AFP ASSOCIATION FOR FINANCIAL PROFESSIONALS

AFP TREASURY IN PRACTICE GUIDE

Adding Certainty to Working Capital Management

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Today's treasury function has been challenged with navigating an unprecedented degree of change in the past several years. Starting with macroeconomic dynamics, the current low-rate environment of the last ten years has been a steady backdrop. After a reduction of the central bank rate to 0% during the pandemic, rates rapidly shot up across the globe at a speed never before seen. 2024 ushered the start of a new period in the rate environment – one where the future direction is hinted at, but can change, based on a number of factors. Coupled with geo-political uncertainty and major general elections in key parts of the world, the current dynamic environment has been a challenge for many treasury professionals.

Against this external backdrop, internal challenges and opportunities are also emerging – artificial intelligence is gaining traction, ever larger data landscapes are being launched, and increasingly demanding business stakeholders are looking to leverage real-time capabilities within new business models. How then does a treasury team move forward? Some techniques and methods for approaching this can be found within working capital management.

Working capital management actively encourages a 'whole company' mindset. To effectively optimize working capital, today's strategic treasurer takes a holistic view of all the activities within the organization. This same disciplined approach served the company well during times of fiscal stress or economic uncertainty – and it can do so again.

Factors vital to effective working capital management not only include liquidity, but also the funding of the business, the resulting cash flow from operating activities and cash velocity. Importantly the net trade cycle is also a factor. Balancing these various factors – and the relationships between them – is the art of effective working capital management.

The low-rate environment of the past decade has put treasury teams at the forefront of thinking about the financial position of the organization at various points in time. It follows that with the new environment, and potential changes in investments, treasury should continue to lead the conversation, allowing the business to balance their objectives for growth, short- and long-term investment, and operational efficiency in an ongoing manner.

Working capital management is a continual process of visibility, control and oversight rather than a one-time tactic. The value provided elevates the financial discipline of the entire organization in a clearly defined framework.

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INTRODUCTION

Working capital is the financial engine that powers the organization, translating shareholder funds into sales and profits. Inefficient use of working capital could lead to missed opportunities and potentially an over-reliance on expensive alternative capital sources. Though treasurers face volatile financial markets and an increasingly unstable geopolitical landscape, there are opportunities to leverage efficiency by using technology to streamline working capital processes and enhance visibility over cash. Action will help organizations build working capital resilience to meet the next economic challenge.

This guide starts by identifying some macro themes that are acting as catalysts for change within organizations before exploring tools that treasurers can employ to help make working capital and, by extension, their businesses, more resilient in the face of financial and geopolitical uncertainty.

MACRO THEMES

There are several triggers in the market that are acting as potential catalysts for change within businesses and treasury departments. Some of these triggers are opportunities for treasurers to harness, notably the ever-more affordable range of treasury technology; others are threats to be managed, not least the volatile geopolitical climate and uncertain interest rate environment.

Interest Rate Challenges

Following a long period of historically low interest rates, treasury practitioners are getting used to an environment of elevated interest rates. Many have forecast a significant amount of interest income, with Fed Funds rates sitting above 4.5% for the foreseeable future. Others have become concerned over the cost of borrowing, especially when required to refinance longer-term debt.

Given constantly changing market expectations, practitioners must manage some specific uncertainties: the timing of the first rate cut, the speed of any further cuts, whether interest rates stabilize at a different rate (and what that rate is), and, finally, whether market expectations are wrong and the next rate movement is an increase.

Being Resilient in All Times

Yet, within this volatile environment, treasury's role is to protect the assets of the business, specifically its cash and working capital. This requires a strategy that supports the protection of cash in any environment. Cash segmentation allows treasurers to identify and manage working capital differently from longer-term and more strategic assets.

Geopolitical Changes

The effects of unanticipated geopolitical events on the business environment are more difficult to analyze. For example, November's U.S. presidential election will cause some economic uncertainty as the fortunes of candidates wax and wane during the campaign. Some investment decisions may be postponed until the winner is known.

Impacts on Supply Chain

There are plenty of potential threats to physical supply chains. For example, the Russia-Ukraine war and the Israel-Hamas conflict both have the potential to escalate and widen, disrupting supply routes. Due to the collapse of the Key Bridge in Baltimore, some organizations will have supply chain problems, which will consequently impact cash flow.

Trade Policy

More generally, it is not difficult to anticipate a host of politically driven decisions affecting both domestic and international trade policy. Many governments use trade tariffs to encourage their domestic economy and as a tool in international relations.

