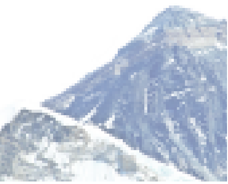




# Mining the cash mountain

IS PUTTING YOUR SPARE CORPORATE CASH TO WORK IN EMERGING MARKETS A WISE STRATEGY OR A FOOL'S ERRAND? **JOHN SALTER** REVIEWS THE OPTIONS.

Concerns over funding gaps, credit availability, access to finance, liquidity calls and issues of potential liquidity exposure have challenged all institutions. As a result, corporates have been keeping their spare cash in-house. However, unused capital and financial resources are seen as rich sources of investment funds by businesses that can offer decent rewards for investors. This is why Asian financial institutions are targeting European and US corporate money to finance suppliers in the region.

It's common knowledge that Apple is the world's most valuable company today, with a market capitalisation of over $600bn in April 2012. What is not so well known is that Apple is sitting on $100bn of cash reserves.

That hoard has been the subject of huge speculation over the past few months. Will the company use its cash to acquire Microsoft? Should it merge with Google? Perhaps it'll buy a country! Instead, the company announced it would spend $45bn over the next three years on cash dividends and a $10bn share repurchasing programme. It sounds like a lot, but Apple is still making $13bn profit a quarter, so that cash pile will only grow.

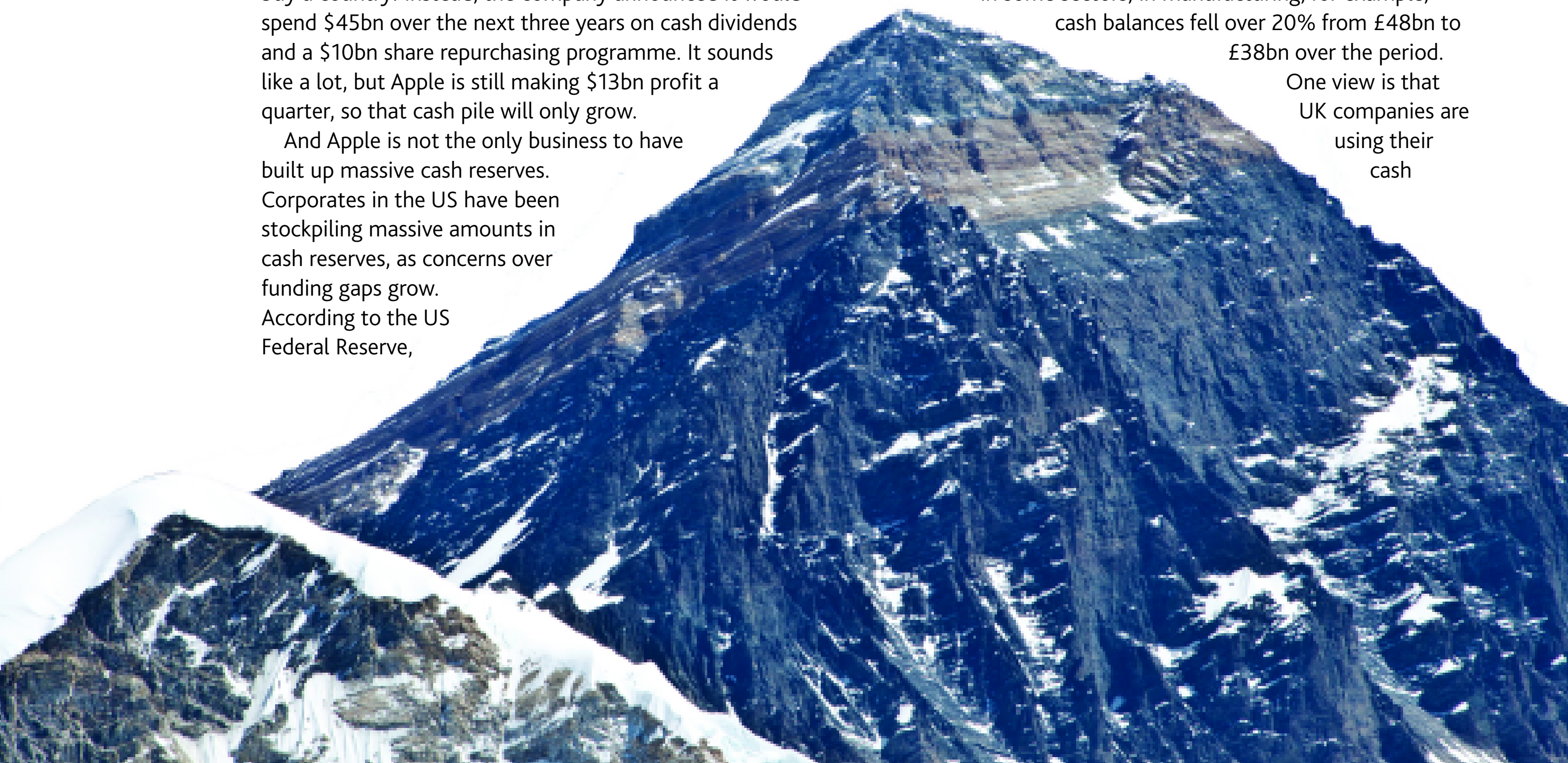
And Apple is not the only business to have built up massive cash reserves. Corporates in the US have been stockpiling massive amounts in cash reserves, as concerns over funding gaps grow. According to the US Federal Reserve, non-financial companies held over $2.2 trillion in cash and other liquid assets at the end of 2011, a rise of more than $113bn over September, and an amount that is increasing quarter on quarter (see Figure 1).

