ICGN International Corporate Governance Network

ICGN Viewpoint

CAPITAL ALLOCATION

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Introduction

Capital allocation often flies below the radar as a governance issue or a topic for investor - shareholder and bondholder - engagement. Yet, capital allocation is highly relevant, even critical, for the success of, and sustainable value creation by, companies. It is where corporate finance meets corporate governance and is one of the key outputs of the governance process affecting investors providing risk capital - both debt and equity. It should, therefore, be a central corporate governance consideration for companies and investors.

This ICGN Viewpoint seeks to explore the topic of capital allocation and offer recommendations on improving communication and enhancing dialogue between companies and investors on this important topic. We believe that a clear framework underlying a company's long-term capital allocation strategy can enhance mutual understanding between providers and users of capital, thus creating reasonable and informed expectations on part of investors. We also highlight the need for companies' communication strategies to include information that would help investors to focus on the long-term.

The importance of capital allocation

Capital allocation is the process of distributing a company's financial resources with a purpose of enhancing the firm's long-term financial stability and value creation—and providing fair returns to providers of risk capital. Capital allocation decisions are made by the company's board and management. These decisions will contribute to the pace of growth and the risk profile of the business and may have a profound effect on its long-term health and long-term investment returns for its shareholders.

The most common uses of capital by publicly listed companies include:

- Investment in organic growth
- Financing mergers and acquisitions (M&A)
- Re-paying debt
- Repurchasing shares
- Paying dividend to shareholders
- Investing in strategic partnerships or establishing cross-shareholdings with other companies

From a balance sheet perspective, capital allocation reflects how a company chooses to finance itself, particularly with regard to the balance of equity, debt and other forms of capital funding. From an earnings or cash flow perspective, a key capital allocation question is how the cash generated by the business is divided between its continuing investment needs, repaying debt, maintaining sufficient cash reserves, and distributions to shareholders[1].

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[1] We note that while discretionary bonus and share awards to senior management may not directly fall within the capital allocation framework, the board's decision to make these payments can directly impact the company's capital base. For this reason, ICGN believes it prudent for non-contractual executive incentive awards to be regarded in the mix of other applications of capital-- such as capital expenditure, dividends, buybacks, etc. We will aim to address this topic more specifically in a future ICGN Viewpoint.

In a corporate governance context, management's approach to capital allocation determines how a company pursues its mission and strategic objectives, how it balances the varied interests of its key stakeholders (i.e. customers, employees, suppliers, creditors, shareholders) and ultimately the extent to which it is able to generate sustainable returns for its providers of capital. Achieving a healthy and fair balance of relevant stakeholder interests can be the most difficult part of any capital allocation strategy, and requires, in equal measure, a well-thought-out approach by company management, and a clear communication to key stakeholders.

Common uses of capital

Investing for organic growth is a long-term strategy, as such investments normally take years to generate returns. Company management must decide which re-investment opportunities are worth pursuing to build long-term value. Generally, shareholders appoint directors to make capital allocation decisions; however, professional investors also have a responsibility to monitor these decisions to ensure long-term sustainable returns on the capital they themselves allocate towards listed companies on behalf of their clients and beneficiaries.

We observe that quality of corporate communications on strategic rationale, key considerations and return expectations underpinning major investments in organic growth differ vastly from company to company. A company's ability to clearly articulate its capital allocation framework, including key principles and their alignment with the company's strategic priorities, expectations for return on investment, governance and decision-making process are critical to investors' ability to assess management's strategy and long-term value-creation capacity. This is particularly important for capital intensive projects.

Financing mergers & acquisitions is a common use of capital which depends heavily on the strategic rationale and financial terms of the deal in question, as well as on successful integration of the acquired business. While M&A deals offer a great potential for significant value enhancement, much academic research suggests that M&A activity often destroys value. It is, therefore, unsurprising that investors pay attention to the company's M&A strategy, which is also the reason why companies' management should clearly articulate key principles of their M&A approach and how M&A discipline is maintained.

