

# Finding Opportunity through the Lens of Capital Allocation

WHITE PAPER #2 (2014)



A cornerstone principle of the Winslow Capital investment process is the analysis of a company's allocation of capital and the link to long term value per share creation. There is no better arbiter of a CEO's ability to manage a company than his or her ability to deploy capital effectively. Frequently the best use of capital is to return it to shareholders via share repurchases. Yet some criticize this approach as short-sighted or a manipulation of earnings. In this paper, we outline why we believe the thoughtful analysis of capital allocation is one of our important ideas.

## EXECUTIVE SUMMARY

The return of capital to shareholders will be an even more critical element of future stock market returns. The market has benefited from considerable price-to-earnings multiple expansion since the Great Recession. As of October 31, 2014, the S&P 500 traded at 16x next twelve month consensus earnings estimates, in-line with the fifteen year average.<sup>1</sup> Thus, equity returns going forward will likely be increasingly driven by earnings per share growth. We forecast that the companies that can distinguish themselves on this basis are poised to significantly outperform the equity markets overall. This will have profound implications for the equity asset class in coming years. As individuals and institutions consider investment alternatives, the ability of a company to repurchase a meaningful percentage of its shares in a given year will drive value even with no change to price-to-earnings multiples. This return profile will almost certainly be compelling versus many fixed income options.

In some respects our thinking is not dissimilar to the analysis of private equity investors. In fact, there may be a convergence of returns between private equity investors and those of exceptionally strong stock pickers in the public markets. However, given space constraints, we will explore this concept in White Paper #3.

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<sup>1</sup> FactSet Research Systems

## SOURCES OF CAPITAL

Companies create value by investing capital to generate future cash flows at rates of return that exceed their cost of capital. There are three major sources of capital for managers to allocate: securities issuance, asset divestitures, and the generation of excess cash flow. The first two are by definition lumpy but can be extremely impactful to per share value creation. Although we consider both when we analyze equities, for this paper we will focus on the generation of excess cash flow as it is more consistent and predictable.

To start, we will review some basic principles of financial theory. For our purposes, free cash flow (**FCF**) is defined as net operating profit after cash taxes (**NOPAT**) less **Investments**.

$$\text{FCF} = \text{NOPAT} - I$$

NOPAT is a decent measure of cash earnings of a business assuming no financial leverage. Investments are the capital required to fund future growth including changes in working capital, net fixed asset investments and net acquisitions.

Understanding a company's ability to generate future free cash flow requires analyzing macroeconomic and microeconomic factors. One way to capture this data is to assess the drivers of a company's revenue growth and return on invested capital (ROIC).

$$\text{ROIC} = \text{NOPAT} / \text{Invested Capital}$$

To calculate ROIC, we again use NOPAT. Invested Capital is the denominator and with the beauty of dual entry accounting can be calculated in two ways. Invested Capital is the assets a company needs to run its business and can be found on the left hand side of the balance sheet. Alternatively it is the amount of financing a company's creditors and shareholders need to fund those assets, or the right side of the balance sheet.

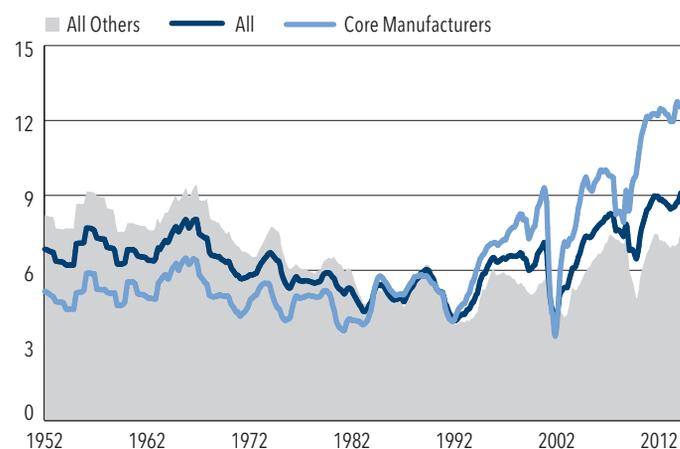
ROIC is a proxy for value creation. Typically companies with high ROIC have competitive advantages and these are the companies we seek as part of our investment process. However, a company's ROIC will only exceed its cost of capital for an extended period if its competitive advantages remain in place. When we analyze a company, we assess its advantages and the sustainability of each. Companies build moats around their businesses through economies of scale and/or product differentiation. Factors such as the global economy, industry dynamics, pricing power, management strength, competition, market share and many other issues require ongoing and detailed analysis. We are advantaged in this analysis given the long tenure of our analysts and the domain expertise each has acquired during their careers.

