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SLOW WITH THE FLOW

MOST COMPANIES APPLIED THE BRAKES TO CAPEX AS RECESSION LURKED. DON'T EXPECT THEM TO ACCELERATE SOON.

VALERO ENERGY CORP., a $95 billion oil refiner headquartered in San Antonio, funneled only a tiny fraction of its cash into capital spending last year. Stingy by comparison with rivals in the North American oil-and-gas industry (which committed seven times as much, on average), Valero earmarked just 2.4 percent of its 2007 sales to capital expenditures. A conservative laggard? Hardly. Valero's stock delivered a stellar total return of 213 percent over three years through December 2007, versus an industry average of 149 percent.

TEXT BY RANDY MYERS

CHART DATA SUPPLIED BY PRTM

Garmin bucked the outsourcing trend and instead spent around $2 million to expand company-owned production facilities in Taiwan. That investment generated $75 million in revenue.

But even companies with capital at their disposal proceeded very cautiously in 2007, and certainly nothing that has happened lately is likely to change that. "We try to be realistic," says Valero CFO Mike Ciskowski. By "realistic" he means "rigorous." The company has put more emphasis on prespending analysis, and works harder to standardize its cost estimates so that comparisons across potential investments will be more accurate. Valero also applies different hurdle rates to different kinds of projects, seeking, for example, at least a 20 percent return on strategic projects and a 12 to 14 percent return on cost-cutting projects.

Using analysis by PRTM, a global management-consulting firm focused on operational strategy, our 2008 capex scorecard takes vital measures of capex performance and ranks companies by their returns on gross fixed assets, or ROGFA. Based on that measure, companies have clearly reined in spending; after increasing by 15 percent in 2005 and 18 percent in 2006, last year capital spending grew a scant 3 percent.

But even at a mere 3 percent growth, capex still outpaced revenue growth, a fragile trend in normal times and far less sustainable in today's climate. High energy prices and a vanishing credit pool will make it very difficult to fund capital investments, adding yet more urgency to the never-ending need to hone a competitive edge, conserve financial resources, and generate adequate returns for investors.

Only 4 of the 14 capital-intensive industries — communication services, network-equipment manufacturers, medical devices, and food and beverage — grew capital spending faster last year than in the prior two years. Two sectors, industrials and automotive, posted a net reduction. For the outliers, the numbers tended to be driven by industry specifics rather than broad economic themes. In the telecommunications sector, for example, the changeover to third-generation wireless systems and fiber-optic networks has kept capital spending high, while in the auto industry, slumping sales of fuel-thirsty trucks and SUVs, long the best-selling models for North American automakers, have dampened the need for manufacturing capacity.

BRIGHT SPOTS

Amid the gloom, however, some companies manage to thrive the old-fashioned way: by spending more to make more. Garmin Ltd., the $3.2 billion maker of GPS navigation devices, tops all electronics companies in this year's capex scorecard, having poured 4.9 percent of sales into capex last year. While CFO and treasurer Kevin Rauckman says, "We spend only what's needed to support the business," Garmin bucked the outsourcing trend and instead spent around $2 million to expand company-owned production facilities in Taiwan. That investment, Rauckman says, generated $75 million in revenue.

Allegheny Technologies follows a very similar approach. The $5.5 billion specialty metals manufacturer grew capex at an annualized rate of 108 percent over the past three years, outpacing the peer-group average by more than two-to-one; its 58 percent ROGFA puts it right behind Reliance Steel (67 percent) in the scorecard.

"Most of our investments over the past three or four years have been strategic," says CFO Richard Harshman, positioning the company "for growth opportunities as opposed to making necessary replacements in plant or equipment." The company boosted its titanium-production capacity, for example, to keep pace with increasing demand from the aircraft industry.

Like Valero, Allegheny applies a rigorous battery of metrics to capex projects, including a flexible hurdle rate that varies by the nature of the project. When Allegheny controls most cost variables, a 15 percent hurdle rate applies; for projects with more market

Measuring Capex

To find out how the 300 companies in its sample fared in terms of return on capital spending, consulting firm PRTM ranked the top and bottom four companies in each industry according to their 2007 earnings before interest, taxes, depreciation, and amortization divided by the book value of their fixed assets, and adjusted to eliminate the balance-sheet effect of operating leases. The resulting ratio — adjusted return on gross fixed assets (ROGFA) — reflects how much a company earns on its property, plant, and equipment. But since that number can be boosted by a decline in asset value, the consulting firm's scorecard also shows how much those companies spent in 2007 and how that amount has changed since 2004. To complete the picture, the analysis also shows a company's degree of capital intensiveness and its revenue growth and shareholder returns.

