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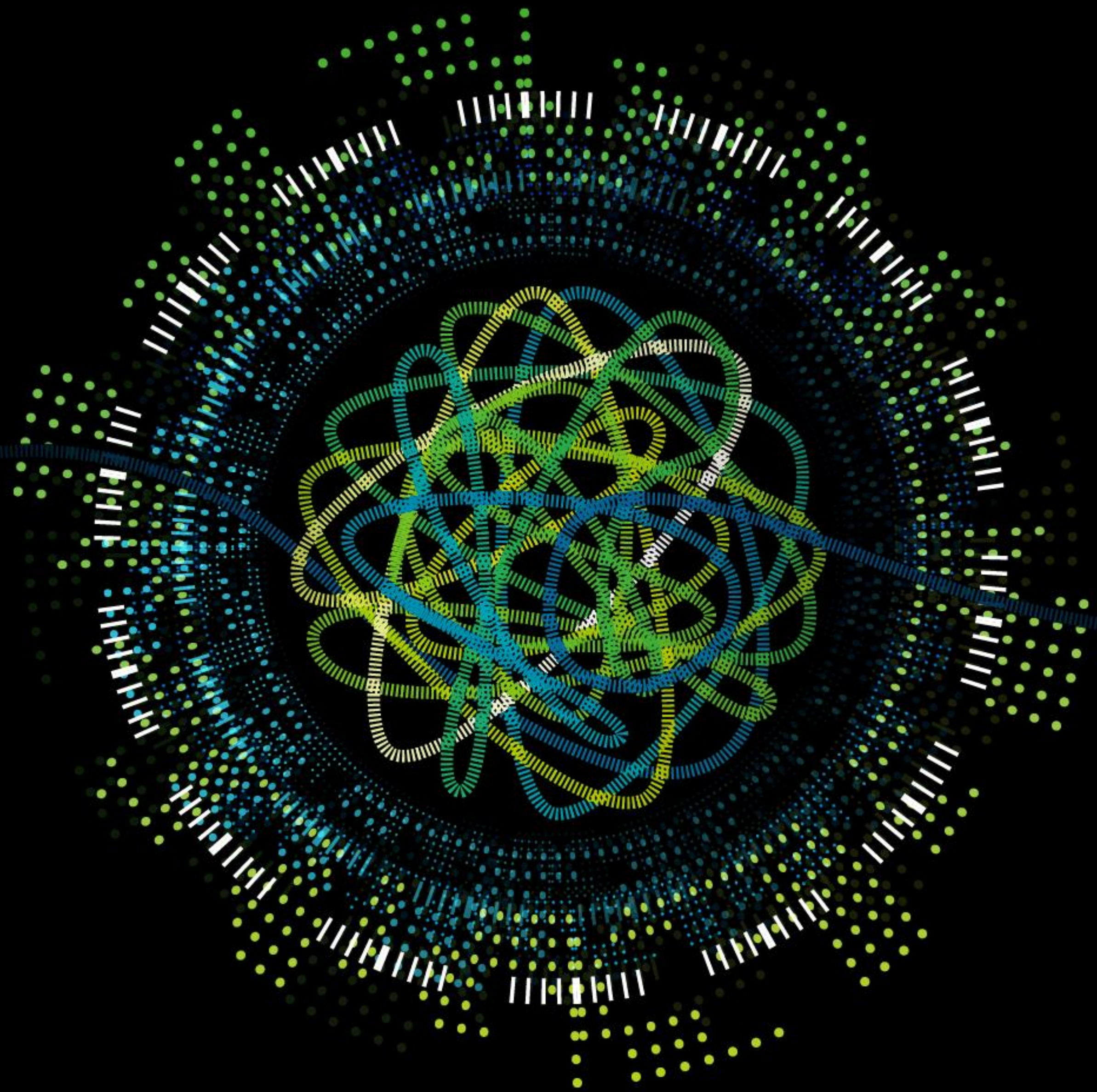


Crunch time series

Untangling capital allocation

How are you thinking about capital allocation these days?

