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Capital allocation: Is it time for a refresh?

CFOs are constantly weighing the return on investments of their business's time, resources, and human capital for the organization's health and shareholder value. But what about the investments themselves? And why should CFOs consider paying attention to capital allocation now?

Part of the reason is that COVID-19 forced businesses to change their capital plans on a dime—and while some could, many couldn't because they didn't have an effective playbook. In addition, environmental, social, and governance risks, as well as activist shareholders, are forcing many executives to reckon with long-term impacts to strategy. Finance leaders, for example, now have to consider the impact of these challenges on their critical investments, like how climate change might affect a new manufacturing facility in a vulnerable part of the world. Moreover, as governments pursue and implement new tax policies, it has an enormous impact on how—and how fast—companies can use tax equity for capital outlays.

Still, capital allocation isn't just about getting higher returns from lower outlays. It's about measuring profit from internal investments and maintaining the cash flow that allows those investments to happen. It's critical to the business's strategy, and without it, the best-laid plans can be compromised. It also means ensuring that the organization can keep creating value as it changes—and finding new ways to do so within its charter and shareholders' expectations, especially as it fields social and environmental concerns.

Done right, capital allocation can give an organization a true edge over its competitors. And in this issue of *CFO Insights*, we'll discuss the stakeholders involved in capital allocation decisions, the biases inherent in those same decisions, and why having the right capital allocation strategy can help narrow the gap between what a portfolio could deliver and what it actually does deliver.

Who are you stakeholders? What's their bias?

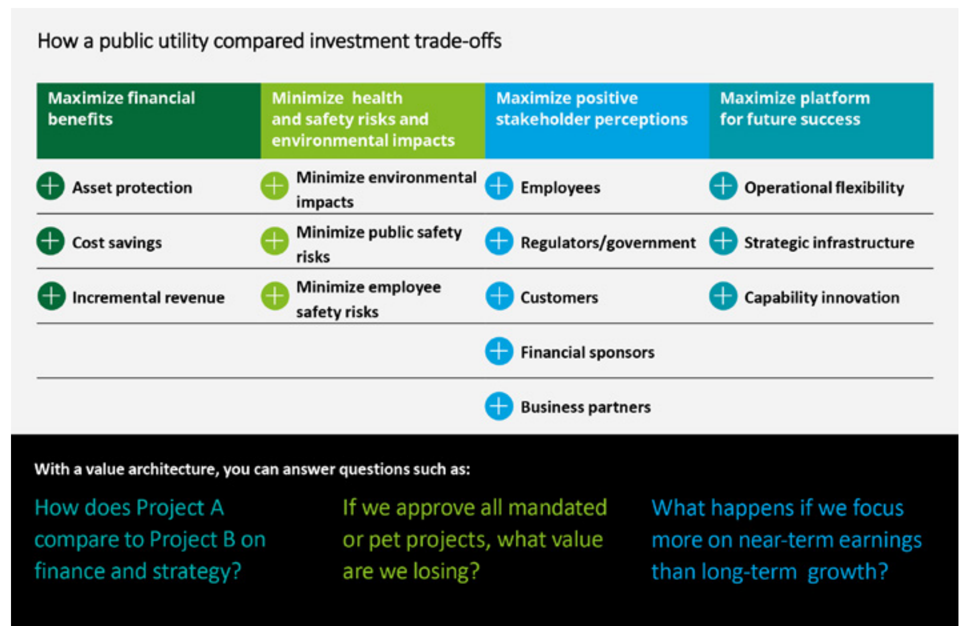
How businesses generate and allocate capital involves multiple choices, trade-offs, and, of course, stakeholders. But by understanding who your stakeholders are and what they want (and why), CFOs can mitigate a major challenge in capital allocation: bias. Talking to your people openly about what they want and the behaviors they're using to get it can boost transparency—and that can help get stakeholders on board for the journey to better decision-making.

The task may be more daunting than it sounds, considering the range of stakeholders. They include: the board, which conducts oversight and makes the final decisions; the finance team, which is responsible for pulling together the information and analysis; members of the executive committee who, along with project managers and others, want to lobby for their own ideas to get funding; and finally, investors, who scrutinize capital allocation decisions to ensure they conform with their vision of the company's future (see "Balancing act: Managing stakeholder groups in capital-allocation decisions," *CFO Insights*, July 2019).

There are many other, including employees (who want to be proud of the choices the organization is making) and customers (who want a well-priced product and company practices that align with their social, environmental, and ethical outlooks.). But what they all have in common is different degrees of bias. In fact, when making capital allocation decisions, there are some behavioral biases to definitely look out for, including:

- **Historical bias**. "It's just the way we've always done things." You've heard that one before. But how often is that assertion really correct, and, anyway, so what? Asking that question can help the CFO dig in to other potential biases and offer new paths for decision-making.
- **Narrow focus**. By only evaluating one or two criteria when making a capital decision, a stakeholder might misunderstand the impact of that decision. Considering multiple criteria in decision-making— and that includes multiple stakeholder voices—is key to a capital plan that can succeed for the long term.
- **The optimist bias**. Consider the CFO of a major company that, quarter after quarter, consistently missed its forecasts to Wall Street because the CFO was overly optimistic about its $10 billion capex forecast for a major capital project. The optimist bias can lead a business executive to have too much confidence in a decision. But by understanding the source of that bias, CFOs and other executives are better able to pause and look closer at the data that could lead to a more accurate forecast.
- **The expert bias**. The business unit leader who "knows what the customer wants" can be trusted to lead the group to the best decision based on their expertise, right? That's called expert bias, and many business decisions are made relying on an expert's opinion that may turn out later to be founded on shifting or incorrect data. (After all, it may be only one person's opinion.) CFOs can correct for expert bias by asking how the experts know what they know, and demanding data and insights to back up their assertions.