Granted, ROGFA may not be the most appropriate measure to determine whether to, say, build a new plant or outsource manufacturing. For that type of decision, a metric that takes into account a company's cost of capital is generally more appropriate. But such measures provide too broad a perspective for assessing capex productivity. For one thing, they assume that assets fully depreciated for tax and accounting purposes have no value, when in fact most companies spend money to maintain tangible assets even after they have been fully written off. They also include working capital. As a result, ROGFA can be more useful in helping companies understand how efficiently they are deploying capital on those assets. — **R.M.**

risk or competitive pressure, the floor may be 20 percent or more.

In all cases, Allegheny charts estimated versus actual returns for two years following completion of capital projects "to make sure we're executing to plan," Harshman says.

One possible complication for capex decisions going forward will be the effects of a switch from generally accepted accounting principles to international financial reporting standards. IFRS allows fixed assets to be valued at historic cost or at fair value, less accumulated depreciation and impairment under either approach. By contrast, U.S. GAAP requires such assets to be valued at historic cost.

Margaret Smyth, controller for $54.8 billion global conglomerate United Technologies Corp., says that while UTC is looking at the potential impact of IFRS on capital spending, nothing it has found to date gives cause for concern. And accounting, she says, does not drive business decisions at UTC.

Reports from abroad sound mixed notes about capex. European companies grew their capital spending just 6 percent in 2007, on the heels of 15 percent and 14 percent gains in 2006 and 2005, respectively. Based on revenue trends, PRTM expects further slippage over the next two years. The Asia-Pacific region showed more strength, according to PRTM. Asian capital spending rose 16 percent following gains of 12 percent and 11 percent in the prior two years.

Macroeconomic considerations aside, at least one CFO cautions that smart capex decisions hinge on people as much as on capital. "The ability to manage multiple projects requires people who can bring them in on budget and on schedule," says Allegheny's Harshman. "That's the bigger constraint for us." These days, that almost sounds like a nice problem to have. **CFO**

RANDY MYERS IS A CONTRIBUTING EDITOR OF *CFO*.

The 2008 Capital Spending Scorecard

TOP PERFORMERS
BOTTOM PERFORMERS

COMPANY	CAPEX in $ millions (2007)	CAPEX CAGR (2004-2007)	Capital Intensiveness (2007)	ROGFA (2007)	Revenue Growth CAGR (2004-2007)	Shareholder Return (2004-2007)
AEROSPACE & DEFENSE						
MANTECH INTERNATIONAL	$3	-18%	0%	135%	20%	85%
L-3 COMMUNICATIONS	157	25	1	89	26	48
BE AEROSPACE	32	30	2	87	32	354
DRS TECHNOLOGIES	56	31	2	86	41	28
GOODRICH	283	23	4	38	11	126
ALLIANT TECHSYSTEMS	81	11	2	37	15	74
MOOG	97	47	6	31	18	52
BOMBARDIER	296	-22	2	17	-8	-23
AVERAGE PERFORMANCE	**$359**	**16%**	**3%**	**57%**	**16%**	**95%**
AUTOMOTIVE						
OSHKOSH	$102	50%	2%	127%	41%	42%
GENUINE PARTS	116	17	1	71	6	17
HARLEY-DAVIDSON	242	4	4	61	5	-18
PACCAR	1,267	26	8	58	10	67
ARVINMERITOR	120	-8	2	7	-7	-40
VISTEON	376	-23	3	6	-15	-53
DANA	254	-8	3	0	-1	-100
DELPHI	580	-16	3	-10	-8	-95
AVERAGE PERFORMANCE	**$1,053**	**4%**	**5%**	**29%**	**6%**	**13%**
CHEMICALS						
RPM INTERNATIONAL	$70	11%	2%	46%	13%	16%
SHERWIN-WILLIAMS	166	16	2	44	9	38
ECOLAB	307	4	6	38	9	50
MONSANTO	509	34	6	36	16	308
DOW CHEMICAL	2,075	16	4	13	10	-9
NOVA CHEMICALS	168	-19	2	12	2	-40
EASTMAN CHEMICAL	518	28	8	10	1	18
SOLUTIA	281	66	8	1	9	-81
AVERAGE PERFORMANCE	**$548**	**19%**	**6%**	**22%**	**10%**	**81%**

