Capital efficiency in a volatile market: Stop burning capital

In a recent poll of 2,000 financial executives who attended a Deloitte Dbriefs webcast, a majority identified capital deployment as the biggest challenge they face in their capital planning processes. Moreover, they considered it a significantly greater challenge than raising capital or distributing it to stakeholders. For this survey, deploying capital was defined as maximizing returns associated with capital expenditures and mergers and acquisitions; maximizing working capital; effective balance sheet and cash-flow planning; and optimizing capital mobility, including international repatriations.

It is hardly surprising that financial executives are challenged with capital deployment today given the financial, political, and regulatory uncertainties buffeting markets worldwide. Some global companies add to this uncertainty by spreading capital evenly across geographies under a "what works in North America works elsewhere" approach. Besides coping with the upheavals of external market conditions, they may also struggle with internal issues, such as cultures with entrenched habits, which might be even more difficult to address.

Adding even more complexity to the capital planning process are challenges such as:

- Developing quality business cases that are aligned with strategic priorities
- Estimating the financial and strategic value of diverse projects
- Quantifying project risks
- Comparing project benefits and risks
- Building buy-in and consensus on which projects to fund

So how can financial executives overcome these challenges in their capital planning and deployment processes?

Effective capital planning and deployment occurs at three levels of an organization: corporate, project portfolio, and individual project. Organizations can benefit from taking a more holistic approach (Figure 1) to capital planning that links corporate-wide activities to both the portfolios and individual projects, and tracks it all in a consistent manner.

Framing capital deployment decisions

An essential element of a holistic approach to capital deployment is a structured process for framing decisions effectively and establishing processes and controls so that those decisions are carried out as planned. A decision framing process is essential because it helps identify as well as clarify the drivers and uncertainties of each capital project's business case, and questions that can facilitate sounder decisions.

Effective decision framing has three key ingredients:

- *Assembling the right stakeholders* helps facilitate an organization's ability to develop a comprehensive perspective about the potential values and risks of proposed capital projects.
- *Creating a good brainstorming environment* allows participants to speak openly and honestly about risks.
- *Asking hard questions* leads to sounder decisions. How can this project turn out worse than expected? How could your assumptions be wrong?

The results of this brainstorming and discussion process can then be represented visually in a risk factor map, illustrated on the left of Figure 1. The map shows stakeholders how different decision points relate to each other and to the overall capital planning process.

One company that employed this decision-framing exercise identified value improvement opportunities in the design and workflow that reduced the capital required for a large project. Framing also helped this company recognize that the project had more downstream flexibility than originally believed. At the end of the process, the company had a more positive probabilistic risk profile than previously projected, resulting in valuable insights into the relative value and risk of the project (Figure 2).

Figure 2: Probabilistic risk profile

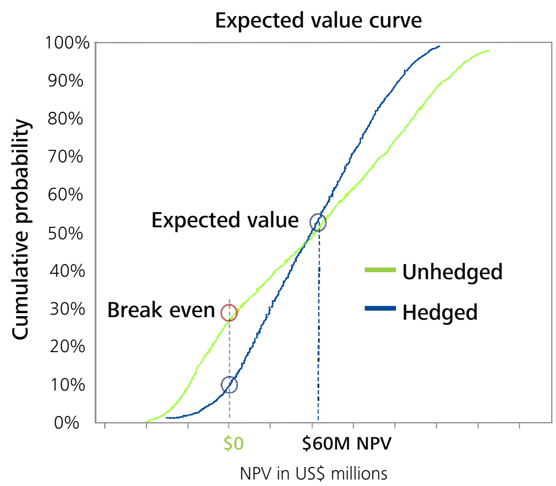
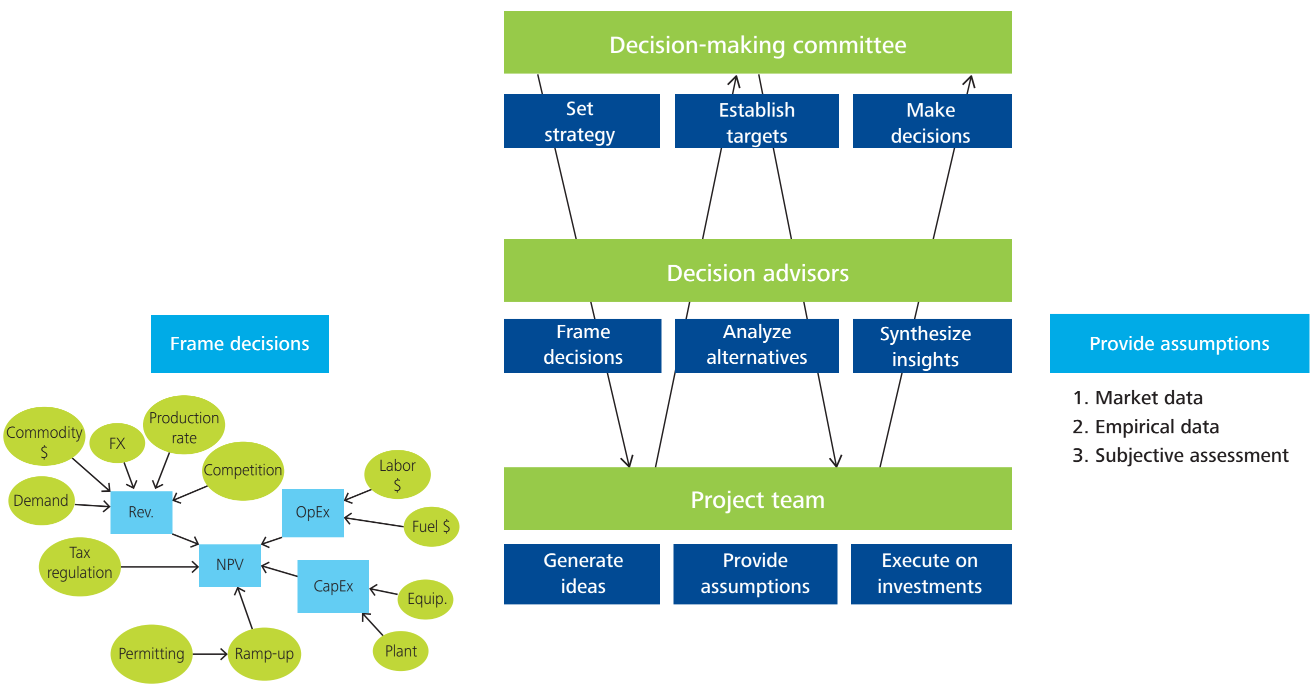


