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# Capital as scarce resource – strategic leadership as a response to the crisis

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## Management Summary

Capital is in short supply and 2009 will evidently not be a good year for the real economy. The financial and money market crisis forces companies, which until recently were growing at full speed, to initiate drastic cuts to their investment budgets. Of course everyone is also talking about the opportunities, which result from this crisis. Low acquisition prices and anti-cyclical growth strategies are long-term value drivers. But unfortunately this is only in theory. Things look very different in practice: complete investment stoppages or undifferentiated 30% reductions throughout all activities characterise the management agenda in a manner seldom seen in the past.

Whilst in the past few years of the boom period it was possible to set multiple investment priorities, things turn out to be very different in this crisis. The underlying dilemma: fresh capital is generally invested in precisely those areas where it was also to be found in the past; the bottom-up process of capital allocation once again directs capital in the hands of the mature units – especially in periods of crisis.

In total five typical traps can be observed when it comes to capital allocation in practice:

1. **The reinvestment trap:** A fixed percentage of annual depreciation used as a base investment budget
2. **The cycle trap:** The returns of the past as an allocation key for the future
3. **The opportunity trap:** The “loudest” shout from below wins the game
4. **The “Cash is King” trap:** Decentralised use of the generated cash flows
5. **The responsibility trap:** An absence of top-down financial targets and a lack of capital costs in performance measurement

These traps can be avoided by means of a consistent top-down steering as well as the active management of the business portfolio. Those companies that depart from old conventions and demonstrate strategic leadership will be successful in the long term.

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## 1. The financial crisis and its impact upon investment strategies and investment funds

More and more economic experts and research institutes forecast considerable burdens for the real economy due to the sustained financial crisis. Thus hardly a day passes in which growth forecasts and economic predictions are not quickly corrected downwards. And it would be astonishing if the levels of confidence were not to become even less optimistic in the future. Some companies certainly have good opportunities of getting off relatively lightly this year. However, the majority of industries are experiencing the combination of the financial and economic crisis directly, immediately and drastically. The transmission belt from the one world to the other world has become tighter.

The consequences and implications for the companies resemble a pincer movement from two directions. On the one hand earnings and cash contributions that had been firmly planned have fallen away at a grassroots level – the rating increasingly comes under pressure. On the other hand procuring capital becomes more difficult, takes longer and the price for the risk increases rapidly in times in which there is a shortage of liquid funds everywhere. Hence, these are difficult times in which we have to throttle back from the growth mode of the past few years.

What are the supposed ways out of the crisis? A closer look at the current agendas in most of the investment committees paints a clear picture. Once again it is true to say: The less you invest the better. Hardly any companies can bypass the trend of general reductions in investments. The proposed countermeasures range from ad-hoc considerations to postponements of major projects or planned growth investments to the well known undifferentiated budget trimmers and extend to complete investment stoppages or simply blindly imitating the actions of the competition.

However, what is of even more grave significance than the deficiencies of these measures is the fact that the actual problem is neither recognised nor is an appropriate solution presented. The undifferentiated demand for less growth and less investment is not enough at all. The actual problem does not only consist of the undifferentiated wiping out of all investment activities but instead is due on the one hand to a strategy that is not sufficiently focused and on the other hand due to a strategy that is too short term oriented. The vehemence with which people in many different companies attempt to turn back the clock again is alarming.

## 2. The crisis as an opportunity of achieving the target portfolio

By its nature change does not only create risks, but also opportunities. A large number of empirical studies demonstrate that anti-cyclical growth strategies represent one of the most successful value drivers in the long term. Companies, which invest at the right point in time, e.g. at the bottom-end of the business cycle will be rewarded with extraordinary value contributions in the new upturn phase due to the capacities they already have. In the chemical industry for instance companies that invest anti-cyclically generated three times the levels of value contribution compared to the industry average throughout the last business cycle! The foundations for profitable growth are generally laid in downturn periods. The systematic planning and management of the point in time and timing of investment decisions is critical to ensure long term success.

In addition it is more than likely that companies have to dispense with a number of portfolio units at very attractive prices to preserve their liquidity. For instance Continental's shares were considered to be very cheap at approximately € 75 only six months ago – now it is not even worth half that amount. The times of high levels of goodwill and the corresponding high hurdles for positive value contributions are certainly a thing of the past for the foreseeable future. However, low levels of acquisition prices simultaneously entail the chances of extraordinary value contributions in the future! The opportunities of positively influencing the market equilibrium in the long term by means of an active portfolio management are extremely promising especially in times of crisis.