Source: PRTM

TOP PERFORMERS
BOTTOM PERFORMERS

COMPANY	CAPEX in $ millions (2007)	CAPEX CAGR (2004-2007)	Capital Intensiveness (2007)	ROGFA (2007)	Revenue Growth CAGR (2004-2007)	Shareholder Return (2004-2007)
COMMUNICATION SERVICES						
DIRECTV GROUP	$2,692	38%	16%	47%	15%	38%
DISH NETWORK	1,445	14	13	41	16	17
COMCAST	6,158	19	20	31	15	-18
U.S. CELLULAR	565	-4	14	21	12	88
QWEST COMMUNICATIONS	1,669	-1	12	9	0	58
LEVEL 3 COMMUNICATIONS	633	30	15	3	5	-10
IDT	36	-26	2	-10	-3	-44
SPRINT NEXTEL	6,322	17	16	-36	14	-37
AVERAGE PERFORMANCE	**$3,288**	**13%**	**16%**	**16%**	**11%**	**32%**
ELECTRONICS						
GARMIN	$157	26%	5%	246%	61%	225%
APPLE	735	61	3	166	43	515
DELL	831	17	1	99	8	-42
HEWLETT-PACKARD	3,040	13	3	74	9	147
NCR	64	-28	1	28	-6	52
LEXMARK INTERNATIONAL	183	-3	4	27	-2	-59
SUN MICROSYSTEMS	488	25	4	25	7	-16
IMATION	15	-26	1	2	19	-28
AVERAGE PERFORMANCE	**$430**	**12%**	**3%**	**61%**	**14%**	**56%**
FOOD & BEVERAGE						
COCA-COLA	$1,648	30%	6%	65%	10%	59%
PEPSICO	2,430	21	6	41	10	54
H.J. HEINZ	245	2	3	41	2	32
GENERAL MILLS	460	-10	4	40	4	25
PILGRIM'S PRIDE	172	29	2	18	12	-5
SMITHFIELD FOODS	478	47	4	17	9	-2
COCA-COLA ENTERPRISES	938	0	4	16	5	29
TYSON FOODS	285	-16	1	15	1	-13
AVERAGE PERFORMANCE	**$706**	**11%**	**4%**	**28%**	**5%**	**28%**
INDUSTRIALS						
TEREX	$112	46%	1%	128%	22%	175%
DANAHER	162	12	1	80	17	53
FOSTER WHEELER	51	75	1	74	24	877
EMCOR GROUP	22	10	0	74	8	109
EATON	354	2	3	31	10	42
BALL	309	16	4	20	11	6
TIMKEN	314	26	6	14	5	35
TYCO INTERNATIONAL	669	-13	4	-5	-22	-26
AVERAGE PERFORMANCE	**$430**	**18%**	**3%**	**47%**	**10%**	**147%**
MEDICAL DEVICES						
PATTERSON	$20	0%	1%	145%	12%	-22%
BARD, (C.R.)	51	-12	2	109	10	51
MEDTRONIC	573	11	5	103	11	4
VARIAN MEDICAL SYSTEMS	64	38	4	99	13	21
BOSTON SCIENTIFIC	363	10	4	32	14	-67
BAXTER INTERNATIONAL	692	7	6	32	6	75
INVACARE	20	-21	1	22	5	-45
HOSPIRA	211	-3	6	22	9	27
AVERAGE PERFORMANCE	**$212**	**12%**	**5%**	**65%**	**12%**	**21%**
METALS						
RELIANCE STEEL	$124	51%	2%	67%	35%	183%
ALLEGHENY TECHNOLOGIES	447	108	8	58	26	306
SOUTHERN COPPER	316	23	5	58	53	414
RUSSEL METALS	17	-13	1	47	2	94
WORTHINGTON INDUSTRIES	58	25	2	16	8	5
UNITED STATES STEEL	692	6	4	13	6	140
CAMECO	501	49	21	12	30	91
NEWMONT MINING	1,670	32	30	4	7	13
AVERAGE PERFORMANCE	**$660**	**42%**	**8%**	**32%**	**25%**	**148%**

