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GS Global Capex Survey: Corporate Risk Appetite Returning

In a favorable macro environment, what are the prospects for a pickup in capital spending this year? Our survey of equity analysts is cautiously optimistic

The biggest challenge for the world economy this year is to resolve two persistent imbalances—extended consumers and the US current account deficit—without major mishap. This will, in part, entail shifts in spending: away from the consumer towards business, and away from the US towards the rest of the world.

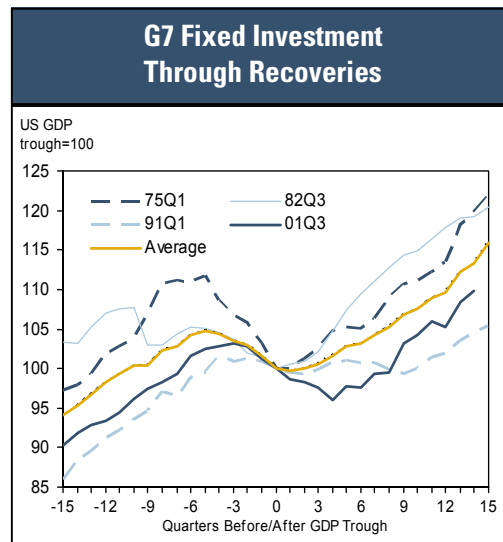
An orderly adjustment of these imbalances would be helped by a pick-up in global investment spending, particularly in the US. Thus far, the capital spending recovery in the major economies since the trough in the economic cycle has been relatively muted by historical standards, as risk-averse companies have used cash to reduce debt, increase dividends and buy back shares.

Five years on from the peak of the bubble, with corporate balance sheets significantly repaired and above-trend growth restored, there appears to be a compelling case for a robust recovery in capital investment ahead. In 2004 the global economy expanded at its fastest rate since the late 1980s, and GDP growth is expected to remain above trend in 2005-2006. The standard accelerator relationship between investment and the change in GDP is usually reliable and highly geared, so that any pick-up in GDP growth will produce a larger rise in capital spending, typically with a lag of one to two years. In 2005 this effect should be reinforced by strong cash flows and unusually low real interest rates. Growing signs of corporate risk-taking and forward-looking indicators also suggest that the investment climate is improving.

In such a favourable environment, what are the prospects for global capex in the year ahead? To explore this, we polled our industry analysts across the US, Europe and Asia about spending prospects in their sectors. With nearly 200 responses across industries and regions, this is an unusually comprehensive look at capex intentions.

The outlook from a bottom-up perspective is encouraging but still tinged with caution. Our analysts do expect higher spending around the world, most notably in the US. At the same time, however, we see a clear aversion to external financing, indicating that the corporate sector feels compelled to tread cautiously and to remain close to financial balance. The perception that the market still favours the return of cash to shareholders rather than investment emerges as a key

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constraint on capital spending. This in turn suggests an upside risk to our views: that companies may accelerate their spending if the market shifts its focus and approval. But if the corporate sector remains unusually risk averse, global real bond yields could be slow to rise from today's unsustainably low levels.

Favourable Macro Fundamentals for a Global Capex Recovery

The bursting of the 1990s bubble led one of the steepest corporate financial adjustments in post-war history. Investment fell by 1.6% in the G7 in 2001, the first decline since 1991, and by a further 4% in 2002. Though the focus tends to be on US excesses, the bust was nearly as bad elsewhere, with a peak-to-trough fall in real investment of about 15% in the US, 14% in Germany, 12% in Japan, and 7% in the UK.

Those hoping that a large downturn in investment would pave the way for a sharp rebound have been disappointed. The upswing in aggregate investment growth in the G7 has been more muted than in previous economic cycles, particularly outside the US, as companies have targeted cash toward net debt

reduction and other purposes rather than capital spending.

The good news is that balance sheets are now substantially healthier, with the combined corporate sector in the US, Japan and Euroland improving its financial surplus by over 3% of GDP since 2000. Yet investment remains low, as a share of both GDP and corporate profits, even in the US. And with capacity utilisation rates now rising in the G3, capex has plenty of scope to expand relative to other parts of overall demand.

