T. Rowe Price

Why capital allocation matters for companies and investors

From the Field
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Key Insights

- Even companies with modest growth can create significant value for long-term shareholders. Strong capital allocation is key.
- Many companies do not deploy capital well, in my experience. Those that do so have an opportunity to differentiate themselves over time.
- The market does not pay enough attention to capital allocation, an inefficiency that can be exploited.

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The market and financial media often gravitate toward companies that are growing rapidly or offer exposure to popular themes.

Capital allocation may seem like a decidedly less exciting subject. But how companies put their cash flows to work can be an important, if broadly underappreciated, driver of a stock's long-run performance.

As a portfolio manager, I'm thrilled by the market's inattention to the power of capital allocation. This inefficiency leads to investment opportunities.

The power of sound capital allocation

Companies that deploy excess capital at attractive rates of return can create significant value for shareholders over time, even in the case of mature businesses that are growing organically at a modest pace.

In the best scenarios, two mutually reinforcing factors drive what can be a powerful flywheel for total returns.

1. Free Cash Flow (FCF) Conversion: FCF is the capital that's left after the costs of running a business and maintaining its physical assets. Companies that turn a higher percentage of their profits into FCF have extra cash to

What's capital allocation?

The process whereby companies decide how to spend their money and time, ideally with the aim of meeting a strategic goal and generating a return on that investment over a reasonable period. Examples include:

- Building or closing a plant
- Research & development (R&D)
- Expanding into a new market
- Buying productivity-enhancing software
- Mergers & acquisitions (M&A)
- Selling or spinning off part of the business
- Repurchasing stock
- Paying a dividend

Historical examples of smart capital allocation

(Fig. 1) How strong capital deployment enhanced modest organic revenue growth

AutoZone	Danaher	Roper Technologies
– Grew revenue by aggressively opening new stores (CapEx) – Used scale and buying power to improve margins and FCF – Added low-cost debt, increasing capital for deployment – Repurchased a lot of stock	– Used FCF to buy faster-growing, less volatile businesses – Operational efficiency and spending on R&D/marketing drove growth – Transformed from focus on industrial technologies to life science tools – Divested or spun out non-core businesses to create value	– Used high FCF to shift business mix to niche software and health care – M&A centered on private companies, where valuations can be more favorable – FCF growth and improved earnings quality drove the stock

The historical examples provided are for illustrative purposes only. Historical information is not representative of future occurrences. Past performance is not a reliable indicator of future performance. The specific securities identified and described do not represent recommendations to buy or sell any security, nor do they represent performance of an actual investment in the specific security. There is no assurance that an investment in any security was or will be profitable. CapEx = capital expenditures.
Source: T. Rowe Price analysis of company reports.

pursue growth initiatives, pay dividends[1], or repurchase shares.

2. Smart Capital Deployment: If a company uses this excess capital in ways that are likely to generate attractive returns, long-term shareholders should benefit from faster growth in earnings per share. And more free cash flow equals more cash for the company to put to work in productive ways. Any dividend payments would also contribute to a stock's total return.

Bottom Line: Companies that reinvest their capital well have the potential to boost their earnings growth.

The stock may also fetch a higher valuation over time if these investments improve the quality of the business by expanding overall margins, reducing the volatility of its cash flows, or adding exposure to faster-growing markets.

Smart capital allocation isn't easy

In my experience, most companies do not deploy capital effectively, so those that reinvest their cash flows wisely typically stand out over time.

Corporate boards and management teams tend to focus on strategic priorities, such as entering a new market via an acquisition.

This emphasis becomes problematic if pursuing these goals results in poor returns because the deal valuation and assumptions about future performance were too aggressive.

Putting money behind strategic objectives is relatively easy, but getting an attractive return on that investment is much harder.

Historical case study: A tale of two General Electrics

How a company reinvests and distributes its excess cash flow can make or break its fortunes over time. Consider General Electric's experience over a roughly 40-year period.[2]

