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How Corporate Governance Matters

Corporate governance and capital allocation

The governing objective, corporate governance and the two camps.

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Properly conceived, corporate governance is a system of checks and balances that a company designs in order to serve its governing objective. A governing objective is a clear statement of what a company is trying to achieve, which ultimately shapes the firm's culture, communications and choices about how it allocates capital (Mauboussin and Rappaport, 2015). In this section, we examine the link between corporate governance and capital allocation.

Since the world of business is dynamic, companies must constantly assess trade-offs and make difficult decisions. A clear governing objective provides executives with a basis to mediate trade-offs in the firm. It also provides the stakeholders, including employees, customers, suppliers, debtors, and shareholders, with information they need to assess a company's prospects and to evaluate its performance.

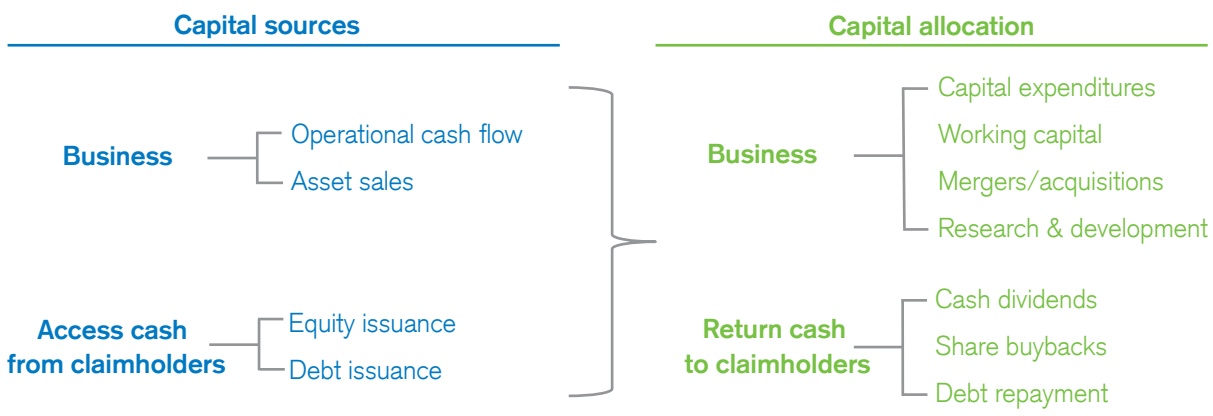
Few companies explicitly state a governing objective, but we can broadly define two camps: maximizing shareholder value and balancing the interests of stakeholders. As a general rule, countries that operate under common law have the strongest protection of shareholders and hence lean towards the shareholder value camp. These countries include the United States, the United Kingdom, and most of the countries that were formerly part of the British Empire (e.g. Australia, Canada and India). Markets for capital and labor play a central role for companies in the shareholder value camp.

Countries that operate under civil law have weaker protection for shareholders and stronger protection for creditors. They tend towards the camp that seeks to balance the interests of stakeholders. These countries include France, Germany and Japan as well as most Scandinavian countries (La Porta and Lopez-de-Silanes, Shleifer, Vishny, 2001). Formal and informal rules about the interaction between constituencies are vital for stakeholder-centered companies.

Naturally, the mindsets of these camps lead to different structures of corporate governance and choices about how a company invests and finances itself. For example, academics who study shareholder and stakeholder-oriented governing objectives have found that firms that are shareholder-centric have a higher proportion of incentive pay for executives in the form of equity, more externally verifiable control mechanisms, more debt as a percentage of total capital, and higher rates of labor turnover than firms that are stakeholder-centric (García-Castro, Ariño, Rodriguez, and Ayuso, 2008).

Some scholars charge that balancing stakeholder interests cannot serve as a company's singular governing objective because it is impossible to simultaneously maximize the interests of all stakeholders (Jensen, 2002). As a result, executives have discretion to make decisions as they see fit. The problem is that investors and other stakeholders have no reliable basis to evaluate a company's strategy as well as the operating and financing choices its managers make.

Figure 31
Sources and uses of financial capital



Source: Credit Suisse

The fundamental role of capital allocation

Capital allocation is the most fundamental responsibility of a public corporation's senior management team. Successful capital allocation means converting inputs, including money, ideas and people, into something more valuable than they would be otherwise. The net present value test is a simple, appropriate and classic way to determine whether management is living up to this responsibility. A company passes the test when the present value of the long-term cash flow from an investment exceeds the initial cost.

