CREDIT SUISSE

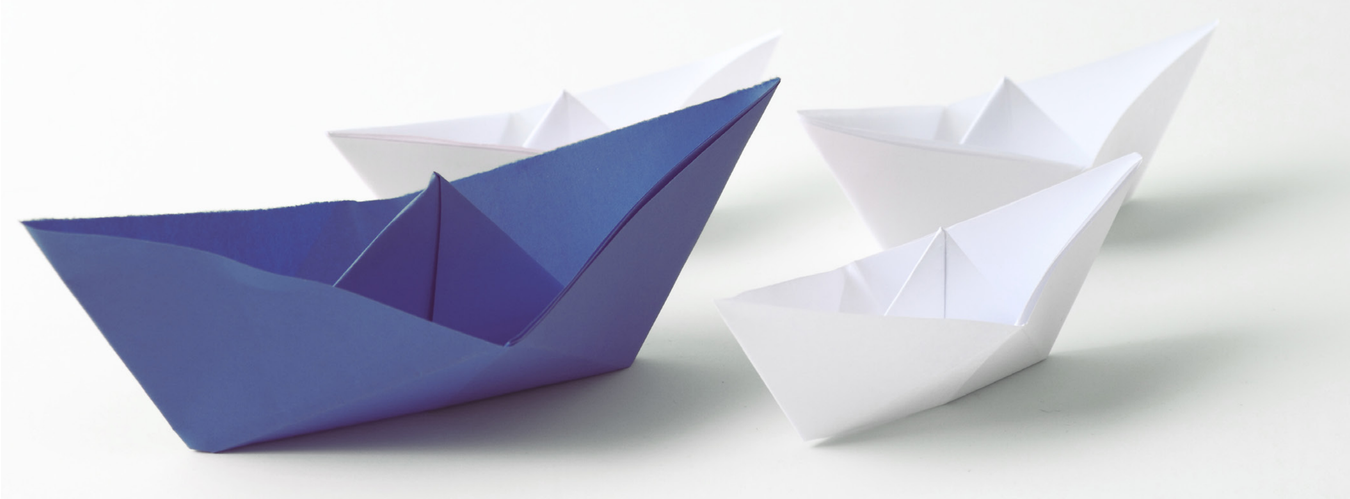
June 2014

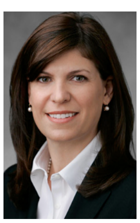
Cash-Rich Companies

Investment Themes from Credit Suisse

Private Banking and Wealth Management

Ahead of the Pack: Uncovering Opportunities Within Cash-Rich Companies





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Executive Summary

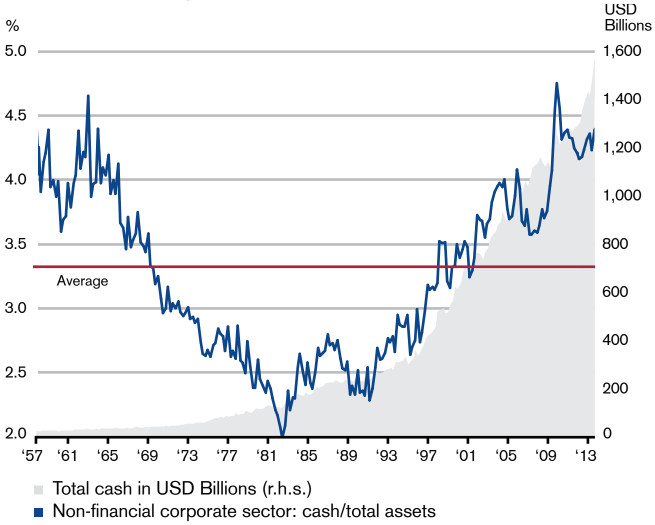
Since the end of 2007, U.S. corporations have accumulated almost $350 billion in additional cash reserves. Now totaling $1.4 trillion, cash on non-financial companies' balance sheets are at a record high. We believe these levels have significant implications for investors for the remainder of 2014 and beyond.

