Give your WORKING CAPITAL a WORKOUT

Optimising working capital and reducing working capital requirement are subjects that seem to be back in the limelight on the treasury scene. ***This article describes the current situation. It explains the frantic efforts being made to put the company on to the very best financial footing and the reasons for this renewed fascination in any technique that will make working capital more dynamic. New, open, non-bank and multi-(counter)party solutions are emerging in this restrictive regulatory environment and with the arrival of Basel 3.***

The current situation: spotlight on working capital

Is it just a passing fashion? Working capital clearly seems to be back on the agenda for quite a few treasury departments. As with fashion, sooner or later some element, look, focus or idea comes back to the fore. Just like a garment, sooner of later, the basics of treasury once again become the flavour of the month and come to overshadow other fashions. The environment in part explains this rise in new solutions for improving working capital.

The situation is fairly clear. We are confronted with very low interest rates – negative interest rates, no less, since May 2015 – and we expect them to stay low for a long time. We also find a liquidity paradox. There is plenty of cash, but not everyone can gain access to it, while at the same time corporates have built up cash piles which earn next to no or no interest, and which are not invested in asset purchases (a sort of dormant reserve). I should also mention regulatory requirements and their collateral effects (for example CMU, B3, Bank Segregation, etc.) which are pushing corporates to revisit their bank strategies. It is no good pointing out that customers are (mostly) paying their suppliers later and later, which is worrying governments and the European Union. The good news is that technological developments and IT solutions are appearing and changing the rules of the game. They enable treasurers to optimize their working capital by means of such things as more central control, better accounts matching and reconciliations, virtual accounts and standardised formats such as XML 20022 or SEPA, etc. All these factors, along with others, are driving a real and profound transformation in treasury departments.

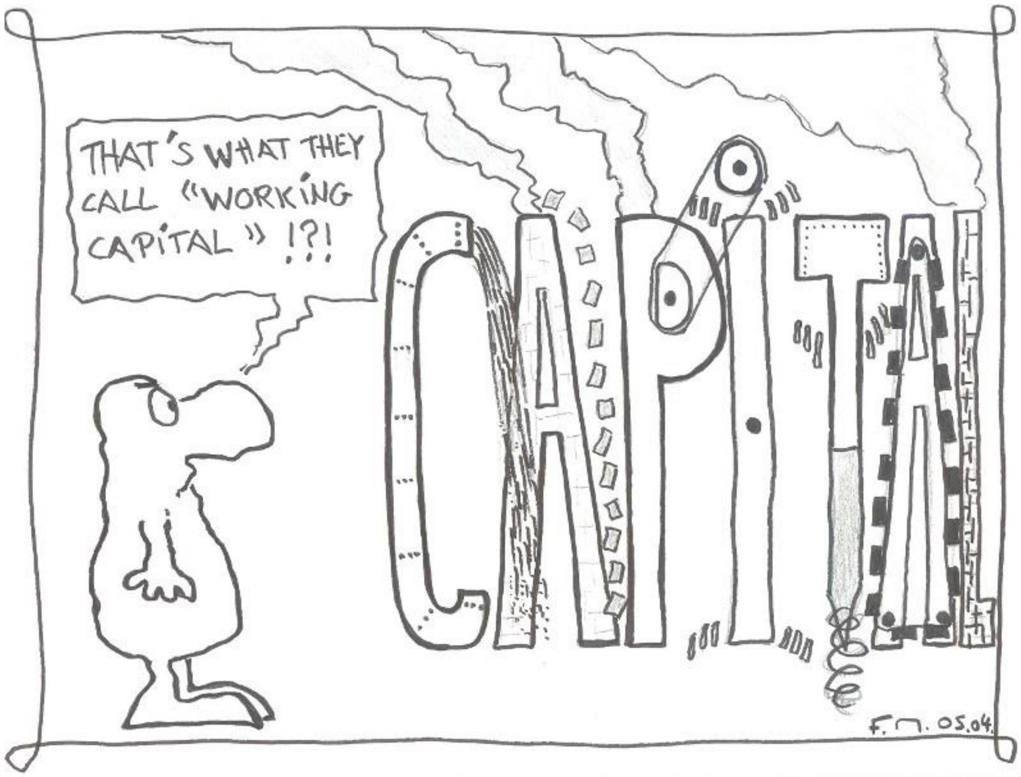
How do we move up to the next level?

