Strategies for Improving Working Capital Management

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In 2004, treasurers worldwide continue to strive to manage working capital more efficiently. They are under pressure to reduce Days Sales Outstanding, to measure Days Payable Outstanding, and to find alternatives for enhancing yield management due to record low interest rates. Other factors are impacting corporate treasurers as well. Corporate governance initiatives such as Sarbanes-Oxley are increasing the treasurer's need for access and visibility to accounts around the world. The continuous rollout of Enterprise Resource Planning (ERP) systems worldwide is to some degree providing the needed increased visibility of accounts, as well as greater control and a single point for information retrieval on a real-time basis. Finally, the trend to gain efficiencies through treasury centralisation continues.

The leaders in treasury and cash management have discovered that regional and global liquidity management are very effective working capital tools. Some are also discovering that newer tools such as Electronic Invoice Presentment and Payment (EIPP) and even Continuous Linked Settlement (CLS) can improve working capital management as well. These treasurers are developing effective strategies – sometimes using liquidity services, EIPP and CLS in innovative ways – to meet their own corporation's unique needs.

The liquidity opportunity

In liquidity management, corporations have for many years concentrated and notionally pooled cash balances domestically to maximise returns on balances and minimise expense. Globalisation and the euro prompted an increase in cross-border concentration. Now, treasurers can leverage target balancing, notional pooling and automated investment products to benefit from a streamlined, electronic global solution. These global liquidity management solutions can be linked to other core cash capabilities – such as payables and receivables – enabling corporations to optimise their funds flows end-to-end, free up working capital, and maximise investment returns while minimising overdraft expense. Debit and credit positions are offset globally, reducing the impact typically caused by overnight overdrafts.

The importance of real-time information integration

With today's technology, treasurers can view and manage their cash positions globally on a real-time or close to real-time basis. They know what their positions are earlier in the day and earlier in their cash cycle. Bank reporting systems, as well as accounts receivable and ERP systems, all establish real-time positions over the course of the day and provide improved forecasting accuracy. Treasurers can project what their net positions are going to be and make earlier more precise investments of excess funds (and realise better returns) or manage a least cost method of acquiring funds if their net position is going to be short. By virtue of earlier, better information, they can decide whether to draw down their working capital line, use a credit line, or redeem some of their invested positions.

Contrasting approaches to maximising liquidity

Some corporations are still leaving millions of dollars in time deposits earning minimal interest while others are concentrating dollars globally and investing them in vehicles such as structured alternatives to realise higher returns.

Concentrating funds worldwide

Motorola won the 2003 Alexander Hamilton Award from *Treasury and Risk Management* for developing an innovative liquidity structure. Citigroup worked with Motorola to create a structure that automatically moves funds from various overseas locations and invests them in special funds managed by Citigroup.

Before this liquidity structure was established, Motorola and its subsidiaries held cash in bank accounts and overnight investment vehicles around the world, and had more than 100 financial managers managing the investments. Motorola estimated half of its overseas investments were generating less than optimal returns. The solution enables financial managers around the world to pool and invest their dollar-denominated cash balances in private money market funds. Each entity still retains owner-ship of its investment thereby eliminating tax issues. The money market funds are managed according to Motorola's guidelines that include slightly longer maturities than usual for most money market funds. To date, the funds have yielded 50 basis points over the company's benchmark, three month LIBOR, boosting interest income by more than US$ 11 million per year. Motorola's overseas managers can access their cash at any time, in case of an unexpected cash requirement, while gaining maximum return on their liquidity.

Asian subsidiaries funding each other and global treasury

A global corporation had excess liquidity in multiple markets in Asia, predominantly in local currencies. It wanted to utilise liquidity in one market to fund an entity in another market. It also wanted to move excess liquidity efficiently out of the region to its global treasury, which was borrowing money from the market.

All of its flows were in local currencies and some were in the more regulated markets like Korea and Malaysia. The client was not banking only with Citibank, but with other banks as well and did not want to change banking relationships.

