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Cash, Caution, And Capex - Why A Trillion Euro Cash Pile Is Unlikely To Drive A European Capex Boom

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Cash, Caution, And Capex - Why A Trillion Euro Cash Pile Is Unlikely To Drive A European Capex Boom

In Europe, the apparent gap between large corporate cash balances and supposedly low capital expenditure (capex) is frequently cited as the "missing link" that is hindering economic recovery. We think this is a misconception. It is true that Europe's nonfinancial corporates have a record-high nominal cash balance. On closer examination, however, the amount of cash held appears not quite as dramatic, rather more precautionary, and less likely to be spent than suggested.

Moreover, capex has been more resilient than commonly portrayed, especially away from struggling southern Europe. It is important to keep in mind that the macroeconomic measures that point to weak capex are only indicative of domestic expenditure. This ignores the large and growing share of European corporate capex that is now directed to emerging markets. Even if capex growth were to pick up strongly, this shift in destination means that the marginal contribution to domestic economic growth will be more modest than it used to be.

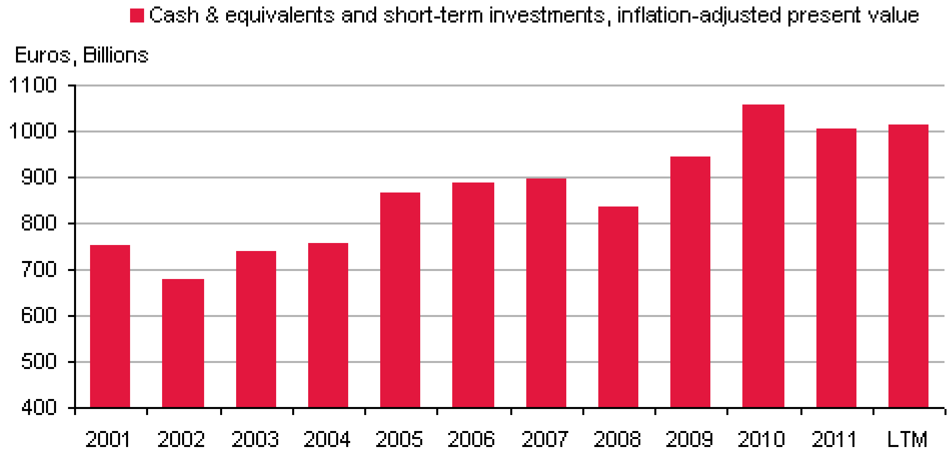
Overview

- Europe's nonfinancial companies have over €1 trillion on their balance sheet in cash and equivalents (as measured over the last 12 months to Jan. 10, 2013).
- Hopes that this will translate to a capex boom are misplaced in our view.
- Cash as a percentage of total assets is not unusually high, especially given downward pressure on operating cash flow and an uncertain economic outlook.
- Industries that have cash are not necessarily ones that will look to quickly boost capex in Europe given long lead times, overcapacity, or because they are global industries.
- Bottom-up data shows that capex has held up better than thought. In 2012, capital spending was only 4% below the 2008 peak.
- A large and increasing share of European companies' capex is directed outside of the region – 42% in the last 12 months, up from 28% five years ago.

A Trillion Euro Cash Pile

Just how big is the cash pile of European nonfinancial companies? Using Standard & Poor's Capital IQ data we have calculated aggregate cash trends (see chart 1) for Europe's 1,000 largest nonfinancial companies in terms of total debt outstanding – a universe we call the Europe Debt 1000. This includes both publically listed companies and private companies with public debt, and constituents are recalibrated annually.

Chart 1 | Europe Debt 1000 – Cash And Short-Term Investments (Real Terms)



