EY Center for Board Matters

How board oversight of capital allocation can drive strategy

Capital allocation is essential to advancing a company's strategy, and its oversight is one of the board's most important and fundamental roles. The current business context is making that role both more challenging and more scrutinized. Current economic conditions — including lower growth prospects, increased geopolitical risks, sticky inflation and "higher-for-longer" interest rates — mean capital allocation decisions are now essential to achieving strategic goals.

Despite current headwinds, for many companies those strategic goals include business transformation. An EY survey of 1,200 CEOs globally in December 2023 found that 95% are planning to maintain or accelerate their transformational change in 2024, with those looking to accelerate plans (58%) nearly tripling from July 2023.

Achieving such transformational goals in today's market reality demands a more disciplined and efficient use of capital, as well as robust governance of investment decisions and related performance. Capital expenditures are strategic decisions that should maximize efficiency, profitability and long-term value, all while mitigating as much risk as possible. Directors are attuned to these demands and have ranked capital strategy the second highest board priority for 2024, according to an EY survey of more than 350 corporate board members across the Americas.

To support boards as they deepen their capital strategy engagement, we offer five actions boards can take to guide capital allocation in the current environment. We also provide a back-to-basics refresher on the fundamentals of capital allocation oversight that can help boards assess and enhance their approach to this core responsibility.

In brief

- Ongoing economic uncertainty and an unyielding commitment to transformation are causing boards to deepen their focus on capital allocation.
- Boards can take five practical steps to enable management to maximize profitability and position for business transformation despite current headwinds.
- By revisiting the fundamentals of capital allocation oversight, boards can assess and optimize their governance practices in this important area.

Five ways boards can guide optimal capital strategy now

1 Build the board's economic acuity

Be proactive in seeking education and training for the board on macroeconomic developments and the potential impact of those trends on the business. Directors come to the boardroom with a wealth of business skills and experience, but economics may not be among their areas of expertise. This is a common area to seek outside perspectives, especially considering today's combination of higher interest rates, persistent inflation and volatile geopolitical risks. Through that education, the board is then better positioned to ask management what economic, financial and customer demand scenarios have been considered, and help probe potential impacts on financial performance and strategy.

2 Guide management in creating capital

Today's capital markets environment makes external capital relatively expensive compared to most of the past two decades. Boards can encourage management to get creative and consider alternative ways to unlock capital from the business. For example, companies may be able to unlock working capital through better receivables, payable and inventory management, or through more rigorous expense management and cost cutting. They can also adopt a more asset-light business model or divest non-strategic or underperforming businesses or assets that don't warrant further investment (see below for more on divestiture opportunities).

3 Challenge management to optimize or exit

There is a resurgence of activist shareholder pressure for CEOs to contend with, and one area where activists see considerable opportunities to intervene is in pushing for divestitures. A key role boards can play is to get ahead of the activist threat by thinking like activists themselves and challenging management to optimize or exit business lines. In overseeing strategic portfolio reviews, boards can press management on how they have evaluated underperforming business units, non-strategic assets or business units that simply aren't deserving of additional capital. If it is not worthy of capital investment, is it really a business or asset worth keeping, or should it be divested to unlock capital for more strategic initiatives? In considering whether underperforming business units can be turned around or sold, or whether to embark on a turnaround in preparation for a sale, leadership must remember that talent, including management's time, is also a capital investment. The board can provide an important check on both the deployment of financial resources and the investment of talent and time.

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Communicating the capital strategy to stakeholders

Companies will face a heightened level of shareholder activism in 2024, and those campaigns are almost always about cash generation and capital allocation at their core. Companies cannot afford to wait for an activist campaign to make the case that their strategy and capital allocation decisions are the right ones to take the company forward.

Boards can encourage a more robust investor communications strategy. That strategy should include proactively communicating the company's capital allocation and value creation narrative to stakeholders with the same level of granularity and detail, and in a manner as compelling as if the company were in a proxy contest. The board can play a key role in ensuring that those communications provide enough clarity on how capital allocation decisions impact short-term earnings and support medium- and long-term goals. Every communication is an opportunity to secure stakeholder confidence and support.

And investors are focusing on capital allocation: 31% of the investors the EY Center for Board Matters engaged prior to the proxy season cited capital allocation as among the top three areas they want boards to prioritize in 2024. Some of the key themes of those conversations were investors' interest in companies' strategic investments in digital or innovation (particularly in a subdued deal market), how companies are navigating capital availability in the current environment and the health of their balance sheets, and potentially emerging M&A opportunities.

4 Enable deal-making agility

Through their oversight, boards can guide management to analyze potential acquisition candidates and be ready to act when the time is right. This will be crucial as the overall deal market picks up after a subdued 2023. Leading practice is for companies to keep a watch list of potential targets (e.g., peers/competitors, suppliers, industry ecosystem members) and have identified ready sources of capital (e.g., bank financing or divestiture candidates) to facilitate opportunistic acquisitions. Management can track those companies to see if the valuation multiples come to a point that make it attractive, or if other developments make it a more opportunistic target. By being proactive about identifying targets and having sources of capital ready to make the deal happen, companies are able to act with more agility, and boards have more opportunity to assess the value proposition of potentially transformational deals.

