Capital Allocation: From Back Office to Boardroom

“As Activism Rises, U.S. Firms Spend More on Buybacks than Factories”

“Ready money signals big problems in the merger market,”
Financial Times, June 4, 2015

A quick scan of the business headlines underscores the importance of capital allocation for management teams and boards today. Going hand-in-hand with formulating and executing strategy, the company’s capital structure and plan—including shareholder returns—will continue to be challenged in a period of weak global growth and interest rate uncertainty.

Moreover, the greater focus by institutional investors and activist hedge funds on underperforming public companies and their use of cash has reinforced the need for the capital allocation process to be clear and robust. And the board has a key role to play.

KPMG’s Spring 2015 Roundtable Series—Capital Allocation and the Board—gathered over 1,200 directors and senior executives across 17 cities to share their views on capital allocation. “There’s a real cultural shift happening. Companies are becoming more transparent with investors on capital allocation and strategy,” said one director. “Activism is pushing capital allocation out of the back office, through the C-suite, and into the boardroom, which I see as a positive thing,” said another director. “But some companies and boards have overemphasized placating a noisy class of investors who are operating with incomplete information and short time horizons.”

As highlighted in our roundtable series, the capital allocation discussion—how best to use cash—is a fundamental issue at the intersection of running the business and delivering shareholder value. Companies achieve success not only by generating cash and achieving business results; they also need to allocate capital in a way that is most beneficial to shareholders and to building long-term value.

Aligning Strategy and Capital Allocation

Strategy and capital allocation are intricately linked. Management and the board cannot develop a strategy without understanding the capital required to execute the strategy—both in the short term and long term. In fact, the long-term strategy often includes a plan to raise capital—particularly for growing businesses.

“What is the financial strategy for the business? Effective capital deployment also includes consideration of the optimal way to return cash to shareholders, as well as understanding how to finance growth at the lowest cost of capital,” said one director.

In our 2015 Global Audit Committee Survey, nearly two-thirds of audit committee members said that they want to know more about management’s capital allocation process. Yet, many roundtable panelists said that the board only devotes one meeting per year to a deep dive on strategy and capital allocation. And only 57 percent of directors and senior executives surveyed at the roundtables said they were satisfied with the quality of discussion regarding the alignment of capital allocation and strategy.

Key areas of board focus to probe the alignment of strategy and capital allocation include:

- **How does the company’s allocation of capital align with and advance its strategic priorities—for both the short term and long term?** Are capital allocation decisions linked to strategic goals and consistent with the company’s risk appetite? What expertise, skill or embedded advantage does the company have in relation to the projects it choses? “Don’t let capital allocation get ahead of strategy.”
What are the real capital requirements of the business—and over what timeframe? How does the company distinguish between maintenance capital expenditures and growth capital? Is the company investing for the long term in projects, relationships, people, and facilities?

To what extent are relative returns on capital considered among the various capital allocation alternatives? While organic growth is often viewed as having the highest risk-adjusted returns, in some situations the cost to gain market share organically may be too high. Similarly, attempting to grow a product or service offering—organically or through acquisition—at the wrong time in the business cycle can have poor risk-return characteristics.

Does the company reallocate capital consistently over the medium to long term—rather than allocate the same levels to business units year after year? Recent research by McKinsey shows that companies generally think about capital allocation on an incremental basis, allocating the same resources to the same business units each year. But companies that consistently reallocated capital earned on average more than 30 percent higher returns to shareholders annually than their counterparts. In fact, 69 percent of directors and senior executives attending the Spring Roundtables were at least somewhat concerned that management tends to allocate the same levels of capital to business units year-to-year, rather than reallocate capital consistently over the medium to long term.

Assessing Management’s Capital Allocation Process

The goal of capital allocation is to build long-term value—and the question for every board is: Is the company allocating capital effectively?

Efficient capital allocation requires understanding the long-term value of an array of opportunities and allocating capital accordingly. It also requires knowing the value of a company’s individual assets and being willing to sell them when they are worth more to others.

In assessing management’s capital allocation process, a good starting point is to consider the spectrum of capital allocation alternatives available to the company and their corresponding risks.

While investing in organic growth (through research and development and opening new lines of business) is traditionally viewed as having the highest return potential, it may not be the right choice for all businesses.

Similarly, debt paydown may be more prudent than share buybacks in certain situations. “Maintaining an investment-grade credit rating means that you don’t have to keep as much cash on hand to stay flexible,” said one director.

SPECTRUM OF CAPITAL ALLOCATION ALTERNATIVES

- **Higher Returns**
  - Organic Growth
    - Reinvest in core business and/or direct capital to new product lines
    - Generally more costly growth vs. organic
  - Acquisitions
    - Deploy capital into transformational and/or bolt-on acquisitions
    - Generally more costly growth vs. organic
  - Share Repurchase/Dividend
    - Return excess capital to shareholders, assuming capital is redeployed with similar cost financing

- **Lower Returns**
  - Repay Debt
    - Reduce capital base and generate incremental returns on earnings
  - Keep Excess Cash
    - Little upside (50–100 bps max return)

Source: Morgan Stanley
In evaluating management’s capital allocation process, here are some areas for the board to consider:

- **Does management have a robust capital allocation process, including the right leadership and talent to determine how best to deploy capital across the enterprise?** How does the capital allocation process actually work? How disciplined and transparent is the process? Who is really making the investment decisions and how are they held accountable for subsequent returns? Has management designed a process that is flexible enough to allow for adjustment as circumstances change?

