AGF INSIGHTS

MARKETS

Intelligent capital allocation

An overlooked concept in investing

AUGUST 2016

Executive Summary:

- Overall, we believe capital allocation is management's most important responsibility and look for management teams that display an unwavering focus on long-term value per share.
- Ultimately, intelligent capital allocation is about understanding the long-term value of an array of opportunities and putting money to its best use.
- With a tepid economic environment and the risks of elevated debt levels lurking in the background, as well as the uncertain consequences of the unprecedented degree of monetary stimulus, now is the time to be investing in companies that understand the importance of their capital allocation decisions.

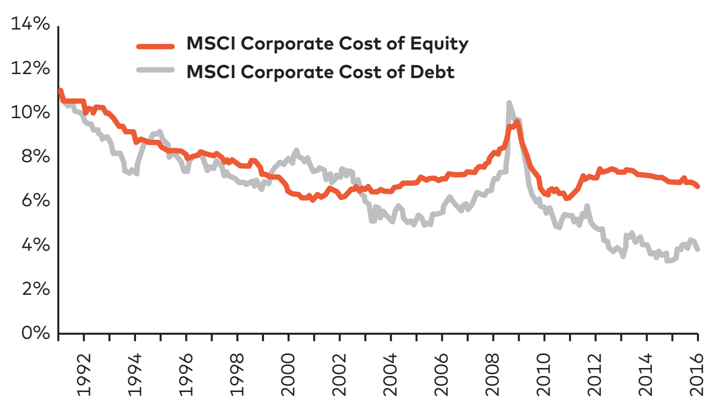
By Stephen Way, CFA
Senior Vice-President and Portfolio Manager
Global Equity Team
AGF Investments Inc.

We believe capital allocation is the most critical way company management teams add (or destroy) value for shareholders. This process of capital allocation or, more simply put, the process by which financial resources are disbursed among different projects, has a significant impact on shareholder wealth. Indeed, we have found that, over time, the returns enjoyed by shareholders are primarily a function of management's decisions about capital expenditures, dividends/share buybacks, and merger & acquisition (M&A) activity as well as the level of debt and equity used to finance the business.

Yet, despite its importance, few management teams understand the importance of capital allocation. In his 1987 letter to investors, Warren Buffett remarked, "the heads of many companies are not skilled in capital allocation," and quipped, "in the end, plenty of unintelligent capital allocation takes place in corporate America, that's why you hear so much about 'restructuring'".[1] This leaves investors with the task of evaluating the companies in their portfolio to ensure that management teams are making capital decisions that enhance shareholder wealth.

The question of capital allocation is particularly important today given a lacklustre growth environment and accommodative central bank policies. A lacklustre growth environment means that top-line sales growth remains challenged, leaving companies scrambling to find ways to engineer growth. Additionally, accommodative monetary policy has resulted in an unprecedented low cost of debt, which has made it easier for companies to obtain financing. While the cost of debt has fallen consistently over the last 25 years, the cost of equity has remained unchanged for the last 15 years[2] and we now have the widest gap between the cost of debt and the cost of equity in history (Figure 1).

Figure 1 – Widest gap in history for cost of debt vs. cost of equity*

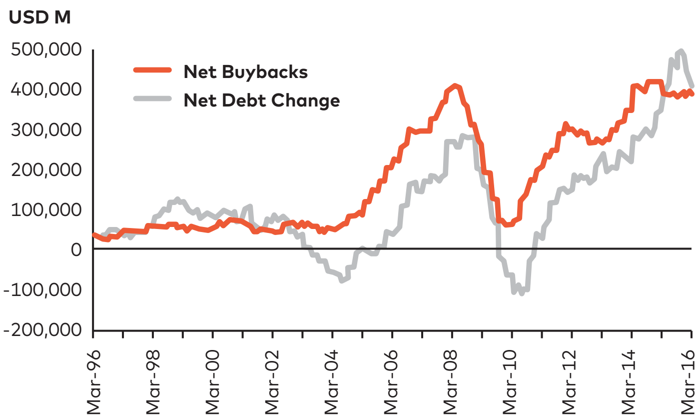


Sources: Citi Research, Datastream. *Average of United States and Europe. March 24, 2016.

