Liquidity management and working capital – a work in progress

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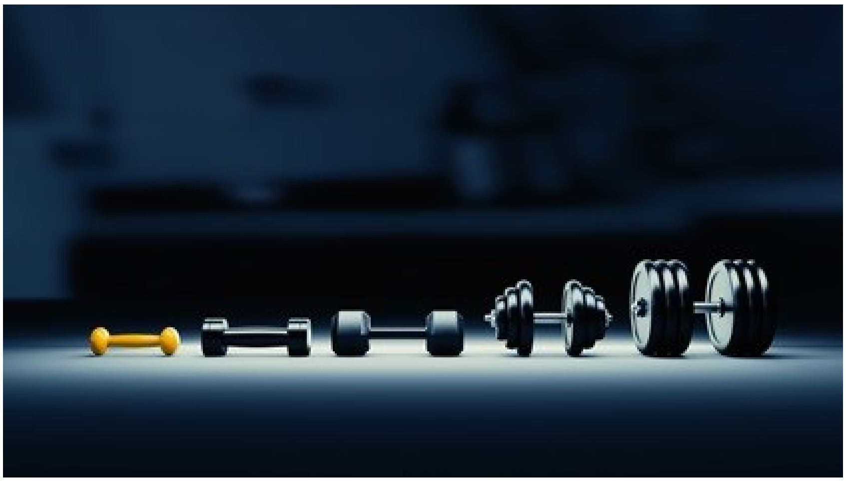
In an environment of rising interest rates, economic slowdown and fragile supply chains, corporate treasurers have challenges in effectively managing working capital and liquidity. Digital technology may be the answer.



In April, the International Monetary Fund (IMF) predicted a pronounced slowdown in economic growth in advanced economies, falling from the 2.7% recorded in 2022 to an estimated 1.3% in 2023. The baseline forecast for global economic growth is 2.8% in 2023 and 3% in 2024. There are myriad headwinds for the global economy, including rising inflation and interest rates, elevated public debt to GDP ratios (a legacy of the COVID-19 pandemic) and supply chain disruptions and geopolitical tensions.

PwC's Working Capital Study 21/22, states that the COVID-19 pandemic exposed the slow reaction of supply chains to external shocks, leading to a significant rise in net working capital (NWC) days. "This lack of agility in adapting working capital levels to disruptive external events is a concern as we face continued challenges in the global supply chain," the report states. "The heightened complexity and lack of visibility over most supply chains also mean that the move from 'just in time' to 'just in case' planning in order to manage supply risk may bring further working capital challenges. That is why 65% of executives in our survey named working capital efficiency as the main objective for change management and restructuring activities."

Timothy Bartlett, Liquidity and Investment Products Director, Global Payments Solutions, HSBC, says post-pandemic, corporate treasurers have focused less on liquidity concerns, such as the stockpiling of cash, and more on addressing issues in the supply chain, such as navigating the impact of supply chain hold-ups including lessened supply and higher prices.

Henrik Lang, Head of Global Liquidity in Global Transaction Services at Bank of America, says some of the working capital issues that arose during the pandemic have been addressed "but not all, as we saw following the stress in the US regional banking sector and the uncertainty around the debt ceiling. There are more liquidity strategies that could be considered to manage through disruptive external events."

Andy Schmidt, Global Industry Lead – Banking at CGI agrees. "Many corporate treasurers are still working through the issues the pandemic caused. These issues have been further complicated by inflation and higher interest rates along with real-time payments. We tend to forget the importance of working capital and liquidity management in a real-time environment," he says.

Corporate treasurers are looking to pay as late as possible to maximise their own interest income and minimise the working capital they need to use to meet certain payments. It is a case of "earn as much and pay as little as they can," he says. This creates a dynamic on the bank side of trying to support corporate treasurer clients that on the one hand make the bank money, but on the other, cost them money, he adds.

An issue raised during the NACHA payments conference in the US during April this year was visibility in payments systems, says Schmidt. "Payments are increasingly made in real time, but banks' accounting systems are run looking at information that is hours old. Corporate treasurers have an appetite for real-time account updates. They want to see where their liquidity is and be able to do something about it, such as move credit or sit on certain payments."

Another theme that emerged from the conference was the idea of integrating accounts payable and receivable to build intelligence into payments systems. This will enable corporate treasurers to decide which payments to make and when, says Schmidt. "It is all about visibility, and some corporate treasurers are closer to this than others."

Lang agrees that visibility is an important goal for corporate treasurers. "On the plus side, the pandemic led to an exponential adoption of digital payment tools, giving corporate treasures greater visibility into their liquidity and ability to mobilise cash more easily to satisfy working capital needs."

However, he adds, the market stress in the first half of 2023 revealed to many corporate treasurers that they needed to review and update their investment and counterparty management policies. "Some of the more common policies include implementing exposure limits to certain investment types or counterparties, and shortening or extending the tenor of investments," he says.

Peter Dehaan, Head of Business Development, Cash and Liquidity Management, SmartStream Technologies, says intraday liquidity is now "front and centre" of discussions the company has with its bank treasury clients. "Prior to the collapse of Silicon Valley Bank intraday liquidity management had been de-prioritised by banks. Now it has been re-prioritised."

Silicon Valley Bank – the largest bank by deposits in Silicon Valley – collapsed in March 2023, and marked the second largest bank failure in US history after Washington Mutual's collapse in 2008. Dehaan says US regulators are likely to tighten regulations following the collapse, putting more focus on stress testing and the availability of liquidity and the different pools in which it can be trapped.

