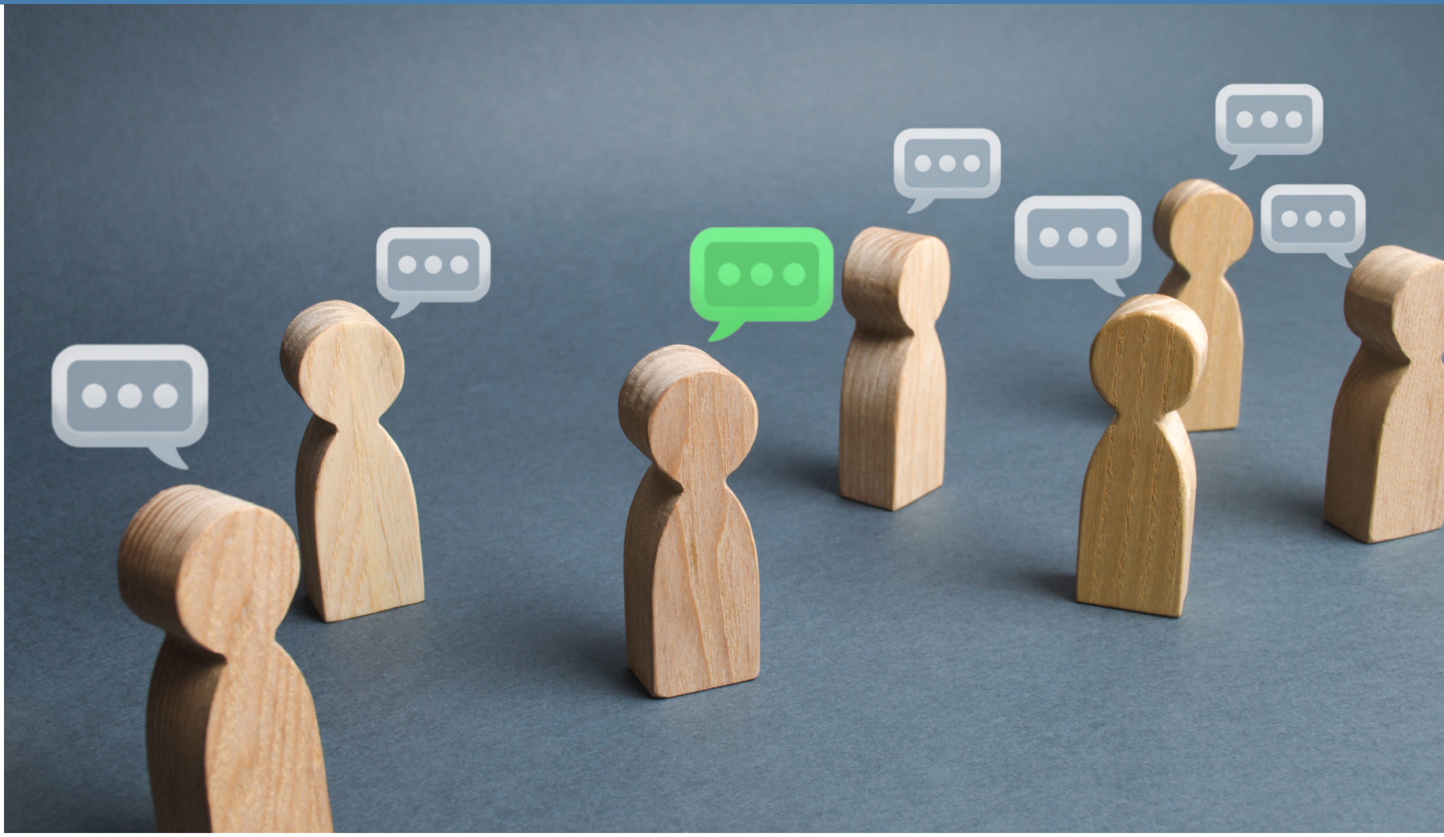


Leading Voices on Strategic Capital Allocation and Its Role in Outpacing Your Peers

Strategic capital allocation is the secret sauce to long-term growth, with ample evidence demonstrating how those companies which master it consistently deliver higher returns to shareholders.

