The Importance of Capital Allocation

Kevin Fogarty, CFA, Portfolio Manager and Senior Equity Analyst

The principal role of corporate management teams is to ensure the long-term success of their core businesses. To accomplish this task, management teams focus their attention on the basic elements of operating their business: investing for growth, competitive positioning, operational efficiency, human resources management, marketing, research and development, financial management, supply chain management, customer relationships, and strategic partnerships. Clearly, there is a long list of tasks that management teams must get right to be effective.

However, there is another important area that deserves considerable management attention: capital allocation. Figuring out what to do with a company's excess capital can pose significant challenges to the CEO as highlighted by Warren Buffett in his 1987 annual letter to shareholders:

"Most bosses rise to the top because they have excelled in an area such as marketing, production, engineering, administration or, sometimes, institutional politics. Once they become CEOs, they face new responsibilities. They now must make capital allocation decisions, a critical job that they may have never tackled and that is not easily mastered. To stretch the point, it's as if the final step for a highly talented musician was not to perform at Carnegie Hall but, instead, to be named Chairman of the Federal Reserve."

As Buffett points out, CEOs do not commonly rise to prominence due to their shrewd capital allocation decisions, yet this skill is critically important in generating long-term value for the enterprise. This is especially true for higher quality companies that have relatively low capital intensity, but generate substantial excess capital. This excess capital is the extra cash flows that the core business generates above and beyond its organic growth needs. The effectiveness of how this excess capital, or free cash flow, is deployed can have a significant impact on long-term value creation of the enterprise.

What to do with Free Cash Flow?

For companies that have forged strong franchises over time and generate excess cash flow, management must choose what to do with this cash. Assuming the company has a comfortable and sustainable capital structure and appropriate debt levels, there are three options: dividends, acquisitions, or share repurchases.

Which of these strategies should management pursue? What is the best use of the free cash flow? From an investment perspective, the company's process is important to understand as it can become a significant long-term driver of value creation. Exactly how important is capital allocation, and what is the magnitude of the potential impact? We explore the math below.

Can Capital Allocation Make Much of a Difference?

There are a significant number of high-quality companies capable of generating 100% of their annual net income in free cash flow. Free cash flow is defined as cash from operations minus capital expenditures needed to maintain and grow the core operations. In a typical company with these characteristics, free cash flow can amount to greater than 50% of the assets of the company over a five year period. To put it in simpler terms, a company like this would have sufficient excess capital to create another company half of its size every five years. Obviously, whether that capital, when invested, yields a return of 3% or 15% can make a considerable difference.

Assume there are two equivalent companies, Company A and Company B (Figure 1). Company A invests excess free cash flow

Figure 1

	Company A	Company B
Revenues	1,000	1,000
Operating Profit	146	146
Margin	15%	15%
Interest	13	13
Pretax Income	133	133
Tax (25%)	33	33
Net Income	**100**	**100**
FCF Per Year	100	100
FCF Conversion (% of NI)	100%	100%
5 Year Cumulative FCF	500	500
FCF Investment Return	3%	15%
Additional Net Income	15	75
Extra Net Income % of Original	15%	75%
New Net Income	**115**	**175**

over five years and earns a 3% return. Company B invests its excess free cash flow over the same time period, but instead earns a 15% return. After the five years, Company B's earnings power would be 52% greater than Company A, and could therefore be valued 52% higher, solely due to superior capital allocation.

Conclusion

Given the significant difference in long term value that can be achieved, we believe it is critically important for investors to not only analyze and assess a company's core franchise strengths and free cash flow generating abilities, but also its process and commitment to further enhance long-term value through capital allocation.

Case Study: TJX Corporation

"Sustainable Value Creator in Retailing"

Key attributes:

- Off-priced leader in U.S. retail with growing international presence.
- Historically recession resistant, same store sales growth in line with off-price retail industry.
- Continued penetration growth in core, Home Goods, and international markets.
- Treasure hunt value shopping experience less susceptible to Amazon threat.
- Competitive advantage in its army of experienced buyers, low cost operations, tight working capital, and flexibility.
- Superior Return on Invested Capital with expansion potential plus generous capital returns.

Key Metrics	10-Year CAGR	Notes
Revenues	+6.0%	Revenues above industry average.
EBIT	+13.4%	Solid operating leverage.
EPS	+16.8%	Capital deployment allocated to significant share repurchases.
Shares Out	-3.6%	Shares reduced by 50% since 1988, $3.4 billion in dividends, $14 billion in share repurchases.

10-Year Average Free Cash Flow Conversion (Free Cash Flow/Net Income) = 97.8%

10-Year Value Creation from Capital Allocation:

EPS grew 27% faster than EBIT and 60% faster than revenues due to capital allocation.

Kevin M. Fogarty, CFA, is the Portfolio Manager for the firm's U.S. Large Cap Value Creators and U.S. Mid-Cap Value Creators strategies within the Global Equity team. His fundamental analysis focuses on the Industrials and part of the Consumer Discretionary sectors. Prior to joining DuPont Capital in 2004, Mr. Fogarty was a Senior Equity Research Analyst at Citigroup Asset Management. He joined the financial services industry in 1995. Mr. Fogarty holds a B.S. in Mechanical Engineering from Villanova University and an M.B.A. in Finance from Columbia Business School. He is a member of the New York Society of Security Analysts, and is a CFA charterholder.

The information contained in this memorandum is intended for the sole use of understanding and evaluating the impact of market events and is not designed or intended to be used for any other purpose. The document may contain forward-looking statements, which are based on current opinions, expectations and projections. DCM undertakes no obligation to update or revise any opinions or statements herein. Actual results could differ materially from those anticipated in forward-looking statements. Information contained herein has been obtained from sources believed to be reliable, but DCM does not guarantee the accuracy, adequacy or completeness of such information. An investment in securities includes risk of loss. There is no guarantee that any investment in the securities mentioned will be profitable. Past performance is not indicative of future results.

This document is not intended as an offer or solicitation for the purchase or sale of any security or financial instrument or as a recommendation to invest in any of the securities or financial instruments discussed herein. Registration of an investment adviser with the SEC does not imply any level of skill or training. No part of this presentation may be reproduced in any form.