This environment is incentivizing companies to borrow to fund M&A activity and share buybacks, with a commensurate increase in leverage (Figure 2). In such an environment, prudence is required; how companies deploy capital will be a key determinant of how they will fare when interest rates start to increase or if growth remains lacklustre. Put another way, where companies choose to invest today will in large part determine their long-term returns for shareholders.

[1] Warren Buffett, 1987 Letter to Shareholders.
[2] Citi Research, March 24, 2016.

Figure 2: U.S. non-financials borrowing mainly to fund buybacks



Source: SG Cross Asset Research/Equity Quant, Factset, company reports and accounts, April 12, 2016.

The discipline of investing capital to earn a return above the cost of capital can also help guard against the tendency for management teams to imitate one another at the expense of shareholders. In the 1986 Berkshire Hathaway annual report, Warren Buffett discussed a force that is often prevalent among corporate executives that leads them to imitate the actions of their peers. He labelled this the 'institutional imperative,' observing that CEOs will mindlessly imitate each other when it comes to corporate actions such as M&A, share buybacks or dividend increases. This was 20 years ago and yet we continue to see the concept alive and well with share buyback activity being financed via debt and with M&A activity at an all-time high.

Economic Value Added – a framework for assessing capital allocation

The AGF Global Equity team spends a lot of time looking at how management is allocating capital in their businesses, particularly as failure to allocate capital wisely can lead to many years of underperformance.

We focus on Economic Value Added (EVA) – the ability to generate returns on investments in excess of a firm's cost of capital – as this is a key indicator of a company's effective deployment of capital. Ultimately, intelligent capital allocation means that monies invested in the business generate long-term cash flows in present-value terms that exceed the initial cost of that investment. If a company can consistently generate returns above its weighted average cost of capital (WACC), and grow its asset base, it has the potential to generate value for shareholders.

The metric we use to measure returns is cash flow return on investment (CFROI). This is an approximation of the average real internal rate of return earned by a firm on all its operating assets. The CFROI must exceed the company's WACC for the company to create shareholder value. Importantly, the compounding effect of a company consistently investing its cash flows to earn a high return that exceeds its WACC – while at the same time growing its asset base, can have tremendous benefits to shareholders. This concept is well supported by research: a study by Credit Suisse HOLT found that companies with a high and stable CFROI outperformed peers by 2.6% on an annualized basis over a 25-year period.[3]

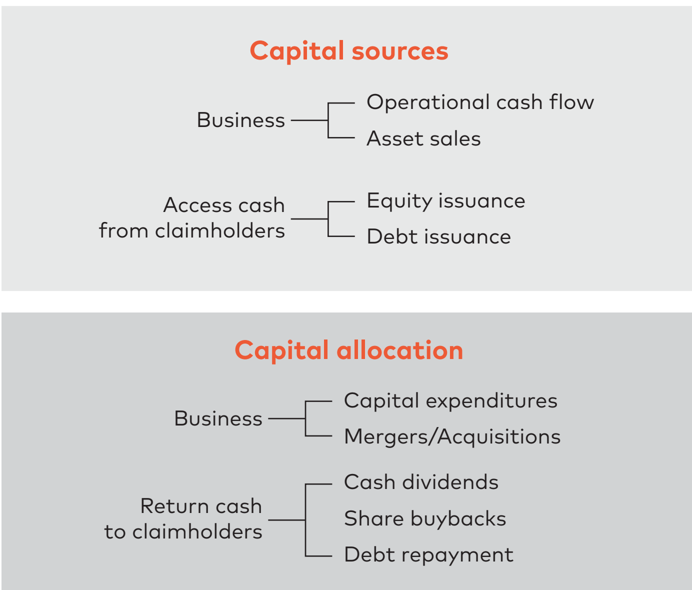
CFROI is a real rate of return earned by a firm on all its assets. CFROI emphasizes a company's cash generating ability, by taking accounting information and converting it to cash, to determine if a company is creating wealth or destroying it. The CFROI measure also adjusts for inflation and allows for comparability of performance across national borders and across time. The level of economic profits earned by a company is driven by both the ability to earn a rate of return that exceeds the cost of its capital, as well as the amount of its assets. As such, economic profits tend to increase when high CFROI companies also deliver high growth.