Forward-looking indicators suggest ongoing improvement in the investment climate:

- Recent economic data point to higher investment in late 2004 and into early 2005.
- Recent credit surveys by the Fed, ECB and BoJ point to a synchronous revival in corporate demand for capital in the G3.
- M&A activity has accelerated after three years of caution. 2004 merger activity was up nearly 50% from 2003, and December was the busiest month since August 2000.
- Our own index of CEO confidence points to broad optimism among global corporates and a focus on

putting record levels of free cash flow to work.

First-Ever GS Capital Spending Survey

In such a favourable environment, what are the prospects for global capex in the year ahead? Have firms overcome their risk aversion, used up capacity and exhausted other alternatives for their free cash flow? To obtain a bottom-up perspective, we conducted our first-ever global survey of all GS equity analysts. With nearly 200 responses, this provides an unusually comprehensive look at the prospects for capital spending, by region and by industry, in 2005.

A brief word of explanation on our survey: Between 27th January and 1st February, we asked GS equity-research analysts about their expectations of capital expenditure this year in the sectors they cover. We aggregated their responses on a market-capitalisation weighted basis; the percentages reported in the tables and charts are calculated against the total market cap of all the sectors included in the survey (representing all the areas in which we have industry coverage). Finally, in order to analyse the bottom-up responses from a macro perspective and to make

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Survey Methodology

- This survey was conducted between 27th January and 1st February. We asked GS equity-research analysts about their expectations of capital expenditure this year in the sectors they cover.
- We aggregated their responses on a market-capitalisation weighted basis.
- The percentages reported are calculated against the total market cap of all the sectors included in the survey (representing all the areas in which we have industry coverage).
- In order to analyse the bottom-up responses from a macro perspective and to make regional comparisons, we have aggregated the sectors into five broad industry classifications: Industrials (including Materials and Energy); Consumer; Financials; IT and Communications; and Utilities.

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Summary Results of Capex Survey*				
	US	Europe	Japan	Asia ex Japan
Percentage of market to increase capex by:				
<0	9	3	6	10
0% - 5%	38	58	49	34
5% - 10%	14	23	15	25
10% - 15%	18	10	18	8
15%+	20	5	11	23
Choice of financing (% citing response as first choice):				
Cashflow	90	79	91	51
Debt	3	19	4	27
Cashflow plus debt	0	2	0	10
Cashflow plus equity	2	0	0	6
Debt plus equity	1	0	0	2
Cashflow, debt and equity	4	0	4	5
Constraint on investment (% citing response as first choice):				
Market focus on returning cash to shareholders	34	34	28	31
Overcapacity or lack of profitable opportunities	26	38	34	28
Uncertainty over demand	21	14	21	27
Cost and availability of financing	15	7	14	9
Other	5	7	3	5
Primary use of cashflow (% citing response as first choice):				
Capex	30	23	39	50
Debt reduction	14	17	25	11
Increase dividends	8	13	4	11
Share buy-backs	21	27	26	7
Use in M&A	17	7	6	13
Other	10	13	0	8
Proportion of capex expected to be invested outside home region:				
None	18	3	19	43
0% - 10%	36	21	53	41
10% - 20%	10	29	10	7
20%+	36	47	18	9
*Values are reported as a percentage of the market capitalization covered by our survey. Results are market-cap-weighted to this universe.				

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regional comparisons, we aggregated the sectors into five broad industry classifications: Industrials (including Materials and Energy); Consumer; Financials; IT and Communications; and Utilities.

GS Analysts See a Better 2005

On the whole, the survey results are encouraging, with all regions expecting a pickup this year. US companies appear most aggressive in their spending plans, with 38% of our universe planning to increase spending by 10% or more over 2004 levels. Roughly 30% of the Japanese and non-Japan Asian markets intend to increase capex by the same amount, but Europe appears more conservative, with 80% slated for rise of less than 10%. The range of responses is lowest in Europe and highest in non-Japan Asia, which has the largest shares of the market planning both to cut spending and to spend 15+% more than in 2004. Elsewhere the pattern is steadier, with results clustered in the single-digit increase range.

