



Worth Noting

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Practice Area: Strategy

Evaluating Investment Decisions

The ability to chart the course ahead in an uncertain environment is one of the characteristics of leadership. In business, where charting the wrong course can cost a company its very existence, using the right compass is critical.

In our business, we are confronted by many different methods of making decisions - from the most sophisticated to the least. On the whole, in our view, major decisions are too often made with flimsy supporting evidence. The odds of success are stacked against most ventures, but businesses can significantly improve the odds by following a simple process before undertaking a new investment. While this framework is developed with existing businesses in mind, it is equally applicable to startup companies assessing where they should focus their business idea.

In the absence of any risk, all business ideas would succeed. It is the ever-present risk of failure which ultimately catches up with most companies at the end of the day. Attempting to minimise risk from Day 1, then, is extremely valuable for all businesses. When we talk of minimising risk, we do not mean only taking up low risk opportunities. Rather, we mean minimising risks in the

area we have decided to pursue. Mining will always be risky: but some mining companies are riskier propositions than others. By minimising risk while seeking to maximise opportunity, companies can create real competitive advantage.

In our view, companies need to consider four major issues when developing a new business concept:

- Strategy behind the idea
- Risk
 - Strategy risk
 - Execution risk
 - Capital risk

Strategy

Strategy is a much misunderstood topic. It is vague in its meaning and application. “Strategic advice” and terms of that like are so over-used that the essence of strategy is often overlooked in the corporate hyperbole.

We think that the essence of strategy is actually quite simple. In our view, strategy comes down to one question:

Is what we are doing now, or plan to do tomorrow, rational?

Disarmingly simple as that formulation is, we feel that this is where the real power of strategy lies. Strategy’s role should be to ensure that everything the entity is doing is rational. And to us, “rational” is an onerous test. If there are ten opportunities, it is not rational to focus on the third or fourth best. But so often, largely through lack of diligence, what may be the best option is not even considered. While a business plan can be produced to say that Option 4 will make money over 5 years, what about Option 1? It is not rational to go with anything other than the most attractive option. But often the most attractive option is either not considered at all or left in the too hard basket.

Frequently, the initial thrust behind an investment decision comes from something other than a rational decision making process. Maybe the company’s business development executive has always had a hunch about expanding into Japan and now, with a new CEO, he sees the chance to make his case. Or maybe the head of a business unit is worried that his area is becoming obsolete and so develops a grand plan to get the board’s attention back.

We are not suggesting that these ideas, whatever the motivation behind them, will be followed if they are clearly bad for the company. The business development executive will need to make the numbers work, the head of the obsolete unit will need to provide sound justification for investing in his area. The

ideas might turn out to be successful, but in the absence of a proper decision making process the company will never know if there were better uses of its capital.

Sometimes, companies invest in projects which are not rational at all. The last few years have seen several examples of high profile companies developing core products with razor thin or zero margins. Resources companies have tried to set up Internet businesses with largely the same executives. Scores of companies have developed technology products, with their guiding principle nothing other than “build it and they will come.”

So companies are not always rational. Usually, an apparently “rational” decision is made in the absence of a proper framework for evaluating its suitability for the business. We have some views on how that framework should be applied.

(a) Size of Opportunity

Perhaps the most elementary of all the tools that should be used in strategic decisions. Simply put, how big could this be?

Often overlooked, this is core to the company’s decision. If a company needs to jump through 20 hoops to bring an idea to fruition, and the idea can only ever be a very small part of the company’s business, why pursue it? Maybe it is worthy of a sustained and integrated effort - but the only way to be sure is to do the numbers on the size of the opportunity.

In determining the size of the opportunity, there is one methodology which we believe should sound alarm bells in the ears of CEOs and Boards. This is the technique of assessing the size of the company’s opportunity simply as a subset of the available market. For instance, “Industry X will be a \$10B market by 2005, we project that we will achieve 10% market share, therefore this is a \$1B opportunity to the company”. Such analysis would be laughable were it not so common.