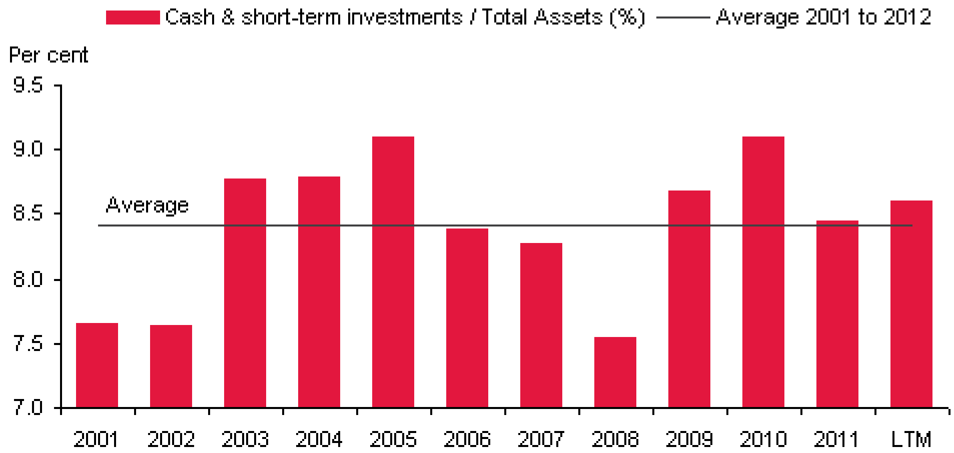
Source: S&P Capital IQ, S&P Ratings calculations. Universe is Europe Debt 1000
Expressed in present-value terms using the EU-27 HICP

As of the last 12 months (to Jan. 10, 2013), these companies had just over €1 trillion (€1,012 billion) of cash, cash-equivalents, and short-term investments on their balance sheets. In nominal terms this is a record high. However, in real terms – adjusted for EU-27 inflation – the aggregate cash balance has retreated from 2010's peak (€1,056 billion). This is still 21% higher than the cyclical trough in 2008 and, at face value, a €1 trillion cash-pile suggests significant financial firepower at the disposal of Europe's corporate sector. It also suggests a great deal of resilience in terms of credit risk.

The argument that this could translate to a recovery-propelling capex-surge starts to break down when one looks at the cash holdings in relation to the broader balance sheet and, most importantly, when considering companies' motivation for holding so much cash and the likelihood of them drawing down the balances sharply enough to boost economic recovery.

Expressing the cash equivalents in relation to total assets (see chart 2) shows that although this measure is above the average for 2001-2012 it is not an exceptionally high figure. The percentage of cash to total assets has been higher in five other years over this period.

Chart 2 | Europe Debt 1000 – Cash And Short-Term Investments / Total Assets



Source: S&P Capital IQ, S&P Ratings calculations. Universe is Europe Debt 1000

Reasons Why Companies May Remain Cautious With Their Cash

In our view, there are three main reasons to be skeptical about the potential for European corporates running down their cash balances to the benefit of Europe's economies any time soon:

• First, there is evidence of a strong precautionary motive in the amount of cash being held that is unlikely to fade in the face of the hard grind of austerity. This is most acute in southern Europe.

• Second, many of the industries that hold most of the cash are not those likely to bring capital expenditure swiftly on stream in Europe.

• Third, pressure on operating cash flow is increasing. Cheap debt capital has been used to bolster balance sheets but trends in the sources and uses of cash point to a high degree of corporate caution.

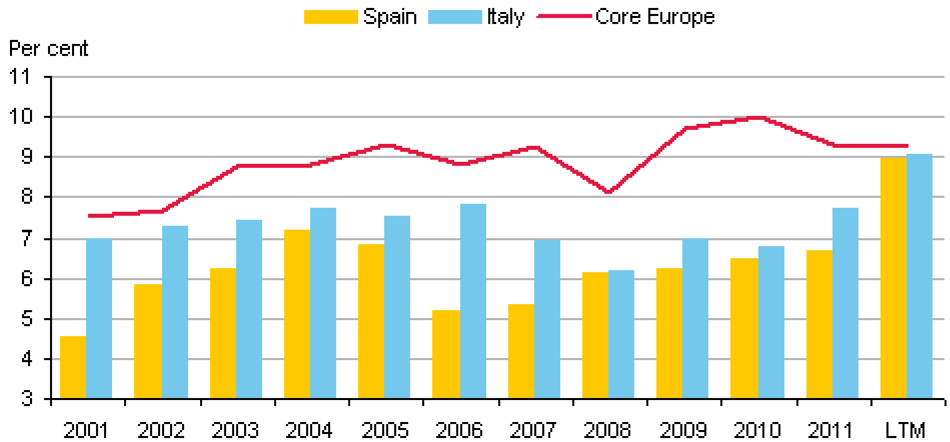
1. Southern Europe

Market fears with regard to the euro's future may have eased, but the eurozone (European Economic and Monetary Union) remains trapped in a quagmire of austerity, high unemployment, and political uncertainty. This has given corporates a strong motivation to hold cash on a precautionary basis, a striking example of which is visible in the cash balance trends of Spain and Italy.

