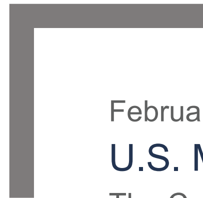

February 2013

U.S. Market Commentary

The Cash Is Not What It Seems

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CAMBRIDGE ASSOCIATES LLC

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The Cash Is Not What It Seems

A closer look at the mounting cash on corporate balance sheets reveals more questions than answers as to how it may benefit shareholders.

The amount of cash and equivalents on the balance sheets of U.S.-based corporations has been increasing steadily for some time. As of September 30, 2012, $1.1 trillion in cash and equivalents was on the balance sheets of S&P 500 companies excluding financial companies (Figure 1),[1] accounting for a near-record 10.6% of assets (Figure 2). Much has been made of what, if anything, corporations will do with this cash hoard. This commentary will seek to provide some context on the increase in cash and equivalents on corporate balance sheets by examining its concentration across sectors and companies and how it is invested. Much of the record amount of cash on corporate balance sheets resides with a handful of U.S. companies' foreign subsidiaries and is designated as "permanently reinvested overseas." Current U.S. tax policy and company behavior raise questions about companies' intent to use their cash held overseas for the benefit of shareholders. Expectations that the record amount of cash and equivalents will be used to increase internal investment, mergers & acquisitions (M&As), dividends, or buybacks to benefit shareholders may be misguided.

While corporate balance sheets appear healthy based on elevated cash balances, a closer look at S&P 500 ex financial corporations makes it clear that the cash on balance sheets is not what it seems. Managing cash flow is a critical component of any business, but evaluating the right amount of cash a company needs on hand at any given time is difficult to assess. A large cash balance allows a company considerable operating and financial flexibility, but eventually investors may question the merit of letting cash sit idle on the books. On a one-off, company-specific basis, investors can usually make an informed judgment about a company's cash balance and whether or not the level of cash plays into the investment thesis for owning the individual stock. The picture becomes less clear at an aggregate level.

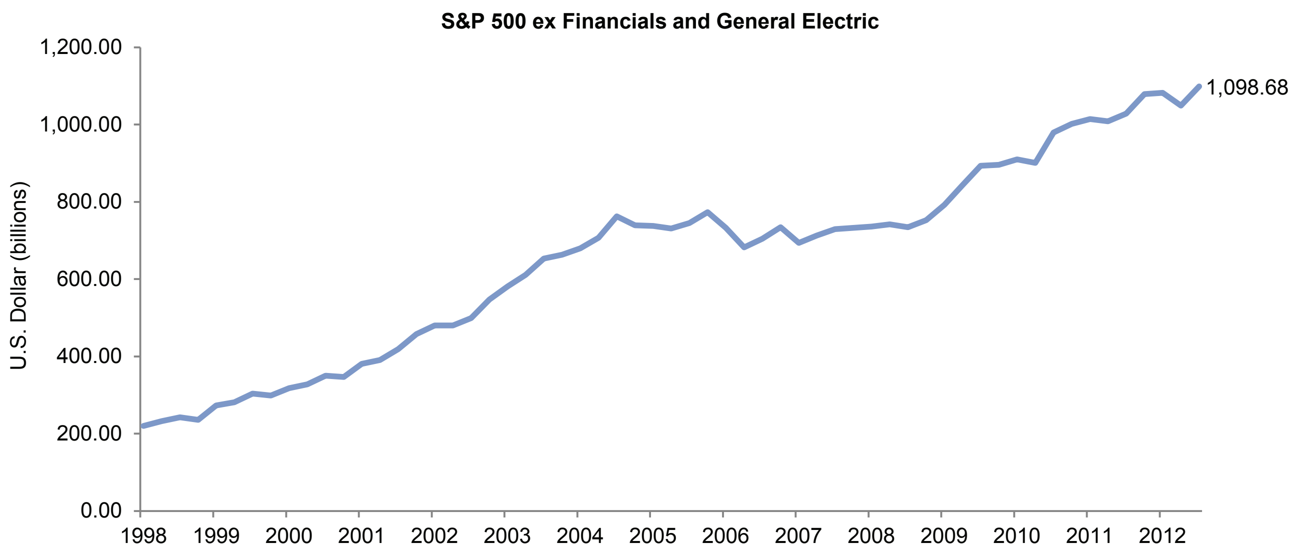
[1] Throughout this analysis (excluding Figures 5 and 6), General Electric Company has been excluded due to the presence of GE Capital on its consolidated financial statements. GE Capital's balance sheet is similar to that of a bank or other financial institution with a considerable amount of short-term, cash-like assets. Failing to incorporate the amount of short-term liabilities of the company would distort the assessment of cash holdings.

