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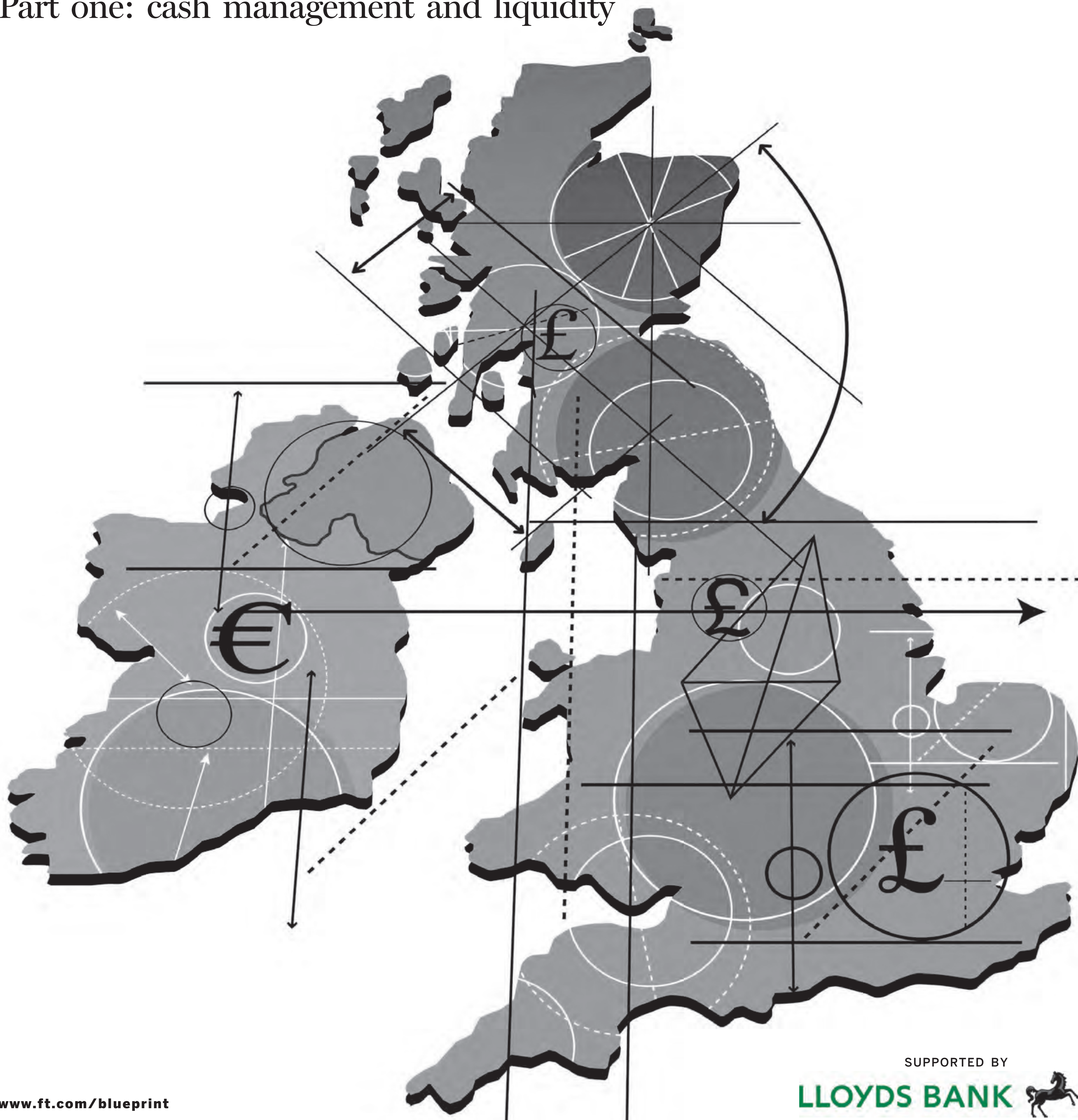
A blueprint for British business

Part one: cash management and liquidity



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Access denied

UK companies are sitting on £754bn in currency and deposits, as they hold back on investment decisions, writes *Brian Groom*

POLITICIANS AND economists have been pressing companies to start spending their cash piles, so an upturn in business investment reported in provisional data for the first quarter has come as a welcome relief for those who manage companies' capital.

According to the UK's Office for National Statistics, business investment – which had fallen sharply during the 2008-09 recession – rose by 3.6 per cent in the three months to March compared with the previous quarter, and by 14.2 per cent compared with a year ago.

It remains, however, more than 9 per cent below where it was in early 2008. With the UK economy in a double-dip recession and fresh instability in the eurozone, companies are bound to remain nervous about investment.

Businesses have been rebuilding their balance sheets, which, in many cases, were over-geared before the financial crisis. UK companies, excluding banks and financial institutions, have amassed £754bn in currency and deposits, equivalent to 50 per cent of gross domestic product, according to official figures. Not all of that may be available for investment in Britain – the biggest growth is in deposits held with foreign banks – but few doubt balance sheets are strong. Yet many companies have been unsure about when to start spending amid uncertain prospects.

"Business will always pause on investment if it thinks it is not going to get a return because the moment is wrong, because there isn't enough consumer and customer demand," says John Cridland, director-general of the CBI, the employers' group.

Peter Spencer, chief economic adviser to the Ernst & Young Item Club, the non-governmental forecasting group, says the UK will not begin to prosper until these funds are put back into the economy. "Until these companies stop stashing the cash and start increasing levels of investment and dividends, the economy will remain on the critical list," he warned last month.

Several large FTSE companies, including GlaxoSmithKline and AstraZeneca, the pharmaceutical groups, and BP, the energy company, have denied they are sitting unnecessarily on cash piles.

BP says it is investing more in the UK now than in recent years, with £4bn committed to various offshore projects over the next five years.

Carmakers have pledged substantial investment, helped by demand in emerging markets and a flexible workforce. General Motors' £125m investment in its new Astra at Ellesmere Port on Merseyside comes on top of £4bn of commitments from Jaguar Land Rover, Ford, BMW, Bentley and Toyota.

InterContinental Hotels, Subway, McDonald's, Starbucks and Marston's are among leisure chains planning expansions that will create thousands of jobs. National Grid aims to spend £31bn by 2021 upgrading Britain's gas and electricity networks.

Companies that invest when others do not can prime themselves for future expansion and steal market share from rivals, provided they do so wisely.

Some are investing with the help of the government's £2.4bn Regional Growth Fund, such as Darchem, an engineering business based at Stillington, near Stockton-on-Tees. It is awaiting confirmation from its US parent of an £8m investment to create production facilities for specialist fabrication for the new-build nuclear market, towards which the fund has offered £1m.

Graham Payne, managing director, admits uncertainty over the government's nuclear power station plans is a "big worry", but says the proposed investment is not a risk. Darchem does other nuclear work including insulation and could use the plant for aerospace manufacturing, too.

Two-thirds of its work is in aerospace, but Mr Payne says the nuclear sector will be "one of the most fundamental parts of our future growth in the next five to 10 years".

MANY COMPANIES, THOUGH, have been holding back on investment decisions until they see more light at the end of the tunnel. "Are they being cautious? Yes. Are they being irrational? Probably not," says Lee Hopley, chief economist at EEF, the manufacturers' organisation.

Richard Jeffrey, chief investment officer at Cazenove Capital Management, says the rebuilding of balance sheets is a hangover from the credit crisis, when companies conserved cash because they feared they would be denied access to credit. "This is where they want their balance sheets to be," he says. "They want to have more liquid assets; they want more cash because that is what provides them with reassurance."

