

## SMARTER PERSPECTIVE: LIQUIDITY RISK MANAGEMENT

# Why Developing a Robust Liquidity Risk Management Strategy Should Be a Top Priority in 2023

By Rob Wilson

Many small to medium-sized companies today have no liquidity risk management plan in place. With Economic uncertainty, geopolitical upheaval and market volatility likely to be with us for the foreseeable future, this article examines the importance of proactively establishing a robust liquidity risk management strategy well before it is needed.

### LIQUIDITY PLANNING & POLICY

Universally speaking, having a plan in place is usually a good thing. Having a plan in place to manage liquidity risk, however, is always a good thing and particularly well-advised as we enter Q4, given current market dynamics.

The past couple of years have brought unprecedented challenges and many companies are well aware that they narrowly averted disaster during that period. Most market analysts expect a good deal of volatility and uncertainty to continue well into 2023. In fewer than 15 years, markets around the world have experienced the equivalent of the proverbial "hundred-year flood" several times i.e., 1) the Great Recession, 2) Brexit, and 3) COVID-19. There is consistent pressure on the bottom lines of companies in both the U.S. and the world over, due to interest rate



hikes, inflation, persistent supply chain interruptions, margin compression and labor shortages. Managing liquidity strategically may well be the differentiator between those companies that thrive and those that struggle for their very existence.

### TEST YOUR SYSTEMS AND CONTROLS

While this may sound somewhat dramatic, financial leaders within virtually every organization would be well advised in the current environment to thoroughly assess how economic and other factors may impact their potential to conduct business effectively. Are your existing

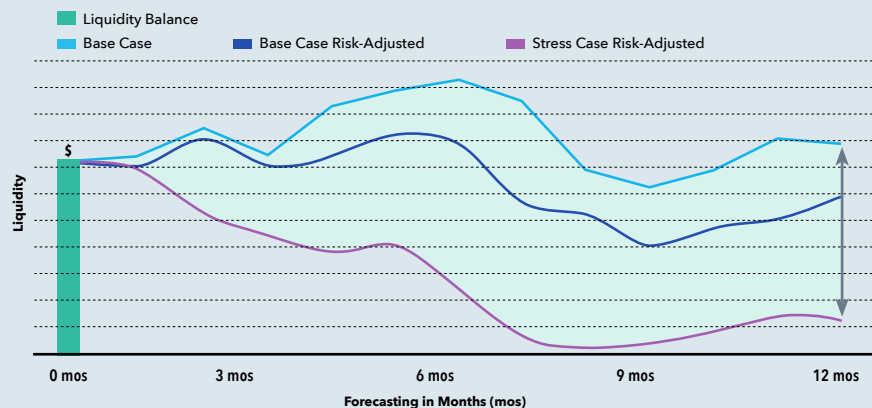
internal systems and controls adequate to help prevent a future scenario from having a detrimental, or even catastrophic, impact on the business? Or is there a need for the development or enhancement of new and improved systems and controls to protect the business? An imminent, looming or distant crisis may impact their business. Effective policymaking comes from examining a range of possibilities and implementing systems and tools that help identify, manage and mitigate the unknowns.

### FIND THE BLIND SPOTS

Many organizations do not have the right analytical tools or reporting mechanisms in place to assess the magnitude of their liquidity risk. One of the first steps we advise our clients to take in identifying and addressing those types of blind spots is to undertake a liquidity stress test review. Conducted as a highly coordinated effort, the review is designed to locate potential points of stress on a company's liquidity, then evaluate and rate each of those for potential likelihood, impact and severity.

Part of the liquidity stress test exercises we conduct on our client's behalf involves identifying what drivers really

## Forecasting Required Liquidity for Risk-Adjusted Scenarios



Source: Hilco Performance Solutions

**It is advisable for companies to consider and map out different liquidity stress scenarios to determine whether they have enough liquidity to withstand them. Historically, many middle market companies have not undertaken this step, which limits their operating margin of error when an actual stress event does occur.**

impact cash flow such as interest rate volatility and raw material prices. We further examine the company's funding platform by getting a better understanding of factors such as minimum cash needs, committed capacity, strength and diversity of banking relationships, maturity profile, lending terms and covenants. The financial strength of key suppliers, customers and lenders is also an area we carefully probe as part of our Counterparty Risk review. Ultimately, a deep dive into each of these areas enables development of a liquidity risk framework capable of informing senior management of the potential impact of these various risk factors on the business as well as effectiveness of addressing those risks given the mitigation policies already in place. After the due diligence is completed and the data is analyzed, a liquidity policy framework can be outlined.

Once such a framework is outlined, the liquidity stress scenarios can be tested against key metrics to determine whether the guardrails are sufficient enough to help protect the company from potential exposure. Establishing Long-term, regular reporting is important as well, as it informs company leaders of the warning signs of potential negative liquidity events.

When deployed, this type of early identification system is designed to raise a red flag, allowing critical adjustments to be made quickly and key relationships to be managed proactively.

It should also be noted that there are certain, typical warning signs that show up in relation to liquidity risk that should be built into any policy framework. For example, a framework should include an alert/notification system that alerts management when the company is close to violating its lending covenants. In fact, there should also be a regular status review around covenants such that an alert is activated well in advance of any breach. Similarly, any time there is a major cash flow disruption, a well-designed warning should be capable of quickly notifying key management of the situation. External forces, such as Federal Reserve rate hikes, and certain changes to key economic indicators that may impact the business, such as unemployment, must also be regularly monitored and analyzed as well.

