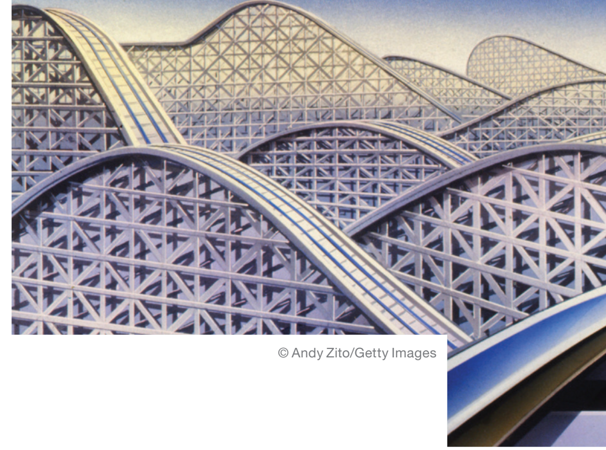
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OCTOBER 2016

Fundamental Finance

Corporate Finance

Improving the investment patterns of cyclical companies

Companies that invest smartly when times are bad typically outperform peers.

Marc Goedhart and Jyotsna Goel

When profits are high and funding is readily available, it's easy for companies to invest in capital projects. But it's also unwise. Not only do companies that do so reinforce cyclicality in profit growth, they also forgo opportunities to invest at lower prices when profits are down.[1]

It's a hard cycle to break. Capital expenditures for the 500 largest US corporations over the past 45 years are highly correlated with prior-year profitability (exhibit). When corporate profits rise, capital expenditures typically go up as well in the following years. This relationship has been remarkably consistent over time—even in the recent years of quantitative easing—with a surprisingly strong correlation of 55 percent since 1972.

The findings correspond with our experience with companies in the energy, mining, transportation, and chemical sectors.[2] From a long-term perspective, they would be better off smoothing out their capital spending, building financial flexibility in good times so that they can spend more in bad. Companies that can time their capital spending and asset purchases to invest countercyclically typically outperform their peers. ■

[1] See Marc Goedhart, Tim Koller, and David Wessels, *Valuation: Measuring and Managing the Value of Companies*, sixth edition, Hoboken, NJ: John Wiley & Sons, 2015, pp. 711–12.
[2] See, for example, Thomas Augat, Eric Bartels, and Florian Budde, "Multiple choice for the chemicals industry," *McKinsey on Finance*, Summer 2003, McKinsey.com.

