Is your capital allocation strategy driving or diminishing shareholder returns?

Three questions CFOs and CEOs need to answer about investment decision-making

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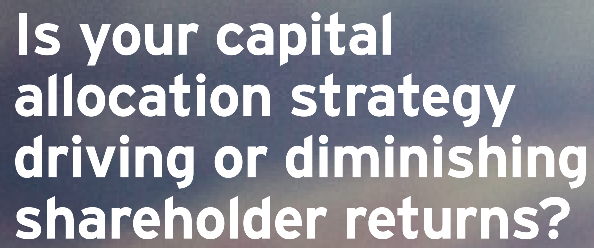

The better the question. The better the answer.
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Building a better working world

72%

of CFOs admit their company's capital allocation process needs improvement.

Making the right capital allocation decisions is essential for senior executives to maintain a company's long-term growth and increase shareholder returns. Unfortunately, in our survey of more than 500 global CFOs, a surprising 72% admit their company's capital allocation process needs improvement.

We regularly see examples of how making objective and data-based decisions, and clearly communicating a company-wide capital allocation strategy, benefits companies and their investors. In two examples we expand on below, Disney manages its risk profile to incorporate high-risk/high-growth investments along with low-risk/core M&A in ways that drive shareholder returns, while Honeywell's fact-based criteria help inform divestments that enable capital redeployment toward higher-growth businesses.

How can companies develop their capital allocation practices to enable the right decisions? In this paper, we outline three essential questions from board members, investors and stakeholders that every management team should be prepared to answer:

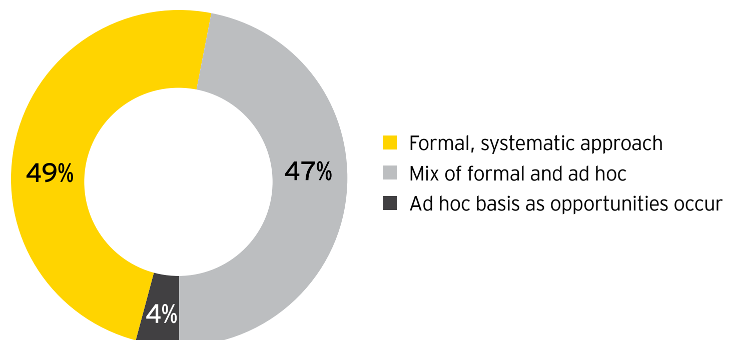
1. **Can we react quickly enough to opportunities and threats?**
2. **Are we making objective, unbiased decisions?**
3. **Are we returning cash to shareholders at the right time, and in the right way?**

Be systematic amid massive disruption

Our survey shows that approaching capital allocation systematically creates value: almost two-thirds (65%) of CFOs who say their company increased in value more than their peers over the past 12 months also say that they take a formal approach to capital allocation. Only about one-third (32%) of CFOs who say that their company decreased in value more than their peers also say the company takes a formal approach to capital allocation.

It seems clear that there is value in taking a systematic approach to allocating capital, but less than half of the companies we surveyed (49%) did so, as shown in Figure 1.

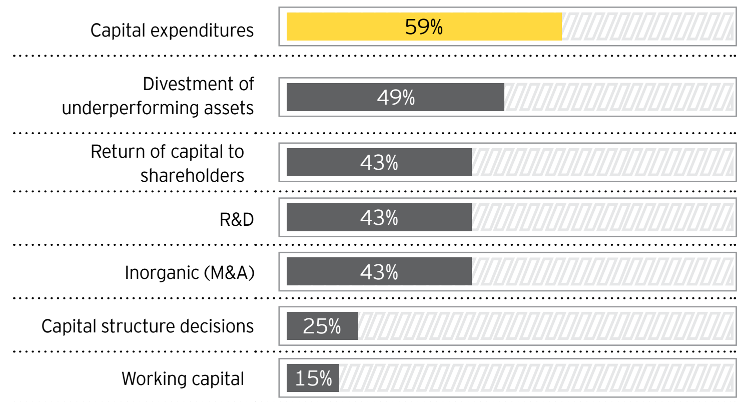
Figure 1. How would you describe your company's capital allocation process?



