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Yuval Atsmon

# Where, how much, and how: Answering the hardest questions of resource allocation

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The challenge of resource allocation is determining *where* the resources will bring the most value, *how much* money and talent to redistribute, and *how* to put those shifts effectively into action.

**I recently listened** to a CEO client lament his company's low growth and the difficulty in shifting resources from a mature business to new fast-growing ones. The challenge he faced is all too common: unit presidents protective of legacy businesses, strenuously arguing that reducing resources would endanger the company's biggest cash cows. Would the returns from investing in the new businesses justify this risk? And how much is really needed to get those businesses onto the growth fast track?

These are essential questions when trying to ensure that the organization's money is working as hard as it possibly can. As I pointed out in my last post, the problem with resource allocation isn't ignorance of its importance—83 percent of executives we polled named it as the most critical management lever for spurring growth. The challenge lies in determining *where* the resources will bring the most value, *how much* money and talent to redistribute, and *how* to put those shifts effectively into action.

Those overarching questions represent the three major phases of the reallocation process. Only by answering them with empirical rigor will you be able to get your team on board and embed the process into the organization.

## 1. Where to reallocate resources

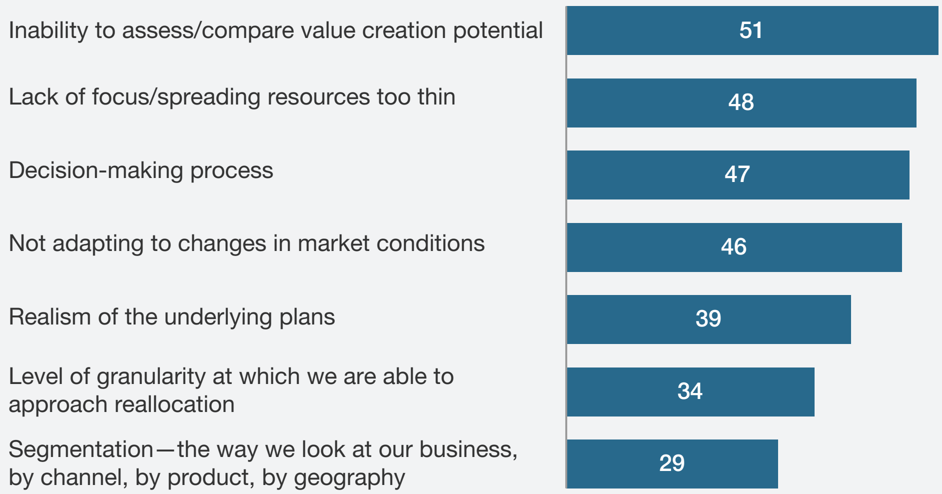
The first step is to create an analytical foundation on which you can build a strong case for resource shifts. This is essential to overcome resistance from losing parties and counter individual biases rooted in self-interest or mistaken assumptions. To identify and prioritize areas where boosting investment would generate the greatest impact for the whole organization, start by assessing the profitability and resource projections for every meaningful business cell.

Managers tend to easily identify the opportunities with the biggest growth upside, but as I explained in an earlier LinkedIn post, growth doesn't guarantee value creation. To have

Exhibit 1

## Top barriers to resource reallocation

n = 217, %




McKinsey&Company | Source: McKinsey resource allocation executive survey, Spring 2015

a comprehensive view, you need to understand projected economic profit (the difference between ROIC and the company's weighted average cost of capital) for each business cell or, in some cases, build a full investment plan and calculate the net present value (NPV) of future cash flows. Then compare that to the resources needed to deliver the projected ROI.

This analysis will indicate that some cells with high projected ROI are obvious candidates for acceleration. Others may be actually destroying value, suggesting it's time to reduce their resource share or even exit the business entirely. In between are businesses with positive but modest economic profit. A large organization may not need to closely analyze every one of these mid-range performers but it should at least look at ones that absorb a lot of resources. Are there better ways to optimize their return on investment?

Now managers will realize this process will influence their budgets, so they will be tempted to inflate their projections or forecast stabilization after a period of decline. Accordingly, any discussions of their proposed strategic plans should start with the question: Why do you believe this improvement will happen?

The best way we overcome the "hockey stick" pitfall is to create a baseline scenario based on objective data, looking at a business's performance track record and carrying that forward for several years to develop a "momentum" case. Factoring in management assumptions (where valid) and additional market and competitive insights can further refine the scenario—which often ends up looking very different than the manager's initial view.

