

# The Morningstar Capital Allocation Rating

We are optimizing our previous stewardship rating to focus on balance sheet health, investment efficacy, shareholder distributions.

## Morningstar Equity Research

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## Executive Summary

We are renaming our stewardship rating to capital allocation, effective Dec. 9, 2020. The name focuses on the key area where Morningstar strives to assess management efficacy. This change avoids confusion with environmental, social, and governance factors to be captured through Sustainalytics company-level ratings for our coverage. We have refined our capital allocation framework to focus on three key items: balance sheet health, investment efficacy, and shareholder distributions. These three drivers are assessed on a forward-looking basis to establish an overall capital allocation rating. This framework aims to enhance the consistency, relevance, and efficacy of the ratings. Opinions on future investment should influence and align with views on returns on new invested capital, overall moat rating, and valuation.

## Key Takeaways

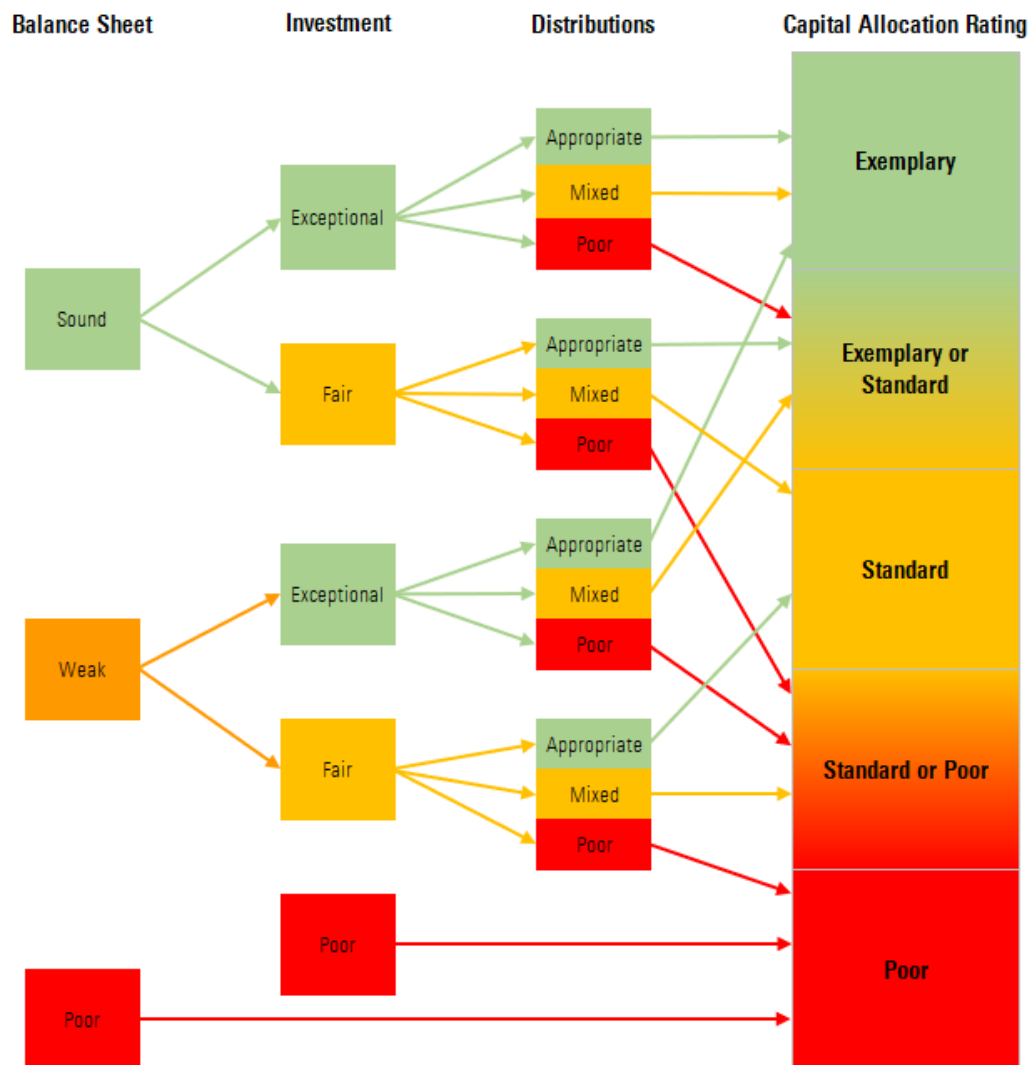
- ▶ Capital allocation is a fundamental driver of long-term shareholder returns. Our opinion on capital allocation is informed by our views on "balance sheet," "investment" and "shareholder distributions," which in turn help inform our forecasts for earnings and returns.
- ▶ We retain the Poor, Standard, and Exemplary ratings for capital allocation, carrying over from the prior stewardship ratings. These ratings clearly communicate our opinions in keeping with our core value of Investors First.
- ▶ We assess capital allocation on a forward-looking basis, over a full economic cycle of about 10 years. History may help inform our expectations, but analysts evaluate balance sheet, investment, and shareholder distributions on what we think is likely to happen in future, rather than the past.
- ▶ Our balance sheet assessment considers if a firm has reasonable or excessive leverage and how the balance sheet will likely evolve. We consider if debt repayment is prioritized and if a firm likely has the cash flow to make meaningful improvement if necessary. Potential for the balance sheet to change in an economic downturn or in the event of material company-specific risks is also assessed.
- ▶ Our view on investment assesses if a firm is likely to invest to fortify or enhance its competitive position in future, and if it is likely to do so at the right price, that is, to generate attractive rates of return.
- ▶ Assessment of shareholder distributions considers if future cash returns to shareholders--dividends and/or share buybacks--are likely the appropriate size and form. Cash flow should be distributed to shareholders unless better uses exist; namely balance sheet repair or value-adding investment.
- ▶ The overall capital allocation rating is guided by the flow chart in Exhibit 1. Where more than one rating could be justified, such as Standard and Poor, analysts assign the overall capital allocation rating by weighting to the most decisive factor from balance sheet, investment, and shareholder distribution.

## The Capital Allocation Flow Chart

Assigning the overall capital allocation rating hinges on three variables: balance sheet strength, investment efficacy, and shareholder distributions. The decision tree in Exhibit 1 guides our ratings.

### Exhibit 1 Morningstar's Decision Tree for Assigning Capital Allocation Ratings

Morningstar assesses the balance sheet, outlook for investment, and shareholder distributions to arrive at our overall capital allocation rating.



Source: Morningstar. Note: There is no implied hierarchy by the level of the arrows pointing to each box. For example, the three arrows pointing to Poor are all Poor, the three combinations to Exemplary are all Exemplary, the three arrows pointing to Exemplary or Standard are all either Exemplary or Standard, with the analyst weighting the final rating to the decisive factor or factors.

The Poor, Standard, and Exemplary ratings previously used for our assessment of Stewardship are retained. Those words say simply and clearly how we think capital will be allocated in future, consistent with Morningstar's Investors First mantra.