Decisions about which acquisitions and divestitures to execute, what emerging technologies to invest in and whether to return cash to shareholders are more critical than ever. Disruptive forces such as technology, industry convergence, geopolitics and regulatory uncertainty have hastened the pace at which executives need to make capital allocation decisions. Examples are shown in Figure 2.

How much disruption are we talking about? Consider a list of the world's 20 largest companies, based on market capitalization: half the names on that list at the end of September 2018 were not there 10 years ago, including six of the top eight. Adopting a capital allocation approach that lets CEOs, CFOs, other top executives and boards focus on the long term can help future-proof the business.

Figure 2. What are your main areas of focus for your capital allocation process? (Select all that apply)



Insights on leading capital allocation practices

This paper builds on the eight leading practices for allocating capital outlined in the recently published EY book, *The Stress Test Every Business Needs*: *A Capital Agenda for confidently facing digital disruption, difficult investors, recessions and geopolitical threats*:

1. Focus on a small number of metrics that reflect an outside-in perspective and tie directly to creating shareholder value
2. Employ consistent evaluation criteria and objective processes for all investment decisions
3. Establish a "cash culture" that prizes cash flow and does not tolerate unnecessarily tying up capital
4. Take a zero-based budgeting approach to deploying capital
5. Practice continuous improvement by examining each investment and implementing lessons learned
6. Embed stress testing across capital allocation to strengthen resilience
7. Align capital allocation, strategy and communications
8. Maintain information systems that generate granular data

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Can we react quickly enough to opportunities and threats?

Ultimately, a company's capital allocation practices should support the long-term strategic plan and create flexibility to re-prioritize investments when situations change.

What can executives do to improve their reaction times?

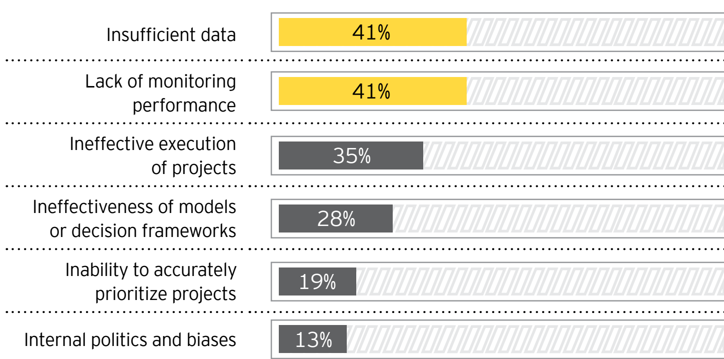
In our experience, the most significant barriers that impede agility are rooted in predicting outcomes and making decisions with inadequate data, having a culture and incentive system that lack a cash focus, and being unable to take risks at the right time and in the right way.

Data dilemma

Financial and operational data are key strategic assets. But 41% of CFOs cite insufficient data as one of the primary barriers to the optimal allocation of capital, as shown in Figure 3. The roots of this data gap can range from not capturing enough data to lacking the tools to efficiently analyze the data.

Data should be the solution, not the problem, so companies first need to define what drives profitable growth in their business and then find ways to obtain the data to measure those drivers. Consider what internal management reports are being produced that did not exist two years ago. If the company is reviewing essentially the same information, it may be standing still in a fast-moving environment.

Figure 3. What are the primary barriers to your company's optimal allocation of capital? (Select all that apply)



If the data does not exist internally, third-party sources can be employed. Companies can also use emerging analytical capabilities to assess relationships between nontraditional and unstructured data — such as weather, location data and consumer sentiment ratings. Bringing together these disparate information sources provides a more complete picture of future prospects and can help executives more accurately assess the value of an acquisition target and other investment opportunities.

If the company has sufficient data, but cannot use it effectively, the solution may be employing tools for improved and consistent data analysis, such as robotic process automation, which can evaluate a far greater amount of data more quickly than humans can on their own.

Data visualization tools can also make the presentation of key value drivers much more clear.

