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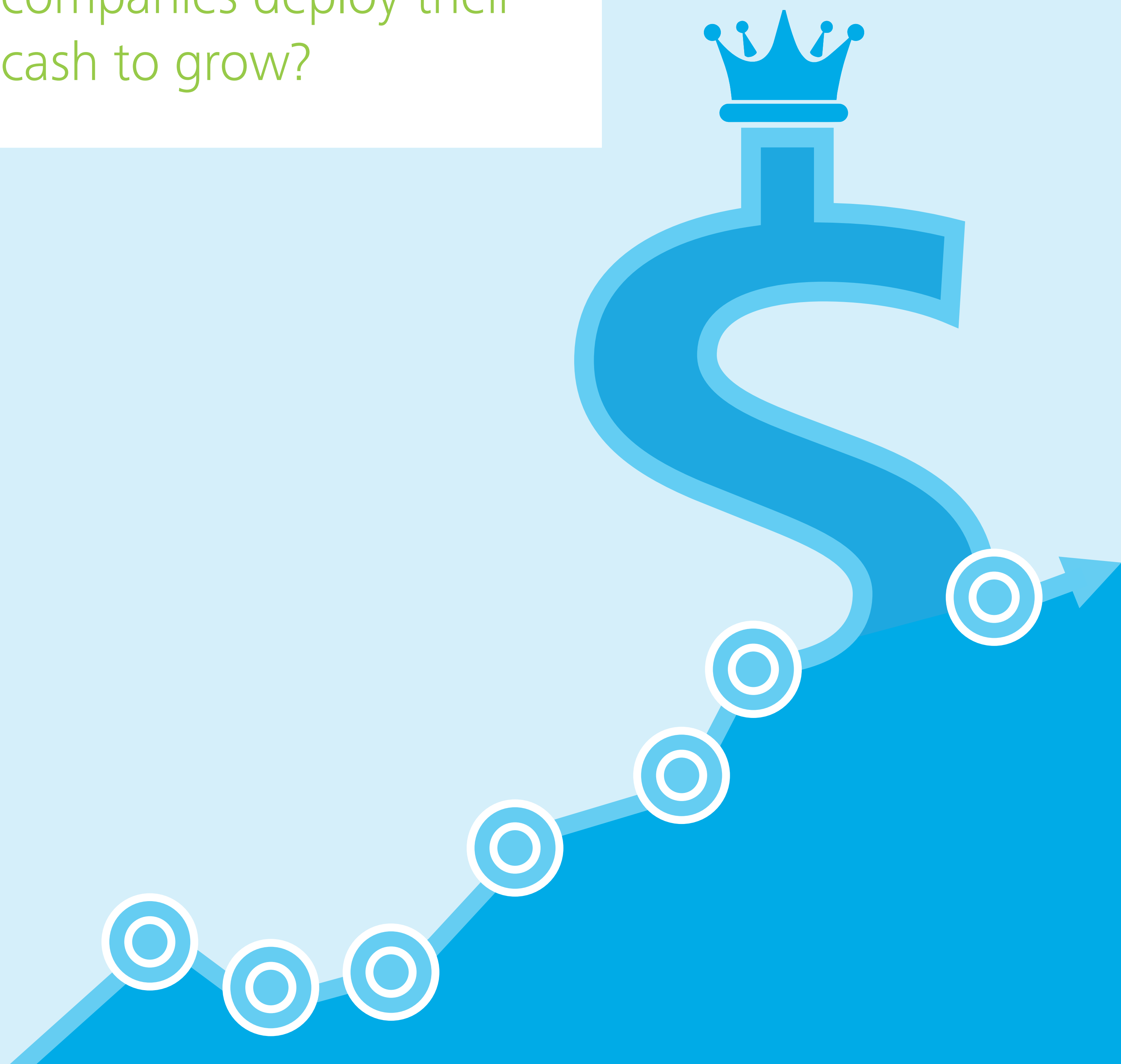
Cash: King or conundrum?