Concentrating on Cash

One of the main difficulties in drawing any conclusions regarding the health of corporations' balance sheets in aggregate relates to the concentration of current cash balances. Over the last decade, the 20 companies with the largest cash and short-term investment balances have accounted for an average of 45% of the total. As of September 30, 2012, the top 20 companies accounted for 44% (Figure 3). The consumer discretionary, health care, and information technology sectors account for 67% of the total, with information technology alone accounting for 39% (Figure 4). This concentration is nothing new, although aggregate cash and equivalents, and its share of corporate assets, is elevated today.

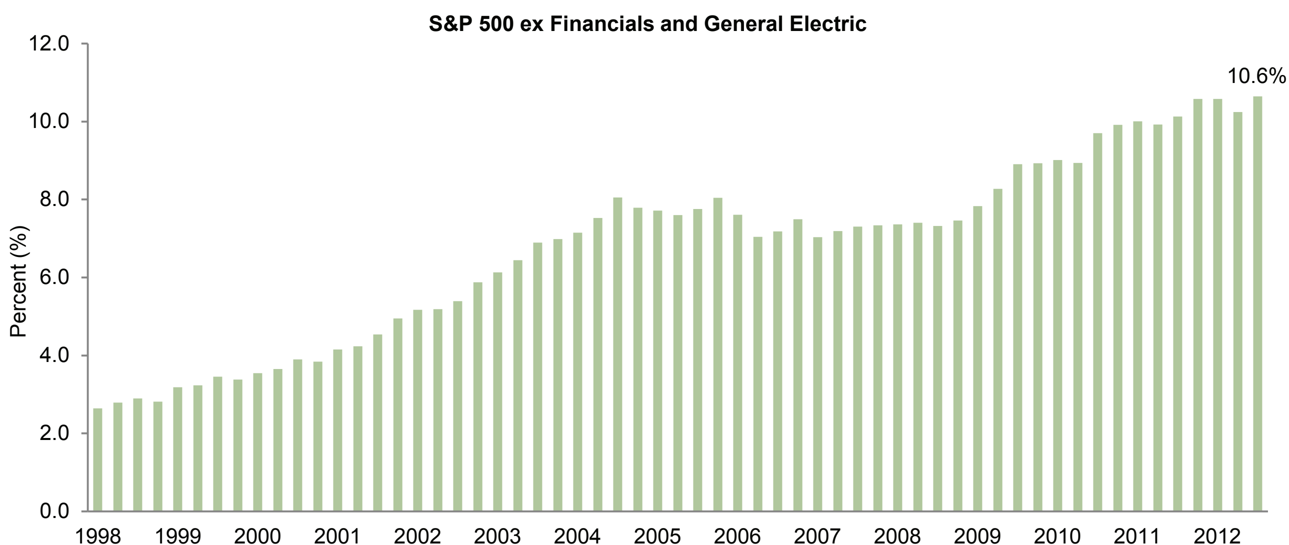
The concentration of cash within certain sectors and companies raises questions about arguments relating to the strength of corporate balance sheets based on high levels of cash. Not only is a majority of the cash for the S&P 500

Figure 1. Cash and Short-Term Equivalents
First Quarter 1998 – Third Quarter 2012



Source: FactSet Research Systems.
Note: Data are quarterly.

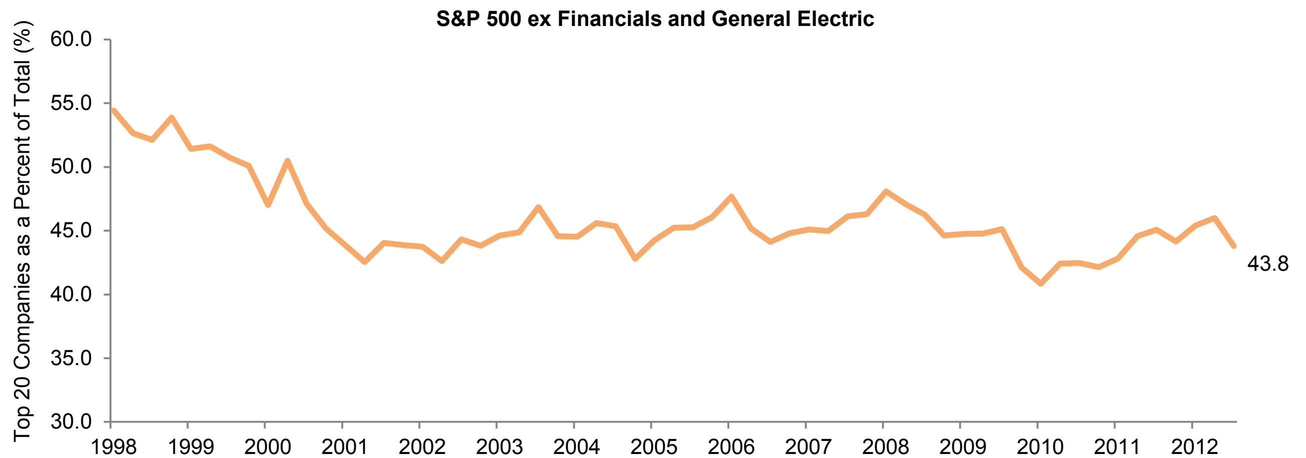
Figure 2. Cash and Short-Term Equivalents as a Percent of Total Assets
First Quarter 1998 – Third Quarter 2012



