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How to resist the allure of 'glamour' projects

Shiny new initiatives can distract you from paying attention to other valuable but mundane projects and investments.

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In this episode of the *Inside the Strategy Room* podcast McKinsey partner Tim Koller, professor of business strategy at the University of Sydney Dan Lovallo, and Sean Brown discuss why people underinvest in so-called unremarkable projects and how to remedy this bias to ensure all projects receive the resources and attention they deserve.

(For more conversations on the strategy issues that matter, subscribe to the series on iTunes.)

Sean Brown: From McKinsey and Company's Strategy and Corporate Finance practice, I'm Sean Brown. Welcome to *Inside the Strategy Room*. Today, we continue our Bias Busters series. We will be discussing the most recent article in the series, "Resisting the allure of 'glamour' projects." Dan is a co-author of this piece, along with Iskandar Aminov and Aaron De Smet. Tim, Dan, welcome.

Dan, it might be helpful to start off with an example of how to distinguish between bright, shiny projects and so-called unremarkable projects.

Dan Lovallo: My favorite example is when you've got a big oil field there are a number of things that have to be dealt with. One of them is drilling new resources, oil or gas. And that's exciting. If you find the oil or the gas, then big kudos to the person in charge of the exploration. Now there's another thing that has to be done in a big oil field, and that's maintenance. You've got to maintain the wells. You've got to make sure that nothing untoward happens. That's not so glamorous.

Sean Brown: A lot of downside risk, right?

Dan Lovallo: Yeah, the best that can happen is nothing.

Sean Brown: Right.

Dan Lovallo: That's your upside! And frequently, those two necessary activities are completely separated. The way to go forward in the company is to be a great explorer, not so much a great maintenance person. That creates a problem and has created some issues that we all know about. We're going to talk about some ways to overcome it at the end of this podcast. This kind of problem isn't just limited to my favorite example in oil and gas. Tim can talk a bit about how this generalizes to many more types of projects.

Tim Koller: Yes. Thanks, Dan. The way this generalizes is that when companies typically evaluate projects, like maintenance projects or the performance of a business unit, they typically assume that if they don't make an investment then things will go along business as usual. Therefore, they end up assuming that a maintenance project has a zero present value. Or a business unit's value is a steady-state kind of thing. The reality is that in many of these cases if you don't make the right decisions and make the right investments, that project or that unit will decline in performance. But it's often not acceptable to show a base case which is a decline. The base case is almost always a steady state. Therefore, the investments that keep it at a steady state don't show up as creating any value. And that's the source of a lot of the issue with respect to focusing on the new versus the maintenance or the old in some situations. That's a mind-set that has to change.

The other thing you find is then companies simply say, "All maintenance projects have to get done, even though they don't have a return." That's a bad way of thinking about it as well. It's a discipline to say, "We need to think about the base case much more seriously and be willing to acknowledge that there is a base case where if we don't do the investment, the performance deteriorates, and sometimes substantially."

Sean Brown: Is this principally an issue for companies with large capital bases and large capital expenditures?

Tim Koller: No. It certainly would apply in those situations. And the example that Dan laid out in the oil and gas business is clear. But it would also apply even in the tech world. For example, as technology is changing you have to make investments or make strategic decisions in order to just keep up. Once again, the base case is not continuing along. I'm working with one company now. They've got a forecast that is a nice, steady increase without any additional investment spending. And this is a tech-related company. It's very fast growing right now. But there's a lot of new competitive entrants and the reality of it is we suspect that if they don't accelerate their investments, in the next generation the proper base case is really a decline in the business. You do see it in all kinds of places and in different manifestations.

Sean Brown: What are some of the tips and tricks that you would offer our listeners in terms of better valuing these maintenance approaches?

Tim Koller: One of the techniques is to make sure that different parts of the organization aren't operating in silos. Decisions should be made where people who are doing maintenance things understand what's going on with the faster-growing businesses and vice versa so people can understand what it's all about. I think that's an important one. Another is the CEO has to take the lead in saying, "We're no longer going to accept the base case being business as usual." There are base cases where the business or the project is declining or we're going to destroy some value because we're not spending enough money on maintenance, for example. It is essential to have that kind of mind-set built into the organization, where we're always looking at, "What would really happen if we didn't spend this money?"

Sean Brown: How do you tie this to the notion of the financial planning and analysis folks and the depreciation charges that companies are taking on their capital base?

