Finance

Rethinking Capital Allocation for the New Normal:

Re-allocation and Rightsizing towards New Growth and Value Creation

Porsche Consulting
Strategic Vision. Smart Implementation.

INSIGHTS

//01

Companies that systematically allocate capital and rightsize structures far outperform their peers.

//02

Re-allocating capital and rightsizing cost structures are essential parts of both a crisis response and a recovery strategy for the new normal.

//03

Executives, especially CFOs, must act now and take a strategic approach to enable future growth as a basis for sustainable value creation.

//04

Four capital allocation imperatives provide CFOs with a pragmatic toolbox to navigate their companies through these turbulent times.

Rethinking Capital Allocation for the New Normal: Re-allocation and Rightsizing towards New Growth and Value Creation

Systematic capital allocation is a distinguishing factor for successful and outperforming companies in the long term. The current economic crisis, triggered by the COVID-19 pandemic, has highlighted the need to re-allocate capital to those business models flourishing in a new normal and to re-size the related resources and costs accordingly. To leverage this opportunity, CFOs should focus on four imperatives of capital allocation as part of their recovery strategy.

Imperative 1

Update your strategic planning assumptions and evaluate new scenarios

The new normal may change planning assumptions that were recently valid. Updating these assumptions and reflecting on the business drivers behind them is the first step in predicting long-term planning implications. The following reevaluation of future strategic scenarios is a key prerequisite for capital re-allocation.

Imperative 2

Challenge your current business, product, and market portfolio

The most promising business models, products, and markets require further strengthening to compete successfully in the new normal. Low-performing businesses, on the other hand, may require revision, with a potential re-allocation of capital to more promising ones. In times where liquidity is key, a rigid evaluation of future products and markets offers a special opportunity for long-term performance increase and a strategic re-allocation to new businesses.

Imperative 3

Rightsize your capital, cost, and resource structure accordingly

With changed planning assumptions, updated strategic scenarios, and a revised view of the business portfolio, all variables are set to dig deeper into operations. Rightsizing capital and cost structures according to these new premises increases liquidity and supports growing businesses with additional resources.

Imperative 4

Systematically deploy re-allocation measures in the organization

The most important step to bringing capital allocation to life is defining and implementing the right measures to achieve the rightsized capital structures. With concrete initiatives for the short-, medium-, and long-term horizon in hand, CFOs are well prepared to recover from the current crisis and create sustainable value.

From short-term survival to long-term growth

"Over time, the skill with which a company's managers allocate capital has an enormous impact on the enterprise's value."[1] According to Warren Buffett, systematic capital allocation is a distinguishing factor for successful and outperforming companies. These enterprises create value by allocating capital to the right businesses and, at the same time, ensure that these businesses are running efficiently. This holds true for periods with solid economic growth and offers a competitive edge in times of economic downturn.[2] The current economic crisis, induced by the COVID-19 pandemic, has brought decade-long growth to an abrupt halt. After the market capitalization of S&P 500 companies increased by 14 percent per annum from 2010 to the end of 2019, the same companies saw 30 percent of their market value vanish within four weeks.[3] The first quarter of 2020 witnessed performance drops across almost all sectors, with profit decreases of up to more than 100 percent—although lockdown interventions in most western countries have been in place since March and thus affected the first quarter with a mere couple of weeks. Even though the outlook for tech and pharma companies remains positive, capital market analysts estimate recovery times of between two and four years to reach precrisis profit levels, underlying mostly U- or even L-scenarios in their forecast models for almost all sectors, as illustrated in figure 1.

	Current performance profits Q1/2020	**Estimated recovery** until pre-crisis profits	**Underlying growth scenario** shape
Aerospace	-120%	2–4 yrs	L
Automotive	-60%	2–3 yrs	U
Industrial Goods	-40%	3–4 yrs	L
Banks	-35%	3 yrs	U
Insurance	-10%	2 yrs	V
Foods & Refreshment	-5%	<1 yr	S
Tech & Software	+5%	–	T
Pharma & Medical	+10%	–	T

© Porsche Consulting | Various investment analyst estimations as of July 2020, S&P Capital IQ

Figure 1. Impact of COVID-19 crisis on current performance (profits Q1/2020) and recovery time (until precrisis profit level) across industries, based on quarter reports and investment analyses for the largest public companies from selected industries.

[1] Buffet and Connors 2009.
[2] Compare Gulati and Nohria 2010, Frick 2019, Flammer and Ioannou 2018.
[3] Porsche Consulting analysis, S&P Capital IQ.

