A simple decision tree to guide the capital allocation process

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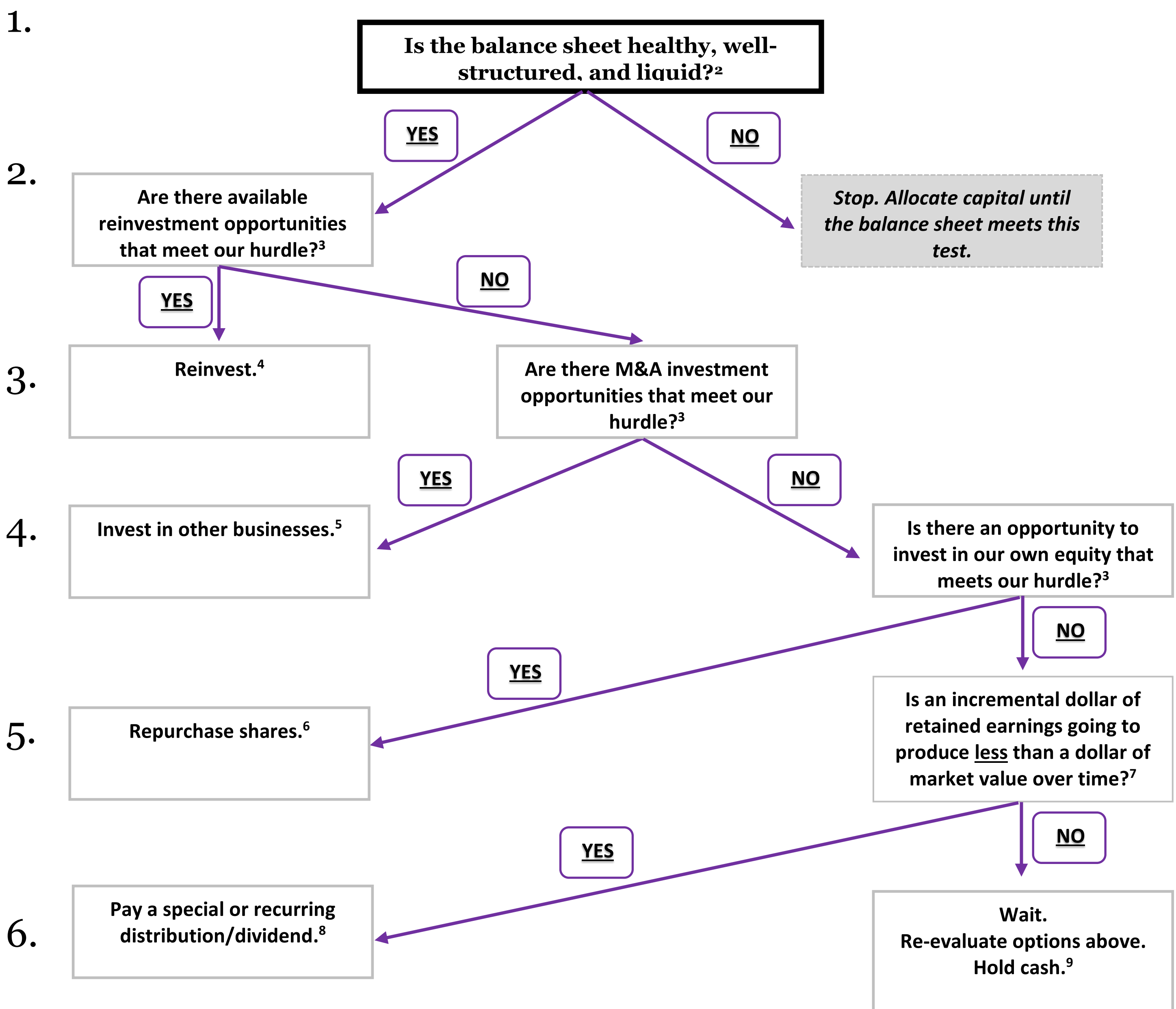
Here we will define investing as the art and the practice of deploying capital, only after careful thought and analysis, in such a way as to maximize our odds of getting our principal back and then earning a satisfactory return on our capital. As such, senior management and directors making decisions regarding the internal uses of the company's capital (i.e., capital allocation) should view the process as one of investment, not a "return of capital" or "rewarding shareholders." Every company is unique and circumstances vary, but having a thoughtful framework bases on these principles will help to avoid many of the company pitfalls suffered by countless companies engaged in the everyday practice of capital allocation.

Sources of capital	Uses of capital
• Operating cash flow • Debt issuance • Equity issuance • Asset sales	• Balance sheet health • Reinvestment[1] • M&A • Share repurchases • Dividends



<u>Notes</u>

[1] **Internal reinvestment** options include R&D, SG&A, working capital, and capital expenditures.

