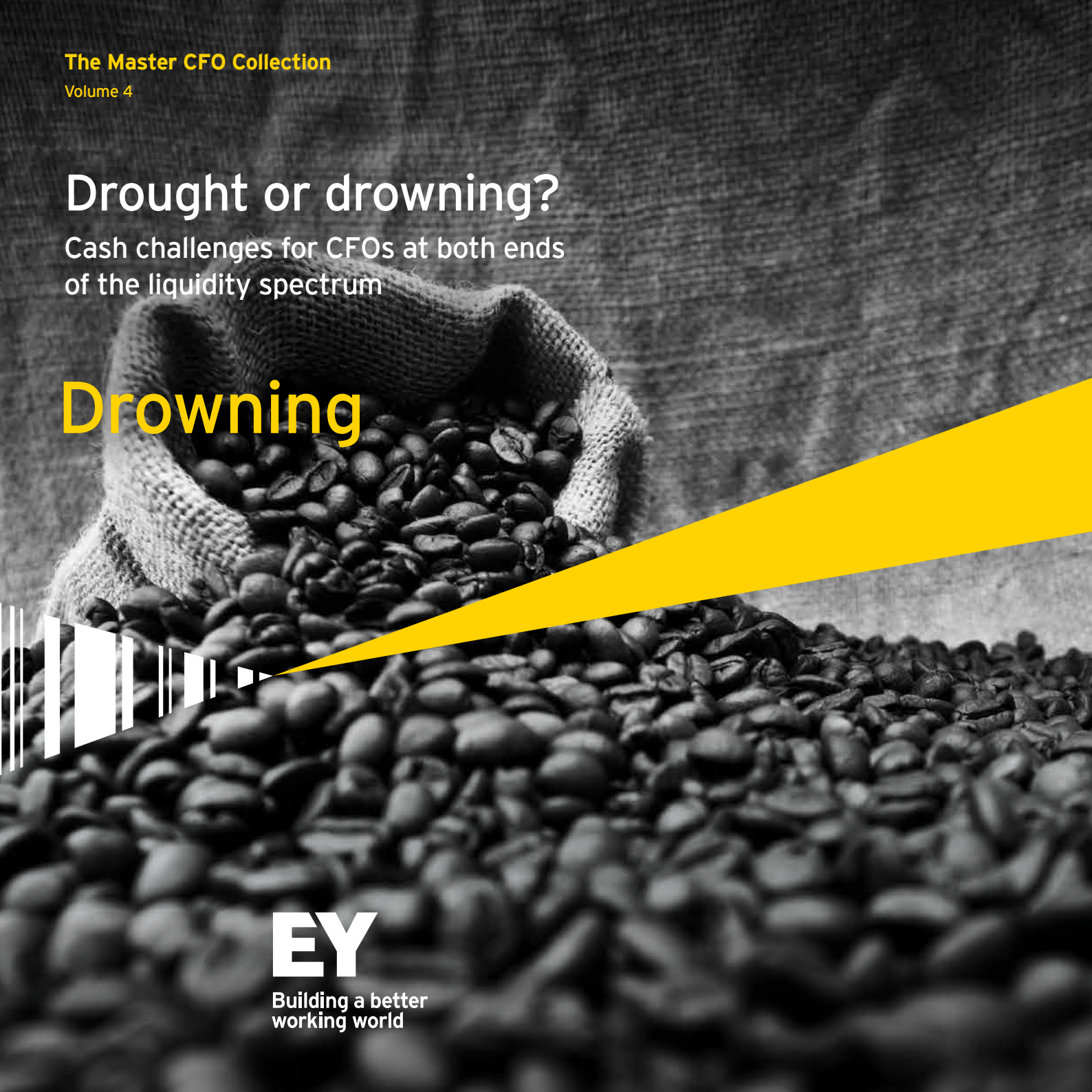
The Master CFO Collection

Volume 4

Drought or drowning?

Cash challenges for CFOs at both ends of the liquidity spectrum

Drowning



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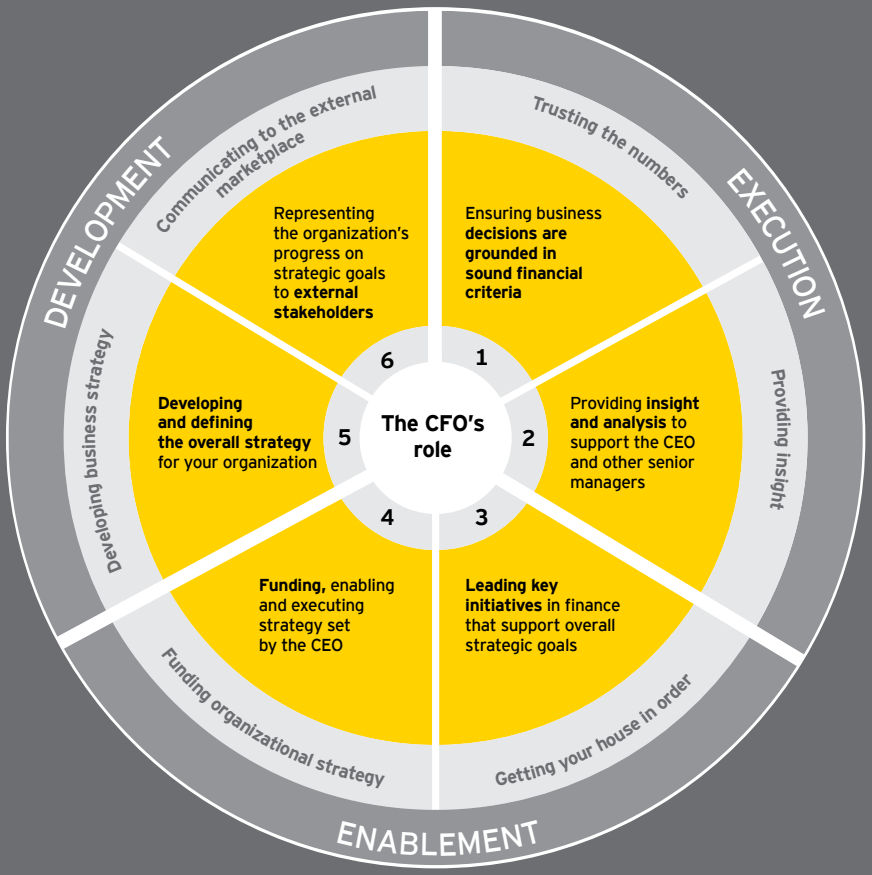
The CFO's role



We believe these six segments represent the breadth of the CFO's remit. The leading CFOs we work with typically have some involvement in each of these six – either directly or through their team. While the weighting of that involvement will depend on the maturity and ambition of the individual, the sector and scale of the finance function, and economic stability, they are all critical to effective leadership.

There are core skills, areas of knowledge, experiences and relationships that are needed to excel in each of these six areas of the role. Further information on these are available in the CFO studies titled *The DNA of the CFO* and *Finance forte and CFO and beyond*. See the center foldout for further information on these reports.

The gap between the "haves" and "have-nots" has rarely been wider.

At one end of the cash spectrum, many investment-grade corporates have amassed formidable balance sheet positions. Fueled by the fear of being locked out of credit markets, and by a lack of confidence in investment options, these companies have built up huge war chests of cash. And, they are showing no sign of opening their coffers yet.

