McKinsey&Company

# The finer points of linking resource allocation to value creation

According to new survey results, exploring the more subjective side of investment decision making yields five elements that correlate closely with outperformance.

The way companies allocate resources and make investment decisions is critical to their ability to create shareholder value. Our past work has focused on the pervasive problems of biases and inertia in resource allocation—and found that when these challenges are overcome, companies can see a lot of value as a result.[1] But far less investigation has addressed the more practical side of investment decision making: the very tactical practices companies use to reach their decisions, such as the steps they take to provide decision makers with information they need and how they sequence their strategic-planning activities.

A recent McKinsey Global Survey set out to explore these questions.[2] When we asked executives about their companies' decision-making processes and their performance relative to peers, the results led us to identify four practices that correlate closely with outperformance: tying budgets to corporate strategy, making evidence-based decisions, setting bottom-up performance goals, and formally ranking


Jean-François Martin

investments. We also found a correlation between portfolio composition and performance: specifically, the companies where business units have similar financial characteristics (such as growth and return on capital) tend to outperform companies where business units have different traits. What's more, executives who say all five elements are at work in their companies are as much as four times likelier than others to report outperforming their competitors.[3]

### Tying budgets to strategic plans

For all the time managers spend developing their companies' strategic plans, they don't always succeed at reflecting those strategic priorities in subsequent budgeting decisions. For example, a company's strategic plan may call for increasing or reallocating R&D spending. But when management puts together an annual budget, they may cut back on the R&D spending to meet a short-term earnings target. Among respondents, only about 30 percent say their current budgets in various areas—capital expenditures, product development, product launches, geographic expansion, and spending on sales and marketing—are similar or very similar to their companies' most recent strategic plans.

In our analysis of allocation practices that link to outperformance, tying budgets to strategic plans correlates more closely with higher growth and profitability than any of the other practices we identified. Respondents with a 75th percentile score for tying budgets to strategy are 53 percent more likely than those in the 25th percentile to say their companies are growing faster than competitors. In addition, they are 29 percent more likely to describe their companies as more profitable than competitors.

### Evidence-based decision making

When deliberating over investment and other strategic decisions, managers have many practices at their disposal to ensure sound decision making: presentation of information that contradicts leaders' views, for example, and explicit discussions of the range of potential outcomes. Only 60 percent of respondents agree that decision makers explicitly discuss uncertainties when making resource-allocation decisions. And only 41 percent agree that their companies consider a range of potential outcomes or scenarios for a given investment.

When asked which specific techniques their companies' managers use to improve decision making, the largest share of respondents, 59 percent, cite scenario analysis. But no more than one-third cite any of 12 other commonly referenced checks on biases, such as pre-mortems, postmortems, and explicit meeting rules.[4]

Nevertheless, the results suggest that the use of such techniques can lead to better performance. Respondents whose companies make the most use of evidence-based decision making are 36 percent likelier than their peers whose companies don't use these techniques to report growing faster than competitors. And they are 22 percent more likely to say their companies are more profitable.

## Setting bottom-up performance goals

How executives characterize their companies' approaches to setting performance targets, either top-down or bottom-up, may be a matter of interpretation. Compared with their C-level peers, business-unit heads are likelier to report that their company-wide targets are set from the top down. The results also indicate that larger companies tend to use more top-down target setting than smaller ones do—which we found surprising, given the complexity and diversity of larger companies. But it may be that large companies are more top-down-oriented to simplify their target-setting processes.

Contrary to what larger companies tend to do, we found that bottom-up target setting is the approach that correlates more closely with strong performance. Respondents whose companies do more bottom-up target setting are 26 percent likelier than those struggling with it to agree that their companies are growing faster than competitors. They're also 18 percent more likely than their peers to say their companies have a reputation for attracting world-class talent.

## Formally ranking investments

When evaluating which opportunities most warrant an investment of resources, many executives report that their companies formally or explicitly rank potential investments—another marker of strong performance. Nearly two-thirds report company-wide rankings of capital expenditures, and more than half say the same for product-development and sales-and-marketing investments. At companies that rank highest at setting priorities for high-value investments, respondents are 20 percent likelier than their peers who rank the lowest to report faster growth than competitors.