He hopes to see "more significant growth" in investment over the next two years than in 2011, when it grew by just 1.2 per cent, but warns that when companies spend, they may be tempted to invest in higher-growth economies rather than in the UK.

Mr Jeffrey says that when investment comes, some companies may be doing it from a position of weakness. "It will be interesting to see what Tesco [the supermarket group] does, for instance. I suspect that when they decide what their future is going to be, it will require some investment."

He also warns that if companies hang on to their cash piles for too long, the government may try to take them away. "If companies continue to grow their share of national income, there is going to be a temptation for government – not just ours but governments in general – to say we should be taxing these companies more heavily."

Philip Booth, editorial director at the Institute of Economic Affairs, says: "If I were a shareholder I would be asking directors why they were sitting on cash that they could return to shareholders – why are we not paying dividends? It's not a company's job to sit on piles of cash."

He agrees, however, that it is rational for companies, particularly smaller ones, to build up cash piles for future investment because of fear that higher capital requirements on banks will make it even harder to get credit.

Prof Booth calls for microeconomic measures to help companies, particularly by further radical deregulation of the labour market and relieving companies of the impending burden of auto-enrolment of their staff in pension schemes such as the National Employment Savings Trust, the low-cost scheme created by the government.

Strategists say that even if the eurozone crisis provokes a renewed economic downturn, companies should have an eye to opportunities as well as simply cutting costs. Research by PA Consulting Group suggests that, in the recession of 2008-09, companies that saw the crisis as an opportunity to acquire assets cheaply or win market share from weakened rivals achieved a 10 per cent higher total shareholder return than those that did not.

Mark Thomas, business strategy expert at PA, believes companies are poorly prepared for the consequences of a Greek exit from the euro. "It is a difficult business to plan for, but I think you need to do some planning – maybe a central scenario where things are not so disorderly, and also an extreme one."

'Until companies stop stashing the cash, the economy will remain on the critical list'

With or without a eurozone apocalypse, some companies see clear virtues in investment even in difficult times. "We have been investing while others have been tightening their belts," says Majid Hussain, managing director of Accrol Papers, a maker of kitchen and toilet rolls, based in Blackburn, Lancashire.

After spending £25m on machines and buildings since 2005, allowing it to make high-quality paper more cheaply, Accrol plans a further £30m investment in the next two years. Mr Hussain adds: "Perhaps it's a bit high risk to be investing in a recession period, but for us it's been paying off."

Additional reporting by Chris Tighe

Case study Center Parcs

MARTIN DALBY, CHIEF executive of Center Parcs, needs no reminding of the value of investment.

"One of the reasons we have been successful for the past 25 years is we are forever reinvesting the profits and refreshing the product," he says.

The holiday operator has begun construction on a £250m village – the company's fifth – on the Duke of Bedford's Woburn estate, north of London, buoyed by strong trading and a 97 per cent occupancy rate at its four existing sites.

This was no sudden decision. Mr Dalby first walked through the greenbelt forest site eight years ago. A battle against local opponents ensued before planning permission was granted in September 2007, after initial rejection.

Since then, the company has been diverting footpaths and bridleways and building new roundabouts. It also took a year to put together finance, of which £100m will come from Blackstone, the group's private equity owner, and £150m in a construction loan from RBS, Barclays, HSBC and Lloyds Banking Group.

Unlike some companies, Center Parcs did not have a cash pile. The trigger for the Woburn funding was refinancing of its £1bn debt, which had been due to expire next year. It has been replaced by a bond issued via a "whole business securitisation" backed by revenue from its existing villages in Cumbria, Nottinghamshire, Suffolk and Wiltshire.

The Woburn Forest site, due to open in spring 2014, will employ 1,200 people in the construction stage and 1,500 once it opens.

Mr Dalby has little doubt that there will be sufficient demand even if economic growth remains slow.

Center Parcs, which attracts families, has so far seemed recession-proof: if money is tight, many trade down to the short-break holidays at which it excels.

Center Parcs, which attracts families, has so far seemed recession-proof

Mr Dalby expects the investment to add 20 per cent to Center Parcs' turnover and 25 per cent to its profits. In the year to April 2011, it had earnings before tax, depreciation and amortisation of £131m on revenues of £290.5m.

This will probably be its last site in the UK, where it views its geographical coverage as complete.

Ireland remains a strong candidate for expansion abroad, though Center Parcs ended talks with the government in Dublin two years ago after the recession hit. In the long term, Center Parcs is eyeing markets such as India and China.

In the six years since Blackstone bought Center Parcs, it has spent more than £250m upgrading the existing villages and will spend a further £60m over the next three years.

Mr Dalby says 60 per cent of customers come back every three years, so it is important to attract them with well-maintained facilities and new restaurants and leisure attractions.

Brian Groom

Cutting back to the bottom line

Reduction in expenditure can generate cash flow, and even finance growth, finds *Jessica Twentyman*

OPTIMISTIC, YET STILL defensive: those are the sentiments expressed by UK finance chiefs in management consultancy Deloitte's CFO Survey for the first quarter of 2012.

In the first three months of this year, optimism among chief financial officers about the prospects for their own businesses saw its sharpest rise since the quarterly survey began in 2007 – but that has not yet translated into more expansionary strategies, such as increased capital spend, mergers and acquisitions or introduction of new products and services.

Instead, the survey shows that British chief financial officers are even more focused on safeguarding strategies, including cost-reduction programmes, than they were a year ago. Thirty-eight per cent of 136 surveyed indicated that cutting costs is a top priority for 2012, compared with the 31 per cent in last year's survey.

Ian Stewart, chief economist at Deloitte, is aware of the apparent anomaly of more buoyant business sentiment and still-cautious corporate strategies. "What we're seeing is that concern over external uncertainty remains high," he says. "The consequence of that concern is that the 'new normal' in terms of corporate behaviour is not to anticipate any kind of steady upturn in the near future, but instead to prepare for erratic growth for some time to come."