In these situations companies have often profited by not sticking to tight to their business portfolio at all costs. In short: The right time for strategic investor's has arrived. However, a strong and healthy capital base is required to finance the investment opportunities. The necessary leeway is created by means of the correct setting of priorities. The business portfolio must be critically analysed, the courage to disinvest must be demonstrated and more focused priorities for further growth must be set. There is the need to manage the entire capital allocation process more markedly in a consistent top-down approach, link it with a clear portfolio strategy and anchor it within the organisation in a sustained manner. Decisive is to use the momentum.

### 3. Typical traps in the area of capital allocation

The credo is certainly not new. During the search for the reasons and causes for the poor status quo in most of the existing capital allocation processes the problem inevitably rears its ugly head. The recipients of capital up to now, that will primarily come across in the mature sectors of the portfolio, seem to be like a black hole, the powerful force of which not even fresh capital can escape. The five most major and frequent mistakes in the current practice of capital allocation are as follows:

#### 1. The reinvestment trap:

The logic appears to be intuitive. A fixed percentage of the annual depreciation, e.g. 40% as a base investment budget, which ensures that necessary investments can be performed irrespective of the business situation and that the company's ability to operate is secured. However, the consequences are dramatic: Preference is given to large and fixed asset-intensive business sectors, projects that are labelled as "must do" investments are not at all subject to a deliberate analysis in terms of how meaningful they are (keyword alternatives!) and a large portion of the total funding capability is limited right from the start.

#### 2. The cycle trap:

The generated relative returns of the past as an allocation key for future capital resources is based on a deceptive feeling of security. The problems: different historical growth strategies (organic growth versus external growth) distort the capital base, capital and personnel intensive business models are not comparable and above all: in cyclical industries the peak of investment activities is launched right at the start of the downturn and vice versa – an anti-cyclical investment strategy is carried out ad absurdum.

#### 3. The opportunity trap:

One can encounter all manner of opportunity traps: "strategic allocation", "strategic war chest", "opportunity driven on a case-by-case basis" ultimately lead to a situation whereby the person from the organisation that shouts loudest wins the battle for scarce capital resources.

#### 4. The "Cash is King" trap:

In decentralised organisations in particular possessory claims for the cash flow generated frequently dominate the capital allocation process. The consequences of this are very severe: The growth of young and upcoming business fields is stunted whilst mature and satisfied business sectors hog value investment resources at the end of the lifecycle. The risk of a disturbing permanent strategic situation becomes evident.

#### **5. The responsibility trap:**

If we inspect the current group structures more closely it can be seen that holdings that operate on a global scale are frequently characterised by decentralised decision-making processes and strong operative business units. Capital allocation is carried out on a bottom-up basis and the focus is frequently upon imprecise statements regarding the company's market position and its long-term growth prospects. The failure to link capital allocation with top-down targets and the frequent forgetting of capital costs in the measurement of performance are a clear indication of a lack of responsibility for the capital resources provided.

#### **4. The way out of the crisis: Strategic leadership**

##### **A) Manage the portfolio in a top-down way and distribute capital in a potential-oriented manner**

It is the task of the management to counter the typical investment traps by means of active and consistent portfolio management and to pin it into place by means of a more marked top-down form of corporate steering. The larger the company is the more the following applies: The board must act like a strategic investor and be a guardian over the precious resource that is capital. It should view every business unit as an investment and should maximise the value of the business units with the existing resources. Investments may not be distributed in accordance with the watering can principle, but must be assigned in a focused and potential-oriented manner.

