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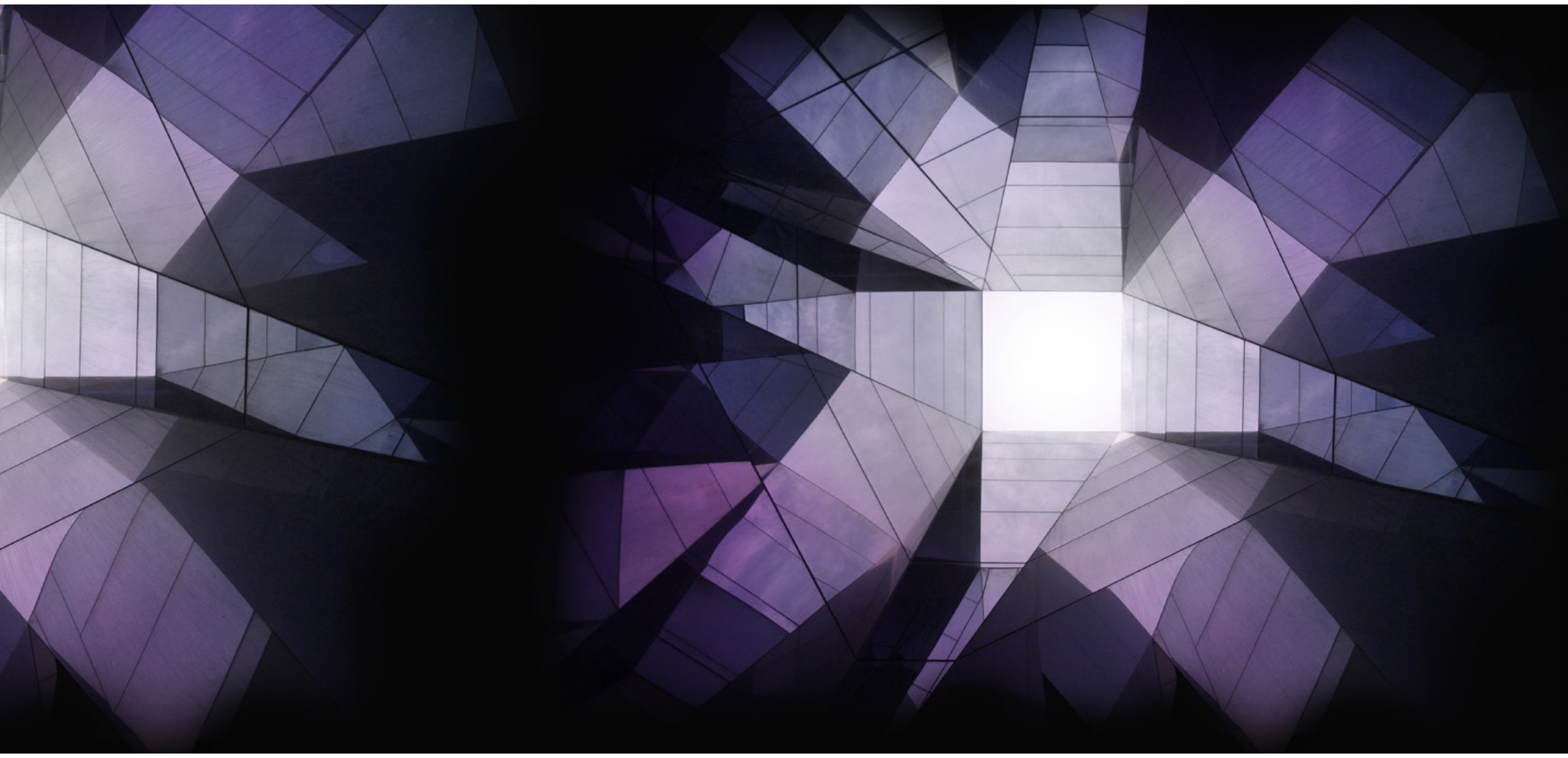


