CREDIT SUISSE

Credit Suisse Corporate Insights

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Welcome to
Credit Suisse Corporate Insights

Our clients frequently discuss the extensive challenges they face in today's market. Many of the old paradigms have shifted or disappeared altogether. Activism poses a looming and continuous challenge, making corporate governance even more complex. The economic backdrop in all regions keeps shifting and sustainable global growth continues to be elusive.

Against this backdrop, key strategic decisions to drive growth, to increase returns, or to gain a competitive edge are difficult and complex. Capital allocation, value creation, acquisition or disposal possibilities, and optimal balance sheet structures are frequent topics of discussions as our clients evaluate the range of opportunities available to them.

These new **Credit Suisse Corporate Insights** periodicals will give you our perspectives on evaluating the key and critical decision points many of you face. In this, our inaugural edition, we explore the topical issue of capital allocation, outlining a proprietary framework to evaluate different capital deployment alternatives.

Delivering world-class financial advice to our clients is of paramount importance to us, and I hope you find this series valuable.

Jim Amine, Head of Investment Banking and Capital Markets

The Capital Deployment Challenge

Background. Companies in the US market are currently in great health as corporate profitability is approaching historical highs. This high level of profitability has produced record levels of corporate cash, and thereby has created a challenge for managers: how to allocate all of this excess cash. Companies may choose to reinvest in their businesses – organically or through M&A – or they may return the cash to capital providers, through dividends, share buybacks or by paying down debt.

A successful execution of the right capital allocation strategy will optimize shareholder value creation, since managers perceived as good stewards of capital tend to be rewarded by the market. Conventional thinking would suggest that growth which generates a return in excess of the cost of capital is generally more value-creating than returning capital to shareholders. But is this strategy always the right answer?

In this issue of **Credit Suisse Corporate Insights,** we evaluate the complexity of the capital deployment challenge and present a framework for corporations to address a fundamental capital allocation choice: to reinvest in your business or to return cash to your shareholders through buybacks or dividends.

We find that balancing returns on capital and growth along with an understanding of where you are in the corporate life cycle are the keys to making the right choice.

Capital deployment trends are shifting, in an environment of rising profitability and cash balances

In recent years, due in part to the pressures of noisy campaigns by activist investors, there has been a shift in capital allocation priorities, favoring share buybacks and dividends over capital investments and M&A. Admittedly, tax policy and the underlying interest rate environment will also influence the fashion for capital deployment, which can in turn sway both investors and companies in favor of one approach or the other.

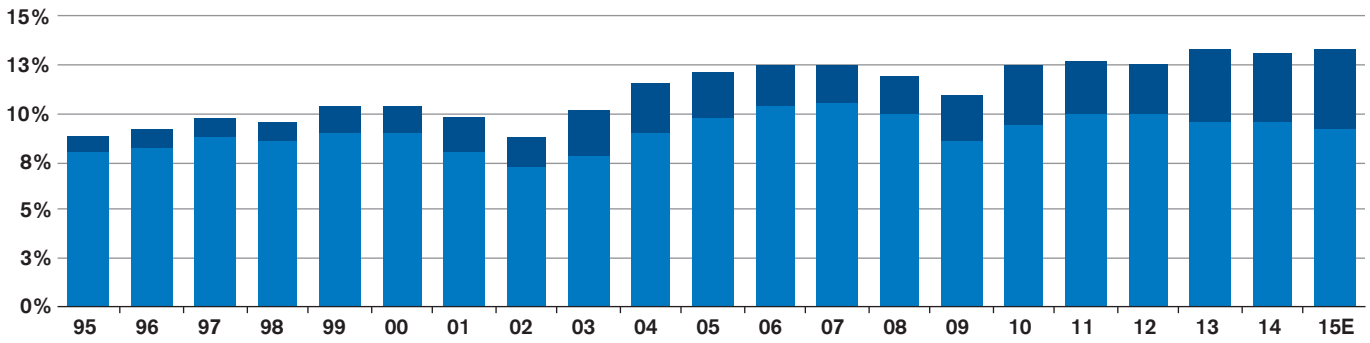
We also recognize that not all investment is equal: organic and acquisitive growth are often rewarded very differently by investors. The market's reaction to acquisitive growth, in particular, is dependent upon market conditions over time.

For example, earlier this year we saw both acquirer and target stock prices rise following the announcement on an M&A deal. While the market reaction to M&A is an important topic, this debut issue focuses on the longer-term market reaction to the fundamental strategic capital allocation choice: whether to invest in your business or return capital to your shareholders.

Corporate profitability in the US is at or near historical highs. We measure profitability using a return on capital metric called CFROI[1] (cash flow return on investment, per the Credit Suisse HOLT framework[2]), which looks past accounting distortions.

We evaluated the aggregate CFROIs for the US market since 1995 (Exhibit 1), looking at CFROIs both with and without excess cash. The latter gives a sense of the improved operational prowess of companies in the US market, as it measures the cash generated on companies' operating asset bases. The former illustrates the increasing weight that cash exerts on companies' balance sheets, as it serves to lower overall returns on capital. Excluding excess cash, 2015 CFROIs are projected to approach 13.5%, which represents an historical high.

