CFO Insights

Capital expenditures: Will your investments deliver the desired result?

Globally, it seems, some companies are slowly loosening their purse strings. In the Q1 *CFO Signals* survey, for example, the outlook for capital expenditures among North American CFOs increased to 7.8%* from a survey-low of 4.2%* the previous quarter.[1] In Switzerland, CFOs' attitudes toward capital spending over the next year finally exited negative territory for the first time in six quarters.[2] And in the UK, CFOs' optimism about demand for their own products as well as growth prospects in emerging markets, the U.S., and Asia-Pacific are seen as drivers of corporate investment in 2013.[3]

With many corporate balance sheets flush with cash, choosing which investments to make is obviously a critical task for CFOs. And amid continued economic uncertainty, many wonder what will make the difference between capital expenditure (capex) programs that deliver value and competitive advantage, and those that don't.

A recent Deloitte webcast, entitled "Capital Productivity: Creating Value through Capital Expenditure Planning,"[4] tackled that issue head on. And the message was that developing a holistic framework for evaluating capital expenditures is a multistep process that can lead to more objectivity in choosing investments and greater return on invested capital. Moreover, one of those steps—the use of metrics to evaluate the effectiveness of a capex program—is a lot more than just lining up the return on investment (ROI) or net present value (NPV) on a set of projects. In this issue of *CFO Insights*, we discuss how to improve capex programs through more-effective frameworks and leveraging metrics that matter.

The importance of framing

As finance executives well know, capital expenditure planning is the process by which an organization sets capital-allocation targets and builds toward an effectively managed portfolio of projects. The goal is to have less-emotional decision-making around capex and more-objective decisions on where to invest. The process involves three steps:

1. **Establishing an iterative capital-budgeting process that allocates funding down to the direct ownership level.**
2. **Developing an effective project-prioritization methodology that quantifies value and risk considerations.**
3. **Implementing a capital management governance structure with clear roles and responsibilities.**

There are several common challenges that can interfere with reaching capex targets, however. Some companies, for example, lack discipline in reviewing capital expenditures to check for the expected return. For others, dealing with surprises can throw off the effectiveness of a capital expenditure program. Little wonder then, that when the 1,841 webcast participants were asked about their organization's level of concern over the quality of capital expenditures, some 67% answered either "somewhat" or "very concerned."[5]

Still, the lack of a strategic framework is a fundamental challenge companies face in capital expenditure planning. Such a framework is integral to setting capital spending totals, prioritizing spending, and aligning the capex program to the organization's overall strategy. Moreover, having a workable framework helps integrate a capex program into everything a company is doing and becomes one of the most important engines of growth.

Critical to building that framework, however, is determining overall spending levels and allocation of capital. For example, deciding how much you are going to commit to capital and how much you might pull off the balance sheet for investment involves a mix of analyses that will vary by company. What is happening in the economy, where a company has been historically, what type of opportunities and plans it has, and what requirements and other constraints there are also should be considered in the framework.

Comparing and choosing among individual projects, though, involves understanding their impact on strategy through the lens of shareholder value. The step begins with looking at the drivers of shareholder value, which typically include revenue growth, operating margin, asset efficiency, and expectations. The framework then can be used to plot and understand where the organization is investing capital and what types of returns are expected from each project. For example, if there are targets against revenue that are expected to be influenced by certain projects, the impact of those projects could be plotted against the framework to see if they offer the desired strategy mix or expected returns.

Another leading practice to consider when building a capex framework is to hold multiple stakeholder meetings in the development stage. If you have a multi-stakeholder approach and you make the process transparent, it helps to expose the biases in the room, whether they are the CEO's or others'. The days of bold, intuitive decision-making around capital planning really have passed.

An additional step is developing an evaluation system that captures the important financial and strategic criteria and enables comparisons of often hundreds of divergent project proposals coming from throughout the business units. For example, one financial-services company included in its framework criteria on whether a project moved the needle on external stakeholder perceptions. To aid in that evaluation, it is important to develop standardized templates and tools for collecting data efficiently and in accordance with the strategic direction. Such templates should also account for management and governing needs of the various projects.

Linking capex and opex metrics

Finally, applying metrics to a capex program is critical. But it can be challenging to link them to the operating expenditure (opex) budget in a systemic way, unless those connections have been established early in the capital planning process. What works effectively is when a common set of metrics—established at an equal level of detail—is used across both capital planning and operational planning.