Stock prices are discounting mechanisms for projected future free cash flows. Companies with low returns on invested capital generate less cash flow to distribute to shareholders. These entities deserve low valuation metrics, such as low price-to-earnings multiples. Monitoring trends in ROIC is critical in assessing if a company's competitive advantages are eroding. The trends can also be predictive of ex-post stock prices.

The faster a company grows its revenues and deploys capital at attractive rates, the more value it creates. In short, the combination of high growth and high ROIC drive equity valuations. Interestingly, while the ability to maintain high revenue growth has been shown to be a rarity, companies with high levels of ROIC have been shown to hold on to this advantage for a more sustained period of time.<sup>2</sup>

In the third quarter of 2014, U.S. equity markets, as measured by the S&P 500, reached all-time highs.<sup>3</sup> Not coincidentally, net profit margins for S&P 500 companies are also at all-time highs. U.S. manufacturers have benefitted from sourcing labor globally and from technology. Excluding recessions, net margins for manufacturers have been on an upward trend since the early 1980s and this improvement has been sufficient to bring up the overall level of margins, as is detailed in Exhibit 1 below.

**Exhibit 1: The S&P 500 Net Profit Margins 1952 - Q2 2014**



Source: Corporate Reports, Empirical Research Partners Analysis. Net profit margins based on trailing four-quarter data excluding financial. Smoothed on a trailing three-month basis.

Companies with high margins and ROIC generate enormous amounts of cash. As of June 2014, the S&P 500, excluding the financial services sector, had \$1.4 trillion in cash representing about 10% of the market capitalization of the index.<sup>4</sup>

<sup>2</sup> *Insights & Publications, McKinsey & Company, "Balancing ROIC and growth to build value," March 2006.*

<sup>3</sup> S&P Dow Jones Indices

<sup>4</sup> FactSet Research Systems

## USES FOR CAPITAL

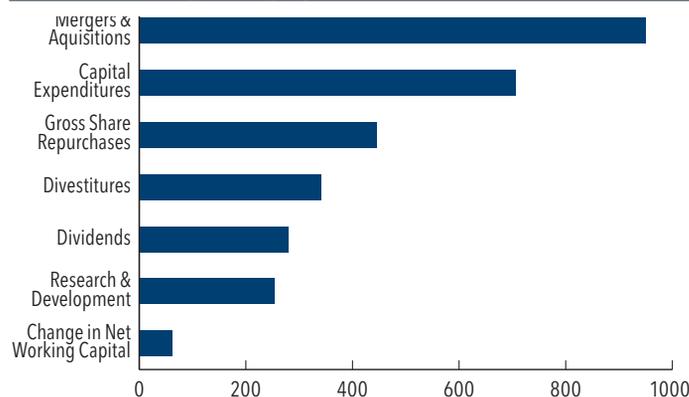
The two largest uses of capital in order of size are acquisitions and capital expenditures. Mergers and acquisitions (M&A) have averaged 9% of the equity market capitalization in the U.S. since 1980.<sup>5</sup> Behavioral finance would predict that M&A activity is highly correlated with the stock market, and that has in fact been the case. Frequently companies can seem to mindlessly imitate one another with the later acquirer enjoying minimal if any true value creation. Research by McKinsey & Co. concluded that about two thirds of all M&A deals are either value neutral or value destroying.<sup>6</sup> Said another way, most companies overpay for their acquisitions.