Yet, the reality is that many business leaders choose to prioritize their company's capital for short-term performance, given a host of factors, not the least of which is the ever-present pressure from those same shareholders.

In this e-book, we'll explore expert opinions on strategic capital allocation that underscore its importance and then provide a roadmap for how to do it well.

> Capital allocation is the most important responsibility of the chief executive officer.

Morgan Stanley

As with most things, corporate performance starts with leadership … and for leaders who have a vision and have articulated a roadmap, that means following up with concrete actions that translate passion and purpose into results.

It's why strategic capital allocation – the process of distributing an organization's financial resources across M&A, dividends, share buybacks, paying down debt, and Capex to maximize shareholder returns – is so important. It's a balancing act, for sure, though growth is clearly tethered to strategic investment.

Morgan Stanley says that capital allocation is the top priority for CEOs, and Credit Suisse agrees, asserting that "capital allocation is a senior management team's most fundamental responsibility."

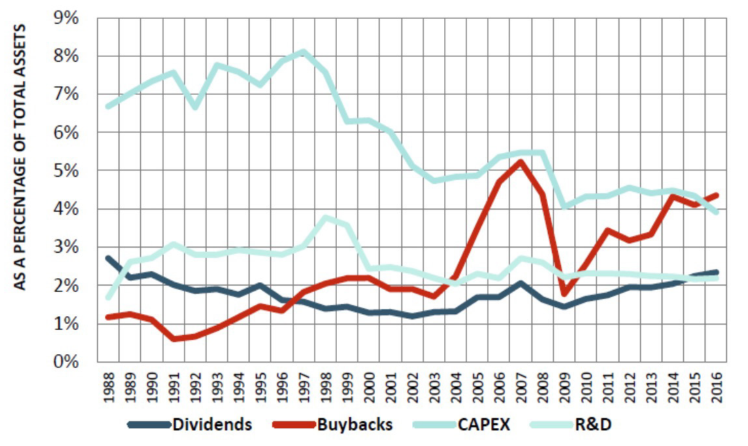
Outperformers invest approximately 50% more in Capex than their peers.

BCG BOSTON CONSULTING GROUP

That's because those that do it well – and dedicate sufficient resources to Capex – consistently outperform their peers.

In recent years, many C-suites have preferred returning cash to shareholders rather than investing in capital projects. A survey from Boston Consulting Group (BCG) "found Capex levels relative to revenues at a 20-year low, having dropped almost 20% between 1995 and 2015. Over the same period, payouts to shareholders (dividends and share buybacks) relative to revenue rose more than 60%."

Exhibit 2: Dividends and Buybacks versus CAPEX and R&D

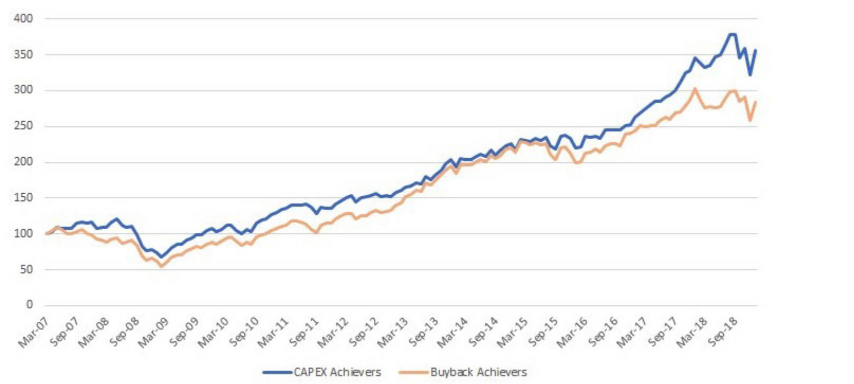


SOURCE: Taking Stock: Share Buybacks and Shareholder Value, Harvard Law School

This shift may result in short-term stock gains, but tends to erode value over time. The same BCG report found that "outperformers—companies in the top third of stock market valuation relative to their peers—invest approximately 50% more in Capex than their peers and achieve approximately 55% higher returns on assets and approximately 65% higher sales growth."