At the other end of the spectrum, after a period of four years in which banks have tightened credit and reduced lending, thousands of companies remain in a precarious cash position. For many, accessing cash is a permanent preoccupation, which means the difference between staying in business, and not.

In *Drought or drowning*? we explore key considerations for the CFOs of cash-rich and cash-poor companies, to help seize the opportunities, manage the complexities and steer their company through this unusual economic environment.

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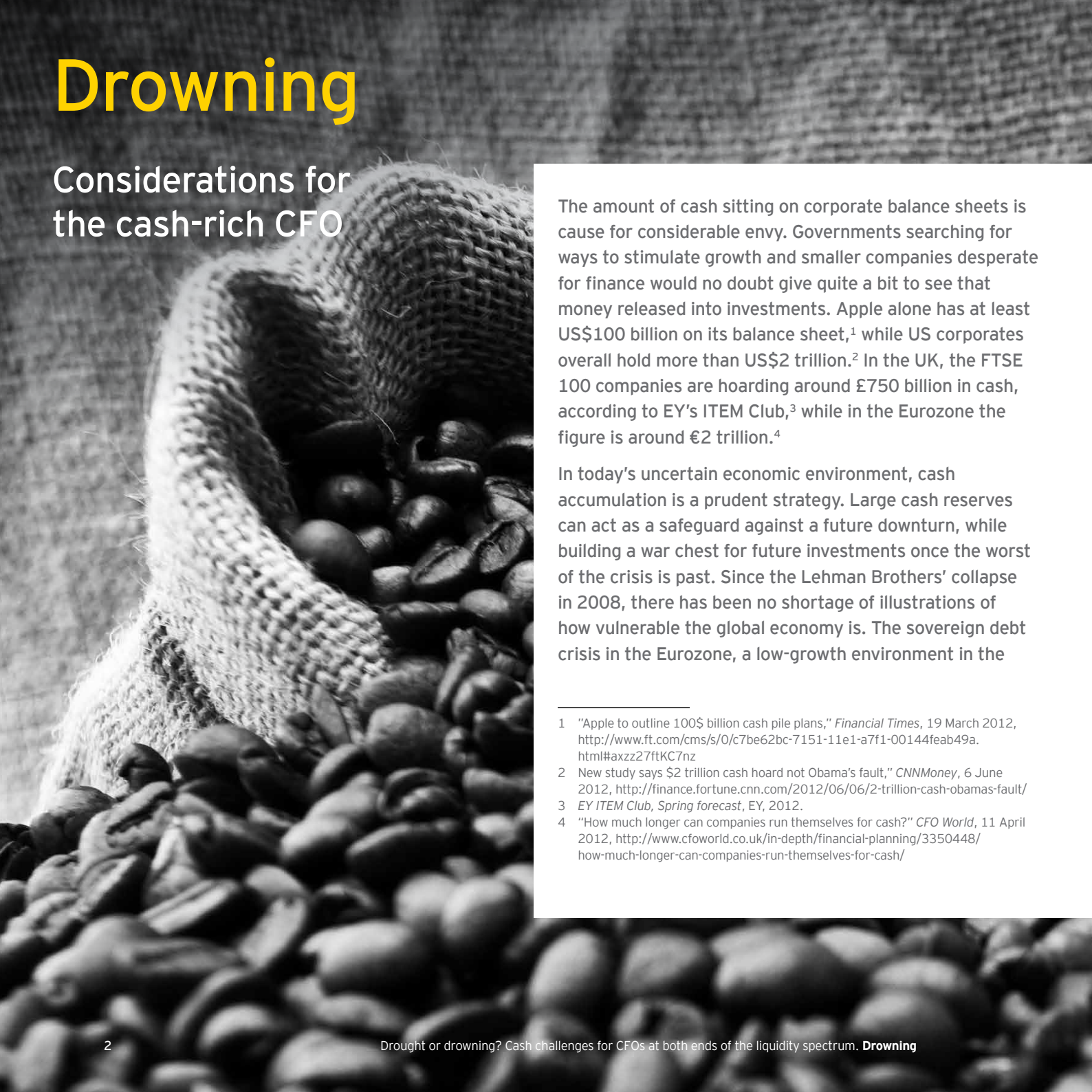
Drowning

Considerations for the cash-rich CFO



The amount of cash sitting on corporate balance sheets is cause for considerable envy. Governments searching for ways to stimulate growth and smaller companies desperate for finance would no doubt give quite a bit to see that money released into investments. Apple alone has at least US$100 billion on its balance sheet,[1] while US corporates overall hold more than US$2 trillion.[2] In the UK, the FTSE 100 companies are hoarding around £750 billion in cash, according to EY's ITEM Club,[3] while in the Eurozone the figure is around €2 trillion.[4]

In today's uncertain economic environment, cash accumulation is a prudent strategy. Large cash reserves can act as a safeguard against a future downturn, while building a war chest for future investments once the worst of the crisis is past. Since the Lehman Brothers' collapse in 2008, there has been no shortage of illustrations of how vulnerable the global economy is. The sovereign debt crisis in the Eurozone, a low-growth environment in the

1 "Apple to outline 100$ billion cash pile plans," *Financial Times*, 19 March 2012, http://www.ft.com/cms/s/0/c7be62bc-7151-11e1-a7f1-00144feab49a.html#axzz27ftKC7nz

2 New study says $2 trillion cash hoard not Obama's fault," *CNNMoney*, 6 June 2012, http://finance.fortune.cnn.com/2012/06/06/2-trillion-cash-obamas-fault/

3 *EY ITEM Club, Spring forecast*, EY, 2012.

4 "How much longer can companies run themselves for cash?" *CFO World*, 11 April 2012, http://www.cfoworld.co.uk/in-depth/financial-planning/3350448/how-much-longer-can-companies-run-themselves-for-cash/

US and Japan and, more recently, slowing growth in key rapid-growth markets, have all combined to create a highly uncertain outlook for demand.

Few signs of an end to cash accumulation

This cycle of cash accumulation is unlikely to be broken any time soon. "Until companies see that consumers are starting to spend and other companies are starting to invest, I think they will be very reluctant to pre-empt the market by starting to spend the cash they have on their balance sheets," says Dougald Middleton, Global Leader of EY's Capital and Debt Advisory team.

Economists have suggested that in the UK and other developed economies, another factor restricting companies from investing their cash is that they are carrying excess labor, and therefore have no need of additional capacity. Since the downturn began, some companies have preferred to maintain their workforce, rather than revising it down to match shrinking demand as they awaited the economic upturn. This would explain the relatively small increase in the number of people seeking work. "Unemployment hasn't grown by anything like the rate predicted at the start of the recession," says Mr. Middleton. "Companies have held on to their workforce in the expectation that output would pick up and therefore they don't need to invest, because there is more capacity than is currently needed in the economy."

A new set of challenges for CFOs

But large cash balances in today's volatile economy create new challenges for CFOs. Cash that would once have been earmarked for acquisitions and other strategic ventures is now lying idle and earning tiny returns in low-interest instruments. To keep cash at the ready in the event of a downturn, companies are avoiding long-term investments. And, since the downgrading of many prominent banks over recent years, even traditionally secure short-term investments instill less confidence than previously.

