Tortoise QuickTake
Credit Podcast

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Welcome to the Tortoise QuickTake podcast. Thank you for joining us. Today, senior members of Tortoise provide a timely update on trending topics in the market.

I'm Greg Haendel, Senior Portfolio Manager at Tortoise. For most of us, tax day came and went on April 17th. If you are one of the fortunate folks who received a tax refund, did you use the money to pay down debt, save it, invest in home improvement projects, or purchase discretionary or non-discretionary items for yourself or for your family? If you're like me, you probably didn't use the money to repay debt and instead spent the money on returning it to your proverbial shareholders, being your family. Similarly, some multi-national companies just received an enormous "tax return" in the form of deemed repatriation of foreign earnings and similarly, they too did not spend the money on repaying debt. In today's podcast we will explore how this repatriated cash is being spent thus far as well as what effects it's having or could have on corporate balance sheets and parts of the financial markets.

Until this year the U.S. operated in a global tax system whereby U.S. domiciled corporations paid U.S. taxes on all income regardless of where in the world it was earned. For foreign earnings, taxes where due when that income was repatriated back to the U.S. while at the same time those corporations would receive a tax credit for any taxes paid to foreign governments (in order to avoid double taxation). As U.S. corporate tax rates historically were some of the highest in the world, many companies, like Apple, would choose to leave foreign earnings overseas and avoid the additional tax liability.

There is an estimated $2 trillion combined of un-repatriated earnings sitting on U.S. corporate balance sheets. Fast forward to today, the Tax Cuts and Jobs Act shifted the tax code toward a territorial tax system where the U.S. will no longer attempt to tax earnings of foreign subsidiaries, with some exceptions. Further, the Tax Cut and Jobs Act included a one-time deemed repatriation tax on all accumulated foreign earnings (payable over 8 years to the IRS) at 15.5% for liquid assets and 8% on illiquid assets such as property, plant and equipment.

With the conclusion of Q1 2018 earnings announcements, we now have our first look at how this repatriated cash is being spent as well as some of the tertiary effects. Several multi-national companies and industries have been effected by the mandatory foreign earnings repatriation, with the technology and healthcare industries having the largest concentration of foreign cash holdings. Digging deeper, the top 24 U.S. companies with the largest foreign cash portfolios equates to over $1 trillion with Apple at almost $285 billion, Microsoft at $146 billion, Google at roughly $100 billion and Cisco and Oracle each at roughly $70 billion at the end of 2017. Some, but not all of this cash will be spent over the coming quarters and years. In fact, Apple's goal is to become net cash neutral over time, meaning they intend to spend a substantial amount of the cash whereby their balance sheet cash would roughly equal their debt outstanding, roughly $120 billion as of the most recent quarter end.

The largest beneficiary of repatriation spending has been the stockholder with the most utilized tool being corporate stock buybacks. Share buybacks increased during Q1 2018 to a record $178 billion, up from $135 billion a year ago. Further, the 24 U.S. companies with the largest foreign cash holdings accounted for 2/3rds of the increase in share buybacks. There has already been $324 billion of buyback announcements year-to-date with an expected total buyback amount of $800 billion for the year. If this amount is achieved it would equate to a $300 billion increase versus 2017 with the majority of the increase expected to be funded with repatriated cash. In fact, Apple recently announced a new $100 billion share repurchase program while Cisco announced a $25 billion share repurchase program.

The remaining beneficiaries of repatriated cash thus far have been capex and dividends on a forward looking basis. Relative to Q1 2017, capex spending has increased 21% with the 24 U.S. companies with the largest foreign cash holdings accounting for over half of the increase in dollar terms resulting in a 57% increase in capex for that group. Although dividend payments did not substantially increase in Q1, some expect dividend income to grow 10% this year, with a portion of that increase being funded with repatriated cash. In fact, Apple just announced a 16% increase in their quarterly dividend, payable in mid-May. We have yet to see any link between repatriated earnings and any substantial increase in pension funding, M&A activity or debt repayment although those are all possible uses of repatriated cash on a go forward basis.

The term “repatriated cash’ is a bit of a misnomer given most of that overseas cash in technically not held overseas and technically not sitting in cash. In fact, most of the foreign cash to be repatriated has previously been invested in a variety of dollar-denominated fixed income securities with maturities of 5 years or less with corporate bonds and U.S. treasuries representing a substantial portion of those cash related holdings. In Q1 2018, the foreign cash portfolios of the 24 U.S. companies with the largest foreign cash holdings declined over 6% with their corporate bond holdings declining roughly 10%. Some of this decline resulted from maturities and some from selling by these companies in February and March, which in turn resulted in the underperformance of short maturity corporate bonds during that time period. Regardless of the mix of selling versus maturities, most of these companies were clearly not investing in new corporate bonds causing a substantial supply/demand mismatch relative to past investment activities. For example, Apple historically purchased roughly $32 billion of marketable securities per quarter in the recent past while they actually reduced overall holdings by $22 billion during Q1 2018, resulting in a decline of $54 billion of net demand for short duration marketable securities. Celgene and Amgen are other cash rich companies that experienced significant shrinkage in there cash and marketable securities holdings during the quarter.

Despite the decline in demand from these cash rich companies with substantial repatriated earnings, they also have virtually no need to issue or refinance their own debt for the foreseeable future. In fact, none of the top ten companies with the largest foreign cash holdings have issued debt in 2018. This compares with that group historically issuing roughly $80 billion per year, which equates to almost 10% of annual non-financial investment grade corporate bond issuance. While this is clearly a positive from a technical supply/demand standpoint, an anticipated increase in debt issuance across other industries to fund M&A and share buyback activity may more than offset the decline in corporate bond issuance from cash rich companies with large repatriation windfalls.

Many companies are still determining their capital allocation plan as a result of repatriated earnings while others, such as Apple, have already announced plans. Regardless, we expect cash allocation plans to be phased in over time rather than through a shotgun approach and we expect the majority of cash portfolio shrinkage to occur due to bond maturities as opposed to outright sales. Further, despite some of the supply/demand imbalances caused by this tax policy change, we continue to find relative value in short maturity securities, including corporate bonds, given the relative flatness of the yield curve and we believe demand from other investor types has and will more than offset the lost demand from cash rich corporations. What has become more apparent is that very little of this repatriated cash has been or will be spent on balance sheet deleveraging at a time when corporate leverage is nearing post financial crisis highs. At least going forward there should be less need for multinational corporations to spend money hiring savvy accountants and lawyers to game the U.S. tax system. Thank you for listening, we’ll talk to you again next week.

Thank you for joining us. And stay tuned for our next cast. Have topics you want covered or other feedback to share? Write us at info@tortoiseadvisors.com.