1 How resilient is your Capital Agenda?

Jeffrey R. Greene

Framing decisions within the Capital Agenda

The Capital Agenda is a comprehensive approach companies should use to manage capital, execute transactions, and apply practical corporate finance tools to strategic and operational decisions. This book synthesizes what we've learned over literally thousands of engagements helping clients as they navigated out of crises to confront technological disruption, unrelenting investor scrutiny, slow gross domestic product (GDP) growth, and geopolitical volatility.[1] EY's Capital Agenda framework has been such a valuable tool that we've built Transaction Advisory Services around it, using it to set priorities for recruiting and talent management, innovation, and thought leadership.

Having a static Capital Agenda, however appropriate for your current environment, is not enough in today's uncertain world. Long-term success comes from building resilience into each element of the Capital Agenda and in the way those elements interact. Banking regulators have mandated well-defined parameters for stress tests of our most important global financial institutions. We believe every *non*financial company should adopt an analogous approach to "future-proofing" its Capital Agenda.

We use a broader, more strategic definition of stress that encompasses not only traditional macroeconomic, sovereign-risk, and commodity-related shocks—such as interest rates, recessions, oil prices, and expropriation—but also forces such as technological disruption, hostile takeovers, and activist shareholders. In this expanded view, companies that make poor strategic decisions or underperform operationally—even in a benign economic and geopolitical climate—can still find themselves facing great stresses. We believe that stress is symmetric; the threat can come from downside risks as well as from missed opportunities.

The Capital Agenda's building blocks

While every company's Capital Agenda is specific to its strategy, operating model, and business environment, Figure 1.1 provides examples of common activities. Each quadrant represents one of the four key processes that make up the Capital Agenda framework:

1. *Raising*. Accessing the capital markets to properly fund growth and day-to-day operations.
2. *Investing*. Deploying capital to new opportunities, both organic and inorganic.

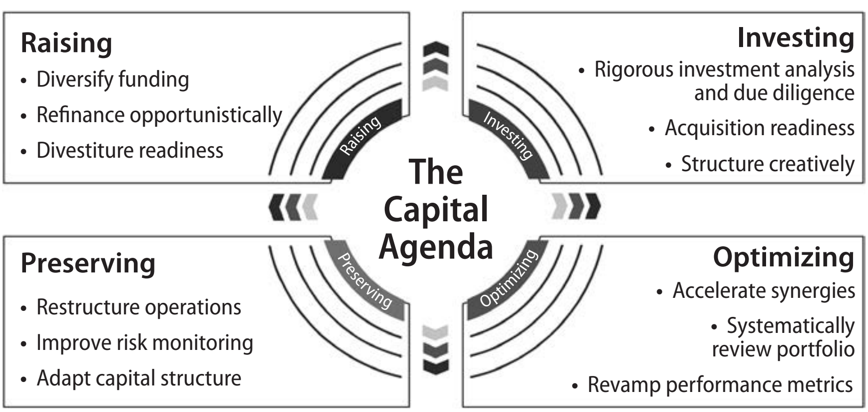

Figure 1.1 Capital Agenda's building blocks

3. *Optimizing*. Reviewing the business portfolio for capability gaps as well as divestment candidates.
4. *Preserving*. Managing risk and adapting to changes in the business environment.

As we'll see, many essential activities affect more than one quadrant. For example, valuation, capital allocation, and tax planning are relevant to the entire Capital Agenda.

Who can benefit from this book?

We created this book to help boards and management teams make better, more informed decisions around their Capital Agenda in an increasingly uncertain business environment that presents both great risks and opportunities every day. How much better? Our friend, Professor Richard Ruback at Harvard Business School, tells students he hopes they'll get 5% better from engaging in his class. It doesn't seem like much, but if you're a professional golfer, 5% better means 14 strokes over four rounds—normally the difference between winning and not making the top 25. In a major tournament, that's likely a difference of more than US$1 million in prize money. As a chief executive officer (CEO) or chief financial officer (CFO), if your stock price is 5% higher each year than it otherwise would have been and that difference accumulates over time, your market value would be more than a quarter larger after five years, and almost two-thirds larger after 10 years—likely enough to ward off a hostile acquirer or activist shareholder. So maybe 5% better at managing your Capital Agenda from reading a book is pretty good.