5 Apply appropriate guardrails to investments in innovation

With the vast majority of companies planning to invest in generative artificial intelligence and other innovations on the horizon, boards can play a critical role by exerting caution and encouraging rigorous governance of "moon shots." Board oversight can reinforce a robust process for measuring success of innovation and fostering a culture that is committed to "failing fast." They can help management see through the hype to challenge the innovation's effectiveness, evaluate the return the company is getting from those investments and "fail fast" when needed to preserve not just the company's financial investment but also the investment of management and employee time.

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Getting back to basics: capital allocation fundamentals for boards

While the current economic environment is generating unique challenges for capital allocation decisions, boards can continue to rely on fundamental oversight practices for capital strategy that will serve them in any environment.

Adopt a dynamic approach to overseeing how the investment roadmap drives strategy

Capital allocation strategy should support and drive overall corporate strategy, working hand in glove. To ensure this alignment, boards need to adopt a more dynamic approach to reviewing capital budgeting and management. The one-off, board strategy session has evolved. Leading boards are now working with management to frequently revisit the strategic plan and its key elements and assumptions to enable more agility and strategic pivots. This same approach should apply to the capital budget, which should be revisited regularly alongside the strategic plan.

When those are in place, the focus should turn to capital management. For the board, this should mean ongoing monitoring of performance to allow for adjustments that reinforce the strategy and optimize capital efficiency. This oversight should include asking management about how they are leveraging in-flight reviews of larger projects to allow for course corrections and leveraging post-mortems to learn from more- or less-successful projects along the way.

Focus on the right metrics

Capital allocation strategy should support medium- and longer-term value creation goals in addition to short-term key performance indicators (KPIs), which makes focusing on the right metrics essential. Leading practice is to use a balanced scorecard approach that leverages a small set of financial (investment timing, ROI assumptions/timing), nonfinancial (e.g., product mix, customer retention) and qualitative (e.g., community engagement, social media sentiment) KPIs in the investment decision-making process that all align to the overall corporate strategy.

When it comes to financial KPIs, return on invested capital (ROIC) is a multifaceted KPI that can be deconstructed to align different business units to the most appropriate value-creating level, given their situation. For example, a company can have a goal of increasing ROIC from 20% to 25%, and each business unit in the company can have its own goal (e.g., a very profitable business unit can focus on revenue expansion; a market-leading unit can focus on margin improvement; a capital-intensive unit can focus on improving capital efficiency by pursuing asset-light strategies). It is the same ROIC KPI, but every business unit can play a different role, allowing for more customization for individual management teams. Anchoring on ROIC as the benchmark for capital allocation decision-making helps management assess risk and make fully informed, unbiased decisions.

Know the value of each component of the business and enable business agility

To enhance their own value to management, boards should understand the value of each business or asset and how it is supporting the corporate strategy. Each business unit or asset plays a role in the portfolio, e.g., driving revenue or profitability, and can be more or less capital intensive. By understanding the value of each business and asset to the company, and to potential buyers, the board is positioned to provide effective challenge to the status quo and accelerate transformational change when needed.

Boards and management teams should take a page from the private equity playbook and be ready to sell a component of the business that is worth more to someone else. Know the market potential and ease of divesting so the company can prioritize business divestitures if it needs to raise capital internally. While their role is one of oversight, boards should feel empowered to suggest transformational deals to achieve strategic goals, leveraging the experience and acumen that make them a strategic resource for management.

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Going forward: enable agility and capital strength

As companies navigate challenges and opportunities related to capital availability and deployment, the board will play a critical role in providing both robust oversight and strategic advice, guiding management in balancing risk management and long-term value creation. Ultimately the current environment requires continued progress along business transformation — and investment in innovation takes capital. By educating themselves and leaning into their governance of capital allocation, boards can enable agility and capital strength, refocus management on the long term, and oversee communications that tell a compelling capital strategy narrative to stakeholders.

Questions for the board to consider

- Does the board know the value of each business unit or asset and the role they play in the portfolio? Does the board know the value of those units or assets to potential buyers?
- How is the company exploiting internal cashflow sources, both cost structures and working capital management, to create capital internally? When reviewing the strategic portfolio, is management evaluating core business units as well as noncore business units?
- How ready is the company to pull the trigger on a divestiture if an opportunistic acquisition presents itself and the company does not want to rely on the external markets for capital?
- Is the board regularly reviewing the capital budget as it revisits the strategic plan? In the investment decision-making process, is the company using a balanced scorecard approach that includes financial and nonfinancial KPIs to monitor performance in line with the strategy?
- For larger projects and investments, is the board overseeing in-flight reviews to evaluate if performance is as expected throughout the process? Does the board's oversight reinforce a "fail fast" culture?
- Do directors have the training and information they need, including outside perspectives, to evaluate how macroeconomic developments could impact the business? How are those learnings incorporated into scenario planning that helps the company plan for a range of economic, financial and customer demand scenarios?
- Do stakeholder communications around strategy and capital allocation decisions provide enough detail for investors to understand the impact on medium- and long-term goals, not just quarterly earnings? If an activist were in the stock, how would the company's communications be enhanced?

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