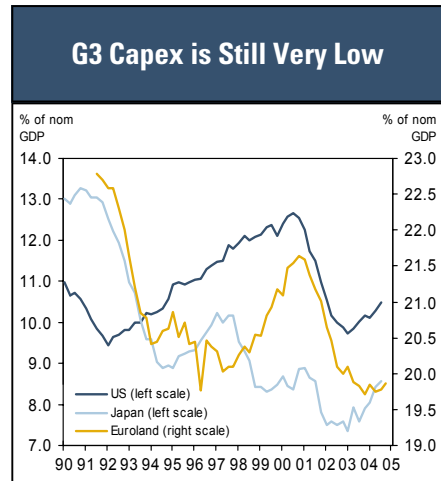
When we look at the data by sector, we

see a few patterns emerging across regions. Capex is likely to pick up significantly among Industrials, with nearly all our analysts expecting an increase of more than 15% in the US and a clear majority of analysts seeing increases above 10% in Japan and Asia. The picture is reversed in the Consumer sector, where expectations are for capex to fall or to rise by less than 5% in Europe, the US and most strikingly Japan. Expectations for IT and Communications spending are higher on average in the US and Asia than in Europe and Japan.

We also find some interesting differences among the sub-sectors within US Industrials. Expectations for capex are more muted (though still quite strong) in the Materials and Energy sub-sectors. When we exclude these, we find that 98% of Industrials anticipate an increase of 15% or more this year.

How will companies finance capex?

We find a clear preference for using free cash flow—not surprisingly, given record high levels of cash generation in the US, Europe and Japan. A full 90% of the US and Japanese markets and 80% of Europe plan to finance spending out of internally generated funds. Asia is the outlier here, with just half the market likely to rely on cashflow alone as the primary source of financing. Debt finance is notably more likely to be used in Asia and Europe than in Japan or the US; this suggests that Asian firms may become more reluctant to invest if they are constrained by the ability to raise funds. We also see no significant signs of plans to finance capex through equity issuance in any region. On the whole, the reluctance to use external sources of finance suggests persistent risk aversion in the corporate sector.



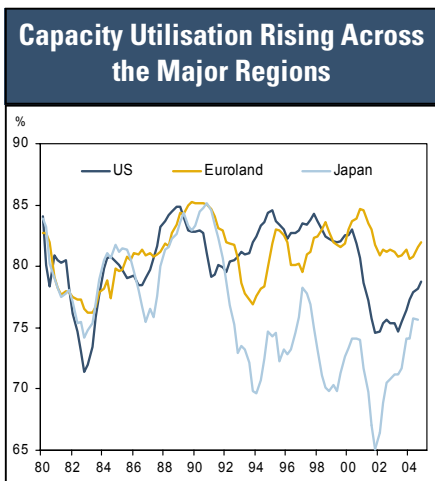
If not capex, what then? Our survey suggests that companies clearly do wish to make the most of the favourable external environment by investing. We polled our equity analysts as to companies' preferred uses of free cash flow. Capex was the clear priority in all regions except Europe, where it trailed share buybacks. Capex is the first priority for companies representing 30% of the market in the US, 40% in Japan and 50% in Asia. Share buyback programs are second in the US and Japan but the last choice in Asia.

Again there are some interesting differences between 'pure' Industrials and the Energy and Materials sub-sectors in the US. Pure Industrials and Energy overwhelmingly favour capex spending, but three-quarters of Materials are inclined to use their free cash flow for debt reduction instead.

