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Companies Send More Cash Back to Shareholders; Activists push for returns, fueling worries about long-term investment

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U.S. businesses, feeling heat from activist investors, are slashing long-term spending and returning billions of dollars to shareholders, a fundamental shift in the way they are deploying capital.

Data show a broad array of companies have been plowing more cash into dividends and stock buybacks, while spending less on investments such as new factories and research and development.

Activist investors have been pushing for such changes, but it isn't just their target companies that are shifting gears. More businesses sitting on large piles of extra cash are deciding to satisfy investors by giving some of it back. Rock-bottom interest rates have made it cheap to borrow to buy back shares, which can boost a company's stock price. And technology-driven productivity gains are enabling some businesses to do more with less.

As the trend picks up steam, so too has debate about whether activist investors—who take sizable stakes in companies, then agitate for changes they think will boost share prices—have caused companies to tilt too far toward short-term rewards.

Laurence Fink, chief executive of BlackRock Inc., the world's largest money manager, argued as much in a March 31 letter to S&P 500 CEOs. “More and more corporate leaders have responded with actions that can deliver immediate returns to shareholders, such as buybacks or dividend increases, while underinvesting in innovation, skilled workforces or essential capital expenditures necessary to sustain long-term growth."

An analysis conducted for The Wall Street Journal by S&P Capital IQ shows that companies in the S&P 500 index sharply increased their spending on dividends and buybacks to a median 36% of operating cash flow in 2013, from 18% in 2003. Over that same decade, those companies cut spending on plants and equipment to 29% of operating cash flow, from 33% in 2003.

At S&P 500 companies targeted by activists, the spending cuts were more dramatic. Targeted companies reduced capital expenditures in the five years after activists bought their shares to 29% of operating cash flow, from 42% the year before, the Capital IQ analysis shows. Those companies boosted spending on dividends and buybacks to 37% of operating cash flow in the first year after being approached, from 22% in the year before.

Dividend boost

While billion-dollar stock buybacks draw headlines, dividend increases also are a big factor, according to data from Moody's Investors Service. At the 400 nonfinancial U.S. companies that Moody's rates as investment grade, the median percentage of cash spent on dividends rose to 11.9% of earnings before interest, taxes, depreciation and amortization, or Ebitda, in the third quarter of last year, from 9.4% in 2013, to the highest percentage since at least 2005.

Companies ranging from the industrial conglomerate DuPont Co. to Apple Inc. are sending more of their cash to their shareholders after coming under pressure from activists. General Motors Co. announced a $5 billion stock buyback in March after investor Harry Wilson and four hedge funds called on the company to return cash to shareholders.

It is it too early to know how—or whether—the shift will affect the overall economy.

Some economists predict an investment reduction will mean less growth and fewer jobs. “If investment falls, then you're losing demand in the economy, you're losing expenditures, you're losing economic stimulus," says Steven Fazzari, an economist at Washington University. “That's hurting jobs."

Other economists say it is appropriate for companies to focus on enriching shareholders, who can then decide where to deploy the money. To the

extent buybacks and higher dividends push up stock prices, they can contribute to what economists call the wealth effect, where rising asset prices make consumers feel wealthier and more confident about spending their money.

Hedge funds run by activist investors contend companies waste a lot of money that they should send to shareholders instead. One such investor, Carl Icahn, says activism with a long-term focus improves the economy by promoting efficient use of capital. “With many, many exceptions, this economy today is being dragged down by too many mediocre CEOs, and it's dangerous if profitability is going down despite interest rates being at zero," he says.

Business investment ticked up in April but remains sluggish and uneven. In recent years, corporate investment in capital goods, beyond replacing and maintaining existing assets, has grown slowly. While falling technology costs may account for some of the trend, companies have been slow to return to higher investment levels since the financial crisis. “One could argue that this has not been a good recovery for investment," says Christopher Probyn, chief economist for State Street Global Advisors.

Capital spending by businesses accounts for about one-eighth of all spending in the U.S. economy. Historically, it has been an important driver of long-term growth, as upgrades make workers and companies more productive, says Michael Feroli, chief U.S. economist at J.P. Morgan Chase & Co.

Money plowed into dividends and buybacks doesn't disappear from the economy. Its recipients can spend it, too.

But Washington University's Mr. Fazzari says that most stock is owned by the wealthy, who tend to save more of their income. By contrast, he says, many kinds of business investment—from building construction to equipment maintenance and purchases—involve payments to contractors and suppliers who pay wages to middle and low-income workers.

Many companies have made changes while under no direct threat from activists. General Electric Co.'s institutional investors had long urged the conglomerate to scale down its large lending business. In April, GE said it would sell off that business and buy back $50 billion of its stock.

The company said it chose to plow the proceeds into buybacks because it already had made substantial acquisitions and has invested sufficiently in its existing businesses.

