An essential journey

Executive summary

- The process of finding the optimal cash balance is complicated by many factors.
- Formulaic, practical and industry-focused strategies help to provide guidance on starting the optimal cash balance journey.
- Identifying and maintaining an optimal cash balance is one sign of a well-managed company.

The identification of and management toward an optimal cash balance is an underlying premise for successful liquidity management. It's a benchmark that enables a treasurer to judge the health of the company's cashflows and thereby provides a strong guideline for assessing whether or not the treasury is running as efficiently as possible – in line with corporate strategy.

Unfortunately for treasurers, the process of finding the optimal cash balance is complicated by a great number of variables. There is no simple, blanket formula that can identify the appropriate amount of cash a company needs for every situation. Without due consideration of the many variables, including industry-specific factors, geographical disbursement and concentration, a company's stage in the business cycle, return on investment and strategic objectives tied to a given time horizon, to name just a few, the end result is a generic formula that is meaningless.

But the journey in search of this intangible is an essential one, for without a clear understanding of the benchmark treasurers have no real guide on whether their policies are leaving the company holding too much cash or too little. Too little forces the company into unnecessary short-term borrowing and prevents it reacting quickly to opportunities. Too much and the company may be subjected to intense analyst scrutiny on the opportunity costs of excess prudence and pointed questions about maximising return to shareholders.

So what is a treasurer to do? Although theory is no substitute for practical knowledge, the following methods may guide a treasurer toward finding their company's optimal cash balance.

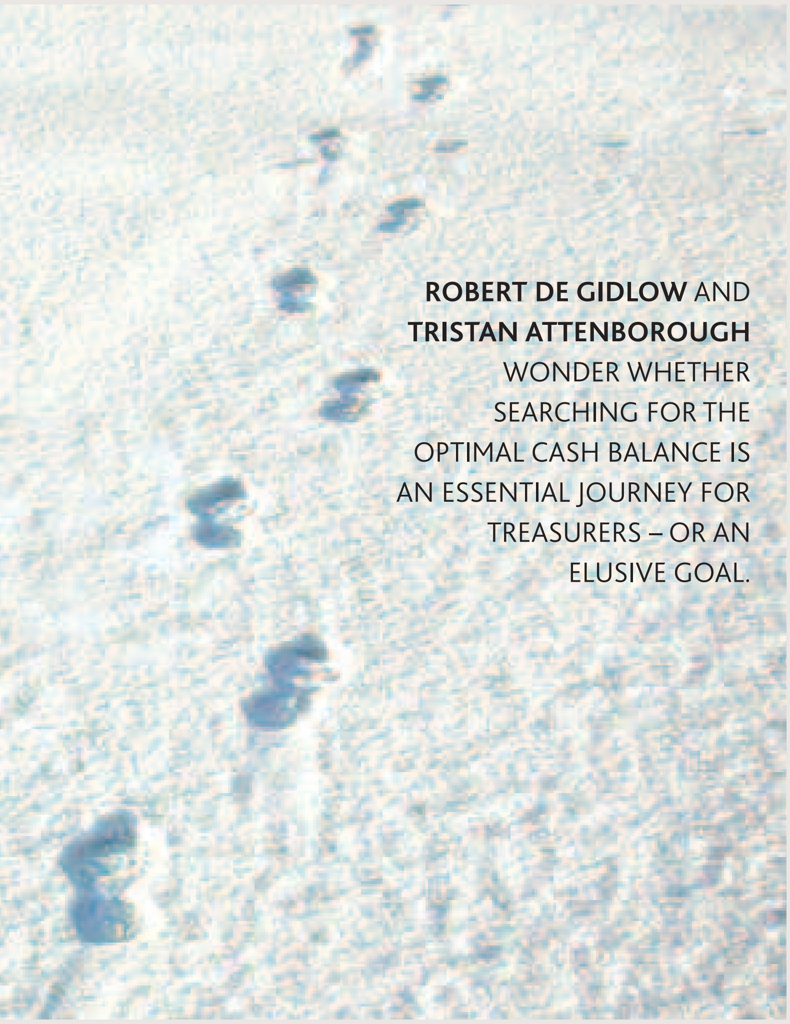
WORKING TO IDENTIFY 'OPTIMAL' Even before optimal can begin to be defined, a treasurer must be clear on the current state of working capital. They can use standard working capital metrics – days sales outstanding, days payable outstanding, inventory turnover – as well as consolidated cash balance over time to get an idea of the current state. The task of getting working capital metrics or consolidated cash balance figures for the whole firm may not be easy or straightforward, depending on the status and compatibility of reporting and systems capabilities, but it is fundamental information. Once current state has been established, certain strategies – formulaic, practical and industry-focused – help provide guidance on where to begin the journey of finding the optimal cash balance.

Formulaic The formulaic approach consists of applying an often published optimal cash balance formula to current practices. Although as a one-time, standalone procedure, a formula is not necessarily effective in determining a company's optimal cash balance, if applied correctly it can help a treasurer identify the optimal balance. The first and most critical step is to identify what information is needed and how to pull this data out of the company's management information systems. Next, after all necessary data is entered into the formula, the treasurer compares the theoretical answer to practical reality – the daily cash position as reported in the bank balances, for example. For the formula's final result to be of use, it is important to apply this practice long enough to extrapolate a trend. Convention says three to six months.

