

A red and white hawk is depicted in flight, perched on a metal grate. The hawk's wings are spread wide, showing detailed feather patterns in red and white. Its head is turned to the right, and its talons are visible. The background is a light-colored metal grate with a grid of small holes. A large, semi-transparent white circle with a red border is centered over the hawk's body, containing the text "CATCH-10".

**CATCH-10**

**KEVIN DUNCAN**

## **CATCH-10 CASH IS CRUCIAL: THE DEMISE OF THE DEBT DUMMIES.**

Pre-crash wisdom had it that most businesses could borrow in one form or another, and on realistic terms – this is no longer necessarily the case. Being granted credit cannot be taken as a given. The shock and aftershock of 2008 continues – some elements of money matters may never be the same again.

Companies need to learn how to cope with cash and deal with it responsibly. Figures can be horribly misleading – businesses must understand what data they are looking at, and exactly what they mean. There are ways to generate extra cash from businesses but they need to be approached with caution. People and businesses respond to basic economic incentives – businesses must learn to understand these fundamentals and not claim to be surprised by predictable events. It is time to learn fiscal lessons properly – and not to forget them by the time the next major crisis occurs.

### **The accepted pre-crash wisdom**

*“So what good is money? In ancient times, money made trading easier...In modern times money has even more benefits, as it*

*allows us to specialize, borrow, and save.”*

Dan Ariely, in Predictably Irrational

Money is a strange thing. It was invented by humans as a method by which goods, and eventually services, could be exchanged and paid for. It attributed a value to an item or a thing done. Societies all over the world developed their own systems – some of them quite extraordinary. The Kula exchange system in the Milne Bay province of Papua New Guinea relies on red shell-disc necklaces heading clockwise around their island chain and white shell armbands heading anti-clockwise. North Pacific Coast Indians created the Potlatch system in which the more possessions a person could destroy, the more status they would attain. Throwing all your wealth into the sea made you simultaneously the poorest and the richest person in the community.

But not everybody had items of equal value to ensure a satisfactory trade. Precious metals became coin that was given specific value. And eventually paper money took on the value previously attributed to gold and silver. Then even the paper disappeared. Invisible money is now easily wired around the world in seconds by anybody. Traders of stocks and shares measure such speeds in milliseconds. It is not uncommon for them to discuss unacceptable latency levels between systems that transfer money – complaining that one is fractions of a second slower than the other. The more we

move from money as cash, the more strangely we behave, and the same is true of businesses.

Many businesses are consistently loss making. Some are leveraged to the tune of millions, or even billions. Governments are also guilty. There is now technically not enough money in the world to go round. Every country, business, and individual wants more than it can afford. When describing the period 2000 to 2009, Tim Footman, in his book *The Noughties*, felt it was strangely appropriate that people were paying for something that didn't exist (brand prestige) with money that didn't really exist either. Years of easy credit have severed any tangible connection between spending and earning, and fuelled a world in which consumers crave brand cachet for ludicrous prices and yet never increase their happiness or satisfaction.

In a sane world, it would be possible to list all the borrowers and all the lenders, and balance the books at zero. Now that debt is sold on from one financial institution to another, this is no longer possible, so we are now in the extraordinary position that, in total, we have borrowed more money than actually exists. Before the crash of 2008, all of this was regarded as fairly normal. Not any more.

## **Autumn 2008: shock and aftershock**

*“The heroes of finance are like beads on a string – when one slips off, all the rest follow.”*

Henrik Ibsen

The whole pack of cards came down in the autumn of 2008, leading to what Thomas Friedman calls *The Great Recession*. The world watched itself implode as bank after bank hit the wall, and analysts and economists tried to work out how it was happening. Observers began to understand the link between the sub-prime market and the real one. People who can't pay back what they have borrowed do not represent a real market. Whole countries were affected. The Icelandic economy collapsed, taking with it billions in investments, including those by highly conservative overseas customers such as town councils and healthcare trusts. This cavalier approach to 'money that isn't' (MTI) hit everybody and everything. The clever money men privatized the gains and socialized the loss. The people paid.