Another important step associated with best practices in designing an effective liquidity risk management strategy involves being particularly diligent about cash forecasting. We view it as essential that cash flow metrics are transparent and visible to all key decision-makers,

and that financial leaders regularly reinforce the company's commitment to proactive liquidity risk management. Regular updating and adjustment to the parameters of the liquidity stress scenarios, including playing out potential scenario outcomes, also helps prepare a company for an expected or unforeseen crisis down the line. Seasonality of cash flow is also a common factor that affects many companies across numerous industries such as retail, agriculture, fashion and others. Accordingly, it should be included as part of scenario planning in the liquidity framework, as we have seen it have a notable, and sometimes highly detrimental, impact on working capital.

### CROWN CASH KING AND BUILD STRONG RELATIONSHIPS

Alongside a dedicated focus on internal controls and reporting, financial executives should be managing their banking relationships with liquidity in mind as well. Understandably, lenders do not like surprises. So, keeping those critical partners/credit sources informed and up to date on liquidity matters is critical to a healthy, long-term relationship in both good times and bad. Most companies' bank credit allocations are finite, so they must be used wisely for liquidity and debt management. Understandably, developing multiple banking relationships and maintaining multiple pieces of business with those financial institutions is a good policy as well. In our experience working closely with many of the world's leading financial institutions, well-managed, active relationships tend to lead to greater opportunities, be they access to new products and services, greater flexibility in negotiating rates and terms, or simply better service—simply because the relationship is based on earned trust and transparency.

Vendor and customer relations must be carefully cultivated and managed as well. Liquidity risk management best



practices dictate working closely with key suppliers and major customers to ensure that the relationship remains mutually beneficial and supportive through both peaks and valleys. As many learned during the peak period of COVID, it may become necessary to ask customers to take on price increases at some point. Similarly, fulfilling contracts or stocking stores may necessitate asking suppliers to boost your allocation or provide priority access to certain critical, high-demand items. A solid, mutually beneficial working history with such partners adds to your organization's overall "stickiness," and is essential to ensuring that these parties will work with you when you most need them. Additionally, beyond indicators such as credit ratings and public stock prices, open dialogue and agreed-upon processes for cross-sharing of financial information are an important part of perpetuating these essential relationships as well. We advocate for scheduling regular conversations between CFOs and senior financial teams as an effective way of sharing information and keeping these partnerships healthy and productive.

#### SHARE ACTIONABLE INFORMATION

As a final point, it is critical to also note the importance of regularly sharing actionable information within the structure of a company or organization as well. From various levels of the financial team, itself, to leaders in areas such as the procurement office and distribution centers, well-informed employees at touchpoints across a business are better able to perform their roles effectively and flag potential concerns that could be relevant to potential liquidity risk early on. History has shown that an active and open dialogue with these internal constituents is highly beneficial even during times of ample liquidity and seemingly limited risk.

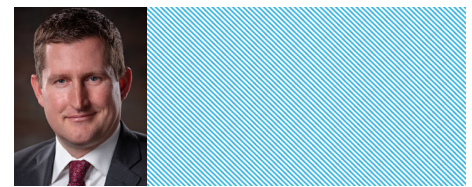
As part of our Financial Intelligence Consulting Services offering, Hilco



Performance Solutions helps to empower and support strong finance and treasury teams by working directly with companies, lenders, and investors to examine liquidity risk, identify mitigation strategies and help implement business processes that increase competitiveness. Inefficiencies across legacy IT systems and an inability to glean and leverage actionable insights from their own captured data can dramatically hinder C-suite and other leaders from being able to move their businesses forward during periods of complex challenges. In our experience, liquidity risk is too often overlooked by middle-market companies that do not have the resources or sophistication to make it a focus, or that are simply growing too fast to make it a priority until an adverse event places the company under liquidity stress. Our team has the knowledge, experience and relationships to assist your business, or clients within your lending portfolio, in developing a highly effective liquidity risk framework. We bring a unique set of skills to the table, including the opportunity to involve Hilco Global's experts in balance sheet restructuring and our specialists across retail, manufacturing, real estate and virtually

every industry category. We encourage you to reach out to us to discuss your situation and needs. Together we can help prepare you or your clients to effectively navigate the liquidity risk management landscape.

*Hilco Performance Solutions helps companies simplify and streamline business processes, and improve operational efficiency to stay competitive and gain market share in an increasingly interconnected economy. Advisory areas of focus include Operations, Supply Chain, People, Mergers & Acquisitions and Commercial to help clients achieve sustainable revenue growth and cost reduction. While many management consulting companies focus on strategy and sharing leading theory, the Hilco team focuses on action, working in the trenches with our clients and translating strategy into actual results.*



**ROB WILSON IS A SENIOR DIRECTOR  
AT HILCO PERFORMANCE SOLUTIONS**

He is a seasoned Financial Services Executive with a proven track record of over 20 years of experience in the fields of finance, strategy, and product management. Rob has achieved impressive results due to his collaborative nature, strong work ethic, and obsession for finding a better way. He has experience in both public and private companies varying from small cap to Fortune 10, including Treasurer of a Fortune 200 Company with over \$35B of Assets. Rob holds a BA in Economics from the University of Michigan and an MBA in Supply Chain Management and Finance from Michigan State University. Contact Rob at 847.849.2962 or [rwilson@hilcoglobal.com](mailto:rwilson@hilcoglobal.com)