Citigroup set up a cash management arrangement that enabled the client to upstream its local currency funds held with various banks in different countries, into accounts at its regional treasury center in Singapore. The funds are then swapped into US dollars. In markets where it can't move the local currency, like Indonesia and the Philippines, it does an onshore FX into dollars, and transfers the dollars to the regional treasury center in Singapore.

This structure enables it to concentrate its excess liquidity, and a good forecasting system ensures the treasury in Singapore knows how much it is receiving. When the entities need the money back, the regional treasury will reverse the process and fund the local entity using the local currency.

The whole structure is automated to re-allocate interest and to account for all the intercompany flows. In addition, the excess US dollars are pooled together, where allowed, for these entities, long and short positions are offset, and excess funds are upstreamed to its treasury in Dublin where it is used either for investment or funding purposes. With this global liquidity management solution, the client is now able to move a significant amount of liquidity, which it had in local currency, to its global pool.

With a relatively small regional treasury team, the client did not want to be encumbered with complicated documentation and interest reallocation. The structure was therefore designed to ensure that the entities in different companies would not be required to complete complex documentation to open offshore accounts. All they had to do was upstream excess balances. In addition, the regional treasury center does not have to reconcile accounts in multiple jurisdictions.

Moving excess balances directly to global treasury

For some companies, rather than establish regional infrastructures, it makes more sense to move convertible currencies directly from individual countries to a global treasury. A company might, for example, establish a policy to move excess balances in Australian dollars, New Zealand dollars, or Singapore dollars to London, Luxembourg or Dublin at the end of every week.

Receivables and Electronic Invoice Presentment and Payment

The nature of the receivables challenge varies from region to region but in 2004, many corporations are still grappling with collection challenges that create serious working capital issues and negatively impact their bottom line. For instance, corporations that are not paid in a timely way frequently need funding and credit to build and deliver goods, and sales representatives often waste a significant amount of time disputing individual line items on invoices with customers rather than selling to them. This is particularly evident in Latin America. Electronic Invoice Presentment and Payment applications, which are gaining momentum around the world and are becoming more innovative, have become an effective working capital tool, helping to mitigate regional collection inefficiencies.

EIPP with invoice discounting and financing

In Eastern Europe, companies are using the EIPP platform with invoice discounting and financing – to radically accelerate collections and/or extend payment terms to buyers. Citibank issues a 'closed loop' credit card to suppliers and buyers, linking various trade instruments and credit lines (that are specific to that particular supplier/buyer relationship) to the card. Buyers then use this credit card to pay invoices issued by the supplier on the EIPP system.

Let's take an example where the standard payment terms between Supplier A and Buyer A are 30 days. Supplier A has cash flow issues and needs to receive accounts payables within 20 days. The bank accelerates the supplier's cash flow by discounting the invoices and providing funds early – on day 1 or day 10, for example, and then on day 30 or later, collects from the buyer.

The value proposition of EIPP with invoice discounting and financing allows treasurers to accelerate collections – shortening the cycle from 30 days to 1 day – while extending buyer payment terms.

EIPP with netting

In Western Europe, EIPP with netting provides a powerful, global e-billing solution to a multinational organisation seeking to present a single invoice for payment in a single currency to customers. Typically these customers would submit multiple payments in different currencies from multiple subsidiaries in a region.

Citibank sets up a central collection facility that pools invoices from the company's local subsidiaries and routes them to their customers' local subsidiaries for approval. All of the subsidiaries approve invoices using the EIPP system or resolve disputes online before approval. When the subsidiaries select 'payment', the bank runs the netting cycle, which calculates how much each buyer owes the seller from a global point of view. EIPP then presents a consolidated invoice in a single currency to the regional headquarters of the buyer for payment.

The regional headquarters gains central control with the ability to see both the total and details for local subsidiaries while local subsidiaries retain the ability to receive and pay invoices domestically, as separate legal entities, in compliance with local legal and regulatory requirements. EIPP with netting allows subsidiaries to maintain their autonomy while benefiting from the netting cycle, which streamlines the payment process and eliminates FX risk.