U.S. Steel Corp. isn't buying back stock. But Chief Executive Mario Longhi has imposed a new analytical framework under which every proposed project must be linked to the value it could create for shareholders. The more disciplined approach sets a higher bar for R&D, which used to get a green light if it could simply boost production, says Mr. Longhi.

U.S. Steel is under pressure from cheaper imported steel and has a high cost structure because its blast furnaces are expensive to turn on and off, says Mr. Longhi. The need to keep the company lean and viable, he says, led to the changes.

Keeping activists at bay, he says, is a side benefit. “If an activist decides to look at our company, I don't think they're going to find a lot of room," he says.

Years of uncertain global demand and revenue growth, combined with corporate-governance changes that have made it easier for dissident shareholders to campaign for board seats, have opened the door to investors with ideas for boosting stock prices.

Activist campaigns

The number of activist campaigns annually has risen 60% since 2010. Last year there were 348, the most since 2008, according to data provider FactSet. An additional 108 were launched in this year's first quarter. Activist funds now control nearly $130 billion in assets, more than double the amount they had in 2011, according to hedge-fund tracker HFR, giving them the war chests to target even the biggest American corporations.

Activists say they are strengthening companies that tend to overspend and holding managers responsible to their ultimate owners, the shareholders.

Network-equipment maker Juniper Networks Inc. came under pressure last year from Elliott Management Corp., a New York-based hedge fund. The fund criticized Juniper for spending $7 billion on acquisitions and nearly $8 billion on R&D when its stock price had underperformed the Nasdaq Composite Index by 63 percentage points between the company's 1999 initial public offering and Nov. 4, 2013.

In February 2014, in an agreement with Elliott that avoided a potential board fight, Juniper appointed two new directors and announced a plan to repurchase stock and cut costs. The company reduced its head count by 7% and repurchased $2.25 billion of stock last year. This year it appointed

two more directors after a joint search, and it plans to buy back almost $2 billion more in stock through 2016. The company paid its first-ever dividend last year. It has borrowed money to fund some of the buybacks and dividends.

In early 2012, New York investment firm Clinton Group Inc. took a stake in teen-fashion retailer Wet Seal Inc. and began urging a share buyback. In February 2013, the company disclosed it was cutting jobs and expenses and would repurchase $25 million of stock after appointing four Clinton representatives to its board.

This January, Wet Seal closed two-thirds of its stores and filed for bankruptcy protection. In court documents, executives cited a broader drag on teen retailers as well as missteps that alienated core customers.

Others contend the buyback ultimately hurt the company. “If we had rewound and…they hadn't done the buyback, that would have given them substantially more flexibility," says Jeff Van Sinderen, an analyst at B. Riley & Co. “In those situations, $25 million dollars can go a long way."

The debate over R&D spending flared up at chemicals maker DuPont amid pressure from activist Nelson Peltz and his Trian Fund Management LP.

On May 13, DuPontwon a proxy fight for board seats, in part by arguing that Trian's suggestions to cut costs and break up the company would get in the way of scientific breakthroughs, a concern that struck a chord with some shareholders and academic commentators. Trian had questioned whether DuPont's current system of R&D can be successful, but said it wouldn't eliminate such spending entirely.

Among other moves, DuPont increased its quarterly dividend in April and has pledged to repurchase about $4 billion in stock after a planned spinoff of its performance-chemicals business.

The choice between investments and shareholder returns isn't simple. Apple, for example, has paid out more than $64 billion to shareholders through dividends and stock buybacks since mid-2013, when Mr. Icahn began pressing the company to stop sitting on so much of its cash. Last month, the company boosted its dividend by 11% and increased its buyback plan by $50 billion, to $140 billion.

But Apple also has long pursued a disciplined approach to R&D that has yielded much bigger payoffs than companies that spent far more. Nokia Corp. outspent the iPhone maker on R&D by a 4-to-1 ratio over the decade

starting in 2001 but still ended up an also-ran in the cellphone market it once dominated.

“The history of corporate America is littered with a long line of companies that relinquished their leading industry position and spent enormous resources attempting to reinvent themselves and ultimately failed," activist fund Starboard Value LP wrote in a letter to Yahoo Inc. in March as it pushed for a multibillion-dollar buyback at the technology company.
Yahoo later decided to buy back $2 billion in stock.

The surge of activism has sharpened the debate about the fundamental purpose of a company. Does it exist to satisfy shareholders or does it have an imperative also to try to build for the long term?

The answer is far from settled. If the activists are right, they are stopping companies from throwing good money after bad.

“If they aren't, then we have to worry about the impact," says Yvan Allaire, the executive chairman of the Institute for Governance of Private and Public Organizations. “It has to be a fairly significant impact on the economy.

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