



Is your capital allocation strategy a long-term plan or a short-term fix?

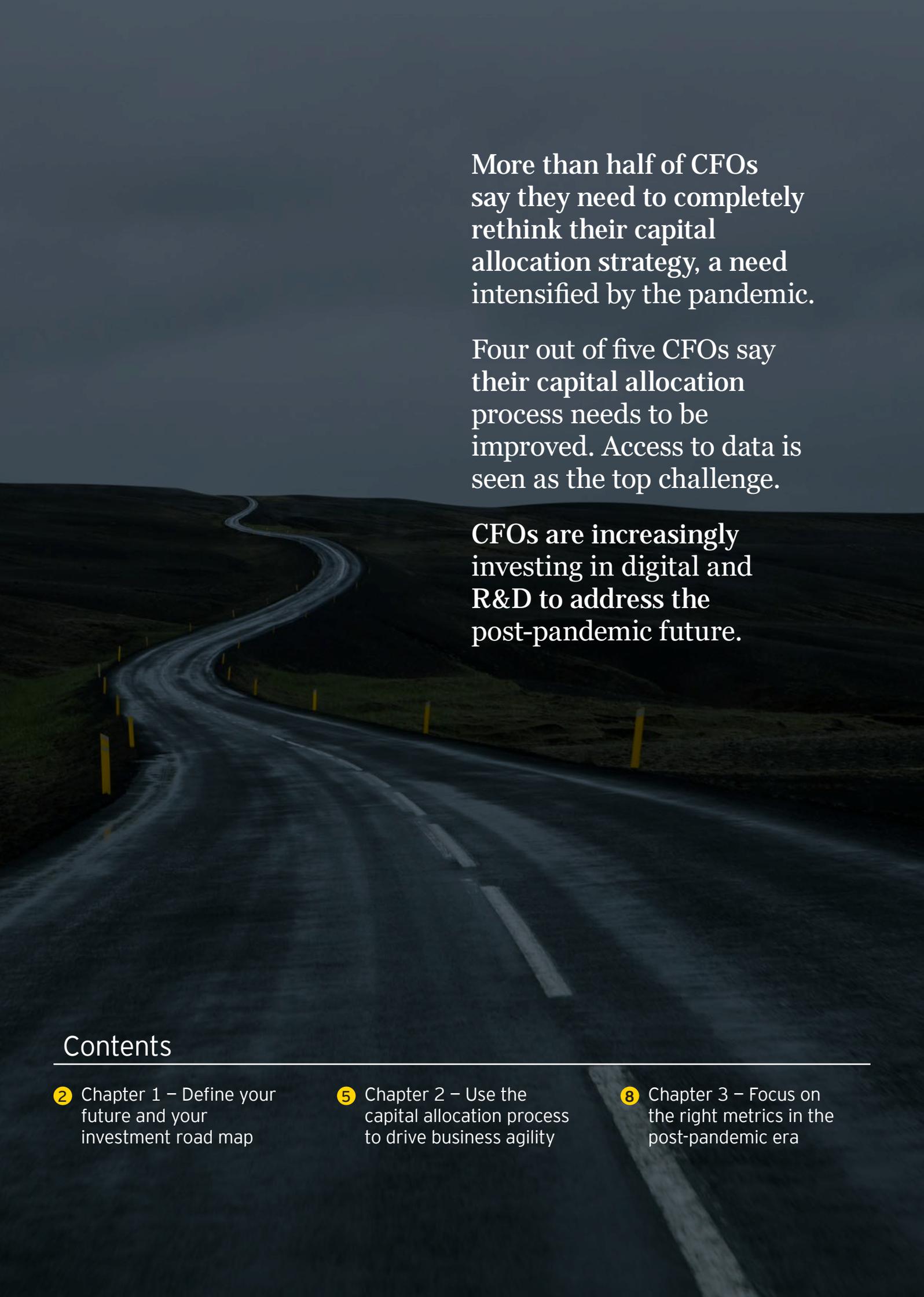
The pandemic shows that CFOs need to remain agile while focusing on long-term value.

■ ■ ■
The better the question. The better the answer.
The better the world works.



EY

Building a better
working world



More than half of CFOs say they need to completely rethink their capital allocation strategy, a need intensified by the pandemic.

Four out of five CFOs say their capital allocation process needs to be improved. Access to data is seen as the top challenge.

CFOs are increasingly investing in digital and R&D to address the post-pandemic future.

