READY. AIM...

After three years of hunkering down, deferring unnecessary investment and cutting costs, companies around the world are sitting on record levels of cash to spend as the global economy strengthens.

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PHOTOGRAPHS BY DAN SAELINGER

By sitting on mountains of cash until the recession has safely passed, companies may think they are acting prudently. On the contrary, they could be setting themselves up to be overtaken by competitors that have been strategically using their financial resources to make acquisitions, launch new products and create more efficient ways of doing business.

Over the course of the 2007–09 recession, as credit markets froze and revenue plunged, companies jettisoned millions of workers and took the scalpel to their budgets, especially in Europe and the United States. Of course, those moves boosted corporate earnings, and companies' coffers swelled. In Europe, for instance, cash makes up 12% of total assets on corporate balance sheets and is almost a third higher than at any point in the last economic cycle, according to UBS. Globally, nonfinancial corporations are sitting on $4 trillion in cash today, a full trillion dollars more than they had on their books in 2007, according to Citigroup's Corporate Finance Advisory Group.

Yet, while the National Bureau of Economic Research in the United States reports that the recession officially ended in June 2009, many companies

have maintained a viselike grip on liquid capital. Whether they worry about a double-dip recession, a lack of investment opportunities or the need to rearm against Asian competitors, their financial prudence risks becoming a liability. The reason: Competitors are already investing strategically and are gaining substantial ground. In industry after industry, companies like Netflix, W.R. Grace, Banner Health and Maersk have used the recession to invest aggressively in new products, markets and operations. As the global economy recovers, these companies will have first-mover advantages that will be hard for others to overtake. Firms that keep hoarding cash face a big risk of being left behind competitively and frustrating multiple constituencies that want them to deploy their capital.

Because returns on cash are at historic lows, investors are taking a dim view of many companies' cash positions. A survey by the law firm Schulte Roth & Zabel in late 2010 showed that excessive cash positions would be the primary catalyst of investor activism over the next 12 months. Political pressure is being brought to bear as well. In February 2011, in an address to the U.S. Chamber of Commerce, President Obama implored CEOs to start investing and hiring, pointing out that "American companies have nearly $2 trillion [in liquid assets] sitting on their balance sheets."

Yet the most important reason for getting off the sidelines and deploying that cash is neither shareholder pressure nor political cajoling. It is that companies will lose competitive advantage. According to numerous studies, companies that emerged in the best shape from past recessions had invested more and saved less than their competitors. As a 2002 McKinsey & Co. study found, the companies that came out of the 1990–91 recession the strongest had outspent peers in R&D (by more than double) and acquisitions while maintaining cash balances 40% lower than their competitors'. By spending their cash on pursuing market share, developing new products and opening new markets, they had significantly strengthened their competitive positions.

It isn't too late for companies that have been conservative with their cash to catch up. But the window of opportunity is closing.

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SPENDING CASH IN ALL THE RIGHT PLACES

A number of companies have used the recession of 2007–09 to enhance their prospects. Even though the days of economic turmoil are not far behind them, they are already reaping the benefits of their contrarian investing ways. How they invested in the downturn while most of their competitors pulled back is instructive.

Consider the case of W.R. Grace. As the recession took hold in 2008, the $2.6 billion (revenue) global specialty chemicals company moved quickly to slash working capital and operating costs. By reducing net working capital days by half (from 106 to 53), Grace freed up $350 million in cash, an amount that was triple its 2007 operating earnings. As the credit markets tightened, that cash became pivotal to Grace's overseas expansion. The U.S.-based company bought and acquired manufacturing capacity in growing markets from China to Saudi Arabia to Brazil.

Those investments are already paying off. In 2010, Grace's sales from overseas markets increased 13% over 2009 — more than four times the firm's overall growth (3%). More important, the company, whose products include catalysts for oil refineries and plastics manufacturers, expects emerging markets to be virtually the only source of growth in those two industries over the next three to five years. Grace's new factories are critical to its participation in that growth.

Grace's lesson: Reinvesting cash strategically is as important as reducing costs and working capital to free up that cash. "There is a direct correlation between the reductions we made in working capital and the cash we had available to make investments in emerging markets," says the firm's chief financial officer, Hudson La Force.