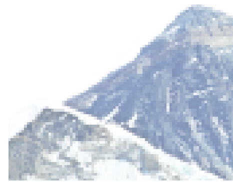
Since the financial crisis hit, cash and liquid assets have jumped by an average of over 16.7% a year to a record level. These assets account for 7% of the total assets of non-financial companies, the highest level since 1963 – and it continues relentlessly upwards.

The same is true in Europe, where companies have cash reserves of $1.54bn on average, 23% more than in 2007, according to data compiled by Bloomberg.

The UK does not fit this profile, though. The Bank of England reported that the balances for non-financial corporations fell from £378bn in December 2010 to £366bn by February 2012. The shrinkage has been particularly marked in some sectors; in manufacturing, for example, cash balances fell over 20% from £48bn to £38bn over the period.

One view is that UK companies are using their cash





reserves rather than bank facilities to fund projects, and while some argue this is because UK banks aren't providing enough liquidity to firms, it is clear that the government and the banks are working together on initiatives to provide support.

The second, and more likely possibility is that it is a reflection of UK corporations deleveraging, something that European companies will need to do if the issues in the euro zone continue.

Moreover, where there are cash reserves in European and US businesses, it's notable that most of this cash is held overseas. According to ratings agency Moody's, over half of US companies' liquid assets are held overseas. Apple, for example, holds two-thirds of its reserves abroad. Similarly, Microsoft keeps 89% of its $52bn liquid asset reserve overseas, and Cisco keeps almost 90% of its $47bn abroad.

It is fairly obvious why companies are hanging on to cash and liquid reserves, as the concerns over the past four years have been all about the availability of credit and the funding of liquidity gaps.

But while this has certainly been the concern, the reality is that it damages economic prospects and growth. Not only does stockpiling cash squeeze investment internally in the economy – many blame the stagnation in Europe and the US on a lack of liquid asset availability – but it means that corporate finance is being held in offshore locations where tax efficiency is optimised.

This is why Apple recently called for a tax holiday in the US, with chief financial officer Peter Oppenheimer saying that "repatriating the cash from offshore would result in significant tax consequences under current US law".

Under current US tax laws, US companies have to pay corporate tax rates – up to 35% of profits – for any profits made anywhere in the world, but can defer paying those taxes until the profits are brought to the US.

This leaves the corporate with a few options, the most obvious of which are to:

- acquire another company, which is often the most likely outcome when businesses are cash-rich;
- leave the funds awash in offshore accounts; or
- expand their operations in fast-growth emerging markets.

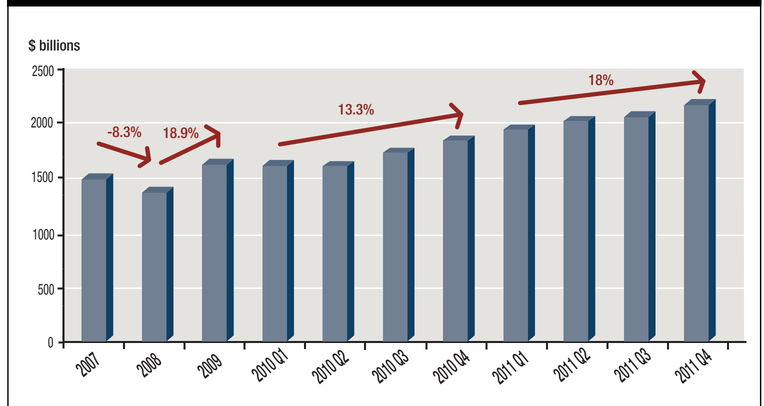
Of course, there are other alternatives, but let's take a brief look at these three.

