Protecting Innovation During a Downturn

By Gregory Milano

Most companies are facing profitability headwinds as inflation drives up their operating costs and rising interest rates make financing more expensive. Some have such strong brand differentiation that they are able to pass these cost increases along in the form of higher prices. For example, PepsiCo announced earnings on October 12 that exceeded analyst expectations for revenue and earnings per share (EPS). Their revenues for the first 36 weeks of 2022 were up 14% and almost all of that was pricing, with a slight increase in aggregate volume.

Unfortunately, many companies don't enjoy such strong product or service differentiation and would lose significant volume if they raised prices to fully offset the cost increases they face. The managements of most of these companies feel they must resort to across-the-board cost cutting to have any hope for a decent profit result. Many finance executives view this as a good opportunity to streamline work flows and eliminate excess waste. As Winston Churchill (likely) said, "Never let a good crisis go to waste."

We should all be in favor of eliminating waste, but these broad slash-and-burn cost cuts often end up harming the long-term value of the organization. Back in the 1990s, a colleague and I were sitting off to the side of a life sciences client executive committee meeting, awaiting our turn to present, when the CEO called over to ask me my thoughts on his initiative to cut costs by five percent in every department. I'm sure he thought as the *shareholder value guy* I'd back him up. But instead I asked, "Why are you cutting R&D?"

Avoid Wasteful Spending

To be sure, there is often wasteful spending in R&D, sometimes to an even greater extent than other departments. We worked with one life sciences client where almost 40%of their current R&D budget was devoted to projects that, over their full life-cycle, were projected to have a negative net present value—i.e., the present value of all cash outflows was higher than the present value of cash inflows. Once we eliminate sunk costs, many of these projects appeared to add incremental value on a forward basis. Yet the fact that such a large proportion of current spending was concentrated in these projects indicated two big problems.

First, the company was not proficient at selecting and executing value-creating projects. Admittedly, life sciences is a tough business and, by default, many projects will not succeed. Second, and of bigger concern, was that the company seemed to struggle with admitting failure. So they kept funding projects whose odds of success looked marginal at best, even when project managers were able to achieve their forward projection, which was a rare occurrence.

The company would have been better off "failing fast" on many of these projects, defunding them, and reallocating more financial and human resources to the more promising initiatives. The pareto principle, also known as the 80/20 rule, asserts that roughly 80% of value comes from 20% of businesses' activities. And in every R&D organization I have worked with, the pareto principle seems to hold true, whether or not managements embrace its implications. The smearing of capital, innovation and marketing resources evenly across business units and projects is often referred to as "peanut buttering," as if we were smearing spread across a slice of bread. Most executives know, at least intuitively, that they should concentrate the resources where they create the most value—the expected (value) benefit of placing fewer bigger bets is not lost on them. But this rarely happens. It seems as if management is unsure where their best opportunities lie, so they disperse resources across the portfolio to be sure they don't mistakenly defund a winner. Another obstacle can be the strength of office politics, which is often one of the most value-destructive attributes in an organization. Thus boards and other company leaders should also seek out objective frameworks for resource allocation to avoid this unfortunate drag on many corporate cultures.

Ownership Culture

Before considering how to protect innovation during a downturn, consider the culture of the organization and whether management's actions are aligned with the *long-term* interests of shareholders. When this is the case, we observe what we at Fortuna Advisors refer to as an ownership culture. In such corporate environments, leadership of the organization thinks and acts as if they owned the company. There are five key traits of an ownership culture that are important, and leaders would do well to assess how well their organizations represent these traits:

1. Act like the money is yours
2. Extreme prioritization
3. Willingness to experiment, and fail
4. Less talking and more doing
5. Focus on both short- and long-term

Leaders in innovation areas should embrace these principles, especially during tough times. When they act like an owner, they don't tolerate wasteful spending because they act like the money is theirs. By defunding marginal innovation projects, they free up resources to prioritize more important projects. They are willing to experiment and try new ideas, but when they don't work out, they fail fast and avoid throwing good money after bad. With a true bias for action, they avoid "analysis paralysis" via endless meetings without decisions. The drive to deliver results in the current year should be very strong, but thoughtful business owners would never get there by cutting vital investments that drive future success.

Still, when asked to slash an innovation budget, don't blindly fight it. Acknowledge there may be some wasteful endeavors that should be eliminated. Try to reduce more than you need so you can increase investment in the best opportunities, at least somewhat, to achieve more with your real winners. In one client, for every dollar we moved from marginal projects to the high-priority initiatives, the net present value of the company increased by three dollars!

Better Accounting for Value Creation

Another obstacle to innovation comes with standard conventions around financial accounting. Traditional investments in assets such as property and equipment are capitalized and amortized over their useful lives. But according to Generally Accepted Accounting Principles (GAAP), R&D and other important value drivers such as brand building, are typically expensed in the current year. The result is to discourage investing in these vital value drivers. And in tough times, it makes them the first areas most executives look to cut.

The problem has become especially pronounced in recent decades as the amount of investment in intangible assets has surpassed the investment in tangible, suggesting they have become a bigger source of value than traditional brick-and-mortar. And while thoughtful business owners (and managers) are fully capable of looking past accounting quirks to make the right decisions for the future of the business, the incentives of most public company executives decidedly discourages investment in innovation and future value creation. The first step in correcting this accounting problem is to examine how well your incentives align with share price and intrinsic value creation, and then to consider capitalizing investments like R&D and brand-building over the long term.

Those with questions or who are interested in learning more are encouraged to reach out to the author at gregory.milano@fortuna-advisors.com.

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