



- A typical company allocates investment cash flows equal to half or more of its market capitalization over a three- to five-year period.
- More than one-third of the \$8 trillion of invested capital in the S&P 1500 does not earn the cost of capital.
- Over a five-year period, half the S&P 1500 companies experience a significant write-off, divest a major business, or see a decline of 50 percent or more in company value.

The CEO as Investor

“All roads of managerial evaluation lead to capital allocation.”
—Michael J. Mauboussin

Of the many roles played by the modern CEO, one of the most important is among the most neglected—the role of the CEO as investor.

A company’s investment choices comprise a critical and underestimated part of the CEO agenda. These choices have extremely high stakes: typically, a company allocates investment cash flows equal to half or more of its market capitalization over a three- to five-year period. These choices are extensive in scope, encompassing not only decisions about reinvestment to drive the business (capital expenditures, acquisitions, and brand and technology investments) but also decisions about the company’s deployment of its cash flow other than for operations (for example, for dividends, share buybacks, capital structure, and management of nondebt liabilities). At first glance, some of these may not seem to involve much choice—just being in a business requires some reinvestment. But taking a passive attitude toward portfolio exposures and managing reinvestment “democratically” is, in itself, a choice—in many cases, a poor one.

Many CEOs and senior teams struggle in the investor role. Strikingly few companies have a coherent process for managing their investment choices and linking these choices to the company’s value over time. Investment failures are surprisingly common. More than one-third of the \$8 trillion of invested capital in the S&P 1500 does not earn the cost of capital. Over a five-year period, half the companies experience a significant write-off, divest a major business, or see a decline of 50 percent or more in company value.

Many CEOs assume that “financial discipline”—especially in the form of a tough CFO who approves or rejects spending requests using tools such as discounted cash flow and earnings per share (EPS)—will protect them from investment failure. Unfortunately, the lesson of experience is that such financial tools are like a racecar’s speedometer: they sometimes provide useful guidance, but they neither prevent accidents nor deliver the power to drive the car forward.

There is a better way. By developing an explicit corporate *investment thesis*, much as professional investors do, a CEO and his or her team can more effectively assess the tradeoffs among competing priorities and evaluate the performance of their company's myriad investment decisions over time.

What an Investment Thesis Is—and Is Not

An investment thesis is not an “equity story” that describes how a company's leaders wish outsiders would see the company's opportunities. Rather, it's a clear and focused summary—grounded in the granular realities of the company's competitive situation, opportunities, and risks—of how the company will create value over time.

In contrast to the typical strategic plan's lengthy list of actions and ambitions, a good investment thesis highlights three to six critical actions that are required to achieve attractive performance over a specific time horizon (usually three to five years). A company's opportunity set for driving value at any point in time is likely constrained by just a few factors, and a good thesis focuses managerial energy.

Finally, a good thesis explicitly considers enterprise risks and embraces contrarian viewpoints. After all, from an owner's standpoint, one shouldn't invest in a company unless he or she can first describe why the consensus view driving today's valuation is too conservative and he or she can also see where the short seller's logic is misguided.

A Tale of Two CEOs

To understand the difference a clear investment thesis can make, consider the experience of two CEOs of a large, highly diversified consumer-products company. The first CEO was a disciplined operator whose agenda was that each of the company's businesses should “be the best growth company” in its respective sector. He challenged each business unit to become the biggest competitor in its served market, raise operating margins, and beat its budget each quarter. And he measured business unit performance using a comprehensive list of more than a dozen measures—from revenue growth and inventory turns to operating-profit margins.

Operationally, these priorities generated good results. Working-capital efficiency improved; selling, general, and administrative expenses (SG&A) were reduced; and a number of acquisitions drove top-line growth. What's

more, the company was able to leverage attractive borrowing rates to fund share buybacks with debt, which contributed to raising the company's EPS nearly 50 percent over a four-year period.

And yet, the company's competitive position was steadily eroding. Whatever progress the company had made in growing its profits was more than offset by a series of poor investment choices. Under pressure to deliver quarterly earnings in excess of plan, some unit managers cut back on long-horizon technology investments. The aggressive search for growth resulted in sizable acquisitions in segments with fundamentally weak returns, diluting earnings quality. In the context of declining gross margins, investors interpreted the cuts in SG&A as bad news—a sign that the company was on a commoditizing trajectory (however much EPS was growing at the moment). As investors fled the stock, the company's valuation multiple shrank more than its earnings increased, putting the company's total shareholder return into the bottom quartile of its peer group. This poor value-creation performance cost the CEO his job.