Chart 3 shows cash and equivalents to total assets for the Spanish and Italian constituents of the Europe Debt 1000. It shows that, over the last 12 months, there has been a dramatic closing of the gap between these two countries and the 'core' eurozone economies in terms of how much cash is held on the balance sheet. Both Italy and Spain are now close to 9% on this measure, the highest value seen from 2001 onward (see chart 3).

No doubt this reflects the intense fears during parts of 2012 that the euro could be heading for break up. But, given that the flip side of avoiding euro break-up is intense austerity and fiscal retrenchment, we see recession, high unemployment, and weak consumption continuing through 2013 in southern Europe. There seems little reason to expect companies with significant exposure to this region to stop hoarding cash.

Chart 3 | Cash And Short-Term Investments / Total Assets



Source: S&P Capital IQ, S&P Ratings calculations. Universe is Europe Debt 1000
'Core Europe' is defined as Austria, Belgium, Finland, France, Germany, Netherlands

2. Industry analysis – those with the cash may not spend it

The second reason to question the link between cash holdings and potential capital spending lies in the nature of the industries that have the most liquidity. Chart 4 shows the nominal amounts of reported cash (plus equivalents and short-term investments) for the last 12 months by industry and ranked in descending order. It also shows inflation-adjusted averages for 2001-2011.

What is striking is that the top seven industries (roughly one-third) have 77% of the cash held by our Europe Debt 1,000. In most cases, they also hold current balances that are significantly higher than their inflation-adjusted average. However, the nature of the sectors suggests that any uplift in capital spending is likely to be gradual. This is because:

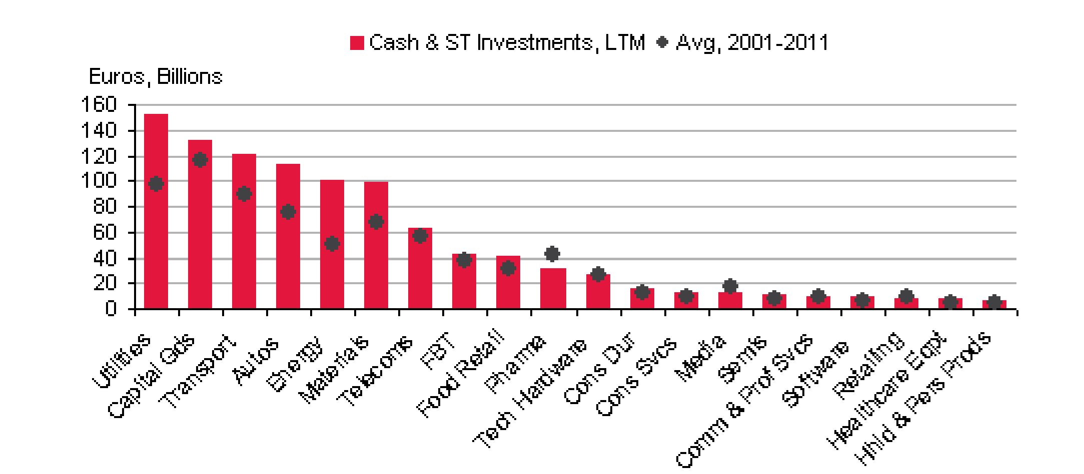
• Utilities, transport, and telecommunications all have long lead times and often significant political hurdles in relation to capital spending. This is not to say that there is not the potential for a major upsurge in capex in these sectors to meet, for example, Europe's pressing energy needs and the arrival of fourth-generation (4G) telecoms networks. Nevertheless, absent government intervention, these are likely to be long-term programs that are less sensitive to near-term movements in the economic cycle.

• Energy and materials are essentially global sectors, meaning that much of their incremental capital spending would take place outside Europe. Shale gas fracking might be one area of rapid domestic expansion, but this would still be a relatively small proportion of the total capex of these industries.

• The auto industry in Europe is already suffering from significant overcapacity.

That leaves capital goods – a sector that would certainly have the potential to boost spending as economic recovery gains traction – but this is only one of the top seven.