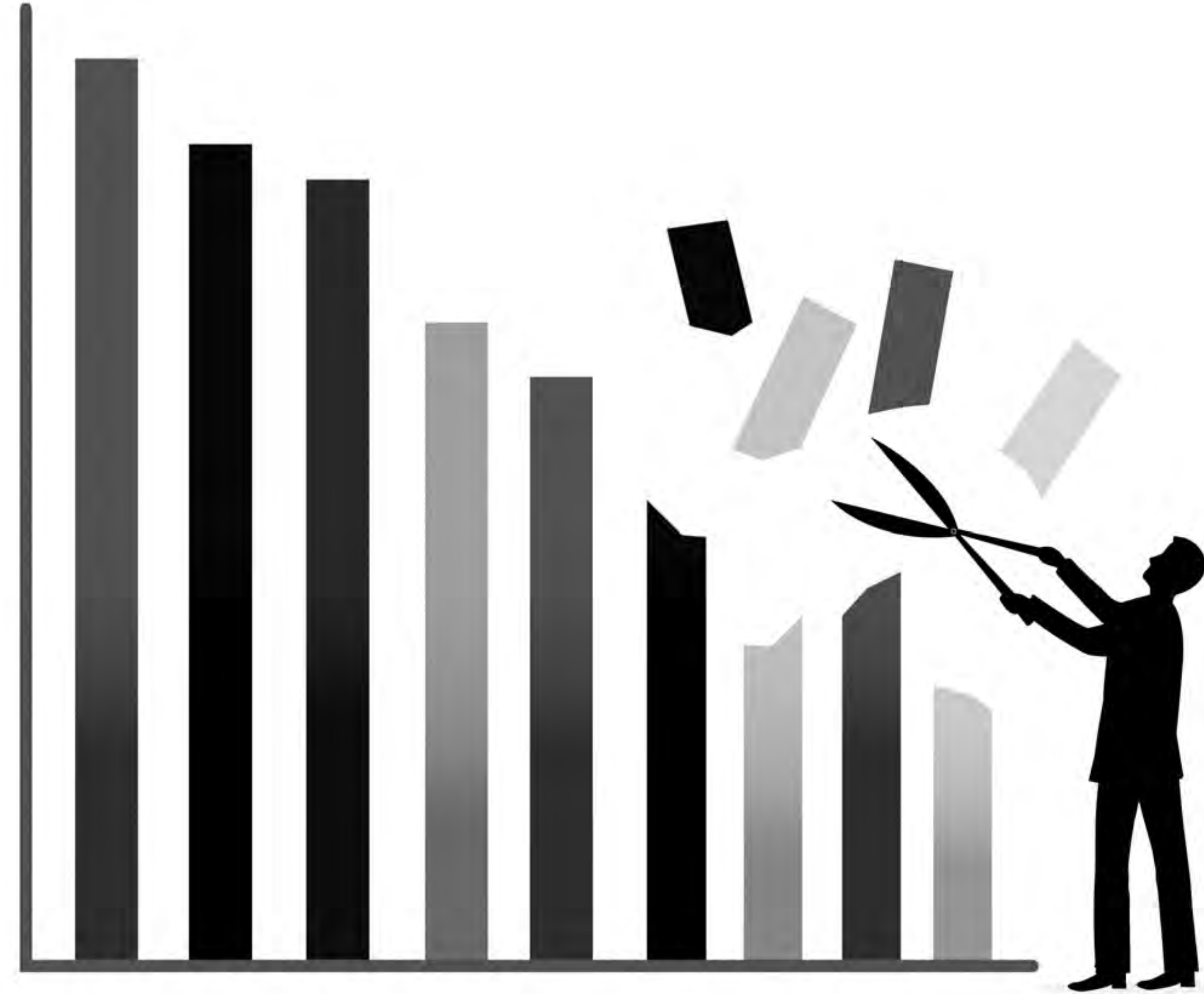
For now, though, the cuts continue. For example, Mothercare, the baby products retailer, has reduced its number of UK stores by 62 over the past 12 months, and, in April, announced plans to shut a further 111 by March 2015, resulting in about 730 job losses. It is also seeking to slash its "non-store overhead costs" by £20m on an annualised basis by March 2015, with the loss of 98 jobs at its UK head office in Watford.

In the financial services sector, meanwhile, HSBC has recently announced that its three-year turnround plan is on target and that it cut costs by £2bn during the first year of this plan. In the coming months, it expects to shed 2,217 jobs from its UK workforce.

But cost-cutting should not just be a response to difficult market conditions. For some companies, it is simply the way they do business, regardless of the external environment.

"A low-cost position wins in nearly every industry," notes a recent report from Bain, the consultants. "Cost leaders can out-invest rivals in areas such as research and development and marketing, while still maintaining attractive margins. They have the resources to capitalise faster and more readily on new opportunities. They can capture share, because they have more price flexibility."

But many cost-reduction efforts continue to fall short of their goals, and relatively few companies succeed in making the savings they do achieve stick, the report adds. A Bain survey of almost 300 executives showed that cost-reduction initiatives launched in 2008 and 2009 in response to the downturn had reaped disappointing results. Forty per cent of respondents at companies that aimed to reduce costs by at least 10 per cent acknowledged that the target was not reached. At companies aiming for ambitious reductions of 20 per cent or more, 60 per cent of respondents admitted failure.



'Gross margin is king – if you do not understand your costs really thoroughly, you are not running your business well'

What can British businesses do to make their cost-reduction strategies more successful? "Ideally, cost-cutting should be a long-term strategy," says Clive Lewis, head of enterprise at the Institute of Chartered Accountants in England and Wales.

However, he acknowledged, some companies had no choice but to cut costs to improve short-term cash flow. "Up to 5 per cent of firms are trading at a loss and more are heading that way," he says, and cutting costs now could help them rectify the situation – but only if they make reductions in ways that will not impair the business's ability to expand in the future. That means identifying areas where cuts will not compromise a company's unique selling points: its specialist skills, for example, or the quality of its products.

MANY ORGANISATIONS choose to start this process by reviewing areas of discretionary spending, including marketing and training budgets. But at Briggs Equipment UK, the Staffordshire-based forklift company, chief executive Richard Close takes issue with this approach. "It is a very short-term response," he says. "You will probably save money, certainly, but you are just avoiding the more painful decision to plan a serious restructuring that would deliver more sustainable savings."

In 2006, Mr Close was brought in to turn the company around, and, by 2011, profits had risen to £3m, up from £300,000 in 2010. In part, that recovery has been achieved through cost-cutting, he says, and in particular, the 2010 closure of a warehouse relatively far from the company's main premises.

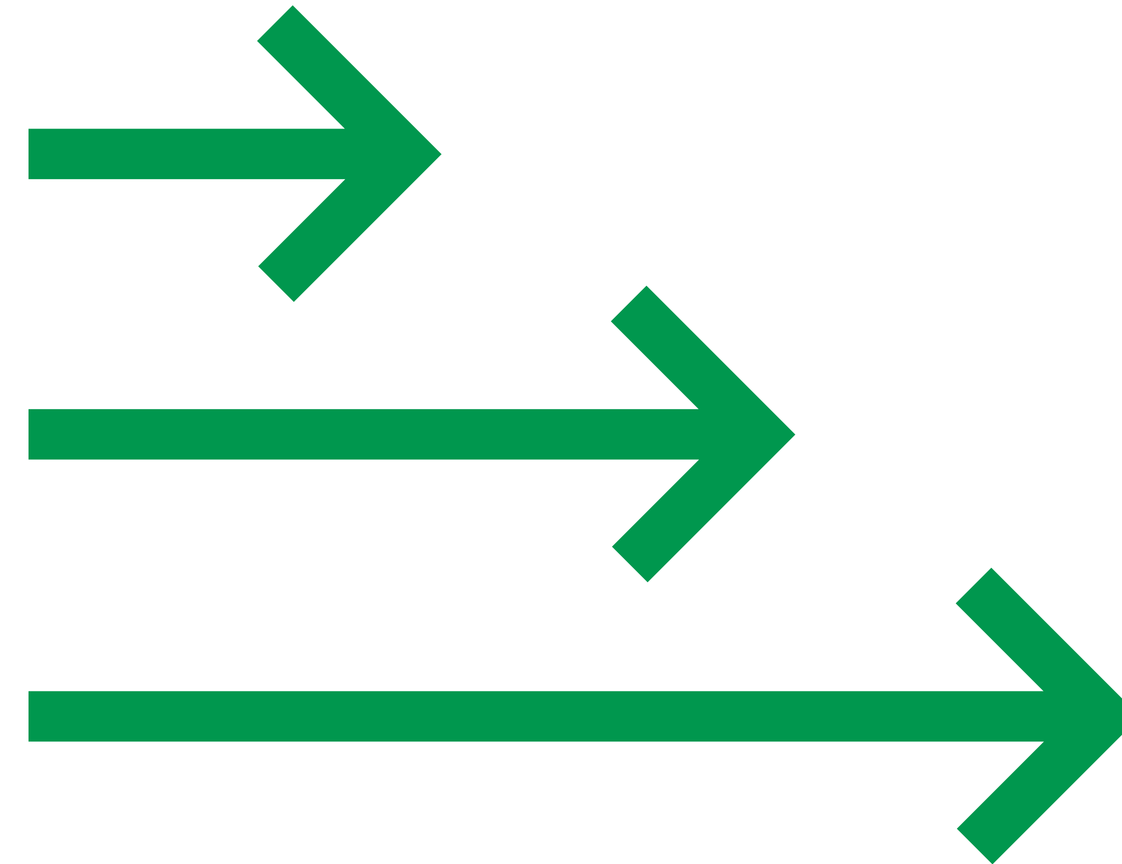
"I hit an amazing wall of resistance within the company when I announced the plans to sell this second site, but that warehouse was costing us £1m a year to run and was full of unsold inventory. My logic was to get rid of the property first and then the inventory problem would solve itself. Now, turnover has increased, as has our stock turn rate and I'm saving money that I would have otherwise spent on rent and interest on stock," he says. "It was a structural cost saving, not a tactical quick win. This is where I think cost-reduction efforts should focus."