Source: FactSet Research Systems.
Note: Data are quarterly.

Figure 3. Top 20 Companies with the Largest Cash and Short-Term Equivalent Balances as a Percent of Total Balances

First Quarter 1998 – Third Quarter 2012

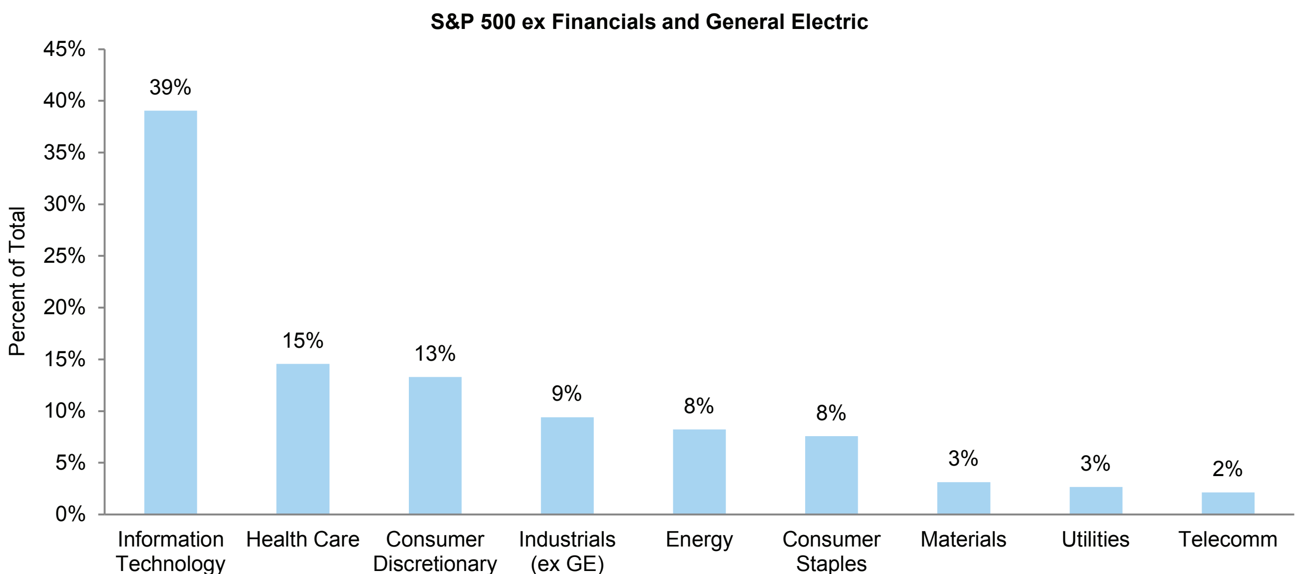


Source: FactSet Research Systems.

Notes: Data are quarterly. Graph represents cash and short-term equivalents held on the balance sheets of the top 20 cash rich companies in the S&P 500 ex Financials and General Electric as a percent of total cash and short-term equivalents held on the balance sheets of the S&P 500 ex Financials and General Electric.

Figure 4. Cash and Short-Term Equivalents by Sector

As of September 30, 2012



Source: FactSet Research Systems.

held by a handful of companies, but a majority of that cash is designated as permanently reinvested overseas and currently out of reach to shareholders. The simple reason why companies have so much cash designated overseas is that if they were to bring it back to the parent company, they would owe additional taxes in the United States.[2] A look at the strategies companies use to reduce their overall tax bills provides insights as to why cash, and particularly foreign cash balances, are so high and may stay high for years to come.

