

### **Capital Allocation: A Sign of Management Savvy**

Sionna's disciplined investment process focuses on the key qualities of a business: competitive advantages, financial strength, quality of management and valuation, among others. Examining quality of management can be difficult to do, because there are so many intangible aspects to it. One area that we focus on because it provides a more concrete way of assessing management's skill is capital allocation.

Capital allocation is basically the process by which companies decide how to spend their money. Ideally, companies allocate capital in a way that maximizes the creation of wealth for shareholders. Another way to think of capital allocation is as a company's "investment discipline" and the outcomes of those investment decisions are the "returns" that either benefit or harm its shareholders.

Companies can generate capital in a number of different ways: externally, by raising equity (issuing shares) or selling bonds (issuing debt) or internally through the profits of the business itself.

Once capital is created, the management team and board of directors have the task of deploying it. In general, there are five potential uses of capital – all of which have the potential to either create significant value or, if inappropriately executed, to destroy value for shareholders. Consider the five uses of capital, listed below, and the kinds of risk/reward trade-offs each offers:

1. **Acquire other businesses or assets.** Management teams can use capital to acquire other businesses. If done at attractive valuations these acquisitions can generate very attractive returns. Conversely, returns can be poor if the price paid for the acquisition is excessive, or the acquisition is of poor quality or strategic fit.
2. **Reinvest in the existing business.** Management teams can also reinvest in their existing business to help maintain and grow the company. Again this can be beneficial for shareholders if the returns are acceptable, but if the business fails to grow, investor returns can suffer.
3. **Pay down debt.** This use of capital can give a firm more financial flexibility. It also reduces the financial risk that common shareholders are exposed to, particularly in a firm that is overleveraged. However, additional leverage can have a number of benefits. For example, repaying that debt can make a firm less

- tax-efficient (because of the favourable tax treatment that interest payments receive), which may reduce profits.
4. **Buy back shares.** A company can also choose to buy back its shares. If the shares are undervalued, shareholders that continue to hold the stock benefit since their notional ownership increases. However, if the shares are overvalued, capital is wasted with buybacks; there is usually a better way to return capital to shareholders such as dividends.
  5. **Pay dividends.** Finally, management teams can choose to return capital to shareholders through dividends. Dividends provide us with an immediate return and can impose capital discipline on a company. And yet, if a company pays a dividend that is not sustainable or pays a dividend at the expense of other options that offer superior benefits, shareholder returns suffer.

Capital allocation can be challenging and each of these five options have to be judged on the return profile and trade-offs that exist between and among all the choices. Sometimes it is in fact a combination of the uses of capital that can offer the best returns to stakeholders.

One example of a company that we believe has shown good capital allocation skills is Methanex. Vancouver-based Methanex is the world's largest producer of Methanol and has, in our opinion, skilfully used capital allocation to benefit shareholders like ourselves and our clients. Not only has Methanex bought back approximately 45% of its shares outstanding since 2000, it has also increased its dividend nine times since 2002, while carefully investing in projects in low-cost strategic locations such as Egypt and Louisiana. We believe these decisions will continue to benefit us as shareholders.

Assessing a company's capital allocation skills is challenging as an investor. It often takes more than a year to determine if a single capital allocation decision has been successful and years to evaluate whether a management team has been consistently effective. At Sionna, we not only take a long-term view, but are students of history. We look at the long-term track record of companies and their managements to analyse the historical decisions that they have made. These observations are informative, since they provide insight into how managements might be expected to perform in the future. We believe that good capital allocation is vital to the prosperity of a business just as Sionna's investment discipline is to our success and to that of our clients. It is an aspect of a business' management that all investors should pay attention to.



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