The second largest use of capital is capital expenditures. These tend to be less correlated to the stock market. In 1980 capital expenditures were roughly 10% of total sales versus 6% in 2013. Some pundits indicate there is a reluctance to spend because of Washington policies or other geopolitical factors. This may be partially true, but the composition of the economy has changed materially over the last three decades. Energy, Materials and Industrials represented 50% of the market cap of the top 1,500 companies in the U.S. in 1980 versus just 25% today.<sup>7</sup> Over the same period, Healthcare and Technology went from 17% to 30%.

Although the accounting treatment is different for capital expenditures and research and development, with the former added to the balanced sheet and depreciated over a theoretical life and the latter expensed as incurred, we view the two similarly. Both are investments made to add future cash flow growth. The long-term benefits of research and development can be seen in the market capitalization of major pharmaceutical and biotechnology companies such as Gilead and Amgen. Both spend about 20% on research and development per year and both have market capitalizations well above \$100 billion.

If we combine capital expenditures and research and development, outlays for these exceed that of M&A as detailed in Exhibit 2.

## Exhibit 2: U.S. Capital Deployment, 2013



Source: Credit Suisse HOLT, Thomson Reuters DataStream. Data for R&D, Capital expenditures, Buybacks, and Dividends exclude financial companies and regulated utilities; data for Mergers & Acquisitions and Divestitures include all industries. Published in: Michael J. Mauboussin and Dan Callahan, "Capital Allocation: Evidence, Analytical Methods, and Assessment Guidance," Credit Suisse Global Financial Strategies, August 5, 2014.

We carefully monitor the sources and uses of capital. We are appropriately skeptical of strategies that boost short-term earnings per share growth. We are also skeptical of those managements who are empire builders, chasing asset growth rather than thoughtful strategic initiatives. Our research is designed to cull these companies from consideration for ownership in our portfolio, allowing our clients to avoid the growth trap.

## RETURN OF CAPITAL TO SHAREHOLDERS

Financial historian, Peter Bernstein, once quipped that managements were more careful when "they're not floating in cash."<sup>8</sup> Managements can return excess cash to shareholders in two ways, dividends and share repurchases. Both are important to equity returns, and we analyze both carefully. For this paper, we will focus on share repurchases.

There are a number of advantages to share repurchases. In 1982, the Securities and Exchange Commission created safe harbors for companies repurchasing their own shares. The ruling effectively allows management to use information asymmetry. Thus, when a thoughtful management repurchases its stock, it can be a strong signal of their belief that the stock price is below its intrinsic value. In addition, share repurchases allow equity investors to self-select with those less optimistic, returning the shares to the company.

<sup>5</sup> Credit Suisse, "Capital Allocation: Evidence, Analytical Methods, and Assessment Guidance," by Michael J. Mauboussin and Dan Callahan, CFA. August 5, 2014.

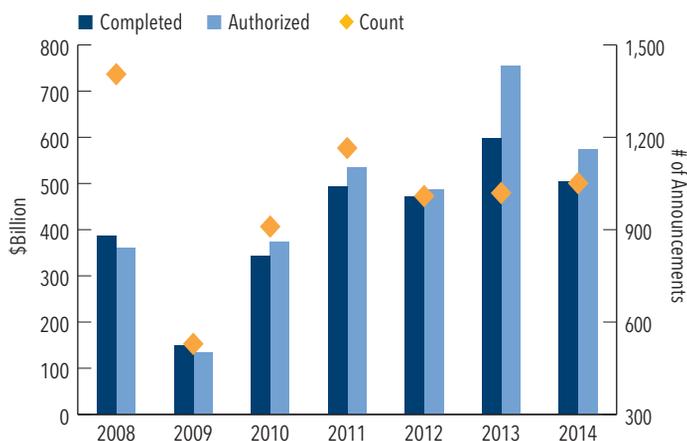
<sup>6</sup> McKinsey & Company, "Merger Management."