His replacement developed a more integrated strategic and investment agenda. The new CEO continued the push for operational excellence, but he also engaged openly with the company's long-term owners, seeking to understand their views. The new CEO developed an explicit thesis that was backed by a financial model linking operational performance to the company's market value over time. That thesis came to be known as “ $8 + 6 = 14$ ”: driving through-cycle operating-profit growth of 8 percent while throwing off 6 percent cash-flow yields would create performance that should drive annual shareholder returns in the neighborhood of 14 percent.

Deceptively simple, this way of articulating the company's financial goals focused attention on the key tradeoffs. The company's operational agenda remained important: without continuous improvement in operating discipline, the model wouldn't work. But the new model clarified the critical role of investment discipline. To create value, the executive team had to focus not only on revenue growth and margins but also on the capital strategy. The executives had to manage the tradeoff between reinvested cash to drive profitable growth and distributed cash (including dividends, share count reductions, and debt paydowns), which provides cash flow yield.

The new investment thesis also pushed the senior team to focus on three key changes that unlocked significant

value. First, instead of aiming to grow all the company's many business units opportunistically, the team developed an explicit portfolio strategy that was grounded in a view of competitive advantage and its drivers. The team clearly differentiated priorities for the various businesses in the portfolio, detailing how each should contribute in its own way to creating value. A few platforms merited disciplined investment in growth, other businesses required a turnaround, and still others were structurally worth more to different companies and were candidates for divestment.

Second, they developed a more rigorous and disciplined approach to acquisitions in order to ensure that each dollar of cash flow reinvested to drive growth would deliver well above a dollar of value to owners. Meaningful acquisition investment would continue to be a key part of the agenda, but—from target screening and deal board approvals to integration management and post-mortem reviews—the company developed new tools and resources to manage the M&A process more effectively.

Finally, the senior team adjusted the control system so that the new investment thesis was reinforced meaningfully and tangibly at the operating units. Metrics, performance assessment, and unit level incentives were simplified and aligned with sustained value creation over a three-year horizon. The team also worked intensively to communicate the logic of the corporate-level thesis, empowering the units to bring forward bolder investment ideas that expressed a more differentiated range of growth-to-yield tradeoffs in the various businesses.

These moves transformed the company's performance. Business unit heads no longer perceived capital as free and growth as the only way to create value. Rather, each dollar of cash flow was allocated toward the best alternative for driving sustainable returns. Investors regained confidence when they saw strategically disciplined, high-return acquisitions and expanding gross margins that were the result of focused increases in innovation spending. The valuation multiple expanded, and the company's value-creation three- and five-year track records were the best of its peer group.

Identifying the Right Value Pattern

One of the greatest challenges for a management team that is developing an investment thesis is to identify the right shortlist of focus areas that fit well with the company's starting position. Every company wants to grow

profits and value over time, but the path and relevant priorities of a Google, a Gazprom, a Gilead, or a General Dynamics will be radically different. Sometimes the best long-term path requires short-term pain—shrinking a troubled business, or eliminating risk from the balance sheet for greater liquidity. Other times, shifts in the competitive landscape require a bold rethink of the business model or of where and how to compete. Many companies find themselves with limited growth exposure in the core but unclear linkages to the many potential adjacent businesses. How does the senior team develop an investment thesis that truly fits the company's starting position and its opportunity set?

Although starting positions are multidimensional and vary widely across companies and industries, recent analysis by The Boston Consulting Group suggests that there is a limited set of common archetypes, each with a distinct set of preferred pathways for creating value. Each of the archetypes—*healthy high-growth*, *high-value brand*, *utility-like*, and *distressed*, to name a few—has its distinct profile and priorities. BCG refers to these starting positions as value patterns. Knowing the value pattern of a company can help define the boundaries of its investment thesis and identify the most promising value-creating initiatives to focus on.

In the past year, BCG has been conducting extensive empirical research into these value patterns and exploring how to use them to inform a company's investment thesis. The next article in this series will introduce BCG's value-pattern concept, describe ten starting-position archetypes, and explore their implications for the leaders of large business organizations.

Gerry Hansell
Dieter Heuskel

Gerry Hansell is a senior partner and managing director in the Chicago office of The Boston Consulting Group and a BCG Fellow. Dieter Heuskel is a senior partner and managing director in the firm's Düsseldorf office.

You may contact the authors by e-mail at:
hansell.gerry@bcg.com
heuskel.dieter2@bcg.com

To receive future publications in electronic form about this topic or others, please visit our subscription Web site at www.bcg.com/subscribe.

© The Boston Consulting Group, Inc. 2012. All rights reserved.
#461 4/12