There are two reasons value should determine whether a management team is living up to its responsibility. The first is that companies must compete. A company that is allocating its resources wisely will ultimately prevail over a competitor that is allocating its resources foolishly. This reason is particularly important for firms that compete in global markets. The second is that inputs have an opportunity cost, or the value of the next best alternative. Unless an input is going to its best and highest use, it is underperforming relative to its opportunity cost.

Figure 31 (and in more depth, Figures 32 to 39) shows the sources of capital and the ways that a company can allocate capital. The primary source of capital is cash flow from operations. Companies can also access capital by selling businesses or raising funds through the issuance of debt or equity. Companies can invest in the business through capital expenditures, increases in working capital, research and development, and mergers. Firms can also return capital to claimholders by repaying debt, issuing dividends and repurchasing shares. While a comprehensive consideration of capital allocation also takes into account human capital, we restrict our discussion here to financial capital.

Over time, a company's results will reflect a combination of the opportunities it has and how the executives allocate capital. Industries and companies generally have a lifecycle where a start-up period is followed by a phase of growth, a fade in return on investment, and ultimately a state of maturity (Madden, 1999). Investment in the business is strongest in the early part of the lifecycle and the proclivity to return capital to claimholders is higher towards the end.

Capital allocation is a dynamic process, so the correct answer to most questions is: "It depends." Sometimes acquiring makes sense and other times divesting is the better alternative. There are times to issue equity and times to retire it. As the components that determine price and value are changing constantly, so too must the assessments that a chief executive officer (CEO) makes. As Warren Buffett, CEO of Berkshire Hathaway says: "The first law of capital allocation — whether the money is slated for acquisitions or share repurchases — is that what is smart at one price is dumb at another" (Buffett, 2011).

A basic equation in finance says that a company's sustainable earnings growth rate is a function of its return on investment and the amount it pays out to shareholders. Companies with high returns on investment can sustain more rapid growth than companies with low returns, holding constant the payout ratio.

As a result, companies in a country with a high return on investment can generally fund a greater percentage of their investments with internally-generated cash than companies in a country with a low return. Figure 40 shows this correlation, using cash flow return on investment (CFROI) as a measure of return on investment. The data reflect the average of the ten years up to 2014.

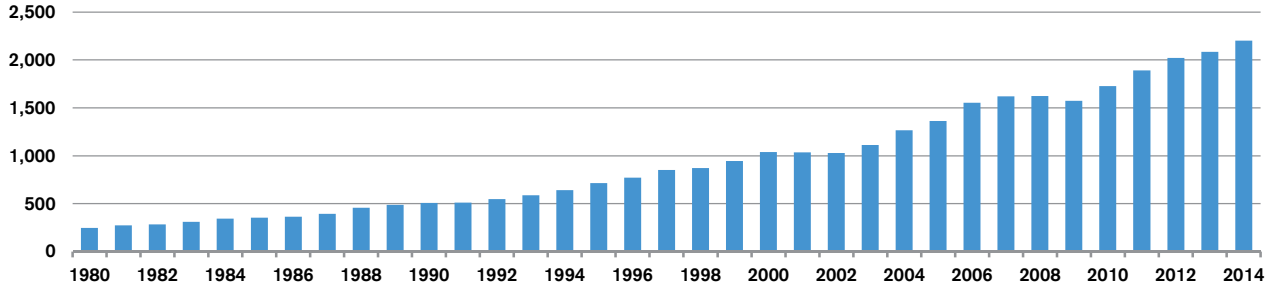
Tying this idea back to corporate governance, countries with a bias towards shareholder value also generate higher CFROI than those that lean towards the balanced stakeholder approach. Specifically, the five largest markets under common law (USA, UK, Hong Kong, Australia, and Canada) have realized an average CFROI of 8.0% since 1994, while representative countries under civil law (Japan, Germany, France, Switzerland, and Sweden) had an average of 6.4%. So for the same rate of growth, common-law countries can afford a higher payout ratio than civil-law countries.

Maximizing long-term value creation per share is the result of making investments that earn in excess of the cost of capital, including the repurchase of shares. A company's governing objective and the corporate governance structures that support it have a profound influence on how the firm allocates capital. We now examine how capital has been allocated across different regions of the globe.

