How to spend it?

Corporate cash piles have increased significantly in the past five years, but what should management do with the money?

– Ole Søeberg
Chief Investment Officer

Seven years ago, the financial crisis changed market behaviour overnight. The housing bubble burst, M&A activity dried up and financial assets plummeted in value. Companies were suddenly compelled to rethink their liquidity and balance sheet strategy amid a squeeze on lending. Banks too had to rebuild capital and their own balance sheets. Fortunately, lower global interest rates made it possible for many companies to re-finance their debt on better terms, often stabilising and even improving cash flows.

Since then, the global economy has chugged along at a decent, if not impressive, pace and companies have changed the way they use their cash. Some firms and regions, such as Greece, have failed to adapt to the new reality, but broadly speaking prudent financial management has been the order of the day.

Since 2012, we have seen cash flows that were previously used to reduce net debt or held in reserve being redirected towards three main areas (or a mix of these): dividends and stock buybacks; acquisitions (M&A) and investments into improving competitiveness and market share.

Taking a global view and using the MSCI AC World Index as a proxy, the 2,500 most widely followed global companies are on track to generate USD 32 trillion of revenues in FY 2015, equivalent to approximately 40% of global GDP, and USD 3 trillion of net income.

MSCI WORLD AC INDEX

	2009, trl $	2015, trl $
Revenues	27	32
Net Income	1.4	2.9
Dividend	0.8	1.2
Market Cap	32	47

Dividends and share buybacks

The proportion of this net income distributed to shareholders via dividends takes USD 1.2 trillion out of the total cash pile, excluding the impact of cross holdings. Company share buybacks account for a further USD 700bn, based on estimates using the 2014 figure for US companies (USD 550bn) among which buybacks are most common.

Once the shares have been bought, we would prefer that they were cancelled to avoid diluting long-term shareholders. Unfortunately some companies keep them to sell later on or give them to employees who then sell them back into the market.

Mergers and acquisitions (M&A)

Company cash can also be spent on growing a business, typically by investing in new plants, upgrading facilities or developing a new product or service. However, it takes time for the benefits of this investment to materialise. So it can be quicker to buy another company that seems to offer the sort of transformation that is required. However, any type of M&A and investment should only be undertaken if it adds value, i.e. generates a higher return than the cost of the capital invested plus the “risk-free” rate (often the rate of interest from government bonds).

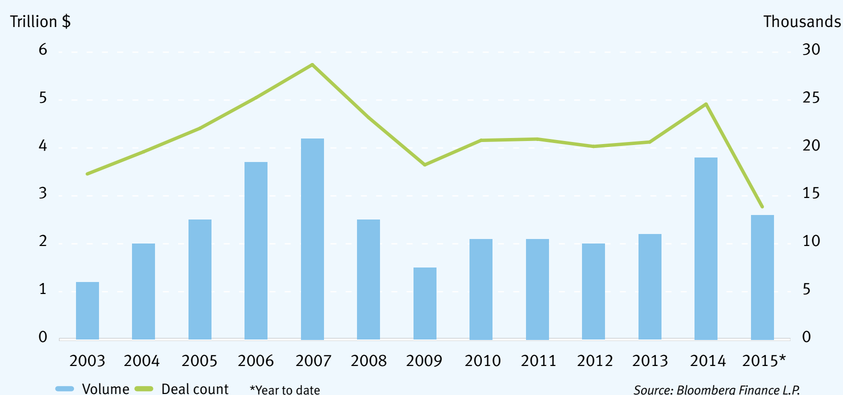
Since 2012, cash has increasingly been

used to finance M&A. The previous high was 2007 when total deal value reached USD 4.2 trillion (see Bloomberg data below). In the first half of 2015, the total value was USD 2.5 trillion, meaning this year is likely to reach or exceed the previous record – good news for investment bankers and lawyers.

In addition to corporate bidders, we have also seen activity from a large pool of private equity players. The graph below shows global M&A activity since 2003. It is interesting to note that the more bullish periods in the stock market coincide with periods of high M&A activity.

It is also worth noting that as private equity firms exit from companies via stock market listings (known as initial public offerings or IPOs) they tend to recycle it back into other M&A. This in turn creates more competition for assets and pushes prices up. In the past 10 years, IPO and secondary deal activity has been running at between USD 0.6 and 0.9 trillion a year. Here too it appears that 2015 is on track for a record breaking year.

GLOBAL M&A ACTIVITY SINCE 2003



Investing in the business

Share prices have increased a lot in recent years, so it is harder to buy a company that can add value. Hence, you might expect investment in business and research and development (R&D) would be the preferred option for enhancing a company's value. This has been a lower priority for many companies since the financial crisis, however, initially due to a need to strengthen their finances and later to an increasingly short-term attitude by the market towards results. In our view, a good management team making the right investment in organic growth typically creates the most long-term value.

Given the recent increases in IPOs and M&A, we sense a lowering of the caveat emptor principle (i.e. taking proper account of the risks involved) and the

use of more aggressive tactics – factors that have historically led to an increase in overall risk. A McKinsey survey showed that corporate M&A is most successful when executed during tough economic conditions, which often coincide with bear markets and inexpensive asset prices, as you might expect. Why then do those engaged in corporate activity not learn from past experience and tread with caution in years such as 2007 and 2015?

Animal spirits

So-called 'animal spirits' may be one reason. Human behaviour is driven by recent experience. After five or six years of a bull market, many investors feel they are financial geniuses, as do listed companies that have seen their stock multiply.

In this sort of environment, we prefer to stand back from the noise and take a long-term view. The pace of global economic growth and inflation levels suggest that interest rates will remain relatively modest, so the returns available from deposits and government bonds compared to equities would continue to favour equities. That is unchanged over the last five years, but the equity advantage has reduced as stock prices have increased.

Nonetheless, we continue to find pockets of value among businesses that have been overlooked. These sorts of companies tend to stick to their knitting and let others do M&A at frothy valuations. They also tend to apply common sense when considering how best to invest their cash. Given the cost of financing is likely to remain lower for longer, we could start to see more spending on R&D and infrastructure. This in turn would broaden economic expansion and increase global growth, rather than simply adding to share valuations, and create favourable conditions for many of our holdings.

INVESTMENT HARDER-HIT BY THE CRISIS THAN GDP IN OECD