[3] Source: Credit Suisse HOLT, August 2016

Capital deployment alternatives

Capital is deployed to various uses, including M&A activity, capital expenditures/research & development, cash dividends and share buybacks. It can be sourced either from internally generated cash flow, debt financing or issuing equity (Figure 3). As each of these deployment alternatives have their own benefits and pitfalls, we evaluate their merits below.

Figure 3 – Capital deployment alternatives

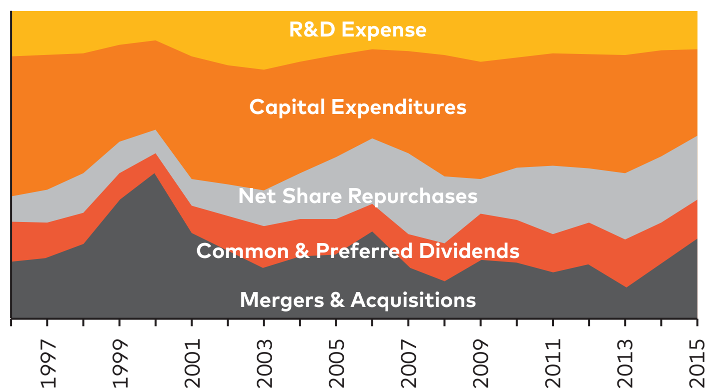


Source: Credit Suisse, June 2015. AGF Investments.

Mergers and acquisitions (M&A)

M&A is one of the largest uses of capital (Figure 4), although the level of M&A activity varies across business cycles. 2015 was a particularly strong year for M&A activity globally, buoyed by a low-interest environment, improved CEO confidence and a search for growth. The United States led the pack with an estimated US$1.5 trillion worth of deals, compared to Europe with US$0.7 trillion and Asia at US$0.6 trillion.[4]

Figure 4 – U.S. Capital Deployment – 2014

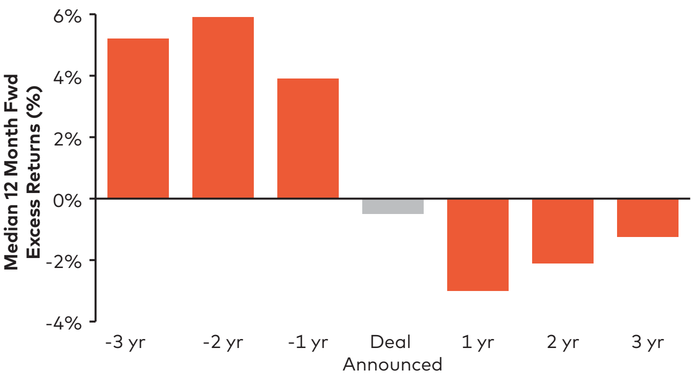


Source: Credit Suisse HOLT, Thomson Reuters DataStream, June 2015. All figures are in 2014 U.S. Dollars (millions). R&D, capital expenditures, working capital, buybacks and dividends is the top 1,500 'industrials' (ex-financials and regulated utilities), whereas M&A and divestitures include all industries.

In this wave of M&A activity, it is important to ask the question – has M&A activity historically benefited shareholders? Research by Credit Suisse found that in the three years following a material transaction, the median firm underperforms by 1-3% after outperforming by 4-6% in the preceding three years (Figure 5).[5] What's particularly concerning today is that the recent surge in M&A activity has been accompanied by an increase in debt levels. Companies have raised almost US$290 billion of debt to purchase competitors, almost triple the level of the same period in 2014.[6]

[4] Dealogic, February 2016.
[5] Credit Suisse HOLT, July 2014.
[6] Dealogic, January 2016

Figure 5 – Global excess shareholder returns for acquisitive firms



Source: Credit Suisse HOLT: Worth the Premium? January 2015. Tom Hillman and Chris Morck. Universe: 9,972 global acquisitions 1992-2010.

