Swiss Corporates through a *capital allocation* lens

Part 1 of our series on Strategic Capital Allocation

A rather well-known chairman and CEO by the name of Warren Buffett once stated – "I was hardwired at birth to allocate capital". It would be hard to argue with his statement considering the stellar shareholder returns generated by Mr. Buffett as the head of Berkshire Hathaway over the last 50 years:

Share Price for Berkshire Hathaway Inc. Class A Shares

Source CapIQ.

But we get ahead of ourselves.
This article is the first in a series of articles on the topic of capital allocation. As our starting point, we define what capital allocation means, consider some of the challenges in allocating capital, and present a retrospective analysis on how Swiss Corporates have allocated capital over the last decade. The analysis reveals a number of initial insights and raises a series of questions for further exploration.

In future articles, we will dive deeper into the various facets of capital allocation and suggest ways to enhance how capital allocation decisions are made. After all, not many executives who need to make difficult capital allocation choices can also claim to be "hardwired" at birth.

Swiss Corporates
We have analysed over 10 years of financial data for corporations listed on the Swiss Performance Index. With the objective to understand the discretionary choices that Swiss corporations have made around sourcing and deploying capital, we exclude industry sectors that are regulated or have restricted capital allocation choices. As a result, financial services companies, utilities and real estate companies are removed from the corporate set, leaving us with a cohort of 140 Swiss corporations.

A Primer on Capital Allocation

What is capital allocation? In broad terms, it is the collection of choices made by corporate leaders with respect to how capital is deployed in order to achieve the enterprise strategy and to meet the objectives articulated to the investor community. Considering that capital allocation involves managing both the demand and supply of capital, we add to our definition the choices made on how capital is sourced.

Capital allocation is the collection of choices on how capital is deployed and sourced in order to achieve your enterprise strategy and maximize shareholder value.

What is the capital allocation plan for your organization?

Common questions that inform capital allocation plans:

- How can we align our capital allocation plan to our enterprise strategy?
- What are our competitors doing and our investors expecting?
- What investments will drive the biggest 'bang-for-the-buck'?
- Who should we acquire to grow and protect our business?
- Will we achieve our objectives on our existing investments?
- Do we have an advantaged portfolio of businesses or should we wind-down or sell certain interests?
- Which projects should we stop, continue or start funding?
- Is my CapEx, R&D and IT budget appropriate, consistently well spent and delivering on our objectives?
- Should we maintain or increase dividends?
- How much cash should we keep? How should we deploy excess cash?
- How should we fund our capital allocation plan?

In practice, capital allocation means something different to companies in different sectors, and the range of choices can be broad or narrow depending on who you ask. The CEO and CFO of an industrial group, for example, apply a broad lens to capital allocation decisions: where to invest organically through brown-field or green-field projects, what acquisitions will strengthen and protect the business today and in the future, whether to carve-out underperforming businesses, how much to return to shareholders through dividends and share buybacks, and so on. The head of R&D for a life sciences company, on the other hand, applies a narrow lens to capital allocation: given capital constraints (e.g., the approved R&D budget), which in-flight R&D projects should we continue and which new programs should we approve?

Regardless of who you ask, however, one thing is clear: capital allocation requires corporate leaders to make repeated, and often difficult, trade-offs.

Importantly, the effective allocation of capital within an organization is driven by the knowledge and perspective of a broad group of stakeholders, and having access to timely information is key to making good choices. To illustrate this point, if the head of R&D does not communicate early that her department needs incremental funding to pursue a potential breakthrough, the C-suite is likely to take the typical approach to budgeting and grant the R&D department a nominal amount above last year's R&D budget.

In our next article, we will further articulate the common capital allocation challenges facing corporate leaders. As a preview, these challenges relate to issues of governance and incentives as well as processes, systems and data.

Consistently making capital allocation choices that drive the biggest return-on-investment is at the heart of why capital allocation is a hard discipline to master, and why Mr. Buffett's track record is so impressive. Are there ways to help organizations tackle the myriad of challenges that stand in the way of consistently making well-informed and value-maximizing choices? This is a topic we will explore in-depth in future articles.

