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A Long-Term Investor's Viewpoint: Capitalizing On Tax Reform

By Lori A. Keith

THE TAX CUTS AND JOBS ACT, ENACTED IN December 2017, dramatically reduced the maximum corporate tax rate from 35 percent to 21 percent and lowered the rate on corporate income brought back home from abroad, providing a tailwind for many companies. These historic tax cuts created an opportunity for companies to redeploy significant amounts of cash that had previously been set aside for tax payments to other parts of their businesses, boosting 2018 corporate earnings growth and opening long pathways for future growth.

Parnassus Investments allocates our clients' capital to companies that we believe are on a path to achieving sustainable multi-year growth. In our view, if a company is not investing over a long horizon, it will risk a loss of relevancy in the future. However, thus far, a significant portion of the tax cuts has been used for share buy backs, one-time bonuses and M&A. These activities may result in short-term bumps in the stock price, but they are not typically sufficient to drive sustainable company success.

Below are some of our perspectives about the choices management teams may make over time as they continue to allocate cash generated by the corporate tax reform. We also offer examples of existing company strategies that are being used effectively to drive sustainable growth and deliver greater shareholder value.

R&D

High value-add products and services command pricing power, and with inflation starting to pick up, prioritizing research and development can counteract pressure from raw material and labor costs. The right investments in efforts to develop new products and services can help companies differentiate themselves from competitors and build sustainable moats.

Xylem Corporation, a leading pure-play water technology provider, has increased its R&D investments as a percentage of sales to accelerate the pace of innovation across its product portfolio. The company's Vitality Index, which measures the percentage of revenue that comes from products introduced within the prior five years, increased dramatically over the past year to 24 percent. Strong customer adoption of its newly released high-margin products has enabled the company to boost its bottom line.

Fortive Corporation, a leading industrial technologies and professional instrumentation provider, is another example of a company that is already taking the right steps to drive more durable growth through innovation over time. Fortive leverages efficiencies to improve its operations and create additional R&D funding. The company uses its Fortive Business System as a framework for driving improvements across its entire operations and optimizing R&D spending across its product portfolio. This approach has enabled Fortive to build a healthy competitive advantage and garner significant share gains.

Talent Development

We believe talent development is another crucial element for creating sustainable growth. The best companies attract the best people over time by taking a broad look at how to find and develop top talent. They also take actions that lower attrition and cultivate a longer-tenured, seasoned, experienced employee base. Management can make many choices to foster and develop talent, promote diversity and plan for succession. For instance, many companies announced one-time bonuses due to the recent tax reform. These bonuses can boost morale in the short term, but clearly do little to sustain engagement. A few examples of better choices for driving positive employee engagement include mentorships, robust talent development programs and employee survey programs to monitor progress.

Cadence Design Systems is a leading electronic design automation (EDA) software player that takes a comprehensive approach to developing its talent base and encouraging a highly engaged workforce. Cadence's investment in a culture of collaboration, inclusiveness and diversity has enabled the company to organically develop a significant number of differentiated new products every year. As a result, Cadence has gained significant market share leadership with its products, enhancing its bottom line.

WD-40 Company, the maker of the ubiquitous household lubricant spray used by millions of consumers, also offers a blueprint for fostering a highly engaged workforce. The company invests in day-to-day employee coaching and team-based culture and measurement, which has led to an employee tenure that is more than double the national average. WD-40 also boasts a 93 percent employee engagement rate, almost three times the national average.

Dividends

Increasing dividends has plusses and minuses for long-term company health. We believe dividends are often a better alternative than overly expensive acquisitions that can dilute shareholder returns, even though dividends don't boost a company's fundamental value. Shareholders certainly benefit when management returns excess cash to them through dividend payments. Moreover, consistent dividend payouts underscore a company's operational health, while raising dividends can keep companies disciplined about how they manage their cash flow and signal management confidence in the future.