In our view, the size of the opportunity must be built from the bottom up, not the top down. In the example above, the opportunity was claimed to be \$1B simply by estimating a percentage of market share. Even if historically the company garners 10% market share in analogous industries, it is spurious to assume the same will be achieved in the new industry. The opportunity should be assessed by engaging at the level of detail of products, margins, sales targets, and so on. If the opportunity is worth \$1B by 2005, how many products do we need to sell by then? If we are starting at zero today, what sort of a growth rate does that imply? Is it realistic? How many sales staff would we need to sell that volume? Will we need new factories?

Only by asking those sorts of process related questions can the size of the opportunity truly be assessed. Failing to make that assessment is an elementary, and surprisingly common, mistake. Everyone is proficient at designing PowerPoint charts pointing up; a much smaller number are proficient at the hard work that provides a sound basis for such conclusions.

(b) Comparison to other opportunities

Olympic athletes are the best because they beat the available competition. Ideas are the same - the best ones are better than the multitude. But how do you know if an idea is good unless you compare it to others? It's not possible to declare yourself an Olympic champion by running around a track by yourself, no matter how fast you go. Ideas should be forced to compete against others too.

It is not enough that a new business idea has a positive NPV. Finding an unusually good interest rate and investing has a positive NPV too, but nobody would suggest that the company's future hinged on such activities. Net Present Value is the right tool to use to evaluate the attractiveness of a new business idea, but only as a comparison tool, not as an end in itself as it is sometimes used. Positive NPV should not equal green light.

Often, vested interests can get in the way of developing a true comparison process. The head of the obsolete business unit is determined to see Product X developed to revive his flagging fortunes. The business development executive has always wanted to test out Japan as a new market. The CIO is sure that simply by using a new technology internally he can create more value than both the other ideas.

It would be naïve to think that the personal interests of executives in this situation do not come into the equation. Plainly, they do. Will the head of the obsolete business unit err on the side of caution in his projections? Probably not - in the absence of the new project he suspects his unit may be closed down. The other executives have their own motivations and incentives.

A third party is needed to take the proposals, apply common sense and a common methodology to them, and reach realistic conclusions. In a larger corporation, ideally this would be someone from the corporate development group with a good background in analysis. Smaller companies might use a business-savvy accountant. Either group might bring in someone from outside to assess the proposals independently.

Part of the process should also be to pinpoint opportunities which have not come up through internal discussions to date. While avoiding a fishing expedition, it can be useful to make a survey of outside industry developments and projections to see where an opportunity might lie.

Only once a number of proposals have been tested using a consistent, objective methodology is the company in a position to truly assess the attractiveness of the opportunity.

(c) **Skills analysis**

Let's say the outcome of the comparison above was that the Japanese expansion appeared to be the best opportunity. The company is about to commit to a major marketing rollout in that country, along with the sales, distribution, and back-office functions to support it.

An important step has been overlooked. Does the company have the skills to successfully enter the Japanese market?

The most useful thing about asking this question is that it forces the company to address the criteria for success in that market. Once you ask "do we have the skills" it immediately follows "what are the skills we need"?

Going through this process is very useful in understanding the sources of competitive advantage which will determine the success or failure of the new business idea. In the Japan example, the ability to successfully market to Japanese customers is a skill which the company will obviously need to either develop or acquire. But other skills may turn out to be equally important. Negotiating contracts with wholesalers and retailers will be a key success factor, as will developing relationships with logistics companies which distribute the product. It may be that Japanese retail relationships are very different to those with which the company is familiar. Perhaps the industry structure is unusual, with only one or two retailers controlling the bulk of the market in which the company's product is a participant. If that were the case, contacts within those powerful retailers - or perhaps a sales executive formerly employed by one of them - would be invaluable.