Despite the negative outlook and obstacles to overcome, any crisis comes with opportunities. Empirical studies from major economic recessions[4] show that companies can outperform their peers in the medium- and long-term with the right strategy during a crisis. Nine percent of companies were able to recover from the respective crisis faster and far stronger than their competition. One key element of a quick recovery strategy is a systematic approach to capital allocation. Certainly, for most CFO organizations short-term liquidity management is priority number one now. However, we believe that by adapting a more strategic and holistic approach to capital allocation, the CFO holds the key to navigating an organization through turbulent times. Now more than ever, the balancing act of fueling future growth opportunities and simultaneously trimming existing business toward high performance depends on applying appropriate capital allocation mechanisms. Successful CFO organizations now follow four capital allocation imperatives to quickly regain track and outperform their competitors, as figure 2 shows:

Imperative 1

Update your strategic planning assumptions and evaluate new scenarios

Imperative 2

Challenge your current business, product, and market portfolio

Imperative 3

Rightsize your capital, cost, and resource structure accordingly

Imperative 4

Systematically deploy re-allocation measures in the organization

Figure 2. Porsche Consulting's four imperatives to successful capital allocation

First, assumptions for the strategic planning and potential new business scenarios need to be evaluated to account for a new normal that might require an adjustment to strategy and operations. Next, the product strategy requires a thorough assessment. Changes in product lines, market coverage, and market timing need to be considered in light of potentially scarce liquidity and changed demand. Accordingly, a re-allocation and rightsizing of capital may be required to account for strategic changes. Finally, the re-allocation of capital and rightsizing of resources need to be systematically deployed in the organization with specific initiatives and mechanisms.

[4] From 1980–1982, 1990–1991, 2000–2002 and 2007–2009. Compare Gulati and Nohria 2010, Frick 2019, Flammer and Ioannou 2018.

PROFESSOR RAPP ON
CAPITAL ALLOCATION AND VALUE CREATION

// AS COOPERATION PARTNERS IN THE FIELD OF CFO VALUE CREATION, PORSCHE CONSULTING AND PROF. RAPP DISCUSSED THE IMPLICATION OF THE CURRENT CRISIS ON CAPITAL ALLOCATION. PROF. RAPP'S RESEARCH COMPRISES ASPECTS OF CORPORATE GOVERNANCE, MANAGEMENT ACCOUNTING, AND CORPORATE FINANCE.

Prof. Dr. Marc Steffen Rapp
School of Business and Economics,
Philipps-University Marburg,
Head of the Management Accounting Research Group

Professor Rapp, why is a stringent approach to capital allocation important in times of crisis?

Prof. Rapp: Capital allocation translates corporate strategy into action. As such, capital allocation orchestrates a firm's business, product, and market portfolio, defines its future composition, and thus provides the basis for any value creation within the firm. When a crisis occurs, management must try to anticipate temporary short-term effects as well as long-term consequences. Regarding the temporary effects, management must carefully revise the orchestration of the firm's portfolio. This often means implementing short-term measures that ensure financial and operating flexibility, such as short-term (working) capital adjustments to secure financial liquidity or short-time work to reduce operating costs. Regarding long-term consequences, management must revisit its corporate strategy and redefine the portfolio composition to enable future value creation in a new-normal scenario. For many sectors, the current COVID-19 crisis is presumed to have profound long-term effects, which will change the fundamental economics of many business models. The airline industry and the retail market are among the most obvious examples, but there are many more. An important aspect in this regard will be “reshoring” and redesigning global value chains.

Which mistakes should executives avoid?

Prof. Rapp: When humans face a previously unknown, potentially dangerous situation, they tend to focus immediately on near-term survival—a deeply rooted response. Executives facing a crisis, however, should try to stay focused on value creation, that is, the two-dimensional construct reflecting both operational excellence, secured by short-term measures, and future growth potential, taking into account the long-term consequences of the crisis. Operational excellence in a crisis means quickly implementing the necessary short-term measures, as room for maneuver will shrink rapidly. For instance, if necessary, assets should be sold quickly, as prices will diminish over the crisis cycle and bargaining power will vanish. However, management should not stop here, but take a strategic standpoint and focus on enabling future growth. Anticipating the new normal, management should transform the business and focus on the most promising playing fields. This may come with significant restructuring needs, or the need for rightsizing initiatives, and often only divestitures will provide the necessary cash to invest in new, promising businesses.

