Overcoming 3 Roadblocks to Strategic Resource Allocation

The highest corporate priority is to create long-term value, which requires resources be allocated to businesses, products and customers that can deliver profitable growth.

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Corporate success often falters due to suboptimal Strategic Resource Allocation (SRA), which includes the allocation of capital, marketing and R&D across existing businesses, which will be covered herein, but also acquisitions, debt repayment, dividends and buybacks. Three primary reasons why strategic resource allocation is often sub-optimal are:

Erroneous Objectives: Most management teams chase too many different and often conflicting goals, and all-to-often end up achieving few of them. All strategies should be aligned with the primary corporate objective of creating long-term value.

Lack of Focus: Few companies have a clear 'line-of-sight' into where and why long-term value is created and destroyed. 'Where' requires the right metrics and measurement capability, and 'why' requires a diagnosis of product markets and the strategic position within those markets.

Decision Paralysis: Decision-making in most companies lacks urgency and is cumbersome with weak accountability links. When line-of-sight information is available, management must develop, evaluate and select strategic options to redeploy resources with discipline and pace.

Having clear and appropriate objectives, focusing investments where value is truly created and quickly and decisively executing strategies leads to better results and a higher Total Shareholder Return (TSR).

Optimizing Strategic Resource Allocation

The first step is to align management on the objective of creating long-term value for shareholders. The only way to balance the ever-present growth versus return tradeoff is to consider long-term value. When companies focus on either growth or return, resources are allocated sub-optimally. And our research in many industries, including, for example, healthcare and tech, shows that delivering long-term value through growth and return produces higher TSR

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The popular press often erects a barrier to this objective by acting as if what's good for shareholders is at odds with what's good for employees and other stakeholders. But the facts tell a different story. S&P 500 companies with above median TSR for the last ten years increased aggregate employment by 46 percent versus 12 percent for those with below median TSR. The high TSR companies created 1.6 million more jobs. It's ok to focus on long-term value creation.

The second step is developing a clear line-of-sight into long-term value creation. Over the decades, we've observed that long-term value creation is usually highly concentrated. The 80/20 rule works in most companies so that roughly 80 percent of value creation comes from 20 percent of the allocated resources. This creates a significant opportunity to redeploy resources and boost performance but to do this, management must know exactly where value is being created and destroyed. They must know which businesses, product lines and customer groups create value to know where they should invest for growth.

Whether or not a business should grow is determined by current and expected profitability measured using Residual Cash Earnings (RCE), which is calculated after all cash operating costs, taxes and the required return on capital. The current and past RCE of a business, product line or customer group is an important signal of value creation. By forecasting RCE, management can determine long-term value creation which may differ from current performance. Corporate finance texts emphasize future cash flow, which is correct, but first examine current RCE and only accept that low current RCE will improve when there is a meaningful and credible improvement in strategy and/or operations.

We must understand why value creation and destruction is occurring. The root causes of high, sustainable RCE, or recurring negative RCE, can be traced to the economics of the market and strategic position. Market economics refers to the growth and return of the market as a whole -- is it economically attractive? Strategic position in a market refers to whether a business has a competitive advantage in product differentiation or costs. Businesses that are advantaged in attractive markets will show high, growing RCE, while disadvantaged businesses in unattractive markets will have negative or declining RCE.

The combination of market economics and competitive position will determine how fast a business can grow and how much value the growth will create. It is far easier for a business to create value when its market is profitable and growing as there is less need to attract customers from competitors. And advantaged businesses also have the opportunity to gain market share to achieve above market growth without price discounting or expensive promotions.

Everyone waxes eloquently about competitive advantages in investor presentations, but is your business truly differentiated? If so, your products either sell at a premium price while maintaining market share, or they gain market share with parity pricing. Do you have other competitive advantages such as a unique manufacturing process or superior distribution? These can propel RCE too. Be dispassionate in evaluating competitive advantages and considering investments in innovation to increase competitive advantages.

Comparing resource allocations between businesses is best done with a "resource investment rate", which is defined as a percent of EBITDA less taxes, rather than using a percent of sales. Instead of smearing resources across the organization based on size, concentrate resources in business opportunities that can and should grow with strong RCE improvement.

The third step is instituting an effective process for creatively developing and rigorously evaluating resource allocation options. Once good line-of-sight is available, we must determine if we can create more value. For high RCE businesses, look for all possible ways to accelerate growth without overly damaging returns. For chronically negative RCE businesses, come up with options to drive RCE higher, often by shrinking or harvesting. This is an exercise in creative thinking grounded in market economics, competitive position and RCE.