"I'd rather think about a root canal."

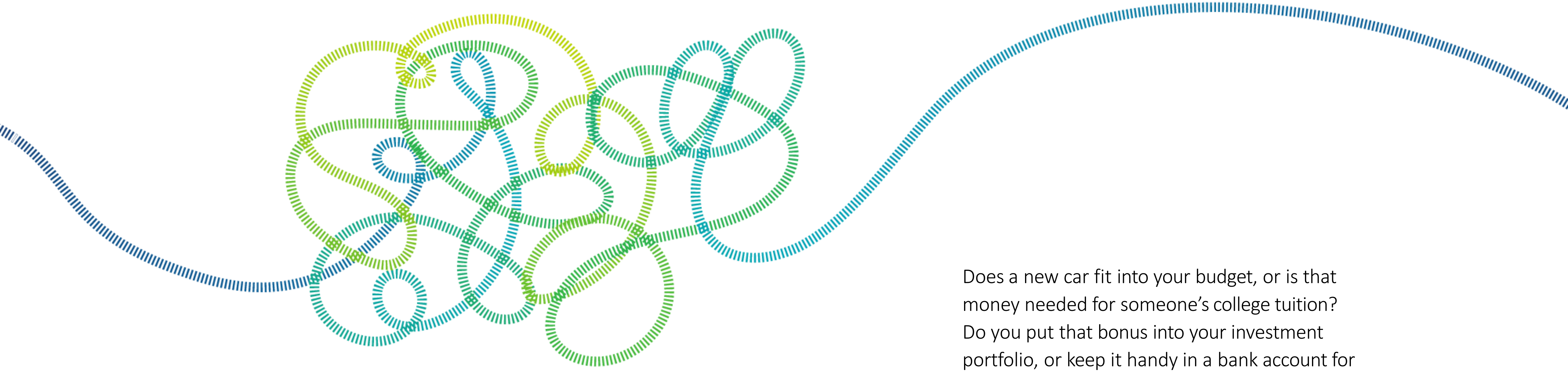
"Too many questions and too much complexity. And I'm not sure I can get everyone on board."

"It's on my list of things to improve, but I have no idea where to start."

"Can't we kick this can down the road a little more? What's the urgency now?"

"We're doing pretty well on some things, but there's always room for improvement."

Chances are, you're thinking some of the above. But the time to address your capital allocation strategy is now. Other CFOs are. (Really.)



How we allocate our money is a knotty question.

Does a new car fit into your budget, or is that money needed for someone’s college tuition? Do you put that bonus into your investment portfolio, or keep it handy in a bank account for projects? It’s complicated, and each decision we make comes with implications and trade-offs. But for businesses, it gets even more complex—and, sometimes, almost as personal.

How businesses generate and allocate capital involves multiple choices, trade-offs, and stakeholders—and all that can add up to an enterprise-size knot of shifting internal priorities, rapidly evolving business environments, and potential biases that have powerful impacts on decision-making.

The giant tangle of capital allocation

Doing capital allocation right is a key pillar of Finance Transformation, one that takes discipline, skill, alignment, and a future-forward view of how to get things done in a rapidly evolving digital world. From the CFO's perspective, this means a few things. One, you need data and insights to understand which projects should go forward, which should stop, and which should be deferred—but maybe you don't yet have the people or processes to create or harness that data. You have to understand your organization's current challenges while war-gaming what might be around the corner: another pandemic, cyberattack, financial crisis, or—and this is top of mind for many CFOs these days—climate change and its vast implications. You've got activist shareholders[1] watching where each dollar goes and a growing concern for corporate impact on social equity. A wrong turn can harm performance and threaten the delicate balance between capital demands and free cash flows. It can shake up shareholder expectations—and stakeholder expectations for social and environmental impact. (And don't forget to keep your eye on your organization's long-term financial goals.)

