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TAKING A PORTFOLIO APPROACH TO GROWTH INVESTMENTS

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AT A GLANCE

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A Differentiated Strategy

First, these companies take a highly differentiated approach to prioritizing growth among business units in the corporate portfolio.

An End-to-End Process

Second, they translate strategy into action by linking these strategic priorities to capital allocation, financial plans, and specific growth initiatives. They also actively manage the corporate investment portfolio from the top to make sure that initiatives stay on track and to maximize flexibility.

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One of the most powerful tools available to CEOs and CFOs to drive growth is their company's approach to capital allocation across its portfolio of businesses. Unlike more operational levers for growth, decisions about capital allocation are fundamentally strategic: they determine the long-term asset base on which future value creation depends. Done correctly, capital allocation can be a highly effective means of delivering on the corporate growth ambition.

And yet, despite its importance, the way many companies allocate capital is remarkably haphazard. In our work with clients, we often encounter a variety of ineffective practices:

- *"Democratic" capital allocation.* The organization spreads investments more or less equally across business units, irrespective of their previous performance or future growth prospects.

- *"The biggest children get the most food."* The organization allocates capital on the basis of the business unit's size, with the biggest units in the portfolio getting the most cash, even though such businesses often have the least growth potential.

- *"We've always done it this way."* The organization sets a given year's investment budget on the basis of what was done the previous year, looking backward to past internal practice rather than forward to future business potential.

There is a better way. Research by The Boston Consulting Group and client experience suggest that capital allocation at the top value creators is characterized by two distinctive practices.[1] First, these companies take a highly differentiated approach to allocating capital among business units in the corporate portfolio. Second, they translate strategy into action by linking strategic priorities to capital allocation, financial plans, and specific growth initiatives and by actively managing the corporate investment portfolio from the top. This approach has four steps.

Prioritizing Growth Among Business Units

Nearly all businesses grow to some extent, but not every business unit can be a corporate growth engine. The first step, therefore, is to understand the different roles of different units in the company's overall growth portfolio and strategy.

For example, some businesses may be large and profitable but so mature that they have little growth potential; these cash cows should be providing cash so that other businesses can grow, not using it themselves. Other businesses may have growth exposure but few or no sus-

tainable competitive advantages. They need to be fixed before they can grow; otherwise, growth will likely destroy value. Still other businesses may have considerable long-term growth potential but may be so small that growth in the near term will not yet contribute substantially to the company's overall growth rate. Only those businesses that are large enough, profitable enough, and growing fast enough can serve as the company's principal growth engines; they should receive the lion's share of growth investments.

To determine the roles that different business units can play in the company's portfolio, it is important to evaluate each one in terms of three different but complementary perspectives. The first perspective focuses on the dynamics of the *market:* Is the market, customer segment, or region in which the business unit operates growing? If so, is the business in a position where it can grow? This perspective is similar to that of the traditional BCG growth-share matrix.

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The second perspective focuses on the *financial* position of the company's business. It is a paradox of growth that while superior total shareholder return over the long term is predominantly driven by growth, not all companies that grow necessarily deliver value. So senior executives also need to ask, Is growth in this business likely to create value? Or will it come at the cost of eroding gross margins or of increasing our risk profile and eroding our valuation?

Finally, in establishing a company's strategic priorities for growth, senior corporate executives must also assess the prospects of each business unit from an *ownership* perspective: Are we the best owner to grow this business? Does the business have synergies with other businesses in the portfolio? In short, how does growth in this business contribute to making the performance of the portfolio as a whole better than the sum of its individual parts?

The last perspective makes clear that it's not enough to consider each individual business unit on its own. Rather, its strategic role should be considered in the context of the portfolio as a whole. Does the portfolio have a good balance, for instance, between short-term and long-term growth businesses? In situations where access to capital is limited, are there enough cash-generating businesses to fund businesses that will use the cash to deliver value-creating growth?

It is striking how frequently companies fail to ask and answer these questions—and what they discover when they finally do. BCG was recently asked to help a major European chemical company develop a growth strategy. When we took the company's senior executives through this three-part exercise, they were surprised to learn that the investment ratio (the ratio of capital expenditures to assets) was sub-

stantially smaller in the company's "growth" business units than in its nongrowth units—precisely the opposite of what the executives had assumed.