We make the following observations on the capital allocation flow chart:

- ▶ If the balance sheet is poor and we expect it to remain so, a Poor capital allocation rating is appropriate.
- ▶ Poor investment--both material and misallocated investment--dictates a Poor capital allocation rating.
- ▶ Exceptional investment and appropriate shareholder distributions are decisive, even if the balance sheet is weak. However, they cannot overcome a poor balance sheet.
- ▶ For edge cases, such as when the flow chart suggests an Exemplary or Poor rating, analysts consider the importance of new investment and growth versus shareholder distributions to total shareholder returns. If investment is likely more important, our capital allocation rating is decided by our opinion on investment, and if shareholder distributions is likely key, our assessment of distributions is decisive.

### **Goals of the Capital Allocation Framework**

Several goals guide this capital allocation methodology and framework:

- ▶ Rename the rating to avoid any potential confusion with environmental, social, or governance analysis as Sustainability ratings are to be incorporated into our research<sup>1</sup>.
- ▶ While we recognize ESG factors can influence how we view the quality of management and its capital allocation, we will incorporate these though our focus on balance sheet, investment, and shareholder distributions where relevant and material.
- ▶ Simplify the capital allocation framework and methodology to improve the consistency of its application and enhance comparability, both within and across sectors and geographies.
- ▶ Enhance our focus on the primary drivers of longer-term shareholder returns, namely, investment, shareholder distributions, and balance sheet to strengthen the rating's meaning.
- ▶ Promote consistency between our firm level views on the likely success of future investment and our modeled forecasts for future investment returns and, if relevant, the moat. Avoid conflicts between our key ratings, including capital allocation, and valuation assumptions.
- ▶ Support forward-looking ratings. Frame our expectations over a full economic cycle and use this to inform our analysis and ratings.

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<sup>1</sup> While we recognize ESG factors can influence how we view the quality of management and its capital allocation, we will incorporate these, though our focus is on balance sheet, investment, and shareholder distributions where relevant and material.

## Why Is Capital Allocation Important?

New assets are key to future returns. Investment today--typically reinvestment in the business or acquisitions--creates tomorrow's cash flows. Some common actions include the purchase of plant and equipment, construction of new buildings, development of natural resources, research and development into new drugs and technology, and mergers and acquisitions.

The importance of investment to overall shareholder returns varies, but in general, the more important future investment and growth is to total shareholder returns, the more important investment is for the overall capital allocation rating. Our expectations for the effectiveness of new investment should also help inform our forecasts for future returns on new invested capital. We make no distinction between a business that expenses its investments, such as is common in the technology sector, and one that capitalizes them. If our view is the assets being built have multiyear lives and value, those expenditures are considered investment for the purposes of assessing capital allocation, regardless of the accounting treatment.

There is a natural tension among investment, shareholder distributions, and the balance sheet. Exhibit 2 shows the generalized sources and uses of cash for capital allocation. It highlights the competing priorities and options for excess cash flow. Morningstar book *Why Moats Matter* states it's "critical to understand how effectively a company's management team allocates shareholder capital toward moat-widening projects and investments while balancing returns of shareholder cash through buybacks and dividends."

With finite cash flows, managers face competing priorities to strengthen the balance sheet, expand the business either through reinvestment or acquisitions, or return cash to shareholders, either through dividends or buybacks. The right balance depends on the attractiveness of the growth prospects--that is, the ability to invest new capital to generate above-WACC returns. Mature firms with limited growth prospects, or firms in declining industries, may be better off returning cash to shareholders than reinvesting. The same may be true of firms with passive assets such as REITs or infrastructure owners, particularly when the cost to acquire or build new assets is high.

Conversely, it may be wise for some mature firms to invest if acquisitions expand market share and scale is an important driver of competitive advantage, provided the investments are at an attractive

price. Early stage firms with high growth prospects are typically better off reinvesting much of the available cash flow and even raising new funds to accelerate growth if valuable assets are generated.

**Exhibit 2** There Is a Natural Tension Among Competing Balance Sheet, Investment, and Shareholder Distribution Priorities

The generalized sources of (in green) and uses of (in red) cash for capital allocation.



Source: Morningstar.

Industry life cycle analysis may suggest an appropriate level of investment and shareholder distributions. We summarize the concept in Exhibit 3. However, generalization is hard and depends on the investment needs and opportunities of each individual business. We assess if managers strike the right balance among an appropriate balance sheet, investment, and shareholder distributions on a case-by-case basis. If a firm faces threats to its competitive position, has opportunities to enhance it, or has plentiful value-adding investment options, then a greater level of investment should be expected. We consider if investments are likely to be wise, supporting or widening the moat, done at the right price, and well executed.

**Exhibit 3** Industry Life Cycle Analysis May Help Guide to an Appropriate Level of Investment and Distributions  
Generalization of the availability of cash flow, investment needs and distribution capacity for firms based on industry life cycle.

<b>Company Life Cycle</b>	<b>Start-up</b>	<b>Growth</b>	<b>Shakeout</b>	<b>Mature</b>	<b>Decline</b>
Growth Rate	Slow	Rapid	Slowing	Slow	Negative
Free Cash Flow	Low/Negative	Low/Negative	Moderate	High	High
Investment Needs	High	High	Moderate	Low	Low/Negative
Distribution Capacity	None	None	Low	Moderate	High

Source: Morningstar, adapted from CFA 2019 Level 1 Curriculum and Aswath Damodaran; Returning Cash to the Owners: Dividend Policy.  
<http://people.stern.nyu.edu/adamodar/pdfiles/acf4E/presentations/divintro.pdf>

We make some general observations on industry life cycle analysis and the tradeoffs between balance sheet strength, investment and shareholder distributions:

- ▶ Early stage firms should focus on investing to strengthen their competitive position and grow.
- ▶ Growth stage firms can be free cash flow negative and may need external financing, so distributing dividends or undertaking buybacks is generally not optimal.
- ▶ As firms mature and investment opportunities dry up, shareholder distributions should be an increasingly important use of funds and increasingly important to total shareholder returns.
- ▶ For cyclical and investment-intensive firms, shareholder distributions that flex with earnings and capital investment requirements may be appropriate—for example, mining or upstream energy firms.
- ▶ Acquisition focused companies should be careful not to overstretch the balance sheet or shareholder distributions as cash flows from acquired companies or future synergies may disappoint.
- ▶ Firms with poor balance sheets should probably focus on strengthening their financial position. Here, dividend cuts and/or restricted investment may be appropriate and long-term value-maximizing.
- ▶ For no moat firms, a focus on value-accretive investments to enhance the competitive position is correct. Cutting dividends to support such an effort is likely favorable for long-term shareholders.
- ▶ Firms with high debt burdens, but stable cash flows, should be able to distribute more funds to shareholders than those with volatile cash flows. This is considered in our balance sheet assessment.

