Kings of cash

The financial crisis triggered companies of all sizes to save hard and they aren't ready to spend again yet. Farah Khalique explains why

Governments around the globe are stepping up the pressure on companies by publicly expressing their dissatisfaction at what they perceive to be a lack of investment in the economy. At the end of October 2013, the UK's Treasury chief secretary, Danny Alexander, urged British business leaders to start spending their £500bn cash pile to help move the economy into 'top gear'.

But the message appears to have fallen on deaf ears. Days later, British oil and gas giant BP reported in its quarterly results that it had boosted its cash reserves by almost $10bn in less than a year, from $19.6bn at the end of 2012 to $29.5bn by the end of September 2013. This figure has steadily crept higher over the past few years, with its cash pile more than doubling since 2011. BP declined to comment for this article.

This trend is playing out across the globe as companies play it safe, according to market participants. US non-financial rated companies had racked up $1.48 trillion in cash by the end of June, with technology giant Apple leading the way with $147bn in reserves, according to estimates from rating agency Moody's. In March 2013, fellow rating agency Standard & Poor's claimed that European non-financial companies were sitting on a massive $1 trillion cash pile between them. Meanwhile, Japanese companies are hoarding some JPY 225 trillion ($2.4 trillion) in cash, according to data released by the Bank of Japan in June – a sum that is greater than Italy's GDP.

Save, save, save

The trend for companies to hoard cash may have stemmed from the financial crisis, but it shows no sign of abating now that there is a cautious return to growth.

"It is a sign of the economic times that [companies] are nervous about investing and are slow to make that investment," says Martin O'Donovan, deputy policy and technical director at the ACT.

Corporates are suspicious as to the authenticity of economic recovery, given the huge amount of central liquidity being pumped into the major economies, according to Nick Raich, chief executive of The Earnings Scout, a US-based macroeconomics research firm.

"Very few people believe that the global recovery in the US and Europe is real. It is a central bank-induced recovery; no one believes that if it wasn't for the Federal Reserve and the European Central Bank that we would be in this place," comments Raich.

This suspicion, combined with ongoing wrangling in Washington over the fiscal budget and the tax cost of repatriating overseas cash, appears to have induced US chief executives into a short-termist coma that is stalling the long-term economic recovery. "Excess cash is being used to buy back shares and pay dividends, which is good for shareholders in the near term, but a lot of companies aren't moving that excess cash to invest in people in the long haul," warns Raich.

The rise of the mini-banks

It seems that the financial crisis and sluggish recovery have done more than just make corporates nervous. They have fundamentally changed the way that corporates fund themselves, which means bloated cash balances are here to stay.

Corporates are turning to the bond market in droves because low interest rates translate into cheap, long-term funding. Apple famously issued a bumper six-tranche $17bn bond in April 2013, with coupons ranging from as little as three-month Libor plus five basis points to a maximum of 3.85%.

Global corporate bond issuance is bigger than ever, according to data provider Dealogic. More than 5,000 companies issued $1.9 trillion worth of bonds between 1 January and 4 November 2013 compared with about half as many companies issuing just $803bn in the same period in 2008.

The balance has shifted over the past five years from bank financing more towards capital markets, says Jean-Michel Carayon, senior vice president in the corporate finance group for Europe, the Middle East and Africa at Moody's. "Many corporates have moved from having huge bank facilities and little cash on the balance sheet to a more balanced liquidity model, with some bank facilities, but also sufficient cash.