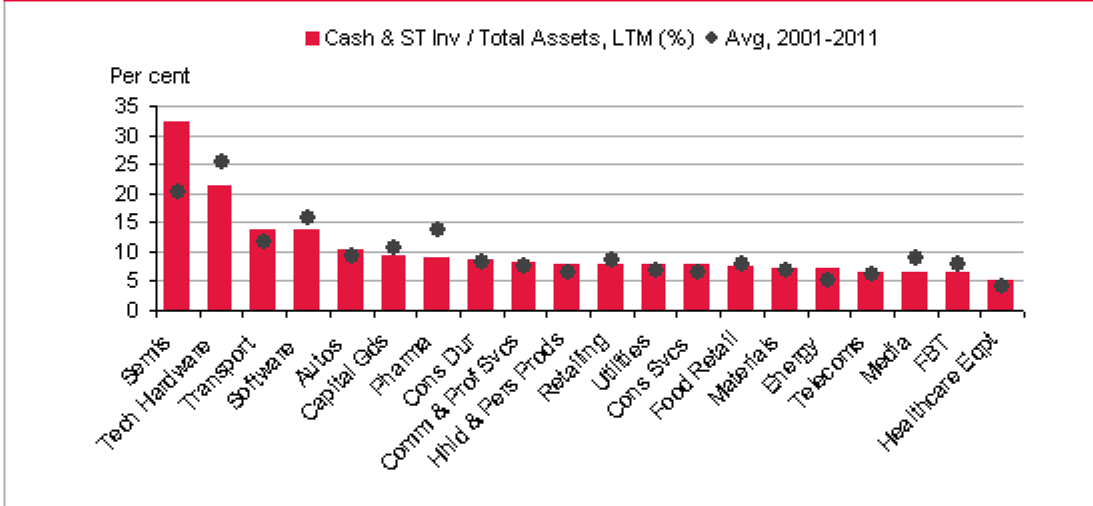
Chart 4 | Cash Balances (Real Terms) By European Industry



Source: S&P Capital IQ, S&P Ratings calculations. Universe is Europe Debt 1000

Chart 5 shows cash to total assets on an industry basis. Interestingly, many of the industries with the highest proportion of cash in relation to total assets are below their 2001-2012 average on this measure. This is true for capital goods, so the high nominal value of cash held by companies in this sector may be of less significance than hoped. The semiconductor industry has a very high cash-to-assets percentage, but again this is a sector that has suffered from periods of overcapacity in the past and is likely to be cautious as a result.

Chart 5 | Cash And Short-Term Investments / Total Assets By European Industry

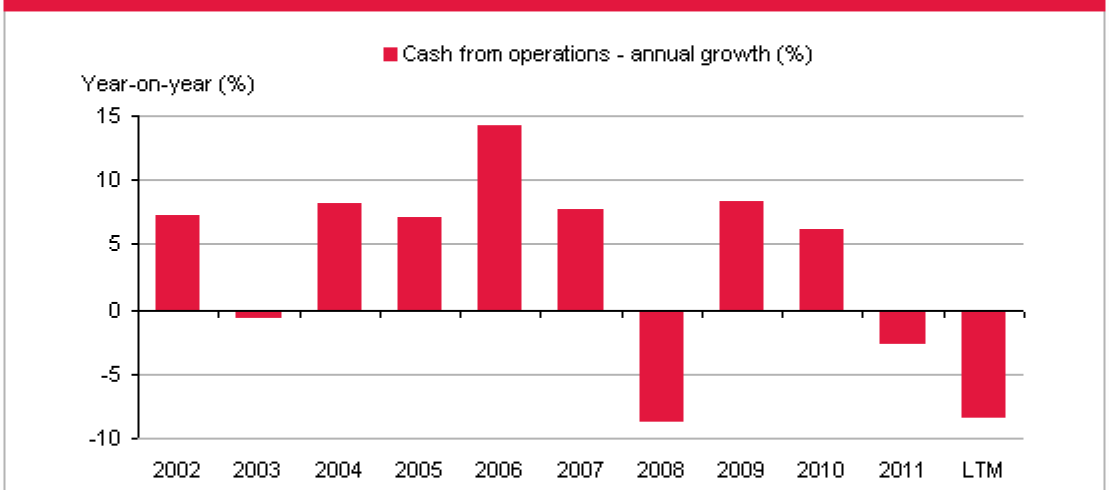


Source: S&P Capital IQ, S&P Ratings calculations. Universe is Europe Debt 1000

3. Pressure on operating cash flow

The final reason to question cash-to-capex optimism is simply that companies are facing significant downward pressure on operating cash flow – as one would expect in a recession. That cash balances have not been eroded as a result is partly a consequence of the sharp rise in debt issuance over the past 12 months. Chart 6 shows the annual growth rate in cash from operations for our Europe Debt 1000. It vividly illustrates the strains of a 'double-dip' recession, with operating cash contracting 8% over the past 12 months and close to the 9% contraction seen in 2008.