In particular, investors want management to set out minimum Return on Capital Employed (ROCE) or Return on Invested Capital (ROIC) requirements for any potential transaction. This discipline reduces the potential opportunistic deals that can prove value-destructive in the long term. "Overpaying" for an acquisition is after all the frequent criticism of M&A activities that failed to deliver on expectations. It is also the reason why many investors focus on ROCE/ROIC metrics as part of executive remuneration and long-term incentive plans.

We note that performance metrics focused on return on capital are highly relevant for both capital intensive businesses and those pursuing an acquisitive growth strategy, but are still insufficiently addressed in companies' disclosures and in executive compensation plans.

Debt/financial leverage policy. Debt obligations are financial contracts between creditors (which can include bond holders, banks or providers of trade finance) and users of capital. Even though individual debt obligations are issued and (usually) repaid, a prudent core level of debt will typical constitute part of a company's permanent capital. For creditors, debt capital enjoys reasonably high predictability and visibility given that much of the listed companies' debt is issued as publicly traded fixed income securities with known yields to maturity and, therefore, known returns on repaid debt. Issuing debt can be an attractive capital raising mechanism in a low interest rate environment, where cheap debt can be used effectively by companies to build or support their business or fund growth, and ultimately to enhance shareholder value by achieving a positive return on its risk-adjusted weighted average cost of capital (an "economic profit"). An effective use of debt capital as a value-enhancing capital allocation tool requires control of the cost of capital and management of the business in a way that enables it to generate a positive economic profit.

Companies seeking positive access to cost effective debt and equity capital will need to provide adequate risk-adjusted balanced returns to both creditors and shareholders. Given that higher debt means greater financial risk (and lower credit quality) a company should articulate its policy on debt and financial leverage in a way that provides a sustainable funding base for the company and optimizes returns to both types of providers of capital relative to the risks they bear.

We note that preferential tax treatment of corporate debt compared to equity capital has been drawing attention in relation to the risk of over-leveraging by companies. Similarly, debt-funded capital return programmes to shareholders have caused controversy raising a question of balance between capital efficiency and shareholder returns.

Dividends are valued by shareholders as they offer them a cash return on their investments. A stable growth in dividend payments is generally seen as a sign of a high-quality shareholder-friendly company, while a clear dividend policy consistently implemented by management contributes to the perception of a mature cash-generative business, whose management is confident in the predictability and quality of its revenues and cash flows. On the other hand, given the value many shareholders attach to dividends, dividend cuts are often punished by the market and can result in a significant share price decline and taint the reputation of the board and management.

As a result, companies may feel pressured by their shareholders to maintain dividends, even if this means forgoing longer-term capital spending that can give rise to future value creation, and company directors may be reluctant to reduce or cease dividend payments even if these have become unsustainable and may harm the long-term health of the business. Consequently, high dividend-paying companies are believed to have less flexibility in capital allocation decisions as even necessary dividend cuts are often implemented as a last resort.

It is, therefore, unsurprising that companies' approaches to establishing and disclosing a dividend policy vary considerably. The choice of a dividend policy depends on the company's business model, stability and long-term visibility of revenues and cash flows, as well as management's preference for an investor base - as dividend predictability tends to attract more long-term stable income-oriented investors. The latter factor may play a significant role in the perceived bias of boards and management of dividend-paying companies towards maintaining the dividend at the expense of re-investment into the business or resorting to using up reserves or financing dividend payments through debt.

Despite the attractiveness of dividend payments to many shareholders, they can also be viewed as an inefficient way of distributing cash to shareholders as in many markets investors effectively get taxed twice - at a corporate and personal levels. An alternative way of generating returns to shareholders is through share price appreciation that is often facilitated by **share repurchase programmes** undertaken by companies. When executed properly and for the right reason, share buybacks can be a powerful tool of shareholder value creation.

Using cash or even debt financing to buy back shares can make economic sense for companies when shares trade at depressed valuations, provided they come after all the capital expenditure, research & development and other necessary business expenditures. The common criticism of share buybacks is that these are often not used prudently and fail to enhance shareholder value in the long-term. For example, large share buyback programmes are often implemented in good times when cash flows and share prices are strong and are much less common during recession times when cash flows are weaker and share prices are depressed. Therefore, instead of being used as a powerful capital management tool to be deployed on an as needed basis, share buybacks have become a regular, even routine way of returning excess cash to shareholders.

