not if) the real rate returned to positive territory, unless there were some way to borrow inflation-linked at today's rates.

There are a variety of approaches to monitoring operating cashflow and incentivising managers and operating units to act in the best interests of the company as a whole. Companies use a relative approach (i.e. actual compared to forecast) or an absolute approach (focusing just on actual results), or both.

One model is to monitor gross cashflow streams such as trade receipts and trade payments, split by operating company rather than net balances. Some delegates focused on control of working capital or capital employed, either by monitoring period end balances, or by doing so on a daily basis where systems allowed. Internal interest can then be charged based on these balances. Daily monitoring/reporting is preferable as it avoids "spiking" at period ends and gives a truer internal charge, although it can be more expensive to administer.

An alternative approach would be to focus on daily cash balances held both in external bank accounts and in internal intercompany accounts, even to the extent of setting up an in-house bank. This latter approach does seem to attract Indian companies where control over cash is important enough to warrant the systems needed, or where the company wishes to centralise remittances – whether payables or receivables. Running an in-house bank is also consistent with setting up a netting centre in order to minimise the number of remittances to and from the same entities (commonly within the company, but also potentially external).

Some companies adopt a far simpler approach, allocating individual working capital facilities at the bank to specific operating units, thus limiting operating units' ability to borrow. However, while this approach limits the maximum amount of working capital that operating units can invest in, it does not necessarily encourage them to optimise or minimise their working capital, unless they are also incentivised on the basis of their interest cost.

OPERATING CASHFLOW BACKUP There was an active discussion of how much cash, if any, a company should hold to provide a backup for operating cashflow – particularly if it is a net borrower. In India the cost of simultaneously borrowing and depositing the proceeds is substantial – greater than the equivalent in Europe, particularly if the interest rate for the borrowing is at current (as opposed to historically negotiated) rates. Whereas in Europe companies have deleveraged or are routinely holding cash (partly due to an increasing concern over the ability of the banking sector to finance them, so they are holding cash instead of setting up bank facilities), in India companies will hold cash only if they really have to.

The decision as to how much to hold is driven both by strategic considerations such as acquisition or expansion plans, but also by the cost of the option created by holding cash. Some companies (for instance, those whose operating cashflow is predictable and have assured access to cost-effective borrowings) hold a minimum of cash – no more than is implied by the monthly or seasonal trading cycle. And such companies will prefer to repay expensive debt.

EXTERNAL BORROWING IS BROADLY ACCESSIBLE AND DESPITE THE HIGH NOMINAL INTEREST RATE IT CAN BE (FOR NOW) CHEAP IN REAL TERMS.

Some acquisitive companies hold cash to fund acquisitions while additional core debt is sourced. And some companies that can borrow relatively cheaply under a historic facility agreement are drawing funds while they can and placing them on deposit. That way they minimise the risk that the bank will seek to renegotiate the loan if the borrower waits until the cash is actually required.

ACCOUNTING CASH VERSUS REAL CASH The distinction between "accounting" and "real" cash in management reporting (i.e. the difference between cash reflected in the management accounts and what is physically at the bank) also came under examination. For some companies that are both receiving and paying cash effectively in real time by integrating their enterprise resource planning (ERP) system with their bank reporting and using real-time gross settlement (RTGS) where appropriate, this is hardly an issue and they can be confident that accounting cash equals real cash.

However, other companies or groups could have significant timing differences over period ends, such as cash held abroad, cheques issued but not cleared, or direct debit receipts recorded on the ERP system but not yet received. In such cases there is significant potential for the true central borrowing position to be misinterpreted from the management accounts. In companies where this is important, board reporting includes a clear explanation of the true position.

To sum up, operating cashflow, comprising profit and working capital movements, is of central importance to CFOs. It seems just as important as external funding – typically bank borrowing (leasing solutions were hardly mentioned by delegates as a source of liquidity). External borrowing is broadly accessible and despite the high nominal interest rate it can be (for now) cheap in real terms, so there is less pressure in India than in Europe for companies to drive operating cashflow in order to deleverage.

However, if, as expected, bank lending tightens and interest rates rise in India – in particular in real terms – then operating cashflow is set to increase in importance. Indian companies may find they have to rely more on internally generated cash if they want to expand.

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