July 2018

Optimizing Cash Management within an Integrated Treasury Operation

Geoff Stenger and Robert Turner

Hospitals and health systems typically maintain short-term liquidity balances for a variety of purposes. Uses include working capital needs, near-term capital expenditures, principal and interest payments, and to varying degrees, "rainy day funds."

It is appropriate for finance teams to optimize the projected balances of working capital. However, Kaufman Hall's experience indicates that teams frequently "overshoot" the optimal amount of cash and short-term securities held on their organization's balance sheets, often without the benefits of quantitative determination, and for the sake of conservatism. Since cash balances typically earn 1 to 2 percent in the current market environment, while longer-term investments earn 6 to 7 percent or more over a long-time horizon, organizations may be forfeiting significant dollars per year in operating or investment returns.

Optimizing the appropriate level of operating cash balances through tactical and quantitative daily cash management and forecasting—within an acceptable risk framework that allows access to cash, when needed—is recommended here. This approach allows finance teams to drive more funds to operations and/or investment portfolios where the capital will generate higher returns.

Optimizing daily cash management is not all art. A science does exist related to determining the appropriate amount of cash to be held on the balance sheet, the right mix of products for working capital, and best-practice processes surrounding both determinations. Described here are five interrelated processes and strategies that finance teams can conduct to achieve the benefits of an optimized art/science balance.

1. Forecast Liquidity Needs

A forecast of liquidity needs provides the starting point. Key inputs include cash flow from operations, current liquidity levels, payroll, payables and receivables, immediate capital spending plans, and other factors that might require liquidity. Metrics used in the forecast should address the impact of liquidity levels on all three financial statements, with a broad review of working capital requirements. Once the liquidity-sizing analysis has been conducted, a buffer of additional liquidity can be added, if desired. In Kaufman Hall's experience, such a liquidity-forecasting process has provided CFOs and Treasurers with an objective, quantitative method to resize liquidity levels by up to tens of millions of dollars.

2. Enhance Treasury Data Infrastructure

The optimization of cash management requires extensive data from many sources and systems that typically use many different formats. Examples include bank credit capacity and debt activity; accounting systems; electronic medical records; capital budgeting; days-cash-on-hand targets; near-term, non-routine spending expectations; and others. Due to source and system proliferation, most organizations use numerous/separate spreadsheets and manually manipulate at least some of the information to determine cash position.

Some organizations use a treasury work station or other software solutions that address cash positioning and forecasting. No one automated tool provides an interface with all data sources to:

- Determine daily cash position
- Project future cash positions and needs months and years into the future, based on different assumptions
- Monitor performance to targets on an ongoing basis
- Integrate all required data elements

Strategies to improve this situation are available, however, and include working to automate as much of the relevant data collection, management, and reporting as possible.

3. Leverage Bank Assistance

Some inputs to the liquidity equation, such as revenue cycle systems, do not have a lot of control over timing, but the Treasury team *can* control visibility in other areas, such as disbursements. Numerous bank services or products—for example, controlled disbursement, automated clearinghouse, and commercial card products—provide the ability to better control both liquidity timing and visibility. Many of the leading commercial banks offer a range of products and services to assist with managing and targeting liquidity levels. The right set of banking services and technologies can go a long way toward ensuring that the Treasurer can better monitor liquidity inflows and outflows and, to a large degree, automate many aspects of the management process.

4. Integrate Projected Liquidity Needs with Financial and Capital Plans

A good line of communication must exist between Treasury and Financial Planning/Capital Budgeting staffs so that the latter can budget specific projects and the former is not scrambling to cover a "surprise" request for a large sum of dollars. As conditions evolve within Financial Planning, related changes should influence how Treasury sizes its liquidity needs. Treasury should develop a feedback loop within the broader Finance team and beyond to ensure that there is good visibility of changes to upcoming capital needs.

5. Rent Liquidity

Many organizations have a line of credit as a backstop facility to draw on if they encounter unexpected calls on cash. Or, they keep the backstop cash on their balance sheet and pay it back over time. This tactic can be relied upon as an effective source or use of funds in the overall liquidity equation. Furthermore, "renting" liquidity can release excess liquidity on hand to pursue higher returns and other purposes. Many organizations will establish a revolving line of credit as backup liquidity, with the main cost being a commitment fee and/or unused fee.

What's Next?

With insights offered by the five processes described here, finance teams can engage a broader framework[1] for overall cash/investment allocation, thinking about liquidity resources and the scheduled and potential claims on those resources in terms of liquidity tiers.[2]

For example, an organization's finance team might dedicate its most liquid cash (Tier 1) to its most immediate claims on cash (e.g., payroll). A component of the Tier 1 liquidity discussion is the focus of this article. Subsequent tiers

(Tiers 2, 3, and 4) have less immediate needs—not fewer, just less immediate. Liquidity in these tiers can be allowed progressively and sequentially to pursue additional investment return, as they can tolerate additional volatility.

A tiered liquidity resource analysis can be performed formally and comprehensively.[3] It builds from a detailed cataloguing of risk and resources and matches cash and investment assets against risks that are not hedged already by a dedicated resource, such as a bank line or letter of credit. Each tier should be appropriately sized and invested. Ultimately, if the organization is generating excess cash flow, the goal would be to "graduate" excess liquidity to the highest possible tier where it can earn the greatest potential return. Regardless of whether teams take on the process of analyzing all four tiers, significant progress can be made by focusing on Tier 1.

Concluding Comments

Strong cash management requires an appropriate balance of art and science. Finance teams will want to ensure that they are doing the right analyses and using the right assumptions and tools related to cash holdings. A disciplined process that includes the five approaches described here, along with regular review, provides important insights. Such insights are critical to balancing quantitative and qualitative factors in order to make the best decisions related to cash and investments. In a rising interest rate environment, organizations that develop the infrastructure that offers visibility into their liquid assets will be able to drive significant value.

For additional information, *Geoff Stenger (**gstenger@kaufmanhall.com**) and Robert Turner (**rturner@kaufmanhall.com**) may be reached at **847.441.8780.***

References

1. Treasury and Capital Markets Services Brief. www.kaufmanhall.com/sites/default/files/Treasury%20and%20Capital%20Markets%20Service%20Brief.pdf.
2. Jordahl, E.A.: "Using the Tiered Liquidity Process to Manage Organizational Risk." Healthcare Finance Blog, HFMA, August 2013. www.kaufmanhall.com/resources/article/using-tiered-liquidity-process-manage-organizational-risk.
3. Jordahl, E.A., and Ratliff, D.: "Stewarding Cash and Invested Assets to Support Organizational Challenges." Kaufman Hall Treasury and Capital Markets, January 2018. www.kaufmanhall.com/resources/article/stewarding-cash-and-invested-assets-support-organizational-challenges.