<sup>7</sup> Credit Suisse, "Capital Allocation: Evidence, Analytical Methods, and Assessment Guidance," by Michael J. Mauboussin and Dan Callahan, CFA. August 5, 2014.

<sup>8</sup> MONEY Magazine, "He may know more about investing than anyone alive," by Jason Zweig. October 15, 2004.

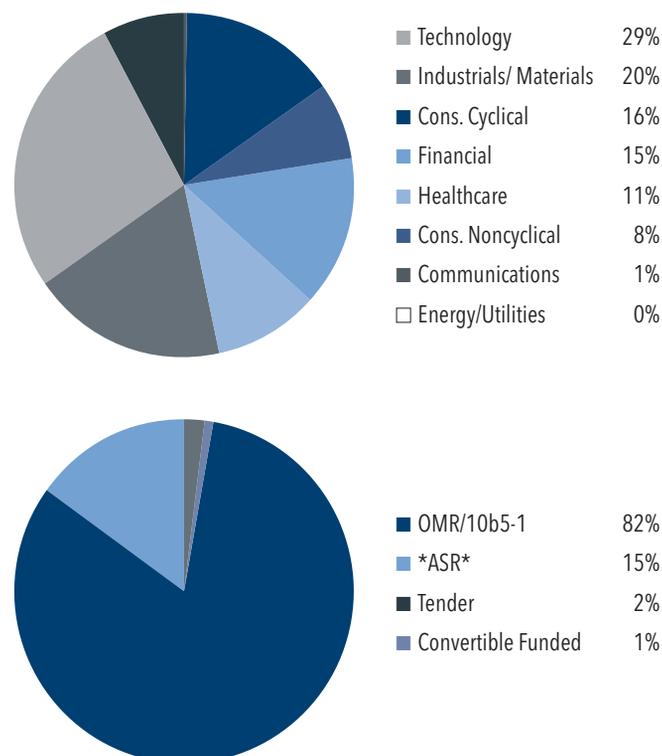
Share repurchases have had an enormous impact on U.S. equities in recent years. Spurred by record levels of cash on corporate balance sheets, liquid capital markets, and low interest rates, share repurchases have been on the rise. Corporations bought back \$339 billion of stock in the first half of 2014, the most in any six month period since 2007 (Exhibit 3). Share buybacks have crossed many sectors with the greatest concentration coming from Technology and Consumer Cyclical (Exhibit 4).

**Exhibit 3: Annual Share Repurchase Trends (since 2008)**



Source: Birinyi Associates, Credit Suisse. 2014 data is through 6/30/2014.

**Exhibit 4: Ytd 2014 Completed Buybacks By Sector / Type (Total = \$340 Bn)**



Source: Birinyi Associates, Credit Suisse. 2014 data is through 6/30/2014.

Given the amount of repurchase activity, it would be easy to assume the choice was obvious for senior managements. However, some believe that returning cash to shareholders represents a dearth of value creating opportunities available to managements. They believe managements are too short-sighted. Some critics are skeptical on the efficacy of share repurchases in enhancing long-term stock price performance. They attribute robust share repurchase activity to the excessive liquidity of the current environment.

We acknowledge these risks and carefully assess the companies we own. We also note that asset growth has not been predictive of strong returns. Academic research has documented that firms with low asset growth generated substantially higher risk adjusted returns than those firms with high asset growth rates. In Exhibit 5 we analyze the capital deployment strategies for large-capitalizations stocks since 1952 and note stark contrasts in shareholder returns. The stocks of those companies with the highest capital expenditures perform considerably worse relative those in the thriftiest quintile. Even more dramatically, companies that minimize common share issuance and return cash to shareholders have materially higher relative returns over one-, two – and three-year holding periods.