At Cheshire-based Oliver Valves, which manufactures valves used by companies in the oil and gas industry including Shell, BP and Exxon, chairman Michael Oliver expects cost control to be a top priority for his procurement team, just as it was for him when he started the company in his garage back in 1979.

In their negotiations with UK-based steel suppliers, they offer the companies guaranteed orders for the coming year, but on three conditions: the suppliers must keep the steel on their own site until it is needed at Oliver Valves; they must ensure that it is pre-certified for quality by independent assessors; and they must offer discounts to Oliver Valves that reflect the volumes the company orders.

The company also works with a wide pool of international suppliers. It has a procurement team in India that deals directly with local suppliers, regularly achieving 30 per cent cost savings on components compared with the prices offered by UK suppliers.

"We know to the penny what our costs are – and I mean to the penny," says Mr Oliver. "We have a saying here that 'gross margin is king', so we simply don't accept an order in the first place if it doesn't offer us a gross margin of at least 50 per cent. If you don't understand your costs really thoroughly, you're not running your business well. It's as simple as that."



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Show me the money

In an era of austerity, a strong balance sheet is vital, says *Paul Solman*

WHEN THE DOWNTURN struck, Booths was better prepared than many businesses in the UK. The family-owned grocery chain, which operates 28 stores in the north-west of England, has been part of the retail landscape since 1847 and has seen its share of peaks and troughs in the economic cycle.

The fallout from the credit crisis of 2008 was not immediately noticeable in Booths' business fortunes, says John Vandermeer, finance director. "People still appeared to have money in their pockets, especially as our customers tend to be among the more affluent," he says. "It's really in the past 12 months that we've begun to see some impact. Unemployment and fuel costs have begun to affect spending habits."

Booths was fortunate last year, too, when it sought refinancing to help fund expansion. "The banks have always seemed to have an appetite for what we're trying to achieve," Mr Vandermeer continues, "although our original bank did suggest we bring some others on board."

Other British companies, however, have enjoyed less success when they went to the bank. The total value of loans to private, non-financial companies dropped by £1.7bn in March, according to the Bank of England, and overall lending to businesses is falling by more than 3 per cent a year.

For many businesses, credit has all but dried up in the years since the financial crisis, forcing them to rethink how to manage their cash flow and liquidity – or perish.

"If you go back to the pre-crisis period, you wouldn't see businesses placing the amount of emphasis on cash flow and working capital management that they are now," says Lesley White, head of Europe, Middle East and Asia treasury products for corporates at Bank of America Merrill Lynch.

"Post-crisis, with bank lending much tighter, the importance of effective, efficient cash-flow management has increased. Cash flow is the life blood of the business."

There are signs that companies – especially in the UK – are adapting to this reality. According to Treasury Strategies, a financial consultancy, UK-based companies have been building larger piles of cash than their counterparts in the US and eurozone since well before the credit crunch began. Cash held by British companies amounted to 50 per cent of the UK's gross domestic product at the end of 2011, compared with 26 per cent in 2000, Treasury Strategies says.

By contrast, US corporate cash was about 14 per cent of GDP at the end of 2011 compared with 10 per cent in 2000, and eurozone companies' cash was 21 per cent versus 15 per cent.

"It could be that UK companies are generally more conservative in their approach to cash," says Monie Lindsey, managing director and head of the London office of Treasury Strategies. "But 2008 made everybody more cautious, and whether you call it hoarding or insurance, companies don't want to get caught out."

Nevertheless, banks' continued reluctance to extend credit is forcing companies to cast their net much wider to secure the cash they need.

Clive Lewis, head of enterprise at the Institute of Chartered Accountants in England and Wales, says: "There is a general understanding among businesses of the importance of cash flow. Many companies have raised it on their priority list.

"But businesses need to remember that there is a whole range of finance options. Term loans and overdrafts are still very popular. But they should also consider options such as asset finance, hire purchase and leasing, invoice discounting and, for some, equity."

Mr Lewis adds: "It boils down to basic, good financial management. And you need to talk about it regularly in board meetings and make sure you have a high standard of financial forecasting."

Ms White at Bank of America Merrill Lynch says companies are also reorganising their internal processes, supported by systems to improve their cash flow. "Anybody who had a crystal ball in 2007-08 would probably have renegotiated their finance conditions before the crisis, even if they weren't up for renewal," she says. "But treasurers also need to make sure they are looking at all aspects of their business impacting working capital management, including supply chain and inventory, to ensure that cash is managed properly.

"Whether you are a medium-sized corporate or a large multinational, there is a lot of emphasis on how to be more efficient when it comes to cash-flow management, and understanding the profit and loss impact of the supply chain," she says. "This could mean negotiating better terms with suppliers. Sometimes just moving payment methods from paper to electronic will make a difference, or moving to other available instruments, such as direct debits."

COMPANIES ALSO NEED TO consider whether their cash pile is being put to best use. Jose Franco, global head of corporate banking liquidity at Bank of America Merrill Lynch, says: "With all the uncertainty in the market, a 'fortress balance sheet' is vital. But there is the threat that it will be eaten up by inflation due to the low [interest] rate environment."

This is why an effective cash-flow management strategy also involves investment. "Cash flow and investment strategy go hand in hand because the stockpile of cash causes other challenges," says Mr Franco.