When evaluating M&A transactions, we focus on 'value accretion' or the ability of the acquisition to generate cash flows that are greater than the amount paid for the company, in present-value terms. Simply put, in order to create shareholder value, a company should get more than what they pay for.

This may sound relatively straightforward, yet the reality is that a large number of acquisitions do not meet this criteria, hence the relatively high failure rate of M&A transactions. Part of the challenge is owing to the market's focus on accounting measures, which can lead to an overstatement of the benefits of the transaction. For example, in a low interest-rate environment, a large number of projects or acquisitions may seem earnings-accretive by accounting profit measures as the cost of new debt is low. However, this measure does not reflect the true cost of capital, which includes both equity capital and debt.

Another challenge is that management teams often do not know their cost of capital and therefore invest without considering whether the transaction will earn its cost of capital within a reasonable time period. A best practice can be observed with Stephen Key, former CFO of Textron and ConAgra, who succinctly stated, "In looking at deals, you better know your cost of capital, your real cost of capital with respect to each and every business you are in. I had different costs of capital assigned to each of these business and you had to be able to cover your cost of capital within a certain time frame."[7] The AGF Global Equity team generally looks for companies to cover the cost of capital within a three- to five-year period.

[7] Bernstein Research, May 9 2014.

Synergies and M&A Success

Companies also often fail to realize projected synergies. Synergy is the additional value that is generated by combining two firms, creating opportunities that would not be available if they were operating independently. There are generally two types of synergies: ***cost synergies***, which include economies of scale and eliminating duplicate operational functions, and ***revenue synergies***, which include increased pricing power, market share and growth potential. We do not generally give companies credit for achieving revenue synergies when evaluating transactions. A survey of corporate executives conducted by McKinsey, a global consulting firm, regarding synergies found that approximately 60% of companies realized 90% or more of the anticipated cost synergies, while only about 30% of mergers delivered 90% or more of the anticipated revenue synergies (Figure 6).

Figure 6 – Cost synergies more reliable than revenue synergies

Source: Scott A. Christofferson, Robert S. McNish, and Diane L. Sias, "Where Mergers Go Wrong", *McKinsey on Finance*, Winter 2004, 1-6. Credit Suisse HOLT, March 2015.

Bolt-ons versus transformative transactions

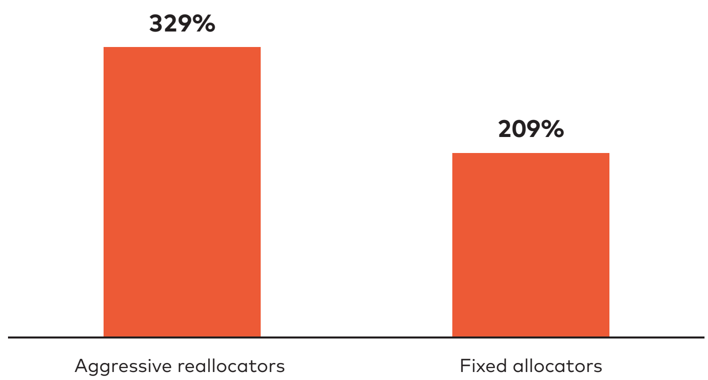
In our view, the closer an M&A transaction is to the company's core business the better and we have found that the odds of success for an M&A transaction decrease the further away the company strays from its core competencies. For this reason, we prefer smaller bolt-on acquisitions to larger transformative transactions, as they are easier to integrate. Other challenges that large transactions present include aligning cultural values of the two companies and a greater risk of overpaying, particularly when the target company is public. Large companies are often publicly listed and to acquire a public company, the acquirer must pay a premium to the prevailing market price and, given the public nature of the transaction, another competitive bid can result, further driving up the purchase price.