Source: PRTM

capital spending

TOP PERFORMERS
BOTTOM PERFORMERS

COMPANY	CAPEX in $ millions (2007)	CAPEX CAGR (2004-2007)	Capital Intensiveness (2007)	ROGFA (2007)	Revenue Growth CAGR (2004-2007)	Shareholder Return (2004-2007)
NETWORK-EQUIPMENT MANUFACTURERS						
FOUNDRY NETWORKS	$7	-6%	1%	203%	14%	33%
RESEARCH IN MOTION	246	113	8	142	62	142
ARRIS GROUP	15	14	2	110	27	42
QLOGIC	32	12	5	107	4	-23
MOTOROLA	527	2	1	10	5	-3
NORTEL NETWORKS	253	-12	2	10	-3	-64
3COM	28	21	2	7	22	8
MRV COMMUNICATIONS	8	42	2	-2	18	-37
AVERAGE PERFORMANCE	**$143**	**17%**	**3%**	**61%**	**20%**	**4%**
OIL & GAS						
SCHLUMBERGER	$2,931	34%	13%	54%	27%	200%
HALLIBURTON	1,583	40	10	51	-9	99
VALERO ENERGY	2,260	21	2	32	20	213
OCCIDENTAL PETROLEUM	4,878	38	26	29	18	174
ENCANA	9,401	14	39	18	16	103
SUNOCO	1,179	12	3	17	22	86
DEVON ENERGY	6,158	26	54	17	7	132
CANADIAN NATURAL	6,550	12	58	13	19	188
AVERAGE PERFORMANCE	**$5,360**	**22%**	**18%**	**25%**	**17%**	**149%**
PHARMACEUTICALS						
GILEAD SCIENCES	$79	15%	2%	353%	47%	163%
FOREST LABS	30	-33	1	121	6	-19
ALLERGAN	142	14	4	87	24	60
KING PHARMACEUTICALS	50	-3	2	85	18	-17
CEPHALON	97	24	5	14	20	41
MERCK	1,011	-16	4	12	2	100
SCHERING-PLOUGH	618	8	5	-24	15	32
MYLAN	111	-2	4	-83	28	-16
AVERAGE PERFORMANCE	**$754**	**4%**	**5%**	**61%**	**16%**	**22%**
SEMICONDUCTORS						
LAM RESEARCH	$60	36%	2%	280%	40%	50%
VARIAN SEMICOND. EQUIPMENT	11	-2	1	165	26	126
MEMC ELECTRONIC MATERIALS	276	23	14	112	23	568
LINEAR TECHNOLOGY	62	44	6	100	10	-13
FAIRCHILD SEMICOND. INT'L	140	-10	8	13	1	-11
MICRON TECHNOLOGY	3,603	49	63	11	9	-41
ATMEL	70	-34	4	8	0	10
ADVANCED MICRO DEVICES	1,685	5	28	-19	6	-66
AVERAGE PERFORMANCE	**$289**	**7%**	**5%**	**28%**	**5%**	**22%**
TRANSPORTATION						
CH ROBINSON WORLD	$44	8%	1%	238%	19%	102%
WORLD FUEL SERVICES	17	91	0	157	34	19
NORTHWEST AIRLINES	1,051	30	8	29	4	33
CON-WAY	139	-3	3	19	6	-14
AMR	714	-11	3	7	7	28
CONTINENTAL AIRLINES	445	40	3	7	13	64
UNITED PARCEL SERVICE	2,820	10	6	7	11	-11
YRC WORLDWIDE	394	25	4	-7	12	-69
AVERAGE PERFORMANCE	**$1,177**	**18%**	**9%**	**30%**	**14%**	**174%**
UTILITIES						
EXELON	$2,674	12%	14%	21%	9%	99%
PUBLIC SERVICE ENTERPR. GROUP	1,348	2	10	20	5	107
DOMINION RESOURCES	3,972	13	25	18	4	59
RELIANT ENERGY	189	3	2	16	9	92
ENTERGY	2,323	18	20	10	4	90
DUKE ENERGY	3,125	15	25	9	-17	-3
AMERICAN ELECTRIC	4,068	34	30	9	-2	53
XCEL ENERGY	2,097	18	21	8	6	43
AVERAGE PERFORMANCE	**$2,134**	**20%**	**16%**	**13%**	**8%**	**68%**

Source: PRTM