Individual corporations do not have the ability to influence these supply chain risks. Still, they should take steps to understand the potential ramifications for their business, and treasurers should understand and communicate internally any potential cash flow implications.

Technology Trends

More positively, the evolution of treasury technology provides treasurers with a wide range of tools to manage these and other risks. As Suraj Kalati, Head of Working Capital Solutions at Wells Fargo, explains, "There are many different treasury technology solutions available to companies today, ranging from full treasury management systems to bespoke solutions offering cash and data analytics. The cost point continues to drop for technology and technology implementation." These changes give access to technology to many more companies, even small and medium-sized enterprises. This impact is noticeable in the evolution of payments technology.

Collection and Payment Trends

Developments in the payments industry, both in the U.S. and globally, provide many opportunities for treasurers to streamline operations to utilize cash and working capital more effectively. Perhaps the most obvious trend in payments and collections is the shift from paper to electronic, which has been ongoing for many years.

New electronic payment rails, such as FedNow®, based on ISO 20022 messaging standards, can transmit much more transaction data along with the payment. This means that, instead of focusing solely on the efficiency of the payment, treasurers can now consider the best way to integrate additional data within the AR (Accounts Receivable) and AP (Accounts Payable) processes. Additional remittance data could eliminate the need for checks or e-checks, and once an organization has transitioned away from checks, it's unlikely to transition back.

Faster Payments

Another development is the introduction of instant payments in the U.S. via RTP® (Real Time Payments) and FedNow®. Companies with established payments strategies will likely view instant payments as a complement to existing payment methods, rather than a simple replacement. As with any service, any shift away from an embedded service involves a cost, so treasurers will need a clear business case (e.g., a hospitality business could pay employees in the evenings and on weekends) to shift toward greater use of instant payments.

Impacts to the U.S. Market

These changes in payments technology are replicated across the full range of company activity, including treasury. New treasury technology solutions are constantly being brought to market, all offering ways to help treasurers manage cash flow and working capital.

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DEVELOPING A PLAN FOR RESILIENCE AND WORKING CAPITAL

Ensuring the company can meet its obligations remains the treasurer's core role. This is achieved by identifying, measuring and managing risk to protect company assets. Today's treasurer will want to determine how to harness treasury technology solutions and payment processes to enhance the resilience of their organization through the efficient use of working capital.

Best-in-Class Liquidity Planning

The most significant change for treasurers has been the evolution of the technology landscape at increasingly affordable prices, enabling the automation of many manual processes. Of all the developments, the one that has the most potential to dramatically change the role and value of treasury is the evolution of forecasting and liquidity planning. Using a liquidity planning approach to model future scenarios gives the treasurer the tools to revisit company liquidity management.

Sourcing Information from Data

The general shift from manual to automated data processing, not just in finance but across the organization, enables all departments to gain real-time access to more data points. For treasury, access to granular data, such as the creation of an invoice or a purchase order, will provide detailed information on actions within the physical supply chain and enable the cash forecast to be updated in real time. Faster payment reconciliation is both an important control and a tool to easily analyze customer payment trends.

Optimal Internal Liquidity

Having a robust understanding of future cash positions will help treasury to align the levels of operating cash more closely with the organization's risk appetite. The board and CFO will set liquidity policy and targets for treasury to follow. These targets inform the investment policy and help define the amount of cash that needs to be held in liquid instruments.

Greater visibility of both cash flows and the levers that affect them will also give treasury a clearer view of how cash flows through the business, where and when the level of group cash varies according to internal and external factors, and how exposed the company is to particular financial risks. For example, a company with a higher level of fixed to floating rate borrowing will see its cash levels less affected by interest rate changes than one with a higher proportion of floating rate borrowing.

Enhanced visibility will also help treasury model with alternative liquidity management structures, which will allow more effective internal use of cash.

> "Cash flow needs to match the business cycle. If one is out of sync, it becomes a liquidity problem. There's a need to focus on internal liquidity."
>
> — Tom Hunt, Director, Treasury Services and Payments, AFP

Identifying Leading/Lagging Indicators for Forecasting

Improving visibility and enhancing planning is only one part of the story. At some point, all predictions translate into actual data, so treasurers will need to identify methods to recognize when the forecast data and positions are accurate and, importantly, when they are not. Having as much warning as possible about any changes to forecasts will help manage any gaps and associated risks. Any changes will also help develop the liquidity planning model to improve accuracy.

Identifying trends is critical. "Every business will incorporate some form of forecasting," Jonathon Traer-Clark, Managing Director, Wells Fargo, explains. "To a certain extent, the underlying details are less important at this point because the forecast will always be a forecast — a projection. Instead of thinking about a particular data point, think of it as a vector, or a data point with a direction, giving a leading or lagging indicator."