For now, we continue with our retrospective analysis on how Swiss Corporates have allocated capital. We have chosen to apply a wide-angle lens to our analysis. The reason for this is two-fold: first, the assessment can be performed across a common set of capital allocation "building blocks" that are relevant to most corporations and, second, we can perform the assessment using information disclosed in financial filings.

Let's start building.

The Building Blocks of Capital Allocation

With respect to how capital has been deployed by the Swiss Corporates, we have analysed the following uses of capital:

- Mergers & Acquisitions (M&A);
- Capital Expenditures (CapEx);
- Dividends; and,
- Share Buybacks.

Reinvesting into the business through M&A and capital expenditures is how corporate leaders sustain and grow their business to ultimately drive corporate profitability. Dividends and share buybacks, on the other hand, represent an outflow of capital from the business to shareholders.

With respect to how capital has been sourced, we have analysed:

- Operating Cash Flow[1];
- Divestitures and Disposals; and,
- Equity Raises.

Operating cash flow represents the cash generated by the regular operating activities of a business. Divestitures and disposals reflect the cash generated from the sale of business interests or assets and can hint at actions taken by management to "rationalize" or "refresh" their business portfolio. Lastly, raising equity is one way management can tap the capital markets to access incremental capital to fund growth or manage liquidity.

To complete our building blocks, we also assess the amount of debt and net working capital utilized by the Swiss Corporates. An increase in debt represents a source of capital for the business, while a decrease represents the use of capital to lower leverage. Conversely, an increase in net working capital reflects a use of capital, while a decrease[2] reflects a source of capital.

With our building blocks defined, we can turn our attention to how Swiss Corporates have allocated capital over the past decade. We begin our retrospective analysis by walking across the capital allocation bridge.

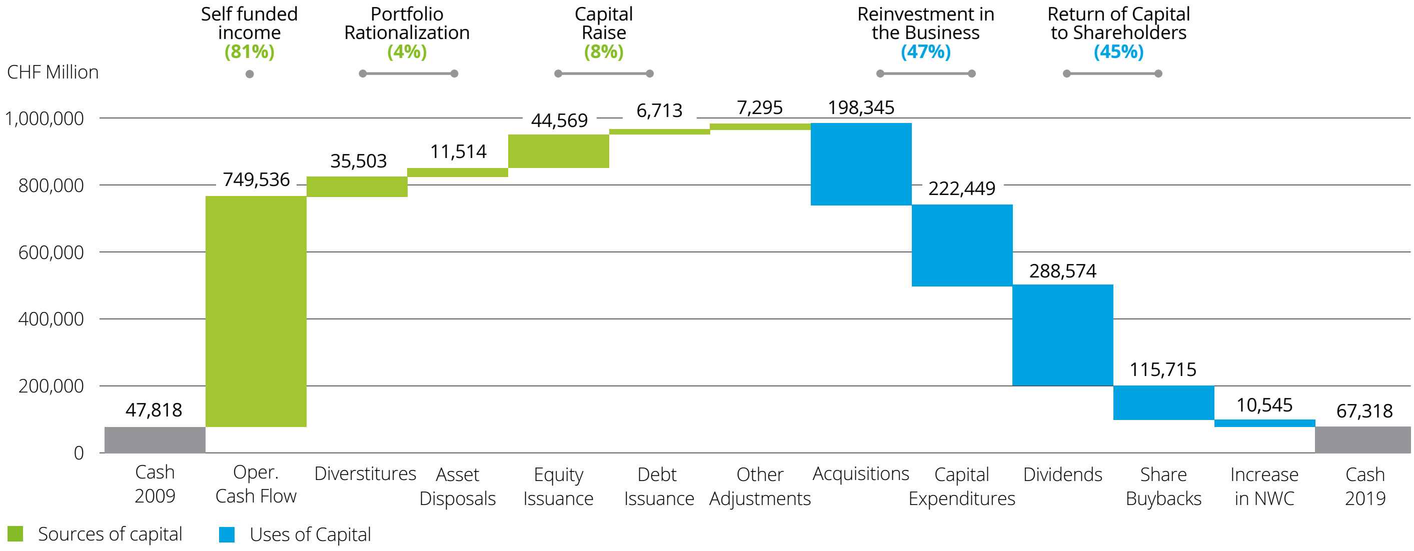
Capital Allocation Bridge

Our bridge visually depicts the sources and uses of capital by the Swiss Corporates over a 10-year period. The starting and ending points reflect the aggregate cash balance of the Corporates in December 2009 and December 2019, respectively. The steps in between are comprised of our building blocks of capital allocation with capital inflows shown in green and capital outflows shown in blue.