The first is the usual outcome when companies find themselves with excess cash at the end of a recession. Therefore, when markets move back towards expansion rather than contraction, the analyst community expect a rash of mergers and acquisitions as buying another business offers a fast way for companies to gain growth or remove competition, particularly if the markets are offering cheap purchases, as is the case today.

However, a wave of M&A probably won't happen until the macro-economic indicators show signs of stability in the global markets. With the euro zone still causing jitters and China's growth expected to hit a 13-year low in 2012, most corporate cash is likely to remain in reserve.

Does this mean that corporates have to leave their cash in reserve offshore or are there other ways to make it sweat?

**Figure 1:** US non-financial company cash/liquid assets 2007–11




Well, there are real incentives to use that cash in reserve to invest in expansion in emerging markets, especially as overseas governments actively encourage the use of those reserves for leverage in their economies.

For many years, governments have actively run foreign direct investment (FDI) programmes to encourage corporates to invest, including tax holidays, grants and free land. Sometimes these incentives are even higher than the investments being made. For example, the Brazilian state of Goiás provided a $125m subsidy to Usina Canada in 2009 for a $25m investment; similarly, the state of Gujarat in India provided a subsidy estimated to be a minimum $800m to gain the rights to produce the Tata Nano motor car in 2008, an amount far beyond the amount invested by Tata.

This means that most large multinational and global corporations will be facing a dilemma:

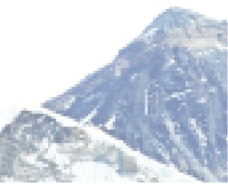
- Cash and other liquid assets are sitting globally in accounts which may not offer the most efficient returns.
- Domestic governments in developed economies seek to tax such assets and act as a disincentive to using such funds.
- Overseas governments seek to gain the investment of those assets in their economies, and offer strong incentives to invest.

Should you therefore release funds into market expansion in growth economies? Possibly, but only if it makes sense as part of a global strategy and, if it does, which economies is another key question.

For example, the Economist Intelligence Unit announced that the growth economies would be the CIVETS back in 2009. The CIVETS is meant to be the new acronym that takes over from the BRICs (Brazil, Russia, India and China) and embraces Colombia, Indonesia, Vietnam, Egypt, Turkey and South Africa. After the Arab Spring, though, Egypt does not look so attractive.

Talking about the BRICs, Jim O'Neill, senior economist with Goldman Sachs, who coined the term back in 2003, has come up with a new Growth8 – the BRICs plus Indonesia, Vietnam, Turkey and Mexico. It is clear therefore that Indonesia, Vietnam and Turkey are significant growth markets.

Alternatively, you may take the view that Latin America – Colombia, Mexico and related markets – will be the key





region in the future. These are markets which encourage FDI and will be supportive of corporates in their overseas expansion programmes.

The key to assessing opportunities in these markets really comes down to market knowledge, ease of entry, appropriateness of the offer and availability of credit. These are all factors that your banking partner should be able to advise on in depth and offer services that support entry into these domains. In fact, for any corporate considering the use of liquid assets or cash reserves in overseas expansion, there should be a brief checklist view of what's important in this process. And there is one. The OECD issued a checklist, which finds that the most important factors considered by investors as they decide on investment location are:

- a predictable and non-discriminatory regulatory environment and an absence of undue administrative impediments to business more generally;
- a stable macro-economic environment, including access to engaging in international trade; and
- sufficient and accessible resources, including the presence of relevant infrastructure and human capital.

In short, it is clear that corporations throughout US and European markets are nervous and are keeping cash and liquid assets in reserve. The increase in such assets has been notable over the past four years, reaching their highest levels since 1963 this year.

The expectation that corporates will continue to hoard liquid reserves will continue as long as the macro-economic climate remains uncertain, but it is likely that many businesses will be tempted to expand into fast-growing overseas markets if they take any action at all. The challenge will be how to trade in such markets. For example, using open account to trade will be a challenge if you have little or no experience in such geographies. That is why it is critical to be with the right bank partner who can provide advice and support on such expansions.