Chart 6 | Europe Debt 1000 – Growth In Cash From Operations (Nominal)

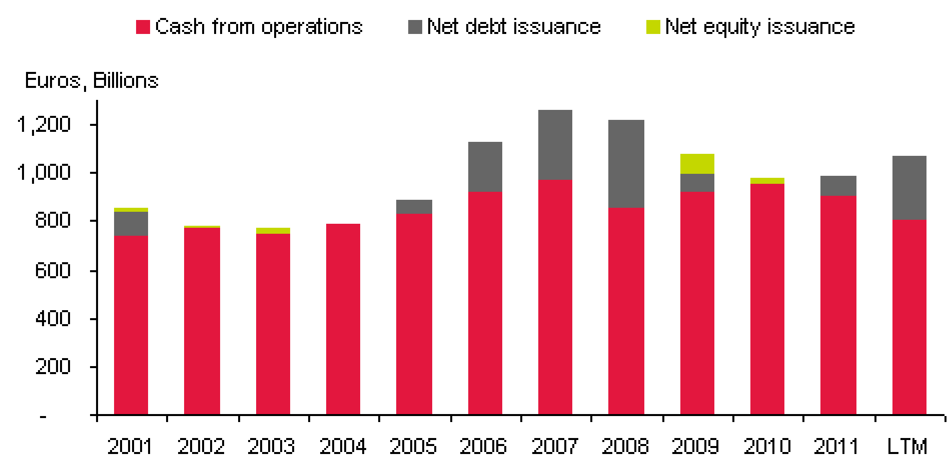


Source: S&P Capital IQ, S&P Ratings calculations. Universe is Europe Debt 1000

Fortunately, companies have been able to cushion the operating pressure by raising cash on the debt capital markets. Chart 7 shows the three main sources of cash for our Europe Debt 1000. If no figure is shown for debt or equity in a given year, it means that companies were making net repayments.

Aside from showing the ebb and flow of capital market access in relation to the operating cash cycle, it shows how relatively unusual the past 12 months have been – debt issuance has risen strongly despite an aggregate contraction in operating cash.

Chart 7 | Europe Debt 1000 – Sources Of Cash (Real Terms)



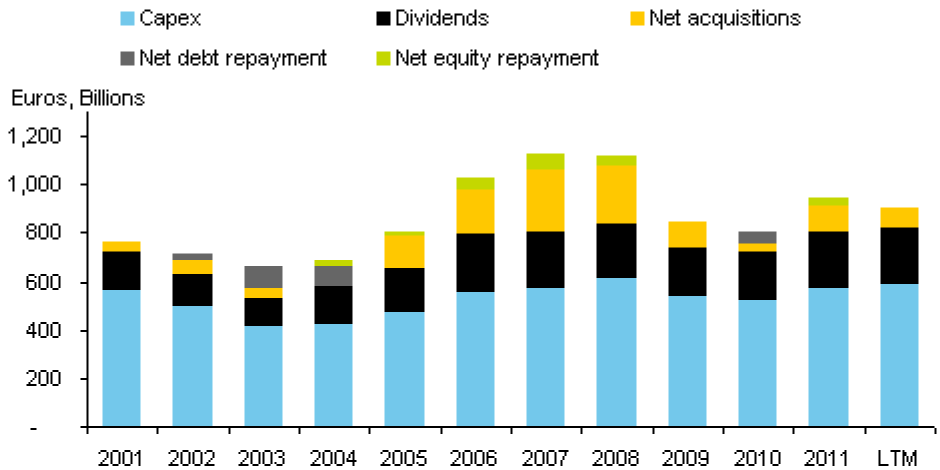
Source: S&P Capital IQ, S&P Ratings calculations. Universe is Europe Debt 1000
Expressed in present-value terms using the EU-27 HICP

The fact that lenders have been so willing to lend and refinance debt in the face of contracting operating cash flow could be taken as a signal of market confidence in recovery over the next few years. It may also reflect the broader search for yield in an era of financial repression and low interest rates. High cash balances offer evidence of financial resilience and may well have helped enable companies to secure debt issuance.

Capex Has Been More Resilient Than Assumed

Chart 8 shows how our Europe Debt 1000 have been putting their cash to use. It shows (in real terms) the cumulative allocation of cash across capex, dividends, net acquisitions (mergers and acquisitions [M&A] less disposals), and net repayment of debt and equity when that has occurred. It illustrates how capex is consistently the largest use of cash and net acquisitions the most volatile. In trend terms, it also shows that the decline in capex has been less pronounced than the consensus view might suggest.

