

How nimble resource allocation can double your company's value

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Companies that actively and regularly reevaluate where resources are allocated create more value and deliver higher returns to shareholders.

“**Dynamic resource reallocation**” is a mouthful, but its meaning is simple: shifting money, talent, and management attention to where they will deliver the most value to your company. It’s one of those things, like daily exercise, that helps us thrive but that gets pushed off our priority list by business that seems more urgent.

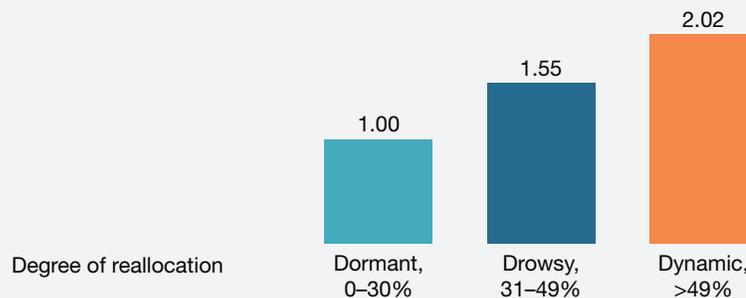
Most senior executives understand the importance of strategically shifting resources: according to McKinsey research, 83 percent identify it as the top management lever for spurring growth—more important than operational excellence or M&A. Yet a third of companies surveyed reallocate a measly 1 percent of their capital from year to year; the average is 8 percent.

This is a huge missed opportunity because the value-creation gap between dynamic and drowsy reallocators is staggering (exhibit). A company that actively reallocates delivers,

Exhibit

Actively reallocating resources increases company value, and rewards are high.

Relative total returns to shareholders, 1990–2010, indexing low reallocator to 1



on average, a 10 percent return to shareholders, versus 6 percent for a sluggish reallocator. *Within 20 years, the dynamic reallocator will be worth twice as much as its less agile counterpart*—a divide likely to increase as accelerating digital disruptions and growing geopolitical uncertainty boost the importance of nimble reallocation.

Why this disconnect? In my experience, executives struggle to figure out *where* they should reallocate, *how much* they should reallocate, and *how* to execute successful reallocation. Additionally, disappointment with earlier reallocation efforts can push the issue off top management's agenda.

To get real value from resource allocation, executives should follow four important principles.

1. Go granular

Beware the tyranny of averages. A single unit may have lines of business or geographic pockets with very different returns. It's not uncommon to see a 10 percent decline in one area while another is experiencing triple-digit growth. In fact, the variability is often much more significant across granular market segments within one business unit than across large business units.

Segmenting the company and defining the level of granularity can be something of an art, as top executives can't debate trade-offs across thousands of micromarkets (although some functions, such as marketing and sales, should). You need to drill down to the smallest *meaningful* business, where a shift in resources will produce a material impact for the overall company (likely more than 1 percent of total revenues). Additionally, each segment you isolate should have a distinct external market—say, premium sports cars in the United Kingdom—even if some resources are not fully divisible. For example, R&D might be shared across premium sports cars regardless of country, but not the marketing spending.

2. Focus on value creation

Sometimes investments have a direct business case and you can quantify the net present value of all future cash flows associated with it. A project to invest in a new mine, or to develop a new vehicle, may look like that. In other cases, the overall economic profit (profit created above the cost of capital) of a segment may be an excellent and more consistent method to assess ongoing value creation. Assessing which segments deserve more or less money and attention requires the right metrics.

One of my favorite and relatively simple return-on-investment (ROI) metrics is calculating cumulative expected economic profit and dividing it by the cumulative (financial) resources it will require to produce (for instance, invested capital, additional R&D, or sales and marketing). How quickly the investment pays off will vary according to the business life cycle. For example, fast-moving-consumer-goods or services companies may take fewer than three years to realize most of the returns from a major investment, whereas products that are more complex may take longer.

3. Overcome biases

Start by acknowledging that everyone has biases. Resource-allocation decisions tend to be heavily affected by these biases: executives are often overconfident, believing they can reverse and improve on past performance, and find it hard to back away from big bets, even when those investments fail to deliver. At the same time, they attribute too much risk to new opportunities and can be slow to embrace them.

Any resource-allocation exercise must be grounded in hard data so that decisions are driven by facts and logic. Some common techniques to overcome biases include these:

- forcing the prioritization of opportunities based on their value creation or ROI
- committing to a minimum annual reallocation—and moving some cash into the bank for new allocations
- role-playing scenarios that force executives to debate against their natural interest or to allocate resources to anonymous business segments that may or may not be their own

My favorite technique is reanchoring, which removes management’s optimistic “hockey stick” projections of rapid improvement. This is done by building a model based on outside forecasts and assuming there will be no improvement in performance; leaders then debate whether it is still an attractive investment. If it’s not attractive, it’s important to test the confidence that a big improvement is achievable before continuing to invest.

4. Be agile

In this volatile business environment, resource allocation should be regularly adjusted, especially when major events occur, such as June’s Brexit vote or last year’s sudden oil-price decline. Some businesses have a systematic stage-gating process for investments. Typically, when developing new products and services, you hold off some of the investment until there is evidence that it is yielding results. The strategic-planning process needs to recognize material uncertainties—both external (demand growth, competitive launches, regulation) and internal (new technology, changes in talent)—and establish clear threshold levels at which decisions on resource deployment would be revisited.

Some argue that this agile approach creates too much change and does not provide enough time and commitment for new business initiatives to flourish. But by clarifying the metrics for weighing whether investments are paying off, you improve the quality of your governance, deal with genuine uncertainties, and can reevaluate quickly when unforeseen events inevitably occur. By setting clear expectations for value creation in each segment and by clarifying the major assumptions about market evolution and internal performance that underpin those expectations, you ensure that the resource-allocation process is continuous rather than cyclical.

Ultimately, even with the best intentions, resource reallocation can fall victim to organizational inertia and internal power dynamics. In companies where unit heads run their businesses like fiefdoms, with little input from those outside the walls unless they fail to make their numbers, the challenge is particularly daunting.

Managers whose businesses are performing well will naturally resist the argument that their resources might produce even better returns elsewhere. To change the conversation, try showing them the potential impact of reallocation on share price. In one case, the chief financial officer of a large company demonstrated that just 1 percent more growth in more attractive segments could raise the share price by 30 percent. [□](#)

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