In many cases the amount of debt that businesses were prepared to run up was horribly exposed for the egregiously poor management that it truly was. And yet the scale of these borrowings pales into insignificance when looking at those of governments. When Gordon Brown became chancellor of the UK in 1997 he inherited a deficit (the gap between

annual tax revenues and spending) of £6 billion. When he called an election on April 6th 2010, this had risen to £167 billion. Fifteen years ago the UK was the fourth most competitively taxed economy in the world – it is now the 84th. To give a measure about how blasé politicians have become about these astronomical figures, the UK chancellor in his 2010 budget spent as long talking about the £100m devoted to road repairs as about borrowing £167 billion in 2010, a figure that equates to more than every single Labour government in history has borrowed in total.

The UK national debt will continue to rise: £776bn in 2010 is due to double to £1.4 trillion by 2015. Merely servicing that debt would cost about £63bn a year under current conditions – 150% of today's entire defence budget. These figures are so large that one could be forgiven for not truly understanding them. Businesses suffer from the same snowblindness, and one can reasonably conclude that responsibility for much of it can be attributed to gung ho government spending. Governments are of course made up of individuals, most of them as fallible as the person in the street. In 2009, some 140,000 senior civil servants and quango chiefs in the UK racked up nearly £1 billion in expenses using government-issued credit cards. It would appear that the lawmakers are as cavalier with credit as the populace they so often chide. And if governments can make a mess of their mathematics, then why can't businesses?

In *Ill Fares the Land: A Treatise on Our Present Discontents*, Tony Judt argues that unregulated capitalism eventually destroys itself and turns to the state for its rescue. Modern politics lacks a sense of collective purpose, and by the 1980s social democracy seemed to have reached its natural limits. These observations could equally be leveled at modern businesses. In April 2010 Goldman Sachs was accused by The United States government of helping cause the financial crisis that led to millions of job losses, business failures and home repossessions. They had, allegedly, designed highly complex mortgage products based on the flawed sub-prime market, and then bet against them to make a \$5 billion gain as they watched the market they had invented collapse. One thing is for sure: it is time for businesses to understand the value of cash better.

## **Coping with cash**

*“Round numbers are always false.”*

Samuel Johnson

Businesses need to learn, or re-learn, how to deal with cash. Margaret Thatcher likened running the economy of a country to managing the household budget. It really shouldn't be more complicated than that, but for many businesses it has become so. Apart from blatant greed and self-deception, one major

reason is the inability of businesses to understand the nature of the figures that they are staring at. Companies should treat information with great suspicion until they know the real story. Blastland & Dilnot analyse this phenomenon in *The Tiger That Isn't*. Seeing a pattern of stripes in the leaves, we would run from what looks like a tiger. There are illusions in numbers too, often just as intimidating. Understanding what the numbers really show exposes the tiger that isn't. Life comes in numbers: public spending, health risks, who is rich and poor, the best and worst schools, and of course, business information. Major pitfalls for businesses are:

#### 1. Counting

Counting things is very difficult, and the results are often wrong.

#### 2. Chance

Frequently things are truly random, but businesses insist on looking for patterns.

#### 3. Up and down

Numbers go one way or the other, regardless of what businesses do.

#### 4. Averages

Disguise huge variation and squeeze everything into a mass.

#### 5. Targets

What they do not measure is as important as what they do.

#### 6. Risk

All that matters is what it means to the company.

#### 7. Sampling

If the sample is flawed, then so is the conclusion.

#### 8. Data

They are often plain wrong, so companies must be careful when drawing conclusions.

#### 9. Shock figures

These are more likely to be wrong or misinterpreted than shocking.

#### 10. Comparison

Mind the gap – they might not be comparable.

#### 11. Correlation

This is not the same as causation – there may be no link between the two numbers.

Businesses must be very careful if they start to believe information that is in fact wrong, because this could lead to a nasty chain of decisions, each of them more flawed than

the previous one. All companies have to deal with numbers, but if they don't understand them then at the very least they should make sure that they do not misrepresent them. When it comes to cash, the moral is simple: you've either got it or you haven't.