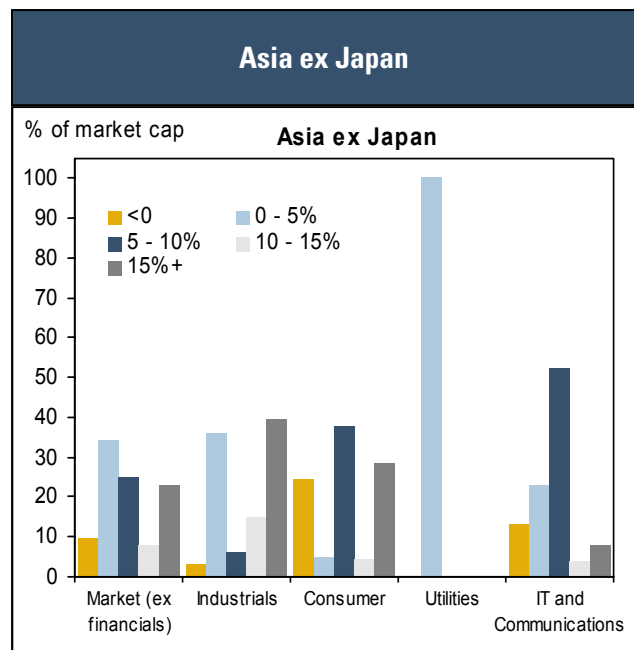
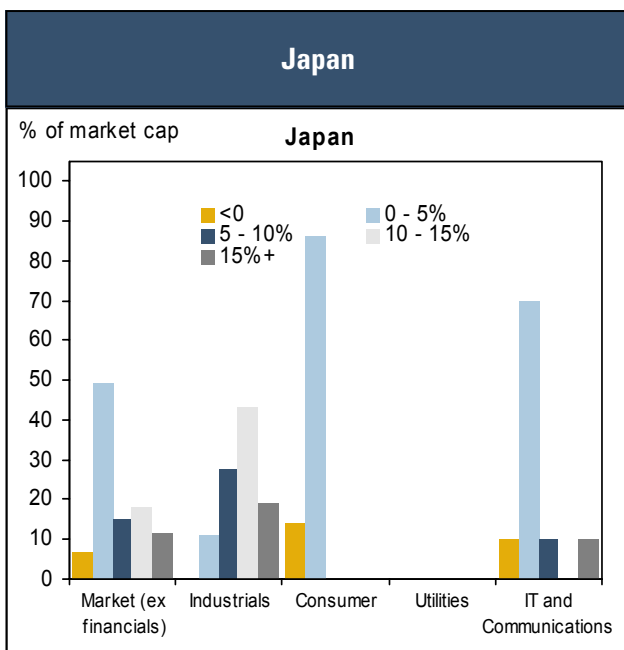
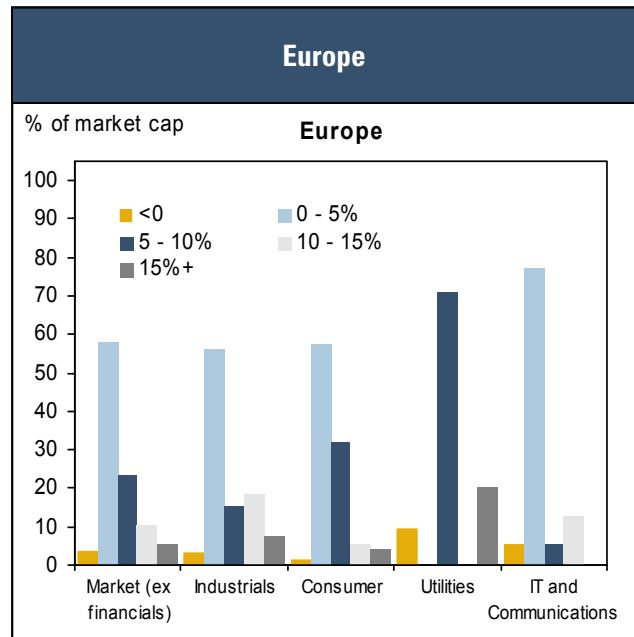
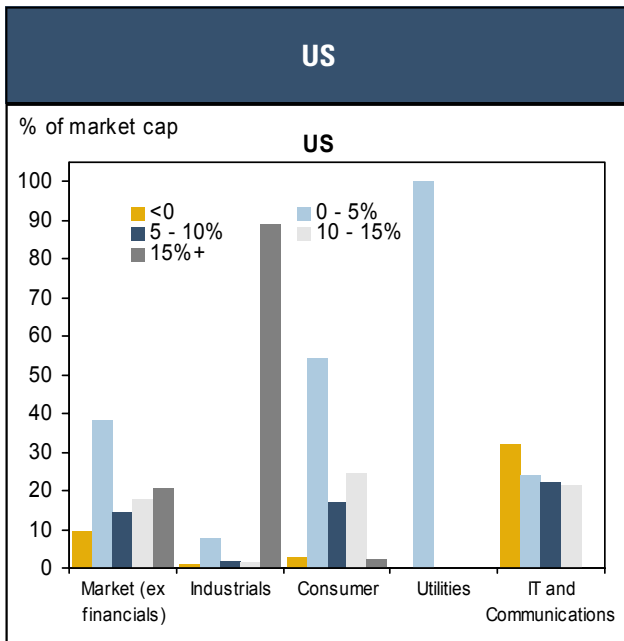
What are the key factors constraining investment?

