Is your capital allocation strategy driving or diminishing shareholder returns?

Spotlight on the technology industry

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Different approaches at different growth stages, but common actions to consider

Tech companies approach capital allocation in different ways, depending on where they are in the growth life cycle. Younger, high-growth companies are — and should be — focused on how fast they can capture customers. These companies are looking at new markets and which products to advance with a focus on customer growth before they focus on profitability. They are not necessarily thinking about capital allocation in the same way as a more mature company, which may have excess cash and seeks to reignite rapid growth.

As a whole, however, technology sector CFOs are less likely to call their capital allocation process "very successful" than CFOs of other industries in a recent EY survey that asked companies about their capital allocation process (23% vs. 27%). Technology CFOs also indicate that their companies are less likely to review their capital allocation process at least once a year (38% vs. 44%) and less likely to say they could react quickly to either market threats or opportunities (33% vs. 40%).

23%

of technology executives say their company's capital allocation process is "very successful."

There is a lot at stake. The top 10 US-based public technology companies showed more than US$520 billion of cash and short-term investments on their most recent public filings. While understanding that companies at different stages of growth have different priorities and in differing levels and needs of cash, in an environment with rising interest rates, as well as geopolitical, trade and regulatory uncertainty, it is essential to make the right capital allocation decisions.

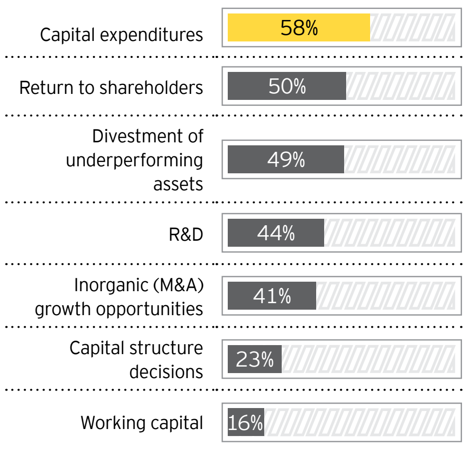
Diversify capital allocation

Capital allocation decisions include more than a choice between M&A or returning cash to shareholders. But in the CFO survey, half of tech CFOs (50%) say one of the main focuses of their capital allocation process was returning cash to shareholders,

41%

say increasing EPS is the primary reason they buy back shares.

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



45%

say there is consistency between project metrics, employee incentives/bonuses metrics, and the long-term strategy.

95%

say their capital allocation process objectively assesses the risk and return profile of investments.

83%

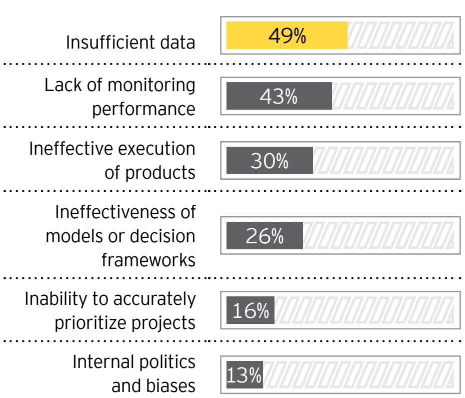
say investment decisions are driven by periodic portfolio reviews.

compared with 43% of CFOs overall. Tech companies are slightly less likely to name M&A as a priority (41% vs. 43%), while capex (including organic growth opportunities) is mentioned by 58%, compared with 59% overall.

Just as telling may be why tech companies are repurchasing shares, as 41% say the primary reason for buying back shares was to increase earnings per share, compared with 31% of CFOs overall. Only 10% of tech CFOs say they are making repurchases because the shares were undervalued in the market and 19% said they had cash in excess of investment opportunities with an acceptable return. However, share repurchases may not always yield favorable returns and may even result in negative return on investment in a rising interest rate environment.

Tech executives need to examine share repurchases like they would any other

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



investment in order to make sure they are not making a short-term investment that will hinder opportunities for long-term growth. Successful tech companies have a balanced, strategically aligned, and value-focused portfolio built upon fact-based decision-making. These companies stress a capital allocation approach that is objective, transparent and flexible.

Find more data and improve analytics

Having the right data, and the right analytics tools to evaluate the data, coupled with proper statistical analysis, is key to not only making capital allocation decisions, but to analyze the performance of past investments in order to course correct when necessary and learn lessons to optimize future decisions. Tech companies with successful capital allocation frameworks have the processes and tools in place to execute upon a nimble, yet effective, decision-making framework. Clearly defined measurement criteria and KPIs built around data analysis are a key pillar of an effective capital allocation framework.

Yet the tech industry, which in many cases generates a trove of data in its operations, is far more likely (49% vs. 41%) to cite insufficient data as a primary barrier to optimal capital allocation. Some mature tech companies use legacy systems that are not always interconnected, making it more challenging to pull meaningful data, which could necessitate investing in systems integration. Also, in order to better utilize data, tech companies should consider data visualization software to understand where capital investment may be needed.

Additionally, companies should scrutinize and carefully assess data to the extent it does exist and search out new third-party sources of data if they do not have the data they need internally. For example, we observed a major technology company rely on a legacy allocation methodology that resulted in misguided conclusions as to the profitability of a business segment. We scrutinized the data and assumptions to present management with a grounded view of segment operations. Company executives were then able to make informed decisions around portfolio rationalization.

Align incentives

Less than half (45%) of tech CFOs say that investment evaluation criteria, management incentives and long-term strategy were fully aligned, compared with 58% of their non-tech counterparts. This misalignment can hinder the long-term thinking required for management to be effective stewards of capital. Instilling a cash culture that balances both long- and short-term risk with ROI can help ensure that executives don't make decisions that might give a short-term boost to the stock price, while crippling the company down the road. Additionally, in a time where it's becoming more common for horizonal companies to enter vertical markets both organically and through M&A, it is important that incentives are rethought as vertical markets which often require a nuanced incentive structure (i.e., subscriber growth on a particular product segment) as opposed to general profitability targets that are often in place at horizontal companies.

Other ways tech companies compare with other sectors

Tech companies with successful capital allocation strategies objectively review, evaluate and approve capital allocation. Strong business cases use balanced scorecards to outline the strategic, economic, commercial and financial impact of a proposed business decision. Additionally, proactive performance monitoring is critical for any capital allocation decision. Regular reporting instills execution discipline and allows for the ability to course correct when necessary.

Tech capital allocation appears to be more strategic in this area than that of their peers. They are more likely (95% vs. 93%) to objectively assess the risk and return profile of investments. They are also as likely (83% vs. 83%) to say that investment decisions are driven by periodic portfolio reviews.

For further reading on the topic, check out the EY Parthenon article, "Can the capital allocation process be a competitive advantage?

Conclusion

Overall, tech companies can better position themselves for the future by taking a fresh look at how they allocate capital, especially as they make the shift from high growth to more mature, profit-focused companies. The muscles for considering different investment decisions change as companies move past the stage of acquiring customers as quickly as possible. A company's capital allocation strategy needs to be optimized as companies grow. The ability to obtain, assess, and analyze operations will enable technology companies to make informed decisions around capital allocation. Companies that take this approach have a leg up when it comes to spurring long-term, profitable growth.

The recent EY Capital Allocation paper, *Is your capital allocation strategy driving or diminishing shareholder returns?* 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 technology industry. Other articles examine capital allocation in advanced manufacturing, consumer and life sciences.

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Ken Welter
EY Global Transactions Technology Leader
kenneth.welter@ey.com
Follow me on LinkedIn

Evan Sussholz
EY Americas Corporate Finance Leader
evan.sussholz@ey.com
Follow me on LinkedIn

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