One company that has posted a remarkable track record of consistent dividend increases is Clorox. The company has increased its dividends each year since 1977, while simultaneously maintaining a strong focus on research and development investments. This approach has supported its successful strategy of commanding significant market share and pricing power with its highly innovative product portfolio of leading brands.

However, in our opinion, companies that have underfunded their pipeline for new product development would be better off bolstering their R&D investments in new growth opportunities or core franchises to generate sustainable earnings growth instead of increasing dividends.

Debt Reduction

Although we generally view dividends as good for investors, in cases where a company has significant debt leverage, particularly in more cyclical industries such as consumer discretionary or capital equipment, paying down debt can lower the risk profile for the company and reduce its interest expenses. Reducing debt can also result in a company being better positioned, particularly for weak economic periods, when companies with low debt levels will have more options for cash flow. Low-levered companies can better manage a range of outcomes, more likely avoiding a permanent loss of capital.

Share Buy Backs

Share repurchases are an increasingly popular way for corporations to return cash to shareholders. Share buy backs may be useful if they reduce the total number of shares outstanding over time and offset dilution from employee stock options. However, while they may boost earnings over the short run, they don't typically create lasting value for shareholders. This is because share repurchases don't improve a company's underlying performance. Focusing on factors such as organic revenue growth and margin improvement—key drivers of earnings growth—will likely have a more meaningful impact on long-term value creation than share repurchases.

Nevertheless, management may be incentivized to prioritize buy backs if the executive compensation structure emphasizes EPS targets, because with a lower share count, all else being equal, earnings per share will rise. To avoid this type of short-sighted financial decision-making, we prefer to see compensation plans built around metrics that reward long-term results, such as ROIC (return on invested capital), organic revenue growth, unadjusted earnings growth, TSR (total shareholder return) and ESG sustainability metrics. Furthermore, we believe that designing executive compensation plans with a heavy emphasis on long-term performance incentives will result in better alignment with long-term shareholder interests and more properly incentivize management to make strategic choices and capital allocation decisions that support multi-year value creation.

M&A

Mergers and acquisitions may add significant risk and debt, and they often fail to create wealth for shareholders of the acquiring company. Moreover, M&A deals, particularly large transactions, often destroy wealth. According to a study published in the May 20, 2016 Harvard Business Review, more than 60 percent of M&A deals destroy shareholder value.

However, selective use of M&A can complement organic growth if it strengthens the company's competitive position, enhances the business model, adds talent or opens up a presence in a new geographical region. An example of a successful acquisition strategy was Teleflex's 2017 acquisition of NeoTract, a leading provider of minimally invasive urology treatment devices. Teleflex has transformed itself from a highly cyclical industrial conglomerate to a pure-play medtech company over recent years, and the NeoTract acquisition further bolstered its growth prospects by expanding its addressable market and improving its gross and operating margin profile.

Integrated Devices Technology, Inc., which provides system-level electronic solutions, is another great example of a company that has selectively used M&A to enhance its technology platform and infuse new talent into its engineering culture. The company's tuck-in acquisition of ZMDI (Zentrum Mikroelektronic Dresden AG) enabled IDT to expand into the fast-growing specialty sensor market in the automotive vertical. As automotive, industrial and even healthcare applications increasingly adopt sensor technology, we think IDT is poised to deliver sustainable growth.

One Size Does Not Fit All

Parnassus believes that it's important for shareholders to carefully evaluate how management's use of the windfalls generated by the tax cuts relates to long-term planning. Each company is unique, with varying cash needs and opportunities for using excess cash. However, in general, we believe businesses will gain competitive advantages from the tax cuts by upping allocations to R&D and talent development. In most cases, choosing M&A and share buy backs will not improve the underlying growth prospects for a company. Each company should carefully consider the best path forward in the context of its particular circumstances, because the strategic choices that corporations make to take advantage of this historic opportunity to allocate capital will likely determine whether they thrive over the coming years. FA

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