Figure 32

Capital sources: Business operational cash flow

USD in billions, gross cash flow (real)



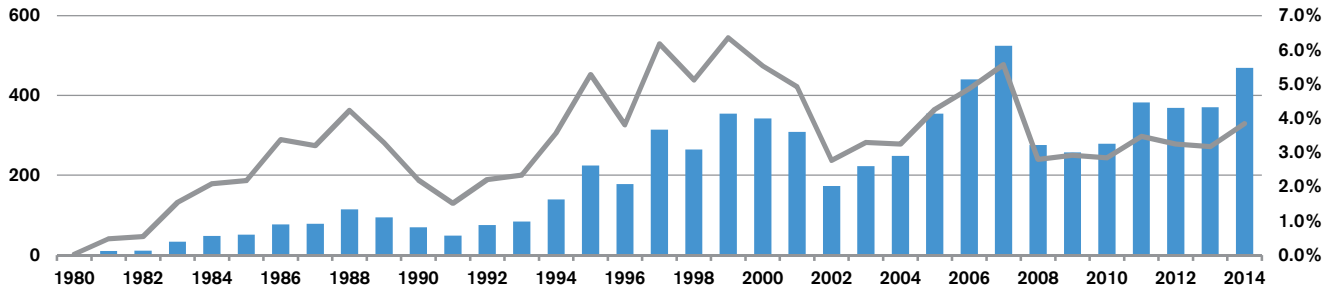
Source: Thomson Reuters DataStream, Credit Suisse HOLT, Credit Suisse

Note: dollar amounts are not inflated. Data includes top 1,500 US industrial firms, excludes financial companies and regulated utilities.

Figure 33

Capital sources: Business asset sales (divestitures)

USD in billions, line (right axis) represents percentage of net sales

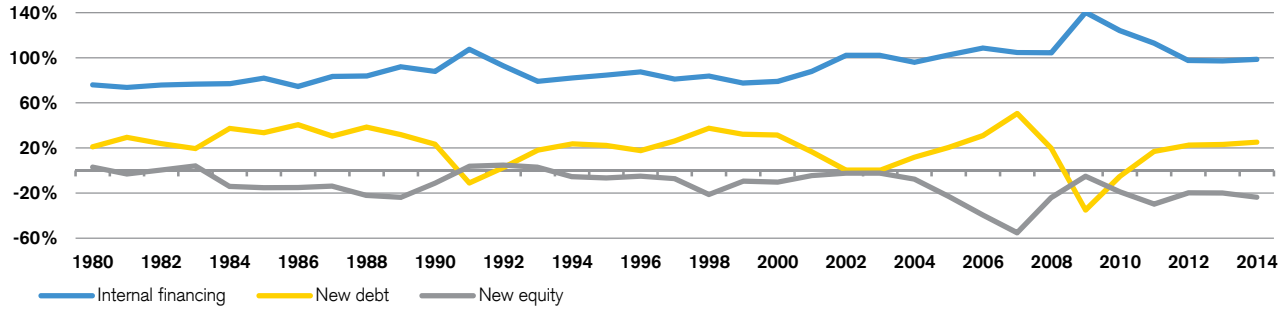


Source: Thomson Reuters DataStream, Credit Suisse HOLT, Credit Suisse

Note: dollar amounts are not inflated. Data includes all industries; excludes debt tender offers, equity carve-outs, exchange offers, loan modifications, and open market repurchases.

Figure 34

Capital sources: Equity and debt issuance

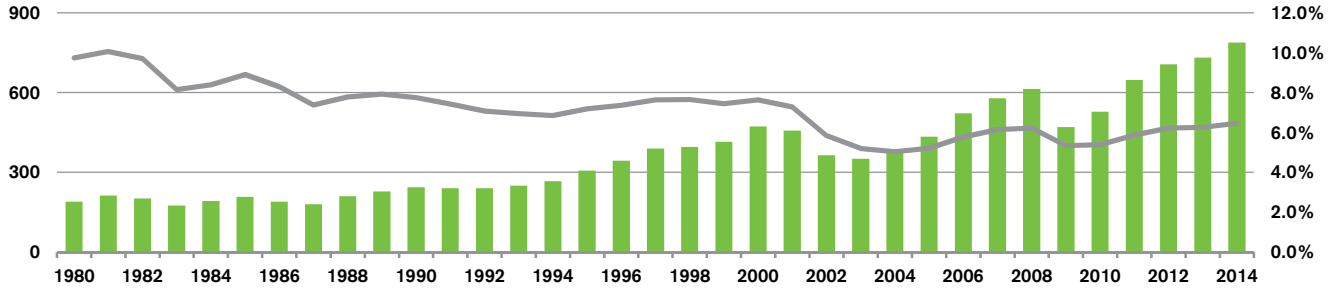


Source: Board of Governors of the Federal Reserve System, Division of Research and Statistics, Flow of Funds Accounts Table F.103.