This inclination towards payouts over Capex isn't surprising, particularly for public companies that face significant pressure to deliver immediate returns to shareholders. However, the substantial rewards of a well-funded, strategically-aligned Capex portfolio shouldn't be overlooked.

Exhibit 3: Performance of the Nasdaq CapEx Achievers Index vs. the Nasdaq Buyback Achievers Index



SOURCE: Capital Expenditures vs Share Buybacks: How Do Investors Want Companies to Spend?, RiXtrema

Organizations that focus on actions across … the capital project portfolio … can reduce project costs and timelines by up to 30% to increase ROIC by 2-4%.

McKinsey&Company

McKinsey highlights that businesses with prudent Capex strategies can “increase returns on invested capital (ROIC), the most important metric of financial value creation … This strategy is even more vital in competitive markets, where ROIC is perilously close to the cost of capital.”

Unfortunately, “short-termism” often stands in the way of top-level returns.

The powerful forces of short-termism affecting corporate behavior … certainly supports returning excess cash to shareholders, but not at the expense of value-creating investment.

BlackRock.

BlackRock CEO Larry Fink warned in his shareholder letter against these powerful forces, and that BlackRock continues “to urge companies to adopt balanced capital plans … that support strategies for long-term growth.”

After all, “Most companies allocate the same resources to the same business units year after year. That makes it difficult to realize strategic goals and undermines performance.”

Trying to make bold changes when you start each year’s budget with last year’s spend can be like trying to turn a cruise ship. Inherently more focused on increments and potentially stifling decision agility when circumstances change, it can be hard to fathom why so many organizations continue in this fashion.

McKinsey calls it “resource allocation inertia,” as it can stall a company’s strategic direction and impede its ability to implement initiatives that can be the catalyst for growth.

Moreover, it can put executives in the hot seat.

“Over an average six-year tenure, chief executives who reallocated less than their peers did in the first three years on the job were significantly more likely than their more active peers to be removed in years four through six,” they go onto say, concluding that:

“Given the performance edge associated with higher levels of reallocation, such static behavior is almost certainly not sensible. Companies that reallocated more resources … earned, on average, 30 percent higher total returns to shareholders (TRS) annually.”

Exhibit 2

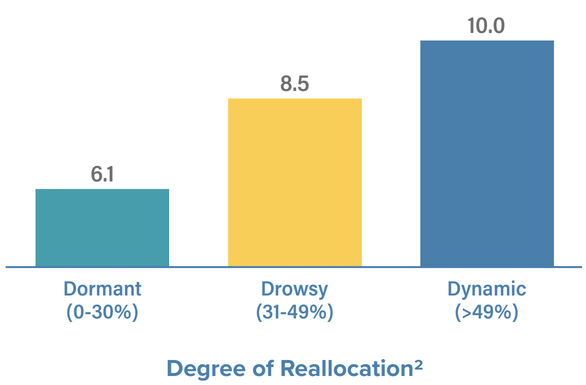
Companies with higher levels of capital reallocation experienced higher average shareholder returns.

SOURCE: How to put your money where your strategy is, McKinsey Quarterly

The reward for high rates of reallocation is considerable: dynamic re-allocators achieve significantly higher TRS

1,508 companies, 1990-2010

Median TRS CAGR1 of companies by degree of reallocation, Percent



A company growing at 10.0% CAGR vs. 6.1% would be worth twice as much in 20 years[3]

SOURCE: Strategic Resource Allocation: Putting Your Money Where Your Strategy Is, McKinsey & Co.