For treasurers, the approach to working capital is evolving. Rather than simply addressing deficiencies and other inefficiencies by making very short-term gains, treasurers must be visionaries and be proactive in seeking to install longer term sustainable strategies into the very heart of the business and into operations to maximise working capital. The aim is to drive this change while ensuring minimal disruption to day-to-day operational activities. We seem to have seen a slow but steady improvement in performance over the last few years (+6%/year according to a REL study). Treasurers not only understand but they also acknowledge the importance of working capital in this turbulent economic environment with low interest rates and hyper-volatile markets. Working capital has suddenly become more than a simple product; it is become a veritable philosophy to be inculcated throughout the company.

Leveraging assets

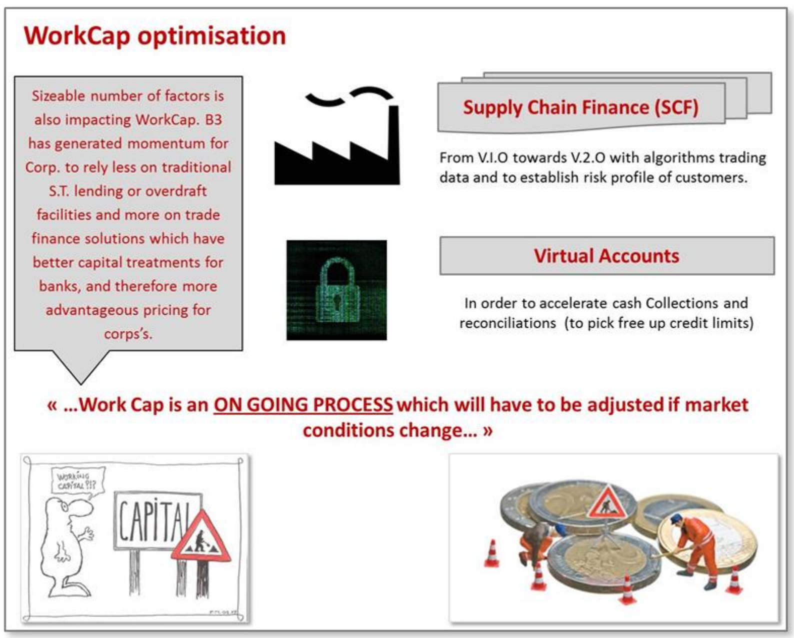
Basel 3 will undoubtedly have an enormous impact on bank strategies, an impact that is all too often underestimated. A huge swing towards widespread reorganisation and restructuring is under way in the banks. They are all trying to get themselves into shape to cope with Basel 3 and other new regulatory requirements. They will not find it easy. The outcome may be a return to some of their core businesses and a withdrawal from others with too low a rate of return. Tough luck for the corporates, they will just have to look elsewhere for their solutions. It will be absolutely essential to diversify sources of finance and service provision. Financing, for example, will become trickier, and it will be crucial to optimize your sources of finance. This will involve using other sources of finance and other counterparties for investments. Banks will no longer be interested in bank deposits, since they are already awash with cheap cash injected by the

European Central Bank. In this environment, businesses understand that they can use their balance sheets as a tool, and become better at allocating any spare cash they may have. There are still opportunities for optimizing corporate resources, and this may be one alternative to traditional banks, both for lenders and for borrowers. Prevention and anticipation are the best advice that can be given to businesses in this shifting environment.



<u>Market trends</u>

The motto "*Make your money work harder for you!*" strikes a chord in the minds of treasurers. Let us beef up the muscles of our working capital and go into training to become more financially fit. Like good new year resolutions – "*this year I am going to do more sport*" – "*Let's give our working capital a workout!"*. The advice is not to rest on your laurels, and to look for alternative avenues. Invoice discounting and accounts receivable buying solutions had a rather negative image in the past. Discounting was done in a piecemeal, random and rather uncoordinated manner. The perception of funding by using Supply Chain Finance has also changed. It is easier to persuade suppliers and customers to use such schemes today, because the benefits to both parties are better understood. Who, today, would want to see their customer or supplier disappear? Nobody, obviously. This new environment explains the growing interest in the famous SCF. Let us help our buyers by broadening the payment terms available to them and/or let us pay earlier (which is what the EU would like) to help suppliers while making more dynamic use of invoice discounting. That would be a win-win situation. It would be a more bilateral strategy than the individualist strategies used in the past. The economic crisis has changed the way people look at things, thankfully. This is even becoming good practice, recommended for everyone.