There's a lot at stake. But when you untangle the knot, and address the challenges one at a time, there is so much to gain. CFOs are in a prime position to take stakeholders on a journey to understand the big picture, the implications, and the trade-offs for each capital allocation decision. With a well-aligned plan and agreement on how to measure what matters, you can build in transparency and more objectivity—and less bias—with each capital plan you make, whether that's to enhance one facet of your portfolio or to improve outcomes of your biggest bets.

It sounds like a lot to tackle, but a capital allocation process that unlocks new value for your organization is worth the journey.

So, let's get going.

What’s inside

“The one thing I know about my long-term plan is that it’s *wrong.*”

—A seasoned CFO

Why are we talking about capital allocation now?

CFOs are constantly weighing the return on investments of their business's time, resources, and human capital for the organization's health and shareholder value. But what about the investments themselves? Here's why you should consider paying attention to capital allocation now.

A changing world

COVID-19 forced businesses to change their capital plans on a dime—and while some could, many couldn't because they didn't have an effective playbook. Environmental, social, and governance risks, as well as activist shareholders, are forcing many executives to reckon with long-term impacts to strategy.[2] Finance leaders are right to be thinking in this direction because they aren't just sustainability risks; they're business risks. Leadership has to consider the impact of these challenges on their critical investments, like how climate change might affect a new manufacturing facility in a vulnerable part of the world. This is an opportunity for businesses to make their balance sheets more resilient and build a plan to adapt and pivot more efficiently while maintaining and increasing value.

Policy matters

As administrations pursue and implement new tax policies, it has an enormous impact on how—and how fast—companies can use tax equity for capital outlays. But it isn't just tax. Consider how the CARES Act changed your current and future liquidity position.[3] This presents new challenges and opportunities for capital allocation.

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More than profit and loss

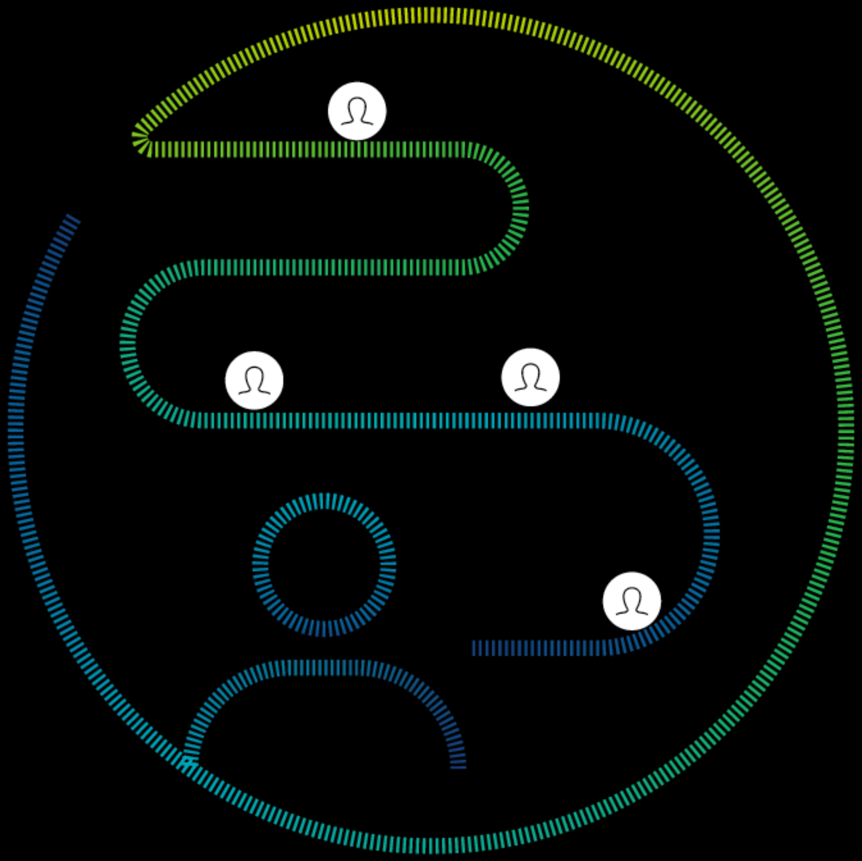
Capital allocation isn't just about getting higher returns from lower outlays. It's about measuring profit from internal investments and maintaining the cash flow that allows those investments to happen. It's critical to the business's strategy, and without it, the best-laid plans can be compromised. It also means ensuring that the organization can keep creating value as it changes—and finding new ways to do it within its charter and shareholders' expectations, especially as it fields social and environmental concerns. Remember when an oil company was just an oil company? Neither do we.

