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Forward thinking finance: The growth challenge



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Foreword

Welcome to 'Forward thinking finance: The growth challenge', a joint study by PwC and HSBC, which explores the rapidly evolving issues facing Chief Financial Officers (CFOs) and corporate treasurers in middle market European businesses¹ at this critical juncture in the economic cycle.

Many European businesses are moving back onto a growth footing, with a key target being the rapidly expanding markets of Asia, Latin America and the Middle East. This shift in strategic focus is going to have a profound impact on the way companies fund their businesses and manage their finances. The most effective finance and treasury teams are developing the forward-looking analysis and insight needed to strike the right balance between curbing finance costs, ensuring effective risk management and maintaining the flexibility to capitalise on opportunities.

The businesses operating in low growth domestically-focused markets face the challenge of sustaining profitability within ever narrowing margins. The ability of their treasurers and finance teams to reduce operational costs and make the most effective use of cash resources will be increasingly crucial in this exceptionally tough commercial environment.

This report examines the key financial challenges confronting European companies and the different ways they are adapting to the particular demands they face. We have crystallised these different approaches into three new 'worlds of finance', each with its own innate strengths, drawbacks and potential to provide greater value for the business, especially now fresh financing opportunities are emerging.

This exploration of the future of finance brings together HSBC's expertise in financing and international markets and PwC's expertise in finance function and operational effectiveness. There are no right or wrong answers in a complex and fast-moving business environment. However, there are critical considerations and potential solutions that are common to all finance and treasury teams. Finding the right path for your business will be crucial to its success in the challenging years ahead.

If you would like to discuss any of the issues in this paper and how they affect your company in more detail, please do not hesitate to get in touch.

John Casey
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1. Companies with a turnover of up to €2bn

Overview

After three years of caution as companies sought to ride out the global financial and economic crises, business confidence and growth aspirations are returning.

While this is welcome news, steering the right course through this stage of the cycle can be as difficult, if not more so, than managing a business through a downturn. The comparable period in the mid-1990s saw a huge surge in business growth, acquisition and profitability within some firms. However, business failures also escalated as companies took more risks and some overstretched themselves.

Finance and treasury teams' ability to provide sharp strategic insights and proactive financial management will be critical in enabling companies to plot the most effective business course and ensure they have the financing model to realise their objectives.

Sizing the prize

The priorities for shaping the financing model will include ensuring that companies optimise their own finances, as well as making the most of the funding options available to them. We believe that the untapped financing potential is considerable. Our analysis of middle market companies in the UK, France, Germany, Italy and Spain reveals that:

- They could generate at least €120bn for investment without duly stretching their balance sheets. This €120bn pot of available funding could contribute a 1.4% boost to economic growth in the five leading EU economies over the next few years. How did we arrive at this figure?
- Many middle market European companies are holding surplus cash accumulated to help sustain them through the downturn. The cash to equity ratios in these leading economies was 8.2% in 2010, compared to 6.8% in 2007. Taking the ratio back to 2007 levels would release around €60bn in cash.

€8 of every €100 invested by shareholders in Europe's five largest economies is held as cash

- Gearing has now begun to decline, falling to 24.9% in 2010. Taking gearing back to prudent pre-crisis levels (an increase of 1.7%) would release a further €60bn in debt funding. Companies should consider any increase in debt finance for

affordability and with regard to higher interest rates in the future. As over half of the middle companies in the EU's five leading economies have gearing levels of less than 10%, the potential increase in debt could be concentrated as a 5% increase in low geared companies.

- Locked working capital is considerable. By improving the forecast to fulfil cycle to median levels, the lowest performing 50% of businesses in our analysis could release €125bn in cash for self-funding.

'Middle market companies in Europe's five largest economies could generate an extra €245bn for investment without unduly stretching their balance sheets'

Making the most of the potential

The most effective finance and treasury teams are already responding to this changing landscape by taking a much more forward-looking approach to budgeting and business planning. They are also rethinking their financing options as they seek to keep step with evolving strategic priorities, operational demands and financial levers within their organisations. This is underpinned by close engagement with the business, a clear understanding of its commercial objectives and a willingness to challenge strategy where necessary.

For this report we have interviewed some of Europe's most forward thinking finance departments on how they are overcoming the challenges of the current economic environment. We have also consulted HSBC and PwC experts across Europe to draw our conclusions on how Europe's mid-market companies can navigate the changing business landscape and deliver their growth aspirations.

In the first section of this report – 'Reasons for a re-think' – we look at why now is the time for businesses to reconsider their financial approach, investigating both macroeconomic drivers and the challenges facing finance and treasury teams. In 'New worlds of finance', we then explore three emerging approaches to financial planning and management. In the concluding section, we set out the options for generating extra finance, the key considerations for ensuring that finance and treasury teams are ready for the future of finance and identify the pressing demands we believe they need to be addressing.

Reasons for a re-think

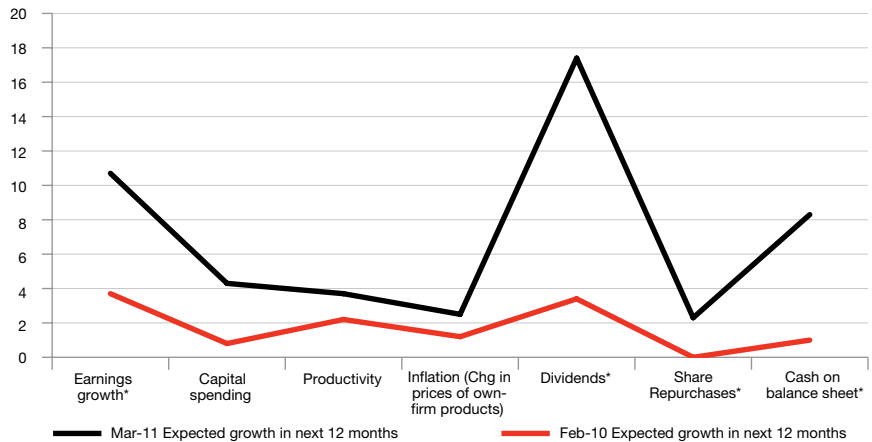
European businesses are looking to deliver double digit growth² over the next year and beyond (see Figure 1). Achieving these ambitious targets in a rapidly changing global economy and financing landscape is going to require a review and possible re-think of financing strategies.

In our study it has become clear that realising the growth objectives of European middle market businesses will require a new approach from their finance departments. Yet these businesses face up to seven different challenges to their finances that the smarter CFO or treasurer will also be looking to overcome as they continue to navigate their business through challenging financial times. In this section, we explore the polarising forces coming to bear on finance departments across Europe, which has led us to conclude that now is the time for European businesses to reconsider their financial approach.

1. Back on a growth footing

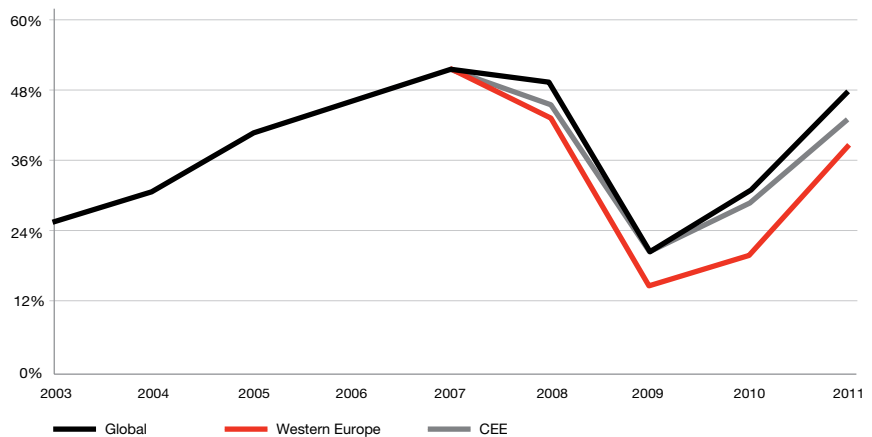
Optimism is on the rise again. The percentage of European CEOs who are very confident about their revenue growth prospects is climbing back to pre-crisis levels (see Figure 2a). A leading indicator of this is HSBC's Trade Confidence Index, which shows a bold outlook for increasing trade volumes across the globe (see Figure 2b). As companies seek to expand once again, their need for finance is set to increase. This is also a risky juncture. Indeed, past experience indicates that insolvency rates can often rise when companies move back into expansion mode following a recession. Having taken a relatively cautious approach to help weather the downturn, companies can often assume considerable risks as they try to make up for lost profits and hence leave themselves more vulnerable to damaging disruptions in supply, demand and financing.