For CFOs in this situation, there are challenges and there are opportunities. In this report, we explore the key considerations for finance leaders of cash-rich corporates.

1. Invest, pay out or buy back

Ultimately, cash-rich companies face a choice. Either they can invest their surplus cash and put it to productive use, or they can return it to shareholders in the form of dividends or share buybacks. For now, companies seem to be favoring the latter. In 2012, a large number of multinationals have announced major share buybacks, including Nike, AT&T, Siemens and Apple.

Share buybacks can help to shore up asset prices in the short term. Companies that have fared well during the downturn and do not trust the other available investment instruments might well choose to back their own company's profits by buying back shares. But this is hardly a sustainable growth strategy. Indeed, some analysts have argued that share buybacks often end up destroying value, particularly if the company pays less than the intrinsic value of the shares.

For Richard Davies, Managing Director of investor relations consultancy RD:IR, the dilemma for cash-rich companies stems from the fact that they have not yet become accustomed to the new economic landscape. "There should be a growing realization that things aren't going to bounce back in the way they traditionally have in previous boom and bust cycles," he says. "That means that companies should start to lower their sights in terms of what is available in the form of investable opportunities. This would spell a strengthening trend of cash-rich companies snapping up those that are cash-poor, given the amounts of cash available on balance sheets and the low valuation of many targets on a fundamental basis."

> "The evidence suggests that those companies that talk to shareholders, tell them about their strategy and communicate their business model fully and transparently, even if the numbers aren't great, have a better valuation over time than those that don't."
>
> — **Richard Davies**, Managing Director, RD:IR

2. Articulate the rationale for your cash-rich position to investors

The rationale for holding large quantities of cash on the balance sheet will vary from company to company. Some may have chosen to build up their cash reserves to increase their resilience against further economic strife, while others have done so on the assumption that a large-scale strategic move is imminent. Others have simply been so spooked by the financial crisis that they never want to be in a cash-poor position again.

But the market may not be as understanding of a strategy which prioritizes cash over growth, unless the rationale is communicated convincingly. "Companies need to articulate their story clearly and explain to shareholders why they are sitting on that pile of cash," says Les Clifford, Chair of EY's CFO Program in the UK and Ireland.

"Very often, companies are not clear enough about the rationale for their balance sheet position, and that creates uncertainty and concern among the investor base."

By communicating regularly with investors about their perceptions of their markets, and how their financing decisions reflect that, CFOs can build strong, long-term relationships with shareholders based around a clear premise of "no surprises." And ultimately, argues Mr. Davies, this leads to a more stable shareholding base and better longer-term valuations. "The evidence suggests that those companies that talk to shareholders, tell them about their strategy and communicate their business model fully and transparently, even if the numbers aren't great, have a better valuation over time than those that don't," he says.

3. Lock in finance at record rates in a golden era for bonds issuance

For CFOs of investment-grade companies in countries with a relatively sound economic footing, it has never been easier or cheaper to sell bonds. Investors need to find a safe haven for their cash, and this has brought down borrowing costs to unprecedented levels. The latest action from the US Federal Reserve, the "QE3," and the European Central Bank's pledge to buy theoretically unlimited quantities of sovereign debt, should also prolong the boom, because they demonstrate a commitment to keeping borrowing costs low and pushing investors into higher-yielding instruments.

While it may be counter-intuitive for cash-rich companies to issue bonds that will further bolster their cash reserves, some CFOs of cash-rich companies are doing just that, in order to lock in finance at historically low rates. In September 2012, the Swiss consumer products company Nestlé set a new record when it issued a 10-year unsecured bond with a coupon rate of just 1.75%.[5] Companies are also seeking to issue bonds with longer maturities. According to Credit Suisse, the average maturity for euro-denominated corporate debt issues had risen from six years at the start of 2012 to eight years by August.[6]

Investor appetite for corporate bonds, combined with difficulties in accessing bank finance, has transformed the balance sheets of many companies in the Eurozone. Traditionally, companies in Continental Europe have been heavily reliant on bank finance, and to a much greater extent than their peers in the US and the UK. But, this situation has changed in recent years, with the value of syndicated lending in the Eurozone falling to an all-time low. "There has been a fundamental switch in Europe from bank finance to the bond market, to the point that the bond market is now larger than the bank market for investment grade corporates as a source of credit," says Mr. Middleton. "Previously, European companies obtained as much as 70% of their funding from banks."

5 "Nestlé Sets New Low Coupon Record," *CFO Insight*, 4 September 2012, http://m.cfo-insight.com/financing-liquidity/loans-and-bonds/nestle-sets-new-lowcoupon-record/

6 "The Kiss of Debt," *Financial Times*, 13 September 2012, http://specials.ft.com/vtf_pdf/130912_BACK1_EUR.pdf

"We see continuing concerns among corporates about counterparty risk in their banking relationships and this is encouraging many to diversify their holdings."

– Olivier Drion, EMEIA Head of Treasury Services, EY

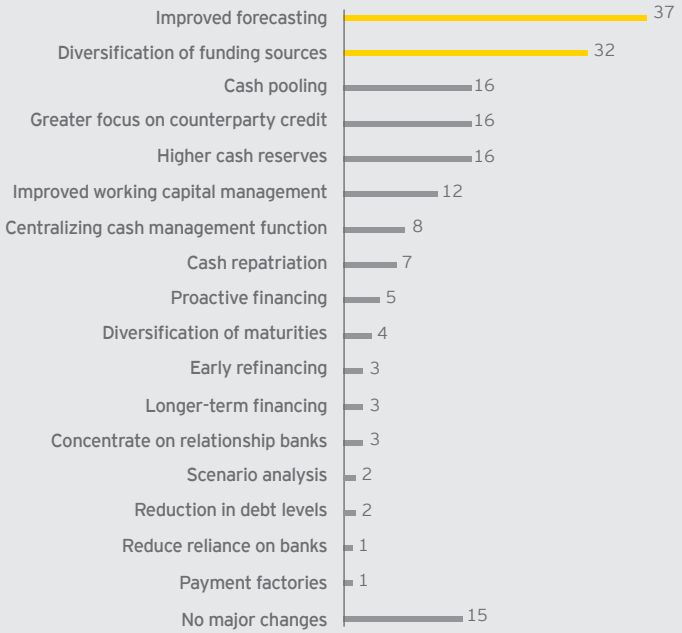
4. Develop a clear treasury risk management strategy

Over the past few years, the role of the treasury department has seen a shift in focus. No longer are its professionals expected to find ways to create wealth and profits – instead, there is a real focus on identifying and mitigating risk. The governance of treasury management has come to the fore, with many companies putting in place clear policies and strategies to ensure that the board and audit committee are comfortable with the risks being taken. "Most organizations today take the view that treasury is all about minimizing risk and making sure that the company has a spread of exposure to different markets, currencies and financial institutions," says Mr. Clifford.