Capital expenditures

Capital expenditure (capex) is another common use of capital, although it tends to be less variable than M&A and dividends/share buybacks. When it comes to capex spending, business unit leaders often compete for more capital, although the year-over-year changes in the capital budget for each unit tend to be modest. This approach is consistent with the view of many management teams that there is *little* capital available but it is *free*. However, we believe a better mindset is that there is an *abundance* of capital but that capital has a cost. This is because when management has strategies that create value, both equity and debt markets should be available to fund those strategies. Such a mindset would also lead companies to explicitly account for the cost of capital in their budgeting decisions.

We also advocate for the re-deployment of capital from divisions that do not earn sufficient returns to pay for their cost of capital. Management teams that are judicious re-allocators of capital also tend to do better over the long term. These companies assess each business unit's performance and adjust the capital available to that business unit based on the relative opportunities available to each unit. A study by McKinsey showed that over a 15-year period, companies that shifted more than 56% of their capital across their business units outperformed those that simply made small adjustments but always followed the same investment pattern (Figure 7).

Figure 7 – Companies with higher levels of capital reallocation experienced higher average shareholder returns 1990-2005



Source: McKinsey & Company, March 2012. 1,616 companies examined.

In looking at the capital expenditures of a given company, we are also mindful of the cyclicality of the industry. Spending in cyclical industries tends to follow the same pattern as the market, which in turn results in companies adding too much capacity at the top of the cycle and paring down investments when the cycle recedes. Whereas most focus on demand, a focus on supply is often a more important indicator of the potential for an industry to continue to generate economic profits. This is particularly important in capital intensive industries such as mining and energy.

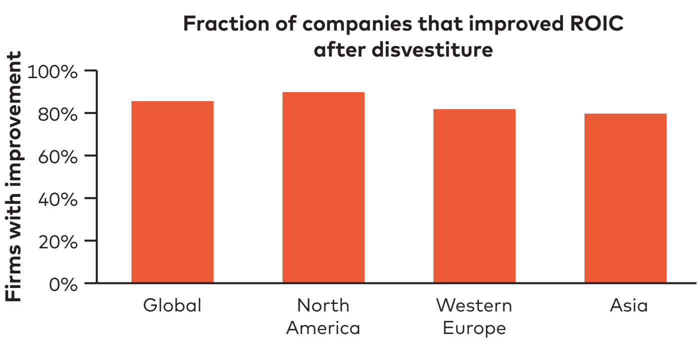
Asset Divestitures

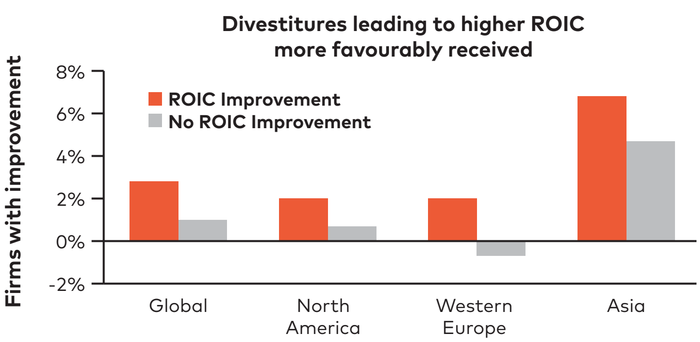
It is worth touching upon the subject of divestitures as they are an important avenue through which management can improve the capital efficiency of their business. This is because, while asset growth is an important driver of economic profits, the ability to generate attractive returns from deployed capital is just as important. An asset sale provides management the opportunity to redeploy resources from businesses that earn returns below their cost of capital (value destructive) to more profitable business units that earn returns well above their cost of capital (value enhancing) and in turn improve economic profits. It also provides an opportunity to unlock value of underappreciated businesses and to deliver meaningful returns to shareholders.

