Can the capital allocation process be a competitive advantage?

Some companies in the technology, media and telecommunications sector are doing it differently — and seeing results.

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Introduction

A new study from EY-Parthenon shows that, when it comes to leading practices in capital budgeting, top performers from the technology, media and telecommunications (TMT) segments might be onto something. That is, these leaders share a handful of common attributes and processes that appear to enhance their overall effectiveness, likely contributing to their well-above-average growth.

First, the similarities

EY-Parthenon surveyed 150 executives from a wide variety of sectors, all of whom are familiar with their companies' capital allocation processes. Companies surveyed averaged over US$1 billion in revenue, including some in excess of US$10b. Respondents described a broad range of formal capital planning processes using a variety of metrics and involving many parts of the organization.

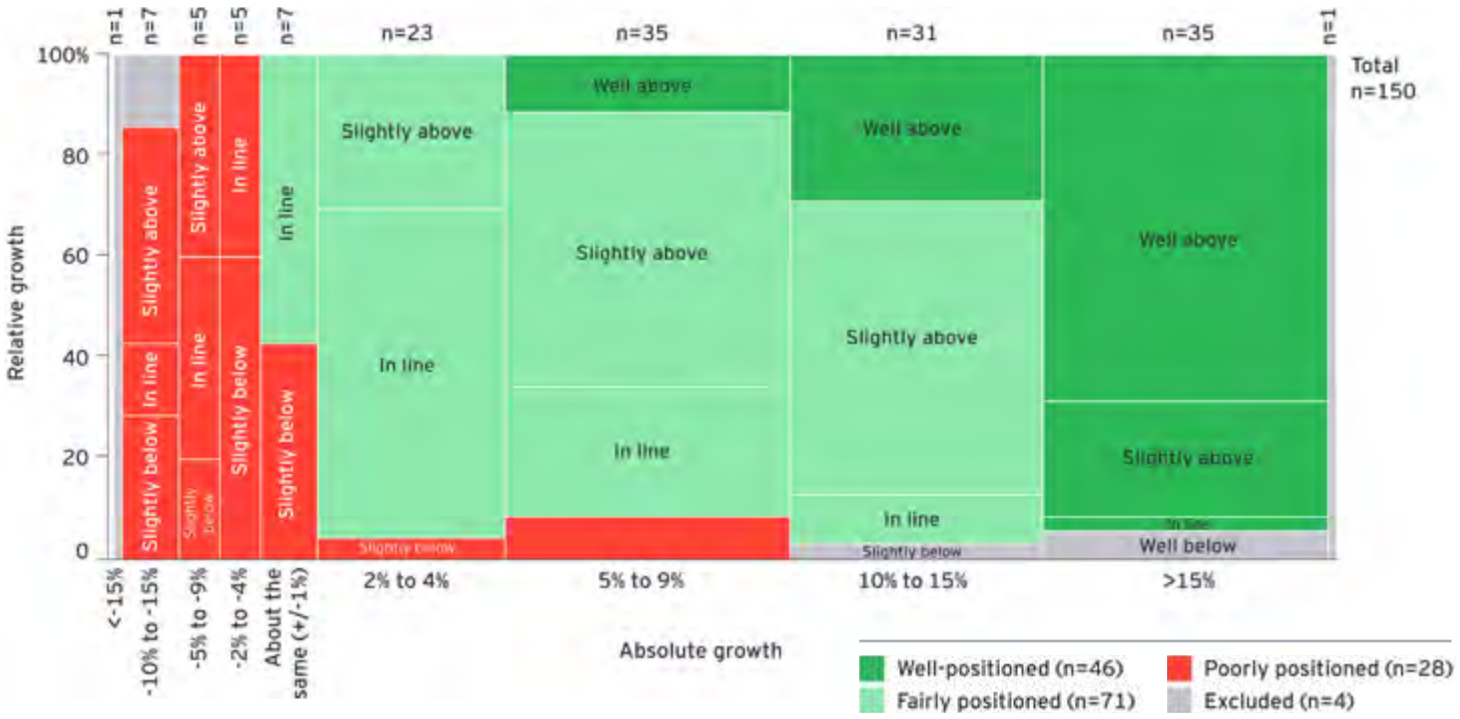
Common practice

When it comes to capital budgeting, most companies:

- Maintain a formal process
- Engage the C-suite and other key executives
- Use common metrics for tracking

While there were some small differences in the way capital planning was performed across various industry sectors, company sizes and maturity levels, the most striking contrast was between those companies that were both faster growing and outpacing their peer groups ("well-positioned") and those that were growing more slowly and not keeping pace with their peers ("poorly positioned"). Among TMT respondents, the contrast between the well-positioned and the poorly positioned was even more striking.

Figure 1: Relative growth vs. absolute growth (all respondents)



Now, the differences

The survey pinpoints four key areas where the capital budgeting practices of the well-positioned TMT companies vary from the pack.

1 **Greater decentralization and business unit autonomy. Well-positioned TMT companies,** the survey demonstrates, tend to have less-centralized capital allocation processes and confer a greater span of capital control to their business units (BUs). For example, BU heads at these companies are more likely to have autonomy, more likely to seek ad hoc meetings with key decision-makers, and more able to respond to market fluctuations. Moreover, these meetings tend to be one-on-one, enabling deeper communication and greater clarity.