How should technology companies deploy their cash to grow?



Cash hoarding: Why is this an issue now?

Technology companies have been accumulating cash stockpiles for some time. Once a sign of vibrancy and robustness, vast cash reserves are no longer a signal to investors that a company is destined for growth, and they have begun to look for other indicators. In fact, a company's cash reserves and dividend policies are no longer sufficient to differentiate growth-oriented stocks from value-oriented ones. Furthermore, the fact that many technology companies lack a structured approach to effective cash deployment has become a concern.

While many companies have historically spent their cash on share buybacks or acquisitions, this is not necessarily an optimal strategy. Today's investors expect technology companies to apply both creativity and a long-term vision to their approach to cash deployment. Many activist shareholders are particularly focused on the effectiveness of the balance sheet, and executives who struggle to take advantage of the unprecedented opportunity presented by large cash reserves have found themselves vulnerable to activist scrutiny.

Big ideas required

Since the 2008 recession, during which high-tech companies tended to hoard cash, the sector has experienced an undeniable upswing.[1] Now they are looking for ways to deploy their cash that go beyond large-scale share repurchases and that derive value in a sustainable, innovative way. One factor that complicates deployment is the proportion of cash many of these companies are holding offshore. Repatriated offshore cash is subject to up to 35 percent of US corporate income tax,[2] although the effective rate can be even higher. This makes repatriation an unappealing option because it reduces cash available for future investment. However, allowing the stockpile to remain overseas does not generate value for stakeholders or enhance valuations. Moreover, companies may soon face new regulations, such as those seeking to address Base Erosion Profit Shifting through higher taxes on overseas income, as well as increased enforcement regarding accumulated earnings. These factors make it imperative that companies quickly develop optimal strategies for deploying offshore cash. For companies pursuing this strategy development process, there are a number of key steps to undertake:

First, companies need to thoroughly understand the local regulatory environment and trends for each market where they are holding offshore cash, especially if there are benefits to deploying the cash in that country. Compared with the US tax consequences for repatriating cash, investing in research and development (R&D) in a country with favorable R&D tax regimes can offer significant benefits. For example, both IBM and Intel have made large investments (IBM: €66M and Intel: €50M)[3,4] in R&D centers in Ireland. Companies can also redirect cash generated elsewhere to foreign jurisdictions that are favorable from a tax perspective, a strategy that is still more tax efficient than repatriating funds to the United States. Additionally, as tax regulations evolve, companies should consider the impact of the changes and adapt their internal organizational and financial structures accordingly.

Second, creating an effective cash management strategy requires a strong understanding of the company's existing cash situation. For example, executives can use cash maps to track tax credits and maximize their value by avoiding expirations. In addition, a more effective matching of debt and cash within country boundaries can improve tax efficiency.

Third, companies should consider investments that create new opportunities to grow the business in ways that are not available to them domestically. For example, many technology companies use overseas cash to acquire foreign companies that can either strengthen or expand their presence in a particular market.

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While many companies have been successful at leveraging these unique opportunities, they will likely face challenges in the future. Strategies that have become more widespread, such as establishing shared services centers in Ireland or supply chain optimization in China, are no longer differentiators for tech businesses. Companies need to look for new ways to build on their local knowledge of specific markets.

For example, in 2005, Yahoo invested $1B in cash and $700M of overseas assets in Alibaba. This was a creative way for a US tech company to break into the Chinese market, where typical routes were not available. In September 2014, when Alibaba went public in the largest IPO in history, Yahoo realized significant returns that some heralded as "the only example of meaningful value creation by a US Internet company in China."[5]

Companies also have the option of conducting some of their product development abroad by using offshore cash to make investments in countries with R&D tax incentives. This strategy may also take advantage of "patent box"[6] regimes, which give tax breaks for intellectual property revenue to companies that use their offshore cash to invest in the country.