Reducing the Tax Bill

At 35%, the United States has one of the highest corporate tax rates in the world. Recognizing this, many U.S. corporations are organized through a vast array of global subsidiaries in an effort not only to expand their business abroad, but also to take advantage of lower tax rates offered in certain countries. Many large companies are able to reduce the taxes they recognize through transfer pricing, cost sharing, and corporate structures designed to allow patents, licenses, and other forms of revenue-sharing agreements to be transferred easily between parent companies and foreign subsidiaries in low tax jurisdictions. Despite the extremely complicated structure of many major corporations, there is still a considerable amount of information we can gather from required disclosures in consolidated financial statements to help draw insights into companies' domestic *and* foreign cash balances.

[2] The amount of additional taxes owed by an individual company will vary, but generally speaking, a company, if it were to repatriate its cash, would likely owe taxes in the United States less any credits it has received for any taxes already paid in the jurisdictions where income was first recognized.

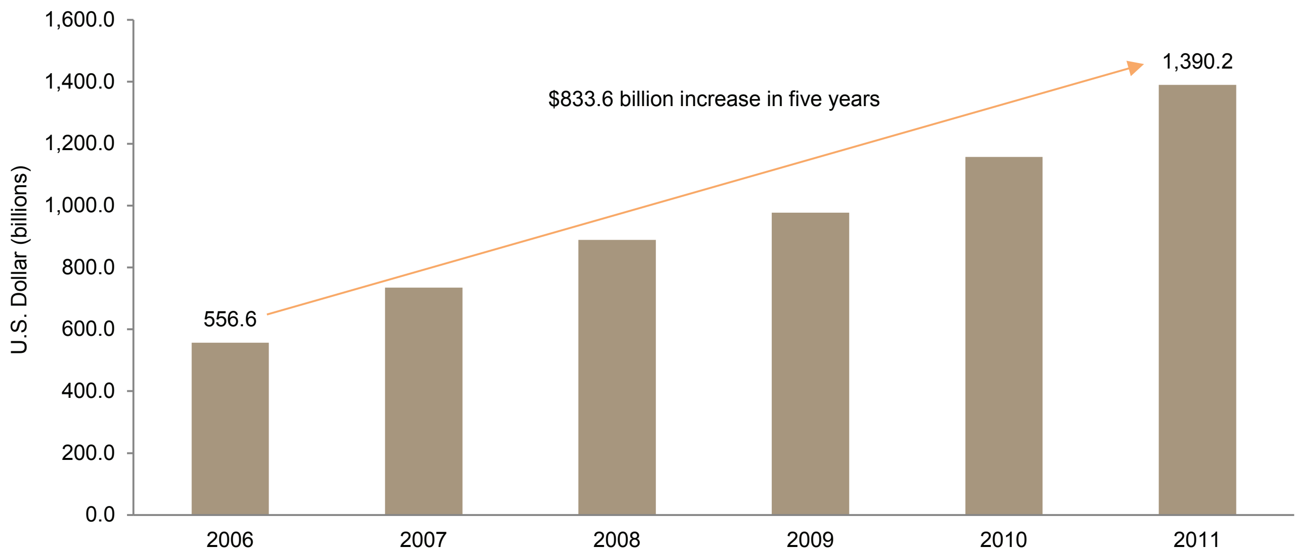
As of December 31, 2011, approximately 44% of aggregate S&P 500 ex financials sales was sourced outside the United States. If a company deems the earnings of a foreign subsidiary to be "permanently reinvested" outside of the United States, it does not have to recognize a U.S. tax liability on those earnings. The company obviously benefits by increasing its after-tax income and reported earnings. While the earnings of foreign subsidiaries are recognized by U.S. parent companies in their consolidated financial statements, once those earnings convert to cash they are typically managed as part of a global cash pool and primarily held in US$-denominated assets. In other words, there is an important distinction between parent companies and subsidiaries from an accounting (taxes, reported earnings) and balance sheet (cash retained as an asset on the balance sheet) perspective.

U.S. companies' annual reports include a disclosure of the amount of "permanently" or "indefinitely" reinvested earnings of their foreign subsidiaries.[3] The number simply states how much, cumulatively, foreign subsidiaries or affiliates of the firm have earned abroad that the company has not recognized as a *U.S.* tax liability. The number is *not* indicative of how much a company has actually invested, holds in cash, or potentially will return to the United States. Despite its imperfect nature, the metric is useful, as ever-rising, indefinitely reinvested earnings balances are concentrated in the same sectors with the largest amount of cash and equivalents of S&P 500 ex financials companies (Figures 5 and 6).