Figure 35

Capital allocation: Business capital expenditures

USD in billions, line (right axis) represents percentage of net sales



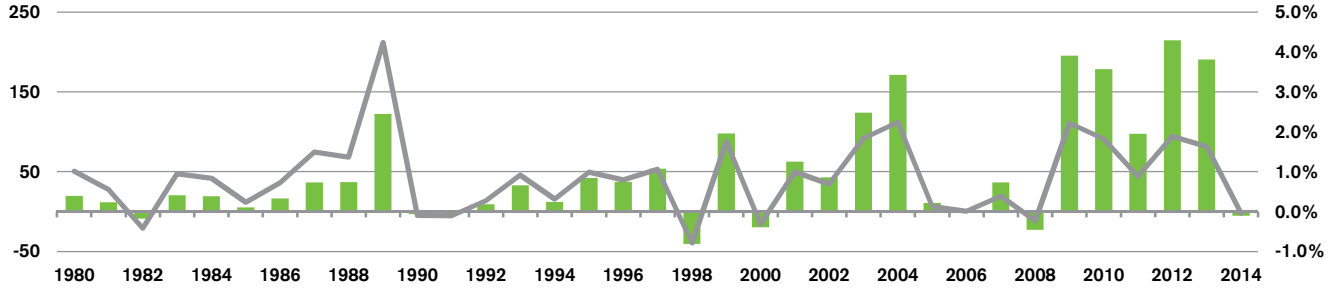
Source: Thomson Reuters DataStream, Credit Suisse HOLT, Credit Suisse

Note: dollar amounts are not inflated. Data includes top 1,500 US industrial firms, excludes financial companies and regulated utilities.

Figure 36

Capital allocation: Change in net working capital

USD in billions, line (right axis) represents percentage of net sales



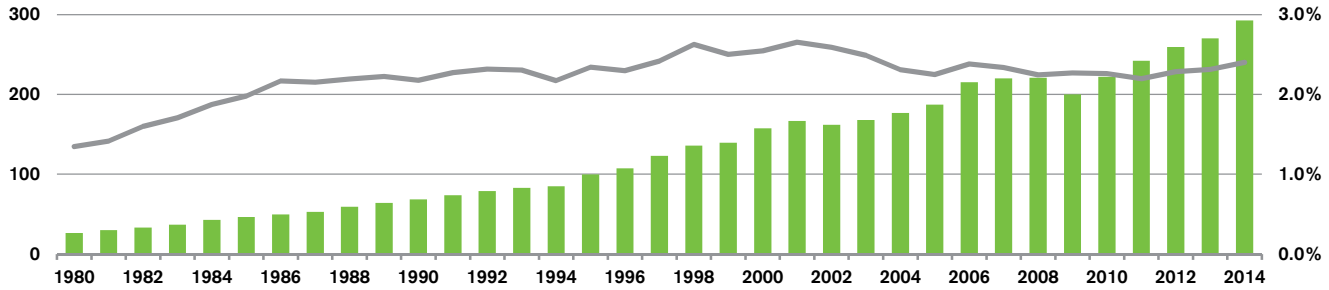
Source: Thomson Reuters DataStream, Credit Suisse HOLT, Credit Suisse

Note: dollar amounts are not inflated. Data includes top 1,500 US industrial firms, excludes financial companies and regulated utilities.