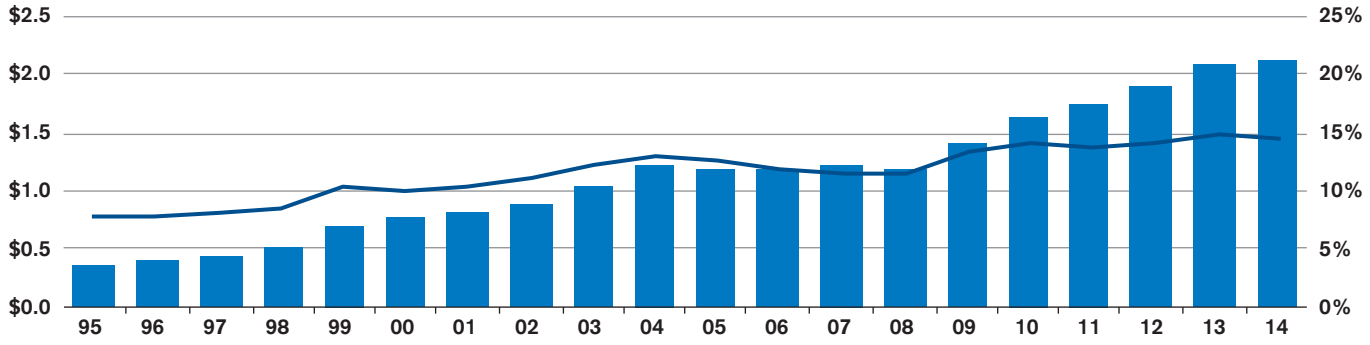
Exhibit 1: Returns on capital (CFROI) for US companies (ex. financials and utilities)



- CFROI
- CFROI excluding cash excess

All of this increasing profitability has produced record levels of corporate cash; although other factors, such as the taxes involved in repatriating overseas cash and post-crisis fears, also provide incentives to building cash balances. Exhibit 2 shows that corporate cash plus financial investments in the US has increased year after year since 1995, and reached $2.1 trillion in 2014, representing 15% of companies' total assets. Both the cash balances and the cash as a share of total corporate assets are at or near all-time highs.

Exhibit 2: Corporate cash plus financial investments for US companies (ex. financials and utilities)
($ in trillions)

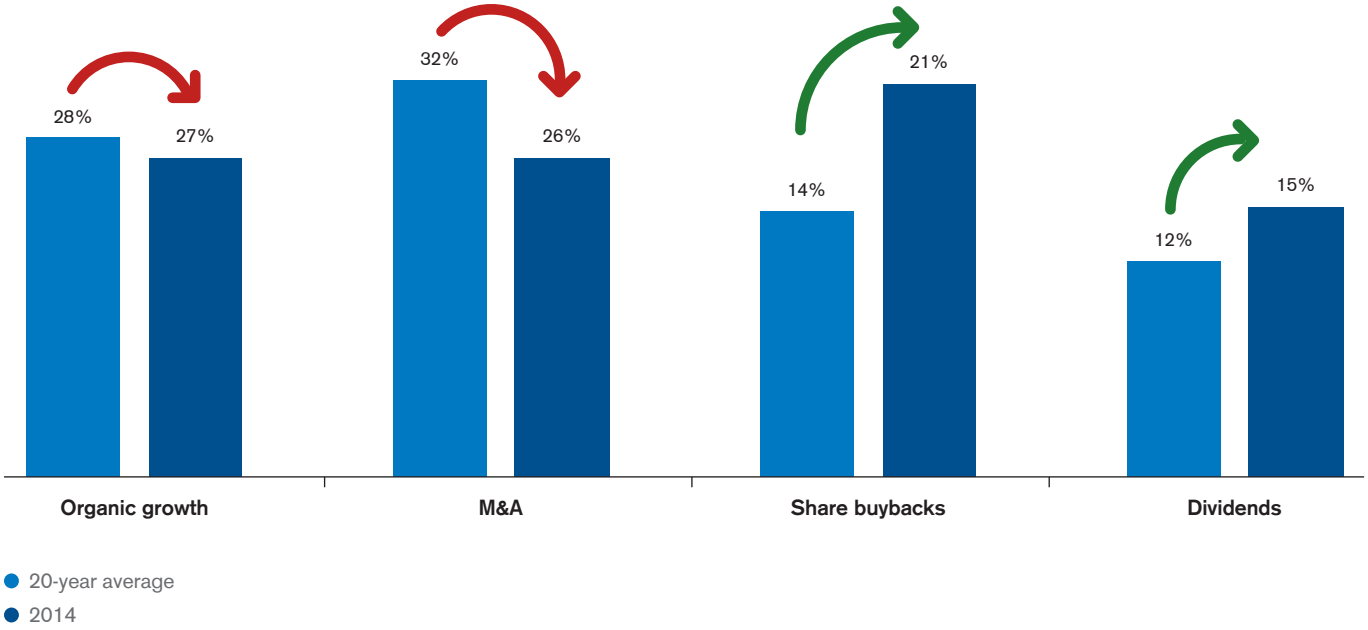


- Cash + investments (lhs)
- Cash + investments / total assets (rhs)