### **Give me some credit**

*“Credit is a system whereby a person who cannot pay gets another person who cannot pay to guarantee that he can pay.”*

Charles Dickens

In 2009, a proportion of the 30 million credit card holders in the UK received something of a shock: their providers wrote to them saying that they were reducing their credit limit. Other newcomers found they were refused credit altogether. Building societies looked a lot harder at their lending book and some mortgage applications were turned down. Banks suddenly got a lot tougher with loan applications, and many small businesses found they couldn't get one. This becomes the new reality for a while, but how long before everything reverts to its previous state? By May 2010, two banks in the UK reintroduced the 0% credit card, vying for new customers by offering those terms for up to 16 months. As Bob Hope famously said, “A bank is a place that will lend you money if you can prove that you don't need it.”

The Payments Council predicts that by 2014 over half of the transactions in the UK will be made electronically, 95% of them for amounts of less than £15. Digital money was effectively invented by a man with the supremely ironic name of Dee Hock. In 1966 he was a junior employee in an American bank who wanted to set money free. He saw that in the coming electronic age money could migrate from metal and paper to become “a range of electrons and photons that moved at the speed of light and bounce around the universe.” He invented the Visa card, electing not to name it after himself. By 2009, debt on credit cards in the UK stood at £63.5 billion.

It seems that financial institutions are happy to shuffle money around so long as they are making something on it. In a peculiar sense, it doesn't matter in what direction the money is heading, so long as the margin can be made. But after a slump like 2008, serious concerns emerged about whether any of it would come back, and in many cases, it never did. So the new reality means some may not receive any credit at all, and those with cash reserves will only be making a few percent on their stash. Highly leveraged deals are out. Long-term plans are out. Modest plans are in, and short term is preferred. The new loans come with high interest rates and tough covenants. Lenders are taking much longer to decide as credit committees cover their backs. Due diligence is more thorough than ever with even seemingly robust deals often

aborted at the last moment.

In this environment, with credit harder and harder to come by, companies that have managed the books well and generated good cash reserves will have an enormous advantage. As Benjamin Franklin said, “Creditors have better memories than debtors.” It goes without saying that it pays businesses to manage cash more tightly than ever, although clearly hindsight is a wonderful thing. Executives need to learn from cash difficulties, and exercise more humility and discretion next time round. If the cash position is negative, there are still areas that can be examined to alleviate the problem.

## **Generating cash**

*“An economist is an expert who will know tomorrow why the things he predicted yesterday didn’t happen today.”*

Laurence J. Peter

Getting back on an even keel after haemorrhaging cash is no easy matter, but there are a number of areas that businesses should examine if they haven’t already.

### 1. Debtor book

Every corner needs to be examined, and every possible

measure taken. Tough credit control is crucial, and more creative initiatives such as early payment discounts can be investigated.

### 2. Stock

Stock levels must be analysed to ensure that they are suitable. Some stock may be sold to release cash. Suppliers may agree to new terms based more on a just-in-time system, or in extreme cases, sale or return.

### 3. Creditors

Deals may be done on payment extensions. Even if they incur an interest payment, this can be compared with finance from elsewhere and may prove better value.

### 4. Assets

Many assets can be sold and leased back. This might be fixtures, fittings, plant, equipment, motor vehicles, and more.

### 5. Staff

Cash creation can come from flexible approaches to employment – freezing pension payments for a short period, for example.

### 6. Factoring

Assuming the small print is not too punitive, factoring or invoice discounting can ensure faster, more secure cashflow

in the short to medium term.

None of these approaches is ideal, but imperfect solutions are required in extreme times. In the purest sense, cash cannot be generated from nothing, and if a business has milked every option, including all of those here, then the situation may be beyond redemption. Economics is a ruthless discipline, and succumbs to the basic laws of mathematics. It cares not who or what falls by the way.

## **The logic of life**

*“If you laid all the economists end to end, they still wouldn’t reach a conclusion.”*

George Bernard Shaw

In *The Logic Of Life* Tim Harford asks: if humans are so clever, why do they smoke and gamble, or take drugs and fall in love? Is this really rational behaviour? And how come your idiot boss is so overpaid? In fact, Harford believes, the behaviour of even the unlikeliest of individuals complies with economic logic, taking into account future costs and benefits, even though we don’t quite realise it. Are businesses subject to the same influences?