Figure 37

Capital allocation: Business research & development

USD in billions, line (right axis) represents percentage of net sales



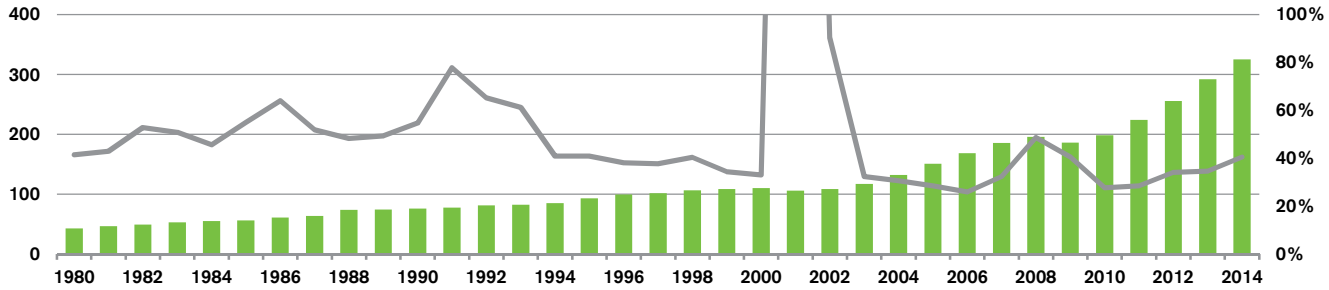
Source: Thomson Reuters DataStream, Credit Suisse HOLT, Credit Suisse

Note: dollar amounts are not inflated. Data includes top 1,500 US industrial firms, excludes financial companies and regulated utilities.

Figure 38

Capital allocation: Cash dividends

USD in billions, line (right axis) represents percentage of net sales



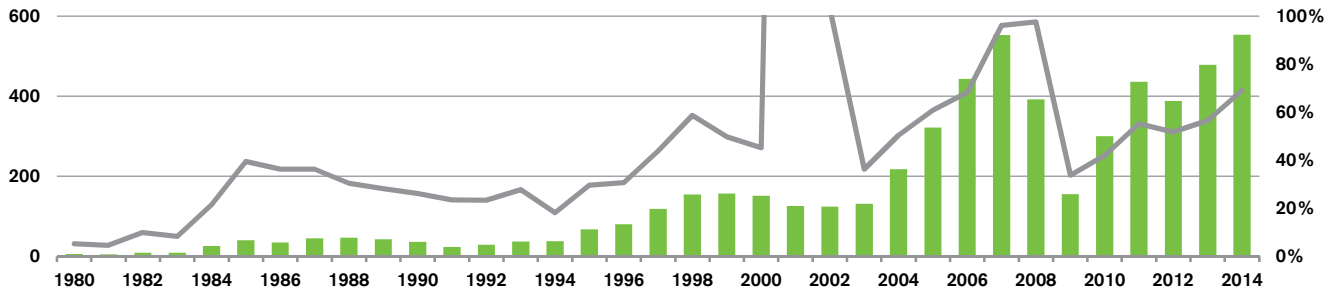
Source: Credit Suisse HOLT

Note: Dollar amounts are not inflated. Data includes top 1,500 US industrial firms, excludes financial companies and regulated utilities.

Figure 39

Capital allocation: Gross share buybacks

USD in billions, line (right axis) represents percentage of net sales



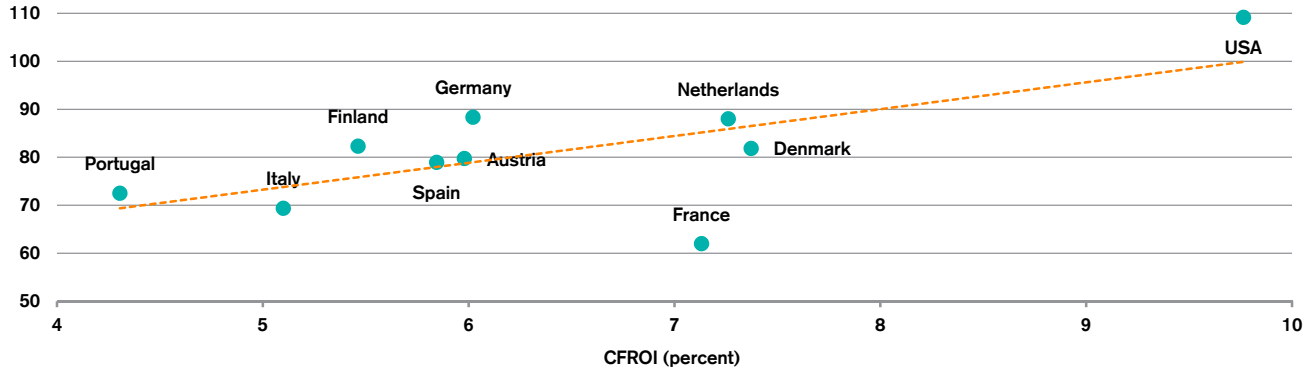
Source: Credit Suisse HOLT

Note: dollar amounts are not inflated. Data includes top 1,500 US industrial firms, excludes financial companies and regulated utilities.

