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The Envelope, Please: The 2012 Capital Deployment Awards

Despite low M&A activity for most of 2012, acquisitions turned out to be the best use of capital for shareholders

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A year ago I published the inaugural Fortuna Capital Deployment Awards based on the success or failure of different capital deployment strategies in 2011. The awards are different from others in that they don't recognize individual company achievements but instead identify the success or failure of different capital deployment strategies.

ANALYSIS

These findings and interpretations are intended to help companies make strategic capital deployment choices for 2013. It is certainly challenging to determine how much capital should be deployed to invest in research and development, purchase plant, buy equipment, or make acquisitions versus distributing capital via dividends or share repurchases. Indeed, choosing capital deployment strategies are among the most significant responsibilities of CEOs, CFOs, and board directors today.

Consistent with last year, for 2012's awards we studied the top 500 U.S. companies by market capitalization. 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 April for year-end financials, we compared the capital deployment rates for the first three quarters to the TSR for the full year.

Drum roll. The envelope, please. And the winner of the gold medal is: acquisitions! The silver medal goes to buybacks and the bronze goes to building cash (believe it or not!).

Gold. In 2012 being a top acquirer tended to benefit TSR more than any other use of capital. This may seem ironic to many, given the plethora of studies showing how share prices tend to decline when acquisitions are announced.

Why did the top 100 acquirers deliver median TSR that was 7.5% higher than non-acquirers in 2012? Perhaps acquisition prices were attractive. Median price-to-book value across the market was over 20% lower than in 2007, and, with less acquisition activity, acquirers conceivably faced less competition.

Or maybe it's just that acquisitions are typically better than many think. Over the last ten years, we have found that the top acquirers outperformed the bottom group. Thus, in terms of direction, this doesn't seem to be a one-off phenomenon--though 2012 was an above-average year for the TSR of acquirers.

Silver. The second best capital deployment strategy in 2012 was stock buybacks. Buybacks deliver better returns when the share price is generally rising so in a year when the S&P 500 index increased 16% it is no surprise that the top 100 buyback companies delivered 4.8% higher TSR than those not doing buybacks.

Just as in 2011, those buying back more than they issued didn't perform as well. Buying up shares issued either directly or via executive compensation plans benefited TSR by avoiding dilution. But going beyond that--to actually reduce the share count--resulted in less TSR. Perhaps many companies that reduce the share count are not investing in their future, so the share price tends to perform worse.

Bronze. In 2012, building up cash balances was the third best use of the cash companies generated. The top 100 companies that built cash on their balance sheet in 2012 delivered median TSR 4.7% higher than companies the bottom 100 companies that reduced their cash balances. This certainly hasn't been the case over the longer term – building cash usually results in lower TSR.

Perhaps the biggest surprise is that dividends, the gold medal winner for capital deployment in 2011, not only didn't warrant a medal in 2012 but the top-dividend payers this time around actually delivered 2.7% lower TSR than the bottom-dividend payers. Dividend payers tend to outperform in bear markets and underperform in bull markets – and the market delivered above-average returns in 2012. Perhaps fiscal cliff concerns took priority as well as uncertainty about dividend tax rates, which seemed to cause a sell-off in the shares of some dividend payers.

Another surprise in looking at this year's awards was that companies deploying capital toward buying property and plant and equipment did the worst in 2012 despite winning the silver last year. In fact these capital expenditures have outperformed all other capital deployment uses over the last ten years.

What does all of this mean for capital deployment strategy next year? Here are five tips for an effective capital deployment strategy:

1. **BE CAREFUL:** Always start by assessing risk, capital structure, and financial policies to determine if building cash balances and/or debt reduction should be prioritized to avoid instigating a crisis that could have been avoided.
2. **PURSUE GROWTH:** Give a high priority to finding all desirable reinvestment opportunities before contemplating distributions. In over 10 years of research on reinvestment opportunities, we found that only capital expenditures, acquisitions, and R&D tended to improve TSR while dividends, buybacks, and building cash all had a negative influence.
3. **GIVE INVESTMENT A CHANCE:** To ensure all desirable investments are considered, remove any biases against investing in growth in planning and decision-making processes. Avoid messages that convey arbitrary capital limitations, and remove excessive conservatism in investment analysis.
4. **DIVIDENDS ARE NOT FOR SPIN:** On average, top dividend payers delivered worse TSR than the bottom dividend payers over the last ten years, yet many companies pay dividends and have strong TSR. Dividends can be effective but avoid using dividend increases to "convey confidence" when earnings and cash flow are flat. Investors are rarely deceived by this.
5. **TIME BUYBACKS WELL:** Companies emphasizing buybacks did well in 2012. But this has not been the case according to our 10 years of data on the topic. Repurchase stock when the stock price is expected to rise due to unfolding profitable growth opportunities that are not fully reflected in the share price. Try to buy more when the stock dips below the ongoing trend and less when it is above. Or, at a minimum, buy back a constant amount each quarter to avoid overbuying when the stock peaks.

Following these five important capital deployment tips will likely lead to better share price performance through a better balance of growth, profitability, and capital utilization.

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