Rational choice theory affects most things, and can sit happily

even with the most passionate emotions. Most things can be explained: overpaid (apparently useless) bosses, proximity to neighbours, racism, and divorce decisions, among others. Rational people respond to incentives: when it becomes more costly to do something, they will tend to do less. In weighing up their choices, they will bear in mind the constraints on them, and their total budget. And they will consider the future consequences of present choices. This applies just as much to prostitutes and criminals as it does to anyone else.

The idea that everybody responds to incentives and consequences may have wider application than businesses think. Game theory (originally posited by Von Neumann) uses rational decision making to analyse every decision in a way that should lead to calmer, more beneficial decisions, but it is hard for the layperson to implement. Most just follow the ‘wisdom of crowds’ principle, but don’t adjust their guesses. In truth, human interactions are so shot through with ambiguity that they are better viewed as focal points to find consensus (according to Schelling). Where and when would two people who can’t talk meet each other in New York tomorrow? Everyone agrees it should be under the clock at Grand Central Terminal at noon.

Tournament theory means that workers sabotage one another to win the top job: the bigger the boss’s pay, and the less they have to do to earn it, the bigger the motivation for everyone

else to aim for it. 'Economics' is mental civil war: should I smoke or not? All humans wrestle with such conflict. For every year that a woman delays having her first child, her lifetime earnings rise by 10%. The 'death of distance' doesn't make the world flatter, it makes it spikier, with evermore activity taking place in cities – centres of innovation and idea exchange. The rate of technological progress is proportional to the world's population – currently we should have a world-beating idea every two months (1 per billion people per year).

Every human being, no matter how diverse, complies with economic logic, and the same should be true of businesses. It's a messy world, but it is possible to make some sense of it. Good information, calm reflection and an inquisitive approach all help. Not everything is what it seems at first and so careful exploration may well be required. Businesses are not always good at this. Their track record is more like that of a dog that doesn't know where its next meal is coming from. Why does commerce never learn from its history of boom and bust?

## **Do we ever learn? Boom, bust and banality**

*“Economic forecasters were invented to make weather forecasters look good.”*

Irwin Seltzer

It is often said that economists are bulletproof because no one ever checks whether what they predicted did indeed come to pass, and if anyone does, they simply invoke a change of circumstances to explain away the discrepancy. That may be true, but businesses must wean themselves off the need for predictions and high order proclamations to decide their fate. Simple principles can be applied to ensure the safety of a business: don't overextend, keep sufficient cash reserves, and don't over borrow. Simple or simplistic? As Einstein said, everything should be made as simple as possible but no simpler.

Is it too much to ask that businesses apply the lessons learned from an event so huge and devastating as The Great Recession? How big a shock does commerce need, exactly, to pay attention? This is the recurring theme of business over the decades. Is business, as an entity, capable of breaking the boom and bust cycle that it has so whole-heartedly embraced? It may be that greed will never allow a balanced view, but it would take a stark world view to assume this either to be true or sufficiently pervasive.

The successful modern business will be capable of demonstrating a number of crucial traits. Humility borne of shocking recent experiences should be the bedrock. Taking nothing for granted is the new norm. Unexpected events, black swans, should be assumed to be a regular feature and thus not intrinsically surprising. Hubris has to go, and be replaced with a less gung ho approach to expansion and extension. The presence of prudent cash reserves plays a crucial role in this, as an indicator of competence and ability to weather tricky times. Without it, businesses will either be defunct, or perpetually in thrall to unwanted external factors.

### **Why business will never be the same**

- Pre-crash wisdom had it that most businesses could borrow in one form or another, and on realistic terms – this is no longer necessarily the case because being granted credit cannot be taken as a given
- The shock and aftershock of 2008 continues – some elements of money matters may never be the same again
- Companies need to learn how to cope with cash and deal with it responsibly
- Figures can be horribly misleading – businesses must understand what data they are looking at, and exactly what

they mean

- There are ways to generate extra cash from businesses but they need to be approached with caution
- People and businesses respond to basic economic incentives – businesses must learn to understand these fundamentals and not claim to be surprised by predictable events
- It is time to learn fiscal lessons properly – and not to forget them by the time the next major crisis occurs

### **CASE STUDY – HONDA (JAPAN)**

In 2010, the Honda Motor Company increased its cash reserves by 62%, or 429 billion Yen. Despite year on year revenues falling 14.3% from 10 to 8.5 trillion Yen, the company grew net income 95% from 137bn to 268bn Yen. So in a falling market it prudently kept sensible cash reserves, alongside a Debt to Total Capital ratio of 0.48%, which changed little from the previous year's 0%.

