CFO Insights

The cash paradox: How cash levels can affect corporate behavior

During the financial crisis, many CFOs served their companies well with financial prudence and by accumulating cash. Now that many companies are refocused on growth, market commentators frequently cite these record cash figures as a key indicator that capital expenditure (capex) and M&A activities can increase and accelerate expansion. But the truth of the matter is far more nuanced.

According to a recent analysis by Deloitte LLP (see "The Cash Paradox: How Record Cash Reserves Are Influencing Corporate Behavior"*), there is an uneven distribution of those cash levels. While at the end of 2013 the S&P Global 1,200 public nonfinancial companies held $3.53 trillion in cash reserves,[1,2] just 32% of the companies held 81% of the cash reserves (see Figure 1).[3]

Moreover, these "large cash-holding" companies tend to be more conservative in their spending habits compared with their "small cash-holding" counterparts, which have been spending more aggressively in the pursuit of growth and appear to be reaping the benefits.[4] The analysis also shows a clear divergence in revenue growth, as well as in share-price performance for these two sets of companies: on both measures, the small cash-holding companies are outperforming their large cash-holding counterparts.[5]

While it is important to note that the terms "large" or "small" cash-holding companies do not imply that they are also large or small by market capitalization, there are lessons in the research for companies of all sizes. And in this issue of *CFO Insights*, we'll discuss the findings and their potential implications for corporate cash strategies.

* Article adapted from "The cash paradox: How record cash reserves are influencing corporate behavior," *Deloitte Review*, July 2014.

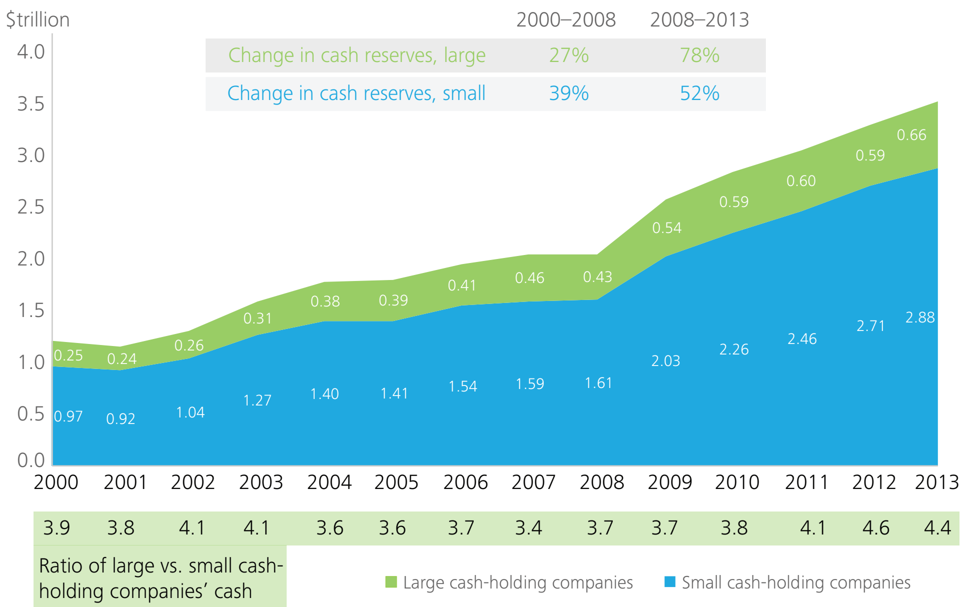
Behind the record buildups

Corporate-sector leverage, aided by a vibrant financial sector, helped fuel the precrisis boom. The subsequent shift of debt from the corporate and financial sector to the government following the high-profile government-led bailouts is one of the defining consequences of the financial downturn. Since 2009, though the corporate sector, particularly in the United States and Europe, managed to successfully deleverage through a combination of rigorous cost-optimization programs and divestments of noncore assets.[6]

As a result, the corporate sector built up record levels of cash reserves. US companies are the largest constituent of the S&P Global 1,200, and with $1.6 trillion in cash reserves, they account for 45% of the total reserves for the index. Then come Japanese companies, which account for 14% of the cash reserves globally, followed by companies based in France, Germany, and the UK.[7]

But cash levels have not typically followed the Pareto Principle, also known as the 80/20 rule—the phenomenon whereby the greatest impact (typically 80%) is attributable to the vital few (generally 20%). According to Deloitte's research, at the height of the precrisis boom in 2007, the large cash-holding companies held $1.59 trillion in cash reserves compared with the $462 billion in cash reserves held by small cash-holding companies, a ratio of 3:1.[8] But when the financial downturn hit in late 2008, caution set in, and many companies started to curtail spending and accumulate cash instead.

Figure 1. Cash reserves of S&P Global 1200 non-financial companies, 2000–2013



Source: Bloomberg; Deloitte analysis. **Graphic: Deloitte University Press | DUPress.com**

Surprisingly, the large cash-holding companies tended to be far more conservative than small cash-holding companies. Between 2008 and 2013, they nearly doubled their cash reserves, from $1.61 trillion to $2.88 trillion, and at the same time, the small cash-holding companies kept accumulating at an even pace and increased their reserves, from $433 billion to $656 billion. By 2013, the ratio of cash reserves became 4:1 in favor of large cash-holding companies.[9] While financial prudence was generally welcomed by the markets in those tough years, such aggressive cash hoarding by these large cash-holding companies remains unprecedented.

Ways companies spend their cash

The research also considers the spending patterns of these two sets of companies by analyzing their capital expenditure as a proportion of cash from operations and their M&A spending as a proportion of cash reserves to understand how these companies allocate their cash.