## Key Questions for Assessing Capital Allocation

### Balance Sheet

- ▶ Does the firm have excessive leverage? Is debt repayment a priority? Does the company have cash flow to repay debt, and can appropriate deleveraging occur in the medium term?
- ▶ What would be the likely impact on revenue, earnings, and free cash flow in an economic downturn? Would a downturn likely materially change our balance sheet assessment?
- ▶ Do material stock-specific risks exist? How likely are they to come to pass? If they were to happen, would our appraisal of the likely strength of the balance sheet materially change?

### Investment

- ▶ Strategy: Does investment widen the moat or fortify the competitive position? This depends if the firm is an industry leader/disruptor or under competitive attack from rivals.
- ▶ Valuation: Is the firm investing at the right price, either via acquisition or reinvestment? Do we expect the returns on new investments to be materially below or above the WACC?
- ▶ Execution: Is material value likely to be added or destroyed through execution? Where ESG risk exists, is it material and should it factor into our assessment of execution?
- ▶ How material are future investments (regardless of whether they are capitalized or expensed) relative to forecast free cash flows?
- ▶ Is material value likely to be added or destroyed by future investments?
- ▶ Is the firm underinvesting to preference excessive shareholder distributions? Are material value-adding opportunities, or relative competitive advantages being forgone?
- ▶ If investment destroys shareholder value, is it value maximizing and likely better than if the firm did not invest at all?

### Shareholder Distributions

- ▶ Is the firm likely to return an appropriate amount of cash to shareholders?
- ▶ Is the opportunity cost of forgone investment or balance sheet strengthening material?
- ▶ Are shareholder distributions likely to be in the appropriate form?
- ▶ Are repurchases likely a material proportion of future free cash flow, and likely repurchased at a price materially different from our fair value estimate?
- ▶ Is material shareholder value likely to be destroyed or added by buybacks?

### The Overall Rating

- ▶ For edge cases, what is the likely largest contributor to future total shareholder returns?

## Assessing the Balance Sheet

We pay close attention to how companies manage their balance sheets. A firm's financial health directly affects its ability to invest in future growth opportunities, return cash to shareholders, or even remain a going concern. The ability to remain a going concern is the lowest hurdle investors need consider for an equity investment. With high leverage, management puts this at risk.

In assessing balance sheets, analysts consider the tradeoff between absolute financial strength and reinvestment. Is the more aggressive balance sheet temporary? Does it facilitate moat enhancement and value-adding growth that would otherwise not be possible? Is there a path to a materially stronger position and do we expect that to occur? If so, we would not assess the balance sheet as poor, and a Poor capital allocation rating based on balance sheet alone would be inappropriate. A rare acquisition that enhances a firm's competitive position, but sees debt elevated for a while, may be worthy, provided we expect the financial position to improve in a reasonable timeframe.

Our forward-looking assessment considers potential one in 10-year events, such as the Great Financial Recession, 9/11, or the COVID-19 crisis.

There are trade-offs for conservatively managed balance sheets and our methodology does not bias towards excessively conservative balance sheets. For sound balance sheets, the other factors in our capital allocation methodology--Investments and Shareholder Distributions--become decisive for our capital allocation rating. Modest debt or excess cash is fine, provided management makes the right value-adding investments at the right rate, and shareholder distributions are in the appropriate amount and form, either dividends or repurchases.

We summarize our thinking on how Morningstar treats "lazy" balance sheets here. By lazy we mean the firm has excess cash or is materially under geared. But exactly what financial settings equate to a lazy balance sheet will differ depending on the firm and the industry. For lower-margin, capital intensive, or cyclical businesses--such as a commodity producer--it may be appropriate and even value maximizing to hold some cash through the cycle to take advantage of lower asset prices and development costs in a downturn. However, for a defensive asset such as a regulated infrastructure stock with secure revenue and profits, holding net cash or even a small amount of net debt would likely be less than ideal.

If a firm has a "lazy" balance sheet, but is still likely to invest well and return appropriate distributions to shareholders, an Exemplary capital allocation rating still fits. However, if the balance sheet is lazy and



material value-adding investment is being forgone, a Poor capital allocation rating is appropriate. If shareholder distributions are being compromised by an excessively cash-rich balance sheet, this could result in a poor assessment of shareholder distributions. If shareholder distributions are likely to be the key driver of total shareholder returns in future, then a Poor capital allocation rating follows.

### **Poor Balance Sheet Management Can Dictate a Poor Capital Allocation Rating**

If the balance sheet is weak such that the firm has significant risk of material shareholder value destruction, a Poor capital allocation rating is fitting. This is true even if we positively rate the other major inputs to the overall rating--Investments and Shareholder Distributions.

Assessment is on a forward-looking basis. This means considering how we expect the balance sheet to evolve in future, and how infrequent events such as recessions or shocks, or more frequent industry cycles, are likely to affect the future balance sheet? Is debt unreasonably high and likely to remain so? Is material shareholder value destruction possible or likely through the cycle? If so, then a Poor capital allocation rating may be appropriate. If debt is high but debt repayment is prioritized and a sustainable balance sheet likely in a reasonable time frame (within a few years), then a poor balance sheet assessment is inappropriate.

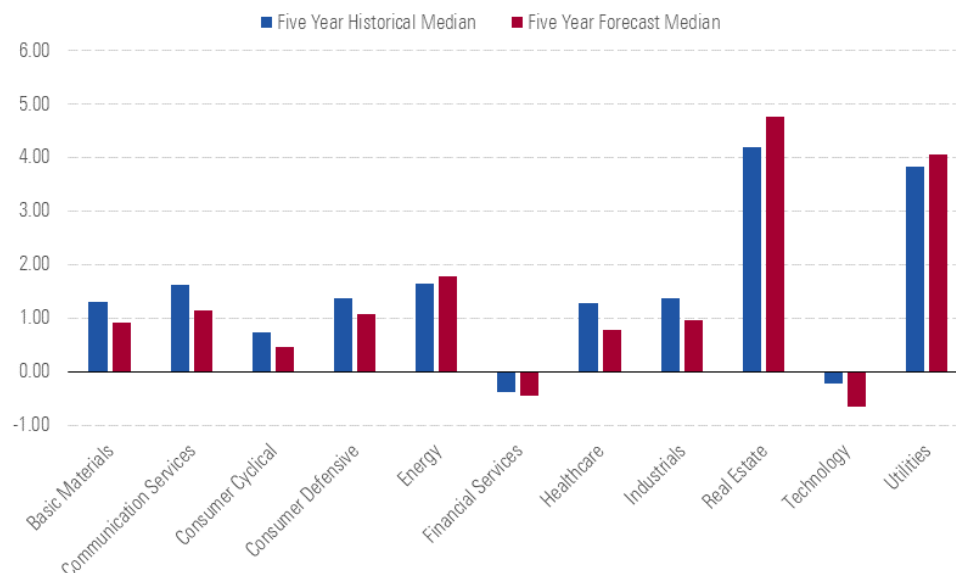
Our reasoning for why a poor balance sheet assessment should dictate a Poor capital allocation rating is simple: if a company risks significant value destruction because of a poorly managed balance sheet, the other inputs to our capital allocation rating--investments and shareholder distributions--may not ultimately matter much to total shareholder returns. For the long-run benefits of worthy investments and shareholder distributions to matter to shareholders, a firm needs to be financially strong enough to make it to the long term. As Warren Buffet said in his 2006 shareholder letter, "You have to be able to play out your hand under all circumstances." A poor balance sheet means managers may not be able to in some circumstances. Tail risks such as one in 10-year events like the global financial crisis or the coronavirus pandemic are considered in our forward-looking analysis.