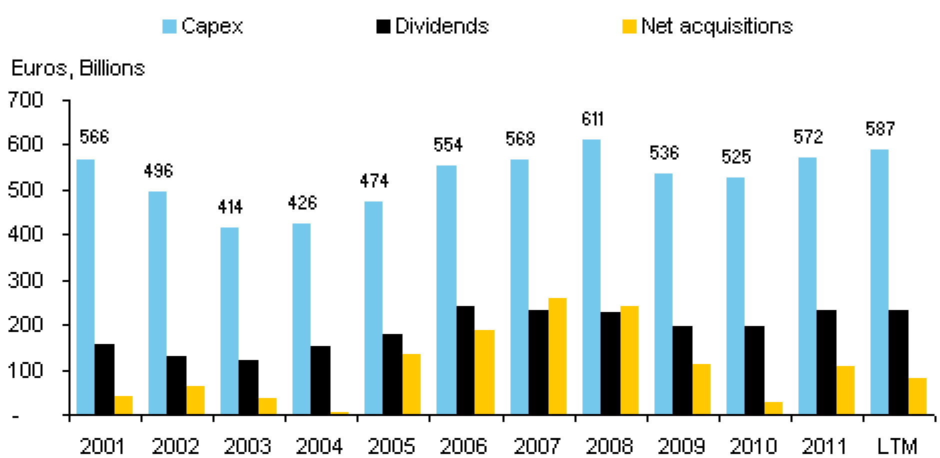
Chart 8 | Europe Debt 1000 – Uses Of Cash (Real Terms)



Source: S&P Capital IQ, S&P Ratings calculations. Universe is Europe Debt 1000
Expressed in present-value terms using the EU-27 HICP

This is made more explicit in chart 9, which focuses solely on individual trends in capex, dividends and acquisitions. It emphasises the recovery in capex from the 2010 low. Capital expenditure over the last 12 months was only 4% below the cyclical peak of 2008 in real terms and up 12% from its 2010 trough. It is the second best year for capex in real terms since 2001. Capex growth rates have slowed -nominal year-on-year growth rates show annual growth falling back to 5% on an LTM basis in 2012, compared with 12% in 2011 (see chart 10). But the data suggest that to deride companies for failing to invest is an unfair criticism.

Chart 9 | Europe Debt 1000 – Capex, Dividends, And Net Acquisitions (Real Terms)



Source: S&P Capital IQ, S&P Ratings calculations. Universe is Europe Debt 1000
Expressed in present-value terms using the EU-27 HICP

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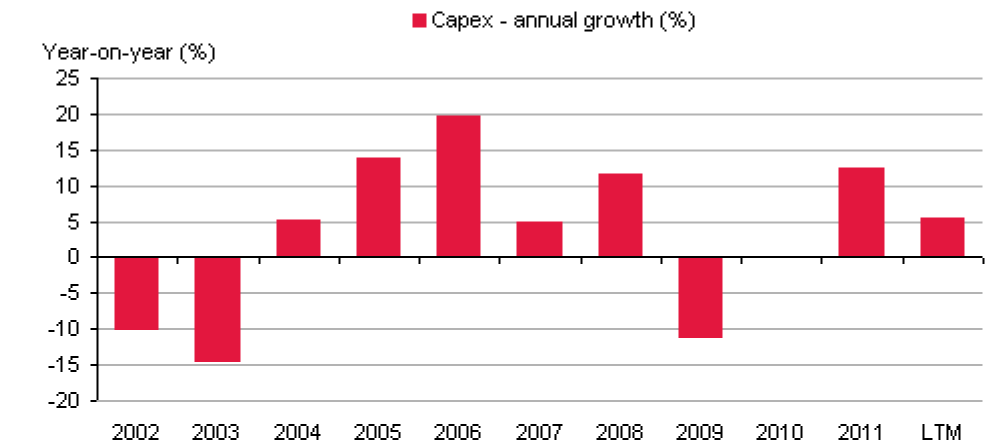
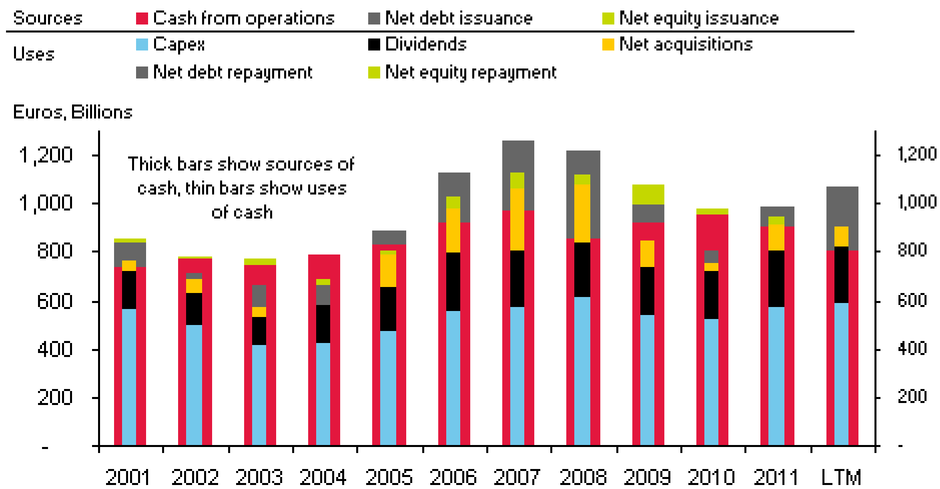
Chart 10 | Europe Debt 1000 – Capex Growth