Diversification of banking relationships is essential

Although many banks around the world are now on a stronger footing than they were two years ago, CFOs should ensure that their treasury departments diversify their banking relationships to limit the exposure to any single institution. A recent EY report, *Reflecting on the future*,[7] shows that the diversification of funding sources is one of the top priorities among treasury professionals (Chart 1). "We see continuing concerns among corporates about counterparty risk in their banking relationships and this is encouraging many to diversify

Chart 1. **In response to the recent liquidity crunch, what key measures has your company taken to enhance your approach to liquidity risk management? (percentage)**



Based on face-to-face interviews with 101 treasurers of leading international companies, covering 14 countries and 21 industry sectors.

7 *Reflecting on the future: a study of global corporate treasuries*, EY, 2012.

their holdings," says Olivier Drion, EMEIA[8] Head of Treasury Services at EY. "They are seeking to reduce as much as possible the maturity of deposits, as well as spread their risk across banks and into other vehicles such as money market funds and mutual funds. For their part, institutional investors such as insurance companies are looking to invest in new types of securitized funds of corporate or mortgage loans to enhance yields and diversification."

Country and currency risks are critical factors to manage

As uncertainty around the fate of the Eurozone persists, CFOs are having to factor country and currency risks into their investment decisions. "We were seeing a flow of cash to German banks, until they too were downgraded. Finding the right banks to invest in is really becoming a burden even if you're willing to cross borders," says Tanguy Coatmellec, EMEIA Head of Treasury Advisory at EY.

Moving money into a more secure currency may not necessarily be a wise move either. "If your costs are in one jurisdiction and you move your cash or debt into a different currency, you add some currency risk to your balance sheet and your profit and loss," says Mr. Coatmellec. "We are seeing companies working to keep their resources in the same currency in which they generate their Earnings Before Interest and Tax (EBIT). For example, an international company which generates 50% of its EBIT in dollars might try to keep an equivalent amount of its debt and reserves in dollars as well, to ensure consistency in case there are significant fluctuations in one currency or the other."

Reconsider the role of the treasury professional

The importance of treasury risk management to the health of the business also means that CFOs should think more carefully about the skills and backgrounds of the executives who populate the treasury department. A growing number of companies are focusing on the recruitment of specialists who have a deep understanding of the instruments used, rather than rotating general finance professionals into the role. "In the past, the treasury function was often run by somebody in finance and the role was seen as a stepping post onto a bigger finance role," says Mr. Clifford. "Today, there is a much greater focus on ensuring that the team has deep knowledge and understanding and is able to advise on procuring better banking and fund-raising relationships."

8 Europe, Middle East, India and Africa.

> "[Supplier finance is] a means to help smaller suppliers by giving them cash flow flexibility, which is financed at a lower cost of capital."
>
> **– Jon Morris**, Working Capital Leader, EMEIA, EY

5. Support your supply chain

A cash-rich company does not necessarily have cash-rich suppliers. Suppliers may be small or medium-sized enterprises (SMEs), which are typically finding it much more difficult than investment-grade companies to access finance in the current environment. Where finance is available, it is often expensive, which has a knock-on effect on the prices that the supplier charges to the customer. Suppliers may also be facing cash-flow problems of their own because some customers may be extending supplier payment terms or delaying payment in order to improve their cash flow.

Many large companies are utterly reliant on a small number of key suppliers within their supply chain. If one of those providers becomes insolvent, the company may be unable to get its products to market or even to operate.

Supplier finance options becoming more common

A growing number of cash-rich companies are exploring a range of supplier finance options, which allow suppliers to get early payment on their invoices in return for a financing charge. "Supplier finance has traditionally been used as a way for a company to support its suppliers while extending their credit terms," explains Jon Morris, EMEIA leader of EY's Working Capital Services. "But it is also seen as a means to help smaller suppliers by giving them cash flow flexibility, which is financed at a lower cost of capital." What's more, some of these approaches can help cash-rich companies to earn a yield in excess of what is possible from a cash account.

Reverse factoring

With this approach, the customer presents invoices from a supplier to a third-party factor, usually a bank, which approves them for early payment. The suppliers can then choose to draw down early payment for some or all of the invoices in return for a discount on the payment. The supplier benefits by being able to receive early payment for some of its invoices, while the customer can maintain the original payment terms, because it is the bank that finances the early payment and earns the discount as commission.

Dynamic discounting

In this more direct approach, there is no third-party bank or factor, and the customer simply accelerates payment for invoices to the supplier in return for a discount. The size of the discount may be small – possibly only around 1% – but it will be greater than the return on cash that could be earned by simply leaving these funds in a low-return liquidity vehicle. Suppliers also benefit by gaining access to earlier payment and addressing their liquidity problems.

Consider supporting your customers, as well as your suppliers

Cash-rich companies can use a similar mechanism with their own customers. "If you are in a strong cash position, you can get your customers to pay you a little later, provided you're happy to carry the risk of default," explains Mr. Morris. "You might then offer your customer a facility to pay in 60 days, rather than 30, but require them to pay a little more in return."

Some companies are providing credit to their customers in order to support their core business. Google, for example, has announced a scheme in the UK to extend credit to customers of its online advertising business. In the US, it plans to offer a credit card to customers, which will provide a low-interest-rate credit line of between US$200 and US$100,000 a month. Amazon has a similar scheme offering loans to sellers of products on its marketplace.[9]

Supportive is fine, but don't be imprudent

It makes sense for companies to undertake initiatives that strengthen the supply chain, but Mr. Clifford advises them to ensure that they do not expose themselves to unwanted risk. "If you've got key suppliers facing potential liquidity problems, then using some of your surplus cash to provide security to them and de-risk your business has to be a good idea," he says. "But it should only be done where it makes commercial and strategic sense and once you have gone through a rigorous due diligence process."

9 "Google makes first foray into credit business," *Financial Times*, 8 October 2012.

"If you've gone through the process of making operational improvements, cleaning up your balance sheet and conducting share buybacks, the next logical step is to buy capacity in order to take out competitors in the market."

– Dougald Middleton, Global Leader, Capital and Debt Advisory, EY

6. Keep your eyes open to M&A opportunities

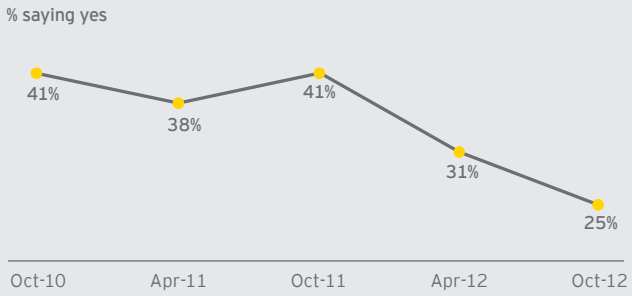
There is currently little sign of a major uptick in corporate M&A activity. Indeed, appetites for inorganic growth appear to be falling. According to EY's most recent *Capital Confidence Barometer*,[10] the proportion of companies worldwide that are considering an M&A transaction over the next 12 months is just 25%, compared with 31% in April and 41% in October 2011 (Chart 2).

With slow growth predicted in the global economy for some time to come, few companies have the appetite – or see the urgency – for major M&A deals. But this cycle will eventually turn, and the cash-rich companies will be the ones best placed to move quickly and acquire prime assets.