Which capex metrics to use is determined by a range of factors, including the strategy in place, the nature of the projects, the insights needed, and where the organization is in terms of financial-analysis skills. But since capital budgeting is very complex, no one metric is typically the answer. Instead, companies should consider using a range of metrics. In addition to offering a wider range of insight, multiple metrics allow users to vary the tool when they have particularly large and strategic projects.

Common metrics, such as hurdle rates, payback period, and NPV, offer benefits, but there are also drawbacks. For example:

1. **Hurdle rates.** While hurdle rates are easy to put in place, they treat all projects as if they have the same risk. Moreover, since hurdle rates are usually set on the high side to help control the demand for funding, they can have the effect of shifting the portfolio to higher-risk projects.
2. **Payback period.** Despite some criticism, payback period can be a useful metric, especially when there is a concern about timing of benefits. For instance, an electronics company wanted to improve its credibility with investors by emphasizing some visible short-term gains to demonstrate the momentum of its strategy. So the company used a payback period as one of the metrics for its portfolio projects.
3. **NPV.** Although a fundamental metric, NPV doesn't help with the challenge of prioritizing many projects. Others to consider include internal rate of return (IRR) or benefit-to-cost.
4. **Economic margin.** Another alternative to NPV, economic margin essentially considers the cash flow that has been generated from a project and makes some adjustments, taking into account that capital projects should not be viewed in perpetuity the way a business enterprise is viewed. Rather, economic margin recognizes that projects tend to have a value that declines over a few years. It also includes a cost of capital, since there is an opportunity cost. In addition, economic margin is considered to be a more encompassing metric, since it looks at the gross assets that are being utilized as well as the capital expenditures that are being requested.

Assessing risk and value

Adding metrics that incorporate a risk component is also important. Many organizations use a set of discount rates adjusted for the risk characteristics of a particular project or business unit, which is often more effective than using one standard rate. Discount rates, however, don't necessarily give adequate insight into the risks. Other possibilities include sensitivity analysis or decision-analysis-based risk-scoring scales, which can help quantify the impacts of risks, particularly across multiple projects. For complex, strategic projects, a probabilistic or stochastic model, such as Monte Carlo simulation or decision-tree models, can provide even more insights.

Given the multitude of projects that corporations run, however, proper consideration should be given to a structured portfolio optimization approach using an efficient frontier. Such an approach can be an effective tool to compare various portfolios of projects, charting the budget size against an expected benefit, such as shareholder value, to find which portfolios can offer the largest value per invested dollar. For example, available funding can be charted on the horizontal axis. As more budget dollars are added, the projects with the greatest likelihood of providing the highest benefit per invested dollar will lie along the highest vertical Y-axis value. Those projects that lie on the efficient curve, or close to it, are more likely to create the greatest value with constrained resources.

When organizations adopt a structured approach using portfolio optimization, it is typical to see a 5% to 10% increase in the value of the portfolio. Besides helping organizations increase project values, such an approach can also save on management time. For example, one large health-insurance company used a portfolio optimization approach for its IT projects, and instead of going offsite for a week to sort through all of the possibilities, its executives were able to identify viable projects in just a two-hour meeting.

Regular review needed

There are both soft and hard benefits of developing a more holistic framework for capex projects. From a soft-benefit standpoint, benefits can include greater efficiency and a focus on value-added activities versus the mechanics of the process. From a hard-benefit standpoint, what can be captured are percentage improvement and return on invested capital based on effective investment of cash. Greater objectivity in prioritizing investments and stronger discipline and alignment with the company's strategic vision are both soft- and hard-benefit by-products.

In addition, choosing a range of metrics to monitor progress and risk can offer greater insight into the effectiveness of capex projects. But to be truly effective, capital expenditure planning requires periodic review. Regular meetings held by a capital planning group, supplemented with monthly and quarterly reviews, provide visibility into how the portfolio is doing, where the money is being spent, and whether the company is getting the returns it wants. Such reviews also offer the opportunity to review and reset the capital budget, as well as the ability to pull the plug on poorly performing projects and reallocate resources to more-promising ones.

*All numbers with an asterisk are averages that have been adjusted to eliminate the effects of stark outliers.

Endnotes

[1] *CFO Signals*, Deloitte U.S. CFO Program, see 1Q2013.
[2] "Optimism rises, caution remains;" *The Deloitte CFO Survey, Switzerland*; 1Q2013.
[3] "Fewer risks, greater optimism," *The Deloitte CFO Survey, UK*; 1Q2013.
[4] "Capital productivity: Creating value through capital expenditure planning;" Deloitte Dbriefs, May 2012.
[5] "Capital productivity: Creating value through capital expenditure planning;" Deloitte Dbriefs, May 2012.

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