EDITORIAL

WILL COMPANIES USE BETTER CASH FLOWS TO INVEST?

A key question in assessing the pace of the recovery in coming quarters is what will happen to corporate investment. Financial analysts are expecting profits of US companies to increase. If confirmed, we can expect better cash flows which, based on historical relationships, should lead, with some delay, to a rise in capital formation by companies. However, there is a possibility that companies which have seen a pandemic-induced rise in indebtedness would prefer to use their extra cash to pay back debt. Cash flow uncertainty is another factor that could weigh on the willingness to invest.

In assessing next year's economic outlook, a key question is the behaviour of corporate investment. Given the traditionally rather steady pace of private consumption growth during a recovery, the dynamism, or lack thereof, of gross fixed capital formation by companies will make the difference between a subdued or robust recovery.

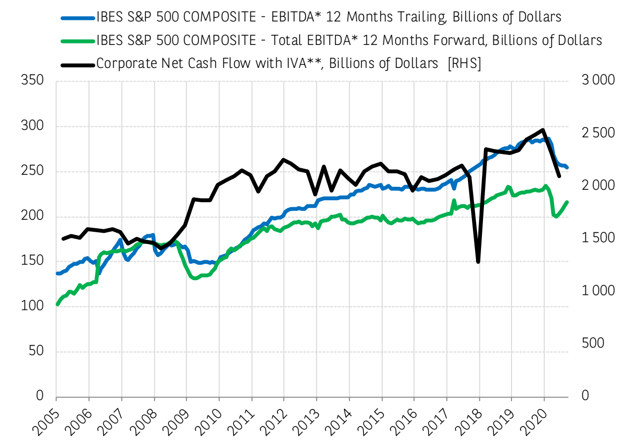
Pending the introduction of a vaccine, uncertainty –both health-related and economic- should remain high and act as a headwind to corporate investment[1]. However, GDP is growing again and with that, company profits should increase. As shown in chart 1, in the US, reported EBITDA -a measure of company profitability- is still trending down though less than before and financial analysts are expecting a pick-up over the course of the next 12 months. EBITDA is quite correlated with cash flow[2], so one should expect an improvement of this metric as well as the recovery continues[3].

From a macroeconomic perspective, cash flow is important because it is one of the drivers of gross fixed capital formation by companies. One could argue that at the current juncture, an increasing number of companies are accumulating cash, whilst being reluctant to invest because of the uncertainty. When the latter drops because the health situation improves, this cash could be unleashed and cause an acceleration of economic growth. As shown in chart 2, in the US, in recent recessions, cash flows increased well before the pick-up of corporate investment. This shouldn't come as a surprise. Companies may still feel uncertain in the early phase of a recovery. According to research of the European Investment Bank, in absolute value terms, a decline in uncertainty has a smaller impact on corporate investment than an increase. Weaker firms also react more strongly to an increase in uncertainty.[4] Unsurprisingly, the negative relationship between cash flow uncertainty on the one hand and corporate investment and corporate employment on the other hand is also stronger in recessions.[5] Companies may also prefer to pay back debt. Empirical research shows that, in the longer run, investments are sensitive to cash flow, but in the short run, financially constrained companies will use the improved cash flow to reduce leverage, rather than increase investment.[6]

1. Corporate investment is particularly sensitive to uncertainty because it represents an irreversible, long-horizon commitment of corporate funds. Irreversibility means that it is difficult to stop a project once it has been initiated.
2. The correlation is far from perfect because the universes are different (companies of the S&P500 versus listed and unlisted companies in the national accounts) and, more importantly, both metrics look at earnings in a different way. EBITDA is a popular measure for company valuation. It is obtained by adding to net earnings (= net income) tax, interest, depreciation and amortization. Operating cash flow is equal to net income adjusted for depreciation, change in accounts payable and receivable and change in inventories (source: www.corporatefinanceinstitute.com). A popular definition for cash flow is profits after tax plus depreciation. In national accounts, *"net cash flow with IVA is equal to undistributed corporate profits with IVA (inventory valuation adjustment) and CCAdj (capital consumption adjustment) plus consumption of corporate fixed capital less capital transfers paid (net). It is a profits-related measure of internal funds available for investment."* (source: US Bureau of Economic Analysis).
3. The big decline in cash flow in the fourth quarter of 2017 is related to the 2017 Tax Cuts and Jobs Act. This law imposed a one-time deemed repatriation tax on accumulated foreign earnings. It is recorded as a capital transfer from business to federal government and, as a consequence, decreases corporate cash flow (source: US Bureau of Economic Analysis).

4. Source: European Investment Bank Investment Report 2019/2020.
5. Source: *Employment, Corporate Investment and Cash Flow Uncertainty*, Sanjai Bhagat and Iulian Obreja, 2011
6. Dasgupta, S., Noe, T., & Wang, Z. (2011). *Where Did All the Dollars Go? The Effect of Cash Flows on Capital and Asset Structure*. Journal of Financial and Quantitative Analysis, 46(5), 1259-1294. doi:10.1017/S0022109011000512

EBITDA VERSUS CASH FLOW



* earnings before interest, taxes, depreciation, and amortization,**Inventory valuation adjustment

SOURCE: US BEA, FEDERAL RESERVE OF ST LOUIS, REFINITIV, BNP PARIBAS

> Cash flow uncertainty weighs on corporate investment. Monetary and fiscal policy can reduce this uncertainty by supporting the recovery and by providing a perspective on the policy stance for the next several years.