### **Some Checks for Assessing Balance Sheets**

In assessing balance sheet strength, analysts apply a series of checks, including some of the following:

- ▶ High-yield credit ratings, especially those in the broad single-B category:
  - ▶ By definition, high-yield firms will likely have a need for refinancing, and single-B issuers often have a very small cushion (in terms of cash plus future cash flows and/or equity value to tap to fund any projected liquidity shortfalls on scheduled debt obligations) to prevent a fall into the CCC territory in an event that puts stress on the balance sheet.
- ▶ Significantly higher leverage and lower interest coverage than industry norms:
  - ▶ In an external economic downturn, creditors may be less likely to fund companies with weaker balance sheets than peers, especially if better-capitalized peers also need financing. At the very least, companies with relatively weak balance sheets may be charged higher interest rates in a liquidity crunch, which could affect cash flows. Exhibit 4 provides some net debt/EBITDA ratios by sector to consider when in the analysis of relative credit risks.

**Exhibit 4** Leverage Varies Significantly Across Sectors, and REITs and Utilities Typically Are More Highly Leveraged  
Five-year average annual median historical and forecast net debt/EBITDA ratios by sector.



Source: Morningstar. Data as at June 2020.

- ▶ Potential for falling profits in an economic downturn
  - ▶ What would be the likely impact on revenue, earnings and free cash flow in an economic downturn? Would a downturn likely materially change our balance sheet assessment?
  - ▶ Key credit metrics, such as leverage and coverage, are considered relative to ongoing profit streams. Consider how lower profits in a downturn could affect the company's credit metrics and credit rating in future. Falling profits could cause the company's market capitalization to fall, increasing the dilutive effects of any equity issuances to meet liquidity shortfalls. Does the firm have excessive leverage?
- ▶ Potential for falling profits due to company specific risks
  - ▶ Do material stock-specific risks exist? How likely are they to come to pass? If they were to happen, would our appraisal of the likely strength of the balance sheet materially change?
- ▶ Weak Distance to Default scores
  - ▶ Distance to default scores measure the how far the value of the company's assets is from the default point, that is the value of debt. The market value of companies with weak DTDs typically are low relative to the debt owed, meaning they may not be able to issue equity to get out of a liquidity crunch, at least not without destroying substantial equity value.
- ▶ Is the balance sheet likely to materially change?
  - ▶ How we expect the balance sheet to evolve is an important consideration. The methodology does not penalize firms for making large investments, such as a strategic acquisition, if leverage is temporarily elevated. We distinguish firms with short-term balance sheet risk

from those continually rolling the dice. Is the firm both able and likely to materially deleverage? Similarly, a strategy to promote and maintain an overly aggressive balance sheet would be negative for our assessment. Our expectation on the likely medium- to long-term balance sheet management is decisive.

**Application of the Framework in Economic Downturns**

It is not desired or intended for our capital allocation ratings to flip from Standard to Poor, to Standard through an ordinary economic downturn. It is not the intention of the methodology to unduly bias capital allocation ratings to Poor in periods of elevated economic risk. Balance sheet assessment is forward looking. If a firm runs an aggressive balance sheet in normal economic times, and substantial value-destruction risk becomes an obvious concern--more than just a tail risk--the balance sheet, and thus the overall capital allocation rating, should be rated as Poor prior to the downturn. However, if we expect balance sheet risk to be elevated for a short period and the firm can return to firmer financial footing by its own means--for example, internal cash flow generation or appropriate noncore asset sales without material shareholder value destruction--a Poor capital allocation rating based on the balance sheet would be inappropriate.

## Assessing Investment

Investment captures either reinvestment in a business or acquisitions, that is organic or inorganic investment. Investment contributes to future shareholder returns, particularly if a firm is investment intensive, regardless of whether the investment is capitalized or expensed. As time passes, new investment becomes an increasingly larger part of the total asset base. The success of that new investment--the return on invested capital it generates--increasingly drives overall returns. For the purpose of assigning a capital allocation rating, we care if a firm is likely to invest or grow earnings materially, and the efficacy of that investment. The importance of investment and growth to total shareholder returns is also considered in assigning the overall capital allocation rating.

### Rating the Efficacy of New Investment

Three variables are key to our assessment of new investment:

- ▶ **Strategy:** Does the investment widen the moat or fortify the competitive position relative to rivals? The importance of moat widening or defending to a firm depends if it is an industry leader/disruptor or under competitive attack from rivals.
- ▶ **Valuation:** Is the firm investing at the right price, either via acquisition or reinvestment in the business? For cyclical industries, the timing of new investment can be material to future returns. Investing near cyclical peaks can be expensive and lock in poor returns. The opposite can be true in cyclical downturns.
- ▶ **Execution:** Is the strategy achievable? Bringing a plan to reality is key to future returns. Acquisitions need to be integrated and cost savings or revenue growth achieved for investment to succeed. New projects or developments need to be delivered, reasonable returns earned, and material risks--including ESG risks--appropriately managed. Material operational missteps also need to be avoided. An expectation of material value destruction from investment due to poor execution should reflect in a Poor assessment of investment and a Poor overall capital allocation rating.

To assess investment, consider if the likely investments/acquisitions enhance or fortify the moat (investment strategy) and if it is likely to add shareholder value. If beneficial to the moat and returns are likely to exceed, or at least meet, WACC, then we'd view the investments positively. Whether the expected investments are sufficiently positive to tilt the scales toward an opinion of exceptional investment depends how much value is likely to be added. This in turn depends on the materiality of the expected investments are relative to free cash flow and the scale of excess returns. The product of the likely proportion of free cash flow attributed to investment, the excess returns above WACC for those investments, and its impact on valuation are considered.

We also consider if investments open a pathway for further value-adding and moat enhancing/fortifying investment--such as the creation of a new business line or extension of an existing offering. Major acquisitions and/or developments could open up these kinds of opportunities. If major investments are likely materially value adding and bring a pathway for further value-adding investment, then an exceptional assessment of investment is appropriate.