Source: S&P Capital IQ, S&P Ratings calculations. Universe is Europe Debt 1000

Where companies have shown caution is in M&A activity. Net acquisitions over the last 12 months are 69% below their peak in real terms in 2007. This to us reflects a continued focus on financial discipline because M&A has so often proved value-destructive in the past. More broadly, the data suggest that companies are operating sensibly within the parameters of a difficult economic environment. While maintaining financial headroom in the form of a healthy cash balance, firms are also sustaining capex at real-term rates not far off the cyclical high. One could argue that companies ought to be investing more due to their high profit margins and ready sources of financing, but that is to ignore the pressures on their cash flow and broader issues of political uncertainty and overcapacity in many industries.

Chart 11 | Europe Debt 1000 – Sources And Uses Of Cash (Real Terms)



Source: S&P Capital IQ, S&P Ratings calculations. Universe is Europe Debt 1000
Expressed in present-value terms using the EU-27 HICP

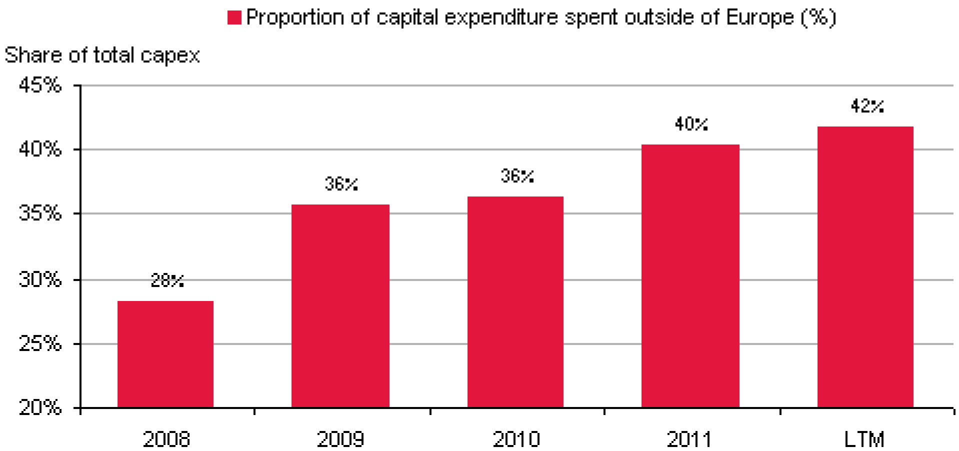
A Large And Growing Share Of European Capex Goes Overseas

A final important issue is the apparent contradiction between the weak capex trends that economists highlight – based on business fixed-investment statistics – and the more resilient picture that emerges from company-level data. A key part of the explanation lies in the fact that an increasing share of the capex undertaken by European nonfinancial companies takes place outside of Europe. This spending is not captured in domestically focused economic statistics.

We have aggregated the geographic segment data available for just over one-third of the constituents of the Europe Debt 1000 to obtain an estimate of how much capex is directed outside of the home region (see chart 12). In the most recent fiscal year, 42% of the capital expenditure by European nonfinancial companies was made outside of Europe, a proportion that has risen steadily over the past five years.