In an environment of increasing profitability and building piles of cash, companies in the US are increasingly shifting their capital allocation towards returning capital to shareholders. Exhibit 3 illustrates capital deployment trends in the US, calculated using cash deployed as a percentage of operating cash flow.[3]

Historically, companies have deployed an average of 60% of cash flows in capital investment[4] (28% in organic growth and 32% in M&A) and have returned[5] 26% to shareholders (12% dividends and 14% share buybacks). In the past several years, the capital allocation balance has swung away from growth towards buybacks and dividends: capital invested has dropped to 53% (27% organic growth and 26% M&A), while cash returned to shareholders has increased to 36% (15% dividends and 21% buybacks).

Exhibit 3: Capital deployed as a percentage of operating cash flow



Capital allocation priorities seem to have changed – even in what are now profitable times – favoring buybacks and dividends over capital investments and M&A. But as Larry Fink of BlackRock recently pointed out in his open letter to the Boards of Directors and CEOs of the S&P 500, this trend runs the risk of starving companies of much-needed growth capital and shareholders of considerable value creation, both in the short and long term.

The capital deployment challenge, then, is how to choose between the competing needs of reinvesting in your business and returning capital to your shareholders. The answer is that there is no one-size-fits-all solution. Making the right capital allocation choice depends on each company's characteristics in terms of CFROI and growth expectations. Our analysis identified what type of companies "outperform" when pursuing capital allocation strategies at either end of the spectrum. We measure outperformance based on excess total shareholder returns (TSR), relative to industry peers.[6]

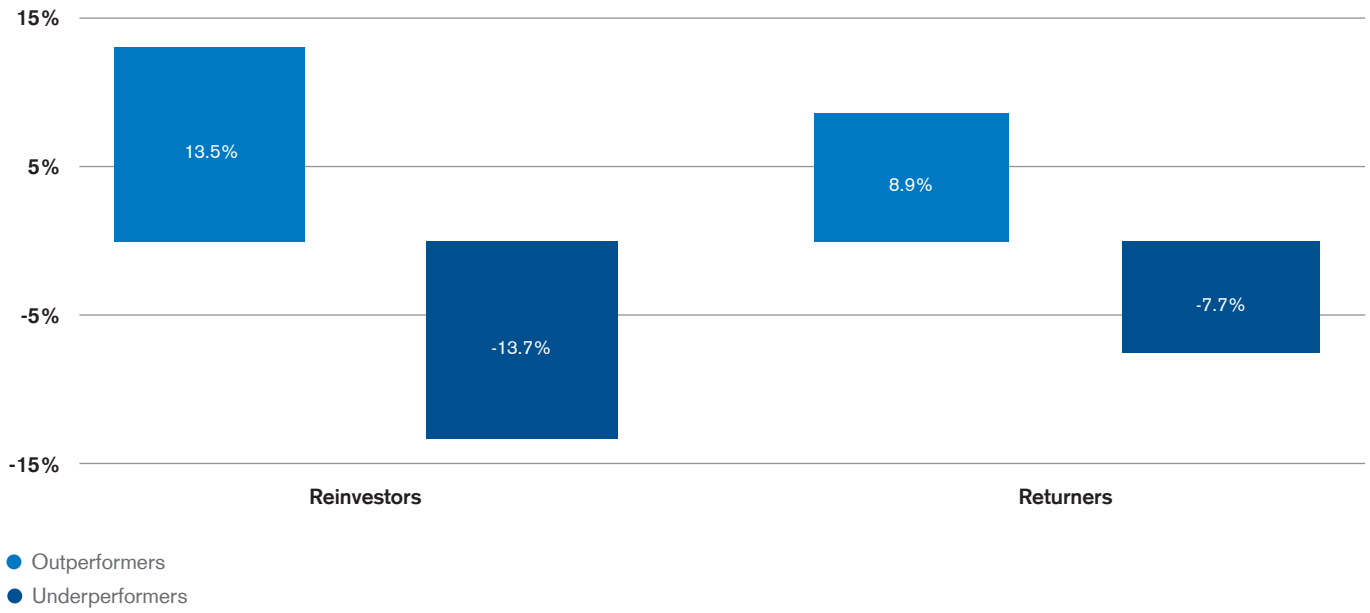
The Keys to Successful Capital Allocation Strategies

So which capital deployment strategy outperforms? What works best? And for which companies, under what circumstances?

Our analysis shows that returning capital to shareholders can indeed be advantageous: Exhibit 4 demonstrates that the companies which chose buybacks and dividends (and did so successfully, i.e., produced a higher TSR than peers), achieved an average TSR outperformance of 9% annually.