One of the more interesting messages from our survey is the suggestion that equity investors may not see the opportunity for capital spending in the same light as do the corporates themselves. 40% of the

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Expected Capex Growth in 2005 by Industry



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market in Europe and 30% in the US and Japan cited share buyback programs and dividends together as higher priorities than capital spending. This focus on returning cash to shareholders is the major constraint on capital spending in the US and Asia, and is a close second behind overcapacity or a lack of profitable opportunities in Europe and Japan. Importantly, in light of Asia's hesitancy in using cash flow for investment, analysts in the region do not currently see the cost or availability of financing as a major obstacle to higher spending. All this suggests one significant upside risk to our views: if and when the market starts more obviously rewarding those companies willing to invest, the upswing in capex could be quite marked.

Our Survey Meshes With Our Views

The results of our survey are (happily) broadly consistent with our expectation of a modest rise in global capex this year.

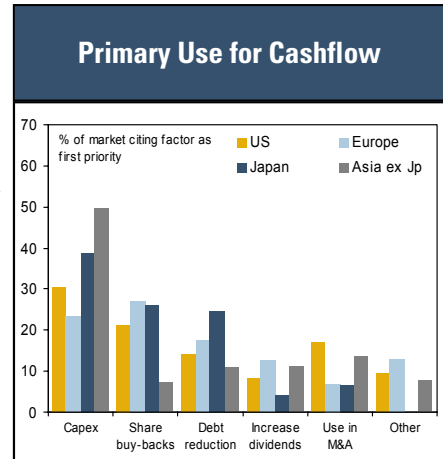
In the **US**, we expect capital spending to grow roughly 8% this year, having risen by more than 10% at an annualised rate since the spring of 2003. Our survey suggests that this pace may cool somewhat, given that half the market is pencilling in increases below 5%. But the factors underpinning our US forecast—low growth in the capital stock, the excellent financial shape of the

corporate sector and a prospective shift in demand toward tradable goods as the trade deficit begins to narrow—all suggest that any slowing will not be abrupt.

One of the more puzzling features of the muted **European** recovery since mid-2003 has been the absence of any meaningful rebound in investment spending, despite healthy balance sheets and record-low real interest rates. This partly reflects the fact that European firms started their balance sheet adjustment after the US. A potentially more worrisome conclusion is that European firms are going through a deeper and longer-lasting adjustment. Our survey reflects this, with analysts reporting continued caution across most sectors.

A further, intriguing finding is that European firms may well be increasing their capital spending—just not in Europe. Nearly half of the European market plans to do 20% or more of its capital spending overseas, by far the highest level in our survey, and two-thirds expect to invest a greater share of the total overseas than did last year. Our European economists have suggested that the strong euro and strict domestic labour laws are pushing firms to invest abroad, and our survey does support them on this point.

