

# Marakon

## commentary

## Using Cash to Drive Profitable Growth: Part 1

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**November 2010** *by Alex Brown with Nathan Farber and Jason Velkavrh*

### Summary

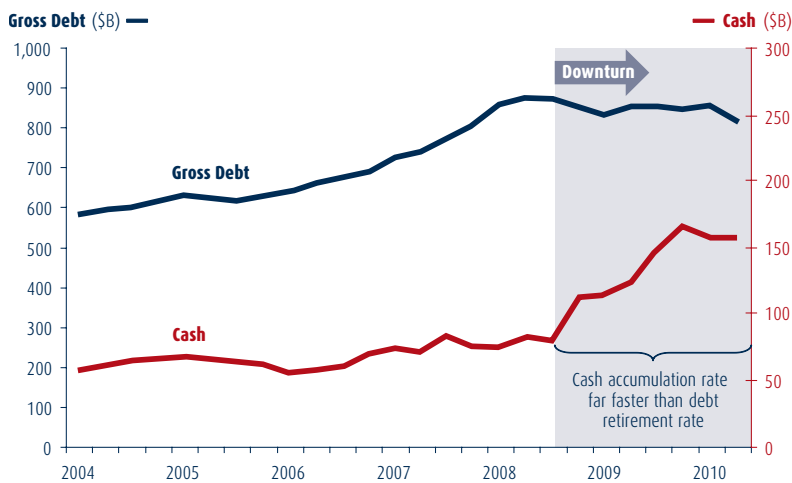
- U.S. industrial companies have generated record cash balances through the worst downturn since the Great Depression
- They have achieved this counterintuitive result primarily by slashing investment and costs
- Companies are not deploying cash for two main reasons:
  - Continued uncertainty about demand, as well as new regulations and taxes
  - Difficulty in finding investments that are both profitable and able to sustain growth
- Management knows that the cash must be invested or given back to shareholders but face two main challenges: (1) investors have already priced in aggressive assumptions for future performance and (2) high levels of volatility have increased the cost of capital raising the bar for value-creating investments
- A company that doesn't invest its cash at returns above this higher cost of capital and meet investor growth expectations is vulnerable
- Delivering a step change in profitable growth requires a new set of tools and capabilities

## Record Cash Balances

A remarkable development coming out of the 2008-2009 recession was the record amount of cash that companies in most sectors had accumulated. As of mid-2010, U.S. corporations had \$1.85 trillion in cash on their balance sheets, the highest level in 50 years. Despite the worst downturn since the Great Depression, U.S. companies managed to not only stay solvent, but to hoard cash.

### Exhibit 1

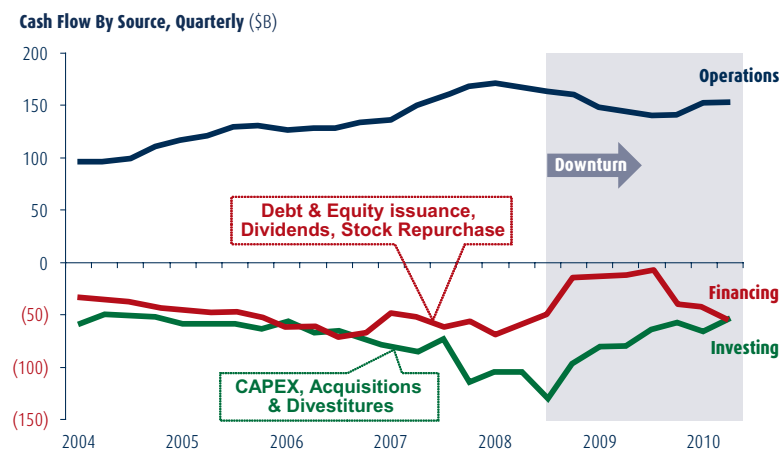
Cash vs. Debt for S&P 500 Industrials, 2004-2010YTD



Sample includes 80 industrial companies in S&P 500  
Source: Capital IQ, Marakon analysis

### Exhibit 2

Cash Flow Decomposition for S&P 500 Industrials, 2004-2010YTD



Sample includes 80 industrial companies in S&P 500  
Source: Capital IQ, Marakon analysis

Industrial companies (the focus of this article) were no exception as Exhibit 1 shows.

Since the downturn started in Q3 2008, the 80 industrial companies in the S&P 500 have nearly doubled their cash balance from \$80B to \$156B: a compounded quarterly rate of over 10%. They now have an average of \$2.0B in cash on hand. While they have retired debt (approximately \$51B since the downturn started) the rate of de-leveraging is less than 1% quarterly. As a result, cash as a percentage of gross debt has increased from 9% to 19% in this short timeframe.