Furthermore, executives should be aware that governance issues and stakeholder management remain important in crisis times. Activist investors will be back in the game in the second half of the year, and reputation among customers and communities is fragile and easily destroyed. Finally, history has shown that it is very valuable to have talented and motivated people on board once the crisis has passed and business starts roaring again.

Looking forward, what future challenges do you see for capital allocation?

Prof. Rapp: In the near-to medium-term future, the challenge of capital allocation will be twofold for many corporations: enabling technological progress (toward digitalization) and ensuring compliance with ESG[5] expectations. Both will provide the basis for more sustainable and more resilient business models. For example, ensuring ESG compliance will not only ensure that businesses become less vulnerable to future regulatory interventions and shifting customer behavior, but also secure sustainable access to capital, as more and more institutional investors add ESG criteria to their portfolio selection processes. The EU is willing to proceed with their New Green Deal, and climate change and “Green Finance” initiatives will soon return to the agenda.

[5] ESG stands for environmental, social, and governance.

Imperative 1

Update your strategic planning assumptions and evaluate new scenarios

Successful companies allocate capital and resources according to their long-term financial and strategic planning. The current COVID-19 crisis, especially with its restrictions on free movement, reveals that many basic premises of this planning might no longer hold true. Macroeconomic assumptions have inverted from a +3.3 percent growth projection for the 2020 global economy as of January to a -3.0 percent contraction three months later, and -4.9 percent as of June 2020, with the Euro area even more affected with a -10.2% growth projection for 2020.[6] Demand for specific products and services fell for most industries and will take years to climb back to precrisis level, varying by sector and region. Despite a multitude of state aid programs, availability of sufficient cash varies widely. Some industries, like automotive suppliers, see their already small cash reserves diminishing at a rapid pace. Further examples of currently changing assumptions are depicted in figure 3.

MACRO ECONOMY

- GDP growth
- Population growth & distribution
- Commodity prices

REGULATION

- Trade & customs tariffs and constraints
- Environmental & social legislation

MARKET DEMAND

- Segment-specific demand forecasts
- Customer price sensitivities

FINANCIAL GUIDELINES

- Capital accessibility
- Investors' return expectations

TECHNOLOGY

- Technological availability & readiness
- Costs of usage

SUPPLY CHAIN & FOOTPRINT

- Reliability of supplier network
- Localization of production sites

Figure 3. Assumption categories for strategic planning with selected examples

[6] Compare IMF 2020a, IMF 2020b and IMF 2020c.

At this point in time, the CFO organization needs to evaluate and disclose potential vulnerabilities of the current strategic planning to the same extent as with global supply chains and production systems. Three activities marked by an objective perspective will help to reassess the new normal in light of the current planning:

Differentiate between short- and long-term effects

After having secured near-term survival with short-term liquidity measures and preparing the full ramp-up of operations, it is crucial to now focus on the long-term effects of the new normal, such as changed consumer behavior or a generally less robust supply chain due to transportation restrictions.

Update existing scenarios with new parameters

The long-term effects of the new normal need to be translated into updated parameters for the most relevant business drivers of existing scenarios. Updating basic assumptions provides guidance for creating a robust set of future scenarios and predicting the corresponding implications. For instance, massively reduced on-time delivery rates for just-in-time production systems, with simultaneously increased transportation costs, can result in ruined business cases for formerly profitable production sites.

Use different perspectives to generate new scenarios and evaluate strategic initiatives

Consequently, it is important to simulate new strategic scenarios to outline the challenges of a new normal. For instance, in addition to delivery shortages in the supply chain, further trade restrictions for specific regions might require a more localized production footprint, with factories closer to the end customer, as well as insourcing of formerly purchased production steps.

Faced with the complexity and variability of future scenarios, the CFO organization can act as a navigator that enables proper decision-making, such as whether current strategic initiatives are still the right answer to upcoming challenges, and whether they still provide an appropriate cost-benefit ratio. This analytical process provides the foundation for necessary adjustments of the corporate planning and overall strategy. Simultaneously, the strategic scenario update initiates the next step in the capital re-allocation process.

Imperative 2

Challenge your current business, product, and market portfolio

As capital and resources—especially management attention—are even scarcer in a crisis, it is vital for not only near-term survival but for future growth in the new normal to focus on the most promising opportunities. Executives need to systematically rethink the planned portfolio of business models, products and services, and market coverage. Business cases for new market entries that were once solid might now take much longer to break even; planned products for specific segments might fail to address customer demands, while other products with rising demand might be missing in the product pipeline. New business models, once on unsteady ground, might no longer yield any return at all.