The proponents of a regular use of share buybacks argue that they offer companies more flexibility as buyback programmes are easier to adjust and do not create expectations of future dividend levels, can be funded out of cash flow during the year, are more tax efficient than dividend payments, and can help provide liquidity to shareholders when markets appear oversold. The opponents point out that routine use of buybacks mean that they are often executed at a wrong price or at a wrong stage in the business cycle, and therefore are value destructive in the long-term. One could argue, however, that the latter point is equally valid for excessive distributions through dividends.

Given the positive impact of share buybacks on "per share" financial metrics and short-term share prices, where executive pay schemes depend on such factors, it has been suggested that there may be a significant perverse incentive for management teams to undertake buybacks for a short-term gain and at the expense of the longer-term health of the business. Where executive incentives are granted in the form of stock options, high vesting levels have the potential to lead to significant shareholder dilution-- which adds to economic costs for investors. However, given normal limits in many markets it would be most unusual for executive incentives to have any material effect on dilution. Investors are free to vote against any scheme which would have this effect.

In view of the issues associated with both pure dividend and pure buyback approaches, a **hybrid distribution policy** where dividends are complemented with more incidental share buybacks is often favoured by investors as an alternative, playing to the strengths or countervailing the weaknesses of both approaches. In a hybrid policy, the dividend part would indicate what management expects the company can continue to pay throughout the cycles, whereas buybacks allow for a more optimal capital structure.

Cross-shareholdings, which still remain a common practice in some markets, is another area of capital allocation that can create value in certain circumstances - for example, when such a structure reinforces critical partnerships and supply chain relationships. But in many cases cross-shareholdings do not play these strategic roles for the companies – and in such cases can be an ineffective, or inappropriate, use of capital. It can lead to value destruction for investors by sheltering ineffective management from market forces such as takeover bids or protest votes by shareholders and by directly affecting returns on capital. From an investor perspective, all cross-shareholdings should be part of a capital allocation plan and reviewed on a regular basis to ensure they add value to the business and its strategic objectives.

Investor perspective on capital allocation

From an investor perspective, the challenge in all markets is to encourage capital allocation practices that establish a sustainable foundation for long-term value creation, thereby servicing the needs of both debt and equity investors and other stakeholders of the company.

As highlighted above, investors should closely monitor a company's approach to capital allocation, as there is a significant potential for decisions and distortions that can have unfavourable outcomes. An overly conservative capital allocation approach can lead to inefficiencies resulting in low returns on capital for equity investors. Asian and Japanese companies in particular are often cited as an example of conservative capital structures with considerable cash balances, non-strategic corporate cross-shareholding and limited use of debt finance. On the other hand, an overaggressive approach to capital allocation can create significant financial risks for companies and providers of risk capital. Examples of risky practices include aggressive use of debt leverage, payment of dividends and repurchases of shares at the expense of necessary capital spending programmes, poorly designed executive pay structures. Commentators in Western economies often cite short-term pressures of financial markets as a major reason driving high risk capital allocation decisions that are not sustainable in the long-term.

ICGN believes that corporate disclosures and reporting are critical for investors' understanding of a company's approach to capital allocation. The information shareholders and bondholders' value and would benefit from most includes the following:

- A framework underlying long-term capital allocation strategy, focusing on key aspects, how balance is achieved among different relevant stakeholder interests and what is believed to be the right balance;
- Governance and decision-making process - respective roles of boards and management in developing capital allocation framework and taking major capital related decisions, independent scrutiny of management's proposals by non-executive directors, thresholds for board decisions;
- A view of the management on their cost of capital and how it relates to the company's long-term value creation, including the company's use of cash, debt and equity;
- R&D projects and CAPEX plans - philosophy, governance & decision-making, key internal metrics and Internal Rate of Return thresholds for capital intensive businesses;
- Degree of financial leverage required to support the company's long-term strategy. This can also include a strategy to maintain a targeted credit rating;
- M&A approach and key criteria for evaluating opportunities (an explanation from the management of how the performance of acquisitions undertaken in the past 5 years compares

to the original assumptions that justified the financial metrics of these individual transactions would enhance investor confidence in the management's M&A strategy);

