AN EMBARRASSMENT OF RICHES

The amount of cash held by some corporates has markedly increased, but if they continue to do nothing with it, they risk disgrace, argues Charles Cara

The 19th-century US industrialist Andrew Carnegie once said that "the man who dies rich, dies in disgrace", and so spent his later years distributing his great accumulated wealth. Just as in the Gilded Age, the 21st century has seen another great accumulation of cash, but this time it has been by corporations rather than by industrialists. Since 2000, the reported gross cash balances of the 1,500 largest listed non-financial companies around the world have grown from $1 trillion to $3.5 trillion. The recent recession has done nothing to dent this accumulation: almost half was amassed in the past five years.

Together, the 20 largest cash balances total $763bn. Six of these companies are in the US technology sector. For instance, Apple has $30bn of cash and if its financial investments are included, its liquid resources balloon to $137bn. In our analysis, the US tech sector alone holds more than the French and UK companies combined. The next two sectors, in terms of size and cash holding, are also American – industrial goods and health care. Over the past five years, these three industries have accumulated just under $400bn. In relative terms, however, the accumulation of cash has been more evenly distributed and most sectors have increased their cash holdings. So 'hoarding' can be seen as a broader issue.

Since cash holdings will typically earn interest at <1%, against a cost of funding from long-term debt of 2-7% and an even higher cost of equity, holding these balances has a cost. Therefore, corporate managers will have strong motives for holding them. We would group these reasons under five headings: liquidity; anticipation of inflation or growth; risk of future losses; taxation; and, finally, derivative collateral requirements.

Liquidity is clearly a key issue. The global financial crisis exposed the dangers of relying on constantly open capital markets, or on committed but undrawn bank facilities. Companies appear to have decided to 'self-insure' by borrowing long term and placing the proceeds on deposit. This 'self-insurance' has taken the aggregate ratio of cash to short-term debt from enough to cover eight months of short-term debt redemptions in 2000 to 21 months of cover now. Short-term liquidity has also increased and cash is now over 40% of current liabilities compared with less than 29% in 2001.

Another possible reason is that cash is being held to fund future growth, or to cover inflation risks. Both require investments in working capital, since raw materials have to be purchased and labour paid ahead of sales proceeds being received. Exits from recession often result in an increased demand for cash. If corporates really are waiting for a surge in demand, this would be positive.

Tax has clearly been significant for US companies, especially in the technology sector. The US pressure group Citizens for Tax Justice estimates that US companies have almost $1.6 trillion of profits held outside of the US (GE had about $80bn in 2011). Remitting these funds to the US would lead to a tax charge of up to 35%. But instead, US companies appear to have borrowed in the US to fund share buybacks and the cost of carry for this transaction would be offset by the reduction in the tax charge.

Many US technology companies also hold a large cash balance as a precaution against technological shifts undermining their products. A current example is the rise of smartphones impacting BlackBerry/Research in Motion. Its cash balances allow it to survive until the product cycle moves back into its favour. Since these balances also reveal management's belief that insurance is needed against technological risks, in our view, they flag that the valuation of these stocks should be capped.

Finally, increased collateral requirements for derivatives might also be a reason for increased cash holdings. These sums can be large – for instance $2bn out of $20bn for oil giant BP.

As we have argued previously in this column, for governments to close their deficits, the aggregate corporate surplus will have to fall, either through investment, inflation or taxation. In the latter two scenarios, high cash balances are an issue. Inflation erodes their real value while their mere existence presents a tax target for politicians.

The near-death experiences faced by corporates during the global financial crisis have prompted many companies to hold large cash balances as a precaution against problems in the financial sector. But these balances now appear to be more than sufficient, in aggregate. As these cash holdings have a negative carry, reduce return on equity and flag up risks of future losses, we believe corporates need to be using them. If they don't, then corporates could face the 'disgrace' of losing them.

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