## How Companies Generated So Much Cash

How did this happen? It seems clear that U.S. industrial companies have become more nimble. This is likely a result of the relentless pressure of global competition over the previous two decades, in addition to the regular cyclical downturns of the past 3-4 decades. As a result, industrial companies over the last two years have demonstrated an ability to alter their business models and restructure with great speed in the face of an unprecedented fall off in demand. Exhibit 2 shows how this nimbleness resulted in a dramatic change in the components of cash flow for U.S. industrials:

1. **Cash Flow from Operations** has remained essentially flat through the downturn despite significant revenue erosion as companies rapidly moved to eliminate costs and capacity (especially headcount) and to reduce inventory positions. Though not back to pre-downturn levels, asset productivity (both PP&E and working capital) has come back by 50% from its lowest levels in 2009. Labor productivity has likely been squeezed as much as possible, with an 18% improvement in revenue per FTE driven largely by a 5% reduction in headcount (an average headcount reduction of nearly 2,100 FTEs per company).

2. **Cash Flow from Financing** flattened out as the downturn continued through 2009, but has become increasingly negative in the last 3 quarters primarily as a result of companies retiring debt. Firms have also continued to return cash to shareholders primarily through dividends (yields were flat through the cycle), although share repurchase has plummeted – likely because companies want to continue dividends as a signal to investors but also want to conserve cash.
3. **Cash Flow from Investing** has seen the most dramatic shift. The strong positive direction of the green line is due to U.S. industrials taking draconian measures to reduce investments in capital (even maintenance CAPEX) and in M&A.

that same timeframe, acquisition activity has dropped over 70% (from \$295B to \$84B). On an average per company basis for the 80 industrials, CAPEX and acquisition activity has dropped from an annualized rate of \$7.4B to \$3.3B.

### Why Companies Are Holding So Much Cash

Why are U.S. industrials holding on to so much cash? Evidence suggests that there are two primary drivers: *continuing market uncertainty and volatility*, and an *inability to find ways to invest in sustainably profitable growth*. We'll discuss each in turn.

It is difficult for companies to make significant investments in growth when the markets continue to be choppy and unpredictable. Though there has clearly been an uptick since the market bottom in 2009, volatility in the markets remains high. This is causing firms to remain cautious and focused on improving margins and cash flow rather than investing to capture growth.

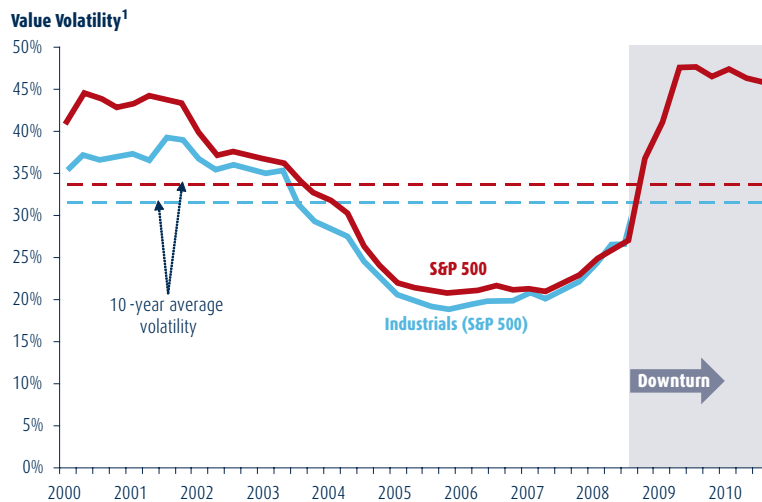
This cautiousness is driven primarily by three factors:

- Concern that core demand has not recovered and that brief upticks are not sustainable
- Demand forecasts that have recovery to 2007 demand levels only by late 2011 or 2012
- Belief that consumer willingness to pay has shifted (that we have experienced a fundamental 'consumer reset') limiting the ability to price

There is compelling evidence for this uncertainty in the U.S. equity markets, as shown in Exhibit 3.