What insights do these results provide for the current recovery? First, the good news is that higher corporate cash flow is eventually followed by increased investments. However, there is a delay. This means that in the near term, household spending and government expenditures will be key for the pace of GDP growth. Second, financially weaker companies invest relatively speaking less. This is an issue considering the increase in corporate indebtedness following the collapse in activity earlier this year and calls for a policy aimed at strengthening the capital base of companies. Third, cash flow uncertainty matters. Here again economic policy has a role to play by supporting the recovery –monetary and fiscal policy- but also by providing a perspective on the policy stance for the next several years. Central banks do this by providing forward guidance. Governments could do the same and offer visibility in terms of taxes and expenditures.

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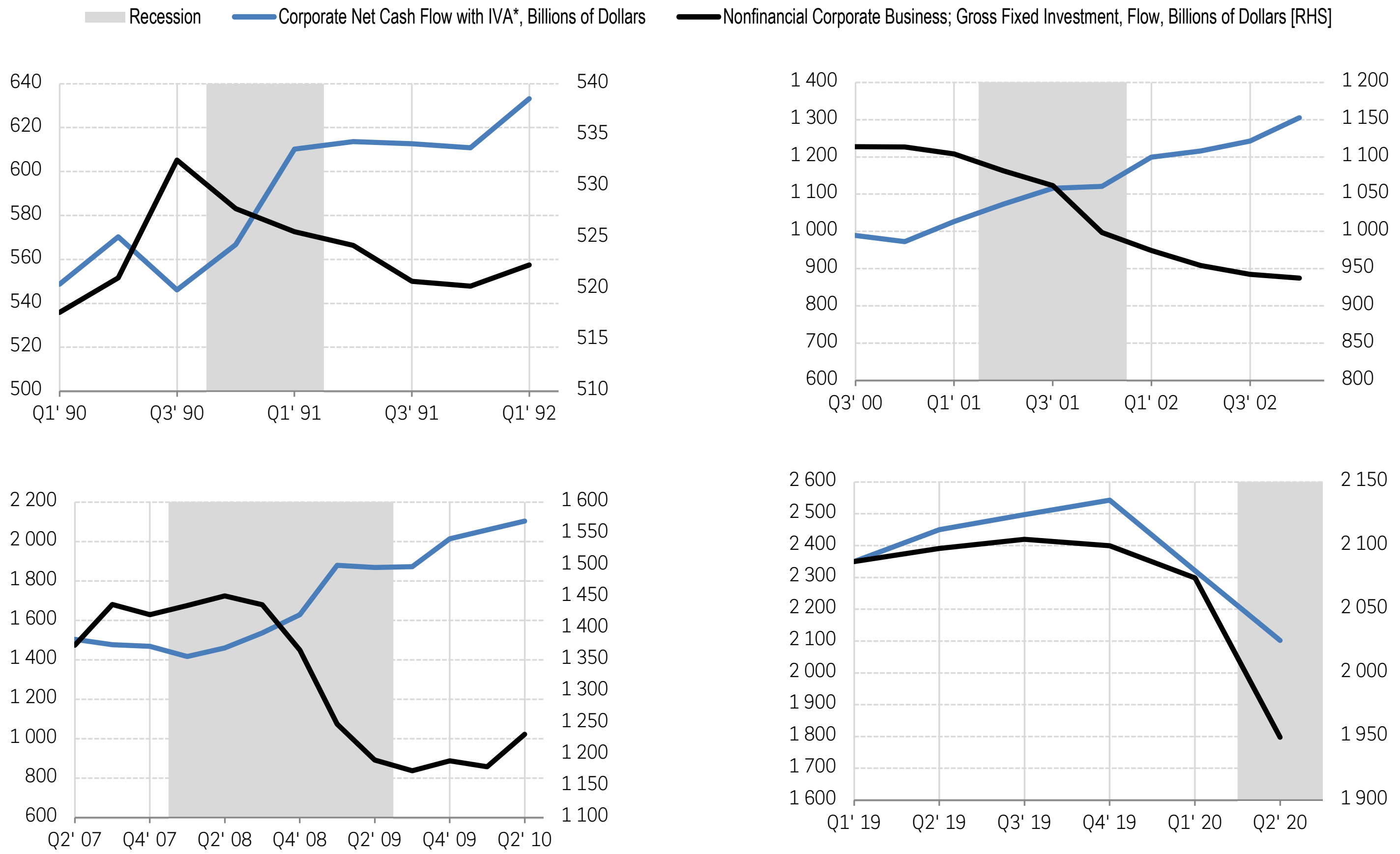
CASH FLOW AND CORPORATE INVESTMENT



SOURCE: US BEA, FEDERAL RESERVE OF SAINT-LOUIS, BNP PARIBAS