Create a cash culture

Sometimes there is not enough capital for all initiatives that meet a company's approval criteria. We are often surprised by how many companies lack the cash culture necessary to optimize capital allocation. They wind up with capital — including human capital — trapped in unproductive uses, such as in underperforming or noncore business units, or in jurisdictions where moving or repatriating capital is structurally difficult.

As noted in *The Stress Test*, CEOs, CFOs and boards need to establish a culture that prizes cash flow and does not tolerate unnecessarily tying up capital. This includes liberating excess working capital and monetizing noncore assets such as excess real estate, surplus R&D projects and off-strategy brands. Conducting regular portfolio reviews can help businesses identify assets that are ripe for divestment. Companies are taking heed on this front: the latest EY Global Capital Confidence Barometer survey shows two-thirds of companies are now reviewing their portfolio at least every six months.

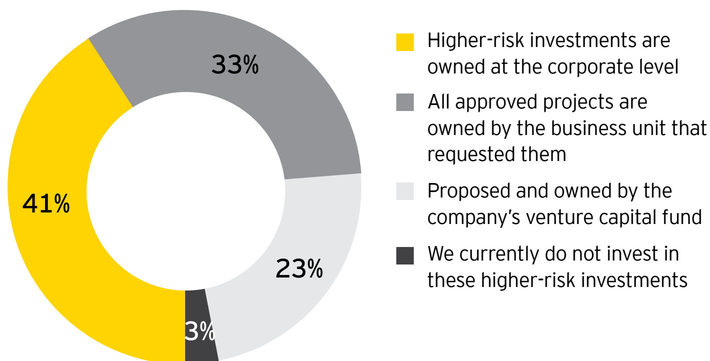
Intelligently take on risk

Agility enables a company to quickly take on higher-risk/higher-return investments that can help it become a disruptor, rather than being disrupted. Examples include Target's investment in online delivery service Shipt and General Motors' investment in self-driving vehicle company Cruise.

The vast majority of CFOs invest in these types of higher-risk investments, though the manner in which such investments are structured and accounted for in each organization varies significantly and greatly affects decision-making. For example, if all investments are owned by the business unit, initial expected losses could negatively impact short-term compensation for business unit leaders and may discourage long-term thinking.

That may be why 41% of CFOs in our survey say higher-risk investments are owned at the corporate level, so that short-term losses do not hurt business unit financials. Meanwhile, 23% say higher-risk investments are proposed and owned by the company's venture capital fund, as shown in Figure 4.

Figure 4. How do you manage longer-term and higher-risk investments, such as emerging technologies or startups?



Still, one-third (33%) of CFOs surveyed say all approved initiatives, independent of risk profile or time horizon, are owned by the business unit that requested them.

Holding higher-risk investments at the corporate level or in a venture capital fund promotes long-term thinking by allowing business unit management "the freedom to fail" without affecting short-term performance.

Case study

How Honeywell leverages data to optimize its portfolio

Honeywell regularly conducts portfolio reviews. In October 2017, the company announced two divestments representing close to US$7.5 billion in revenues. At the time, new CEO Darius Adamczyk said the divestments were the result of a review that was "objective and fact-based, involving extensive analysis and input from industry experts and participants as well as from our shareowners. The foundation of the announcement was a set of criteria … against which each business was measured." He noted the optimized capital structure resulting from the divestments and said he was excited to invest in any of the company's four remaining platforms.

The approach even won praise from a prominent activist shareholder who had pushed for a different path but said he was pleased the board and management chose to conduct a thorough portfolio review and agreed that Honeywell should narrow its business focus.

