

Capitalising on Market Uncertainties

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- Today's working environment is one of the most challenging for company treasurers and chief financial officers.
- Though demanding, this environment represents an opportunity to tighten and hone business and financial processes that may have become overly relaxed during the era of growth.
- The current situation also represents an opportunity to reassess and enhance working relationships with both financial and commercial suppliers.
- Some companies are beginning to appreciate that a purely "commoditised" relationship with suppliers has its limitations. A similar situation applies to banking.

It is clear that today's working environment is one of the most challenging for company treasurers and chief financial officers (CFOs). A range of factors have combined to create uncertainties that were perhaps unforeseen even 12 months ago. Understanding the nature of these changes and capitalising on them is key to the value that finance functions bring to organisations.

Many companies in Asia have customers in regions such as the US and Europe that have been severely affected by the credit crisis, both directly as demand in their industry sectors has slowed or indirectly as the availability of credit has reduced. This customer demographic is now looking extremely uncertain in terms of future order flow. Although intra-region demand is buoyant and credit availability in Asia has not been hit as hard as in many other regions of the world, the spectre of inflation is raising its head in most of the major economies. For Asian companies exporting to customers in the US, this inflationary problem is proving especially awkward. If they are manufacturing in countries such as China, they may find themselves confronted with a combination of inflating local factor costs priced in local currency and sales revenues priced in weakened US dollars.

At the same time, credit conditions are proving extremely taxing. Companies have noted the impact of the credit crisis on many banks and are asking themselves some serious questions about

which of their banks will actually be capable of supporting them. The condition of some bank balance sheets is problem enough, but this is being further compounded by continuing liquidity constraints in the interbank market. This lack of available bank credit obviously feeds through into a liquidity shortage for companies, but is further exacerbated by the generally low level of business confidence. As a result, organisations are looking to extend their days payables outstanding (DPO) while simultaneously contracting their days sales outstanding (DSO) to improve their liquidity.

The final toxic ingredients in this decidedly unpalatable recipe are global commodity prices. General price inflation in some Asian countries is a serious issue in itself, but it almost pales into insignificance when compared with the recent explosion in certain raw material prices. Apart from the immediate impact on the price of finished goods, these are not risks that are easy to hedge as the sheer volatility of commodity prices has pushed pricing on hedging instruments such as options to unattractive levels.

Implications

Risk

The risk management implications of this inclement environment are significant. At the most fundamental level, company treasuries have had to undertake a re-assessment of all their trading relationships. Particularly where they are dealing with customers in depressed markets such as the US, there is the question of credit limits to be considered. Should these be reduced or the credit terms shortened?

The company's funding situation may also need review. Is there sufficient contingency funding available from banking partners? Can it actually be relied upon? And what about the balance sheet? In calmer conditions, shareholders and analysts frown upon anything other than the bare minimum of cash on the balance sheet, but in the current environment should cash levels be increased? *Can* they be increased?

The counterparty risks of financial as well as commercial partners need re-evaluation. The risks of lenders withdrawing support have already been mentioned, but there is also the matter of the robustness of fund managers and deposit holders, especially if the company is attempting to hold a greater percentage of its assets in cash. There are also the hedging implications to consider – is there a need to diversify risk counterparties for foreign exchange, interest rate or commodity hedges? What contingencies should be put in place for existing positions? Finally, there is the matter of business continuity planning with regards to the supply chain. If economic activity is depressed, it is imperative that available sales opportunities are not squandered through a failure to deliver caused by the demise of a key supplier. Should additional suppliers be considered as a contingency? Or could a banking partner provide a supply chain finance solution that would strengthen the working capital position of key suppliers?

Demand, Costs and the Bottom Line

As economic activity weakens, predicting demand for products and services becomes increasingly difficult. This, in addition to working capital costs, is usually a strong motivation for organisations to attempt to drive their inventories down to the irreducible minimum. The downside to this approach is obviously the possible inability to deliver in the event of unexpected sales. This again emphasises the importance of having a resilient supply chain that includes loyal suppliers prepared to make exceptional efforts to ship inventory at very short notice.

With general and commodity-specific inflation to contend with, it is inevitable that most companies are experiencing a rise in operating and production costs. Other than hedging, there is seldom much that a treasury can do about these. However, it can influence one very important cost – that of working capital. Now more than ever treasuries need to bear down on the total amount of working capital their companies require and the costs of funding it.

In the current market conditions, such a working capital reduction can provide a significant boost to profitability that is otherwise likely to be depressed. The liquidity constraints in the banking sector noted above have inevitably driven up pricing, so the interest expense saving of even a small reduction in the working capital requirement can have a substantial effect on the bottom line.

The CFO's Concerns

Profitability

A decline in profitability is obviously of concern to CFOs, but seems difficult to resist in the light of reduced order books, weakening demand from customers and increased cost of goods caused by inflating raw material and operating costs. Increased focus on the supply chain can do something to alleviate this situation. Recent years have seen many companies adopting a far more collaborative approach with their suppliers. Rather than continually driving down prices and looking to increase credit terms, some companies have started to appreciate the benefits of building supplier relationships that will benefit the organisation in all market conditions.