"Many banks in the US in particular are managing a significant amount of transactions on Excel spreadsheets and this should not be done on Excel," says Dehaan. "There will be costs involved in moving away from spreadsheets, but by doing so, bank treasurers will find themselves in a more comfortable position that gives them greater visibility over liquidity. They will be working with actuals, rather than projections. In a rising interest rate environment, they will be more informed about where to place the right amount of liquidity at the right time."

Now, more than ever, says Bartlett, the key driver for managing working capital is ensuring access to the cheapest sources of funding with utilisation of a corporate's own funds being the most efficient. "Managing the working capital cycle is a balancing act at the best of times, but more so in a high interest rate environment and where supply is limited. This is because it is difficult to accurately forecast payables and, consequentially, receivables if there is uncertainty around production of finished goods due to interrupted supply of raw materials. The ability to utilise self-funding, combined with accurate cash flow forecasting, is essential."

Lang says in the current economic climate there are three main challenges for corporate treasurers in effectively managing working capital and liquidity: gaining intraday visibility of liquidity positions, accurately forecasting working capital needs and efficiently mobilising liquidity. "With regards to visibility, having intraday visibility of global cash positions is always a challenge, especially if liquidity positions are spread across multiple bank providers, currencies and geographies," he says. "In the current climate, the cash flow forecast needs to be dynamic and be able to support a wide range of market scenarios including broad based market stress. Finally, on mobilising liquidity, getting liquidity to the right place at the right time at the lowest possible cost is a challenge especially for corporations managing working capital needs across multiple legal entities, geographies and currencies."

Digital technology is playing an increasing role in helping corporate treasurers to get a better handle on their working capital and liquidity management. CGI's Schmidt says digitising processes gives corporate treasurers greater command and control over liquidity and working capital, enabling them to be more proactive in finding funding when it is required. "When a corporate treasurer is pressed for cash, he or she wants to be able to identify which primary relationships they need to maintain and whether there are payment discounts they can take advantage of, for example," he says.

HSBC's Bartlett says the real-time forecasting, payment functionality and receivables reconciliation that the latest digital technology offers, enable treasurers to stay ahead of potential issues such as funding gaps, lack of liquidity and monitoring of accounts receivables. "In turn, digitisation enables corporates to have the ability to tactically adapt their strategy quickly and in fast enough time to circumvent a major issue. This is a luxury that customers were not afforded in the era of manual instruction and paper reconciliation," he says.

Lang notes that there are more digital technologies available to corporate treasurers "than ever before". These technologies include application programming interfaces (APIs), mobile applications, machine learning, predictive data analytics and artificial intelligence. "APIs have significantly reduced the cost and implementation timeline of system integration between bank providers and clients, for example," he says. "Also, app-based mobile banking applications give corporate treasury teams on-demand payment and liquidity capabilities that they also enjoy in other areas of their life." Finally, he says, machine learning and predictive data analytics can make cash flow forecasts more dynamic and accurate.

Bartlett says an ideal working capital and liquidity management set up will be largely dependent on a range of factors, including industry segment, size of the business, number of markets and customers involved. “Whilst there are industry benchmarks, there is no hard and fast rule for any one corporate,” he says. “Moreover, the ideal working capital set-up is constantly changing dependent on both internal and external factors. Generally speaking, it is prudent to achieve the right level of payment terms with suppliers in the context of a suitable credit period without pushing up costs, whilst ensuring customers are given enough time to pay at a price that is affordable, but ensures account receivables are timely enough to meet account payable obligations.”

For the treasury department to manage working capital and liquidity management efficiently, they must be able to rely on the right information from their own enterprise resource planning and treasury management systems, as well as input from their banking partners and the rest of the organisation. “Significant restructuring suggests a ‘Big Bang’ approach and that is normally a hard sell at a Board level because of the expected associated costs and complete overhaul of technology and systems which are not easy to implement whilst maintaining business as usual. An incremental change might solve for all of the above, but of course it takes longer to realise the overall benefits.”

Lang agrees that an ideal set up will depend on many client specific factors including corporate financial goals, funding needs, corporate structure and risk appetite. However, there are at least two common characteristics that apply to most ideal liquidity management set-ups, he notes.

First is a high level of automation – physical cash concentration and notional pooling structures are often favoured by corporate treasurers as they allow a high level of automation, reducing cost and the likelihood of human error. Second is flexibility and control. “Market conditions can change quickly; therefore the best liquidity structures offer corporate treasurers configurable features that they can manage via digital tools. For example, they can add, cancel or modify physical cash concentration relationships, adjust intercompany borrowing and lending rates.”

Some treasury departments are making small, incremental steps towards their target state liquidity structures. More established, sophisticated treasury departments already operate a highly efficient liquidity structure, he says. “However, regardless of their size or evolution, all companies realise the cost implications of an unfunded overdraft in the current interest rate environment. Likewise, trapped cash that stays uninvested overnight can be a drag on firm profitability. Therefore it is critical to have a highly automated liquidity structure in place such as an automated overnight sweep.”

All companies should have plans to implement a longer-term liquidity structure, he adds, but trying to achieve too much too quickly can result in significant costs and resource challenges. “A more practical approach would be to gradually introduce changes in smaller increments and realise benefits early. For example, corporate treasurers could start by initially focussing on a few accounts or entities. Alternatively, they could consolidate large currency pools that can be easily mobilised and invested to enhance yield. Another idea would be to prioritise and add those legal entities and accounts to the automated sweeping and notional pooling structures that are frequently overdrawn due to their working capital needs.”