Re-allocate capital along the life cycle

While realigning the planned portfolio, executives need to find the right balance between investment opportunities within the current core business and future business. A systematic approach to capital allocation can serve as a first guideline to help reshape the business portfolio by focusing on three investment "buckets" along the life cycle of business models. Around 70 percent of capital—that is, not only capex but especially R&D spending, financial investments, and resources—should be committed to current core activities, approximately 20 percent to adjacent businesses, and about 10 percent to transformational businesses that do not yet exist. Companies roughly following this rule statistically deliver significantly higher long-term returns than those who do not follow this guideline.[7] Especially during economic downturns, this becomes a valuable competitive advantage.[8]

Prioritize business cases for each life-cycle cluster

Within these investment "buckets", a variety of business models, products, services, and markets need to be prioritized. It is important to not only prioritize the planned portfolio components but consider inactive business models, new product and service ideas, and undeveloped markets. Promising M&A targets can also help complement the target portfolio, especially during the short time frame of a crisis, when valuation multiples are considerably low.[9] Regarding each potential portfolio component as a business case in which the company can invest benefits the decision-making process. Based on our experience with various clients, two main criteria help senior management to focus on the most relevant opportunities:

Value contribution:
a quantitative evaluation of future returns compared to required capital, accounting for both value drivers performance, and growth expectation.

Strategic fit:
a qualitative assessment of contribution to the corporate vision and mission, an evaluation of further synergies with the portfolio composition, and impact on ESG factors.[10]

[7] Compare Voehl et al. 2019.
[8] Compare Gulati and Nohria 2010, Frick 2019, and Flammer and Ioannou 2018.
[9] Compare Salsberg 2020.
[10] ESG stands for environmental, social, and governance.

As figure 4 illustrates, the business case portfolio can generally be divided into four segments. The focus of the capital and resource allocation must be placed on those businesses, products, and markets with **high value contribution and high strategic fit**. Promising business models within the currently planned portfolio require sufficient capital to deliver returns. New ideas for products and services need to be added continuously to the existing portfolio; strong markets and regions can be expanded to generate higher returns and growth. All in all, these components will make up the future core of the portfolio and create most of the value.

Businesses and products with **low value contribution and low strategic fit** need to be carefully examined regarding their future viability. Screening the market for potential carve-outs of current, but no longer planned portfolio components, or at least monetarizing existing but no longer used assets, gives additional financial leeway. Freed capital and resources can then be used to finance better suiting portfolio opportunities.

Executives can consider those opportunities with a **high value contribution but low strategic fit** as financial assets to skim returns and dividends. For these components of the portfolio, it might be suitable to assume a financial holding perspective, with limited management attention and invest activities to stay viable and deliver cash flows, but without holding up capital or resources required elsewhere.

Those opportunities with **high strategic fit but low value contribution** might be a necessary part of the portfolio as enabler for further but hardly quantifiable growth. Selected business cases, that develop synergies with the rest of the portfolio composition can still represent value creating portfolio components as for instance a regional branch for a strategic customer in an otherwise unattractive market, or a product that delivers low return but high impact on the social perception of the brand.

Having challenged the current portfolio, companies should then adjust the allocation of capital and resources as part of their strategic planning. A holistic capital allocation approach goes beyond merely selecting prioritized business cases. It must be accompanied by target setting to achieve the right-sized capital, cost, and resource structure. Under the impact of COVID-19, for instance, the German rental car company SIXT quickly responded to lowered demand by reducing its fleet by 13 percent, initiating further cost-saving measures totaling €150 million, and expanding its product portfolio in the growing subscription and car-sharing business.[11]