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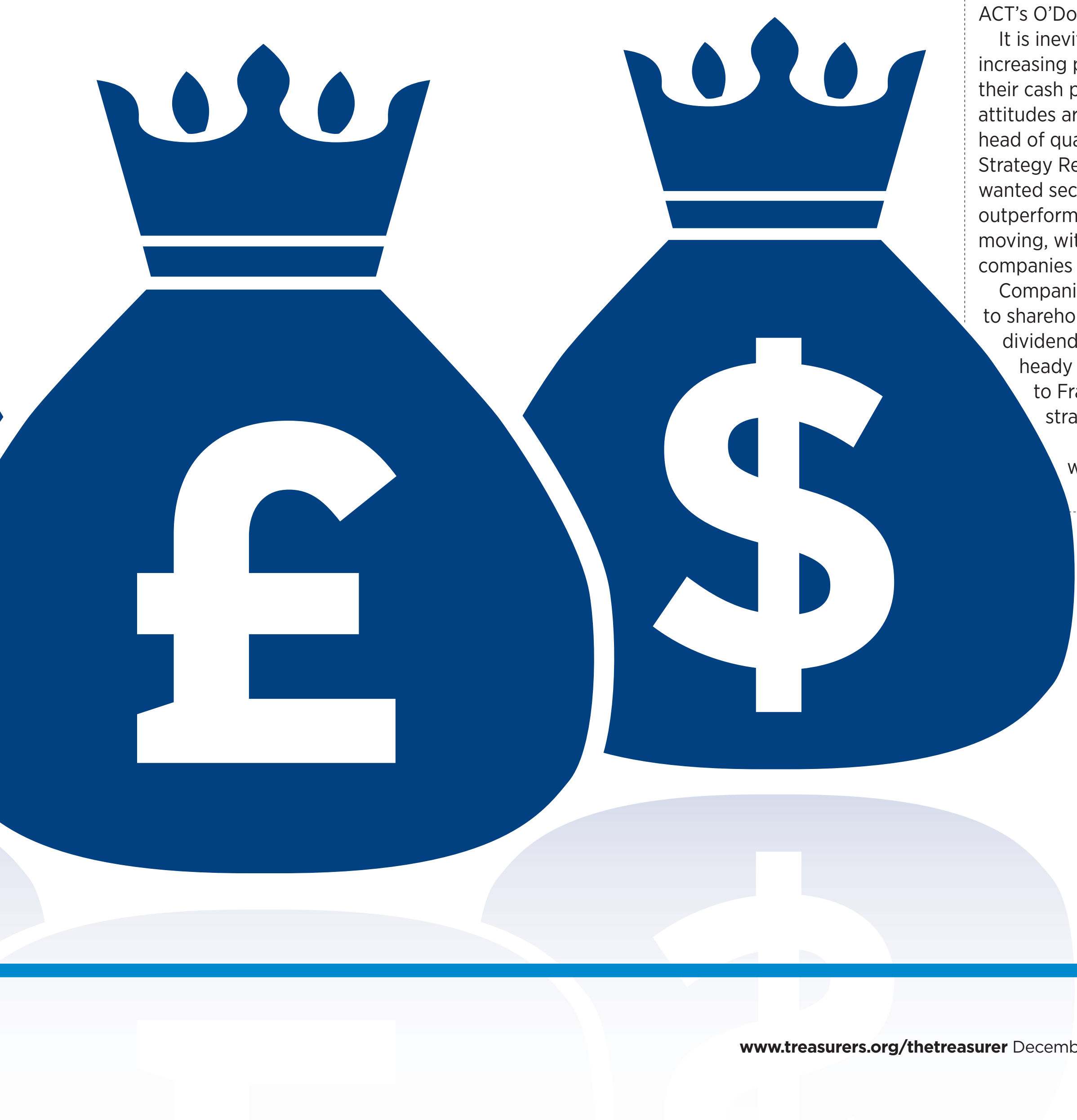
"Some have issued more [in the bond market] than their refinancing needs would have suggested, therefore accumulating more cash."

This has led to the rise of the so-called 'mini-banks', as companies build up so much cash that they start to resemble financial institutions, according to the global head of corporate investment products at a European bank. "The multinationals want to become a bit independent of the financial industry. Many also have huge pension liabilities on their balance sheet, and use the cash to finance these liabilities," he says.

German electronics company Siemens even has its own banking licence, while some companies have taken the drastic step of avoiding the banks altogether. These days, airline easyJet does not invest a single penny in any mainland European bank, preferring instead to use money market funds.

Politicians accuse these companies of under-investing in the economy, but many have come up with novel ways of using their cash piles to benefit their suppliers. Mark Coxhead, managing director at supply chain finance solution provider Woodsford TradeBridge, says that many of its customers find themselves sitting on surplus cash piles and wondering what to do with them.



"The problem is that there is very little they can do with it on a short-term basis that gives any kind of return. But they can use the cash to pay their vendors early without getting stuck with changing payment terms," he says.

Large companies, such as mobile telecommunications firm Vodafone, offer supply chain finance programmes, where they offer to pay suppliers promptly in return for an early-settlement discount.

Political pressure

Nevertheless, politicians and investors alike have expressed their unease at the growing size of companies' cash balances.

