

The liquidity risk management evolution

Managing liquidity has become a top priority for treasurers in the current environment of reduced sales and cash flows and constrained borrowing. Not only is maintaining adequate levels of liquidity critical for companies to meet their financial obligations, but investors are increasingly rewarding companies with high liquidity.

A study conducted by Citi's financial strategy group of the world's top 1,000 companies discovered that over the past 18 months corporates that are liquid and have a high degree of funding from internal sources have on average generated 15%-18% more incremental returns than their less liquid rivals. The stock price performance of more liquid companies is 27% higher on average than those with a greater reliance on external borrowing.

At Citi's annual Treasury and Finance Conference, a panel of treasurers from leading companies in Asia shared their experiences on implementing effective liquidity risk management techniques. Their insights illustrate the strong focus many companies are placing on cash flow visibility and forecasting, as well as the need to establish an effective liquidity risk management framework to visualise, mobilise and optimise.

PANELISTS

Philippe Jaccard, Asia-Pacific head of global liquidity and investments, global transaction services, Citi (moderator)

Charles Fei, financial controller, greater China region, Cabot Corp.

Jason Hua, chief financial officer (CFO), Voith Paper, China

Wolfgang Ratheiser, corporate treasurer Asia Pacific – Middle East, Johnson Controls

Kok Wei Saw, CFO, Electrolux China

Edward Zhou, treasurer, greater Asia region, Eastman Kodak



PHILIPPE JACCARD
head of global liquidity and investments in Asia-Pacific global transaction services, Citi.

Philippe Jaccard, head of global liquidity and investments in Asia-Pacific global transaction services, Citi (PJ): *By definition, managing liquidity is the process of moving the right amount of money, at the right time, and at the right place. As liquidity remains tight, liquidity risk on the corporate balance sheet is the number one priority on many treasurers' agenda. Given this backdrop, how does your company measure and manage liquidity risk?*

Jason Hua, CFO, Voith AG (JH): In reality, everyone knew that a recession was going to happen, but we were surprised it came so quickly.

As a capital equipment supplier, we look at every customer on a case-by-case basis. We have found that some customers have halted capital expenditure altogether, while others are slowing their investment. Most customers pay progressively during the project, and unexpected non-payments can create serious cash flow problems for us.

Therefore, we are approaching customers in order to understand their business pressures, and to analyse our risk to each one. Many companies have been our customers for a long time, so we try to be flexible and help wherever we can. For example, we use local letters of credit to enable customers to extend payments, so we can continue with production and avoid surplus capacity.

We are also taking steps to improve our own working capital, as well as enhance days sales outstanding (DSO). We are also extending supplier payment terms slightly, using cash pools to increase access to cash, and reducing our own capital expenditure.

Wolfgang Ratheiser, corporate treasurer, Johnson Controls (WR): At Johnson Controls, we have always taken a very conservative view of liquidity risk and our debt-to-capital ratio to maintain our credit rating and ensure access to capital markets. We have local

cash pools and a global notional cash pool provided by an overlay bank. We then finance these accounts using commercial paper. By maintaining a portfolio of banks we can support from both the cash management and credit perspective, with a revolving credit facility in place to back up our commercial paper programme.

In 2008, we put in place a new system which gave us access to daily bank account statement information. This system ensures we have complete next-day visibility over our cash, including in countries with capital restrictions. When the crisis hit, we became concerned about whether our banks would step in and finance us in the event that the capital markets declined further. The deterioration of the automotive industry has also affected our credit rating and potential availability of funding.

We decided to focus more on working capital, although we already managed this carefully, being in a low margin industry. However, we now align payments and receivables as far as possible to flatten our working capital needs and alleviate pressure on our commercial paper programme.

Kok-wei Saw, CFO, Electrolux (KWS): Like Voith, Electrolux was also not entirely caught by surprise. Even before the crisis, Electrolux in China had been losing money for a number of years. To counter this, we launched a massive restructuring project which stood us in good stead when the crisis happened. For example, we shut one factory, reduced headcount, slashed costs and terminated loss-making categories and segments. This was a basic, common sense approach, and our efforts have paid off. As of February and March 2009, Electrolux China had a positive operating cash flow for the first time.

Edward Zhou, treasurer, Kodak (EZ): At Kodak, we have not made any substantial changes in the way we manage our liquidity since the



JASON HUA
CFO, Voith AG.

onset of the crisis. We have always been conservative in our liquidity management, with security of principal and liquidity being our priorities. In addition to ensuring the liquidity needs of our daily operations, we plan long-term investments well in advance using cash flow forecasts.

Charles Fei, financial controller, Cabot (CF): At Cabot, we have always been very conservative and kept cash on our balance sheet. This helped to keep our strong investment grade rating. Cabot Corp. is a chemical company, and our principle product, carbon black, is an important raw material for the tire business. We have seen a major increase in our raw material costs and this has created major challenges. In addition, we are building a major new production line, so cash flow becomes a major issue for us.

We have implemented various working capital management initiatives. On the collections side, we have maintained close communication with customers to understand their needs and our risks. On the purchasing side, we have negotiated with our suppliers to extend payment terms. It is important that everyone has a complete and synchronised view of information to achieve working capital improvement targets. In other words, decisions on inventory, purchasing and sales are now interrelated. The outcome has been a working capital reduction of almost 50% over the past six months for our China operations.

