SEPTEMBER 2017

A New Capex: Implications Beyond the Bottom Line

Technology is reshaping corporate capital expenditure programs. Despite the aging of business infrastructure, healthy top-line revenue and ample financial resources, corporations around the world have been reluctant to increase their capital expenditures in recent years. Reasons for this reluctance include relatively low capacity utilization rates and better returns through spending on buybacks and other types of financial engineering. But we believe another reason for lower traditional capex — and one largely ignored by sell-side analysts — is the rise of spending on high-tech productivity improvements, which in addition to reshaping capex, will have broad implications for investors.

AUTHORS:

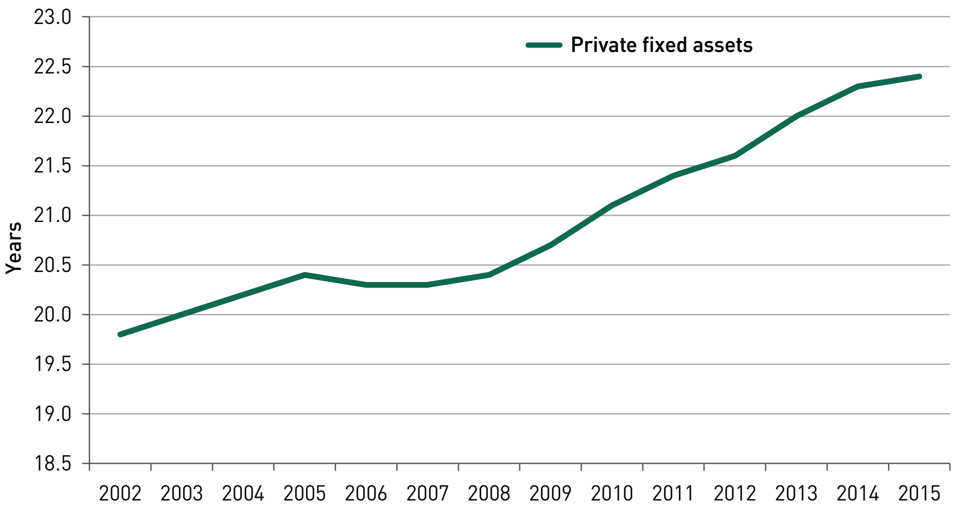
ANIK SEN
Global Head of Equities

KENNETH RUSKIN, CFA
Senior Research Analyst

The rise of higher-tech capex

Over the past two years of economic recovery, investors and economists alike have been eager for signs of greater corporate capital spending. It's been hoped that lower unemployment, stronger consumer confidence and more fiscal stimulus in the form of public works and infrastructure spending would stimulate capex, which in turn would trigger even more growth. After all, the age of private fixed assets globally rose to 22.4 years in 2015 from approximately 19.8 years in 2002, indicating that a good deal of the private US capital stock is past its prime.

Capital Stock is Aging

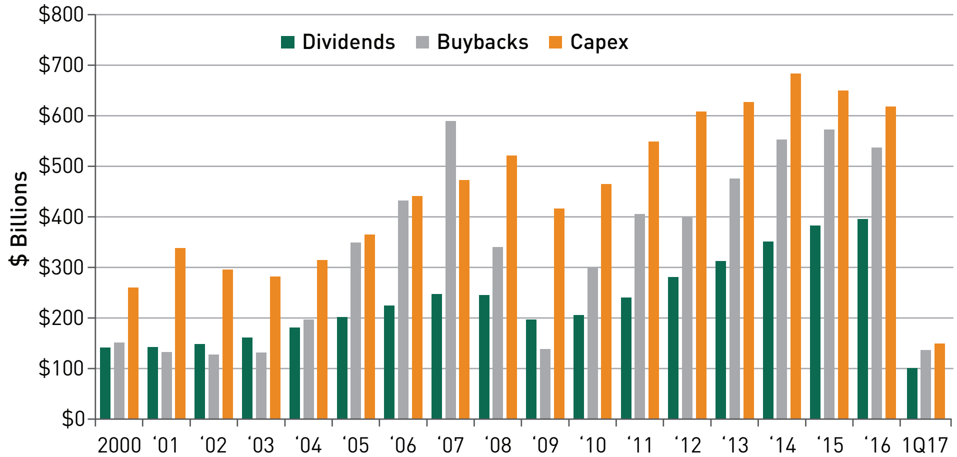


Source: Bureau of Economic Analysis. Annual data through 31 December 2015.

Yet instead of rising, the absolute level of capex has declined in each of the last two years, even as the economy has continued to grow. In place of investments in new capacity, companies have used retained earnings and borrowed capital to buy back shares, offer special dividends and buy other companies. In fact, dividends now stand at about 60% of capex spending and buybacks at around 80%, whereas a little over a decade ago, each was under 50% of capex.