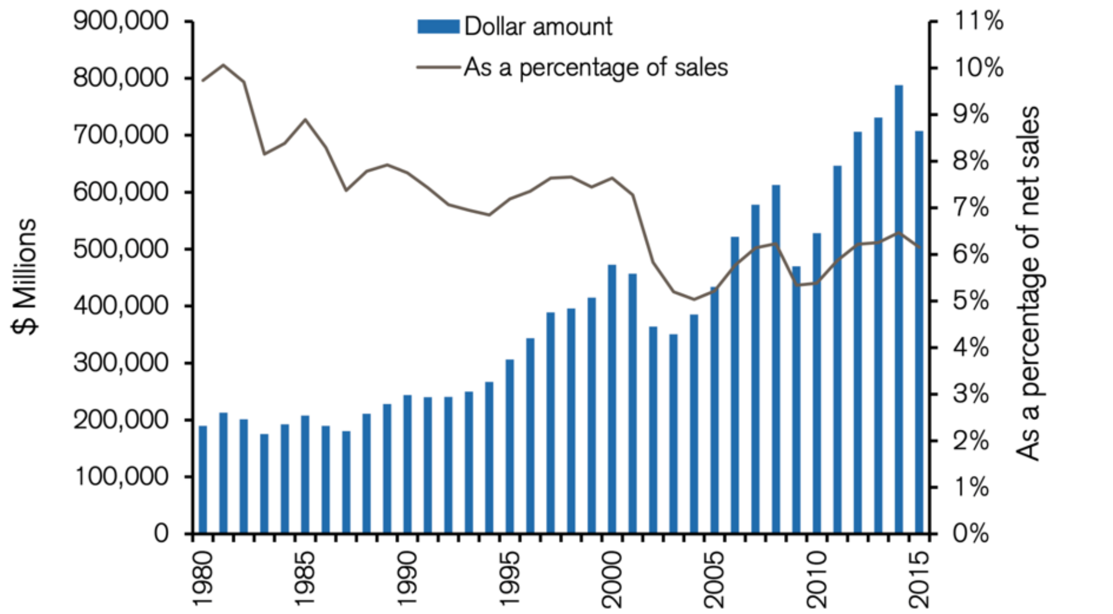
Despite the higher returns that these “dynamic allocators” generate, research shows that public companies tend to fall into the short-termism trap more than their private counterparts.

Public companies invest less than comparable private companies because they want to maximize short-term earnings.

CREDIT SUISSE

Credit Suisse found that, between 1980 and 2015, U.S. Capex as a percent of sales decreased from roughly 10% to 6%, with one cause of the dip being that "public companies are now investing too little. Academic research suggests that public companies invest less than comparable private companies because they want to maximize short-term earnings."

Exhibit 23: U.S. Capital Expenditures, 1980-2015



SOURCE: Capital Allocation: Evidence, Analytical Methods, and Assessment Guidance, Credit Suisse

But the idea that investors put a premium on short-term performance is misguided—"Academic work on capital expenditures broadly supports the idea that the market rewards value creation and refutes the idea that investors prefer short-term earnings gains at the expense of long-term value creation."

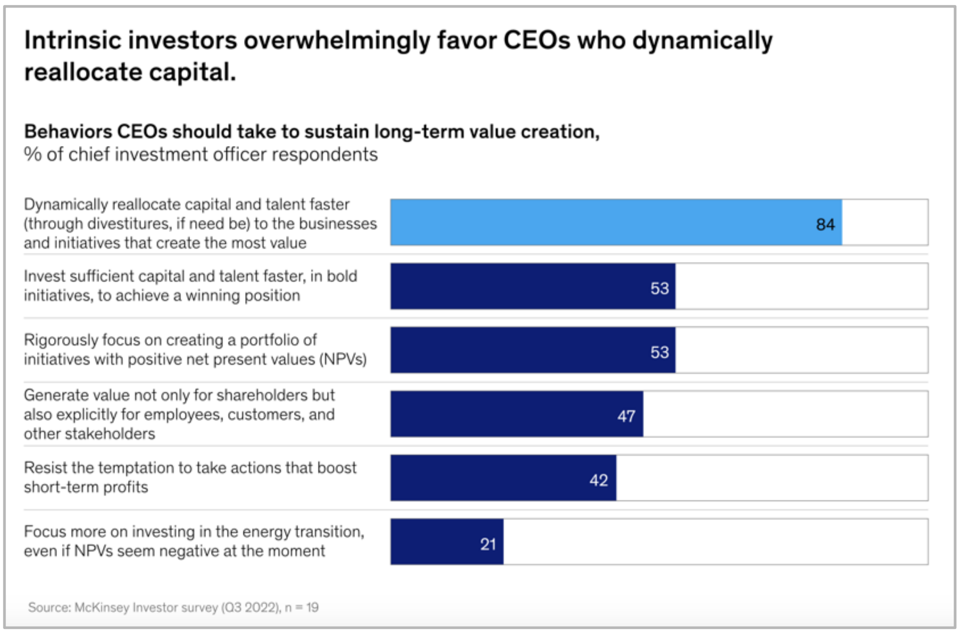
The evidence is clear—businesses that orient their capital portfolios around long-term value creation outperform over time. But how can you get to this point?