In these pages we distill more than 400 years of the contributors' collective experience into practical guidance for executives trying to master both the Capital Agenda and the ability to future-proof their companies. We measure business success in two ways:

1. *Shareholder value creation*. How well are you rewarding shareholders, and what's expected over the next two to three years?

2. *Resilience*. Are you adaptable enough to absorb unexpected threats *and* to seize unanticipated opportunities? This applies to evolving long-term trends—like demographics and consumer tastes—and to the rapid pace of short-term changes.

Consistently creating value and maintaining resilience are complicated by the demands of optimizing all the individual elements of the Capital Agenda, as well as managing them holistically. Your ability to control your own corporate destiny faces ever-greater challenges created by:

- Accelerating uncertainty from technology-driven disruption and industry convergence.
- Less bounded macroeconomic and policy uncertainties.
- Growing political divergence with emerging nationalism and subnationalism.
- The formidable power of traditional investment managers and activist hedge funds.

Implementing the Capital Agenda well requires an integrated, strategic focus from C-suite leaders who can see and work across the enterprise. But fluency with the Capital Agenda is necessary for everyone from the board of directors to middle managers. Boards need to exercise their governance responsibilities by asking the right questions that are informed by the Capital Agenda, such as:

- Do our large share repurchases signal to investors that we've exhausted our opportunities to grow organically?
- Is this acquisition candidate a good strategic fit, and do we have the ability to earn an adequate return on our purchase price?
- Are we the best owner of each business in our portfolio?

Leaders in key functions—manufacturing, supply chain, sales and marketing, research and development (R&D)—should understand how their day-to-day activities align with, and support, the Capital Agenda to create value and build resilience. Likewise, practitioners within companies working on strategy, corporate finance, mergers and acquisitions (M&A), tax planning, and operations have essential roles to play in helping make their company's Capital Agenda complete, internally consistent, and resilient. Our thinking should also resonate with advisors looking for new perspectives to address their clients' challenges at the intersection of global capital markets and competitive strategy. Academia represents another important audience: teachers and students who want to explore how financial theory works in practice.

Universal lessons from Allergan and Valeant

The 21st of April 2014 started out like any other beautiful day in Southern California. Despite a Monday packed with meetings, Allergan Inc.'s longtime CEO, David Pyott, took a break around noon to stop by the employee cafeteria and grab lunch.

It was the quiet before the storm.

Within hours, Pyott and his senior team learned of two US Securities and Exchange Commission (SEC) filings that put Allergan in the crosshairs of both an activist shareholder, Pershing Square Capital Management LP, and a hostile acquirer, Valeant Pharmaceuticals International, Inc. The next day Valeant went public with a US$47 billion offer for the Irvine, California–based pharmaceutical company.[2]

Pyott, who had been Allergan's CEO for 16 years, is candid about the takeover attempt. "It felt a little bit like December 1941," he says, and it's not difficult to understand his surprise. Allergan's 2013 revenues had grown nearly 12%, while total shareholder return jumped more than 90%. Few would have labeled Allergan an "underperformer." Its flagship product was growing at double-digit rates, and the company had recently divested a lagging business to free up resources.

It's also not difficult to see how an arbitrageur could develop a rationale for why the company was an enticing target. The year before, Allergan allocated 17% of its total revenue to R&D and 38% to selling, general, and administrative (SG&A) expenses. Both were on the high side for a specialty pharmaceutical company. Given its US headquarters, Allergan also had an effective tax rate 8.5 percentage points higher than the overall average for specialty pharmaceutical and generics players. Moreover, with roughly US$1.6 billion in cash on its balance sheet and little debt, Allergan had a stockpile of financial firepower waiting to be deployed.

These facts created an attractive opportunity for Valeant, a strategic buyer with a lean operating model and a focus on growing through serial acquisition. In his 22 April presentation to investors, Valeant's CEO outlined the "financially compelling" results he believed would come from a merger, including US$2.7 billion in annual cost savings.