Companies have recently favored dividends/buybacks over capex which has caused the capital stock to age.

S&P 500 Companies: Uses of Cash



Source: Haver Analytics, FactSet, and Citi Research as of March 31, 2017.

There's no denying that financial engineering has worked; companies that have engaged in these practices have been rewarded with higher stock prices. Corporate management, therefore, has felt little market impetus to allocate capital to new plants and equipment. Other reasons not to invest include capacity utilization rates of only about 75% and equity returns on traditional capex investments averaging just 10% over five to 10 years.

But while industry generally is skimping on traditional capital investment, we see many manufacturers and other users of capital equipment making modest to significant investments in high-tech modernization and automation tools. Importantly, these high-tech investments are producing cash-on-cash returns in the high double digits over three to four years. Most of these new investments — in high-tech equipment ranging from drones to automated forklifts, continuous mining equipment and advanced materials-handling robots, to cite just a few specific examples — are neither as costly as conventional capex nor attract as much attention as a new factory. Most are financed through cash flow.

Immediate implications

For companies making high-tech investments in modernization and automation equipment, there can be significant bottom-line impact. One materials company with which we recently met has announced a four-year $300 million investment in automation. It expects the investment will generate $100 million of incremental EBITDA by 2021 and boost earnings by more than 20%. The investment's 33% cash-on-cash return far exceeds the company's cost of capital or returns from any alternative uses for the cash. Another industrial company believes its earnings could double if it achieves all the cost savings it anticipates. Other companies are making similar investments and expect similar results.

For two key reasons, however, these investments and their effects do not appear to be incorporated in the earnings models of sell-side analysts at the moment and therefore are widely being overlooked. First, since capex hasn't been rewarded by the market for more than a decade, analysts have a tendency to assume that any capex is wasted. They, therefore, tend to ignore it. Second, the new capex falls outside traditional capital expenditures. As a result, the high-tech investments typically do not show up in corporate financial or disclosure documents. And even if they are aware of the spending, analysts have no way to gauge its impact and will have to wait for bottom-line evidence before giving companies credit for having made the investment.

As a result, active identification of companies poised to profit "unexpectedly" from their high-tech investments could result in significant portfolio opportunities. Similarly, companies supplying high-tech products, devices and services to a broad swath of industrial, materials and logistics-oriented companies also may present opportunities in selective cases, if priced attractively.

The possibility of margin expansion at larger, established companies, as well as possibilities for concurrent revenue and profitability growth opportunities at select high-tech providers, are two of the largely positive potential outcomes resulting from investment in new high-tech capex. Other outcomes may not be as sanguine.

Longer term, multi-asset implications

The margin gains resulting from investments in automated, high-tech equipment largely are the result of labor elimination. One large company that plans to spend $200 million to $300 million on plant modernization over the next two years said it anticipates an equal level of cost savings over a similar time span, the majority of which will come in the form of employee costs, a subject on which they don't focus publicly.

While companies contend that a shortage of trained workers is a significant driver of their investments in automated high-tech equipment, the result of these new investments — however inadvertent from a policy perspective — may not be wholly positive. While the economy likely will benefit from higher productivity and higher corporate profits, as well as muted inflation and wage gains, labor force insecurity from continued job elimination and low labor participation rates could pose political problems.

In such an environment, raising interest rates to more "normal" levels could well prove challenging for central banks, making reflation efforts in the wake of any future economic contraction or financial panic more difficult. The paucity of economic reasons for interest rates to rise, therefore, could mean that the long-predicted end of the years' long bull market in bonds may still lie in the future, even if further gains are slim.

At this stage at least, one takeaway from the new high-tech capex spending is that investment opportunities in fixed income, as well as equity markets, are likely to come not from broad directional moves, but rather from selective, opportunistic choices in emerging, as well as developed markets, in a cross-section of categories.

About PineBridge Investments

PineBridge Investments is a global asset manager with experience in emerging and developed markets, and investment capabilities in multi-asset, fixed income, equities and alternatives. Our firm is differentiated by the integration of on-the-ground investment teams of approximately 200 professionals, providing investors with the combined benefits of global fundamental perspectives and analytical insights. We manage over US$85 billion as of 30 June 2017 for a global client base that includes institutions, insurance companies, and intermediaries.

MULTI-ASSET | FIXED INCOME | EQUITIES | ALTERNATIVES

This information is for educational purposes only and is not intended to serve as investment advice. This is not an offer to sell or solicitation of an offer to purchase any investment product or security. Any opinions provided should not be relied upon for investment decisions. Any opinions, projections, forecasts and forward-looking statements are speculative in nature; valid only as of the date hereof and are subject to change. PineBridge Investments is not soliciting or recommending any action based on this information.