Importantly, though, our analysis also reveals that investing in your business can generate even higher returns: the companies that successfully invested back in their businesses produced annualized excess returns to shareholders of 14%. But riskiness lurks… if not done correctly, reinvesting in the business can also have the largest downside potential: reinvestors that underperformed generated negative TSR, on average of -14%.

Exhibit 4: Average excess TSR relative to industry group (annualized)



What is it about those companies that persuaded the market that they chose correctly? Navigating the capital deployment choice and doing so in a way that helps to drive strong total shareholder returns requires companies to pay attention to three important factors:

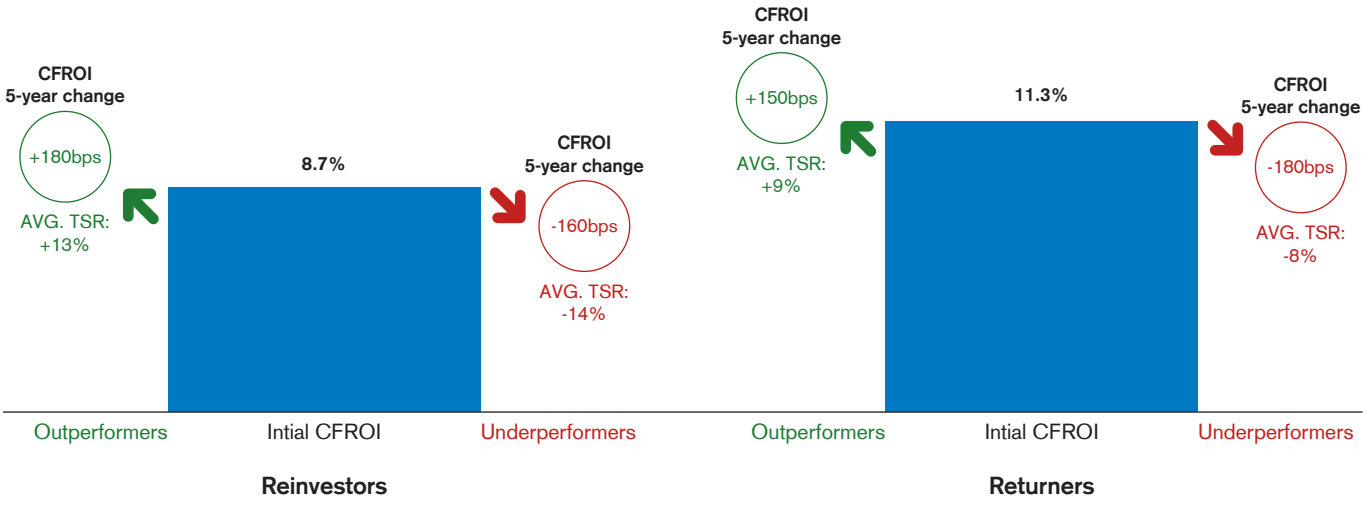
- **Returns on capital:** continued and consistent value creation requires a company to pursue strategies that improve returns on capital
- **Growth expectations:** meeting or beating the market's expectations for growth in your business serves to compound and maximize the value creation generated by improving returns on capital. A company that persuades the market of its ability to sustain or increase its pace of growth will likely outperform its peers, and the market
- The **corporate life cycle** is the underpinning for both the returns on capital and growth elements. The trade-offs between returns on capital and growth vary over the life cycle of a company – relative to its industry and to the broader market. Understanding where your company sits can help illuminate your strategic choices

1. Increasing Returns on capital

A corporate strategy which improves underlying returns on capital is the strongest driver of long-term value creation. Companies that have opportunities – whether organic or M&A – to invest at higher rates of return in the future will maximize shareholder wealth by in fact making those investments.

Exhibit 5 shows that the initial level of returns on capital is generally lower for reinvestors than for returners, with an average of 9% and 11%, respectively. The reinvestors and returners who outperformed their peers both improved their CFROI. However, the outperforming reinvestors generated a greater operating improvement (180bps vs 150bps for returners).

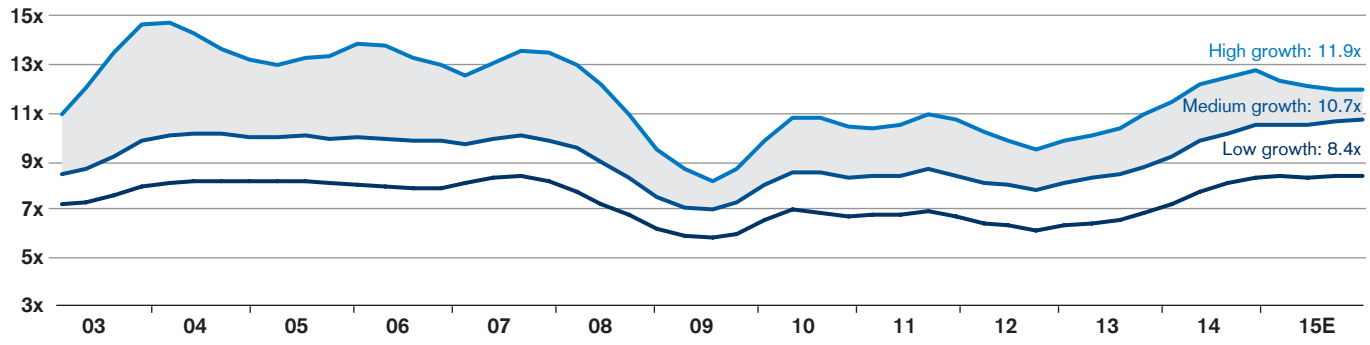
Exhibit 5: Average returns on capital (CFROI) and 5 year change