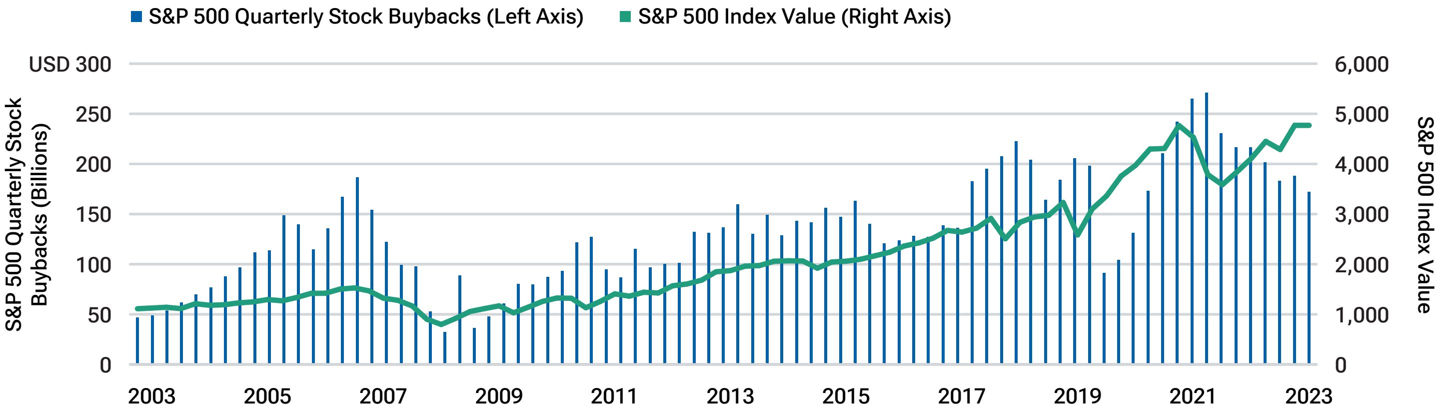
- **1980–2000:** The conglomerate improved its industrial portfolio by getting rid of lower-quality businesses, such as coal and natural gas production. A focus on operational excellence and an improved mix of businesses helped to boost General Electric's free cash flow significantly. Strong execution and smart deployment of this excess capital, including share buybacks and dividends, contributed to growth in earnings per share that was routinely above market.
- **2001–2018:** Poor capital allocation resulted in hundreds of billions of value destruction, even excluding the problems at GE Capital that came to a head in the global financial crisis. Much of the damage came from buying assets in oil and gas and power plant construction that already faced headwinds. General Electric also overpaid for growth assets in water and health care that it ended up selling at significantly lower prices.

Key Lessons: Bigger is not necessarily better. The risk of value destruction increases when operational execution and a realistic view on potential returns take a backseat to empire building or buying revenue to try to hit an overly ambitious target earnings growth.

[1] **Dividends are not guaranteed and are subject to change.**
[2] **The historical examples provided are for illustrative purposes only. Historical information is not representative of future occurrences. Past performance is not a reliable indicator of future performance. The specific securities identified and described do not represent recommendations to buy or sell any security, nor do they represent performance of an actual investment in the specific security. There is no assurance that an investment in any security was or will be profitable.**

Share repurchase timing has been poor

(Fig. 2) Buybacks declined in past market downturns and increased in stronger markets*



December 31, 2003, to December 31, 2023.

Past performance is not a reliable indicator of future performance.

Source: T. Rowe Price analysis using data from Bloomberg Finance L.P. See Additional Disclosure.

*Aggregate quarterly buybacks for companies in the S&P 500 Index are based on the index members at the end of each year.

Behavioral bias and timing issues

Academic research highlights just how difficult and counterintuitive good capital allocation can be:

- **CapEx:** Companies that stepped up their capital spending meaningfully—think of this as investments in production plants or other physical infrastructure—tended to underperform the market and their peers.[3]

- **M&A:** More than half of transactions failed to generate a return that is equal to or greater than the acquirer's cost of capital—a low bar, in my view. Large deals generally performed the worst.[4]

This dismal track record reflects a variety of factors, but the tendency to dial up these activities when times are good can make it harder to generate favorable returns.

Large CapEx programs, for instance, appear most enticing when customer demand and the company's cash flows are relatively strong. However, new production capacity takes time to build and bring to peak efficiency. By that point, the demand environment may not be as strong. Like-minded competitors may also have brought more supply to market.

M&A and share repurchases likewise have tended to accelerate later in the economic cycle when earnings and valuations tend to be elevated. Poor timing increases the risk that a company is overpaying for an acquisition or for its own shares.

And these activities typically have slowed during market and economic downturns. Uncertainty is high at these times, so valuations are usually more attractive.

[3] See, for example, Jeffery S. Abarbanell and Brian J. Bushee, "Abnormal Returns to a Fundamental Analysis Strategy," *The Accounting Review* 73, no. 1 (January 1998): 25; and Sheridan Titman, K.C. John Wei, and Feixue Xie, "Capital Investment and Stock Returns," *Journal of Finance and Quantitative Analytics* 39, no. 4 (December 2004): 678.