*The OECD's checklist for foreign direct investment incentive policies is at: http://bit.ly/KwR6Q4*

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cash management
MONEY MARKET FUNDS

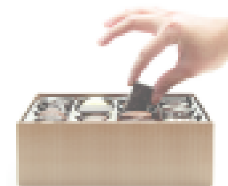
# Select with care

**MARK STOCKLEY** CONSIDERS MONEY MARKET FUNDS IN TODAY'S FINANCIAL ENVIRONMENT.

Corporations of all sizes, insurance companies, pension funds, sovereigns, universities and local government entities are among the retail and institutional investors that use money market funds (MMFs) to meet their liquidity needs and manage their operating cash. The existence of MMFs that adhere to the code of practice of the Institutional Money Market Funds Association (IMMFA) offers many investors the key benefit of funds with similar characteristics to bank deposit products given their objective of maintaining a stable net asset value (NAV) per share. IMMFA funds also give investors access to portfolio diversification rather than exposure to single-counterparty risk.

The European debt crisis has presented MMFs and their strategies with challenges, including heightened concerns around credit risk, a reduced supply of investable securities, lower yields, and less liquidity in the market. It has also made it harder for asset managers to source suitable investment instruments in sectors such as the market for European sovereign bills. At the end of 2011 this was clearly felt by the market, with the German and Dutch authorities issuing bills at negative yields of anything up to minus 20 basis points.

MMFs continue to be important tools within a liquidity risk management framework, particularly as the primary goals for an IMMFA fund are preservation of capital and liquidity; yield is a key priority too, but a lower one. IMMFA funds must be



triple-A rated by one or more of the three big ratings agencies – Moody's, S&P, Fitch – and therefore prudently managed, minimising interest rate, credit and liquidity risk.

IMMFA funds usually offer shares or units with a constant net asset value (CNAV) held at $1.00, €1.00 or £1.00. Their CNAV is maintained through the use of amortised cost accounting for their short-dated fixed-income instruments as permitted for MMFs by both fund regulation (UCITS) and international accounting standards (IFRS).

Investors should take the time to understand the credit research and investment processes of their MMF providers. All asset management firms follow their own unique investment philosophy and it's important that investors understand that the firms' investment styles are different from each other. Asset managers do not always interpret risk the same way – some may stay away from an issuer which others think represents suitable risk for their portfolios, while each asset manager may put differing exposure or maturity limits on particular counterparties' debt issuance.

One of the greatest challenges for asset managers and investors in the near future will be a loss of liquidity in the market as uncertainty increases. Lower levels of liquidity combined with reduced levels of supply can make conditions fairly difficult for cash investors. Should the euro zone crisis worsen over the coming months, cash investors can expect to see great demand for high-quality short-term sovereign debt, which can create a great deal of pressure in the market.

Also in the background is the possibility that regulatory changes may be on the agenda for the MMF industry. In the US the Securities and Exchange Commission (SEC) has some pending Rule 2a-7 recommendations and new proposals which may be released over the coming months. It is unclear yet exactly what the draft proposals will be, but there may be a set capital requirement, redemption holdbacks and an option to offer MMFs as floating NAV products. In the US all MMFs maintain a CNAV, similar to IMMFA funds.

Whatever happens, it will be interesting to see the impact of any SEC changes on the European industry. The markets are interlinked, as was seen following the 2008–09 crisis, when the US and European regulators amended the rules around MMFs. For instance, the SEC introduced more stringent guidelines around transparency as well as amending the rules around credit, liquidity and interest rate risk. At much the same time the European Commission adopted new rules for MMFs, as proposed by the European Securities and Markets Authority (ESMA), categorising funds as "money market funds" or "short-term money market funds".

**AN OPEN AND CLEAR DIALOGUE BETWEEN THE INVESTOR AND THEIR ASSET MANAGER ENSURES THE CASH-INVESTING OBJECTIVES OF EACH ARE SHARED AND UNDERSTOOD.**

ESMA brought some clarity to the European industry by doing this, and the consensus from the industry and investors has been that the SEC's changes have been positive too. While these are major steps for the US and European markets, it is clear that there is a high level of transatlantic co-ordination between the various regulatory bodies and greater focus on trying to put some additional regulation in place; in theory, to make money funds safer.

Managing cash is a discipline in its own right and requires expertise. Investors have a choice of a large number of MMF providers and it's important they complete thorough due diligence in the selection process as each MMF will be managed according to differing credit and investment processes. An open and clear dialogue between the investor and their asset manager is important to ensure that the cash-investing objectives of each are shared and understood. A strong relationship between investor and asset manager can and will increase the value of MMFs as an important cash investment tool.

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