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10 Key Principles for Effective Capital Deployment: Part 1

Here are the principles that provide a foundation for establishing an enduring capital deployment process to drive long-term value creation.

By **Greg Milano**

Capital deployment decisions are among the most important strategic choices facing managements and boards. However, it can be difficult to choose between investing organically or acquisitively in the business versus paying down debt, building cash, or distributing capital via dividends or share repurchases.

Some companies are better off distributing more while others should emphasize investing. But many find the tradeoffs to be unclear, because companies often use different metrics for evaluating the different options. This complexity is best dealt with by establishing principles to guide management and designing processes to rigorously follow those principles.

We've identified 10 key principles for effective capital deployment that provide the foundation for establishing an enduring capital deployment process to drive long-term value creation. The first five principles appear below; the other five will be covered in the second article of this report.

Principle 1: The Top Priority Is Survival

To have an opportunity to achieve success, company leadership must first circumvent complete failure by ensuring business survival. Management must avoid excessive risk-taking, provide adequate financing capacity and liquidity, and protect important tangible and intangible assets, including key personnel, brands, technologies, and other essential differentiators.

Many business failures are avoidable with adequate forethought and planning, but most truly difficult challenges come from underestimating change.

For example, companies producing record albums when CDs were introduced in 1984 probably expected a more gradual transition, but what they got was an abrupt upheaval. By 1990, most music was purchased in the form of CDs. And then CDs were replaced by electronic content ownership, which has now been replaced by streaming. What's next?

Survival is obviously the top priority, but most managements don't pay enough attention to change. Management must devote resources to identifying potential threats to survival and then act to get ahead of change and turn these potential threats into opportunities.

The biggest obstacle, of course, is short-termism, which is reinforced by overconfidence, procrastination, and a distaste for cannibalizing existing products or services. It also doesn't help that many managers feel they can readily influence their own short-term compensation but often view long-term incentives as a bit of a lottery.

Management processes and incentive compensation must be structured to explicitly address and reduce the impact of each of these obstacles.

Principle 2: Buy Low and Sell High — Really

To emphasize **net present value** in capital deployment requires a mindset of always buying low and selling high. In the movie "Caddyshack," Rodney Dangerfield bellowed into his golf bag phone, "What's that? Then sell! Oh, they're selling? Then buy!" Audiences laughed because of the absurdity, but also because of the cliché.

Still, clichés are clichés for a reason, and the value of selling when others are buying, and vice versa, is obvious to the vast majority of investors. But corporate executives tend to do the opposite. It can sometimes be difficult to tell when prices are too high or low, so executives must pay careful attention to cycles and rely on thoughtful analysis to actually buy or sell assets when prices are favorable.

One important way to do this is to explicitly factor the expectation of operational, financial, and other cycles into planning and decision-making.

One oil and gas CFO explained how he uses the same midrange oil price when considering the acquisition of new oil and gas reserves, regardless of where the industry is in the commodity price cycle. That way, he tends to buy more reserves when they are cheap and fewer when they are expensive.

For companies in industries that don't experience much cyclicality in financial performance, it's still important to pay attention to market cycles.

From the 2007 peak to the trough of the market in the 2009 financial crisis, the median utility company suffered TSR of –41%. Utilities are not viewed as being cyclical. Indeed, the median utility, Exelon, saw its EPS increase slightly from $4.03 to $4.09 from 2007 to 2009, while its EBITDA increased 9.5%.

Sp why was its TSR–41%? Market fear. Exelon acquired no competitors that year, but perhaps it could have improved its long-run performance by buying a very stable competitor that would have essentially been on sale.

Principle 3: Don't Follow the Crowd

Make it a strong policy to never select capital deployment choices because some loud shareholders ask you to do it, or because bankers say everyone is doing it, or because you overheard on the golf course or at the yacht club that your rival is doing it.

Did Warren Buffett see everyone buying railroads in 2009 when he announced the investment of $34 billion to buy the Burlington and Northern Santa Fe railroad? Doubtful. In fact, it was the fact that everyone lost interest in railroads that created the opportunity. Did he care what the immediate investor reaction would be, or did he focus exclusively on whether he could buy an asset for less than his assessment of its long-term intrinsic value?

We seek to make capital deployment choices that create value regardless of whether they are perceived as "trending." And indeed the best investments are often not trending; good — that is, value-creating — ideas that everyone is pursuing aren't value-creating for long.

This contrarian mindset is not new. In 1841, Charles Mackay published "Extraordinary Popular Delusions and the Madness of Crowds, "which discusses Dutch tulip-mania, the South Sea Company bubble, and numerous other examples where the crowd, or the market for our purposes, got it wrong.