To underscore the magnitude of this issue, tech bellwether Microsoft is a useful example. In its latest available annual report (June 2012),

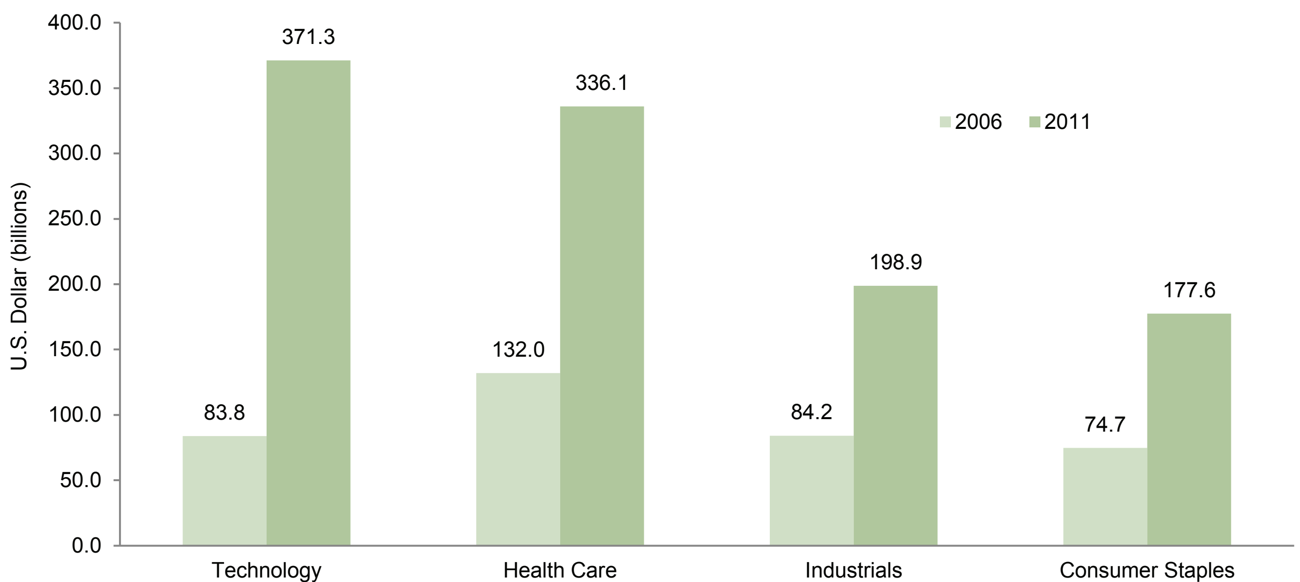
[3] This number is reported annually in 10-K filings, and data are shown as a year-end balance.

Figure 5. S&P 500 ex Financials Indefinitely Reinvested Earnings
2006–11



Source: R.G. Associates, Inc.
Note: Graph represents reported indefinitely reinvested earnings for 229 companies in 2006 and 286 in 2011.

Figure 6. Indefinitely Reinvested Earnings by Selected S&P 500 Sectors
2006 vs 2011



Source: R.G. Associates, Inc.

Microsoft lists $54 billion in "foreign cash," and states the following (emphasis added):

> As of June 30, 2012, we have not provided deferred U.S. income taxes or foreign withholding taxes on temporary differences of approximately $60.8 billion resulting from earnings for certain non-U.S. subsidiaries which are permanently reinvested outside the U.S. The unrecognized deferred tax liability associated with these temporary differences was approximately *$19.4 billion* as of June 30, 2012.

Translation: Microsoft has not recognized a U.S. tax liability on $60.8 billion in profits sourced through its foreign subsidiaries. If the company wanted to access *all* of its foreign profits that have been converted to cash, it would owe the U.S. government $19.4 billion—an amount roughly equal to Microsoft's annual operating income for 2012. As this example makes clear, companies that designate large amounts of their earnings outside of the United States as permanently reinvested may face significant tax liabilities in the United States upon repatriation. The top 20 companies in the S&P 500 ex financials with the largest foreign cash balances account for more than 40% of all the cash for the S&P 500 ex financials, and of that cash, 76% is held by their foreign subsidiaries (Figure 7).

Figure 7. Companies with High Foreign Cash Balances

As of December 31, 2011*

Company	Total Cash US$ (bn)	Foreign Cash US$ (bn)	Foreign as a % of Total
Apple Inc.	137.1	94.2	69%
Microsoft Corp.	68.3	61.0	89%
Cisco Systems, Inc.	45.0	37.5	83%
Google Inc.	48.1	31.4	65%
Oracle Corp.	33.7	26.0	77%
Johnson & Johnson	24.5	24.5	100%
Pfizer Inc.	24.0	19.2	80%
Amgen Inc.	19.4	16.6	86%
Qualcomm Inc.	26.6	16.5	62%
The Coca-Cola Co.	15.8	13.9	88%
Dell Inc.	13.9	11.8	85%
Merck & Co. Inc.	19.5	9.2	47%
Medtronic, Inc.	8.9	8.3	93%
Hewlett-Packard Co.	8.1	8.1	100%
eBay Inc.	8.0	7.0	88%
Wal-Mart Stores Inc.	6.6	5.6	85%
Corning Inc.	5.8	3.8	66%
EMC Corp.	10.8	3.6	33%
Agilent Technologies Inc.	3.5	3.4	97%
National Oilwell Varco, Inc.	3.5	3.3	94%
Total	**531.2**	**404.9**	**76%**

Sources: J.P. Morgan Securities, Inc. and the U.S. Securities and Exchange Commission.