Figure 1: CFO optimism about their own company
Results for 126 European firms (own firm changes expected during the next 12 months)



Source: Duke/CFO magazine, European CFO survey, March 2011

Figure 2a: 2011 CEO Survey Confidence – 12 months

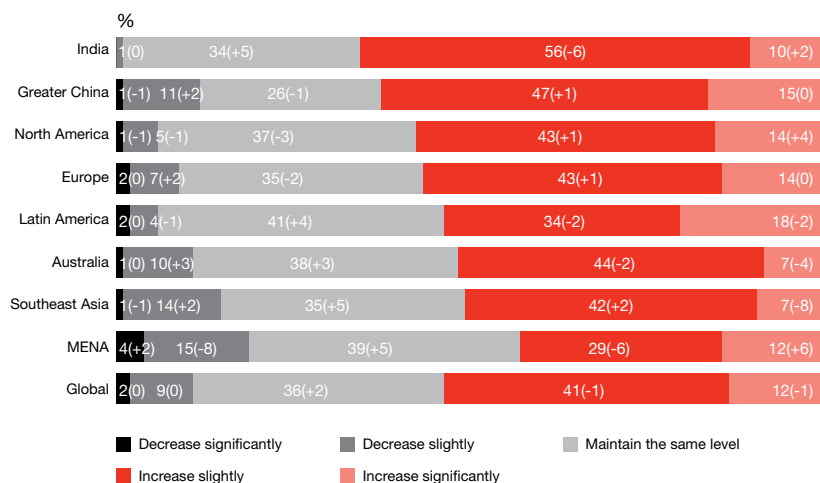


Source: PwC 14th Annual Global CEO Survey

Note: Percentage of CEOs who are 'very confident' about their companies' prospects for revenue growth

Figure 2b: Outlook on trade volume – Global

Q. How do you expect the volume of your import, export business to change in the next six months?



Source: HSBC Trade Confidence Index 2011

Notes:

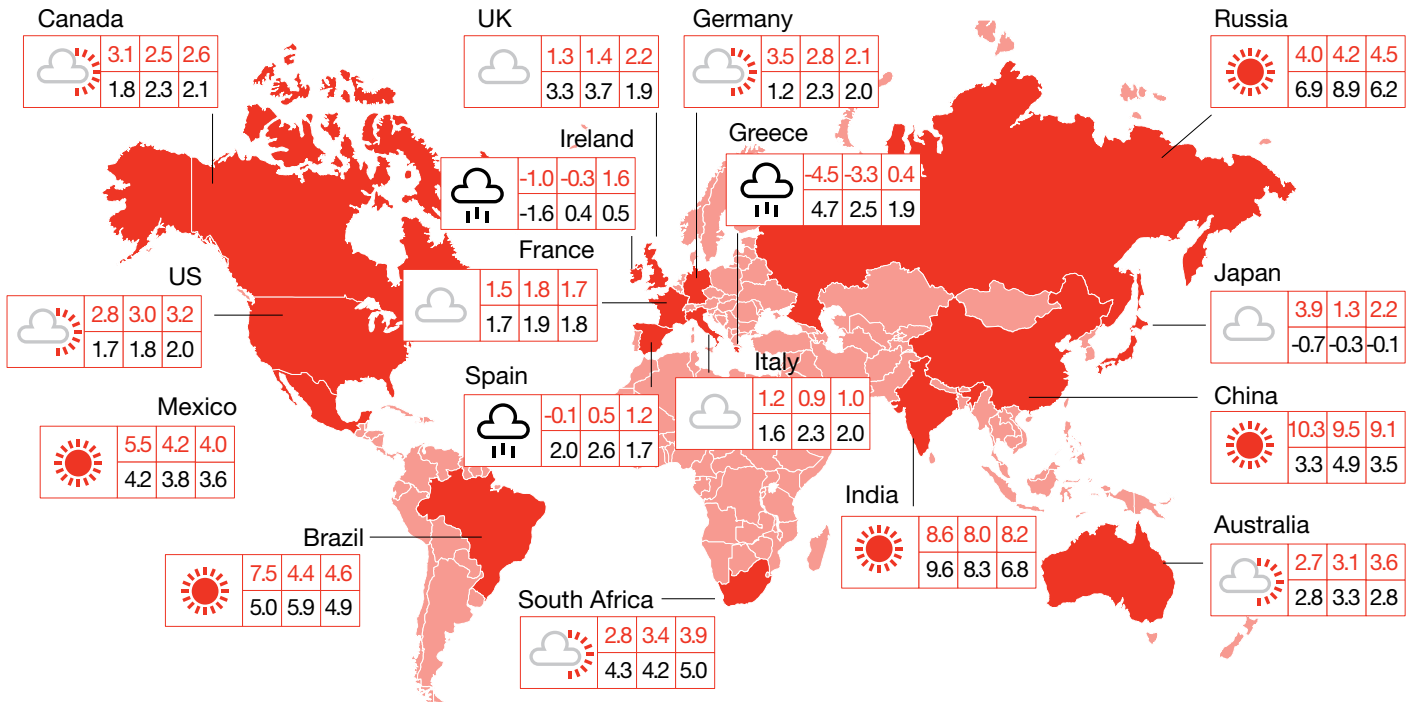
(1) Figures may not add up to 100% due to rounding and the exclusion of "Don't know / Refused" responses.

(2) Greater China includes Hong Kong & Mainland China; Southeast Asia includes Indonesia, Malaysia, Singapore, & Vietnam.

(3) MENA includes Saudi Arabia, UAE & Egypt; Latin America includes Brazil, Mexico and Argentina; North America includes USA & Canada; and Europe includes UK, France, Germany, Poland and Turkey.

Figure 3: Prospects for the global economy

Eurozone faces a tough two years, while emerging markets are expected to expand rapidly



Key	2010	2011 ^f	2012 ^f
Outlook	GDP growth		
	Consumer price inflations		

Source: PwC forecasts (f) April 2011

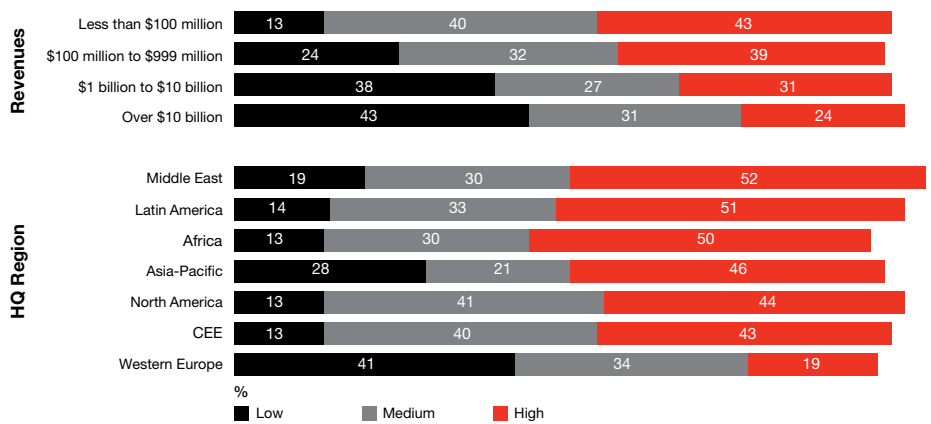
2. Looking to new markets

Domestic growth remains largely subdued, spurring most CEOs to look to the emerging markets as their main focus of business opportunity and expansion. Figure 3 outlines the varied prospects for the global economy.

Figure 4a and 4b highlight the changing pattern of world trade as growth in exports to, from and between emerging markets takes centre stage. This is likely to be an enduring trend. A survey of middle market companies in the UK found that international business will account for 55% of their sales in five years' time, compared to 47% today.³ Export-led businesses (more than 50% of sales from overseas) have set the highest targets for growth.

Figure 4a: Companies are upbeat on domestic growth in Western Europe

Q. Compared to other markets where your organisation operates, does the country where you are based offer high, medium or low potential for your company's growth?



Source: PwC 14th Annual Global CEO Survey

3. PwC, 'Realising ambitions for growth' 2011

Companies that are looking to develop their business overseas face complex new challenges:

- The strategic and financial risk of operating in new and unfamiliar markets.
- Different funding cycles and payment terms from their established markets.
- Demand for security of transactions in areas such as foreign exchange and third party credit insurance are increasing.
- A highly flexible and cost-effective approach to sourcing and supply.
- Effective management information will be crucial in directing more complex and fragmented international businesses. The ability to draw on information from partners including banks will be vital for enterprises that lack the necessary data gathering and analytical capabilities.