Excessive shareholder distributions or an excessive allocation of cash flow to an already sound balance sheet can also impact our assessment of investment. If material shareholder value is likely to be foregone or destroyed due to excessive shareholder distributions or an excessive allocation of cash flow to an already sound balance sheet, this would justify a Poor overall capital allocation rating. Via the framework in Exhibit 1, this would be from either a poor assessment of investment, which is sufficient for a Poor capital allocation rating assuming investment is likely the key driver of total shareholder returns. If shareholder distributions are the likely main driver of total shareholder returns, a fair assessment of investment and a poor assessment of shareholder distributions would justify a Poor capital allocation rating.

Note: Forgoing investment to strengthen an otherwise poor balance sheet may be the best use of cash flow to mitigate and reduce the potential for value destruction in some cases. For those, it would be inappropriate to penalize the lost shareholder value-adding investment opportunities if balance sheet repair is a likely better use of funds. However, we also consider if the stretched balance sheet should have been avoided in the first place.

Optimistic manager assumptions are the enemy of future returns. Buffett provides an amusing relevant analogy in the book *The Warren Buffett CEO* by Robert P. Miles.

*"In the past, I've observed that many acquisition-hungry managers were apparently mesmerized by their childhood reading of the story about the frog-kissing princess. Remembering her success, they pay dearly for the right to kiss corporate toads, expecting wondrous transfigurations. Initially, disappointing results only deepen their desire to round up new toads. ('Fanaticism,' said Santayana, 'consists of redoubling your effort when you've forgotten your aim.')* Ultimately, even the most optimistic manager must face reality. Standing knee-deep in unresponsive toads, he then announces an enormous 'restructuring' charge. In this corporate equivalent of a Head Start program, the CEO receives the education, but the stockholders pay the tuition."

The criteria of strategy, valuation, and execution is assessed by analysts on a forward-looking basis over a full economic/business cycle. Our view on the effectiveness of future investment is framed in terms of what we expect to happen in future with history to inform our expectations where relevant. Events, such as a change in strategy or management, can signal meaningful breaks from the past. A strategy to sell weak segments to focus on more competitively advantaged ones could warrant a change in our view of investment, and potentially the capital allocation rating.

### Considerations in Assessing the Likely Efficacy of New Investment

Here are some of the factors we may consider when assessing investment:

- ▶ **Cyclical:** Cyclical changes in asset prices for acquisitions, the cost to build new capacity and cyclical end demand can have a material impact on the success of investments. Investing countercyclically is likely a positive for our opinion on a firm's investment. Investing pro-cyclically, particularly if investment is likely to be value destructive in future, is likely to be assessed unfavorably and could be reasonable grounds for a poor investment opinion and a Poor overall capital allocation rating.
- ▶ **Capital Intensity:** Greater capital intensity increases the importance of future investment to valuation and future returns. For capital intensive businesses, the price paid for new productive capacity is an important driver of future returns.
- ▶ **Cyclical and Capital Intensive:** Poor cyclical and capital-intensive businesses call for much or all of the operating cash flow to be reinvested for growth during a cyclical upswing, but during a downswing, the resulting overcapacity can result in fierce competition and a lack of pricing power.
- ▶ **Acquisition Driven Growth:** This approach brings its own challenges. Watch for acquisition-multiple inflation as the model matures, targets exhaust, or copycats emerge. Declining returns on invested capital may suggest management is overpaying.
- ▶ **Execution Risk:** How hard is delivery? Some investments are a continuation of an existing business model. Opening a new big-box hardware store—for example, Bunnings or Home Depot—is a relatively low-risk endeavor. The population catchment and market size can be estimated with relatively high confidence prior to investing. Other investments are discrete new projects with returns unrelated to the existing business. A new mine, for example, is likely to have its own capital requirements, and operating and geological challenges. Building a new office for an REIT is generally a discrete new investment.
- ▶ **Competitive Position:** Does the investment support the competitive position, either by widening or defending the moat? Morningstar's moat source frameworks are a useful resource for assessing where a business should invest. For example, if competing on cost, does investment improve the cost position, say, through increased scale? Is the improvement replicable? New fuel-efficient aircraft may yield fleeting operating cost advantages, but the need to buy successive generations of planes can be onerous.
- ▶ **Impairments:** Substantial impairments and write-offs suggest future investments may be poor. Are impairments from something intrinsic to the firm, such as cyclical and capital intensity, suggesting potential recurrence? However, if the write-offs reflect a defunct business line or strategy, the mistakes may be unlikely to repeat. A management change may also alter the likelihood mistakes repeat.
- ▶ **Compounding:** Is a business able to compound earnings with little or no new capital investment? Can the business invest or grow at high rates of return? Will the strategy exploit this advantage, and is the company likely to execute?

For cyclical and capital-intensive businesses: watch for a lack of free cash flow, or negative free cash flow, during "the good times," and be skeptical if expansions are being funded with growing debt. Ask "when will shareholders get paid?" and "will this business have pricing power when the music stops?" Examples include firms that provide short-term leasing of mining equipment to miners, exploration drilling contractors, and some shipping companies.

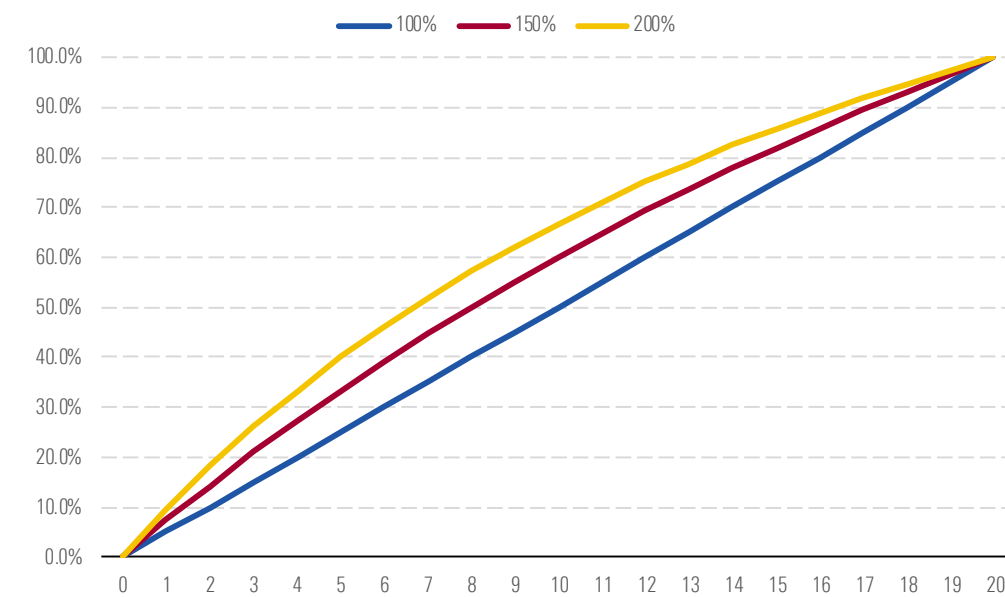
Charlie Munger makes a clear distinction:

*"There are two kinds of businesses: The first earns twelve percent, and you can take the profits out at the end of the year. The second earns twelve percent, but all the excess cash must be reinvested--there's never any cash. It reminds me of the guy who sells construction equipment--he looks at his used machines, taken in as customers bought new ones, and says, 'There's all of my profit, rusting in my yard.' We hate that kind of business."*

### How Important Is New Investment?

A simple example: assume a firm depreciates its assets over 20 years on a straight-line basis, no inflation and capital expenditure equals depreciation. By year 10, assets from the new investments make up half of the total asset base. If we instead assume capital expenditure at 150% of the rate of depreciation, the new assets make up half of the asset base by the end of year eight and at 200% it does so around year seven, as shown in Exhibit 5.