[2] **"Healthy, well-structured, and liquid" are subjective tests.** Each business will have specific capital and liquidity needs, and each balance sheet should be evaluated in that context. Capital markets are deep and liquid in most of the world most of the time, but they are also prone to occasional panics and seizures when liquidity disappears quickly, often when it is needed most. Long-term owners should evaluate the balance sheet on the basis of its required level of capital and liquidity in a range of scenarios, focusing on those rare but important instances of recession, panic, adverse randomness, etc. Required spending in *cash* – for operating expenses, capital expenditures, dividends, interest payments, etc. – should be weighed against after-tax *cash* operating income that could be reasonably expected in times of economic stress. Common proxies such as EBITDA (non-cash, often heavily and absurdly adjusted) are often more distracting than helpful.

[3] The **hurdle rate** should be derived using an opportunity-cost-driven approach: take the return of the best opportunity available to the business, and benchmark everything against that.

[4] **Reinvestment** in the business has been empirically shown to have the highest odds of success. This makes intuitive sense since management should have superior knowledge of its own operations, competitive landscape, threats and opportunities, etc.

[5] **Mergers and acquisitions** are a source of opportunity and also a frequent cause of trouble. Evidence shows that most of the value in a merger is transferred from the buyer to the seller. Psychological factors and non-economic influences often come into play. M&A does not have to be limited to whole-company acquisitions; investing in the debt and equity securities of other companies is often viewed as a distinct activity despite having motivations and principles that should be nearly identical to that of a whole-company M&A process.

[6] **Share repurchases** should be viewed as an investment, just like anything else, but in practice they often take on mythical or psychological qualities that defy logic and reason. The (re)purchase of a company's own shares is simply an investment the company is making in itself. That investment can be made according to three frameworks. The **fair-value approach** believes that timing and valuation do not matter; the company is going to be a consistent purchaser of its own shares and has no opinion on the value of those shares, so it will buy them back over time assuming that periods of overvaluation and undervaluation will come out as a wash in the end. The **intrinsic-value approach** believes that a company should only repurchase its shares when they are undervalued and/or represent an attractive use of capital. The **accounting-motivated approach** uses share repurchases to mask or offset the effect of equity issuance (for stock-based compensation or otherwise) or to boost certain metrics such as earnings per share (which is silly and meaningless but can be the basis for certain executive compensation metrics).

[7] If a business cannot earn a satisfactory return on its retained capital, it should pay out that capital to owners. This **"return of capital"** often gets lumped together with share repurchases, but they are different in very important ways. A dividend is a true return of capital; it is paid out of after-tax corporate dollars and taxed again as dividend income for the recipient; the recipient may not choose to opt in or opt out of the dividend; and recurring dividends are often associated with vague, antiquated notions of being a "blue-chip" or "quality" company that should be prized for its "consistency." (As an aside, the term dividend should be banned in favor of the phrase **"liquidating distribution,"** because that's what it is. The company is deciding to partially liquidate itself by making a payment to its owners out of its after-tax retained earnings, shrinking the company in the process.) Any retained capital and ~~dividend~~ liquidating distribution should be subject to Buffett's "one-dollar test": a dollar retained today should produce at least one dollar of value in the future. In other words, a dollar of retained earnings would be justified only if it produces incremental earnings and market value equal to or greater than those generally available to investors. If a retained dollar is going to be worth less than a dollar in the future – over a meaningful period of, say, several years – it should be paid out to owners. Likewise, if a company claims a long line of high-return projects that require incremental capital but is concurrently paying a ~~dividend~~ liquidating distribution, it has failed the one-dollar test.

[8] **Special ~~dividends~~ liquidating distributions** can be very effective ways to manage a business's capital base. They are, by definition, more flexible than the typical recurring ~~dividends~~ liquidating distributions, which often attain "sacred cow" status and come with all sorts of fuzzy thinking rooted in history and psychology. (Traded equities were preceded by bonds, and to attract early equity investors many companies and marketers used coupon-like dividends to tout the investment merits and supposed stability of a company.) **Recurring ~~dividends~~ liquidating distributions** have declined in popularity in recent decades but still amount to hundreds of billions of dollars per year in the U.S. In any case, many boards allow a dividend to persist well past the point at which it should be reduced or eliminated, putting the company's financial stability in peril. Worse yet, a shocking number of companies pay recurring ~~dividends~~ liquidating distributions while simultaneously raising new equity. On the other side of the problem, some management teams and boards allow capital to pile up inside a company at a subpar rate of return when special or regular liquidating distributions would have been more beneficial to owners.

[9] Holding (excess) cash is often overlooked in the capital allocation process for several reasons: it is not an "active" decision; it is rarely if ever recommended by an investment banker; and it can be viewed as inefficient in theory (but not in practice!). Despite the popular phrase, cash is <u>not</u> trash, even in periods of low interest rates. Cash provides optionality in the future, and as such, it should be valued on the basis of the current income it can provide <u>and</u> using a measure of its option value.