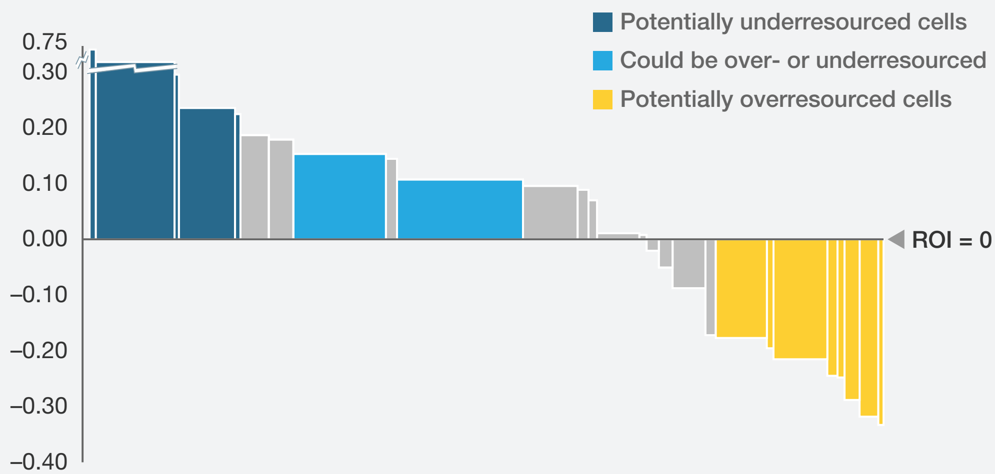
### 2. How much resources to reallocate

Determining the right magnitude of action is often harder than identifying the targets for it. The relationship between investment and return is not linear, as capturing some opportunities requires a major investment (in new IT systems, for example, or establishing a direct sales

Exhibit 2

## Finding ROI outliers

**Projected economic profit/resource spend, next 3 years,** $ million

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force). Conversely, if you want to lower your capital investment, you may still be stuck with some "maintenance" costs.

Managers want to know the return on the marginal dollar but this non-linearity makes that impossible. In my experience, a pragmatic alternative is to approach resource shifts differently depending on whether they are candidates for increase or decrease.

For underresourced cells, ask yourself: Is there additional market upside we're not capturing? It may be that ROI is high because you have a strong leadership position and to grow more you would have to increase the overall market demand—which may be possible in some areas but not in others. If there is upside, how much money and talent would you need to apply to tap it? Is the business case still attractive when you've factored in all the risks, such as a change in competitive dynamics or regulations? Would it be better to boost resources dramatically to drive a higher level of return or to be incremental? In some cases, gradual increases may suffice while other opportunities require big bets to gain meaningful market share.

For overresourced cells, start by analyzing what's behind the low performance—is it an industry-wide issue or your company's problem? If your business is performing a lot worse than its peers, you need to understand what is holding it back. In rare cases, you may discover that the issue can be addressed by injecting more resources, with potentially high rewards. More often, it's a market problem or the company is facing a structural competitive disadvantage. If so, it's time to ask whether lower investment levels would bring the unit to an acceptable ROI—and if not, consider divestiture.

### 3. How to execute resource reallocation

The fundamental goal of resource reallocation is to embed agility in the organization so it can move as opportunities shift. Many companies, however, face internal barriers, ranging from business leaders seeking to protect their turf to resources being embedded in ways that makes them hard to free up. For example, if you need to shift R&D investment, the existing people may not be the right fit or the facility may require an expensive relocation.

Here are some steps you can take to overcome internal resistance and fear of change.

- Clearly communicate to your team that dynamic reallocation is a priority and that decisions are final unless there is a material external change.

- Create a common language around resource reallocation that integrates it into the culture of "how we do things" and stresses its importance in realizing growth aspirations.

- Establish clear accountability between corporate-center and business-unit levels, and determine which resource decisions need whose approval, what gets monitored and reported, and what escalation mechanism will be used in case of delays.

- Regularly review the assumptions behind allocation decisions to make sure they still hold, both around new investment requests and previously allotted resources yet to be deployed. If managers are protesting decisions on resource allocation, is there a reason to update the assumptions?

- Consider organizational changes to improve resource flexibility, such as creating shared resource pools or enabling talent to be more easily redeployed.

- Embed dynamic resource reallocation into the planning process and management incentives. You want to make it necessary and beneficial for management to continuously seek ways to apply resources for the benefit of the overall company rather than their own fiefdoms. For example, ask every business cell to start next year's budget with 10 percent less in operating expenses; the combined amount becomes a central investment pool for which the cells compete. □

**Yuval Atsmon** is a senior partner in McKinsey's London office.