Buy out the competition

One option open to cash-rich companies is to buy, rather than build, capacity. In other words, cash-rich companies may lack the appetite for bold, transformational deals, but there are numerous opportunities to use smaller acquisitions to increase market share and take out competitors. "If you look at any recession, there is always corporate takeover activity based on rationalizing competitive pressure in the market," says Mr. Middleton.

Chart 2. **Do you expect your company to pursue acquisitions over the next 12 months?** (percentage)



Based on a survey of more than 1,500 executives (including 754 CEO, CFO and other C-suite respondents) from 41 countries and 24 sectors, surveyed in Autumn 2012.

10 *Capital Confidence Barometer*, EY, October 2012.

"So if you've gone through the process of making operational improvements, cleaning up your balance sheet and conducting share buybacks, the next logical step is to buy capacity in order to take out competitors in the market."

Seek out the unloved assets of others

The past few years have seen companies everywhere reconsider their competitive strengths and make difficult decisions about where their core competencies lie. Many companies have come under pressure from shareholders to focus on a narrower set of business priorities. At the same time, the disposal of non-core assets through a divestment or carve-out process is, for companies in a less fortunate cash position, a quick and relatively easy way to raise finance.

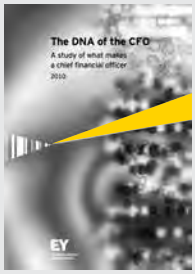
Over the past year, many large corporates have conducted portfolio reviews and chosen to divest non-core assets. In April, for example, Pfizer announced a deal worth US$11.9 billion to divest its infant nutrition business to Nestlé. Other companies, including Nike, Shell, Statoil and GSK have all embarked on divestment programs.

Acquiring these unwanted assets can be a powerful opportunity for cash-rich companies, particularly if there is a neat strategic fit with their own business. One of the reasons why a company divests a non-core asset is because it does not believe it has the resources, capability or know-how to get the most out of it. This is something that private equity acquirers have known for a long time, but any company can apply the same logic. "Private equity houses are very attracted to non-core assets because they think that, by putting in place a management team that has a single focus on the business, it enables them to generate better returns than would be possible for the asset on the periphery of another business," says Robin Jowitt, Partner for Telecoms, Media and Technology and Pharmaceuticals M&A, EY UK.

Other CFO program titles

This is one of a series of studies from our CFO program, which provides insight and guidance on aspects of personal interest to the CFO as they seek to develop themselves, their teams and learn from others within their community. Other publications from the program include:

The DNA of the CFO series



The DNA of the CFO
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Finance forte
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The possibilities and pathways outside finance

The Master CFO Collection

Drought or drowning? is the fourth edition of *The Master CFO Collection*. This series provides insight on specific aspects of the CFO role. Previous titles include:

Back seat or center stage?
Vol. 1
CFOs and the media

What lies beneath?
Vol. 2
The hidden cost of entering rapid-growth markets

A tale of two markets
Vol. 3
Telling the story of investment across developed and rapid-growth markets

For further information on these titles, and our program of investment in CFOs, please visit www.ey.com/cfo, or contact **Katherine Brinkley** on katherine.brinkley@fr.ey.com or +33 1 46 93 56 12.

Drought or drowning?

Drowning

The CFO's role in a cash-rich organization

The CFO's unique optic across the business facilitates a greater understanding of the different forces at play in the current environment, and helps forge a path for a cash-rich organization to seize the opportunities and manage the risks. We outline actions for CFOs of cash-rich companies to consider, as they relate to EY's CFO wheel, which is our way of illustrating the core components of the job.

1
- Work with the CEO and management team to determine appropriate opportunities for investing surplus cash
- Identify risks in business proposals
- If the time is not right or risks too great, be ready to challenge key business stakeholders

2
- Communicate financial information clearly to internal stakeholders
- Provide evaluation of the key risks and opportunities
- Analyze market trends to determine whether to invest, return cash to shareholders, or continue to increase cash holdings

3
- Ensure that the right skills are in place in key finance functions, including treasury risk management
- Explore options for supplier financing
- Assess whether surplus cash can be used to drive internal improvements, including within the finance department

4
- Determine the best approach to long-term funding
- Take advantage of highly liquid bond markets
- Determine the right mix of different funding types for investments

5
- Analyze opportunities and create a business case for investing or not investing
- Allocate resources to appropriate internal and external investments
- Work with C-suite colleagues to design appropriate business and operating models

6
- Communicate clearly the rationale for the company's cash position to external investors
- Articulate why a strong cash position is good for the business
- If the company is not investing, explain why not

DEVELOPMENT
Communicating to the external marketplace
Representing the organization's progress on strategic goals to **external stakeholders**
Developing business strategy
Developing and defining the overall strategy for your organization
Funding organizational strategy
Funding, enabling and executing strategy set by the CEO
ENABLEMENT
Getting your house in order
Leading key initiatives in finance that support overall strategic goals
Providing insight
Providing **insight and analysis** to support the CEO and other senior managers
EXECUTION
Trusting the numbers
Ensuring business **decisions are grounded in sound financial criteria**
1
2
3
4
5
6
The CFO's role

Drought or drowning?

Drought

The CFO's role in a cash-poor organization

The CFO plays a vital role in developing, enabling and executing strategies to help steer cash-poor companies towards a better position. We outline actions for CFOs of cash-poor companies to consider, as they relate to EY's CFO wheel, which is our way of illustrating the core components of the job.

1
- Work with the CEO and management team to determine whether changes to the business model and strategy are required
- Identify key risks in the current strategy and business proposals
- Challenge assumptions and current thinking among the management team and other business stakeholders

2
- Articulate clearly the current financial position and outlook to internal stakeholders
- Identify key risks and opportunities that could change the cash position
- Analyze market trends to determine whether external conditions will change the current cash-poor situation

3
- Embed operational working capital processes to reduce cash requirements
- Consider outsourcing or shifting to a shared service model to reduce costs
- Build stronger relationships between tax and the business to identify tax efficiencies

4
- Assess availability of non-bank finance
- Explore ways of rolling over or refinancing current debt
- Work with finance providers to explore creative solutions to current cash problems

5
- Assess feasibility of strategic goals in current financial position
- Allocate resources internally to activities that will do the most to strengthen the cash position
- Work with C-suite colleagues to design appropriate business and operating models

6
- Build trusting, open relationships with key providers of finance
- Anticipate problems and communicate clearly with key stakeholders
- Articulate a clear, long-term business plan to providers of finance

The Master CFO Collection

Volume 4

Drought or drowning?

Cash challenges for CFOs at both ends of the liquidity spectrum

Drought

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Building a better working world

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The gap between the "haves" and "have-nots" has rarely been wider.

At one end of the cash spectrum, many investment-grade corporates have amassed formidable balance sheet positions. Fueled by the fear of being locked out of credit markets, and by a lack of confidence in investment options, these companies have built up huge war chests of cash. And, they are showing no sign of opening their coffers yet.

At the other end of the spectrum, after a period of four years in which banks have tightened credit and reduced lending, thousands of companies remain in a precarious cash position.
For many, accessing cash is a permanent preoccupation, which means the difference between staying in business, and not.

In Drought or drowning? we explore key considerations for the CFOs of cash-rich and cash-poor companies, to help seize the opportunities, manage the complexities and steer their company through this unusual economic environment.