How strategic capital allocation is done well

Leading industry experts recommend a systematic capital allocation approach for getting into the top quartile of ROIC:

1. There is no such thing as a "fair share" in capital allocation.

Every capital allocation choice should be tightly aligned with the company's overall strategy. As McKinsey points out, "highly effective companies manage capital allocation differently. That starts with corporate governance ... There is no such thing as a "fair share" in capital allocation," and CEOs need to dedicate a significant portion of their time being "relentless in allocating resources toward growth."

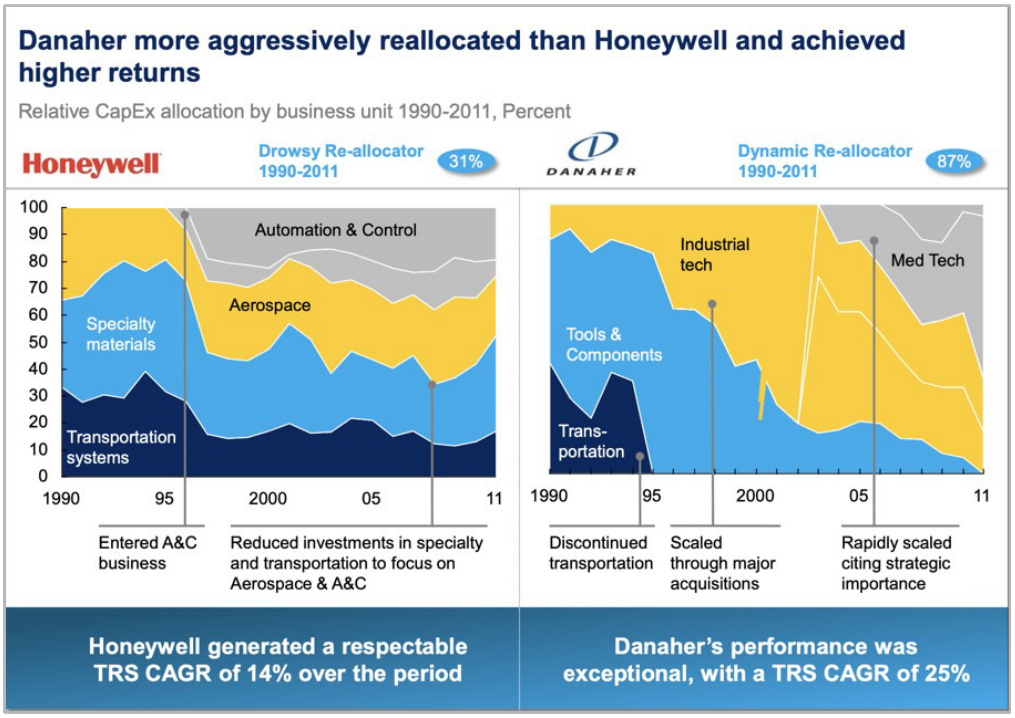


SOURCE: Capital allocation starts with governance—and should be led by the CEO, McKinsey & Co.

