MAY 2018

Resources Management Corp

MARKET COMMENTARY

ON CORPORATE CAPITAL ALLOCATION

As shareholders of publicly traded securities, it can be easy to feel disconnected from the businesses that underlie a stock. Despite the fact that there is very limited contact between the executives of a public company and its shareholders, the primary role of corporate executives is to serve as stewards of shareholder capital. In this capacity, there are a variety of different ways that funds can be deployed: reinvesting in the core business, mergers & acquisitions (M&A), share repurchases and dividend payments. Each of these options, when utilized properly, can create value for shareholders. Far too often, however, management deploys funds in ways that do not generate the highest returns on shareholder capital over the long term. Rather than using broad generalizations to determine if a certain corporate action is appropriate, shareholders should review the actions of management more critically to determine how effective it has been at generating adequate returns for the owners of the business.

As can be seen in *Figure 1*, dividend payments and share repurchases are at very high levels relative to where they have been since 2000. Unsurprisingly, both of these uses of cash tend to be sensitive to market and economic performance. This tendency is generally due to management's propensity to deploy excess cash when they have confidence in the economy and their own businesses' prospects. While this is certainly logical with dividends, implementing share buybacks in this way does not necessarily make sense. Share repurchases are value creating for shareholders of a stock if the repurchases are made at sensible prices. Buying shares back at prices that are lower than they are worth creates significant shareholder value by increasing the proportion of the business owned by the remaining investors at a high rate of return. Similarly, however, repurchasing shares at prices that are higher than they are worth destroys value for the remaining owners. By overpaying for the reduction of shares, managers are effectively investing in assets that, at that time, offer a low rate of return.

Figure 1

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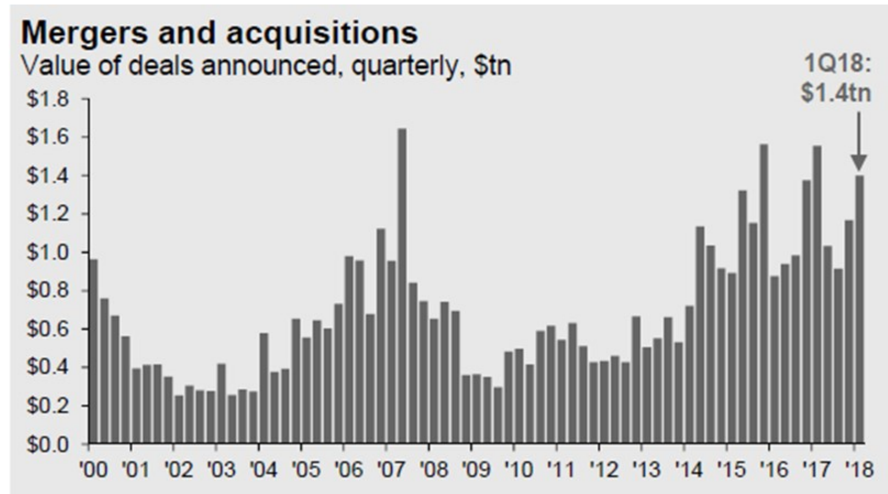
Much like the range of possibilities with share repurchases, deploying capital for large acquisitions can have a transformative impact of the businesses' performance over the long term, and this can be both a good or a bad thing. As can be seen in *Figure 2*, M&A in the first quarter of 2018 sat at around $1.4 trillion. This is not out of line with previous quarters but is substantially higher than the activity that was seen between 2009 and 2014.

Figure 2



While acquiring another company can certainly create substantial value for shareholders if the target is a good fit and the price paid is appropriate, far too often the acquiror will overpay, resulting in poor outcomes for investors. Growing an organization through acquisition can create a disconnect between the incentives for management and the desired outcomes for shareholders. Creating a larger organization increases job security, to some extent, by establishing a larger earnings base to support the executive team. Management can also be seduced by the idea of "empire building" and believing that they can cause target companies to perform better than they have historically. We are certainly not suggesting that these issues are present in all companies and in all acquisitions, but they create conflicts that can cause executives to overpay for a target.

Rather than viewing each individual use of shareholder capital as inherently good or bad, it is important to evaluate the management team on how effective they have been at creating value for their owners. Indiscriminate repurchases of stock, for example, should not be applauded, and managers should be encouraged to repurchase shares opportunistically only when they view the stock as undervalued. Shareholders should also carefully consider the long-term impacts of large mergers, especially when large cost saving are being used to justify the combination. It is our view that capital allocation is the primary job of the Chief Executive Officer of the businesses we invest in, and we seek only to entrust our capital to managers who have demonstrated discipline in deploying cash over time.

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