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Drought

Considerations for the cash-poor CFO

While some investment-grade corporates are amassing formidable balance sheet positions, those at the other end of the cash spectrum would no doubt regard this as a nice problem to have. After a period of four years in which banks have tightened credit and reduced lending, thousands of companies across Europe remain in a precarious cash position. Although many banks are now on a stronger footing, their willingness to lend, particularly to small and medium-sized enterprises (SMEs), remains low. Credit conditions may have improved compared with the darkest days of 2008, but net new lending remains well below pre-crisis levels.

In the UK, for example, the Bank of England's latest *Trends in Lending* report identified a reduction in the stock of lending to UK companies in the three months to May.[I] This reflects a lack of both demand and supply, but the overall picture is one of ongoing challenges. The stock of lending to SMEs, in particular, has contracted significantly since 2009. EY's most recent *Capital Confidence Barometer*[II] finds that just 26% of companies consider credit availability to be positive (Chart I).

The picture is similar across Europe, although the problems are even more acute in Eurozone countries such as Greece, Portugal, Spain and Italy. An April 2012 report from the European Central Bank(ECB), on access to finance for SMEs, found "considerable worsening" in the availability of bank loans across much of the Eurozone, but singled out these countries as facing a particularly difficult credit environment.[III]

Chart I. **Please indicate your level of confidence in the following at the global level:**

Based on a survey of more than 1,500 executives (including 754 CEO, CFO and other C-suite respondents) from 41 countries and 24 sectors, surveyed in Autumn 2012.

With their access to new finance constrained, cash-poor companies are relying on rolling over existing debt packages as they hope for credit conditions to improve. SMEs or companies rated below investment grade have fewer options because, unlike larger companies, they have limited access to capital markets and syndicated lending facilities.

I *Trends in Lending*, Bank of England, July 2012, http://www.bankofengland.co.uk/publications/Documents/other/monetary/trendsJuly12.pdf

II *Capital Confidence Barometer*, EY, October 2012.

III *Survey on the access to finance of small and medium sized enterprises in the Euro area*, October 2011 to March 2012, ECB, April 2012 http://www.ecb.int/pub/pdf/other/accesstofinancesmallmediumsizedenterprises201204en.pdf

Lack of funding to SMEs is creating a barrier to a return to global growth

SMEs are crucial engines of growth and employment. The dearth of funding available to them raises broader questions about how the global economy can fully recover. According to a report from the European Commission (EC), SMEs are responsible for more than two-thirds of total employment in the private sector and 85% of net job growth.[IV] *Funding the future*,[V] an EY survey of 1,001 entrepreneurs from all G20 countries, also found that access to finance is a critical barrier to the success of their businesses. Almost two-thirds say that they find access to finance difficult in their country. Today's SMEs are tomorrow's multinationals, but their chances of reaching this goal without finance are very limited.

A wall of debt that will need to be refinanced is looming

Much has been made of a "wall of refinancing" in 2013–15, when a huge volume of debt issued in the pre-crisis years, often on favorable terms, will become due. According to the credit rating agency Standard & Poor's, companies around the world will need to refinance existing debt of as much as US$46 trillion over the next five years.[VI] And, although many banks are on a more secure footing than they were at the height of the crisis, there are doubts about the availability of sufficient funding to meet these demands. This suggests that there will be an abrupt rise in the number of restructurings, although the steady process of de-leveraging that has taken place in the corporate sector over the past few years has reduced this risk somewhat.

But cash can still be found, either from within or without

Despite the acute practical difficulties they face, there are several important steps that CFOs of cash-starved companies should take. Although many will already have spent the past four years seeking out efficiency improvements and cost-cutting opportunities, there is potentially more that can be done. Improvements to working capital management, increased tax efficiencies and operational changes to the finance function can all be important sources of additional cash. And, to increase their chances of obtaining finance, CFOs must also ensure that they have strong relationships with finance providers and that they communicate regularly with them, even if the news is not always good.

With a sharp upturn in the global economy looking increasingly unlikely, the outlook for lending remains bleak, particularly for SMEs. This means that cash-poor companies may need to make more fundamental decisions about their business model, and adapt it for a low-growth, low-cash environment. We explore some of the options that are available for cash-poor companies, and examine the role of the CFO in enabling these changes.

IV "Do SMEs create more and better jobs?" *Europa*, 16 January 2012, http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/12/11&format=HTML&aged=0&language=EN&guiLanguage=en

V *Funding the future: access to finance for entrepreneurs in the G20*, EY, 2012.

VI "Standard and Poor's warns of potential US$46 trillion 'perfect storm' in global credit markets," 11 May 2012, *interest.co.nz*, http://www.interest.co.nz/bonds/59258/standard-and-poors-warns-potential-us46-trillion-perfect-storm-global-credit-markets

I. Build trust with banks and other finance providers

Although overall credit conditions remain poor, particularly for SMEs, banks are still willing to lend to companies with the right management team, strategy and processes. CFOs of cash-poor companies may have to work harder than ever to convince banks to finance them, but the funding is there for companies that have the right story to tell.

For Caroline Ross, Director of EY's Key Executive Program,[VII] this starts with having a transparent, open relationship with banks. "You have to maintain a very close dialogue with banks and ensure that there are no surprises at any time," she says. "It's essential to have absolute clarity on the numbers and to be able to communicate that regularly to finance providers."

If problems are looming, Ms. Ross advises CFOs to anticipate them and communicate the situation as early as possible to the banks. "Don't just say 'We're going to run out of cash'," she says. "Tell them you have a seven-month window, that you've done your numbers and set out what you plan to do to rectify the situation."

By ensuring close dialogue with the bank when trouble flares up, a CFO can explore the possible options more clearly. For example, it may be possible to negotiate a covenant holiday, or explore whether there are some alternative financing arrangements, such as equity, private placements or mezzanine finance, that can be brought into play.

VII The Key Executive Program connects candidates with those looking to fill executive roles in the private equity sector.

"You have to maintain a very close dialogue with banks and ensure that there are no surprises at any time."

— **Caroline Ross**, Director of the Key Executive Program, Private Equity, UK & Ireland, EY

II. Move from tactical to operational working capital improvements

In the immediate wake of the financial crisis, cash-poor companies were forced to try every approach going to strengthen their balance sheet and ensure survival. Working capital management was a key source of focus as many companies had let their discipline slip while times were good.

There have been significant improvements since then. EY's recent report on working capital management[VIII] shows that, in the US, cash-to-cash (C2C) fell by 3% in 2011, bringing the cumulative reduction in both the US and Europe to 16%. Companies have also reduced their days sales outstanding (DSO), which reflects the continuing benefits of a strong focus on cash collection and billing across the board (Table I).

Nevertheless, there remain significant opportunities for further refinement. Among the 2,000 leading US and European companies, there is up to US$1.2 trillion of cash unnecessarily tied up in working capital, which is equivalent to 7% of their aggregate sales.