Tim Koller: Depreciation is very crude, but sometimes it can be very useful. It's a rare business that doesn't have to spend enough money on depreciation to keep the assets in good shape. There's one industry I've come across, which is the pipeline industry.

Sean Brown: OK.

Tim Koller: You put a pipeline in the ground and you let it sit there for 20 or 30 years without really spending much money. There aren't too many businesses like that. Most companies, any kind of factory, any kind of hotel or retail store, if you don't continually keep that thing up-to-date, in the case of a factory, the performance will decline. In the case of a retail store or a hotel, the customers will notice it and the business will decline because of that. It applies across the board in different ways.

Sean Brown: Does depreciation typically match the investment? Or is there some way that they can set financial charges to capture the positive value that this maintenance contributes to the company's bottom line?

Tim Koller: The depreciation is a crude metric. If you're spending is less than the depreciation, you might want to be worried. If you're spending much more but not growing, you want to be worried as well. It's a little bit too crude though. It's a starting point but it's not sufficient. You really need to look at the business from the bottom up to make the right decisions. Once again, you don't want to be anchored in the past. You want to be thinking about the future. The people who are closest to those assets will know what needs to get done or when something needs to get done. And you need to have a mechanism where you can hear their voices so that you can take that into consideration as you're making your investment decisions.

Dan Lovallo: And one of the mechanisms from the oil and gas example earlier is really quite simple and I think somewhat ingenious. It's the committees in most oil and gas companies. There'll be an exploration committee and a maintenance committee and different people oversee those. This leads to underinvestment in maintenance because there are more senior people on the exploration committee.

Sean Brown: That's the glamorous thing, right?

Dan Lovallo: That's right. What one company did—and this company had a great safety record—was to have overlapping committee members. This allowed them to more easily balance out investments in maintenance and exploration.

The committee members that overlapped on the exploration committee and the maintenance committee could understand the needs of maintenance and had an easier way to argue to the leader of the field and say, "Listen, they really need this money." Overlapping committees are generally a way to get more information to the top in a more direct manner. In this case it really helped. The maintenance budget went up.

Sean Brown: Why doesn't everybody do this?

Dan Lovallo: Well, why doesn't everybody dunk like LeBron James? Some people are better than others.

Sean Brown: Is this something that comes from the CEO? In the example that you just shared, Dan, what was the precursor? Whose epiphany was it to put these people on overlapping committees?

Dan Lovallo: There were two things; they had noticed other companies having issues that were due to underinvestment in maintenance. And one of the heads of the fields came up with this idea and did it in one field, and then the CEO said, "We're going to do this in all the fields." This came from the head of the field, which is pretty high up in an oil and gas company, but not the highest. The CEO recognized it as a good idea and spread it throughout the company.

Sean Brown: Any other suggestions for how executive teams can avoid this issue?

Dan Lovallo: Differential preferences for investment that can lead to underinvestment in some projects can be attacked in a few ways. One of the ways is to take personality out of the system. In one company, people are allowed to propose projects. The head of the business unit or division proposes the projects and puts them in writing. When the allocation decision is made, they're not in the room. The CEO, the CFO, and the head of technology make the decision without anyone else. And you don't get the head of the most glamorous division, or the head of the biggest division, or somebody who's been there longest arguing for their project face to face. That makes a big push toward objectivity and I would recommend that. It's not going to happen, but I would recommend that to all companies. Having the business-unit heads in there is something that can work, but you are risking politics that may favor one business over another.

Sean Brown: Tim?

Tim Koller: I have seen situations where by making the investment decision-making process more systematic, even if you don't go so far as to take them out of the room, prior to the meeting there's a corporate team that will put together what they think are the right investment decisions or the right reallocation, which may be different than what the individuals want. But the corporate team is looking at it from the perspective of the company as a whole. They're doing what Dan is saying, but they're acting as the staff that puts together that recommendation for those top executives. That becomes the starting point from which people might have to argue a change, as opposed to starting at a different level.

Sean Brown: Any final thoughts you'd like to share before we close out our session?

Dan Lovallo: I think people should think a lot more about overlapping committees, because it's really simple. Think about where you need it. It can be things that you think are underinvested in, but it can also be useful if you think different businesses are preferred for nonobjective reasons.

Sean Brown: Awesome. Tim, Dan, thanks for joining us today.

Sean Brown is McKinsey's global director of communications for strategy and corporate finance and is based in the Boston office, **Tim Koller** is a partner in the New York office, and **Dan Lovallo**, an alumnus of McKinsey's San Francisco office, is a professor of business strategy at the University of Sydney.

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