Contents

2 Chapter 1 – Define your future and your investment road map

5 Chapter 2 – Use the capital allocation process to drive business agility

8 Chapter 3 – Focus on the right metrics in the post-pandemic era

Chief financial officers are recovering from a once-in-a-generation shock to their capital allocation strategies.

Even as they deal now with the upheaval induced by the COVID-19 pandemic, they must make plans to improve long-term business performance. This means developing a capital allocation process that is fit for a future that may be radically transformed in a few short years by the impact of digital technologies, a changing workplace and evolving business models.

How can CFOs develop the right capital allocation strategy and process while investment decisions are being scrutinized by investors and employees, regulators and society at large?

To better understand how businesses are addressing market changes – and how they should adapt their capital allocation strategies going forward – EY teams surveyed 1,050 CFOs around the world and across industries in the first weeks of 2021. Findings include:

- ▶ Over half (56%) of CFOs say their capital allocation strategy needs to be completely rethought.
- ▶ Four in five CFOs say their capital allocation process needs to be improved.
- ▶ About two-thirds were unable to fund all planned projects in 2020, which could have consequences going forward, especially as the pace of transformation quickens.
- ▶ Only 47% say their capital allocation process effectively meets total shareholder return (TSR) goals.

The lack of confidence in their capital allocation strategy, combined with the shortage of capital to fund all projects, underscores the need for companies to address potentially long-term changes to their market, refocus their portfolios on their core business and carefully choose which initiatives to fund.

Companies' next steps will vary depending on the pandemic's impact. Some industries such as transportation and hospitality have seen their entire business model upended. They urgently need to improve elements of their capital allocation process. Others, such as technology and life sciences, have seen increased demand and financial benefits. Still, they should not let that mask long-term changes that need to be made lest they fall behind in the future.

CFOs and their companies must:

- ▶ Define their future and investment road map
- ▶ Use the capital allocation process to drive business agility
- ▶ Focus on the right metrics in the post-pandemic era

We invite you to read our Global Capital Allocation Report 2021 where we review CFO perspectives and leading practices to improve your capital allocation strategy and process.



Loren B. Garruto

EY Global and Americas Corporate Finance Leader
Strategy and Transactions



Chapter 1 – Define your future and your investment road map

How will your company deliver long-term value to your stakeholders? And how will your capital allocation strategy enable you to reach those goals?

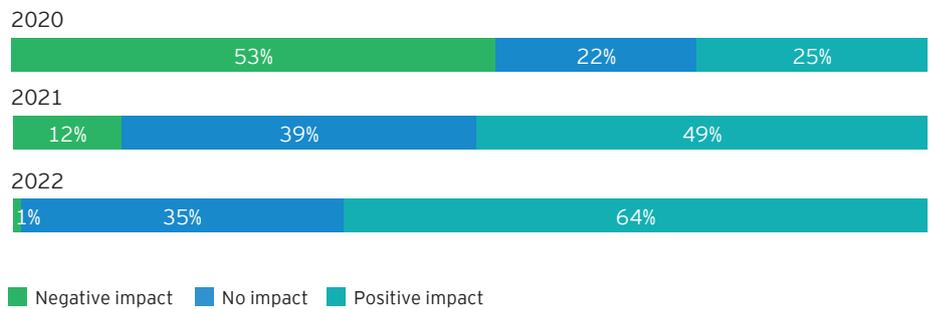
The pandemic tested the effectiveness of companies' capital allocation strategies, planning and execution. Companies that were able to quickly re-prioritize investments and re-allocate capital have weathered the storm and, in some cases, even improved their competitive position. But more than half of CFOs say the pandemic had an overall negative effect on their company's ability to effectively invest capital in 2020.

Most CFOs say changing customer demands (60%) and an inability to accurately forecast future business performance (54%) are the most challenging business issues they have faced during the pandemic. Other issues like supply chain disruption and softness in the end-consumer market are prevalent in specific sectors.

Looking ahead through 2022, CFOs expect their investing to rebound (Fig. 1.). The key is how to decide on the best areas to focus that investment. This poses challenges especially when many companies do not have the capital to fund all their projects, future customer demands and competition may change rapidly, and the metrics by which companies are measured keep evolving.

Figure 1

Q How much of an impact did the pandemic have on your company's ability to invest capital in 2020?