Translating Roles into Actions

It's one thing to define the different strategic roles of the different business units in the corporate portfolio. It is quite another to translate those roles into actions through the establishment of KPIs, performance targets, capital budgets, and, ultimately, detailed business and financial plans. (See *The Art of Planning,* BCG Focus, April 2011.) This is another area where a customized approach is necessary.

Take the example of KPIs. Many companies use exactly the same KPIs to manage each business unit in the portfolio—usually on the theory that consistency is important or for reasons of "fairness." But a large mature business that generates a lot of cash but has minimal growth prospects shouldn't be assessed the same way as a small business that produces far less revenue but has strong growth prospects. In the former business, one of whose primary roles is the provision of cash to fund promising growth businesses, cash flow margin will be the KPI. In the latter, however, the rate of revenue growth will be far more important.

Once senior executives at the chemical company had systematically classified their business portfolio, the next step was to establish a set of rules that made it possible to focus the company's capital expenditures on its genuine growth opportunities. According to these rules, cash cows could invest no more than 50 percent of their operating cash flow back into the business. Distressed businesses in need of a turnaround could invest only in initiatives that had payback within two years. These rules freed up cash to invest in the portfolio's growth engines.

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Differentiating Among Types of Growth Investments

When it comes to translating such high-level rules into the details of financial plans and budgets, different types of growth investments also need to be evaluated differently. Too often, companies evaluate every potential growth initiative in terms of NPV. But that approach can lead to an overemphasis on clearly defined, incremental short-term investments—at the cost of neglecting more long-term but strategically important investments whose NPV is uncertain or difficult to calculate.

All growth investments are not created equal. Basic research, technology platform investments, product development, and product updates all have different profiles in terms of ability to forecast financials, payback,

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and risk. It makes sense to assess a simple product update in terms of the revenue it is likely to generate in the next one to two years.

But that criterion will be inappropriate for longer-term initiatives such as the development of a new technology platform in which short-term revenue will be highly uncertain (or even nonexistent). Better to evaluate such an investment in terms of the likely strategic options that the platform makes possible over a far longer term.

In prioritizing among different types of growth investments, the general principle should be to compare "like with like." Start by defining different buckets of growth investments. Given the company's strategic priorities, how much should be invested in basic research, product development, or product updates? Once the corporate center sets the global budget for each type of growth bucket, it can prioritize investments within each bucket on the basis of criteria appropriate for that type of investment.

Actively Managing the Investment Portfolio

Finally, once capital allocation decisions are made, the corporate center must actively manage the investment portfolio over time to make sure that initiatives stay on track and to maximize flexibility. The best way to do so is by establishing an interdisciplinary investment committee made up of representatives from key constituencies such as strategy, finance, operations, and R&D. The committee's primary task is to continuously evaluate the overall investment portfolio to ensure a good fit with the company's strategic growth priorities.

Investing in growth, however, isn't just about money; it's also about people. The investment committee must direct senior management attention and talent to critical growth projects in order to ensure quick execution and to resolve obstacles and roadblocks. Executives on the committee need to think much like venture capitalists do: invest in the team, not just in the idea or project. Doing this effectively requires a tight link among the committee, operations, and HR.

Most important, the investment committee must regularly monitor project execution and approve additional funding. The best approach is to establish "stage gates" in which budgeted capital is released in phases and only when certain intermediate performance criteria have been met. This approach is especially important for growth investments. Since payoffs are often uncertain and market conditions can change rapidly, growth projects need to be adjusted frequently. Because regular monitoring and frequent adjustments limit the downside, they make it possible for the organization to take on more risk when it makes good business sense to do so.

By following these four steps, senior corporate executives can substantially improve their company's overall growth trajectory. The chemical company, for instance, was able to raise its growth rate from the bottom fifth of its peer group to well above average—and without any increase in the overall quantity of investment. At a time when growth is increasingly hard to come by, what leader could ask for more?

NOTE

1. See Ulrich Pidun et al., "Corporate Portfolio Management: Theory and Practice," *Journal of Applied Corporate Finance* 23, no. 1 (Winter 2011): 63–76.

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