"To start with, it was a natural reaction to consolidate, cut back on investment and preserve cash, but you do wonder now. Investors are right to ask about a company's strategy, and a return to shareholders might be the appropriate thing to do," says the ACT's O'Donovan.

It is inevitable that governments will apply increasing pressure on companies to invest their cash piles, and moreover investors' attitudes are changing, says Charles Cara, head of quantitative strategy at Absolute Strategy Research. "After the crisis, everyone wanted security with the least volatile stocks outperforming. But there are signs that is moving, with investors preferring high-growth companies that are investing."

Companies are increasingly returning capital to shareholders via buybacks and special dividends, but we have yet to return to the heady M&A pre-crisis days, according to Frances Hudson, global thematic strategist at Standard Life Investments.

This has prompted a debate about whether governments should tax >

THE CASE FOR CASH

Politicians love to point the finger of blame at large corporations for hoarding billion-dollar cash piles, but the headline figures bandied about often belie what's really going on

Rio Tinto, the world's second-largest iron ore producer, had cash reserves of $7.2bn at the end of June 2013. Critics might argue that figure is burning a hole in Rio Tinto's pocket, but its global head of corporate finance, Jono Slade, begs to differ.

"There is no 'one size fits all' for the appropriate level of cash reserves and each sector is different," says Slade.

The mining sector's success naturally correlates with commodity prices, but these are prone to volatile fluctuations, not least of all the iron ore market, which is the bread and butter of Rio Tinto's business.

The price of iron ore tumbled by almost a third in less than two months over the late summer of 2012, demonstrating the potential effect volatility can have on cash flows. A healthy cash balance is key to weathering these storms.

Market volatility aside, the metals and mining sector is forward-looking and it needs its large cash piles to fulfil its future, long-term projects.

Rio Tinto's capital expenditure for 2012 exceeded $17bn, and the figure for 2013 is expected to total around $14bn.

"A cash balance of $7bn doesn't necessarily last very long when you bear in mind our high levels of capex and the potential commodity price volatility," Slade explains. "Inevitably, there will be bumps along the commodity road and we want to make sure we can carry on with those important projects and not run short of liquidity in the intervening period.

"Access to financial markets is not as reliable as it once was, whether via bond or commercial paper markets, and at times the banking sector has shown signs of severe distress. Because of quantitative easing we have experienced historically low interest rates, which have reduced the cost of carry. These all lead to holding large cash balances," says Slade.

The global banking crisis changed everyone's view of credit, and Rio Tinto is no exception. These days many corporates are looking very carefully at where their money is deposited.

The critics still argue that large multinationals should spend their burgeoning cash piles, but over the past few years, the mining industry has already invested in its future and returned capital to shareholders.

Rio Tinto's net debt increased from $8.5bn at the end of 2011 to $19.3bn a year later due to its capital expenditure, acquisitions, dividend increases and completion of its $7bn share buyback programme.

Now is the time to save, says Slade. The miner is expected to further reduce its capital expenditure in 2014 and is targeting savings in its operating and exploration and evaluation costs by the end of 2014. "The mining sector is in cost control and capital discipline mode," comments Slade.

He believes it may be the uncertain economic outlook holding back investment or just the need to protect against potential liquidity shortfalls, which explains why companies haven't invested their cash as much as the critics would like. "We know from the global financial crisis that the world is a pretty volatile place and it is still going through some tough times, so a combination of cash reserves and access to bank lines is important for a company like Rio Tinto," he says.

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large companies on their cash piles in a bid to encourage spending, but the idea has been met with much derision.

"It's not really the place of governments to tax [companies'] cash any more than they should suddenly turn around and tax savers for having money in the bank," says Hudson.

A corporate treasurer at a FTSE 100 company dismissed the idea as "crazy". "We don't do M&A and when we do, it's limited. The thought that some tax position might cause you to make rash business decisions is nonsensical."

And for the many SMEs that are crucial to powering economic recovery, the debate on cash piles is completely irrelevant anyway. William Beckett, founder of William Beckett Plastics, says that few SMEs can afford to hoard money. His company almost went bust in 2009 after business fell by 35% and he had to lay off 40% of his workforce, but he fought back.

"We invest everything in people, machines, technology and new products. You need to develop new products and markets, [otherwise] you don't deserve to be in business," he says.

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