Capital allocation & shareholder value creation

How capital allocation can create or destroy value

Measuring the success of management strategy

Capital allocation is one of a firm's key decisions. Management strategy for capital allocation, past and present, are vital if management is to deliver on its promises for shareholder value creation, and indeed its sustainability. This is particularly true in the case of a company who future value component accounts for a large chunk of the valuation.

Key insights delivered

Track record of capital allocation strategy, and value creation trends

Where is the emphasis for capital allocation? How does a company's capital allocation strategy compare to its peers? Is it an aggressive approach to value creation or is it a defensive approach to value creation?

How successful has management's strategy been to create shareholder value? What is the outlook for incremental economic value added (I-EVA) and is it likely to extend the duration of the implied competitive advantage period (I-CAP)?

Management's capital allocation strategy. Is it driven by M&A, reinvestment in the company or is the company returning capital to shareholders?

See end page for legal, disclaimer. Investors should consider this report as only a single factor in their investment decision making process

The four levers management could pull

In allocating capital, there are four main options for management teams:

• Invest in the business and grow organically through capex, usually by expanding capacity

• Invest in other businesses and grow inorganically through acquisitions (M&A)

• Pay down debt – this might be high on the agenda for companies with too much leverage

• Reward shareholders – either through ordinary or special dividends, or share repurchases

Capital allocation and incremental value creation

In allocating capital, in order to enhance shareholder value, the two main options for management teams are to grow organically through deploying capital into R&D, increased capital expenditure or through an expansion of the invested capital base. It could also grow inorganically through acquisitions (M&A).

In dissecting management's capital allocation strategy, we offer insights on companies that have reinvested (under-invested) heavily compared to peers; and we sift companies that have undertaken significant expansion of the balance sheet against companies that have compressed their balance sheet. Any of these capital allocations can be a prelude to shareholder value creation (or destruction), the unique insight that we provide give investors' confidence in whether management strategy will succeed or fail.

Ultimately, we seek to determine whether I-EVA set to expand, or contract, as this is what drives valuations. A company enjoying strong I-CAP, accompanied by strong I-EVA momentum will command high valuations. Does the capital allocation strategy enable this?

Both, aggressive and defensive and defensive capital allocation strategies may create value

For management, the main levers for creating shareholder value rests in their approach to capital allocation. This can involve an aggressive approach where shareholder funds are deployed liberally as management goes after potential opportunities.   However, management could also adopt a defensive approach to tapping opportunities by reining in funds deployed and yet create value for shareholders.

An aggressive (play-to-win) strategy may be deployed by management as they pursue high I-EVA and momentum. This can be done through an aggressive expansion of the invested capital base and/or through an aggresssive reinvestment rate. We identify stocks that have recently delivered high I-EVA rate and having pursued an aggressive approach to deploying invested capital and reinvesting in its business that are likely to see high forecast I-EVA rates, supported by a strong momentum in I-EVA growth.

Incremental shareholder value creation can also be achieved through a defensive (play-to-not-lose) strategy. We identify stocks that have recently delivered high I-EVA rate and having pursued an a defensive approach with cautious deployment of funds with potential to deliver not only high rates for I-EVA, with continuing strong momentum in value creation.

There are two other options for management: pay down debt – this might be high on the agenda for companies with too much leverage; or, reward shareholders – either through ordinary or special dividends, or share repurchases. However, while these two capital return options reward shareholders, they are not value creating for the company. Investors interested in capital returns may wish to look at our companion reports entitled Shareholder Return Champions.

Key components of capital allocation

Invested capital deployed

Invested Capital = Total short-term debt + total long-term debt + total lease obligations + total equity + non-operating cash . Invested capital is deployed to implement strategic and financing decisions in order to created incemental shareholder value. The capital structure, the exact mix of debt and equity may vary and will depend on various factors such as the maturity of the industry, the size of the company and the stage of growth of the company. Causing significant influence on the invested capital base is M&A activity, which can cause material impact on cash and debt levels. Invested capital deployment may be aggressive of defensive, but either approach can create (or destroy) shareholder value.

Acquisitions

Acquisitions are considered by many as value-destroying, but this may not always be the case and much will depend on the strategic aims and how post-merger integration is managed. Questions need to be asked, such as: does offer increased competitive advantage and ultimately is it liklely to lead to a sustained improvement in I-EVA.

Change in working capital

Change in non-cash working capital, with an increase a negative cash flow (rising invested capital) and a decrease repreesnting a positive cash flow, a reduction in the invested capital base. This can be a volatile number and trends and patterns do vary across industries. This metric represents the sum of: accounts receivable, inventories, accounts payable, accrued expenses, payable/accrued, taxes payable, other liabilities and other assets & liabilities, net.

Reinvestment rate

Our definition reinvestment rate a broad one and includes capex, R&D, depreciation and changes in working capital. On the one hand reinvesting in the business is necessary to simply to maintain the competitive edge. On the other, reinvestment can also improve a company’s strategic positioning and, hence, the possibility of significantly higher shareholder value creation. However, even reducing reinvestment rates can create shareholder value, for example, if resources are pulled from inefficient projects of production facilities. But, in general, companies cannot indefinitely scale back reinvestments, especially critical ones that are necessary to maintain or increase competitive advantage.