It is notable that responses vary by a company's level of complexity. About two-thirds of respondents in the least complex companies (that is, those with three or fewer business units) say their companies rank their marketing investments. By contrast, only 36 percent of those at the most complex companies (those with more than 15 business units) say the same.

## Similarity of financial characteristics

Finally, a company is likelier to outperform when its business units share characteristics of financial performance, such as similar revenue levels, profit margins, and returns on either capital or equity. Companies tend to have a harder time managing businesses that are growing at different speeds or levels within the same portfolio.

Indeed, respondents at companies in the top quartile of our similar-characteristics factor are more likely than those in the bottom quartile to agree that their companies are growing faster and seeing greater profitability than competitors. In addition to similar financial characteristics, we also tested for the degree of relatedness—that is, similar customers, distribution systems, technology, and manufacturing—across divisions' assets. Relatedness emerged as a factor in its own right, but it had only a marginal effect on performance when a company doesn't also have similar financial characteristics in place.

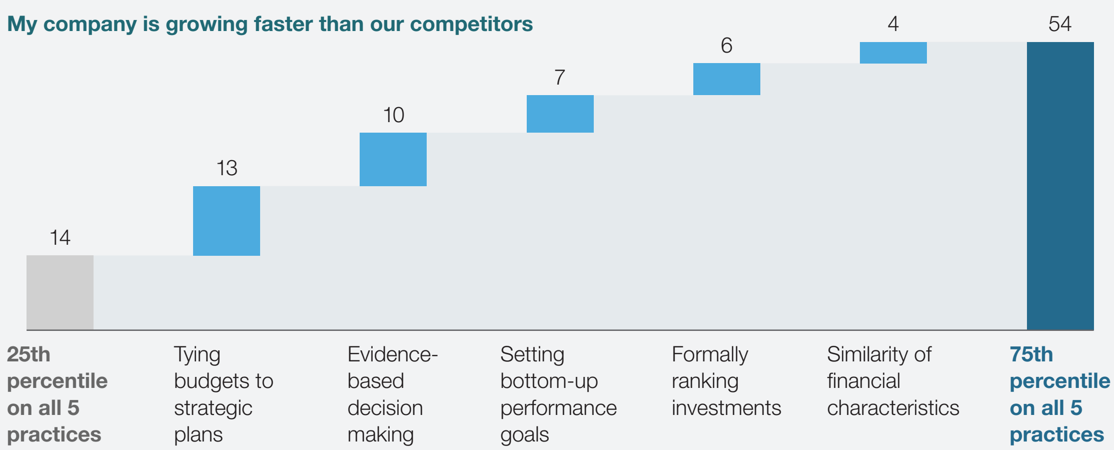
## The five factors' cumulative effects

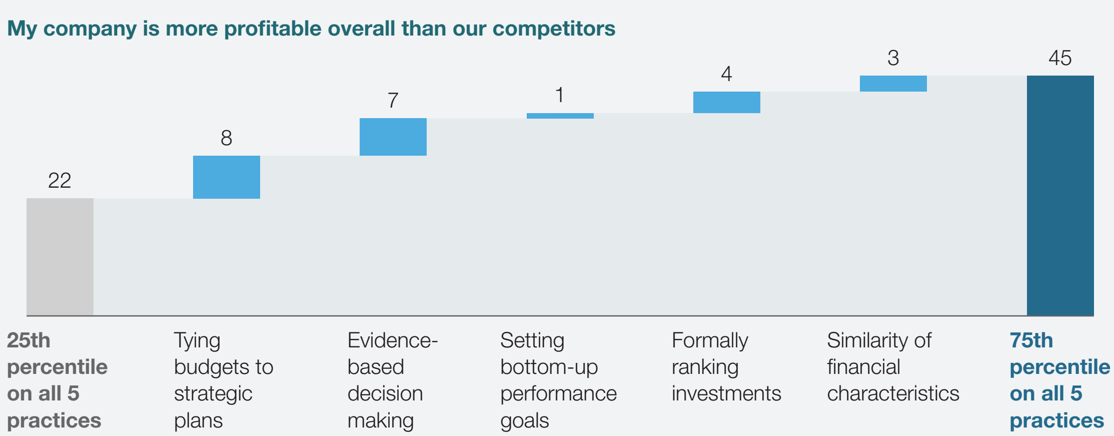
Individually, each of the five factors—the four practices and the similarity of business-unit performance—has a significant impact on profitability and growth. When combined, the factors are even more powerful (exhibit).