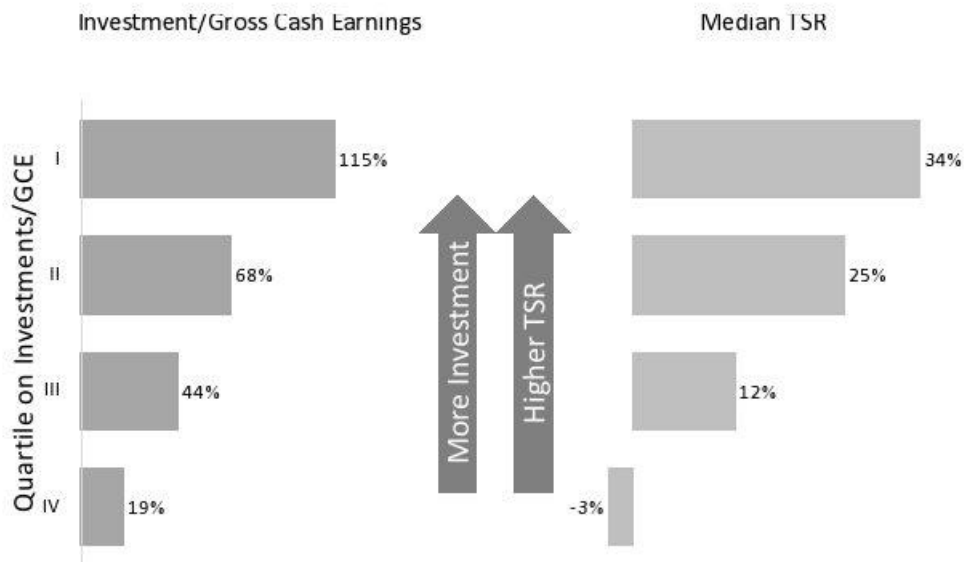
Market bubbles are an unbelievably interesting deviation from long-run market efficiency, and Mackay's book offers one of the earliest commentaries on the subject. What's most useful for corporate managers is to understand the innate desire to follow the crowd. This type of "herding" can be seen today by both companies and investors in the market.

For those who were old enough at the time, look back at the Internet bubble and think about the typical business news commentary in those days. The repetitive buzzing of "profits don't matter anymore, it's about clicks and eyeballs" fueled an emotional response, a "fear of missing out." The FOMO, afflicted even the well-schooled in finance, valuation, and basic economics, among other less sophisticated investors.

Capital deployment processes must explicitly contemplate emotional bubbles and their effect on the likely trends and opportunities to be managed.

Principle 4: Investment Usually Outperforms Financial Engineering

Much more long-term value comes from investment and execution than from financial engineering. The graphic below shows the positive relationship between investment in the business and TSR.



Investment creates value, on average, because it's not a zero-sum game; and companies, on average, deliver returns well above the required return demanded by investors.

Managers need to be disciplined, since it's easy to make bad investments, but this should only lead them to be extra careful rather than lead them to avoid making investments altogether. As long as the incremental return is above the required return, managers should drive the reinvestment rate as high as possible.

Principle 5: Prioritize Organic Investment

Virtually all great business success stories began with some form of organic investment, especially investments that increased differentiation through innovation and branding. So, organic investments should always be given priority over acquisitive investments.

The range of organic investment opportunities is wide. It includes projects that are familiar, have reasonable risk exposures, and are expected to produce decent, but not extreme, upside potential.

Such projects include expanding production capacity, improving efficiency and productivity, and updating the look and feel of retail stores, restaurants, and hotels. These can be classified as either doing more of what we already do or doing what we do better.

Opportunities also exist to invest in less familiar areas, sometimes taking on greater risks and potentially realizing extremely substantial returns. This can include the development of new products and services,

the marketing launch of totally new or significantly rejuvenated brands, or the expansion of delivering products and services to new geographies.

For example, consider a pharmaceutical company that contemplates investing for many years in expensive scientific research with the hope of developing a new drug that then requires tremendous research and marketing to ensure efficacy, navigate regulatory approval, and bring the treatment to market.

Every company should dedicate at least a reasonable portion of its investment budget to higher risk-reward areas; and for those with existing commercial products and services, there will usually be plenty of opportunity to make lower risk-reward investments to drive the existing business forward.

But both the low- and high-risk organic investments should be prioritized over acquisitive investment.

10 Key Principles for Effective Capital Deployment: Part 2

Acquire carefully, beware of leverage, have rules-based buyback processes, don't bank on dividends, and realize that value creation is hard work.

Principle 6: Be Willing to Grow Carefully by Acquisition and Shrink Through Divestitures or Spinoffs

It has become a bit of a business cliché to say that "most acquisitions destroy value." Fortunately, this is not true, generally.