Specifically, given the record levels of cash and an improving U.S. economy, we see an important investment opportunity in "cash-rich companies." We expect a meaningful driver of returns to come from companies deploying their large cash reserves, whether by investing in growth through mergers and acquisitions (M&A) and capital expenditures, or by returning cash to shareholders through dividends and share buybacks. In this paper, we examine the underlying factors that may drive companies to begin using the cash on their balance sheets and the four key ways they will put this cash to use. We also identify the investment styles, sectors, industry groups and hedge fund strategies that can benefit from the improving outlook for M&A, capital expenditures, dividend growers and share buybacks.

Current Environment: Corporations Have Enormous Capital Cushions

A hallmark of the equity market recovery over the last five years has been the enormous capital cushions non-financial U.S. corporations have established. This war chest has climbed to $1.4 trillion *(Display 1)*. In absolute terms, U.S. corporate cash balances have more than doubled since 2000, and have climbed by 30% since the end of 2007. In addition, a meaningful build-up of cash reserves is held overseas as corporations are disinclined to bring foreign profits back to the U.S. given the repatriation tax; even given this technicality, the deliberate cash build-up has been substantial.

Display 1: Non-financial U.S. companies cash balances are at a record high



As of March 31, 2014
Source: Datastream, Credit Suisse / IDC

Why Are Companies Holding So Much Cash?

Four key factors have contributed to corporations building up their cash positions:

- Memories of the dual corporate credit crunches—first in 2001-2002 with accounting irregularities scandals, and second in 2008 during the global financial crisis—have disposed chief financial officers and treasurers to hold high cash levels to meet liquidity needs.
- The sluggish pace of the U.S. economic recovery has left corporations reluctant to undertake projects requiring multi-year capital commitments due to low visibility.
- Macro policy uncertainty has deterred long-term planning. In the last three years, the U.S. government avoided unprecedented debt defaults only by reaching last-minute deals in 2011 and 2013, and, during that period, the Eurozone crisis reached its most acute phase.
- The profit recovery, while persistent, has its doubters. As every quarter passes, resistance builds to corporate profits continuing to beat all-time highs.

Companies May Be More Willing to Use Cash Now

But that was then. We now foresee a very different landscape in 2014—one in which there will be more proactive uses of cash by corporates. Here are the reasons why:

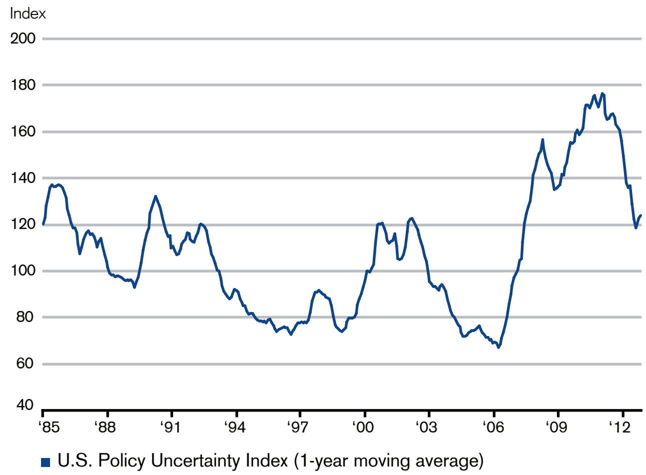
Deleveraging is largely behind us, U.S. consumer confidence is building

The effects of the two credit crunches of the 2000s are starting to abate because a) lending standards are now higher; b) financial institutions have been fortified; and c) the U.S. consumer has deleveraged. In fact, a New York Federal Reserve report released in May noted that nearly five years of consumer deleveraging is coming come to an end. To us, this signals that confidence is returning to the consumer segment, as they feel willing to borrow again. This is a meaningful development, as the consumer makes up over two-thirds of the U.S. economy.

Economic headwinds, like the budget deficit, are fading

While the U.S. economy has been unable to ignite robust growth in any single quarter, some of the headwinds—such as the contraction in government spending of 2.2% of GDP in 2013—are now abating. In the aftermath of the 2008 recession, the U.S. was running a massive budget deficit. At its peak, the deficit was 10.1% of GDP, but it has now declined to a far more manageable 2.9%, which has helped reduce macro uncertainty *(Display 2)*.