But with a market capitalization roughly equivalent to Allergan's and a balance sheet that was already heavily leveraged, Valeant needed help with its bid. Enter Pershing Square, with US$13 billion under management. The hedge fund's sum-of-the-parts valuation analysis showed that its likely return was worth the associated risks of an activist campaign. In other words, as a result of Allergan's relatively high tax rate and operating expense levels, there was a big-enough gap between its market value and its perceived intrinsic value to attract a credible strategic buyer—and a powerful activist shareholder.

A seven-month battle of dueling investor presentations, acrimonious press releases, and litigation ended in a white-knight bid by Actavis PLC valued at more than US$70 billion, roughly twice Allergan's market capitalization before Valeant weighed in. That Valeant ultimately didn't succeed in its bid mattered less to Allergan's stakeholders than the fact that together with Pershing Square it had succeeded in putting the company into play.

Throughout the book we'll consider examples from many industries, but for now there is more for all companies to learn from in seeing how the story played out. Like many corporate tales, Allergan's journey had a happy ending for shareholders, but a bittersweet one for its CEO and management team. They might be forgiven their *schadenfreude* over what happened to Valeant barely a year later.

Valeant's rise and epic fall

Valeant's stock soared from less than US$20 per share in 2010 to more than US$340 by August 2015, based on a widely celebrated business model of acquiring specialty pharmaceutical companies and individual drugs, then raising prices, cutting R&D spending, and rationalizing SG&A costs. In order to fuel this roll-up machine, acquisitions got larger and more expensive as pharma equities roughly doubled in price. Valeant's debt levels rose to fund these transactions.

In mid-2015, public opinion began to turn decisively against drug companies that were thought to be aggressively raising prices. One analyst published a report saying Valeant had raised prices on more than 50 drugs by an average of 66%—well above the industry average.[3] A congressional subpoena soon followed.

The company also faced investor concerns over some accounting practices and a lack of transparency in dealing with certain third parties. In March 2016, management announced it might be in danger of violating loan covenants. That month the stock fell under US$30 and Valeant joined the "90% club," reminiscent of once high-flying stocks in the dot-com bubble's aftermath. The CEO resigned after seven years at the helm. There were no happy endings for anyone in this story.

To learn from these examples, let's start by examining the resilience of each company's Capital Agenda, because things went quite well for years and then hit a wall owing to unanticipated outside forces. While Allergan's performance looked strong relative to the company's peer group, its *absolute* performance created an opening for Valeant's critique, as some outsiders saw a path to even better results. David Pyott acknowledges that investors might have viewed its high

SG&A-to-revenue ratio as a weakness, but counters that Allergan had "cogent arguments" for its decisions. "We had to create not only sales forces but market competencies," he said.

Two trends converged to create real stress for the company:

1. Investor sentiment shifted in favor of cost reductions to increase margins versus investing in sales and marketing to create longer-term growth.
2. Activist hedge funds attracted more resources and gained credibility with institutional investors.

As the activist campaign wore on, priorities within Allergan did turn from enabling longer-term growth to demonstrating nearer-term earnings. Allergan cut 13% of its workforce and optimized capital allocation. These steps were motivated by conversations with investors, who told Allergan and its board that if the company couldn't get to US$10 earnings per share (EPS), Valeant's offer was too enticing.

Stress test your Capital Agenda

How might management have inoculated itself against these pressures? The well-documented process of scenario planning goes back decades, but we find that very few companies have come close to fully implementing its fundamental practices. One way to get started is to perform a "*pre*mortem"[4] for important decisions. As with many powerful ideas, this one is simple and straightforward to apply to new strategic, operational, and capital decisions, as well as to initiatives already underway. Instead of asking what could go wrong, the team begins by assuming the effort failed in dramatic fashion. Then everyone writes down individually all the possible reasons he or she can think of for the failure, before each is considered in turn for ways to better future-proof the project. Even Nobel laureate Daniel Kahneman, widely regarded as one of the godfathers of modern-day behavioral economics, has complimented the power of the premortem approach.

Here are a few plausible action items that could have come out of an Allergan premortem on its Capital Agenda:

- Strengthen our dialogue with investors to make sure they understand and buy into how our sales and marketing programs will drive future growth.
- Demonstrate the productivity of our long-term R&D investments with compelling analysis.
- Take a fresh look at all costs, and eliminate any unnecessary expenses.

