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Why Tax Reform Changes Nothing — and Everything

With so much cash on company balance sheets, U.S. companies face competitive pressure to use the tax windfall strategically.

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Companies in the U.S. were already sitting on piles of cash before tax reform passed in December 2017. Now, with a strengthening global economy and a tax overhaul that lowers the corporate tax rate from 35 to 21 percent and incentivizes U.S. companies to repatriate all their previously untaxed foreign earnings, those piles of cash are poised to grow substantially. Some estimate there may be more than US$330 billion in tax savings for corporations over the next 10 years, not including the trillions of dollars held overseas that may now come home. Already companies are reporting significant tax savings, including Berkshire Hathaway's $29 billion and AT&T's $3 billion. The big question is: What will companies do with this windfall?

We know that many will continue their habit of returning money to shareholders in the form of buybacks and dividends, or paying down debt. Already $178 billion has been earmarked for shares in what Birinyi Associates, a market research firm, is reporting as the largest number of buybacks ever unveiled in the first six weeks of the year. But we believe the most strategic-minded executives will see this opportunity as a watershed moment to reevaluate how they allocate cash, and to invest in giving their businesses a long-term competitive advantage. We believe the starting gun has sounded on what will be a strategic arms race for assets, capabilities, and talent. Companies need to act now or risk their future.

That said, the actual changes in the tax law may not be enough to spur executives to act because, at first glance, little has changed for most companies. Most of them already had plenty of cash to make investments and had access to cheap credit. The reasons for not investing are complex, and specific to each company.

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Some have conservative, risk-averse cultures that avoid these big bets, and many simply do not have the bandwidth to pursue transformative deals. Most companies are not green-lighting the positive investment opportunities that come their way and are struggling simply to adapt to the disruption brought by new technology. That makes it hard to make choices about how to shape their own future.

In the ongoing global survey of company executives conducted by Strategy&, PwC's strategy consulting business, 65 percent of the 5,400 respondents said they didn't think they had a winning strategy. In another survey of more than 500 senior executives around the world, nine out of 10 said that they were missing major opportunities in the market. A recent survey by Strategy& of 180 chief strategy officers shows leadership is spending a lot of time discussing the big strategic questions, but not actually addressing them.

For all these reasons, the recent tax overhaul changes nothing. But look at it from another perspective, and tax reform actually changes everything. We've never had a moment in which so much cash is sitting on the balance sheets of so many companies at the same time, demanding attention. This is forcing executives to discuss how much to return to shareholders, how much to keep, and where to invest.

PwC recently asked 20 large-cap companies how they would use the newly freed-up cash from tax reform. The results: 45 percent said returning it to shareholders, 45 percent said raising internal investment, and 10 percent said acquisitions. According to Dealogic, global M&A volume for the year has gotten off

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to the fastest start ever. As of March 20, 2018, M&A volume had passed the $1 trillion mark, almost double the 23-year average of year-to-date volume.

However, the real impetus for action may be game theory. CEOs will likely be concerned about whether they need to take action ahead of their competitors, given that others will be considering many of the same questions. This may lead to strategic moves to block competitors, particularly in the M&A space. We expect that executives will be keeping a keen eye on what their peers are doing for the next several quarters.

Even if just a small percentage of companies decide to invest more of the extra cash in acquisitions and strategic investments, it could quickly lead to an arms race. Our advice: Get in early but be smart, because assets of all kinds will be harder to come by and will become more expensive. Companies will need to sort through the range of choices in front of them and invest to build advantage. This could be organic investments in a company's capabilities — there are dozens of areas just within a function such as IT. Truly differentiated advantages, however, are almost always cross-functional; the key is to distinguish the capabilities that a company merely needs to be good at from those capabilities that need to be world-class. For example, it is the way IKEA integrates design, supply chain, and deep consumer understanding to develop innovative, affordable products that makes it the market leader.

In fact, in our experience, the number one reason strategies fail is that companies don't devote sufficient attention and investment to their differentiating capabilities, that is, the specific intersection of people, knowledge, IT, tools, and

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processes that allow them to outperform competitors. But when companies get capabilities right, as IKEA does, they are a force to be reckoned with.

Developing and maintaining differentiating capabilities is tough work and can be expensive. But it's also why the tax reform windfall presents an excellent opportunity for companies to reexamine what makes them special, and to consider how to invest in critical capabilities to put them or keep them in a position of strength.

Ultimately, the only way to generate long-term value is to make tough choices about how to invest in the business and generate profits. Share buybacks might be a tried-and-true formula for short-term value gains, but now is the time to double down on the things that define the best in a business, the differentiating capabilities that give your company the right to win. Your competitors are likely to be doing just that. +

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