Companies that primarily focus on mature and lower growth markets face contrasting challenges. Finance and treasury will play a key role in enhancing the cost efficiency, risk management and profit margins of the enterprise.

Figure 4b: Growth to come in emerging markets' operations, regardless of location

Q. In the next 12 months do you expect your key operations in these regions to decline, stay the same or grow?

Company headquarters	Region of operations							
	Africa	Asia	Australasia	Eastern Europe	Latin America	Middle East	North America	Western Europe
Africa	93%	89%	33%	100%	100%	75%	29%	36%
Asia-Pacific	73%	88%	77%	40%	80%	70%	40%	32%
CEE	80%	87%	83%	73%	80%	55%	71%	69%
Latin America	87%	86%	18%	59%	86%	47%	48%	31%
Middle East	70%	100%	50%	0%	0%	85%	25%	0%
North America	64%	94%	71%	67%	80%	73%	67%	51%
Western Europe	74%	92%	57%	75%	86%	75%	55%	48%

Base: Respondents who reported operations in said region (168-672)
Note: Percentage of respondents who expect to grow their key operations in the region
Source: PwC 14th Annual Global CEO Survey

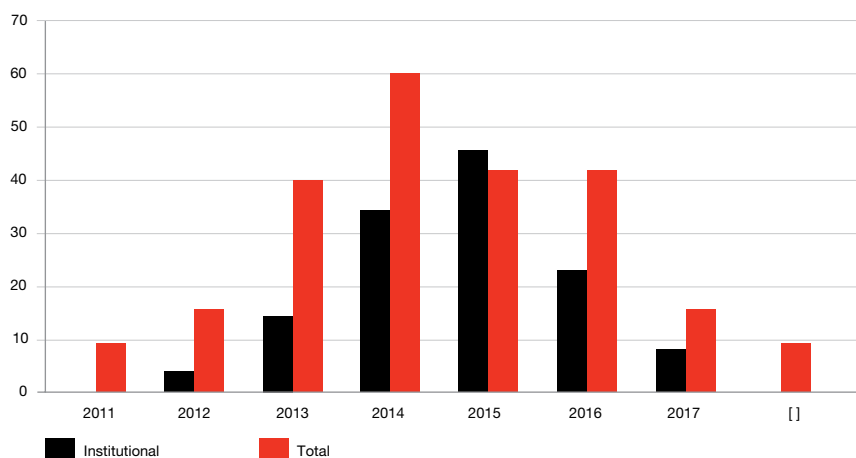
3. Wall of debt maturity

Much of the surge in borrowing that preceded the crisis is scheduled to reach maturity over the 2013-2016 period. As Figure 5 highlights, leveraged institutional loans by themselves will generate €175 billion in maturities by 2015, let alone other facilities due to mature in 18 to 24 months. The timing of financing deals and re-financing is therefore going to be crucial to ensure adequate supply at the right cost and

terms is available to fuel growth strategies. Companies will need to allow sufficient time to assess the options, liaise with funding partners and ensure that the finance is secured, rather than assuming that this can be achieved at the 'last minute'. The ability to provide clear revenue projections based on ample supportable data is going to be even more crucial in securing sufficient funding.

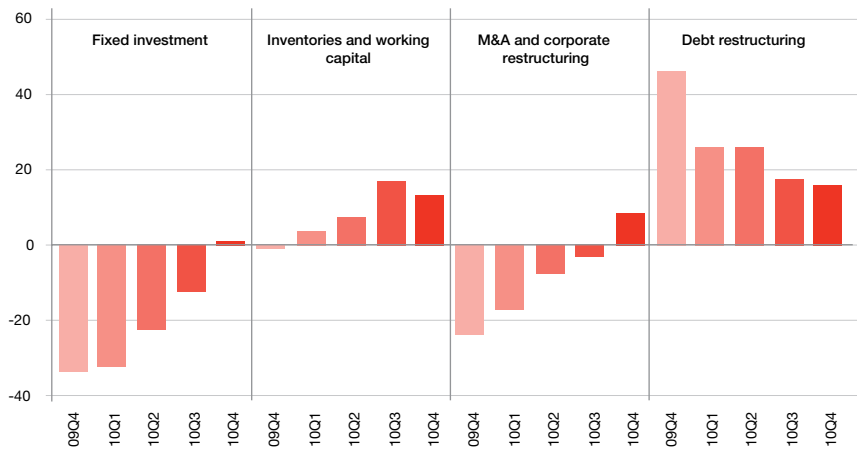
Figure 5: European leveraged maturities

Institutional v total debt



Source: LCD/Fitch analysis, 2011

Figure 6: Factors affecting demand for loans and credit lines to enterprises
(Net percentage) of banks reporting a positive contribution to demand



Source: ECB Bank Lending Survey, 2011

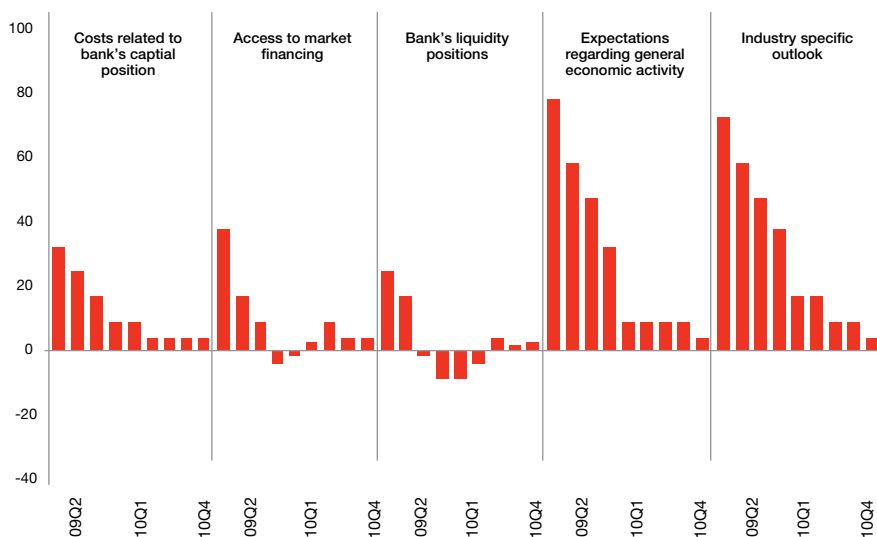
4. Increased demand for credit

Demand for credit is increasing once again as European companies renew their focus on growth, (see Figure 6). Working capital financing, the traditional lead indicator, is beginning to rise again. In the last two recessions, working capital was the Achilles heel of many companies. The short-term liquidity pressure created by the need to restock their inventories to growth levels separated out the winners from the losers and ultimately placed some companies in danger 18 months into the 'recovery'.

However, this time round confidence is still taking some time to return and many companies appear to be overcautious in waiting for confirmation that economic growth is here to stay. Indeed, utilisation of existing facilities is still quite low (utilisation of overdrafts and revolving credit facilities is running at around 30% in the UK, for example).

While credit supply is stabilising, there will be increased competition for funds over the next few years, especially within short-term lines, which are one of the fastest growing areas of demand.

Figure 7a: Changes in credit standards applied to the approval of loans or credit enterprises
(net percentage of banks contributing to tightening standards)



Source: ECB Bank Lending Survey 2011

5. Credit standards stabilised for now, but may change

While credit standards are stabilising (see Figure 7a), new capital and liquidity requirements under Basel III could affect risk evaluation and credit pricing. We are already seeing growth in bond issuance as companies look to diversify their funding options. Bonds do not have covenants and therefore leave more control with the business. While sub-investment grade bonds are by nature high yield bonds, the pricing for these have been moving closer to fixed-rate funding. Private placements open up opportunities for lower value issues (minimum of around €50m), with current supply outstripping demand.