These lessons apply to companies that are as different from process manufacturers like Grace as baseball is from cricket. Take Banner Health, a $4.7 billion (revenue) U.S. healthcare provider that owns 22 hospitals. In the recession, the company not only had to contend with flat or declining patient volumes, but it also had to prepare for the healthcare industry's looming day of reckoning: healthcare reform legislation. Hospital systems like Banner face a future of declining public and private reimbursements for treatments and hospital stays. And because future reimbursements will be tied to the quality of care, Banner's senior management knew the company had to upgrade facilities and medical equipment. Indeed, it has — to the tune of more than $1 billion in construction projects for new and existing hospitals.

W.R. Grace and Banner Health could have conserved their cash until the financial storm had long passed. The stockpiles of cash that companies around the world are sitting on today suggest that many firms have done just that. Yet both companies decided to invest and strengthen their competitive positions. They and other companies that exit the recession having laid the building blocks for growth are likely to outrun competitors that continue to hoard their cash.

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Trillions of dollars in cash held by nonfinancial corporations around the world, a full trillion dollars more than in 2007

DECIDING WHERE TO INVEST: THE STORIES OF NETFLIX, POLO RALPH LAUREN AND MAERSK

So if companies decide it's better to spend strategically today than continue to save, where should companies invest? To be sure, the answer will be different for every firm. The right opportunities depend upon a firm's unique circumstances: the markets in which it sees the greatest potential, its core capabilities and competitive position, the unfilled needs of its customers and more. The stories of companies that have aggressively deployed their cash during the recession provide useful insights on where to look.

I'll organize these stories into three categories: new products, new markets, and redistributing work around the world.

NEW PRODUCTS. Netflix is the world's largest movie subscription service. The firm has gone from launch in 1997 to $2 billion in annual revenue today and has 12 million subscribers. It is led by Reed Hastings, its CEO and co-founder.

Hastings has long believed that, although DVD rental by mail will be a source of growth for Netflix for many years, subscribers will increasingly want the immediate response of movies streamed over the Internet to their television screens. In 2007, Netflix began investing in software that would enable streaming on other companies' devices, such as Blu-ray players, set-top boxes, game consoles and TiVo DVRs. Netflix was faced with a big investment, one that could have appeared untenable as the economy began backsliding into recession. But the company didn't flinch, making streaming a focus of its research and development efforts. Between 2007 and 2009, Netflix doubled R&D spending from $70 million to $140 million. Meanwhile, it ran down its cash balance by two-thirds, from $400 million at the close of 2006 to $134 million at the end of 2009.

Today, Netflix's investments during the bleak years look prescient. In the third quarter of 2010, two-thirds of its subscribers were streaming movies online, nearly double the number in mid-2009. The company's revenue last year was 80% higher than 2007's, and profits have soared 140%. At the end of 2010, Netflix's cash position was on the mend, rising to $194 million. These numbers have clearly dazzled investors. Netflix's stock more than tripled in value in 2010 alone. Since 2007, the share price has risen tenfold.

NEW MARKETS. History shows that recessions spread pain unevenly around the globe. While demand can be moribund in a company's home market, emerging economies can offer lucrative opportunities. The combined gross domestic product of the BRIC countries (Brazil, Russia, India and China), for instance, is now almost 70% of Europe's aggregate GDP. But what's more remarkable about the $11 trillion BRIC GDP is its impressive growth. Between 2000 and 2008, the BRIC countries contributed almost 30% to global growth, compared with 16% in the previous decade. Since the start of the crisis in 2007, the BRIC countries' contribution has risen to 45%, according to analysis by Goldman Sachs.

Companies like Grace believe that rapid growth requires participation in emerging markets. "If you are a global company, as we are, and you are not investing in these markets today, you really run the risk of falling behind," says CFO La Force.

