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Are Your Capital Allocations Strategic?

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For many companies, the capital allocation process is where big strategic goals fizzle out. Companies aren't wishing for that result, but most capital allocation processes are poorly equipped to deal with change.

A leading factor is that capital planning and profit planning often are maintained as two separate processes that are rarely cross referenced. Year after year, capital is doled out to business units either evenly or arbitrarily based on size, with little regard given to strategy.

Years later, with past earnings goals missed, companies design new strategies but rarely change the root cause of their problems.

Effective capital allocation requires a prioritization of investments, a clear focus on where the company wants to compete, and an ownership mindset that expands the definition of teams from business unit silos to the consolidated company. This creates a dynamic flow of capital with clear linkages to strategy that aligns the entire organization with a shared goal for success.

Put Your Best Ideas First

The best investment options should always find funding. Unfortunately, silo thinking fogs the view of your investment landscape.

The walled gardens of your business units must be temporarily broken down to evaluate where capital is flowing at a granular level, regardless of its end destination. How you define financial success will be critically important to this filtering process. We recommend using an RCE Profitability Index (RPI) to benchmark your investment opportunities.

Residual Cash Earnings (RCE) is a cash flow-based economic profit measure that judges whether a company is generating sufficient cash earnings to cover the cost of capital invested. RPI divides the net present value of the RCE generated over the investment's life by the investment's cost, creating a percentage measure.

With RPI you're able to reliably compare investments regardless of size and timing of their cash flows. Charting investments' RPIs clearly visualizes where you get the most bang for your buck. And with scenario planning you can determine the optimal funding strategy to shift capital from low-return to high-return investments.

Move from Possible to Probable

But investments shouldn't be given a free ride on forecasts alone, or managers will quickly vie for the title of "highest hockey stick forecaster." Investment opportunities must be grounded in reality, which requires companies to have a clear vision on where they want to compete.

One method of determining this is to triangulate each business unit's "right to grow." By analyzing a business unit's historical performance, its forecast expectations, and the performance of its relevant peers, you can better understand when an investment will *possibly* create acceptable value, versus when it *probably* will do so.

This filtering process also creates a laser-like focus for your team on "where are we competing" versus "where should we be competing." While this comparison is a seemingly obvious one to make, the complexity that many companies have created by separating capital planning, profit planning, and investment decision approvals can make it difficult to answer at the time of a decision.

Align Your Team with a Shared Goal

Your competition lies outside the company, but often, business unit leaders' incentives are not aligned with that fact. Private business owners consider how individual investment decisions affect the company as a whole, yet many decision makers' incentive programs are structured within isolated silos.

The result of those silos is an unproductive internal hoarding of capital by business units. Effective implementation of a dynamic capital allocation process requires decision makers from across the organization to be aligned with maximizing the value of the company as a whole.

Key decision makers should have financial performance incentives that weighs both performance from their respective business units and the consolidated company as well, this is how owners think.

How you define financial success will determine your team members' behaviors. Market share should not be the sole goal of your financial performance metric; rather, you should be focused on the value market share obtains above your costs of doing business.

In our work with companies, we suggest the use of RCE for financial performance measurement. It provides a clear signal as to whether a company is able to cover all of its operating costs, including a cost for the capital it uses.

With RCE, decision makers can easily understand if the investments and market share they pursue are generating value for the company. Also, when capital has a cost, decision makers that are not confident they can put capital to work profitably will gladly relinquish resources rather than create additional expense hurdles for themselves.

Incentives are a great tool for imbedding an ownership culture within your company and opening the levies that will allow capital to flow freely across your organization.

Most companies strive to be leaders in their fields, but sometimes things break down in the planning process that stalls out their engines.

For high-performance results, the capital planning process must be viewed as the linchpin that brings strategic goals to reality. That means actively managing capital across your businesses.

Having a defined marker for value, choosing where you will compete, and cultivating an ownership mindset could provide the tipping point that energizes your team to race ahead of the competition.

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