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Everything Must Earn an ROI

Too often executives use the term strategic to describe poor investments.

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Strategic investments only become "strategic" if they actually deliver an adequate return compared with what would have happened if one did not make the investment.

Too often executives describe an investment in the future by saying, "it's not financial, it's strategic." Such statements come with an air of altruism, as if the executives could step beyond traditional planning and decision-making processes to "do what is right for the business." Frankly, in most cases, such statements are nonsense.

Every investment needs to earn an adequate return on investment, or ROI, or it will destroy value for the shareholders. Admittedly, even executives who believe this find it hard to apply an ROI framework to some decisions. In such cases, they rely on business intuition and experience to decide if the investment is beneficial. Since they cannot calculate a finite ROI number, they say "it's strategic." But in many cases they could better articulate the returns.

The concept of the ROI is pretty straightforward: it is simply the gain from an investment divided by the amount of upfront investment. For example, if you invested $200,000 in your house and then sold it for $288,000, your gain would be $88,000, or a 44% ROI ($88,000/$200,000).

A more advanced version is the internal rate of return, or IRR. In simple terms, the IRR indicates the return "per year" on investment. Let's assume we held the house mentioned above for two years. The IRR would be 20% per year, growing in the first year to $240,000 and then to $288,000 the second year. The math gets more complex if there are varying cash inflows and outflows over multiple years, but the principle remains the same.

In reality, everything has an ROI; it's just hard to calculate it sometimes. If we look closely, we can usually define the types of benefits expected from an investment. Even where it is difficult to quantify these benefits, we can at least determine what the benefits need to be for the ROI to be adequate. Thus we can make sure we believe at least qualitatively that enough quantitative benefits will materialize.

Consider an investment in personnel training. Sometimes we can estimate an ROI if the expected results of the training are quantifiable in terms of improved efficiency when we teach new operating processes, more growth when we teach sales skills, or fewer accidents and lower insurance costs when we teach safety practices, etc.

OPINION

But what about an ROI that is harder to quantify, such as learning to make better presentations or to resolve workplace conflicts? While the benefits of training in this area may be abstract, we know what they are. For a company with frequent workplace conflicts, for example, training to reduce this problem has a high ROI. But if conflicts are rare, the benefits will be small. With fewer workplace conflicts, there is less down time, however. And when people feel the company is investing in them, they are more satisfied with their job and attrition declines.

Similar ROI approaches can be applied to other hard-to-quantify investments, such as basic research, brand-building advertising, or even IT. It has been widely known that IT investments must be evaluated on the basis of more than just ROI. Once again, quantifying the return can be thorny — but it is not without a solution. The problem lies with those analyzing IT: too often they simply look at the cost of the system and obvious cost reductions. This is simply inadequate.

It is true that the financial benefits of IT are often underrated. But just saying "IT is strategic" isn't the right answer. Some IT, though, is a waste of money if the company doesn't have adequate needs.

For other functions of a company's business, ROI is easier to quantify, though it involves more evaluation to determine the success of an investment. If the purchase price of an acquisition seems by normal standards to be at a high premium to the target company's stock price, management feels the need to say how strategic it is as opposed to touting its financial benefits. But often in these high-priced acquisitions, the buyer is getting technology or customer access

that can be highly leveraged to provide substantial financial benefits, and the purchase price is well worth it.

Another obstacle to determining the true financial benefits of an acquisition is that companies and advisers often seem more willing to identify cost-cutting opportunities than they are to specify specific sources of revenue growth. But in many cases, the growth is worth much more.

Company management, therefore, should reach further to quantify the benefits of so-called strategic investments to improve the quality of their investment decisions. To do this requires a solid grasp of the drivers of revenue, cost and capital investment, and an eagerness to apply this information in a deliberate manner to determine which investments deliver high ROIs and which do not.

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