2. Meeting or beating the market's expectations for growth

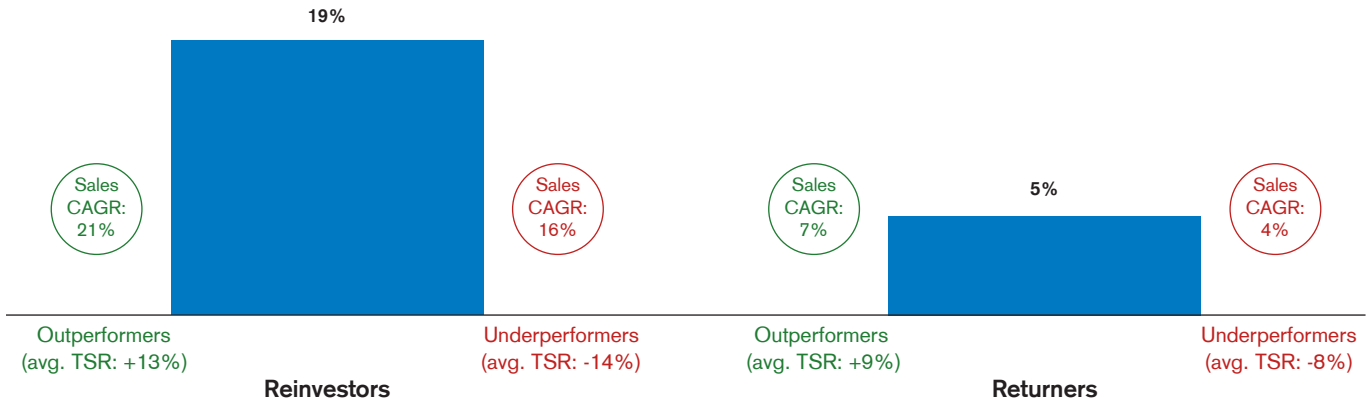
Managing the market's expectations for growth is the second key element to monitor. The market persistently pays a premium valuation for companies that offer compelling growth stories. Exhibit 6 shows that companies with higher growth expectations consistently trade at premium EV/EBITDA valuations – even during the depths of the 2008 financial crisis.

Exhibit 6: Market premium paid for growth, over time[7]



For the capital deployment question, our analysis suggests that the key to market outperformance depends on being able to sustain or raise the market's expectations for growth. Not surprisingly, as illustrated in Exhibit 7, reinvestors achieved significantly higher growth than returners.

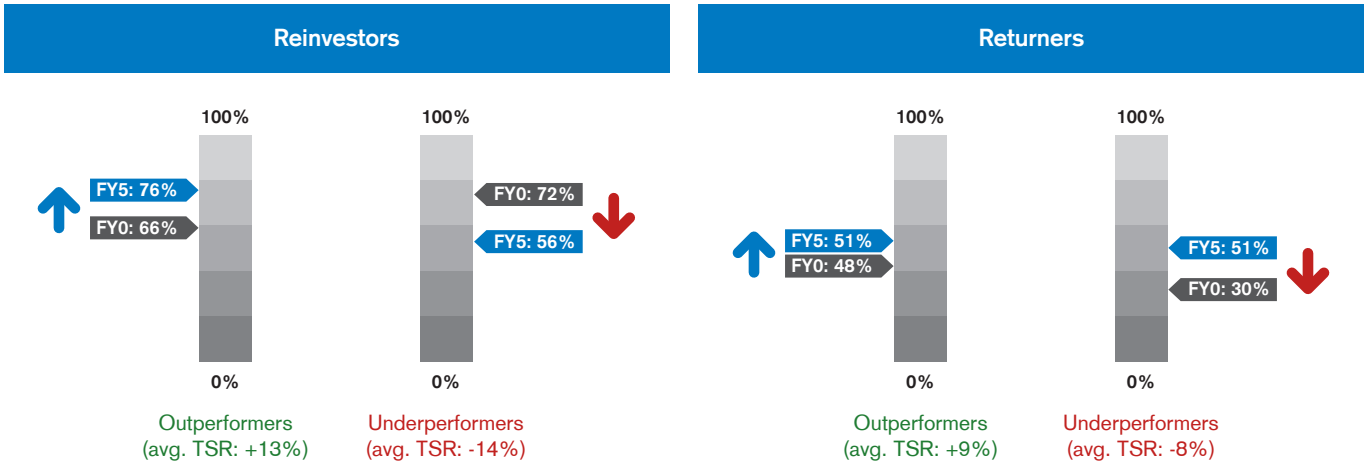
Exhibit 7: Average sales growth: 5 years sales CAGR



What about managing those growth expectations? We measure growth expectations using our Credit Suisse growth factor. This growth factor[8] ranks the universe based on the market's expectations of each company's future growth potential. The ranking ranges from 0% to 100%, where the 0% is given to the company with the lowest growth expectations and 100% to the company with the highest growth expectations at each point in time.