[8] Credit Suisse HOLT: Capital Allocation – Updated. June 2, 2015. Michael J. Mauboussin, Dan Callahan.

In an era of empire building, the sale of underperforming assets can also be an important signal that management is focused on ensuring capital is deployed to its best use. William Thorndike in his study of eight most successful CEOs over the last 50 years observed that the truly exemplary CEOs were skilled resource allocators that were not shy about selling or closing underperforming divisions.[9] Research by CitiGroup corroborates this notion and found that 86% of firms conducting asset sales in the period between 2010 and 2016 experienced improvements in their ROI. More importantly, firms exhibiting a return on investment improvement after divestiture outperformed the market, generating short-term excess returns of approximately 3% (Figure 8).

Figure 8 – Favourable equity investor response to firms exhibiting ROIC improvement after divestiture





Source: SDC and Fact Set, Citigroup Global Markets, July 2016.

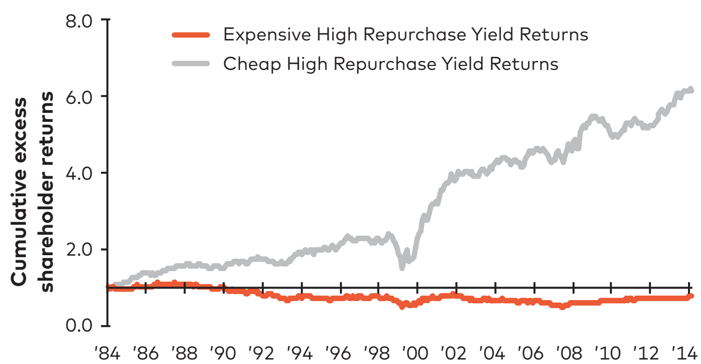
Note: Analysis based on divestitures since January 2010 with transaction value greater than US$500 million. ROIC improvement based on company's ROIC two years prior to the transaction closing date and the ROIC two years after the closing date. Short-term excess returns is defined as the risk-adjusted return over the local index (-10, +10) around announcement.

Share buybacks and dividends

Another common use of capital is share buybacks and dividends. Spurred by low interest rates, buybacks and dividends have been on the rise. In 2015, buybacks and dividends accounted for 90% of net income in the United States, about 80% in Europe and about 40% in Japan.10

The premise of buybacks is that repurchasing shares when the shares are cheap benefits shareholders. In his 1984 letter to shareholders, Warren Buffett succinctly states, "when companies with outstanding businesses and comfortable financial positions find their shares selling far below intrinsic value in the marketplace, no alternative action can benefit shareholders as surely as repurchases."[11] A recent study spanning a 30-year period found that companies that repurchased shares when they were attractively valued significantly outperformed those that repurchased when their shares were expensive (Figure 9).

Figure 9 – Repurchasing stock when shares are undervalued yields excess returns



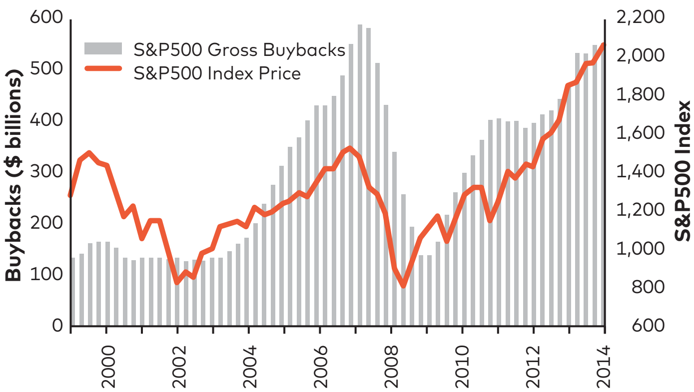
Source: Credit Suisse HOLT: Cash Deployment Trends and Chartbook, December 1, 2015. Ron Graziano and Chris Morck. Universe: United States >US$1B.