The story shown in this chart is relatively simple, but very important. Market volatility increases significantly in downturns (seen by

**Exhibit 3**  
Value Volatility Among S&P 500 Industrials



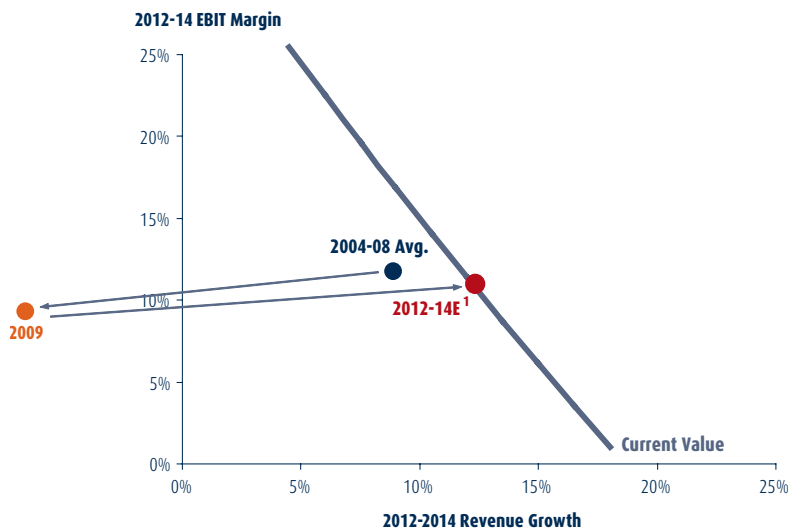
<sup>1</sup> 2-year trailing value volatility calculated based on weekly returns  
Sample includes 80 industrials companies in S&P 500  
Source: Capital IQ, Bloomberg, Marakon analysis

In sum, U.S. industrials acted with breathtaking speed to slash operating costs (especially labor) and to retire expensive debt. But the single most impactful measure was to take a scalpel to investments in growth, both organic and M&A. From the end of Q3 2008 through Q2 2010, CAPEX is down nearly 40% (from an annualized rate of \$293B to \$182B). Over

the peaks in 2000-2001 and 2008-present). Higher volatility increases the cost of equity for companies because investors expect higher returns to compensate for the higher risk of making investments in a less stable environment. This generally means that a company – or any initiative they pursue to create growth – is worth less because the discount rate has increased.

#### Exhibit 4

Double Value Growth & Return Requirements: 80 U.S. Industrials in S&P 500



<sup>1</sup> Expected performance for basket of 80 industrials companies in S&P 500, using consensus analyst estimates for 2010-11 and tying valuation to current total market capitalization of \$1.4 trillion  
Sample includes 80 industrials companies in S&P 500 Source: Capital IQ, Thompson Reuters, Marakon analysis

As a result of this increased volatility the cost of equity for the average U.S. industrial company is now around 12%. This means that the average firm – with a debt/capital ratio of 30% – now has a weighted average cost of capital of about 10%, an increase of several percentage points over the historical average

For U.S. industrial companies the implication is clear: investors are expecting significantly higher volatility and risk, requiring management to deliver much higher levels of profitable growth to move the needle on value. The debate about whether a structural shift in the market has occurred will no doubt go on, but investors are clearly saying that it's a new, riskier world out there.

This gets to the second driver of these record cash balances: *the difficulty in finding investments that are both profitable and able to sustain growth.* In mature industrial markets like the U.S. and Europe, gaining share and extending into new customer/product markets is very competitive making it difficult to earn good returns. Extending into emerging markets requires specific capabilities, has higher failure rates, and near-term profitability is often very low or negative. Tack on the higher hurdle rate for new growth initiatives and it becomes easier to understand why so many companies are simply holding on to their cash or returning it to shareholders.

Exhibit 4 illustrates this challenge for U.S. industrials trying to grow their value.

The blue dot shows the average 2004-2008 growth (revenue) and returns (EBIT margin) for the 80 industrial companies in the S&P 500: on average U.S. industrials generated 12% EBIT margin and 9% revenue growth over that 5-year period. The orange dot to the left shows 2009: the big shift to the left highlights the magnitude of the downturn. The red dot represents current investor forecasts for the 80 industrials on average – this red dot is on a curve representing all the combinations of revenue and EBIT margin that would equal the current equity value of these 80 firms.

We can make three key observations from this analysis:

1. On average, the market has priced in high expectations for near-term revenue growth (about 13% from 2012-2014). The market is effectively assuming that these 80 companies return to 2008 demand levels by 2012: very fast growth for the next few years but off of a very low point in the downturn.
2. As a result, to 'break out' of this current valuation a company must demonstrate that it is on track to produce future earnings that exceed already high expectations. Marakon's research has shown that the top 25% of industrial firms double equity