- A distribution strategy, providing a realistic picture of what distributions can be expected and what the management's priorities are, comprising:
  - A dividend policy, including rationale behind payout ratios/levels and changes in circumstances that may result in reducing or not paying a dividend; approach to special dividends; use of scrip dividends (if any);
  - Use of share buybacks as a capital management tool, including triggers for a share buyback programme, determination of a repurchase price, and explicit disclosure on whether and if so how share buybacks could impact performance metrics under executive incentive schemes;
- Rationale behind any strategic shareholding in another listed company and cross-shareholdings, in particular, and their impact on the returns on capital.

While the above seems logical and intuitive, investors often find they have to gain understanding of the company's capital allocation strategy in a piecemeal fashion from corporate disclosures, investor presentations, discussions with the management and past experience of a company handling any of the above actions. A more holistic and coherent approach on the issuer side would not only help communicate management's thinking on capital allocation but would contribute significantly and positively to investor understanding of companies' capital allocation decisions and enhance their ability to provide constructive feedback to companies. It would also bring a long-lasting benefit of building trust between company management and equity and fixed income investors, which would offer companies more flexibility in implementing long-term strategy or adjusting capital allocation approaches in response to changes in business environment without causing over-reaction from security markets.

We note that even inherently long-term investors will have to react to material developments in the near term, which can be seen as negative if management's rationale is poorly understood and the trust in the company's governance and internal processes is low. The latter often turns companies into easy targets for aggressive activism, which can be mitigated by the establishment and clear communication of a long-term strategy and capital allocation framework, including governance and decision-making processes, and timely updates on any material changes.

It is clear that investors should be interested and prepared to discuss capital allocation issues with boards and management. However, companies report that in some markets this is still rare, particularly during board-level dialogue with investors which often focuses on environmental, social and governance (ESG) issues. But in other markets, Japan for example, capital allocation is growing as an engagement topic between companies and investors.

A meaningful discussion on capital allocation requires good knowledge of the business itself, the industry and the environment it operates in. This topic strides across the analysis of fundamentals and financial performance of the business and that of its purpose, governance, culture and consideration of stakeholder interests. Therefore, a robust dialogue on capital allocation with companies requires deep integration of fundamental and ESG analysis within investment institutions, and strong commitment to stewardship by investment professionals. Intensive dialogue on matters that have a direct and profound impact on investment decisions should be investors' top priority for engagement meetings with company leadership and involve investment professionals from fundamental and ESG backgrounds.

In a comparative context there can be considerable differences in the influence that investors, and shareholders in particular, have on major capital allocation decisions in different markets. This ranges from the ability to express views on capital allocation, to approving dividend payments, authorising dilutive equity issuances and major buyback programmes, or approving large corporate transactions. Rights of this nature help to establish a greater discipline and accountability at the company level, and a greater responsibility for shareholders to engage.

Of course, there are pros and cons to giving investors a greater voice in capital allocation decisions. On one hand, companies are concerned that short-termism in security markets would inhibit management's ability to take decisions that will be value-enhancing in the long-term and could make companies more vulnerable to aggressive shareholder activism. On the other hand, investors often have views and insights, gained from looking into multiple cases of corporate success and failure, which can help avoid value-destructive actions. Deep informed dialogue between companies and major investors would be the best way of achieving the right balance. However, until investment stewardship is deeply embedded into investment processes and its value recognised by companies, shareholders' ability to vote on material capital allocation decisions will remain the most robust conduit to greater capital allocation discipline and better dialogue between companies' management and investors.