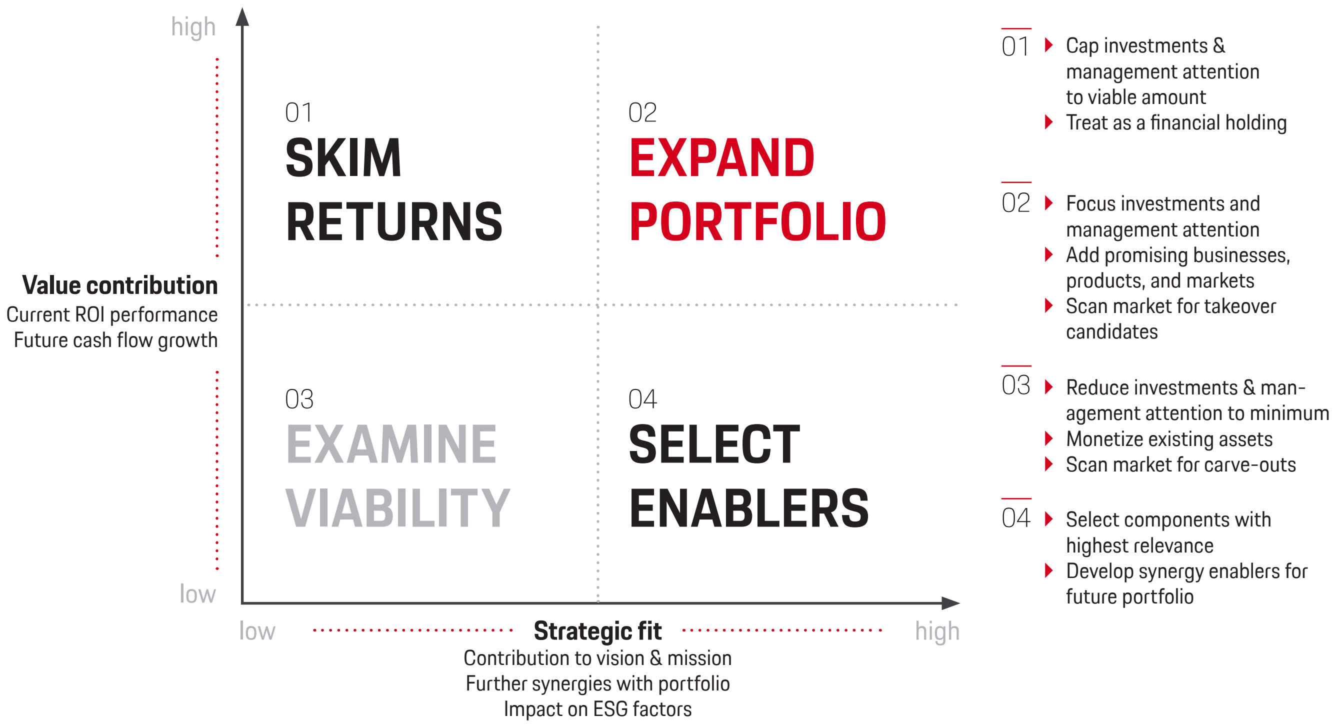

Figure 4. Criteria matrix for business case portfolio applied to business models, products, and markets.

[11] Compare SIXT 2020.

Imperative 3

Rightsize your capital, cost, and resource structure accordingly

Redefining the business, product, and market portfolio also requires a re-allocation and rightsizing of cost structures. For further operationalization of strategic portfolio decisions, it is vital for the CFO to set appropriate targets. Planned budgets need to be revised, sometimes even from scratch, to reflect updated strategic assumptions. A top-down and benchmark-oriented approach can be applied to translate the future portfolio into measurable targets. Generally, four key recommendations are relevant to derive rightsized targets:

Take an investor's perspective

From a capital allocation and investor perspective, each portfolio component represents a business case with a required investment and an expected return. Hence, earnings as well as the required size of investment should be considered in the process of translating general capital allocation guidelines into operational budgets. Return on investment (ROI) can be used as a central steering KPI. ROI adequately focuses on balancing both the input, resources and capital costs, and the output, revenue and profit. The ROI's return-on-sales component offers executives incentives to optimize the cost structure and increase revenue. In our experience, however, many companies tend to focus their steering model on KPIs based on costs or profit and neglect the effect of bound liquidity and resources on their operations. The ROI's component of capital turnover also accounts for invested capital and its efficient utilization. Executives are thus incentivized to optimize both cost and capital structures to maximize the return on the allocated capital and to set capital free for further value-creating purposes.

Rightsize the most relevant variables

All relevant variables with major impact must be analyzed for both ROI components, return on sales and capital turnover. The return-on-sales component often requires the main cost types to be rightsized, including material, personnel, overhead, and development costs. Capital turnover applies this requirement to additional capex investment, but no less importantly to existing fixed assets and the working capital.

