The new corporate priorities

The economic crisis has dramatically changed the business environment but opportunities still exist for treasurers

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Beginning as a financial services problem, the global economic downturn quickly spread to the corporate world, prompting a recalibration of corporate treasury priorities. The economic and business environment for corporates in Asia-Pacific will remain challenging in the near term, but for the informed corporate treasurer opportunities exist.

As corporates reposition their priorities towards refinancing risks, rethinking capital deployment, re-equitising the balance sheet, engaging in M&A opportunities and adjusting hedging strategies, the corporate treasurer will move front and centre. Primarily, with a strategy based around working capital and supply chain management, the latest evolution of the corporate treasurer is as a growth enabler and catalyst for investment and recovery.

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Cash flow under pressure

Corporate earnings in Asia-Pacific will continue to feel the impact of economic turmoil. Citi estimates that corporate earnings have declined 25% since the onset of the recession and could decline by a further 25% before the recession plateaus.

A 50% drop in corporate earnings represents a huge decline and comes with defined implications. Firstly, liquidity dries up. Secondly, capital preservation becomes an imperative goal for growth and recovery in Asia-Pacific. This is proving challenging for corporates.

In a recent study conducted by Citi's Financial Strategy Group of 1,000 large global corporates, we considered a scenario where operating cash flow drop to a 10-year low. The results were sobering. Capital preservation and the role of liquidity must be front of mind for any corporate treasurer.

The good news is the study showed that approximately 43% of the corporates surveyed will not experience any cash flow shortfall in the short term. 36% will not experience cash flow problems if they cut all share buybacks, halt all dividends and drastically reduce capex. The remaining 21%, even if they have started employing these rather draconian measures to ensure cash preservation, will effectively run out cash.

This is a frightening scenario, but there are options for corporates to ensure a healthy cash flow. Refinancing may be tough, but a new set of priorities for corporates in Asia-Pacific is redefining how capital preservation can be assured with the help of corporate treasurers.

New priorities

Refinancing is a conspicuous priority for corporates. This year over $500 billion of corporate bonds and over $1 trillion in drawn corporate bank loan commitments are up for refinancing. Pre-crisis most of this came from banks that are now looking to reduce assets globally, presenting a large refinancing vacuum here in Asia-Pacific.

With the decline of traditional financing, sovereign refinancing may play a role in the region. However, corporates still need to be mindful of refinancing risks.

Liability management solutions provide cash-strapped corporates access to public market alternatives, including fixed-price and exchange offers, where new notes can be exchanged for maturing debt. Private market transactions, including open market debt repurchases, targeted debt buybacks or debt for equity exchanges, are also lowering refinancing risk. M&A transactions also present an opportunity for cash-rich corporates.

The higher cost of capital, resulting in dividend, share buyback and capex cutbacks means a rethinking of capital management strategies to preserve capital and ensure liquidity. For example, as corporates see a 5% to 6% share price drop on dividend cuts, certain corporate treasurers have used cuts to strengthen the balance sheet and increase financial flexibility. Similarly, share buybacks, which dropped by approximately $370 billion in 2008 for S&P 1500 non-financial stocks, were offset by structured repurchase solutions. All and all, we anticipate a rethinking of capital deployment, where dividends, buyback and capex expansion are muted to remain a trend.

The loss earnings and ratings downgrades have also led corporates in Asia Pacific to re-equitise their balance sheets. However, with lower earnings on the horizon, the optimal capital structure requires equity, as debt market opportunities are scarce.

The New Corporate Priorities

- Refinancing risk and liability management
- Rethinking capital deployment
- Re-equitising the balance sheet
- Adjusting hedging strategies
- Taking advantage of M&A opportunities
- Renewed focus on working capital

With pressure on corporate ratings expected to continue into the latter part of 2009 corporates require enhanced options to re-equitise balance sheets. Public equity issuance has emerged as one alternative, particularly in the US, but going forward corporates across all sectors will look to corporate treasurers to rebuild balance sheets in diverse ways, using structural innovations.

From where we stand, corporates will need to look at structures including convertible preferred or common/preferred stocks to re-equitise balance sheets. In Asia-Pacific, we see a proactive trend towards rights issues, given the fact that large discounts of these offerings has served as a powerful incentive for shareholders to provide additional capital and shore up cash flow.

Risk management strategies have been severely tested. The spike in volatility, dollar depreciation reversal, strengthening of emerging market currencies and fluctuating oil prices, forced many corporates to recalibrate hedging strategies.

As is to be expected, some overhedged corporates have responded by pulling back. In our experience, hedging in challenging markets and volatile economies should not be cut, irrespective of the complexity. Investors will take greater notice of diligent hedging strategies in volatile markets.

Citi analysis of the 2,000 largest corporates internationally found that investors demonstrated a strong preference for stable earnings. The same research found that investors designate an 11% relative premium to firms with lower volatility over the under hedged and more volatile firms. Although hedging prices have increased by an average of 3% since the onset of the crisis, the reward for corporations, especially in finding confident investors to fill balance sheet gaps, is priceless.

The capital preservation imperative will also be fuelled by M&A – an area which we see huge opportunities for growth in Asia-Pacific. With rising corporate defaults and restructurings and financial distress, distress M&A is poised to grow and provide a major opportunity for strong and cash rich corporates to grow.

Treasurers enable change

The aforementioned corporate priorities are providing opportunities to firms in Asia-Pacific to recover quicker and expand faster. However, as all these priorities centre on continual cash flow, they ultimately rely on capital preservation.

At the centre of capital preservation is a renewed focus on working capital. Across the region, corporations are turning to Citi to provide solutions to reduce working capital and streamline cash management processes that are closely aligned to this priority.

It is here where the corporate treasurer can truly act as enabler of change. Citi research on S&P 500 firms found that investors are quick to reward corporations with visible working capital efficiencies, in other words more focused on financing priorities. By taking a proactive approach to reducing working capital and the cash conversion cycle, the research shows average earnings per share accretion of 2% to 3% when corporates improve working management by approximately 30%.

An equally compelling value proposition for corporate treasurers within the new finance priority paradigm is supply chain efficiency. Globally and regionally, lines to credit have become scarce, resulting in payment delays and ultimately exposing chinks in the cash flow armour of many corporates.

To provide adequate cash flow we recommend several supply chain strategies. Firstly, corporate treasurers are well-positioned to execute supplier finance programmes, or reverse factorings, wherein suppliers can take advantage of buyer creditworthiness. Corporate treasurers can also present value through tools including distribution finance that helps support sales growth without increasing days outstanding on receivables.

Supply chain programmes also increase investor attractiveness. The S&P/Citi PMI Global Index suggests that highly liquidity corporates, backed by reduced working capital and solid supply chain efficiencies, provide over 12% in excess returns compared to low liquidity firms. Again, this makes a compelling case for the power of corporate treasurers to influence investors and creates an upside that no CFO could ignore.

The economic crisis caught many corporates off guard, but is ushering in a new age of treasury priorities. These priorities will make corporates stronger and more resilient, but also ensure the cash flow problems of the past can hopefully be avoided in the future.

The corporate treasurer sits as the agent of change when cash flow and capital preservation is concerned, as the lynchpin behind the new corporate priorities. By partnering with an established provider of not only working capital and supply chain solutions but of corporate and investment banking, these new priorities become more attainable. ■