6. Working capital isn't working

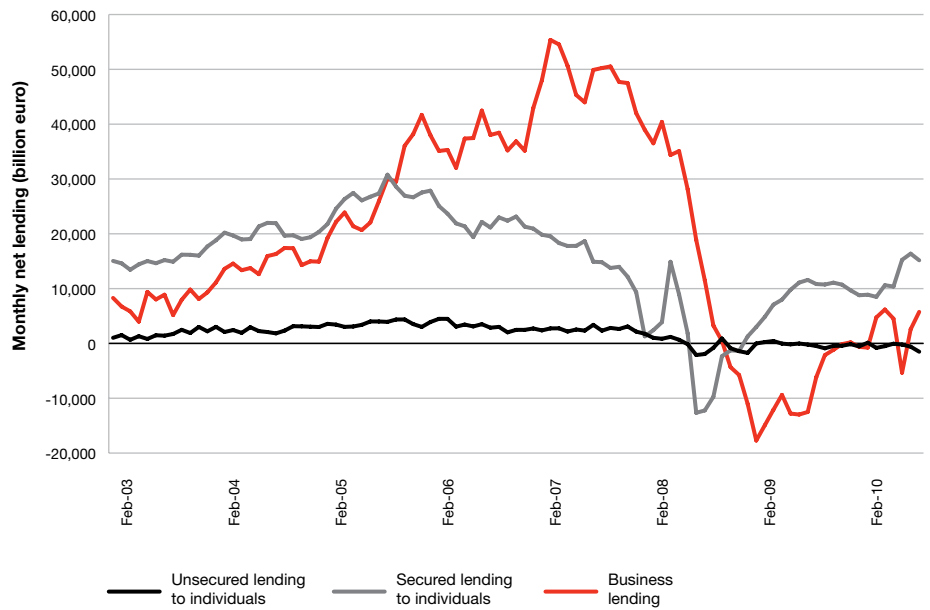
Internally generated cash flows continue to be an under-utilised source of finance. A recent study revealed that the working capital ratio – the relationship between working capital and annual turnover – actually increased in 2009, having fallen every year since 2005. Companies had been able to improve their ratios through relatively straightforward measures such as selling off inventories or re-negotiating payment terms, though these quick wins are now largely exhausted.

More enduring improvements in working capital management (WCM) are required in areas such as improvements in forecasting accuracy, reductions in stock in hand and lead times and reductions in slow moving and obsolete stock. The 1,200 companies analysed in the study could potentially release €475 billion through more effective WCM, 30% of their net working capital.⁴

7. Fresh sources of investment

A key challenge for middle market companies is how to attract the market attention they need to secure further investment and sustain growth. Share liquidity tends to be limited, which in turn makes it harder to attract analyst attention. This underlines the importance of developing clear and compelling market communications, with the ability to convey a strong growth story at its heart (Figure 8 outlines the key priorities for attracting investment cited in a recent survey of middle market companies in the UK).

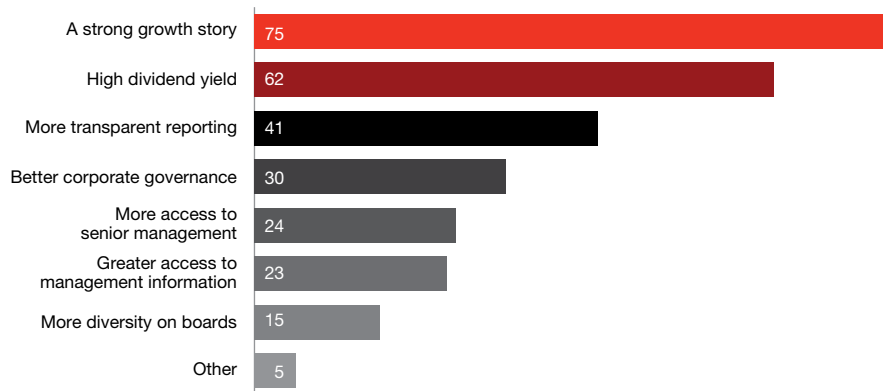
Figure 7b: Overall Euro area lending is stabilising
 Monthly net lending (€m)



Source: ECB, 3 month averages, PwC, May 2011

Figure 8: Executive priorities for attracting investment

Three quarters of respondents think investors want a strong growth story



Source: PwC FTSE 250. Realising ambitions for growth, PwC, March 2011

4. 'PwC's European Working Capital Management Study 2011'



Getting ahead: Developing a more forward-looking basis for decisions

According to a recent report*, developing forward-looking processes to plan for and guide the organisation are the key priority for CFOs as they move back into growth mode. Yet, by their own admission, they are the greatest challenge too.

Pre-crisis, leading forecasting companies outperformed their peers in share price gains by 33% and similar lower levels of share price loss against their peer group average.

Then why are finance functions still grappling with forecasting, budgeting and planning – only 37% of companies citing these core disciplines as a strength, yet 75% still have it as their number one priority.

While finance and treasury teams will have a strong focus on financial risks, they may be less attuned to the broader operational and strategic risks that will form a key part of any effective assessment. Data and information is often of variable quality without adequate internal control to ensure it is complete/accurate/reliable and the business finds it difficult to articulate growth drivers that Finance can rely on. As a result, it is often difficult to generate credible revenue projections.

Forward thinking companies are therefore developing common business-wide metrics that can provide relevant, reliable and comparable performance assessments and projections from around the business. These can then be brought together within an integrated planning framework, which seeks to align budgeting, forecasting and risk analysis from across the different functions and geographies.

Getting this right will strengthen management confidence and lead to quicker and more collaborative decision making. Particular benefits include more effective strategic planning and performance management, along with more precise cash management.

For example, forward-looking cash forecasting processes are a key part of understanding and driving the desired growth. Forecasting at three levels will be required:

- Daily – liquidity updates and cash position management
- Short term – direct forecasting for bank account funding and liquidity to manage short term cash positions
- Long-term – indirect (cross currency) cash flow forecasting for strategic purposes including capital management and investments

Further planning will involve capital strategy (including debt strategy), financial scenario evaluation and risk capital management. Finance must influence the business and ensure that key metrics to aid robust planning processes are embedded in executive scorecards and reward.

The underlying requirement is the right people to provide this level of decision support. Finance teams also need to be efficient enough to free up time to provide more value adding insight and analysis for the business. However, PwC's latest benchmark analysis of finance function effectiveness reveals a huge gap between the capabilities and cost-efficiency of the top performing and typical finance teams.⁵

The front runners have streamlined their processes and invested in greater automation. This enables them to operate at around 40% lower costs than a typical finance function, while still having more skilled and experienced people dedicated to advising the business. The savings also allow the top performers to pay more to attract the brightest and best finance professionals.

*Source: EIU/CFO Research 2009 and 2011

5. 'Drifting or driving? Finance benchmark survey 2011', published by PwC in March 2011