The challenges

The greatest challenge with such endeavours is that they are not single isolated undertakings but continuous, long-term undertakings. The operational departments must be involved just as much as the financial departments, which is by no means always the case, sadly. We increasingly need to distance ourselves from looking at A/P or A/R or inventories in isolation, and instead consider all of them together at the same time. Three ingredients, but nevertheless requiring delicate alchemy in the nature of a dilemma, because we have to achieve the best formula by fine tuning the balance of the ingredients. To that we have to add the group discipline that needs to be ingrained into the troops and then maintained, as this is a key component of the undertaking's long-term success. Close links need to be forged between procurement and finance to decide on better terms and conditions throughout the whole group, in spite of potential divergences between departments – one department may be trying to get the best price while another tries to hold onto as much cash as possible. Central computerised control of working capital is very important and needs good coordinated organisation if it is to avoid disrupting the running of the business. In the final analysis, it must work to the benefit of the business and not act as a brake on it, especially in these times of crisis. Finance should be the oil in the machinery and not a brake on operations. And it is particularly in times of need that we have to increase discipline to enable us to spring back more strongly when the recovery comes. And finally, it is worth remembering the need to diversify your sources of finance and investment. It may be advisable to benchmark yourself against your peers, which some organisations are planning to do. It enables them to take stock of where they stand and helps them set targets that they can realistically achieve. All they then have to do is to get the "buy-in" from management and win the CFO's full support.

Where will the responsibility for such undertakings lie?

The responsibility is usually fragmented, which is what makes such undertakings so difficult. All the ingredients mentioned above are handled by different people. Treasury is only one link in the chain, a key link certainly, but only one single link. Installing a COBO system for instance will streamline reconciliations and accounts matching and free up cash from customer credit lines. This benefits everybody, and shortens the financing cycle. Local and regional differences, and market habits and practices could be a brake on standardisation. You face a long, hard struggle in carrying all the local players along with you. It is not easy, that's for sure. The first step is to decide on the terms and then the key performance indicators to be monitored. Without comparison over time and across all functions, there are no targets. You need a sort of financial Esperanto to embark upon such an undertaking.

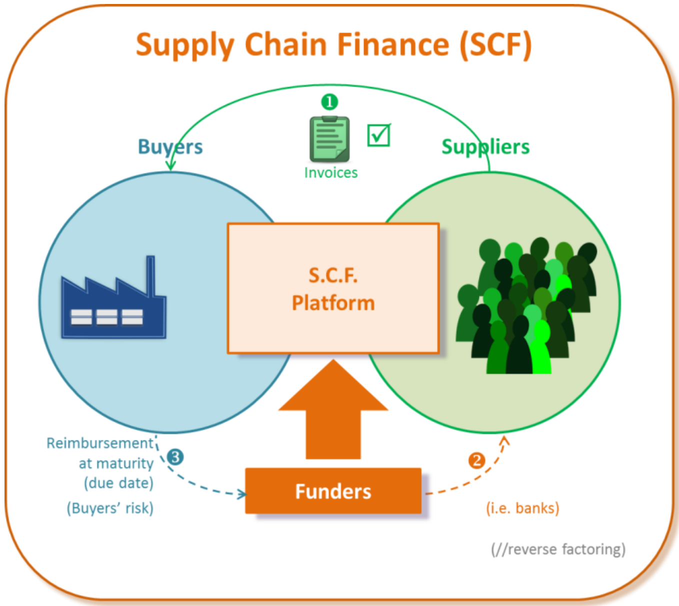
Payment terms are not getting any better