Figure 40

Relationship between CFROI and internal financing capability (2005-2014 average)

Internal financing (percentage of total)



Source: Europe: Eurostat European Sector accounts; U.S.: Board of Governors of the Federal Reserve System, Division of Research and Statistics, Flow of Funds Accounts Table F.102; Credit Suisse.

Table 3

Capital deployment by region

Historical averages for USA, Japan, Europe, APEJ, and GEM

	Uses of capital (as a percentage of sales)							Economic returns and growth	
	M&A	Capex	R&D expense	Net working capital	Gross buybacks	Divestitures	Dividends	CFROI	Real asset growth rate
USA	10.4%	7.1%	2.2%	0.8%	2.1%	3.3%	2.2%	8.5%	5.6%
Japan	1.2%	4.6%	2.1%	1.2%	0.2%	0.4%	0.6%	3.0%	3.3%
Europe	9.7%	7.0%	2.0%	1.5%	0.6%	5.1%	2.2%	6.7%	3.9%
APEJ	10.2%	10.5%	0.8%	2.8%	0.4%	5.1%	2.6%	6.4%	9.8%
GEM	15.8%	12.1%	0.3%	3.7%	0.5%	6.5%	3.2%	6.3%	9.3%

Source: Credit Suisse HOLT.

Note: for uses of capital, historical averages are based on the following years: USA (1980-2013), Japan (1985-2013), Europe (1985-2013), APEJ (1992-2013), GEM (1992-2013), For CFROI® and real asset growth rates, historical averages are based on the years 1993-2013 for all regions.

The history of capital deployment

Table 3 shows capital allocation in recent decades by region, including the United States, Japan, Europe, Asia Pacific ex-Japan (APEJ) and global emerging markets (GEM). The exhibit also shows CFROI and asset growth, adjusted for inflation, over the last 20 years.

The main observations on spending in recent decades include the following:

- M&A is the largest use of capital in the USA, Europe and GEM, the second largest use in APEJ, and the fourth largest use in Japan. The rarity of M&A in Japan is of particular note.
- Capital expenditures are the largest use of capital in Japan and APEJ and the second largest use in the USA, Europe and GEM.
- R&D is the second largest use of capital in Japan, the third largest in the USA and Europe, and the fourth largest in APEJ and GEM. Developed markets spend substantially more on R&D than developing markets.
- Divestitures play a significant role in each of the regions, constituting roughly one-third to one-half the level of total M&A. They are also larger than dividends and share buybacks in all regions but Japan.
- Dividends substantially exceed share buybacks in all regions except the USA, where they have been roughly equivalent on average. Buybacks are modest in Europe and fairly insignificant in Japan, APEJ and GEM.
- Share buybacks have been meaningful in common-law countries and inconsequential in nearly all other regions. This pattern reflects cultural and regulatory constraints.

A country's legal tradition appears to lead to implicit assumptions about what the governing objective should be as well as the society's rules and regulations.

PHOTO: ISTOCKPHOTO.COM/CERCHI

Incentives and capital allocation

One of the enduring lessons of economics is that incentives matter. It is also the case that incentives designed to achieve one objective can lead to unintended consequences. The goal of this section is to consider whether the incentives a company has in place encourage judicious capital allocation. Most of these incentives address compensation.

Agency theory is the classic way to explain why the managers of a company may not act in the interests of the shareholders (Jensen and Meckling, 1976). The idea is that conflicts can arise when there is a separation between a firm's ownership (principal) and control (agent). There are three areas where these conflicts tend to arise (Lambert and Larcker, 1991).

The first is that while it is clear that shareholders want management to maximize the value of their holdings, management may derive benefits from controlling resources that don't enrich shareholders. For example, if remuneration is roughly correlated with the size of the firm, management may seek value-destroying M&A deals to grow.

The second area of conflict is with risk tolerance. Since shareholders tend to hold stocks as part of a diversified portfolio, whereas managers are disproportionately exposed to their own company, managers may seek less risk than shareholders would deem appropriate.

The final conflict is with time horizon. To the degree that compensation plans have a shorter time horizon than the period shareholders use to assess the merit of an investment, there can be a mismatch. So managers may dwell on short-term boosts in earnings. Indeed, research shows that a large majority of managers are willing to forego value-creating investments to deliver near-term earnings (Graham, Harvey and Rajgopal, 2006).