Competitive advantage

Done right, capital allocation can give an organization a true edge over its competitors. Narrowing the gap between what a portfolio could deliver and what it actually does deliver is enormously beneficial—and the right capital allocation strategy can set the stage for that and help you build agility as uncertainties unfold.

Think about manufacturers that shifted their operations to make masks when the pandemic hit by pivoting their capital and workforce and moving fast to meet a huge need. That can be a competitive advantage.

Who is on this journey with you?



By understanding who your stakeholders are and what they want (and why), CFOs can mitigate a major challenge in capital allocation: bias. Talking to your people openly about what they want and the behaviors they're using to get it can boost transparency—and that can help you get your stakeholders on board for the journey to better decision-making.

Who is on this journey with you?

The people inside the building (so to speak)

Boards
Want a clean report to Wall Street.

CEOs
Want an ever-growing market cap.

CFOs
Want a lot of things, but how much is this thing going to cost?

Employees
Want to be proud of the choices the organization is making.

Product managers
Want attention and enthusiasm for their product.

R&D
Wants funding for their latest and greatest project.

Tax
Wants minimal tax liability and a seat at the table early on.

The people outside the building

Shareholders
Want return on their investments and dividend predictability.

Creditors
Want assurance that the organization will pay its bills.

Suppliers
Want more orders and their invoices paid promptly.

Customers
Want a well-priced product and company practices that align with their social, environmental, and ethical outlooks.

Auditors and regulators
Want compliance, controls, and materiality, please.

Communities
Want an organization that plays a positive role for its people.

“Bias and impartiality are in the mind of the beholder.”

—Samuel Johnson

What’s your bias?

Now that you know who is playing for what, and why, here are some behavioral biases to look out for.
They can exist in practically every human decision, from buying groceries to jaywalking. Here’s how they may work when it comes to capital planning:

Historical bias

“It’s just the way we’ve always done things.” You’ve heard that one before. But how often is that assertion really correct, and anyway, so what? Asking that question can help the CFO dig in to other potential biases and offer new paths for decision-making.

Narrow focus

By only evaluating one or two criteria when making a capital decision, a stakeholder might misunderstand the impact of that decision. Considering multiple criteria in decision-making—and that includes multiple stakeholder voices—is key to a capital plan that can succeed for the long term.

The optimist bias

Consider the CFO of a major company that, quarter after quarter, always missed its forecasts to Wall Street because the CFO was overly optimistic about their $10 billion capex forecast for a major capital project. The optimist bias can lead a business executive to have too much confidence in a decision. But by understanding the source of that bias, we can see when to pause and look at the data that could help the CFO develop a more accurate forecast.

The expert bias

The business unit leader who “knows what the customer wants” can be trusted to lead the group to the right decision based on their expertise, right? That’s called expert bias, and many business decisions are made relying on an expert’s opinion that may turn out later to be founded on shifting or incorrect data. (After all, it may be only one person’s opinion.) We can correct for expert bias by asking how they know what they know, and for data and insights to back up that assertion.

Measure twice. Do it again.

With the broad view of their organization and its priorities, CFOs can help their stakeholders better understand decisions—and diminish their bias—by applying measurement to choices that can otherwise feel subjective. But measurement isn't always in numbers. Using multiple criteria to make a decision—or, more simply, looking at it from different angles—can shine a light on overall strategy, risk, trade-offs, and how it fits into an organization's portfolio.