Dimensions of a complex, innovative cash strategy

As executives determine the best cash deployment strategy to maximize their companies' returns, they need to evaluate and prioritize both onshore and offshore options. Because foreign income taxes are typically lower than US corporate income tax, offshore cash may be more valuable overseas after tax when compared with repatriated cash. Companies are therefore well advised to consider offshore investment options, and they will benefit from evaluating offshore/onshore trade-offs during the financial planning process.

Clearly, optimizing cash deployment begins with a broad awareness of the opportunities in different markets. The deployment options selected should also closely align with company strategy. Three dimensions are key to a winning set of investment decisions: risk appetite, scalability/rate of return, and uniqueness of the strategy.

01 Risk appetite

02 Scalability and rate of return

03 Uniqueness of the strategy

Risk appetite. Some strategies are clearly riskier than others are, especially when investing in foreign markets. Yet, these riskier strategies may also help differentiate a company's cash strategy. When evaluating risk appetite, companies should consider not only the magnitude of investment that is required to pursue the strategy in question, but also how far from or adjacent the new investment strategy is to the core business. For example, many companies invest closer to the core by using offshore cash to reinvest in their existing overseas operations by taking advantage of capabilities they have already developed abroad. Alternative investment vehicles would be riskier, and further from the core business.

Scalability and rate of return. When evaluating the expected scalability or, the degree to which additional investments will continue to provide positive returns to the company as it grows, executives should consider the company's short- and long-term growth objectives, its existing capabilities, and the capabilities it will have to build to win in the marketplace. For example, upon determining that appealing investments in existing markets are limited, a company may choose to grow by using its overseas cash to expand or enter certain carefully selected markets that are closely aligned to short and long-term growth objectives. This way, not only is cash used strategically overseas, it considers the company's growth agenda over time.

Uniqueness of the strategy. Settling on a unique strategy for cash will help the business create a competitive advantage that is a custom fit to the company's overall strategy, and that others may not be able to replicate—making it one that investors are likely to view favorably. When tech executives consider all three of these dimensions together, they are more likely to develop a creative cash deployment approach that moves beyond simple asset allocation to become a true strategic differentiator.

Turning the cash challenge back into opportunity

For many technology companies, the abundance of cash accumulated has proven to be a double-edged sword—it is both an unprecedented opportunity and a cause for concern. While Wall Street rewarded these companies for amassing cash reserves immediately following the recession, it is now pressuring them to use cash not only wisely, but also creatively. This reflects an increasingly predominant view that strategic use of cash is a significant factor in a company's long-term global business strategy.

While there are numerous ways to use cash stockpiles, companies should consider their risk appetite and desire for scalability in planning their approach. Being a part of an industry driven by innovation may tempt executives to implement an aggressive cash strategy swiftly. However, the seriousness of cash repatriation penalties and the proliferation of competitors in offshore markets present challenges that require significant deliberation and multiple angles of analysis, making it difficult for executives to design an executable, truly differentiated course of action. Companies need to assess the markets where their cash is sitting, but also recognize that while investments may pay off overseas, foreign environments will likely remain unpredictable and more difficult to control.

It is important for companies to grasp the complexities of cash use, and then analyze specific markets before choosing a path that optimizes cash use and reflects the strategy's true value to investors. Ultimately, each company will need to evaluate not only the strategies they select individually, but also how they commingle as a portfolio mix of investments. Not only will the strategies for handling such issues as repatriation costs, foreign tax credits, and intellectual property need to be compatible with existing business priorities, but they also need to be consistent with any other planned uses of cash. The challenge for executives will be to develop a clear strategy first and then to factor in the realities of offshore cash usage. Technology executives who move beyond using cash as a liquidity tool, and actively evaluate new, big ideas for strategic cash use, stand to create additional opportunities and higher return on investments.

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Endnotes

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