

Capital productivity  
Creating value through  
capital expenditure planning





### What separates a good company from a great one?

Often it is an organization's financial strategy; its capital productivity framework. For leading companies within the S&P 500, more than 25% of their market value can be accredited to expectations from unidentified, future investments. The proficiency with which a company can raise, deploy, and distribute its capital directly impacts shareholder value (capital productivity). Attention to capital expenditure (CapEx) planning, the process by which an organization sets capital allocation targets and builds towards an optimized leveraged project portfolio, is paramount to generating and sustaining stakeholder value.

CapEx planning is top-of-mind for many executives, with good reason. Corporations today sit on a stockpile of cash, to the tune of \$2 trillion, a whopping 33% increase from prerecession levels in 2007. Many companies, now more than ever, are in a position to leverage capital investments for gain. International Strategy & Investment<sup>1</sup> polled 98 organizations across 16 industries with annual sales representing approximately 12% of the national GDP. Most frequently, chief financial officers (CFO) polled projected capital expenditures as one of the top two incremental uses of cash for 2012. Deloitte's CFO Signals Survey<sup>2</sup> revealed that nearly two-thirds of CFOs interviewed pegged capital investments chief among competitive advantages in 2011. In fact, on average over the next year, many companies expect to boost capital spending by 12% — the most significant surge since Deloitte began conducting its quarterly survey.

Nearly half of CFOs interviewed cited deep concern about the quality of investment decisions. Only five years since the onset of the economic recession, deployment of capital investments in the present landscape requires decision-makers to be prudent custodians of capital, armed with a systematic process. Leaders should be able to pinpoint CapEx's core purpose — how the function drives value in the organization, targets existing gaps, and forecasts potential risks. Miscalculating an opportunity

comes at the expense of shareholders, and no enterprise needs a panicked shareholder. Companies should assess whether their current capital investments align with market predictions as a failure to meet expectations translates to diminished share price and overall organizational value. In order to increase the likelihood of high returns and emerge stronger from a fragile market, an organization should equip itself with a broad methodology to capital productivity and risk mitigation.

Yet as the marketplace evolves, so should an enterprise's approach to capital productivity. Adaptability becomes a premium asset. To triumph, companies should define CapEx with a precise strategy buoyed by the ability to nimbly change course as real-time information comes to light.

What common barriers impede effective capital expenditure planning? The shared set of challenges endemic to corporations spanning a wide range of industries is a lack of the following attributes:

- A strategic framework
- High level of commitment to the process
- Accurate metrics and measures for evaluation
- Standardized processes to govern decision-making
- Proper organizational skill set

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<sup>1</sup> International Strategy & Investment Web of Knowledge Survey, "Top 2 Incremental Uses of Cash for 2012," November 2011.

<sup>2</sup> Deloitte LLP CFO Signals Report, Second Quarter 2011.

### How to construct a strategic framework

Merely having a CapEx process in place may not be sufficient evidence that the conversation doesn't need to change. All too often, capital projects may not effectively leverage their potential by failing to integrate a company's overall strategy. As is the nature of any flimsy structure, it unavoidably drives erratic processes, which can then hinder proper prioritization of projects based on value and risk, resulting in miscues. This type of breakdown carries a risk for exponential fallout because capital projects seldom work in a vacuum; more often, multiple projects work symbiotically, underscoring the need for an effective mechanism to assess projects. Leaders should cross-reference capital investments with the company's strategic goals in order to pinpoint areas where capital spending should increase or decrease based upon gaps or redundancies. Ultimately, this meaningful exercise can help to determine proper fund allocation, enhance the quality of project submissions, and better position an organization to reach its performance targets.

In order to leverage capital allocation objectives, leaders should establish a standard set of factors for consideration, including:

- Analyze economic performance
- Review historic spending patterns
- Translate strategic plan into tactical evaluation framework
- Evaluate market and industry expectations
- Estimate required capital commitments
- Incorporate constraints

Economic margin<sup>3</sup> performance is a leading driver for tactical decisions. A multi-dimensional metric, economic margin, links revenue, cost, and asset efficiency in order to provide a close/correct correlation to shareholder value. As a company's asset growth trajectory accelerates forward, a shift in capital allocation target occurs, contingent upon economic margin performance. Leaders should use the momentum to forge the path ahead with steadfast awareness and measurement of how capital project portfolios align to the organization's overall strategic goals.

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## The approach should be holistic, fusing capital expenditure with operating expenditure.

### How to bolster commitment

Companies don't get to swim with the big fish by doing things in half-measures. Implementation of a compelling capital productivity plan enlists the entire organization, top-down, to row upstream together. It is important to have the involvement of appropriate leadership levels when it matters most. The board of directors and c-suite establish a strategic focus and urgency. Top executive/corporate managers hone in on the most critical capital projects, approving allocations. Capital planning groups manage and monitor portfolios, cull information, and assess project progress. Business groups generate business case templates, produce investment ideas linked to the organization's strategy, and execute capital investments to secure projected returns.

