Flashing the cash

A sizeable cash surplus presents companies with significant medium-term and long-term choices. The obvious option of sitting on the cash may also be the most logical when a company anticipates attractive acquisitions shortly becoming available. In a period of weaker economic growth, it may be able to snap up a struggling rival and strengthen its position in the market. The low cost of borrowing in recent years has also seen many UK companies deliberately accumulate cash for use at a later date.

PROVIDING REASSURANCE While a company can be cashflow-poor and still highly profitable – utility companies are a prime example – a large cash surplus is generally regarded as positive. It reassures partners and investors, can boost growth by funding acquisitions and organic expansion, and may also be used to pay off revolving loans or even fixed loans. Major capital expenditure can also improve the company's existing operations. Another use could be to reduce a pension fund deficit. All are viable alternatives, provided they comfortably exceed the cost of capital.

This strategy can be maintained for a lengthy period. Some companies have been sitting on a cash pile for years. A sizeable reserve also provides a cushion for a period of weak growth, particularly when the company carries a significant debt load.

But companies need to assess the short-term cost of carry – at its crudest, borrowing at Libor plus 25bp and investing at, say, Libor minus 5bp. Other potential minuses are the credit exposure from investing cash and the possibility that a large cash pile conceals a low enterprise value (the market value of the business after the cash element has been stripped out).

CYCLICAL REASONS In the life of a company there are cyclical reasons to build up cash at some times and deplete the cash pile at others, depending on whether the business is at an investment stage or benefiting from investment.

In the current business environment, there are few good uses for a cash reserve, but hanging onto it is likely to attract investor criticism that it doesn't represent efficient use of capital. Activist investors are lobbying for the money to be used to benefit shareholders.

Another option is a share repurchase programme. A buyback reduces the number of shares and will normally boost the earnings per share figure, which can give the share price a lift. It can be a particularly astute move if the company's shares are trading cheaply, helping achieve optimum capital structure.

The downside is that buyback money doesn't go towards acquisitions or developing the company's infrastructure, both moves that could develop the business. Essentially, it's an admission by management that it sees no better options for investing its cash, including that of expanding the business.

Some FTSE blue chips have instigated buyback programmes, while others have opted for increasing the dividend – another good strategy in the absence of attractive acquisition opportunities. Shareholders tend to favour cash returns and, if and when required, the company can subsequently request new investment via a rights issue.

PREMIUM PRICING Access to a cash pile for acquisitions clearly benefits a company when a merger or acquisition will improve the overall corporate result. The drawback is that companies with a large cash pile are assumed to be able to pay a high price. Deals have often been thwarted by a bidder walking away because the potential acquisition hasn't been strategic enough to merit a premium price.

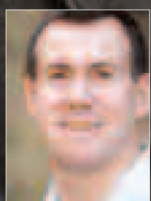
However, an equity bidder is more likely to overpay than a cash bidder. Vodafone's acquisition of Mannesmann in 2000 is regarded as a prime example of an equity-based deal in which the acquirer overpaid. By contrast, the legendary Warren Buffett's policy has generally been to pay cash for acquisitions rather than shares, thereby avoiding giving away chunks of his own company.

It could be assumed that the high prices recently paid by private equity firms for acquisitions are deterring corporates from making acquisitions. However, the impact of private equity has largely been restricted to sectors ripe for consolidation, such as infrastructure, utilities and food manufacturing.

Substantial cash holdings have led to ill-considered acquisitions, with companies suffering deterioration in value and performance after buying a competitor with problems or diversifying into an unrelated business sector. GEC under Lord Weinstock offers a prime example of a cash-rich conglomerate, which subsequently changed its policy when the company became Marconi. Under successor Lord Simpson, it made an ill-fated venture into telecoms through costly

Executive summary

- Recent corporate history suggests some approaches to dealing with surpluses are more successful than others.
- A large cash surplus reassures investors, can boost growth and help reduce pension deficits.
- Large cash holdings have fuelled a poor acquisition strategy. But buybacks can be seen as an admission by management that they cannot see a better use for the cash.



COMPANIES WITH A SIZEABLE CASH RESERVE NEED TO CONSIDER CAREFULLY HOW THEY USE IT. **GRAHAM BUCK** REVIEWS THE OPTIONS.

acquisitions. Cable & Wireless similarly used its cash pile for a buying spree as it attempted to become an IP and internet services provider.

A more successful policy was followed by electronics and engineering group BTR in the 1980s, when it expanded aggressively. To ensure future capital, it carried out each year a free scrip issue of share warrants – effectively an option into shares – to investors, which at expiration were exercisable into new shares to give it a future 'drip feed' of new capital.

During the 1990s, National Grid used a special dividend and the issue of convertible debt effectively to give capital back to shareholders with one hand, while with the other setting in place a mechanism to restore the share capital several years later.

It should also be noted that a cash-rich company might itself present a tempting takeover target. However, using a reserve sensibly should gain the approval and backing of shareholders, making it resistant to predators.

CASH TO SHAREHOLDERS Recent examples of shareholder-focused companies include Smiths Industries, which picked up $5.1bn from the sale to GE of its US aerospace business. The group is returning most of this sum to shareholders, accompanied by a share consolidation programme.

Further afield, cash-rich developing market economy companies are now on the lookout for overseas assets to propel them into the top league in their sector. Tata Steel's acquisition of Corus Group was a recent example, with the Indian group comfortably outbidding its Brazilian rival with a £4.3bn offer.

And companies in both the mining and oil and gas sectors are currently cash-rich, thanks partly to continuing high commodity prices and also due to past investment decisions that have paid off.

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