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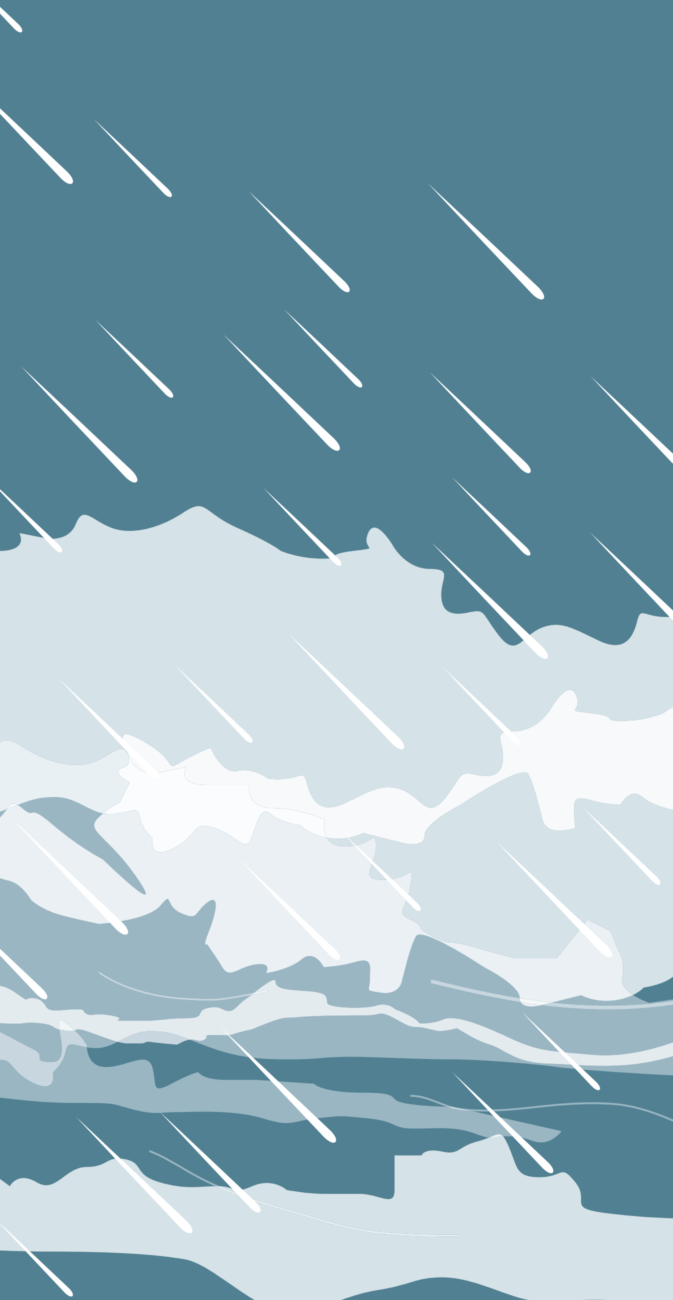
SHELTER
FROM THE STORM

APPLYING EFFECTIVE CASH MANAGEMENT TO SAFEGUARD INVESTMENT CAPABILITY



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APPLYING EFFECTIVE CASH MANAGEMENT TO SAFEGUARD INVESTMENT CAPABILITY

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Stefan Heppelmann, Dr. Tobias Braun

Management Summary

In spite of the shadow on the horizon cast by the economic situation and the ongoing euro crisis, there are still good investment opportunities for many companies. Owing mainly to the ongoing increases in demand in the emerging markets, there is a huge need for liquid funds. At the same time, the volatility of operational business and of the financial markets is draining liquid funds in the relevant investment time period.

In this difficult environment, cash management and safeguarding liquidity are increasingly focus areas for management. Prevailing strategic management control mechanisms often only inadequately consider the liquidity situation in terms of the actual management, and the medium- and long-term planning. Four steps have been found to incorporate effective cash management into the overarching management:

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1. Create transparency as regards the liquidity situation and identify liquidity drivers 2. Integrate liquidity management and cash-flow forecast into the planning process 3. Actively manage core operational processes with a high liquidity impact 4. Apply liquidity management to make investment possible.

Introduction

Cash management is the basis for central management – generation and allocation – of all funds received and spent at the operating, financial and strategic level. It has an elementary function with regard to the continuance, success and, on this note, especially with regard to the investment capability of the company.