New worlds of finance

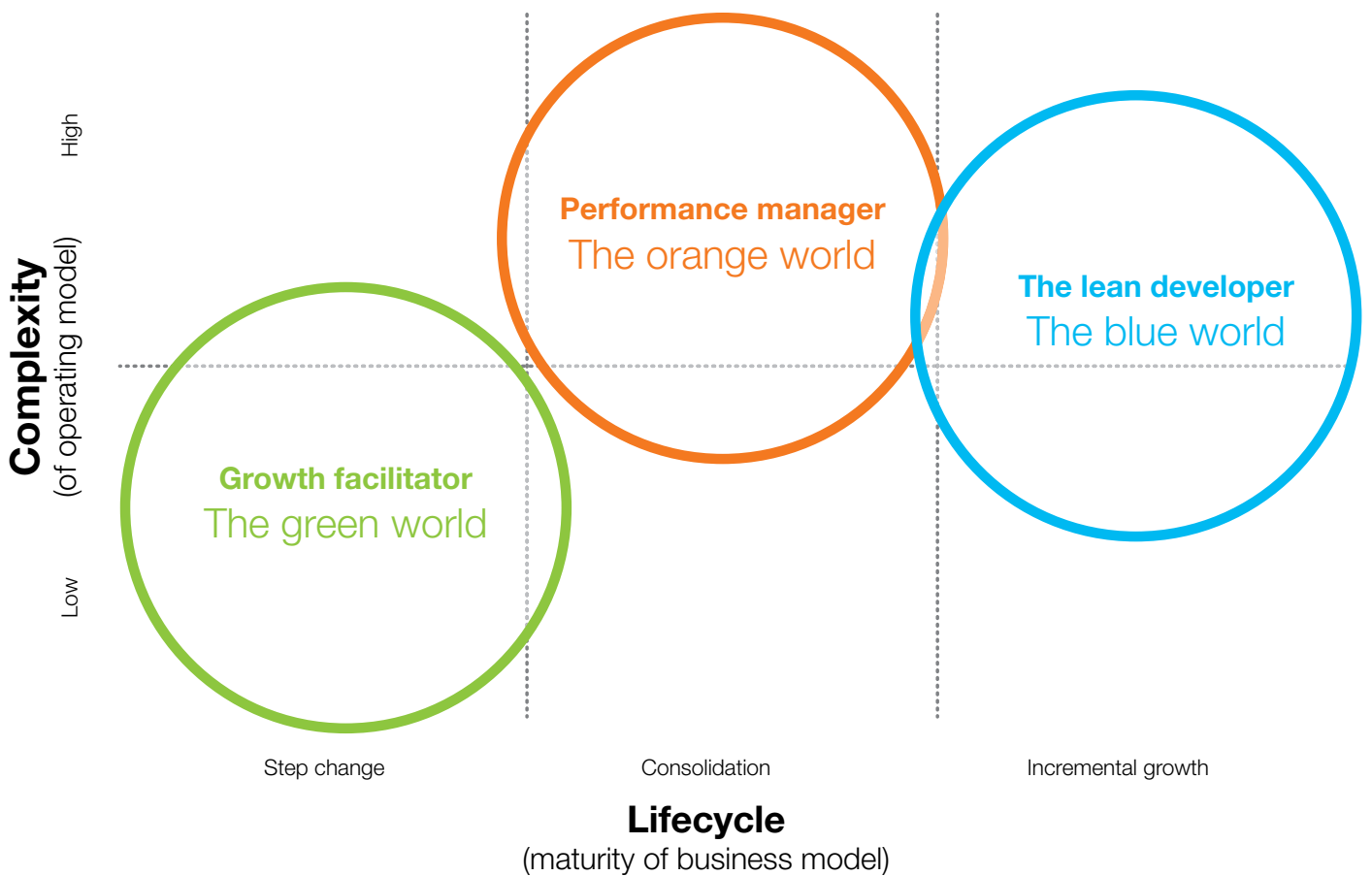


The combination of new growth-centred strategies and a more complex funding environment will require a much more proactive and sharply focused approach to financial management.

In this section, we introduce three emerging 'worlds of finance' and describe how we believe these worlds will need to respond to the market opportunities, relative risk appetite and credit dependency within their businesses, along with the need to make sure of the effectiveness of the finance function.

There will be no single approach to best practice as we enter into a new economic cycle. Each of our worlds therefore requires clear management of its inherent advantages and drawbacks. The ability to deal with the challenges and make the most of the advantages of each approach will be critical to the future success of the enterprise.

This section also includes a series of case studies, examining how forward thinking finance teams are addressing their particular financing and strategic challenges.





Strategic profile

The growth facilitator is likely to have set ambitious targets for growth and wants funds available to move quickly to capitalise on opportunities. The growth facilitator supports this through a nimble ‘private equity mindset’. Joint ventures and strategic partnerships form an important part of developing business coverage and minimising risk.

Operational characteristics

The growth facilitator is marked out by its operational flexibility. It is typically decentralised to enable it to stay close to end markets as a source of competitive advantage. It sets internal competition for corporate funding and accepts a higher cost of finance as a trade-off for strategic flexibility. Its accent is on expansion rather than cost control and it has adopted a collaborative approach to supply chain management and strategic partnerships. While less data rich than its blue counterpart (see page 16), it uses a few golden metrics to drive management behaviour.

CFO/Finance function features

The finance function is a facilitator for growth – a ‘strategic partner’. This function’s core competence is in forward and capital planning at a corporate level – value chain analysis, market assessment, scenario planning and forecasting.

The function is marked out by its market savvy and strong communication skills, both internally and externally. Finance has less influence on day-to-day operational management – for example, working capital and cash management are managed locally.

Strategy for financing

The growth facilitator wants funds available even if this means paying more interest and fees. It has active bank and external funding relationship management, with finance playing a key role in presenting the corporate strategy and investor story. The strategy favours longer corporate facilities. The function is also likely to use mixed facilities, managing its portfolio of funding rather than specific lines. This allows greater flexibility in agreeing local banking facilities.

At a glance

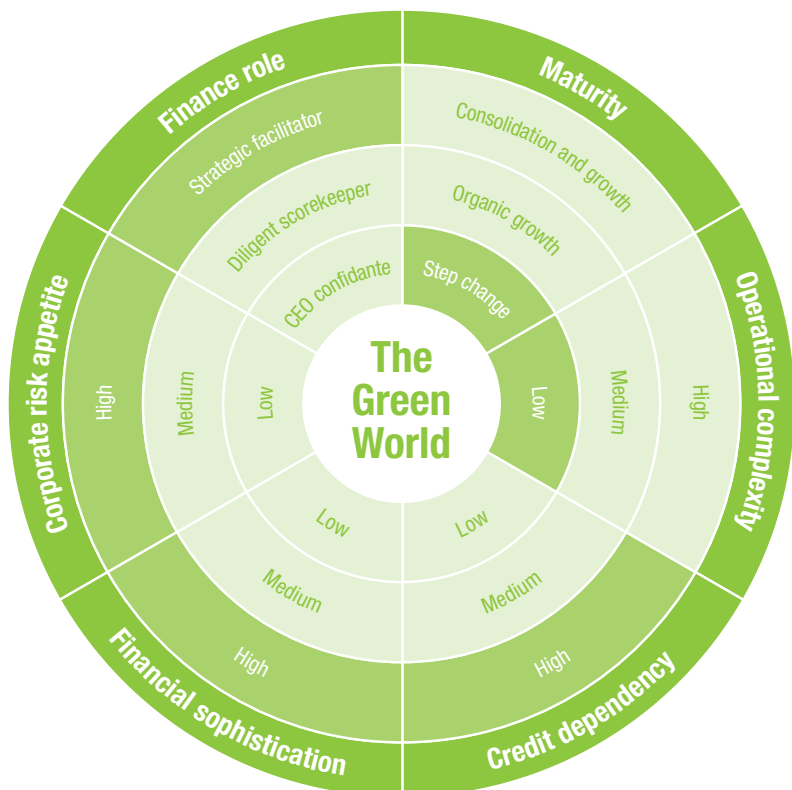
Features

- Inorganic/M&A growth strategy
- Basic systems & processes
- Low operational complexity
- Private equity mindset
- Low integration with Operations
- Long-term capital focus

Priorities

- Maintaining financial flexibility
- Headroom and maturity management
- Active external engagement

Main features of The Green World



Advantages

The growth facilitator is strategically nimble and can move quickly to capitalise on acquisitions, which makes it a more credible bidder. Its approach aligns closely with management strategy.

Drawbacks and challenges

The model may not be sustainable in the longer term as the eventual saturation of markets will drive diversification or efficiency. As competition for its core sources of funding increases, it will need to augment its 'growth story' with more supportable detail about risk and rewards to satisfy lender demands and curb finance costs. The development of stronger internal processes akin to the blue world will provide greater credibility with its banks.

Even with adequate medium to long-term funding, the growth facilitator may need to supplement its funding pool with more effective working capital management and alternative short term sources of credit.

The lack of track record and accompanying data may impair the ability to attract working capital financing/cashflow credit. Asset backed finance may suit as it will track against physical supply, flex the size of facility against demand and provide cost transparency.

The growth facilitator will also need to be more active role in managing and advising on risk and cost management. For example, the cash conversion cycle may appear better than it actually is and the finance and treasury teams will need to closely monitor this. At this stage in the economic cycle revenues may be rising faster than costs, but eventually there will be a need to rein in on expenses. The finance and treasury teams will need to anticipate and take the lead in facilitating this.

Common attributes of the green world CFO

- Agile and forward-looking
- Adept at developing and implementing forward-looking tools
- Highly integrated with business leaders
- Capital markets savvy
- Strong on insight – manages financial and non-financial metrics
- Risk shaping rather than mitigating mindset
- Maintains a hands-off approach to operations

Corporate and leveraged loans

The end of 2010 witnessed a strong loan market and we entered 2011 with positive market sentiment. Q4 2010 European volumes demonstrated strong growth. The corporate loan market proved resilient to the shocks in 2010 of the Eurozone debt crisis, and global macroeconomic concerns. Barring a systemic shock such as a sovereign default, the corporate loan market should continue with the positive trends seen in 2010.

A number of the established funds are in the market raising new financing and this improved liquidity is expected to manifest itself in tighter pricing across both primary and secondary markets. On a cautionary note, the political instability in the Middle East, greater inflationary pressures, persistent trade imbalances and fiscal deficits across key Western economies present very real risk factors to the health of the debt markets.



Strategic profile

The performance manager is likely to be working within a company that is at a pivotal point in its development. It has expanded rapidly in recent years, but has not yet developed the sophisticated financial management to match this. It now needs to realign its financing model to keep pace with its evolving strategy and changing funding demands.