In **Japan**, the survey bolsters our forecast for 2005 and 2006 GDP



growth, which remains one of our most controversial calls. We are forecasting GDP growth of 1.8% for 2005 and 3.0% for 2006, well above the consensus of 1.1% and 1.9% and predicated on three factors: a recovery in capex, robust exports to China and a sustainable consumer upswing. Our survey confirms that companies are willing to use their record cash flow to fuel investment spending this year, and it is in line with our expectation that the capex recovery will broaden from manufacturing to the non-manufacturing sector.

Our current forecasts show GDP growth in **non-Japan Asia** slowing from 8.3% in 2004 to 6.8% in 2005. Part of this is due to the fact that Asia's domestic demand recovery in recent years has been 'derived' from

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How Will Corporates Finance Capital Spending?				
% citing response as first choice	US	Europe	Japan	Asia ex Japan
Existing cashflow	90	79	91	51
Cashflow plus debt	3	19	4	27
Debt	0	2	0	10
Cashflow plus equity	2	0	0	6
Debt plus equity	1	0	0	2
Cashflow, debt and equity	4	0	4	5

Constraints on Capex Expansion				
% citing response as first choice	US	Europe	Japan	Asia ex Japan
Market focus on returning cash to shareholders	34	34	28	31
Overcapacity or lack of profitable opportunities	26	38	34	28
Uncertainty over demand	21	14	21	27
Cost and availability of financing	15	7	14	9
Other	5	7	3	5

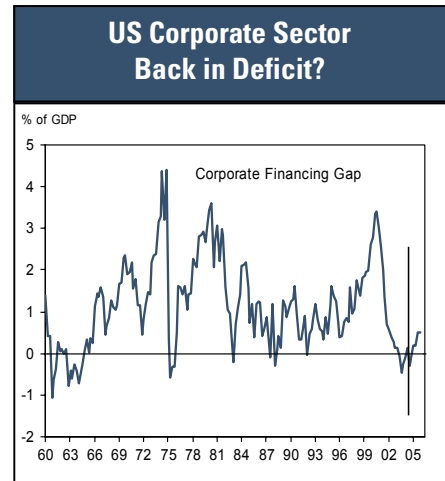
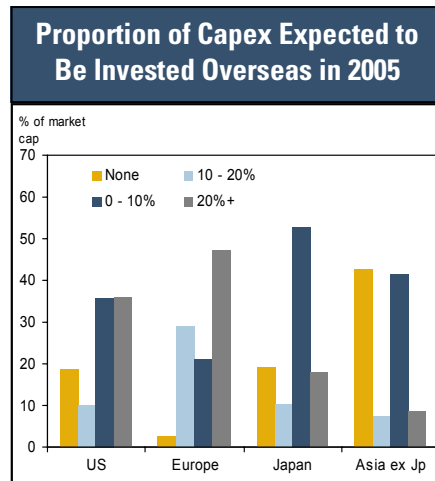
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the strength of the external sector. This is particularly true with capex, where the recovery has been largely confined to machinery and equipment investment, which has closer links to the tradable sector. Our forecast is for capex growth to slow from 7.9% in 2004 to 5.2% in 2005. Our survey does flag some upside risks to this capex forecast, with 40% of Industrials and nearly 30% of Consumers likely to increase capex by more than 15% this year.

Risks and Implications

Our survey points to both upside and downside risks to capital spending this year. Concerns about the market response to capex are clearly weighing on spending. If sentiment shifts, and markets instead begin to reward companies for investment, then we may well see a larger pickup. On the downside, however, a continued aversion to external financing and a desire to further reduce leverage, along with a capacity overhang in some



sectors, could limit the investment pick-up.

A revival in corporate risk appetite also has implications for our view on bonds. Since March 2003, real long-term bond yields have fallen despite improving growth, rising inflation, smaller output gaps, lower unemployment rates, a rally in equity markets and a deterioration in fiscal positions. A key explanation for this has been the lack of global demand

for capital from the corporate sector.

