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Cash Flow | January 20, 2012 | CFO.com | US

The Envelope, Please: The 2011 Capital Deployment Awards

If your company holds a lot of cash, think about doing something with it.

Gregory V. Milano

Among the most important responsibilities of CFOs, chief executive officers, and board members is deciding on the deployment of capital. They must chose whether to invest in the business via capital expenditures, acquisitions, and other investments or distribute capital to shareholders via dividends and share repurchases.

Those strategic selections have differing effects on growth rates, margins, earnings per share, cash flow, rates of return and risk. That makes choices complex and difficult.

Which capital deployment strategies led to the best performance for shareholders in 2011? To allot our virtual Gold, Silver, and Bronze medals to the best strategies, we studied the top 500 companies in the United States by market capitalization to find out. We compared the median total shareholder return (TSR) (including dividends and share price appreciation) of the top 100 companies in terms of capital deployed as a percent of cash flow against the bottom 100.

To avoid waiting until March and April for year-end financials, we compared the capital deployment rates for the first three quarters of the year to the TSR for the full year.
Drum roll. The envelope, please. And the winner is: dividends, which take the 2011 Capital Deployment Gold Medal as the most important differentiator of shareholder returns in 2011.

The 2011 Silver Medal goes to capital expenditures and the 2011 Bronze Medal to buybacks – but only to the degree that the repurchases soaked up share issuance. Acquisitive companies outperformed as well, but by too low a margin to earn a medal. The thinking behind our choices follows.

Gold. Although buyback announcements and trends got the majority of press last year, dividends were a more important differentiator of returns for shareholders. The top dividend group deployed a massive 30% of their cash flow toward paying dividends and generated 13.7% higher TSR than the low-dividend companies (none of which, in fact, that paid any dividends at all.)

In terms of dividends, we again split the companies by their cash holdings. The top dividend companies with above-median cash holdings delivered 24.3% higher TSR than their low- dividend counterparts. To an even greater degree than buybacks, dividend policy was important and highly valued by investors in 2011 for companies with high cash balances.

We tested revenue growth and found a small advantage for slower growth companies over faster growing ones. But dividends seemed to provide strong TSR benefits for both high and low-growth companies.

Executives should interpret the stellar results of deploying capital into dividends with caution, however. Over the trailing ten years, the high-dividend companies only delivered 0.1% higher TSR per year than the low-dividend companies – a statistically insignificant benefit. It remains to see whether high dividend payers can gain a second gold in 2012.

Silver. The most beneficial reinvestment use of capital in 2011 was in capital expenditures. The top capex group delivered 8.2% higher TSR than the bottom group.

That's consistent with the 8.1% advantage of high capex companies over the last ten years. In fact, over the decade, capex was the best capital deployment alternative - better than acquisitions (gross or net of divestitures), research and development, buybacks (gross or net of issuance), or dividends.

That's not to say it would be a good idea to frivolously boost capex budgets without a true business need. But it does suggest that the bias against capital spending and toward squeezing capital efficiency may be taken too far by some CFOs.

Bronze. Share buybacks surged in 2011 in response to investor demands to distribute what they perceive as excess cash balances. Indeed, the 419 current nonfinancial members of the S&P 500 index held $776 billion in cash on their most recent quarterly balance sheets, which is up 72% compared to five years ago.

Many buyback advocates quote research showing that buyback announcements are typically greeted by share price increases. This hypothesis seemed to hold in 2011, as the top gross buyback group delivered 4.2% better TSR than the bottom group. But compared to other uses of capital, the excess return of buybacks was only worthy of a Bronze.

In the case of buybacks, however, there's a clear distinction between the results for companies which actually reduced the share count versus those that merely bought back shares to counter the dilution often caused by executive compensation.

To understand buyback strategies better, we must distinguish between gross buybacks and net buybacks. The latter reflect the difference between stock buybacks and stock issuances.

Buybacks don't shine quite as brightly when we examine the relationship between shareholder returns and net buybacks. The top net buyback group generated TSR that was 0.5% *worse* than the bottom group. In other words, companies buying back shares in excess of those they issued didn't seem to realize any added benefit in their share price.

Those net buyback findings are directionally consistent with our observation over the long term. Over the last ten years, the top net buyback companies generated cumulative TSR of -21.6% (-2.4% per year) less than the bottom group. In separate research we have found that in nearly every industry, the top net buyback companies deliver lower TSR over the long run.

How do you know if buybacks are right for your company? Companies hoarding heavy cash balances benefited more from buybacks in 2011. We separated the companies by whether their cash balance as a percent of enterprise value (EV) (the sum of net debt and the market value of equity) is above or below the median of 7.1%.

Among the cash hoarders, the top net buyback group delivered TSR that was 1.9% better than the bottom group. To an even larger degree, companies suffering low revenue growth benefited more from buybacks than high-growth companies in 2011. For those with lower-than-median expected growth, the top net buyback group delivered 11.1% higher TSR than the low buyback group.

Over all who were the losers in terms of TSR last year?

Those companies that deployed more capital to pay dividends, make capital expenditures, buy back shares, and even acquire other companies tended to outperform those that did none of these in any meaningful way.

The lowest shareholder returns came from the companies that did none of these and just continued to accumulate cash. Given how high cash balances are now, it would seem undesirable to continue with such a policy. If your company holds a lot of cash, think about doing something with it.

Gregory V. Milano, a regular CFO *columnist, is the co-founder and chief executive officer of Fortuna Advisors LLC, a value-based strategic advisory firm.*