2. Monitor and adjust regularly—resist "resource allocation inertia."

Companies should resist the urge to base the current year's capital budget on last year's spend—instead the process should be dynamic. Leaders should regularly review and adjust their capital allocation decisions as conditions change, and make bold investments when opportunities present themselves. Always playing it safe will erode returns over time.

For example, between 1990 and 2011, the global conglomerate Danaher frequently and significantly changed the makeup of its capital portfolio to respond to market shifts, while its competitor, Honeywell, kept its portfolio largely the same. Danaher was rewarded with a Total Return to Shareholders (TRS) CAGR of 25%, compared to Honeywell's 14%.



SOURCE: Strategic Resource Allocation: Putting Your Money Where Your Strategy Is, McKinsey & Co.

3. Communicate decisions clearly.

Companies should clearly communicate their capital allocation decisions to all stakeholders, including employees, investors, and analysts. Clear communication helps build trust and ensures that everyone understands the company's overall strategy so they can pull in the same direction.

4. Capital allocation is about looking at the forest and the trees, and top performers look at the forest first.

As BCG notes, "The outperformers in BCG's capital allocation database invest systematically in businesses that create value from a strategic as well as a financial point of view." Looking at both of these factors in tandem helps companies avoid "the maturing-business trap (not reducingn Capex even though the business is maturing) and the egalitarian trap (every business unit gets its "fair Capex share," irrespective of potential)."

There are many examples of this “business-potential based” approach leading to superior outcomes. After sensing a shift in the market, IBM was able to quickly pivot from hardware to cloud services and capitalize on a new growth area. Similarly, even though Tata Consultancy Services’ call center business was doing well, it reoriented its focus into more value-adding services, which helped boost shareholder value.

5. Maintain a balanced investment portfolio.

Whether it’s M&A, dividends, buybacks or Capex, each component of a capital stack deserves consideration, and none of them individually should dominate the portfolio. Leaders should resist the urge for short-termism and focus their energy on relentlessly pursuing initiatives that boost long-term growth.

Amazon is famous for its laser-focus on long-run returns. Its aggressive reinvestment strategy poured nearly all its profits back into the business, fueling capital projects that set it up to become the cash-generating machine it is today.

6. “68% of CFOs say ROIC is the most helpful KPI in their dashboard.”

EY

ROIC may not be the most talked-about metric in the C-suite, but it’s hard to overstate its importance. An EY survey found that 68% of CFOs label ROIC as the most helpful KPI in their dashboard.

During Tom Scalera’s tenure as CFO at ITT Corporation, for example, the company grew its market cap from $1 billion to $8.6 billion. He viewed ROIC as the most important metric to measure himself against, since it provided credibility with shareholders and the board, which allowed him to extend his tenure and make bold investments.

Ultimately, achieving high ROIC isn’t just about making profitable investments—it’s also about avoiding poor performing ones. Companies need to be willing to divest from underperforming businesses or projects so they can free up capital and reallocate it to more profitable opportunities.

In Summary

As the cost of capital rises, and the impact of making missteps increases exponentially with 24/7 public attention, truly proactive management of the capital investment pipeline has never been more important.

It would be a mistake to say that the typical process of adjusting the budget year-over-year, asking project owners to compete for a "slice of the pie," and then revisiting the forecast quarterly is logical when there are few or no headwinds facing a business.

Because, even then, capital investments aren't necessarily being made on the individual merits of a project, how strategic factors might warrant consideration over and beyond classic metrics such as hurdle rate, unforeseen changes in demand for a product or services, etc.

Today, with a pandemic in the rearview mirror, but persistent supply chain challenges, the rising cost of capital, a data-empowered public and activist Wall Street, issues surrounding sustainability becoming more urgent, and so forth, companies that adapt a "set it and forget it" approach to capital allocation do so at their own peril.

At Finario, our mission as a company has always been to empower those who are stakeholders in how capital is allocated and deployed ... who believe that Capex is about investing, not spending ... who aim for the very best.