If this were to change, a pick-up in credit expansion (particularly in the US) against the backdrop of tighter monetary policy would put upward pressures on real short term interest rates. But if the corporate sector remains unusually risk averse, and demand for external funding remains low, global real bond yields could be slow to rise from today's unsustainably low levels. ■

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CEO Confidence is Back

Business confidence returns, with a strong outlook for M&A and capex as the year begins

Business confidence has picked up again after a soft patch last summer and fall, according to our first-quarter CEO Confidence Index. Greater optimism in both the US and Europe has pushed our global index to its second-highest level in nearly three years and well above the average reading over that period.

This survey polls our investment bankers as to their corporate clients' views on the general business outlook and the prospects for M&A and capital spending. We report the results as a diffusion index, with 50 representing an equal balance between those who think conditions are improving and those who think they are worsening. Our global reading of 82 is therefore strongly positive.

This latest reading of CEO confidence is in line with our forecast of above-trend global economic growth in 2005. It is more encouraging than the ongoing readings from our Global Leading Indicator (GLI), and supports the notion that growth may accelerate again after a softer patch.

Business outlook brightens. Readings for the general business

outlook rose significantly in both the US and Europe, driven by abating geopolitical concerns and solid economic growth. The weak result in the US last quarter now appears to have been a blip, as the index has returned to strongly positive territory. US industrials are benefiting from operating leverage and resultant earnings gains. Exporters are also enjoying a weak dollar and, in some industries, strong end-market demand from high commodity prices.

In Europe the tone is similar, with bankers citing a higher confidence level among both corporate managements and boards. The reading for Europe is in fact notably higher than it has been over most of the history of our survey.

A good year ahead for M&A? December 2004 was the best month for global M&A since August 2000, and the confidence underpinning that activity appears to have extended into the new year. Our consolidation reading for Europe is at its highest level yet. US corporates too have become 'more comfortable and even aggressive in considering acquisitions' and are bolstered by

'unprecedented cash flows.' Our Asian bankers also expect a pickup in M&A, specifically overseas, as firms look to power growth that cannot be obtained in domestic markets alone.

Capex should follow cash flow. Our survey also points to a robust environment for capital spending, with a solid rise in the US bringing the global reading to its best level in a year. The upbeat tone of our anecdotal comments suggests that strong demand and record-high levels of cash flow in much of the world should translate into better spending.

Our survey does point to one lingering potential constraint on both M&A and capex: investor concerns. For many companies still smarting from the bursting of the 1990s bubble, the 'emphasis remains on strong balance sheets and then on returning cash to shareholders.' One US banker notes that 'clients seem somewhat cautious about capacity adds despite strong demand—they seem to be trying to "stretch" capacity rather than to spend.' This may also broaden the opportunity for financial sponsors, who repeatedly surface in our survey as drivers of M&A activity. ■

CEO Confidence Index															
index	General Business Outlook			Overall Consolidation			Capital Investment in Domestic M&A			Capital Investment in International M&A			Capital Investment in Existing Assets		
	Global	US	Europe	Global	US	Europe	Global	US	Europe	Global	US	Europe	Global	US	Europe
Feb-05	82	79	92	84	81	92	70	71	58	59	48	83	81	81	83
Oct-04	63	54	79	74	69	83	78	79	75	50	38	75	72	67	83
Jul-04	57	72	52	71	78	64	59	81	43	52	50	54	65	81	61
May-04	78	90	76	74	75	74	58	100	44	63	70	63	74	100	67
Feb-04	94	94	94	92	94	91	91	94	88	82	76	88	97	100	94
Oct-03	81	87	74	80	80	82	69	67	76	54	47	65	77	93	65
Jul-03	77	87	71	76	80	73	71	73	69	44	39	55	80	93	73
Apr-03	45	52	49	59	54	52	33	43	44	13	29	38	58	54	53
Feb-03	52	58	52	68	72	72	38	43	30	20	17	26	51	43	57
Sep-02	15	20	14	37	40	33	21	13	22	13	20	11	40	33	42
Jun-02	44	33	42	61	56	67	39	33	33	26	22	33	39	22	42
Average	62	66	63	70	71	71	57	63	53	43	41	54	67	70	65