"BUs know their business cycles well," explains one such executive. Their front-row seat gives them an intimate understanding of their process life cycles "so they understand the [activities] that require large cash investments [or] that have a longer lead time."

Another executive explains, "[We] have meetings with all the senior executives, on a one-on-one basis every week." Such familiarity also means more opportunities for ad hoc decisions to be made even outside of such meetings. Overall, clearer communication and open access leads to a more effective capital budgeting process.

By comparison, the "fairly positioned" and "poorly positioned" companies tend to have more structured and bureaucratic processes often hamstrung by additional layers of management between BU heads and key decision-makers. Those corporate decision-makers tend to convene annual meetings and quarterly check-ins, but are less engaged between these meetings. As a result, discussions around core capital allocation decisions are more likely to be filtered or muted, with capital allocation plans tending to be more static or fixed for each cycle.

While those firms in the fairly positioned segment also have formal procedures for quickly injecting capital on an as-needed basis, the power to tap such resources does not reside with the BUs. Instead, such decision-making and capital controls remain the purview of a more centralized finance team.

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2 **Greater frequency and flexibility.** Well-positioned TMT companies are much more likely to describe their capital allocation decision-making as fluid or ongoing. Such companies begin with an annual, formal discussion, but they revisit allocations quarterly and are more apt to encourage ad hoc meetings.

"My job is making sure we have a dynamic budgeting and forecasting process," explains another such executive. "We forecast, but then either monthly or quarterly, go back, look and ask: 'Is my allocation right?'" So in practice, the company is able to execute "constant minor tweaks throughout the length [of the] project," as needed.

Those companies categorized as fairly positioned reported having a similar number of formal meetings as the well-positioned ones. However, they exhibit significantly fewer ad hoc meetings. Meanwhile, instead of focused one-on-one discussions, such companies primarily convene in larger groups. The poorly positioned companies differ in that they set a budget annually and then revisit matters after the fact — when results are finalized.

The poorly positioned companies are less able to respond quickly and have longer intervals without recalibration. These firms tend to over-allocate capital from the start, adding greater uncertainty into their models and projections, with interim adjustments unlikely except for dire circumstances. As one executive explains, "Things can come up in the middle of the year, but aside from [emergencies], it's basically a once-a-year process with little new action."

3 **Greater use of data.** Capital allocation at well-positioned TMT companies is, according to the survey respondents, a decidedly data-driven process. Such companies are significantly more likely to review key business metrics and performance using advanced analytics and visualization. They also tend to be more comfortable sifting through large data sets. As a result, these companies are better able to identify specific metrics that are more effective or otherwise simplify and streamline decision-making.

As one executive explained, "I'm seeing more data coming into the decision." But an important caveat, the executive cautions, is the need for consistency of data across the evaluation timeline. To be effective, "there has to be a track record with the data; you have to have some history."

Those fairly positioned firms are also making use of data, but in less robust terms. These companies tend to rely on forecasts and internal metrics for allocating their capital. Finally, those in the poorly positioned growth segment are relying primarily on financial models whose principal levers include comparables and historical performance. Advanced data analytics and statistics are used sparingly at such firms in favor of traditional capital budgeting metrics. As one executive explains, "We look at the expected internal rate of return of a project and account for the standard deviations around it within our forecast models."

4 **Emphasis on focused, fair and accountable allocations.** According to the survey, well-positioned TMT companies are more likely to make capital allocation decisions that promote focused investments (as opposed to dilution across disparate projects). They feel that their allocation is more agnostic to company politics and more likely to be focused on the BUs most likely to create value. They are also more likely than their poorly positioned peers to hold BUs accountable for previous forecasts during the capital budgeting process.

In these three areas — focus, fairness and accountability — the well-positioned TMT firms stood out from the well-positioned non-TMT firms and their poorly positioned counterparts, with accountability serving as a key differentiator. As one executive put it, "It's not just, 'Hey, I've set my budget for the year; now leave me alone.' It's 'No, we're holding you accountable monthly now.' There is a cadence built into the annual plan and budget: everybody has goals and performance indicators to which they have to manage."

Capital budgeting at top performers

Well-positioned firms follow common practice, but also exhibit:

- Decentralized processes and greater BU autonomy
- More frequent, often ad hoc interaction and planning
- Data-driven evaluation and planning
- Emphasis on focused, fair and accountable allocations

Time for review?

This survey found that well-positioned TMT companies are doing things differently than the sample at large. Does different mean better? Performance as measured by growth is one indication. While the survey cannot conclude causality, we believe in the age-old economic theory that greater optimization of capital leads to higher returns. Companies must scrutinize not just the investments made with their capital, but also the processes used to arrive at those investment decisions. The process attributes of the well-positioned TMT companies in our survey may provide inspiration to those looking to increase the effectiveness of their capital.

With global credit markets more dependent than usual on global political events, and with increased uncertainty in the future of interest rates, tax rates and market valuations, efficient use of capital may become an increasingly important tool in the competitive landscape. What better time for a critical review of capital allocation practices for all companies?

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