Is your capital allocation strategy driving or diminishing shareholder returns?

Spotlight on Advanced manufacturing

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With cash from divestments, manufacturers need a systematic approach to capital allocation

Advanced manufacturing companies have been focusing more on divestments in recent years. But many indicate they lack a strong, systematic capital allocation process needed to invest the cash raised from these divestments.

In a recent EY survey of CFOs, only 38% of manufacturing executives say their company takes a formal, systematic approach to allocating capital. That is well below the 47% of the entire 500-plus CFOs surveyed who say they take such an approach.

As advanced manufacturing companies look to utilize their cash, especially in the quest for technology assets that allows them to offer more innovative or holistic solutions to customers, how can they overcome some of the barriers they face?

38%

of manufacturing executives say their company has a formal, systematic approach to capital allocation

Use data to better understand customers

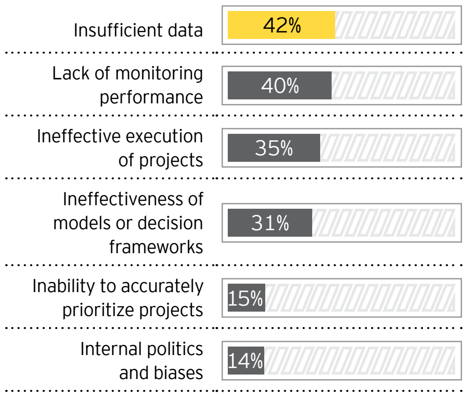
Companies need to bring in customer data to help make unbiased investment decisions, especially when those investments are being made in technologies that are outside the core business or traditional focus. But like the rest of their global CFO peers, CFOs of manufacturing companies name insufficient data as the primary barrier to optimal capital allocation, citing it 42% of the time.

Since they often sell to distributors, installers and other intermediaries, manufacturing companies don't have a direct view of the end user's buying habits and needs. This can hinder product development and also can leave manufacturers out of the loop when the need for replacement supplies, repairs and other aftermarket opportunities arise.

42%

say insufficient data is the primary barrier to optimal capital allocation

What are the primary barriers to your company's optimal allocation of capital? (Select up to two)



58%

name divestment of underperforming assets as a main focus of capital allocation

9%

say that their primary motivation for buying back stock is that the business is undervalued in the market

45%

say they can quickly pivot to assess new opportunities

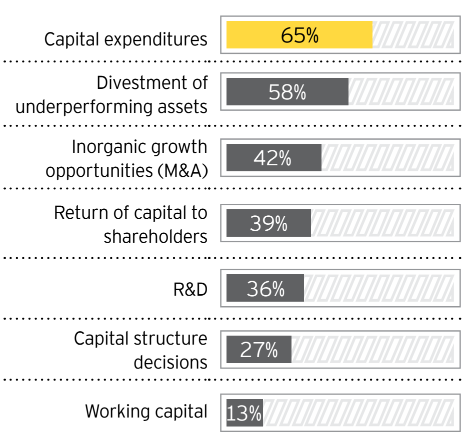
To help solve the data problem, manufacturing companies need to focus on reaching agreements with their distributors that let them view customer data even if it is aggregated to customer privacy. Another solution is to acquire a distributor in order to get this data or set up an online direct-to-consumer sales channel.

At the same time, companies should make sure they have the right analytics tools to let them get the most out of that data. These include data visualization tools and robotic process automation to process large amounts of data quickly.

Shift the capital allocation focus

Manufacturing CFOs are more likely than those of other sectors to name divestment of underperforming assets as a main focus of the capital allocation process (58% vs. 49%). In fact, in the latest EY Advanced Manufacturing *Capital Confidence Barometer* report, 72% of manufacturing companies say they identified an asset to divest as a result of their latest portfolio review. This has served companies well over the past several years as they have looked to hone their focus on their core business.

What are your main areas of focus for your capital allocation process? (Select up to three)



At the same time, manufacturing companies are less likely to name R&D as a focus (36% vs. 43%). Instead, 65% name capital expenditures, such as maintaining existing equipment or building new capacity as a focus area. This could indicate that innovation is getting less investment than it should.

As manufacturing companies shift to offering comprehensive solutions, raising the focus on R&D could help advanced manufacturing companies stay on the forefront of the innovation curve and help ensure that their future portfolio reflects products that their customers will embrace in the future. Manufacturing companies need to keep up with the pace of innovation, something that might not have been a priority in the past, in order to fuel their growth strategies and ensure continued relevance.

Determine if buying back shares is the best use of capital

Only 9% of manufacturing CFOs say that their primary motivation for buying back company shares was that the business was undervalued in the market. This result is roughly the same as that in the overall survey (10%). Conversely, manufacturing CFOs are more likely to say they repurchased shares to fulfill shareholder or analyst expectations (37% vs. 32%).

Manufacturing executives need to examine buying back shares through the same lens as other capital investments. If the company is not undervalued, they need to question whether repurchasing shares is the best use of capital or if other investments will generate a higher long-term return.

How manufacturing companies are outperforming other sectors

There are also some areas of capital allocation strategy where manufacturing companies appear to outperform other sectors.

They are more likely to perform portfolio reviews routinely (52% vs. 40%), which allows them to identify divestment candidates and also can help direct investment dollars to areas that have the greatest potential returns. They are also more likely to say they can quickly pivot and effectively assess new opportunities (45% vs. 40%), which may be the result of having a system of regular portfolio reviews in place. However, this is still an area for improvement for more than half of manufacturing companies.

Manufacturing CFOs also more frequently say there is consistency between investment evaluation criteria, management incentives and the company's long-term strategy (65% vs. 58%). One way this may be accomplished is moving higher-risk investments out of the business unit. When manufacturing companies take on longer-term and higher-risk investment, they are more likely to hold them in a venture capital arm (30% vs. 23%) than their global counterparts, which means business unit leaders aren't likely to be impacted by short-term losses that could come from these long-term investments.

In conclusion

Manufacturing companies are ahead of some of their global peers when it comes to regularly reviewing their portfolios and divesting non-core assets. Many are also in the midst of a transformation, injecting technology into their offerings in order to give their customers more comprehensive solutions. In order to effectively decide how to invest their capital to enable this long-term transformation, they need to improve their access to data and take a systematic, unbiased approach to capital allocation decisions that will determine future growth.

Case study

3M Ventures and strategic venture capital

3M offers a good example of how manufacturing companies can utilize a venture capital arm to hold high-risk investments. 3M Ventures invests in start-ups and innovative companies that are strategic to 3M's future, offering anything from seed funding to capital investment. It focuses on companies in advanced materials and process technologies, smart infrastructure, health care and life sciences and digitization (big data, analytics, internet of things and other applications).

3M Ventures has the same return on capital focus as the rest of the company, but the time horizon for measurement is long and its individual investments are smaller to limit exposure.

These smaller investments can bring significant returns:

- 3M gets insights into new technologies, solutions and methods before the competition
- The company also fosters partnerships with portfolio companies that help 3M accelerate strategic growth priorities and programs

The recent EY Capital Allocation report, *Is your capital allocation strategy driving or diminishing shareholder return?*, poses three questions CEOs and CFOs need to be able to answer:

1. Can we react quickly enough to opportunities and threats?
2. Are we making objective, unbiased decisions?
3. Are we returning cash to shareholders at the right time, and in the right way?

This sector spotlight article examines capital allocation challenges and opportunities in the advanced manufacturing industry. Other articles examine capital allocation in tech, consumer and life sciences.

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