The reality, though, is that management teams tend to repurchase shares when their shares are expensive, which erodes shareholder value. For example, buybacks last peaked in 2007, just before the market crash, whereas few firms bought in 2009 when shares were cheap. Further, since 2009, the level of share buybacks has continued to increase just as the S&P 500 has moved higher (Figure 10).

[9] William M. Thorndike, Jr. The Outsiders. *Eight Unconventional CEOs and Their Radically Rational Blueprint for Success*. 2012.

[10] www.investmenteurope.net/opinion/japan-equity-outlook-2016/.
[11] Warren Buffett, Berkshire Hathaway Letter to Shareholders, 1984.

Figure 10 – Management teams tend to repurchase shares when their shares are expensive



Source: Credit Suisse: Capital Allocation – Updated June 2, 2015. Michael J. Mauboussin and Dan Callahan.

As previously noted (see Figure 2), a concern is that the recent increase in share buyback activity has been accompanied by rising debt levels as companies seek to boost earnings per share. Share buybacks reduce the number of outstanding shares and, by so doing, increase the earnings per share, even with profitability/earnings unchanged. In fact, recent ratings data in the high-yield market segment of the United States indicates that credit rating downgrades are now being increasingly caused by firms returning cash directly to shareholders through share buybacks and dividends.[12] The risk is that when interest rates increase or the economy slows, this will result in reduced cash flows and impact the ability of firms to repay the debt.

We generally prefer buybacks and dividends to M&A transactions given the lower risks of execution. However, we are watchful of companies increasing leverage to fund buyback activity as this increases the risk profile of companies. Repurchases should also not be done in order to prop up the share price, but rather because they offer the most attractive alternative for allocating capital at a particular time.

Management compensation

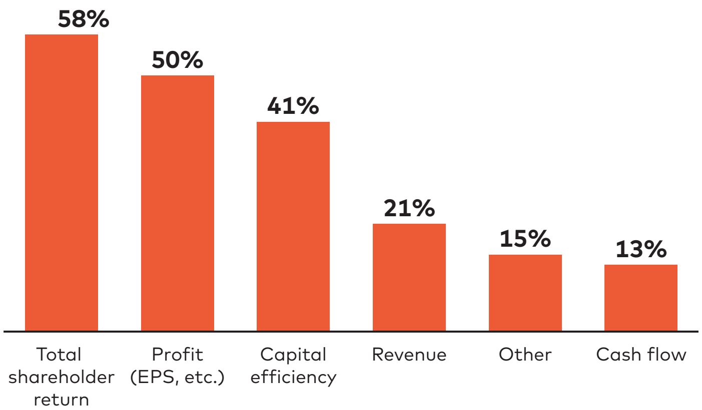
In our opinion, incentives matter. At AGF, we pay particular attention to the incentive schemes of the companies we invest in for this reason – compensation packages have a significant impact on the actions of management. Case in point, a survey of 400 chief financial officers in the United States found that management was less likely to invest in a project that had a positive net present value (that is, that boosted long-term value per share) if this resulted in the company missing earnings estimates.

Earnings per share (EPS) as an incentive measure remains prevalent among corporations and is the second-most commonly used incentive scheme in the United States (Figure 11). The challenge is that the EPS measure can be easily manipulated and is distorted by differences in leverage, taxes and levels of capital investment. A management team that is measured on EPS may then become overly focused on meeting EPS targets, at the expense of pursuing actions that further the strategic vision of the company and boost long-term value. For example, if a project requires a three-year investment phase, management, if their compensation is linked to interim EPS results, may forego the project in favour of a less attractive project that boosts short-term EPS.

More companies have now moved toward total shareholder returns (TSR) as an incentive scheme (Figure 11). In fact, in 2015, TSR was the most commonly used incentive scheme in the United States. This is certainly better than EPS, as it challenges managers to think about what drives share prices over the medium term. However, the challenge with such incentive schemes is that they are unduly affected by the start and end point of measurement. For example, if the stock price at the start or end date is inflated by general overvaluation in the stock market, this would unduly alter the level of compensation. Management could also be riding a wave of multiple expansion in the market/industry as a whole with total shareholder returns not reflective of actions taken by management to enhance shareholder value.