**Exhibit 5** The Greater Rate of New Investment, the Sooner New Assets Become Most of a Firm's Assets  
Forecast new assets as a proportion of total assets per year assuming reinvestment at 100%-200% the rate of depreciation.



Source: Morningstar.

Our expectations for the return on new invested capital, or RONIC, from those new investments is important to our assessment. Earnings growth is a function of both the reinvestment rate, and the rate of return on new investment. RONIC measures the increase in aftertax earnings--before interest--for a given increase in invested capital. Measuring RONIC over a single period is noisy as there is often a delay from when an investment is made to when profits increase. Cyclicalities may also cloud the view.

Regardless of RONIC's limitations, the expected rate of return from new investment helps inform our view if a firm should invest, in what, and at what rate. All else equal, if the returns on new invested capital are below the WACC, and are expected to remain so, then the firm should not invest and instead should direct available cash flow either to the balance sheet or shareholders. One caveat for no-moat firms in competitive industries is if we think the sub-WACC investment is shareholder value maximizing. That is, if the firm did not undertake the investment, that greater value would be destroyed.

Another way to put this logical test is whether we expect investments to be value accretive. If investments are not immediately profitable, but instead help to build the firm's competitive advantage and strengthen the moat longer-term, investment may still be justified, provided the longer-term returns compensate. Economic profit in future, such that they add shareholder value, means investment should be pursued. Amazon is an example of a firm that makes big bets and is prepared to suffer large up-front losses to establish long-term profitable positions.

For a no-moat business, a poor assessment of investment and a Poor overall capital allocation rating is justified if a firm allocates material future investing cash flows to substantially below WACC investments, and if significant shareholder value is likely to be destroyed. Value destruction or creation is measured against the theoretical valuation case where no material new investment is made.

### **The Importance of High RONICs and Compounding**

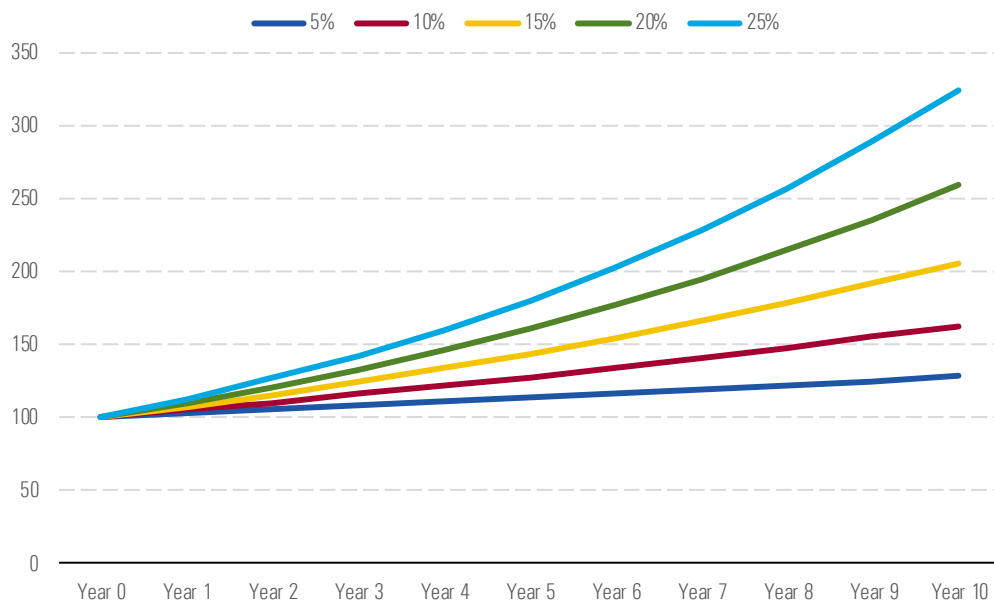
Some businesses can invest to compound earnings at high rates of return, and some can't. Over time, the difference in total shareholder returns can be stark. For businesses unable to reinvest to compound earnings, or where investment options are limited to acquisitions with immaterial synergies, some skepticism on the ultimate value creation for shareholders is warranted.

Take, for example, an REIT with a single building on a fully developed site. The RONIC may be high or even negative (a good thing in this case as earnings may grow despite capital declining if depreciation exceeds capital investment), but the firm's ability to reinvest is limited, particularly if asset prices are high. In this case, assuming a sound balance sheet and a lack of attractive acquisition opportunities, cash flow should be returned to shareholders. An exceptional assessment of investment is justified if we think management is appropriately disciplined, this could include making little or no new investments.

To quantify the difference between a business that can compound earnings and one that cannot, we show a simplified example. Assuming a starting EBI of USD 100 million a year, and assuming the business reinvests 50% of EBI into new capital, for a business that generates RONIC of 5%, EBI compounds at 2.5% a year to USD 128 million in 10 years. For RONIC of 25%, EBI compounds at 12.5% a year and more than triples to USD 325 million in 10 years.



**Exhibit 6** Compounding Matters Over Time, and Businesses That Can Reinvest at High Rates, Should Forecast growth in EBI over a 10-year period assuming 50% of EBI is reinvested at rates of return from 5% to 25%.



Source: Morningstar.

If we assess future investments as likely to be poor or value destructive, this will impact our forecasts, fair value estimate, and in some cases, the moat rating. For example, we may rate a qualitatively moatworthy firm as no-moat if we think there is a significant risk that management will destroy material shareholder value and/or if there is a significant risk that returns on invested capital will be driven below the WACC. For these cases, a poor assessment of capital allocation and a Poor capital allocation rating is likely to be appropriate. The same goes if we expect successful, value-adding investment. Expecting consistent, above-WACC investment adding material shareholder value justifies an exceptional assessment of investment, and for firms where investment is the key driver of total shareholder returns, an Exemplary capital allocation rating.

## Assessing Distributions

To assess shareholder distributions, we consider two key factors: the appropriate amount to return to shareholders and the form. How much is appropriate depends on the opportunity cost of forgoing reinvestment or strengthening the balance sheet. The optimal form of shareholder distributions depends on the general tax implications and the share price relative to our fair value estimate for buybacks.

However, we generally don't opine on the virtues of dividends versus buybacks for cases where the choice is immaterial to total shareholder returns, or where specific shareholders may have different preferences. Rather, we care if buybacks are likely to meaningfully add to or dilute shareholder value. We consider the proportion of future free cash flow directed to repurchases and if they're likely to be undertaken at either a significant discount or premium to our fair value estimate. For dividends, do we expect the payouts to be appropriate given the forecast cash flows, likely balance sheet needs, and the value-adding investment opportunities?

