Cash management

Mick McLoughlin explains how keeping a tight grasp on the basics of cash management can make the difference between corporate success and failure.

In a rapidly changing marketplace, today’s corporate success stories can easily become tomorrow’s casualties. Globalisation requires businesses, their stakeholders and their advisers to operate in unfamiliar circumstances with few precedents. At the same time, the need for companies to evolve is resulting in ever more complex financing packages, while the supplier base of finance providers is fragmenting.

One of the more underrated tools available to managers in this tough trading environment is systematic and strong cash management. More and more investors, analysts and rating agencies are treating “free cash flow” as a key indicator of corporate health. All businesses can benefit from a regular, systematic review of their liquidity.

One of the most popular strategies for making the most of cash flow – even for companies with access to the equity markets – is internal restructuring to free up cash and debt. Even if you’re borrowing to pay for new plant or an expanded workforce, it could also make sense to restructure business units or streamline transactional procedures at the same time to improve your firm’s capacity for cash generation. Raising debt will simply treat the problem, whereas strong cash management is a preventive measure.

In practice, the benefits that you gain from a restructuring programme often have a direct correlation to inherent risk. According to Ann Davies, head of operational restructuring at KPMG, businesses have a range of options, from “low-risk quick wins through to long-term strategies that are often high risk”. At the “quick win” end of the spectrum, improved payment and purchase controls and faster invoice-to-collection times, coupled with more effective debt collecting, can have a rapid and tangible impact. This is not simply a question of procedural change; it’s about creating a cash-conscious company. “Underpinning these activities should be a better focus on cash flow, so that everyone knows what drives cash,” she says.

That understanding should inform your firm’s negotiations with its customers and suppliers. A buyer may focus on achieving the best price when buying components, but fail to consider the effect that tight payment terms will have on the cash situation. As Davies says, payment is as important as price. Buyers should also beware of tying up capital by buying too much stock at one time.

The problem is, of course, that as businesses grow and become more complex it becomes harder to control spending, purchasing and the negotiation of sales. In an owner-managed business one person signs all the cheques, monitors how clients are won and so on. In a multinational conglomerate each business unit will have its own management structure, sales team, purchasing department and financial software package. “You can lose the ability to communicate and end up with many financial decisions being made in isolation,” Davies says.

The challenge is to reconnect the top of the organisation with the outposts of its empire and to change everyone’s behaviour. Senior managers should lead by example here.

In the longer term, many firms are tempted to take more radical steps to improve their cash situation. But, although a major restructuring initiative such as outsourcing manufacturing may deliver huge savings, such a move is risky
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and may have unintended side-effects. Davies cites the case of a furniture supplier that decided to buy its products from overseas. The products were cheaper and better made, so it seemed like a smart move. What the company hadn’t realised was that it would change the whole supply/payment cycle and this left it struggling to manage its cash flow.

This is not an argument for avoiding all radical restructuring proposals, but it is a cautionary note. “You need to follow a process to ensure that all the risks are identified and planned,” she says. “Change programmes should have an element of project management.”

Restructuring might help you to achieve liquidity, but most firms must borrow at some stage to meet their cash requirements. Money is currently cheap and lenders are eager to provide it, but it’s important to consider the long-term effect of debt on the business.

“Everyone wants to borrow cheaply,” says Simon Collins, head of debt advisory services at KPMG. “But what they really need is robust access to cash.”

The cheapest finance deal may prove to be a false economy if the covenants attached to the loan prevent your company from accessing funds when it needs them most. For example, what would the consequence be if a shortfall in trading breached a covenant? “It’s the quickest way to lose access to funding,” Collins says. “It’s a classic trap.”

You must ensure that you agree terms you can adhere to and, if covenants are important, don’t go for the cheapest deal. Before talking to lenders, it’s important to take stock of the business, not only to establish your requirements but also to reduce the risk of breaching covenants or defaulting on a payment. What are the forecasts? What are the potential risks and opportunities? Are there extra contingencies that the firm should be planning for?

Look at your business cycles and, if necessary, plan operations for the bank and bond markets accordingly. “It’s not only the cycle of your company,” Collins warns. “You also have to consider the cycle of bank finance.”

You also need to be clear about what you are borrowing for and how much you need. For example, do you require core funding, working capital, contingency insurance, or – as is often the case – a mixture of all three?

When considering the amount of money you need, you should also think about the most efficient way to structure the borrowing. Do you need it to be available within the business at any time or as a flexible credit facility? There is also the question of whether you should look to the banks or the bond market. For sums above £100m, the bond market may be a viable alternative to bank loans.

If the maturity of the debt is seven years or more and your industry is not cyclical, the bond market can be cost-effective, according to Collins. But he warns that it can be a dangerous choice for firms with weak credit ratings operating in cyclical industries.

Of course, lenders do their own research. Potential bond-holders will scrutinise your credit rating, while banks will want to understand the competitive landscape and your company’s position on it. One advantage of debt finance compared with equity finance is that lenders have no ownership rights or interest in your business other than ensuring that the repayments are made. This doesn’t mean that you can ignore their opinions, of course.

“You have to know your lenders.” Collins advises. “If you think you might have to go back to them, you can’t afford to be cavalier.”

As recent corporate history illustrates, even rock-solid blue-chip companies can find themselves in life-or-death negotiations with their lenders when the market changes or a strategic decision goes wrong.

Mick McLoughlin is global head of corporate recovery at KPMG. He is speaking at CIMA’s annual conference on November 10 (see panel for details).