Table I. **Change in working capital metrics by region, 2010–11**

US	2011	Change from 2010
DSO	38.0	-3%
DIO	29.3	-2%
DPO	30.5	-3%
C2C	**36.8**	**-3%**

Europe	2011	Change from 2010
DSO	52.1	-1%
DIO	34.5	1%
DPO	45.7	-1%
C2C	**40.9**	**0%**

Source: EY analysis, based on publicly available annual financial statements.
Note: DSO (days sales outstanding), DIO (days inventory outstanding), DPO (days payable outstanding) and C2C (cash-to-cash), with metrics calculated on a sales-weighted basis.
Based on a review of the working capital performance of the largest 2,000 companies (by sales) headquartered in the US and Europe, drawing on companies' latest fiscal 2011 reports.

VIII *All Tied Up: working capital management report*, EY, 2012.

Very often, the steps that companies took in the immediate wake of the crisis were short term and tactical in nature, and often designed to ensure that the balance sheet looked strong at a particular point in time. "Companies were in panic mode and, for many, the crucial thing was to ensure at particular crunch points – say, the end of the financial year – that they could manage their balance sheets to achieve the cash performance that they needed," says Jon Morris, EMEIA[IX] leader of EY's Working Capital Services. "So they would pay suppliers late, run stocks low and do deals with customers to get money in early."

Working capital management should be embedded sustainably

After several years of this tactical approach to balance sheet management, Mr. Morris argues that companies now need to adopt a more strategic stance. "Companies have realized that these tactical changes to working capital take a huge amount of effort and often don't actually lead to better earnings."

As a result, a growing number of companies are trying to move to a more sustainable approach by making operational, business model or strategic changes that help to put the balance sheet on a more stable footing over the long term. "Companies need to make changes that drive improved cash flow not just on 31 December, but throughout the rest of the year as well," says Mr. Morris. "If you do that, you can reduce the amount of cash that you need to tie up in the business."

Small changes can bring big results

Simple changes to internal processes can make a big difference in reducing cash requirements and improving working capital management. For example, a company may decide to establish a more aggressive and systematic "follow-up process" for contacting customers who are late in settling payment. They may reduce the time lag between steps in the follow-up cycle, or make calls before a debt becomes due. More fundamentally, a company may decide to shift to a global procurement model or create a shared service center to manage the company's entire payables requirements. "By creating a step-change in your operational processes, and instituting that as standard practice across your business, you can make a dramatic improvement in cash flow," says Mr. Morris.

IX Europe, Middle East, India, and Africa

> "CFOs are increasingly pushing tax directors to manage cash taxes and generate up-front benefits, and many of their KPIs are being established around these goals."
>
> — **Herwig Joosten**, Managing Partner Tax, Belgium, EY

III. Turn to the tax department

Tax is no longer an island. There is a growing acceptance that stronger links need to be forged between the tax function and the business to optimize the company's tax position and uncover inefficiencies. "Although it is below the line, tax has an immediate impact on cash," says Herwig Joosten, Managing Partner Tax at EY, Belgium. "As a result, CFOs are increasingly pushing tax directors to manage cash taxes and generate up-front benefits, and many of their KPIs are being established around these goals."

There are a range of possible approaches that may unleash some of these benefits, depending on the company's specific circumstances.

Cost of sales accounting

One approach that may yield benefits is to look at the way in which the company accounts for its cost of sales. Depending on the approach to pricing used, companies may be able to allocate their costs into the cost of sales, which will reduce the gross margin and therefore reduce tax costs. Companies should also determine whether indirect expenses, such as research and development (R&D), need to be capitalized, and accounted for as an intangible or an up-front cost. "By looking at these types of choices, you can bring forward cash inflows based on the tax treatment of these expenditures," says Mr. Joosten. "It is essential, however, to discuss this with your auditor and tax advisor to determine the positions that are appropriate to take."

Sale and leaseback of assets

A second approach that cash-poor companies may be able to take is the use of a sale and leaseback transaction. Gains generated from these types of transactions may be able to be offset by net operating loss carry-forwards (NOLs). Specifically, a company that has NOLs might be able to sell its assets (usually movable rather than immovable) to a related party in the group that is currently subject to tax, which then leases them back. "Cross-border leasing becomes particularly interesting if the qualification of the lease as a finance or operating lease differs between the lessee and lessor jurisdictions," says Mr. Joosten. "For many years, cross-border leasing has been a way to accelerate positive tax cash flows or defer negative ones."

Tax credits and incentives

Companies involved in R&D, or that have large intellectual property assets, will probably already be aware that many countries provide tax credits or incentives that encourage investments in innovation. There are now so many programs available, that it can be difficult for even the largest companies to keep up and ensure that their tax position on these investments is optimized. "The savings that are possible from the use of these regimes are considerable but very few companies know about all the possibilities, particularly when

you include subsidies as well as credits," says Mr. Joosten. "We see a considerable amount of interest among our clients to explore the available options and take advantage of them appropriately."

Going back to basics can yield surprising returns

Companies should pay careful attention to the processes that they employ in the tax department, as this could unlock savings that have previously been ignored. Even a simple miscoding on an invoice or expense form can lead to significant tax inefficiencies, particularly if it is repeated many times. A review of these processes to spot mistakes or incorrectly followed processes can help to uncover problems and eradicate inefficiencies.

Customs duties are a good example of this. A common problem is that the responsibility for these duties may fall between the cracks – tax directors may not know how much duties are paid because they do not see it in their account, while the business units do not see tax affairs as their responsibility. The result is that major inefficiencies can quickly creep in, particularly when measured over a long period of time.

"Looking at customs duties is a quick win because you often find that there is no-one in the company looking at this," says Mr. Joosten. "Simple changes, such as changing the importer of record, or revising the way in which products are categorized when they are imported, may make a big difference to the amount of customs duties that you pay."

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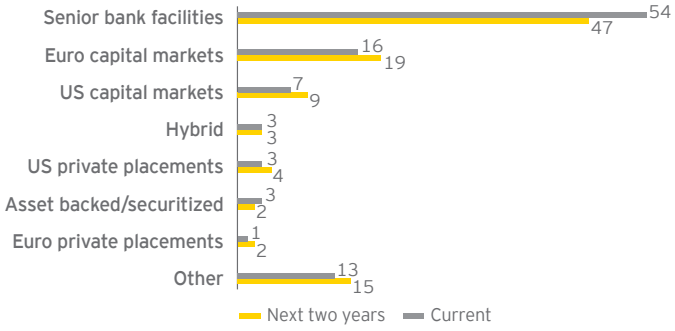
IV. Explore non-bank sources of debt

A recent report from Morgan Stanley and Oliver Wyman highlighted a global funding gap of US$5 trillion, of which US$3 trillion is in Europe.[X] Put simply, the banking sector will struggle increasingly to meet the demand for credit in the economy. This is because it needs to de-leverage and because it faces more stringent regulation, which is aimed at strengthening the capital position of the sector as a whole. "Under the new Basel rules, banks will be unable to lend profitably relative to the amount of capital that they have to hold against certain categories of loans and risk-weighted assets," says David Barker, Head of Transaction Advisory Services for Financial Services, EMEIA at EY.

In consequence, companies are being forced to look more widely for funding, as is illustrated in *Reflecting on the future*,[XI] a recent EY study of corporate treasuries. It describes how companies are expecting to decrease their reliance on banks, while increasing their exposure to capital markets, private placements and other sources of funding (Chart II).

Chart II. **What is your main source of funding (longer than 12 months) currently and what do you expect it to be in two years' time? (percentage)**



Based on face-to-face interviews with 101 treasurers of leading international companies, covering 14 countries and 21 industry sectors.