As a cash-rich business, cash flow visibility is important, so we produce an integrated financial forecast that enables us to decide on an appropriate treasury strategy. With the support of the cash pooling platform we built up in the beginning of 2008, in the majority of cases, we can self-finance projects with only a small reliance on project loan facilities. We have focused on paying off short-term external loans and we may try to repay some longer-term loans.



WOLFGANG RATHEISER
corporate treasurer,
Johnson Controls.



The challenge for us will be to continue our debt repayment programme while maintaining sufficient cash flow levels, particularly with continued raw material price increases. We will continue to focus on maintaining good relationships with our banks and make sure we have access to external financing if necessary.

PJ: *What's interesting here is that companies have spent a lot of time getting the data together to visualise their risk. This has been a particular focus for Citi. The process of aggregating and presenting the information can be quite straightforward; what's harder is capturing the right data at the right time, to clean up the small processes that divert from the task in hand.*

CF: In our industry, creating a cash flow forecast is very difficult, particularly during a period of extreme volatility. Therefore, we host weekly supply chain review meetings, and regularly review our cash flow forecasts.

JH: The importance of cash flow forecasting is one of the lessons we've learned from the economic crisis. In the past, we only performed a cash flow forecast at the company level, not for each project. Now we detail forecasts for every project in SAP, so project managers have complete access to cash flow information including outstanding collections and payment terms. Project managers, rather than just treasury, are now responsible for all relevant cash flows relating to each project, with specific key performance indicators.

WR: There are two elements to forecasting in our business: first in treasury, where we have visibility over bank accounts that are man-

aged by treasury; second, on the business side, we put in place a incentive scheme a couple of years ago wherein business leaders would be measured on working capital improvements. More recently, we introduced daily cash reporting on the business side as we had huge working capital volatility. We were making payments at the beginning of the month, but collecting cash at month end, creating a gap which we needed to finance through the commercial paper market.

Our revolving credit facility was quite large, but as liquidity in the commercial paper market deteriorated we had to look at other ways to increase our liquidity provision. Treasury proposed a plan to reduce working capital, align payments and collections more closely, which was warmly supported by the board and by business unit heads.

It took two–three months to put in place, starting with the US and Europe where we have shared service centres. Payments are easier to manage, but collections are a little more difficult. Fortunately, on the automotive side, we had always been in continuous discussion with our customers to make sure that payments were made in accordance with payment terms.

Although Asia-Pacific followed on from the US and Europe, we did not focus on countries with capital restrictions where we still have trapped cash. However, we are looking closely at payment terms in place to manage credit risk more closely, and in some cases, we have replaced open account with letters of credit.

KWS: We have put more focus on our sales and order planning process to make it more robust, improve forecast accuracy and reduce working capital. In addition, we now provide incentives to management and senior employees on balance sheet management



and cash flow, including training to show staff the financial implications of their decisions, which has proved highly successful.

EZ: At Kodak, we have also looked to enhance cash visibility and forecasting. Everybody should be responsible for the improvement of a company's cash flow and working capital, rather than just treasury. On the collections side the sales team understands a customer's pressures and payment behavior and whether they need any help in this area. The team needs to monitor inventory and supplies carefully.

In treasury we first assess cash balances, which is challenging here in Asia as we need to deal with some local banks in addition to our global banks. Having established visibility over cash, we aim to generate more value through greater cash mobility and funding business units.

PJ: *These experiences illustrate the evident similarities between banks and corporates. Clearly visualisation requires the right technology to facilitate the flow of information. However, more important is collaboration between business units as well as with clients to understand their behavior and what the movements in cash will be. An issue that is important for banks is stress testing the balance sheet. Is stress testing important for corporate treasurers as well?*

WR: Stress testing isn't an extensive area for us, but we do some on the automotive side, particularly bearing in mind the troubles that the big three automotive firms in the US have been experiencing. We look at the implications of bankruptcy of our major clients and also take into account the impact on our primary suppliers.

JH: We have not yet focused on stress testing although some is done at a corporate level. We anticipate developing this programme over the coming year, although it will be relatively complex due to the group's broad business portfolio which is impacted by different market dynamics.

CF: At Cabot, we have started to project worst-case scenarios and develop our treasury strategy accordingly. Although we are in a strong cash position, we have developed some new financing facilities with our bank partners and we need to prepare for the start-up of a new production line.

EZ: Scenario analysis is often helpful, particularly during more benign conditions. During extreme market conditions however, the assumptions made in scenario analyses are often found to be unrealistic, with knock-on effects throughout the supply chain.



CHARLES FEI
financial controller,
Cabot.

As the panel illustrates, liquidity management is a business-critical activity which requires commitment across the company. Treasury has a vital role to play in coordinating working capital requirements and managing cash flow across the business, including cash mobility for internal funding, cash flow forecasting and securing external liquidity.

Citi has developed a suite of solutions and expertise in Asia and globally to enable treasurers to visualise, mobilise and optimise cash more effectively. Across the region, companies are already benefiting from our technology, global cash structures and local insight. By partnering with Citi, companies are creating competitive advantages, enhancing their liquidity position and improving earnings per share. ▲



If you would like to discuss how Citi can help your company to optimise working capital and reduce liquidity risk, please contact your Citi representative.

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