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Capital Allocation Strategies For Audit Committee Members

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Audit committees in the United States are facing increased demands from many quarters in 2015, which expand their responsibilities, expose them to greater shareholder and regulatory scrutiny and potential liabilities, and can provide the basis for proxy advisers and shareholder activists to oppose the re-election of audit committee members to the board of directors of the company.

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For example, audit committees, given the financial sophistication and independence of their members, can be seen as logical corporate governance bodies to initially address pressures on board oversight of capital allocation that are resulting from heightened shareholder activism, growing desires by institutional investors for substantial capital returns to shareholders, and current academic and business school focus on capital efficiency. Currently, there is little concrete regulatory or legal requirements or guidance for audit committees and boards in addressing capital allocation issues, and best practices are still taking shape and evolving.

This article[1] discusses the increasing need for boards of public companies, and potentially their audit committees, to focus on capital allocation strategies in response to the growing influence and pressure from activists and institutional investors.[2]

Shareholder Activism Pressures and Capital Allocation

Shareholder activism, at its core, is often a challenge to corporate capital allocation priorities. There are more than 100 hedge funds with more than $200 billion in capital pursing activist strategies,[3] and that activist capital can be magnified many times more through leverage and derivative strategies. Activists often receive strong support from such institutions as: Institutional Shareholder Services, the leading proxy adviser; leading pension funds, such as the California Public Employees' Retirement System, California State Teachers' Retirement System and NY Retirement; and leading mutual fund complexes, including Fidelity, Invesco and T. Rowe Price. In 2014, there were 348 activist attacks on public companies, with many more behind-the-scenes pressuring of companies. An additional 108 activist campaigns were launched in the first quarter 2015.[4]

When activists pursue a proxy fight to the end, the activists generally win 80 to 90 percent of the time.

The recent publicized proxy victory of DuPont over Trian Partnersshould not be viewed as fundamentally changing this trend, but rather as the exception that proves the rule. The DuPont vote was very close and tipped by the votes ofBlackRock and Vanguard with their immense portfolios in support of DuPont's management.[5] Yet, DuPont's management made large expenditures to prevail, and DuPont's management was distracted from full-time strategic pursuits for many months by this costly proxy fight.

In response to the ISS recommendations to support the Trian activists over DuPont, Marty Lipton, the prominent long- time takeover defense adviser, recently and reluctantly acknowledged that it may be advisable for many companies to accede to activists' strategies rather than face the cost and disruption of opposing them and facing likely defeat. "[Some activists] have become respected members of the financial community ... in some cases even winning a drawn out proxy battle can be more damaging to a corporation than a reasonable settlement with acceptable board representation."[6]

Institutional Shareholder Pressures and Capital Allocation

It is not only the activists who are pressuring public companies in capital allocations, as assertive institutional investors have begun to directly engage with public companies and their boards, with capital allocation a recurrent priority. In July 2014, the Shareholder-Director Exchange, an organization that describes itself as "a working group of leading independent directors and representatives from some of the largest and most influential long-term institutional investors," announced that it had sent a letter to the lead directors and corporate secretaries of every Russell 1000 company proclaiming "SDX Protocols" for institutional shareholder/director engagement.

The signatory investor members of the Shareholder-Director Exchange represent more than $10 trillion in assets under management and include prominent investment groups such as BlackRock, CalSTRS, and State Street Global Advisors. The SDX Protocols provide guidance for "the growing trend toward shareholder director exchange," with one of the highlighted topics that is emphasized for discussions being "board oversight of capital allocations,"[7] which many boards view as code word for increased capital allocations to dividends and share buybacks.

Activists, Institutions and Capital Allocation

How do shareholder activists and assertive institutional investors look at companies? The activist playbook focuses heavily on capital generation and capital reallocation strategies. To increase capital internally, the standard activist strategy is to raise internal capital through divestitures, while reducing capital allocations to research and development, capital expenditures and working capital. To generate additional capital from internal earnings, the standard activist strategy is to reduce compensation, benefit and other costs and to establish structures that reduce effective tax rates and costs.

