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Is Excess Cash a Problem?

Investors are willing to reward fast-growing, high-return companies by letting them hold cash.

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Investors are growing restless, and in some cases downright furious, about what they see as the "inefficient balance sheets" of managements who are building large cash balances. They often demand fat share repurchases to disgorge the cash cushions that they claim erode management's accountability to the capital markets and reduce the company's return on capital.

Cash balances are, to be sure, clearly on the rise. We examined the largest nonfinancial U.S.-domiciled companies, eliminating those without adequate accounting and share-price data for the last 10 years. At the end of 2010 those 885 companies held almost $750 billion in cash and equivalents -- nearly four times the level of 10 years earlier. This represents a doubling of the ratio of cash to assets, from 3.7% to 7.3%, over that period. Although most of the companies now hold less than 15% of their assets in cash, some hold as much as 40% or more.

Do such large cash balances have a negative impact on expected share price performance, as investors claim? To answer this, we defined a group of "cash hoarders" as companies with over 15% of their total assets in cash and cash equivalents on average over the last 10 years. In this group are some very successful companies, such as Apple, Amazon.com, and Celgene.

Given such successes, is the public outcry of investors warranted? Do companies that hold large cash balances deliver lower total shareholder return (TSR)? Our research of the period from 2001 to 2010 shows that the cash hoarders deliver median TSR about 4.6% lower per year in comparison with the companies that hold less cash. Holding cash doesn't seem to affect TSR much until it exceeds 10% of assets, but then it seems to have a fairly strong negative effect once cash rises above 15% of assets.

Are there conditions in which holding more cash is a good investment? We have found through our research that cash affects different companies differently. Investors are willing to reward those companies that are successful in terms of high cash return on capital and high revenue growth by letting them hold cash. The message here is that when investors think you're likely to do something productive with the cash, they're willing to accept your holding on to larger amounts of it. On the other hand, if you don't deliver strong return on capital, or if you're not growing quickly, investors become concerned about what you will do with the cash.

So what should a management team do if cash balances are high? Should they continue to stockpile cash? Should they reinvest more in the business? Should they succumb to the pressure and distribute the cash to investors?

Our research suggests that all but the fastest-growing, high-return businesses should be wary of holding more than 10% or 15% of their assets in cash, as it will likely drag down their TSR over time. Growth opportunities are not likely to be sufficiently frequent and profitable enough to warrant holding excess cash. For the fastest-growing companies, however, holding more cash facilitates rapid investment in profitable growth opportunities and can improve the future value of the company.

Managements are reinvesting a smaller percentage of their cash flow back into the businesses in recent years, even though many companies are achieving record profits. Executives are understandably concerned about the future economy and business environment. But companies that fail to invest in innovation, new products, and new services may be poorly positioned for growth when the economy gets back on track. So in many cases, stepping up reinvestment is a constructive use of cash.

For those companies that want to reduce cash balances but are maintaining a low reinvestment strategy, share repurchases are an alternative. But such companies should be careful. Our separate research on buybacks shows that three out of four companies deliver low returns on their buyback programs because they tend to buy back shares when share prices are high.

Some companies have the problem that much of their cash is "trapped" overseas. Management faces large tax payments if they repatriate the funds back to the United States. As a solution, they often pursue offshore investments at a lower effective cost of capital.

For example, consider a company with $100 million of trapped cash that faces a 35% tax rate upon repatriation. They can invest $100 million overseas, perhaps in a high-growth emerging market, or they can repatriate the cash, pay the tax, and invest $65 million in the United States.

The $35 million of avoided tax is effectively free capital that reduces the average cost of capital and subsidizes foreign investment relative to similar investments in the United States. Hopefully Congress will agree on a long-term solution to eliminate this subsidy of foreign investment.

There are many additional factors that should affect cash management policies: the amount of debt, the volatility and seasonality of cash flows, the need for customer surety and exposure to currency, commodity and other risks, and so on. But a useful starting point is to consider whether the company is rapidly growing and expects a strong return on its reinvestment opportunities. For those cash hoarders that don't meet those criteria, perhaps investors are justified in their outcries.

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