Capex: In the last couple of years, both the large and the small cash-holding companies increased their capital expenditure, suggesting they have confidence in their ability to generate cash.[10] The large cash-holding companies increased their spending by 16% from $979 billion in 2008 to $1.14 trillion in 2013. However, they channeled just 37% of the cash they generated from operations toward capex in 2013—well below their long-term average of 50%.[11] On the other hand, the small cash-holding companies increased their capex by 37%, from $461 billion in 2007 to $633 billion in 2013. In 2013, they channeled 63% of their cash from operations into capex.[12]

M&A: Since 2009, the large cash-holding companies spent $1.02 trillion on M&A deals, 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 with a high of 60% in 2007, which was a record year for global M&A deal volume.[13] In comparison, the small cash-holding companies have spent $603 billion on M&A deals 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.[14] This suggests that large cash-holding companies, even when they are making M&A deals, continue to remain financially conservative.

Divergence in performance

The divergent attitudes toward cash accumulation and spending gain more context when the relative performances of both sets of companies are considered. Both sets of companies grew their revenues at a consistent pace since 2000, but there was a clear divergence after the financial downturn, when the small cash-holding companies grew revenues at a faster pace than their larger counterparts. In part, this can be attributed to more-bullish M&A activities.[15]

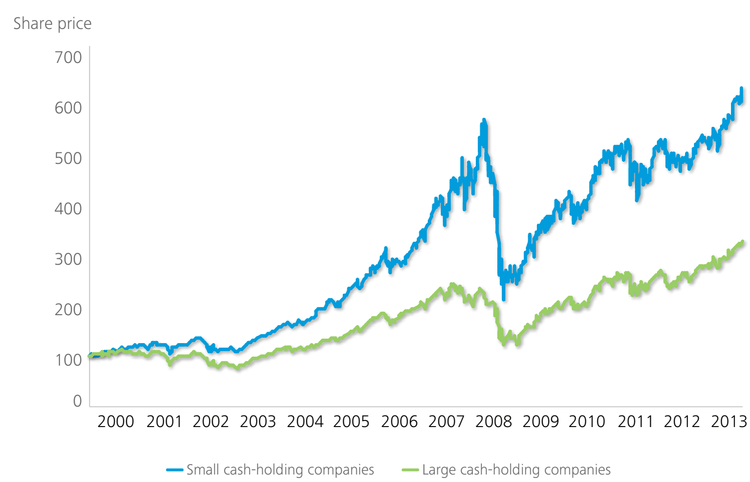
At the same time, a divergence in share price between the cash hoarders and the spenders has also emerged (see Figure 2). Since 2000, the share price performance of the small cash-holding companies has outperformed their large cash-holding counterparts, growing by an astonishing 632% compared to 327% for their larger cash-holding counterparts. Remarkably, the gap widened even more after the financial downturn. This suggests that in the long run, the markets are rewarding companies that take a more-bullish attitude toward growth.[16]

In the coming years, companies should consider finding a way to thrive in a new economic reality characterized by below-average growth conditions and shorter, but more volatile, economic cycles. In such conditions, pursuing growth opportunities may be less about earnings-per-share enhancement and more about long-term prospects. Therefore, in pursuing opportunities, corporate leaders, including CFOs, may want to make a combined assessment of their company's relative strategic capability, which can indicate its ability to capture growth, as well as its financial strength, which may reveal its ability to fund future growth opportunities. And they should keep the lessons of the research in mind: whereas financial conservatism served companies well during the downturn, in times of economic recovery it could be a double-edged sword, dragging companies into a cycle of cash accumulation at the expense of investing in growth.

Endnotes

1 "Cash reserves" refers to cash and near-cash items and marketable securities and other short-term investments. Companies considered for the analysis are the non-financial constituents of the S&P Global 1,200 that had reported their 2013 results as of April 8, 2014. The constituents are as of March 6, 2014.
2 Deloitte calculations based on Bloomberg data, accessed April 8, 2014.
3 Ibid.
4 "Large cash-holding companies" are defined as those with cash reserves of, or in excess of, $2.5 billion at the end of fiscal-year 2012. "Small cash-holding companies" are those with cash reserves of less than $2.5 billion at the end of fiscal-year 2012. Fiscal years are as defined by Bloomberg.
5 Deloitte calculations based on Bloomberg data, accessed April 8, 2014.
6 "The cash paradox: How record cash reserves are influencing corporate behavior" *Deloitte Review*, July 2014.
7-16 Ibid.

Figure 2. Relative share price performance of large cash-holding and small cash-holding companies, 2000–2013



Source: Bloomberg; Deloitte analysis. **Graphic: Deloitte University Press | DUPress.com.**

Primary contacts
Iain MacMillan
Partner; Head of M&A and New Growth Insight
Deloitte LLP, United Kingdom member firm of DTTL
imacmillan@deloitte.co.uk

Sriram Prakash
Director; Head of M&A and New Growth Insight
Deloitte LLP, United Kingdom member firm of DTTL
sprakash@deloitte.co.uk

Irina Bolotnikova
Manager, M&A and New Growth Insight
Deloitte LLP, United Kingdom member firm of DTTL
ibolotnikova@deloitte.co.uk

Jon Warshawsky
Director; Editor-in-chief, *Deloitte Review*
Deloitte Services LP
jwarshawsky@deloitte.com

Deloitte *CFO Insights* are developed with the guidance of Dr. Ajit Kambil, Global Research Director, CFO Program, Deloitte LLP; and Lori Calabro, Senior Manager, CFO Education & Events, Deloitte LLP.

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