Some of these may seem to use too much hindsight, but they amount to basic tenets about "thinking like an activist" and staying in touch with major shareholders—concepts that all boards and management teams should adopt, and which we discuss in detail in Chapter 13. In 2017, shortly after the US$130 billion DowDuPont merger closed, no less than four activists were criticizing the planned separation of the combined group into three publicly traded entities. DowDuPont responded by surveying its top 25 shareholders before making meaningful changes to its separation plans.[5]

Had Valeant management done a premortem around its business model, it might have given itself some to-dos as well:

- Be transparent to investors about the role that product price increases will play in our ability to extract value from acquisitions.
- Reduce our dependence on debt, in order to build more flexibility into our capital structure in case cash flow falls below our base-case expectations.

Hindsight again? Not really. Though there was additional complexity in the Valeant story, a common trait of roll-up strategies is that they eventually run out of fuel. Often competition bids up the price of desirable acquisition candidates, or the value of the strategic premise erodes—both of which happened here.

Turning to the components of Allergan's and Valeant's Capital Agendas and their internal alignment, we can see strengths and weaknesses:

- Allergan's conservative leverage provided a financial cushion but also suboptimized capital costs, and created the opportunity for a hostile acquirer to tap into its unused debt capacity.
- David Pyott also admits the company should have looked harder at M&A opportunities: "In hindsight, we should have used the balance sheet more aggressively. We were trying to be disciplined," he says. Indeed, had Allergan used some of its balance sheet to acquire a competitor—a move it attempted once the hostile bid became public—it might have moved out of Valeant's reach.
- In many ways, Valeant's capital structure and M&A challenges were the opposite of Allergan's. As debt levels rose for each successive acquisition, capturing the cash flow synergies of increasingly expensive targets became essential to reducing leverage. The cycle ended when substantial drug price increases became untenable.

Premortem stress testing generates valuable insights

Figure 1.2 shows some additional possibilities for answers to the question "What went wrong?" in a Capital Agenda premortem exercise. Of course, many are discovered after the fact—during the *post* mortem. You can use these examples to stress test your Capital Agenda as you build and refine it.

During an introductory meeting on improving transaction processes, an executive said to us, "We have a great process in place to capture lessons learned from our strategic investments. The problem is that they're always the same lessons!" Employing the premortem approach will increase your chances of designing and implementing your Capital Agenda properly in the first place.

What went wrong?	What caused it?
We overpaid for the acquisition.	▪ Our CEO fell in love with it. ▪ Our due diligence did not properly vet the optimistic projections.
We failed to capture the planned synergies for the acquisition.	▪ Integration planning wasn't considered during due diligence. ▪ We didn't allocate enough resources to the functional work streams.
We waited too long to divest an underperforming business.	▪ We thought we could fix it. ▪ The group leader was incentivized on revenue and EPS contributions, not on shareholder value.
We had to retreat from an important market.	▪ A new competitor from another sector provided our best customers with a dramatically better value proposition.
We had to give the activist shareholder a board seat.	▪ We couldn't refute the activist's detailed critiques of our business units' returns on invested capital (ROICs). ▪ We couldn't articulate why our strategy was better for shareholders.
Our stock was downgraded.	▪ We have too much cash unnecessarily tied up in working capital.
We lost money on the joint venture.	▪ The business unit sponsor rotated into a job in another part of the company.

Figure 1.2 Possible answers to "What went wrong?"

Making the most of your Capital Agenda

Keeping in mind the following guiding principles will help provide order and prioritization as you hone all the moving parts of your company's unique Capital Agenda.

- *Principle 1: Enterprise-wide capital allocation*. Investing experts from Warren Buffett to large money managers to hedge fund icons agree that capital allocation is one of the most important functions of your executive team. All types of investment decisions–capital expenditures, R&D, acquisitions, dividends, and share repurchases—must be evaluated using consistent criteria. This applies equally to new uses of capital and to decisions on how to manage your existing business portfolio that represents capital already invested. See Chapters 3 and 4.
- *Principle 2: Comprehensive transaction strategy and processes*. There are well-defined, repeatable practices that raise the odds of success for M&A, divestments, and other inorganic investments. Chief among them is having a clear, actionable view on how you will create strategic and financial value. Another is to build organizational readiness at a tactical level to acquire and divest when opportunities arise unexpectedly. See Chapters 5 and 6.
- *Principle 3: Adaptive financing and payout policies*. Overall capital structure and financing choices for individual investments go a long way to determining your company's resilience. See Chapter 7. Dividends and share repurchases must balance shareholder preferences, operating needs, and risk. For private firms, the decisions concerning if and when to go public can have existential consequences.
- *Principle 4: Finance in sync with, and enabling, strategy and operations*. Your strategy and your operating model are translated into shareholder value through the Capital Agenda. As uncertainty rises, success requires closer collaboration among the policymaking