Key considerations for CEOs, CFOs and boards:

- Develop a robust, data-based model for making capital allocation decisions and stress-test the model to see how it reacts to various scenarios
- Perform portfolio reviews at least annually to find assets that can be divested in order to fund more strategic initiatives; a portfolio review approach can also be applied to operating expense budgets to deprioritize inefficient or ineffective spending in order to fund value-creating strategic initiatives
- Strongly consider holding high-risk, high-reward investments at the corporate level or in an internal venture capital arm to avoid concerns from business unit leaders that these investments will harm short-term performance
- Balance the risk profile of the overall business; higher-risk, higher-return investments can be offset by lower-risk/lower-return investments when necessary; this enables a company to take necessary chances for future growth while maintaining an overall risk profile that is acceptable to the business and investors

Case study

How Disney adapts to convergence and disruption

Disney provides an example of balancing flexibility and risk. The company has maintained a well-communicated capital allocation strategy over the years that has helped it adapt to convergence and disruption in the media and entertainment industry. Its investments have included organic projects and M&A with a variety of risk profiles:

- Lower-risk/core investment — Parks and Resorts (e.g., the Shanghai Disney project, new attractions at Orlando and Anaheim locations, new cruise ships)
- Lower-risk/core M&A — the acquisition of film studios Lucasfilm and Marvel, which drive Disney's filmed entertainment performance while also providing valuable, popular intellectual property for use in consumer products, theme parks and elsewhere across the portfolio
- Higher-risk/technology-driven M&A — the acquisition of the BAMTech streaming video platform from Major League Baseball Advanced Media; BAMTech now serves as a big accelerant to Disney's pivot to a direct-to-consumer strategy
- Higher-risk/technology-driven investment — part ownership of the Hulu streaming video property, which requires significant amounts of cash to maintain its high growth

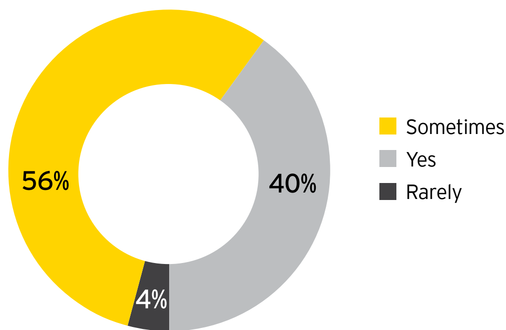
Disney has demonstrated this agility while maintaining a strong balance sheet, evidenced by significantly less leverage and the highest credit rating among its peers. Disney's approach appears to have been rewarded by the market: over the past five years, Disney has outperformed both peers and the market; its annual total shareholder return of 13% was approximately 300 basis points higher than the averages by its peer group and the S&P 500.

Are we making objective, unbiased decisions?

In an ideal world, all capital allocation decisions would be unbiased and based on empirical data. But decisions are made by people, who can have their own inherent biases: a preference to invest in a business line they developed; "shiny object syndrome" that steers capital to "trophy" acquisitions or investments that do not create sustainable value; overestimating the benefits or the probability of success; or preferring short-term benefits to long-term value creation.

Only 40% of CFOs say they have a consistent process that is always followed and is free from bias and internal politics, as shown in Figure 5.

Figure 5. Are capital allocation decisions made on an objective basis?

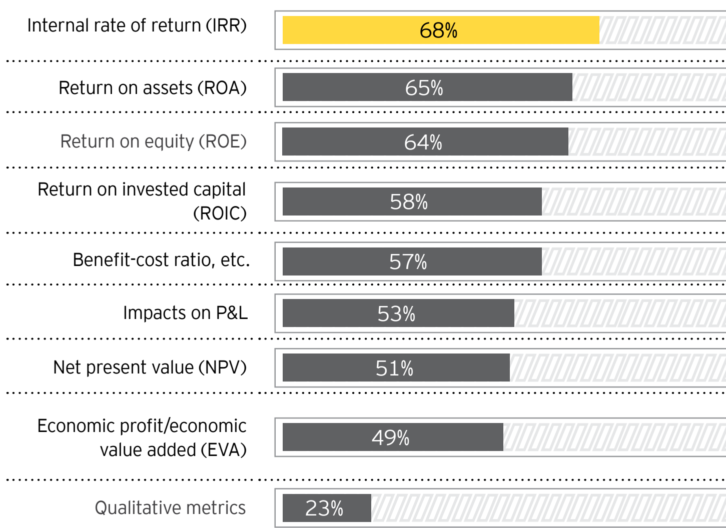


Use the right metrics

Consistent and appropriate metrics help maintain understanding of risks and returns across disparate capital uses. Two commonly used metrics are internal rate of return (IRR) for evaluating new investments and determining the value of current assets, and return on invested capital (ROIC) for determining the performance of existing assets, as shown in Figure 6.