Display 2: Policy uncertainty has declined significantly



As of April 30, 2014
Source: Economic Policy Uncertainty

Earnings revisions are improving

In analyzing earnings, we note that, as of mid-May, the four-week moving average of U.S. earnings revisions has turned positive for the first time in almost a year, and the 13-week moving average has turned positive for the first time since 2012 *(Display 3)*. If GDP growth accelerates in line with our estimates to 2.5% in 2014 from 1.9% in 2013, it may spur a long-awaited rise in sales growth.

Display 3: S&P 500 Index earnings revisions are improving

As of May 23, 2014
Source: Datastream, Credit Suisse / IDC

Activism is picking up

While corporate directors have remained cautious, shareholders are favoring more aggressive action, and shareholder activism may push companies to deploy cash. According to data from Activist Insight, the number of large-cap activist investments almost doubled in 2013 to 42 from just 23 in 2012. Indeed, activism surrounding cash exploitation increased most significantly last year, with 13% of all activist campaigns focused on share buybacks and dividends, compared to 8% in 2012. We expect to see an uptick in spending on capital expenditures, M&A and capital distributions as companies begin to feel more pressure from activists, or look to avoid activists' attention.

Reinvestment rate remains low

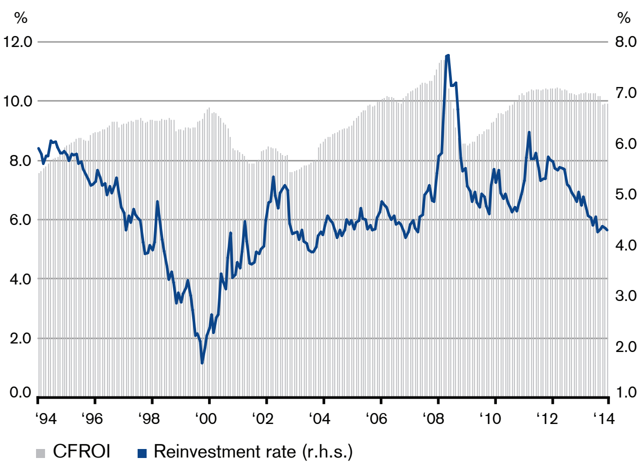
We believe corporations will start using their cash as a hedge against the possibility of higher financing costs, even if in modest amounts. Their decision seems wise as:

- The U.S. may be past the point of maximum liquidity as the Federal Reserve seems likely to conclude its quantitative easing program as early as this fall; and
- Credit Suisse forecasts that the Fed will raise interest rates in the fourth quarter of 2015, which could raise overall borrowing costs.

Financing costs aside, companies are beginning to find it more attractive to deploy cash than continuing to build reserves because of:

- The significant gap between the reinvestment rate and current cash return on investment *(Display 4)*.
- The negative total return on cash investments on an inflation-adjusted basis.

Display 4: Reinvestment rate remains low compared to returns on investment



Cash Flow Return on Investment (CFROI®) is the ratio of gross cash flow to gross investments translated into an internal rate of return recognizing the finite economic life of depreciating assets and the residual value of non-depreciating assets.

As of May 31, 2014
Source: Credit Suisse HOLT

Corporations Have Several Options for Using their Cash

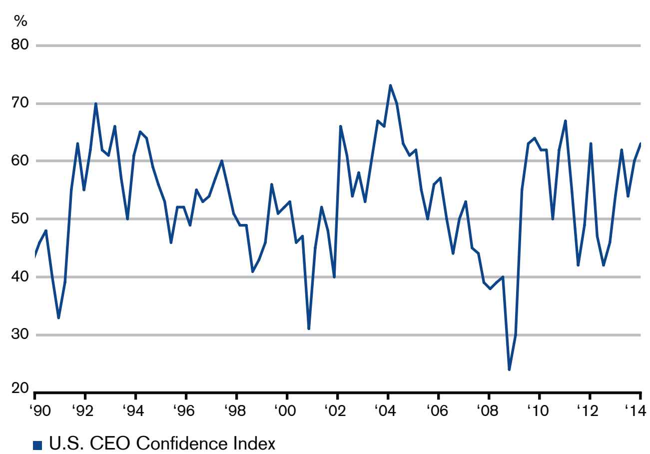
Corporations could use their cash in several ways, including:

Mergers & acquisitions

We have been waiting for the recovery in asset prices to ignite M&A activity. As 2014 unfolds, our wait appears to be over, and we believe the renaissance in M&A should have durable momentum due to:

- Increasing CEO confidence, which despite its volatility, has broken through the 50 threshold and has remained there since 1Q 2013 *(Display 5)*.
- A 32% gain for U.S. equities last year. M&A activity tends to track the equity market with a lag of about one year, so it is natural to see it starting to gain traction *(Display 6)*.
- Meaningful corporate cash trapped overseas, which can be unlocked in the form of cross-border M&A, and often with favorable tax treatment as compared to repatriation to the U.S.
- Corporate balance sheets being underleveraged.
- Buying being cheaper than building for companies with market capitalizations trading below replacement value.
- The growing importance of a mobile and internet strategy, which in many cases is forcing a rapid change in business models, often requiring M&A.

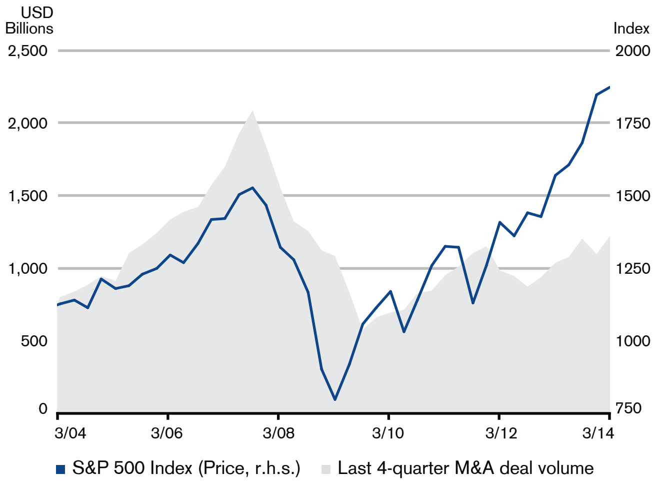
Display 5: Corporate confidence is improving



The CEO Confidence Index is a survey conducted by the Conference Board and PwC that measures CEOs' assessment of current economic conditions. A reading above 50 indicates more positive responses than negative and that CEOs expect economic conditions to improve.

As of March 31, 2014
Source: Datastream, Credit Suisse / IDC

Display 6: S&P 500 hits records levels while M&A activity reaches multi-year highs



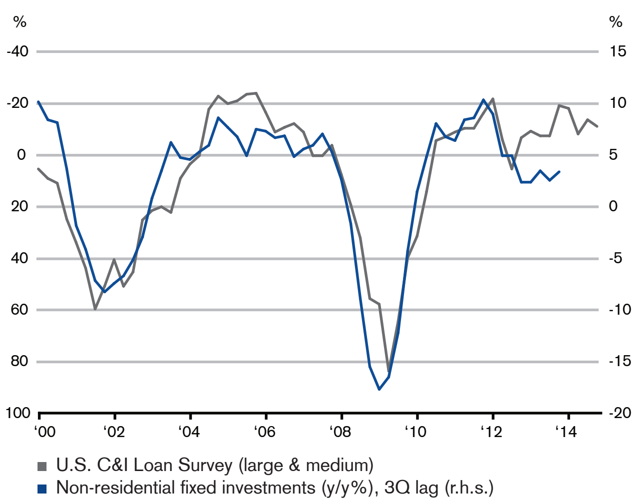
As of May 31, 2014
Source: Datastream, Credit Suisse / IDC

Capital expenditures

In our view, a comeback for capital expenditures is in its early innings—and we believe U.S. corporations need to reinvest in 2014 to replenish equipment and capital stock. Although peak profit margins and aged plant and equipment have been with us for some time, three factors support our view that the time for more capex is now:

- Rising capacity utilization, which is finally getting close to pre-recession levels. Its current reading of 78.6% is the highest level since summer 2008, a level consistent with companies engaging in capital expenditures plans.
- Growing bank lending intentions, which indicate a 7% pick-up in capital expenditures *(Display 7)*.
- Bottoming net business investment is currently only at trough levels of the past two recessions *(Display 8)*.

