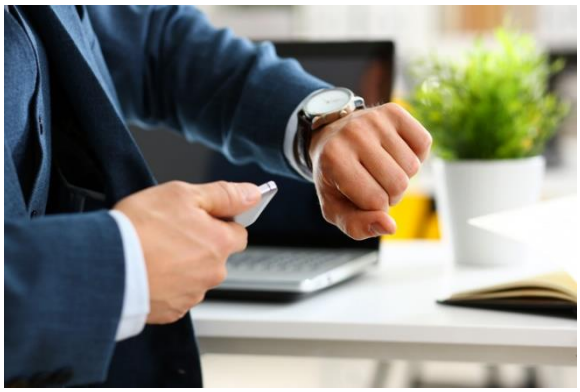
How to Allocate Less Time to Allocations

Don't let the allocation process endlessly drag on and impede or undermine the formulation and execution of value-focused strategies.

Joseph G. Theriault

In a conference room somewhere, there is likely an ongoing and charged debate about how to best set pricing for an important customer or how to determine the right amount of capital to invest in a business unit with mediocre performance. What do the numbers suggest? Are we actually making money from that customer? Have we reinvested too much for too long in management's favorite business unit despite its inability to deliver adequate results?



To answer these questions, we first need to define success. Should we use a fully allocated profit or profit margin? Is cash flow better than profit? Should we instead look only at variable direct costs and compute a contribution margin? And what about the investment in the assets needed to deliver the profits? Perhaps a rate of return measure would be better.

We recommend using a comprehensive cash-flow-based financial performance measure called Residual Cash Earnings (RCE). In order for a strategy, plan, or decision to drive positive RCE improvements, the net effect of changes in volume and pricing needs to cover all *incremental* cash costs, as well as the investors' required return on newly deployed capital.

The measurement of RCE involves estimating and pushing down all unallocated costs and assets in order to generate financial information that represents the complete economic picture. But this is often where 'analysis paralysis' sets in. Regardless of how thoughtfully and accurately we allocate the aforementioned costs and assets, unexpected findings often lead to endless discussions that get bogged down in the weeds of the assumptions. "There must be something going wrong in the allocations. This can't be true. Those are corporate's costs! Why are we allocating so many more resources to that business? Come back after you redo the analysis."

At this point, important strategic initiatives stall, often stuck in an endless loop of analysis and review, which frequently ends with the initiative being shelved. The following are recommendations on how to conduct the analysis, prioritize the findings, cut out some of the unnecessary debate, and get on with using the analysis to execute strategies and deliver results.

Transparently Summarize the Impact of Allocations and Learn When to Move Past Any Imprecision

The skepticism of any allocation process is understandable. When cost allocation weights are modified, in what are usually massive allocation spreadsheets, many of the insights can change. And who really knows how the cybersecurity specialist in a shared services IT group or the employee welfare manager in corporate HR should be allocated anyway? Analysts certainly need to do their best to get the numbers right, but managers should also confirm and convince themselves that the numbers are reasonable and, importantly, defensible.

In order to do this, we recommend clearly identifying where allocations may seem to advantage or disadvantage various entities. Often, this can be best achieved by presenting common-sized ratios such as allocated costs to sales or volumes. The numbers to use can be total values as of a point in time or even the changes in those values across time – so long as there is consistency within the ratio. Reviewing these types of relationships offers greater visibility into the 'proportionality' of allocations between entities, which can then help sanity check the allocation process, as well as offer outsiders a better view into the otherwise unclear cumulative impact of the numerous allocation drivers.

This sort of transparency can also help improve the conviction to act on the findings of the analysis since it may become obvious that modifying allocations to align more closely with preconceived notions will only make the findings and strategic insights stronger. For example, a segment may have been initially allocated an above-average amount of shared capital as a percent of sales despite this segment *actually*being relatively asset light. If the segment is currently measured to have a high return, a lighter capital allocation would only further increase this segment's rate of return, as well as the urgency behind the strategic next step: searching for ways to reinvest in and grow this high-return business.

This gets at a broader point on prioritization. Whether we are allocating by product or service, by geography or by customer type, business activities generally fall into one of three buckets: (1) very strong performers that you should meaningfully invest in to grow; (2) very weak performers that you either need to fix, sell, or stop; and (3) those activities in the middle. Regardless of how we allocate costs and capital, the strong stays strong and the weak stays weak, but the items in the middle flip back and forth between appearing marginally strong and marginally weak. Once a manager realizes this, he or she can become more confident in increasing investments in strong performers and cutting investments in weak performers, thereby achieving a more differentiated and value-maximizing allotment of reinvestment spend.

