

Some Aspect Of Corporate Liquidity Management

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The Cost of Liquidity

A common cost inefficiency of corporate treasury is associated with the selection and maintenance of targeted levels of liquidity.

Most corporates, especially those in acquisition mode, are net borrowers and for net borrowers, cash surpluses represent a significant cost, represented by the spread between the most expensive corporate borrowings and the lowest yielding cash balances. The bank spread (often concealed by mis-matches of maturities or of currencies) is, typically, not less than 1% pa on relevant values. Further, at current Irish corporation tax rates, (16% reducing to 12.5%), the tax rate levied on non-trading income, 25% adds a further 0.75% to the after tax cost of such cash balances, bringing the total cost to 1.75%pa. For borrowers, moneymarket surpluses, accordingly, cost some €17,500 for each €1m of cash balances – a not insignificant cost for liquidity. Why pay it?

The answer, of course, lies in the uncertainty of business and in the comfort level desired for unforeseen contingencies, effective obeisance to the credo – “Cash is King”.

What Constitutes Liquidity?

Liquidity is commonly presented as being the sum of all cash balances, plus undrawn bank facilities. This perception is worth scrutinizing, especially when one has to pay such a high price for what can, at critical times, become a mirage – ie, an illusion of liquidity. We consider first:

- For The Corporate Experiencing Difficulties

First consider potential adverse corporate circumstances, eg where cashflow and profitability are declining and where certain borrowing covenants are being breached. Here, the bank's right of Lien or 'Set Off' can be invoked to net or set off any and all cash surpluses against existing borrowings. At the precise time that undrawn commitments may, because of deteriorating circumstances be set aside, cash balances can also disappear. In those circumstances, expensive and well-husbanded cash 'war chests' can disappear overnight. Further, where a bank has an 'all charges' mortgage, bank balances with other institutions may also be required in settlement of bank debt. The reality, of course, is that for net borrowers, cash surpluses simply represent borrowings from other institutions or other jurisdictions and, in a crisis, are likely to be netted away.

We now consider liquidity management in an alternative, more positive, scenario:

- For the Corporate in Growth Mode

Where a corporate, (again assumed to be a net borrower), is considering further acquisitions and where corporate circumstances are favourable, viz high profitability, good cashflow and high interest cover, cash surpluses, again, constitute a minimum cost of 1.75%pa. This cost, however, is commonly justified in terms of the 'war chest' and the perceived need to have 'ready cash'. More often, this 'war chest' is simply a contingency fund, maintained as an expensive alternative to careful planning and cashflow forecasting.

The opportunities for good acquisitions rarely emerge overnight. They are foreseeable and are the subject of many months of due diligence before any offer is made. In positive circumstances of projected growth, a superior – and far less expensive – approach to liquidity management is to arrange bank commitments to provide accommodation when required. Such bank commitments typically cost 0.25% to 0.5% - very considerably less than the alternative, invisible cost of concurrent cash surpluses and, as discussed above, they are at least as reliable.

The Maturity Profile of Liquidity

It is popular to extend the term profile of one's borrowings as far as possible. It is, accordingly, not unusual to find more than 50% of corporate borrowings having maturities of more than five years, with the other 50% being fairly evenly distributed across the first five years and, with less than, say, 10% of total liquidity, (including overdrafts, revolving loans, term loans and leases), maturing in any one year. For many corporates, such an arrangement can starve the short run and result in an unhelpful financial