"We are constantly refining our forecasts," says Greg Lattanzi, Manager, Treasury, IGS Energy. "We do a lot of variance analysis by looking at our initial projection and forecast for the month and then seeing whether that is trending on target or if there are gaps. If there are gaps, why is that? Is it because a customer is late with a payment, or is it because we have included inaccurate information in the initial forecast?"

Incorporating Process Disciplines in Working Capital

Building resilience requires companies to take advantage of opportunities to improve operational efficiency and risk management. Improving the visibility of both the physical and financial supply chains makes it easier to identify exposures and pressure points within the cash conversion cycle. Technology enhancements offer the opportunity to streamline and automate many processes and, via the latest payment rails, improve the efficiency of processing payables and receivables.

When identifying ways to improve working capital, many organizations analyze potential improvements using the components of the cash conversion cycle: days sales outstanding (DSO), days inventory outstanding (DIO) and days payables outstanding (DPO).

Reduce DSO

Although payment receipt dates are often outside an organization's direct control, there are plenty of actions companies can take to try to reduce DSO. Below are some suggestions.

- **Automate the invoicing process.** The aim is twofold: to get invoices to customers more quickly and to reduce the risk of error associated with manual processing.
- **Accept new payment types.** Payers have a much wider choice of payment types in today's market. Making it easier for customers to pay by accepting their preferred payment methods will help to accelerate cash flow. Any shift away from paper will help eliminate costly processing costs.
- **Offer early payment incentives.** After years of ultra-low interest rates, the economics of early payment discounts for both parties have changed. Offering early payment discounts will help to get cash onto the balance sheet.
- **Provide credit to customers.** At higher interest rates, there are greater potential supply chain advantages if a strong credit can help fund its customers (subject to any credit checks).
- **Automate the cash application process.** Doing so will allow earlier confirmation of the receipt and, consequently, a more efficient use of cash.
- **Monitor client collection times.** Keeping on top of client collection times will help to minimize the risk of late and/or non-payment. It is possible to analyze payment trends to identify customers with potential problems (e.g., if a customer starts paying later) so precautionary action can be taken. A quicker cash application process will help AR focus on collecting past dues.
- **Shorten contractual payment terms**. It may be possible to shorten contractual payment terms, although companies should consider the impact on their customer base before doing so.

Reduce DIO

Treasury cannot usually directly affect the level of DIO as the company's operational practices determine this. While reduced DIO will improve the cash collection cycle, executive management may not want to move towards a more "just-in-time" inventory policy, especially if they are concerned about the potential impact of supply chain disruption. However, with access to improved data analytics, treasury can work with FP&A to provide insights to help the board and executive management understand how the business holds inventory and to model the impact of different levels of inventory on both cash flow and the financial statements. For example, it may be possible to model the cash flow implications of a short-term disruption to production or to model an assumption that a proportion of customers move to a competitor if a finished product becomes unavailable. This level of insight will help the C-suite make more informed decisions to improve resilience in terms of cash, liquidity and operations management.

CASE STUDY: BEING STRATEGIC WITH PAYMENT TERMS

There can be opportunities to improve cash flow by managing suppliers' payment terms. "We try to be strategic with payment terms and use financial products to achieve our objectives," Holly Olson, Corporate Treasurer, AFL, explains. "For example, if vendors want specific payment terms, what will that cost?"

Olson has created a model that allows procurement to calculate the cash flow impact of different payment terms by entering some key details. "[Procurement] can then decide whether to amend terms, knowing the cost of that change. This is strategic. Procurement decides how important a vendor is and will manage the relationship. Generally, there is an approval process. If a vendor is important enough not to be offered standard terms, the decision will be reviewed by finance."

Increase DPO

In theory, DPO should be the easiest part of the cash conversion cycle to manage, as the company determines its liabilities and when to make payments. From a purely cash perspective, companies will become more efficient by increasing DPO, e.g., by paying later and/or extending payment terms. However, as with managing inventory, a company may assume more operational risk by doing so, especially if any liquidity risk is transferred to its suppliers. That said, below are some options to improve DPO.