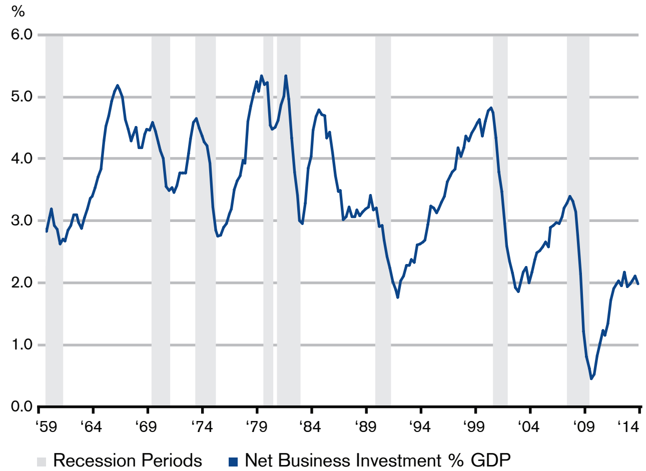
Display 7: Bank lending intentions point to a pickup in investments



The U.S. C&I Loan Survey measures the percentage of respondents to the Federal Reserve's Senior Loan Officer Survey on Bank Lending Practices that are tightening standards for commercial and industrial loans to large and middle-market businesses.

As of March 31, 2014
Source: Datastream, Credit Suisse Research

Display 8: Net business investment has more room to go



As of March 31, 2014
Source: Datastream, Credit Suisse Research

Dividends

One of our long-time favored investment strategies has been to own the dividend paying companies and those that are consistently growing their dividend. To examine the importance of dividends and dividend growth, look at the S&P 500 Dividend Aristocrats Index—an equally weighted index of S&P 500 companies that have increased their dividend payouts every year for the last 25 years. From a total return standpoint, since the low in March 2009, the compound annual growth rate has been 21.8% for the S&P 500 Index, and 24.0% for the S&P 500 Dividend Aristocrats Index.

To put it into historical perspective, owning the strategy of the Dividend Aristocrats would have given an investor an extra 11.5% over a five-year period.

We continue to favor this strategy for two key reasons. First, bond yields are low, and while they are likely to rise at some point, the duration risk from longer-dated maturities has kept many market participants in shorter maturities, which have lower yields. As a result, investors are still starved for income—and are likely to hunt for yield in dividend paying and growing equities.

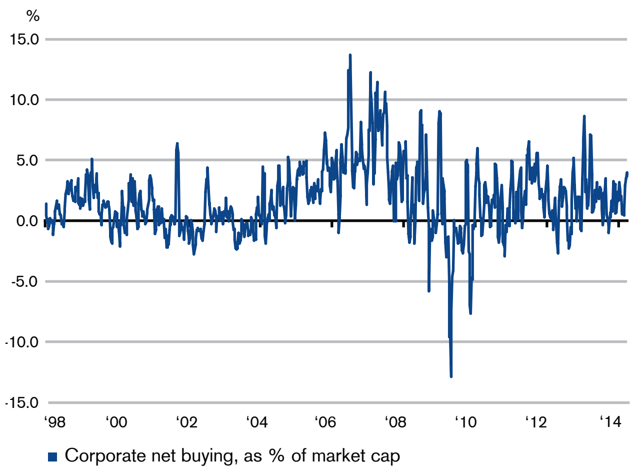
Second, an aging population with a longer life expectancy will need income in retirement, and will seek income through other avenues rather than simply fixed income. While the S&P 500 Index payout ratio remains well below its long-term average, we have seen some interesting trends—the 391 companies in the S&P 500 Index that pay a dividend have, on average, raised their dividends per share by 19% in 2013.

Share buybacks
U.S. corporate net buying is very high, and at 3.6% of market capitalization, is twice its long-term average *(Display 9)*. We believe buybacks will continue as the difference between the free-cash-flow yield and high-yield bonds is at a 25-year high.

Moreover, in analyzing non-financial companies in the S&P 500 Index, we measured cash and near-cash equivalents (short-term securities with a maturity of less than 90-days) for the 411 companies in that universe, and found:

- Average cash as a percent of total assets was about 9.2%.
- Companies with higher than average cash as a percent of total assets shrank their share count outstanding by 1.2%. From a performance perspective, these companies delivered a gain of 31.7% versus 25.0% for the S&P 500 Index from the first quarter of 2013 to the first quarter of 2014.

