Assessing Strategic Investments

Recently, I was involved in a discussion about a major strategic investment that a company was contemplating. This investment was a possible game-changer involving the development of an important new business capability.

The key question on the table was: Will the prospective benefits exceed the costs, yielding returns greater than the cost of capital? What could be more obvious?

Two critical questions

In fact, assessing investments using the cost of capital, often called capital budgeting, is not obvious at all. It is a process that seems like second nature to virtually all managers, but one which only a few use correctly.

And it is critically important. If you get it wrong, it can lock your company in place, block your most important initiatives, and prevent you from getting in front of competitors.

Two key questions lie at the heart of sound investment assessment: (1) What is the cost of capital? and (2) How should I assess the value of investments?

Not so obvious

Let's start with the first question: What is the cost of capital? Just look it up in a Finance textbook. It is the weighted average of the company's cost of debt and cost of equity (with a few minor adjustments). Obvious, right?

In fact, the answer is not so obvious.

This seems like a technical question, but in reality it is a very important management issue because it tacitly determines a company's asset productivity.

The cost of capital is actually a composite. It is the weighted average of the risk/return profile of the company's *portfolio* of investments (ranging from buying new machines to developing new product lines) that together constitute the existing business. This portfolio is comprised of some investments that have a very low risk and low return, other investments that have a very high risk and high return, and many in between.

Contrast an investment in a well-tested new machine to improve the efficiency of an existing process, with another investment to develop a new product line. The former investment has a low risk profile, and thus is a sensible investment even if it generates returns that are lower than

the company's composite (overall) cost of capital. The latter has a high risk profile, and thus requires a higher return than the company's composite.

Here's the key point: it is wrong to evaluate each investment by the standard of the company's composite cost of capital – instead the right measure is how its risk-adjusted return compares with relevant investments, those with similar risk/return characteristics, in the company's portfolio.

As a practical matter, I think of three levels of risk/return: low, medium, and high. This makes the task of specifying a hurdle rate (the appropriate cost of capital) much easier.

Strategic vs. tactical investments

The second question – How should I assess the value of investments? – is vitally important to a company's competitive success. The bottom line is that assessing strategic initiatives is fundamentally different from assessing tactical investments.

Tactical investments, which produce incremental improvements to the business, are the appropriate domain for traditional capital budgeting, featuring net present value (NPV) and return on investment (ROI) analysis setting well-understood costs against benefits over time. (Remember that even here, most companies' capital budgeting processes fail to differentiate between low risk/return investments that warrant a lower hurdle rate, from the high risk/return investments that require a higher hurdle rate.)

In the world of major strategic investments, a completely different financial assessment process is needed: one that goes beyond simply adding up costs and benefits to also reflect strategic relevance, the prospective cost of capital, and the payback period.

Bad profits

Should you make all investments that pass the cost of capital recovery test? I wrote a very popular blog about this: *What are Bad Profits?*

The heart of the blog was this illustration:

Investment Decision Matrix

Return on Investment	Low	High
High	*Discipline*	*Yes*
Low	*No*	*Courage*

Strategic Relevance

The essential point is that in assessing investments, profitability alone is not enough – and this is especially true of major strategic investments. The other critical dimension is whether the investment is strategically relevant.

For example, investing in offering a service that is demanded by only a few customers, but not most customers, probably is not strategically relevant and, if so, you should avoid it even if the investment is profitable. On the other hand, investing in a showcase project to discover an important new customer need in your main line of business may well be very worthy in the long run, even if it does not offer immediate returns.

Yet, a simple business case would favor the former investment and discourage the latter. How can this be right?

Consider a profitable investment that is not strategically relevant, which would indeed pass the cost of capital test. What's really happening is that this situation has two hidden costs that typically do not appear in the business case calculation.

First, an investment in a new service almost always exponentially increases the complexity of the business in unforeseen ways, and this increases the cost structure of the whole business. (In general, increasing the volume of existing business creates arithmetically increasing costs, but increasing the complexity of the business creates geometrically increasing costs.)

Second, an investment of this sort generates an inexorable future demand for more resources. Why? Because top managers generally do not really act for purely economic reasons – after all, how can you really estimate the costs and benefits of a service offering five years from now? Rather, at the executive level, they often act to ensure "fairness" – i.e. the executive in charge needs an opportunity to show what he or she can do with this new opportunity. And, it is much easier to start trying to grow an opportunity than to end it because the former is easy to measure, while the latter is difficult because turning it around is "just around the corner."