Polo Ralph Lauren is another global company that took this to heart three years ago and ramped up its investments in Asia-Pacific. The $5 billion (revenue) apparel and fragrances company began buying its Asian licensees in 2008, believing the product range they offered was too narrow and their inventories too low. With sales of luxury consumer goods exploding in Asia, the company needed to capture a bigger share of the pie. At the beginning of this year, it acquired its South Korean distributor, the seventh successive purchase of a Polo Ralph Lauren licensee in Asia. In a February earnings call, COO Roger Farah made it clear that the firm's $1.3 billion in cash and investments was at its disposal for more investments in Asian markets. Analysts and investors appear to have no problems with that. The stock has risen from the $70s last July to more than $120 this February.

REDISTRIBUTING WORK AROUND THE WORLD. This investment category is less obvious than the other two, and many companies have ignored it. But others have made substantial investments and have seen sizable

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returns. It is about redistributing the work of an organization — the activities of the finance department, information technology, customer service and other support functions — to take advantage of such conditions as lower labor costs and preferential tax treatments in other regions.

A great example is the $60 billion Danish conglomerate A.P. Moller-Maersk Group. A major ocean shipping and energy firm, Maersk has been slowly but steadily building global "shared services" operations since 2003. Based in six centers in India, China, the Philippines and Denmark, these operations have enabled Maersk to standardize and reduce the costs of support functions, such as finance, accounting, human resources and IT. In 2008 the global economic downturn produced the most challenging year ever in the container business. In response, as well as taking aggressive steps to cut costs, Maersk accelerated its investments in shared services. The company set a target of increasing the share of finance and accounting work done by the centers from 30% to 70%. Over 18 months Maersk hired 1,200 additional people for shared services, absorbing finance and accounting operations from 85 countries. The result: The operations are better standardized; the costs of those operations were reduced by 10% in 2010; the savings will increase as the remaining countries are rolled in and the new processes stabilize; and Maersk has a cost structure that better positions it to compete as the global economy recovers.

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GETTING PAST THE OBSTACLES TO INVESTING IN LEAN TIMES

Should every company follow the lead of Netflix, Maersk, Polo Ralph Lauren and W.R. Grace and make major investments in new products, markets or operations in spite of uncertain economic times? Shouldn't some companies hang on to their cash until better times are clearly ahead? For most, we think not. Almost every company has opportunities for growth in bad times as well as good. Take the chemicals industry. Even though it doesn't seem like a sector with high potential during a global manufacturing downturn, W.R. Grace found prosperity in distant lands.

In any event, it isn't necessary to hold on to a pile of cash for future needs such as making an acquisition. As Tenet Healthcare chairman Edward Kangas says in our roundtable discussion in this edition, "It's generally better to arrange a large line of credit for that purpose than to keep a lot of cash."

Highly leveraged companies may have more urgent priorities for their cash, such as shrinking their debt. Firms uncertain about repaying maturing loans might consider refinancing and extending maturity dates first. (See "Restricted Access," page 34.) But once they've straightened out their capital structures, even these companies should seek profitable investment opportunities.

We do excuse some companies from investing during the downturn. Managers in mature sectors with more capital than they can profitably invest should consider returning it to shareholders through share repurchases or dividend increases. Or they might consider merging or being acquired, especially if they operate in a sector that is consolidating. But there is risk in doing nothing: Companies that are neither acquirers nor acquired may be marginalized by their shrinking market share, or their shareholders may take the decision out of management's hands by forcing a sale, breakup or return of capital.

We continually hear executives argue against investing too soon. "The economy could tank again." "Domestic markets are flat." "Overseas markets are risky." "We are in a mature sector." "Deals are too expensive," and so on.

While there is truth in all of these objections, leading companies have managed around them, and in many cases investors are rewarding them for it. Several recent acquirers have seen the values of their shares increase after they announced acquisitions, in contrast to the normal market reaction. Danaher Corp.'s stock rose on the announcement of its acquisition of Beckman Coulter Inc. in February, despite paying a 45% premium on Beckman shares. Cliffs Natural Resources Inc. stock rose nearly 3% on Jan. 11 after it announced the purchase of Consolidated Thompson Iron Mines Ltd.

At some point, the majority will follow the minority, and a stampede will commence. Several indicators say it is about to begin. History tells us that companies that deploy their cash before their slower-moving competitors can overtake them. ■

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Catalyst for investor activism over the next 12 months: excessive cash positions