For example, if suppliers are allowed sufficient working capital to invest in new production techniques and innovation in benign market conditions, the customer is likely to reap the benefits in terms of reduced costs and faster turnaround times. Yet again, supply chain finance can play a crucial role here. If suppliers can use a buyer's credit rating to obtain a lower cost of working capital, they will have the opportunity to invest for mutual benefit.

Bank Relationships

Relationships with banking partners are currently near the top of most CFOs' agendas. While the most fundamental questions about bank relationships tend to centre on the likelihood of banks being willing or able to provide support in the future, there are related issues to consider.

In view of the pressure that banks are under in terms of their own financial performance, one important consideration is whether they will be looking for a greater share of a company's wallet for a given amount of credit support. This represents a major juggling act for the CFO or treasurer, who in the current economic conditions will probably have a reduced wallet size that may have to be distributed across a group of banks all looking for a larger share.

From the corporate perspective, there is an analogy here with supplier relations. The banks that can offer most, in addition to credit, are deserving of a greater wallet share. In practical terms that translates into the banks that are most proactive in adding value through tailored, and often innovative, solutions.

Geographic and Economic Impact

In certain Asian markets, a combination of high inflation and currency restrictions are of considerable concern. Costs are rising sharply in the face of declining or stagnant export markets, so margins are inevitably squeezed. This is particularly problematic where the company is selling in US dollars, which has been weakening against many emerging market currencies. Add in currency restrictions and the inability to hedge and the effect on profitability can be dire. Those companies fortunate enough to have a good geographic spread of production facilities or suppliers are already responding to this situation by sourcing from less inflationary economies and/or ones where foreign exchange hedging is feasible.

The CFO's Opportunities

Supply Chain Streamlining

The administrative costs of a disparate supply chain become more noticeable when trading conditions are weak. While it is true that multi-sourcing provides an element of contingency, this can soon be outweighed by the additional supplier management workload. Furthermore, given the trend towards forging closer supplier relationships, there is a practical limit on the number of such relationships that can be supported and developed. Finally, there is the question of volume discounts – a few suppliers handling larger orders are more likely to be willing or able to pass on economies of scale than multiple suppliers handling small orders.

These considerations have seen many companies preferring to rationalise their supply chains. Resources are being focused on developing relationships with a few companies that are identified as already either core suppliers or having the potential to become so. Apart from the opportunity to reduce costs, there is a risk management angle to this approach. In certain sectors the reduction in demand, or the rise in costs of production have driven suppliers out of business – sometimes leaving their workforces unpaid and orders unfulfilled. Apart from the disruption to sourcing, there are also the reputational risks to consider.

Supply Chain Collaboration

This trend towards a more collaborative approach with suppliers offers certainty to both parties. The buyer can rest assured that the goods will arrive on time and to specification, while the supplier can take comfort from more

favourable contract terms. As the degree of collaboration increases, so do the potential benefits. For example, it is not uncommon in the electronics industry for suppliers to have personnel working in-house at customer sites. The result is that the supplier gains a better insight into how the buyer operates and is therefore able to offer suggestions for process and manufacturing improvements that will benefit both parties.

One of the most mutually beneficial opportunities for buyers and suppliers lies in supply chain finance. A company may be an expert and highly cooperative supplier, but if it lacks sufficient working capital, the buyer is running significant business continuity risks. There is of course the possibility that the supplier will fail entirely, leaving the buyer with a large hole in its production schedule. But even where the supplier does not fail outright, a lack of working capital may leave it unable to pay its own suppliers punctually, which may result in them suspending supplies. From the end buyer's point of view the result is the same – disrupted supply.

If the buyer is able to take advantage of its credit rating in partnership with a bank to offer supply chain financing, the situation changes dramatically. Preferred suppliers may already have certainty of order flow, but now they will also have certainty of working capital – and at preferential financing rates.

Working Capital Improvement

A further advantage of supply chain financing is that it is often largely neutral with respect to the buyer's own working capital position. In fact, it can potentially be used to improve it. In return for being able to draw against approved invoices at preferential interest rates, suppliers may be prepared in return to extend the credit period on their invoices, thereby increasing the buyer's DPO and reducing its working capital funding requirement.

Particularly in the current economic climate, extending DPO consensually outside the supply chain finance environment may not be so easy, but may still be possible if the supplier can be offered something in return such as certainty of order flow.

The Information Game

Inevitably, any discussion of working capital improvement sooner or later includes DPO's counterpart – DSO. A variety of factors feed into the reduction of DSO, but one of the most fundamental is information. Particularly in countries where clearing system limitations result in truncated or lost remittance data, it can be extremely difficult to reduce working capital cycle time.