These issues are central to growing profitability in a robust, lasting way.

Past or future cost of capital?

Let's return to the question of the strategic investment at the opening of this blog. Here the investment was being judged by the current cost of capital, a measure that is *backward-looking* by definition since it reflects the current portfolio of investments made in prior periods. Yet the investment in question was being made to have a quantum effect on the company's *future*.

For a strategic investment that will really change the business, the right measure really includes the *prospective* cost of capital, because it will change the basic shape of the company's risk/return portfolio of investments into the future. It makes no sense to gauge it solely by a measure that doesn't take into account what the strategic investment is designed to accomplish.

Consider a major strategic investment that promised to really change the company's relationship with its key accounts – its islands of profit – accelerating major account profitability by increasing the value footprint, and growing high-potential underpenetrated accounts. In this situation the company would have a high likelihood of actually *lowering its cost of capital*, and a lower likelihood that the cost of capital would stay the same.

Viewed from this perspective, the proper cost of capital to use to evaluate the investment would be a blend of the current cost of capital with *the prospective cost of capital* – the cost *after* the strategic investment was made, and not solely the cost in the absence of the game-changing investment. After all, if the strategic investment has the effect of reducing the cost of future investments, shouldn't this be counted as a major benefit?

This consideration is especially relevant for major strategic investments in public companies, where investment bank analysts' views of a company's prospects can have a major impact on the company's stock price and multiple.

The practical-minded retort is that it is prohibitively difficult to estimate the prospective cost of capital for every possible investment. This is true and compelling. But, it certainly is possible, and indeed feasible, to estimate it for the occasional critical strategic investments that will really change the business.

Managing big risks

So, how do top managers actually assess major strategic investments? An important study conducted a number of years ago found that one of the most important measures actually used by top executives was the discredited measure, payback period.

Payback period is simply the number of years needed to recoup an investment. It is discredited relative to NPV and ROI because it fails to account for the time value of money: two investments may have the same payback period, while the first generates most of the benefits right away and the second generates most benefits at the end of the interval. Clearly, the first investment is superior, even though they both look the same by the payback measure.

So why do top managers pay so much attention to payback period in evaluating major strategic investments? Because a major strategic investment by definition changes the paradigm of the business, creating new value and often provoking competitive response. Therefore it is extremely difficult, if not impossible, to gauge the costs and benefits. It also may well absorb the company's ability to undertake major change for some time. In this situation, a key top management question is: When will we able to make another major strategic move? Payback period provides an important insight into this critical question.

Cost of confusion

I remember working with a major telephone company in the early days of deregulation. The

company served a broad area that included a major metropolitan area with a number of global companies clustered in a few dense locations. These companies were a prime target for new emerging competitors.

As the competitors entered the city and gobbled up the telephone company's islands of profit customers by deploying fiber and offering new services, the incumbent was hobbled and couldn't respond. It lost block after block of its most important business.

Why? Because its traditional business case process required an explicit estimate of costs and benefits for each investment (a holdover from the days of regulation). And, preventing a competitor from taking existing business – preventing the erosion of critical customers – was deemed by the finance group as not counting toward investment benefits because it was too "hard" to quantify.

Here, the erroneous use of a tactical investment evaluation process for evaluating strategic investments nearly cost the company its most lucrative business.

Profit maps into action

Thoughtful assessment of investments is the key to maximizing both asset productivity and strategic success.

For tactical investments, the key is developing a hurdle rate that reflects the right cost of capital for the risk/return profiles of the respective investments. As a practical matter, try bundling the candidate investments into three groups: high risk/return, medium risk/return, and low risk/return. Each group requires a different hurdle rate reflecting its different cost of capital. In this context, the traditional assessment measures, NPV and ROI, are very useful.

Strategic investments, however, are fundamentally different from tactical projects. They require a very different assessment process – one that goes beyond traditional cost/benefit analysis to reflect the strategic relevance, the prospective cost of capital, and the payback period.

The strategic relevance incorporates the important hidden costs of complexity and future opportunity costs, the prospective cost of capital embraces the possibility of game-changing gains that fundamentally alter the company's risk/return profile, and the payback period speaks to the chess-like issue of when the company will be in a position to make its next major strategic move.

In the critical process of converting a profit map into results, wisely assessing investment opportunities is critical. And getting strategic investment assessments right makes all the difference between long-run success and failure.