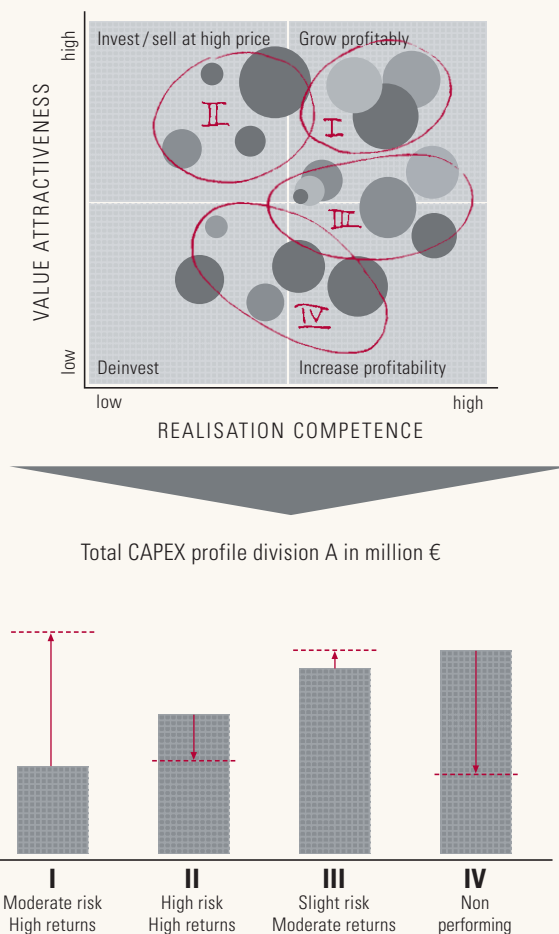
To this end it is imperative to initially develop a clear understanding of which business fields in the portfolio will drive the value creation in the future. Two dimensions serve as decision making criteria in this process: (1) The value attractiveness of the market (external variable) and (2) the company's own competence, in relation to the competition, to realise parts of the potential value for themselves (internal variable). The dimension of value attractiveness answers the question of to what extent positive value contributions are at all possible in a business field due to the customer benefits offered as well as the market and competitive situation. The dimension of realisation competence answers the question of how capable a company actually is to realise the value potential in the anticipated growth sectors based on its strengths and weaknesses compared to the competitors.

The precondition for this kind of quantitative evaluation is the thorough identification and analysis of the respective key value drivers of each strategic business unit:

- What factors will influence and shape the medium and long-term competitive environment?
- Which changes strengthen or weaken the company's own competitive position?
- How can internal competences and intangible assets from the core business be used to the best possible extent to mobilise growth and efficiency reserves?

The complete business portfolio should be analysed and evaluated on this kind of solid basis whilst taking account of the relevant key influential parameters. The management must then ensure that all business units are provided with the necessary capital funds. The allocation logic appears very clear in this process: The limited capital resources are directed into the potential growth areas in the portfolio in a consequent top-down approach. A long term investment story for the future thus is the result for each business unit.

FIGURE 1: PORTFOLIO LOGIC AS THE STARTING POINT FOR TOP-DOWN CAPITAL ALLOCATION – BASED ON THE EXAMPLE OF AN INDUSTRIAL CONGLOMERATE



Growth investments should be realized in specific business fields if those offer high value contributions in the future and if the realisation competence is high compared to the competitors. In these cases there should be the focus of capital allocation – sometimes the growth path must even be “forced” upon the businesses in this area. If on the other hand the forecasted areas of value potential are low this does not have to lead to the business field in question being sold off – in the event that the company simultaneously has high levels of realisation competence these lower areas of value potential could be exploited by means of increases in efficiency. However, it generally requires much lower capital resources to this end. In the event of a high level of value potential set against a low level of realisation competence the answer does not have to be that levels of competence should be increased by definition – this is because other market participants are generally prepared to pay substantial premiums here. If both variables are at low levels there would be hardly any alternative to a reduction in commitment or the sale. The logic is certainly not new – the decisive thing is the top-down process and the consistent manner in which it is implemented.

**B) Securing responsibility –  
combining capital allocation with a top-down financial target**

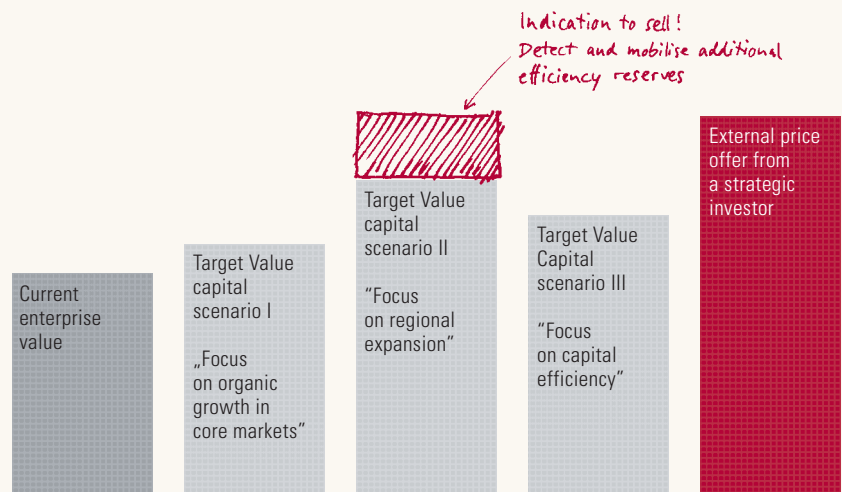
The implementation of a viable portfolio strategy can only be successful if its value contribution is determined both at a company level and also for the different strategic units. If the fundamental investment story and thus the capital allocation have been stipulated for the business sector then it is important to link the allocation of investment funds with a top-down financial target that goes with it. The fundamental logic is based on the idea “the higher the capital resources allocated are – the higher the corresponding performance target will be.” The revenue pearls and the supposed stars in the portfolio in particular do indeed frequently absorb high levels of capital resources but are not, or not sufficiently, challenged by means of stretch targets.