[12] BCA Research, May 26, 2016.

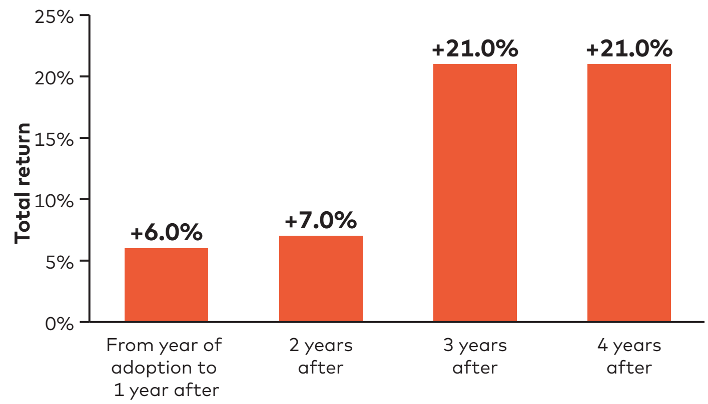
Figure 11 – Most commonly used incentive metrics in the United States



Source: Frederic W. Cook & Co., Inc. *The 2014 Top 250 Report*.

For this reason, we prefer the use of capital efficiency measures, such as return on capital, as they force managers to focus on long-term shareholder wealth creation. Return on capital, defined as net operating profit after tax/capital employed, is also associated with a higher CFROI.[13] A focus on capital efficiency, therefore, helps guide management toward projects that are value accretive and guards against excessive risk-taking. In fact, a study by Mukhchaou and Hillman indicates that use of return on capital as a management incentive measure leads to a boost in shareholder returns[14] (Figure 12).

Figure 12 – Adopting return on capital performance measures results in average improvement in shareholder returns



Source: Credit Suisse HOLT: Alex Mukhachou, Tom Hillman. Do Return on Capital Incentives Drive Improvement? November 2015. Universe: United States >US$5B Mkt Cap

Conclusion

Overall, we believe capital allocation is management's most important responsibility and look for management teams that display an unwavering focus on long-term value per share. To assess management's skill in capital deployment, we:

1. Analyze how the team has allocated capital in the past,
2. Assess the ability to drive incremental cash flow return on investment from new investments and
3. Review incentives to assess the degree to which they encourage long-term value creation.

Ultimately, intelligent capital allocation is about understanding the long-term value of an array of opportunities and putting money to its best use. We believe that outstanding companies are those that know how to deploy capital well and have a discipline that is untethered by prevailing market trends. With a tepid economic environment and the risks of elevated debt levels lurking in the background, as well as the uncertain consequences of the unprecedented degree of monetary stimulus, now is the time to be investing in companies that understand the importance of their capital allocation decisions.

[13] Credit Suisse HOLT: Alex Mukhachou, Tom Hillman. *Do Return on Capital Incentives Drive Improvement?* November 2015. Universe: United States >US$5B Mkt Cap
[14] Credit Suisse HOLT: Alex Mukhachou, Tom Hillman. *Do Return on Capital Incentives Drive Improvement?* November 2015. Universe: United States >US$5B Mkt Cap

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AGF Institutional Offices

Toronto

66 Wellington Street West, Suite 3300
Toronto, ON M5K 1E9
Phone: 416 367-1900
Toll Free: 1 888 243-4668

Boston

53 State Street, 13th floor
Boston, MA 02109
Phone: 617 742-3290
Toll Free: 1 866 622-2438

London

80 Coleman Street, 6th Floor
London
EC2R 5BJ
Phone: + 44 207 653 6737

Dublin

34 Molesworth Street
Dublin 2
Ireland
Phone: + 353 1 661 3619

Beijing

Suite 11A16, Tower A, Han Wei Plaza
No. 7, Guang Hua Road, Chao Yang District
Beijing 100004, China
Phone: 86-10 8526-1820x15

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