The bridge helps us to quickly grasp the relative magnitude of the sources and uses of capital and leads us to several observations on how the Swiss Corporates, in the aggregate, have allocated capital.

Starting with how capital has been deployed, we observe an even split between investing to grow the business through M&A & CapEx and returning capital to shareholders through dividends & share buybacks. Coincidentally, growth pursuits have also been evenly split between inorganic (M&A) and organic (CapEx) investments.

Figure 1. 10-Year Capital Allocation Bridge for Swiss Corporates



1. Operating cash flow reflects net income plus non-cash expenses. We don't adjust operating cash flow for changes in working capital as net working capital levels are analysed separately in our retrospective analysis.
2. Working capital optimization is often a low-hanging fruit pursued by organizations looking to free up capital for higher-value uses.

Dividends, on the other hand, clearly outweigh share buybacks as the mechanism by which the Swiss Corporates return cash to shareholders. Moreover, dividend payments represent the largest single use of cash for the Swiss Corporates amongst our defined allocation choices. As we will still observe in our analysis, dividends may be more appropriately characterized as a constraint rather than a choice when it comes to capital allocation.

Can we conclude that deploying capital in this manner is the optimal approach to create shareholder value? Hardly. While shareholder returns averaged 8% per year over this period, the deployment choices made by senior management are driven by the unique circumstances of their business and influenced by numerous internal and external factors. In a future article, we will explore how these circumstances and factors can be framed to help shape an enterprise's capital allocation plan.

Turning our attention to the sources of cash, the Swiss Corporates have predominantly relied on their own operating cash flow. By most accounts, the past decade has been favourable[3] to businesses and corporate profits have followed suit, giving management sufficient capital to not only fund their growth ambitions and continue to pay dividends, but to also partake in share buybacks.

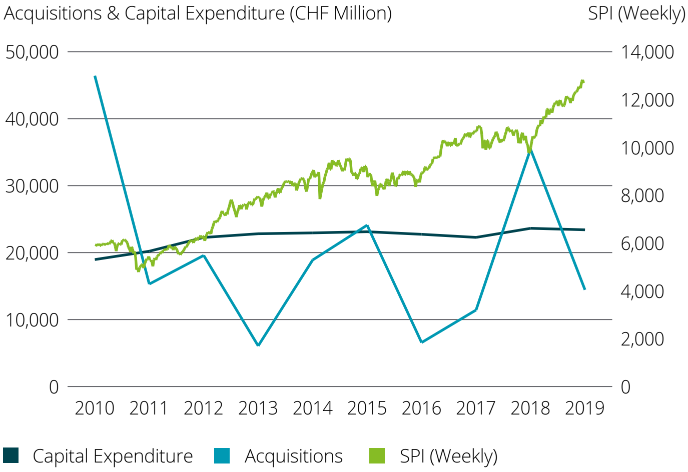
We observe a relatively small proportion of cash sourced from the disposal of businesses and assets. This masks the fact that Swiss Corporates executed a number of significant carve-outs and spin-offs over the past few years. Similarly, the Corporates have felt a limited need to tap the capital markets for additional equity and debt to fund their enterprise strategies and manage liquidity. The change in the level of working capital has been insignificant over the period and is captured in other sources and uses of capital.

One final observation we can draw from the bridge is that the Swiss Corporates have not hoarded cash, as depicted by comparable starting and ending cash positions. This is typically an indication that management is confident in the prospects of their business and have ample investment choices to continue to pursue their strategic and operational objectives.