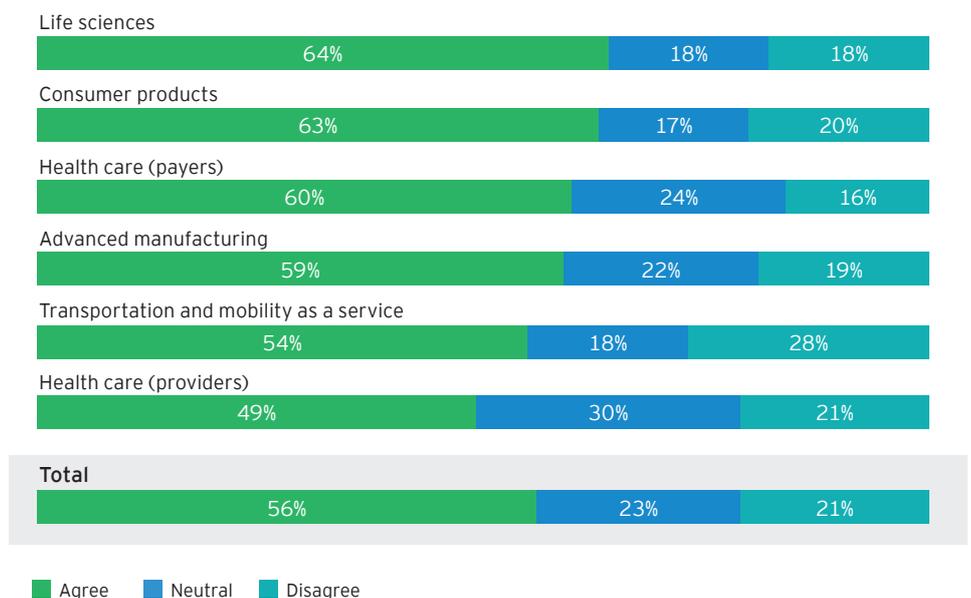


Define the future state of the business

Most CFOs say the pandemic has forced them to completely rethink their capital allocation strategy or process (Fig. 2). Health care providers have embraced telemedicine. Manufacturers have established new health and safety procedures. Many companies have embraced remote work. The question companies now need to answer is which of the many business model changes will stick and which are only temporary.

Figure 2

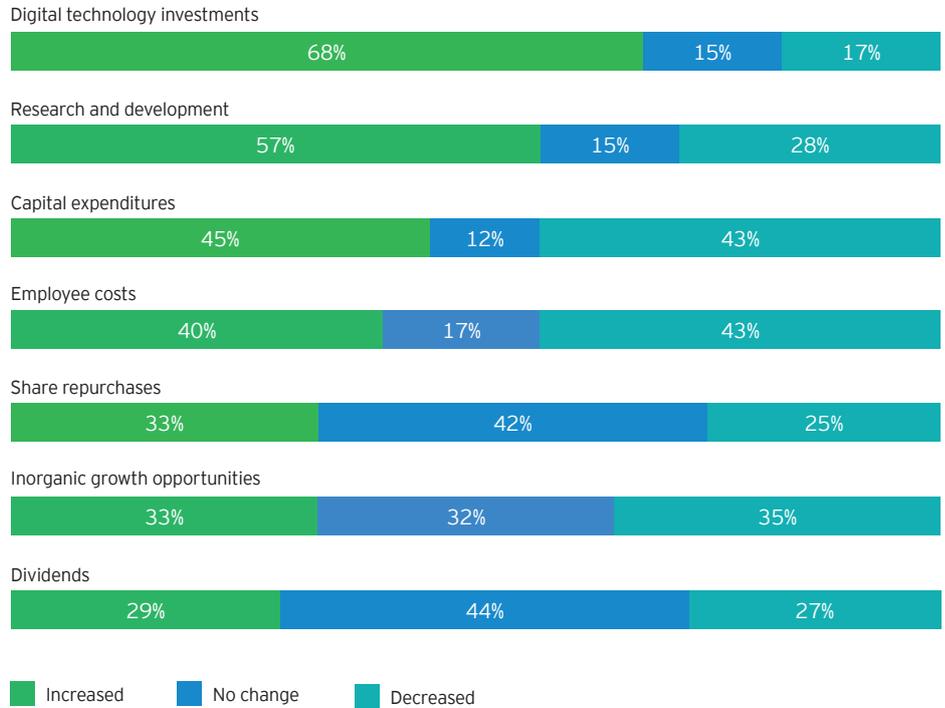
Q We had to completely rethink our capital allocation strategy/process.



At the same time, the pandemic has supercharged some trends that were already in place, such as the push into all things digital. In fact, digital technology, which supports trends such as telemedicine and remote working, is the area where CFOs most frequently say investment increased in 2020 vs. 2019 (Fig. 3), and 62% say accelerated digital transformation will impact capital allocation going forward.

