A Tale of Two Worlds

The shifting influences of emerging and developed markets are transforming treasury priorities for 2011

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The gross domestic product (GDP) growth rate of emerging nations has steadily outpaced that of developed industrialized countries in recent years. Citi economists predict that the shift of the economic center of gravity from West to East is set to continue for the foreseeable future. Emerging markets accounted for only 38% of world GDP in 1950, 52% in 2010 and are expected to account for 79% in 2050. In the same time, there will be more modest growth in today’s developed economies.

As companies expand their businesses in emerging markets, treasurers face new liquidity optimization and risk minimization challenges. According to a research conducted through the Citi Treasury Diagnostics™ global benchmarking survey, these trends are shaping top treasury management priorities for 2011 among major corporations.

Managing cash, risks and growth

Overall, operating margins among the corporate sector are back to pre-crisis highs and cash balances are surging. Flush with cash, major corporations are seeking business expansion opportunities.

Undoubtedly, companies are looking beyond low-growth markets such as the U.S., Western Europe and Japan and investing in fast-growing emerging economies, opening up a whole new world of risk and management challenges. A growing number of emerging markets-based companies – sometimes dubbed “emerging market champions” – are also rapidly extending their footprint across growth markets around the globe. For example, cross-border M&A transactions last year represented 40% of global M&A volumes, the second-highest share in recorded history, and revealed a notable pattern of Asian firms buying into Latin America, the Middle East and Africa. Regardless of where companies are based, there are common themes in their liquidity and risk management goals.

I. Maximizing cash efficiency

One of the biggest challenges facing businesses is gaining global visibility into their enterprise-wide liquidity. For companies engaging in mergers and acquisitions, this is complicated by the need to quickly centralize and integrate the treasury and banking activities of the acquired entities. Nevertheless, a timely, consolidated picture is fundamental to liquidity planning and to supporting working capital needs.

A clear and comprehensive perspective on positions across currencies, instruments, tenors and counterparties is critical to maximizing the value of internal cash, optimizing liquidity and monitoring whether far-flung business units are in compliance with risk and performance policies.

In their quest to standardize processes across operating units and coordinate practices globally, treasurers are seeking to implement single-instance treasury workstations or ERP treasury modules across their functional organizations. However, despite the huge operational cost-savings and risk-control benefits of integrated, consistent processes, treasurers often have difficulty justifying technology investments.

Treasurers are looking for opportunities within their companies to piggyback on enterprise-wide financial transformation initiatives. They are also easing the path to centralization by staying current on best-in-class technologies and by aligning with banking partners that are employing the latest advances.

In choosing such a banking partner, it pays to work with one that has the breadth and depth of experience and on-the-ground familiarity with local regulatory and other constraints. Given the need for integrated, consistent treasury processes, the banking partner should also have a track record of deploying solutions using common technology in emerging and developed markets alike.

II. Establishing robust risk management processes

The financial crisis was a stark reminder that firms need to plan for extreme stress events. Thus, risk management continues to be a top priority among treasurers, in general. Volatilities in FX and interest rates create a unique set of challenges; so does an ever-expanding list of counterparties. Companies with extended cross-border business and trade activities must monitor risks and exposures related to a wide range of counterparties that includes their financial institutions as well as key buyers, suppliers, systems and services providers, and joint venture and business partners.

Risk management is tied to putting in place the proper systems and processes to aggregate, monitor and mitigate liquidity, interest rate and FX risks on a firm-wide basis. Mitigating various risk scenarios depends on combining cross-business visibility with appropriate mitigation strategies, such as relevant FX hedging techniques, liquidity structures and financial instruments.

Partnering with banks that have on-the-ground experience is important. Cross will occur and companies should seek banking partners that can continue to deliver assistance with risk assessment and mitigation at times of greatest need.

III. Managing organic and inorganic growth challenges

An enormous and increasing share of global economic activity takes place today wholly within the economies of nations that a few decades ago barely registered in the world economy.

Many companies see the initially small-scale businesses they built in these emerging markets now expanding much faster. At the same time, companies with financial flexibility, whether in developing or emerging markets, are increasing their stakes in promising growth markets through M&A.

In all cases, the challenges related to shifts in currency exposures and to liquidity and risk profiles multiply. More than ever, centralized visibility and uniform processes and policies are key to managing potential economic or financial shocks.

IV. Releasing trapped cash

Businesses that are expanding operations into markets with restrictive capital and regulatory controls, such as China, India and Brazil, face additional liquidity challenges related to cash trapped in those markets. For example, in China, companies can lose out on significant VAT refunds, depending on where they set up their treasury management centers and how they structure their trading entities.

Strengthening oversight of subsidiary funding and repatriation and effective cash forecasting systems helps avert costly missteps such as pumping liquidity into a country where it will be trapped. Additional steps include setting up in-house banks and large foreign exchange reserves – such as intercompany netting, re-invoicing centers and financially efficient trading company models.

Again, relationship banks that are conversant in local regulations and liquidity management structures are a valuable resource for identifying opportunities to release trapped cash.

V. Navigating through changes in regulations and laws

Across developed and emerging markets alike, regulatory reforms and changes in tax laws and accounting rules can have a profound impact on treasury practices and financial costs.

In general, developed countries are trending towards tighter regulation, as evidenced by Dodd-Frank in the U.S. On the other hand, in many emerging economies the trend is toward gradual greater deregulation. Examples include the lifting of capital account restrictions in Malaysia and China’s movement toward deregulating the renminbi.

On the multilateral front, new capital and liquidity requirements for banks outlined in the Basel III amendments, as they are adopted, could drive up the cost of and drive down accessibility to bank funding. Banks that lack scale will likely pass on increased costs to clients or withdraw from some markets and business lines where they operate. While companies should focus on reducing dependence on external funding, it will be important to identify banking partners that have both scale and long-term strategic interest to serve them.

Across the globe, the lack of consistency in banking regulations and capital requirements for banks requires companies to continue to assess their counterparty risks. The European sovereign debt crisis, focused attention on the linkages between weak national fiscal management and local banks’ balance sheets. However, even companies with strong fiscal positions and strong risk management. Increasingly, the treasury challenges and opportunities are linked to straddling markets in various stages of maturity.

The last financial crisis prompted treasurers to appreciate the importance of good cash management practices.

The control and information flow that comes from robust treasury operations practices and banking structures is vital to identifying, managing and mitigating risks, whether liquidity, interest rate, foreign exchange or others. Fortunately, banking partners with operations and experience across developed and emerging markets, and with technology-based solutions that can interconnect them, can help companies navigate through the complexities of managing cash and mitigating risks across disparate and far-flung locations.