The Australian Cash Paradox

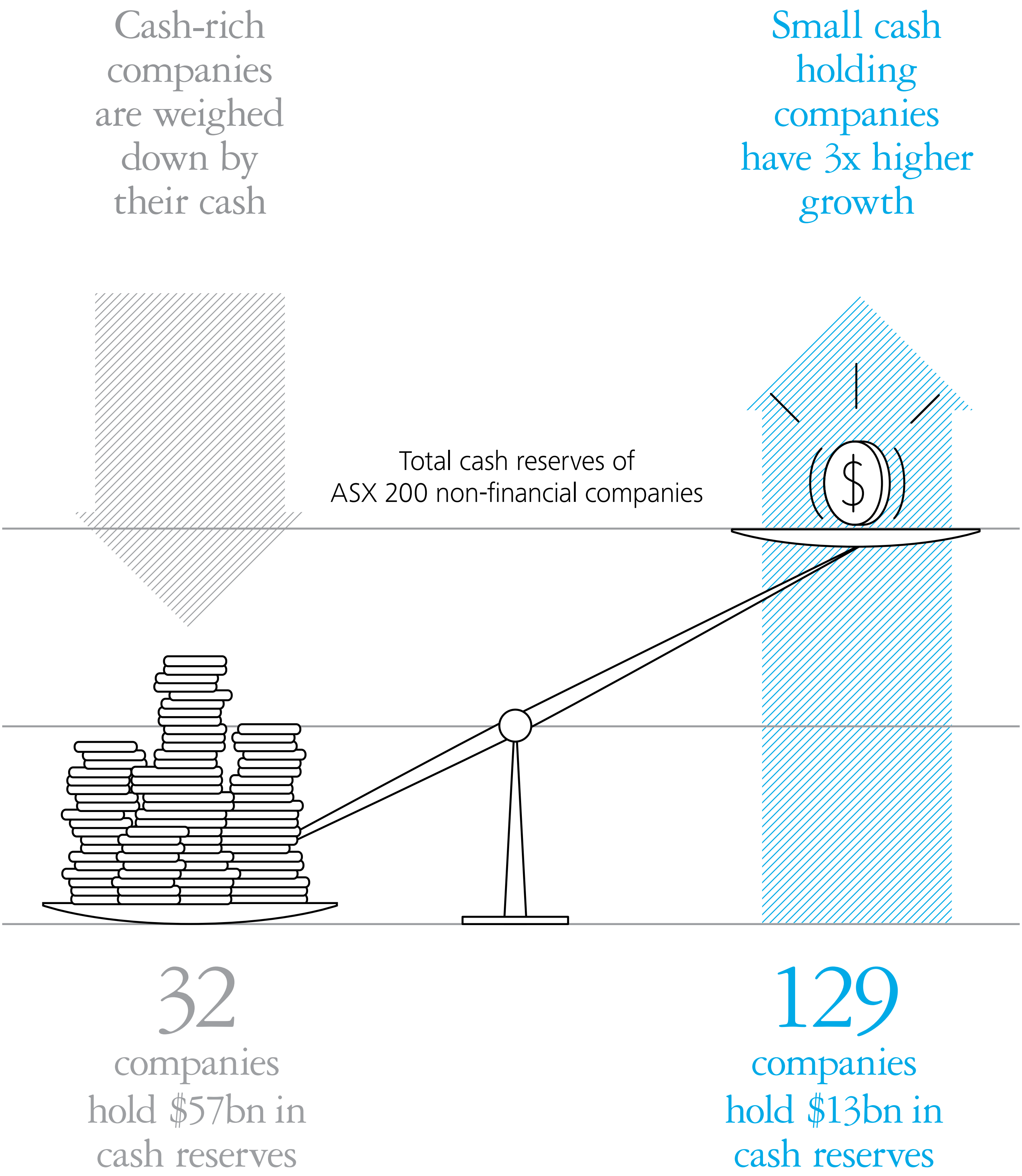
Corporate Capital
Making more growth

Record levels of passive cash reserves are destroying shareholder value for corporate Australia – lazy capital delivers lazy growth. It's time to shift the corporate agenda and re-focus on growth and M&A.