and implementation teams in finance, operations, and strategy. See Chapter 10. Proper stress testing across the Capital Agenda will help management more clearly understand and better communicate the explicit trade-offs between flexibility and efficiency.

Three essential traits of a sound Capital Agenda

The right Capital Agenda for your business has three important characteristics:

1. *Complete.* In addition to having all the requisite elements, each needs to work properly on its own. For example, a well-functioning portfolio management process helps ensure that every business unit is regularly reviewed using a consistent set of strategic and financial criteria. We cover this in more detail in Chapter 4.
2. *Aligned.* All these elements need to complement each other and align with your strategy and operations. It's no surprise that technology companies whose strategies emphasize heavy innovation tend to be predominantly equity financed in order to cushion the cash flow fluctuations that come with the ups and downs of R&D and commercial execution. Alignment among individual elements also helps executives make trade-offs, such as balancing share repurchases, capital expenditures, and M&A investments.
3. *Resilient.* This is where stress testing is particularly important. A complete Capital Agenda with good alignment also has to help your company thrive by absorbing downsides and, equally important, by taking advantage of new opportunities that crop up. Building divestiture readiness—via execution capabilities, a robust watch list, and virtual carve-out analyses—provides the flexibility to respond quickly both to unexpected cash shortages and to overheated market conditions for in-demand assets.

Performance improvement opportunities

Throughout the book we highlight valuable by-products that come from great execution around your Capital Agenda. These performance improvement opportunities often show up in financial results and operating processes. Though not a comprehensive list, we summarize a few here so you can be on the lookout for them:

- During acquisition integration, learn from the target to transform your own processes (Chapter 5).
- As part of regular portfolio reviews, simulate a *virtual* carve-out of each business. Analyzing the stand-alone costs may shed light on ways shared services can be rationalized (Chapter 4).
- Optimizing working capital management to liberate cash often leads to reduced costs (Chapter 8).
- Performing an activist shareholder vulnerability assessment highlights where information systems need to improve (Chapter 13).
- Analyzing your company's intrinsic value provides the basis for a more compelling dialogue with investors (Chapter 2).

Navigating the book

The remaining chapters first delve into the essential principles and practices for building a resilient Capital Agenda that drives shareholder value (Chapters 2–9). Then we turn to organizational capabilities like getting strategy, finance, and operations to collaborate, and extracting value from outside advisors (Chapters 10 and 11). Next we illustrate holistic applications—real-life examples, if you will—in digitalization, activism, and restructuring (Chapters 12–14). We conclude by outlining a strategic framework to support the Capital Agenda (Chapter 15).

With more than 20 contributors to the book (see Contributor Biographies), each chapter naturally has its own voice, so we hope you'll enjoy the variety as you gain actionable insights to help shape and execute your company's Capital Agenda. If you'd like to explore any of the topics we discuss in more depth, we have a companion website ey.com/capitalagenda that regularly refreshes our current thinking.

Notes

1. Throughout the book the terms *we*, *our*, and *us* refer to the authors and contributors collectively, who in turn represent EY.
2. Jeffrey Greene and Ellen Licking, "Capital Allocation in the Age of Shareholder Activism," *In Vivo: The Business and Medicine Report* 33, no. 5 (May 2015).
3. "What Caused Valeant's Epic 90% Plunge?," Reuters, 20 March 2016.
4. Gary Klein, "Performing a Project Premortem," *Harvard Business Review*, September 2007.
5. David Benoit, "How to Carve Up DowDuPont? Four Activists Sharpen Their Knives," *The Wall Street Journal*, 30 July 2017; "DowDuPont Alters Post-Merger Breakup Plans in Response to Investor Pressure," Reuters, 12 September 2017.