Capital Management: A High-Wire Balancing Act

The value of good capital management is almost priceless, especially in high-spend industries such as telecommunications and utilities. Much in the way a tightrope walker works, success springs from a few basic principles.
A tightrope walker daringly takes on a task that is magnified by the possibility of a great fall. A small misstep can have disastrous consequences. However, the performer has a secret: Focus on a few basic principles and follow them perfectly to reduce the chances of making a mistake.

Managing multibillion-dollar capital expenditures (capex) is also a balancing act where it is easy to lose sight of the basics. People often get distracted by the intricacies of the allocation process, the internal politics, or the complexity of the business case. This last distraction is almost always dealt with by quantifying every aspect of the business case, which may give the impression of “managing all the details” but in reality often results in at least three symptoms of poor capital management:

- **Failure to prioritize.** When capital investments are not linked to corporate strategy and financial targets, it is almost impossible to capture the required level of returns across the portfolio.

- **Loss of accountability.** When accountabilities are not clearly defined, followed, or enforced, and reviews are not conducted (either while in progress or post-implementation), no one owns the outcome.

- **Poor visibility.** Without a corporate-wide reporting structure there is limited visibility into spending and even less control of the investment portfolio. As cost overruns mount and projects slow down, the economics of the original investment case are often lost.

Any one of these symptoms can lead to poor returns for the project and for the entire portfolio. However, four principles—classification, criteria, context, and control—can lessen the chance of a fall.

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**Classification: Think Judiciously**

Classifying capital expenditures into predefined groups will help avoid unnecessary debate and delays. The groups can be based on similar risks, outcomes, or stakeholder characteristics, with the selection criteria likely to vary by portfolio. Although there is no one-size-fits-all way to classify capital expenditures, the following three classifications are considered best practice:

- **Business enablement.** This refers to investments in new business capabilities to deliver new products or services to the market. These projects are usually linked to a company’s strategic agenda and can include launching new business lines, expanding capacity, developing new products or services, and improving efficiency.

- **Infrastructure.** These investments are for maintaining day-to-day operations that do not directly result in revenue growth or cost reductions. Projects typically include refurbishing a factory or office, or investments in new technologies such as core platforms, desktop software, and network upgrades.
Regulatory. Investments in this case are required to comply with mandatory regulations or legislation, or to perform internal or external audits. These generally range from making small changes in the product portfolio or IT capabilities to launching major regulatory initiatives in response to new government legislation. Basel III and Sarbanes-Oxley are good examples from the financial services industry.

In addition to classifying investments by type, best-practice capex management also accounts for the size, nature, and accountabilities within the portfolios. For example, business enablement investments are usually multimillion-dollar projects that require rigorous planning to gain approval. Because the approval process can be long and involve multiple business divisions, a cross-business investment committee is usually established to review, approve, and track these major projects. Such committees have strict project-proposal and assessment processes that typically begin with a feasibility study to investigate the costs, benefits, dependencies, and risks.

There is typically too much focus on portfolio returns and not enough on the risk being carried to achieve the returns.

By comparison, infrastructure investments are usually smaller and can be bundled. For example, managing various small projects under one umbrella might amount to 50 percent of a capital expenditure budget. Here, obtaining pre-budget approvals and actively managing the allocations so they are less than 20 percent of the total capex budget improves investment efficiency.

Criteria: It’s Not Just the Financial Measures

Determining return on investment is crucial when making capital investment decisions. But relying solely on one or two financial measures, such as net present value or payback, can be a mistake as vital factors such as strategic fit, project risk, and urgent time frames are never accounted for. Simple financial measures are also prone to manipulation and creative accounting, which can distort the true investment value. And merely increasing the number of measures will not solve the problem: decision makers tend to aggregate the information presented to them or simply rely on the “system” answer, a formula that effectively has arbitrary weights against these measures.

For these and other reasons, we recommend a multifactor approach to capital allocation (see figure 1 on page 4).

The number of factors must be realistic. Choose as few factors as possible to capture the substance of the business case. Each factor is quantified for comparative purposes using a standardized scoring approach. The relative weight of each factor is tuned over time to better align with the organization’s investment profile. It is often appropriate to adjust these weights to align with the firm’s competitive position in the marketplace.

Detailed scoring and backup analysis are normally required for all large, strategic initiatives, such as a telecommunications company adding a new type of network. Smaller projects, such
as enabling voicemail on an existing private network, may require only a simple cost-benefit budget and risk assessment.