Use benchmarks to define ambitious budgets

One of CFOs' most crucial—and most difficult—tasks is the translation of adjusted planning assumptions into ambitious yet realistic target and budget values. A benchmark-oriented derivation of targets has proven to be a lean approach. Benchmarks not only deliver competitive targets but indicate improvement areas as early as during the budgeting process. Figure 5 (see next page) presents exemplary benchmark inputs to define target values for the most relevant elements of the ROI.

For **material costs**, the source of most costs in production companies, rightsized targets for example can be derived with a product-cost modeling approach for the most important material groups on product level. This delivers input for price negotiations and non-value-adding product features for improvement projects as well. For **personnel costs and overhead costs**, capacity indications from productivity and organizational benchmarks should be combined to size each business unit, functional area, and local entity to be competitive, even if that means halting or outsourcing these activities.

For **development costs** as well as product-related growth **capex investments**, budgets based on project norm costs link the profit and loss statement and balance sheet with the defined product and market portfolio, hinder the use of free budgets for projects outside the strategic direction, and increase the available liquidity.

MAIN COST AND CAPITAL ELEMENTS

EXAMPLE

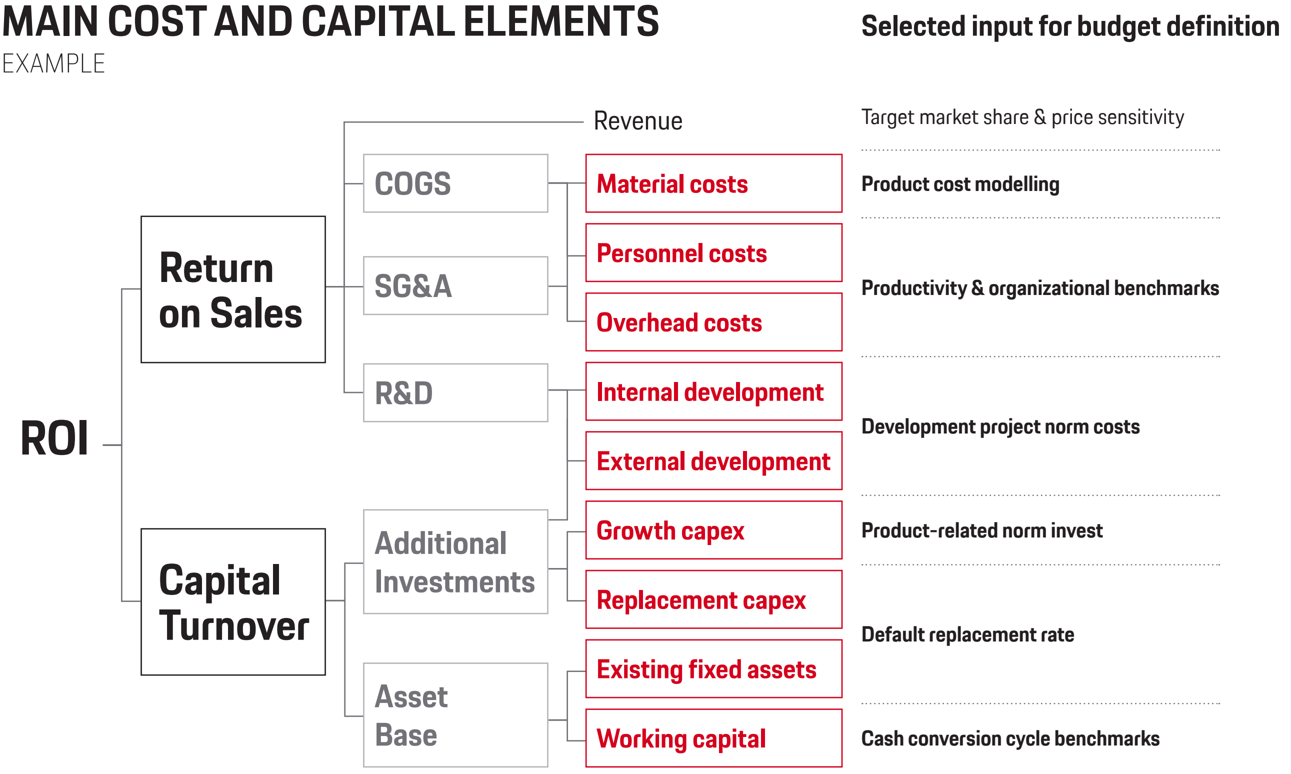

Figure 5. Exemplary input to derive rightsizing targets for main cost and capital elements