- **Standardize payment terms.** One way to improve operational efficiency is to standardize payment terms to make it easier to manage relationships with suppliers. Having regular payment cycles can also help improve the efficient use of cash (e.g., reduce the frequency of redemptions from money market funds).
- **Offer financing to suppliers.** Depending on their credit rating, larger companies can often finance their suppliers through methods such as dynamic discounting or a supply chain finance structure. Supporting suppliers helps to manage the inventory risk outlined above and will reduce costs within the wider supply chain by lowering the suppliers' cost of funds.
- **Improve AP processing.** Automating the accounts payable process will reduce the risk of error and fraud by minimizing manual intervention and helping accelerate payment reconciliation, ultimately delivering more accurate cash forecasts.
- **Update payment methods.** Innovation has given companies more choices regarding how to pay employees, suppliers and other third parties. Treasurers need to determine which mix of payment methods best fits their organizations' requirements. Same-day and real-time payments are increasing in popularity due to the control they offer over the timing of disbursements and, in most cases, the lower processing cost. Newer electronic payment rails support the transmission of a wider range of transactions alongside the payment in a format that can be seamlessly processed at both ends, eliminating the need for the costly manual processing traditionally associated with checks.

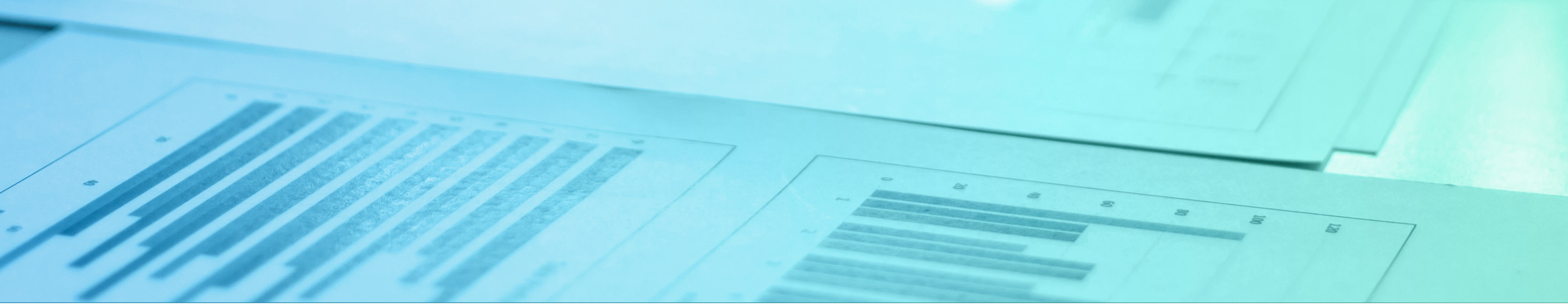
IGS Energy is one company transitioning AP payments from paper to electronic instruments. As Lattanzi explains, this is for two main reasons, which improve the company's working capital position: "It reduces the risk of fraud and gives us a known payment date so we can appropriately position cash."

Lattanzi is also aware his banking partners don't want to process paper payments either, as the "associated costs keep going up."

Managing the Cash Conversion Cycle (CCC)

The key is to understand the various components of the CCC. What are the steps and what is the timing of those steps? Try to understand what is happening. For example, why do some customers pay earlier than others? Consider what happens if any of the steps change. For example, what would the impact be if a key customer starts paying a few days later?

Finally, what levers does the company have to influence the CCC? What can the company do to standardize and streamline processes or improve the flow of information? Prioritize decisions that will have the greatest impact.



Establishing a Plan to Pivot — Knowing When to Switch Direction

Treasurers can also manage access to working capital via their funding streams and short-term investment strategies. In a more volatile interest rate environment, treasurers may need to reconsider their approach to both borrowing and investing to try to maintain sufficient working capital as efficiently as possible.

While a higher interest rate means a higher cost of borrowing, it also impacts other key metrics. Higher interest rates mean that any cash sitting "idle" in bank accounts or tied up in inventory becomes relatively more expensive to hold, especially if the company has external borrowing to fund this cash. On the flip side, the returns available when investing in short-term cash are higher before taking any additional risk. When interest rates start to fall, these positions reverse.

While markets and the Fed expect the next interest rate to move downwards, there is considerable uncertainty about both the timing of any change and the future path of interest rates more generally. As a result, treasurers must consider their funding and borrowing strategies.

Developing Opportunity Costs of Funding

Given the uncertainty over the level of future interest rates, treasurers need to think strategically about how they fund working capital. Improving visibility to cash flow and cash positions is crucial. Doing so provides treasury with as much advance warning as possible about potential funding requirements. The treasurer can then actively plan a funding strategy that ensures access to liquidity when needed, without incurring any unnecessary expense.

"We have a credit facility that we use, particularly at certain times of the year," Lattanzi explains. "We look to the cash forecast as a tool to help us only borrow what we need while also paying back the credit facility as quickly as is prudent. Our team works hard to make sure we efficiently utilize our credit facility to save on costs while at the same time meeting our working capital needs."