[4] See Clayton M. Christensen, Richard Alton, Curtis Rising, and Andrew Waldeck, "The New M&A Playbook," *Harvard Business Review* 89, no. 3 (March 2011): 49.

Past performance is not a reliable indicator of future performance.

Market inefficiencies lead to investment opportunities

Outside of expected dividends and share buybacks, the potential earnings uplift from companies reinvesting their cash flows typically receives little attention from Wall Street research analysts and professional investors.

Time horizon is part of the challenge. The market tends to fixate on the short term—what could happen in the next quarter, the next month, or even the next week. However, the actual impact of a company's investment in new capacity or an acquisition usually doesn't become apparent for several years.

How can a portfolio manager take advantage of this disconnect for clients?

Focus on companies where the potential contribution from capital allocation to long-term earnings and free cash flow appears to be large, sustainable, and underappreciated.

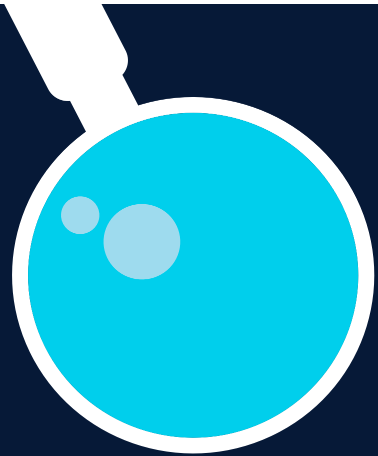
Signs that a company has been a good capital allocator include:

- Strong returns on acquisitions and share repurchases,
- Recent M&A has improved the company's financial profile,
- Its FCF has been stable or has increased over time, and
- A history of returning capital through dividends and share buybacks.

Of course, past performance is not necessarily indicative of future results, even if it reveals a lot about a company's culture.

Keeping on top of a management team's motivations and strategic priorities provides insights into how they think about using their cash flow and whether they are more or less likely to do right by shareholders.

Giroux's views on capital allocation



Internal Investment:

- Prefers R&D over CapEx
  - R&D leads to new products
  - CapEx adds productive capacity

M&A:

- Likes deals where targets have:
  - Faster growth potential
  - Potentially lower earning volatility
  - Lower capital intensity
- Situations that may lead to attractive valuations:
  - Smaller, private deals with less competition
  - Periods of economic uncertainty
  - Acquisition target faces near-term headwinds but long term looks attractive
- Reasonable assumptions for post-deal performance

Stock Buybacks:

- Timing is important
- Can destroy value when companies face sustained earnings pressure from disruption

Dividends:

- Prefers when dividends are set at levels that should be sustainable even in a downturn

For investors, the key is to evaluate whether these initiatives are likely to generate attractive returns over time, relative to all other uses of the company's capital.

For illustrative purposes only.
Not to be construed as a recommendation to buy or sell any security. There is no assurance that any form of capital allocation by a company will lead to a favorable outcome for investors. Investing involves risks including possible loss of principal.

Case study: Oil and gas producers

The energy sector recently has emerged as an area where we see the potential for improving capital allocation.

Almost a decade of low oil and gas prices has helped to move the focus from increasing production in U.S. shale as fast as possible to a more modest pace of growth.

This shift, along with what we view as a potentially more supportive environment for energy prices in the coming years, could set the stage for higher FCF that oil and gas producers can use to buy back stock and pay dividends.

Capital allocation matters

I've focused on how companies deploy their capital for almost two decades—I even wrote a book about it.

I believe that now more than ever, capital allocation is an important, if overlooked, driver of a stock's long-term performance.

Technological innovation is accelerating, M&A has started to pick up after a lull, and higher interest rates have increased companies' cost of capital. The stakes for capital allocation are high. Some companies will flourish because of these decisions, and some will falter.

A well-resourced active manager can make a difference.

The key is focusing on high-quality companies where the market may not fully appreciate their potential to boost long-term earnings by deploying capital thoughtfully.

Investment Risks:

Active Management–There is no assurance that investment objectives will be met or that active management will lead to outperformance relative to an index.

The value approach to investing carries the risk that the market will not recognize a security's intrinsic value for a long time or that a stock judged to be undervalued may actually be appropriately priced.

Dividends are not guaranteed and are subject to change.

Oil and Gas–Because of the cyclical nature of natural resource companies, their stock prices and rates of earnings growth may follow an irregular path. Factors such as natural disasters, declining currencies, market illiquidity, or political instability in commodity-rich nations could also have a negative impact on stock prices.

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