For the activities within the top and bottom buckets, it's important to stop the current debate, at least temporarily, and achieve consensus. Future rounds of analysis and discussion will help to fine-tune the results of items in the middle bucket, but any current imprecision and uncertainty should only delay action on those in-between items. The time it takes to gain confidence on the middle items should not delay important changes in strategy for items at the extremes.

Focus on Incremental Benefits and Costs within the Right Context

To illustrate the importance of context and the need to focus on incremental benefits and costs, we'll discuss pricing and resource allocation as they are two of the most important strategic priorities affected by cost and capital allocations.

Pricing decisions are often considered in both the short run and the long run. In the short run and especially during times of excess capacity, surplus inventory, or depressed market demand, it may be worthwhile to reduce pricing to levels that just cover marginal costs. The goal is to hopefully cover some of the fixed costs that would otherwise go uncovered and preserve market share that would otherwise be lost. If successful, a marginal-cost pricing strategy drives incremental profit, cash flow, and value in the short run, which can lead to long-run benefits as well.

Setting prices below total costs over sustained periods of time, however, does not lead to success. As the short run turns into the long run and as unutilized capacity becomes utilized, fresh capital and costs will be required to maintain operations and to expand capacity. When this happens, the pricing methodology must transition to

cover all cash costs, including those unallocated to an operating unit. Otherwise, each additional sale will destroy value.

For capital allocation decisions, a fully allocated view is also necessary. The analysis for a future investment should always incorporate the fully-loaded costs and benefits anticipated. Again, costs should include a capital charge on any new assets employed and the goal is to measure the incremental value impact of the decision.

While this may seem obvious, it is easy to get lost in the accounting or be misled by traditional measures of performance. For example, when new investments are evaluated, historical performance is often used to inform projections and help ground them in reality. But history may include non-recurring costs and sunk uses of capital that are unlikely to reoccur in the future and therefore should be excluded from the analysis.

For example, some of the most common and impactful line items are those for goodwill and intangibles, which can be viewed as sunk uses of capital. While we all hope they earn an adequate return, it is often best to exclude an allocation of goodwill and intangibles – whether they are partial or total allocations – because doing so may more accurately reflect the on-going economics of the operation. This view will enable a better assessment of the operation's worthiness for future organic and even inorganic reinvestment.

While unintentional, the inclusion of goodwill and intangibles could make organically high return businesses that had been acquired at a premium now look like under-performers, potentially leading to their under-investment. This would be the exact opposite of the optimal strategy of investing to grow these prized businesses. It sometimes seems as though the anticipated profitable growth that justified a target company's premium acquisition price generates goodwill for the acquirer that then, ironically, impedes sufficient investment to drive valuable growth within the acquired business.

To be clear, the recommendation to exclude goodwill and intangibles, like other normalizing adjustments, pertains to the measurement of a business' *historical*performance and how that historical performance informs *future* strategies and investment decisions. In the review of future investments, performance measurement must include all newly anticipated costs and uses of capital, including new goodwill and intangibles. And, of course, the present value of performance must remain positive in order to justify an investment.

In summary, it is important to conduct analysis and make allocations in a way that focuses on the incremental impact of a decision. To do this properly, understanding the context – such as whether a decision is made in the short run versus the long run or whether the decision is informed by historical versus projected performance – is critical.

Making allocations when measuring performance is often a tricky, time-consuming, and iterative process that frequently leads to never-ending debate, inaction, or signals that impede strategic decision making. Even when done right, some managers often hold onto legacy perceptions of performance that are no longer true, dismissing new findings and their strategic implications. When done wrong, inappropriate measures and allocations generate results that lead to sub-optimal or even value-destructive actions. In either scenario, opportunities for improvement are wasted.

To avoid this, we recommend the following steps:

1. Use a complete measure of success that incorporates cash costs and a required return on investors' capital,

2. Relate allocated costs and capital to common references such as revenue or units of volume to help summarize the cumulative impact of underlying allocation drivers,
3. Identify where the allocations are heavier or lighter across business entities to sanity check your allocation methods and reduce outsider skepticism,
4. Focus decisions on the incremental benefits and costs of an impending decision,
5. Exclude sunk and non-recurring costs and uses of capital when historical performance is used to inform future expectations,
6. And don't let forms of imprecision and uncertainty impede consensus-building and execution in areas where the signals are clear and unlikely to change.

These steps will help your organization improve its ability to find clear, fact-based answers, which in turn will lead to more effective decision making and action to drive long-term value.

Joseph G. Theriault is a Senior Vice President at Fortuna Advisors LLC.