Companies can choose other metrics, but they should avoid revenue growth and earnings per share (EPS), two commonly cited metrics that only indirectly and imperfectly relate to value creation. Pursuing growth or size in spite of profits destroys value; companies overpaying for acquisitions and repurchasing shares may raise EPS without creating real value.

Figure 6. What key metrics are used to assess projects?



Set the right hurdle rates

Companies also need to set appropriate hurdle rates for different types of investments based on their risk profiles. Using a single discount rate for all investment opportunities will result in underfunding initiatives with a lower required cost of capital, and overinvesting in those with a higher capital cost. Similarly, companies may misprice or fail to pursue acquisitions and reject fair offers for businesses that should be divested.

Ultimately, choosing proper metrics helps encourage decisions that deliver attractive long-term returns.

Instill a culture that supports healthy debate

Once the appropriate metrics are chosen, they should be consistently applied to all investment decisions. Then management should challenge assumptions in the data by benchmarking against the results from previous similar investments, using both internal and external examples. Management needs to ask: "What would need to be true for this project to succeed?" or, alternatively, "What are the reasons this project will fail?"

Executives need a framework to assess the underlying rationale for each potential investment, the assumptions inherent in the investment case and any potential negative implications. But to make the debate effective, companies also need to include diverse representation from marketing, manufacturing, IT and even outside the company to discuss an investment's merits.

This culture is set from the top: CEOs and CFOs need to make sure it is clear they are seeking different viewpoints, not just tolerating them. Some companies even set up a contrarian team to make a case against a project to ensure all viewpoints are considered as a way to combat confirmation bias such as having data or assumptions picked specifically to support a project.

Tie it to incentives

Companies also should make sure management incentives, long-term strategy and investment evaluation criteria are aligned, but 42% of CFOs say they have no such alignment.

Tying compensation to cash flow and other measures of long-term value creation, rather than solely focusing on EPS or quarterly accounting metrics, can foster long-term thinking throughout the company. These types of incentives, along with embracing a culture of value creation and continuous improvement from the C-suite to the shop floor, are key ingredients to the recipe for sustainable growth and total shareholder return outperformance.

Key considerations for CEOs, CFOs and boards:

- Apply appropriate outside-in metrics both to decision-making and to monitoring the programs once the capital is allocated
- Establish a culture that encourages healthy debate in order to challenge assumptions and investment theses
- Regularly review the portfolio from an outside investor perspective for both acquisition needs and divestment opportunities
- Routinely conduct a postmortem to learn how well the decision-making process aligned with results; apply lessons to future decisions

Monitor performance

The capital allocation process doesn't end when a decision is made. Proactive performance monitoring and a mindset of continuous improvement are critical to extract value, quickly identify issues and fix them. If there is no fix, leadership needs to consider ending the investment rather than incurring further losses. However, 41% of CFOs say they don't sufficiently monitor performance.

We also recommend postmortem analyses in order to understand past challenges — such as how effectively synergies were achieved in an acquisition — and to enact future measures that will create, or protect, value. This review should include both initiatives that were funded and initiatives that were rejected, as well as share repurchase programs.

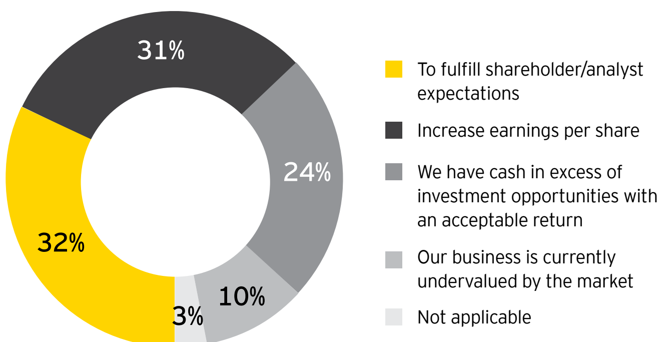
3 Are we returning cash to shareholders at the right time and in the right way?