Operational characteristics

The company has been expanding in multiple ways and its operational infrastructure and footprint are reaching beyond its economic value.

CFO/Finance function features

The primary focus is profitability and earnings improvement. This includes a strong understanding of corporate valuation, financing and acquisition. The finance function also acts as a barometer for performance evaluation across the businesses, including financial metrics, economic capital and risk appetite. It provides segmented services to

business lines and plays a lead role in performance improvement projects. It also helps to define and prioritise business requirements based on core, emerging and non-core value; this definition being used to tranche and align financing requirements.

Strategy for financing

The function has built multiple banking and funding relationships to provide specific best-in-class funding. It self-finances through targeted disposals and bolt-on acquisitions. It has established a ring-fenced core funding programme.

A key priority is aligning sources of capital and business funding based on the strategic maturity of the business (e.g. highly cash generative, future stars and poor performers).

Advantages

It helps the business to focus on growth and reduces the financial drag on core and emerging business.

At a glance

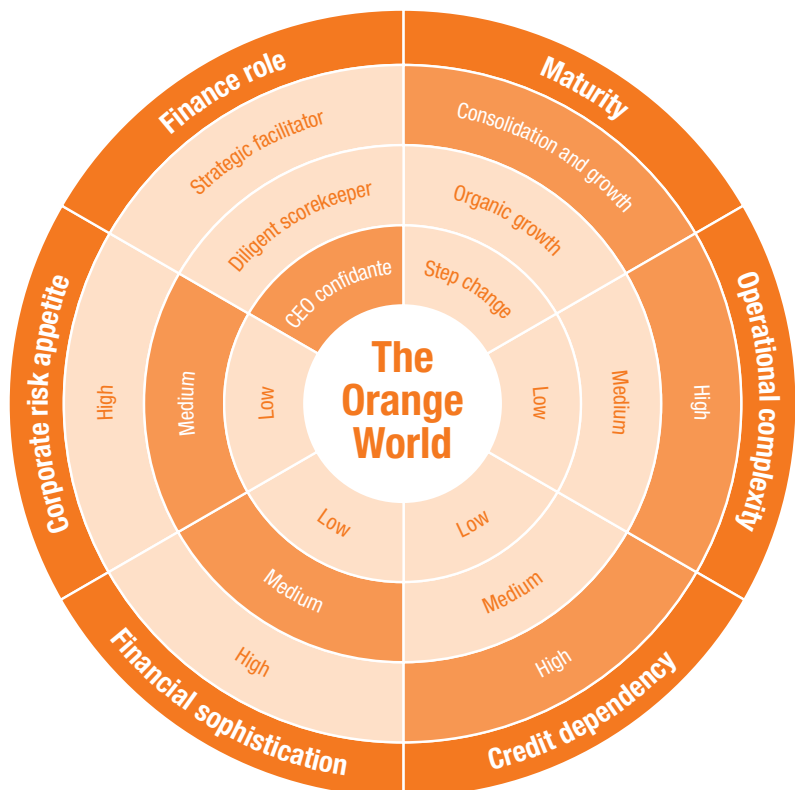
Features

- Recently expanded into markets/ segments/new operations
- Variety of business and operating models
- Federated finance structure following growth
- Working capital management requirements on the rise
- Portfolio management mindset

Priorities

- Segment businesses by maturity/growth
- Tranche and align financing
- Utilise cash cows to fund and incubate growth
- Streamline banking structure

Main features of The Orange World



Drawbacks and challenges

The function is facing tough choices and is likely to require bold strategic decisions.

It is likely to require fresh sources of funding and funding partners. This may include intrusive funding partners to parcel out financing opportunities. Banking relationship management will need to be more active and rationalised to ensure priority client status and support. Debt maturity management may also need to be more sophisticated. Other key priorities are likely to include releasing more cash from highly cash generative operations as part of an overall improvement in working capital management.

Common attributes of the orange world CFO

- Challenges the status quo
- Strong analytical review skills – lives by the numbers
- Tough operator – ready to challenge as required
- Likely to have a financial and strategic background
- Able to review across capital, operational and financial measures
- Stress tests business revenue projections and plans

Bonds bounce back

For long-term financing, alternatives are available beyond the traditional bank loan, revolving credit facility or overdraft.

Equity Capital is beginning to look attractive again as share prices continue to recover. Critical to success is a strong external story as the markets are still selective in their support for fund raising.

High yield bonds are currently a strong market for both corporate and investors. €44bn* in new funding was provided in 2010 and commentators believe that this level of funding will continue. High yield bonds are attractive as boom years loans mature and can be refinanced as bonds. They offer longer term maturities and potentially more favourable terms than bank debt. They also help to steer clear of peak periods for debt refinancing.

*Source: Restructuring Trends, PwC, Feb 2011

Liquidity – a strategic funding discipline

Orange World

Orange world corporates now concentrate more on liquidity management in response to the pressure that reduced credit availability during the financial crisis. Our experience shows these companies are improving practice to support further growth, although Treasury resourcing is likely to have been a challenge. Effective liquidity practices have included:

- exploring physical and notional cash pooling structures to consolidate and maximise liquidity where the business requires this for growth
- a broader investment strategy through the creation and active management of a Treasury policy with surplus cash being consolidated and invested in a range of instruments, over a range of terms and with a number of institutions/counterparties
- reducing cross border liquidity complexity by streamlining accounts and bank relationship management



Strategic profile

The lean developer is likely to be working in a well-established company, which is operating in a relatively low growth and low margin mature market. In the face of subdued consumer demand, the key priorities are risk minimisation, operational efficiency and highly sophisticated financial management to enable the company to maximise returns and make the most effective use of its resources.

Operational characteristics

The lean developer takes the lead in the operation of a highly controlled 'just-in-time' approach. This includes timely and precise tracking of supply, production, stock and delivery. This 'world' is also marked out by strong connectivity and integration within the organisation.

Its supply chain management is built around a stable commercial ecosystem of buyers, suppliers and alliance partners, underpinned by hedging against operational disruption. This enables the company to make the most of its buying power and economies of scale.

CFO/Finance function features

Efficiency is at the heart of the finance function priorities. The team manages its processes on a highly centralised and automated basis, freeing time to play a strong and influential role in the strategic and operational management of the business. Financial management is driven by access to timely and granular data and analytics. The function is also marked out by its strength in managing non-financial metrics and management information.

Covenant optimisation

Active monitoring of debt covenant calculations help to make sure that bank waivers of renegotiations are identified in a timely manner. Effective approaches include a range of scenario options in the forecasting models. Finance and Treasury teams can also seek to identify the underlying lead indicators that might flow through to the covenants (usually lag indicators).

At a glance

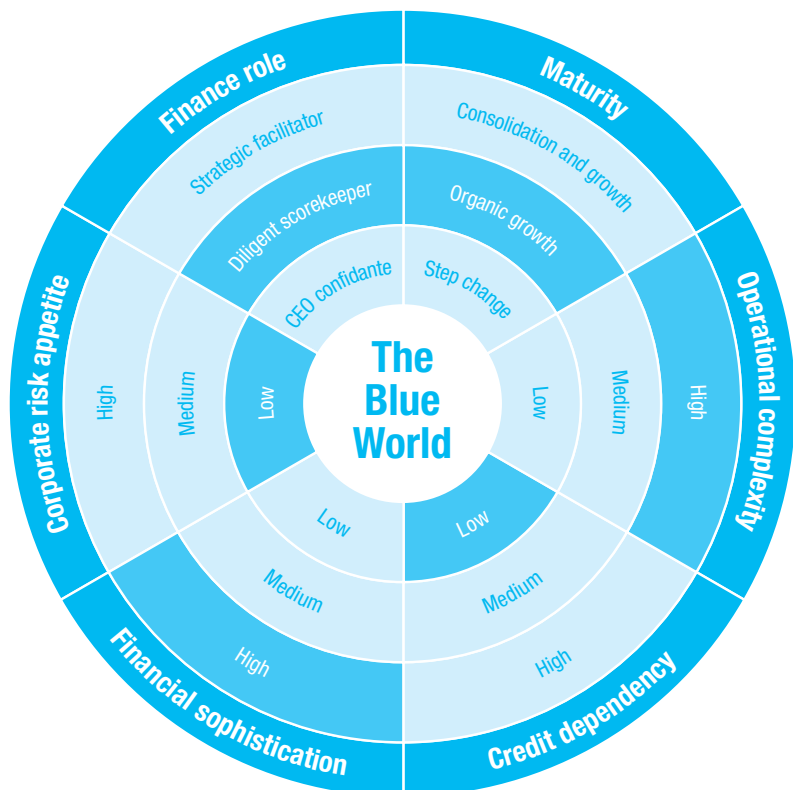
Features

- Operating in mature/saturated markets
- Strategy to grow market share
- Strong operational and financial integration
- Cost and margin management
- Process mindset

Priorities

- Optimise working capital
- Minimise risk
- Minimise cost of Finance – centralise/automate
- Vendor relationship management of financing providers
- Minimise fixed and maximise variable funding

Main features of The Blue World



Strategy for financing

At the heart of this is tight WCM to eliminate cash blockages and reduce borrowing. The implementation of transaction processing through such developments as payment factories has helped to improve cash generation. Flexible end-to-end supply chain facilities are used to spread risk and improve balance sheet management. (See Figure 9 for trade financing channels).