Distinguish between downsizing and upsizing

For resources as well as for costs and capital, rightsizing therefore does not necessarily mean downsizing. “Old” business models facing a decreasing revenue perspective, such as Deutsche Telekom’s fixed network connections, will generally be downsized, while new business models, such as fiber-optic communication and 5G networks, will rather receive an upsized capital and resource structure. For business models with break-even points mostly in the distant future, such as smart-home solutions and subscription-based streaming services[12], a traditional ROI and benchmark-based budgeting approach might not be suitable now. Rightsizing must focus on the required structures to reach critical milestones of business development, similar to the approach used by venture capital investors. Hence, rightsizing of new businesses is based less on traditional financial KPIs, such as return on sales, and more on future-oriented KPIs, such as revenue growth or costs for acquired customers. Structures upsized in this manner enable an accelerated, strategic transformation towards growing business models. Even if these portfolio components do not generate profits now, they still create value through a credible growth story and expectation of future cash flows. For a long time, this has been illustrated by Netflix’s high market capitalization despite relatively low profits in the recent years.[13]

By setting appropriate targets and budgets for each component in the defined portfolio, CFOs can gain profound insight into existing gaps to benchmarks and respective operational levers. This proves to be very helpful for the following step that initiates the right deployment measures.

[12] For example, RTL Group plans to break even with their streaming services TV Now and Videoland by 2025. Compare RTL Group 2020.

[13] At the end of 2019 Netflix had a market capitalization of around €140 billion (125; 100) and operating income of around €2.3 billion (1.4; 0.7). Brackets show respective values for 2018 and 2017. Source: S&P Capital IQ.

Imperative 4

Systematically deploy re-allocation measures in the organization

A systematic deployment mechanism is required to achieve the defined targets. Target gaps need to be translated into immediate measures and initiatives. To initiate capital re-allocation and rightsize cost structures, executives need to think along different time horizons, each with a different set of potential re-allocation measures, as shown in figure 6 for selected examples.