ICGN considers the following as good practice with regard to capital allocation, irrespective of market rules and regulations:

- Meaningful public disclosure by companies on capital allocation on an annual basis. Where supported by a transparent capital allocation framework, such disclosure offers an opportunity for the management to explain payout levels and any changes thereof and should encourage meaningful discussions between investors and management with the objective of building mutual understanding and trust.
- Shareholder approval of:
    - Dividend payments;
    - Significant M&A transactions by both acquirer and a target company;
    - Share issuance and share buyback authorities, with such authorities not exceeding realistic business needs. Investors are typically willing to grant larger authorisations when real needs arise if they are confident that these are being used prudently;
    - Any new dilutive issuance of share capital.
- Informed and prudent voting by shareholders on the above-mentioned proposals. We note that dividend and share buyback proposals (where these are put to shareholder vote) tend to attract very high levels of support, which may be a sign of lesser scrutiny by investors than warranted given the importance of these proposals.
- Companies' exercising all capital related authorities in a way that does not favour one group of shareholders over another. This particularly concerns private placements, where large discounts to the market price are often offered, which hurts existing shareholders.
- Boards of directors' ensuring that executive pay schemes are neutral to whether capital is distributed through dividend or through share buybacks. In particular, where per-share performance metrics are used under executive pay schemes, shareholders often observe asymmetry in corporate disclosures, whereby adjustments to performance targets to reflect share issuances are normally reported, but no similar disclosures are readily available in relation to share buybacks.

We accept that shareholders appoint boards and management to make decisions regarding capital deployment and believe that few investors want to be engaged in "back-seat driving". However, seeking share issuance and buyback authorisations, approval of dividend payments and of significant transactions helps instill discipline and is more likely to result in better due diligence, more robust analysis, higher accountability of boards and management, and better-quality decision-making thus reducing losses and costs for investors.

Conclusions and recommendations

Executive management and board directors are expected to review their companies' balance sheets, and consider how cash positions, debt and equity can be blended to achieve acceptable returns for investors and sustainability for the company while maintaining a sufficient level of capitalisation and liquidity to provide a cushion against foreseeable risks. This provides a foundation for company capital allocation decisions relating to how company cash flows are allocated between capital spending, debt repayment, dividends, share buybacks, and any other investment in non-strategic assets that may not be core to the company's own business or sector.

ICGN believes that development and communication of the long-term strategy and capital allocation framework is critical for ensuring full understanding of management decisions by investors - shareholders and bondholders - as well as other relevant stakeholders. The capital allocation framework should focus on what the company believes to be the optimal balance between the interests of key stakeholders, address all main uses of capital that are relevant for the business, and set out governance and decision-making process around major capital decisions.

In view of concerns over share buybacks' role in inflating executive pay at the expense of the long-term health of the business, ICGN specifically recommends that companies explicitly disclose how the impact of buybacks is taken into account when determining performance and vesting levels under executive pay schemes.

Investors should see it as their core responsibility and be expected to engage with companies on capital allocation issues as a fundamental part of their stewardship programme. This means that investors should be proactively offering their views on companies' capital allocation approach and its individual components, governance and disclosures via their normal communication channels with companies (e.g. during regular meetings with management, by means of feedback to Investor Relations teams, meetings with and in letters to the Board Chairman or Company Secretary, as appropriate).

Finally, regulators, stock exchanges and issuers should consider enhancing shareholder rights in respect of capital allocation decisions in markets where these are not sufficiently robust. Shareholder votes on dividend proposals, significant M&As and capital issuance and buyback authorities are likely to increase discipline and accountability on the issuer side and scrutiny and responsibility on investor side, and substantially improve investor-company dialogue on capital allocation matters.

About ICGN Viewpoints

This ICGN Viewpoint was drafted by Eugenia Unanyants-Jackson, co-chair of ICGN's Shareholder Rights Committee, with input from ICGN's Shareholder Rights Committee and George Dallas, ICGN Policy Director. This Viewpoint builds from an earlier version of this article, written by George Dallas, which appeared in Ethical Boardroom magazine in March 2019.[2] While not defining a formal ICGN position on the subject, ICGN Viewpoints provide opinion on emerging corporate governance issues and are intended to generate debate.

ICGN Viewpoints are produced by Secretariat and by our member-led Policy Committees, and we encourage dialogue with the ICGN Secretariat and Committees as follows:

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[2] See: https://ethicalboardroom.com/capital-allocation-a-governance-perspective/