Display 9: Corporate net buying is climbing



As of May 15, 2014
Source: Trim Tabs, Credit Suisse Research

How Investors Can Profit from Corporations Spending Cash

We believe investors can benefit from opportunities in cash-rich companies in many ways:

Mergers & acquisitions
As M&A continues to pick up, we favor:

- Media and Information Technology
  Companies in this sector should be acquisitive in 2014, given large cash stockpiles and continued consolidation; this consolidation is being driven by companies looking to expand their customer base and technology platforms, particularly in the mobile and cloud computing space. Examples include Facebook's acquisition of WhatsApp and Comcast's acquisition of Time Warner Cable.
- Healthcare
  So far this year, Healthcare M&A is running at its fastest pace on record, with some noteworthy deals, including Valeant Pharmaceuticals acquiring Allergan and the deal between Novartis and GlaxoSmithKline. After a period of producing blockbuster drugs, large-cap pharmaceutical companies are having little success with internal R&D and need to refresh their pipelines. With ample free cash flow, these companies can acquire new products from R&D-driven biotech names or competitors with products and platforms that complement their business. We expect this trend to continue, which should benefit both large-cap pharmaceuticals and smaller biotechnology names being acquired.

Additionally, for companies with cash on their balance sheets overseas, there remains a meaningful repatriation tax. M&A is an effective way to use the cash trapped abroad, which cannot be used for dividends, or share buybacks, without tax implications.

Capital expenditures
Based on the Credit Suisse Executive Panel Survey, U.S. corporate spending intentions are primarily focused on information technology, employment, travel and machinery. IT spending was by far the strongest category, with almost 55% of respondents indicating additional spending. As companies look to spend money on improving IT infrastructure and upgrading technology, firms in the IT services and software industries should benefit.

We also like business services companies, which will benefit from higher spending on employment services and travel, and industrials, where we expect to see spending on purchasing machinery and replacing aging fixed asset investments.

Certain companies and styles
In addition to specific sectors, we think companies with certain attributes will benefit most from high levels of corporate cash. While we see opportunity to own attractive acquisition targets, we also see opportunity for owning the acquirers. Interestingly, the market's reaction has been positive for both target and acquirer, although the latter is less common. We expect large-cap acquirers to outperform, given strong balance sheets.

In terms of company characteristics, we like companies with low leverage and high free cash flow. These attributes point to companies with strong corporate balances that are more likely able to deploy capital to M&A and capital expenditures, or are generating excess cash flow to be distributed to shareholders, either through dividends or share buybacks.

Hedge funds

We recommend hedge funds as part of a well-diversified portfolio because they have flexible investment strategies that allow them to produce uncorrelated alpha and asymmetric returns by investing in company events, arbitrage and fundamental dispersion. Specifically, hedge funds:

- Provide unique diversification benefits, given that they typically have lower correlations to traditional asset classes and generate similar return premiums as equities, but with lower volatility—that is, they can generate higher risk-adjusted returns.
- Are well positioned, in our view, to take advantage of mispricing, while managing risk exposure. In particular, we like event driven strategies designed to exploit pricing inefficiencies surrounding specific corporate actions, such as M&A action or buybacks. In fact, event-driven hedge funds outperformed in 2013 and that strong performance continues in 2014 *(Display 10)*.

Display 10: Event driven funds are leading the way

Total Return in USD	YTD 2014	2013
Broad Hedge Funds	0.7%	9.7%
Hedge Funds Event Driven	**2.9%**	**15.5%**
Hedge Funds Directional	-1.0%	13.2%
Hedge Funds Relative Value	1.4%	6.4%
Hedge Funds Tactical Trading	-2.2%	0.9%

As of April 30, 2014
Source: Bloomberg, Credit Suisse Investment Strategy & Research

Conclusion

In summary, 2014 is likely to usher in more proactive uses of cash, and we see critical opportunities for investors to benefit as corporations utilize their war chests.

In terms of the investment opportunity set, we like:

- The Information Technology and Healthcare sectors, and select Industrials;
- Companies with high free cash flow, low leverage, or those likely to be acquirers; and
- Event-driven hedge funds.

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