Embracing the unpredictable: a practical approach to managing treasury in volatile markets

Tackling the volatile marketplaces that make up the world's emerging economies can be a challenge for corporates looking to expand. For treasurers, a pragmatic approach will keep the ship steady but how does this translate into action?

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Despite the best efforts of corporate due diligence, there is no economy in the world that will reveal in advance its hand in quite the level of detail that companies would like. For trade in the emerging markets (EM), the concern that it generates may be amplified many times over. Whilst the ground can to an extent be prepared in advance, the everyday experience of operating in a volatile market will at times be challenging. If not properly managed, the attendant risks could prove costly.

For the treasurer, anticipating risk is par for the course. However, at a broader level, the difference between thriving in a volatile market and merely surviving depends not only on putting the right processes in place as early as possible but also on the quality of advice received.

The strategic intent to tap into low-cost growth markets will likely mean new trading partners on the procurement and sales sides. This potentially introduces several new risk elements – especially around the handling of new currencies. The role of treasury thus takes on a new importance in the EM space. The ability to quickly and precisely establish what this means from a funding, liquidity and cash management perspective could be the difference between success and very expensive failure.

Advisory role

It is no coincidence then that in the last few years the corporate landscape has witnessed the emergence of treasury as an advisory function. In their capacity as a trusted resource, Peter Cunningham, Consumer & Healthcare sector Sales Head for EMEA, Treasury and Trade Solutions, Citi, believes treasurers are increasingly called upon to bring their knowledge to the table. This is notably the case when a company is seriously looking to expand into new territories, and in particular the EMs. By bringing pragmatic, fact-based input, the treasurer enables the business "to make more informed decisions", he says.

The knowledge-based approach of the treasurer traverses a broad sweep of concerns, bringing aspects such as sovereign risk, counterparty risk, operational risk and regulatory risk into sharp relief, alongside the treasury fundamentals. It thus becomes the role of the treasurer-educator to raise awareness across the business of potential hazards. In practice, Cunningham suggests that it may be more effective to influence other business functions by tapping into the common KPIs and scorecards used by the CFO, using that office as the focal point of change.

Where the risks of emerging market trade are as clear as the benefits, it may even be prudent to consider an organisational or structural rethink to facilitate lines of communication and learning. However, as EM trade becomes established and business risks become tangible, it is apparent to Cunningham that in some cases the significance of this initial set-up phase has not been fully recognised. "They may have a well thought out strategy and business plan but that organisational element is critical," he warns.

Once a business has found its EM feet, the role of treasurer takes on renewed importance. The management of working capital, and in particular the cash conversion cycle, will be determined to a large extent by the nature of the commercial relationship the business has with its customers and suppliers. In many large businesses there will be silos of operation which can generate conflicting objectives – sales may not consider how the offer to clients of extended terms to secure a contract may negatively impact days sales outstanding and free cash flow. This, says Cunningham, is why CFO sponsorship and organisational alignment are so important. Whilst policy can be imposed across the board, EM trade often requires flexibility. With the right support, the treasury advisory role can help strike the right balance and offer solutions where necessary.

Keep it liquid

In the current phase of commodity market volatility lower prices can be beneficial to many corporates' material input costs. However, in counterpoint, Cunningham notes that plummeting prices may impair revenues of suppliers, many of whom are EM-based. As a result, if the ability to fund their own cash conversion cycle is weakened, the stability of the supply chain becomes a matter of extreme concern to all. In this case, working capital solutions such as supply chain finance and dynamic discounting can be used as a means of injecting essential supply chain liquidity.

As a liquidity solution this may also tackle one of the key differences found between developed and emerging territories when managing routes to market, notes Cunningham. A fast moving consumer goods (FMCG) business, for instance, will sell into large and generally liquid retailers, often multinationals, tending not to generate immediate working capital concerns. In the EM space, often the route is via smaller retailers, wholesalers or distributors. These will almost certainly be weaker-rated than their major global or multinational counterparts. However, he advises, the focus is now on implementing sales-channel finance structures which enable channel partners to defer payment terms, facilitating increased sales for the FMCG company as their partner is able to fund their own working capital cycle. "This can be a solution where a corporate sees latent demand for its products in an emerging market but does not want those smaller distributors to be a choke point in realising that market share or sales growth."