Having time to plan a funding strategy also means treasury can evaluate different solutions and sources of finance, both to minimize cost and retain flexibility and access to liquidity. For example, there may be scope to adopt more of an asset and liability approach towards balance sheet management, with fixed assets used as security against longer-term borrowing and variable assets (i.e., inventory and receivables) used against short-term facilities.

Expanding Investment Opportunities

For companies with surplus cash who have become used to generating a return on short-term cash, any interest rate cut would affect the ability to continue to do so. In anticipation of rate cuts, one option is to sacrifice liquidity to earn a higher return. But doing so is only possible if treasury can accurately forecast its short-term liquidity needs and segment its cash balances accordingly. Short-term operating cash can be placed in liquid instruments, with medium-term cash available to be committed for longer terms. Again, developing the cash forecasting capability is key to enhancing choice for cash investment opportunities.

This approach means the strategy does not change, even when interest rates do. So, operating cash is always held in more liquid instruments, with the amount of operating cash defined by the company's risk appetite. Then, with the next interest rate movement expected to be downwards, treasurers can respond tactically, for example by, as Kalati highlights, "optimizing investments for yield, within the scope of [the organization's] investment policy," perhaps by committing medium-term cash for longer in anticipation of falling interest rates.

Cash Concentration Cycle Changes

Traer-Clark describes organizations as having sources of cash (such as borrowing and liquidity management) and uses of cash (such as payables and M&A), with the working capital engine in between. "The objective for treasury operations is twofold: improvements in efficiency and allocation of capital effectively for the business."

Most improvements to working capital take place gradually, as treasurers and the wider business tackle problems in order of priority. Kalati wants treasurers to be forward-looking and strategic: "We want treasurers to identify key challenges and lay out where they want to be in [say] three years. Then to plan back from that and sequentially set up and incrementally implement the various elements (bank account structure, technology solution, etc.) towards the target solution."

Continuous Evolution of Treasury for Working Capital Support

Even so, treasury's job is never done. There are always new risks to manage and new market conditions to navigate. Treasury's role within the business is expanding, too, as the opportunities afforded by new technology become available at lower price points. By utilizing some of the available tools, treasury can extend its reach within the business by becoming a more efficient department and sharing insights across the organization. And, by engaging more with the business, treasury will become an even more important partner to support the development of working capital resilience.

> "We continue to refine our communications and work to make the forecast better so we can keep executives and our internal businesses informed. Cash forecasting and constant communications are the biggest pieces in terms of how we are improving our working capital management."
>
> — Greg Lattanzi, Manager, Treasury, IGS Energy

TAKEAWAYS

Improve Visibility

First, look for opportunities to improve visibility over cash flows, positions, and risk exposures. As Holly Olson, Treasurer, AFL, says, "Our cash forecast is key. We use our treasury workstation to forecast cash and are laser-focused when it comes to when to borrow, how much to borrow, when to pay back. Our view is the more precise we can get our forecast, the more we can reduce the cost of working capital."

Communicate with the Business

Second, as Traer-Clark says, "Treasury has an opportunity to be a valued partner of the business." The financial acumen that treasury brings can help the business make more informed decisions. The objective "is to add a balance sheet and cashflow lens to decision-making."

For example, treasury can help procurement and sales understand the impact of their decisions on the company's cash, cash flow and working capital, as Traer-Clark illustrates, "not by saving 10% on the cost of inventory by buying in bulk, but by seeing inventory in terms of the use of the company's capital and the impact on the cash conversion cycle alongside the opportunity cost or benefit created."

Think Strategically

Third, think strategically about how to implement and support change. With technology constantly evolving, there are always opportunities to adopt a new process to improve efficiency. However, all change consumes limited corporate resources, so being able to prioritize initiatives is an important determinant of success.

"The overall benefit of implementing a supply chain finance program might be $40 million, assuming all 2,000 suppliers sign up, which would take time," Traer-Clark explains. "It might be more effective to focus on the top 20 core suppliers, who account for the bulk of the potential benefit. All solutions have a trade-off, whether in relationships or timing. Sometimes a solution is simple in principle, but the implementation effort must also be considered as part of the business case."

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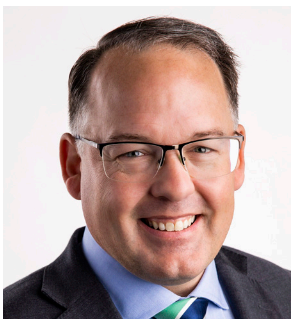

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