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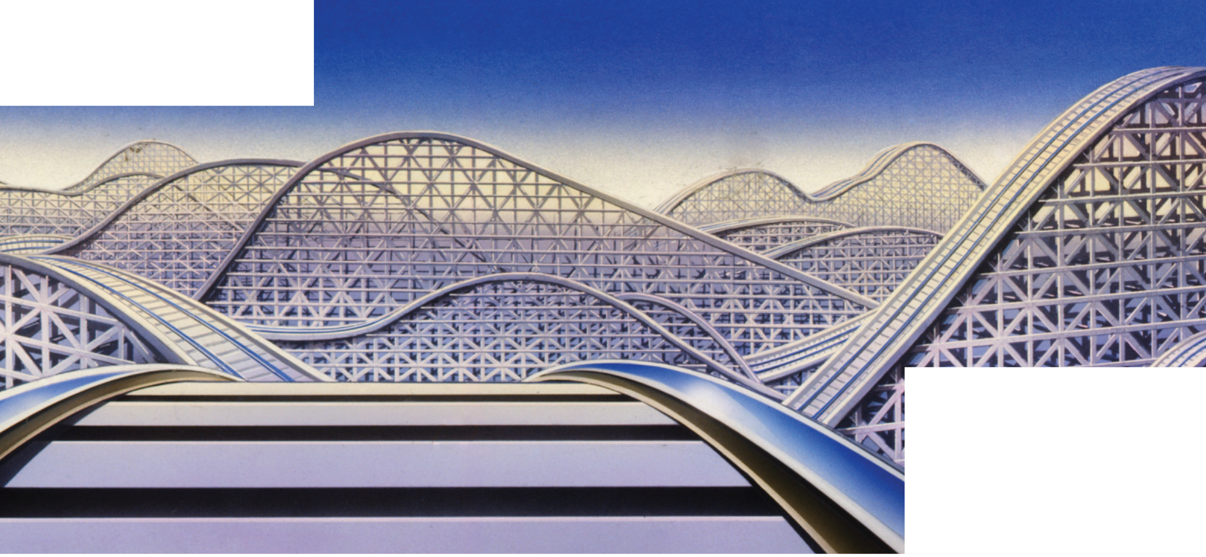
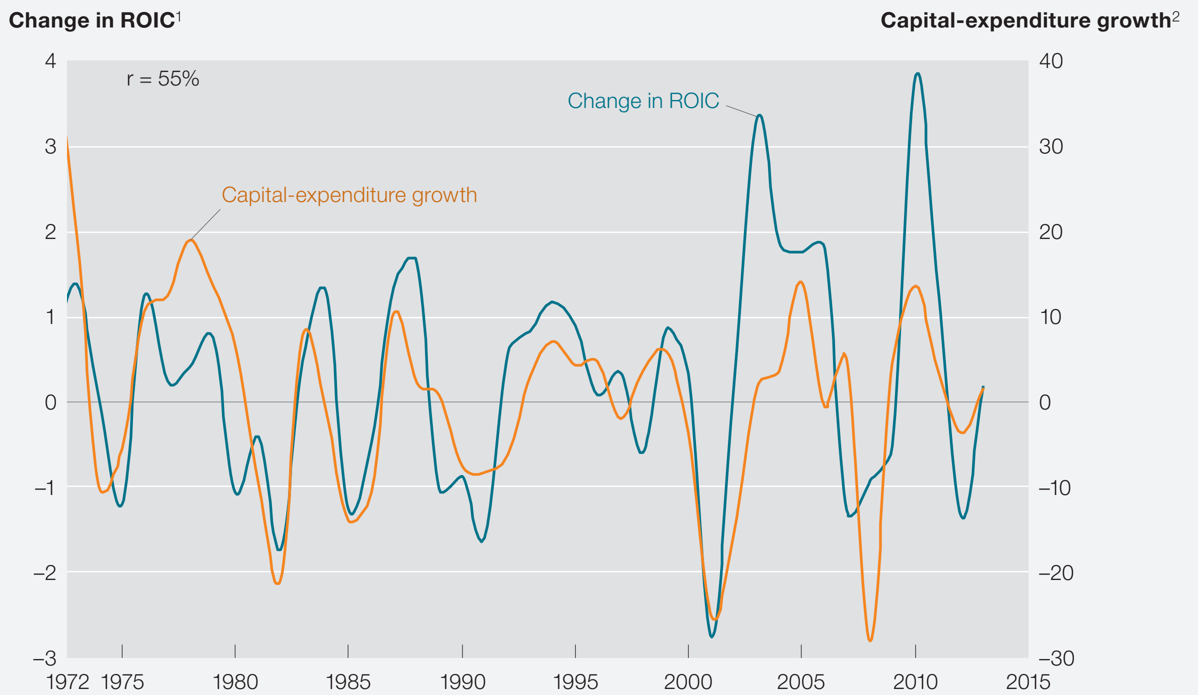


Exhibit

Capital investments are highly correlated with prior-year profitability.

1972–2014, %



[1] Based on aggregate net operating profit less adjusted taxes divided by average invested capital, excluding goodwill.
[2] Based on gross capital-expenditure growth relative to annual changes in ROIC, normalized against long-term CAGR of 6%.

Source: Corporate Performance Analytics, a McKinsey Solution