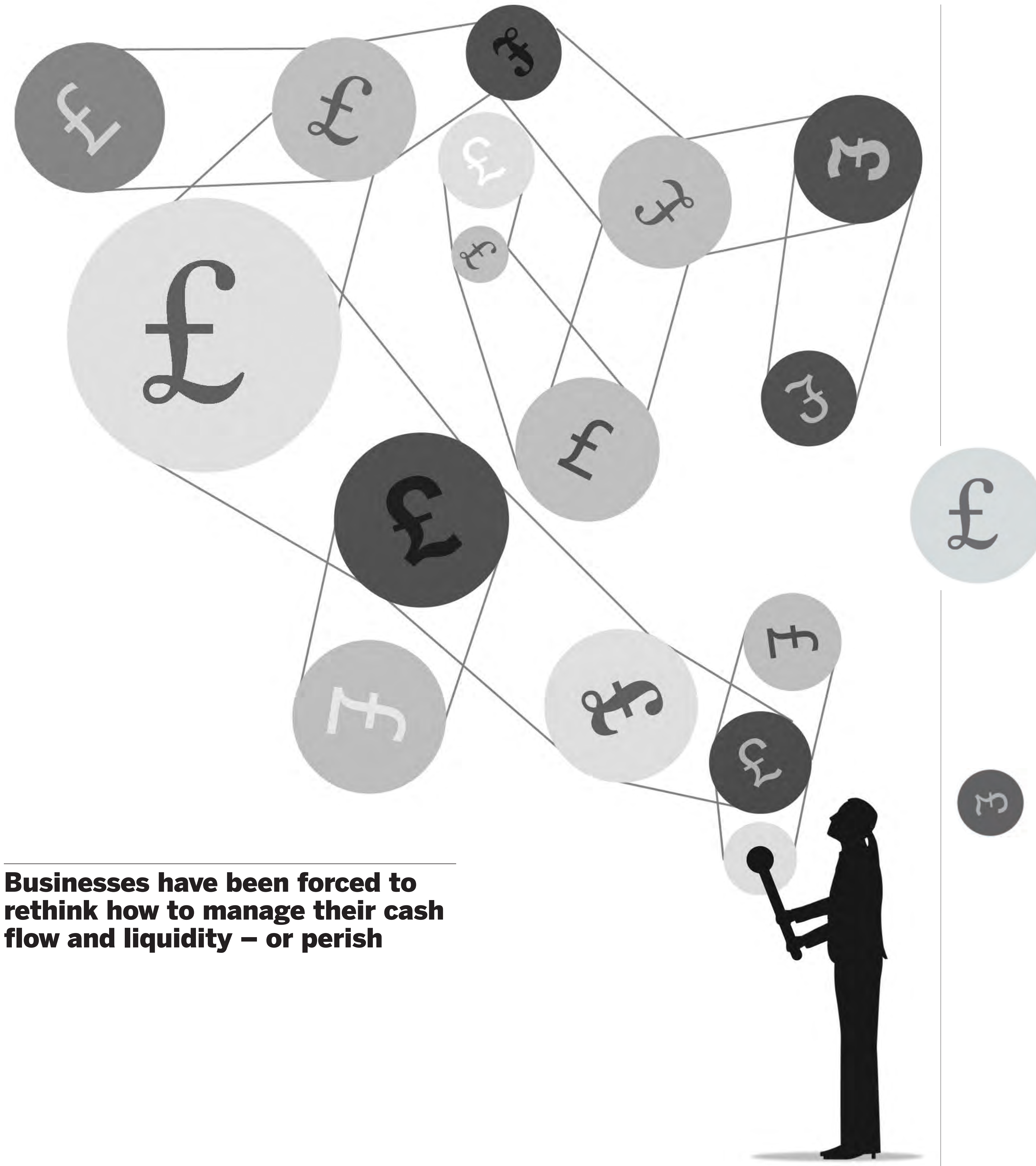
"Cash can be classified as operating cash, which is needed immediately; reserve, which is needed in a 6-12 month window; and strategic, which isn't needed so can be invested for the longer term. That investment could be in an instrument or it could be in purchasing one of your suppliers, or even a similar business in another geography. But the critical point is that not all cash should be treated as operating," he explains.

Mr Franco adds that the emphasis on effective cash-flow management is likely to remain a focus for businesses for the foreseeable future. "It wasn't critical when credit was cheap," he says, "but risk appetite will also become more important in the next five years as interest rates rise. The UK and the US are in a strong position, Europe is challenged."

At Booths, Mr Vandermeer says the company's refinancing has secured funding for the next four and a half years. But he says an understanding of cash flow is critical to ensure that the company does not overextend itself in its expansion plans.

"We have seven or eight stores in the pipeline, and there are a lot of factors that will impact when a new store build will come through," he says. "But a lot of the control is still within our remit, which helps an awful lot from a cash-flow planning point of view."

Businesses have been forced to rethink how to manage their cash flow and liquidity – or perish



A capital idea

Start-ups need banking support, writes *Jonathan Moules*

FOR MOST ENTREPRENEUR-led businesses, capital management is one problem they would actually like to have.

Young businesses do not generally have huge cash piles. The first few years is usually a hand-to-mouth existence, saving money wherever possible and spending whatever money is available building operations.

Those that survive can start to think about selecting a finance team to take charge of their capital management. However, most manage without a finance director, instead relying on financial controllers or even book-keepers.

The financial crisis created a double blow for many entrepreneurial businesses – not only did they have to cope with the implications of a sudden drop in demand for their product or service but the credit to support their operations became harder to come by.

Stats Group, an Aberdeen-based engineering business that provides tools for oil and gas companies to isolate sections of their pipelines for testing, had been growing between 50 and 100 per cent in the four years leading up to the collapse of Lehman Brothers in September 2008. In the next year, however, its revenue fell from £16m to £9m, forcing it to cut its headcount from about 140 people to 80.

Although its oil market quickly recovered, Stats, which up until then had been wholly debt funded, faced problems getting the working capital it needed to rebuild its capacity.

"The reality was that it was an awful rock bottom that led us to be very constrained," Peter Duguid, Stats' chief executive recalls. "We had to reassess our levels of debt. Certainly, from an entrepreneurial perspective, my focus on the day-to-day management of cash was front and centre."

Stats recovered its position, rebuilding its workforce to previous levels and returning to strong top-line growth. Revenue this year is expected to be £25m, up from £14m in 2011. However, it has not been easy, Mr Duguid says: "When you are a niche engineering business you need very specialist design experts, so when you let some of those go, it is quite detrimental to the business."

In March this year, Stats accepted a £7.8m investment from the Business Growth Fund, a bank-financed venture capital fund. The relationship has already produced results, with the BGF helping Stats find a non-executive chairman and finance director to lead the finance team.

It is this support, as much as the funding, that has made the relationship with the BGF worthwhile, Mr Duguid says. "What I see is stronger internal disciplines, stronger accountability in the internal functions of the business and probably stronger banking relationships," he says. "I have far better visibility [of what is happening in the business] without doing more myself."

If there has been a benefit from the financial crisis it is that many entrepreneurial businesses have been forced to reassess their reliance on debt and how they manage available capital.

Guy Rigby, head of entrepreneurs at accountancy firm Smith & Williamson, says: "There is an old saying: don't borrow short to invest long. In practice this means having both fixed capital (also known as equity) and debt in the business."

The level of debt capacity of a business will depend upon the availability of cash flow to service the interest and capital payments, Mr Rigby notes. "Overdrafts, which are repayable on demand, should be fully fluctuating. In other words the account should swing into credit from time to time and the debt should not be permanently bumping up against the facility."

He says small businesses are generally not very good at managing banking relationships. "The banks and the businesses are divided by a common language. Entrepreneurs talk vision and the future. Bankers talk cash and now."

Reliance Fibres, a London-based paper recycling business, trades in seven countries, but gets almost all of its £12m annual revenue from exports to India. As a result, it needs currency hedging support and a large amount of working capital to buy stock. It also needs to ensure that invoices are settled quickly and that suppliers are paid on time.

Good banking support is essential, as is a diligent finance director, according to Pankaj Chowdhary, founder and chief executive. "For us, managing cash is all about rolling it as soon as you can," he explains. "One thing we make sure of is that we don't pay anybody up front. We squeeze as much as we can out of our credit limit with suppliers and get as much finance as possible from our buyers."

Reliance buys its raw materials from large waste management companies, many of them family-owned businesses that are careful about whom they deal with. As a result, Reliance has had to make sure its reputation is exemplary. Being UK-based helps in this regard, Mr Chowdhary notes. It also helps that the business banks with HSBC, which has made Reliance one of the small businesses it promotes. "Reputation is first and foremost for us," he says.

WHILE ACCESS TO FINANCE remains a struggle for many entrepreneurial businesses, alternatives have appeared to enable companies to bypass the banks. Some companies, such as men's toiletries business King of Shaves and confectionery business Hotel Chocolat, have turned to customers for funding via retail bonds.

The digital age has also created a variety of new business models and technologies that can help them in this process, such as peer-to-peer lending and short-term loans available at the swipe of a smartphone screen.

According to Tony Cohen, head of entrepreneurial business at Deloitte, the accountancy firm, the danger for many young growing businesses is that they get too caught up in the short-term requirements of credit control and so miss out on funding opportunities that could increase their cash balances.