Not surprisingly, companies are directing their resources to the fastest growing parts of the world economy. So even if there were to be a surge in capital spending, recent trends suggest that a major part of that money would be directed outside of Europe. Capex is not necessarily the economic panacea that it is thought to be.

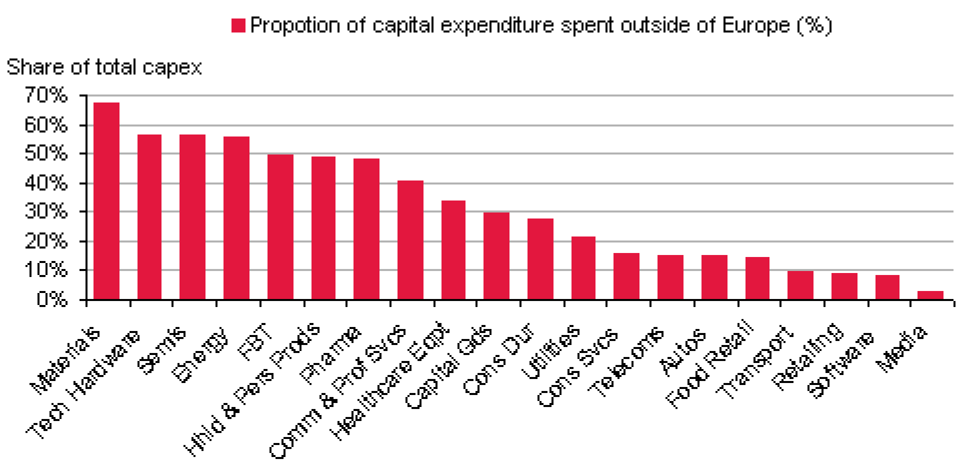
Chart 12 | Europe Debt 1000 – Proportion Of Capex Spent Outside Europe



Source: S&P Capital IQ, S&P Ratings calculations. Universe is Europe Debt.
For the most recent year, capex segment data was available for 374 companies

We can also break the data down by industry to test our earlier observations about industries that are more likely to direct capex overseas. This should be viewed as a rough estimate given that the majority of companies do not break down capex by region. That said, the results tally with what one would expect intuitively. Materials, technology, semiconductor, and energy all spend over one-half of their capex outside Europe. Food, beverages, and tobacco spend 50%, a reflection of their wave of expansion into emerging markets in recent years. Sectors that are most 'domestic' in terms of their investments are media, software, retail, and transport.

Chart 13 | Europe Debt 1000 – Capex Spent Outside Europe By Industry Group



Source: S&P Capital IQ, S&P Ratings calculations. Universe is Europe Debt.
For the most recent year, capex segment data was available for 374 companies

Conclusion: Reassuring For Ratings, Less So For The Economy

There is a widely held view that capex is the missing driver of recovery in Europe and that if companies could be persuaded to unleash their cash reserves this would transform the economic outlook. We think this is a misconception. While companies have a record-high aggregate cash balance in nominal terms of more than €1 trillion, in real terms cash holdings peaked two years ago. Furthermore, set in relation to the total balance sheet, the amount of cash currently held by European nonfinancial companies is only moderately above average.

More importantly, the reasons for holding on to cash are significant: caution in southern Europe in the face of austerity and substantial downward pressure in operating cash flow for the region as a whole. Furthermore, the industries with the largest cash balances are not necessarily those likely to spend it in Europe either because of long lead times, overcapacity, or the fact that they are global industries. Our analysis of capex by geography suggests that 42% of the capex spent by European nonfinancial companies goes outside of Europe. This helps explain the puzzle of why economic data are so gloomy in contrast to bottom-up data, which show that capex spend in real terms over the past 12 months is only 4% below the 2008 peak.

Certainly, there is a question to ask about what optimal capex spend should be given cheap financing and high levels of profitability. Examination of capex to depreciation trends would also be highly relevant. But in cash terms it is hard to argue that Europe's companies are failing to invest.

For corporate credit and ratings our findings are reassuring. Companies have maintained healthy cash balances, but not at the expense of capex. Where they have exercised most discipline is in M&A activity. Given the poor historical returns on M&A this is helpful for credit quality.

For the economy as a whole, the findings are less favorable. Corporate capex is unlikely to be the panacea that many hope for. Recovery in Europe will continue to hinge on the extent to which the continent can address its structural issues and whether or not the U.S. and Asia can maintain their recent positive economic momentum.

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