Why Post-Recession Spending Equates To Success

David K. Randall, AP Business Writer

NEW YORK (AP) — It's not easy being the most optimistic guy in the room.

Most companies are hoarding cash after two-plus years of cost-cutting. The members of the benchmark Standard & Poor's 500 index are sitting on a record $960 billion in cash on their balance sheets. All told, companies now have more than 10 percent more cash than the previous peak in 2004. While the days of mass layoffs and eking out another year from ever-older computers might be largely over, few companies are expanding.

But there are exceptions, those companies that are bold — or some might say, crazy — enough to invest for the next boom while others remain cautious.

Caterpillar Inc., Union Pacific Corp., and Google Inc. have each announced major plans to hire new workers or build new factories. Despite recent signs that the economy is slowing, none of them have said that they intend to back off.

So should investors make a bet on a company that's expanding when others are still playing defense?

A handful of academics, analysts and fund managers say yes. They say that despite the gloomy reports, companies that are hoarding cash will be left behind when the economy hits its next major growth stage. These companies won't have the people or projects in place to cash in on new business opportunities.

"If you're not using your cash, you're going to be less competitive in the future," says Eric Marshall, the director of research at Hodges Capital, an investment advisory firm in Dallas that has $800 million in assets under management. He says that there was a time following the financial crisis that sitting on cash made sense because of concerns that the recession would be prolonged. "But now the risks have changed," he says. He thinks that the economy's recent stall will be a temporary one.

Marshall points to Cummins Inc., one of his firm's longstanding holdings. In 2007, the company had about a 20 percent share of the heavy-duty truck engine market. It continued to reinvest during the downturn — $752 million in 2009-10, more than it spent in 2006-07 -- and spent more money on things like research and expanding capacity. One result: technology the company developed allowed its engines to meet more stringent environmental standards at a lower cost than its competitors, a fact not lost on investors.

Today, largely based on the success of its fuel-efficient engines and because it spent on technology when others didn't, Cummins owns 40 percent of the heavy-duty truck market. Its stock, in turn, is up more than 180 percent — or nearly tripling — over the past two years.

"The weaker caribou don't make it through the winter," Marshall says, explaining his rationale for buying businesses that are expanding or reinvesting when others are not.

There are plenty of reasons to put off expansion. And many companies are content to earn tiny interest rates on their stored cash because they are happy to continue to strengthen their balance sheets while they watch their profit margins go higher, says Jonathan Golub, the chief U.S. strategist at UBS. They don't want to be caught off guard if the economy sputters again.

By some accounts, that's already happening. Over the last month alone, reports on manufacturing, retail sales and unemployment came out weaker than economists had expected. And the cash on hand could provide a nice backup if things get worse.

But companies expanding aggressively believe that now is the time to spend that money. Caterpillar, for instance, said in its last earnings call in April that it will spend $3 billion this year — double what it spent last year — on new factories from Muncie, Ind., to China. The bold move wasn't well-received by investors. Its stock is down nearly 12 percent since then.

For its part, Caterpillar says it's not looking at the short term. It's looking a few years out when millions of people entering the middle class in emerging countries like China and Brazil will increase the demand for its construction products. The company generally has a lag time of three to five years after announcing a new factory before it is fully running. That makes a big expansion project hard to undo. But the company also doesn't think only in terms of the short-term U.S. economy.

"The global trend of urbanization is going to continue, and that will drive the need for roads, bridges, ports, and schools" and the machinery to make them, Jim Dugan, a company spokesman, said on Thursday. He said that the company was largely ignoring last week's economic data and would only change its plans if it were concerned about another global downturn.

Some investors in the company welcome the aggressive approach and continue to buy the stock despite its recent losses. "If they don't spend the capital to expand, then that opportunity is going to be filled by someone else," says Bob Shearer, whose $13.1 billion BlackRock Equity Dividend Fund owns nearly 3 million shares of Caterpillar. The economy, of course, could leave him waiting if what economists are calling a soft patch turns into a real recession.

There are other standouts that have announced major hiring or expansion projects. Google said it expects to hire more than 6,000 new workers this year, which would add 25 percent more to the current workforce at the company. And Union Pacific raised its initial spending plan by $100 million and now says it will reinvest $3.3

billion this year on updating its rails and terminals.

Like other railroad operators, Union Pacific has continually reinvested in its business over the past five years. The company spent $2.6 billion on capital expenditures last year, and plans to spend 27 percent more this year, on things like improving rail tracks and buying new locomotives that will make service more reliable.

It all adds up to a competitive advantage for railroads, which have been taking business from the trucking industry. "Big retailers are depending more on more on rail because they've got the systems in place now to deliver consistent service," says John Mims, an analyst at BB&T Capital Markets who covers the rail industry. It's not only a result of high gas prices, he says. "Fuel prices start the conversation, but railroads are stealing customers because they see that they are reliable," he says.

While these strategies are certainly outside the norm in U.S. corporate circles, they tend to be standard practice overseas. And several academic studies show that there's good reason for American companies to mimic their overseas counterparts. Martin S. Roth, a professor at the Moore School of Business at the University of South Carolina, and Richard Ettenson, a professor at Thunderbird School of Global Management, looked at how companies in emerging markets respond to volatile business climates.

Their takeaway: Thriving means taking risks coming out of recessions. They found that companies that invested in high service or other strategies, such as lowering their profit margins to gain market share, thrived when the broad economy rebounded after past recessions. Their competitors, including American multinational companies, were not as prepared for the recovery. Each professor was traveling and unavailable for comment.

Thinking in those terms, when will it be too late to expand? That's a hard question that could be made even more difficult by someone watching stock prices alone. Golub, from UBS, says that companies that keep high cash levels will continue to surprise investors with their short-term profit margins. That's one reason why he argues that the S&P 500 will end the year near 1,420, a 9 percent gain from its current level of about 1,300.

"After a downturn, managements become extremely cautious, like bullied children afraid to re-enter a playground," Golub wrote in a recent note to clients.

Source URL (retrieved on *07/25/2014 - 3:54am*):
http://www.impomag.com/news/2011/06/why-post-recession-spending-equates-success