Businesses are under increasing pressure from shareholders and financiers to continually optimise the deployment of capital and maximise returns. Capital optimisation brings a unique set of challenges and opportunities to businesses. This paper is just one of our perspectives on this topic.

The Australian Cash Paradox

Deloitte's recent research of the ASX 200 has identified the emergence of a cash paradox. The companies holding the majority of the cash war chest in corporate Australia are growth laggards.



The Australian Cash Paradox

The world's largest 1,000 public companies held US$3.5 trillion in cash reserves at the end of FY13[1]. Here in Australia just 20% of ASX 200 companies have accumulated 82% of total cash reserves.

Cash-rich corporates have been underperforming by a factor of three since the GFC, compared to companies with relatively small cash holdings, measured either by quarterly revenue growth or share price performance.

Companies holding small cash balances have been more bullish in their pursuit of growth and consistently more aggressive in their M&A activities – an approach consistently rewarded by share markets since 2009.

As a result, we have a cash paradox.

"At some stage, the equity analysts, shareholders, fund managers, commentators and so on will want to be asking not 'where's your cost cutting or capital return plan?'... but 'where's your growth plan?'" [2]
– RBA Governor Glenn Stevens.

Cash-rich corporates need to re-evaluate their 'yield vs growth' strategy and re-focus on growth. The 24 growth pockets identified by Deloitte Access Economics and a number of overseas countries have the potential to create these opportunities.

It's time to address the cash paradox in corporate Australia.

1 Excluding those in financial services
2 Governor Glenn Stevens, 'Address to CEDA Luncheon', Adelaide, 3 September 2014

The haves and have-nots

Deloitte Australia analysed the cash reserves of the 200 largest companies on the ASX and explored their spending patterns. Collectively, this group (excluding companies in the financial services sector) held A$70 billion in cash reserves in 2014 – and most of this was held by the miners (39%), followed by consumer businesses (18%) and industrials (18%). Remarkably, just 20% of companies have accumulated 82% of the cash reserves – we call these the 'large cash holding' companies. As we dug deeper, we found that, when cash reserves and historical spending patterns are compared, a cash paradox emerges.

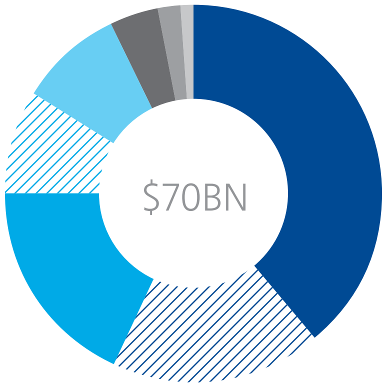


Figure 1. **Cash holdings of ASX 200 non-financial companies by industry**

- Materials (incl. mining)
- Industrials
- Consumer Business
- Energy
- Telecommunications Services
- Healthcare
- Utilities
- Information Technology

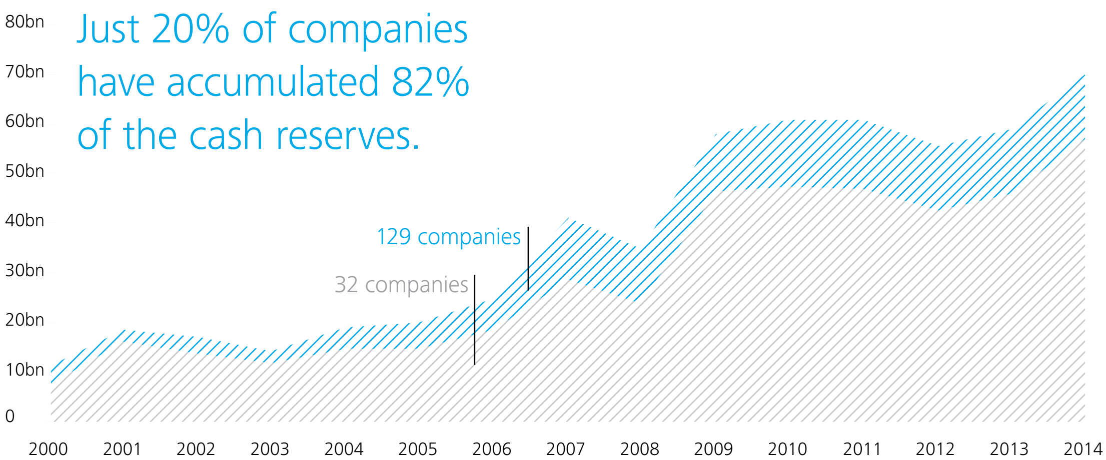


Figure 2. **Cash reserves of ASX 200 non-financial companies (A$bn)**

- Small cash holding companies
- Large cash holding companies

This Australian phenomenon is also observed globally.