Figure 1. An example of a value architecture



Source: "Untangling capital allocation," Crunch Time series, October 2021, Deloitte Development LLC

Measure twice. Do it again.

With a broad view of their organization and its priorities, CFOs can help their stakeholders better understand decisions—and diminish their biases—by applying measurement to choices that can otherwise feel subjective. But measurement isn't always just numbers. Using multiple criteria to make a decision—or, more simply, looking at it from different angles—can shine a light on overall strategy, risk, trade-offs, and how it fits into an organization's portfolio.

Take the big bets, for example. A big decision worth millions or billions of dollars deserves the same amount of scrutiny and governance as a company of the same value. Treat it that way. In analyzing a big bet, think about evaluating your organization with a maturity model to better understand how you currently make decisions and how you could streamline and bolster your existing processes and introduce new tools to up your game. Consider making independent analysis or reviewers—that use risk and analysis tools and report directly to the board or CEO—part of the process. Build in look-back measures and track progress so learnings don't just disappear.

For the smaller decisions that determine your organization's everyday pursuits and cash flow, trade-offs are likely inevitable. To truly understand the risk and potential benefit of these, build a value architecture—a top-down portfolio view of financial, risk, and strategic issues that defines the organization's priorities and shows how potential projects ladder up to them (see Figure 1). It is a collaborative effort that can help CFOs bring their stakeholders along and strengthen the tie between strategy and capital decisions. This makes tradeoffs easier for everyone to understand, and that's a good thing. Once the CFO and stakeholders define the value architecture—and optimally, your future state with a maturity model—you have also laid the foundation to evolve your project portfolio management and technology tools, which starts with people.

What's on your capital allocation checklist?

Every trip requires a checklist, including your capital allocation journey. Start with these and add your own as you go along:

- **Goals**. Do you want to improve big-bet decision-making or day-to-day project planning? Is there one particular project keeping you up at night? Be absolutely clear on what you want to do and build a goal supported by data and insights—and be transparent with your stakeholders about it.
- **Data**. Do you have the data and insights you need to make informed decisions? Work with your stakeholders to determine what those are, where they need to come from, and how you can get them.
- **Tools**. Where could data analytics, scenario planning, and risk-sensing tools improve your decision-making? Which tools do you already have, and which do you need? Engage your stakeholders on what data they need to generate from their business units.
- **People**. Are you building your team for the right strengths? Does your team have the diversity of thought to approach decisions in new ways? Have you fostered an inclusive environment that is hospitable to new ideas? And how are you bringing stakeholders along for the journey?
- **Details**. Understand your cash profile and flow, and analyze the impacts these changes will have in the short and long term. Get a grip on leadership's appetite for risk.
- **Plan**. Start small and implement these changes slowly. Take the time to track behaviors and outcomes, and demand it of your stakeholders as well. This tracking is the foundation for real data sets that can be useful in other decision-making. Finally, measure progress like it's your job. (Because it is.)

Untangling capital allocation

Capital allocation can seem like the ultimate knot to untangle, involving countless stakeholders, competing priorities, and an uncertain timeline. But this is an opportunity for CFOs to see possibility where others see challenge. It takes asking the hard questions, ensuring that your stakeholders are—and feel—heard, and educating your leadership on the risks and value of each project. It's a tall order for anyone, no matter where your organization may be in its maturity. But by setting off on this journey, you can build a new competitive advantage for your organization—one that keeps an eye on what the future might hold while building on the success of what's right in front of you.

For more information, please visit www.deloitte.com/us/CrunchTime17.

Capital allocation in action

A health sciences CFO translates ideas to dollars and strategy

A finance lead can help align the company's board, leadership, and stakeholders on long-term shareholder focus, as well as internal capital strategy. One CFO's powerful tactic to do this: education.

This company's health sciences organization had recently completed an acquisition and subsequent drug launch that was very successful and generated a significant amount of free cash flow, as well as a great outcome for patients. This meant they needed to rethink their capital allocation strategy. They made a number of changes over time, including increasing R&D investments and also returning cash to shareholders in the form of share repurchases and the addition of a dividend.

The strategy prompted many internal questions, however, and the CFO knew it was important to include all internal stakeholders on a journey of understanding the organization's financial life cycles and capital planning. The CFO created a planning process based on a scenario modeling of the tradeoffs needed to maintain and grow free cash flow. This gave stakeholders a clear window into the importance of cash flow and the company's cycles of investment: What happens with that cash flow? What's the minimal investment needed to grow the company? What does it mean for the balance sheet and shareholder return?

By answering these questions, the CFO helped stakeholders see clearly how the investment decisions and tradeoffs could impact future financial returns, including the impact on shareholder returns.

> "It all goes back to the metrics and the numbers. The more I engaged the team in the development of a shared model of potential outcomes, the more I could push the team on the possible outcomes of our strategy."

— CFO of a major health sciences company

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