	Use of Cash	Typical Value of \$100 in Cash	Rationale
<b>Value Negative</b>	Keep on balance sheet	\$90-\$95	\$100 earning money market rates minus a charge for cost of equity (Ke)
	Repurchase debt	\$93-\$95	\$100 less the difference between Ke and cost of debt: exchanging cheap money for more expensive money
<b>Value Neutral</b>	Return as dividends or repurchase stock	\$97-\$103	Signal to market can be positive or negative; actual value impact depends on whether intrinsic value is greater or less than the stock price (at parity, value neutral)
<b>Value Creating</b>	Invest in organic growth	\$80-\$150	Often the highest value use of cash; actual value depends on customer and competitor responses to initiatives
	Invest in M&A	\$50-\$130	High value, but wide dispersion of results for acquirers: consolidation deals worth the most, then adjacent market deals, then new platform acquisitions

value every 4-5 years. To double value and achieve top-quartile performance given already high investor expectations will require a step-change improvement in performance.

3. Finally, the valuation of U.S. industrials is significantly more sensitive to growth than returns. The slope of the value line in Exhibit 4 is more vertical, highlighting that the equity value of U.S. industrials is more than twice as sensitive to revenue growth than EBIT margin improvement.

What are the implications for U.S. industrials with lots of cash? In short, U.S. industrials need to create a step-change in profitable growth in a riskier world. The fact that they are holding on to so much cash suggests that they are having difficulty figuring out how to do that.

### The Value Growth Imperative

The problem with holding on to cash or returning it to shareholders is that these are typically value-neutral or value-negative actions, as the table above summarizes.

There are, of course, many conditions that affect the value impact of each use of cash, but we have described above the typical outcomes. The appropriate takeaways are: (1) continuing to hoard cash or pay down debt is almost always unprofitable; (2) buying back

stock or paying dividends is almost always value neutral; and (3) finding the right organic and M&A investments are the best bets for generating profitable growth.

What happens if industrial firms don't figure out how to profitably invest excess cash? The short answer is that someone else will. Simply put, companies that don't grow shareholder value at rates equivalent to their capital market peers fail at very high rates. By 'fail' we mean loss of independence via bankruptcy or acquisition.

As the table on the next page shows, over the past twenty years, industrials companies generating bottom quartile shareholder returns were more than twice as likely to have filed for bankruptcy or to have gone out of business relative to the broader set of industrials: 1-in-7 companies. Looking at companies that have been acquired, failure rates are even higher: 1-in-6 among the bottom quartile.

In combination, over the past 20 years 1-in-3 bottom quartile industrials have failed.

Being acquired is not necessarily failure, but is often a sign that new owners – both strategic and financial buyers – believe that they can unlock value by better leveraging the target's balance sheet. A telling recent example is the acquisition of the biometrics company Cogent by 3M. 3M is investing to

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Shareholder Returns* Quartile (1990-2010)	Average Shareholder Returns* (1990-2010)	Failure Rate (1990-2010), as Defined by:	
		Bankruptcy	Acquisition
1st	14%	1-in-16	1-in-6
2nd	10%	1-in-21	1-in-10
3rd	5%	1-in-48	1-in-16
<b>4th</b>	<b>(12%)</b>	<b>1-in-7</b>	<b>1-in-6</b>
Total	4%	1-in-15	1-in-8

\*Shareholder returns represent the total returns to common shareholders, including share price appreciation and dividend yield  
Sample of companies includes industrials with market capitalization at some point greater than \$1B  
Source: Capital IQ, Marakon analysis

build a franchise in the fast growing logical security marketplace, and Cogent has distinct capabilities in that emerging market. When purchased for \$943MM, Cogent – a company with \$130MM in annual revenue – had \$514MM of cash and liquid investments on its balance sheet. Not only did this make the deal much more favorable, it highlighted the likely result for a company that cannot make use of its cash for investment in profitable growth.

## Conclusion

The downturn and recent volatility has caused U.S. industrial companies to generate record cash balances. They've achieved this primarily by dramatically reducing investment. Now they have to figure out how to invest for

profitable growth in a riskier world, or they will not survive. In our next article we will describe a specific set of tools and processes to identify, prioritize and execute profitable growth opportunities, both organic and via M&A.

## About Marakon

Since its founding in 1978, Marakon has partnered with senior executives of companies across the Global 1000 to help them drive step-change increases in value. Hundreds of companies from around the world have adopted our approach to improving their business models and management practices. A key measure of our success is the continued outperformance of many of our long-standing clients.

Today, we are focused on building on our legacy as the pioneer of value-based management as we help companies adapt to the new economic reality, when the need for business and management model innovation is greater than ever.

Marakon does not deploy armies of consultants and we are not answer-led advisors. Our senior leaders partner closely with client executives to jointly develop solutions and to embed capabilities.

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