Activist investors often push for companies to return cash to shareholders and can encourage companies to make short-term decisions to accomplish this. Rather than treating share repurchases as a separate category, companies should view buybacks through the same lens as any other potential investment.

Warren Buffett's guidance on repurchasing shares is instructive here. He said that under most circumstances, companies should buy back stock only when the share price is well below intrinsic value and when cash exceeds operational and liquidity needs. That does not preclude buying back shares altogether. In fact, Buffett's Berkshire Hathaway bought back stock in 2018, though that was the first time in six years that it made such a purchase.

But only 10% of the CFOs we surveyed say they repurchased shares because their business was undervalued in the market. Another 24% say they repurchased shares because they had cash in excess of what was needed to fund with an acceptable return, as shown in Figure 7.

Figure 7. What is the primary motivation for buying back shares in excess of the dilutive effects of options?



Meanwhile, almost two-thirds (63%) of CFOs say they repurchased shares to fulfill shareholder or analyst expectations or to increase earnings per share. Although this may result in a short-term boost to the stock price, it will likely hamper long-term growth as there is less capital available to invest in sustainable value creation opportunities.

Repurchasing shares is an arbitrage opportunity, so CFOs should consider if they would purchase the shares of a similar company at the same valuation if all other considerations were the same. They should ask if the current stock price is lower than the intrinsic value that management can achieve.

Companies also repurchase shares to offset the dilutive effect of stock option grants. Stock-based compensation is often seen as "cash-less" compensation, but it is a very real expense for shareholders. Repurchasing shares at a premium to intrinsic value in order to offset dilution can destroy shareholder value.

Gain investor trust

To avoid pressure to repurchase shares, managers need to earn investor trust and then demonstrate how the company plans to invest capital in other value-creating ways, such as developing a new product line, making an acquisition, improving technology or enhancing antiquated facilities. The best way to earn this trust is by establishing a track record of successful investment decisions that are made using a replicable process.

As Doug Giordano, Pfizer Senior Vice President, Worldwide Development, said in *The Stress Test*, "If investors see you as prudent stewards of capital and you're actually beginning to reap some current benefit from past investments, they will give you more of an opportunity to invest for the long term. If you start to lose that credibility, investors are going to want their money back sooner, in the form of dividends and repurchases."

Key considerations for CEOs, CFOs and boards:

- Evaluate share repurchases with the same criteria as other investment decisions
- Determine if the stock is actually undervalued in the market and if cash exceeds operational and liquidity needs
- Show that you are an effective steward of investors' capital in order to lessen pressure to repurchase shares

Case study

Foot Locker: Evaluating dividends, buybacks as part of larger capital allocation strategy

Foot Locker was considering increasing its dividend and share repurchase program as part of refreshing its capital allocation plan. Management wanted to maintain sufficient financial flexibility to execute its strategy while also maintaining the company's current credit rating. Among the steps that helped management's decision process were:

- Assessing the company's liquidity profile, including the projected cash balance, with adjustments for offshore cash repatriation expense and pension funding
- Identifying key strategic alternative uses for the company's capital as part of the company's plan to return cash to shareholders
- Analyzing the ROIs achieved by past repurchases in relation to the company's cost of equity
- Commissioning an independent analysis of the company's intrinsic value
- Developing a weighted average cost of capital (WACC) model and a company threshold for capex returns with a spread above WACC
- Understanding the relationship between the company's dividend policy and its expected EPS growth rates

With this thorough, data-based analysis, management better understood the relationship between various capital structure elements and was able to make an informed decision on when and how to return cash to shareholders.

Time to act

Clearly there can be barriers to optimal capital allocation, including inadequate data, poor execution of the right decisions, cultural biases and failing to learn from previous decisions. But, as our CFO survey shows, getting capital allocation right is essential. Ineffective capital allocation can lead to slow growth, declining profits and lower levels of value creation. This can make a company a target for a hostile acquisition or activist intervention, throwing the future of management, board members and the company in doubt.