The approach should be holistic, fusing capital expenditure with operating expenditure. Capital planning spend should drive direct benefits to a company's operating plan, the two functions working in concert.

Furthermore, CapEx planning should be a living process, evolving with the marketplace. It cannot be relegated to annual assessments, but instead should be monitored with intentional regularity; e.g., ongoing auditing, monthly evaluation, quarterly reallocation, and certainly ad hoc responses to any major market shifts. An organization's degree of commitment to any effort is typically directly proportional to the amount of time allocated. Considering the enormity of the value proposition and potential returns, the CapEx planning process merits a substantial investment in time.

<sup>3</sup> Economic margin (EM) is a trademark of AFG, Ltd.

### How to devise evaluation methods

Innovative capital planning evolves beyond comparing individual projects to leveraging ideal portfolios of projects for any funding level. As such, the direct and indirect value of each project should be measured; effective tools are essential elements of project evaluation. Tangible and intangible valuation metrics are the foundation of a broad prioritization model, allowing practitioners to calculate value versus risk in varying levels of sophistication and decision support. A typical solution includes tailored, intuitive business case templates, simplifying collection, comparison, and aggregation at the portfolio level.

By making pragmatic use of tools and techniques gathered from decision analysis, portfolio management/leveraging, and data visualization, Deloitte's approach is designed to provide streamlined decision-support offerings customized to an organization's particular CapEx planning agenda. Such approaches can help facilitate the following capabilities:

- Assess and quantify strategic benefits along with financial benefits
- Incorporate risk and project interdependencies in the evaluation criteria
- Identify which portfolios of projects return a higher value for the funding level
- Utilize a management dashboard showcasing the data required to run "what-if" scenario analyses and portfolio management

In order to enhance the efficiency of existing processes, Deloitte counsels clients on an effective and beneficial governance model. We build an integrated tool as a leave-behind resource to be used to manage/leverage CapEx portfolios year after year. A dashboard of rigorous metrics allows practitioners to probe and map portfolio effects, including interdependencies, multi-year horizons, deferral options, and alternate funding levels; this approach provides a multidimensional selection process for capital portfolios at various funding levels.

### How to streamline processes

CapEx planning is an iterative progression of pursuits: set allocation targets, build capital budgets, prioritize projects, and manage effective portfolios. Each series of incremental activities delivers a specific output.

When it comes to the selection of large capital projects, some companies have a handle on matters; yet these same organizations may lose their grip on small, high-volume projects. Others have a knack for choosing low-dollar, high-volume projects, but flub high-dollar decisions. Both patterns sacrifice plenty of potential value in the longterm. Corporations should have and/or establish standardized procedures to govern the CapEx planning life cycle and decision-making process, reducing subjectivity.

Companies use capital in diverse ways. The hallmark of effective CapEx planning is to ensure acute awareness of a corporation's investment profile. A company can be categorized into a specific CapEx archetype framework — each with its own distinct investment features that determine a prudent approach to capital budget forecasting. Archetypes range from the "capital exploiter," the most extreme, scale-driven industries (e.g., telecommunications, automotive, semiconductors, and aerospace and defense) to the "capital minimalist" (e.g., professional services, banking and securities, insurance, and private equity). The capital exploiter's potential competitive advantage is capital, while capital assets are a necessity of doing business for capital minimalists.



### How to reinforce human capital

Deployment of any program is only as dynamic as its talent. In addition to capital constraints, the appropriate human resources to execute and manage capital projects become a real limitation to the enterprise. A fruitful outcome requires project managers who oversee daily operations and supervise projects to completion, technical resources with company-specific technical knowledge, and subject matter specialists whose collective insight embodies a critical source of guidance.

In order to deliver a CapEx plan, an organization should assess its collective resource pool — internal, external, and outsourced — adapting decisively to shore up any gaps in skill set. Financial practitioners at every level should be required to adopt the approach, accept it, and repeat it, speaking a common language. A company's people strategy and business strategy should sync together.



### Benefits

CapEx planning is a vital engine of growth. A penetrating capital productivity framework brings with it pervasive gains by boosting stakeholder return and overall organizational value while mitigating risk. In addition, the approach can improve portfolio returns, fine-tune monitoring and reporting protocols, and enhance mechanisms for adjusting projects. Further benefits comprise expanded process efficiency, deeper alignment of strategic vision, and enhanced data accuracy and decision-making.

In this new landscape, old structures will not likely endure. No one is immune to a fickle market, and companies who survive are readied and steadied to leverage capital productivity. An effective strategy to counteract a delicate economic environment and transcend shareholder value is to make CapEx planning a core competency tightly woven into an organization's corporate fiber.

### Contacts

#### Miles Ewing

Principal  
Deloitte Consulting LLP  
miewing@deloitte.com

#### Charles Alsdorf

Director  
Deloitte Financial Advisory Services LLP  
calsdorf@deloitte.com

#### Tim Gross

Senior Manager  
Deloitte Consulting LLP  
timgross@deloitte.com



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