The leading 1,000 public non-financial services companies held US$3.53 trillion in cash reserves at the end of 2013, and our analysis found that just 32% of them have accumulated 81% of total cash reserves.

The ratio of cash reserves held between large and small cash holding companies remained broadly at 3:1 over the last decade. However, the GFC has had a profound impact on 'cash hoarding' tendencies among larger companies.

Globally, the ratio of cash reserves widened post-GFC, and in Australia, the cash reserves of the large cash holding companies jumped from A$24 billion in 2008 to A$46 billion in 2009, widening the ratio gap with small cash holding companies.

In contrast, the small cash-holders held a balance of A$11 billion in 2008. This remained fairly constant throughout the crisis years, and currently stands at A$13 billion.

Notes.
1. 'Cash reserves' refers to cash, near-cash items, marketable securities and other short-term investments.
2. All analysis of the ASX 200 does not include those within the financial services industry.

How corporates spend their cash

We considered the spending patterns of these two groups of companies by analysing their capital expenditure and the proportion of cash reserves allocated to this spending category.

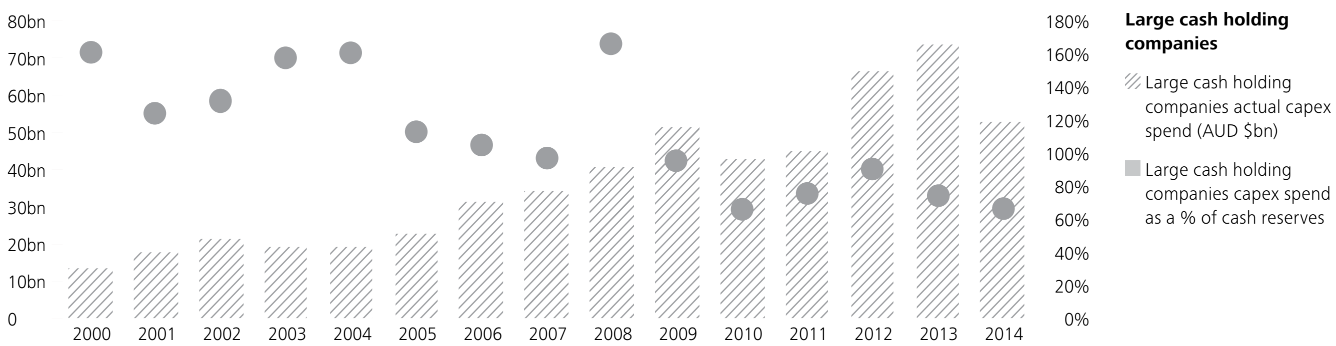
Both have increased their capital expenditure in recent years, although at different rates. However, when we compared capital expenditure as a percentage of cash reserves we found that this ratio was lower for the large cash holding companies.