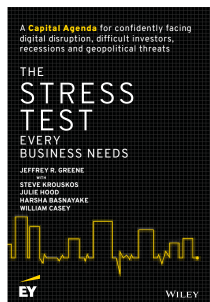
Fortunately, executives can take steps to make sure that capital allocation is driving — instead of diminishing — sustainable growth.

- Instill a cash culture that avoids tying up capital in unproductive investments but rather maximizes cash flow to quickly react to opportunities and threats.
- Base decisions on rigorous, objective analysis centered on the data and metrics that support long-term thinking.
- Apply capital allocation processes across all potential investments (e.g., M&A, organic growth, debt repayment, dividends and share repurchases) to filter out bias and defend against pressure to make decisions that may look good in the short term, but will stymie long-term growth.

A robust capital allocation strategy can drive attractive returns for shareholders, enabling access to capital and providing more opportunities to gain a competitive advantage.

This article is based on the EY survey of 536 global CFOs of companies that generate more than US$1 billion in annual revenue, as well as our experiences in helping clients prioritize the use of financial resources to create a balanced and strategically aligned portfolio that can help increase shareholder value. EY teams can help you:

- Create a capital allocation strategy
- Develop an objective, fast-paced approach
- Implement data-gathering systems and analytics and evaluate performance
- Assess long-term impact



Further reading

In our new EY book, *The Stress Test Every Business Needs: A Capital Agenda for confidently facing digital disruption, difficult investors, recessions and geopolitical threats*, the authors extend the banking stress test concept to a company's "Capital Agenda" — managing capital, executing transactions, and applying corporate finance tools to strategic and operational decisions.

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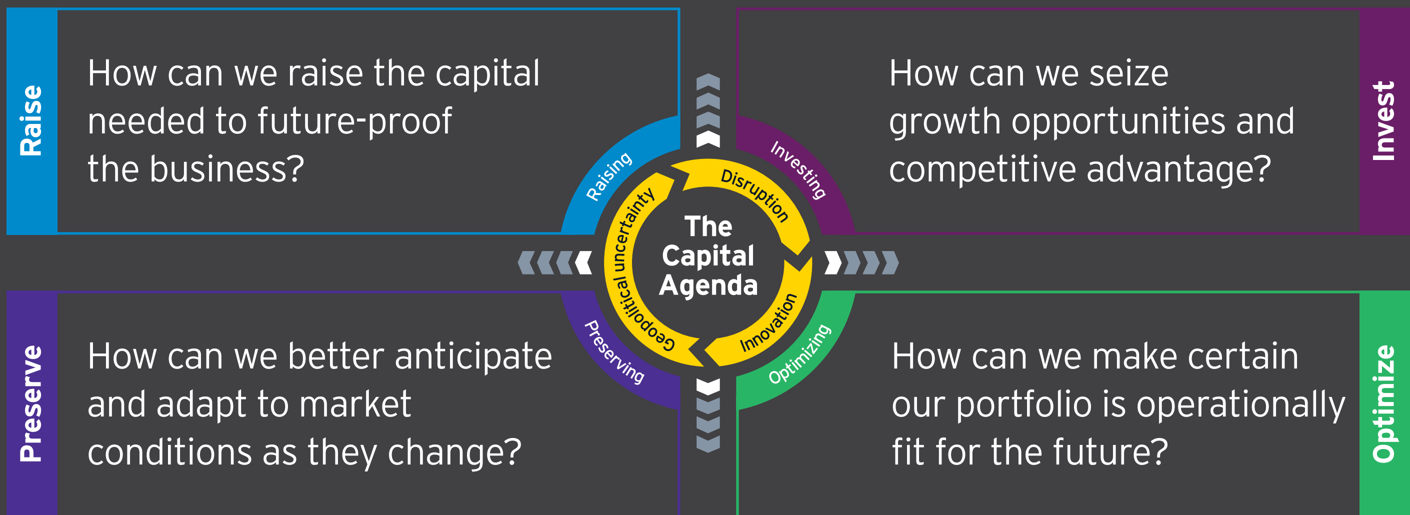

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