EIPP with netting reduces the number of payments that must be made. And, like standard EIPP, it provides flexible payment methods that accommodate local requirements – for example, the ability for a customer in Europe to pay via direct debit, and a customer in Japan to pay by cash.

Many companies have subsidiaries that buy and sell to one another and generate a high number of invoices in a mixture of currencies across a broad geographic reach. EIPP with netting enables subsidiaries to send and receive invoices to each other and take advantage of online dispute resolution capabilities to resolve issues.

The industry vertical exchange: a new model

In the United States, an entirely new EIPP model has recently emerged. In the classic seller-centric model, a single supplier invoices multiple buyers. In the new multiple seller/multiple buyer EIPP model, virtually all the billers in one industry invoice all of the buyers through one EIPP system. With the Citibank EIPP-hosted exchange for Cargo Network Services (a clearinghouse owned by major airlines for billing freight forwarders and cargo agents), 75 airlines invoice 1,500 cargo agents. Cargo Network Services' EIPP exchange consolidates invoices from multiple airlines into one invoice for presentment to each cargo agent, radically reducing the number of invoices and payments required. The airlines benefit from faster funds availability, enhanced credit monitoring, and the elimination of mail costs, while the cargo agents benefit from operational efficiencies resulting from processing one rather than many invoices – electronically. The airline industry's striking 95 per cent adoption rate of the Cargo Network Services EIPP exchange on day 1, suggests industry exchanges are the way of the future.

Continuous Linked Settlement: a new cross-border payments paradigm

Continuous Linked Settlement not only virtually eliminates FX settlement risk; it enables corporations to manage funding, working capital, and liquidity more efficiently. Rather than make multiple gross payments for each trade, CLS third parties manage one net position per currency (a single debit or credit position) in their end-of-day funding process with their Settlement Member. In this way third parties benefit from the 'CLS netting effect'. Global corporate treasuries with medium to high trading volumes – greater than 200 trades per month – can reap significant funding and liquidity benefits from CLS, through this CLS netting effect.

With CLS, a corporation sees the projected balance – one position for each currency – a day in advance. With greater transparency of information available through CLS, a corporation can manage trading and funding in a more optimal way – making adjustments to tomorrow's balances at the end of each business day.

CLS nearly eliminates settlement risk, and along with it, the need for settlement risk credit lines – which frees up credit that corporations can use for additional trading. CLS makes increased FX trading more attractive – more secure, efficient and cost-effective. As a result, corporations may want to consider using FX trading mechanisms in the CLS environment to fund subsidiaries, to manage capital and liquidity on a regional or global basis, or simply to hedge exposure in certain currencies.

For example, the process of funding subsidiaries in various countries and generating revenue cross-border often leaves corporations with large overdrafts and idle cash balances around the world. With CLS, trading is less risky and less expensive so it may make sense to use FX trading mechanisms to reduce overdraft and idle cash balances by funding subsidiaries and receiving dividends on a more frequent basis. With a desirable way to fund operations cross-border and/or sweep excess funds back to the home-office, corporations may be able to match costs and revenue and manage their capital on a global basis more effectively.

Implications for the corporate bottom line

In the year 2004, as corporations strive to manage their treasury more efficiently, treasurers should, like a handful of innovators, take a global view and conduct an enterprise-wide evaluation of how they are managing their receivables and liquidity around the world. Using EIPP solutions, treasurers can radically reduce Days Sales Outstanding and speed the collection of cash. Regional and global liquidity solutions can then aid in the consolidation and maximisation of these more rapidly collected funds while reducing the use of credit. Finally, in the more secure, more transparent CLS environment, corporations can leverage FX mechanisms to manage their working capital more effectively on a global basis.

As treasurers seek to free up working capital and manage liquidity more effectively, they must work closely with knowledgeable bank partners to develop optimal strategies for meeting their corporation's unique needs locally, regionally and globally. Those corporations that implement the most effective working capital strategies using treasury's new tools will improve their bottom line and gain competitive edge in a challenging global economy. ◆

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