### **The Opportunity Cost of Shareholder Distributions**

A company should reinvest when it can do so at attractive rates of return, i.e. above the cost of capital. In practice, there may be physical limits to how quickly a firm can deploy capital for growth – for example management bandwidth or limited value-adding investment opportunities. Assuming a sound balance sheet, if value-adding growth prospects are limited, management should return cash to shareholders, rather than chase earnings growth through sub-WACC, value destructive investments.

If a company has plentiful opportunity to reinvest at attractive rates of return, dividends and share repurchases should be deemphasized. Retaining all cash for reinvestment, and paying no distributions, may be most appropriate in some cases. But, mature firms with limited growth opportunities should probably return cash to shareholders, particularly if the balance sheet is sound. Reinvestment in a mature or declining franchise risks diluting returns while acquisitions, as a substitute for organic growth, often destroy shareholder value.

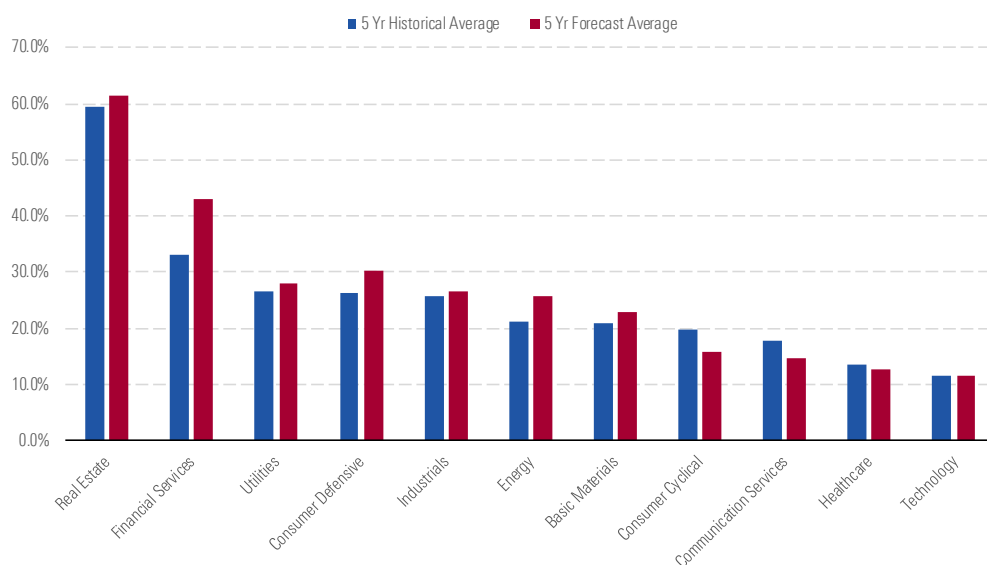
Per Exhibit 3, factors such as the maturity of the industry, underlying market growth rates, competitive threats, and financial leverage are considered when evaluating appropriate quantum of shareholder distributions. These factors will also feed into our assessment of a firm's investment. In short, consider if the firm could better deploy cash elsewhere.

### Key Considerations for Buybacks and Dividends

We consider the right amount and form of shareholder distributions--dividends or buybacks--and their timing. Large or special dividends might be a worthy use of excess cash, but unwise if a significant investment cycle looms. A share buyback may be positive if the stock is fairly or undervalued, but can be value destructive if overvalued. Paying dividends when there are few value-adding investment opportunities is positive, but if the stock is materially undervalued, buybacks would probably be better a use of cash. If a balance sheet is poor or valuable investments exist, strengthening the balance sheet or investing should take precedence over maximizing shareholder distributions.

As Exhibit 7 shows, real estate, utilities, and consumer defensive companies tend to allocate a higher proportion of cash flows to reward shareholders in the form of dividends. Those sectors tend to have fewer value-adding reinvestment opportunities relative to the rest of our coverage. On the one hand, utilities in developed economies tend to be relatively stable, mature, low-growth firms with limited reinvestment opportunities. Energy consumption tends to grow at or below GDP. For real estate firms, dividend distributions are supported by the obligation for REITs to distribute a certain percentage of earnings as dividends to maintain their preferential tax status. On the other hand, healthcare and technology firms often have significant growth opportunities, so de-emphasizing distributions is generally logical. Firms in these sectors may also be disrupted, so investment in R&D may be necessary to protect and grow value. Zero shareholder distributions are appropriate if there are better uses for the cash.

**Exhibit 7** Real Estate, Financial Services, and Utilities Pay Most Cash to Shareholders, Healthcare and Tech Least Five-year historical and forecast averages of the annual median for dividends/cash flow from operations by sector.



Source: Morningstar forecasts. Data as of May 2020.

We do not favor firms with high dividend payout ratios, but poor balance sheets. Similarly, excessive distributions when significant value-adding investment opportunities exist is a negative for our

assessment. Firms with stable cash flows and payout ratios may be investing and distributing capital in an appropriate fashion. Conversely, for a cyclical firm, flexing dividends with the cycle is probably wise.

Overall, we care if the cash directed to shareholder distributions is broadly correct. The opportunity cost of shareholder distributions, the stability of the balance sheet, and the best use of funds should be considered.

For share buybacks, management should consider the internal rate of return and compare it with other alternatives and the firm's cost of capital. Opportunistic share buybacks when shares trade at a discount to fair value can create shareholder value. However, share buybacks can also be value destructive. If we think a firm is likely to direct material free cash flows to materially overvalued share repurchases, and significant shareholder value is destroyed, we assess shareholder distributions as poor. In practice, we think this is likely to happen relatively infrequently.

Some firms see buybacks as a way to return cash to shareholders regardless of valuation. While benefiting long-term shareholders if the shares are undervalued, buybacks can be value destructive. In addition, some firms, for example cyclicals, can be seduced to buy back shares when times are good as cash is plentiful, only to re-issue them at much lower prices. Steel makers and airlines have many examples. Multiples such as P/E or EV/EBITDA may help assess if buybacks, but our fair value estimates directly influence our opinion. For cyclicals, earnings and cash flow multiples may be inflated at cyclical lows, and what may appear an expensive buyback may be cheap. The opposite may apply if buybacks are undertaken at cyclical highs when those same multiples look compellingly low but are based off unsustainably high profits. Analysis should consider mid-cycle multiples and earnings for cyclical firms.

For share buybacks, our framework considers:

- ▶ If a firm can generate better returns for long-term shareholders by buying back shares than investing?
- ▶ Share buybacks may be more tax effective than dividends in some jurisdictions, such as the U.S, but in others, such as Australia dividends are favorably taxed. However, it's unlikely the choice of dividends or repurchases will be material to our assessment of distributions or likely total shareholder returns.
- ▶ Share buybacks funded with debt should be only done if the post-buyback balance sheet remains appropriate, or if the likely value-add more than compensates for the weaker balance sheet. Debt funded buybacks may be more appropriate for companies with stable or defensive cash flows.