Figure 3

Q Compared to 2019 levels, how did your capital allocation change in the following areas in 2020?



With so much uncertainty, companies need to weigh the likelihood of various scenarios to determine what their business may look like in the future, and then align their strategy and capital allocation accordingly.

Determine what assets and capabilities you have and what you need

Once the future-state of the company is envisioned, the next step is to take an inventory of the businesses and assets in your portfolio. Regular portfolio reviews can help companies find assets that no longer align with the company’s long-term strategy but that can be divested to fund future investments. The pandemic has spurred a closer look at portfolios; more than two-thirds of CFOs say they plan to rebalance their portfolios to focus on the core business.

Companies should then evaluate which assets and capabilities within the portfolio will help enable their future state business model. Should these assets and capabilities be owned because they are at the very core of the business? Could they instead be acquired through partnerships or purchased from third parties, with the trade-off of giving up some control? Many companies are considering these “asset-light” business models that look to source non-core capabilities or inputs into the business through alliances, partnerships, joint ventures or outsourcing agreements. The goal of evaluating whether your company is the best owner of each asset is to free up capital to invest in the capabilities that will be core to the business in the future.

Communicate the strategy to key stakeholders

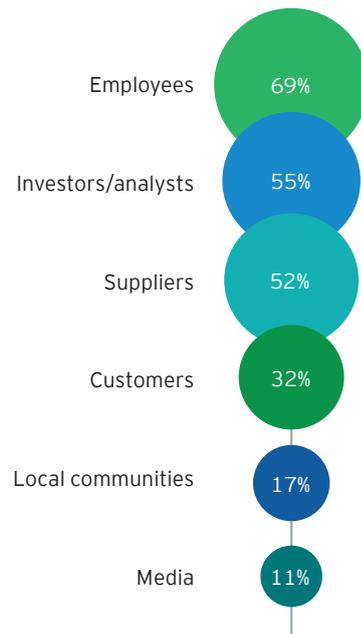
It is essential to share with stakeholders the capital allocation strategy and how it drives long-term value. Amid rapid change, companies need support and buy-in from employees who will be the drivers of the company’s growth journey. In fact, 69% of CFOs say they communicate their capital allocation plans with employees (Fig. 4).

However, there appears to be room for improvement when it comes to communicating with the investor and analyst community – only 55% of CFOs say they communicate their capital allocation strategy with these stakeholders. A lack of transparency can erode trust. When companies execute their capital allocation strategy, investors should understand the investment decisions being made and how these will enable the company’s future success.

Figure 4

Q With which of the following parties do you communicate about your organization’s capital allocation strategy and the impact of the rapidly changing business environment?

Select all that apply.



Key takeaways

- ▶ Define the future of the business and what capabilities and assets are needed to get there.
- ▶ Align the capital allocation process with the strategy.
- ▶ Rigorously review the portfolio for opportunities to divest to fund reinvestment in the core business.
- ▶ Communicate the plan to key stakeholders.

Chapter 2 – Use the capital allocation process to drive business agility

47%

of CFOs say their capital allocation process is successfully helping them achieve their TSR goals.

67%

note that they review their capital allocation process annually.

53%

of companies say their processes or investment criteria are applied inconsistently.

Funding the future requires a capital allocation process with governance that instills discipline and enables unbiased decision-making. The process must also be agile enough to adapt to changing business needs. But many CFOs say their capital allocation approach is not flexible and regularly updated nor informed with necessary data. And even if the process is established and well documented, more than half (53%) say their capital allocation process isn't always followed.

As a result, less than half of CFOs say they can quickly assess market threats and opportunities and reprioritize planned investments accordingly. This can hinder long-term shareholder returns – only 47% of CFOs say their capital allocation process is successfully helping them achieve their TSR goals.

Changes in customer demand and behavior, uncertainty over the pace of the post-pandemic recovery, difficulty in developing forecasts, and the need to decide which changes spurred by the pandemic are permanent and which are temporary all point to the importance of continuous improvement in the capital allocation process. While most (67%) note that they review their capital allocation process annually, only 8% perform postmortem reviews and regularly analyze how the process needs to be changed. Given the speed of market change, companies should be striving for a capital allocation process that continually evolves.

Establish proper governance

To drive sound and timely decisions, a company's capital allocation approach should be underpinned by a governance structure that strikes the right balance between both formal and objective. It should also not be so encumbered with rules and processes that it impedes a company's ability to move quickly from ideation through implementation.