"There is lots of work around creditor terms, cash collection and cash flow, but they are so focused on what they are doing day-to-day that they haven't the time to think more broadly about where they might be able to get some funds in the future," he explains.

Larger companies, on the other hand, are inherently better at managing working capital. They also have significant power over smaller businesses they buy from or sell to.

It might seem unfair to those on the receiving end, but it also forces these smaller companies to use their entrepreneurial skills to manage their cash wisely as well as grow their businesses, according to Julian Ramsey, a director at Ernst & Young, the accountancy firm. Smaller businesses should not see themselves as victims. Being small actually has its advantages, he says.

"The most successful entrepreneurial businesses focus on better management of the peripheral – rather than the headline – terms relating to cash in contracts," he says, "less on whether payment is in 30 or 60 days and more on rebates and payment frequencies."

'Banks and businesses are divided by a common language'

Hedging your bets

Companies can use financial instruments to guard against a strong pound, says *Michael Hunter*

THE PERCEIVED HAVEN properties of sterling on international currency markets generate a clear problem for British business: a strong pound makes exports more expensive.

At a time when domestic demand is also under pressure from faltering consumer confidence and a return to recession, the impact of adverse currency movements on competitiveness abroad adds a fresh layer of difficulty.

For companies, this makes mitigating the impact of a strengthening pound all the more important, and there are four main types of financial instruments that can be utilised to soften the blow.

Options contracts come in two types. "Call" options give a company the right, but not the obligation, to buy a currency at a predetermined price within a defined time frame. A "put" option allows the company to sell at a certain price, and within a defined time frame.

Futures contracts provide a standardised way to buy or sell currency at a set price and a set time, both defined at the time the contract is drawn up. Because the contracts are standardised, they can be subsequently traded on exchanges.

Forward contracts work in a similar way, and tend to be drawn up between banks or brokers, with the price of the sale or purchase also agreed at the time the contract is written. But because they are private contracts, they cannot be traded among third parties on open exchanges.

Carry spot trades allow companies to take long or short bets on the value of a currency, funded in another, in order to gain positive exposure to a relative change in value that might otherwise add to a business's costs.

Michael Stumm, co-founder of Oanda Corporation, the operator of the fxTrade website, offers an example. "You are a small company in the UK that has an accounts payable of €250,000, due in three months," he says. "In order to protect yourself, you can buy €250,000 using sterling, thereby eliminating any currency exchange risk, since you will be getting today's rate. It doesn't matter if the euro goes up in value or down as you are controlling a €250,000 euro position in your account thus ensuring you have hedged the full amount of the pending payable."

The impact of such strategies on business can be significant, and the current volatility on foreign exchange markets means they are becoming more popular.

Philip Evans, director of strategy and business development at Ramsden International, a food exporter, is looking into adopting hedges, and says the currency market is becoming "more influential" as the business grows.

"Historically, we have sold only in sterling. But customers' memories tend to only go back a year or so, and as we need to avoid looking uncompetitive, exchange rates are becoming more of an issue. For some larger customers we now need to invoice in local currencies, but with longer-term contracts, with payment terms of up to 90 days, you have to evaluate factors influencing margins, and the volatility of the currency market is an important part of that. It's not all easily predictable. The issue is one of balancing competitiveness and risk and that has started to move against exporters."

Sarah French, finance manager at IT4Automation, started using currency hedging four years ago, after becoming aware that the business, which distributes networking products, was paying more than it needed to in euros for products bought from Taiwan.

"We brought in specialist help to reduce the frequency with which we had to revise prices, as well as to keep down our euro-costs. We were not getting a great exchange rate through the banks, and we also had to pay transaction costs.

"The services offered by our hedging provider have been more flexible and offer us greater clarity. I have three forward positions at the moment, and can look at them at any time. For us, it definitely has worked, and has also been cost effective. If I was marking our strategy out of 10, I would give it a nine, although we remain aware there is an element of risk, and the [currency] price can always go against us."

One chief executive of a medium-sized company based in the south-east of Britain says that the pound's ascent would need to be steeper before it became necessary for his business to take action. He also says that many exporters buy parts or raw materials from abroad, which can act as what he termed "an internal hedge" against a strong pound.

Oanda's Mr Stumm points out that some hedging strategies are more complicated than others: "Banks typically generate more revenue from selling options than from selling the other instruments used in hedging.

'With the outlook for the eurozone still unclear, we expect more clients to use foreign exchange platforms for hedging'

"Options are relatively complex derivatives, and unless you fully understand the maths behind options pricing, you cannot know if you are getting a good deal or not. Hence, we recommend clients stay away from options unless they have a financial background."

Angus Campbell, head of market analysis at London Capital Group, said the demand for the hedging services he provides is growing as the currency markets remain turbulent.

"With the outlook for the eurozone still very unclear, we would expect to see more clients use our foreign exchange platform for hedging purposes. A simple and effective way for exporters to mitigate risk is to buy or sell those currencies that they are exposed to in order to protect themselves against any adverse fluctuation in the exchange rate."

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REAL-TIME OPPORTUNITIES

We keep talking about real-time liquidity as though it's mandatory – but is it really necessary? The truth is, it's getting more critical, argues JOHN SALTER, Director of Cash Management and Payments, Lloyds Bank Wholesale Banking & Markets.

John Salter

To my mind, these new standards are a robust launch-pad for improved real-time liquidity management reporting not just for ourselves, but also for our clients.

About ten years ago, I remember an innovative little software firm working on real-time 'Nostro Account' reporting on foreign exchange settlements. Its idea was to see the cash positions of banks' corporate clients in real-time, so that banks could better manage the risks.

It was a good idea, but by the time it was delivered no-one considered they needed it – banks simply didn't see that knowing a corporate client's real-time cash position was important for risk management purposes. End-of-day or intra-day was fine.

It's not just the banks who weren't convinced. The software firm also talked about real-time cash positioning as a great value-added tool for corporate treasury operations, providing a 'dashboard' of cash movements.

Once again, though, this wasn't deemed important – treasury managers tend to focus far more sharply on tomorrow's cash positions than their position right now. As a result, real-time cash management is seen to be far less important than accurate cash flow forecasting.

That's why treasury services concentrate more on consolidating cash forecasting into a single global platform, rather than relying upon individual or line-of-business spreadsheets and enterprise resource planning (ERP).

So, a decade down the line from that intriguing software initiative, the question remains: when does real-time cash positioning become critical? The most obvious answer, you could argue, is that it becomes key in a liquidity meltdown. Yet the truth is that many banks, let alone corporations, have no such capabilities today.

A survey by the UK-based Financial Services Club in late 2011 found that, although 1 in 4 banks would know their unsettled transactions in real-time should a clearing and settlement disruption occur, only 3 out of 20 banks know their future financial exposure in real-time. Interestingly, 6 out of 10 banks have not even automated this area of their business.

This will change, as new rules and regulations come into force. Many firms have already been forced to move towards real-time liquidity management, for example, by the FSA's 2009 rules for improving liquidity amongst financial institutions – PS09/16: Strengthening liquidity.

That Policy Statement, which aligned the requirements for liquidity management with Basel III standards, was the sixth liquidity publication to be issued by the FSA as part of the thorough post-crisis consultation that started in December 2007.

In summary, the key features of the new regime for liquidity reporting, which are far more stringent than before, are:

- Granular reporting requirements for Individual Liquidity Adequacy Standards (ILAS)
- Data being collected for benchmarking liquidity risk comparisons across firms
- Monthly or even greater liquidity reporting frequencies, which increase during times of stress
- Currency reporting for those firms with material liquidity risk in multiple currencies
- Several levels of reporting, reflecting liquidity flows within a firm or group of firms

For both financial institutions and their clients, these changes aim to achieve much improved liquidity management, reporting and risk mitigation than was mandated before the crisis.