Exhibit 8 shows the market expectations for growth at the beginning and end of each five year period we evaluated.

Exhibit 8: Average change in market growth expectations, based on the Credit Suisse growth factor



The companies that re-invested in themselves and outperformed had relatively lower growth expectations at the outset but, in the end, they exceeded those expectations and achieved the highest growth. More importantly, the market's expectations for subsequent growth by those companies increased materially, while expectations for the underperformers declined.

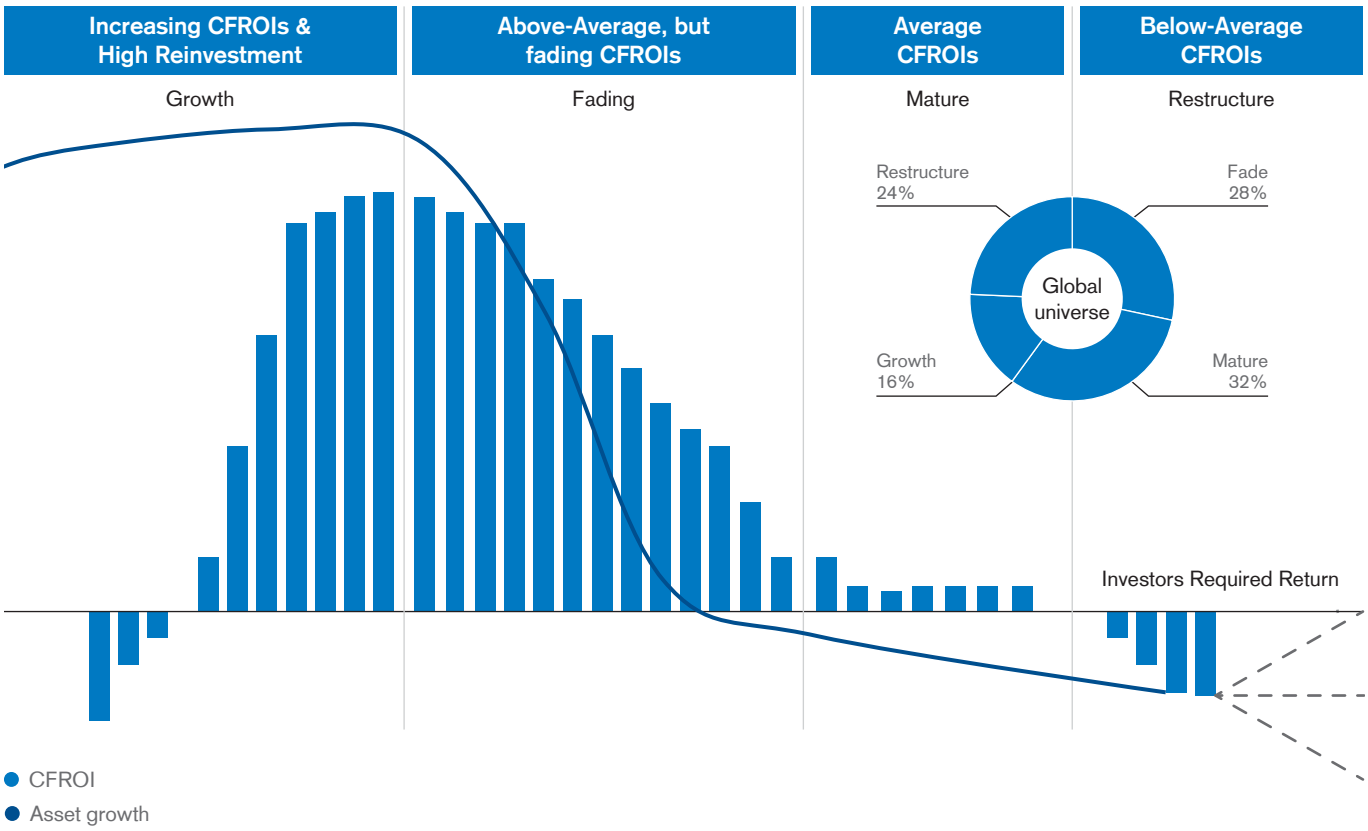
The companies that returned capital to their shareholders all tended to have relatively modest embedded expectations for growth. Those that returned capital and outperformed their peers also managed to beat growth expectations and achieve relatively healthy growth. As a consequence, the market's subsequent expectations for growth also rose for them.