Note: Represents the top 20 companies in the S&P 500 ex financials and GE with the largest foreign cash balances.

* Data are as of December 31, 2011, for all but the five largest companies, for which the most recent data available was used (either September 30, 2012, or December 31, 2012).

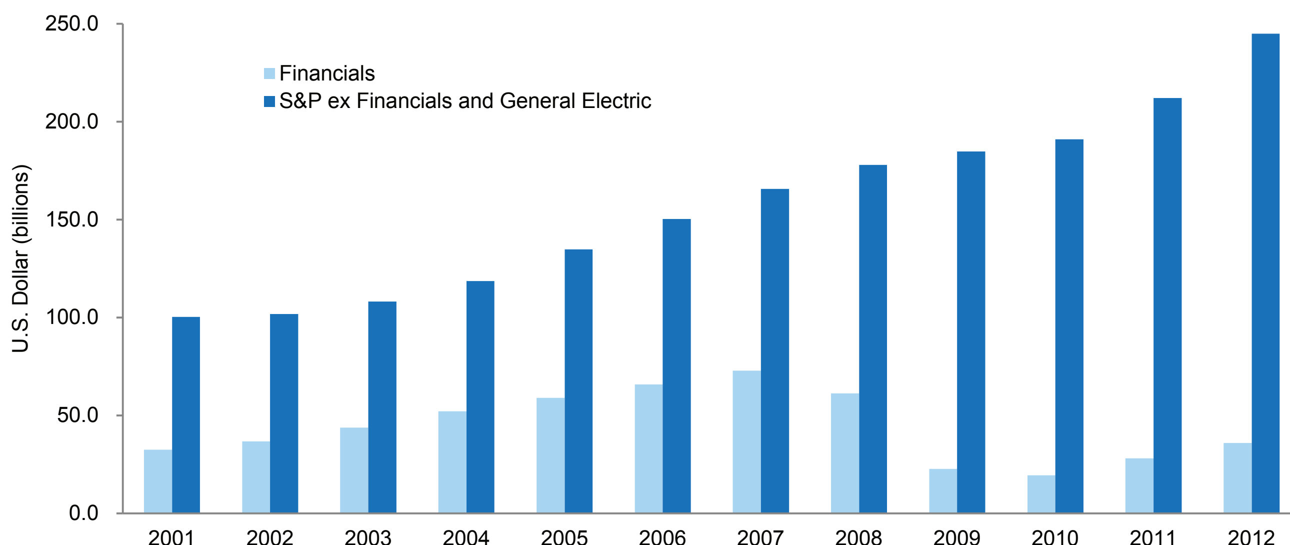
How Valuable Is All That Cash?

This raises important questions about what companies plan to do with all the cash on their balance sheets. Investors expecting this cash to benefit shareholders through internal investment, M&As, share buybacks, and dividend payments may be overly optimistic.

Cash designated as permanently reinvested abroad can be used for investments, and if these investments take place outside of the United States, they can be done without creating a U.S. tax liability. However, many of the industries with the highest amount of foreign cash and indefinitely reinvested earnings are asset-light with little need for ongoing or recurring capital expenditures. While there may be some benefit to M&A activity, as foreign subsidiaries can use their reinvested cash to purchase other businesses outside the United States, the fact that cash continues to pile up within these companies in the technology and pharmaceutical industries reinforces the point that reinvesting back into the business is not a main use of cash designated as held by foreign subsidiaries. Further, companies do not make investments because they have cash on their balance sheets. Rather, they will invest in projects that they feel will generate returns above their cost of capital over an appropriate time horizon.