As the company goes through this analysis, it will become apparent the extent to which its skills are sufficient to meet the need. The more that it will need to rely on outside parties, the more hesitant it should be about the investment. If the company is effectively purchasing services on the open market for key elements of its business, its ability to develop competitive advantage in those areas is limited. For instance, if the company's source of domestic competitive advantage has been its superior distribution through retail outlets, it should look very closely at the Japanese investment. If distribution is effectively locked up and the company cannot add real value in this area, in what other area will it excel in order to succeed? Only by comparing in-house skills to the skills required can the company reach an appreciation of these issues.

Risk

The fact that a company is careful in reaching its investment decisions does not mean that it negates risk. Most new ventures fail, and even the best thought out strategies may not live up to their promise.

But even before the project commences, it is generally possible to identify the risk involved with a reasonable degree of certainty. As we discussed above, we think these risks come down to three categories:

Strategic risk - we define this as all strategic issues eg market and macro-economic factors, industry change etc

Execution risk - the acceptance of the simple fact that sometimes management fails to execute on a sound strategy

Capital risk - the scenario in which strategic and execution factors are under control, but the company faces problems with financing which ultimately make the project unsustainable

Strategic Risk

Sometimes, industries develop in ways that nobody could have foreseen. A new product might make all before it obsolete, a patented technology might lower one competitor's costs so much that its pricing cannot be matched by the rest of the market.

These events are very difficult to foresee before they occur. However, one can generally determine *whether or not the industry is one in which major unforeseen changes are likely to occur*. If this question was asked about the semiconductor industry the answer would be yes, if about the construction industry the answer would be no. The fact that an industry may be susceptible to a seismic shift does not mean that it should be avoided. It simply means that there is a greater risk in semiconductor investment than construction investment.

Another key strategic factor to consider is the competitive makeup of the industry. For instance, is it an industry which naturally lends itself to concentration of market share? Is there currently an incumbent that could crush the new business idea if it chose to? Or is it an industry with relatively low barriers to entry, in which case others may enter with similar ideas?

Macro-economic factors should also be considered. If the business is particularly cyclical in nature, then launch timing is critical. The business concept may be sound but if it is launched into an adverse environment all the preparation in the world may not be sufficient to save it. If the business focuses on a core or must-have product, it will tend to be more immune to such factors. But understanding the ebb and flow of the economy and its impact on the business is critical.

Another strategic risk factor relates to the cost structure of the industry. The analysis on which the business was entered into would most likely have assumed industry standard costs. For instance, a software product plan might include COGs of 15%, SG&A of 25%, and other costs of 20%, leaving a gross margin of 40%. The question which needs to be asked is: how likely is it that this industry cost structure might change? What factors might bring that about? Generally, the cost structures which are under the most pressure are those with healthy margins. In our software example, for instance, it is quite conceivable that industry standard gross margins might move from 40% to 30% over a 5 year period. Unless the processes of the company are extraordinarily efficient, it will need to drop its gross margins to 30% in order to compete. And if the business plan only stacks up if gross margins are 40%, suddenly the proposition becomes very risky indeed. Ensuring that modeling assumptions are valid is critical.

Finally, strategic planning should have regard to any legislative or regulatory issues which may arise. Issues such as import and export laws, consumer privacy legislation, and product certification are all relevant to consider. It goes without saying that if the project concerns a nation without a Western legal system, particular caution should be exercised.

Execution Risk

So the company's strategic planners have done their job, the plan is approved, the Board is enthusiastic, shareholders are informed and execution starts. But after a while, it isn't working - or at least, doesn't seem to be working.

This is a difficult time for any company. The problem is that the reaction of many companies to this difficult time often makes the situation worse.

This is the case because companies are often too slow to put on the brakes. Having worked up a head of steam about the project and put their weight behind it, senior executives don't like to admit that things haven't worked out as planned. And because most companies lack an internal mechanism for deciding when to increase or decrease spending on a particular project, "success" and "failure" become subjective concepts.

For instance, take the example of a company which develops a new product, not expecting its sale to reach profitability for two years. The business plan says that after 6 months it should have sold 1 million units. In fact, it has only sold 400,000. At its current growth rate, it will not be a profitable part of the business for 5 years and even then will only be one of the company's lesser lights.