If this situation is combined with mediocre bank reporting systems, the result is unnecessary inefficiency. For example, a customer might pay outstanding invoices on Day 1, but it could be Day 4 or 5 before the seller's accounts receivable (A/R) department knew that a payment had been made. In addition, if remittance information was truncated or missing, it might quite possibly be Day 8 or 9 before the A/R department was able to apply the payment correctly to the invoices. In the meantime, the next shipment for the customer might be waiting on the loading bay or possibly waiting to start production pending clearance of the outstanding invoices. In addition to extending the working capital cycle time, this situation obviously also risks damaging the customer relationship.

However, this is an area where the engagement of a suitable banking partner can reap dividends. Bank reporting systems capable of transmitting information in, or near, real time can advise on incoming funds potentially before they appear as cleared funds in the recipient's account. In addition, the bank may also be able to offer a parallel routing service for remittance information, which will facilitate the correct application of remittances to outstanding items. Taken overall, the availability of timely and complete information can easily lop several days from DSO, with commensurate working capital performance improvement as well as benefits to the profit and loss account.

Reality, Inventory, Liquidity

A further opportunity to bear down on working capital lies in a more general scrutiny and overhaul of A/R processes. Are invoices being issued punctually? Does anyone check that the correct person received the invoice and that there are no disputes or queries? Does anyone make a reminder call shortly before the due date to check

that everything is in order and that payment will be made punctually? In a perfect world the answer to all the above questions will be a resounding “yes”, but in reality . . . ?

For many organisations, inventory represents a major element in their working capital requirement. This is another area where the involvement of a banking partner in providing supply chain finance and timely data can pay dividends. If the buyer wishes to minimise inventory by requesting just-in-time shipments, a considerable degree of trust on the part of the supplier is required. However, this is unlikely to be an issue if the supplier is already benefiting from a finance programme initiated by the buyer and has access to rapid and accurate information on buyer payments.

As with coins lost down the back of a sofa, many companies still have unused pockets of liquidity that could be deployed to reduce their working capital requirements – clearly desirable in view of the rising cost and uncertainty of bank borrowing. While certain country restrictions make pan-Asian concentration or pooling unfeasible, a growing number of companies are realising that there is still much that can be done to optimise their liquidity on a “per country” basis. However, this very much depends upon the quality of information available to them – invisible cash is unusable cash. Yet again, banking partners with suitable systems infrastructure can do a lot to improve the situation by consolidating data and cash, even from third-party local banks.

Even where it is not possible to physically consolidate cash, it may still be possible to obtain an enhanced rate of interest on the total credit balance across the region, albeit in different accounts at the bank.

Outsourcing Financial Processes

In an uncertain business environment, there is more than ever a need to focus resources where they can add most value. This consideration is driving a growing number of companies to outsource financial processes. The outsourcing of accounts payable is now relatively commonplace, but to date the sensitivities around the ownership of customer relationships has seen fewer attempts to outsource A/R. However, an interim step that is growing in popularity is the outsourcing of A/R reconciliation, whereby a bank or other provider handles the matching of receipts and invoices and returns a fully matched file for upload to the company’s enterprise resource planning or accounting system.

In addition to the potential reduction in operating costs, the outsourcing of non-core processes also represents an opportunity to increase the size of the company wallet from a bank perspective. In view of the pressures on maintaining bank credit relationships, that could prove particularly timely.

Rationalisation and Risk

The rationalisation of the physical supply chain has a financial parallel: focusing on fewer core banking relationships is just as vital. Just as the company needs to know that it can depend on its suppliers for deliveries of goods, it needs to know it can depend on its banks for deliveries of credit. In return, it offers certainty of revenue in terms of share of wallet just as it offers physical suppliers certainty of order flow. Again, this is a two-way relationship that should benefit both parties, as a greater understanding of each other’s business models and strategies should lead to closer collaboration and more efficient tailored services.

In a sense, the process of rationalising bank relationships represents an element in the corporate risk management strategy – namely, the risk that bank funding support will be unavailable when most needed. Now may also be a propitious moment to tighten up on the management of other risks – particularly trade credit.

When the business climate is positive and default rates low there is a tendency for the vetting of trade customers for credit accounts to be less than entirely rigorous. As with A/R, tightening up procedures here can save a lot of working capital leakage. Are *all* trade references being called? Do they appear genuine? Have sales or other personnel picked up information in the market that may indicate that all is as it should be with the potential customer?

Conclusions

The upside to the current volatile and uncertain conditions is that they beget truly exceptional opportunities. CFOs/treasurers prepared to seize these opportunities will be doing far more than merely preparing for difficult times, they will be risk-proofing their organisations and fine-tuning them for future optimal financial performance. For instance, strong earnings growth in the previously benign economic environment has made it all too easy for companies to become lax about cash efficiency. Idle cash pockets have appeared and DSOs have slipped, so effort expended on financial processes now will yield bottom line benefits both immediately and going forward.

While optimising processes is one current and valuable opportunity, optimising relationships is another. Purely “commoditised” supplier relationships are limited; when times are hard, suppliers have negligible incentive to put themselves out. Banking relationships are little different, so developing a closer rapport now delivers far more than potential balance sheet support. It also opens the door to a multi-dimensional collaboration that yields efficiency and innovation dividends – whatever the market conditions.