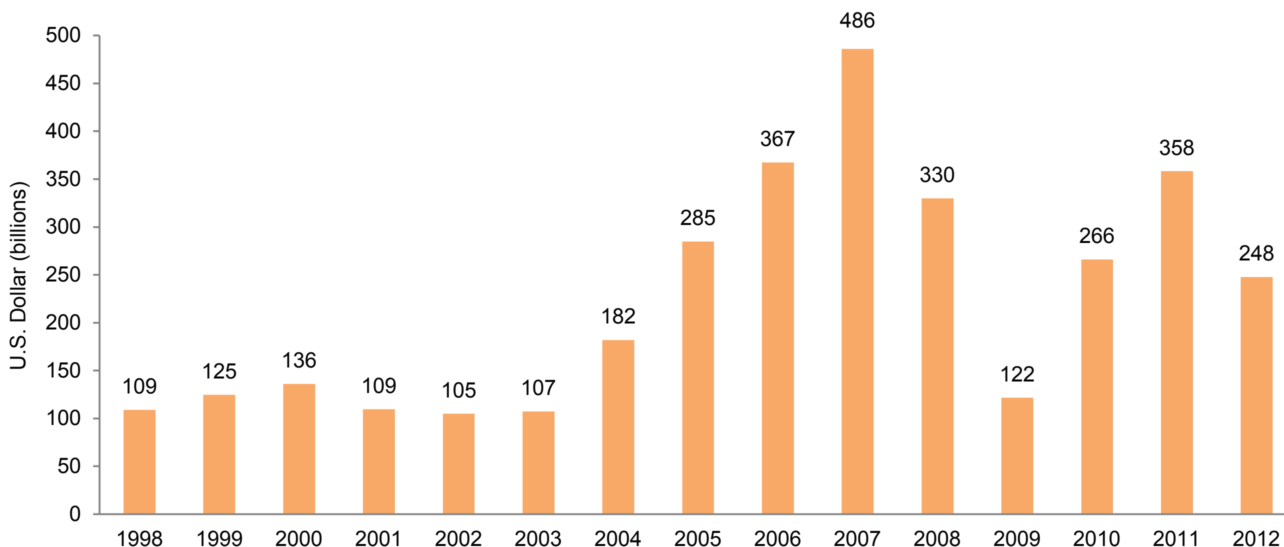
The most direct way to use cash for the benefit of shareholders is by paying dividends. Companies can also return capital to shareholders by buying back shares. Over time, the dollar amount of dividends paid by S&P 500 ex financial companies has been relatively stable and rising (Figure 8). Buybacks, on the other hand, have been much more volatile (Figure 9). The fact that cash designated with foreign subsidiaries has been piling up in the same companies for years now while dividends and buybacks have not increased in a mean-

Figure 8. Dollar Value of Dividends Paid by S&P 500 Constituent Companies
2001–12



Source: FactSet Research Systems.
Note: Data for 2012 are as of December 31.

Figure 9. Share Buybacks of S&P 500 ex Financials and General Electric
1998–2012



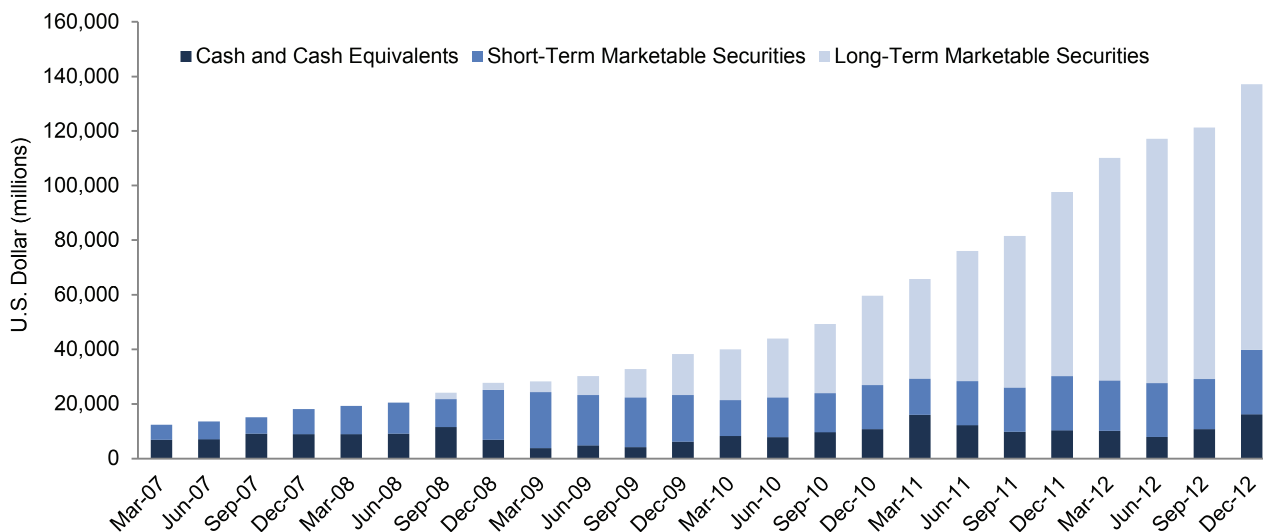
Source: FactSet Research Systems.
Note: Data for 2012 are as of September 30.