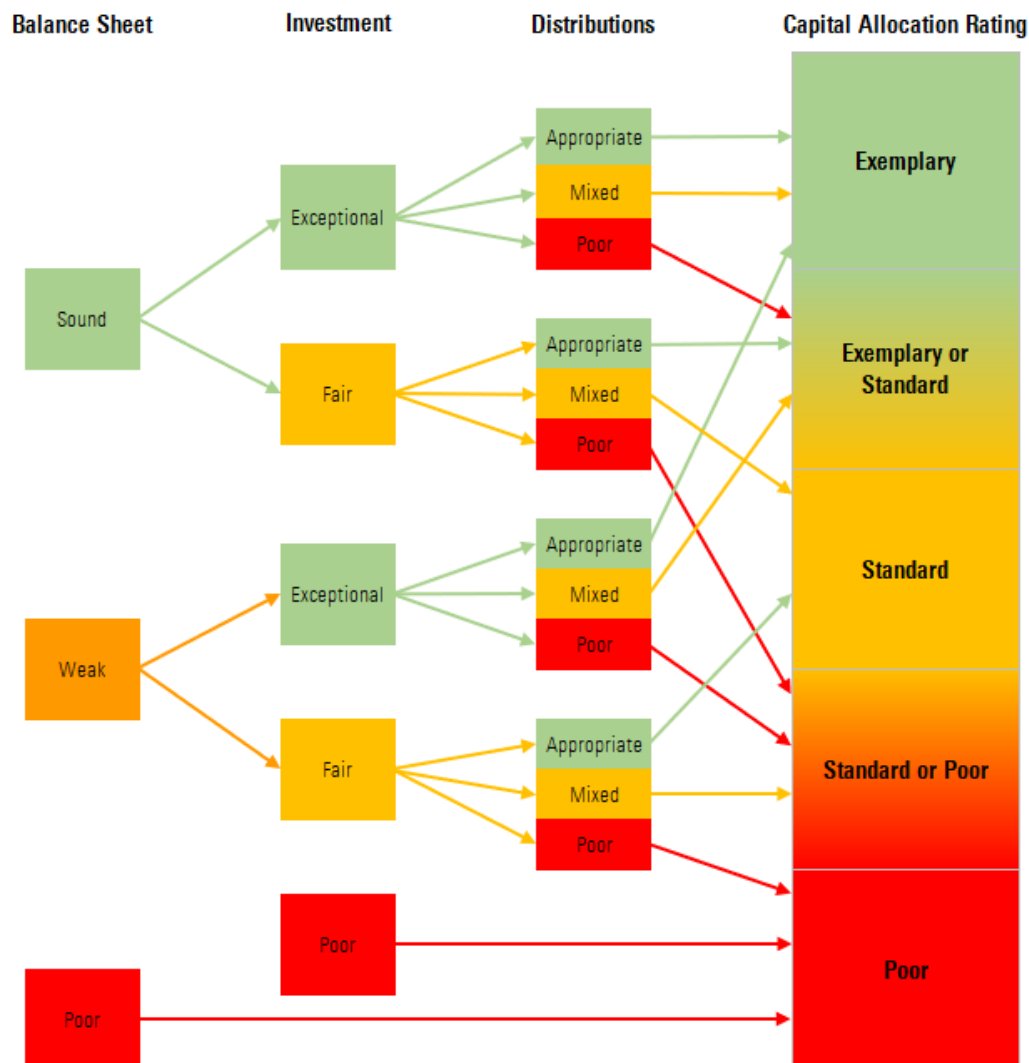
When assessing shareholder distributions overall, materiality matters. The choice of whether to employ share buybacks versus dividends is likely to only be important if significant funds are expected to be returned to shareholders, and if buybacks are expected to be at a material premium or discount to such that they are likely to be materially worse or better than dividends.

## Navigating the Capital Allocation Flow Chart

We first score a company's balance sheet health, investment, and shareholder distributions individually. Then, based on the assessment for each, our capital allocation flow chart guides to an overall rating.

### Exhibit 8 Morningstar's Decision Tree for Assigning Capital Allocation Ratings

Morningstar assesses the balance sheet, outlook for investment, and shareholder distributions to arrive at our overall capital allocation rating.



Source: Morningstar. Note: There is no implied hierarchy by the level of the arrows pointing to each box. For example, the three arrows pointing to Poor are all Poor, the three combinations to Exemplary are all Exemplary, the three arrows pointing to Exemplary or Standard are all either Exemplary or Standard, with the analyst weighting the final rating to the decisive factor or factors.

For edge cases, such as when the capital allocation rating could be Exemplary or Standard, or Standard or Poor, the deciding factor is the major contributor to total shareholder returns.

We make the following observations for edge cases:

- ▶ If we expect shareholder distributions to be the primary contributor to total shareholder returns, our assessment of shareholder distributions is decisive. This includes the portion of value accretion we would expect to come from shareholder buybacks.
- ▶ If we expect investment and earnings growth -- excluding the portion from buybacks -- to be the primary driver of total shareholder returns, then our capital allocation rating biases to our assessment of investment.
- ▶ Whether a firm is trading at a discount or premium to our fair value estimate is irrelevant to our assessment of whether investment or distributions is decisive for the capital allocation rating. However, it may have an impact on our assessment of shareholder distributions if buybacks are expected to be a significant proportion of future free cash flow.

### **What Our Capital Allocation Framework Is Not**

Carl Jacobi's maxim to "invert, always invert" is relevant. To understand what our capital allocation philosophy, methodology, and framework is, it's useful to consider what it is not.

- ▶ A large check list/box ticking exercise. We instead focus our attention on the material drivers of long-term shareholder returns--namely, balance sheet, investment, and shareholder distributions.
- ▶ A menu of broad decision factors of ill-defined importance. A Buffet-style approach is likely to produce inconsistent ratings with limited meaning or value.
- ▶ Heavily fact-based corporate governance summaries. We offer our opinion on key capital allocation and shareholder value drivers, and do not aim to summarize the annual report.
- ▶ Detailed fact-based commentary on remuneration structures and incentives. Remuneration matters to capital allocation only where it incentivizes materially good or bad capital allocation decisions.
- ▶ A summary of ownership and related party issues. Our concern is limited to cases we expect the potential for meaningful impacts on the balance sheet, investment, or shareholder distributions.
- ▶ A factual summary of management's backgrounds. Our assessment of management only matters if it has an impact on our expectations for balance sheet, investment, and shareholder distributions.
- ▶ Health, safety, environment, stakeholder, and/or governance commentary. This is primarily covered in Sustainalytics' ESG-focused research and ratings. Substantial risk of shareholder value destruction from these factors is reflected in our moat ratings and our assessment of investment via execution where relevant. ■■■

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