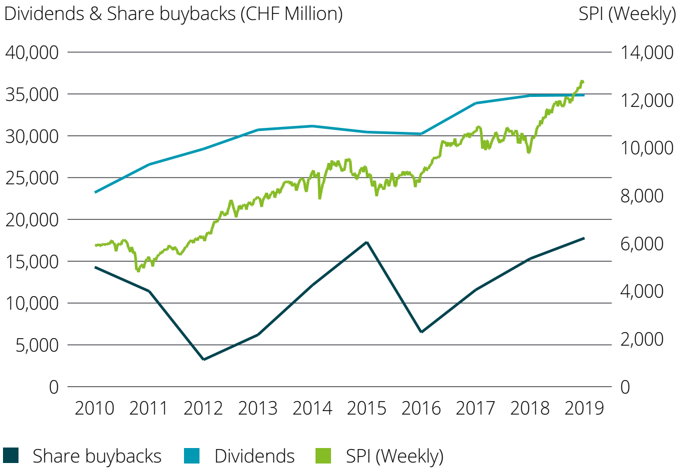
The sudden outbreak of Covid19 at the end of our analysis period, however, means future capital allocation choices and priorities may look very different from our retrospective view. Will Swiss Corporates more actively manage their portfolio and dispose of non-core or underperforming businesses and assets? Will companies abruptly reduce growth investments? Are they equipped to do so in a manner that minimizes disruption and preserves value? Prior crises give some indication of the likely response and we will delve into this in an upcoming article.

We conclude our capital allocation retrospective by analysing the 10-year annual spend profile related to the various uses of capital.

Re-investing in the business



Returning Capital to Shareholders



3. Shareholder returns for the Swiss Corporates have exceeded 8% per annum over the analysis period.

Capital Deployment Trend

Earlier, we observed that the Corporates allocated approximately the same amount of capital to inorganic and organic investments. Upon further inspection, we see a spend profile that is anything but uniform when it comes to acquisitions and capital expenditures:

The spend on capital expenditures is stable from period to period. Asset-intensive businesses need to continuously invest to upkeep and enhance property and equipment in order to maintain safety standards, increase capacity and remain competitive.

Does the flat spend profile during a period of strong corporate growth imply that Swiss Corporates are "sweating " their assets? A deeper analysis would be required to answer this question. What we can observe, however, is that capital expenditures are "sticky". In other words, companies tend to invest similar amounts from period to period. This is a topic we will explore in great detail in a future article.

From a capital allocation perspective, does management have limited choices when it comes to CapEx spend and dialing-up or down investments? Or is this the result of not being adequately equipped to actively prioritize and manage their CapEx portfolios?

In contrast, M&A spend is not uniform and reflects the opportunistic and transactional nature of deal making. As conditions become more or less favourable, management can more easily make go/no-go choices on individual transactions. The overall allocation to M&A is significant and shows the Swiss Corporates are actively acquiring the technology, skills, products and market access they need to pursue their corporate objectives.

Lastly, we turn our attention to how the Swiss Corporates have returned cash to shareholders. Dividends exhibit a "sticky" trend while share buybacks exhibit an "opportunistic" trend, much like the profiles for CapEx and M&A spend, respectively.

Corporations and their investors tend to treat dividend payments as "sacred ground." Unless their business is facing severe headwinds, most management teams will allocate sufficient capital to maintain or increase dividends yields, and the analysis reveals that dividends have indeed kept pace with increases in stock prices. Tying back to a point made earlier, dividends could be viewed as a constraint rather than a choice when it comes to capital allocation.

Share buybacks, however, are typically opportunistic and discretionary in nature. From the perspective of investors, there are arguments for and against share buyback programs which we will touch on in a future article. For now, suffice it to say that the Swiss Corporates do use this mechanism to return capital to shareholders but to a lesser degree than dividends.

Where to next?

Capital allocation is at the heart of value creation and arguably senior management's most important responsibility. If you are looking to further articulate and strengthen your organization's capital allocation plan, performing a similar retrospective analysis on your company and industry peers can be a useful tool to assess different capital allocation strategies and outcomes.

There is no one-size-fits-all approach to enhancing capital allocation decisions but there are frameworks and best practices that can be applied to help increase the effectiveness of your capital allocation plan and choices. By doing so, you can create a competitive advantage for your business and strong shareholder returns.

Our next article will explore common challenges in capital allocation. We hope you will join us.

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