At their core, the activist strategies are largely directed at increasing and then reallocating capital, principally to dividends and buybacks. It was recently noted that 449 companies in the S&P 500 that were publicly listed from 2003 through 2012 applied more than 90 percent of their net income to dividends and share repurchases during that period.[8] Recently, the Wall Street Journal reported a study by S&P Capital IQ showing that companies in the S&P Index sharply increased their spending on dividends and buybacks to a median of 36 percent of operating cash flow in 2013, from 18 percent in 2003, while cutting capital expenditures on property, plant and equipment (PP&E) to 29 percent of operating cash flow in 2013, from 33 percent in 2003.[9]

For those S&P 500 companies targeted by activists, the spending cuts were more dramatic. According to

the study, targeted companies reduced business-related capital expenditures in the five years after activists bought their shares to 29 percent of operating cash flow, down from 42 percent the year before. Those companies boosted spending on dividends and buybacks to 37 percent of operating cash flow in the first year after being approached by activists, from 22 percent in the year before.[10]

Also from this capital allocation perspective, professors from Columbia and Rutgers recently observed that most activist shareholder gains can be explained as wealth transfers to shorter-term, activist shareholders and extracting wealth and capital allocations from longer-term creditors, employees and government tax recipients.[11] Again, this observation makes sense against the broader capital reallocation strategies of activists.

Capital Allocation and Capital Efficiency

Spurred by activists, how are sophisticated institutional investors and academic strategists increasingly looking at companies? Often, through capital allocation analyses that focus more on return on invested capital (ROIC) and return on equity (ROE). Recent academic research suggests that rapid asset growth is associated with poor relative shareholder returns and ROIC, and that companies that contract their assets often create substantial value per share and ROIC.[12] McKinsey has determined that companies that strategically determined to reallocate capital resources across business units earned, on average, 30 percent higher total returns for shareholders as compared to companies that were more static in their capital allocations. Such corporate capital reallocators were also 13 percent more likely to avoid takeover or bankruptcy, McKinsey found.[13]

Audit Committees and Capital Allocation

Capital allocations are a core corporate responsibility, central to corporate independence, strategy and forecasts. Among standing corporate board committees, the audit committee can become a focal point of capital allocation responsibility for many reasons, including its role in overseeing the corporation's financial statements, reviewing the corporation's budgets and forecasts, monitoring corporate and financial risk, as well as its familiarity with the corporation's historical results and capital allocation.

Another reason capital allocation can be seen as a topic for the audit committee arises from the focus, as noted in the SDX Protocols, on discussions between institutional investors and independent directors regarding capital allocation issues, which aligns with the independent director status of audit committee members. Also, new audit committee responsibilities — driven by the regulatory requirements for auditors adopted by the Public Company Accounting Oversight Board — to discuss the long-term financial incentives and risks of executive compensation with auditors is likely to deepen audit committee involvement with capital allocation decisions.

While the audit committee may well be a very good corporate governance body to initiate and address capital allocation determinations, the full board needs to address capital allocation determinations given its fundamental importance to long-term corporate strategy.

What Do Audit Committees Confront With Capital Allocation Discussions?

An initial challenge for audit committees is that they have no specific directive to address capital allocation decisions, neither are there any definitive regulatory, legal or other guidance, or any recognized best practices for audit committees and boards to consider in addressing capital allocation strategies. This challenge is further heightened by some very practical, real obstacles.

According to Credit Suisse, many CEOs and companies, though well-intentioned, are not familiar with capital allocation analyses and strategies and simply don't know how to allocate capital effectively.[14] According to McKinsey, corporate inertia from internal status quo politics and cognitive discomfort and dissonance anchored in past practices are the biggest hurdles to companies confronting capital reallocation.[15] Capital allocation decisions can reallocate winners, survivors and losers internally.

Practically speaking, a good time to pursue capital allocation issues is as part of the annual or periodic reviews of corporate budgets and/or review of financial targets for executive compensation and long-term incentives.

In the face of corporate inertia, boards and the executive management might ask themselves, "Shouldn't we consider and examine ourselves proactively, and stay abreast of our competitors instead of waiting for shareholder activists and aggressive institutional investors to force these inquiries on their timetable and for their purposes?" As the Shareholder-Director Exchange more bluntly emphasizes, "it is shortsighted for corporate boards to avoid engaging with their long-term investors when activists frequently meet with those same institutions to pursue corporate change."[16]

What Should Audit Committees Ask Now About Capital Allocation?

Looking at capital allocation challenges, what might be some current questions and best practices for audit committees, recognizing there is no definitive requirements or guidance in examining capital allocation issues?

- Look at the company's historical capital allocations (mergers and acquisitions, capital expenditures on PP&E, research and development and working capital) and capital repayments and returns during the past three to five years, and consider the ROIC or ROE on these capital allocations.

- Look at the company's historical capital allocations and consider these capital allocations and their ROIC or ROE against industry and market norms. Are there industry or market benchmarks that should be considered in evaluating company capital efficiency? Is working capital actively managed in order to free up capital to its most productive uses? Are there fixed assets, including PP&E, that could be sold or redeployed in order to free up capital for more productive purposes?