The function maintains strong vendor relationship management with its banks, supported by clear analysis of margins to ensure that pricing remains competitive. The lean developer uses its banks to reduce risk and increase efficiency, with structured trade and asset-backed lending at the fore. It also concentrates its banking pool to rationalise borrowing and reduce the amount of time and expense needed to secure refinancing.

Advantages

The advantages of this approach are low funding costs, excellent understanding of costs and profit drivers and a well-developed information exchange with partner banks, which means that the lean developer is seen as a good risk.

Drawbacks and challenges

This controlled approach may limit the strategic options of the business and its ability to capitalise on opportunities. Any volatility in the supply chain can disrupt this predictable model. Regulations such as controls on cash movement can also inhibit efficiency. Other potential drawbacks include the tension between risk and efficiency as concentration of risk creates potential maturity/refinancing risks.

The lean developer is an important, but often passive partner in the business – ‘you give us the data and we’ll make the operation work’. The new environment will require a more active and adaptable role within the business.

If the company is looking to move into new markets, for example, the lean developer may need to move away from its familiar path to explore new options that may be more appropriate to the circumstances. This might include refocusing on capital structure, ROE and other similar measures to right-size the business for the next step change phase of growth. As the company looks for new equity or debt finance, the lean developer will be required to be much more of the public face of the company, developing a compelling growth story and communicating this to investors. This in turn is likely to require stronger external engagement skills and closer partnership with frontline business teams.

Working capital – by-lines for profitability

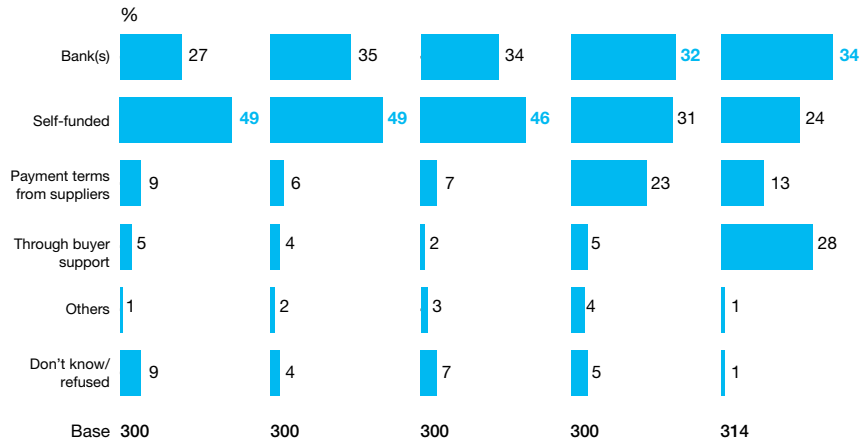
According to a survey of European corporates, improving working capital from median to upper quartiles practice will result in a 6.5 to 15.6% improvement to RONA (return on net assets)⁶. Similarly, improving the cash conversion cycle by only five days is equivalent on average to more than a 2% improvement in net operating profit after tax (NOPAT).

Working capital is particular to the business model and industry sector across Europe. Retail remains the best performer; manufacturing, technology, consumer goods, basic materials and the pharmaceutical industry confirm their positions as the major ‘consumers’ of working capital.

PwC estimates there is over €475bn in working capital able to be potentially released into cash across the top 30% of corporates in Europe. Key to releasing this value is finance’s clear integration with the business to enable it to galvanise the information, organisation and process required to drive business change and realise financial opportunities.

6. ‘PwC’s European Working Capital Management Study 2011’

Figure 9: Channels to meet future trade financing needs – Europe



Source: HSBC Trade Confidence Index 2011

Common attributes of the blue world CFO

- Risk averse
- Operational mindset – will have spent time within the business
- Highly integrated with operational management
- Cost a key discipline
- Process management expertise (operational and financial)
- Strong analytical skills

Liquidity – a strategic funding discipline

Blue World

These companies are likely to be up the curve from orange in operational treasury management quality, sophistication and complexity. They will have implemented as efficient account structures as possible, relying on good cash flow forecasting and working capital management. From a liquidity perspective they:

- are increasingly utilising cross border structures and balance flows between parents and subsidiaries
- value automation in their liquidity management to increase efficiency vs. cost
- have visibility over their cash positions
- are using multiple banking partners on regional or currency basis
- are accessing local clearing and payment systems which are invariably far cheaper through their subsidiary's money transmission capabilities
- have a clear treasury policy for cash investment using multiple but high quality, secure counterparties – security and liquidity has replaced yield as the key objective

Trade and Supply Chain – volatility impacts growth

In general we have seen increased utilisation of trade facilities as both suppliers and sellers have sought more security of payment. Balances have increased by 11% YOY (Apr-10 to Apr-11).

Since November 2009, volumes of imports have increased, and the value of each of those imports has increased by approximately a third since May 2010. This is a consequence of the increased costs of commodities driving up the price of imported goods, and the increase in fuel driving up the transport costs. There is also evidence that shipping companies are shipping slower to improve fuel efficiency and stopping at more destinations to minimise travel.

Importers are therefore having to react by reviewing their supply chain, with the possibility that markets closer to home could become more attractive, especially if this allows them to maintain just in time sourcing. Terms of trade are likely to increase, or change, which will require importers to change their funding structures and potentially their pricing strategies. If the importer is seeking to reduce transport costs, they may need to import higher quantities in one shipment, which will change their stockholding profile and have an impact on cash management.

Source: HSBC UK data, May 2011

Case studies

Case study: Air Energi

Sustaining strong growth

Formed in 1987, UK-based Air Energi provides manpower and recruitment services for the oil and gas industry around the world. The company employs over 180 staff and places around 1,000 contractors a year. In 2009, the company underwent a management buy-out, which was supported by Palatine Private Equity.

Air Energi has grown rapidly in recent years, with turnover increasing by 17% to reach £153m in 2010 and Gross Profit up by 22% to £19.4m*. The company is on track to meet its objective of doubling EBITDA and shareholder value every three years. Key developments in 2010 included the acquisition of Pacifica HR in Papua New Guinea and the opening of new offices in the UAE, France, Saudi Arabia and Iraq. Investment is primarily self-funded, with cash management supported by a \$50m invoice finance facility.

Air Energi's CFO is Ken McPherson, who joined the company in 2008: 'I was excited by the opportunity to work in this truly international company and feel I could make a real difference in helping the company to achieve its growth aspirations,' said Ken.

'With our focus on the Global energy sector, we have continued to expand despite the global downturn. However, the financial crisis has affected the availability of senior debt within private equity-backed businesses. This has reinforced the importance of maximising our cash position and generating funds for future growth through other facilities; in our case primarily invoice financing. Looking ahead, minimising the drain on our cash and ensuring that we have access to invoice financing facilities across the globe will be crucial in sustaining our continued expansion.

'We can only continue to grow if we manage working capital efficiently.'

'Effective financial forecasting is crucial to achieving our plans. We produce detailed 12 month plans and a rolling higher level three-year projection. We need to identify where the growth opportunities are and how we can put in place the local banking facilities to support this. We also need to look closely at the impact of growth on our cash position and how we can proactively manage this to ensure it is sustainable.

'In a business like ours it is vital that finance professionals are commercially-minded and can think on their feet – we need to be integrated into the business and integrated into strategic planning. To be effective, we need to be able to combine a 'helicopter view' and maintain an attention to detail in assessing the financial consequences of our plans and actions.'

* Figures are taken from management accounts with audited accounts expected soon.

Case study: Merchandise Mania

Building a stable platform for success

Formed in 2000, UK-based Merchandise Mania supplies personalised business gifts and promotional products to businesses around the world. Its international client base includes Google, Bosch and McDonald's.