These FSA policy changes come at a cost, of course – an average of approximately £70,000 per firm for compliance with the new liquidity standards, it's estimated, along with incremental costs of around £2m per firm. But, considering the billions that firms will be spending on new liquidity management and reporting, to my mind, the key question is whether firms view these changes as a challenge or an opportunity.

Those that view the new liquidity standards purely as a regulatory requirement will doubtless do the minimum to comply with the reporting and risks management requirements. But it's clear that others, like Lloyds Bank, are seeing this as an opportunity – a robust launch-pad for improved real-time liquidity management reporting not just for ourselves, but also for our clients.

That's why the new regime is welcome. It creates an impetus away from historical counterparty exposures and opaque market risks, to one where we can not only see our own exposures (and those of our clients) in real-time, but also gain far more insight into our counterparty positions, too.

So, when we talk real-time, we'll know more precisely when and how it's relevant:

- For treasury operations, real-time reporting of cashflow forecasts is far more important than real-time reporting of cashflow positions
- For regulatory requirements, real-time reporting of liquidity is far less important than accurate collection of liquidity positions across firms operating in the markets
- For banks and their counterparties, real-time liquidity reporting is far more important than post-trade exposures to settlement risks

That is why we believe it's now more important than ever for corporate treasurers to ensure they have a provider who is equipped to offer real-time liquidity management reporting in today's new world of financial flows.

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Beyond the bean counters

Companies can no longer rely on bank lending – but are coping surprisingly well. By *Michael Kavanagh*

While Britain's political and banking leaders contemplate the extent of the damage that might be inflicted on the domestic economy by the eurozone crisis, those supplying manufactured goods for sale or export would do well to keep calm and carry on.

For Will Butler-Adams, managing director of Brompton Bicycle, a stagnation of high street spending in the UK and European slowdown has not hindered 20 per cent year-on-year growth in sales of its niche range of folding bikes that can cost more than £800.

But the company, one of Britain's few remaining bicycle manufacturers in a sector dominated by east Asian suppliers, is typical of many small businesses that successfully navigated the financial crisis and subsequent recession of 2009. Like many of its small and medium-sized enterprise (SME) peers, it is pondering investment, but wary of relying on bank borrowing to do so.

Investment plans for Brompton – which include new factory space for expanded production and a first store in China – are tempered by the desire to maintain a £1m buffer within larger cash balances.

"We have £2.5m in the bank," Mr Butler-Adams says. "Four years ago we were operating in the red – now we want £1m in the bank as a minimum against [problems] and if the banks don't lend – and another £1.5m to play with."

Mr Butler-Adams' reluctance to rely on bank borrowing even during a phase of expanding export-led sales growth might appear overly conservative to many. Surely it is precisely at such times that businesses ought to be borrowing rather than hoarding cash?

But such an approach appears to fit a pattern of fractured trust between the SME sector and banks. Created during the crisis of 2008-09, it has yet to heal. Now the relationship is threatened still further by nervousness over the future willingness and ability of banks to extend credit as the eurozone crisis deepens.

A report commissioned by the Institute of Chartered Accountants for England and Wales into access to finance for SMEs, published early last year, concluded the majority of respondents felt that "whatever trust existed between banks and SMEs in 2009 has mainly dissipated, due to the ways SMEs have been treated by banks in the last nine to 12 months, in particular when seeking finances".

It added: "Most feel that there is currently no real 'relationship' between the banks and their SME clients. Any relationship, such as it is, is mainly seen as weak or poor, and certainly worse than it was before the credit crunch."

Learning to live without lending from banks appears to be a pattern that has stuck for many companies, regardless of their creditworthiness. And, in a reversal of positions, cash-rich companies are now concerned about the health of the banks.

The latest quarterly SME finance monitor published by BDRC Continental, the consultancy, suggested there was an increasing proportion of medium and smaller businesses who were "happy non-seekers" of bank lending, who had neither applied for finance nor wanted or needed to.

"There is a lack of trust in the banks in this market," confirms Mr Butler-Adams. "There is a very uncertain situation in Europe – we are not out of the woods."

Concern over the health of banks exposed to large-scale defaults in Europe has also provoked a defensive financial strategy at JML, the consumer goods distributor.

More than three years on from the demise of one of its best-known outlets, Woolworths, JML's founder John Mills argues that in spite of continued pressure on the UK high street, the company is thriving – it is the banks he is worried about.

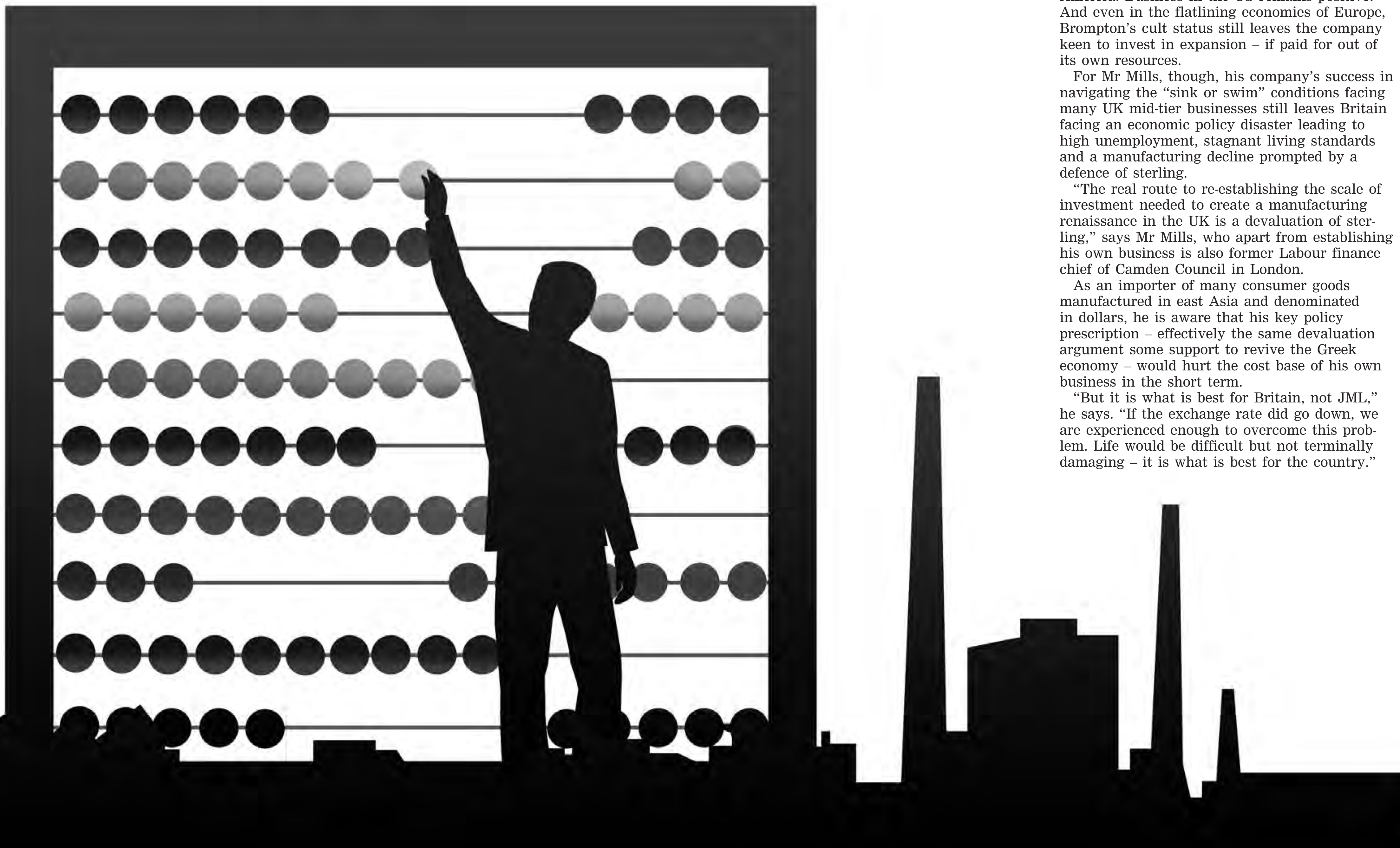
"We are in a strong position. We are a profitable company with a strong customer base," he says. "And shopping groups are, with one or two exceptions, creditworthy."