Leadership should align on a shared vision that ties the process back to strategy, identifying the strategic goal that is supported by the investments being made. Is the company trying to drive growth? Be more sustainable? Enable innovation?

Aligned on a common goal, each business unit should use the same framework and similar metrics to make capital allocation decisions. This allows projects to be evaluated consistently across the business and should help eliminate personal bias. Unfortunately, more than half (53%) of companies say their processes or investment criteria are applied inconsistently.

Leadership alignment on goals and metrics early in the capital allocation process avoids the need for various guardrail processes and improves performance and agility.



Follow up on implementation

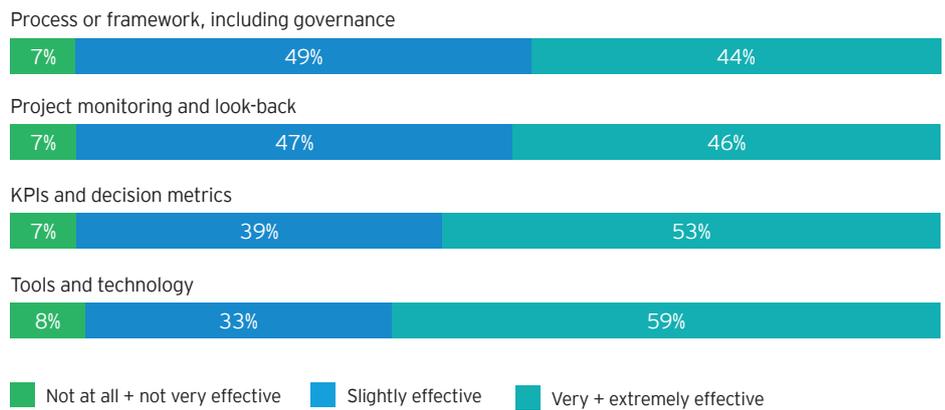
The capital allocation process does not end when decisions are made. During implementation, CFOs and their teams should verify that the assumptions made around the investments are proving out or require in-flight adjustments.

After implementation, governance should also call for postmortem reviews to determine what went right or wrong and then incorporate those learnings into future investment decision-making.

CFOs say their process framework and governance (56%) and project monitoring and look-back (54%) are only slightly or not at all effective (Fig. 5). These challenges can hinder agility during changing market conditions, leaving companies unable to pivot when needed.

Figure 5

Q Please rate the effectiveness of the following aspects of your capital allocation process.



Consider the human element

People and corporate culture are key elements of successful capital allocation but are often overlooked. Having the best business cases, decision models and prioritization frameworks cannot drive success without personal accountability – and executives' freedom to acknowledge failure.

Project owners should be evaluated on project success and the reliability of business case assumptions. The level of reliability should also inform future investment decisions. For example, if the head of a segment repeatedly underestimates costs in business cases, that executive's business cases need to be risk-adjusted going forward.

Certain projects may require high levels of personal interaction to develop a common purpose and achieve success within the organization. These may require integration partners or other influential leaders to incorporate new capabilities and assets into the larger business. Project owners should have a clear implementation plan to verify that new projects dovetail into existing structures, projects and work streams.

At the same time, project owners should be empowered to cancel an underperforming project and allow the capital to be redeployed, instead of trying to save the project with inefficient workarounds to avoid realizing the loss.

It is critical to develop a shared definition of "winning" throughout the organization that does not hinder agility when circumstances change.

Use advanced tools to gather and analyze data

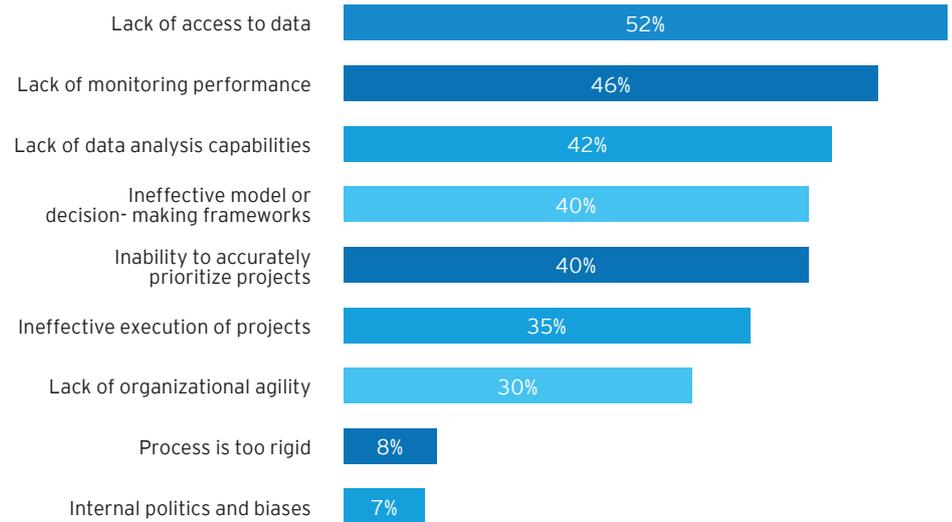
Companies are being evaluated on more metrics than ever before, both quantitative and qualitative. It's no longer just a matter of revenue and profits but also the social and environmental impact of their decisions. Misfiring on any of these metrics can imperil earnings, corporate reputation and long-term value creation.