Context: Take a Step Back to See the Big Picture

High-performance capital budgets are actively managed from a top-down portfolio perspective. This helps determine the right balance between competing business needs—for example, large, strategic projects versus smaller projects that generate revenue. It also means balancing low-risk versus high-risk projects, business-unit versus company-wide requirements, and long-term infrastructure versus asset refreshers.

This top-down perspective needs to be maintained throughout the capital management process. It is not enough to construct a risk-adjusted portfolio to deliver the optimal return as part of a capital-planning cycle and sit back. The portfolio needs to be actively managed with projects constantly evaluated to be culled or scaled up, depending on the results achieved by the overall

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**Figure 1**

**A multifactor approach to capital allocation works best**

<table>
<thead>
<tr>
<th>Business and technology strategy fit</th>
<th>Opportunity window</th>
<th>Value-delivery prerequisites</th>
<th>Project risk</th>
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| • Projects classified into one of five categories:  
  — Mandatory  
  — Infrastructure “refresh”  
  — High (directly deliver on strategic objective)  
  — Medium (support or enable strategic objective)  
  — Low (not related to strategic objective)  
| • Project urgency classified into one of two categories:  
  — Benefits can be realized only if implemented within 12 months  
  — Benefits can be realized any time within three years  
| • Agreed standard measure of economic value-add for the project (such as NPV or IRR measure)  
  • Standard methodology:  
    — Standard spreadsheet based tool  
    — Common guidelines for benefit and cost measurement  
    — Business case experts team to ensure consistency  
| • Risk score based on:  
  — Project duration  
  — Dependency on other projects  
  — Technical difficulty  
  — Breadth of implementation  
  — Senior management buy-in  
  — Project size (FTEs)  
  — Local buy-in  
  — Level of change required (organizational and processes)  |

- Projects are given an overall priority from 20 out of 20 to 6 out of 20 based on their scores for these criteria. Process can be automated to generate a scorecard for highest priority projects with the following characteristics:
  — High strategic fit  
  — High technology fit  
  — Opportunity window of less than 12 months  
  — High IRR  
  — Low risk

Notes: NPV is net present value; IRR is investment rate of return; FTE is full-time equivalent.
Source: A.T. Kearney analysis
portfolio. We typically find too much focus on portfolio returns and not enough on the risk being carried to achieve those returns. Further, the project teams tend to focus on absolute risk and absolute return with no visibility of relative risk or return.

Control: Good Governance and Appropriate Accountability

Disciplined governance and accountability processes will help ensure that project proposals are prepared with the appropriate level of detail and accuracy, that investment decisions and funding have been through formal prioritization and approval processes, and that accountabilities are not only monitored but also enforced.

Figure 2
Best practice capital governance structure means effective steering by senior management at all stages

SOURCE: A.T. Kearney analysis
Strong governance begins with developing quality standards for business cases and investment proposals. We found in our recent work with a client that, despite having a good assessment framework, 80 percent of the company’s investment requests had either incorrect business-case assessments or none at all. Our first step was to develop a consistent project-request process and a monitoring mechanism to ensure that everyone follows the procedures.

A decision-making governance structure ensures that senior management makes all major decisions, while minor decisions are appropriately delegated (see figure 2 on page 5). Large corporations usually set up a hierarchy of capital committees that mirrors the accountability structure. Business units, for example, usually make decisions, within certain constraints, about investing to achieve unit objectives. Similarly, the operations team typically makes decisions about infrastructure projects. The portfolios are rolled up to the division and enterprise levels, allowing senior management to look at portfolio decisions and approve, tweak, or override them where appropriate. This system gives each level of management a suitable degree of discretion within a consistent, transparent framework.

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Finally, accountability must flow through to the realization of net business benefits. Too many organizational processes are flawed by inadequate accountability for end results.

Preventing the Fall

Like all high-impact activities, managing capital has potential pitfalls. Achieving a long-term sustainable solution need not be overly complex, however. Focusing on the basic principles of classification, criteria, context, and control can help ensure disciplined and transparent capital allocation. This reduces the impact of poor prioritization, lack of accountability, and poor visibility of spending. Addressing these problems makes it much easier for organizations to prevent a fall from the often precarious tightrope of capital management—and make a positive immediate impact.

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