Currency matters

On the other side of the coin, from a payments perspective, as companies build commercial relationships in EM territories, one of the key judgements will be around mitigation of FX volatility risk, says Emanuela Saccarola, Global Product Manager Cross-Currency Payments Treasury and Trade Solutions, Citi. In Latin America, for example, where certain currencies have devalued significantly over the past 18 months, suppliers have been seeking payment in local currency. Whereas some suppliers have tried to outsource the FX risk to the buyer, where invoicing in local currency has been agreed, she notes a trend towards the negotiation of better terms or lower unit costs for the buyer as they take on FX volatility – a risk, she adds, which they can then mitigate by hedging or making payments through a bank-provided cross-currency solution.

Regardless of the direction of cash flow, for many businesses the EM regulatory environment means trapped liquidity remains a threat, despite the best efforts of core countries such as China to liberalise. The means deployed to handle this issue will depend on corporate need, says Saccarola. Having a manufacturing and sales function in-country can easily create a natural currency hedge of receivables and payables, if desired. But if a company needs to invest significantly in an EM operation before it sees a major return, it will have a funding choice to make. This, she notes, will be contingent upon the desire or ability for cash to be sourced from a central operation, or risk keeping it in-country. Especially at the beginning, sourcing cash centrally through a cross-currency payments solution may be the smarter approach leading to increased visibility and control, cash management efficiencies, and smaller risks. A global bank like Citi can power the EM investment stage, provide ongoing advice, and seamlessly support a company's transition to a local solution if and when required.

Of course, the need is to optimise the funding of local subsidiaries wherever they are. Forecasting the requirement for cash and using intercompany funding on an 'as needed' basis should ensure excess capital is not injected locally. But when cash balances are built up, it would be provident of treasury to explore options such as periodic dividend repatriation or royalty payments.

A profitable partnership

Even where cash is trapped locally, Cunningham argues the need to observe the treasury fundamentals of security, liquidity and yield when managing short-term excess cash. It is here, he believes, that partnership with a global banking group such as Citi can deliver tangible benefits. "Often where a multinational has operations across highly regulated markets, we can work to compensate them on a multi-country basis," he explains. "Cash may be trapped but we can take a holistic view of deposits and provide yield-uptick on balances across different markets."

Such a view also yields results where none might be expected. Where counterparty trading-partner concerns require the use of financial risk mitigation tools such as Letters of Credit (LCs), or where perhaps local rules require the issuance of guarantees, it may be possible to cash collateralise those risk products. From a Basel III perspective, a bank issuing an LC or guarantee as a straightforward product would price each based in part on its balance-sheet treatment. Cash collateralisation will afford the bank balance sheet relief under Basel III, lowering overheads. By generating an implied yield on the cost differential – which may be more attractive than a short-term investment of similar tenor – it becomes "an effective way of recycling cash," notes Cunningham.

The value of connections

In EM trade, the benefits of a well-connected banking partner both on and offshore are without question. A bank that offers multiple solutions globally that also has fully integrated streams – whether those flows are initiated centrally or locally by the client – is, says Saccarola, "advantageous". Core activities such as in-country account opening, cross-currency payments and direct access to local clearing are today perhaps a given. However in providing global visibility and control, a bank must also be well-positioned with people on the ground who are not only able to determine and advise on the most appropriate solutions for the client, especially around regulatory and reporting aspects, but who also understand the local language and culture. "A proprietary network and access in all key EMs is an intangible value to clients," says Saccarola.

There is perhaps one further desirable facility that few banks can claim with any legitimacy and for Cunningham this is a clear differentiator at Citi. By combining its strong local presence with its weight as a global systemically important bank, the bank has access to the world's regulators and central banks. "We are often the voice of our clients when talking to these bodies about policy-setting and advisory matters," he explains. "When trading in EM territories, having a partner such as Citi allows direct communication with the authorities." In fact, in an unpredictable world, staying connected may well be the strategy that makes the difference. ■