With the plethora of data that must now be considered, it's no wonder that lack of data access (52%) and lack of data analysis capability (42%) are among the most cited barriers to optimal capital allocation (Fig. 6). In fact, lack of access to data is up 11 percentage points from when we asked CFOs about similar barriers to success in 2018.

Figure 6

Q What are the primary barriers to your company's optimal allocation of capital?

Select all that apply.



The more data being collected, the more time and effort it takes to analyze it accurately. Some tools just don't bring the firepower needed to manage and analyze the vast amount of data.

Companies need to employ advanced data and analytics tools to manage the broad spectrum of metrics and produce usable insights, including highlighting any issues that need to be addressed immediately.

Automation tools that can pull various internal and external sources of data into dashboards can help speed up the process and lessen the possibility of human error. Analytics software can reveal data points that are essential for decision-making, and data visualization tools can help provide actionable insights.

Key takeaways

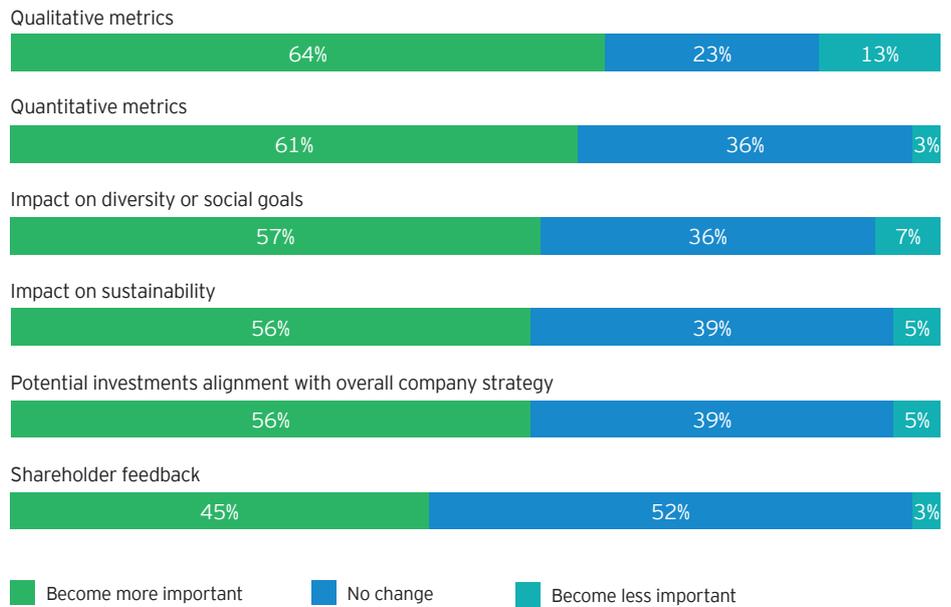
- ▶ Establish proper governance to drive consistent decision-making across businesses.
- ▶ Follow up to confirm that decisions are being implemented effectively, make in-flight changes if necessary and conduct postmortem reviews.
- ▶ Consider the human element, instilling personal responsibility and allowing the freedom to acknowledge failure and correct mistakes.
- ▶ Leverage data and advanced technology to increase decision-making efficiency and effectiveness.

Chapter 3 – Focus on the right metrics in the post-pandemic era

Data management and analytics tools are only as good as the information that goes into them. CFOs note that a host of metrics have become more important in the capital allocation process in the past year, with qualitative metrics leading the way (64%), but quantitative metrics following closely behind (61%) (Fig. 7). This may be an indication that the disruption from the pandemic is forcing more rigor in decision-making and that a broader set of stakeholders (employees, customers and regulators in addition to the board and investing public) is demanding to understand more about the rationale behind each decision.