Assess the incremental RCE for each viable option, after contemplating how customers and competitors will respond. Compare the options based on ease of implementation, likelihood of success and scale, which is the quantum of RCE and value. The best options can then be selected and converted into a strategic plan. This review, evaluation, selection and planning process requires candor, transparency, thoroughness and discipline, with pace and decisiveness, in order to drive action and results.

Case Study Examples of Strategic Resource Allocation

Three client examples illustrate how SRA can deliver step-changes in results. The first is a specialty chemical company with two global businesses. The company had high returns but growth had stagnated. Management measured revenue and gross profit for the segments but extensive sharing of costs and assets stood in the way of a clear line-of-sight. The culprit was an accounting mindset that sought precision in allocations and every meeting generated a new list of “analytical improvements.”

By introducing an economic mindset and a set of defensible allocation rules, we generated a complete RCE view down to the customer level as well as information on market economics and competitive position. Management historically had disproportionately allocated resources to large customers that were a drag on returns due to their ability to negotiate lower pricing while demanding costly extra services. The highest RCE customers were smaller and got less attention. Management also identified customers with negative RCE and took immediate action to renegotiate pricing and reduce cost and asset intensity even though volume would suffer.

The company redeployed resources to lift growth in the highest RCE areas and increased operating profit nearly $20 million within two quarters.

The second case was a well-known consumer products company with a portfolio of brands that was quite profitable but unable to grow faster than GDP. Marketing expense was the biggest resource commitment with Advertising and Promotion (A&P) averaging nearly 10 percent of sales. Traditionally, A&P was allocated proportional to sales with slight variations across the brand portfolio. The primary metric was the brand's contribution margin. Once detailed line-of-sight information was available, management realized that the largest brand was RCE neutral, while some of the specialty brands were hugely profitable. The value of several smaller brands was greater than the core brand, though they received a smaller A&P allocation measured by spend-to-value.

Strategic options were selected along three themes: (1) allocate A&P spend using brand value, (2) invest significantly more in innovation to extend and grow the high RCE brands, and (3) reduce the cost and capital intensity of the big core brand to drive RCE higher so it could grow profitably. Within two years, returns and growth increased materially and the company's TSR topped the industry.

The third case was a global oilfield service company with high asset intensity and fixed costs. Management dreaded losing a project bid for cost absorption reasons. Management did very sophisticated financial analysis at the time of each bid but only high level sales and gross profits were tracked after the fact.

We developed a line-of-sight into the RCE of each client project. In each global region, revenue, costs and assets were allocated to determine customer RCE. Rolling this up globally by customer showed that many large customers delivered negligible RCE. Up to this point, each bid was justified based on retaining the customer's global business but there wasn't much value created.

The client created a small marketing group to oversee global clients to ensure they were properly serviced and that they would only accept a marginal RCE project if there were meaningful positive RCE projects elsewhere. One very tough negotiating customer generated such poor RCE that the client offered a contract renewal ultimatum. Either the customer would pay more or they would reallocate resources. The customer thought it was a bluff and the negotiations collapsed. Within months, the resources were working for a more profitable customer.

In each of these three case examples, the Strategic Resource Allocation process drove better growth and returns. It was not easy, but the work that went into the process paid for itself many times over.

A Higher TSR is the Ultimate Reward

Some managers say they don't need such a rigorous strategic resource allocation process because "it's obvious which of our businesses are good and which are bad." They clearly haven't read Moneyball. Opinions, views and gut feel are no match for clear fact-based analysis. And senior executives are often surprised by the RCE analysis findings which confirms that their preconceived views were different from the insights the analysis showed them.

Others focus too much on where they *can* grow and not enough on where they *should*, because they have difficulty determining fully loaded profitability. They fall into the trap of focusing too much on decimal places of allocation precision when all that's really needed are approximate allocations that highlight which businesses are true stars or dogs, even if it's occasionally imprecise near the border. And it is always worth the effort to develop better ongoing allocations so Strategic Resource Allocation can become a recurring process.

The main benefit of a core competency in Strategic Resource Allocation is the concentration of the company's scarce resources in areas where value is likely to be created and away from activities that will destroy more value if given the chance. This enables management to know both where they can grow and where they should grow, and will tilt the investment rates to focus more capital, R&D and marketing resources where they can do the most good. Faster growth, greater profitability, higher multiples and superior TSRs are the reward for companies that excel in Strategic Resource Allocation.

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