Capital Allocation | April 11, 2017| CFO.com | US

In Health Care, Reinvestment Outshines Dividends, Buybacks, Debt

To drive shareholder returns in health care, CFOs should stress financial policies that build financial flexibility rather than leverage.

Greg Milano, **Marwaan Karame, Joseph Theriault**

Health care executives are pulled in many different directions, and strategic and tactical choices have become increasingly complicated in such areas as capital deployment and financial policy.

One question could be, for example, Should the company invest more capital in research and development and acquisitions? Or should reinvestment be pared down to allow for more dividends and stock repurchases? Should the company build cash and maintain financial flexibility, or should it lever up with tax-deductible debt to reduce the theoretical weighted average cost of capital?

Industry experts, sell-side stock analysts, journalists, consultants, and university professors have varied opinions. These opinions may even differ with those of shareholders, the most important constituent. We believe, however, that it's best to look at actual market in making such decisions because what people (including shareholders) say and what actually happens in the market are often very different.

In that context, we recently completed the Fortuna Advisors 2017 Healthcare Shareholder Value Project with the generous financial support of a few health care company sponsors. In this article, we'll cover capital deployment and financial policy, while in the second one we'll discuss business strategy and performance measurement.

The ultimate financial performance goal of executive management is to drive long-term total shareholder return (TSR) via share price appreciation and dividends. We used financial performance and capital market data on about 100 companies over 52 rolling three-year periods going back to 2003 to test the relationship between TSR and 19 capital deployment metrics and 16 financial policy metrics.

For each metric in each three-year period, we sorted companies into high, medium, and low groups, and then aggregated all three-year periods so we could compare the median TSR of the high and low groups. This law of averages approach cuts though the noise and mood swings of the market that often cloud or weaken traditional methods such as regression analysis. We find this method to not only be directionally accurate in its conclusions, but easy to intuitively understand.

Capital deployment strategy involves the allocation of financial resources to such uses as capital expenditures, acquisitions, R&D, dividends, and stock buybacks. Many view capital deployment as one of the most important responsibilities of senior executives and the board.

The R&D reinvestment rate showed the strongest positive capital deployment relationship to TSR, where the median TSR for the high group was 6% greater per year than that of the low group. These "rate" metrics are defined as the capital deployment item (such as R&D or capex) divided by after-tax EBITDAR (R&D added back).

Those reinvestment rates test better than percent-of-sales metrics in capital market research. They also have the behavioral benefit of encouraging higher investment as a percent of sales in more profitable businesses and lower investment intensities in less profitable businesses.

The total reinvestment rate (+3.3%/year) and the total gross cash acquisition reinvestment rate (+3.3%/year) also tested well. But surprisingly, the capex reinvestment rate did not test well (-2.1%/year). Many view organic capex investments as being less risky, but the facts show that health care companies that emphasized R&D and acquisitions performed much better than those investing in organic capex.

The biggest inconsistency we find between what investors say and what they do involved distributions. Despite endless investor requests for dividends and buybacks, the capital deployment metric with the worst relationship to TSR in health care is the total distribution rate (-7.3%/year), which combines dividends and stock buybacks.

Right behind it are the dividend distribution rate (-7.2%/year) and the net buyback distribution rate (-6.7%/year), which reflects buybacks net of issuance. Interestingly, the gross buyback distribution rate (-0.6%) doesn't fare as badly, which seems to indicate that buybacks only seem to be a drag on TSR if the share count actually declines.

Overall, while most forms of investment are beneficial, distributions are not. This may be best understood in the context of the superior overall industry performance during this decade and a half. The health care industry has significantly outperformed the broad stock market. That was even true during the first quarter of 2017, when new potential industry regulation was being considered in Washington.

In such a value-creating environment, putting money to work by investing in growth and innovation has, on average, led to much higher TSR than simply giving the money back to shareholders via dividends and buybacks.

These capital deployments are consistent with and corroborated by our financial policy findings. Maintaining and building financial flexibility is associated with higher TSR, while companies with higher debt levels tend to have lower TSR.

In perhaps the most astonishing finding of the study, high net issuers of shares outstanding proved to earn the highest difference in median TSR in the financial policy category (+9.0%/year). That's probably more because of the drugs, products, indications, or markets pursued with the proceeds from share issuance than just the act of issuing shares.

But that's still a counterintuitive finding, since so many view shareholder dilution as something to be avoided at almost any cost. And this benefit proves to be fairly consistent through time.

Net debt pay down as a percent of total capital (+7.2%/year) was the next most important TSR driver. And, not surprisingly, having higher levels of net debt as a percentage of total capital (-5.1%) is associated with lower TSRs.

In an industry with such large and, on average, successful organic and acquisitive investment opportunities, maintaining the financial flexibility to be able to make these investments opportunistically has been quite valuable.

For the typical health care company, future TSR would likely benefit from more generous R&D and acquisition strategies, fewer stock buybacks, less dividend growth, and paying down debt or building cash when no immediate investments are available.

Few companies are typical, though. The findings presented here varied somewhat when our research was extended to sub-industries (pharmaceuticals, equipment, services, or biotech, for example). So when you set capital deployment strategy and financial policy, it's important to consider the nuances of the company and sub-industry.

Gregory V. Milano is the founder and chief executive officer of Fortuna Advisors, a value-based strategic advisory firm. Marwaan Karame and Joseph Theriault are partner and vice president of the firm, respectively