For the big bets

A big decision worth millions, or billions, deserves the same amount of scrutiny and governance as a company worth the same amount. Treat it that way. In evaluating a big bet, think about evaluating your organization with a maturity model to better understand how you currently make decisions and how you could streamline and bolster your existing processes and introduce new tools to up your game. Consider introducing independent analysis or reviewers into the process that use risk and analysis tools and reports directly to the board or CEO. Build in look-back measures and a way to monitor progress so learnings don't just disappear.

Ask the question that no one else wants to think about.

That is: How could we be wrong? No capital planning decision should be made without asking this question. It is up to you as finance lead to look at each financial decision holistically, and that means examining it from the angle of failure. Circumstances change, the markets shift, and stakeholder priorities evolve. How could each of these factors affect the success of your decision? What are your modeling and analysis tools telling you? No one likes to think how they could be wrong in the future—but it's far more effective than wondering where they went wrong in the process. Have your team embed this question in the business-case process for all capital requests.

To optimize your portfolio

For the smaller decisions that determine your organization's everyday pursuits and cash flow, trade-offs are likely inevitable. To truly understand the risk and potential benefit of these, build a value architecture—a-top-down portfolio view of financial, risk, and strategic issues that defines the organization's priorities and shows how potential projects ladder up to them. It is a collaborative effort that can help CFOs bring their stakeholders along and strengthen the tie between strategy and capital decisions. This makes tradeoffs easier for everyone to understand, and that's a good thing. Once the CFO and stakeholders define the value architecture—and optimally, your future state with a maturity model—you have also laid the foundation to evolve your project portfolio management and technology tools, which starts with people.

Example of a value architecture

How a public utility compared investment trade-offs

Maximize financial benefits	Minimize health and safety risks and environmental impacts	Maximize positive stakeholder perceptions	Maximize platform for future success
Asset protection	Minimize environmental impacts	Employees	Operational flexibility
Cost savings	Minimize public safety risks	Regulators/government	Strategic infrastructure
Incremental revenue	Minimize employee safety risks	Customers	Capability innovation
		Financial sponsors	
		Business partners	

With a value architecture, you can answer questions such as:

How does Project A compare to Project B on finance and strategy?

If we approve all mandated or pet projects, what value are we losing?

What happens if we focus more on near-term earnings than long-term growth?

Real-world examples of finding their way

Let's take a look at how a few organizations asked questions to improve their capital allocation process, beginning with the CFO who took their stakeholders and business on a journey that transformed their immediate and long-term strategies. The end result for all of them (no spoilers here): a more efficient process, better decisions, and fewer dollars left on the table.

Example

A health sciences CFO translates ideas to dollars and strategy.

A finance lead can help align their board, leadership, and stakeholders on long-term shareholder focus, as well as internal capital strategy. One CFO's powerful tactic to do this: education. Their health sciences organization had recently completed an acquisition and subsequent drug launch that was very successful and generated a significant amount of free cash flow in addition to a great outcome for patients. This meant they needed to rethink their capital allocation strategy.

They made a number of changes over time, including increasing R&D investments, and returning cash to shareholders in the form of share repurchases and the addition of a dividend. Their strategy prompted many internal questions, however, and the CFO knew it was important to include all internal stakeholders on a journey of understanding the organization's financial lifecycles and capital planning. The CFO created a planning process based on a scenario modeling of the trade-offs needed to maintain and grow free cash flow.

This gave stakeholders a clear window into the importance of cash flow and the company's cycles of investment: what happens with that cash flow? What's the minimal investment needed to grow the company? What does it mean for the balance sheet and shareholder return? By answering these questions, the CFO helped stakeholders see clearly how the investment decisions and trade-offs could impact financial returns including the impact on shareholder returns in the future.

"It all goes back to the metrics and the numbers. The more I engaged the team in the development of a shared model of potential outcomes, the more I could push the team on the possible outcomes of our strategy."

— CFO of a major health sciences company

Example

A federal agency sees the forest for the trees.