But the general fragility of the UK and European economies has continued to threaten the amount of help many businesses can expect to receive from clearing banks as the threat of a double-dip recession looms.

"We have a variety of credit lines. We are not deciding against doing anything because of a shortage of cash," says Mr Mills. "But we have been diversifying our banking facilities – we are nervous and there is safety in numbers."

Instead, the main constraint on trade, he says, is the general lack of confidence in economic demand in the UK and continental Europe, which accounts for the bulk of the 40 per cent of JML's sales not generated in the UK.

In a reversal of positions, cash-rich companies are concerned about the health of the banks



"The corporate sector is strong in cash, though some are now struggling, while some continue to expand," he says. "If you have an economy that is shrinking, the average business is not going to expand – it is very difficult to convince people to invest if there is no prospect of recovery in the future."

Though Brompton has enjoyed success in expanding exports, sterling's recent appreciation against a weakening euro has forced the company to impose a mid-year price increase on its range of folding bikes destined for the continent, which accounts for about 40 per cent of sales. Much of its business is naturally hedged, as the proportion of sales made in the eurozone is matched by the proportion of parts priced in euros – just as parts sourced in Asia and priced in dollars are matched by dollar-pegged receipts.

And Mr Butler-Adams argues that businesses caught by surprise in the last recession are better prepared in general to face the next phase of difficulties. "Businesses struggling three years ago have gone bust or done something to make their situation better. But we have to get out and export. There is no recovery coming from the UK – or Europe."

Plans for a new shop in Shanghai reflect booming Asian prospects, and new sales and distribution leads are being pursued in South America. Business in the US remains positive. And even in the flatlining economies of Europe, Brompton's cult status still leaves the company keen to invest in expansion – if paid for out of its own resources.

For Mr Mills, though, his company's success in navigating the "sink or swim" conditions facing many UK mid-tier businesses still leaves Britain facing an economic policy disaster leading to high unemployment, stagnant living standards and a manufacturing decline prompted by a defence of sterling.

"The real route to re-establishing the scale of investment needed to create a manufacturing renaissance in the UK is a devaluation of sterling," says Mr Mills, who apart from establishing his own business is also former Labour finance chief of Camden Council in London.

As an importer of many consumer goods manufactured in east Asia and denominated in dollars, he is aware that his key policy prescription – effectively the same devaluation argument some support to revive the Greek economy – would hurt the cost base of his own business in the short term.

"But it is what is best for Britain, not JML," he says. "If the exchange rate did go down, we are experienced enough to overcome this problem. Life would be difficult but not terminally damaging – it is what is best for the country."

Jonathan Guthrie A doomed golden age for UK plc

Walls of cash often prove less durable than the kind made of bricks and mortar. Prudent businesses build up cash or pay down debt when performance has been strong, lest it disappoints later on. That is the position of many large businesses as continuing eurozone turbulence – most recently manifested in Spain's property crash – threatens to depress growth further. The dissipation of these reserves through cost subsidies during periods of tougher trading or, indirectly, through bank deleveraging mean that their impact is rarely as dramatic as suggested by such bald numbers as the $2tn of surplus liquidity reputedly lurking on the balance sheets of US and European companies at the end of 2011.

European politicians would it were otherwise. Most of them believe, with varying degrees of fundamentalism, that austerity is the only route to post-financial crisis stability and then growth. The implicit contradiction is that many of the tribunes of the people would nevertheless like companies to make the stimulatory investments seen as inadvisable for the public sector because of its higher indebtedness.

Unsurprisingly, company boards remain sceptical that their hurdle rates for investment can be surpassed when spiking yields for Mediterranean government debt point to a long period of turbulence and weak growth. For example, the UK's Office for Budget Responsibility, an independent forecaster, expects output to grind along at below 3 per cent a year until 2015.

In a recent note, Morgan Stanley, the investment bank, argues that an improvement in the availability of credit is needed to stimulate investment even when company balance sheets are healthy. A loans drought weakens collective economic confidence, even among those who do not want to borrow, the argument runs. European banks are shrinking their balance sheets as they write down dud loans and seek to meet tougher capital requirements, so no recovery is likely soon. After the decade hubristically dubbed "nice" (non-inflationary, constantly expanding) come the years of collective paralysis.

Business has at least benefited from a recovery that came in the wake of the credit crunch and was propelled by such engines as restocking and unrepeatably rampant Chinese growth. UK corporate earnings before interest, tax, depreciation and amortisation as a percentage of sales rose from 9.9 per cent in 2008 to 15.4 per cent in 2011, but slipped to 13.5 per cent in the last quarter, according to the S&P Capital IQ database. The dread hand of mean reversion weighs heavily on the shoulder of business.

For bosses, investment cycles are overlaid by their own career plans. If you are not intending to stick around – or fear that increasingly assertive investors might provide you with an expedited exit – the temptation is to forget about capital expenditure and bolster payouts to shareholders instead. Similarly, no stock analyst ever got fired for short-termism. BT Group, the telecommunications company, recently suffered City criticism for raising its final dividend by 12 per cent. This increment was regarded as derisory when a higher total could have been achieved by the simple expedient of spending less on the roll-out of faster broadband, a cost that promises to benefit both BT and the broader economy.

A loans drought weakens collective economic confidence

Many billions of the putative wall of cash have been returned to shareholders. There is plenty more to come. UK listed companies paid gross dividends of £68bn in 2011, according to Capita Registrars, the UK administrator of company share registers. This is a 19.4 per cent increase and the highest figure for five years and the company's forecast for 2012 is £76bn.

Shareholders reasonably expect that a one-off gain by a company should mean a one-off payout to them. More broadly, extempore returns of capital are a signal that current rates of return.

Share buybacks have been a sop to investors over the past couple of years, despite the reasonable objection that repurchases represent poor value when made, as is customary, during market rallies. Buybacks are automatically earnings enhancing and tax free for continuing investors, who are thus happy to ignore the critics.

Takeovers – another use for corporate cash – have by contrast been notable for their scarcity. Here, as with investment in organic growth, a heightened perception of risk is to blame. Meanwhile, private equity companies, reliable purchasers of publicly listed companies before the crunch, have suffered the double indignity of tighter credit and a boycott by equity funders of the weakest of their number.

Raising top-line growth through mergers and acquisitions is a long-standing, if unspoken, strategy of chief executives hungry for a pay increase. With that avenue blocked, they can at least expect the boost to remuneration that special payouts should deliver via bonus formulae shackled to total returns. But, as UK shareholders seize back the ownership that was always theirs for the taking, bosses can no longer look forward to the upward rebasing of their pay. All in all, for both executives and investors, there is just a hint of a doomed golden-age vibe to cash-rich 2012. It is appropriate that a remake of *The Great Gatsby* will be released this year.

Jonathan Guthrie is the FT's City editor

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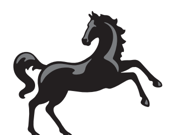

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