The principal-agent problem arises in capital allocation choices. For example, some companies repurchase stock to offset the dilution of equity issuance to employees (Kahle, 2002) or boost earnings per share (Hribar, Jenkins, Johnson, 2006) without consideration of the economic merits of such repurchases. Further, research shows that companies with strong anti-takeover provisions, which are less subject to market pressures, are more likely to pursue acquisitions that build an empire and destroy shareholder value than companies with fewer such provisions (Masulis, Wang and Xie, 2007).

There is also a link between compensation and capital allocation. Recent research suggests that overall CEO compensation and the use of compensation based on equity have a positive correlation to institutional ownership and board independence, variables that academics commonly use as proxies for quality and governance. Further, convergence in ownership structure and the globalization of capital markets have led to a narrowing of the dispersion between US and non-US CEO pay (Murphy, 2013).

The main point is that compensation practices should be consistent with a firm's governing objective. The goal is to encourage executives to allocate capital so as to maximize their long-term remuneration. While the structure of incentives depends on the governing objective a firm selects, the main task is to ensure that remuneration is congruent with those objectives.

Five principles of capital allocation

Here are five principles that investors can use as a sound benchmark to measure management's mindset regarding capital allocation (McTaggart, Kontes and Mankins, 1994).

1. **Zero-based capital allocation:** Companies generally think about capital allocation on an incremental basis. For example, a study of more than 1,600 US companies by McKinsey found that there was a 0.92 correlation between how much capital a business unit received in one year and the next. For one-third of the companies, that correlation was 0.99. In other words, inertia appears to play a large role in capital allocation (Hall, Lovallo, Musters, 2012).
   The proper approach is zero-based, which simply asks: "What is the right amount of capital (and the right number of people) to have in this business to support the strategy that will create the most wealth?" There is no reference to how much the company has already invested in the business, only how much should be invested. Research by McKinsey suggests that those companies that showed a zero-based allocation mindset, and hence were the most proactive in reallocating resources, delivered higher total shareholder returns than the companies that took more of an incremental approach.
2. **Fund strategies, not projects:** The idea here is that capital allocation is not about assessing and approving projects, but rather assessing and approving strategies and determining the projects that support the strategies. Practitioners and academics sometimes fail to make this vital distinction. The key to this principle is recognizing that a business strategy is a bundle of projects and that the value of the bundle is what matters. The CEO and board must evaluate alternative strategies and consider the financial prospects of each.
3. **No capital rationing:** The attitude at many companies, which the results of surveys support, is that capital is scarce but free. The sense is that the business generates a limited amount of capital, which makes it scarce, but since it comes from within it is free.
   A better mindset is that capital is plentiful but expensive. There are two sources of capital that companies can tap beyond the cash generated internally. The first is redeploying capital from businesses that do not earn sufficient returns. Management can execute this inside the company or sell the underperforming businesses and redeploy the proceeds. The second is the capital markets. When executives have value-creating strategies that need capital, the markets are there to fund them in all but the most challenging environments.
4. **Zero tolerance for bad growth:** Companies that wish to grow will inevitably make investments that do not pay off. The failure rate of new businesses and new products is high. Seeing an investment flop is no sin; indeed it is essential to the process of creating value. What is a sin is remaining committed to a strategy that has no prospect of creating value, hence draining human and financial resources.
5. **Know the value of assets, and be ready to take action to create value:** Intelligent capital allocation is similar to managing a portfolio of stocks in that it is very useful to have a sense of the difference, if any, between the value and price of each asset. This includes the value of the company and its stock price. Naturally, such analysis must incorporate considerations including taxes.
   With a ready sense of value and price, management should be prepared to take action to create value. Sometimes that means acquiring, other times that means divesting, and frequently there are no clear gaps between value and price. As we have seen, managers tend to prefer to buy than to sell, even though the empirical record shows quite clearly that sellers fare better than buyers on average.

Summary

A governing objective is what a company says, capital allocation is what a company does, and corporate governance is the mechanism to make sure companies do what they say. Most companies around the world don't articulate a clear governing objective, but countries under common law tend to favor shareholders, and those under civil law tend to favor other stakeholders.

Over time, capital allocation determines a company's growth, cash flows, and viability. It is the most important responsibility of management. Thoughtful investors need to understand the history of a company's capital allocation and critically assess its actions in light of its goals (Mauboussin and Callahan, 2015).

PHOTO: ISTOCKPHOTO.COM/JOHNNYGREIG

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