- **How effectively has management deployed capital in the past?** Michael Mauboussin, chief investment strategist at Credit Suisse, writes that a good first step in assessing a company’s capital allocation process is to see how effectively management has allocated capital in the past. “The numbers will speak to you,” said one director. What is the company’s return on invested capital and return on incremental invested capital across its various businesses and geographies—and how does it compare with competitors?

- **Do we have the right controls and metrics in place to monitor management’s performance?** Do we understand why the company’s return on invested capital differs from its competitors over multiple time periods and business cycles? Does the board receive independent input—unfiltered by management or investment banks—as to how investors view the company’s strategy and capital allocation priorities?

- **Are we sensitive to possible biases—in the capital allocation process?** Corporate politics can certainly inject bias into the capital allocation process. In his recent letter to shareholders, Warren Buffet said “at Berkshire, we are free of historical biases created by lifelong associations with a given industry and are not subject to pressures from colleagues having a vested interest in maintaining the status quo. That’s important: if horses had controlled investment decisions, there would have been no auto industry.”

- **Do incentive compensation plans encourage managers to make value-creating investments rather than deliver short-term earnings?** “When you set the CEO’s goals, you set the company’s goals,” said one director. Nearly two thirds of roundtable attendees expressed concern that the company’s compensation incentives do not encourage managers to make long term, value-creating investments, properly balancing the short and long term.

**Return Cash or Reinvest It: Considering the Demands of Activists**

Activist hedge funds now manage over $120 billion in assets, according to Hedge Fund Research, and their influence and clout is far greater. The activists’ positions have sharpened companies’ attention on optimizing cash and aligning capital allocation and strategy.

Some of the activism has been short-term focused—pressuring companies to pay extraordinary dividends or accelerate or increase share repurchase programs. At the same time, many of the activist grievances are built around the idea that companies are misallocating capital at a time when free cash flow generation is high.

When evaluating the company’s use of cash as well as methods for shareholder returns, the board can consider the following questions:

- **How much cash should the company retain for investment and managing volatility?** In the financial crisis, the only companies that prospered and had access to capital were those with sufficient resources and flexibility on their balance sheet. Post-financial crisis, many companies increased the cash on their balance sheets and are now being targeted by activists.

- **How much should the company return to shareholders?** Shareholder expectations are critical—particularly for a mature, profitable company with a history of growing dividends. If the company has a track-record of value-creating investments and reinvestment, then shareholders are well-served to have management redeploy excess capital.

- **Should the return be in the form of a dividend or stock repurchase?** When considering the dividend level, companies have conditioned shareholders to expect that dividends will only be cut in dire circumstances. As a result, management is often reluctant to establish a dividend level that they aren’t comfortable that they can sustain. “Dividends are a long-term proposition. They often signal a shift and attract a different class of investor.”

- **Should the company reassess its offshore cash position and repatriation policy?** Sources of capital span geographies, but exchange rates, interest rates, and capital market environments are not necessarily aligned globally, said one director. How are tax rates and repatriation policies limiting the company’s ability (and willingness) to move cash across borders for new projects or shareholder returns?

- **Have we communicated our capital allocation policy or framework to investors and obtained their input?** “In many ways, it’s not the buyback or the return of cash, it’s about communicating to investors what the company’s ‘return opportunities’ are over multiple years,” said one director.

**Final Thoughts: The Role of the Board**

Given the critical importance of capital allocation today—with investors sharpening their focus on how companies are deploying their capital, and competitive pressures requiring more frequent shifts in strategy and spending priorities—it is clear that the board has a key role to play. Yet, as highlighted in our roundtable discussions, ensuring the board is effectively engaged and adding value can be challenging, particularly given the many factors driving capital allocation—strategy and risk, operations, incentives, and more. Where on the board is the capital allocation conversation taking place? What roles are various standing committees—finance, audit, compensation—playing in assisting the board in its oversight of the capital allocation process? Does the board have the view of the capital allocation process it needs to help create long-term value?
KPMG Roundtable Survey Findings

How concerned are you that management tends to allocate the same level of capital to business units year-to-year, rather than re-allocate capital consistently over the medium to long term?*

- Concerned: 19%
- Somewhat concerned: 50%
- Not concerned: 31%

Are you satisfied with the quality of the discussions your board (or board committee) is having with management regarding the aligned company’s capital allocation and strategy?

- Yes: 57%
- No: 32%
- Not sure: 11%

How satisfied are you that your company’s incentive compensation plans encourage managers to make long-term value creating investments, properly balancing the long term and short term?

- Satisfied: 39%
- Somewhat satisfied: 45%
- Not satisfied: 16%

How concerned are you that activist demands for special dividends and stock buybacks may adversely impact the company’s longer-term financial flexibility?

- Concerned: 40%
- Somewhat concerned: 35%
- Not concerned: 25%

Has your company adopted a formal capital allocation policy, which describes its framework for allocating capital, including returning free cash flow to shareholders?

- Yes: 24%
- No – but may consider: 33%
- No: 43%

Who plays a significant role in overseeing management’s capital allocation process, including recommending board action with respect to dividend and share repurchase strategies? (select all that apply)

- Full board: 84%
- Finance committee: 21%
- Audit committee: 12%
- Other board committee: 7%
- Not defined (unclear): 8%

*Survey responses from 250 directors and executives attending ACI’s Spring Roundtable Series, May/June 2015

ACI’s Spring Roundtable locations

- Boston
- Cleveland
- Dallas
- Denver
- Detroit*
- Fort Lauderdale
- Houston
- Kansas City
- Los Angeles
- New York
- Orange County
- Orlando
- Philadelphia
- Pittsburgh
- Portland
- San Diego
- San Francisco
- Silicon Valley
- Washington, DC*

*Alternate topics were discussed.

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