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Is Fear Dampening Corporate Performance?

Double-dip-recession worries have prompted cuts in capex and R&D spending.
Gregory V. Milano

“I’m more concerned about the lack of confidence than about market fundamentals,” said Alcoa’s chairman and CEO, Klaus Kleinfeld, on an October 11 earnings call. “It almost looks like the world is worrying itself into another recession, and that should not be allowed to happen.”

Kleinfeld suggested that an otherwise recovering economy might stall, and companies may begin to decline again, if the rhetoric about a double-dip recession causes companies to be too conservative in pursuing growth investments and hiring employees.

Are big businesses like Alcoa in decline? Based on our analysis of sales and earnings before interest, taxes, depreciation, and amortization (EBITDA) for the 500 largest nonfinancial U.S. companies that have full quarterly data availability back to 2006, it does not appear so. In the second quarter of 2011, the total revenue and EBITDA for these companies have recovered to within 1% and 3%, respectively, of their peaks in 2008.

But where can those companies expect to go from here? Wall Street analysts, apparently, don’t expect large companies to decline in revenue or EBITDA anytime soon. For the next 12 months, revenue for the companies will jump 8.9% higher than that recorded for the past 12 months, according to the consensus of forecasts of security analysts, who expect total EBITDA to rise 14.5%.

It has become common to claim that much more of the improvement, at least in terms of EBITDA, is coming from belt tightening than from companies' investments in their own business. Are companies pursuing growth investments? Although they haven't been for a while, they have stepped up investment this year.

Through the first two quarters of 2011, capital spending for these companies has reached 38% of EBITDA. That matches the rates of 2007 and 2008 and is well above the 32% doled out in 2010. In absolute dollars, average quarterly capital spending so far this year is up 23% over 2010. In the second quarter, however, capex dropped 17% from the first quarter. The decrease may have been caused by the double-dip-recession fears that have taken over blogs, airwaves, and newspapers.

Research and development has averaged 11% of EBITDA thus far this year, a bit higher than the 10% level of 2007 and 2008. Like capital spending, though, R&D for the second quarter of 2011 is down slightly versus the first quarter.

In contrast, investments in acquisitions are down considerably. Companies have devoted only 13% of their EBITDA to cash acquisitions this year, versus the peak of 18% achieved in 2006 and 2008. Since the immediate reaction to acquisitions is often a share-price decline, this reduction in M&A activity should be good for short-term share prices.

Nevertheless, our capital market research on the longer-term effects of acquisitions shows that over time acquisitive companies tend to deliver higher total shareholder return (TSR). That implies that the decline in acquisition activity might actually turn out to be bad for the stock market over the longer term.

The overall economy is likely to benefit from the capex and R&D increases. It would benefit more if those investments increase further in coming years. Between 2000 and 2009, the top 25% of companies in terms of the rate of reinvestment of cash flow delivered higher revenue growth, more employment expansion, and better TSR than the bottom 25%. Individual companies must maintain adequate investment discipline, but anything that leads companies at large to invest more tends to be good for all stakeholders over time.

As we approach the 2012 presidential election season, several key factors seem to be affecting the economic outlook and the confidence of corporate executives, investors, and other stakeholders:

• **High unemployment rate.** Among the uppermost concerns are the persistently high unemployment rate and the impact that has on long-term economic growth. Our research provides evidence that over time, companies that increase their investments in the business deliver better job growth. Why are so many companies still hesitant to invest in the future?

• **Burden of U.S. tax policy.** The United States now has the highest central-government corporate tax rate among all 34 OECD (Organisation for Economic Co-operation and Development) countries, with a rate of 35.0% versus the OECD average of 23.6 %. This gap adds 1.0% to 1.5% to the pretax return on capital that U.S. companies must earn to meet their aftertax cost of capital versus their competitors' in the average OECD country. If interest rates and required returns of shareholders rise, as may happen if inflation picks up, the effective cost of this higher tax rate will rise even higher.

• **Cost of regulation.** Some reports show the number of pending costly regulations has doubled over the past five years compared with the first half of the last decade. This trend began during the last two years of the Bush Administration and has continued under President Obama. How costly is regulation? In a report for the Small Business Administration, Nicole and Mark Crain estimated the total cost of all federal regulation to be $1.75 trillion in 2008, which they estimated to be $7,755 per employee for large companies. This regulatory cost represents almost 8% of sales for the typical company in our sample. Our analysis indicates that each 1% of revenue increase in regulatory costs drags 6% of companies' returns on capital below their cost of capital. It's easy to see how these costs (in addition to salary, payroll taxes, benefits, and other costs of employment) can discourage the hiring of new workers, especially when this is viewed in comparison with hiring employees in China or Brazil.

• **Risk-averse corporate leadership.** In the wake of Enron, WorldCom, Sarbanes-Oxley, Dodd-Frank, and the financial crisis, executives at many of the companies we studied who haven't stepped up investment seem more worried about making a mistake than eager to create a success. They have tightened their investment-approval processes, increased hurdle rates, enhanced risk-assessment procedures, and added more executives to the list of those who must sign off on and approve of an investment. While some of this increased oversight was necessary, it is likely that the pendulum has swung too far, and that such actions may now be inhibiting future growth and investment.

Thus far in 2011, while some companies have stepped up investments, others have lagged and still seem overly conservative in their consideration of investing in their future. Executives at these latter companies express genuine concerns about taxes and regulation, and these concerns are standing in the way of their investing to seize opportunities. Along with government policymakers, these executives can contribute to our economic recovery by encouraging more investment in the future growth of their companies. All stakeholders will benefit.

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