### **WHAT EXACTLY HAPPENED?**

Honda develops, manufactures and distributes motorcycles, automobiles, power products, and provides financing for their sale. The company operates chiefly in the motorcycle, automobile, financial services, and power product businesses.

Their principal manufacturing facilities are in Japan, the USA, Canada, Mexico, the UK, Italy, China, India, Thailand, Vietnam, Argentina, Brazil and Turkey.

The consolidated financial results for the fiscal year ended March 31 2010 reveal a lot about how a large company can manage its cash, even in the tightest of times. Year on year revenues fell 14.3% from 10 to 8.5 trillion Yen, but the company managed to grow net income 95% from 137bn to 268bn Yen. In a falling market it prudently kept sensible cash reserves, alongside a Debt to Total Capital ratio of 0.48% - very close to the previous year's 0%.

Its balance sheet showed total assets decrease from \$2,040 million to \$124,990 million), mainly due to decreased inventories. Total liabilities decreased by \$5,545 million, to \$77,092 million, mainly due to decreased current liabilities, despite an increase in long-term liabilities. Total equity increased by \$3,505 million, to \$47,898 million. Meanwhile, the company earned 1.54 trillion Yen from its operations for a cash flow margin of 18%. It also used 595 billion Yen for investing activities and paid 559 billion in financing cash flows.

Consolidated cash and equivalents increased by \$4,617 million to \$12,037 million for various reasons including cash flows from operating, investing, and financing activities. Net

cash provided by operating activities amounted to \$16,597 million, mainly attributable to net income, depreciation and a decrease in inventories. Cash inflows from operating activities increased by \$12,474 million compared with the year before.

Net cash used in investing activities amounted to \$6,403 million, due mainly to capital expenditures, the acquisitions of finance subsidiaries-receivables, and the purchase of operating lease assets, which exceeded collections of finance subsidiaries-receivables and the sales of operating lease assets. Cash outflows from investing activities decreased by \$5,778 million compared with the previous year. Net cash used in financing activities was \$6,011 million, due principally to a decrease in short-term debt, repayments of long-term debt and dividends paid, which exceeded proceeds from long-term debt. Cash outflows from financing activities increased by \$11,717 million compared with the previous fiscal year.

If that all sounds like a whole lot of numbers, it is. That's what cash is all about. What it amounts to for the layperson is that, even in the biggest financial crash the world has ever seen, it is possible to be sensible with cash. While many others were panicking, Honda wisely increased its cash reserves by 62%.

Should it ever wish to borrow however, credit ratings for the company (for long-term unsecured debt securities)

held at premium levels: A1 for Moody's Investors Service, A+ for Standard & Poor's Rating Services, and a AA for Rating and Investment Information, Inc. – no mean feat in such straitened times. These ratings are of course based on information provided by Honda and other information deemed credible by the rating agencies, and are based on their assessment of credit risk associated with designated securities issued by Honda. Each rating agency uses different standards for calculating Honda's credit rating, and makes its own assessments.

### **WHAT CAN BUSINESSES LEARN FROM THIS?**

- It is perfectly possible for revenues to decrease whilst cash reserves are increasing
- Cash provides a helpful cushion against the volatility of world markets
- Prudent fiscal management relieves pressure elsewhere, including in the area of credit rating, should well thought out borrowing ever be needed

### **VITAL STATISTICS**

- Revenues down 14.3%
- Net income up 95%

- Cash reserves up 65%
- Debt to Total Capital ratio of 0.48%

### **To deal with this catch, businesses need to:**

- Acknowledge that it is perfectly possible for revenues to decrease whilst cash reserves are increasing
- Use cash as a helpful cushion against the volatility of world markets
- Pursue prudent fiscal management to relieve pressure elsewhere, including in the area of credit rating, should well thought out borrowing ever be needed