Figure 7

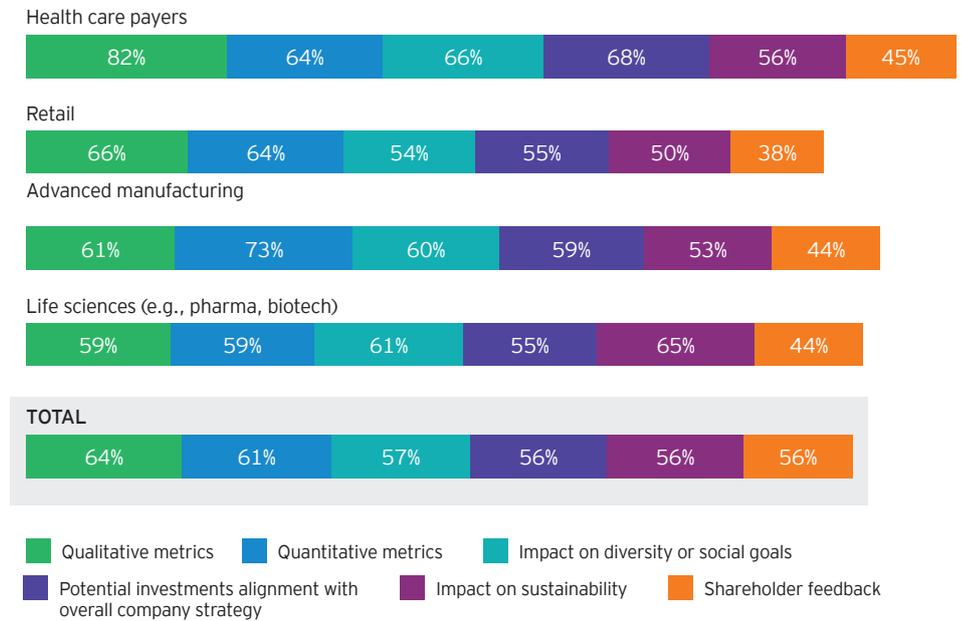
Q Please rate how the following factors in your capital allocation process changed over the past year.



Certain metrics have become more important over the past year, with many tailored to the specific strategic needs of an industry. Nearly three-quarters of advanced manufacturing executives, for instance, say quantitative metrics have grown in importance, while for health care payers, qualitative metrics have come to the forefront. Sustainability is growing in importance for all industries, but especially in life sciences (Fig. 8).

Figure 8

Q Please rate how the following factors in your capital allocation process changed over the past year.



A balanced scorecard approach, combining financial metrics with quantitative nonfinancial metrics (e.g., efficiency and yield) and qualitative metrics (e.g., regulatory risk, people impact), is the most effective way to strike this balance.



Track the right KPIs of long-term value

As the definition of long-term value has expanded to include not only financial value but also customer, people and societal value, companies are striving to identify and measure the right KPIs to evaluate their performance across these categories. In selecting KPIs, CFOs need to understand what is most important to the company's success and to its stakeholders and determine how to measure it.

CFOs are well aware of financial KPIs such as growth rate, free cash flow and return on invested capital. But other KPIs are increasingly critical. Among those that could be considered are:

- ▶ Customer value – satisfaction, trust and loyalty, and brand value
- ▶ People value – engagement, employee loyalty, leadership, diversity and inclusion, and health and wellness
- ▶ Societal value – sustainability, total economic impact, carbon footprint, water consumption and ethics

There are a host of other metrics that can be measured. [For example, the World Economic Forum's International Business Council, with support from EY leadership, has proposed a set of common metrics to spur sustainable value creation.](#) The key is to choose the KPIs that align with the company's long-term strategy and mission statement in order to make capital allocation decisions that support the aspirational future state of the business.

Quantify qualitative metrics

CFOs in the EY survey named qualitative metrics such as safety and regulatory requirements, workforce impact, and alignment with corporate strategy as the most common qualitative measures they consider in their investment decision process. The impact on diversity or social goals and sustainability are also becoming increasingly important. However, a common concern related to qualitative metrics is that they can be subjective.

With the advancement of digital technologies, more and more qualitative aspects are becoming measurable (e.g., social media engagement). In the absence of having a completely unbiased quantitative method to measure, a balanced scorecard approach can incorporate qualitative factors. In the absence of quantitative data, qualitative metrics can be assigned a weighting, creating a data point or "score" that can be included on the balanced scorecard and utilized in the evaluation process.