Cash management that is integrated into the instruments of corporate management is capable to evaluate the projects and decisions of management from the standpoint of liquidity. In the process, possible gaps and leeway will be shown, and the necessary strategic liquidity reserves in rough periods will be highlighted to ultimately ensure the investment ability of the company at any time.

The key elements involved in establishing and anchoring this form of cash management will be discussed briefly in the next four steps:

Step 1:
Create transparency as regards the liquidity situation and identify liquidity drivers

The basis of active cash management is to create transparency with regard to the liquidity situation. This is done by taking the liquidity situation based on the values of its key parameters (free cash flow, net debt and debt) and translating it into a simple and understandable color code using traffic lights: (GREEN) complete freedom of action for the board based on sufficient internal financing; (YELLOW) cash reserves are going to be depleted and no sustainable economic activity is possible and (RED) covenants can no longer be kept and the ability to act is severely restricted.

In order to ensure a steady overview of the liquidity situation, the traffic light color code is drawn up not only monthly for the actual values, but also simulated on the basis of strategic planning for the future. In this way, management's decisions can be held up against the current liquidity situation with a view to evaluating their effects. In the process, the risk stemming from the changed liquidity situation is compared with the earning opportunities and effects, thereby creating the basis for a dynamic cash management.

To improve liquidity management, the capital flow statement (CFS) is operationalized. To begin with, this means optimizing the structure of the CFS and the allocation of subcomponents to the CFS in accordance with fundamental management logic. The CFS has to be set up in such a way so that each management unit is confronted with the funds generation and usage which are both relevant and amenable to the unit. Second, benchmarkable key performance indicators for liquidity have to be defined for each core driver of the CFS. This enables a more targeted view of the progression over time as well as the categorization of past business situations. At the same time, select comparisons can be made across sectors and competitors.

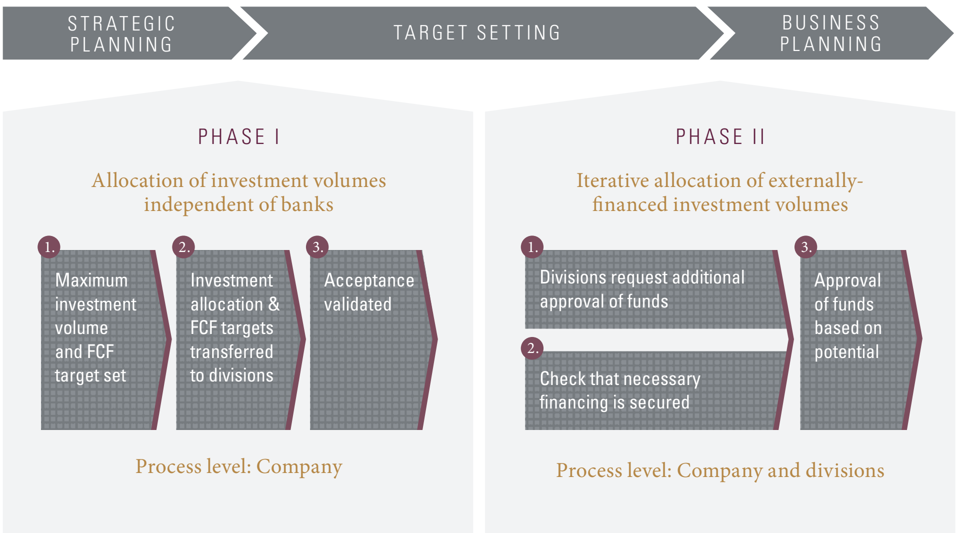
This ensures that not only the company's liquidity situation but also that of the operating units appear as transparent and manageable items before the eyes of cash management. Policy decisions made by management can now be tracked considerably more effectively.

Step 2:
Integrate liquidity management and cash-flow forecast into the planning process

By integrating cash management into the planning process the latter is expanded by two phases. The first phase regulates the allocation of investment volumes independent of banks and free cash flow stipulations in the goal-setting process at the company and business level.

PLANNING PROCESS

Manage liquidity targets and use of resources



The second phase describes the iterative allocation of externally-financed investment volumes at the company and business level in order to approve additional investment requests by taking into account the liquidity situation as well as possible new borrowing debt without exceeding the maximum limits stipulated by the traffic light color code.