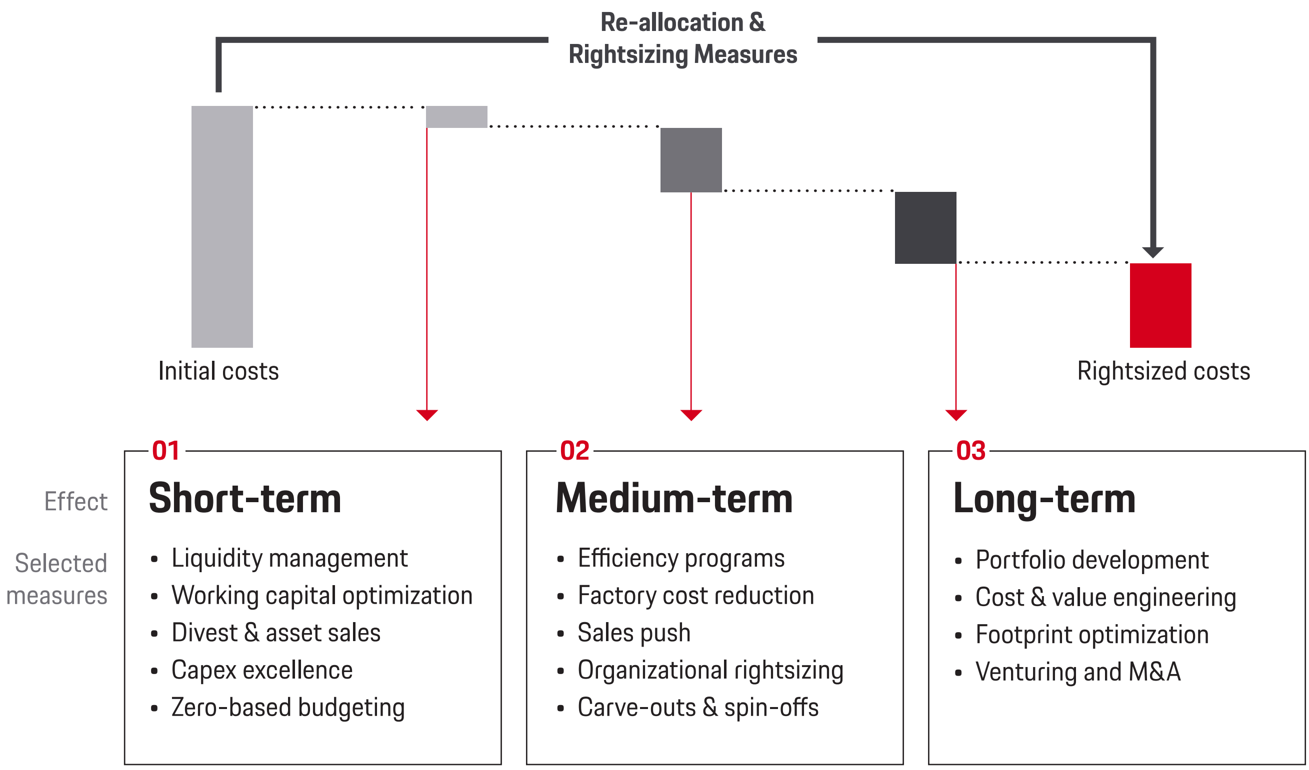

Figure 6. Exemplary measures to implement rightsized cost and asset base structure

01 Short-term measures

Companies ensure near-term survival by initially focusing on measures with an immediate effect. The main rationale is to improve the cash situation and liquidity, for example, with strict liquidity management, resized working capital and capex spending, or even by selling assets that are no longer required. This sets the foundation for a rightsized asset base and raises the cash required to invest in new portfolio components.

In the short term, the cost and resource structure can be tackled as well, for instance, with a zero-based budgeting approach. Thus, challenging all expenses for the remainder of the year in an immediate effort, reduces costs and frees up resources that can subsequently be allocated to strategically crucial initiatives.

02 Medium-term measures

The CFO's medium-term perspective must push operational excellence and sales measures to drive performance and stabilize returns. This is especially true for corporate-wide efficiency programs that focus on indirect areas, but also applies to the reduction of factory costs, which helps achieve the desired cost structure. Furthermore, organizational rightsizing programs may be required to re-allocate personnel on a larger scale, which can even mean carving out or spinning off specific organizational units.

Shifting the focus from short-term survival measures to medium-term oriented operational excellence is a crucial transition to prepare the organization for upcoming challenges of the new normal and the implementation of the adjusted strategic planning.

03 Long-term measures

To see strategic portfolio decisions come to life and unfold their value-creating potential, CFOs must prepare the organization for a longer time horizon of five to ten years. New, innovative business models on the receiving end of capital re-allocation must be nurtured to generate the expected payback. Cost and value engineering approaches for example develop products that deliver true customer value with rightsized material and development costs. Digitalization of the production with a smart-factory approach in a globally optimized production network sets up the structures to produce and deliver products at the right costs.

Starting these long-term strategic initiatives in the nearer future brings to life the adjusted strategic planning with an adapted portfolio and thus achieves the rightsized targets.

Strategic overview, foresight, and a clear understanding of the main rightsizing cost and capital elements with their respective impact—CFOs with these tools in hand are well prepared to manage their company's performance, recover from the current crisis, and drive sustainable value creation.

CFO VALUE CREATION AS THE GUIDING PRINCIPLE:

There is no better time for a value-creating transformation.
Use the crisis to rethink capital and resource allocation.

Now more than ever, CFOs are required to navigate their company through business challenges with strategic thinking, data-driven insights, and prompt decision-making. A company's sustainable recovery strategy must include a shift in focus to the new normal. We believe that a systematic approach to capital re-allocation can provide a valuable head start, to help companies recover from crises faster and much stronger than their peers.

Appendix

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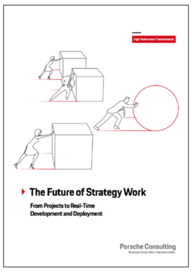

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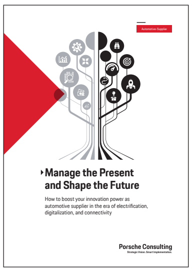

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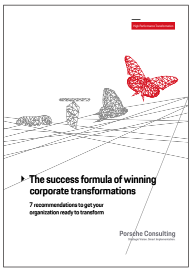

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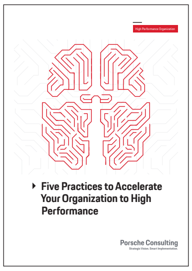

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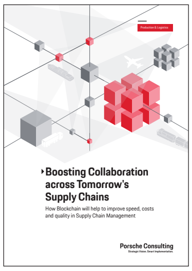

Boosting Collaboration across Tomorrow's Supply Chains

What retailers can learn from China's response to COVID-19

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