The vast majority of our capital market research across industries and varying time periods shows that those investing more in acquisitions do, on average, deliver higher average TSR.

We all know of spectacular acquisition failures, such as the 1998 acquisition of Chrysler by Daimler and the 2010 acquisition of Palm by HP. Both deals turned out terribly for the acquirer in rapid fashion. These and other such disasters make for eye-catching news headlines but are truly a small minority of cases.

Although acquisitions should be a second priority behind organic investment, it is quite possible to build a successful acquisition track record. Like learning all other skills, acquisition expertise requires development and practice. That's why serial acquirers tend to perform better than occasional acquirers.

It's also critical to align acquisition strategy with business strategy. Companies should actively monitor a list of potential targets and constantly grade them on fit and desirability, as indicated by the value expected to be received in relation to the price.

Success is much less likely with such a deliberate process, versus when deals originate with a banker stopping by with a pitch book of ideas, or an offering memorandum on a company that wasn't otherwise contemplated by the acquirer. It's like having a real estate agent regularly show you and your family houses that are available; you may end up moving to a bigger and more expensive house than you'd previously considered.

Principle 7: Leverage Tends to Stifle Investment

Maintaining high debt leverage can be a bigger problem than buybacks in some companies. In good times, leverage seems good. If our business is growing strongly with nice profit margins and decent rates of return, having more leverage will amplify the EPS growth rate, and total shareholder will often follow it, to at least some degree.

But if, or frankly when, the economy falters, the industry loses momentum, or our company suffers a competitive setback, perhaps due to a new competitive product that leapfrogs our own, then the leverage will amplify the downside just as it did the upside.

From the S&P 500 peak on October 9, 2007, through the trough on March 9, 2009, the S&P 500 fell 57%. In most sectors, the companies that had higher total debt as a percentage of EBITDA at the start of the market downturn had worse TSR over the 17-month period than their less-levered peers. The most notable exception to this was health care, which is among the least cyclical of industries.

What's worse is that the amount of debt leverage seems to also have a negative impact on the willingness to invest in growth. This is unbelievably important, yet generally goes unrecognized.

Many corporate finance experts claim that having more debt creates value by causing a reduction in the weighted average cost of capital and showing how the present value of free cash flow rises. But they fail to incorporate the effect the debt has on the amount of long-term free cash flow.

Companies faced with the financial risk associated with high debt levels tend to invest less in the business, and this behavioral effect can make company value drop even though the company has reduced its weighted average cost of capital.

Principle 8: Implement Buyback Execution Rules

The goal of buybacks should be to create value for the remaining shareholders by buying back shares that management believes are worth more than what must be paid to repurchase them. It's no different from buying stock in another company.

To combat the tendency of companies to buy back more stock when it's expensive than when it's cheap, as discussed above, companies should implement rules-based processes for executing stock buybacks.

It's important to recognize that companies pursuing buybacks tend to suffer declines in their price-to-earnings valuation multiple. So, perhaps companies should mandate that the words "buyback" and "EPS" never be mentioned in the same meeting, and whoever breaks this rule has to put $20 in the holiday lunch fund. At least for the first year of this policy, it should provide a tidy sum for some joyous celebrating at year-end.

Principle 9: Dividends Are Value-Neutral

Potentially the most misunderstood use of capital is the dividend, which is only a means of giving shareholders access to money they already own. Nothing more, nothing less. By definition, dividend policy cannot create long-term value.

There is a theory that dividends communicate confidence in the business, and sometimes this is true. But frankly, a faltering dividend trend is more likely to convey a lack of confidence. Dividends are more an outcome of capital deployment strategy than they are a strategy in and of themselves.

One potentially beneficial, but rarely tapped use of dividends is as a better alternative to stock buybacks when a company wants to distribute excess capital while its share price is above the midpoint of the market cycle. This still isn't true value creation; it's the avoidance of the value destruction that would come from buying back what will later seem to have been overpriced shares.

Principle 10: Value Creation Is Hard Work

Recognize that there are no tricks, easy paths, or quick fixes. For example, if the company's earnings have been growing for a few years, but now the economy is peaking and earnings growth is slowing, a quick fix to boost next quarter's EPS by repurchasing a boatload of stock may give the share price a pop on the announcement date.

But over the ensuing cycle, management and shareholders alike will probably regret the move and wish management had held the cash to be used when assets, including the company's own share price, were more attractively priced.

Of course, the golden rule of capital deployment — whether we're considering capital expenditures, acquisitions, or buying back our own shares — is that value is created only when we buy something that turns out to be worth more than what we paid.

If we're interested in long-term, sustainable value creation, what matters is what something worth over the long haul, not the day after we buy it.

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