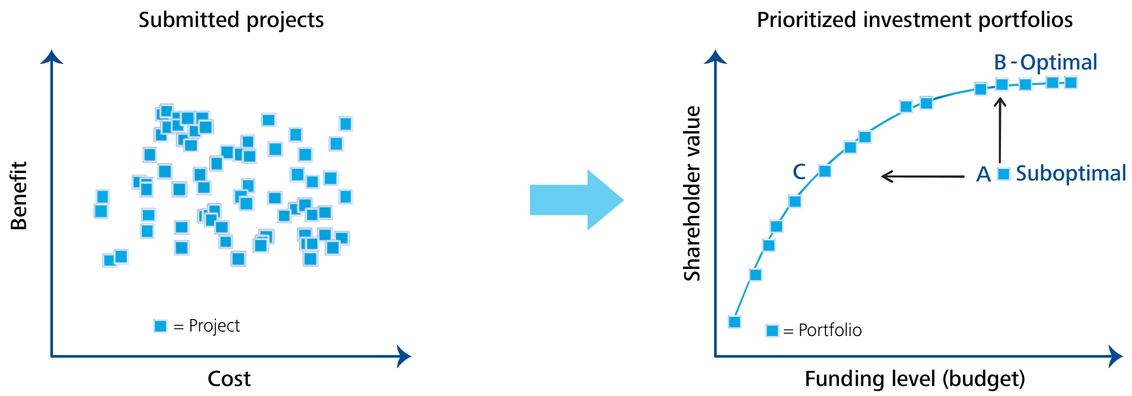
Figure 1: The three levels of capital planning



Portfolio management's impact on capital deployment

In addition to an effective decision-framing process, companies may benefit from a refined approach to the management of their capital projects portfolios. Project teams and decision advisors can collect a group of project business cases and assemble the related data, yet the decision-making committee still might not have a consensus about how to prioritize projects for capital funding. Understanding the “efficient frontier” from a portfolio distribution perspective can help the committee prioritize investments in alignment with the company’s overarching strategies and shareholder value (Figure 3).

Figure 3: Building an “efficient frontier” of prioritized investments



In Figure 3, and as a company adds more dollars to its capital budget, it should focus on projects — represented by the blue squares on the left-hand graph in Figure 3 — that provide maximum benefit for that funding level. By incrementally adding more capital budget, and identifying portfolios that provide the maximum benefit for each funding level, the efficient frontier becomes apparent in the second graph of Figure 3.

Equity risk premium: a vital metric for capital planning

In the capital planning and deployment context, the equity risk premium (ERP) is an important, but often overlooked valuation factor — overlooked because companies sometimes use a static ERP assumption in the development of a discount rate or hurdle rate without adjusting for the near-constant volatility of markets today. Such an approach can cause companies to overpay for acquisitions or underinvest in capital projects. In a volatile environment, companies should constantly evaluate the assumptions it uses to make capital decisions including using an ERP-calculation methodology appropriate for their circumstances.

Pulling it all together

Capital planning need not be a difficult conversation in an organization. An effective capital planning and deployment process can invigorate an organization, encourage innovation, create linkages across otherwise siloed business units, and lead to a more efficient use of capital. By developing strong business cases, using a defined decision framing process, letting the efficient frontier guide portfolio and project prioritization, and then applying a timely and current ERP to the overall project valuation, companies can improve their understanding of the risks and value of their capital projects.

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