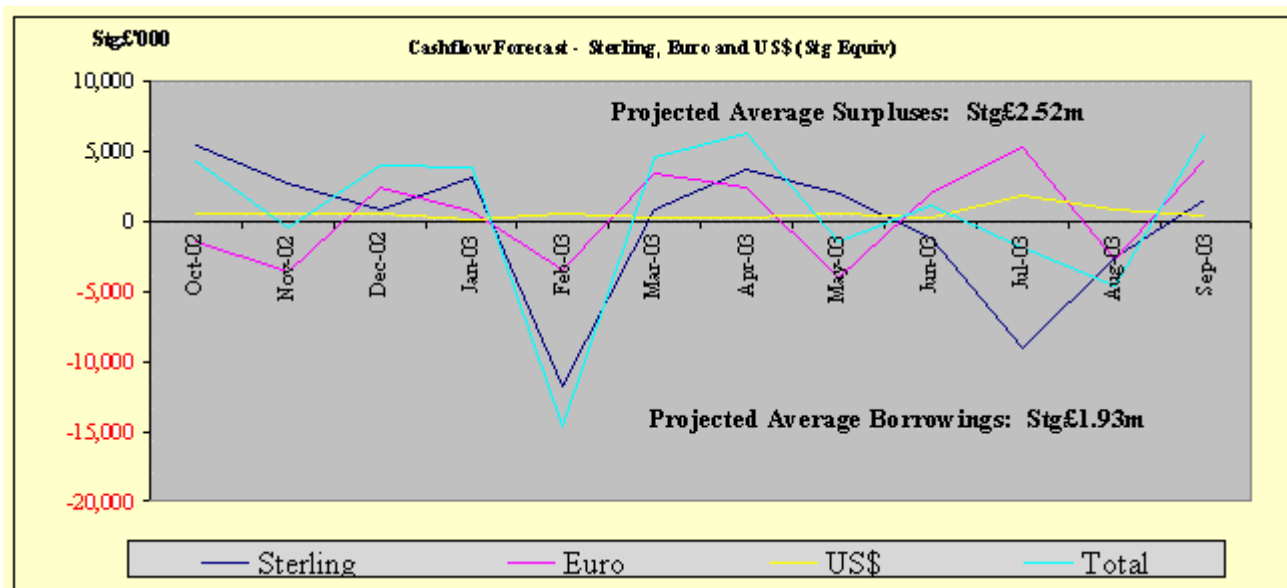
straightjacket. Such inadequate short-term facilities then necessitate excessively high, expensive, cash balances to provide day-to-day working capital. Good liquidity management requires instead that short-term bank facilities should also be sufficient to meet fully the volatilities of the short run.

How Much Liquidity Should I Have?

The answer to 'How Much Liquidity' lies in the corporate cashflow forecast. Too often, because of other work pressures, (more usually because of inadequate information flows within the corporate), reliable cashflows are not prepared or maintained, with the inevitable fall back on inflated levels of cash surpluses.

It is an important principle of liquidity management that banking arrangements should be managed to respond to the requirements of business. They should not be allowed to determine or to inhibit either business operations or business development. A detailed, rolling 12 month cashflow forecast should be prepared and maintained with at least quarter-end cashflows being prepared for the following three years and with all items of capital expenditure being mapped for later years. Cashflows should reflect not only relevant Highs and Lows but also Best and Worst scenarios. These forecasts should then be subdivided by currency. (Currency bank positions offer important opportunities for cost economies via natural hedging). Such cashflow forecasting is critical to reliable and cost efficient liquidity management and sophisticated software packages are currently available to assist in the process.

Below, we illustrate the challenge for liquidity management and the opportunity represented by a recent client's cashflow forecast



This graph illustrates both the cost of concurrent cash surpluses and the potential for cross currency synergy.

The Optimum Structure of Liquidity

For corporate liquidity management, identification of the optimum structure, maturity profile, interest rate flexibility, currency and type of borrowing facility is as important as the actual level of liquidity selected. Very often, in the name of autonomy, the corporate may indulge a number of discrete banking operations across wholly owned subsidiaries or across national frontiers and currencies. Such 'legacy' arrangements are, however, unwise and cost inefficient. While it may be appropriate, at a group level, to decentralise eg marketing, production or personnel, treasury should above all, be centralised. Decentralised treasury operations can be hugely expensive in terms of the potential mis-match of currencies, failure to pool efficiently or to draw down available synergy. (A recent review by Finalysis of a UK plc produced annual cost savings of some Stg£450k – this without stressing either the banking relationships or internal group relationships!)

Working Capital Management is Central to Liquidity Management

It is perhaps a curiosity that cash management is commonly viewed as somehow being distinct from liquidity management. It is also a curiosity that many Treasury Policy Statements (some prepared by

banks), explicitly exclude working capital from their scope. The reality is that, for the treasurer, cash management/working capital management represents an integral part of liquidity management and failure to integrate it fully into treasury policy can, at the very least, produce high costs and, at worst, lead to financial embarrassment.

Conclusion

Cash may long continue to be viewed as 'King'. However, in the republic of commerce, Liquidity Management should be made amenable to the laws of good business and of good treasury practice.