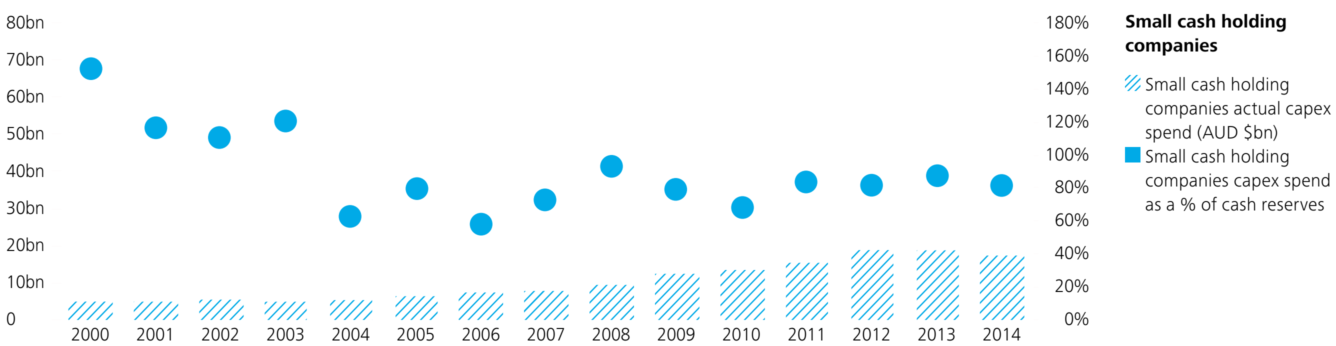
In the five years since the end of the GFC, large cash holding companies have averaged capital expenditure at 74% of cash reserves, down drastically from 131% in the prior decade.

The small cash holding companies have consistently maintained their capital expenditure at an average of 81% of cash reserves over the same period, down somewhat less from the prior decade, which averaged 95%. This suggests an unwavering attitude towards capital expenditure as a proportion of cash reserves among this group, regardless of economic conditions.

> Both groups of companies have increased their capital expenditure in recent years, though at markedly different levels when compared as a percentage of cash reserves.

Figure 3. **Capital expenditure of ASX 200 non-financial companies as a percentage of cash reserves (2000-2014)**





Divergence in performance

The importance of diverging attitudes towards cash accumulation and spending are put into context when the relative performances of both groups of companies are considered.

In Australia, small cash holding companies have experienced higher revenue growth since 2009 – a five-year compound annual growth rate (CAGR) of 6.5% compared to large cash-holders that experienced a CAGR of 1.9% over the same period.

More striking is the relative share price performance of the two groups. A clear divergence of performance exists from 2009, with small cash-holders producing better returns.

Globally, we have seen the same trend. Since 2000, the share price performance of small cash holding companies has outperformed their large cash holding counterparts, growing by an astonishing 632% compared to 327%.

Remarkably, the gap widened even more after the GFC, suggesting that in the long run, financial markets are rewarding companies that take a bullish attitude towards growth.

> Deloitte analysis suggests that financial markets are more rewarding of companies that are willing to take a bullish attitude towards growth.