In order to achieve this financial targets are derived for the individual business units based on competitors’ performance and capital market expectations whilst considering the long-term potential from the portfolio analysis. In this process two external challenger views are available for the validation. The comparison with 1) the relevant competitive environment and 2) with investors’ expectations within an industry or a specific business field.

- 1) The competition benchmarking refers to the financial performance of the relevant peer companies. It addresses the three key performance dimensions: profitable growth, operating efficiency and capital efficiency.
- 2) The benchmarking of investors' expectations takes account of the long-term demand levels of capital markets upon certain business fields and company sectors. The question relates to the anticipated future financial performance of the competitors – and thus ultimately translates into a turnaround of the management perspective from backward-looking to forward-looking.

The linkage of business strategy, capital allocation and target enterprise value must be implemented for each portfolio unit and thus forms the basis for a strategic dialogue with the divisions. The target enterprise values can be viewed simultaneously as being "price tags" for the individual business unit and should build the basis for evaluating each and every portfolio decision. In those cases in which an external price offer for certain portfolio units increases the overall company value more markedly than it would have been possible in accordance with the internal strategy, the disinvestment of the unit from the portfolio in accordance with best ownership principles would be the necessary implication. As a consequence, capital is released to finance growth potential somewhere else in the business portfolio.

FIGURE 2: LINKING CAPITAL ALLOCATION AND TARGET ENTERPRISE VALUE – EXAMPLE FROM THE HEALTHCARE BUSINESS SECTOR

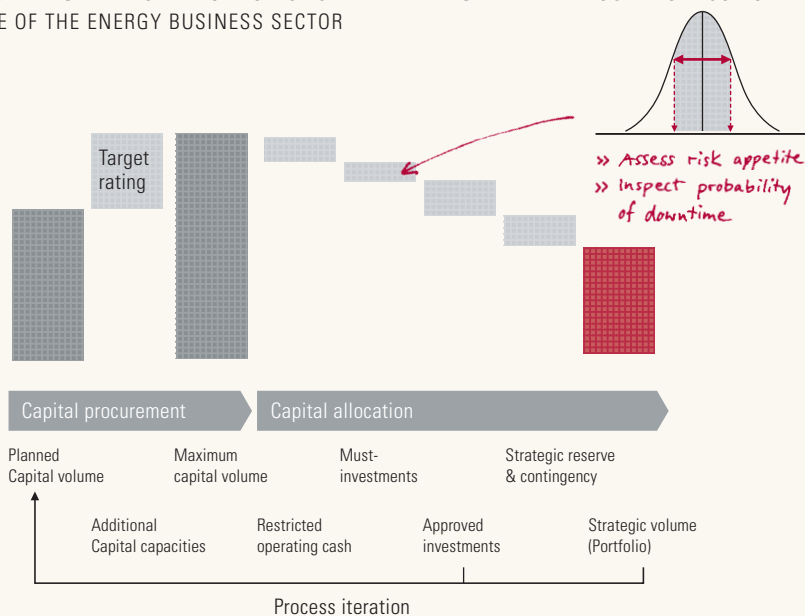


**C) Manage the capital allocation process in an integrated manner – mobilise additional capital reserves**

In addition the entire allocation process must be managed in an integrated manner and optimised in a sustained way to ensure a more careful form of interaction with capital resources in times of crisis. In a first step it must be ensured that the cash flows generated by the individual business divisions are collected as part of a consequent cash pooling process. Too-high self-consumption of excess capital resources by the divisions must be thwarted with the aid of clear guidelines. The overall investment framework that results from this process is then reduced step by step by the resources for investment decisions to preserve the business, Capex for legally binding contracts as well as obligations that cannot be postponed.