A US government agency was told to cut its energy use deeply. That meant changing its maintenance spending, a key pillar of its capital allocation strategy. Usually, capital allocation decisions were examined with one criterion: How much is this going to cost? But what if someone wanted a new fleet of hybrid trucks or electric cars, which tend to cost more than gas-powered vehicles, but could provide a cost benefit down the road? The agency knew it needed a different way to look at these decisions, which had broader implications than need and cost—and more avenues to introduce bias. First, their finance team decided on a metric that could be applied to each decision—in this case, translating dollars per carbon pound, which gave each proposal a true cost.

The agency trained its stakeholders to understand this new process and introduced metrics for project criticality, internal alignment, and future value so trade-offs could be measured.

The agency was able to capture tens of millions of dollars in cost savings the first year, and carbon savings per proposed project increased from a median $4 per carbon pound to $97 per carbon pound.

Source: Charles Alsdorf, "Capital bias: Reducing human error in capital decision-making," Deloitte, November 2017.

Example

A mining company excavates new value.

A large mining company wanted to improve the quality of its capital allocation decisions and to better understand—and increase—its return on investments by finding more ways to create value. Through a risk-framing workshop, stakeholders were challenged to identify potential risks and uncertainties of different looming decisions to be made, and then developed a "risk factors map" so that each stakeholder could see the challenges holistically. The map offered a visual opportunity to do some probabilistic scenario planning for each possibility, combining scenario and cash flow models to determine the expected value of each decision and the impact of potential risks. The results were presented to the CEO and board. The team modified the organization's existing model to add an appropriate risk profile, and the board better understood the likelihood of a major capital project breaking even.

Over four years, the company moved from the bottom quartile to the first quartile in its peer group's ROIC (return on invested capital).

Source: Charles Alsdorf, "Enhancing decision quality in capital planning," Deloitte, 2012.

The checklist

Every trip requires a checklist, so here's one for your capital allocation journey.
Start with these and add more of your own as you go along. Your journey, your rules.

Goals

Do you want to improve big-bet decision-making or day-to-day project planning? Is there one particular project keeping you up at night? Be absolutely clear on what you want to do and build a goal supported by data and insights—and be transparent with your stakeholders about it.

Data

Do you have the data and insights you need to make informed decisions? Work with your stakeholders to determine what those are, where they need to come from, and how you can get them.

Tools

Where could data analytics, scenario planning, and risk-sensing tools improve your decision-making? What tools do you already have, and what do you need? Engage your stakeholders on what data they need to generate from their business units.

People

Are you building your team for the right strengths? Does your team have the diversity of thought to approach decisions in new ways? Have you fostered an inclusive environment that is hospitable to new ideas? And how are you bringing stakeholders along for the journey?

Details

Understand your cash profile and flow, and analyze the impacts these changes will have in the short and long term. Get a grip on leadership's appetite for risk.

Plan

Start small and implement these changes slowly. Take the time to track behaviors and outcomes, and demand it of your stakeholders as well. This tracking is the foundation for real data sets that can be useful in other decision-making. Finally, measure like it's your job. (Because it is.)

It’s crunch time.

Capital allocation can seem like the ultimate knot to untangle, involving countless stakeholders, competing priorities, and an uncertain timeline. But this is an opportunity for a CFO to see possibility where others see challenge. It takes asking the hard questions, ensuring that your stakeholders are—and feel—heard, and educating your leadership on the risks and value of each project.

It’s a tall order for anyone, no matter where your organization may be in its maturity. But by setting off on this journey, you can build a new competitive advantage for your organization—one that keeps an eye on what the future might hold while building on the success of what’s right in front of you.

Acknowledgements

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Endnotes

1 Chris Ruggeri, "Activist shareholders: How will you respond?" Deloitte, accessed September 17, 2021.
2 Chris Ruggeri, "Board members: Think like an activist investor," Deloitte, accessed September 17, 2021.
3 "The CARES Act: Summary for financial services," Deloitte, accessed September 17, 2021.
4 "Capital allocation: Seeing the value in a value architecture," CFO Insights, Deloitte, April 2018.

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