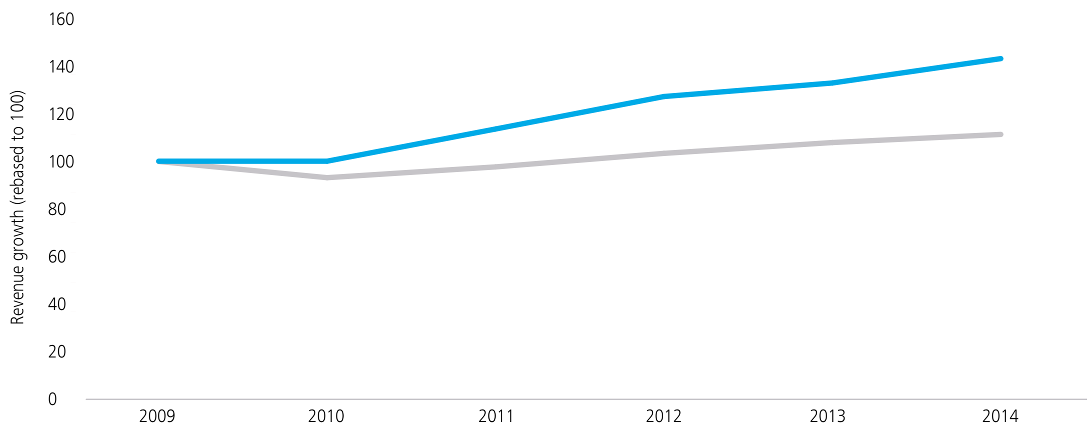


Figure 4. **Relative revenue growth of ASX 200 non-financial companies**

- Large cash holding companies
- Small cash holding companies

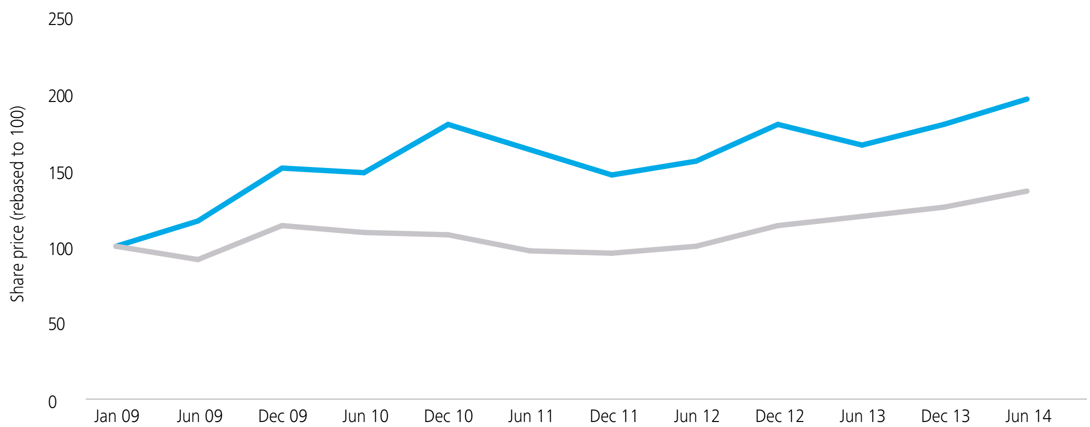


Figure 5. **Relative share price performance of ASX 200 non-financial companies**

- Large cash holding companies
- Small cash holding companies

The cash paradox and M&A

M&A activity tends to be a significant area for utilising cash reserves. And since the onset of the GFC, there has been a significant decline in global M&A volumes, as companies waited for market sentiment to improve before taking on greater risk in the pursuit of growth.

Globally, and since 2009, the large cash holding companies spent US$1.02 trillion on M&A. But as a proportion of their cash reserves, annual M&A spending has been on the decline – in 2013, M&A spending as a proportion of cash reserves was just 13%, compared to a high of 60% in 2007, a record year for global M&A deal volumes.

By comparison, small cash holding companies have spent US$603 billion on M&A since 2009, and in 2013 their M&A spending amounted to 78% of their total cash reserves, far higher than their cash-rich counterparts. In fact, during the boom year of 2007, small cash holding companies spent 217% of their cash reserves.

> Small cash-holders have been consistently more aggressive in their M&A activities.

This suggests that large cash holding companies, even when they are pursuing M&A deals, remain financially conservative. On the other hand, smaller cash-holders are far more bullish in their pursuit of growth, and have been consistently more aggressive in their M&A activities.

2014 proved to be a turning point in post-GFC M&A activity. Globally, companies announced M&A deals with a combined value of US$2.8 trillion in 2014, making the year the best for deals by value since 2007. The defining theme for 2014 was the return of mega-deals over US$10 billion, with 27 announced, and worth US$647 billion in value, again the highest since 2007.