Because the business lacks an internal trigger mechanism for reviewing the project, the development and sale of the product continues. While sales are below expectations, they are not so bad as to make the decision to give up on the project obvious. The company works away on the project and after 5 years is

still struggling to break even. It would have been better off cutting the product and marshaling its resources into areas that deliver its shareholders real value.

If the company had instituted a measurable review process, it would have been in a much better position to stop the project. The factors involved in this process vary from situation to situation, but might involve obvious issues such as sales targets and margins, to more complex (but still measurable) matters such as consumer brand response and capital expenditures as a percentage of revenues. Whatever the red flag is, the point is that there needs to be a red flag to look for. Often, management doesn't want to see the red flags. And in the absence of looking for a red flag, things have to be truly disastrous before they become self-evident. Recent corporate failures in both the US and Australia emphasise the apparent reluctance of management to read the writing on the wall.

How to execute successfully varies immensely from industry to industry. But the process for evaluating success or failure should be the same, and its absence is a direct cause of loss of shareholder value at many companies.

Capital Risk

Probably the most frustrating experience for any executive is to suffer from a lack of capital when all other matters are going well. This situation is particularly prevalent at the moment as companies across the board err on the side of \$x cashflow today rather than a potential \$2x cashflow tomorrow. Companies are clinging tightly to the birds in their hands, and treating as academic those in the bush.

In this situation, the strategy is right, and execution is going well. The only problem is that more cash is needed to see the plan to fruition, and the company doesn't have it. Many technology companies find themselves in this situation today. Despite strong products and a clear path to profitability, the capital simply isn't there for them to continue with their plans. Tarr'd with the dot-com brush, they understandably complain that they have done what they said they would do, and yet cannot get funded to finish the job.

This is a key issue, and the last substantive risk hurdle. Companies should know where the money will come from before they embark on a project. Admittedly, there will be times when it simply isn't possible to be sure of 100% funding at the commencement of a project. But if this is the case, a third element of risk beyond strategy and execution has been introduced into the equation.

The problem with relying on external funding is that you are *relying* on external funding. To rely on something over which you have little or no control is problematic. Unavoidable often, but still problematic. Failure to consider a

capital risk as a potential reason for failure is another mistake in many business plans.

One of the problems with capital risk is that in tough times, the problem tends to be self-perpetuating. Say company x needs \$50M to embark on a project. It can raise \$25M, but the investors of the \$25M do not want to commit their funds until they see the other \$25M on the table. Aware that the other \$25M is a long way off, management tries to re-jig the business model to work with only \$25M. The original investor becomes uncomfortable: if they needed \$50M a week ago, how come they can get by now on just \$25M? The original investor withdraws their support and the company is left with no cash and a confused strategy. Worst of all, in the whole transaction the company has very little power. It is really at the mercy of the whims of investors, which have a tendency to move in the opposite direction to the company's need for cash.

So doing everything possible to minimise capital risk should be a priority for senior executives. And when some capital risk must be taken on, the issue should not be swept under the carpet. The best way to get the funding will often be to remind oneself of its criticality - it tends to focus the mind.

Summary

Making a major investment decision is not easy. No analytical process can ever guarantee success - assessing risks and opportunities is a necessary but not sufficient part of the process. The problem is that in many companies, a proper assessment process simply does not occur. Ideas get supported because an executive got it right last time, or because of internal political reasons, or simply because of gut feel. Gut feel is important and the essence of great entrepreneurs, but gut feel unregulated is very dangerous in the hands of most executives.

By truly understanding the risks involved in a new project, companies put themselves in the position to answer the central question: is what we are doing rational? By developing a proper review process once the project is in train, they can ensure that good money isn't thrown after bad. And by doing everything they can to minimise capital risk, they can ensure that their company succeeds if its management soundly executes strategy.

No one factor is the magic bullet, but a careful consideration of each of these issues can save significant amounts of time and money. And it can help to pinpoint those one or two strategic ideas that all great companies were built on.