ingful way in aggregate makes it fairly clear that the companies with the largest foreign cash balances may not want to give up the powerful benefits of recognizing lower tax rates and higher reported earnings anytime soon. For example, Apple has the largest cash hoard among S&P 500 constituents. In 2012, the company announced plans to initiate a dividend and to repurchase stock. While investors cheered, perhaps the most telling detail of the announcement was that the company, in its second quarter 2012 10-Q, states: "over the next three years Apple will utilize approximately $45 billion of *domestic cash* to pay dividends, repurchase shares …" (emphasis added) with not a word of what it might do with the ever-growing $94+ billion of foreign cash.

Cash and Treasuries and Corporates, Oh My

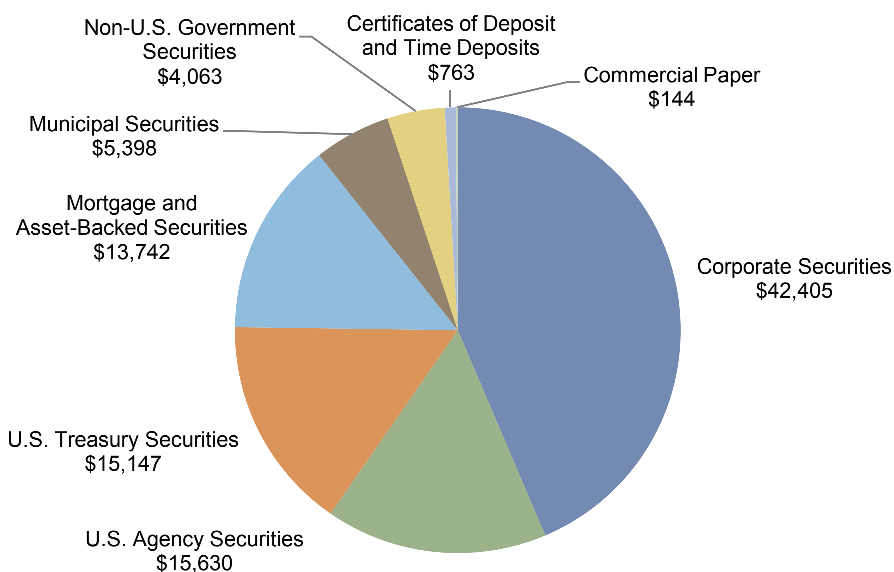
One way to assess companies with significant amounts of cash designated as held by foreign subsidiaries is by examining how their "cash" is actually invested. Again, Apple provides a useful example. Figure 10 shows that a majority of what investors would think of as Apple's cash is actually investments in long-term marketable securities. The level of Apple's cash and cash equivalents (money market and money market mutual funds) investments coupled with its short-term marketable securities balances has been fairly stable over the last five years; however, it is the significant increase in long-term marketable securities that stands out. Figure 11 shows the current breakdown of Apple's $97 billion in long-term marketable securities. Breakouts like these resemble more of what a large asset manager may hold

Figure 10. Apple's Cash and Investments Portfolio
First Quarter 2007 – Fourth Quarter 2012



Sources: Apple Inc. and the U.S. Securities and Exchange Commission.
Note: Data are quarterly.

Figure 11. Apple's Long-Term Marketable Securities Portfolio by Asset
As of December 31, 2012 • U.S. Dollar (millions)



Sources: Apple Inc. and the U.S. Securities and Exchange Commission.

in a diversified fixed income portfolio—in fact, that is exactly what it is. While many of these assets are highly liquid and likely able to be converted to cash very quickly, the fact that large consumer products and technology companies effectively have large and complicated portfolios of financial securities making up a significant chunk of their balance sheets makes any assessment of how the cash may end up being used to benefit investors not entirely clear.

A common story is that companies are flush with cash and much of it is sitting on the sidelines waiting to be used in ways that will benefit shareholders. However, a closer look shows that much of that cash resides with foreign subsidiaries of just a handful of major U.S. companies, and it does not seem as if it will be making its way back to shareholders anytime soon, absent a change in U.S. tax law, availability of attractive investment opportunities, or changes in attitudes about maintaining large cash balances. Investors hoping for a giant return of cash through dividends, buybacks, or a pickup in earnings as a result of new investment projects may need to curb their enthusiasm. In a global economy overflowing with liquidity, it is no surprise that so much has found its way onto the balance sheets of major corporations—whether any of that liquidity gets put to productive use remains to be seen. With respect to the cash held by S&P 500 ex financial companies in aggregate, the cash is not what it seems. ■