Providing a consistent framework for the qualitative assessment of individual investments helps decision-makers compare alternatives.



Regularly review and refresh KPIs

Backtesting can help sort through the myriad of available qualitative and quantitative metrics to determine which KPIs actually drive value, based on the company's strategic goals. Executives should look for past correlations with the results the company is trying to achieve and use those to inform decisions.

Companies should also regularly evaluate KPIs. As the pandemic showed, the future is uncertain, and the business environment can change without warning. Make sure your KPIs keep pace.

Key takeaways

- ▶ Choose KPIs that reflect the company's long-term value creation strategy.
- ▶ Use a balanced scorecard and assign weight to qualitative KPIs.
- ▶ Regularly refresh KPIs to make sure they still align with the long-term strategy.

In summary: Use your capital allocation strategy to drive long-term value

While the pandemic's impact on individual companies has been unique, most executives agree that it has driven a renewed focus on capital allocation. CFOs have found they need to look beyond the bottom line and take a more holistic view of capital allocation, incorporate effective data management and analysis, and focus on building trust with stakeholders through effective communications.

In the current business environment, there is great opportunity to improve the capital allocation decision-making process. Striking the right balance between rigor and agility will enable companies to achieve their long-term strategy and value creation goals while navigating short-term disruptions.

About the research

In January and February of 2021, Oxford Economics and EY teams surveyed 1,050 chief financial officers or equivalent titles worldwide and across industries.

Respondents came from companies with revenues more than \$500m, with 33% having revenues from \$500m-\$4.9b, 33% with revenues \$5b-\$14.9b and 33% with revenues more than \$15b.

Industries were evenly mixed (about 10% each) between advanced manufacturing, retail, technology, telecom, automotive, life sciences, health care (payers and providers), media and entertainment, consumer products, transportation, and mobility as a service.

More than half (60%) of respondents came from publicly-traded companies; 40% came from privately-owned companies.

Respondent companies are headquartered in the United States (50%); Canada (10%); Western Europe (20% in the United Kingdom, France and Germany); and Asia-Pacific (20%, in China, India, Japan and Australia).

Contacts

Let's talk about your capital allocation strategy.

Global

Loren B. Garruto
EY Global and Americas
Corporate Finance Leader
Strategy and Transactions
loren.garruto@ey.com

Americas

Evan Sussholz
Partner
Strategy and Transactions
Ernst & Young LLP
evan.sussholz@ey.com

Ben Hoban
Senior Manager
Strategy and Transactions
Ernst & Young LLP
ben.hoban@ey.com

Asia-Pacific

Andre Toh
EY Asia Pacific Valuation,
Modelling and Economics Leader
andre.toh@sg.ey.com

Europe, Middle East, and Africa (EMEA)

Adrian Nicholls
EY Global Leader for Valuation,
Modelling and Economics Services
anicholls@uk.ey.com

Sebastian Schmidt
EY Europe, Middle East, India and
Africa Valuation, Modelling and
Economics Leader
sebastian.schmidt@de.ey.com

EY | Building a better working world

EY exists to build a better working world, helping create long-term value for clients, people and society and build trust in the capital markets.

Enabled by data and technology, diverse EY teams in over 150 countries provide trust through assurance and help clients grow, transform and operate.

Working across assurance, consulting, law, strategy, tax and transactions, EY teams ask better questions to find new answers for the complex issues facing our world today.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. Information about how EY collects and uses personal data and a description of the rights individuals have under data protection legislation are available via ey.com/privacy. EY member firms do not practice law where prohibited by local laws. For more information about our organization, please visit ey.com.

About EY Strategy and Transactions

EY Strategy and Transactions teams work with clients to navigate complexity by helping them to reimagine their ecosystems, reshape their portfolios and reinvent themselves for a better future. With global connectivity and scale, EY Strategy and Transactions teams help clients drive corporate, capital, transaction and turnaround strategies through to execution, supporting fast-track value creation in all types of market environments. EY Strategy and Transactions teams help support the flow of capital across borders and help bring new products and innovation to market. In doing so, EY Strategy and Transactions teams help clients to build a better working world by fostering long-term value. For more information, please visit ey.com/strategyandtransactions.

© 2021 EYGM Limited.
All Rights Reserved.

EYG no. 003197-21Gbl
2101-3677280

ED None

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax, legal or other professional advice. Please refer to your advisors for specific advice.

ey.com