3. Corporate life-cycle position as a key driver of capital allocation

It should now be clear that strategies to maximize long-term value creation should begin with an evaluation of the competitive position and prospects for each company.

This competitive positioning – in terms of prospects for higher returns on capital and growth – is a function of a company's position in its life-cycle. The corporate life-cycle concept, as illustrated in Exhibit 9, recognizes that companies have different opportunities and constraints at different stages of their evolution and, as a result, should pursue different strategies to maximize value creation.

Exhibit 9: Corporate life cycle



For early stage companies, profitable growth opportunities are abundant and should be aggressively pursued. As businesses mature, cash flows typically expand while growth opportunities tend to diminish, leading firms to increasingly return excess cash to shareholders.

When profitable investment or growth opportunities exist, investors reward management for putting capital to work, back in the business, through capex, R&D and even M&A. In the absence of any such high-return growth opportunities, cash should generally be returned to shareholders.

These opportunities to increase returns on capital, or to pursue growth opportunities, are a direct function of where a company is in its life-cycle. Understanding these elements – returns, growth opportunities and how companies frame their life cycle positioning – are important to the prudent allocation of excess cash. Understanding these elements can reduce the risk of overinvestment at the wrong time, or the risk of missing out on value-creating growth opportunities.

Conclusion

When it comes to deploying capital, conventional thinking favors reinvesting in growth that generates a return in excess of the cost of capital. Yet recent trends in capital deployment have placed a greater focus on returning capital to shareholders. Therefore, coming back to the question we posed at the beginning of this discussion: which approach drives the most value creation?

Our analysis shows that the answer is much more nuanced than conventional thinking may suggest or current trends in capital deployment behavior may indicate. The capital deployment decision is highly dependent on company-specific fundamentals as well as the market backdrop.

Continuing to invest capital back into your business generates the highest potential payoff, but it's also riskier. Under the appropriate conditions and with the right strategy, companies that reinvested in their business outperformed the market by 14% on average. However, companies that misinterpreted the conditions or pursued the wrong strategy *underperformed* the market by 14%.

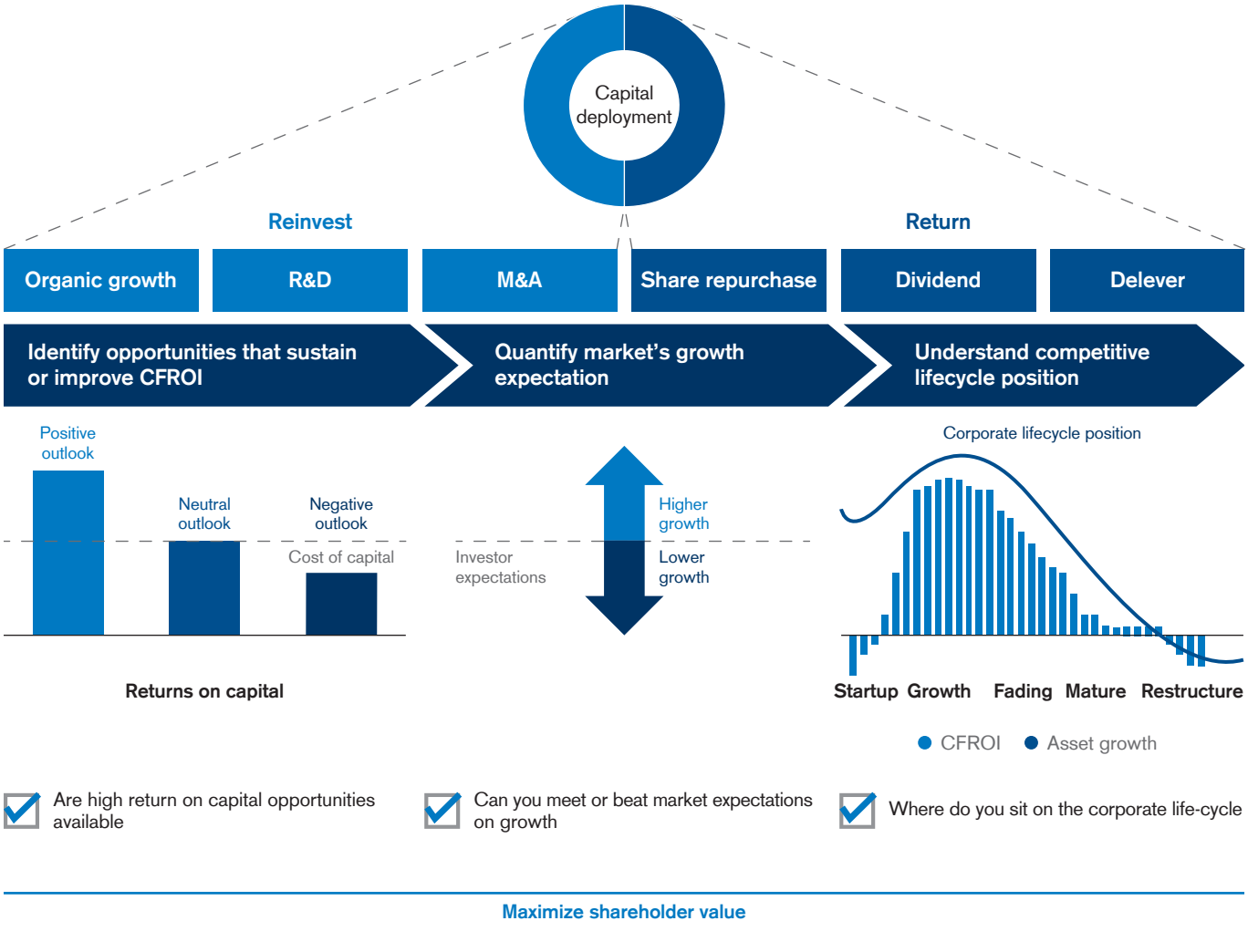
Our analysis suggests the following checklist of three key fundamentals to consider:

1. Assess your corporate life cycle positioning and the market's expectations for your future growth
2. Meet or beat these market expectations for growth
3. Invest in projects/companies that will ultimately lead to improvements in returns on capital

In cases where the above conditions are met, conventional thinking seems to hold true: reinvesting in your business will drive the most value creation. Absent these conditions, companies that have cash to deploy may better serve their investors by returning capital via share buybacks or dividends.

Knowing what kind of company you are – in terms of prospects for improving returns on capital and growth – and where in your own life cycle you sit are the keys to choosing the best capital allocation strategy today.

Our analysis of corporate performance – and the market's reaction to capital allocation choices and outcomes – suggests that management evaluate capital deployment in accordance with the framework below.



At Credit Suisse, we can use these insights – and apply this framework – for the benefit of our clients. We can help empower companies with the information and tools needed to make the right choices – at the right times – about capital deployment. And making those correct choices should go a long way toward helping management to drive long-term shareholder value.

End notes

1 Credit Suisse HOLT CFROI (cash flow return on investment) compares a fiscal year's operating cash flow (essentially EBITDA less taxes plus rent expense, R&D expense and stock-based compensation) to that year's gross plant, adjusted for inflation to make the plant value current, plus capitalized leases and R&D, plus cash and net working capital.

2 HOLT is a Credit Suisse framework used by many buy-side investors. It combines an extensive corporate data base with a powerful valuation framework. Its key operational metric for corporates is the return on capital, or CFROI.

3 Capital invested/returned calculated as a percentage of gross cash flow. Gross cash flow is calculated as EBITDA + rent + R&D – tax. This metric is a proxy for the cash available for investment.

4 Capital invested includes capex, investment in operating leases, R&D and M&A, and nets off maintenance capex.

5 Capital returned to shareholders includes dividends and net share repurchases.

6 TSR includes dividends and buybacks and is measured for each company relative to its respective industry peers, not to the broader market. Our universe included all US listed companies between December 1995 and May 2015 (companies that ceased to exist over the period are included in the analysis for the periods they were in business to remove survivorship bias from the results). Our analysis excludes financials and utilities, and includes companies with market capitalizations in excess of $250 million (over our analysis period, that means 2,100-3,000 companies were analyzed. To capture long-term trends for value creation, we studied 5-year rolling periods throughout the 20 year time frame, and in each period:

- We looked at the amount of cash (as a percentage of gross cash flow) spent on investment vs. that returned to shareholders
- We selected the top third of reinvestors and returners based on total capital returned or invested as a percentage of gross cash flow (Top third of the companies were measured by the amount of capital spent on investment and by capital spent on returning cash to shareholders, via buybacks and dividends over each five-year period)
- We measured the annualized (TSR) relative to respective industry groups, and we sub-divided returners and reinvestors into those who outperformed vs. those who underperformed their peers on a TSR basis
- Finally, we identified the key metrics shared by companies that outperformed in each strategy

7 Includes all US companies (ex-financials and utilities) over $250mm market cap (in 2014 = 2,078 companies). Growth defined as quartiles of growth, where current bottom quartile growth <= 4.1%, 2nd and 3rd quartile > 4.1% and < 6.9%, Top quartile growth >= 6.9%.

8 HOLT growth factor ranks companies between 0% and 100% based on their score on four metrics: expected change in CFROI from LFY to NTM (30% weight), expected change in cash flows in FY1 relative to 3-year historical median (30 weight), market-implied growth for the next two years (30% weight), and size (based on revenue) (10% weight).

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Rick Faery, Managing Director
John Bordes, Director
Conchita Gonzalez, Vice President
Charu Sharma, Vice President
Michael Masten, CFA, Assistant Vice President
Peter Fox, Analyst

HOLT Equities

Richard Curry, Ph.D, Vice President
Special thanks to Katie House

CREDIT SUISSE SECURITIES (USA) LLC
Eleven Madison Avenue
New York, NY 10010
credit-suisse.com