- Consider appropriate capital allocation returns and the targeted ROIC or ROE for the company's business strategies and plans for upcoming years. Consider when adequate capital returns will be assessed, measured and then the subject of corporate decision. An aphorism at Google — "fail fast" — distills the concept of boldly allocating capital, but then also boldly deciding when a capital allocation has been misspent and should be discontinued.

- Consider the value of assets and their capital productivity in the hands of the company as compared to their value in the external market or their prospects in the hands of other organizations. Should assets be sold or redeployed?

- Consider how the company's allocation of capital aligns with and advances its strategic priorities. Does the audit committee understand the alignment of the company's business strategies and capital allocation strategies — considering the capital requirements, timing and

risk adjustments to capital allocations, expected capital rates of return, and monitoring and measurements of these capital returns? (A consistent view of many observers is that many companies do not closely link capital allocation strategies with business, operating and expansion strategies.) During the capital allocation process, how much is the long-term strategy taken into account? To what extent are relative returns on capital considered among the various allocation opportunities? Are capital allocations linked to strategic goals and consistent with the company's risk appetite?

- To challenge corporate inertia, some companies consider, and more activist investors are wanting, capital allocations on a "clean slate," or by "zero-based budgeting," not anchored to past capital allocation budgets. (Many boards share a concern now that capital allocations are static, continuing from prior periods, and not re-evaluated or reallocated.) What are the status quo politics and inertia that might narrow creative capital reallocation strategies?

- Does the company have the right controls and metrics in place to enable the board to oversee management's capital allocation decisions and monitor their performance? Is it clear what authority different management levels have over capital expenditures? Is there an expectation as to when capital allocations will be viewed as not meeting expectations and changed? Is there an appropriate level of board participation in the capital allocation process — both in reviewing and approving major capital expenditures and in taking a holistic view of the company's capital allocation strategy?

- Are executive compensation and incentives consistent with efficient allocation of capital along with long-term corporate capital, strategic and other objectives? (Most companies benchmark company performance for executive incentive purposes on earnings, earnings per share or total shareholder returns, none of which focus fully on capital allocation efficiency.) Are executives explicitly or indirectly rewarded for accomplishing capital deployment and balance sheet targets, and capital return targets, not simply income statement targets? Or, are executive compensation incentives tied to short-term income statement results, instead of longer-term, risk-adjusted capital returns?

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[1] Portions of this Update were initially presented at the KPMG LLP Audit Committee Institute Board Perspectives Spring 2015 Audit Committee Roundtable Series, "Is the Company Using Its Capital Wisely? Audit Committees and Capital Allocations," June 10, 2015, although this Update solely expresses the views of our firm, and not KPMG.

[2] This article follows from our earlier articles: "3 More Considerations For Audit Committees," which discusses internal investigation privilege and confidentiality, expanding PCAOB-mandated rules for audit committees, and continued ISS corporate governance scrutiny of audit committee members; "3 Considerations For Audit Committees In 2015," which discusses tax, whistleblower and revenue

recognition issues for audit committees; and “Three Things US Audit Committee Members Should Consider Now,” which addressed auditor independence, cybersecurity and Foreign Corrupt Practices Act/bribery issues for audit committees.

[3] “Dealing With Activist Hedge Funds,” Wachtell Lipton Rosen & Katz (November 2014).

[4] “Companies Send More Cash Back To Shareholders,” Wall Street Journal (May 2015).

[5] “BlackRock CEO Larry Fink Just Told the World’s Biggest Business Leaders To Stop Worrying About Short Term Results,” Business Insider (April 2014).

[6] “Some Lessons From DuPont-Trian,” Wachtell Lipton Rosen & Katz (May 2015)

[7] See Shareholder-Director Exchange (SDX) Protocol, www.sdxprotocal.com

[8] “Profits Without Prosperity,” by William Lazonick, Harvard Business Review (September 2014)

[9] “Companies Send More Cash Back To Shareholders,” Wall Street Journal (May 2015).

[10] “Companies Send More Cash Back To Shareholders,” Wall Street Journal (May 2015).

[11] “The Impact of Hedge Fund Activism: Evidence and Implications,” John Coffee/Columbia University and Darius Palia/Rutgers Business School (2014).

[12] “Capital Allocation: Evidence, Analytical Methods, and Assessment Guidance,” Credit Suisse Global Financial Strategies (August 2014).

[13] “How to Put Your Money Where Your Strategy Is,” McKinsey Quarterly (March 2012).

[14] “Capital Allocation: Evidence, Analytical Methods, and Assessment Guidance,” Credit Suisse Global Financial Strategies (August 2014).

[15] “How to Put Your Money Where Your Strategy Is,” McKinsey Quarterly (March 2012).

[16] See Shareholder-Director Exchange (SDX) Protocol, www.sdxprotocal.com.

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