A major component of integration is the cash flow forecast. Instead of retrieving just the net cash positions from the operating units, a uniform method comes into play at the company and unit levels. The method is based on individual balance sheet and profit and loss positions as well as on defined liquidity KPIs.

CASH DRIVERS

Disclose the impact on the cash flow statement

KEY PERFORMANCE INDICATORS FOR LIQUIDITY

1.	Gross margin	Gross result/turnover
2.	R&D in %	R&D costs/turnover
3.	Distribution costs in %	Distribution costs/turnover
4.	Administrative costs in %	Administrative costs/turnover
5.	Operating result in %	Operating result/turnover
6.	DIH	Inventory/turnover per day
7.	DSO	Receivables turnover per day
8.	DPO	Payables/turnover per day
9.	DWC	DIH + DSO + DPO
10.	Investment cycle	Investments/allowance for depreciation
...	...	...

CASH FLOW STATEMENT

The KPIs determine the plausibility and validation of the prepared forecasts. In order to roll out the forecasting to this extent in the company, a uniform instrument is indispensible. All of the positions contained therein, notably the KPIs, are reported based on actual. The key here is that the KPIs, via chargebacks, correctly reflect the actual procedural view. Examples for these accruals are: (a) provisions, that are built up in the quarter, are visible monthly in the result and not in the cash; (b) Inventory revaluations via COGS differ in the quarter between the booked and the actual and (c) payables towards purchasing are not, in the case of investments, visible in the cash flow.

Step 3:
Actively manage core operational processes with a high liquidity impact

Once liquidity management has been integrated into the planning process, the goal is to reach the set liquidity goals in operative business. The prerequisite for this is actively managing the core operational processes with a high liquidity impact. In order to achieve this as a company, a four-step approach is recommended: (a) Draw up a cash flow map of the company which highlights the cash use or creation per core operational process and organizational unit; (b) Identify, based on the cash flow map, the core operational processes with the highest cash use or highest cash creation per organizational unit; (c) Integrate components geared to liquidity in the decision-making and management of identified core processes and (d) Develop and implement specific measures to improve liquidity contribution for each identified core process.

In industry, cash flow maps identify purchasing as one of the key levers in the liquidity situation. In particular, this can include the strategic compilation of the supplier portfolio which often in its decision-making process does not adequately consider the expected impacts on liquidity which a supplier choice can have (e.g. financing necessity of the supplier or horizontal integration or acquisition of the supplier).

Step 4:
Apply liquidity management to make investment possible

To come back to the original problem whereby the list of profitable investment requests is long, and the investment resources against the backdrop of a company's long-term solvency are scarce, the goal here is to generate the necessary funds for the investment requests that are located within the strategic framework.

Liquidity management enables the effects of an individual investment to be shown in the liquidity situation. Precisely at the point where available and planned resources do not suffice to fulfill the investment plan, a decision can now be made on the effects of individual investment projects. In the process, possible earnings from the project are compared to the risk, such as that of higher indebtedness, an increase in internal financing or the lack of a strategic liquidity buffer. This applies above all for capital-intensive investments, which span several years and involve a lot of research and development like turbine projects for a new type of airplane.

The approach outlined below for establishing and anchoring cash management can generally be implemented in four to six months:

IMPLEMENTATION

Manage flow of cash and establish investment ability

1. CREATE TRANSPARENCY OF LIQUIDITY SITUATION
   - Develop a traffic light color code to evaluate the liquidity situation
   - Simulate the actual and planned liquidity situation

2. INTEGRATE LIQUIDITY MANAGEMENT INTO THE PLANNING PROCESS
   - Analyze existing planning processes
   - Close managing gaps in the planning process

Roughly 2-4 weeks

3. MANAGE KEY OPERATING PROCESSES WITH HIGH FLOW OF LIQUIDITY
   - Set up cash flow map and integrate it into management
   - Define measures to generate and use funds

4. APPLY LIQUIDITY MANAGEMENT TO MAKE INVESTMENT POSSIBLE
   - Combine investment controlling and liquidity management
   - Show effects of individual investments (earnings and risk)

Roughly 16-25 weeks

Stern Stewart & Co.

Stern Stewart & Co. is an independent strategy consulting boutique. Our consulting focus is on the key management issues. This includes strategy and corporate finance, as well as organization and performance management. We see the company's management as a strategic investor in the business and support them to increase the value of their company.

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