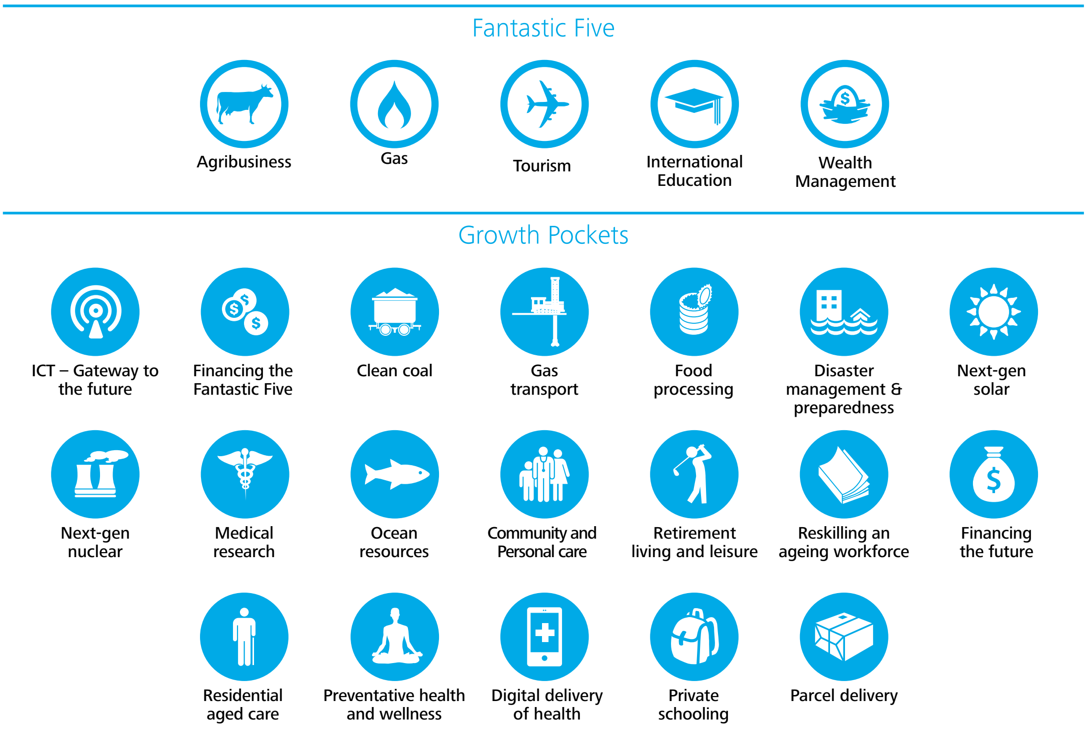
27

mega-deals worth US$647 billion announced in 2014, the highest since 2007.

Growth opportunities for corporate Australia

For Australian corporates, we see many opportunities for growth.

The third report in Deloitte's *Building the Lucky Country* series, Positioning for Prosperity? Catching the next wave, identified the 'Fantastic Five' sectors (agribusiness, tourism, gas, wealth management and international education) that offer the next waves of above market growth over the long term. Together with many other growth opportunity pockets, including aged care, medical research, retirement living and financing the 'Fantastic Five', we have identified 24 sectoral hotspots for the future.



Outside Australia, market opportunities in a number of Asian economies are also plentiful.

China: Late last year, Australia and China signed a free trade agreement and, notwithstanding the slowing growth rate within the Chinese economy, we expect this market to offer growth opportunities for companies in the food and beverage, professional services, financial services and health and aged care sectors.

India: India has recently reduced barriers to foreign direct investment in a number of sectors, including insurance and pharmaceuticals. In addition, the new government is focussed on reducing bureaucracy and regulation and increasing investment in infrastructure. We expect to see significant opportunities for Australian companies in India's financial services, resources and construction services sectors.

Indonesia: With a new government and a young and growing middle class experiencing a significant increase in wealth, Indonesia will present opportunities in the retail, food and beverage and health sectors.

Four strategies for growth

Companies will continue to grapple with 'yield vs growth' strategy dilemmas. But the challenge for CEO and CFO agendas remains to optimise capital between investment, financing and dividend decisions. Ultimately, the ability to create sustainable growth will be paramount in terms of optimising capital.

We analysed a number of high performing companies and how they have executed their growth strategies. Four key themes emerged:

1. They made inorganic investments in adjacent markets/offerings through acquisitions rather than building this growth themselves.
2. They invested in 'growth pockets' or sub-sectors, which offer above average market growth capitalising on their core competencies.
3. Where outright acquisitions weren't available or they didn't have the complete core competency, they formed strategic alliances and joint ventures to mitigate their risks.
4. They considered the optimal use of capital from the perspective of shareholders and where appropriate, returned capital to shareholders (in a tax effective manner in a number of cases).

> Our analysis indicates that 'doing nothing' and holding on to the cash is destroying shareholder value. Winners will likely be those that understand the cash paradox, those that take a long term outlook, and those that are decisive and steadfast in their pursuit of growth. In other words, it could be a case of triumph awaiting the optimists.

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