X *Light or shade? The future of bank-intermediated credit: Some issues and implications of shadow banking – July 2012*, Allen & Overy, http://www.allenovery.com/SiteCollectionDocuments/gliulightorshade.pdf

XI *Reflecting on the future: a global study of corporate treasuries*, EY, 2012.

So who will step in to fill this funding gap? In the past couple of years, a number of different non-bank sources of finance have started to emerge, including private equity, asset managers, pension funds and even sovereign wealth funds. These institutions are establishing a range of different business models, including setting up their own lending operations, or establishing new collective investment vehicles and other platforms that can make lending decisions on their behalf.

Private equity in a new form

Many large private equity firms, including Blackstone, Bain Capital and KKR, have also set up credit businesses over the past few years to provide lending to companies in need of greater financial flexibility. Rather than simply replacing the role of the banks, however, private equity firms will seek to use their deep industry and financial expertise to have an influence on the business and place it on a stronger operational and financial footing. "These firms have seen a gap in the market and believe that they can do a better job than what is currently offered," says Sachin Date, EY's EMEIA Private Equity Leader. "This is part of a broader trend whereby the biggest firms are transforming themselves from pure play private equity funds to multi-asset managers."

Peer-to-peer lending for micro-businesses

A range of internet-based, peer-to-peer lending services aimed at the very smallest companies have also sprung up, along with innovative services for advancing cash against invoices, and "crowd-funding" initiatives that enable money raising from multiple small investors using online channels. Taken together, these may not fill the funding gap outright, but they do represent an important shift in the provision of credit and an increasing disintermediation of the banking sector.

The private placement market is a growing option in Europe

Some mid-sized companies have started to look to the private placement market as an alternative to bank lending. This has been well established in the US for many years but, until recently, few European companies tapped this particular source of funding. This is changing, with European and UK issuers representing an increasingly large proportion of issuance over the past year. "The private placements market is booming at the moment," says Mr. Barker. "A lot of European companies have dollar needs and this is one way in which they can fulfill those requirements at a time when European banks have been reluctant to extend credit as dollar lenders."

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Dougald Middleton, EY's Head of Lead Advisory Services, UK & Ireland agrees. "Private placements have become an important source of longer-term debt capital. We have helped clients in a range of sectors raise over US$2 billion in the private placement market this year. Investors are looking increasingly at sectors such as project financed infrastructure, which requires debt with longer maturity. This is an exciting development for a sector that banks are generally exiting."

Private capital funds a potential lifeline

In recent years, a number of large institutional investors, including Axa, M&G and Alliance Bernstein, has set up private capital funds that lend directly to corporates. Other pension funds and insurance companies, whose business models have suffered as a result of record low interest rates, are also stepping into the market in search of yield. This market represents a good opportunity for these institutional investors to secure a good return, which may be in the region of 8% to 10%. For borrowers, the market offers a lifeline at a time when many find it extremely difficult to access bank finance.

Shadow banking can provide a lifeline, but the risks need to be factored in

Mr. Middleton emphasizes that the high costs of tapping the non-bank market for credit mean that any company choosing that route needs to be confident that it can achieve a significant rate of return. "If you're having to pay 7% or 8% for your credit, plus putting a bit of equity on top, then you're getting to a weighted cost of capital that is significantly higher than 10%," says Mr. Middleton. "There are not many investment cases around that show a return of greater than 10%."

There are also regulatory concerns associated with the growth of the "shadow" banking sector. In a recent Bloomberg interview, Michel Barnier, the EC's Commissioner for Internal Market and Services, described shadow banking as "one of my top priorities." The concern is that this new breed of lender is not currently regulated in the same way as the traditional banking sector, but should face the same type of supervision.

Taking matters into your own hands

In recent years, a number of small private companies, including King of Shaves and Hotel Chocolat, have launched their own retail bond issues that primarily target customers and "fans" of the brand. Hotel Chocolat raised £3.7 million from a three-year "chocolate bond" that pays a return in chocolate to members of its tasting club. This might not meet every investor's needs, but at least it will provide some pleasure.

V. Rethink the supply chain and business model

Uncertain patterns of demand and a volatile economic environment have increased the need for close collaboration between suppliers and their customers. Traditionally, suppliers have been unable to get a clear picture of demand, because the end customer will not deal directly with them. To address this lack of visibility, many suppliers and customers are now working more closely together in order to understand when peaks and troughs of demand might occur. Suppliers to a supermarket, for example, may request point-of-sale data on the products that are being sold, so that they have a better picture of demand and how it is changing. "If companies can think of themselves as being part of an overall supply chain rather than focusing on their own internal issues, they will be much more efficient at predicting and managing demand," says Mr. Morris. "Visibility and collaboration are very important drivers of improvement."

Review business model to release working capital

At the most fundamental level, companies should look at their business model to determine whether it could be changed in such a way that it improves their working capital position permanently. Consider the difference between a manufacturer that sources all its products from China, and one that sources them closer to home in Continental Europe. The company that sources from China may benefit from lower input costs, but the physical distance usually means that inventory holdings are high due to longer lead times, higher minimum order quantities and the low order flexibility, which leads to buffer stocks.

By contrast, the company that sources from Continental Europe may pay slightly more on its input costs, but can get its goods to market more quickly, with more flexible ordering systems and hence lower levels of working capital. "Thinking through different fulfillment models can completely change the amount of cash that you need in the business at any one time," says Mr. Morris.

Improve commercial frameworks and processes to reduce the need for cash

Companies can also make structural changes to the way in which they conduct business with suppliers and customers. This might include changing customer and supplier commercial frameworks so that, rather than billing on delivery of goods or services, the supplier stipulates part-payment up front. It also includes fundamental changes in the way that key working processes operate."By changing your operating processes to be more effective from a cash perspective, you carry out structural changes, which reduce the need for working capital," says Mr. Morris.

> "Raising cash in order to be able to use it in more effective areas ought to be at the heart of everybody's agenda, and therefore selling subsidiaries makes sense."
>
> **—Robin Jowitt**, Partner M&A, UK & Ireland, EY

Review asset performance regularly

Cash-poor companies may need to take a close look at their portfolio to determine whether there are any assets that could be offloaded to free up cash and improve performance. Robin Jowitt, Partner for Telecoms, Media and Technology and Pharmaceuticals M&A, EY, advises that companies should put in place a structured, systematic approach to reviewing the portfolio to determine which assets are working and which are not. "Raising cash in order to be able to use it in more effective areas ought to be at the heart of everybody's agenda, and therefore selling subsidiaries makes sense," says Mr. Jowitt. "Every company ought to have a process for reviewing the returns from each area of the business, to make sure that each asset continues to be consistent with overall strategic goals. If it's not, or if it's not performing in the way that it should, then companies should consider churning it and using the money more effectively elsewhere."

Manage your timing to manage perceptions

Companies that leave it too late to sell an asset, and that do so only for liquidity purposes, may create a perception that they are selling a distressed asset. This can lead to a negative reaction in the markets and also make it difficult to realize an expected valuation. "Selling out of distress is too late and companies ought to be thinking about their portfolios and planning disposals well in advance," says Mr. Jowitt.