Exhibit

**The cumulative effect of five key allocation practices exceeds each one's individual impact.**

**% increase in likelihood of respondents agreeing or strongly agreeing with each statement,** comparing bottom- and top-quartile companies for given practice[1]




[1] Respondents who answered "somewhat agree," "neutral," "somewhat disagree," "disagree," "strongly disagree," or "don't know" when asked to rate their companies' performance were not included in this analysis.

At the companies ranking low on all five factors, only 14 percent of respondents say their companies are growing faster than competitors; at the companies that rank high for all five, 54 percent report higher growth. The results are similar for profitability: 22 percent of executives at companies ranking low on the factors say their profits exceed competitors', compared with 45 percent who say the same at companies ranking high on all five.

## Looking ahead

The survey results themselves clearly suggest how managers and their companies might improve their resource allocation and investment decision making. And while managers should take steps to implement all five factors that contribute to overall value, the following may be the easiest to implement in the short term:

- *Collaborate to set performance targets.* Although bottom-up target setting correlates with stronger performance in the survey, we suspect that the best practice lies at neither of the extremes. Top-down targets can be arbitrary because they sometimes don't take into consideration the market conditions that each unit faces. Targets set using a purely bottom-up approach are susceptible to sandbagging by the business units. Ideally, executives at headquarters (or the corporate center) will have enough information on an individual unit's prospects to work with its leaders and tailor each unit's performance targets. To get there, some companies need to strengthen the capabilities of their corporate centers, so their executives can work more thoughtfully with business units on target setting and ensure that it's a collaborative process.

- *Ensure comparable project valuation.* Although managers often already rank investment opportunities across their entire companies, too many do not. This is often true when business units use different assumptions when valuing their projects, when they neglect to consider the network effects of valuation under different scenarios, or when project proposals overstate the expected internal rate of return in order to ensure funding. The more that companies ensure comparable valuation, the more likely—and able—they are to meaningfully rank opportunities and allocate resources to those with the highest potential payoff.

- *Explicitly review financial characteristics.* We know from prior research that companies that reallocate resources typically outperform companies with more static resource allocation. One characteristic that is often overlooked, as companies examine their portfolio of businesses, is the similarity of financial performance—which our survey identified as critical. Companies should add this to variables they consider when shaping their portfolios of businesses. ■

---

[1] Tim Koller, Dan Lovallo, and Zane Williams, "A bias against investment?," September 2011, McKinsey.com; Stephen Hall, Dan Lovallo, and Reinier Musters, "How to put your money where your strategy is," March 2012, McKinsey.com; and Yuval Atsmon, "How nimble resource allocation can double your company's value," August 2016, McKinsey.com.

[2] The online survey was in the field from April 12 to April 22, 2016, and received responses from 1,271 executives representing the full range of regions, industries, company sizes, and functional specialties. To adjust for differences in response rates, the data are weighted by the contribution of each respondent's nation to global GDP.

[3] We asked respondents a series of questions about their companies' decision-making processes, such as whether they set financial targets bottom up or top down, and assessments of their companies' performance relative to peers. We then used a statistical technique called factor analysis to identify groups of variables that drove performance. All differences noted between responses from 25th-percentile companies and 75th-percentile companies are statistically significant.

[4] We define "pre-mortems" as an analysis of what can go wrong or right before the project is under way and "postmortems" as an analysis of what went wrong or right after the project is completed. "Explicit rules for meetings" could include getting all ideas onto the table before discussing and/or the CEO expressing his or her opinion after everyone else on the management team or group has done so.

The contributors to the development and analysis of this survey include **Tim Koller**, a partner in McKinsey's New York office, and **Zane Williams**, a senior expert in the New York office. **Dan Lovallo** is a professor at the University of Sydney Business School and an adviser to McKinsey.