By comparing the result of the formula with the actual cash balance over a discrete period of time, the treasurer should be able to identify accurately whether or not the formula yields a useful tool/benchmark toward optimal. It is important to realise that the formula is simply a tool and may not take into account all the factors affecting a company – it is not an end in itself, but a means to clarify sub-optimal factors in the company's current cash position.

Practical The practical approach considers, at a micro working capital level, the factors that are most important to a particular company – having a high return on investment, for example – and uses the treasurer's own experience over time to gauge directional results.

Most companies should consider three important metrics – days sales outstanding, days payable outstanding, and inventory turnover. In addition, thought must be given to a cost/benefit analysis of



ROBERT DE GIDLOW AND **TRISTAN ATTENBOROUGH** WONDER WHETHER SEARCHING FOR THE OPTIMAL CASH BALANCE IS AN ESSENTIAL JOURNEY FOR TREASURERS – OR AN ELUSIVE GOAL.

achieving a positive change in any, or all, of these metrics. For example, if a company has to spend £1m to renegotiate for an extra day on payables terms, will the investment outweigh the return?

Here, where ideally the treasurer can guide working capital management and hence cashflows, the treasurer is looking to actively manage the metrics that best support the company's strategic plan. For example, in a steady-state business cycle, a treasurer may seek zero-balance in-country cash positions to minimise in-country risk and tax issues and to optimise investment opportunities. The treasurer is looking to achieve directional consistency in managing these metrics – for example, making sure they move over time in line with working capital goals. This continual self-examination, again an iterative/trending process, will put the treasurer in a better position to gauge progress toward finding the company's optimal cash balance.

Industry-specific This strategy suggests the treasurer take a more macro view of the factors underlying the company's optimal cash balance. Industry-specific factors can suggest norms, as put forth by organisations like Hackett-REL, and in the absence of practical experience may provide a valuable guide. In such cases, treasurers should measure their company relative to a peer group facing the same factors, including payment terms, currency exposure, an industry's exposure to external shocks or non-financial risks, the maturity of the industry itself, and so on. From this analysis, the treasurer can extrapolate an acceptable cash balance range for the industry, which can be applied in relation to the company's own priorities in order to better determine where 'optimal' lies.

All these processes can also be undertaken retrospectively – for example, by comparing current metrics or cash balance to levels a year ago – and can therefore demonstrate historical progress, or otherwise, toward finding a company's optimal cash balance.

THE PROCESS OF REFINING These strategies will not lead to a single optimal cash balance, but will provide the first steps toward identifying, directionally, where to find optimal. As a company changes, its priorities change (for example, requiring a cash ramp-up to support a strategic acquisition) and so too will the definition of optimal. Because the process of identifying optimal cash balance can only be progressive, developmental and iterative, the treasurer must actively manage the endeavour.

Given a company's own priorities, in each formula and in each analysis, there will be variables that hold more import than others. These variables should be an area of focus for the treasurer, because paying close attention to their movements and trends will affect liquidity management practices. As an example, for a retail company, the days sales outstanding metric should be managed towards zero, while in a manufacturing organisation inventory turnover should be consistent or better than the industry peer group. At each iteration, the treasurer can adjust these variables until optimal is achieved. In the retail example, payable contracts can be renegotiated, and in the manufacturing example, a look at the whole supply chain or product pricing may be required to bring inventory turnover in line with peers.

The process of identifying a company's optimal cash balance is a repetitive and complex journey, so it is fair to wonder how you know when you've got there. In general, it is reasonable to assume that when a single factor is massaged a bit further to the detriment of another factor, a company may be at an optimal balance for that given time horizon with that set of identified variables. For example, a change in payment options may inadvertently limit distribution, which in turn affects revenue. At this point, the process is anything but over, for this is a dynamic evolution and it is critical for the treasurer to focus on maintaining this balance, while adapting and shifting other factors to obtain an efficient frontier between all cash balance variables. This must all be done with an eye to external (market, competitive) and internal (business strategy) factors.

Identifying and maintaining an optimal cash balance is one sign of a properly managed company and a major part of a treasurer's responsibility. But there are others. A treasurer's overall goal should be to support the company's objectives as determined by the company's stage of growth, industry specifics and risk appetite. This must be done with reference to a specified time horizon and in such a way that the organisation is neither starved of cash nor flooded by it, neither exposed to excessive risk nor getting poor returns on its cash holdings. For some treasurers, reaching an efficient balance will be the true goal. For others, success lies in the discipline and the progress of the journey.

Robert de Gidlow is Sales Consultant EMEA at JPMorgan's Treasury Services division.
Robert.De.Gidlow@jpmorgan.com

Tristan Attenborough is Head of Liquidity and Investment Products EMEA at JPMorgan's Treasury Services division.
Tristan.Attenborough@jpmchase.com

www.jpmorganchase.com