**Exhibit 5: Relative Returns to Select Capital Deployment Factors**

Large Capitalization Stocks, 1952 - October 2014

	One Year	Two Years	Three Years
<b>Capital Spending-to-Depreciation</b>			
Lowest Quintile	2.3%	3.2%	3.8%
Highest Quintile	(1.9)	(1.5)	(1.4)
Spread	4.3	4.7	5.2
<b>Change in Common Shares Outstanding</b>			
Lowest Quintile	2.2%	3.8%	5.6%
Highest Quintile	(3.1)	(5.5)	(6.8)
Spread	5.3	9.3	12.3

Source: Empirical Research Partners Analysis using equally-weighted data relative to equally-weighted large cap stocks.

Our size and reputation allow us to actively dialog with managements on their capital allocation strategies. When appropriate, we favor and advocate share repurchases. We will only own companies where the interests of both management and shareholders are aligned.

**AN EXCEPTIONAL TOOL IN LOWER GROWTH ENVIRONMENTS**

To illustrate how efficacious the return of capital can be to stock selection, we will highlight two iconic U.S. companies. Both have been a part of the fabric of the economy for more than 100 years. Both were impacted by the muted global growth

environment over the recent period. Both have high returns on invested capital and return capital to shareholders through share repurchases and dividends. Despite these similarities stock price performance has differed dramatically.

Railroad company, Union Pacific Corporation was founded in 1862 and has approximately 32,000 route miles of track that cover 23 states in the western two-thirds of the United States. Union Pacific has a big moat. The company is well positioned to benefit from drilling activity in the west, as well as the growth in auto manufacturing and increased agriculture shipments. Volume growth and price increases in excess of inflation have led to sales climbing from \$20 billion in 2011 and to an estimated \$24 billion for this fiscal year.<sup>9</sup> Operating leverage has allowed net income to easily outpace sales growth. (Exhibit 6). Although there is sizable capital investment required annually to maintain and enhance its rail services, excess cash flow generation has facilitated meaningful capital returns to shareholders. Total shares outstanding have declined 8% in the period. The stock price has reflected the per share value creation with the stock performance more than doubling the returns achieved by S&P 500 since 2011 (Exhibit 7).

**Exhibit 6: Union Pacific Financial Summary**

Union Pacific	2011	2012	2013	Est 2014
Revenues (\$bn)	19.6	20.9	22.0	23.9
Year-on-year growth		7%	5%	9%
Net income (\$bn)	3.3	3.9	4.3	5.0
Year-on-year growth		20%	10%	16%
ROIC	12%	14%	15%	15%
Shares Outstanding (mm)	980	953	932	901
EPS (non GAAP)	\$3.36	\$4.14	\$4.71	\$5.62
Year-on-year growth		23%	14%	19%