Operating expenses

Operating expenses are sometimes seen as a cost that should always be kept low or even reduced over time. This may be true of mature companies facing severe challenges and cutting out the fat at central office or reducing sales and marketing could well shore up finances in the near term. But this is unlikley to be a lasting strategy for incremental value creation. On the other hand, for companies who may want to take advantage of high growth opportunities, burgeoning central office will provide an efficient infrastructure to fulfil the strategy fo value creation, aided by R&D expenditure that drive competitive advantage and sales and marketing expenditure to help caputure increasing market share.

Measuring the success of capital allocation

We measure the success of capital allocation strategies using multiple metrics, but the key question we ask is whether it is set to improve I-EVA trends & forecast

Incremental economic value added (I-EVA)

The methodology behind our I-EVA measure, unlike traditional EVA measures, is quite different as it targets the equity investor who needs to determine whether management has delivered, and

can deliver into the future. Our emphasis is not on absolute economic value creation but on the forecast rate of change - the “incremental future outlook” in value creation (as measured by I-EVA). In our methodology even companies with low, or even negative, returns on capital can be attractive investments if the forecast incremental returns is set to improve, and for that reason we address marginal economic profits. Finally, a significant advantage of using I-EVA measure is that it allows an investor to justly compare stocks across sectors due to its focus on rate of change, especially for invested capital. Such comparisons are nearly impossible in the traditional EVA approach due to the need for complicated adjustments to invested capital.

Competitive advantage

Capital allocation policies should also enhance the competitive advantage of the firm. Competitive advantage has been called the “moat”, or the length of time it will take for competitive forces to erase the company’s excess returns to zero. It estimates the duration over which the company is expected to generate above average cash flow growth.

Competitive advantage may be influenced by multiple factors including changing business models, outdated products; irresponsiveness to customer spending patterns; changes in technologies; erosion in the balance of power with customers (customer); and, acquisitions that simply do not work.

Competitive advantage is hard to measure and is mostly explained qualitatively - which is not of great value in equity analysis when a reference point is required at a stock level and also for comparative purposes. Our proprietary measure on implied competitive advantage provides a useful proxy measure. For stock selection, the analyst merely needs to take a view on whether the metric appears sensible; whether it will expand/contract in the future.

Revenue growth

Optimal capital allocation and strong competitive advantage should lead to higher rates of revenue growth, and revenue growth is often a primary driver of I-EVA into the future.

Gross margin

Gross margins are a good indicator of the quality of management execution and uncompetitive products. Increased automation, while causing short term disruptions to gross margins, it can reduce the costs of goods sold in the medium term. Also, companies selling premium products tend to enjoy higher gross margins. Gross margins may also be masked or manipulated by management through large acquisition activities or inventory accounting. For instance, taking on large intangibles & goodwill from an acquisition improves cash flow due to higher tax decustions.

Adjusted EBIT margin

EBIT - adjusted usually excludes non-recurring items, such as restructuring, as well as recurring non-cash items, such as stock options and capitalised R&D expense, from EBIT - as reported. Non-recurring charges can in some industries and for some companies, in practice, a recurring and routine business expense.

Free cash flow

Cash flows from operations are that which a company can distribute after investing in working capital and fixed assets - after maintaining and expanding its asset base. Free cash flows can be used to pay dividends, finance debt reductions, for share buybacks, invest in organic growth opportunities or to make acquisitions. Free cash flow is defined as the cash flow from operations less capex (capex includes PP&E but also Intangibles and software development costs). However, free cash flows can be manipulated through, for example, factoring of receivables, and large acquisition goodwill and intangibles booked in order to increase tax deductions

Capital efficiency

Capital efficiency looks at the effectiveness of invested capital deployed a year ago (t-4 quarters) on revenues (t0).

Opex efficiency

Opex efficiency looks at the effectiveness of operating expenditures a year ago (t-4 quarters) on gross profits (t0). Linking gross profits to opex gives an indication of whether spending on items such as sales, marketing or R&D are contributing not just to top-line growth but also to profitable growth.

Capex efficiency

Capex efficiency looks at the effectiveness of capital expenditures of two years ago (t-8 quarters) on gross profits (t0). Linking gross profits to capex gives an indication of whether spending on capital expenditures, such as factories or data centers, are contributing not just to top-line growth but also to profitable growth.

Cash conversion cycle

Cash conversion cycle of a company measures the time it takes to sell the inventory, collect receivables compared to the time to make payables. This ratio helps assess the management of working capital. It is calculated as the sum of days inventory outstanding & days sales outstanding less days of payable outstanding. The longer the cycle, the greater the company's need for liquidity.

Inventory turnover

A high inventory turnover ratio benefits the top line and also reduces holding costs. A high ratio is may also indicate a firm where cash flows lag its earnings metrics. Ratios can vary across industry; for example, companies that sell premium products with sales turnover may have to maintain have to maintain high inventory levels.

Receivables turnover

Accounts receivable are transactions shipped but yet to be paid for. Taking too long to collect these will result in poor utilization of invested capital which is detrimental to value creation.

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Plain english

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