The recession was especially tough for the promotional industry, with many companies going out of business. Although Merchandise Mania experienced its first falls in revenue in 2008/9, its prudent financial management enabled it to weather the industry-wide difficulties and quickly capitalise on the upturn – its revenue increased by some 40% in 2010.

Simon Patnick is Merchandise Mania's Managing Director and one of the husband and wife team that formed the company: 'The rapid growth we achieved in the middle years of the last decade taught us the vital importance of good cash flow management. It doesn't matter how much new business you're winning, if you don't get the money in quickly enough and ensure you have enough cash to see your company through any fluctuations in trading you'll go out of business.'

'You need to know your cash flow to know your business – no cash flow, no business.'

'2008/9 was a test for us, but we knew what to expect and how to mitigate it. Now business is picking up again, the stability we showed during the recession is attracting a lot of leading international clients – whatever they need, they know we'll be able to deliver.'

'We've placed our banking and invoice financing with a single institution HSBC, which has improved the co-ordination and efficiency of our cash management. One of the most important steps we took to strengthen liquidity during the downturn was sharpening up collections, reducing payment days from an average of 45 to 38. You can't just sit back and wait for the money – we run collections as a partnership between us and our collection bank. We believe it is particularly important to identify, track and keep in close contact with any potentially difficult collections – this might include getting money in from a remote location, for example.'

'While a lot of companies have extended payment times to suppliers, we've actually speeded up payments to help support our supply partners in what continues to be a difficult commercial environment. This support gives us greater certainty over supply. In turn, they're happy to give us favourable terms and go the extra mile when we need their support – for a big order, for example.'

'Looking ahead, we've set a realistic and achievable 10% target for revenue growth in 2011. As we continue to expand our business, good working capital management keeps our overdraft down, reduces interest payments and gives us the money to sustain growth. We only use a certain proportion of our invoicing finance facility, which gives us a built-in cushion as and when we need it.'

Forward thinking finance: The growth challenge



Seizing the prize

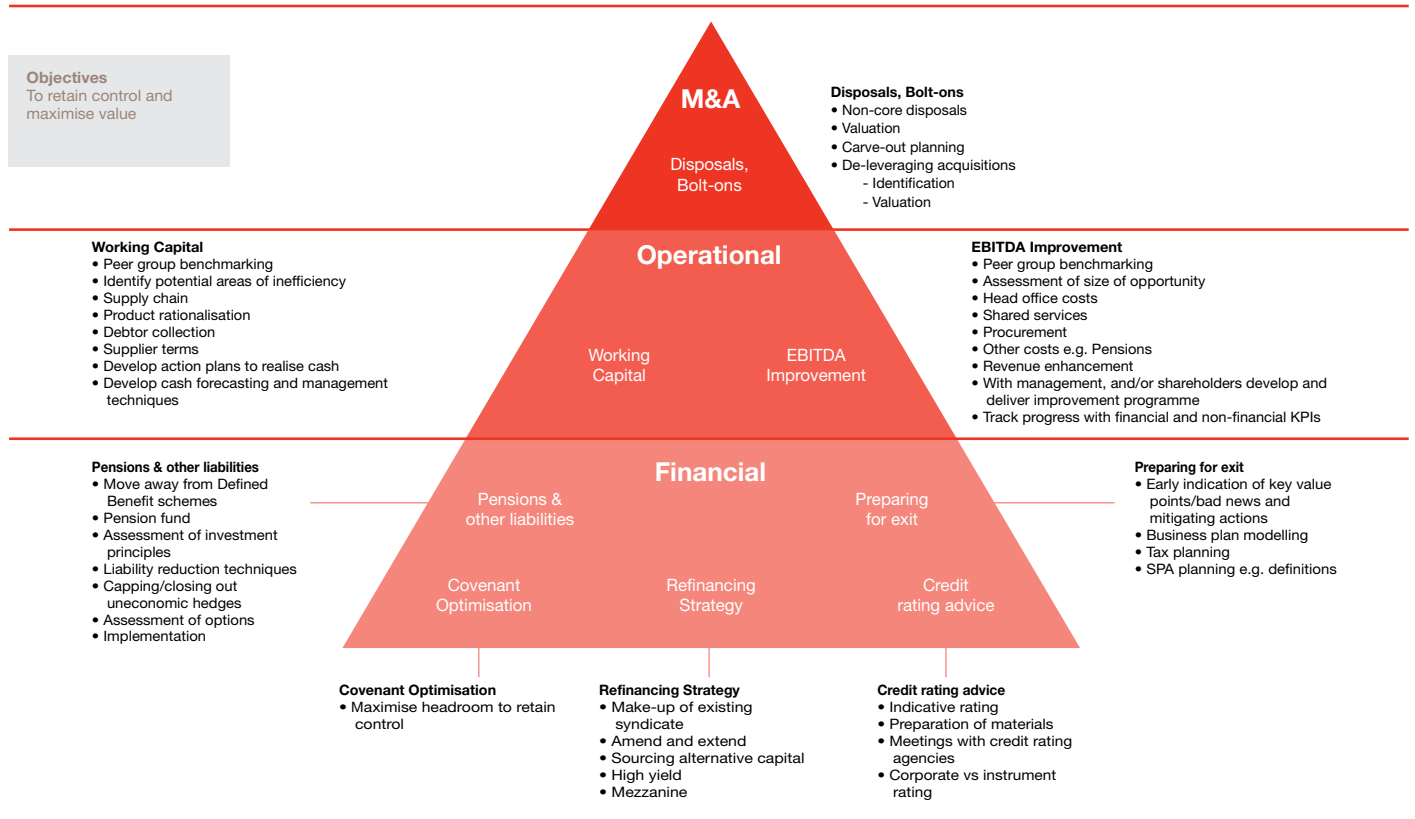
Our research estimates that there is at least €245bn of available funds that have yet to be tapped in UK, France, Germany, Italy and Spain alone. Figure 10 outlines the options for generating additional finance and making the most effective use of existing capital as companies seek to make the most of these funding opportunities.

Some are more applicable to particular 'worlds of finance' than others. The growth facilitator ('green world') could greatly broaden its access to the debt markets through securing a credit rating. There is also likely to be room for debt covenant optimisation through more effective forecasting. In turn, this may be an ideal time for performance managers ('orange world') to identify and

dispose of non-core assets as they seek to release finance and management time for further growth. Even though the lean developer may be adept at identifying and maximising efficiency gains, there will still be considerable openings for further refinement. Exploring fresh options will also help to improve the flexibility and adaptability of funding as market conditions evolve.

The underlying funding options can then be assessed against the risk, cost, access, coverage and counterparty risk considerations. Ideally, the funding options should also be evaluated against the degree of control and flexibility they confer and whether this supports the overall strategy of the business.

Figure 10: Sources of Finance



Conclusion

In this paper, we have sought to highlight the key changes ahead and how finance and treasury teams can adapt their strategies and operational capabilities to reflect them.

There is no magic bullet, especially as each business has different characteristics and demands. What is clear is that as a finance and treasury professional, you can no longer rely on tried and trusted financing models and ways of working to see you through. The marketplace has changed. Boards and executive management are going to be looking to you to judge where to direct investment and ensure the risks are understood and controlled.

Above all, there is a huge amount of funding, internally and externally, that is available. Smart firms will use this to capitalise on opportunities and drive profitability, leaving their competitors trailing in their wake.

The next two years therefore offer a unique window of opportunity to refinance, restructure and reorganise your business to gain first mover advantage.

We believe that success will come down to how well you address four pressing demands:

- Objectively reviewing your financing strategy's alignment to the corporate strategy.
- Assessing existing funding arrangements against the ability to meet the operational, financial and business development priorities in areas such as acquisition and new market entry.
- Putting in place the processes, information and support needed to be able to provide the most effective insight, control and efficiency.
- Underpinning this with regular periodic Finance function effectiveness evaluation to drive continuous improvement.

Are you ready for the future of finance?

Questions that every finance and treasury team should answer:

Do you have the funding you need to support growth objectives over the next three to five years?

Are you moving early enough to address your refinancing and new credit requirements?

Are you identifying and making the most of all available funding options?

Do you have the right metrics (financial and non-financial) to provide a sufficiently credible and forward-looking basis for strategic planning and performance management?

Are your strategic forecasts accurate enough to be trusted by boards, business teams and investors/analysts?

Are you able to bring together data from around the organisation and turn it into consistent and reliable analysis?

Are you close enough to the frontline of the business to understand and help address their priorities?

What are the strategic and operational risks that could derail growth or put the business in jeopardy?

Helping you to stay ahead

PwC

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