But we advise caution! The stipulation of investment volumes to maintain current substance and capacities is very often treated too generously – in addition a one year valuation of substance maintaining investments does not go far enough in the case of very long life-cycles. Maintenance investments may also not be carried out at complete odds with the actual bottom-up requirements, but must instead be strictly based on value considerations whilst representing “genuine” maintenance cycles. To this end appropriate prioritisation measures must be implemented for maintenance investments at the various levels and incentives for the selective use of funds must be anchored throughout the organisation. It goes without saying that investment volumes that are not exhausted by the end of the year may not be used just for the sake of making investments.

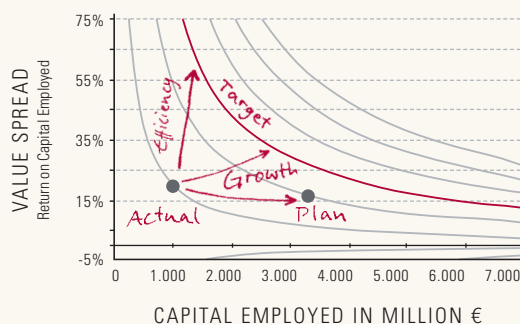
FIGURE 3: INTEGRATED OPTIMISATION OF CAPITAL MANAGEMENT WITHOUT “HOLY COWS” – EXAMPLE OF THE ENERGY BUSINESS SECTOR



#### D) Operationalise and implement top-down directions

Once the target portfolio, capital allocation and the medium-term financial targets have been established, the operationalisation of these specifications within the individual business units must be initiated as a next step. In this process it is initially important to gradually convert the three essential strategic value creation paths: profitable growth, increases in operating efficiency and an improvement of capital efficiency into their underlying action programmes. In addition the corresponding capital requirements and capital releases linked to the individual initiatives as well as all relevant value and cash effects can be determined, clearly represented and assigned to the individual financial years. All results are then summarized by means of a value agenda that also builds the bridge to the existing mid-term planning and budgeting process.

FIGURE 4: OPERATIONALISATION OF THE INITIATIVES AND MAPPING OF THE CAPITAL REQUIREMENTS – BASED ON THE EXAMPLE OF THE REAL ESTATE BUSINESS SECTOR



2 initiatives critical  
 >> Cash release from Net-Working Capital  
 >> Optimisation of maintenance investment decisions

Target Value Added	2007	2008	2009	2010	2011	2012	
	100	150	180	200	250	300	
Initiatives / Value added effects	2008	2009	2010	2011	2012	Present value	
Profitable growth (4 initiatives)	-5	0	10	30	60	61	
Operational efficiency (4 initiatives)	20	40	60	80	120	225	
Capital efficiency (3 initiatives)	10	15	30	45	70	118	
Value added from initiatives	25	55	100	155	250	404	
Value added from current operations	100	100	100	100	100	379	
Total Value added	125	155	200	255	350	783	
Surplus (+) / Deficit (-)	-25	-25	0	5	50		

This proceeding simultaneously guarantees the necessary security of the derived actions for the operative units in order to consistently implement the action programmes and initiatives being striven for. The contribution towards the attainment of the performance goals is ultimately decisive in terms of the implementation of the measures, the positive trend of the value driver is decisive in terms of their ultimate success. In this way a road map is produced that has been specified and assessed in sufficient detail, which reveals critical actions and supports and secures the implementation in overall terms in a sustained manner.

## Summary and conclusion

The consequences of the current financial crisis are pressurising companies from virtually all industries to throttle back from the successful growth path of the past few years. Undifferentiated reductions in investments that trim the budget or complete investment stoppages do not solve the problem. Those companies will be successful in the long-term, which view the crisis as an opportunity, implement a clear top-down portfolio strategy and demonstrate strategic leadership.

The essential focus areas are to be found in the following sectors:

- Active portfolio management and implementation of a focussed portfolio strategy
- Implementation of a top-down capital allocation process
- Linking of capital allocation, top-down targets and a sum of the parts perspective
- Integrated optimisation of the capital tie-up without “holy cows”
- Operationalisation of the strategic specifications relating to the capital tie-up and cash flow within the framework of a binding road map
- Consistency, resoluteness and severity during the implementation of the process

The hour of the strategists has arrived. Decisive is to depart from old conventions and to use the existing momentum.

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