Source: FactSet, internal modeling

**Exhibit 7: Relative stock performance UNP and the S&P 500 Index**



Source: FactSet

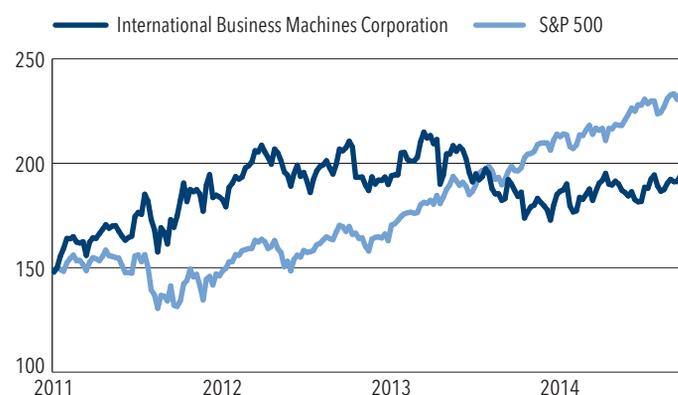
However, the ability to return meaningful capital to shareholders cannot be viewed in isolation when assessing potential stock price performance. International Business Machines is a case in point. Founded in 1911, the information technology company has seen its moat shrink in recent years. IBM is losing share through competitors' innovations in cloud computing, software as a service, and eCommerce. Total sales were nearly \$107 billion in 2011 but have declined since. Net income during this period has been essentially flat at approximately \$16 billion. However, the company aggressively repurchased stock shrinking its share count by 18% over the period.<sup>10</sup> Engineered earnings per share grew from \$13.44 in 2011 to an estimated \$16.13 in 2014 (Exhibit 8). As highlighted in the chart below (Exhibit 9), investors initially applauded the company's ability to manufacture earnings per share growth. However, ultimately the company's weakening fundamentals undermined stock performance.

**Exhibit 8: IBM Financial Summary**

International Business Machines Corporation	2011	2012	2013	Est 2014
Revenues (\$bn)	106.9	104.5	99.8	93.9
Year-on-year growth		-2%	-5%	-6%
Net income (\$bn)	15.9	16.6	16.5	16.0
Year-on-year growth		5%	-1%	-3%
ROIC	40%	40%	34%	34%
Shares Outstanding (\$bn)	1,214	1,166	1,103	1,006
EPS	\$13.44	\$15.25	\$16.28	\$16.13
Year-on-year growth		14%	7%	-1%

Source: FactSet, internal modeling

**Exhibit 9: Relative stock performance IBM and the S&P 500 Index**



Source: FactSet

It is worth noting that the microeconomic trends impacting both Union Pacific and IBM are distilled in the ROIC trends. Union Pacific's ROIC has consistently increased. Total sales have also increased resulting in meaningful growth of cash available to distribute to shareholders growing. Despite exceptionally high ROICs, IBM's cash available for shareholders has shrunk as ROIC has deteriorated. In fact, the company has had to borrow in order to meet all of the demands on its capital in recent years.

## SUMMARY

Through October 31, 2014, the S&P 500 had nearly tripled from the lows in March 2009.<sup>11</sup> Despite this spectacular performance, our work on the impact of the return of capital to shareholders demonstrates that certain U.S. equities remain highly attractive. The drivers of stock returns since 2009 have been global growth, margin increases, and multiple expansion. We model each of these as having a more muted impact on stocks going forward. Given this backdrop, those companies with high ROIC and prudent capital allocation strategies, will be rewarded.

<sup>11</sup> S&P Dow Jones Indices

We believe the stocks of these companies will also be attractive relative to fixed income instruments. Interest rates across developed nations are near historic lows and the most likely path is for interest rate hikes, potentially resulting in losses for fixed income investors. Capital will likely flow to companies that can convert single digit revenue growth into solidly double digit value per share growth. Over a market cycle, equities from these companies with big moats, high ROIC and disciplined managements may generate less volatility and higher total returns than those of fixed income securities, perhaps challenging the conventional wisdom of the efficient frontier.

Although the principles of our investment process have remained unchanged over the last 16 years, we are pleased that one of these principles is so perfectly suited for the current equity market environment. Given the current valuation starting point for U.S. stocks, the market is likely to become more selective with capital allocation as a major opportunity for differentiated returns. ■

## RISKS AND OTHER IMPORTANT CONSIDERATIONS

The information presented is the opinion of Winslow Capital Management, LLC. The information presented is subject to change without notice. Securities identified within the white paper are for illustrative purposes only to demonstrate the capital allocation strategy of representative companies as referred to on page 5. It should not be assumed that the securities discussed were profitable or that investment decisions made in the future will be profitable. The statistical analysis information is presented for informational purposes to illustrate calculating free cash flow and return on invested capital. Such analysis may or may not result in profitable investment decisions. This white paper is for investment professionals and institutions only.