It is a regrettable fact that in spite of many national initiatives, payment terms are still lengthening. A sign of the times? To do with economic problems? Perhaps, but the fact still remains that the situation is not getting any better. In France, since the Modernisation of the Economy Law, average payment times have been lengthening. Fine words but no action. Initiatives like the UK "*Prompt Payment Code*", the US "*SupplierPay Initiative*" and the "*Betaal Me Nu" initiative in the* Netherlands, for example, will change nothing. You can try to legislate, but it does no good. The law of the jungle prevails, and it can be rather cruel. For instance, ABInBev is said to take over 120 days to pay. Top Shop requires suppliers to agree to a 2% higher discount for payment in under 60 days. It beggars belief! The press is swamping us with stories of such practices which, while they are certainly understandable, have a sorry effect down the rest of the chain. And there is also a second dilemma: (1) how not to disrupt your own business and optimize your working capital, and (2) how not to undermine the financial health of your suppliers and customers. Finding the right balance is no easy matter. Supply chain finance programmes can form part of CSR (Corporate Social Responsibility) strategies, by treating creditors (and customers) more fairly and even-handedly, particularly SMEs which find difficulty in attracting funding. A company that pays slowly or that is seen as a "bad payer" (paying very late) runs a reputational risk. In offering advantageous solutions to its small suppliers, a car manufacturer would obviously be contributing to meeting its corporate social responsibility objectives and securing the long-term future of its business.

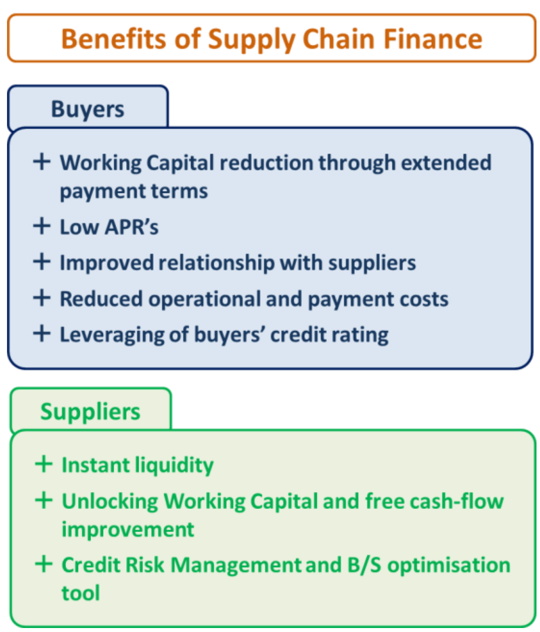
New services

Thankfully, B2B solutions exist and are gaining ground in the world of supplier finance. We have in mind solutions such as *C2FO, Prime Revenue, Tradeshift, Hanse Orga, Taulia, Kyriba, WallStreet Suite, MarketInvoice*. Many other solutions and platforms have sprung up offering multi-banking (bank-agnostic), multi-product and multi-counterparty techniques. Of these, I would like to pick out two that look to be really worthwhile: (1) Supply Chain Finance (SCF) and (2) dynamic discounting. In spite of all the efforts made by governments, it is probably only the market that can produce solutions for speeding the flow of funding to SMEs and supporting them financially. Creativity and technology, too, can contribute to serving the economy.

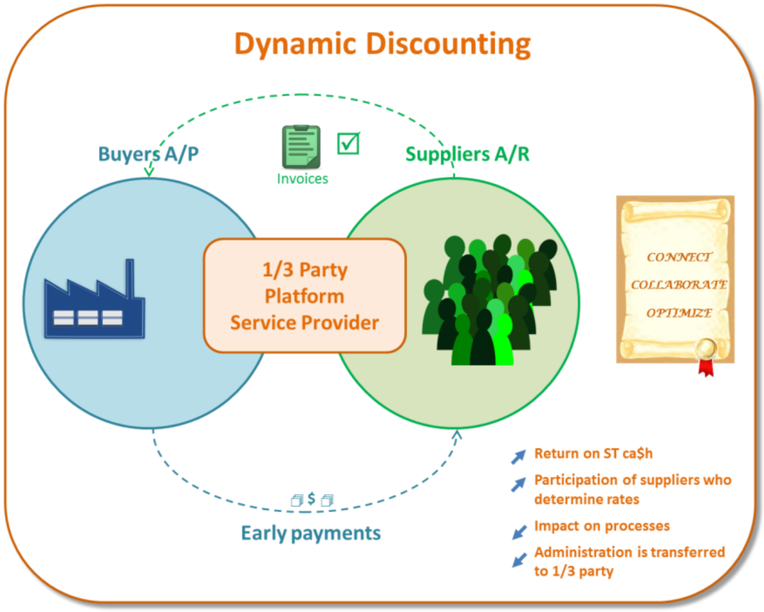
A). Supply Chain Finance:



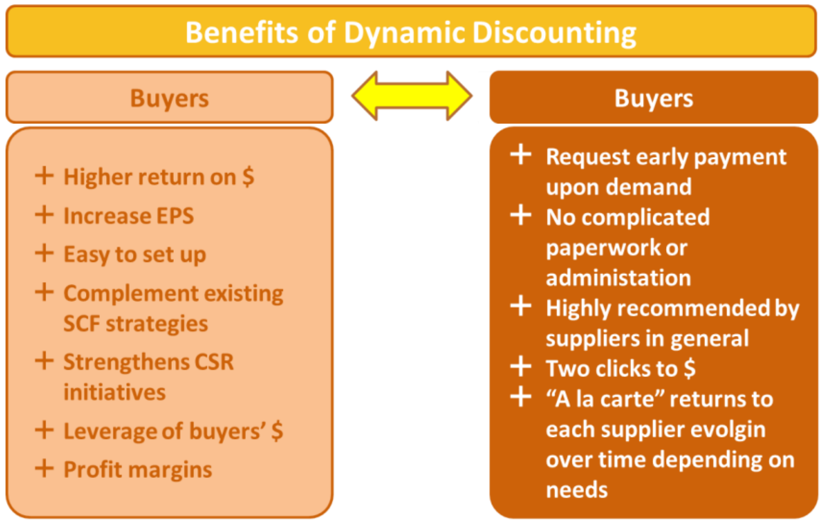
The idea of SCF is to set up a platform on which suppliers and buyers can find finance by means of diversified external funding. This is called "reverse factoring". It helps buyers to optimize DPO (Days Payables Outstanding). The buyer enters into an agreement by which the financial institution advances the funds to the seller on the basis of invoices issued. At maturity, the buyer pays the bank and not the seller.



B) Dynamic Discounting:



The idea of DD is to have a third party platform that handles supplier discount dynamically as and when required. It is a way of optimizing your cash by "investing" in a supplier for the discount rather that for miserable rates of interest, or even no interest at all. The rate of return on cash produced by such arrangements is estimated at 6%-7%. It has low risk and helps make the financial cycle more robust. What more could you want? The suppliers take an active part in deciding on the rates at which they would like to see their payments speeded up. In the final analysis, solutions of this type – this is what is so neat about it – strengthen the relationship with suppliers and enhance supplier satisfaction. The rise of P2P (Purchase to Pay) technology helps with developing new solutions. The success of these new solutions lies in how they work and their speed and responsiveness.



Conclusion

Let us bear in mind the principle of the three R's (Risk, Return and Regulation). Recent surveys have identified that optimizing and generating free cash flow is a key priority for treasurers. Furthermore, no company should ever forget that it can run out of cash only once in its existence, so it is crucial to make sure that it has cash available.

In this connection, Supply Chain Finance (SCF) and Dynamic Discounting are two cornerstones in ensuring sources of finance are available. Multinationals are looking for multi-bank and bank-agnostic solutions to be able to change easily, so as never to need to depend on just one bank. This is especially so in times like these when some banks are liable to do sudden about turns. RBS is a perfect example and the most recent illustration of this, but there will be more. Let us be positive, in the knowledge that new solutions exist and are gaining ground, to come to the aid of treasurers. However, wide-ranging projects of such broad scope need the unswerving backing and support of C-level management if they are to succeed, and they need to involve all of the players including procurement, treasury, payments and receipts processing, finance, controlling, legal, IT and central accounting. Coordination between all of them is crucial. Furthermore, this also backs up strategy and the CSR (Corporate Social Responsibility) programme. In the long run, ensuring the survival of the smallest suppliers matters. Imagine a car manufacturer that took subcontracting to extremes and ended up having to give financial support to its small subcontractors to stop them going under. Keeping them going and healthy is more a corporate good citizenship duty than a financial responsibility, and guards against the risk to reputation in big bad groups that push their suppliers to the limit. Think of the accusations levelled against large retail, which is wiping out farmers and small producers. Regulations and bank strategies will keep on evolving, and not in the right direction for corporates, sadly. It is therefore vital to be prepared and to diversify your sources of finance and investment, while seeking to achieve an optimal financial position. Treasurers need to develop a more dynamic attitude and take the lead in undertakings of this type. A real challenge for every treasurer through to 2020! Pablo Picasso said "*taking action is the first step towards success*".

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